Utkarsh Small Finance Bank Limited

December 20, 2021

Ratings

Facilities/Instruments	Amount (Rs. crore)	Rating[1]	Rating Action
Bonds	40.00	CARE A; Stable (Single A; Outlook: Stable)	Reaffirmed
Tier II Bonds	150.00	CARE A; Stable (Single A; Outlook: Stable)	Reaffirmed
Total Long Term Instruments	**190.00 (Rs. One Hundred Ninety Crore Only)**		

Details of instruments/facilities in Annexure-1

Detailed Rationale & Key Rating Drivers

The rating assigned to long term Tier–II bonds of Utkarsh Small Finance Bank Limited (USFBL) continues to derive strength from the bank's long track record of operations in microfinance lending, experienced management team for managing the various banking operations, strong growth in income with robust growth in assets under management (AUM). The rating also factors in significant mobilization of deposits with increasing share of the retail and CASA deposits and access to diverse funding sources since commencement of operations as a small finance bank resulting in comfortable liquidity position of the bank. The rating also draws comfort from diversified institutional equity investors base at the hold-co level and comfortable capitalization levels of USFBL.

The rating, however, continues to be constrained due to geographic concentration in Uttar Pradesh and Bihar, significant concentration to micro finance lending, lack of diversity in earnings profile, moderation in asset quality parameters, short track record in non-microfinance lending (MSME, Home Loans and wholesale lending portfolio) and the inherent risk involved in the microfinance segment including socio-political intervention risk. Additionally, CARE takes note of unprecedented situation of COVID-19 outbreak that has led to elevated risk aversion in general and particularly with respect to microfinance sector owing to uncertainty arising from unsecured lending to customers with weaker credit profiles.

Rating Sensitivities

Positive Factors - Factors that could lead to positive rating action/upgrade:

- Diversification of product offering along with geographical diversification on sustained basis with significant scale up
- Increase in its retail deposit base
- Improved profitability indicators on a sustained basis

Negative Factors- Factors that could lead to negative rating action/downgrade:

- Significant weakening of asset quality leading to decline in profitability metrics with RoTA below 1.0% over medium term.
- Inability to materially Improve the share of CASA and retail deposits

Detailed description of the key rating drivers

Key Rating Strengths

Experienced management team

The operations of USFBL are headed by Mr. Govind Singh who is the Managing Director and CEO of USFBL. He has an extensive experience of over 30 years in the Banking and Microfinance sector including having founded Utkarsh Micro Finance Limited (UMFL) in 2009 for carrying out micro lending activities. The overall operations of the bank are governed by the Board of Directors consisting of eminent members from across banking, financial services, consulting and social sector. The operations (Lending, Treasury, Risk, IT, Legal & Compliance, Liability etc.) of the bank are managed by a senior management team having rich experience in the financial services, banking and microfinance sector. The bank has appointed Business heads for each of the product verticals as the product mix is gradually moving towards MSME and Affordable Housing loans, although JLG loans would continue to majorly contribute to the product mix.

Strong and diversified investor base and comfortable capital adequacy with the scale up loan book

USFBL is a wholly subsidiary of Utkarsh CoreInvest Limited (UCL), formerly known as Utkarsh Micro Finance Limited (UMFL). UCL is registered as a CIC-ND-SI with RBI. UCL has a strong investor base with CDC (Commonwealth Development Corporation) Group PLC, the development financial institution of UK Govt, being the key foreign investor in UMFL besides NMI Frontier Fund KS, responsAbility Participations Mauritius, Sarva Capital, Aavishkaar Goodwell India Microfinance Development Company and International Finance Corporation (IFC).

As one of the pre-requisites for formation of the Small Finance Bank by RBI was capping of the foreign shareholding in SFB to less than 49%, substantial capital of Rs.395 crore was raised in UMFL in Oct 2016 prior to receipt of license for commencement

[1]Complete definition of the ratings assigned are available at www.careedge.in and other CARE Ratings Ltd.'s publications

of operations as SFB from the domestic investors in with another round of equity infusion of Rs.150 crore at the holding company level through right issue in FY18. Major investors in UCL as on March 31, 2021 were CDC Group PLC (14.06%), RBL Bank Ltd (9.94%), NMI Frontier Fund KS (7.89%), Faering Capital India Evolving Fund (7.84%), Hero Enterprise Partner Ventures (4.96%), Shriram Life Insurance Company Limited (4.94%), ICICI Prudential Life Insurance Ltd (4.25%), SIDBI (4.35%), Jhelum Investment Fund (3.28%), HDFC Standard Life Insurance Company Limited (3.19%) etc.

The capital raised in UCL had been further fully invested in USFBL. USFBL's capitalization is comfortable as reflected by its CRAR and Tier-I CRAR of 28.06% and 23.50% respectively as on Sept 30, 2021. The bank is required to maintain minimum CRAR of 15% as per the regulations applicable to the Small Finance Banks (SFB). During FY21, the bank raised a total capital of Rs.240.47 crore, with another Rs.150 cr in H1FY22. As a result, the gearing came down to 6.70x as on Sept-21 as against 8.06x as on Mar-20.

Further, USFBL had filed the Draft Red Herring Prospectus (DRHP) dated March 04, 2021 with SEBI on March 5, 2021 to raise upto Rs. 1,350 Crore through the prospective Initial Public Offering (IPO). This comprises a fresh issue of equity shares of Rs. 750 Crore, and an offer for sale of Rs. 600 Crore by the promoter company Utkarsh CoreInvest Limited (UCL).

Adequate risk management systems
USFBL has in place an efficient monitoring structure for overseeing its operations at various levels, at branch, area level, regional level and divisional levels. It has put in place risk management systems since inception viz. defined credit appraisal, collection and monitoring systems including profile of the clients and outer limit of loan size with risk monitoring matrix defined for measuring operational, market, liquidity and credit risks. Specialized software and user level restrictions are in place to ensure a speedy access to the information with data security. Core banking Solution has also been implemented for undertaking banking operations.

Growth in loan portfolio
USFBL had registered a robust growth of 26.37% in its AUM from Rs.6660 crore as on Mar-20 to Rs.8416 crore as on Mar-21, registering a three-year CAGR of 39%. The AUM has further grown to Rs.8470 crore as on Sept-21 mainly on account of expansion of business operations. As on Sept 30, 2021, the operations of the bank were spread across 20 states/ 2 UTs i.e. Uttar Pradesh, Bihar, Madhya Pradesh, Haryana, Uttarakhand, Maharashtra, Himachal Pradesh, Chhattisgarh, Jharkhand, West Bengal, Odisha, Rajasthan, Gujarat, Telangana, Delhi, Chandigarh, Andhra Pradesh, Karnataka and Tamil Nadu. As on Sept-21, its AUM comprised MFI loans (78% of loan book), MSME loans (~8%), wholesale lending (~8%), housing finance (~3%), BC loans (2%) and balance being contributed by other loans. The bank is focusing to build its MSME and Housing Loans (including affordable housing loans), leveraging its branch network and as a result, the share of these loan segments in USFBL's loan book is expected to increase going forward. However, these being new products and loan book being small, the track record of asset quality and profitability in these segments, is yet to be established.

Moderate profitability during FY21 and H1FY22
USFBL's total income grew by 23% from Rs.1406.24 crore during FY20 to Rs.1725.14 crore during FY21 on the back of strong growth in AUM during FY21. However, the net profits declined by 40% YoY in FY21 due to high provisions during the year and stood at Rs.111.82 crore as against Rs.186.75 crore in FY20. The provisions and write-offs increased by 187% in FY21, leading to a credit cost (Provisions & Write-offs / Average Total Assets) of 2.68% from 1.28% in FY20. Similar to the previous two fiscals, in FY21 as well, the opex ratio (operating expenses / average total assets) declined and stood at 5.08% as against 6.11% in FY20. The bank's net interest margin (Net interest income/ Average Total Assets) in FY21 stood at 7.83%, down by 151 bps Y-o-Y. The bank's pre-provision operating profit (PPoP) stood at Rs.438 crore end FY21, up 25% Y-o-Y. Owing to some asset quality headwinds amidst the Covid -19 pandemic, coupled with growth in loan book, the provisions grew by 2.87 times Y-o-Y. This resulted in bank reporting a moderate RoTA of 1.04% end FY21 as against 2.40% previous fiscal.

For half year ending September 2021, the bank reported PAT of Rs.38 crore (PY: Rs. 78 cr) on net interest income of Rs.479 crore translating into annualised RoTA of 0.62%. The moderation in profitability has been underpinned by sharp rise in provisions in the first two quarters especially in the wake of Covid-19 that impacted collections.

Improvement in resource base with significant mobilization of deposits
USFBL commenced operations as SFB in January 2017. With transition to banking operations, USFBL has raised significant funds through deposits which now constitute 80.40% of the funding mix as on Sept-21 as against just 1% as on Mar-17 which have helped in reducing the funding cost of the bank. USFBL has also raised funds in the form of Certificate of Deposits from Institutional Investors primarily Mutual Funds and Banks. Besides deposits, the bank has also raised refinance borrowings from SIDBI and NABARD. The bank has been accorded the scheduled bank status by RBI and can thus access money market and also raise borrowings under MSS and LAF window from RBI in case of exigencies. USFBL has been running down its high cost secured borrowings.

Key Rating Weaknesses
Moderate asset quality as a result of write-offs/provisioning; along with decline in collection efficiency due to Covid-19

The asset quality parameters of USFBL were improving since FY18, partially supported by write offs. The bank reported GNPA and NNPA at 0.71% and 0.18% as on Mar-20 as against 1.39% and 0.12% as on Mar-19. However, in FY21, the bank added Rs.309.58 cr of Gross NPA and closed the year with GNPA and NNPA of 3.75% and 1.33% respectively. The uptick in GNPA has been due to increase in delinquencies in the wake of covid-19. As on March 31, 2021, the bank had COVID-19 additional provision of Rs. 50.13 Crore to cover the potential stress in advances, including restructured portfolio. As of Sept 30, 2021, GNPA and NNPA had further increased to 8.27% and 3.55% respectively. Credit cost on total assets stood at 2.68% in FY21 (PY: 1.28%) and at 3.00% (annualised) for H1FY22 on account of provisioning done for Covid-19.

In line with RBI guidelines on Resolution Framework 1.0, the Bank had also restructured loans worth Rs. 283.63 Crore for 98,475 eligible borrowers. As a result, there was an increase in provisions by Rs.56.73 crore. The bank has also done restructuring under Resolution Framework 2.0 as permitted by the RBI and subsequently restructured 1.57 lakh accounts aggregating to an exposure of Rs.408.52 crore. As on Sep-21, the standard restructured book outstanding is around 5.2% of Gross Advances.

Collection efficiency dropped significantly in the month of April and May 2020, impacting the bank's asset quality. However, with the improvement in economic activities and easing of lockdown restrictions, collection efficiencies started improving in subsequent months. The collections witnessed a substantial improvement towards Feb and March 2021 as the COVID-19 impact receded further, however with the onset of 2nd wave of Covid, the collection efficiencies again declined in H1FY22. As of Sept-21, CE stood at 94.3%.

High reliance on bulk deposits albeit increase in retail deposit base with expansion of the general banking network
End FY21, the bank had set up 138 general banking outlets across the country, increased from 103 in FY20 and 61 outlets FY19. With the set-up and expansion of the branch network, the deposit base of the bank has improved. The share of retail deposits (CASA and Retail Term deposits) has also been gradually increasing, although it still remains moderate at 61.11% (including CASA deposits of 20.02%) as on Sept 30, 2021. Majority of the deposits of the bank are term deposits (Retail TD constituting 40.1% and wholesale term deposits, including certificate of deposits constituting 38.90% of total TD as on Sep 30, 2021). However, given that most of the bulk deposits are non-callable deposits, it insulates the bank against short term liquidity shocks. Retail deposit build-up, especially CASA build-up would take time as the bank expands its branch network, brand awareness and leverages the existing JLG borrower base to garner the retail deposits.

Geographical concentration and lack of diversity in product mix and earnings profile

While as of Sept-21, USFBL had presence in 20 states/UTs, a sizeable loan portfolio is concentrated in two states (Bihar and UP) which contributed 62.9% of the total on-book portfolio (down from 69.20% as on Sept-20). Going forward, the bank intends to further diversify its operations and plans to enter new territories thereby bringing down the concentration of the two states in the overall loan portfolio. JLG loans formed nearly 77.73% of the total AUM as on Sept 30, 2021, with balance being contributed by corporate loans, MSME Loans and Housing Loans. USFBL intends to grow its MSME and Housing loan book while introducing new products and bring down the share of MFI loans in the overall loan portfolio over the medium term. Diversification in product mix and consequently reduction in micro finance loan book as well as reduction in geographical concentration would be critical for its credit profile.

Inherent risks associated with micro lending
With significant share of advances continuing to be microfinance lending, USFBL will continue to face the challenge of risks associated with such segment viz. socio-political intervention risk and risks emanating from unsecured lending and marginal profile of borrowers who are vulnerable to economic downturns besides operational risks related to cash based transaction.

Liquidity: Adequate
As per the bank's structural liquidity statement (SLS) as on Sept 30, 2021, liquidity profile is comfortable with no cumulative negative mismatches in any of the time buckets on account of comfortable capital structure and short-term nature of its loan assets as most loans are JLG loans having maximum tenure of up to 2 years.

The liquidity profile of USFBL is also supported by access to diverse funding sources including inter-bank borrowing limits, un-availed refinance lines and ability to borrow from RBI under MSS/LAF window and from call money market against the excess liquidity maintained over and above the regulatory requirement of SLR of 18.5%. Liquidity Coverage Ratio (LCR) of USFBL stood at 219% as on Sep-21 as against the regulatory requirement of 100%. In addition to mandatory CRR and SLR requirement, the bank had an excess liquidity of Rs. 1,702.31 crore as on Sep 30, 2021. The bank also benefits from the rollover of deposits.

Analytical approach: Standalone

Applicable Criteria
Criteria on assigning 'outlook' and 'credit watch' to Credit Ratings

[CARE's Policy on Default Recognition]
[Rating Methodology - Banks]
[Criteria for Rating Basel III - Hybrid Capital Instruments issued by Banks]
[Rating Methodology: Notching by factoring linkages in Ratings]
[Financial Ratios – Financial Sector]

About the Company

Utkarsh Small Finance Bank Limited (USFBL), based out of Varanasi is a wholly owned subsidiary of Utkarsh CoreInvest Limited (UCL). The company commenced banking operations on January 23, 2017 upon receipt of license from RBI on Nov 25, 2016 and subsequent transfer of business from UCL which was carrying on the micro lending operations since September 2009. USFBL extends microfinance loans based on JLG Model to individuals which constitute nearly 78% of the Assets under Management (AUM) of the company as on September 30, 2021. The bank also extends wholesale loans, MSME Loans and Housing Loans to borrowers. USFBL provides microfinance loans through Business Correspondence activities as well. The AUM of USFBL stood at Rs.8470 crore as on Sept 30, 2021. The operations of the bank are currently spread across 20 states/ 2 UTs i.e. Uttar Pradesh, Bihar, Madhya Pradesh, Haryana, Uttarakhand, Maharashtra, Himachal Pradesh, Chhattisgarh, Jharkhand, West Bengal, Odisha, Rajasthan, Gujarat, Telangana, Delhi, Chandigarh, Andhra Pradesh, Karnataka and Tamil Nadu.

Brief Financials (Rs. crore)	31-03-2020 (A)	31-03-2021 (A)	H1FY22 (A)
Total operating income	1406.24	1725.14	953.78
PAT	186.74	111.82	37.67
Total Assets	9366.80	12079.94	12161.30
Net NPA (%)	0.18	1.33	3.55
ROTA (%)	2.40	1.04	0.62

A: Audited

Status of non-cooperation with previous CRA: Not Applicable

Any other information: Not Applicable

Rating History for last three years: Please refer Annexure-2

Covenants of rated instrument / facility: Detailed explanation of covenants of the rated instruments/facilities is given in Annexure-3

Complexity level of various instruments rated for this company: Annexure 4

Annexure-1: Details of Instruments / Facilities

Name of the Instrument	ISIN	Date of Issuance	Coupon Rate	Maturity Date	Size of the Issue (Rs. crore)	Rating assigned along with Rating Outlook
Bonds *	INE735W08012	09-Jul-18	10.58%	09-Jul-25	25.00	CARE A; Stable
	INE735W08020	31-Aug-18	10.58%	30-Aug-25	15.00	CARE A; Stable
Bonds-Tier II Bonds	INE396P08066	12-Jan-17	12.00%	30-Jun-22	150.00	CARE A; Stable

**Against the rated amount of Rs.40 crore (2 NCDs of Rs.25 crore and Rs.15 crore)*

Annexure-2: Rating History of last three years

Sr. No.	Name of the Instrument/Bank Facilities	Current Ratings			Rating history			
		Type	Amount Outstanding (Rs. crore)	Rating	Date(s) & Rating(s) assigned in 2021-2022	Date(s) & Rating(s) assigned in 2020-2021	Date(s) & Rating(s) assigned in 2019-2020	Date(s) & Rating(s) assigned in 2018-2019
1	Debentures-Non Convertible Debentures	LT	-	-	-	-	1)Withdrawn (23-Dec-19)	1)CARE A; Stable (20-Sep-18)
2	Fund-based - LT-Term Loan	LT	-	-	-	1)Withdrawn (22-Dec-20)	1)CARE A; Stable (23-Dec-19)	1)CARE A; Stable (20-Sep-18)
3	Debentures-Non Convertible Debentures	LT	-	-	-	1)Withdrawn (22-Dec-20)	1)CARE A; Stable (23-Dec-19)	1)CARE A; Stable (20-Sep-18)
4	Bonds-Tier II Bonds	LT	150.00	CARE A;	-	1)CARE A; Stable	1)CARE A; Stable	1)CARE A; Stable

Sr. No.	Name of the Instrument/Bank Facilities	Current Ratings			Rating history			
		Type	Amount Outstanding (Rs. crore)	Rating	Date(s) & Rating(s) assigned in 2021-2022	Date(s) & Rating(s) assigned in 2020-2021	Date(s) & Rating(s) assigned in 2019-2020	Date(s) & Rating(s) assigned in 2018-2019
				Stable		(22-Dec-20)	(23-Dec-19)	(20-Sep-18)
5	Debentures-Non Convertible Debentures	LT	-	-	-	1)Withdrawn (22-Dec-20)	1)CARE A; Stable (23-Dec-19)	1)CARE A; Stable (20-Sep-18)
6	Debentures-Non Convertible Debentures	LT	-	-	-	1)Withdrawn (22-Dec-20)	1)CARE A; Stable (23-Dec-19)	1)CARE A; Stable (20-Sep-18)
7	Debentures-Non Convertible Debentures	LT	-	-	-	1)Withdrawn (22-Dec-20)	1)CARE A; Stable (23-Dec-19)	1)CARE A; Stable (20-Sep-18)
8	Bonds	LT	40.00	CARE A; Stable	-	1)CARE A; Stable (22-Dec-20)	1)CARE A; Stable (23-Dec-19)	1)CARE A; Stable (20-Sep-18) 2)CARE A; Stable (10-Jul-18)

Annexure-3: Detailed explanation of covenants of the rated instrument / facilities - NA

Annexure 4: Complexity level of various instruments rated for this company

Sr. No	Name of instrument	Complexity level
1	Bonds-Tier II Bonds	Complex
2	Bonds	Simple

Annexure 5: Bank Lender Details for this Company
To view the lender wise details of bank facilities please click here

Note on complexity levels of the rated instrument: CARE Ratings Ltd. has classified instruments rated by it on the basis of complexity. Investors/market intermediaries/regulators or others are welcome to write to care@careedge.in for any clarifications.

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About CARE Ratings Limited:
Established in 1993, CARE Ratings Ltd. is one of the leading credit rating agencies in India. Registered under the Securities and Exchange Board of India (SEBI), it has also been acknowledged as an External Credit Assessment Institution (ECAI) by the Reserve Bank of India (RBI). With an equitable position in the Indian capital market, CARE Ratings Limited provides a wide array of credit rating services that help corporates to raise capital and enable investors to make informed decisions backed by knowledge and assessment provided by the company.
With an established track record of rating companies over almost three decades, we follow a robust and transparent rating process that leverages our domain and analytical expertise backed by the methodologies congruent with the international best practices. CARE Ratings Limited has had a pivotal role to play in developing bank debt and capital market instruments including CPs, corporate bonds and debentures, and structured credit.

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