Initiating Coverage

Five-Star Business Finance Ltd.

June 19, 2023

Five-Star Business Finance Ltd

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
NBFC	Rs.600	Buy between Rs.594-606 and & add more on dips to Rs.530-540 band	Rs.658	Rs.709	2-3 quarters

HDFC Scrip Code	FIVESTAR
BSE Code	543663
NSE Code	FIVESTAR
Bloomberg	FIVESTAR IN
CMP June 16, 2023	600
Equity Capital (Rs Cr)	291
Face Value (Rs)	1
Equity Share O/S (Cr)	29.1
Market Cap (Rs Cr)	17476
Adjusted Book Value (Rs)	147
Avg. 52 Wk Volumes	348223
52 Week High	687
52 Week Low	448

Share holding Pattern % (March, 2023)	
Promoters	34.87
Institutions	12.03
Non Institutions	53.10
Total	100.00

* Refer at the end for explanation on Risk Ratings

Fundamental Research Analyst
Varun Manek
varun.manek@hdfcsec.com

Our Take:

Five Star Business Finance Limited (FSBFL) is an NBFC-ND-SI registered with the RBI, and provides secured business loans to micro-entrepreneurs and self-employed individuals, and employed individuals in the informal sector, each of whom are largely excluded by traditional financing institutions. It is headquartered in Chennai, Tamil Nadu and has an experience of two decades in lending to small business customers. This long run has allowed the company to tune its underwriting and collection model in a manner that suits its nature of its business. Geographically, southern India is its strong hold, while it is taking steps to diversify to other territories. All of its loans are secured by its borrowers' property, predominantly being self-occupied residential property (only pakka houses with supporting documents).

Five Star's market opportunity in secured, small loans to the unbanked small entrepreneurs is huge at INR22tn – as per CRISIL Research – against its low market share of 2.7%. The company has deep understanding of its customer behaviour & local markets, strong underwriting & collections, well experienced management, and has a focused branch expansion approach, that drives its best in class AUM, which has grown from Rs. 30 crores as of March 2010, to Rs. 6,915 crores, as of March 2023. While Five Star's borrowers belong to the bottom of the pyramid with high early-bucket delinquencies, its track record of keeping GNPLs low is comforting. This is because the company has mastered the art of assessing cash flows in the absence of documentary proof of income.

Five Star has a proven track record of a fast compounding AUM at 64% CAGR over FY 2015-23, while its total income compounded at 61% and PAT compounded at 67% over the same period. While most financial segments of the company are very competitive, Five Star's business faces low competition because it requires local knowledge, aggressive branch expansion, strong underwriting and diligent collections. With two decades of experience and consumer data, Five Star is placed better than peers to benefit from the small-lending potential in our view.

Key downside risks: i) Limited ability of its low-income borrowers to absorb economic shocks. ii) Increasing competition from banks, which may lend at lower rates, iii) Geographical concentration, etc remain the key concerns.

Valuation & Recommendation:

Five Star has a strong track record of growth and profitability in the highly underpenetrated small business lending segment with a potential market opportunity of INR22tn (as per a research conducted by CRISIL). We reckon the company could deliver a NII CAGR of 25.5%, PAT CAGR of 21.4% and advances CAGR of 29% over FY23-25E, with its RoA sustaining at the best-in-class level of 7.8% by FY25E.

Over the last five years, Five Star's NIM, AUM growth and earnings growth have been among the highest in the sector while its NPLs have been amongst the lowest. Five Star's IRR loss on closed NPLs has been as low as <2% since April 1, 2018, though it lends to a highly vulnerable segment.

We feel that investors can buy the stock between Rs. 594-606 & add more on dips to Rs. 530-540 band. We expect the Base case fair value of Rs. 658 (3.25x Mar-25E ABVPS) and the Bull case fair value of Rs. 709 (3.5x Mar-25E ABVPS) over the next 2-3 quarters.

Five Star Business Finance Financial Summary

Particulars	Q4FY23	Q4FY22	YoY (%)	Q3FY23	QoQ (%)	FY21	FY22	FY23P	FY24E	FY25E
NII	346	251	38%	320	8%	690	903	1233	1531	1941
PPOP	232	167	38%	206	12%	512	650	825	1002	1231
PAT	170	117	45%	151	13%	359	454	603	722	889
EPS (Rs)						14	15	21	25	31
ABV (Rs)						89	126	147	172	202
P/E (x)						43	39	29	24	20
P/ABV (x)						7	5	4	3	3
RoAA (%)						7	7	8	8	8
RoAE (%)						17	15	15	15	16

(Source: Company, HDFC sec)

Industry Update

As per a research report published by CRISIL, the total addressable market of these loans is Rs. 107 trillion as of FY22 but only Rs. 21 trillion of formal MSME loans have been extended. This credit gap shows a huge under penetration of Rs. 85 trillion. The potential demand is evident from historical figures like a 25% CAGR in small business loan segment between FY2017-22, the share of small business loans has reached ~ 8.9% in FY22 from ~4.3% in FY17. NBFCs have a total of 44% share in small business loans market in India as of FY22. This share of MSME loans to this segment is likely to grow in the future as there is an absence of income and cash flow related documents with the borrowers, which restricts them from obtaining loans from traditional finance institutions. Hence, only 31% of the total MSME credits have been extended by public and private sector banks as of FY22. Further, its report also mentions that the share of loans advanced to New-To-Credit customers has increased from 9% in FY17 to ~40% in FY22. FSBF has a 2.7% market share in the small business lending segment as of FY22.

However, there are a few bottlenecks that the companies in this segment face, some of which are as follows:

- Negligible credit history of potential borrowers.
- Negligible amount of business assets at borrower's helm to offer as collateral to the lenders and the assessment of collaterals offered is complex.
- Physical verification of collaterals is very essential and hence on the ground presence is important.
- Most of the potential borrowers are engaged in businesses which do not have an easily verifiable income due to lack of records such as tax returns, minimal banking habits, etc.

FY23 Business Updates

In FY23, the total AUM of the company stood at Rs. 6,915 crores up 37% YoY, and it disbursed Rs. 3,391 crores, up 93% YoY. The total number of disbursals stood at 1,11,808 in FY23 as against 66,007 in FY22. This shows the granularity of the company's loan book. Its PAT for FY23 stood at Rs. 604 crores improving by 33% on a yearly basis and it reported RoA of 8.62%.

Recent Developments

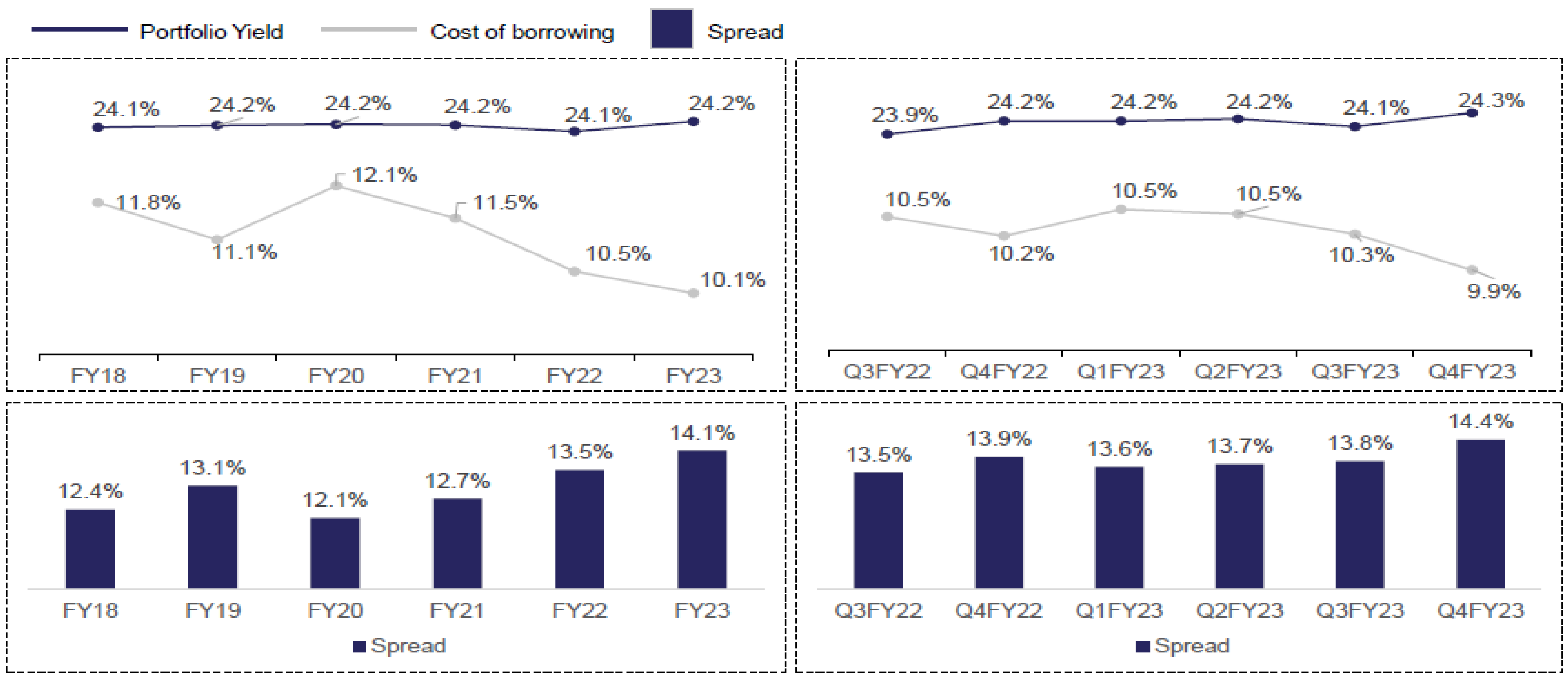
Q4FY23 business update

The company continued to deliver strong quarterly performance in Q4FY23 across growth, profitability and quality. Its business, disbursals and collection momentums are back to pre-COVID levels. As of March 2023, it has an AUM of Rs. 6,915 crores which is up 37/11% YoY/QoQ. It has a 100% secured loan book, of which 95% is secured against self-occupied residential properties. It disbursed loans worth Rs. 1,110 crores which is up 72/22% YoY/QoQ. The average ticket size of loans disbursed in Q4FY23 stands at Rs. 3.2 lakhs. On the liabilities side, it reported total borrowings worth Rs. 4328 crores which is up 66% YoY. This makes it quite evident that the company is healthily capitalized, with a CAR of 67.17%. The collection efficiency stood at 100.5%

In terms of financial performance, in Q4FY23, the company has reported total interest income of Rs. 424 crores, up 35/11% YoY/QoQ. On the other hand, it incurred interest expense of Rs. 77.4 crores, which increased by 23/23% YoY/QoQ. Hence, the Net Interest Income (NII) stood at Rs. 346 crores, up38/8% YoY/QoQ., primarily driven by robust growth in its loan book while the NIM compression was marginal at 7bps QoQ. It reported total operating expenses of Rs.130 crores which have increased by 35%/9% YoY/QoQ. The company continued spending funds on its digital initiatives, however, controlled employee costs which fell by 1% sequentially, helped the company to control its overall opex during the quarter. The employee costs were flat sequentially on account of a one-time IPO bonus equivalent to one month's salary rolled out to employees in Q3FY23. The company provided for Rs. 7.4 crores against its loans and other contingencies. Finally, the PAT stood at Rs. 170 crores which is up 45/13% YoY/QoQ.

Based on the above results, the yield on advances (as a % of average portfolio) of the company came to 24.3%, marginally up 10/20bps YoY/QoQ and the cost of funds (as a % of average borrowings) stood at 9.9%, down 30/40bps YoY/QoQ. Hence, the company has earned a healthy spread of 14.4%. The NIM was reported at 18.47% as against 18.55% in the previous quarter and 16.81% in Q3FY22. The RoE stood at 16.1% and RoA stood at 8.62% which is quite healthy when compared to the industry standards. The cost to income ratio was displaying a rising trend but stood flat in this quarter at 38.18% as against 38.11% in the previous quarter. It has a provision coverage ratio of 49.33% against its stage 3 assets. Further, the company's Debt to Equity ratio has risen to 0.98:1 in Q4FY23 as against 0.76:1 in Q3FY23.

The company has added 4 branches in Q4FY23, which takes the total to 373 branches as of March 2023. In FY23, it has added a total of 73 branches and 1,600 employees. Further, the company has plans to open 50-60 branches each year. The company has a total of 7,347 employees as of March 2023 out of which 4,003 members are in business and collections department. The company has witnessed a collection efficiency of 100.5% in Q4FY23.

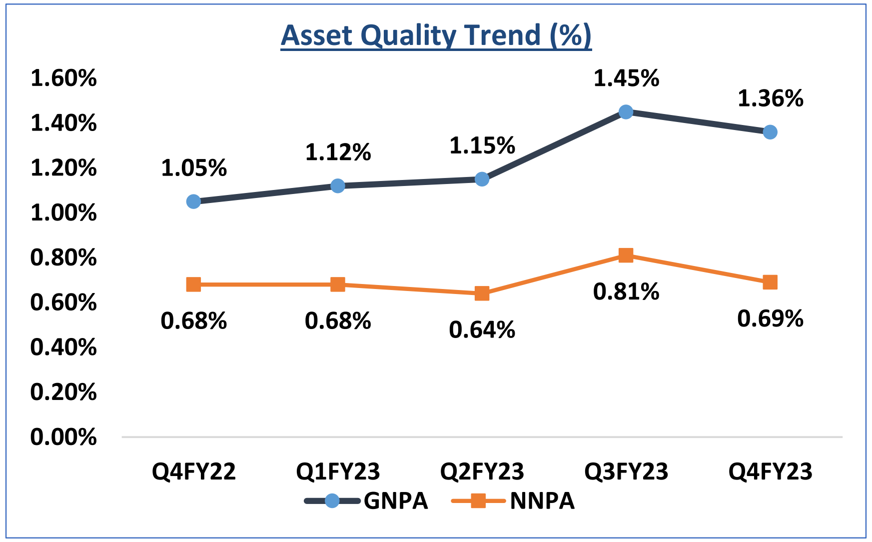


(Source: Company, HDFC sec)

Improving Asset Quality

The GNPA came at 1.36% compared to 1.45% in last quarter, while NNPA was at 0.69% as compared to 0.81% in Q3FY23. There was jump in the GNPA and NNPA ratios in Q3FY23, on account of the implementation of a circular issued by RBI in relation to recognition of NPAs. The RBI, via the circular, required that any loan account which is due past 90 days, as of the quarter end, has to be recognized as an NPA and can be brought back to standard asset only if they clear all their dues before the quarter end. Hence an additional amount of Rs.22 crores (being 0.32%) was included in the GNPA which were in the bucket of 31-60 and 61-90 DPD but were overdue for more than 90 days during a part of the quarter. If we remove the impact of this change, the GNPA would come to 1.04% as against 1.16% in the previous quarter, and the NNPA would come to 0.47% as against 0.58% for the preceding quarter.

Its business model is such that early delinquencies are relatively high, but its policy to hold 100% collateral has ensured that the company faces minimal losses even during the COVID crisis and demonetization. It has a healthy LTV of 37.8% which protects it against haircuts on sale of repossessed assets at times of distress sale, which have been very few in case of the company. The total 30+ DPD book stood at 10.51% v/s 12.1% as of Q3FY23 and 16.78% as of Q4FY22.



(Source: Company, HDFC sec)

The company has reported a total of Rs. 633 crores as stage 2 assets and Rs. 94 crores as stage 3 assets which comes to 9.15% and 1.36% of the total AUM as compared to 10.65% and 1.45% respectively in Q3FY23. Further, the company has total provisions worth Rs. 111

crores as of March 2023, up 7/8% YoY/QoQ and the Provision Coverage Ratio wrt Stage 3 assets improved to 49.33% from 34.89% in Q4FY22. The restructured book stands at 0.86% of the total AUM and this has a provision coverage of 59.18%. Hence, if there is any credit cost on this book, the provisions would cover it, rather than impacting the P&L account. Further, 91% of this restructured book is categorized as standard assets. The company's AUM has an average ticket size of Rs. 3.2 lakhs and hence is very granular. This helps it to keep its credit costs low. In Q4FY23, the credit costs stood at 0.38% to the average total assets and the management feels that it would stabilize around 1-1.5% going forward.

Though there are operational issues in sanctioning loans primarily because of the kind of customers it serves, the company has done well to contain its NPL numbers. The current MD, Mr. Lakshmipathy Deenadayalan, had joined the company in 2002 and he had spent the first ten years in the company to understand the customer's behaviour. Only after 2014, when the company raised capital from Matrix Partners, the company started aggressive expansion of its AUM.

The improvement in the 1-30, 31-60 and 61-90 DPD book is not just in percentage but also in absolute terms as can be seen in the table below.

Amount in ₹ Mn	As at Mar 2023[1]		As at Dec 2022[1]		As at Mar 2022[2]	
Bucket	AUM	% AUM	AUM	% AUM	AUM	% AUM
Current (Stage-1)	57,743	83.51%	50,484	80.87%	36,449	71.93%
1-30 (Stage-1)	4,140	5.99%	4,385	7.02%	5,721	11.29%
31-60 (Stage-2)	3,140	4.54%	3,384	5.42%	5,158	10.18%
61-90 (Stage-2)	3,185	4.61%	3,264	5.23%	2,812	5.55%
90+ (Stage-3)	939	1.36%	907	1.45%	530	1.05%
Total	**69,148**		**62,424**		**50,671**	
Stage 1 Assets	61,884	89.49%	54,869	87.90%	42,170	83.22%
Stage 2 Assets	6,325	9.15%	6,648	10.65%	7,971	15.73%
Stage 3 Assets	939	1.36%	907	1.45%	530	1.05%

Amount in ₹ Mn				
As of March 31, 2023[1]	**Stage 1**	**Stage 2**	**Stage 3**	**Total**
Loans Outstanding (Gross)	61,884	6,325	939	69,148
ECL Provision	203	443	463	1,111
Loans Outstanding (Net)	61,681	5,882	476	68,037
ECL Provision %	**0.33%**	**7.01%**	**49.33%**	**1.61%**
As of December 31, 2022[1]	**Stage 1**	**Stage 2**	**Stage 3**	**Total**
Loans Outstanding (Gross)	54,869	6,648	907	62,424
ECL Provision	149	481	406	1,037
Loans Outstanding (Net)	54,720	6,166	501	61,387
ECL Provision %	**0.27%**	**7.24%**	**44.78%**	**1.66%**
As of March 31, 2022[2]	**Stage 1**	**Stage 2**	**Stage 3**	**Total**
Loans Outstanding (Gross)	42,170	7,971	530	50,671
ECL Provision	145	699	185	1,029
Loans Outstanding (Net)	42,025	7,272	345	49,642
ECL Provision %	**0.34%**	**8.77%**	**34.89%**	**2.03%**

(Source: Company, HDFC sec)

Healthy capital positioning

As mentioned above, the balance sheet remains well capitalized with a total Capital Adequacy Ratio (CAR) of 67.17%, as of March 2023. In FY22, the company listed its equity shares on the stock markets in India and raised ~Rs. 907 crores from its promoters as well as new investors. In a span of last 7 years, till March 2022, the company has raised ~Rs. 2,300 crores towards equity, from a wide range of investors. As of March 2023, its net worth stands at Rs. 4,340 crores. As mentioned earlier, the company has a very healthy Debt Equity ratio of 0.98:1. We believe that the capitalization level remains healthy at the current level to fund the expected growth at least for the next couple of years.

Key Takeaways from Management Call

- The management is confident about a 30% + yearly growth in the AUM for next 2-3 years.
- It targets to achieve a PCR of 35-40% on Stage 3 assets.
- It plans to add 50-60 branches and enter the states of Gujarat and Rajasthan.
- The management is confident of earning an operating spread of 12-13% on its advances.
- Credit Costs are expected to be with the range of 75-100bps as against 72bps for FY23.
- The management has said that it is comfortable in operating at up to a Debt-Equity level of 3-3.5 in the coming years.
- The company targets to increase its liability book to Rs. 8,000-8,500 crores by next year in order to meet the demand for its products.
- It wishes to maintain healthy liquidity levels at Rs. 1000-1200 crores as it expects Q1FY24 to be stronger than Q1FY23 in terms of disbursals.
- Expected incremental costs of borrowing for FY24 are 9.5-9.75% which is almost what the company witnessed in Q4FY23. It further expects the cost of borrowing to dip by a further 20-25bps from 10.1% in FY23 to 9.9% in FY24. Hence the company does not expect further increase in its cost of incremental borrowings, on the back of various rating upgrades in FY23. It also wishes to bring its fixed rate borrowings down to 25-30% from the current level of ~35% and hence the floating rate book to 70-75% level in the liability book. Going forward, bank term loans would be the first priority of source from which the company would prefer to raise funds.
- The company has guided for spread levels of 12-13% going forward, on account of cost of funds dropping once the interest rates start falling and also on account of passing on the benefit of lower interest rates to its borrowers.
- The company has a sticky customer base where in 10% of its customers migrate to larger NBFCs and banks while another 10% falls back to moneylenders as they fail to service regular payments. Rest 80% borrowers contribute to the company's sticky customer base.

Key rationale:

High potential business model supported by macro variables:

As mentioned earlier, the company is involved in providing business loans to micro-entrepreneurs and self-employed individuals, and employed individuals in the informal sector, each of whom are largely excluded by traditional financing institutions. As per CRISIL's report referred to earlier, there is a total addressable market of Rs. 107 trillion as of FY22 for this segment but only Rs. 21 trillion of formal MSME loans have been extended. This is equivalent to a credit gap of Rs. 85 trillion.

FSBF has a 2.7% market share in the small business lending segment as of FY22. The company is targeting urban and semi urban customers which makes it easier to identify and reach them. Most of its customers derive income from daily provision of their services. The loans are provided against 100% collateral and there is a mandatory co-applicant from the customer's family. This, along with FSBF's capability to conduct credit assessment of such informal source of income, has allowed to operate profitably in the business for over decades.

Customer Selection

- Lending to the same segment for 35+ years
- Seen customer behaviour across cycles
- 100% in-house sourcing
- Strong focus on Tier 3 to Tier 6 cities

Typical Customer Profile

- Small business owners and self employed individuals
- Everyday cash and carry businesses with bias towards services
- Family's collective loan decisioning
- Typical family cashflows (gross) ~ ₹ 25,000 to ₹ 40,000 per month and typical collateral value of ₹1 Mn (land and building)

Product Offering

- 100% of the book backed by a hard collateral, of which ~95% is SORP
- Average LTV and IIR of ~50% at the time of sanction
- EMI typically of 7-10 days of borrowers' family cashflows (gross)

Typical Product Features

- Loans provided for business expansion, home renovation / improvement and other mortgage purposes (marriage, education, emergency etc)
- Typical ticket sizes between ₹ 0.1 Mn to ₹1 Mn
- IRR of ~24%-26% with loan tenure of 2 to 7 years

(Source: Company, HDFC sec)

The company has identified a few growth levers in order to tap the under penetrated market. There is not much of cross selling of products possible in this segment and hence the main way to expand the business is by tapping new-to-credit customers. To achieve this, FSBF is rapidly expanding its physical presence. The primary states of its operations as of now include Tamil Nadu, AP, Telangana, Karnataka and Madhya Pradesh, while it is expanding its presence in Maharashtra, Chhattisgarh, and UP. As of March 2023, 94% of the company's AUM is sourced to South Indian states. The company is planning to add 50-60 branches each year. It added a total of 373 Branches in FY23, while 85% of its branches are located in tier 3-7 towns. In FY23, the company added 73 branches and it took the company 6-9 months to breakeven 96% of these new branches. Apart from secured business loans, FSBF also offers loans for asset creation such as home renovation, improvement or meeting expenses of significant events like marriage, healthcare, and education. The company has also targeted and maintained the average ticket size (ATS) to Rs. 3-3.5 lakhs over the past few years.

State-wise portfolio break-up

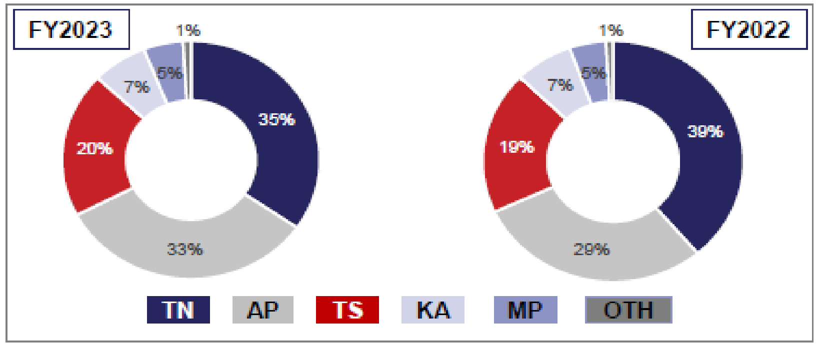
State	No of branches	FY2023	FY2022	FY2021	FY2020
Tamil Nadu	106	35%	39%	41%	43%
Andhra Pradesh	121	33%	29%	28%	28%
Telangana	59	20%	19%	18%	19%
Karnataka	33	7%	7%	7%	7%
Madhya Pradesh	44	5%	5%	4%	3%
Others	10	1%	1%	1%	1%
Total	373				

Geography	# branches	Total AUM	% of AUM
South India	319	65,123	94%
Non-South	54	4,025	6%

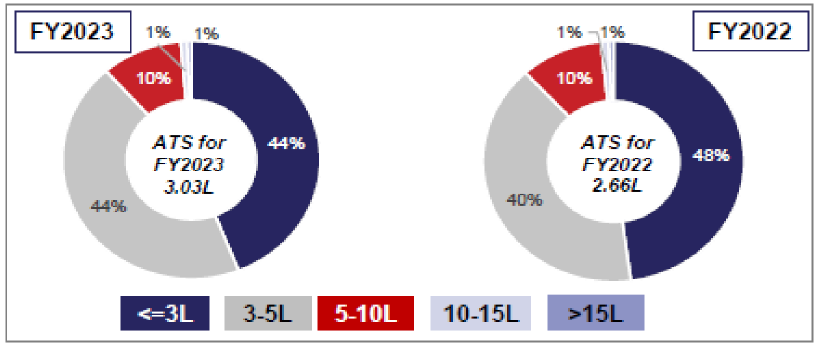
(Source: Company, HDFC sec)

The interest rates charged in this segment are typically high (between 24%-26%) with an average tenure of 5-7 years. Almost 95% of the loans are backed by self-occupied residential property and the loans are for business, asset creation and other economic purposes. Mostly multiple members within a family are co-borrowers. Hence, this way, the company is able to earn a higher spread by keeping the risks under control.

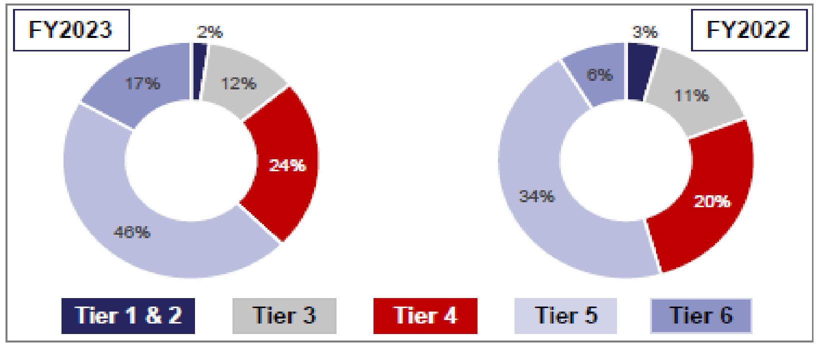
AUM by Geography



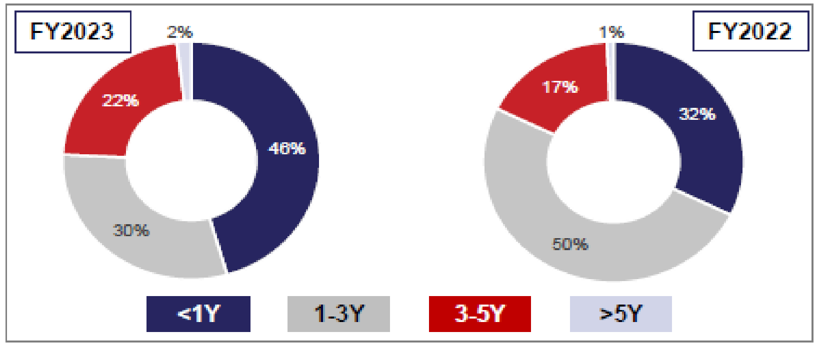
AUM by Ticket Size[1]



AUM by Branch Tier[2]



AUM by Vintage of loans



(Source: Company, HDFC sec)

A conservative loan sanction model:

The business model of FSBF requires it to target low income customers in rural areas who generally do not have much of income and cash flow related documents and neither any credit history. In such an exceptional scenario, the company, in order to reduce the credit risk, has implemented strict underwriting models to ensure that credit is extended only to fundamentally strong individuals. In total, there is a five-layer filter before credit is advanced to a customer:

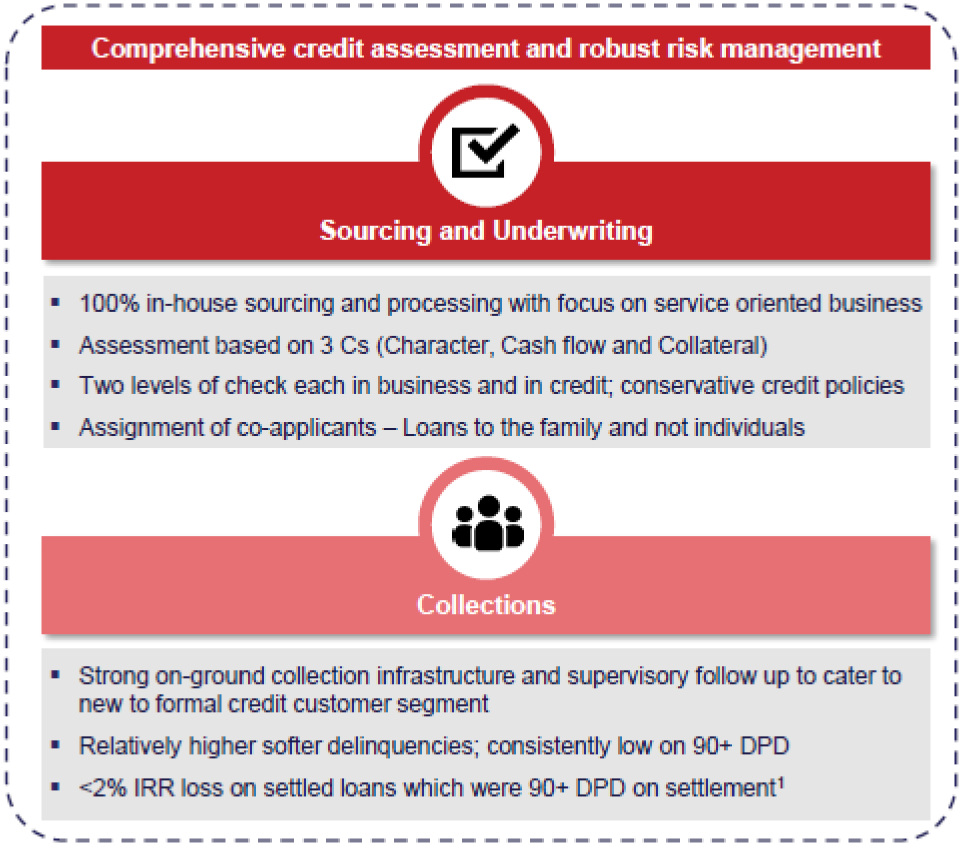
1. Once a lead is identified, the relationship officer carries out a pre-login assessment, which includes basic review checks of the prospective borrower.
2. If satisfied, the branch manager reviews the application and conducts collateral valuation. The branch manager has the authority to reject a lead. If satisfied, the branch manager submits an estimate of income of the applicant and the co-applicant and valuation of

the property collateral, a recommendation of the loan value and an estimate of the installment to income ratio, pictures of the place of business and residence of the applicant, including of the surrounding area and proposed mortgage property, in digital form to the credit team.

3. After this, a marketing officer carries out a detailed assessment of the prospective borrower, including multiple visits to understand cash flows, income documents, nature of co-applicants and collateral.
4. The field credit team is a branch-based network of credit officers that have recommendation powers. The field credit team submits a similar observation like the branch manager regarding the character assessment of the applicant, cash-flow analysis, collateral valuation, etc.
5. The credit team finally reviews all the documents and after conducting telephonic calls with the applicant and co-applicant, either approves or rejects loans.

The company has ensured that there are necessary internal controls in the process of approval of loans. The relationship manager is directly responsible to the loan he/she has sourced and is incentivized to source suitable files and undertake follow-up activities with the customer until loan closure. The incentives of the branch staff are linked to the business and collection targets, resulting in motivation for stringent sourcing and robust collections. The business and collections team (relationship officers, branch managers and supervisory and head office support layers) focuses on early warning signals. There are localized teams to monitor cases that show signs of delinquency. The company uses credit bureau checks and has setup a system of case monitoring by the risk team, whereby these employees can review certain information of borrowers, identify areas of concern and initiate prompt action.

Five Star incentivizes branches to contain GNPLs, and incentives of each individual at the branch are linked to overall GNPL target achievement of the respective branch. For customers with 1-30 DPD default, the company sends reminder messages and activates follow-up calls from the branch. In addition, the branch manager visits the customer’s business residence to understand the reasons for the difficulty in repayment. For accounts with 90+ DPD, there is a coordinated effort between the corporate office and the branch to drive roll-backs of a delinquent account.



(Source: Company, HDFC sec)

Experienced Top Level Management & Promoter Group:

Promoter Group

Mr. Lakshmipathy Deenadayalan is the founder, promoter, Chairman and MD of the company. He has been associated with the company for more than 20 years. The company is backed by large institutional investors, viz., TPG Capital, Sequoia Financial Group, Matrix Partners, Norwest Venture Partners, KKR and TVS Capital Funds. The promoter group together holds 34.9% stake in the company. Further, as of December 2022, none of the promoter holdings have been pledged.

Top Level Management

Following table provides a gist of the company's top level management:

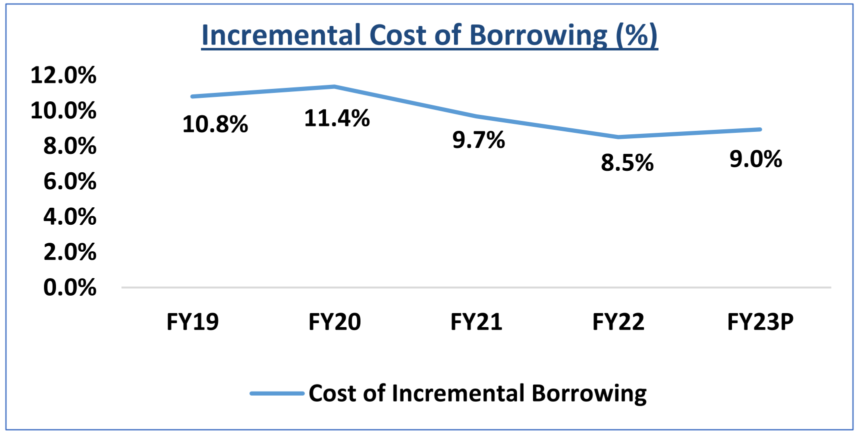
Name	Designation	Background
Mr. Lakshmipathy Deenadayalan	Chairman and Managing Director	He has a Bachelor's degree in Engineering in Computer Science and Engineering from the University of Madras and was first appointed as a director on the board of directors of the company on June 21, 2002. He was also a member of the managing committee of Finance Companies' Association (India).
Mr. Rangarajan Krishnan	Chief Executive Officer	He was previously associated with The World Bank, HDFC Bank Limited, Spark Capital Advisors (India) Private Limited and Standard Chartered Bank India in various roles and was promoted to CEO of Five-Star on May 22, 2018.
Mr. Srikanth Gopalakrishnan	Chief Financial Officer	He was previously associated with Citi in various roles and has served as CFO of Asirvad Microfinance.
Mr. Vishnuram Jagannathan	Chief Operating Officer	He has about 19 years of experience. He was previously worked with HDFC Bank, Deutsche Bank AG and HSBC.
Mr. Jayaraman Sankaran	Chief Risk Officer	He has about 22 years of experience. He was previously worked with Redington (India) Limited and Arabian Automobile Alliance LLC.
Mr. Parthasarathy Srinivasan	Chief Credit Officer	He has about 18 years of experience. He was previously worked with DBS Bank Limited, ICICI Bank and Standard Chartered Bank.
Mr. Naveen Raj	Chief Audit Officer	He has more than 16 years of experience. He has previously worked with leading audit firms like B S R & Co. LLP (KPMG) & Deloitte. He was the Audit Director in B S R & Co. LLP.

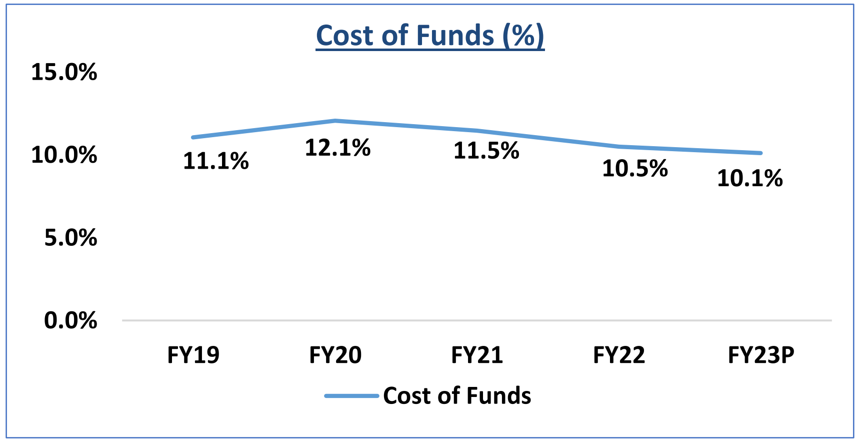
(Source: Company, HDFC sec)

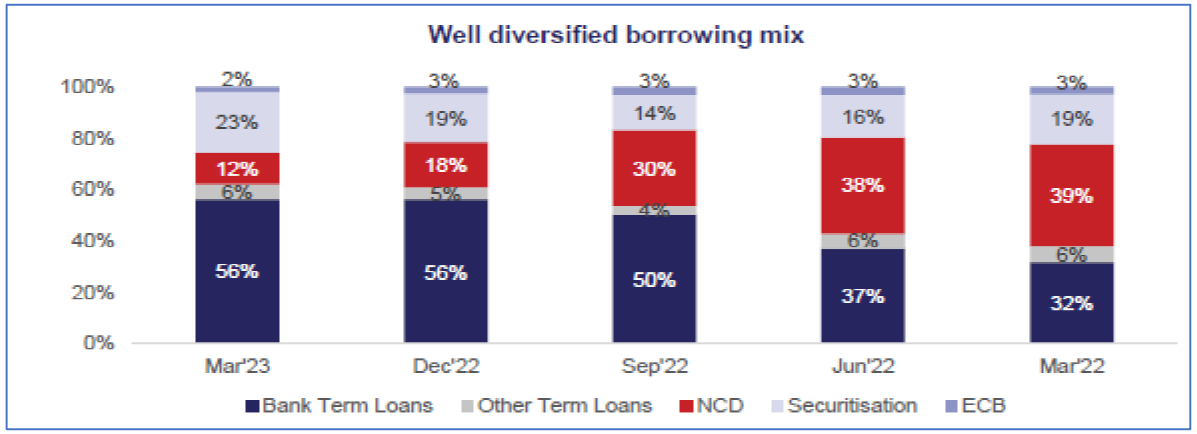
Well Blended Funding Profile:

The company has a diversified liability profile. It has outstanding debt securities (NCDs) worth Rs. 525 crores and has borrowings from sources other than debt securities worth Rs. 3,722 crores. During the entire FY23, the company raised an incremental debt of Rs. 3,104 crores. ICRA has upgraded its rating as AA- (Stable) for both these borrowings of the company. India Ratings and Research has also assigned an AA- (Stable) rating to the term loans raised by the company, while CARE has assigned A1+ Short term credit rating to the company. The company has raised term loans from 50 banks and NBFCs which shows the granularity in its funding mix. The company has NIL exposure to Commercial Papers. During FY23, the company has raised a total of Rs. 3,104 crores of debt at an incremental cost of borrowing of 8.95% v/s 8.51% in FY22. Though there is a marginal increase in the incremental cost of borrowing, it has led to a reduced average cost of funds to 10.12% for FY23 from 10.51% as of FY22. This is commendable as the company has reduced its average cost of borrowings in a rising interest rate environment. Hence, relatively, the company has been successful in keeping its borrowing costs under control.

Further, the company has a comfortable liquidity position of Rs. 1,777 crores as of March 2023, which includes un-availed sanctioned loans from banks and financial institutions worth Rs. 140 crores. Though such high levels liquidity help improve ALM position of lenders, they do impact the return ratios negatively. The company has reported a liquidity coverage ratio of 373% which the management feels is sufficient for the next 2 quarters. In the concall, the management also specified that the excess levels of liquidity were maintained keeping in mind the maturity of NCD and bonds which is nearby. As of March 2023, ~35% of the company's borrowings were fixed rate in nature with an average cost of funds of 9.25-9.5%. The loans obtained from banks by the company are linked to MCLR with 6-months and 1 year reset intervals and not directly to repo rates. The duration of its liabilities is 4 years as compared to the duration of assets (after factoring in prepayments) is at 4.5 years.







(Source: Company, HDFC sec)

Strategic Technological Focus

Over the past few years, the company has been focusing and investing in technology to enhance efficiency of its operations. Some of its digital initiatives/achievements in the recent past include:

- Transition from a manual underwriting process to ERP system based underwriting process from FY2017 onwards which is completely paperless and uses cloud to store data.
- Investments in API infrastructure to leverage strengths of third party service providers/fintechs.
- Using data analytics and machine learning to process loan applications and analyse credit risks, leading to faster decisions and lower turnaround time from login to loan sanction.
- The company is in the process of implementing Sales-force for loan origination and Oracle for financial reporting. These are expected to go-live in the coming FY.

Risks & Concerns

Geographical concentration risk

As mentioned above, the company has its presence across 8 states. However, the four south Indian states of Tamil Nadu, Telangana, Andhra Pradesh, and Karnataka contribute 94% of the overall AUM, which brings geographic concentration risk. Any economic slowdown especially in the areas where the company has a strong presence could impact the business of the company. Further, the management has clarified that 80-85% of future expansions are going to be in southern states due to the familiarity and experience they have there. Hence, it is quite evident that the company is not going to aggressively diversify in terms of its geography in the coming few years. We shall remain watchful about the expansion of the company in new unchartered territories.

Risky nature of business

Small business lending is an inherently risky business because of the lack of income and cash flow documents of the borrower and hence, the verifiability of income stream is low. Due to lower income, the borrowers do not file GST returns. They run their businesses generally on cash and carry model. Clients have below-average credit risk profiles and lack the access to formal credit. The borrowers are typically micro-entrepreneurs and self-employed individuals, and employed individuals in the informal sector. They are economically weaker class which faces income volatility. Further, there is a huge correlation between their repayment capacity and rural demand which is in turn dependent on monsoons.

Difficulty in repossession and sale of collaterals

In case of non-repayment of loans by the borrowers, the company might find it time and cost consuming to repossess and sell the collaterals to recover its loan amounts. Furthermore, distress sale of repossessed assets attracts a material amount of haircut to the market value of the asset. In India, NBFCs do not have the protection of SARFAESI Act for loans below Rs. 20 lakhs (unlike in case of banks). Hence, the company runs a risk if it has to sell the collateral and recover its losses.

Operational Issues may hinder scalability

As the company is targeting customers primarily in the rural markets, there are a lot of operational issues it is exposed to. These customers are not well versed with using new age technologies, cash collections in interior rural areas is difficult in absence of necessary infrastructure, finding local talent is a challenge, etc. All these issues might stand to be a big obstacle in the company's growth targets. Hence, scalability of the business is a concern on the growth prospects of the company.

High Growth Expectations

So far, the company has shown healthy traction in terms of its AUM, profitability, etc. If the company does not grow at the same or higher pace that is expected, the shares of the company might underperform. We remain watchful about the company's future results.

Highly competitive business segment

Though the segment is not tapped by traditional financial institutions and big banks, there are a number of NBFCs, SFBs, Fintech companies trying to expand their base in this segment. The company also faces competition from unorganized lenders mainly present in rural areas. Further, FSBF offers interest rates as high as 24-26% pa. Such interest rates in this business segment would warrant newer entrants in the market. An increase in competition could mean downward pressure on NIMs and spreads.

Volatile interest rate environment

As the company plans to raise debt in its capital structure organically, we expect the spreads and NIMs of the company to fall. As the interest rates are increasing, this might add to the overall borrowing cost of the company. Further, the management has commented that once the interest rate hike is paused and RBI starts cutting down the rates, it will also cut down its lending rates. This will put a further downward pressure on the spreads and NIMs. We shall be watchful for the impact of this in the coming results.

Anchor Investment in IPO

In the recently concluded IPO, the promoter group offered around ~ 4 crore shares as an OFS out of which 1.24 crore shares were allotted to anchor investors. Such investment by anchor investors has a lock in period of 6 months. As these shares were listed in November 2022, the period of 6 months would have ended in May 2023. Any large stake sale by these investors, once the lock-in period ends, can put downward pressure on the share prices of the company.

FSBF is overcapitalized and underleveraged resulting in lower return ratios. It needs to correct this as soon as possible.

Company Background:

As mentioned earlier, Five Star Business Finance Limited (FSBFL) 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. It has developed a business model that is predicated on arriving at an appropriate risk framework, with the optimal instalment to income ratio to ensure that its customers have the necessary means to repay the loan after meeting their regular obligations and other event-based capital requirements. FSBFL growth is primarily volume led through increasing its customer base while keeping the ATS stable, and it expects this to continue.

The Company targets customers:

- In urban and semi-urban locations, as well as in the rural markets of India, where CRISIL expects faster growth 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 Rs. 25,000 to Rs. 40,000 per month;
- Who can provide collateral (typically land and building of approximately Rs.1.0 million in value.
- Whose family will act as co-applicants on the loan.

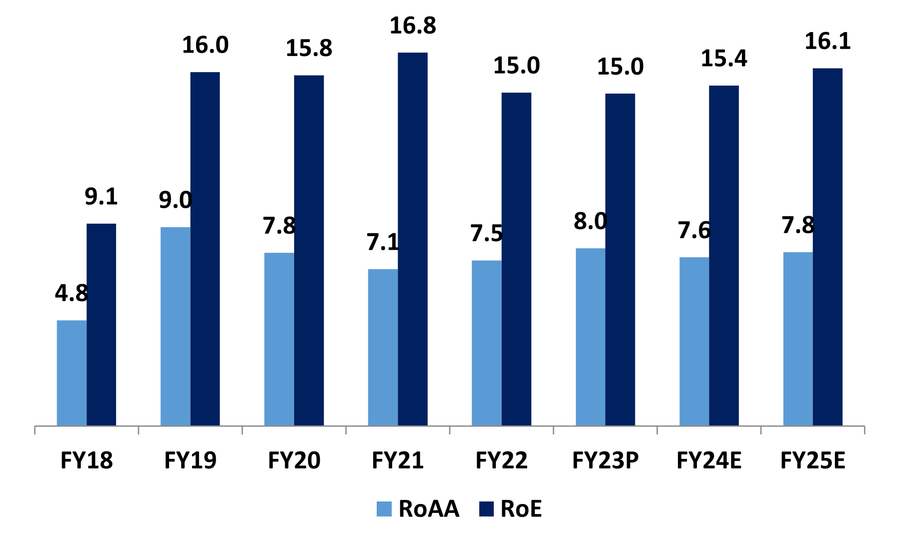
These customers have unencumbered title to the collateral, are reasonably resistant to business cycles and macro events, and are typically more motivated to service the loan without defaults primarily as a result of high customer equity in the collateral property. The company has a total of 373 branches and 2.94 lakh borrowers as of March, 2023.

Peer Comparison:

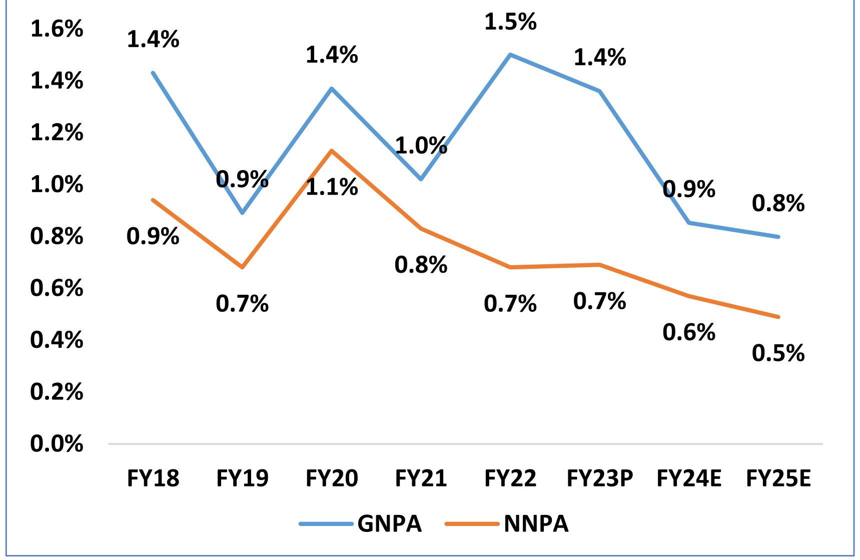
	CMP	P/BV			P/E			FY23P					
		FY23P	FY24E	FY25E	FY23P	FY24E	FY25E	ROAE (%)	ROAA (%)	NIM %	GNPA %	NNPA %	Loan Book (Rs. Cr)
FSBF	600	4.0	3.5	2.9	28.9	24.2	19.6	15	8	20.7	1.36	0.69	6,822
Aavas	1,354	3.27	2.82	2.49	24.9	20.85	17.34	14.09	3.51	8.28	0.92	0.68	11,476
Aptus	268	3.99	3.53	3.05	26.5	22.23	18.17	16.34	8.44	8.90	1.15	0.86	6,738
Shriram	1402	1.21	1.15	1.02	8.73	8.01	7.12	14.84	2.89	7.08	6.21	3.19	1,85,683

Five-Star Business Finance Ltd

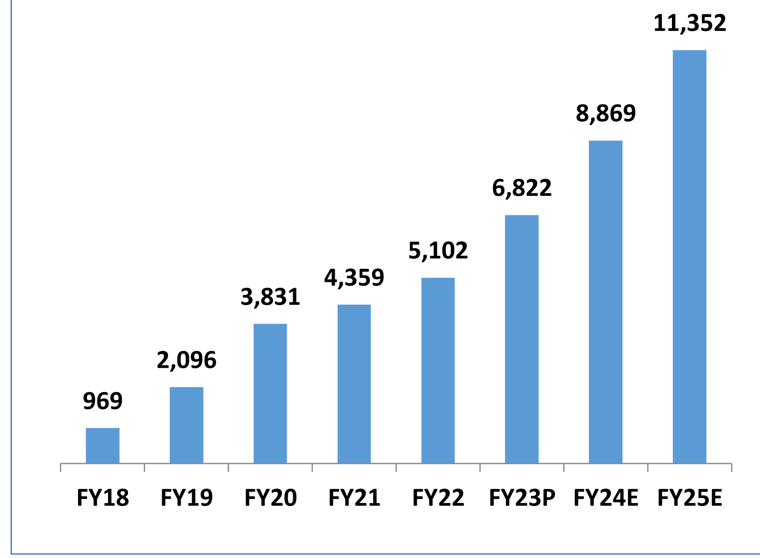
Return Ratio (%)



Asset Quality (%)



Loan book top grow at 29% CAGR between FY23-25E



Five Star Business Finance Financials

Income Statement

Particulars	FY21	FY22	FY23P	FY24E	FY25E
Interest Income	1015	1204	1499	1883	2386
Interest Expenses	325	301	266	351	445
Net Interest Income	**690**	**903**	**1233**	**1531**	**1941**
Non-Interest income	35	50	30	55	61
Other Income	2	2	0	0	0
Operating Income	**726**	**956**	**1263**	**1586**	**2002**
Operating Expenses	214	306	438	584	771
PPP	512	650	825	1002	1231
Prov & Cont	35	46	20	39	45
Profit Before Tax	476	604	805	963	1186
Tax	117	151	201	241	296
PAT	**359**	**454**	**603**	**722**	**889**

Balance Sheet

Particulars	FY21	FY22	FY23P	FY24E	FY25E
Share Capital	26	29	29	29	29
Reserves & Surplus	2293	3681	4310	5033	5922
Shareholder funds	**2318**	**3710**	**4340**	**5062**	**5951**
Borrowings	3451	2613	4328	5171	6391
Other Liab & Prov.	24	18	35	44	55
SOURCES OF FUNDS	**5794**	**6342**	**8703**	**10276**	**12397**
Fixed and Other Intangible Asset	25	33	45	54	64
Investments	0	248	145	300	400
Cash & Bank Balance	1356	879	1581	898	354
Advances	4359	5102	6822	8869	11352
Other Assets	54	80	110	155	227
TOTAL ASSETS	**5794**	**6342**	**8703**	**10276**	**12397**

Key Ratio

Particulars	FY21	FY22	FY23P	FY24E	FY25E
Return Ratios					
Calc. Yield on adv	24.8%	25.4%	25.1%	24.0%	23.6%
Calc. Cost of borr	9.4%	11.5%	6.2%	6.8%	7.0%
NIM	16.8%	19.1%	20.7%	19.5%	19.2%
RoAE	16.8%	15.0%	15.0%	15.4%	16.1%
RoAA	7.1%	7.5%	8.0%	7.6%	7.8%
Asset Quality Ratios					
GNPA	1.0%	1.5%	0.9%	0.9%	0.8%
NNPA	0.8%	0.7%	0.6%	0.6%	0.5%
PCR	17.9%	34.9%	31.7%	33.1%	38.7%
Growth Ratios					
Advances	13.8%	17.1%	33.7%	30.0%	28.0%
AUM	13.8%	17.1%	33.7%	30.0%	28.0%

Key Ratio

Particulars	FY21	FY22	FY23P	FY24E	FY25E
Borrowings	44.6%	-24.3%	65.6%	19.5%	23.6%
NII	30.5%	31.0%	36.5%	24.3%	26.7%
PPP	46.7%	27.0%	27.0%	21.5%	22.8%
PAT	37.1%	26.3%	33.1%	19.7%	23.1%
Valuation Ratios					
EPS	14.0	15.6	20.7	24.8	30.5
P/E	42.8	38.5	28.9	24.2	19.6
Adj. BVPS	89.0	126.2	147.5	172.0	202.4
P/ABV	6.6	4.7	4.0	3.5	2.9
Dividend per share	0.0	0.0	0.0	0.0	0.0
Other Ratios					
Cost-Income	29.5	32.0	34.7	36.8	38.5
Avg Networth/ Avg Total Assets	2.2	2.5	1.7	2.0	2.0

(Source: Company, HDFC sec)

Price Chart Since Listing in November 2022

Varun Nitin Manek

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HDFC Sec Retail Research Rating description

Green Rating stocks

This rating is given to stocks that represent large and established business having track record of decades and good reputation in the industry. They are industry leaders or have significant market share. They have multiple streams of cash flows and/or strong balance sheet to withstand downturn in economic cycle. These stocks offer moderate returns and at the same time are unlikely to suffer severe drawdown in their stock prices. These stocks can be kept as a part of long term portfolio holding, if so desired. This stocks offer low risk and lower reward and are suitable for beginners. They offer stability to the portfolio.

Yellow Rating stocks

This rating is given to stocks that have strong balance sheet and are from relatively stable industries which are likely to remain relevant for long time and unlikely to be affected much by economic or technological disruptions. These stocks have emerged stronger over time but are yet to reach the level of green rating stocks. They offer medium risk, medium return opportunities. Some of these have the potential to attain green rating over time.

Red Rating stocks

This rating is given to emerging companies which are riskier than their established peers. Their share price tends to be volatile though they offer high growth potential. They are susceptible to severe downturn in their industry or in overall economy. Management of these companies need to prove their mettle in handling cyclicality of their business. If they are successful in navigating challenges, the market rewards their shareholders with handsome gains; otherwise their stock prices can take a severe beating. Overall these stocks offer high risk high return opportunities.

Disclosure:

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