Equity Research

June 20, 2023

BSE Sensex: 63168

ICICI Securities Limited is the author and distributor of this report

Initiating coverage

Financials

Target price: Rs765

Shareholding pattern

	Dec '22	Mar '23
Promoters	34.9	34.9
Institutional investors	12.1	12.0
MFs and others	1.0	1.0
FI/Banks	3.5	2.8
Insurance Cos.	1.1	1.2
FIIs	6.5	7.0
Others	53.0	53.1

Source: NSE

ESG disclosure score

Year	2020	2021	Chg
ESG score	**NA**	**NA**	**NA**
Environment	NA	NA	NA
Social	NA	NA	NA
Governance	NA	NA	NA

Note - Score ranges from 0 - 100 with a higher score indicating higher ESG disclosures.
Source: Bloomberg, I-sec research

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INDIA

ICICI Securities

Five-Star Business Finance

BUY

The stars are aligned!

Rs650

Five-Star Business Finance (Five-Star) is a direct play on the increasing formalisation of credit, especially in the small-ticket business loan segment (total lending opportunity: Rs22trn). Peers include SCUF, Aavas, Aptus, HomeFirst, Equitas, AU, Repco, Can Fin, Veritas, Vistaar, etc. Barring SCUF and Repco, key players in similar ticket-size SME loans reported >30% AUM CAGR during FY18-FY23 while Five-Star delivered an industry-leading 47% during the same period. Notably, gross stage-3 assets and credit cost remaining at <2% during its high growth phase (FY17-FY23) is testimony to the company's proven credit underwriting model built on >2 decades of experience in the segment in urban and semi-urban locations.

While its low leverage ('debt to equity' ratio at an average of 1.2x during FY15-FY23) has aided NIM at >17% since FY15, stable asset yield at ~24% (given ~30% new-to-credit customers imparting high pricing power) and ~135bps reduction in average cost of borrowing, even during rising rate cycle, improves visibility on it sustaining spread at 12-13% going ahead. We expect >25% AUM CAGR for Five-Star over FY23-FY25E on the back of: 1) one of the most extensive branch network of ~370 *vs* <300 for most peers as of Mar'23, 2) deep understanding of the customer segment it serves, and 3) focus on deepening presence in existing geographies. Overall, we believe Five-Star is poised to sustain industry-leading RoA of >7% and deliver RoE of >15% over FY23-FY25E. Initiate with BUY and a target price of Rs765, valuing the stock at 4x on Sep'24E BVPS.

- **Scalability in small-ticket / self-employed financing is cognisant to distribution capabilities – Five-star has one of the most extensive branch networks.** Since FY15, the company has added an average of 40 branches each year, taking its total branch count to 373 as of Mar'23 – highest among select peers (chart 7). We believe distribution infrastructure is a prerequisite to scale a business model involving high human touch. Five-Star's focused target market is semi-urban and rural areas and self-employed customers with household-level net cashflows between Rs25,000 to Rs40,000 per month.

- **Proprietary credit model built over >2 decades of experience in small-ticket SME financing is key enabler of pristine asset quality across cycles.** While Five-Star's target customers appear to be vulnerable to even the smallest external event, its careful customer selection, deep understanding of customer behaviour (gained through >2 decades of experience in catering to this customer segment) and preference for high customer equity (in collateral) have enabled it to maintain pristine asset quality across credit cycles. (refer table 1)

Market Cap	Rs189bn/US$2.3bn
Bloomberg	FIVESTAR IN
Shares Outstanding (mn)	291.4
52-week Range (Rs)	650/474
Free Float (%)	65.1
FII (%)	7.0
Daily Volume (US$/'000)	1,227
Absolute Return 3m (%)	22.7
Absolute Return 12m (%)	NA
Sensex Return 3m (%)	9.6
Sensex Return 12m (%)	24.5

Year to Mar	FY22	FY23	FY24E	FY25E
NII (Rs mn)	9,032	12,325	15,787	20,178
PAT (Rs mn)	4,535	6,035	7,356	9,588
EPS (Rs)	16.1	20.8	25.4	33.0
% Chg YoY	14.8	29.3	21.9	30.3
BVPS (Rs)	127.9	149.6	174.9	208.0
P/E (x)	40.8	31.2	25.6	19.7
P/BV (x)	5.1	4.4	3.8	3.1
Net NPA (%)	0.7	0.7	0.9	0.8
RoA (%)	7.5	8.0	7.6	7.8
RoE (%)	15.0	15.0	15.6	17.3

- **100% in-house sourcing, ~95% self-occupied residential property as collateral and conservative LTVs at ~38% provide resiliency to business model.** Five-Star's preference for customer-led growth journey rather than increasing average ticket-size requires detailed screening of borrowers before onboarding. With 'spend time with borrowers before disbursements rather than on collections post onboarding' philosophy, it has built 100% in-house operational capabilities – right from sales to credit to collections. In-house sourcing allows complete control over quality of customers approached for loan and the process involved in disbursements.

  Further, to contain probability of default (PD), the company strategically prefers self-occupied residential property as collateral and high customer equity. Also, maintaining LTVs at <40%, it has ring-fenced its loss given default (LGDs). Combination of these strategies reflects in its average GNPL at <2.5% and credit cost at <1% between FY17-FY23.

- **Strong pricing power (serving underserved) and scale with stable asset quality are key enablers of steady >12% spread since 2018.** Five-Star's key strength is in its ability to acquire new customers that are not yet serviced by any formal lenders – as reflects in 63% CAGR in live accounts *vs* 55% CAGR in AUM between FY17-FY23. The same gives it strong pricing power – ~95% of loans sanctioned are priced between 24%-26%. Since FY18, reported yield has fluctuated in a narrow range of 10-20bps and remained at ~24%.

  Secondly, Five-Star has demonstrated robust financial performance as reflected in >50x growth in AUM, 10x growth in branch network and >60x growth in PAT during FY15-FY23. Notably, asset quality even during high growth phase remained pristine (average GNPL at <2.5% and credit cost at <1% between FY17-FY23). The same has enabled it to broad-base its lending relationships (30 lenders in FY19 to 50 in FY23). As a result, cost of borrowing steadily fell to 10.1% by Mar'23 from 11.1% in FY19 despite the rising rate cycle.

  Combination of strong pricing power and declining cost of borrowing led to spread improving to 14% by Mar'23 from 12.1% in FY20.

- **Valuation.** Five Star, with a two decade-long experience in self-employed business loans, well-diversified borrowing profile, strong pricing power and stable management team, is likely to emerge as a preferred player to gain exposure to India's financial inclusion story. We initiate coverage on Five Star with a BUY rating and target price of Rs765, valuing the stock at 4x Sep-24E BVPS. Stock is currently trading at 3.1x FY25 BVPS, at par with Aptus and Home First, FY25E PBV multiple at 3.1x. Considering better return & growth outlook, we believe Five Star would command premium over peers.

- **Key risks.** Deceleration in AUM growth, and stress unfolding higher than anticipated.

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What stands out for Five-Star

Calibrated approach while scaling business – it took >2 decades for AUM to cross Rs50bn

Five-Star's industry-leading asset quality and credit cost outcome is a function of its calibrated approach while scaling its business. It took more than 2 decades to cross the critical milestone of Rs50bn AUM as it prioritises process build-up, collection infrastructure, and building proven underwriting model across cycles. During this journey, Five-Star gained deep understanding of customer behaviour, strong knowledge of the local markets and regional dynamics. Based on its >2 decades of experience in serving the underserved self-employed segment, it has built a proprietary underwriting model to overcome the challenges involved in extending credit to self-employed customers who don't have formal income proofs and whose banking habits are limited.

Chart 1: Calibrated growth journey

Source: Company data, I-Sec research.

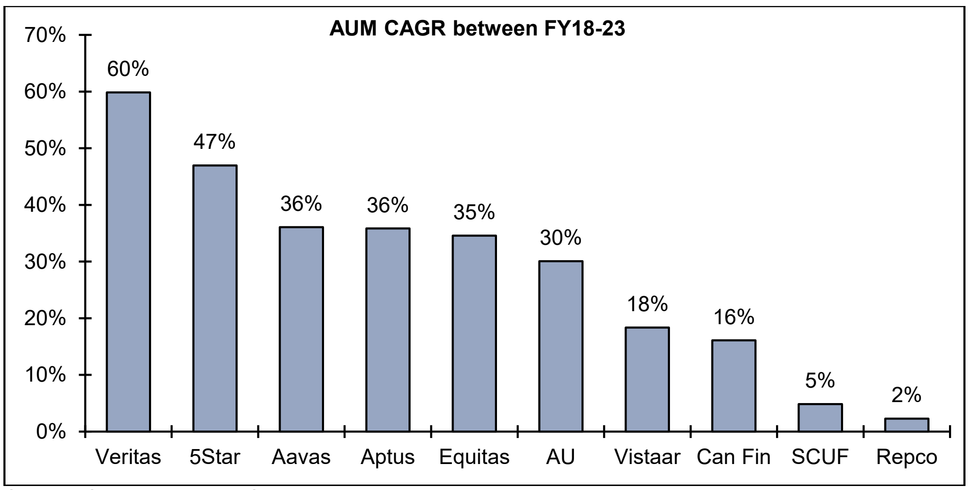
During the initial two decades of its journey, Five-Star focused on understanding the customer segment (informal income source and lack of credit history), which was highly vulnerable to business cycles but, at the same time, was equally resilient. Accordingly, the company built a customer-centric model. The same reflects in its AUM remaining at only Rs1bn till Mar'15 despite it being in operations since 1984. However, once it gained rich experience in assessing and underwriting the low-ticket self-employed segment (not many players operating), it strategically opted to scale its business between FY15-FY23. During this period, its AUM expanded to Rs69bn. More importantly, during its high-growth phase it continued to pursue a calibrated growth approach as reflected in ~60x growth in customer base *vs* ~50x growth in AUM. Its average ticket size thus remained static at around Rs0.25mn during the same period.

Chart 2: >50x growth in AUM driven by new customer acquisitions as reflected in ~60x growth in borrower base during FY15-FY23

	FY15		FY23
Number of Branches	39	~10x	373
Loans to borrowers ('000)	5	~60x	294
Relationship Officers	59	~70x	4,003[1]
Disbursements (₹ Mn) p.a.	793	>40x	33,914
Assets Under Management (AUM) (₹ Mn)	1,315	>50x	69,148
Total Income (₹ Mn)	336	>45x	15,289
Profit After Tax (₹ Mn)	99	>60x	6,035
Net Worth (₹ Mn)	713	>60x	43,395
Gross Stage 3 Assets	1.81%[2]		1.36%[3]

Source: Company data, I-Sec research

Chart 3: Five-Star's AUM CAGR between FY18-FY23 was one of highest amongst players operating in a similar customer segment

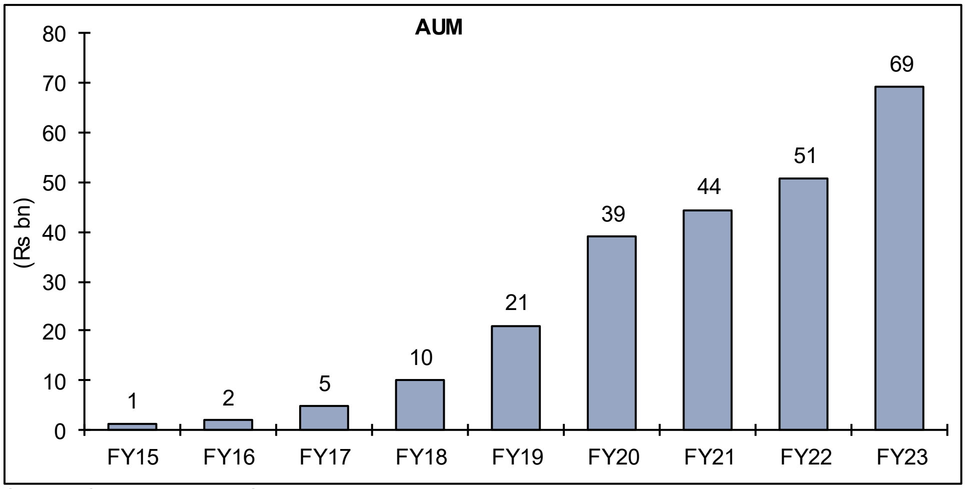


Source: Company data, I-Sec research.
Note: Veritas & SCUF AUM CAGR is for FY18-22, for Vistaar FY18-Dec'22.

Growth strategy underpinned by new customer acquisitions and expansion into underpenetrated areas

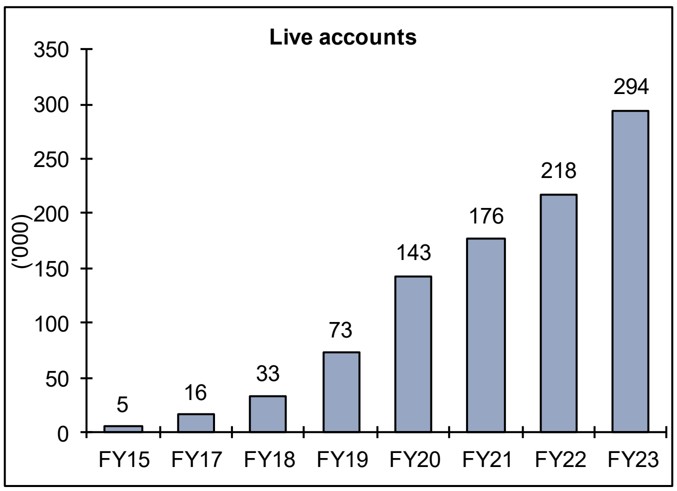
Five-Star delivered healthy 55% CAGR in AUM led by customer growth (up 63% CAGR). Strategically, it shifted its focus towards lower ticket-size segment since 2017 as reflected in decline in outstanding per borrower at 5% CAGR between FY17-FY23. Outstanding per borrower as of Mar'23 stands at Rs0.24mn *vs* Rs0.3mn in Mar'17. Management's successful execution of business strategies reflects in the steady business growth despite uncertain business environment owing to demonetisation, liquidity crunch and covid crisis. Its growth strategy was underpinned by high rates of customer acquisition and expansion into underpenetrated areas. Loans to ~95% of its customer base vary between Rs0.1mn to Rs1mn.

Chart 4: AUM grew >50x between FY15-FY23…



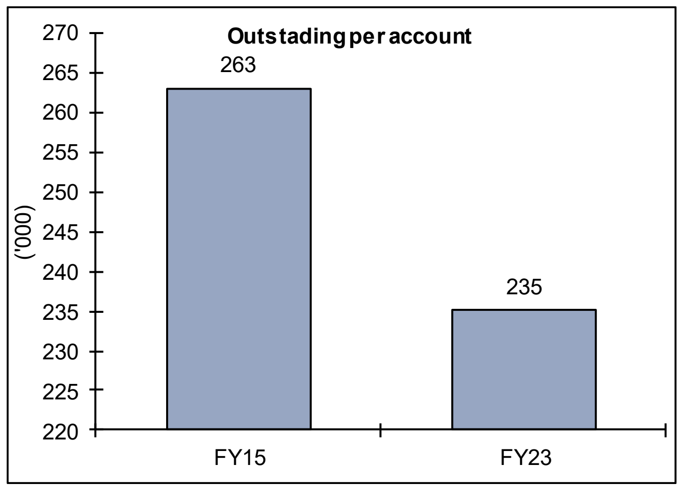
Source: Company data, I-Sec research

Chart 5: …driven by new customer acquisition, up ~60x between FY15-FY23



Source: Company data, I-Sec research

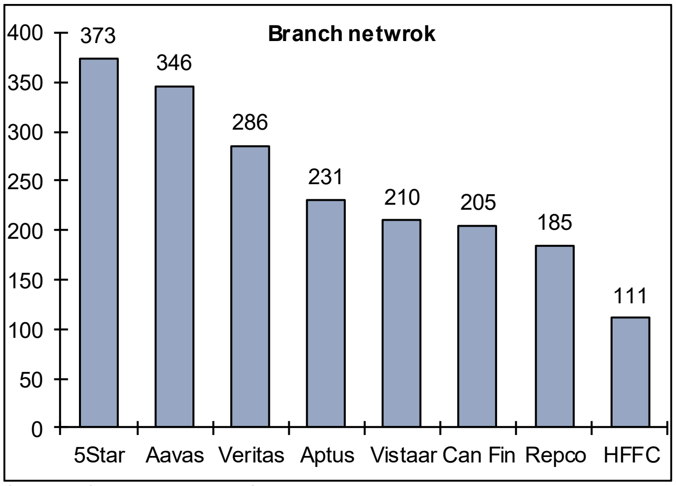
Chart 6: Outstanding per account remained at ~Rs0.25mn during the high growth phase



Source: Company data, I-Sec research

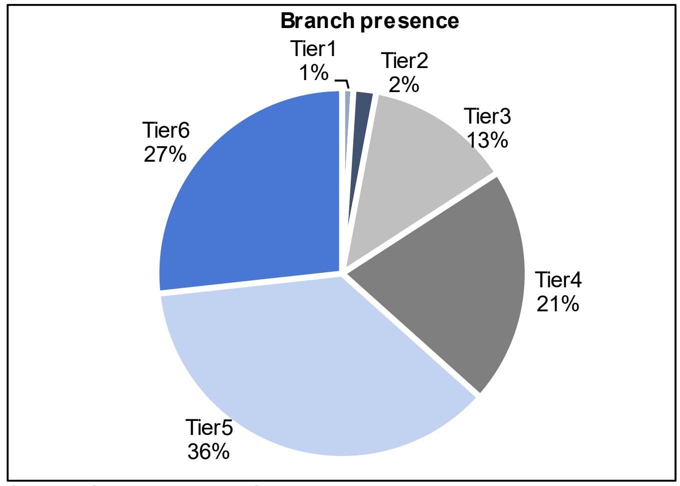
The prerequisite for scaling business, especially beyond metro and tier-1 cities, is constant investment towards distribution expansion and to expand reach in new states and deepen presence in existing states. Striking a right balance between cost ratios and business scale & profitability requires in-depth knowledge about the target market, customer and more importantly credit behaviour. Its >2 decades of experience in serving the underserved has helped Five-Star in ticking all the prerequisite boxes. As of Mar'23, Five-Star has the highest branch network of 373 *vs* average of 225 for closest peers and employee base of >7,000 *vs* 6,000 for closest peers.

Chart 7: Five-Star has one of the highest branch networks with 373 branches as of Mar'23…



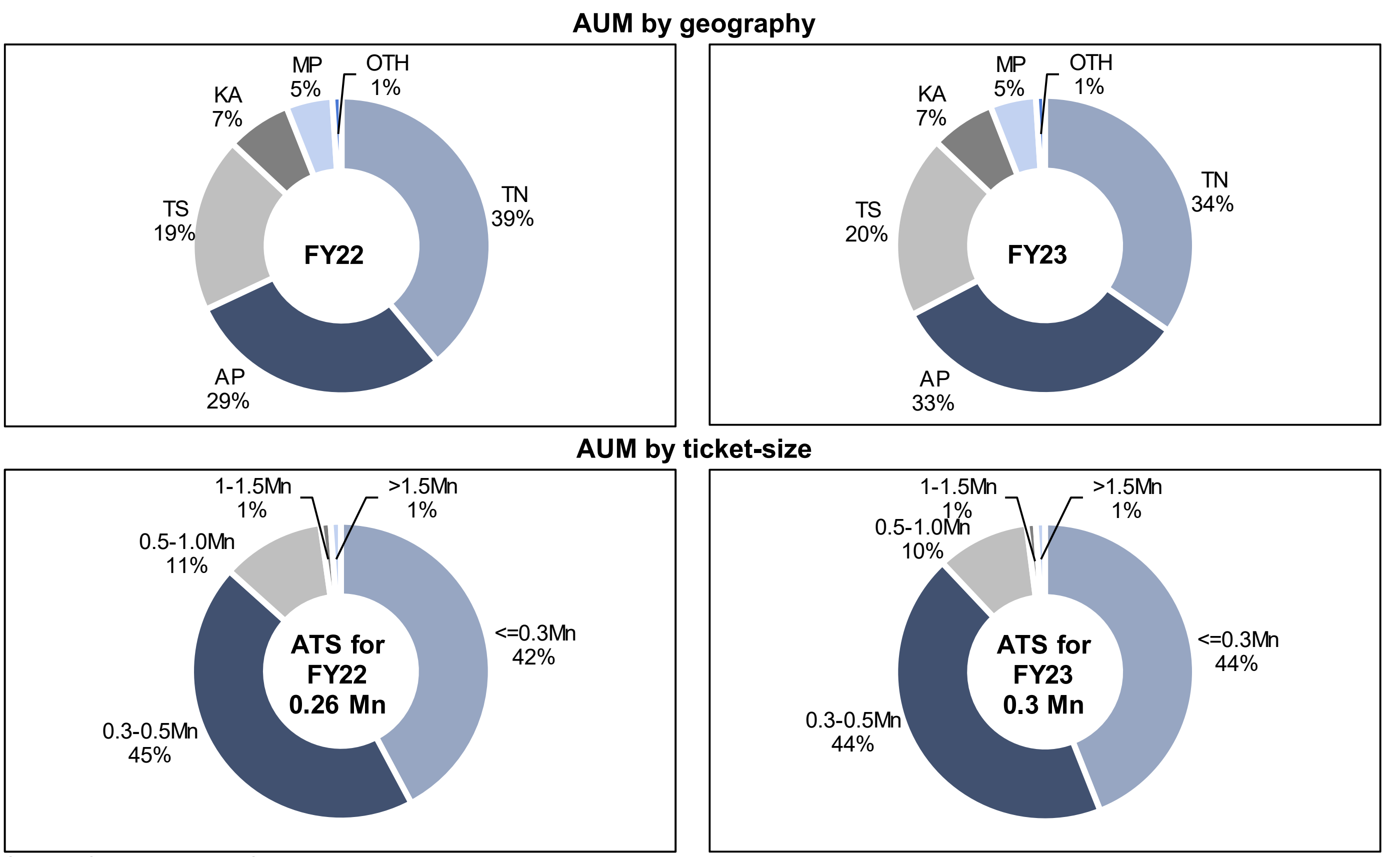
Source: Company data, I-Sec research

Chart 8: …with nearly 65% of the branches located in tier-5 and tier-6 towns



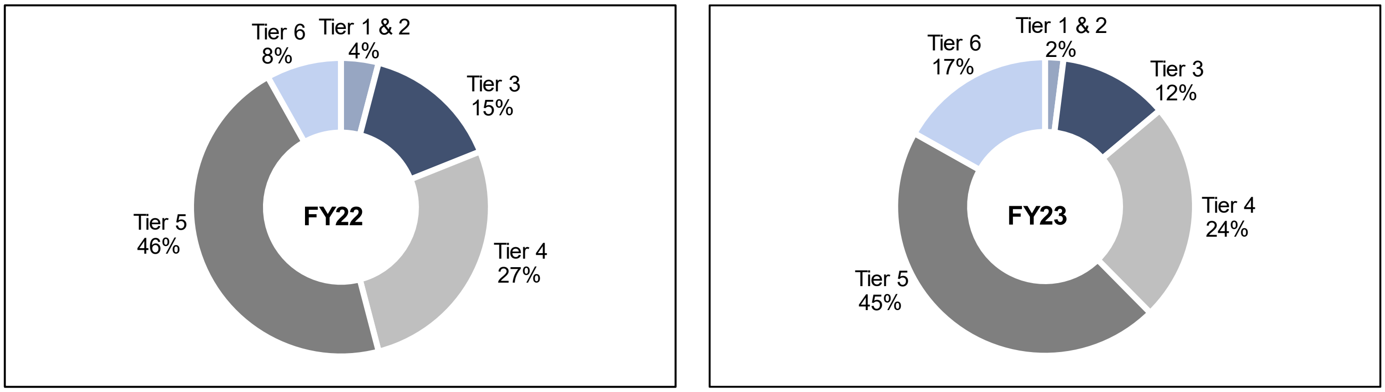
Source: Company data, I-Sec research

Chart 9: Well diversified portfolio across the parameters

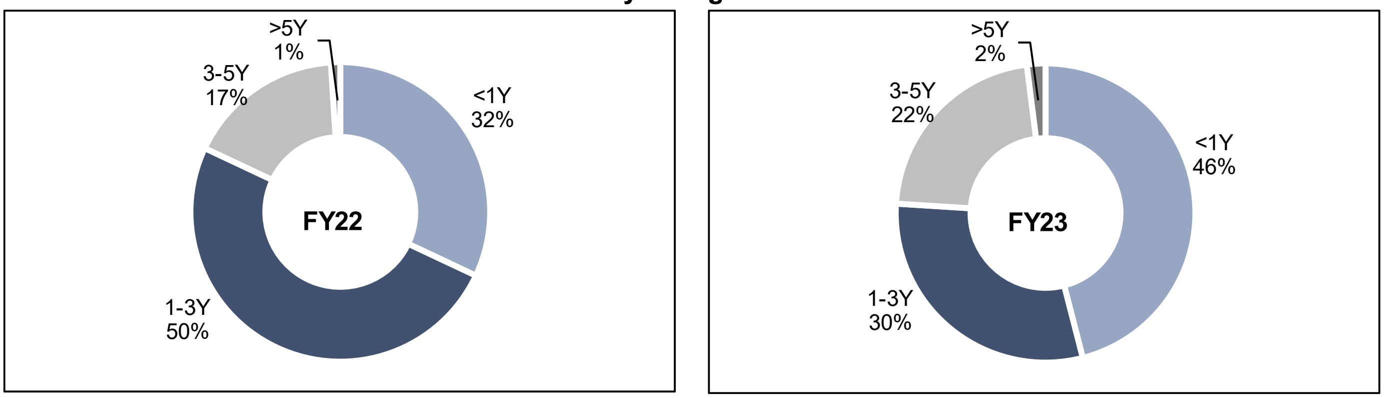


Source: Company data, I-Sec research.

AUM distribution by location – contribution from Tier III & beyond cities stands at 86% as on Mar'23

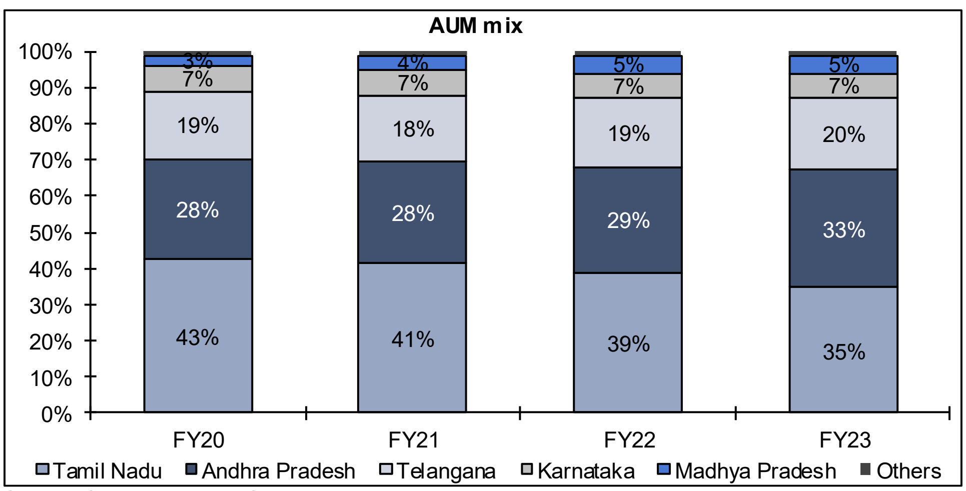


AUM by vintage of loans



Source: Company data, I-Sec research.

Chart 10: Steady improvement in geographical concentration – reflects Five-Star's strategy to enter underpenetrated markets



Source: Company data, I-Sec research

Going forward, the company will continue to focus on small-ticket/self-employed customers with focus on increasing penetration in existing markets through continued investment towards increasing staff numbers, expanding branch network in the existing geographies and diversifying into contiguous markets.

Created a niche in <Rs0.5mn self-employed ticket size segment

MSME financing is one of the most preferred lending segments across financiers including banks (both private & public), NBFCs and SFBs, given the lucrative product proposition. The segment offers high yields, ranging from as low as 10% to as high as >20%, security cover with LTVs between 40-75%, long asset tenure (hence gradual unwinding of portfolio) and vast systemic lending opportunity of Rs22trn.

Chart 11: With >2 decades of experience in servicing the informal segment, Five-Star has created a niche in small-ticket MSME financing

Institutionalized Lenders - Key Underwriting Parameters	Medium Enterprises	Small Enterprises	Small Business Owners and Self Employed Customers
Verifiable income stream	Assessed from formal contracts since predominantly B2B clients	Typically assessed from VAT, sales tax, service tax records	Predominantly backed by informal/ kaccha documents, daily noting
Formal documentation	Formal & structured – records of IT returns available	Semi-formal – Have banking habit to the extent of business transactions	Highly Informal –Have minimal banking habits
Extent of 'on the ground presence' required	Presence of formal, verifiable documents reduces requirement	Moderate level of physical verification required	Ability to conduct physical verifications essential
Credit history	Well documented	Moderate level of documentation	Nil or negligible credit history for medium / high ticket loans
Credit discipline	Low variance – usually high discipline	Moderate variance – on average high discipline	High variance in segment with both high & low credit discipline observable
Ability to offer collateral	Significant business assets to offer as collateral	Moderate ability to offer business collateral	Negligible business collateral – ability to offer personal collateral varies
Assessment of collateral	Simple to assess with supporting documentation	Moderate – with some supporting documents available	Complex with ability to carry out ecosystem checks required

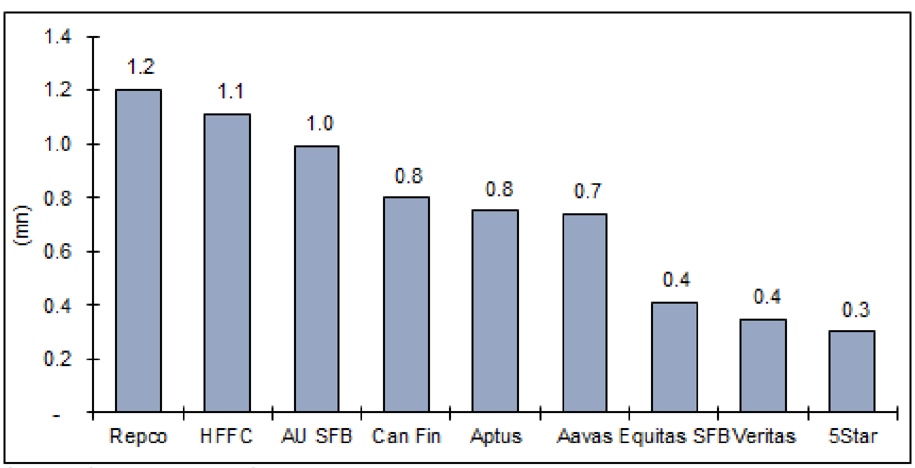
Inability to verify income, lack of credit history & varying ability to offer collateral make profitable operation difficult for traditional financiers

Simple to Assess; Moderately Simple to Assess; Complex to Assess; Highly Complex to Assess/ Low

Source: Company data, I-Sec research

While the market appears crowded, our deep analysis suggests that it is highly sub-segmented. For example, large banks focus on MSMEs with ticket-size of >Rs5mn, small banks Rs2.5mn-5mn, NBFCs and AHFCs Rs1mn-2.5mn, and MFIs and NBFCs <Rs1mn.

Chart 12: Five-Star's target customer segment (low ticket-size at Rs0.3mn) is less crowded



Source: Company data, I-Sec research

Chart 13: Ecosystem to serve small-ticket business loans

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

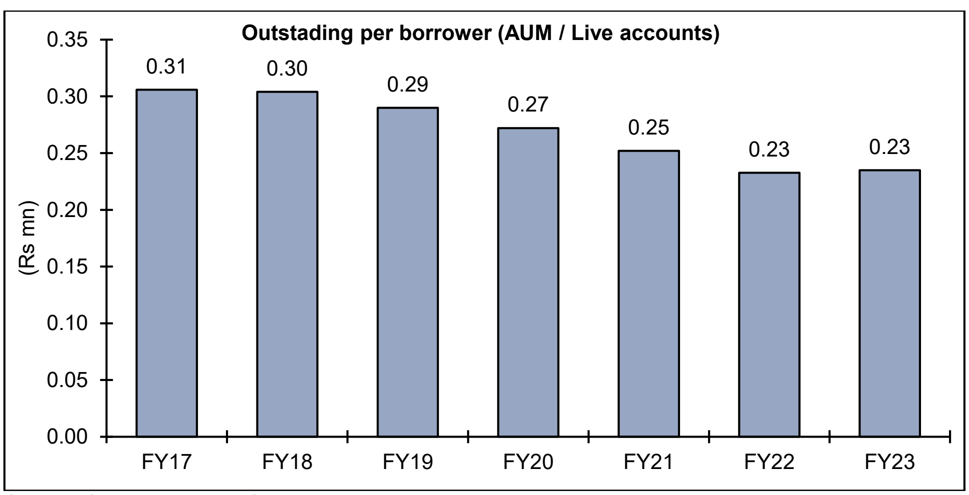
- Loans provided for business expansion, home renovation / improvement and other mortgage purposes (marriage, education, emergency etc)
- Typical ticket sizes between ₹ 0.1 Mn to ₹1 Mn
- IRR of ~24%-26% with loan tenure of 2 to 7 years

Shops / small businesses are typically the last to get hit in an economic cycle, and the first to bounce back

Source: Company data, I-Sec research

Five-Star operates in the <Rs1mn category and, within it, it is amongst very few which focus on <Rs0.5mn ticket-size. As of Mar'23, 88% of its total portfolio has a ticket-size of less than Rs0.5mn with average of Rs0.3mn. Most financiers are averse to small-ticket MSME lending (<Rs1mn category) due to intensive operations, informal income thus making it difficult to underwrite, and vulnerability to business cycles. Through its >2 decades of experience in servicing the informal segment, Five-Star has created a niche in the small-ticket MSME lending space.

Chart 14: Average outstanding per borrower remained at <Rs0.3mn since FY17

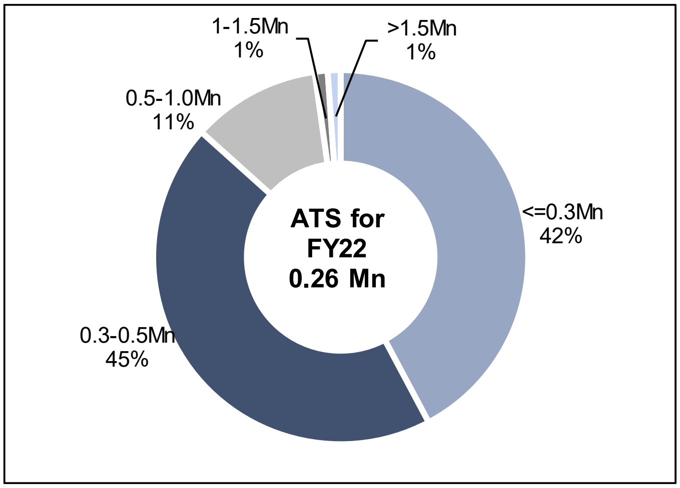


Source: Company data, I-Sec research.

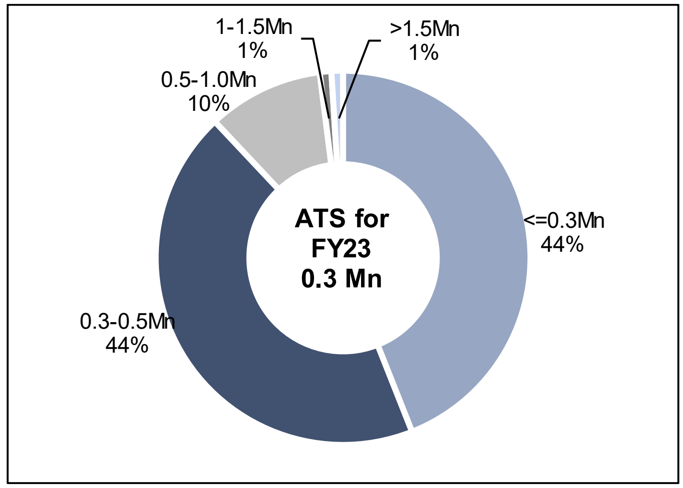
To build an underwriting model for customers with loan ticket-size of <Rs0.5mn is a challenging task. This is due to lack of documented income proofs and credit history, hence need for rigorous efforts in terms of evaluating cashflow of such customers. With more than two decades of operations in this particular segment, Five-Star has developed an underwriting model enabling lending to small businesses in India. The

model is customer-centric and is underpinned by underwriting practices that triangulate the character, cashflow and collateral of potential customers. This methodology of underwriting ensures both the willingness and the ability of the customer to repay the loan despite the absence of traditional documentary proofs of income.

Chart 15: 88% of portfolio has a ticket-size of <Rs0.5mn



Source: Company data, I-Sec research



Source: Company data, I-Sec research

Table 1: Successful scale of business with steady asset quality and return profile across cycles

	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	Average
RoA	7.0%	6.9%	4.2%	5.8%	8.8%	7.3%	7.0%	7.2%	8.6%	7.0%
RoE	16.7%	16.5%	12.3%	13.0%	15.1%	15.4%	16.9%	13.9%	15.0%	15.0%
GS-3	1.8%	1.8%	2.5%	1.4%	0.9%	1.4%	1.0%	1.1%	1.4%	1.5%
NS-3	1.5%	1.5%	2.1%	0.9%	0.7%	1.1%	0.8%	0.7%	0.7%	1.1%

Source: Company data, I-Sec research

Consistent investment towards franchise build-up

To build a sustainable and scalable lending business, especially when catering to the informal segment which often lacks credit history and verifiable income, steady investment towards human capital, technology and distribution network becomes a prerequisite. Five-Star has well understood this and made steady investment towards franchise build-up. It has a proven track-record of adding 50-60 branches every year and deploying more manpower per branch with increasing branch vintage. The same helped it go deeper in the states in which it operates. During the first phase of diversification, it chose to go deeper in Tamil Nadu where it expanded its distribution from 6 branches in Chennai in FY15 to 39 throughout the state by FY15. In its second phase, it started to expand in the neighbouring states of Andhra Pradesh, Telangana and Karnataka, growing from 3 branches in FY15 to 72 by FY18.

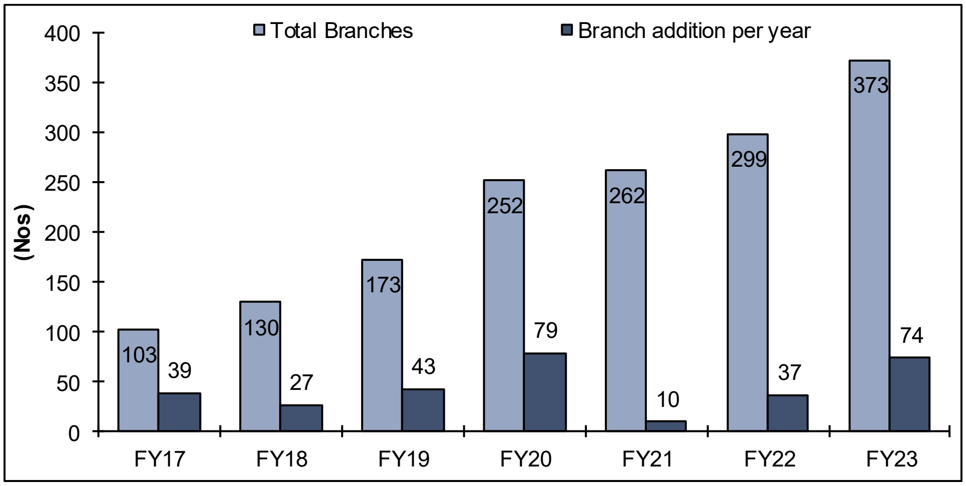
During its third phase, it has further deepened its presence in Tamil Nadu by taking total branch count in the state to 106, and AP / KTK / Telangana to 213 by FY23 and also entered new states like Maharashtra, Chhattisgarh and Uttar Pradesh with a combined branch network of 10 in the 3 states as of Mar’23.

Table 2: Successful scale of business with steady asset quality and return profile across cycles

State	Year of entry	Districts	Number of branches	% of total branches	% of super branches	% of normal branches	Gross term loans (Rs mn)	% of total gross term loans
Tamil Nadu	1985	39	100	32.15%	65.00%	35.00%	20,172.11	38.09%
Andhra Pradesh	2014	20	84	27.01%	60.71%	39.29%	15,770.01	29.77%
Telangana	2016	31	48	15.43%	62.50%	37.50%	10,325.80	19.50%
Karnataka	2014	20	33	10.61%	18.18%	81.82%	3,793.47	7.16%
Madhya Pradesh	2018	33	37	11.90%	37.84%	62.16%	2,455.70	4.64%
Maharashtra	2018	3	5	1.61%	20.00%	80.00%	330.45	0.62%
Chhattisgarh	2019	3	3	0.96%	0.00%	100.00%	71.33	0.13%
Uttar Pradesh	2019	1	1	0.32%	0.00%	100.00%	46.49	0.09%

Source: Company data, I-Sec research

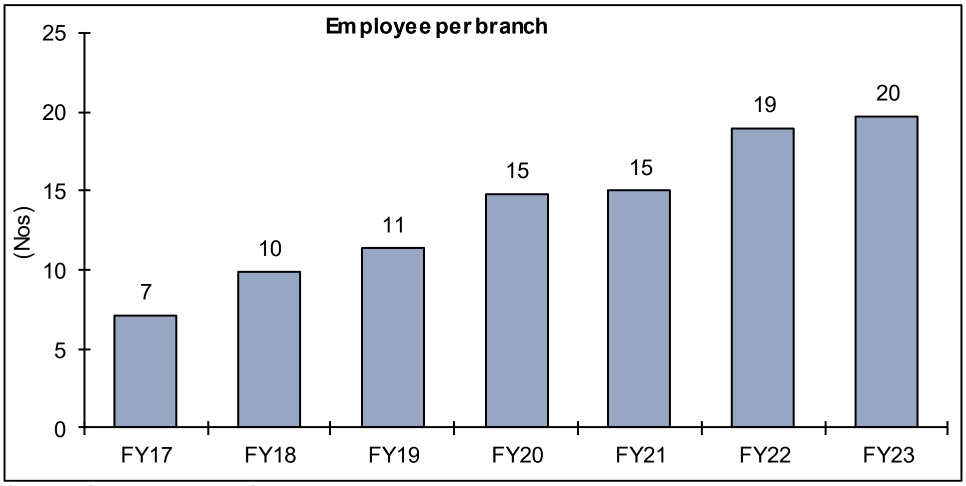
Chart 16: Steady investment towards building distribution



Source: Company data, I-Sec research

Unlike other NBFCs, Five-Star has adopted a contiguous expansion approach rather than entering multiple states without knowing the credit behaviour and local environment. Its geographical diversification journey is underpinned by utilising nearest branch experience to evaluate local credit environment and then enter new location. Further, even in the contiguous expansion strategy, the company follows a calibrated growth journey. It typically starts any new location with minimum branch staff, spends time on gaining local market understanding and, once it is comfortable about the market dynamics, it gradually increases sales personnel at branches. It prefers hiring local staff with an understanding of the catchment area, strong local personal and professional networks.

Chart 17: Branches are adequately equipped with human capital – as reflected in employee per branch increasing to 19 by FY23 from 7 in FY17



Source: Company data, I-Sec research

Unique: Super-branch concept

Five-Star enters new location with normal branch set-up (4-6 business officers) and post 18-24 months of consistent branch performance it gradually invests for ramp-up. Key metrics typically comprising quantitative factors such as the collection efficiency, asset quality and where the ratio of business officers and branch managers begins to suggest a branch transition is necessary, it converts a normal branch into super-branch (10-12 business officers).

In addition, each branch has specific performance targets which is set basis population of the city in which the branch operates, whether the branch is a normal branch or a super-branch, and the number of relationship officers in each branch.

Table 3: Five-Star enters any new location as normal branch (small set-up) and, once branch shows performance as per expectations, it start investing further to convert into super-branch (large set-up)

Branch particulars	Normal Branch	Super Branch
Branch size	500-600 sq. feet	1,200-1,600 sq. feet
Branch managers/Senior Branch Managers	1 Branch Manager	2 Branch Managers; 1 Senior Branch Manager
Business Officers	4-6	10-12 (2 teams of 5-6 each)
Field Credit Officers	1 (Exclusive/Shared with neighboring branches)	1 (Exclusive)
Cashiers and Operations Personnel	1 Cashier; 1 Operations Personnel	1-2 Cashiers; 1-2 Operations Personnel
Catchment Area Radius	Approx 25-30 km	Approx 40-45 km

Source: Company data, I-Sec research

Table 4: As of Jun'22, Five-Star has 144 normal branches and 167 super-branches, with each contributing 46% and 54% to gross term loans, respectively

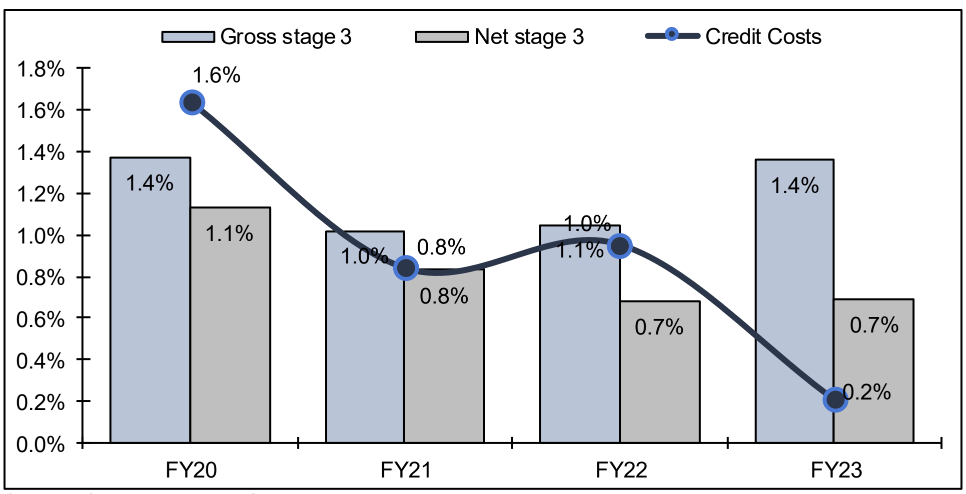
Metric	Three months ended June 30		Financial Year				
	2022	2021	2022	2021	2020	2019	2018
Number of super-branches	167	96	160	95	92	-	-
Number of normal branches	144	167	140	167	160	173	130
Branches with gross term loans: >Rs400mn	8	7	8	5	7	1	-
Branches with Gross term loans: >Rs300Mn and <Rs400Mn	37	35	34	33	19	2	1
Branches with Gross term loans: >Rs200Mn and <Rs300Mn	70	61	67	61	68	27	1
Branches with Gross term loans: >Rs100Mn and <Rs200Mn	93	73	90	74	60	67	37
Branches with Gross term loans: <Rs300Mn	103	87	101	89	98	76	91
Gross term loans per branch (Rs mn)	170.31	174.05	168.90	169.67	154.45	122.13	77.56
Disbursements per branch (Rs Mn)	18.7	12.67	64.33	48.07	122.03	96.25	52.60

Source: Company data, I-Sec research

Credit cost at an average of 1% in a customer segment where 1+ DPD is >10%

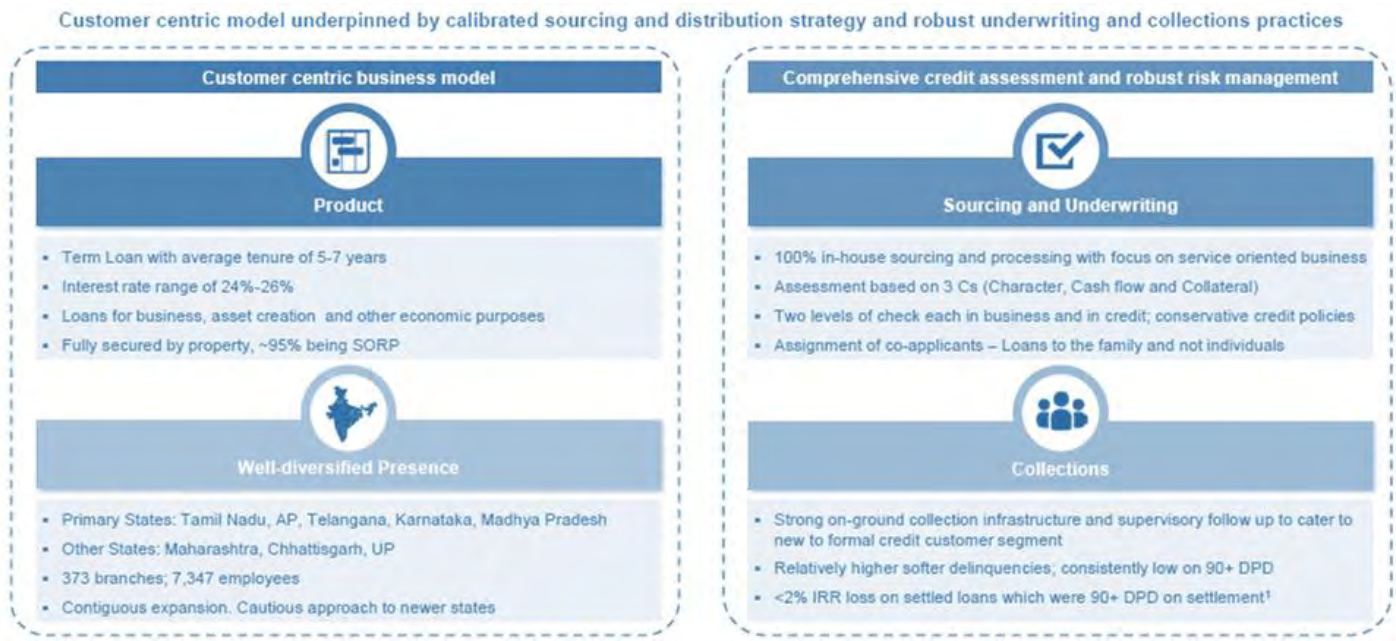
Lending to the informal segment, especially below Rs0.5mn ticket-size, requires deep understating of customers, tailor-made product offerings, strong underwriting and collection mechanism. Five-Star is amongst a very few entities who have successfully built underwriting models that have been stress-tested. This is reflected in its gross stage-3 assets remaining in the range of 1-1.5% in last 4 years, which supported the company in containing credit cost at sub-1% during the same period.

Chart 18: Steady improvement in asset quality…



Source: Company data, I-Sec research

Chart 19: …supported by superior underwriting and collection mechanism



Source: Company data, I-Sec research

Table 5: Asset quality performance, even with 1-2 year lag, remains robust

Amount in Rs mn	FY2023	FY2022	FY2021
Loan Portfolio	69,148	50,671	44,454
Gross Stage-3 assets	939	530	452
Gross Stage-3 assets %	1.36%	1.05%	1.02%
Gross Stage-3 assets % - 1 year Lag*	1.85%	1.19%	1.16%
Gross Stage-3 assets % - 2 years Lag#	2.11%	1.36%	2.14%

Source: Company data, I-Sec research
*1 year lag Gross Stage-3 assets computed as Gross Stage-3 assets as at the end of a period as a % of the loan portfolio 1 year ago
#2 years lag Gross Stage-3 assets computed as Gross Stage-3 assets as at the end of a period as a % of the loan portfolio 2 years ago

Table 6: Steady increase in PCR; as of Mar'23 PCR on GS3 stands at 49%

As of March 31, 2023 (Rs mn)	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 (Rs mn)	**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 (Rs mn)	**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%

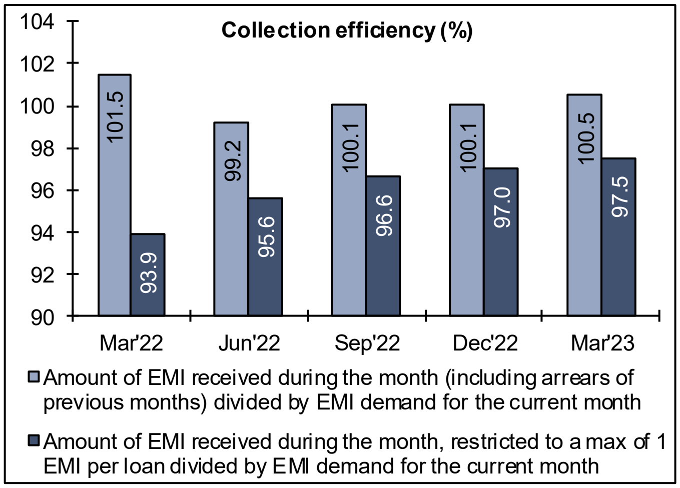
Source: Company data, I-Sec research

Table 7: Share of stage-2 and stage-3 assets improved sharply during FY23

(Rs mn)	As at March 2023		As at December 2022		As at March 2022	
	AUM	% of AUM	AUM	% of AUM	AUM	% of 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	61,884	89.49%	54,869	87.90%	42,170	83.22%
Stage-2	6,325	9.15%	6,648	10.65%	7,971	15.73%
Stage-3	939	1.36%	907	1.45%	530	1.05%

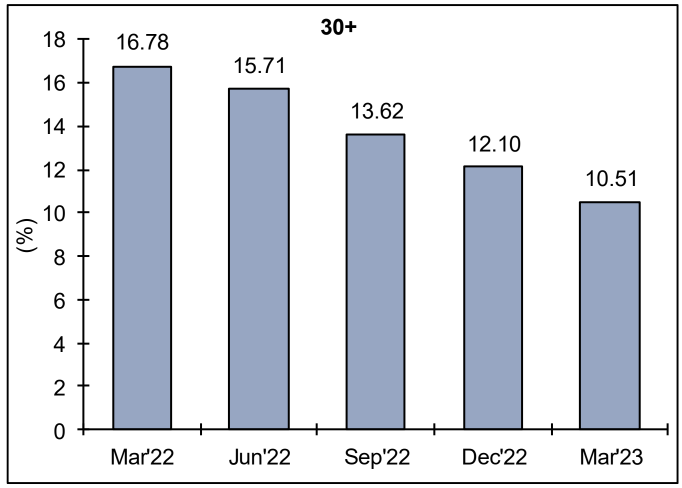
Source: Company data, I-Sec research

Chart 20: Collections (ex-arrears) remained robust at 98% as of Mar'23…



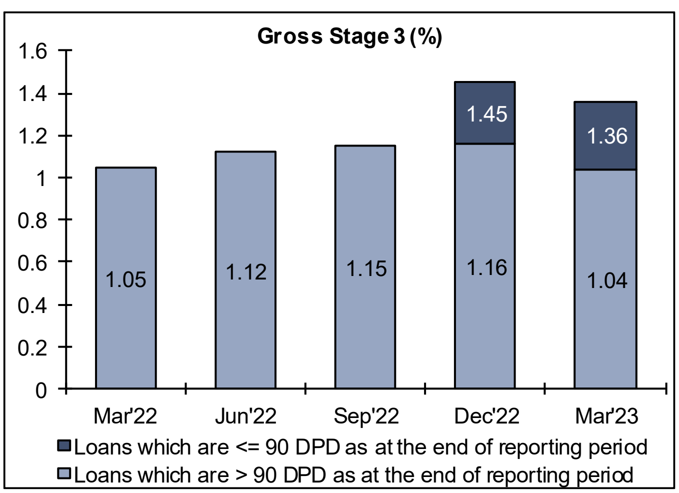
Source: Company data, I-Sec research.

Chart 21: …resulting in 30+ portfolio falling to 10.5% by Mar'23 from 16.8% in Mar'22



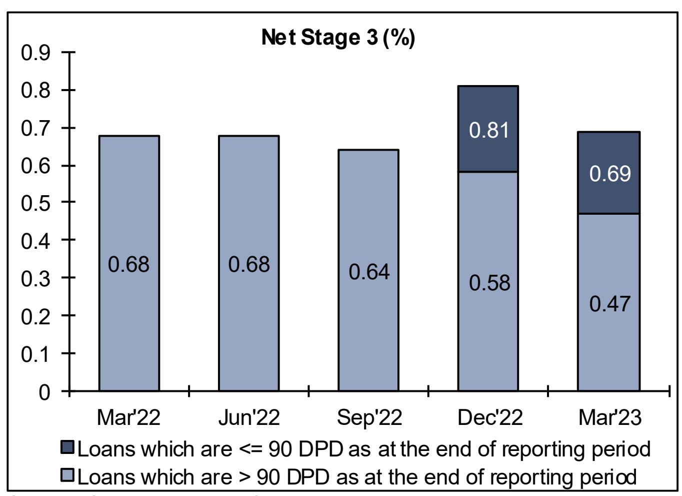
Source: Company data, I-Sec research.

Chart 22: GS3 increased marginally during FY23 due to revised regulation on NPL recognition…



Source: Company data, I-Sec research.

Chart 23: …however, company has strategically increased PCR to keep NNPL flat YoY at 0.69% in Mar'23



Source: Company data, I-Sec research.

A. 100% in-house sourcing

Sourcing the right customer in any lending business is of utmost importance to build a quality asset portfolio. Further, choosing the right customer acquisition channel (in-house, DSA, connectors, digital channel, etc.) becomes important to have complete control over the quality of customer and process involved in disbursements. Underwriting an informal self-employed customer (in the absence of traditional income evidence), requires special skillset. Thus, instead of acquiring customers via third-party (not necessarily their skillset would align with Five-Star as they work for multiple financial institutions), Five-Star has built in-house sales team to acquire customers.

Company's 100% customer acquisition is in-house, either through branch-led local marketing efforts (i.e. door-to-door, or specific referral marketing), repeat customers or through walk-ins.

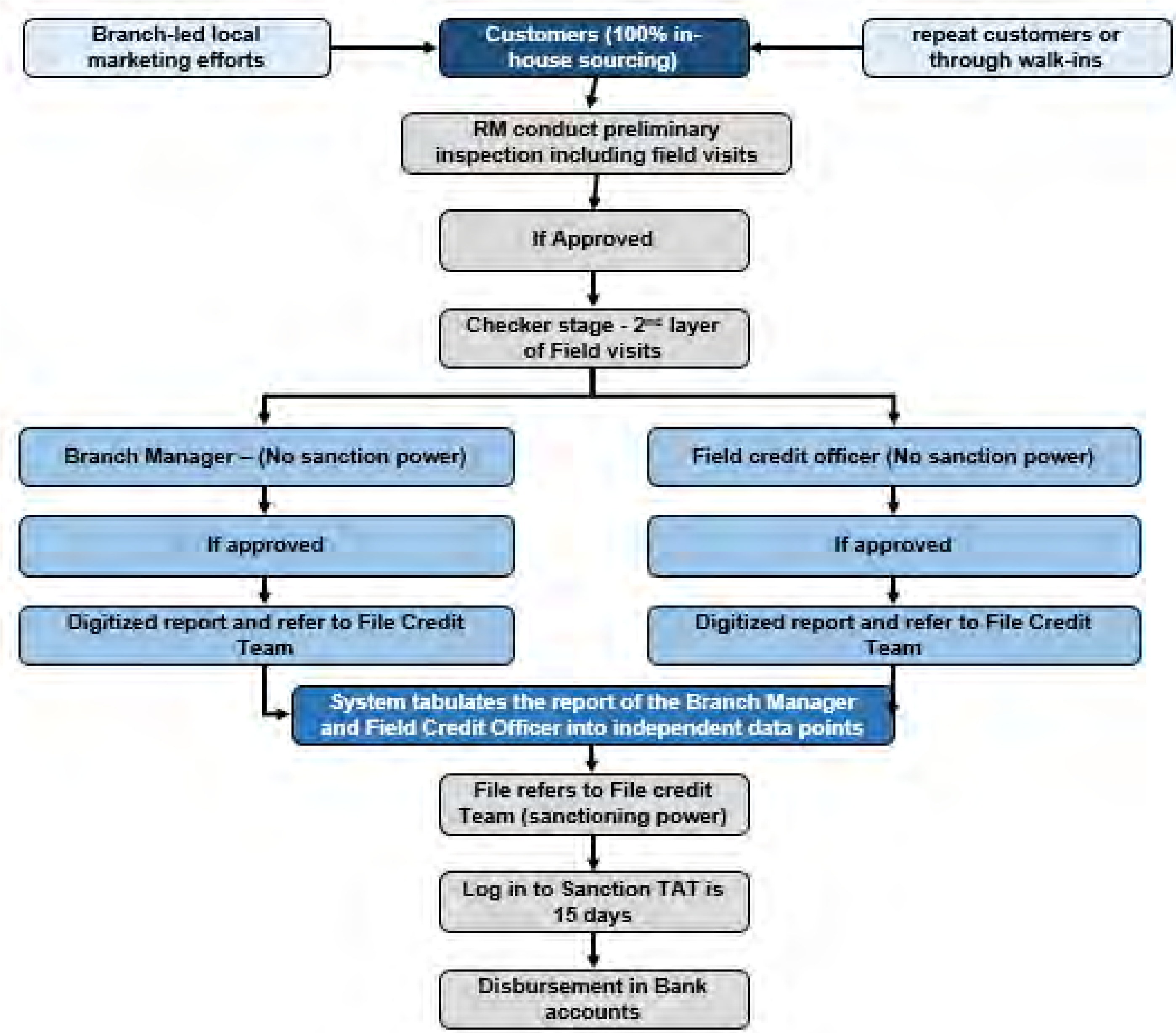
Currently, Five-Star has >4,000 people in business and collection verticals spread across 8 states. In-house sourcing also results in low customer churn given strong customer relationships and ability to retain customers with tailor-made product solutions.

B. Stringent credit assessment and risk management

Five-Star has built a proprietary underwriting model, which has been fine-tuned over 2 decades of experience, based on the deep understanding of customer behaviour and strong knowledge of the local market and regional dynamics. The assessment done is based on 3 Cs: character, cashflow, and collateral. Key fundamental elements of its underwriting model, include:

- **Household-level credit evaluation rather than borrower-level:** While evaluating the proposal, the company factors cashflows of all household members, or those who have a current or potential claim on the property being mortgaged and included as co-applicants to the loan proposal.
- **More focus on service-oriented business:** Company strategically focuses on individuals who are into service-oriented businesses that are typically last to be impacted by macro downcycles, while being first to revive from such cycles.
- **Maker-checker concept:** Multiple physical verification touchpoints by business and collection teams and field credit teams to assess applicants and collateral.
- **95% of collaterals** are self-occupied residential properties.
- **Staff accountability:** Entire underwriting process is undertaken by internal employees.
- **Sanctioning power with file credit team:** Complete independence between the credit team and business and collection teams, and all incentives for credit team, are linked to file processing, not file approval.
- **Conservative loan-to-value (LTV) ratios:** As of Mar'23, LTV stands at ~38%.

Chart 24: Underwriting process – multiple layer of checks



Source: Company data, I-Sec research

While underwriting small-ticket self-employed segment is extremely critical, setting-up a stringent risk management framework is equally important to manage asset quality. Key risk management practices followed by Five-Star are:

- **Mandatory women co-applicant:** All loans require the woman of the house as either the applicant or co-applicant. Such initiatives improve the financial discipline to the repayment behaviour and ensures that monies are carved out from the business income to meet repayment obligations.
- **Conservative installment to income ratio** at ~42%.

Chart 25: Well-defined supervisory mechanism

Assistant Branch manager

Branch manager

Sr. Branch manager or Area manager (oversight 4-6 branches)

Regional manager (oversight 3-4 area managers)

State head

Deputy Head of Business and Collections

Source: Company data, I-Sec research

C. Robust collection mechanism

While Five-Star has developed a strong underwriting model, considering that its target segment often lacks credit discipline, it has created a strong 'on-ground' collection infrastructure to ensure that a high asset quality is maintained. To instill a sense of responsibility in its business development team, the same team that sources the loan is responsible for collection up to certain vintage. Given that many of the customers are new-to-formal credit, minor delays in the servicing of regular monthly instalments is part of normal repayment culture; however, such delays don't necessarily translate into loan defaults. In order to maintain a credit and repayment discipline of the borrower, Five-Star has developed a strong collection infrastructure. Its collections infrastructure is underpinned by the following:

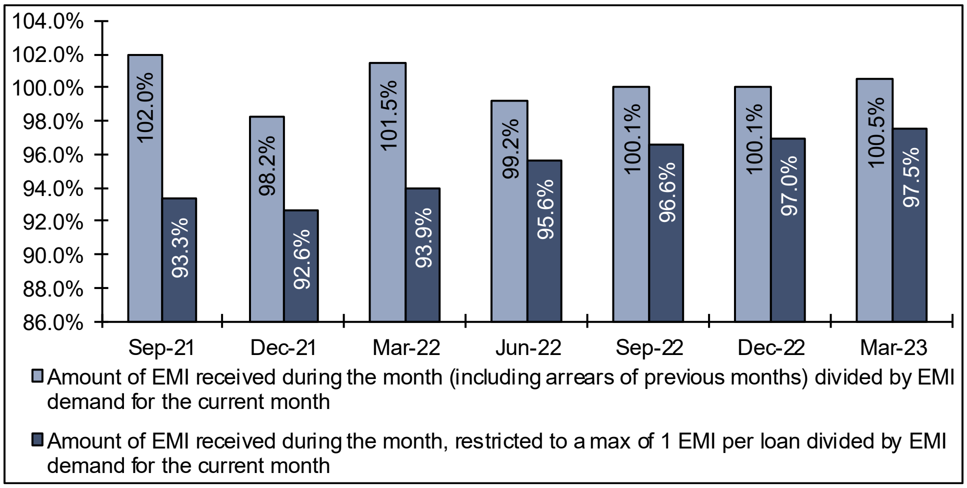
- Branches adequately staffed with business officers, with maximum 120 loans per relationship officer, which is expected to provide each officer with the capacity to undertake both business and collection activities effectively.
- Older branches with a collections vertical to which the collections responsibility of accounts is transferred once the accounts cross a certain vintage, which effectively frees up the time for business officers to focus on new business.
- Branches staffed with persons sourced from the local area, with each branch servicing an area within a limited radius, resulting in branch staff being able to quickly attend a customer's location as issues arise.
- Keeping the responsibility of sourcing and collections with the same relationship officer so that he/she is incentivised to source suitable files and undertake follow-up activities with the customers until closure of the loan.
- Branch staff incentives aligned with both business and collection targets, so that meeting such targets in both areas are required to qualify for incentives.

Table 8: Bucket-wise collection mechanism

DPD buckets	Collection practice
1-30 DPD	Reminder message, calls from branch and visits by BM to customer's house
31-90 DPD	Supervisors and senior management involvement
90+ DPD	Coordinated efforts by HO and branch

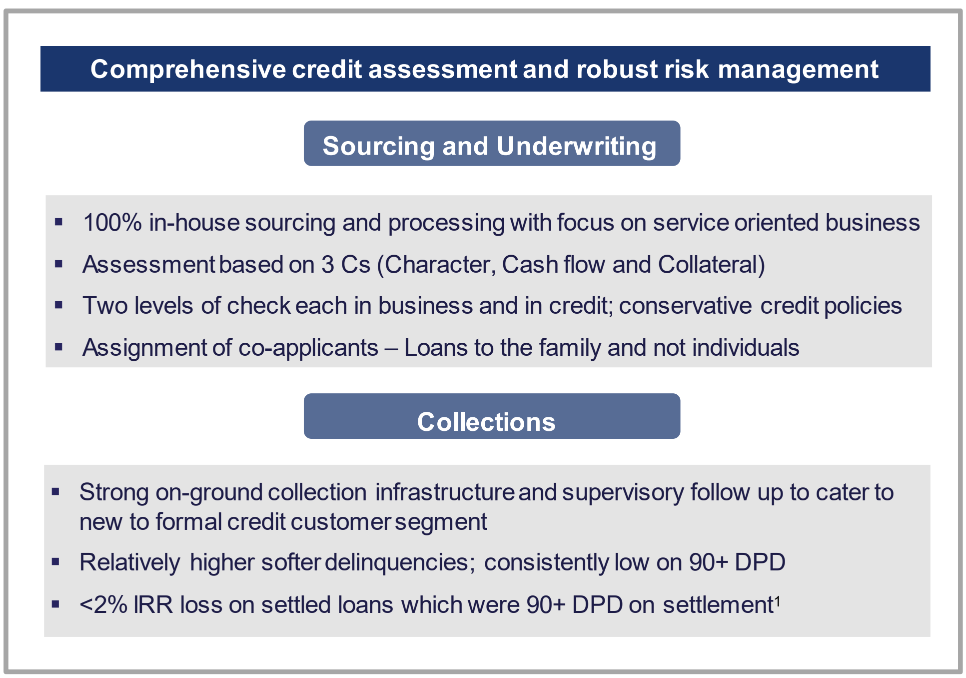
Source: Company data, I-Sec research

Chart 26: Steady improvement in collections



Source: Company data, I-Sec research

Chart 27: Credit and collection process

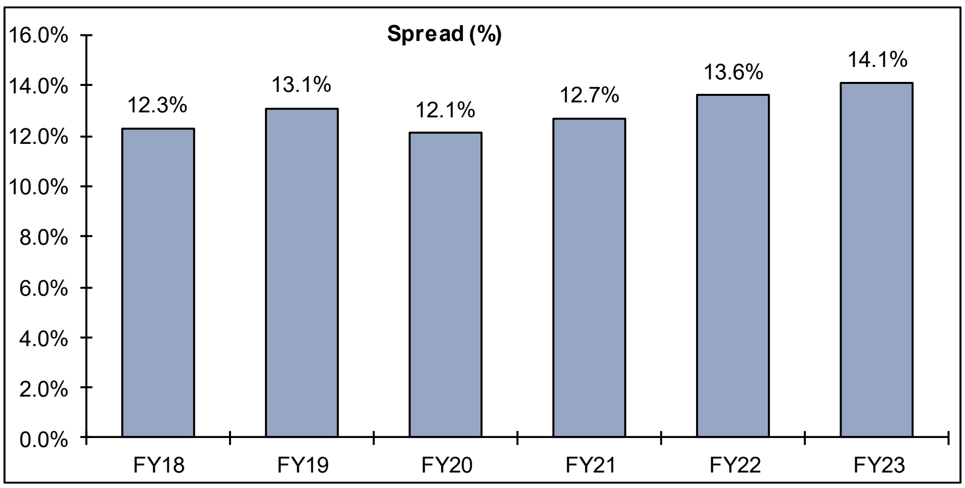


Source: Company data, I-Sec research

Spread analysis – sustainable spread to be 12-13% in near term

Five-Star has been able to improve its spread during past 4 years despite rising rate cycle (spread improved to 14.1% in FY23 from 12.1% in FY20). More than 12% of spread since 2018, reflects its strong pricing power in a segment it operates and effective liability management. Such a strong spread is predominantly driven by higher asset yields at ~24% and falling borrowing cost between FY20-FY23. Healthy spreads enabled it to deliver average 7% RoA and 15% RoE during FY15-FY23. This was despite the company steadily investing towards franchise build-up as reflected in: 1) total branches increasing to 373 by FY23 from 39 in FY15, and 2) total employee base expanding to 7,347 in FY23 from 167 in FY15.

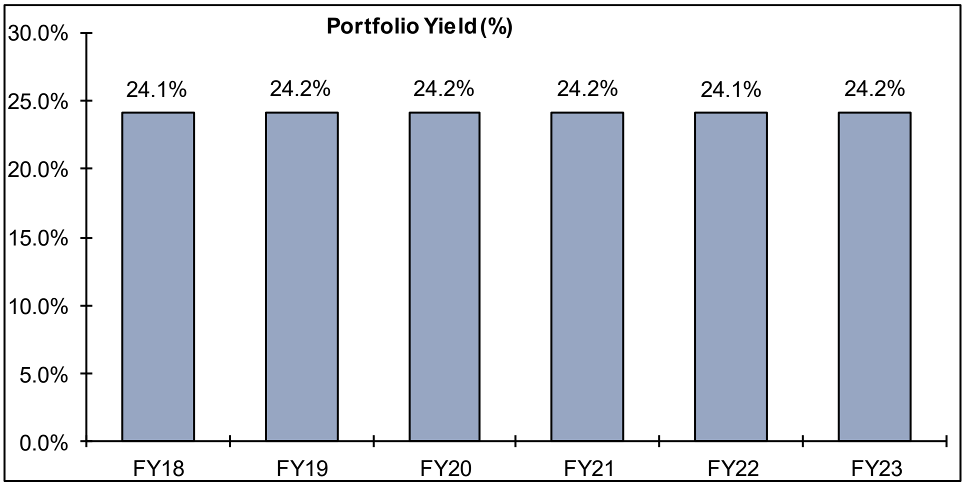
Chart 28: Strong pricing power and falling borrowing cost led to steady increase in spread



Source: Company data, I-Sec research

Five-Star enjoys strong pricing power in its customer segment as reflected in the steady 24% yield since FY18. Niche positioning in <Rs0.5mn ticket-size with limited competition given complexity, involves in underwriting such segment and operational intensity, deep distribution network thereby reaching clients before peers and its continuous focus on operating in same segment are key enablers for such a strong pricing power. The customer profile is such that many customers are new-to-formal credit market and were earlier borrowing from the unorganised market at monthly 4-5% interest rates; this makes these customer segments less vulnerable to lending rates.

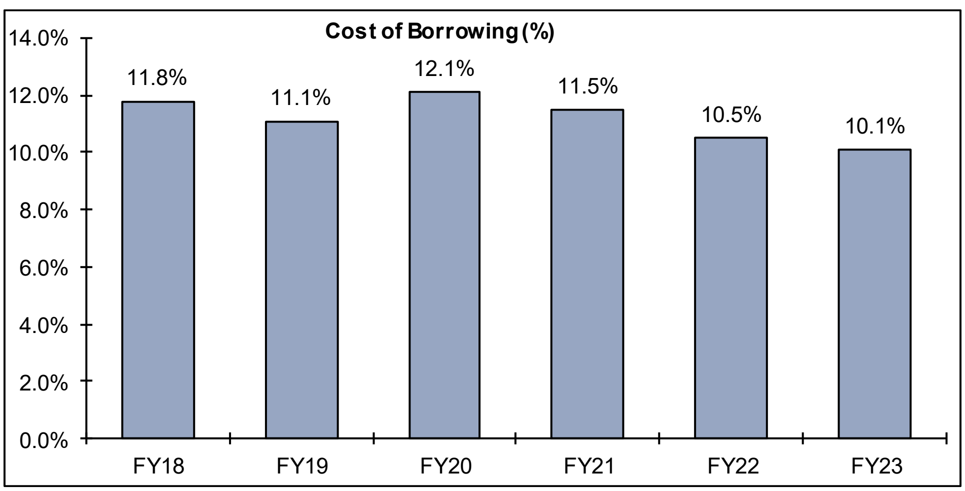
Chart 29: Asset yield remains steady at 24% reflecting company's strong pricing power



Source: Company data, I-Sec research

Effective liability management assumes utmost importance for any NBFC and Five-Star has consistently delivered on it as reflected in: 1) the steady decline in its cost of borrowing to 10.1% by Mar'23 from 12.1% in FY20 (despite rising rate cycle), 2) the increased number of lending relationships from 30 in FY19 to 50 in FY23, and 3) its diversified borrowing mix. Within bank borrowing, the number of private banks lending to Five-Star has increased to 23 as of Mar'23 from only 7 in Mar'15.

Chart 30: Borrowing cost fell to 10.1% by Mar'23 from 11.8% in FY18 – driven by steady improvement in credit rating



Source: Company data, I-Sec research

In addition, Five-Star requires its customers to pay certain login fees prior to the loan application being processed and certain charges prior to the disbursement of the loan. These fees and charges are collected at different stages of the loan application to cover the initial cost of underwriting the loan, document verification and storage. These fees and charges are subject to periodic changes based on market conditions and regulatory requirements. Additionally, prior to disbursement of a loan, the company registers the mortgage at the state registrar's office.

What would drive profitability going ahead?

Investment towards technology to ensure effective management of the lending process and improve productivity

During the early phase of its organisational journey (till 2017), Five-Star's underwriting process was completely manual with minimal technology involvement. However, between FY17-FY23, as a part of its transformation journey, it accelerated its tech spending with major initiatives being: a) moving to *FinnOne Neo* (ERP solution) with automated workflow and rule engine configuration, and b) adopting a completely paperless underwriting model with all data available on cloud.

Going forward, in order build in-house tech capabilities to manage scale, Five-Star has built a 30-personnel team in IT and data science. It recruited Mr. Vanamali Sridharan as chief technology officer (>28 years of experience in working with banks and technology strategy consultancies). Company also appointed a dedicated head of engineering (development and data sciences) to lead in-house technology development and data analytics, and a head of technology to oversee the customer acquisition system, loan management system and collections system.

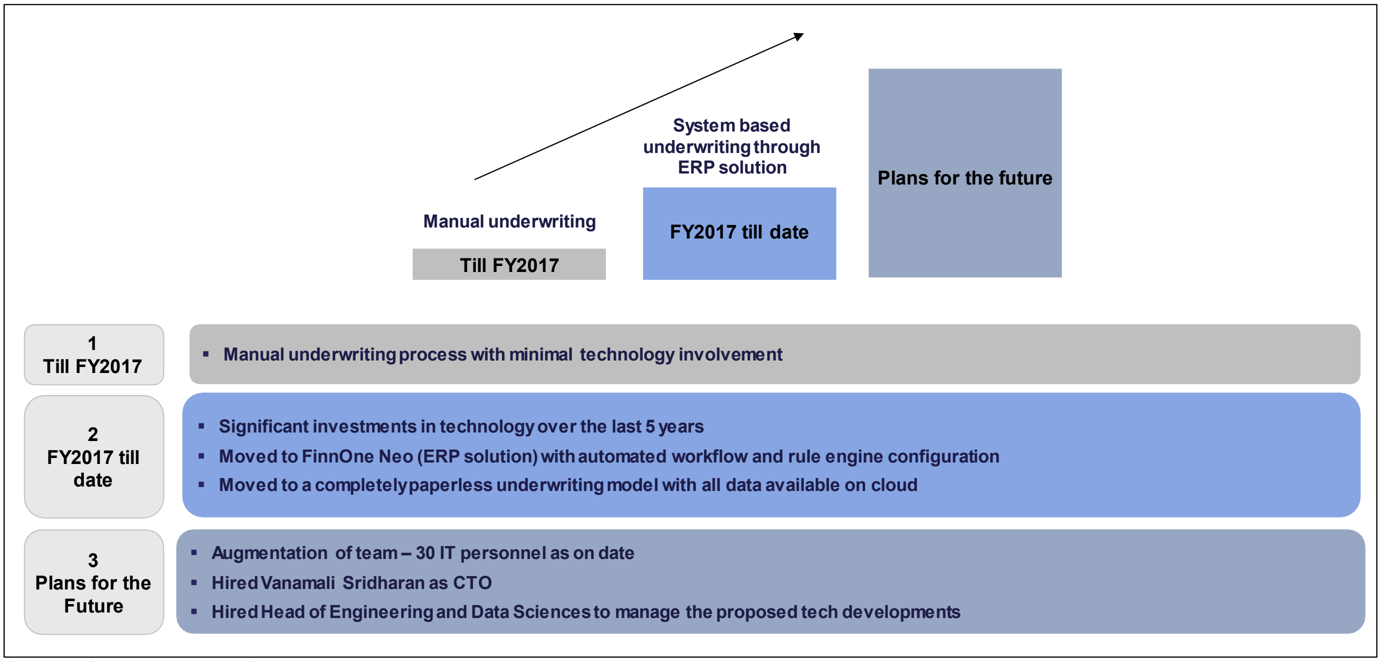
Key technology-led initiatives include:

- Developing an application programming interface (API) infrastructure to leverage the strength of various third-party service providers / fintech companies and aim to partner with them to augment / create more efficient processes.
- Improving accuracy and breadth of customer data capture across the portfolio for data analytics and insight generation.
- Use data, analytics and machine learning to complement current underwriting processes to ensure onboarding the right borrowers and maintain a robust asset quality.
- Developing a robust customer credit scoring model; automation of existing manual activities within its underwriting process to improve TAT and reduce transaction costs.
- Supplementing collections infrastructure by leveraging existing payment architecture towards collecting EMI repayments.

Five Star is focused on building technology and establishing presence in more states. Further, it remained committed in investing towards enhancing customer experience, attaining greater operational and management efficiencies and productivity. Early investment towards employing a comprehensive 'touch & tech' model across operations (which focus on maintaining frequent technology-based communication points that enhance efficiency and customer experience) has enabled it to benefit from the economies of scale, FY18 onwards.

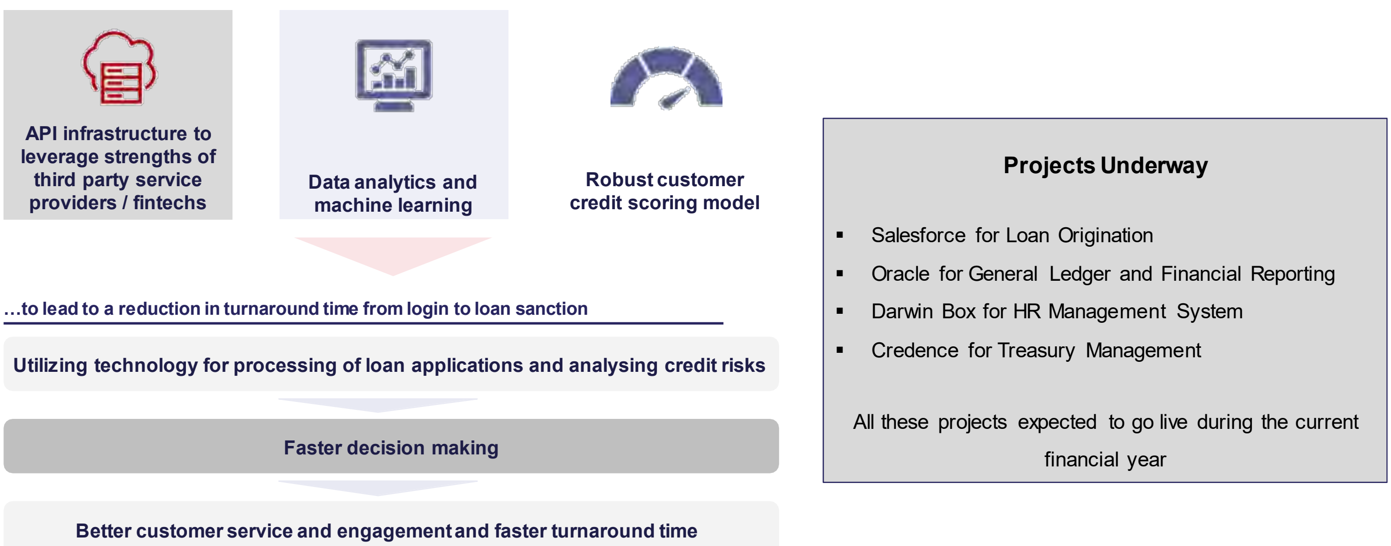
Further, Five-Star started building separate collections team to manage the next asset quality cycle better than the past cycle.

Chart 31: Investment towards technology to accelerate



Source: Company data, I-Sec research

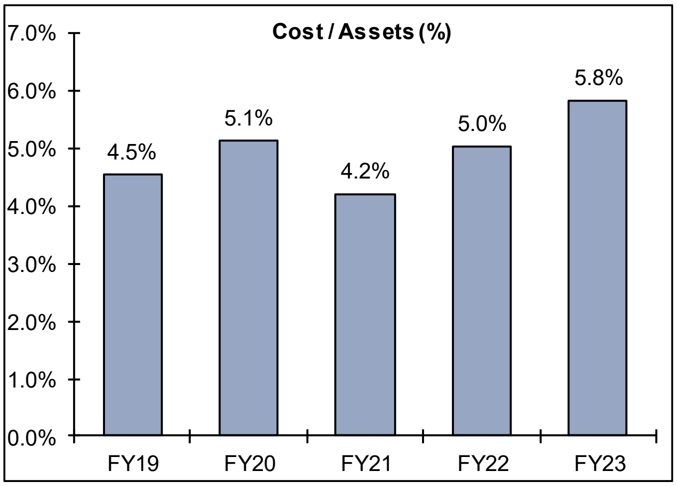
Chart 32: Upgraded tech platform and new digital initiatives to bring in operational efficiency and improve underwriting



Source: Company data, I-Sec research

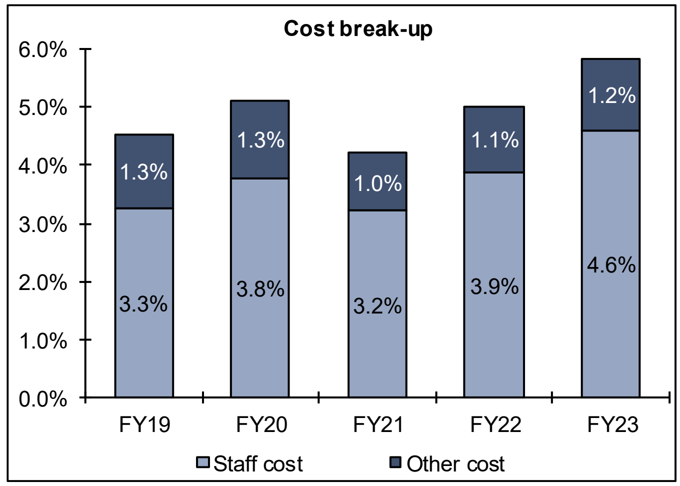
Cost / assets ratio has increased significantly during FY21-FY23 largely due to accelerated investment towards technology and >100 branch additions and >3,400 employee additions during the period. Company added >100 branches in two years (FY21-FY23) while it took 5 years (FY17-FY21) to add 160 branches. Similarly, it added >3,000 employees in last 2 years while it took 5 years to add same number of employees between FY17-FY21.

Chart 33: Cost / assets ratio peaked out at current levels; productivity improvement to drive operating leverage going ahead



Source: Company data, I-Sec research

Chart 34: Higher employee addition (>3,000 people) during FY21-FY23 led to rise in cost/assets to 5.8% in FY23 from 4.2% in FY21



Source: Company data, I-Sec research

Table 9: Non-staff cost breakup; higher tech expenses and legal costs resulting in 30-60bps higher non-staff cost than Aavas and Aptus

Data as on FY22	Aavas	Aptus	Five-Star
Travelling and conveyance	0.07%	0.09%	0.05%
Manpower outsourcing/manpower management	0.30%	0.00%	0.00%
Advertising	0.06%	0.01%	0.00%
CSR expenditure	0.06%	0.11%	0.15%
IT and analytics Expenses	0.05%	0.02%	0.23%
Communication cost/Postage & Courier charges	0.07%	0.04%	0.13%
Legal expenses	0.07%	0.04%	0.32%
Repairs and maintenance	0.03%	0.01%	0.07%
Electricity charges	0.03%	0.01%	0.02%
Collection and legal recovery expenses	0.03%	0.00%	0.06%
General office expense	0.03%	0.09%	0.00%
Directors' fees and commission	0.01%	0.02%	0.02%
Printing and stationery	0.01%	0.02%	0.06%
Auditors' remuneration	0.01%	0.01%	0.03%
Rent, rates and taxes	0.01%	0.08%	0.02%
Other expenses	0.07%	0.04%	0.05%
Total non-staff cost	**0.91%**	**0.57%**	**1.21%**

Source: Company data, I-Sec research

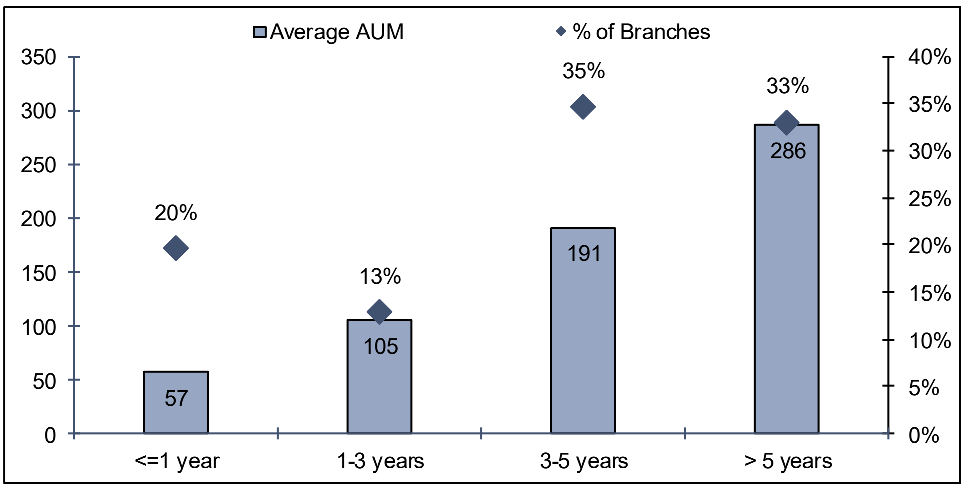
Addition of more than >3,000 employees during FY21-FY23 impacted employee productivity as reflected in AUM per employee falling sharply by >20% YoY to Rs8.9mn in FY23 from Rs11.3mn in FY22. Similarly, disbursement per employee fell to lowest level of Rs3.1mn in FY23 from peak of Rs7.5mn in FY20. While its cost/assets ratio has increased in the recent past due to its accelerated investment towards franchise build-up, the company's incremental focus on sweating existing infrastructure is likely to drive productivity improvement, which would likely result in gradual decline in cost ratios going forward.

Table 10: Key productivity metrics

Rs mn	FY18	FY19	FY20	FY21	FY22	FY23
Employee per branch	7	10	11	15	15	19
AUM per branch	46.9	77.6	122.1	154.5	169.7	169.5
AUM per employee	6.6	7.8	10.7	10.4	11.3	8.9
Disbursement per branch	36.2	52.6	85.6	95.6	47.5	58.7
Disbursement per employee	5.1	5.3	7.5	6.5	3.2	3.1

Source: Company data, I-Sec research

Chart 35: Average AUM per branch (Rs mn) for ~30% of its branches (<3 years of vintage) is less than half compared to >5 years' vintage branches



Source: Company data, I-Sec research

Diversified sources of funding and effective asset liability management to help sustain spread at 12-13%

Effective asset liability management and timely availability to funds at competitive rates are extremely critical to build a long-term scalable and sustainable lending business. More than 20 years of lending experience, 100% secured asset portfolio, superior asset quality performance (average credit cost of 1% over past 7 years) and low leverage (2x net worth) have helped Five-Star improve its credit rating over the years. This has resulted in steady decline in cost of borrowing since FY18. Steady improvement in credit rating from 'BBB' in FY16 to 'A / stable' as of Dec'22 reflects successful execution of business strategies and ability to navigate challenging times better than peers.

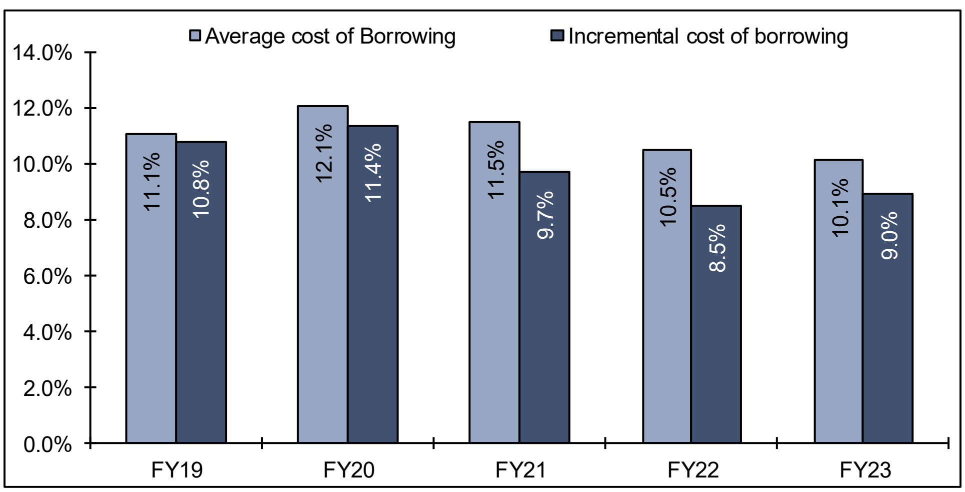
Table 11: ICRA upgraded ratings to AA- in FY23

	Type	FY18	FY19	FY20	FY21	FY22	FY23
CARE Ratings	**Bank facilities**	A - Positive	A Stable	A Positive (LT), A1 (ST)	A Stable (LT), A1 (ST)	A+ Stable (LT), A1+ (ST)	AA- (LT), A1+ (ST)
	Non-convertible debentures	A - Positive	A Stable	A Positive	A Stable	A+ Stable	
ICRA	**Bank facilities**	A - Stable	A Stable	A Stable	A Stable	A+ Stable	A+
	Non-convertible debentures	A - Stable	A Stable	A Stable	A Stable	A+ Stable	

Source: Company data, I-Sec research

Stable credit history and relatively better business performance during covid led to steady credit rating improvement between FY19-FY23. CARE has upgraded its rating for long-term bank facilities to AA- by Mar'23 from A positive in FY20. Similarly, ICRA upgraded its long-term debt rating to A+ by Mar'23 from A stable in FY20. *The same enabled Five-Star to limit the incremental cost of borrowing to only 50bps vs 250bps increase in the repo rate. A combination of curtailed funding cost and stable asset yield at 24% would likely ensure improving NIM trajectory going ahead.*

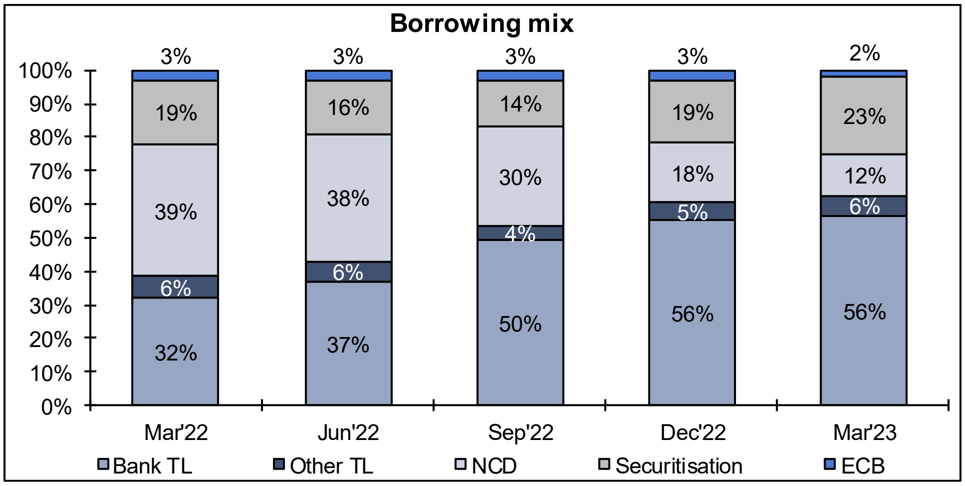
Chart 36: Steady improvement in funding cost



Source: Company data, I-Sec research

Five-Star has focused on widening its lender pool: as of Mar'23 it has lending relationship with 50 lenders, comprising a range of public sector banks, private banks, foreign banks and financial institutions. The share of bank funding (relatively lower cost) increased to 56% by Mar'23 from 32% in Mar'22, while NCD funding (high cost) fell to 12% from 39% in Mar'22.

Chart 37: Diversified funding mix



Source: Company data, I-Sec research

Company's judicious and prudent liquidity management reflects in it ensuring that the average maturity of liabilities is always higher than the average maturity of assets by sourcing funding with larger repayment cycles. As of Mar'23, the average maturity of assets stood at 4.5 years and average maturity of liabilities at 4 years.

Five-Star generally maintains liquidity (cash and cash equivalents + investments in G-Sec + liquid money market mutual funds) at least the gross of: (i) debt repayments for next three months, (ii) operational costs of next three months, and (iii) projected disbursements for next one month.

Proprietary underwriting model & deep understanding of customer behaviour to help maintain credit cost at sub-1%

Key enablers for sub-1% credit cost between FY15-FY23 for Five-Star, despite a series of challenging events like demonetisation, floods and covid, are: 1) its proprietary underwriting model, 2) deep understanding of customer behaviour built on its >2 decades of experience in small-ticket business loans, 3) complete control over customer quality (100% in-house sourcing), and 4) strong on-ground collection mechanism.

While the average credit cost at 1% (even during covid phase) appears low, it is at par compared with players broadly operating with similar customer segment (self-employed segment).

Table 12: Player-wise credit cost

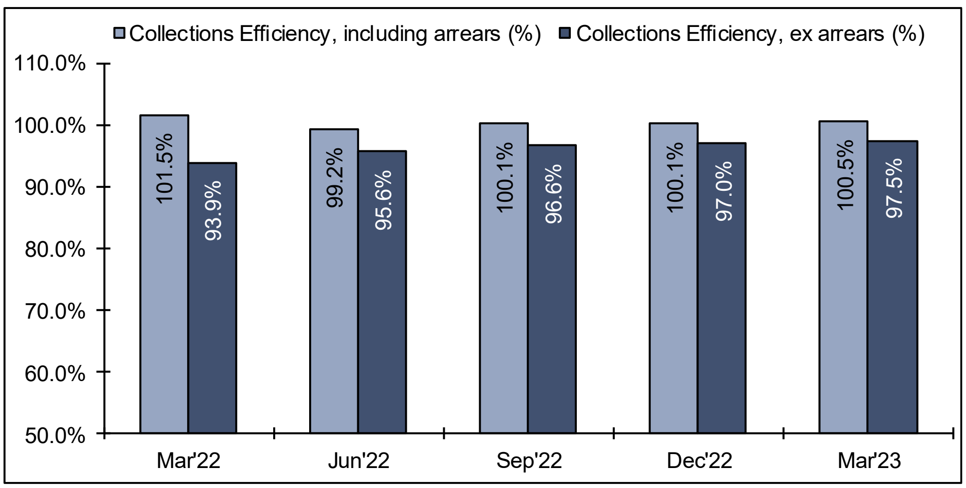
	FY20	FY21	FY22	FY23
Core housing finance (>80% HL)				
Average of below companies	**0.5%**	**0.8%**	**1.1%**	**0.5%**
LIC HF	0.5%	0.6%	0.8%	0.7%
Repco	0.5%	0.7%	2.0%	0.4%
HomeFirst	0.6%	1.0%	0.6%	0.4%
Hybrid (>65-70% HL)				
Average of below companies	**0.6%**	**0.6%**	**0.6%**	**0.7%**
HDFC	0.4%	0.5%	0.7%	0.8%
PNB	1.5%	1.1%	0.8%	1.1%
Aavas	0.2%	0.4%	0.2%	0.1%
Aptus	0.1%	0.2%	0.8%	0.6%
Business Loans				
Five-Star	1.2%	1.5%	0.7%	1.0%

Source: Company data, I-Sec research

Key strategies adopted by Five-Star to ensure healthy asset quality going forward

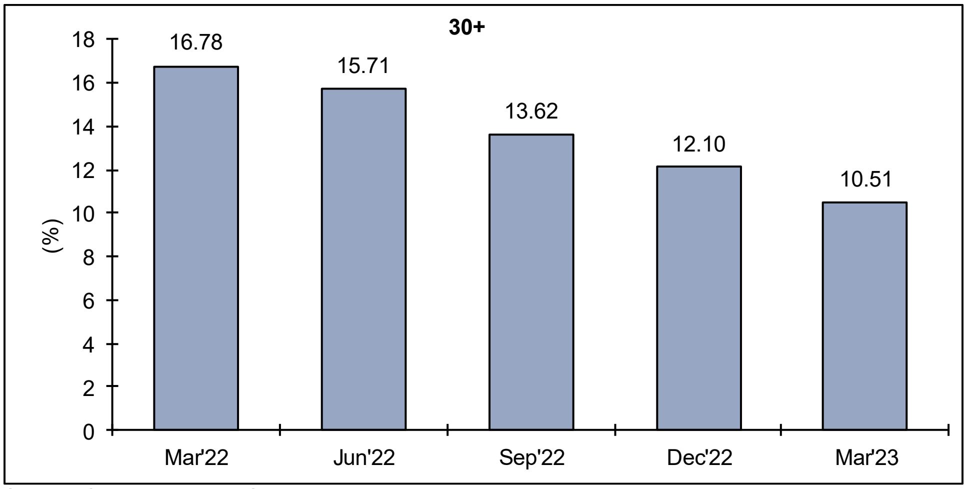
- **Calibrated expansion approach:** Five-Star follows a contiguous expansion strategy and, also while entering a neighbouring state, it spends ~2 years to understand the market, customer behaviour and set up a local team. For first two years, a primary responsibility of branch staff is to develop a deep understanding of the target market.
- **Top management involvement for hiring staff at a new branch:** Small-ticket business loans involve a high degree of human touch, as it requires physical verification of property, personal discussion with customer, cashflow assessment, etc. Hence, quality of staff is of utmost importance to build a successful business in a new location. To inculcate Five-Star's DNA in employees, top management involves itself in hiring in a new state – from business officers to branch manager.
- **Hiring is only through referrals:** The company doesn't advertise vacancies.
- **Separate audit and risk management teams** are set up with clear KRAs and functionalities to ensure complete adherence to laid-down business policies and early detection of frauds and malpractices, through rigorous review mechanism.

Chart 38: Collections, ex-arrears, improved to 97.5% in Mar'23…



Source: Company data, I-Sec research

Chart 39: …leading to steady decline in 30+ DPD portfolio to 10.5% as of Mar'23



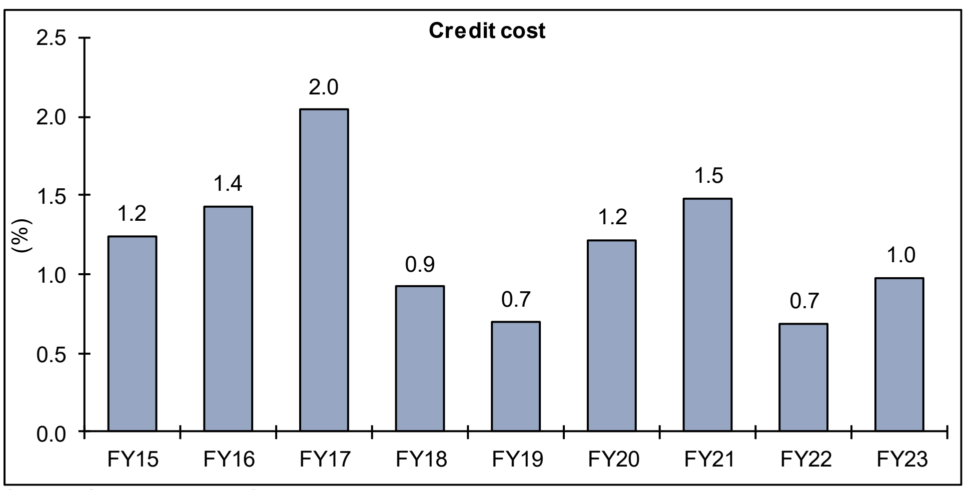
Source: Company data, I-Sec research

Table 13: Stressed asset pool negligible as of Mar'23

As of Mar'23	DPD bucket	AUM (Rs mn)	% of AUM	ECL (Rs mn)	Coverage ratio
Stage-1	0-30	61,884	89.5%	203	0.3%
Stage-2	31-90	6325	9.2%	443	7.0%
Stage-3	90+	939	1.4%	463	49.3%
Total		**69,148**	**100.0%**	**1,109**	**1.6%**
- GNPA (stage-3)					**1.4%**
- NNPA (Net stage-3)					**0.7%**

Source: Company data, I-Sec research

Chart 40: Credit cost likely to sustain at 1% going forward



Source: Company data, I-Sec research

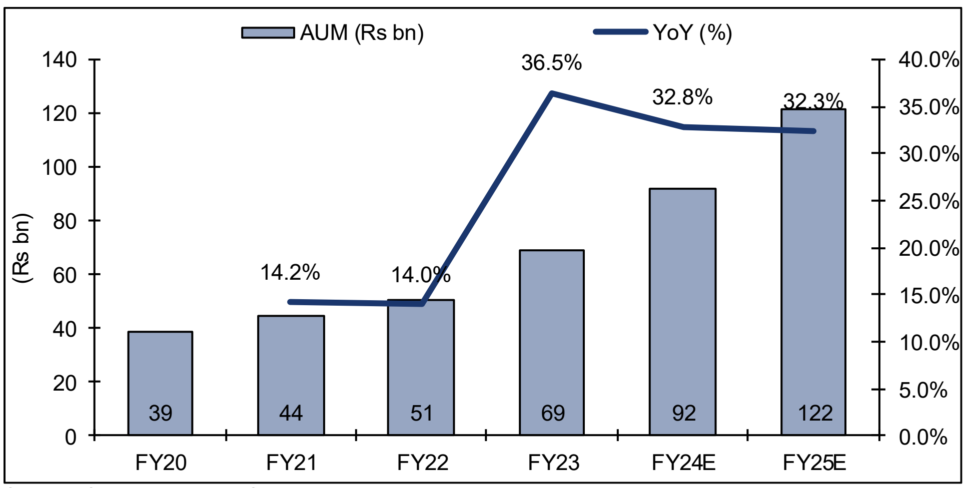
Financial outlook

Deep distribution, strong liquidity, adequate capital and vast untapped opportunity to drive >30% AUM CAGR over FY23-FY25E

Five-Star delivered a healthy 47% AUM CAGR between FY18-FY23 despite uncertain business environment due to factors such as demonetisation, liquidity crunch and the covid crisis. The same was driven by steady investment towards franchise build-up. Company added >100 branches and >3,000 employees during FY21-FY23. Currently, 94% of total AUM is originated in south India; however, considering the vast untapped opportunity at ~Rs20trn in small-ticket business loans pan-India, Five-Star has started expanding its branch network in western and northern India as well. In the recent past, it entered Maharashtra, Chhattisgarh and Uttar Pradesh by opening 10 branches in the 3 states. It is also planning to enter Rajasthan and Gujarat in the near future.

Five-Star's total branch network at 373 is one of the highest within its peer group. Its deep distribution network, entry into new states with high growth potential coupled with adequate capital and diversified funding sources would help the company sustain the current growth momentum. We estimate 33% AUM CAGR over FY23-FY25E.

Chart 41: AUM CAGR likely to remain at 33% over FY23-FY25E



Source: Company data, I-Sec research

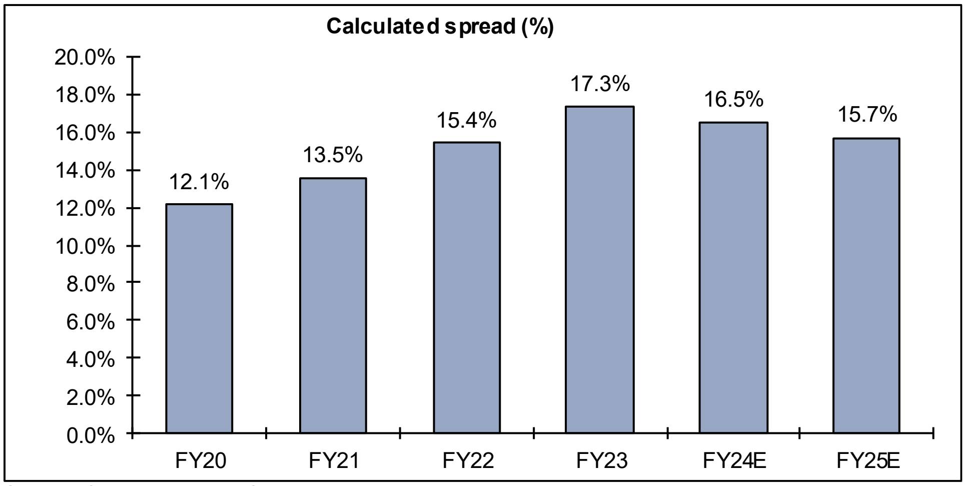
Improved credit rating and strong pricing power to ensure spread sustaining at >15% over FY23-FY25E

Over the years, Five-Star has built diversified funding sources including public, private and foreign banks, NBFCs, NCDs, NBFCs, etc. In order to ensure funding availability at competitive rates, it strategically replaced NCD funding with bank funding. As of Mar'23, funding from banking channel stands as high as 56%, while NCD funding fell from 39% in Mar'22 to 12% in Mar'23. Healthy payment track-record and strong financial performance across cycles have helped Five-Star improve its credit rating on continued basis. This resulted in the cost of borrowing reducing from 11.1% in FY19 to 10.1% in

FY23, despite the rising rate cycle. Further, marginal cost of borrowing over the past 1 year has increased by only 50bps.

Asset yield for Five-Star has remained steady at 24% between FY18-FY23 reflecting strong pricing power in the segments in which it operates.

Chart 42: Spreads are likely to sustain >15% over FY23-FY25E



Source: Company data, I-Sec research

Productivity improvement and enhanced digital platform to drive cost efficiency

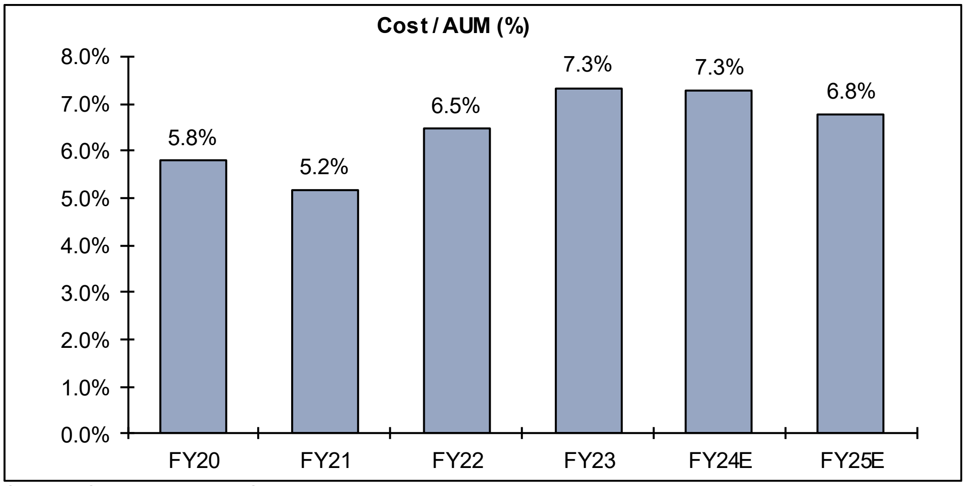
Five-Star is at an inflection point with the build-up phase now behind, hence operating leverage is likely to drive profitability in the near term. Its steady investment towards branch and manpower addition led to cost/asset ratio increasing to 7.3% by FY23 from 5.2% in FY21. Strategically, during the covid phase, it spent on franchise build-up when most peers were staying away from investments. During the past two years, Five-Star added >100 branches and >3,000 people.

Further, the company has formulated an IT strategic roadmap that closely aligns with its business growth plans, which manage growing business volumes without increasing costs proportionately. Projects underway (all projects are likely to go live in FY24) are listed below:

- Salesforce for loan origination
- Oracle for general ledger and financial reporting
- Darwin Box for HR management system
- Credence for treasury management

Company has upgraded its technology platform to enable faster decision-making and reduction in turnaround time. With incremental focus on productivity improvement, likely higher business per employee and continuous focus on process improvement by adopting latest technology to drive cost/asset lower over FY23-FY25E.

Chart 43: Increasing focus on cost optimisation

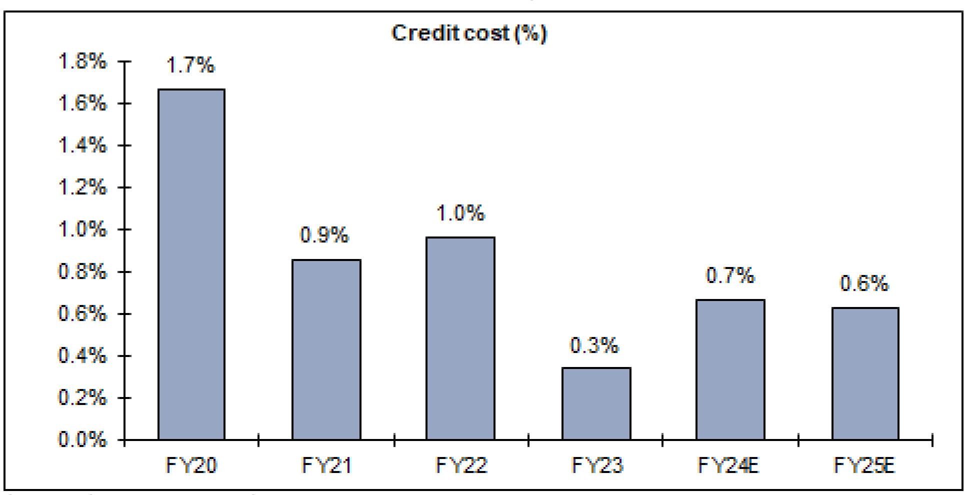


Source: Company data, I-Sec research

Proactive risk management and stringent underwriting process coupled with negligible stressed asset pool to reduce credit cost

Credit cost during the past five years (FY18-FY23) remained at an average of ~1% despite a series of challenging events like demonetisation, floods and covid-led disruption. Asset quality indicators during the pandemic were healthy due to: 1) careful selection of geographies, 2) 100% in-house sourcing and processing with focus on borrowers in service-oriented businesses, 3) assessment based on 3Cs (character, cashflow and collateral), 4) two levels of check each in business and in credit, and 5) assignment of co-applicants (loans to the family and not individuals). GNPL ratio during FY21 / FY22 / FY23 remained at 1.02% / 1.05% / 1.23% respectively. Total ECL provision stands at 1.61% as of Mar'23. We expect this to ensure credit cost remains at sub-1% over FY23-FY25E.

Chart 44: Credit cost as % of loans likely to remain at <1% over FY23-FY25E



Source: Company data, I-Sec research

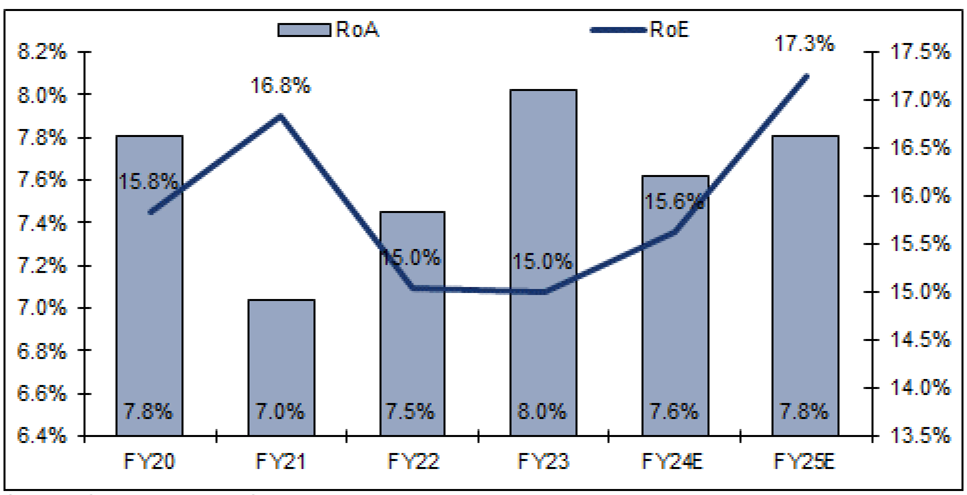
Healthy RoE of >18% to sustain over FY23-FY25E

Five-Star delivered an industry-leading average RoA of >7% during past 5 years, including the covid-impacted years of FY21-FY23. Declining cost of funds (10.1% in FY23 *vs* 12.1% in FY20), benefits of fresh capital raising via IPO, strong pricing power in the customer segment in which it operates (steady 24% yield during past 5 years) and credit cost at ~1% were the key enablers of RoA expansion between FY20-FY23. Notably, the company utilised the covid phase to expand its distribution network and build a strong base to remain ahead of the curve when the cycle turns.

We believe Five-Star's investment phase broadly concluded in FY23 in terms of upfront business expansion costs, investments towards building branch distribution and workforce, and deployment of technology. The same is likely to drive >30% AUM CAGR over FY23-FY25E. We expect the benefits of the economies of scale, hence decline in operating cost, to drive healthy RoA of >7% and RoE of >15% over FY23-25E.

While investments towards the rapidly evolving technology and branches would continue, it would be more calibrated and specific to business needs. Hence, we expect cost ratios to moderate gradually. Negligible stressed asset pool with NNPL at 0.7% and ECL provision pool at 1.61% would likely ensure credit cost settling much lower at <1% during FY24E-FY25E. The same reinforces our view that Five-Star would sustain its current healthy profitability over FY23-FY25E.

Chart 45: Healthy profitability likely to sustain



Source: Company data, I-Sec research

Valuations

Five Star, with a two decade-long experience in self-employed business loans, well-diversified borrowing profile, strong pricing power and stable management team, is likely to emerge as a preferred player to gain exposure to India's financial inclusion story. We initiate coverage on Five Star with a BUY rating and target price of Rs765, valuing the stock at 4x Sep-24E BVPS. Stock is currently trading at 3.1x FY25 BVPS, at par with Aptus and Home First, FY25E PBV multiple at 3.1x. Considering better return & growth outlook, we believe Five Star would command premium over peers.

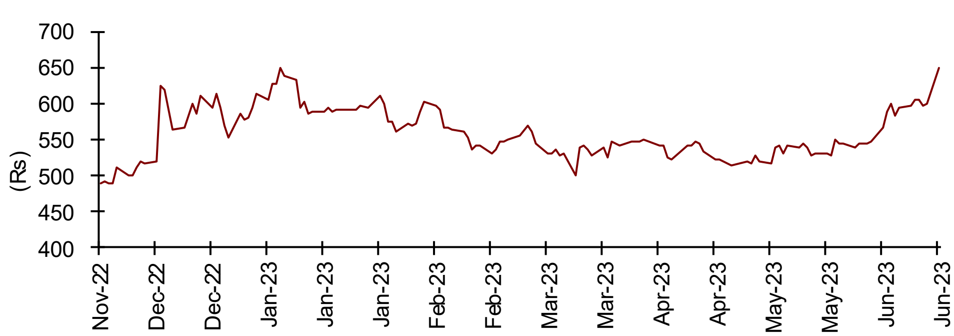
Table 14: Peer valuations

Particulars	CMP	P/E (x)				P/BV (x)				EPS (Rs)			
		FY22	FY23	FY24E	FY25E	FY22	FY23	FY24E	FY25E	FY22	FY23	FY24E	FY25E
SFBs													
Equitas SFB	88	39.2	17.0	12.6	9.6	2.6	1.9	1.6	1.4	2	5	7	9
Suryoday SFB	145	-16.5	19.8	8.2	4.9	1.0	1.0	0.9	0.7	(9)	7	18	29
Ujjivan SFB	36	-15.0	6.4	6.6	5.7	2.4	1.8	1.4	1.1	(2)	6	5	6
NBFC/HFC													
Credit Access	1,226	54.1	23.6	16.8	13.6	4.8	3.8	3.1	2.5	23	52	73	90
Spandana	700	69.3	400.6	11.9	8.5	1.6	1.6	1.4	1.2	10	2	59	83
Fusion	503	192.0	13.0	9.3	7.1	3.1	2.2	1.8	1.4	3	39	54	71
Aptus	268	36.0	26.5	21.8	17.5	4.7	4.0	3.6	3.1	7	10	12	15
Aavas	1,377	30.6	25.4	22.7	18.4	3.9	3.3	2.9	2.5	45	54	61	75
HFFC	835	39.3	32.1	26.3	20.3	4.8	4.2	3.6	3.1	21	26	32	41
PNB HF	571	11.5	9.2	11.2	9.2	1.0	0.9	1.0	0.9	50	62	51	62
LIC HF	390	9.4	7.4	6.9	6.0	0.9	0.8	0.7	0.7	42	53	57	65
Five Star	650	40.4	31.2	25.6	19.7	5.1	4.3	3.7	3.1	16	21	25	33
Repco	288	9.4	6.1	5.0	4.5	0.8	0.7	0.6	0.6	31	47	57	63

Particulars	BV (Rs)				RoAA (%)				RoAE (%)			
	FY22	FY23	FY24E	FY25E	FY22	FY23	FY24E	FY25E	FY22	FY23	FY24E	FY25E
SFBs												
Equitas SFB	34	46	53	63	1.1	1.9	2.0	2.1	7.3	12.2	13.9	15.8
Suryoday SFB	142	149	167	196	(1.3)	0.9	1.8	2.4	(5.9)	5.0	11.5	16.2
Ujjivan SFB	15	21	26	32	(1.9)	3.9	2.9	2.8	(13.8)	31.4	22.5	21.0
NBFC/HFC												
Credit Access	255	321	394	484	2.2	4.2	4.8	4.8	9.2	18.2	20.4	20.5
Spandana	447	437	496	578	0.9	0.2	4.2	4.4	2.4	0.4	12.7	15.4
Fusion	162	231	285	356	0.3	4.6	4.9	4.9	1.7	21.2	20.9	22.1
Aptus	58	67	75	86	7.3	7.8	7.6	7.5	15.1	16.1	17.2	18.9
Aavas	353	411	472	547	3.6	3.5	3.3	3.3	13.7	14.2	13.7	14.7
HFFC	173	199	235	273	3.9	3.9	3.6	3.7	12.6	13.5	14.4	16.2
PNB HF	585	649	569	630	1.2	1.5	1.8	2.0	8.9	10.0	10.3	10.3
LIC HF	448	492	541	597	0.9	1.1	1.1	1.1	10.1	11.2	11.0	11.4
Five Star	128	150	175	208	7.5	8.0	7.6	7.8	15.0	15.0	15.6	17.3
Repco	357	402	456	516	1.6	2.4	2.7	2.7	8.9	12.5	13.4	13.0

Source: Company data, I-Sec research

Price chart



Source: Bloomberg

Financial summary

Table 15: Profit and Loss statement

(Rs mn, year ending March 31)

	FY21	FY22	FY23	FY24E	FY25E
Interest earned	10,149	12,038	14,988	19,719	25,753
Interest expended	3,252	3,006	2,663	3,932	5,575
Net interest income	**6,897**	**9,032**	**12,325**	**15,787**	**20,178**
Other income	364	524	301	421	549
Staff cost	*1,637*	*2,361*	*3,464*	*4,790*	*5,906*
Depreciation	*114*	*122*	*173*	*201*	*267*
Other operating expenses	*393*	*575*	*741*	*855*	*1,072*
Total operating cost	**2,144**	**3,058**	**4,378**	**5,846**	**7,245**
Pre-provisioning op profit	**5,116**	**6,497**	**8,249**	**10,362**	**13,482**
Provisions & contingencies	352	455	201	531	669
Profit before tax & exceptional items	**4,764**	**6,042**	**8,047**	**9,830**	**12,813**
Exceptional items	-	-	-	-	-
Profit before tax & exceptional items	**4,764**	**6,042**	**8,047**	**9,830**	**12,813**
Income taxes	1,174	1,507	2,012	2,474	3,225
PAT	**3,590**	**4,535**	**6,035**	**7,356**	**9,588**

Source: Company data, I-Sec research

Table 16: Balance sheet

(Rs mn, year ending March 31)

	FY21	FY22	FY23	FY24E	FY25E
Capital	256	291	291	291	291
Reserves & surplus	22,925	36,812	43,104	50,460	60,048
Networth	**23,182**	**37,104**	**43,395**	**50,751**	**60,339**
Borrowings	**34,252**	**25,588**	**42,473**	**54,324**	**78,038**
Provisions	0	0	0	0	0
Other Liabilities	866	739	1,160	921	1,328
Total liabilities & stockholders' equity	**58,300**	**63,431**	**87,028**	**1,05,996**	**1,39,705**
Loans & advances	**43,587**	**51,024**	**68,222**	**91,848**	**1,21,534**
Investments	0	2,482	1,446	1,490	1,534
Cash and Balance	13,557	8,799	15,809	11,022	14,584
Fixed Assets	249	328	449	597	790
Current & other assets	906	797	1,103	1,040	1,264
Total Assets	**58,300**	**63,431**	**87,028**	**1,05,996**	**1,39,705**

Source: Company data, I-Sec research

Table 17: Key ratios

(Year ending March 31)

	FY21	FY22	FY23	FY24E	FY25E
Growth (%):					
AUM	13.8	17.1	33.7	34.6	32.3
Loan book (on balance sheet)	13.8	17.1	33.7	34.6	32.3
Total Assets	33.4	8.8	37.2	21.8	31.8
Interest Income	35.9	18.6	24.5	31.6	30.6
Interest Expenses	49.9	(7.6)	(11.4)	47.7	41.8
Net Interest Income (NII)	30.2	31.0	36.5	28.1	27.8
Non-interest income	(10.2)	44.0	(42.5)	39.5	30.4
Net Income	27.3	31.6	32.1	28.4	27.9
Total Non-Interest Expenses	24.8	42.6	43.1	33.5	23.9
Pre provisioning operating profits (PPoP)	28.3	27.0	27.0	25.6	30.1
PAT	37.0	26.3	33.1	21.9	30.3
EPS	35.2	17.0	30.7	21.9	30.3
Yields, interest costs and spreads (%)					
NIM on AUM	16.8	19.1	20.7	19.7	18.9
Yield on loan assets	24.8	25.4	25.1	24.6	24.1
Average cost of funds	11.2	10.0	7.8	8.1	8.4
Interest Spread on loan assets	13.5	15.4	17.3	16.5	15.7
Operating efficiencies					
Non interest income as % of total income	3.5	4.2	2.0	2.1	2.1
Cost to income ratio (%)	20.4	24.3	28.6	29.0	27.5
Op.costs/avg AUM (%)	5.1	6.4	7.3	7.3	6.8
No of employees	3,938.0	5,675.0	7,347.0	7,794.0	8,874.0
Average annual salary (Rs '000)	415.7	416.1	471.5	614.6	665.5
Salaries as % of non-int.costs (%)	76.3	77.2	79.1	81.9	81.5
AUM/employee(Rsm)	11.3	8.9	9.4	11.8	13.7
Balance Sheet Structure					
Loans/ Total assets	74.8	80.4	78.4	86.7	87.0
Loans/NDTL	127.3	199.4	160.6	169.1	155.7
Capital Structure					
Leverage (x)	2.5	1.7	2.0	2.1	2.3
CAR (%)	58.9	75.2	67.2	62.6	56.5
Tier 1 CAR (%)	58.9	75.2	67.2	62.6	56.5
Tier 1 Capital (Rs mn)	19,669.0	33,581.5	36,886.0	43,138.6	51,288.5
RWA (Rsmn)	33,416.4	44,658.6	54,914.5	68,897.3	90,808.4
Asset quality and provisioning					
GNPA (%)	1.0	1.1	1.4	1.5	1.5
NNPA (%)	0.8	0.7	0.7	0.9	0.8
GNPA (Rsmn)	451.9	530.5	864.1	1,377.7	1,823.0
NNPA (Rsmn)	370.7	345.4	469.4	771.5	911.5
Coverage ratio (%)	18.0	34.9	45.7	44.0	50.0
Credit costs as % of average AUM	84.4	95.7	33.6	66.0	62.7
Return ratios					
RoAA (%)	7.0	7.5	8.0	7.6	7.8
RoAE (%)	16.8	15.0	15.0	15.6	17.3
Valuation Ratios		14.8%	29.3%	21.9%	30.3%
EPS (Rs)	14.0	16.1	20.8	25.4	33.0
EPS fully diluted (Rs)	13.6	15.9	20.8	25.4	33.0
Price to Earnings	46.4	40.4	31.2	25.6	19.7
Price to Earnings (fully diluted)	47.8	40.8	31.2	25.6	19.7
Book Value (fully diluted)	85.3	127.9	149.6	174.9	208.0
Adjusted book value (fully diluted)	79.0	126.7	147.6	172.6	208.0
Price to Book	7.6	5.1	4.3	3.7	3.1
Price to Adjusted Book	8.2	5.1	4.4	3.8	3.1

Source: Company data, I-Sec research

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Tables

Charts

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