Utkarsh Small Finance Bank Limited

December 22, 2020

Ratings

Facilities/Instruments	**Amount (Rs. crore)**	**Ratings**	**Rating Action**
Long Term Bank Facilities	- (reduced from 13.64)	-	Withdrawn@
Total Bank Facilities	**0.00**		
Long Term Tier – II Bonds	40.00 (Rs. Forty crore only)	CARE A; Stable (Single A; Outlook: Stable)	Reaffirmed
Long Term Tier – II Bonds	150.00 (Rs. One Hundred Fifty Crore only)	CARE A; Stable (Single A; Outlook: Stable)	Reaffirmed
Non-Convertible Debentures	- (reduced from 50.00)	-	Withdrawn@
Non-Convertible Debentures	- (reduced from 77.50)	-	Withdrawn@
Non-Convertible Debentures	- (reduced from 135.00)	-	Withdrawn@
Non-Convertible Debentures	- (reduced from 50.00)	-	Withdrawn@
Total Long Term Instruments	**190.00 (Rs. One Hundred Ninety Crore Only)**		

Details of instruments/facilities in Annexure-1

@CARE has withdrawn the rating(s) assigned to the Bank facilities and NCD issue of Utkarsh Small Finance Bank Limited with immediate effect, as there is no outstanding under the said bank facilities and it has repaid the aforementioned NCD issues in full.

Detailed Rationale & Key Rating Drivers

The ratings assigned to long term Tier–II bonds of Utkarsh Small Finance Bank Limited (USFBL) continue to derive strength from the bank's long track record of operations in microfinance lending, experienced management team for managing the various banking operations, improved financial performance during FY20 and H1FY21 supported by strong growth in income and profitability in line with robust growth in assets under management (AUM) and incrementally lower delinquencies resulting in healthy asset quality. 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 small finance bank resulting in comfortable liquidity position of the bank. The ratings also draw comfort from diversified institutional equity investors base at the hold-co level and comfortable capitalization levels of USFBL given substantial capital raised which has allowed USFBL to grow its loan book and absorb the high credit costs following weakness in collections post demonetization.

The ratings, however, continue to be constrained by geographic concentration in Uttar Pradesh and Bihar (74.13% of JLG book as on Sept 30, 2020), significant concentration to micro finance lending (JLG loans forming 87% of AUM as on Sept-20), lack of diversity in earnings profile, 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 and due to unsecured lending. 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

- 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

- Significant weakening of asset quality leading to decline in profitability metrics with RoTA below 1.5% 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 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 capital adequacy albeit increasing gearing levels with the scale up loan book

USFBL is a 100% 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 Commonwealth Development Corporation Group PLC (CDC), the development financial institution of UK Govt, being the largest foreign investor (14.09% holding) besides, NMI Frontier Fund KS (7.90%), responsibility Participations Mauritius (4.97%), Aavishkaar Goodwell India Microfinance Development Company II Ltd (4.11%) among others. Total Foreign shareholding in UCL was 39.23% on Oct 31, 2020.

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 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 UCL as on Oct 31, 2020 were RBL Bank Ltd (9.96%), Faering Capital India Evolving Fund (9.96%), Hero Enterprise Partner Ventures (4.97%), Shriram Life Insurance Company Limited (4.95%), ICICI Prudential Life Insurance Ltd (4.26%), SIDBI (4.36%), Jhelum Investment Fund (3.28%), HDFC Life Insurance Company Limited (3.19%).

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 24.87% and 19.02% respectively as on Sept 30, 2020. The bank is required to maintain minimum CRAR of 15% as per the regulations applicable to the Small Finance Banks (SFB). In H1FY21, it raised capital through Basel II compliant debt capital instruments (redeemable unsecured non-convertible debenture) for 7 years aggregating to Rs.195 crore. With the scale up of loan book, the gearing levels have increased to 8.6x as on Sept-20 as against 8.3x as on Mar-20 and 7.1x on March-19 though the company has sizable liquid buffers. The bank is also planning to raise further equity funds to provide the required growth capital to support its growing scale of operations.

With respect to the bank's impending IPO, as per the current timelines, the bank has time till June 2021 to get listed, keeping in line with RBI's mandate of listing within three years of launch of bank's operations. However the RBI's Internal Working Group's draft report that was released in November 2020, it was stated that SFBs and Payments Banks may be listed either 6 years from the date of reaching net worth equivalent to prevalent entry capital requirement prescribed for universal banks or 10 years from the date of commencement of operations, whichever is earlier. The recommendation, if accepted, can provide greater timeframe for the bank to get listed.

Improvement in asset quality as a result of write-offs/provisioning and increase in collections post demonetization impact; however, CE has declined due to Covid-19

The asset quality of USFBL have improved 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. It had not restructured any accounts during the year ended March 31, 2020. USFBL has reported GNPA of 0.64% and Nil NPA as on Sept-20. It follows a conservative provisioning policy than that recommended by RBI and consequently made provisions of Rs.95 crore due to covid-19 for

H1FY21. Credit cost on total assets stood at 1.53% in FY19 and 1.28% in FY20; however it rose to 2.39% on account of provisioning done for Covid-19.

Overall collection efficiency of the bank stood at 99.39% for FY20. An aggregate amount of Rs.9.01 crore was collected in FY20 from written-off clients. Due to the nationwide and local lockdowns imposed by the government in light of Covid-19, the bank's operations including the collection efficiency were limited. Also in line with RBI's notification, the bank granted moratorium on the payment of installments and / or interest, as applicable, falling due between March 1, 2020 and August 31, 2020 to all eligible borrowers in case of JLG portfolio and in Retail / WSL portfolio. However, with easing of lockdown in subsequent months and business gaining its usual momentum, the bank's collection efficiency improved from 10% in May 2020 to 85% in Oct -20 and as of Nov-20, it is close to 88% (excluding pre-payments)

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 40.4% in its AUM from Rs.4,742 crore as on Mar-19 to Rs.6,660 crore as on Mar-20 registering a three year CAGR of 60%. The AUM has, however, slightly de-grown to Rs.6,643 crore as on Sept-20 mainly due to lower disbursements in first two quarters of FY 21. As on Sept 30, 2020, the operations of the bank are spread across 15 states and 2 UTs i.e. Uttar Pradesh, Bihar, Madhya Pradesh, Haryana, Uttarakhand, Maharashtra, Himachal Pradesh, Chhattisgarh, Jharkhand, West Bengal, Odisha, Rajasthan, Gujarat, Assam, Telangana, Delhi and Chandigarh. As on Sept-20, its AUM comprised MFI loans (87% of loan book), wholesale lending (~5%), MSME loans (~5%) and housing finance (~2%). 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.

Profitable operations during FY20 and H1FY21

USFBL's total interest income grew by 48% from Rs.881.04 crore during FY19 to Rs.1,307.69 crore during FY20 on the back of strong growth in AUM during FY20. The total income grew by ~50% YoY and stood at Rs.1406.24 corer as on March 31, 2020. Consequently, USFBL reported PAT of Rs.187 crore in FY20 as against Rs.93.89 crore during FY19. Similar to previous fiscal, in FY 20 as well, the opex ratio (operating expenses / average total assets) stood 6.11% and declined to 4.95% in H1FY21. USFBL made covid-19 provisioning of Rs.95 crore hence reported net profit of Rs.77.87 crore on a total income of Rs.835.19 crore during H1FY21 as against PAT of Rs.115 crore on income of Rs.661 crore in H1FY20.

The improvement in profitability in FY20 was owing to the higher asset base, marginal increase in yield resulting in higher Net Interest Margin (NIM) at 9.34% in FY20 as against 9.31% in FY19, higher other income (including income from sale of PSL certificates) of Rs.98.56 crore seen in FY20 (as against Rs.58.05 crore in FY19). Non-interest income / Average Total Assets was 1.26% in FY20 as against 1.08% in FY19. Also, the credit cost declined from 1.53% in FY19 to 1.28% in FY20 as much of the credit cost was absorbed in FY18 and FY19. The provisioning done in FY20 also included covid-19 related provisions. However, it rose to 2.39% in H1FY21 on account of provisioning done due to covid-19. Consequently, ROTA improved from 1.75% in FY19 to 2.4% in FY20.

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 67% of the borrowing mix as on Sept-20 as against just 1% as on Mar-17 which have helped in reducing the borrowing 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

High reliance on bulk deposits albeit increase in retail deposit base with expansion of the general banking network

End FY 20, the bank had set up 103 general banking outlets across the country, increased from 61 outlets FY 19. 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 58.27% (including CASA deposits of 14.5%) as on Sept 30, 2020. Majority of the deposits of the bank are term deposits (Retail TD constituting 40.1% and wholesale term deposits, including certificate of deposits constituting 59.9% of total TD as on March 31, 2020). Top 20 depositors constituted 27.6% of all deposits as on Sept 30, 2020 as against 36% end FY20 and 45% end FY19. 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-20, USFBL had presence in 15 states and 2UTs, a sizeable loan portfolio is concentrated in two states (Bihar and UP) which contributed 69.20% of the total on-book portfolio. 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 87% of the total AUM as on Sept 30, 2020 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, 2020, 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 272.10% as on Sep-20 as against the regulatory requirement of 90%. 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
CARE's Policy on Withdrawal of ratings

About the Company

Utkarsh Small Finance Bank Ltd (USFBL) based out of Varanasi is a 100% 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 88% of the Assets under Management (AUM) of the company as on September 30, 2020. 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.6,643 crore as on Sept 30, 2020. The operations of the bank are currently spread across 15 states and 2 UTs Uttar

Pradesh, Bihar, Madhya Pradesh, Haryana, Uttarakhand, Maharashtra, Himachal Pradesh, Chhattisgarh, Jharkhand, West Bengal, Odisha, Rajasthan, Gujarat, Assam, Telangana, Delhi and Chandigarh.

Brief Financials (Rs. crore)	FY19 (A)	FY20 (A)
Total operating income	939.09	1406.24
PAT	93.89	186.74
Total Assets	6223.78	9366.8
Net NPA (%)	0.12	0.18
ROTA (%)	1.75	2.4

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

Name of the Instrument	ISIN	Date of Issuance	Coupon Rate	Maturity Date	Size of the Issue (Rs. crore)	Rating assigned along with Rating Outlook
Long Term Tier-II 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
Long Term 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 2020-2021	Date(s) & Rating(s) assigned in 2019-2020	Date(s) & Rating(s) assigned in 2018-2019	Date(s) & Rating(s) assigned in 2017-2018
1.	Debentures-Non Convertible Debentures	LT	-	-	-	1)Withdrawn (23-Dec-19)	1)CARE A; Stable (20-Sep-18)	1)CARE A; Stable (21-Jul-17)
2.	Fund-based - LT-Term Loan	LT	-	-	-	1)CARE A; Stable (23-Dec-19)	1)CARE A; Stable (20-Sep-18)	1)CARE A; Stable (21-Jul-17)
3.	Commercial Paper	ST	-	-	-	-	-	1)Withdrawn (21-Jul-17)
4.	Debentures-Non Convertible Debentures	LT	-	-	-	1)CARE A; Stable (23-Dec-19)	1)CARE A; Stable (20-Sep-18)	1)CARE A; Stable (21-Jul-17)

Sr. No.	Name of the Instrument/Bank Facilities	Current Ratings			Rating history			
		Type	Amount Outstanding (Rs. crore)	Rating	Date(s) & Rating(s) assigned in 2020-2021	Date(s) & Rating(s) assigned in 2019-2020	Date(s) & Rating(s) assigned in 2018-2019	Date(s) & Rating(s) assigned in 2017-2018
5.	Bonds-Tier II Bonds	LT	150.00	CARE A; Stable	-	1)CARE A; Stable (23-Dec-19)	1)CARE A; Stable (20-Sep-18)	1)CARE A; Stable (21-Jul-17)
6.	Debentures-Non Convertible Debentures	LT	-	-	-	-	-	1)Withdrawn (21-Jul-17)
7.	Debentures-Non Convertible Debentures	LT	-	-	-	1)CARE A; Stable (23-Dec-19)	1)CARE A; Stable (20-Sep-18)	1)CARE A; Stable (21-Jul-17)
8.	Debentures-Non Convertible Debentures	LT	-	-	-	1)CARE A; Stable (23-Dec-19)	1)CARE A; Stable (20-Sep-18)	1)CARE A; Stable (21-Jul-17)
9.	Debentures-Non Convertible Debentures	LT	-	-	-	1)CARE A; Stable (23-Dec-19)	1)CARE A; Stable (20-Sep-18)	1)CARE A; Stable (21-Jul-17)
10.	Bonds	LT	40.00	CARE A; Stable	-	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 – Not Applicable

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

Sr No	Name of instrument	Complexity level
1.	Bonds	Simple
2.	Bonds-Tier II Bonds	Complex
3.	Debentures-Non Convertible Debentures	Simple
4.	Fund-based - LT-Term Loan	Simple

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

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About CARE Ratings:
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