Utkarsh Small Finance Bank Ltd

October 31, 2024

Instruments	Amount (₹ crore)	Rating[1]	Rating Action
Tier-II Bonds	200.00	CARE A+; Stable	Assigned
Tier-II Bonds	15.00	CARE A+; Stable	Reaffirmed

Details of instruments in Annexure-1.

Rationale and key rating drivers

The rating assigned to Utkarsh Small Finance Bank Ltd (USFBL) continues to derive strength from its comfortable capitalisation levels through regular equity infusions with the latest round of equity infusion coming through initial public offer (IPO) of ₹500 crore in July 2023 supported by accretion of profits and sustainable growth in scale of operations with comfortable asset quality. The rating also factors in the stable profitability as the bank reported a profit after tax (PAT) of ₹498 crore in FY24 (refers to April 01 to March 31) against ₹405 crore in FY23 resulting in return on total asset (ROTA) of 2.32% in FY24 against 2.38% in FY23.

However, the rating continues to be constrained by geographic concentration in advances wherein top two states contribute 54% and product concentration with high exposure to micro-banking segment, exposing it to inherent risk of the microfinance sector. Over the years, the bank has diversified its non-microbanking retail portfolio, leading to a steady improvement in its proportion of the overall loan portfolio. While the bank has been able to grow its deposit base in recent years, the current account savings account (CASA) ratio continues to be relatively low with a CASA of 19.01% as on June 30, 2024.

Rating sensitivities: Factors likely to lead to rating actions

Positive factors – Factors that could lead to positive rating action/upgrade

- Significantly increasing scale of operations with sustained improvement in asset quality while maintaining comfortable capitalisation levels.
- Sustenance of profitability with ROTA above 2.25%.
- Diversification in resource profile with continuous improvement in CASA proportion on a sustained basis.

Negative factors – Factors that could lead to negative rating action/downgrade

- Significant weakening of asset quality leading to declining profitability metrics with ROTA below 0.5% over medium term.
- Deteriorating asset quality with gross non-performing asset (GNPA) escalating above 4%.

Analytical approach: Standalone

Outlook: Stable.

The stable outlook reflects the likely continuation of steady growth in advances with comfortable capitalisation levels and healthy profitability levels while maintaining stable asset quality.

Detailed description of key rating drivers:

Key strengths

Comfortable capitalisation levels

The bank continues to be adequately capitalised by maintaining adequate cushion over the minimum regulatory requirement. USFBL reported a total capital adequacy ratio (CAR) at 23.18% (March 31, 2024: 22.57% and March 31, 2023: 20.64%) and Tier-I CAR of 20.39% (March 31, 2024: 20.95% and March 31, 2023: 18.25%), as on June 30, 2024. The capitalisation is supported by regular equity raise and consistent internal accruals. The latest equity was raised through IPO of ₹500 crore in July 2023. The bank also raised ₹200 crore through lower Tier-II bonds in June 2024. CARE Ratings expects the bank to maintain sufficient cushion as it scales up its operations going forward.

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

Stable profitability

USFBL's net interest income (NII) grew by 23% from ₹1,529 crore in FY23 to ₹1,886 crore in FY24 supported by healthy growth in business in FY24. Bank's net interest margins (NIMs) declined marginally from 8.99% in FY23 to 8.81% in FY24 considering declining share of high yielding micro-banking loan portfolio and cost of fund increased in line with industry trend. Opex increased by 30% due to investment in technology, branch expansion, and manpower leading to increase in cost to income to 56% for FY24 compared to 54% for the previous year. USFBL's pre-provisioning operating profit (PPOP) increased by 19% year-on-year to ₹997 crore in FY24 compared to ₹838 crore in FY23. Credit cost was relatively lower at 1.58% for FY24 compared to previous year. The ROTA was stable at 2.32% for FY24 vs 2.38% for FY23. On an absolute basis, the bank's PAT increased by 23% in FY24 to ₹498 crore vs. ₹405 crore in FY23.

The bank reported net profit of ₹137 crore for Q1FY25 growing 28% YOY compared to ₹107 crore for Q1FY24. The ROTA was stable in Q1FY25 at 2.26% compared to 2.24% in Q1FY24. The credit cost increased in Q1FY25 due to deterioration in asset quality and increase in floating provision. However, CARE Ratings expects the profitability to remain stable over the medium term.

Sustained scaling up of operations, however, asset quality remains monitorable

The bank registered a 31% growth in the gross loan portfolio year-on-year and stood at ₹18,798 crore as on June 30, 2024. Majority of the portfolio continues to be micro-banking loans, though its share has seen a gradual decline from 95% as on March 31, 2017, to 61% as on June 30, 2024. While the bank will continue to grow micro-banking loans, it is focusing on increasing other non-micro banking segments, especially secured loans.

Going forward, while the bank intends to continuously grow microfinance portfolio at healthy pace, other lending verticals (being smaller in size) are expected to grow even faster than micro-banking business and hence the share of micro-banking loans in overall loan book is expected to reduce further.

The GNPA levels peaked at 6.10% as on March 31, 2022, due to COVID-19 and have since declined to 2.51% as on March 31, 2024. However, the asset quality has seen moderation in Q1FY25 with stress in the microfinance segment leading to increased slippages resulting in GNPA to increase to 2.78% as on June 30, 2024. The GNPA may remain elevated for Q2FY25 and the improvement may happen from Q3FY25 onwards. The bank-maintained provision coverage ratio (PCR) including floating provision of 91% on GNPA. Gross stressed assets to gross advances and net stressed to net worth stood comfortable at 2.82% and 1.64% as on June 30, 2024 compared to 3.46% and 4.23% as on March 31, 2023. CARE Ratings observes, the bank's ability to manage asset quality and credit cost remain critical for stability of its profitability and return ratios going forward.

Key weaknesses

Geographical and product concentration of loan portfolio

The bank has 916 banking outlets spread across 22 states and four union territories (UTs) as on June 30, 2024. The top two states - Bihar and UP, constitute ~46% of branches and 54% of gross loan portfolio (70% of micro-banking loans) as on June 30, 2024. However, the geographical concentration is improving gradually with the opening of new branches outside of these two states and diversification in product mix with scaling of other retail loans. The reduction in micro finance loan book and reduction in the geographical concentration would be critical for its credit profile and is a key rating monitorable.

Relatively low CASA

The bank's liability mix has undergone substantial change as deposits as a percentage of total liabilities has been increasing with reduction in dependence on borrowings as is evident from the improving credit to deposit ratio. USFBL's deposits have grown ~30% y-o-y and stood at ₹18,163 crore with CASA proportion remaining relatively modest at 19% as on June 30, 2024. The bank's CASA proportion remains lower compared to its peers in the small finance banking industry. The bank has been focusing on building its granular retail deposits book and its CASA plus retail term deposits (upto ₹3 crore) constituted 67% as on June 30, 2024. Its dependence on wholesale term deposits continues to be high at 33% as on June 30, 2024, although the same has been improving in the last few years. CARE Ratings expects the bank to focus on raising CASA deposits, which would provide the bank a stable depositor base and reduce cost of funding over the medium term.

Socio-political and regulatory risks inherent in the micro finance industry

Micro-banking continues to be the key lending segment for the bank forming ~61% of the total loan portfolio as on June 30, 2024 (March 31, 2023: 66%). The microbanking customers have marginal credit profile being from the economically weaker section (EWS) and low-income group (LIG) segments remain vulnerable to economic downturns and political events, which affects their repayment capacity. Over the years, the bank has diversified its non-microbanking retail portfolio, leading to a steady reduction in the composition of the micro-finance loan portfolio. The portfolio continues to be impacted by the inherent risk involved, socio-political intervention risk, and risks emanating from unsecured lending.

Liquidity: Strong

Per the structural liquidity statement as on June 30, 2024, there were no negative cumulative mismatches for time buckets up to one year. The bank also maintained the excess SLR of ₹2,200 crore (12.35%) over and above regulatory requirements, which provides liquidity buffer. In addition, the bank has access to borrowing from Reserve Bank of India's (RBI's) liquidity adjustment facility (LAF) and marginal standing facility (MSF) and option to refinance from Small Industries Development Bank of India (SIDBI), National Housing Bank (NHB), and National Bank for Agriculture and Rural Development (NABARD) among others, and access to call money markets. The bank's liquidity coverage ratio was comfortable at 177.41% as on June 30, 2024, against the minimum regulatory requirement of 100%.

Environment, social, and governance (ESG) risks:

Environment

- Exclusion list which restricts funding to certain sectors.
- Energy saving drive across bank.

Social

- The bank serve bottom of pyramid through micro-banking and other retail products.
- Joint-liability group (JLG) loans are lent to women for income generation.

Governance

- Diversified Board with women representation.
- Bank has created separate committee ensuring strong governance.

Applicable criteria

Definition of Default
Rating Outlook and Rating Watch
Bank
Financial Ratios - Financial Sector
Rating Basel III - Hybrid Capital Instruments issued by Banks

About the company and industry

Industry classification

Macroeconomic Indicator	Sector	Industry	Basic Industry
Financial services	Financial services	Banks	Other bank

USFBL, based out of Varanasi is a subsidiary of Utkarsh CoreInvest Limited (UCL), a non-banking financial company non-deposit taking systemically important core investment company (NBFC-NDSI-CIC) with the RBI. The company commenced banking operations on January 23, 2017, upon receipt of license from RBI on November 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 the JLG model to individuals, which constituted nearly 61% of the gross loan portfolio of the company as on June 30, 2024. The bank also extends wholesale

loans, MSME loans, and housing loans to the borrowers. USFBL provides microfinance loans through Business Correspondence activities as well. USFBL's gross loan portfolio stood at ₹18,798 crore as on June 30, 2024. The bank's operations are currently spread across 22 states and four union territories (UTs). As on June 30, 2024, it had 916 banking outlets, 321 ATMs, and 641 micro-ATMs. The bank is headed by Govind Singh, MD & CEO, whose reappointment as MD & CEO has been approved by RBI for three years on September 21, 2024.
USFBL vide announcement to the stock exchanges on September 20, 2024 informed the exchanges that its board of directors approved scheme of amalgamation of UCL, the holding company with USFBL, subject to the approval of shareholders, debenture holders, RBI, Stock exchanges, NCLT and other competent authority, as may be applicable. The scheme is subject to the expiry of the lock-in restriction on equity shares held by UCL in the USFBL which expires on January 19, 2025. The amalgamation would be through share exchange ratio of 669 equity shares of face value of ₹10 each of USFBL, for every 100 equity shares of face value of ₹10 each of UCL. The Scheme would result in increase of public shareholding in USFBL from 30.98% as on June 30, 2024 to 100%.

USFBL Financials

Brief Financials (₹ crore)	31-03-2023 (A)	31-03-2024 (A)	30-06-2024 (UA)
	12M	12M	3M
Total income	2,804	3,579	1,071
PAT	405	498	137
Total assets	19,030	23,798	24,780
Net NPA (%)	0.39	0.03	0.26
ROTA (%)	2.38	2.32	2.26

A: Audited; UA: Unaudited; Note: these are latest available financial results
All calculations per CARE Ratings

Status of non-cooperation with previous CRA: Not applicable

Any other information: Not applicable

Rating history for last three years: Annexure-2

Covenants of rated instrument / facility: Annexure-3

Complexity level of instruments rated: Annexure-4

Lender details: Annexure-5

Annexure-1: Details of instruments

Name of the Instrument	ISIN	Date of Issuance (DD-MM-YYYY)	Coupon Rate (%)	Maturity Date (DD-MM-YYYY)	Size of the Issue (₹ crore)	Rating Assigned along with Rating Outlook
Bonds-Tier-II Bonds	INE735W08020	30-Aug-2018	10.577	30-Aug-2025	15.00	CARE A+; Stable
Bonds-Tier-II Bonds	Proposed	-	-	-	200.00	CARE A+; Stable

Annexure-2: Rating history of last three years

Sr. No.	Name of the Instrument/Bank Facilities	Current Ratings			Rating History			
		Type	Amount Outstanding (₹ crore)	Rating	Date(s) and Rating(s) assigned in 2024-2025	Date(s) and Rating(s) assigned in 2023-2024	Date(s) and Rating(s) assigned in 2022-2023	Date(s) and Rating(s) assigned in 2021-2022
1	Bonds-Tier II Bonds	LT	-	-	-	-	1)Withdrawn (29-Sep-22)	1)CARE A; Stable (20-Dec-21)
2	Bonds	LT	15.00	CARE A+; Stable	1)CARE A+; Stable (24-Sep-24)	1)CARE A+; Stable (26-Sep-23)	1)CARE A; Positive (29-Sep-22)	1)CARE A; Stable (20-Dec-21)
3	Bonds	LT	200.00	CARE A+; Stable				

LT-Long term

Annexure-3: Detailed explanation of covenants of rated instruments/facilities: Not applicable

Annexure-4: Complexity level of instruments rated

Sr No	Name of the Instrument	Complexity Level
1	Bonds	Simple

Annexure-5: Lender details - Not applicable

Note on complexity levels of rated instruments: CARE Ratings 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 clarifications.

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About us:

Established in 1993, CARE Ratings is one of the leading credit rating agencies in India. Registered under the Securities and Exchange Board of India, it has been acknowledged as an External Credit Assessment Institution by the RBI. With an equitable position in the Indian capital market, CARE Ratings provides a wide array of credit rating services that help corporates raise capital and enable investors to make informed decisions. With an established track record of rating companies over almost three decades, CARE Ratings follows a robust and transparent rating process that leverages its domain and analytical expertise, backed by the methodologies congruent with the international best practices. CARE Ratings has played a pivotal role in developing bank debt and capital market instruments, including commercial papers, corporate bonds and debentures, and structured credit.

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