June 28, 2022

Utkarsh Small Finance Bank Limited: Ratings reaffirmed; outlook on the long-term rating revised to Positive from Stable

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Subordinated debt programme	200.00	200.00	[ICRA]A(Positive); reaffirmed and outlook revised to Positive from Stable
Certificate of deposit programme	1,000.00	1,000.00	[ICRA]A1+; reaffirmed
Total	**1,200.00**	**1,200.00**	

**Instrument details are provided in Annexure-1*

Rationale

The revision in outlook takes into consideration the healthy increase in Utkarsh Small Finance Bank Limited's (USFB's) scale of operations with the expectation of trend to continue going forward. In addition, ICRA expects the bank to witness improvement in its asset quality and its profitability metrics going forward, which had deteriorated in FY2021 and FY2022 because of Covid-19-induced disruptions. Also, USFB is in the process of listing its shares on stock exchange to meet regulatory requirement and raise primary equity capital, however, ICRA takes note of the delay in completing the same and will continue to monitor the further developments. ICRA expects the bank's capitalisation profile to remain adequate supported by regular equity infusions.

The ratings continue to take into consideration USFB's experienced management team, strong investor base and its adequate systems and processes. ICRA notes that USFB has registered a healthy growth in its scale since starting operations as SFB and has witnessed a compound annual growth rate (CAGR) of around 61% in its portfolio during FY2017 to FY2020. The growth declined to 26% in FY2021 and FY2022 each, owing to Covid-19-induced disruptions, however, the same remains healthy. As on March 31, 2022, USFB was managing a portfolio of Rs. 10,631 crore with the share of microfinance portfolio coming down to 77% as on March 31, 2022 from 84% as on March 31, 2021. Further, the bank's funding profile remains well diversified with good traction in deposit mobilisation in FY2022 and steady increase in share of current and savings account (CASA). The total deposits increased by 34% in FY2022 to Rs. 10,074 crore as on March 31, 2022 and share of CASA increased to 22.4% as on March 31, 2022 from 17.7% as on March 31, 2021. The ratings factor in USFB's comfortable capitalisation profile supported by regular capital infusions (most recent infusion was Rs. 150 crore in FY2022). USFB reported capital adequacy ratio (CAR) of 21.6% (Tier I: 18.1%) as on March 31, 2022, compared to regulatory requirement of 15.0% (Tier I: 7.5%). The ratings also continue to factor in the bank's strong liquidity profile and financial flexibility.

The ratings are, however, constrained by the deterioration in USFB's asset quality indicators with consequent impact on its profitability metrics, given the Covid-19 pandemic-induced challenges. The asset quality indicators had deteriorated in H1 FY2022 amid the wave 2 of the pandemic, though the same improved thereafter with some recoveries and write-offs. USFB reported gross non-performing assets (GNPAs) and net NPAs (NNPAs) of 6.1% and 2.3%, respectively, as on March 31, 2022 compared to 3.8% and 1.3%, respectively, as on March 31, 2021. With the deterioration in the asset quality indicators, the bank's solvency (net NPAs/net worth) deteriorated to 15.0% as on March 31, 2022 from 8.0% as on March 31, 2021. Given the deterioration in the asset quality, the bank's profitability indicators were negatively impacted in FY2022. The bank reported a net profit of Rs. 61 crore in FY2022, translating into a return of 0.5% on average assets and 4.2% on average net worth (Rs. 112 crore, 1.0% and 9.4%, respectively in FY2021).

The ratings also remain constrained by the high share of the microfinance portfolio and the geographically concentrated nature of the same. Over the years, USFB launched various products such as loans to micro, small and medium enterprises (MSMEs), housing loans, construction equipment and commercial vehicles (CE/CV), etc. However, the share of new products on the asset side, albeit improving, remained low at 23% as on March 31, 2022 (16% as on March 31, 2021). Further, the share of the microfinance portfolio in Bihar and Uttar Pradesh continues to remain high (42% and 29%, respectively, of the microfinance portfolio as on March 31, 2022). USFB's ability to improve diversification of its product profile and the geographical distribution of its portfolio, will be important from a credit perspective. The ratings also factor in the risks associated with the unsecured nature of microfinance loans, the marginal borrower profile, which is susceptible to income shocks, and the political and operational risks inherent in the microfinance business.

Key rating drivers and their description

Credit strengths

Experienced management team; strong investor profile – The senior management team comprised experienced professional with relevant domain experience. USFB has developed a good second and third line of management for its operations in key areas like liabilities, information technology, risk, operations, compliance and treasury among others. USFB is a subsidiary of Utkarsh CoreInvest Limited (formerly Utkarsh Micro Finance Limited; 84.8% stake as on March 31, 2022). British International Investment plc (formerly CDC Group plc) is Utkarsh CoreInvest Limited's largest shareholder followed by RBL Bank. Other shareholders include International Finance Corporation, Faering Capita, Aavishkaar Goodwell, Norwegian Microfinance Initiative and ResponsAbility. The bank raised equity capital of Rs. 150 crore in FY2022 (Rs. 240 crore in FY2021) from various investors.

Diversified funding mix with good traction in deposit mobilisation – The total deposits increased by 34% in FY2022 to Rs. 10,074 crore as on March 31, 2022. USFB has been successfully diversifying its borrowing profile while increasing its deposits, which comprised 80% of the total funding as on March 31, 2022 (74% as on March 31, 2021). The share of CASA in its total deposits has also improved to 22.4% as on March 31, 2022 from 17.7% as on March 31, 2021. With healthy traction in deposit mobilisation, the share of funding from financial institutions (FIs) through refinancing lines declined to 15% of the total borrowings as on March 31, 2022 from 21% as on March 31, 2021.

Capitalisation profile supported by regular capital infusions – The bank's capital adequacy ratio of 21.6% (Tier I: 18.1%) as on March 31, 2022 was well above the regulatory requirement of 15% (Tier I: 7.5%). While pace of growth has been higher than the internal capital generation, the bank has been regularly raising equity capital to maintain its capitalisation profile. During FY2022, the bank raised Rs. 150 crore equity capital from various investors (Rs. 240 crore in FY2021), albeit gearing remains high at 8.3 times as on March 31, 2022 (7.6 times as on March 31, 2021). The high gearing levels can be partly attributed to the excess liquidity being carried by the bank. The bank is in the process of getting its shares listed through an initial public offering (IPO), which would help bolster its capitalisation profile while supporting its growth plans and also meet regulatory requirement.

Healthy liquidity position and financial flexibility – The bank's liquidity profile is supported by its strong borrowing ability on account of its 'scheduled' status and the large portion of relatively shorter-tenor assets. The liquidity coverage ratio was healthy at 173% as on March 31, 2022 (220% as on December 31, 2021) on a daily average basis for the respective quarter. The bank's structural liquidity statement as on March 31, 2022 did not have any cumulative mismatches for a period of one year, even under the stressed scenario of 80% collection efficiency on advances. The liquidity profile is also supported by the availability of lines from FIs as well as the large share of non-callable deposits.

Credit challenges

Deterioration in asset quality amid the pandemic – The bank's overall asset quality indicators have weakened with gross NPAs of 6.1% as on March 31, 2022 (3.8% as on March 31, 2021) compared to 0.7% as on March 31, 2020. Also, it had an outstanding standard restructured portfolio of 1.3% of its AUM as on March 31, 2022. ICRA notes that the bank had not provided additional moratorium to restructured loans for microfinance borrowers and the collections have been steady from the standard restructured loan portfolio outstanding as on March 31, 2022.

The bank is carrying sizeable provisions on its portfolio. Consequently, the net NPAs were lower at 2.3% as on March 31, 2022 (1.3% as on March 31, 2021; 0.2% as on March 31, 2020). Also, the bank reported a provision coverage of 17.5% on the standard restructured portfolio as on March 31, 2022. Additionally, the bank was carrying floating provisions of Rs. 9.8 crore and additional Covid-19 provisions of Rs. 65 crore, taking the total provisions outstanding to Rs. 550 crore (5.2% of the bank's AUM) as on March 31, 2022. Bank's ability to arrest further slippages and improve its asset quality will be a key monitorable.

Subdued profitability indicators due to elevated credit costs – The bank reported a net profit of Rs. 61 crore in FY2022, translating into a return of 0.5% on average assets and 4.2% on average net worth (Rs. 112 crore, 1.0% and 9.4%, respectively in FY2021). The net interest margins (NIM) improved marginally to 8.2% of average assets from 8.1% in FY2021, with a decline in cost of funds for the bank. ICRA notes that the cost of deposits declined by ~100bps in FY2022, which supported the net interest margins. Operating expenses increased in FY2022 to 5.4% of average assets from 5.1% in FY2021 with expenditure on capacity building and administrative expenses. Credit costs increased to 3.2% of average assets in FY2022 from 2.5% in FY2021 owing to deterioration in asset quality. The bank's ability to control the credit costs and improve its profitability will be important from a credit perspective and ICRA expects the bank to improve its profitability metrics going forward.

Ability to diversify the product mix and increase the retail deposit base – USFB reported good traction in deposits in FY2021 and FY2022 while reporting a growth of 43% and 34%, respectively. The share of CASA stood at 22.4% as on March 31, 2022, albeit improved from 17.7% as on March 31, 2021. Further, the share of new products on the asset side, albeit improving, remained low at 23% as on March 31, 2022 (16% as on March 31, 2021) and the bank's ability to successfully scale up its operations while diversifying its product profile will be important from a credit perspective. The ratings are also constrained by the limited seasoning of the non-microfinance portfolio.

Geographically concentrated microfinance operations – USFB's microfinance business had a presence in 12 states through a network of 493 branches as on March 31, 2022. However, the share of the microfinance portfolio in Bihar and Uttar Pradesh continues to remain high at 42% and 29%, respectively, as on March 31, 2022, though declining year-on-year. Further, there is scope for improving the district-level diversification of the portfolio. Going forward, the bank's ability to diversify its operations geographically as it scales up its operations will remain important from a credit perspective.

Ability to manage political, communal and other risks, given the marginal borrower profile – As a large portion of the bank's portfolio continues to comprise microfinance (77%[1] as on March 31, 2022), the portfolio remains vulnerable to asset quality shocks as witnessed after demonetisation and during the pandemic. The ratings factor in the risks associated with unsecured lending to marginal borrowers with limited ability to absorb income shocks and the rising borrower leverage levels owing to an increase in multiple lending in the areas of operations. The microfinance industry is prone to socio-political, climatic and operational risks, which could negatively impact the bank's operations, and thus its financial position. USFB's ability to onboard borrowers with a good credit history and recruit and retain employees while scaling up its operations would be key for managing high growth rates.

Liquidity position: Strong

The liquidity coverage ratio was healthy at 173% as on March 31, 2022 (220% as on December 31, 2021) on a daily average basis for the respective quarter. The bank's structural liquidity statement as on March 31, 2022 did not have any cumulative mismatches for a period of one year, even under the stressed scenario of 80% collection efficiency on advances. As on March 31, 2022, USFB was carrying on-book liquidity (including mandatory investments) of Rs. 4,220 crore. The bank's liquidity profile

[1] *Including microfinance loans sourced through business correspondents*

is supported by its strong borrowing ability on account of its 'scheduled' status and the large portion of relatively shorter-tenor assets. The liquidity profile is also supported by the availability of lines from FIs.

Rating sensitivities

Positive factors – ICRA could upgrade the long-term rating if the bank is able to further scale up its operations profitably with diversification in the asset mix while improving asset quality and maintaining a prudent capitalisation profile.

Negative factors – Pressure on the bank's ratings could arise on further deterioration in the asset quality or in the operational efficiencies, which could affect the profitability. A deterioration in the capitalisation profile or the weakening of the liquidity profile could also exert pressure on the ratings.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Rating Methodology for Non-Banking Finance Companies Rating Methodology for Banks
Parent/Group Support	Not Applicable
Consolidation/Standalone	Not Applicable

About the company

Incorporated in 2009, Utkarsh Micro Finance Limited received small finance bank (SFB) license from Reserve Bank of India (RBI) in November 2016 and completed the conversion to a bank in January 2017. The bank is headed by Mr. Govind Singh, who was earlier the business head of micro banking at ICICI Bank. Operating in 22 states as on March 31, 2022, the bank offers deposits, microfinance loans, MSME loans, affordable housing loans and corporate loans, among other products. USFB had a portfolio of Rs. 10,631 crore as on March 31, 2022, of which 77% (84% as on March 31, 2021) comprised microfinance loans (including loans sourced by business correspondents). As for liabilities, USFB had a deposit base of Rs. 10,074 crore as on March 31, 2022, of which 78% comprised term deposits.

Key financial indicators (audited)

Utkarsh Small Finance Bank Limited	FY2020	FY2021	FY2022
As per	**IGAAP**	**IGAAP**	**IGAAP**
Profit after tax (Rs. crore)	187	112	61
Net worth i.e., Capital + Reserves (Rs. crore)	1,020	1,368	1,572
Net Loan book (Rs. crore)	6,282	8,217	10,228
Total assets (Rs. crore)	9,404	12,138	15,064
Return on average assets (%)	2.4%	1.0%	0.5%
Return on average net worth (%)	20.8%	9.4%	4.2%
Gross NPA (%)	0.7%	3.8%	6.1%
Net NPA (%)	0.2%	1.3%	2.3%
Solvency (Net NPA/Net worth)	1.1%	8.0%	15.0%
Gearing (times)	8.0	7.6	8.3
CRAR (%)	22.2%	21.9%	21.6%

Gearing: (Total borrowings including deposits and interest accrued but not due)/Net worth
Source: *Company, ICRA Research; All ratios as per ICRA's calculations*

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2023)				Chronology of Rating History for the Past 3 Years			
		Type	Amount Rated (Rs. crore)	Amount Outstanding as of May 31, 2022 (Rs. crore)	Date & Rating in FY2023	Date & Rating in FY2022	Date & Rating in FY2021	Date & Rating in FY2020	
					Jun-28, 2022	Jun-29, 2021	Jun-15-2020	May-15-2019	Apr-11-2019
1	Subordinated Debt	Long Term	200	195	[ICRA]A(Positive)	[ICRA]A(Stable)	[ICRA]A(Stable)	[ICRA]A(Stable)	-
2	Certificate of Deposit	Short Term	1,000	-	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+

**Source:* Company

Complexity level of the rated instruments

Instrument	Complexity Indicator
Subordinated debt programme	Simple
Certificate of deposit programme	Very Simple

The Complexity Indicator refers to the ease with which the returns associated with the rated instrument could be estimated. It does not indicate the risk related to the timely payments on the instrument, which is rather indicated by the instrument's credit rating. It also does not indicate the complexity associated with analysing an entity's financial, business, industry risks or complexity related to the structural, transactional, or legal aspects. Details on the complexity levels of the instruments are available on ICRA's website: www.icra.in

Annexure-1: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE735W08038	Subordinated debt	Jun-26-20	12.50%	Jun-26-27	195.00	[ICRA]A(Positive)
NA	Subordinated debt – Yet to be issued	NA	NA	NA	5.00	[ICRA]A(Positive)
NA	Certificates of deposit – To be issued	NA	NA	7-365 days	1,000.00	[ICRA]A1+

Source: *Company*

Annexure-2: List of entities considered for consolidated analysis – Not Applicable

ANALYST CONTACTS

Karthik Srinivasan
+91 22 6114 3444
karthiks@icraindia.com

Sachin Sachdeva
+91 124 4545 307
sachin.sachdeva@icraindia.com

Prateek Mittal
+91 33 7150 1132
prateek.mittal@icraindia.com

Jatin Arora
+91 124 4545 846
jatin.arora@icraindia.com

RELATIONSHIP CONTACT

Jayanta Chatterjee
+91 80 4332 6401
jayantac@icraindia.com

MEDIA AND PUBLIC RELATIONS CONTACT

Ms. Naznin Prodhani
Tel: +91 124 4545 860
communications@icraindia.com

Helpline for business queries

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

For more information, visit www.icra.in

ICRA Limited

Registered Office

B-710, Statesman House, 148, Barakhamba Road, New Delhi-110001
Tel: +91 11 23357940-45

Branches

ICRA ratings should not be treated as recommendation to buy, sell or hold the rated debt instruments. ICRA ratings are subject to a process of surveillance, which may lead to revision in ratings. An ICRA rating is a symbolic indicator of ICRA's current opinion on the relative capability of the issuer concerned to timely service debts and obligations, with reference to the instrument rated. Please visit our website www.icra.in or contact any ICRA office for the latest information on ICRA ratings outstanding. All information contained herein has been obtained by ICRA from sources believed by it to be accurate and reliable, including the rated issuer. ICRA however has not conducted any audit of the rated issuer or of the information provided by it. While reasonable care has been taken to ensure that the information herein is true, such information is provided 'as is' without any warranty of any kind, and ICRA in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness or completeness of any such information. Also, ICRA or any of its group companies may have provided services other than rating to the issuer rated. All information contained herein must be construed solely as statements of opinion, and ICRA shall not be liable for any losses incurred by users from any use of this publication or its contents.