Five Star Business Finance

NBFCs

Reaching the unreached; niche position in INR 22trn MSME lending

Five Star Business Finance's FY23 annual report provides an insight on how it is progressing towards its vision of "reaching the unreached through suitable credit solution" and capturing the INR 22trn MSME lending opportunity. AUM growth reviving to 37% in FY23 vs 14% CAGR between FY20-22 (covid impact) is a testimony to its agility and business resiliency. In a high human touch model, adherence to standard-operating-process (SOPs) becomes a prerequisite, and negligible frauds / mishandling of cash in FY23 (and even in previous years) reflects its tight control on processes and staff quality. Notably, gross stage 3 increased marginally to 1.36% in FY23 vs 1.06% in FY22 despite the implementation of daily DPD recognition from Oct'22. Maintain **BUY** with an unchanged target price of INR 860, valuing the stock at 4.5x on Sep'24 BVPS.

Huge untapped opportunity of INR 22trn

CIRSIL Research estimates total self-occupied residential property backed small business lending market at INR 22trn. Five Star with more than 2 decades of lending experience in small business loans is uniquely positioned to capture the largest pie of this huge untapped market. Unique underwriting model based on 3Cs – character, cashflow and collateral – and its continued investment towards branch expansion could help Five Star become a formidable player in small business loan segment.

37% AUM growth in FY23 reflects its agility and business resiliency

While Five Star has been able to deliver ~100% AUM CAGR during FY15-20, taking gross AUM to >INR 40bn by FY20 from INR 1.3bn in FY15, covid onset derailed its growth trajectory as reflected in AUM growth decelerating to 14% during FY20-22. However, with subsiding covid impact, Five Star has re-emerged into a strong growth phase as it reported strong 37% YoY AUM growth in FY23, showcasing its agility and business resiliency.

Set-up of separate collection team

With increasing balance sheet size and to sharpen its focus on collection as well as sustain growth momentum, Five Star has set up a separate collection vertical. While the primary responsibility of early collections still remains with the sourcing officer, accounts with certain vintage will now move to collections vertical, which will free up the time for business team to on-board new business.

Key Risks.

Deceleration in AUM growth, and stress unfolding higher than anticipated.

Financial Summary

Y/E March (INR mn)	FY22A	FY23A	FY24E	FY25E
Net Interest Income (NII)	9,032	12,325	15,787	20,178
PAT (INR mn)	4,535	6,035	7,356	9,588
EPS (INR)	15.6	20.8	25.4	33.0
% Chg YoY	26.3	33.1	21.9	30.3
P/E (x)	46.6	35.0	28.7	22.0
P/BV (x)	5.7	4.9	4.2	3.5
Gross Stage - 3 (%)	1.1	1.4	1.5	1.5
RoAA (%)	7.5	8.0	7.7	7.9
RoAE (%)	15.0	15.0	15.8	17.5

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Market Data

Market Cap (INR)	212bn
Market Cap (USD)	2,566mn
Bloomberg Code	FIVESTAR IN
Reuters Code	FIVS.BO
52-week Range (INR)	877 /448
Free Float (%)	29.0
ADTV-3M (mn) (USD)	4.6

Price Performance (%)	3m	6m	12m
Absolute	33.8	33.3	0.0
Relative to Sensex	5.3	11.1	12.7

ESG Disclosure	2021	2022	Change
ESG score	-	-	-
Environment	-	-	-
Social	-	-	-
Governance	-	-	-

Note - Score ranges from 0 - 100 with a higher score indicating higher ESG disclosures.

Source: Bloomberg, I-sec research

Previous Reports

31-07-2023: Q1FY24 results review

29-04-2023: Initiating coverage

A large, untapped market with Five-Star being "category creator"

As per CRISIL Research, small-ticket size secured MSME segment has a lending market potential of INR 22trn.

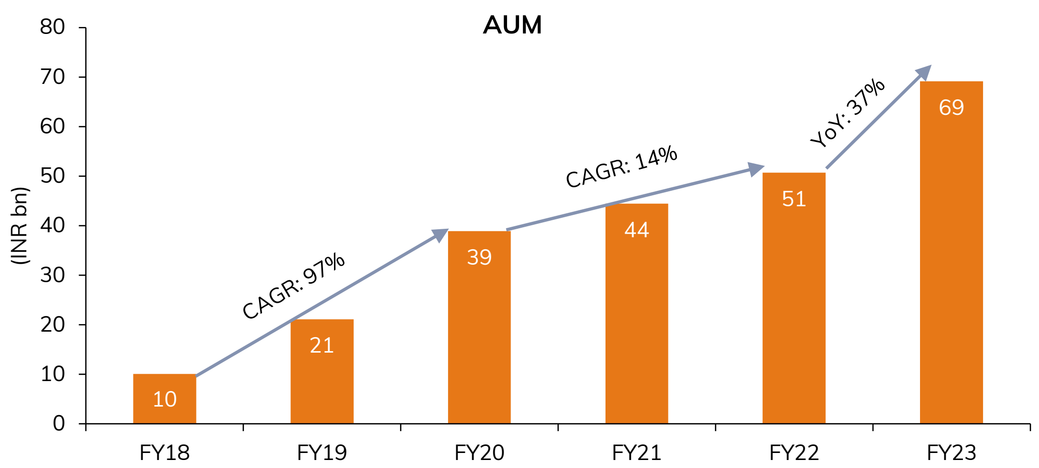
Exhibit 1: MSME lending market potential

Source: Company data, I-Sec research

Five Star has been a "category creator" and has conceptualised a credit solution to SORP backed small business lending 2 decades ago, when most lending institutions were focusing on consumer durables and vehicles. It took almost a decade for Five Star to understand the credit need of consumers, who are graduating from unorganised market to organised market, and build underwriting model which can help it evaluate customers from this segment, who may often lack formal cashflow proofs.

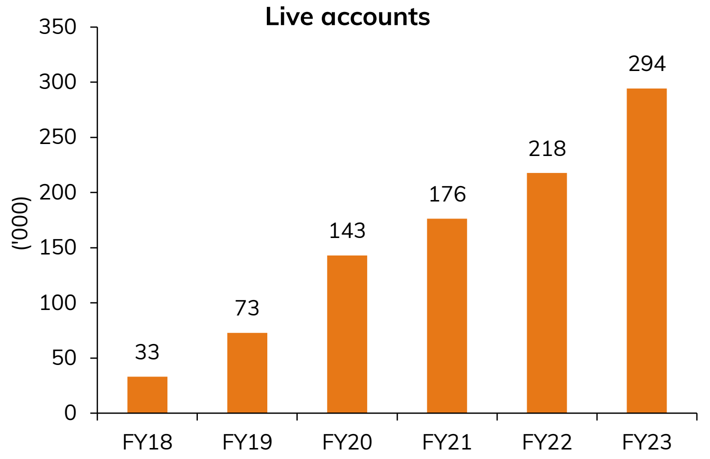
FY23 was an eventful year, wherein Five Star was listed and it re-emerged into a strong growth phase after successfully navigating two years of covid. It delivered strong 37% YoY AUM growth in FY23 vs 14% CAGR between FY20-22.

Exhibit 2: AUM growth revived sharply to 37% YoY, after subdued 14% CAGR between FY20-22



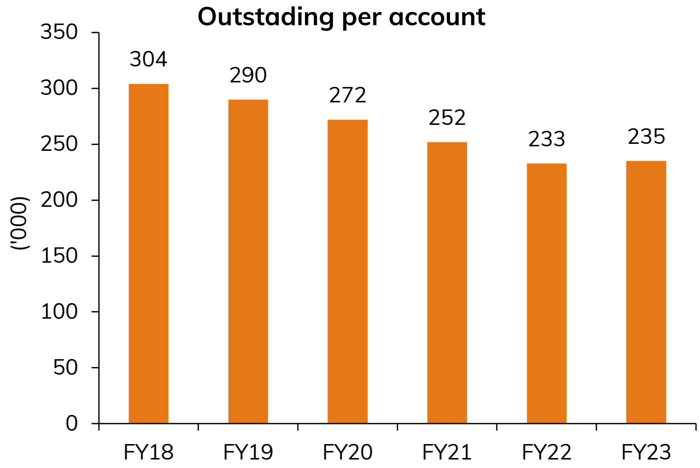
Source: Company data, I-Sec research

Exhibit 3: New customer acquisition remained robust during FY23, up 35% YoY



Source: Company data, I-Sec research

Exhibit 4: Outstanding per account remained at ~INR 2.35mn even during the growth phase

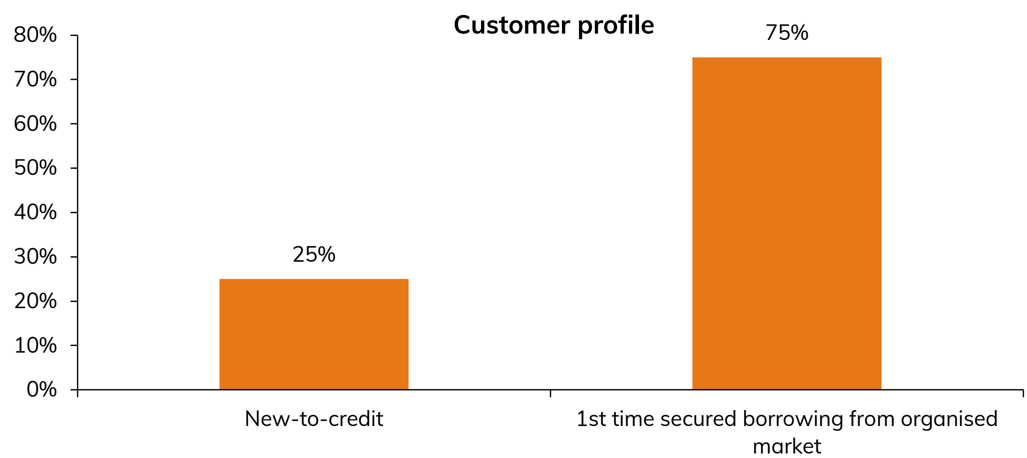


Source: Company data, I-Sec research

Strategically focuses on "unreached" customer and locations

The share of new-to-credit customers stands at 25% and for ~75% of its new customers SORP backed small business loan would be 1st ever secured borrowing from formal financiers, indicating its unwavering focus on organisational vision of "Reaching the Unreached". Further, in line with this, it has built significant branch presence in tier 3 and beyond locations to ensure its reach to last-mile customer - >80% of its total branches are located in tier 4 / 5 / 6 towns.

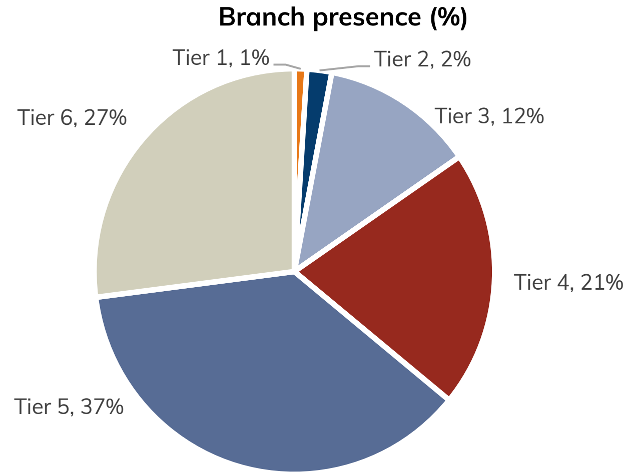
Exhibit 5: Continued focus on extending "Lending to the Unlent"



Source: I-Sec research, Company data

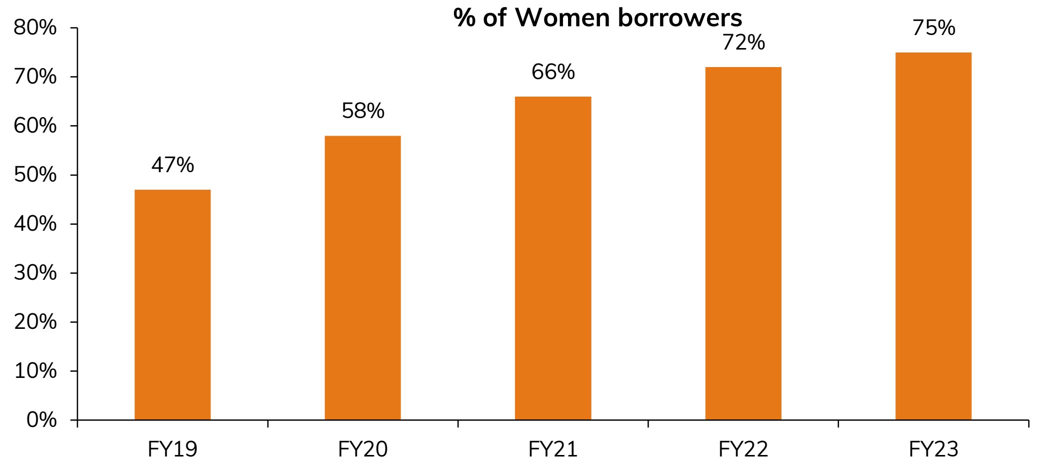
Note: Data as on March'23

Exhibit 6: Significant branch presence in beyond tier 3 cities is driving strong credit demand



Source: Company data, I-Sec research

Exhibit 7: Increasing share of women borrowers



Source: Company data, I-Sec research

Steady investment in technology and branch infrastructure

Given the segment in which Five Star operates, where the availability of formal documentation is minimal and hence, it becomes challenging to conduct credit assessment of such customers, it is important for the company to enhance its processes in order to better manage the portfolio. Five Star has been continuously investing in technology in order to ensure efficient and effective risk management practices.

To meet this, the company has built a strong technology team headed by Mr Vanamali Sridharan (Chief Technology Officer). The company has also hired senior professionals heading the areas of analytics and data science to manage its proposed tech developments.

Some of its broad key initiatives that are either ongoing or the company plans to take towards the technological advancement are as follows:

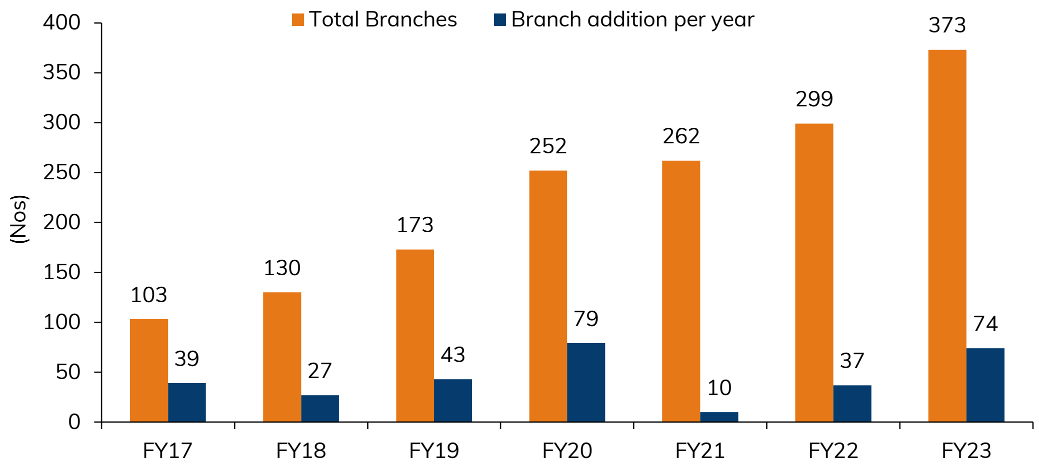
- **Developing Application Performance Interface (API)** – The company plans to develop API infrastructure to leverage the strength of various third party service providers / fintech companies and aims to partner with them to augment / create more efficient processes.

- **Improving accuracy and breadth of customer data** captured across the portfolio for data analytics and insight generation.
- **Using of data, analytics and machine learning** – The company plans to increase its usage of data analytics through AI/ML run credit models, which may help in faster processing of loan applications with lower turnaround time.
- **Supplementing collections infrastructure** by leveraging the existing payment architecture for collecting EMI repayments.

With increasing size, it has also tied up with several service providers to replace existing applications as well as enhance technology stack in the years to come.

- **Salesforce** for customer acquisition and loan origination.
- **Oracle** for general ledger and financial reporting.
- **Darwinbox** for HRMS.
- **Credence** for treasury management.

Exhibit 8: Continued investments in building franchise; 74 branches added in FY23



Source: Company data, I-Sec research

Stringent sourcing and risk management framework

Five Star, with its 2 decades of experience, has implemented a comprehensive and robust credit assessment and risk management framework to monitor and manage the risks inherent in its line of business. The company primarily caters to small business owners and self-employed customers, where the inherent risks are relatively high. In line with the same, the company has taken the following step to mitigate these risks:

- **100% in-house sourcing** – The sourcing process of the company is completely in-house, which is driven either by branch-led marketing efforts, repeat customers or walk-ins. In-house sourcing allows the company to have better control over its customers and helps it manage its portfolio quality in a better manner. Furthermore, with no third-party being involved in the sourcing process, the churn rate for customers also remains low.
- **Multi-level evaluation** – The company follows a multi-level evaluation for each of its loan starting from preliminary assessment at the sourcing stage, followed by an independent assessment by the field credit team and the final check by file credit team.

- **Assignment of co-applicants** – Loans are given to households, where all family members' cashflows are factored in, and are asked to sign the loan agreement as co-applicants, thereby, enforcing further moral obligation to repay the loan.
- **95% of loans are secured by single-unit, self-occupied residential properties.**
- **Conservative average loan to value ratio (LTV) and instalment to income ratio (IIR)** – The company maintains 50% LTV and IIR ratios at the time of origination, which ensures that the loan is adequately provided during its tenure.

Exhibit 9: Stage 2 assets fell sharply in FY23 to 9% from 16% in FY22

	March'22		March'23	
	Portfolio (Rs mn)	% of AUM	Portfolio (Rs mn)	% of AUM
Stage 1	42,170	83.2%	61,884	89.5%
Stage 2	**7,971**	**15.7%**	**6,325**	**9.2%**
Stage 3	531	1.1%	939	1.4%

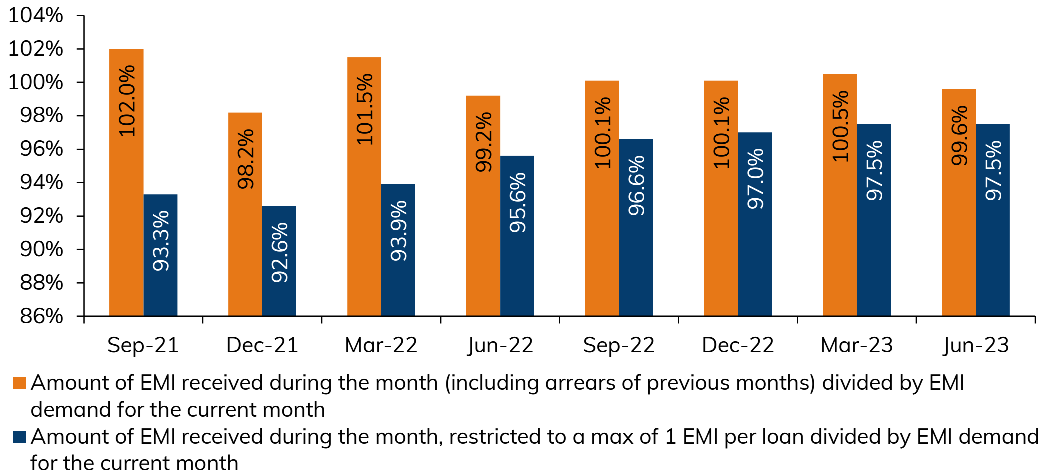
Source: Company data, I-Sec research

Robust collection mechanism; creating separate collections vertical

In order to instil a sense of responsibility in its business development team, Five Star used to hold its sourcing officer responsible for the collections. The incentives of field officers and other branch staff are also decided in a manner that is linked to both the business and the collections.

However, the company understands that its complete reliance on the business officer for collections impacts its ability to generate leads, and at the same time, completely delineating the business and collections vertical hampers the accountability of the business team. Therefore, in order to strike the balance between the two, the company has started creating collections verticals at each of its branches, wherein the business team will be responsible for the collections until a certain stage, post which, collections team will take over. So far, collections verticals have been piloted in 2 states and the company will continue to put up these verticals in the remaining states over coming quarters.

Exhibit 10: Strong collection efficiency across the quarters



Source: Company data, I-Sec research

Stable asset quality with negligible write-offs

While headline asset quality metric continued to be robust even during covid, fresh NPA accretion has elevated as reflected in gross slippage increasing to 1.4% in FY23, much higher than pre-covid level of 0.8%. However, average write-offs at only 30bps during the past 5 years despite >1% of slippages show Five Star's deep understanding of its customer base and ability to work with customer in challenging times to help them get back to normal, which eventually leads to better recovery.

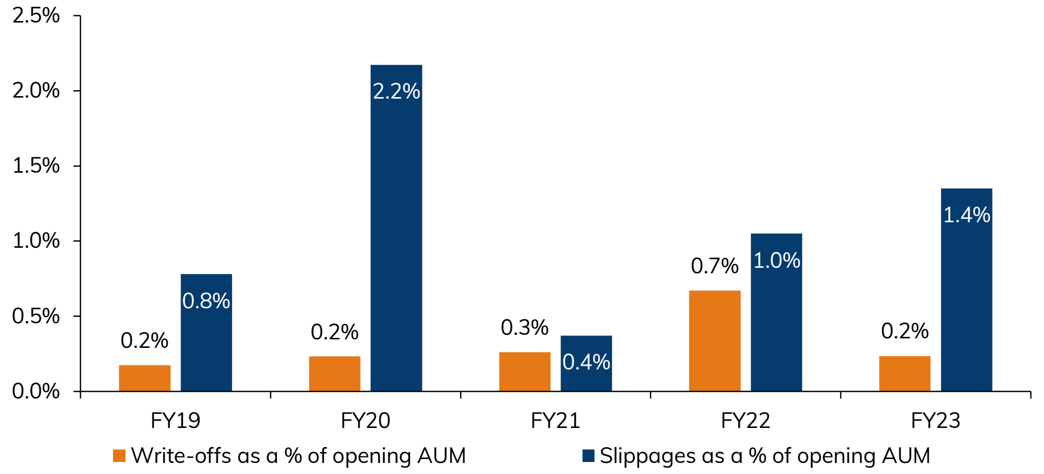
The asset quality metrics remained healthy with GNPA/NNPA ratio of 1.4%/0.7% as of Mar'23.

Exhibit 11: Movement in NPA

	FY18	FY19	FY20	FY21	FY22	FY23
Gross NPA (%)		**0.9%**	**1.4%**	**1.0%**	**1.1%**	**1.4%**
Net NPA (%)		**0.7%**	**1.1%**	**0.8%**	**0.7%**	**0.7%**
Opening GNPA (INR Mn)	152	176	187	532	452	530
Additions during the year (INR Mn)	105	79	455	142	458	689
Reductions during the year (INR Mn)	-36	-50	-61	-123	-86	-161
Write-off (INR Mn)	-45	-18	-49	-100	-293	-120
Closing GNPA (INR Mn)	175	187	532	452	530	939

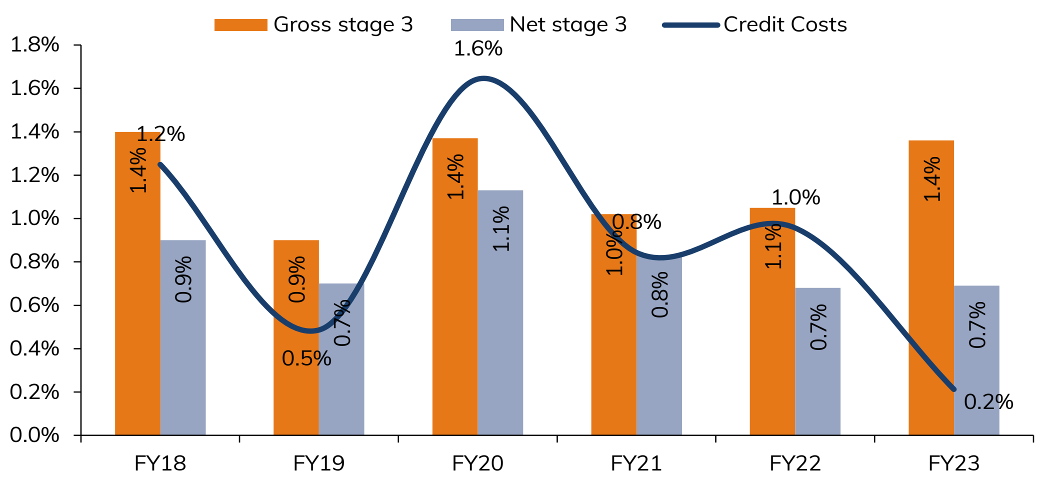
Source: Company data, I-Sec research

Exhibit 12: Slippages and write-offs as a %age of opening AUM



Source: Company data, I-Sec research

Exhibit 13: Scale up in business with steady asset quality



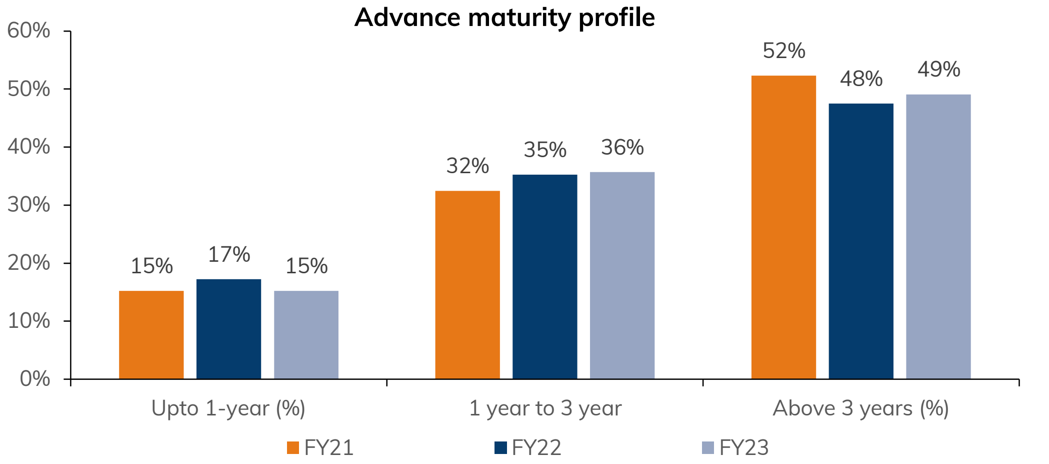
Source: Company data, I-Sec research

Effective asset liability management (ALM) - >3 years of borrowings form 26% of total borrowing, highest share in last 3 years

Asset-liability management becomes extremely important for a business having asset maturity of >5 years and Five Star scores high on effective asset-liability management. Notably, in FY23, it had further strengthened its liability profile by increasing the share of longer-tenure borrowing – the share of more than 3-year borrowings increased to 26% in FY23 from 4% in FY22 and 10% in FY21.

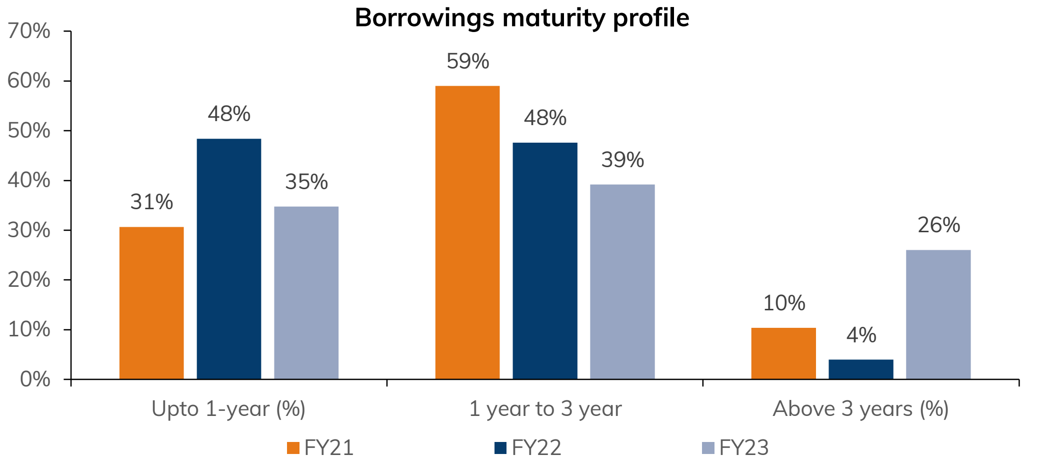
Similar to past years, as of Mar'23, the company had positive cumulative gap across all buckets. Even liquidity coverage ratio, which is a measure of the next 30 days' liquidity position, stood at 302% in Mar'23.

Exhibit 14: Asset maturity profile broadly remained stable in FY23 with ~50% of advances maturing in >3 years



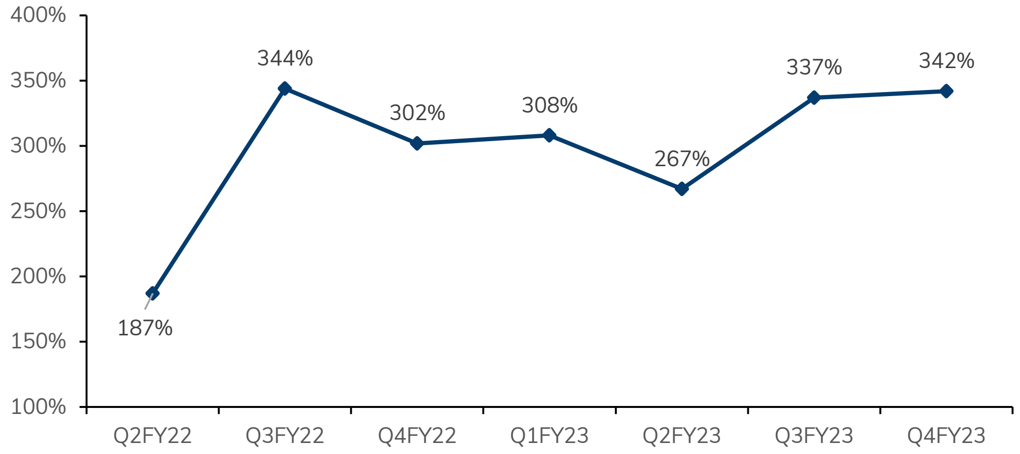
Source: Company data, I-Sec research

Exhibit 15: Share of >3 years' borrowings increased to 26% in FY23



Source: Company data, I-Sec research

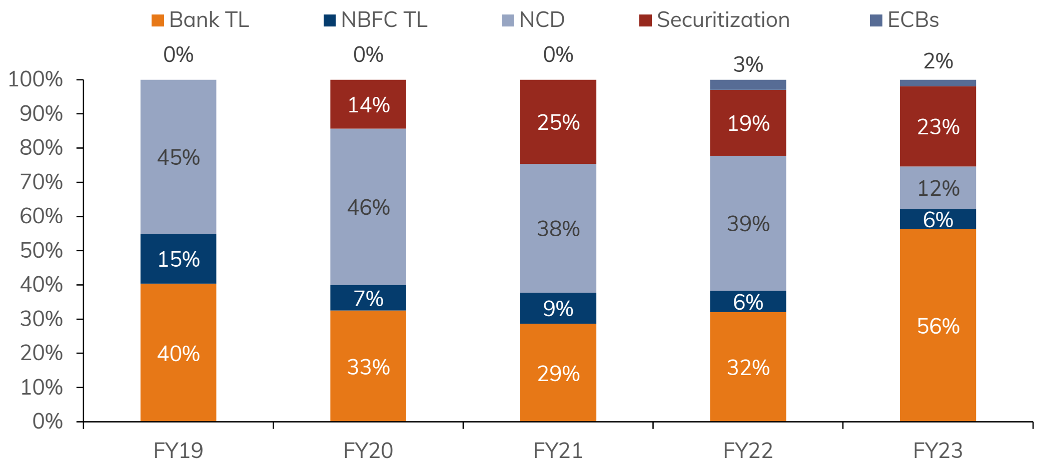
Exhibit 16: Average liquidity coverage of 300% maintained across quarters



Source: Company data, I-Sec research

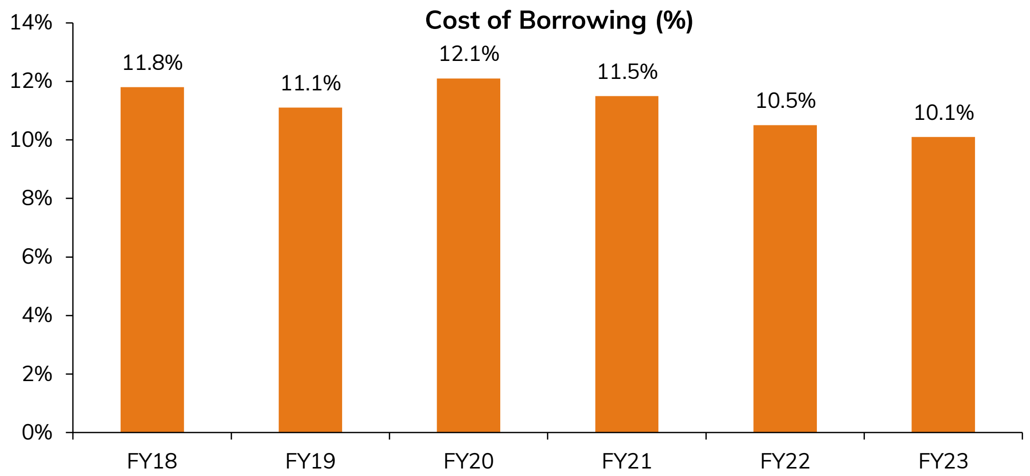
The effective asset-liability management is further complemented by the diversified funding mix spread across loans from banks/FIs, NCDs, ECBs and securitisation. The share of loans from banks (relatively lower cost) increased to 56% in FY23 from 40% in FY19, while the share of NCDs reduced to 12% in FY23 from 45% in FY19. The share of securitisation also increased to 23% in FY23 from nil in FY19, which has further enhanced its liquidity position and reduced its cost of funds. The company's average cost of borrowing reduced to 10.1% in FY23 from 11.1% in FY19, despite the RBI rate hikes.

Exhibit 17: Increasing share of bank borrowing to ensure stability in securing funding at competitive rates



Source: Company data, I-Sec research

Exhibit 18: Steady decline in cost of borrowing



Source: Company data, I-Sec research

Employee turnover rate increasing; management is cognisant of this and has implemented best HR policies to retain talent

Post covid, with the opening up of economy, Five Star has witnessed rapid increase in its employee turnover rate which increased to as high as 48% in FY23 from 27% in FY21. In a high human touch business model, managing attrition is a prerequisite and retaining key employees becomes extremely important to manage book quality and sustain growth.

To retain top talent, the company has initiated certain incentive schemes as a means to appreciate employees' relentless contribution to the organisation's success.

Lakshathipathi Scheme

- Senior employees are given INR 0.1mn on successful completion of 3 years at Five Star.

The scheme was introduced in 2018 - 175 employees were covered under the scheme with benefits ranging from INR 0.1mn-0.5mn.

Two employee stock option schemes

- Five Star Associate Stock Option Scheme 2015 (ASOP 2015).
- Five Star Associate Stock Option Scheme 2018 (ASOP 2018).

Total 314 employees have been granted ESOPs under the above schemes.

Group personal accident policy

In the event of a medical emergency or casualty, employees working as collection agents are entitled to receive the basic pay component of their salary for the duration of the treatment period under a group personal accident policy.

Exhibit 19: Employee turnover increased to 48% in FY23

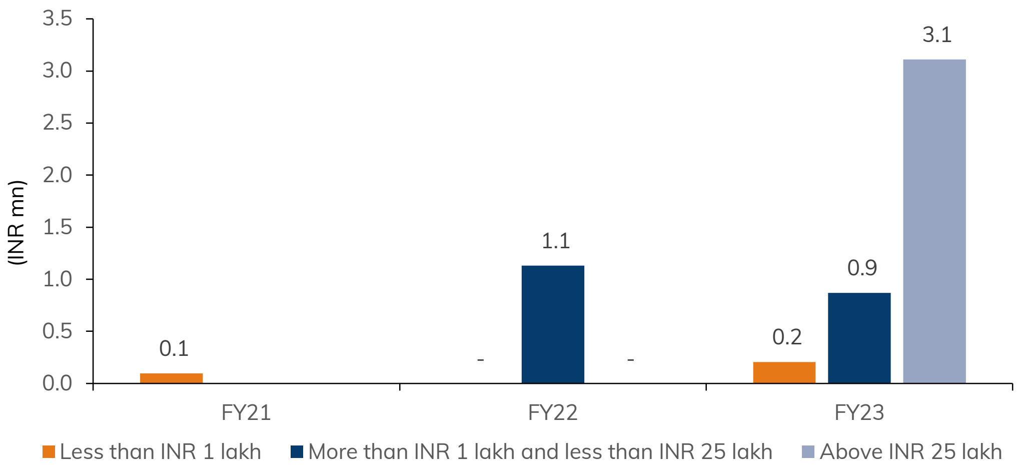
	FY21	FY22	FY23
Male employees	26%	42%	49%
Female employees	75%	26%	40%
Total	27%	41%	48%

Source: Company data, I-Sec research

Negligible fraud instances reflect its tight control on processes

Majority of fraud instances primarily occur from cash mishandling. However, the company has been able to fully recover the amount involved in the fraud in the past, i.e. in FY21 and FY22.

Exhibit 20: Fraud instances across years



Source: Company data, I-Sec research

Cases and penalties

There were no penalties, strictures imposed on the company by any statutory authority / regulatory authority, on any matter related to capital markets, during the last three years.

Audit framework

Five Star has strengthened its audit framework and has implemented Risk-based Internal Audit Framework (RBIA) as mandated by the RBI. The Audit Committee of the Board oversees the audit processes which are broken into 3 parts –

- Statutory audit undertaken by statutory auditors
- Internal audit undertaken by an external audit firm
- Internal process audit undertaken by an in-house audit team.

All the aspects across regulatory compliance, company-specific policies and procedures, financial reporting and adherence to accounting standards, etc. are covered and reported to the Audit Committee of the Board.

In FY23, the RBIA framework had taken into account all the functional processes, found out the risks inherent in those processes and accordingly defined the audit scope in line with the risk profiles. All the findings of the audit exercise are presented to the audit committee on quarterly basis. In FY23, the company also appointed a Chief Audit Officer (Naveen Raj) to overlook audit procedures.

Exhibit 21: Shareholding pattern

%	Dec'22	Mar'23	Jun'23
Promoters	34.9	34.9	34.4
Institutional investors	12.1	12.0	13.4
MFs and other	1.0	1.0	1.1
FIs/ Banks	3.5	2.8	3.8
Insurance Cos.	1.1	1.2	0.8
FIIs	6.5	7.0	7.7
Others	53.0	53.1	52.2

Source: Bloomberg, I-Sec research

Exhibit 22: Price chart

Source: Bloomberg, I-Sec research

Financial Summary

Exhibit 23: Profit & Loss

(INR mn, year ending March)

	FY22A	FY23A	FY24E	FY25E
Interest Income	12,038	14,988	19,719	25,753
Net gain on fair value changes	209	83	202	277
Interest Expenses	(3,006)	(2,663)	(3,932)	(5,575)
Net Interest Income (NII)	**9,032**	**12,325**	**15,787**	**20,178**
Other Income	-	-	-	-
Total Income (net of interest expenses)	**9,556**	**12,627**	**16,208**	**20,727**
Employee benefit expenses	(2,361)	(3,464)	(4,790)	(5,906)
Depreciation and amortization	(122)	(173)	(201)	(267)
Fee and commission expenses	-	-	(19)	(26)
Other operating expenses	(575)	(741)	(835)	(1,046)
Total Operating Expense	**(3,058)**	**(4,378)**	**(5,846)**	**(7,245)**
Pre Provisioning Profits (PPoP)	**6,497**	**8,249**	**10,362**	**13,482**
Provisions and write offs	(455)	(201)	(531)	(669)
Profit before tax (PBT)	**6,042**	**8,047**	**9,830**	**12,813**
Total tax expenses	(1,507)	(2,012)	(2,474)	(3,225)
Profit after tax (PAT)	**4,535**	**6,035**	**7,356**	**9,588**

Source Company data, I-Sec research

Exhibit 24: Balance sheet

(INR mn, year ending March)

	FY22A	FY23A	FY24E	FY25E
Share capital	291	291	291	291
Reserves & surplus	36,812	43,104	50,460	60,048
Shareholders' funds	**37,104**	**43,395**	**50,751**	**60,339**
Borrowings	25,588	42,473	54,324	78,038
Provisions & Other Liabilities	739	1,160	921	1,328
Total Liabilities and Stakeholder's Equity	**63,431**	**87,028**	**1,05,996**	**1,39,705**
Cash and balance with RBI	8,799	15,809	11,022	14,584
Fixed assets	328	449	597	790
Loans	**51,024**	**68,222**	**91,848**	**1,21,534**
Investments	2,482	1,446	1,490	1,534
Deferred tax assets (net)	467	533	533	533
Other Assets	330	569	506	730
Total Assets	**63,431**	**87,028**	**1,05,996**	**1,39,705**

Source Company data, I-Sec research

Exhibit 25: Key ratios

(Year ending March)

	FY22A	FY23A	FY24E	FY25E
AUM and Disbursements (INR mn)				
AUM	51,024	68,222	91,848	1,21,534
On-book Loans	51,024	68,222	91,848	1,21,534
Off-book Loans	-	-	-	-
Disbursements	17,562	33,914	43,108	57,823
Repayments	11,345	15,437	20,408	28,137
Growth (%):				
Total AUM (%)	17.1	33.7	34.6	32.3
Disbursements (%)	41.1	93.1	27.1	34.1
Repayments (%)	64.0	36.1	32.2	37.9
Loan book (on balance sheet) (%)	17.1	33.7	34.6	32.3
Total Assets (%)	8.8	37.2	21.8	31.8
Net Interest Income (NII) (%)	31.0	36.5	28.1	27.8
Non-interest income (%)	35.8	(30.7)	(0.1)	24.3
Total Income (net of interest expenses) (%)	31.6	32.1	28.4	27.9
Operating Expenses (%)	42.6	43.1	33.5	23.9
Employee Cost (%)	44.2	46.7	38.3	23.3
Non-Employee Cost (%)	56.7	28.8	12.8	25.2
Pre provisioning operating profits (PPoP) (%)	27.0	27.0	25.6	30.1
Provisions (%)	29.4	(55.7)	163.8	25.8
PBT (%)	26.8	33.2	22.2	30.3
PAT (%)	26.3	33.1	21.9	30.3
EPS (%)	26.3	33.1	21.9	30.3
Yields, interest costs and spreads (%)				
NIM on loan assets (%)	17.7	18.1	17.2	16.6
NIM on IEA (%)	15.4	17.1	16.9	16.9
NIM on AUM (%)	19.1	20.7	19.7	18.9
Yield on loan assets (%)	23.6	22.0	21.5	21.2
Yield on IEA (%)	20.6	20.8	21.1	21.6
Yield on AUM (%)	25.4	25.1	24.6	24.1
Cost of borrowings (%)	10.0	7.8	8.1	8.4
Interest Spreads (%)	15.4	17.3	16.5	15.7
Operating efficiencies				
Non interest income as % of total income	71.9	80.6	78.4	76.7
Cost to income ratio	32.0	34.7	36.1	35.0
Op.costs/avg assets (%)	5.0	5.8	6.1	5.9
Op.costs/avg AUM (%)	6.5	7.3	7.3	6.8
No of employees (estimate) (x)	5,675	7,347	7,794	8,874
No of branches (x)	299	373	433	493
Salaries as % of non-interest costs (%)	77.2	79.1	81.9	81.5
NII /employee (INR mn)	1.6	1.7	2.0	2.3
AUM/employee(INR mn)	9.0	9.3	11.8	13.7
AUM/ branch (INR mn)	170.6	182.9	212.1	246.5
Capital Structure				
Average gearing ratio (x)	0.7	1.0	1.1	1.3
Leverage (x)	1.7	2.0	2.1	2.3
CAR (%)	75.2	67.2	62.6	56.5
Tier 1 CAR (%)	75.2	67.2	62.6	56.5
Tier 2 CAR (%)	-	-	-	-
RWA (estimate) - INR mn	44,659	54,914	68,897	90,808
RWA as a % of loan assets	87.5	80.5	75.0	74.7

Source Company data, I-Sec research

	FY22A	FY23A	FY24E	FY25E
Asset quality and provisioning				
GNPA (%)	1.0	1.3	1.5	1.5
NNPA (%)	0.7	0.7	0.8	0.8
GNPA (INR mn)	531	864	1,378	1,823
NNPA (INR mn)	345	469	772	912
Coverage ratio (%)	34.9	45.7	44.0	50.0
Credit Costs as a % of avg AUM (bps)	96	34	66	63
Credit Costs as a % of avg on book loans (bps)	96	34	66	63
Return ratios				
RoAA (%)	7.5	8.0	7.6	7.8
RoAE (%)	15.0	15.0	15.6	17.3
ROAAUM (%)	9.6	10.1	9.2	9.0
Valuation Ratios				
No of shares	290	290	290	290
No of shares (fully diluted)	290	290	290	290
EPS (INR)	15.6	20.8	25.4	33.0
EPS fully diluted (INR)	15.6	20.8	25.4	33.0
Price to Earnings (x)	46.6	35.0	28.7	22.0
Price to Earnings (fully diluted) (x)	46.6	35.0	28.7	22.0
Book Value (fully diluted)	128	150	175	208
Adjusted book value	127	148	173	206
Price to Book	5.7	4.9	4.2	3.5
Price to Adjusted Book	5.7	4.9	4.2	3.5

Source Company data, I-Sec research

Exhibit 26: Key metrics

(Year ending March)

	FY22A	FY23A	FY24E	FY25E
DuPont Analysis				
Average Assets (INR)	60,865	75,229	96,512	1,22,851
Average Loans (INR)	47,306	59,623	80,035	1,06,691
Average Equity (INR)	30,143	40,249	47,073	55,545
Interest earned (%)	19.8	19.9	20.4	21.0
Net gain on fair value changes (%)	0.3	0.1	0.2	0.2
Interest expended (%)	4.9	3.5	4.1	4.5
Gross Interest Spread (%)	**14.8**	**16.4**	**16.4**	**16.4**
Credit cost (%)	0.7	0.3	0.6	0.5
Net Interest Spread (%)	**14.1**	**16.1**	**15.8**	**15.9**
Operating cost (%)	5.0	5.8	6.0	5.9
Lending spread (%)	**9.1**	**10.3**	**9.8**	**10.0**
Non interest income (%)	0.5	0.3	0.2	0.2
Operating Spread (%)	**9.6**	**10.6**	**10.0**	**10.2**
Tax rate (%)	24.9	25.0	25.2	25.2
ROAA (%)	**7.5**	**8.0**	**7.7**	**7.9**
Effective leverage (AA/ AE)	2.0	1.9	2.1	2.2
RoAE (%)	**15.0**	**15.0**	**15.8**	**17.5**

Source Company data, I-Sec research

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