Utkarsh Small Finance Bank Limited

July 10, 2018

Ratings

Facilities	Amount (Rs. crore)	Rating[1]	Rating Action
Long Term - Tier-II Bonds	40 (Rs. Forty Crore only)	CARE A; Stable (Single A; Outlook: Stable)	Assigned

Details of instruments/facilities in Annexure-1

Detailed Rationale & Key Rating Drivers

The rating of Utkarsh Small Finance Bank Limited (USFBL) derives strength from adequate track record in microfinance lending, diversified institutional equity investors base, experienced management team, diversified resource profile with significant mobilization of deposits post small finance bank license and comfortable liquidity position. The rating also factors in comfortable capitalization level given substantial capital raised (~Rs.550 crore since October 2016 including Rs.150 crore during FY18) which has allowed USFBL to grow its loan book (AUM Growth of 99% during FY18) and cover for net loss in FY18 following weakness in collections post demonetization. Subsequent to demonetization in October 2016, UFSBL's collection efficiency dropped significantly and led to overall write-off / credit provisions of Rs.212 crore in H2FY17-FY18 (12% of loan book pre-demonetization), resulting in the bank reporting net loss of Rs.60.94 crore in FY18 (at consolidated level). However, as most of the losses are provided for till Mar-18, bank's Gross and net NPAs were 1.84% and 1.09% as on March 31, 2018.

The ratings continue to be constrained by moderate geographic concentration, lack of diversity in earnings profile, short track record in non-microfinance lending (Micro Enterprise Loans and Home Loan portfolio) and the inherent risk involved in the microfinance segment including socio-political intervention risk and due to unsecured lending.

Going forward, the ability of the bank to maintain healthy collection efficiency and asset quality, thereby limiting credit losses and maintain adequate capitalization levels would be crucial. Also, ability to grow the loan portfolio and geographically diversify the operations, improve earnings and profitability, successfully stabilize the operations as an SFB (Small Finance Bank) including raising low cost retail deposits and refinance loans and diversify the product mix would remain the key rating sensitivities.

Detailed description of the key rating drivers

Key Rating Strengths

Experienced promoters and management team

USFBL is a wholly owned subsidiary of Utkarsh Micro Finance Limited (UMFL, registered as CIC-ND-SI with RBI) which had been carrying out micro lending activities since 2009. UMFL is promoted by Mr. Govind Singh who has an experience of over 30 years in the Banking and Microfinance sector. He was formerly the Business Head of Micro Banking at ICICI Bank having relationship with over 100 MFIs overseeing a large microfinance portfolio. As on now he is an Independent Director of USFBL and a member of various Board level committees including Risk Management Committee, Customer Service Committee, IT Strategy Committee and Stakeholder Relationship Committee. He had stepped down as the Managing Director and CEO of the small finance bank in May 2018 due to regulatory compliance. Subsequently, a special committee of directors has been formed to drive the business growth. The overall operations are governed by the Board of Directors at UMFL and USFBL 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 expected to gradually move towards MSME and Affordable Housing loans although JLG loans would continue to contribute to the product mix majorly during the initial stages of operations of the SFB.

Strong and diversified investor base and comfortable gearing and capitalization levels

UMFL had 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

[1] *Complete definition of the ratings assigned are available at www.careratings.com and other CARE publications*

commencement 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 domestic investors in UMFL as on Mar-18 are RBL Bank Ltd (9.99%), Faering Capital India Evolving Fund (9.99%), Hero Enterprise Partner Ventures (4.99%), Shriram Life Insurance Company Limited (4.97%), ICICI Prudential Life Insurance Ltd (4.27%), SIDBI (4.38%), Jhelum Investment Fund (3.3%), HDFC Standard Life Insurance Company Limited (3.21%) with Mr. Govind Singh Holding 0.50% stake in the company.

The capital raised in UMFL had been further invested in USFBL; Till March 31, 2018 UMFL had infused Rs.470 crore as equity and additional Rs.267 crore in the form of 0.01% Compulsorily Convertible Debentures (CCDs) which have subsequently been converted into equity in June 2018. USFBL's capitalization is comfortable as reflected in adjusted gearing of 5.96 times as on March 31, 2018 (including CCDs in tangible net worth and off-book securitized portfolio as part of debt). Its CRAR was 17.4% as on Mar-18, however CCDs are not included in capital in CRAR and hence CRAR position will improve from Q1FY19 upon conversion of CCDs into equity.

The Adj. overall gearing level at consolidated level (UMFL consolidated) was lower at 5.28x as on Mar-18 (P.Y. 2.95x) as part of the capital raised was retained in the form of cash in UMFL and was yet to be infused un USFBL as on Mar-18.

Restoration in asset quality as a result of write-offs/provisioning and increase in collections post demonetization

The collections of Utkarsh had been impacted post demonetization due to lack of availability of cash, political interference, and the RBI circular on relief in asset classification for NBFCs being misinterpreted as a loan holiday by the borrowers. The collections of the USFBL were mostly impacted in Maharashtra (cumulative collections 40%), Uttarakhand (65%) and parts of Madhya Pradesh (83%), together constituting 19% of the portfolio as on Mar-17 and 9% as on Mar-18. The operations were largely insulated in both Bihar and Eastern Uttar Pradesh (constituting 80% of the portfolio of UMFL as on Mar-18) where cumulative collection efficiency (Nov 2016-March 2018) has been over 99%.

Utkarsh's overall collection efficiency had dropped significantly to 79% for the period November 8, 2016-Jan 31, 2017(immediately post demonetization) as against nearly 99-100% collections previously. Although the collections have improved month on month, the cumulative collections for the period post demonetization (Nov, 2016-Mar-2018) were 89.5% resulting in Utkarsh having to provide Rs.212 crore in the form of write-off / credit provisions during H2FY17-FY18 (12% of pre-demonetization AUM of Rs.1774 cr as on Sept-16). However, as most of the losses are provided for till Mar-18, bank's Gross and net NPAs were 1.84% and 1.09% as on March 31, 2018.

The collections for the month of March-18 were however still lower at 97.5% vs. historical collection level, as nearly 14% of the book as on Mar-18 still pertains to loans originated pre-demonetization. However, the collection efficiency of loans originated post demonetization (Jan-17 onwards) remains comfortable with 99.17% of this portfolio being current with delinquencies mostly in the softer buckets.

Adequate risk management systems

Utkarsh 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. The incentive structure limits the number of client additions to ensure adequate loan appraisal processes is being followed. 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. However, the bank is still in its nascent stages of operations in the small finance bank set-up i.e. on liability side products as well MSME, Affordable Housing and other new loan products.

Growth in loan portfolio post demonetization

UMFL had registered a robust growth of 99% in its AUM from Rs.1613.61 cr as on Mar-17 to Rs.3229.99 cr (including investments in NCDs) as on Mar-18, *post* de-growth in loan portfolio seen post demonetization. Presently, the operations of the bank are spread across eleven states i.e. Uttar Pradesh, Bihar, Madhya Pradesh, Haryana, Uttarakhand, Maharashtra, Delhi and Himachal Pradesh, Chhattisgarh, Jharkhand and West Bengal. As on Mar-18, its AUM comprised MFI loans (88% of loan book), wholesale lending (8.2%), MSME loans (3.3% and affordable housing finance (0.5%). The bank is focusing to build its MSME and Affordable Housing Loan, 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, the track record of asset quality is yet to be established.

Improvement in resource base with significant mobilization of deposits however most of the deposits are bulk deposits

The bank has tapped funds in the form of borrowings from diversified sources which includes term loans from banks/FIs, Non-Convertible Debentures, Subordinated Bonds, External Commercial Borrowings and public deposits while also accessing the securitization route. With transition to banking operations (commencement of operations as SFB in January 2017), USFBL has raised significant funds through deposits which now constitute 59% of the borrowing mix as on Mar-18 as against just 1% as on Mar-17. However, most of these deposits are bulk deposits (87% of the overall deposits as on Mar-18).

Comfortable liquidity profile
ALM profile remains comfortable with no cumulative mismatch 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.

Key Rating Weaknesses
Geographical concentration and lack of diversity in earnings profile
USFBL has presence in 11 states with the recent entry being in West Bengal and BC arrangement. Going forward, the bank intends to further diversify its operations and plans to enter new territories viz. Assam, Odisha and other states during FY19. Currently a sizeable loan portfolio is concentrated in two states (Bihar and UP) which contributed 80% (P.Y 71%) of the overall loan portfolio as on March 31, 2018. However, given the significant capitalization levels, the single largest state (Bihar) portfolio /Networth stood at 181% as on March 31, 2018.
Further, JLG loans formed nearly 88% of the total AUM as on March 31, 2018 with balance being contributed by Corporate loans, MSME Loans and Housing Loans.

Losses during FY18 on account of lower collection efficiency post demonetization
UMFL's total operating income (Consolidated) grew by 34% from Rs.422.60 crore during FY17 to Rs.465.73 crore during FY18 on the back of 99% growth in AUM during FY18 (99%) due to recovery in disbursements post demonetization. However, the growth in income was lower than growth in loan portfolio as much of the disbursements have taken during Q4FY18. Despite the higher income, UMFL reported net loss of Rs.60.94 cr (PAT of Rs.34.36 cr during FY17) on a consolidated level due to increase in operating expenses on setting up/conversion of existing branches into bank branches including legal, administrative and professional charges and induction of senior management team for managing the banking operations and impact of provisions and write-off of Rs.169.79 cr, a part of which was absorbed from the pre-provisioning profits of Rs.78.43 Cr during FY18 (P.Y. Rs.101.82 cr).
UMFL has reported profits of Rs.20.80 cr during Q4FY18 after reporting cumulative loss before tax of Rs.112.06 cr during 9MFY18 due to lower incremental provisioning and rationalization of expenses over a larger asset base.

Industry Risk
Microfinance lending continues to be key lending segment for the company. The microfinance industry continues to be impacted by the inherent risk involved viz. socio-political intervention risk and regulatory uncertainty and risks emanating from unsecured lending.

Prospects
On account of various events post demonetization, collection efficiency of the MFIs/SFBs has deteriorated. This has impacted the asset quality of the MFIs/SFBs leading to increase in credit costs. Consequently, the profitability of the MFIs/SFBs took a severe hit in FY18 on account of higher provisioning costs. However, with much of the credit cost being absorbed by the MFI's/SFBs during FY18, and given the market potential, the sector is likely to continue its high growth going forward with MFIs/SFBs continuing to attract funds and improving operational efficiencies to maintain profitability.

Analytical approach: Consolidated

Applicable Criteria
Criteria on assigning Outlook to Credit Ratings
CARE's Policy on Default Recognition
Rating Methodology for Non-Banking Financial Companies
Bank - CARE's Rating Methodology for Banks
Financial Sector Ratios

About the Company
Utkarsh Small Finance Bank Ltd (USFBL) based out of Varanasi is a 99.99% subsidiary of Utkarsh Micro Finance Limited (UMFL). 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 UMFL which was carrying on the micro lending operations since

September 2009. USFBL extends microfinance loans based on JLG Model to individuals which constitutes nearly 88% of the Assets under Management(AUM) of the company. The company also extends wholesale loans, MSME Loans and Housing Loans to borrowers. The AUM of USFBL stood at Rs.3229.99 Crore as on March 31, 2018 including managed portfolio (Securitized Portfolio) of Rs. 103.77 crore. The operations of the bank are currently spread across eleven states i.e. Uttar Pradesh, Bihar, Madhya Pradesh, Haryana, Uttarakhand, Maharashtra, Delhi, Himachal Pradesh, Chhattisgarh, Jharkhand and West Bengal.

Brief Financials (Rs. crore)	FY17 (A)	FY18 (A)
	UMFL	UMFL
	Consol.	Consol.
Total operating income	422.61	565.73
PAT	34.36	-60.94
Interest coverage (times)	1.29	0.63
Total Assets	2635.13	4522.48
Net NPA (%)	0.00^	1.09
Adj. ROTA (%)*	1.56	-ve

A: Audited; -ve: Negative
** Calculated based on opening and closing balance of total assets including off-book portfolio*
^ NPAs were Nil due to RBI dispensation on classification of loans extended pre-demonetization

Status of non-cooperation with previous CRA: Not Applicable

Any other information: Not Applicable

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

Note on complexity levels of the rated instrument: *CARE has classified instruments rated by it on the basis of complexity. This classification is available at www.careratings.com. Investors/market intermediaries/regulators or others are welcome to write to care@careratings.com for any clarifications.*

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About CARE Ratings:

CARE Ratings commenced operations in April 1993 and over two decades, it has established itself as one of the leading credit rating agencies in India. CARE is registered with the Securities and Exchange Board of India (SEBI) and also recognized as an External Credit Assessment Institution (ECAI) by the Reserve Bank of India (RBI). CARE Ratings is proud of its rightful place in the Indian capital market built around investor confidence. CARE Ratings provides the entire spectrum of credit rating that helps the corporates to raise capital for their various requirements and assists the investors to form an informed investment decision based on the credit risk and their own risk-return expectations. Our rating and grading service offerings leverage our domain and analytical expertise backed by the methodologies congruent with the international best practices.

Annexure-1: Details of Instruments/Facilities

Name of the Instrument	Date of Issuance	Coupon Rate	Maturity Date	Size of the Issue (Rs. crore)	Rating assigned along with Rating Outlook
Long Term Tier-II Bonds/Debentures (Proposed)	-	-	-	40.00	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 (Rs. crore)	Rating	Date(s) & Rating(s) assigned in 2018-2019	Date(s) & Rating(s) assigned in 2017-2018	Date(s) & Rating(s) assigned in 2016-2017	Date(s) & Rating(s) assigned in 2015-2016
1.	Debentures-Non Convertible Debentures	LT	45.00	CARE A; Stable	-	1)CARE A; Stable (21-July-17)	1)CARE A; Stable (15-Dec-16)	1)CARE A- (26-Aug-15)
2.	Fund-based - LT-Term Loan	LT	500.00	CARE A; Stable	-	1)CARE A; Stable (21-July-17)	1)CARE A; Stable (15-Dec-16)	1)CARE A- (21-Sep-15)
3.	Commercial Paper	ST	-	-	-	-	1)CARE A1 (15-Dec-16) 2)CARE A1 (05-Aug-16)	1)CARE A1 (07-Oct-15)
4.	Debentures-Non Convertible Debentures	LT	75.00	CARE A; Stable	-	1)CARE A; Stable (21-July-17)	1)CARE A; Stable (15-Dec-16) 2)CARE A- (25-Apr-16)	-
5.	Bonds-Tier II Bonds	LT	150.00	CARE A; Stable	-	1)CARE A; Stable (21-July-17)	1)CARE A; Stable (15-Dec-16)	-
6.	Debentures-Non Convertible Debentures	LT	-	-	-	1)CARE A; Stable (21-July-17)	1)CARE A; Stable (15-Dec-16)	-
7.	Debentures-Non Convertible Debentures	LT	160.00	CARE A; Stable	-	1)CARE A; Stable (21-July-17)	1)CARE A; Stable (30-Dec-16)	-
8.	Debentures-Non Convertible Debentures	LT	135.00	CARE A; Stable	-	1)CARE A; Stable (21-July-17)	1)CARE A; Stable (25-Jan-17)	-
9.	Debentures-Non Convertible Debentures	LT	50.00	CARE A; Stable	-	1)CARE A; Stable (21-July-17)	1)CARE A; Stable (25-Jan-17)	-
10.	Bonds-Tier II Bonds	LT	40.00	CARE A; Stable	-	-	-	-

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