April 13, 2023

Utkarsh Small Finance Bank Limited: Long-term rating upgraded and outlook revised to Stable from Positive; short-term rating reaffirmed

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+ (Stable); rating upgraded from [ICRA]A and outlook revised to Stable from Positive
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 I*

Rationale

The rating upgrade factors in the healthy growth in Utkarsh Small Finance Bank Limited's (USFB) scale of operations with the improvement in its asset quality and profitability indicators. The bank reported an annualised growth of 24% in its portfolio in 9M FY2023 to Rs. 12,543 crore with a gradual decline in the share of microfinance to 71%[1] of the portfolio as on December 31, 2022 (Rs. 10,631 crore and 77%[2], respectively, as on March 31, 2022). Further, its overall asset quality indicators have been improving with USFB reporting gross non-performing assets (NPAs) of 3.6% and net NPAs of 0.7% as on December 31, 2022, compared to 6.1% and 2.3%, respectively, as on March 31, 2022. With the improvement in the asset quality and the increase in the yields in the portfolio, the overall profitability indicators have also improved, in line with ICRA's expectations. USFB reported a net profit of Rs. 271 crore in 9M FY2023, translating to an annualised return of 2.2% on average total assets (ATA) and 19.4% on closing net worth (Rs. 61 crore, 0.5% and 3.9%, respectively, in FY2022).

The ratings also factor in the bank's adequate capitalisation profile and its plan to raise primary equity capital in the near term. USFB's capital adequacy ratio of 20.4% as on December 31, 2022 (21.6% (Tier I: 18.1%) as on March 31, 2022) was well above the regulatory requirement of 15%. Also, it is in the process of listing its shares on the stock exchange to meet the regulatory requirement and raise primary equity capital. However, ICRA takes note of the delay in completing the same and will continue to monitor further developments.

The ratings remain constrained by the geographically concentrated portfolio with microfinance accounting for a high share. The share of Bihar and Uttar Pradesh remained high at 34% and 26%, respectively, of the portfolio as on December 31, 2022, despite declining gradually. Further, the share of the microfinance portfolio, albeit declining, remained high at 71% as on December 31, 2022 (77% as on March 31, 2022). Given the high share of microfinance, the ratings continue to 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. Further, while the bank has been able to garner sizeable deposits, it remains important for it to improve the granularity of its deposits while increasing the share of current account and savings account (CASA) deposits.

The Stable outlook on the long-term rating reflects ICRA's expectation that USFB will continue to maintain its growth trajectory with a gradual improvement in product diversification and granularity in the deposit base while maintaining a healthy earnings profile and adequate capitalisation.

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

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

Key rating drivers and their description

Credit strengths

Steady growth in scale of operations – USFB has registered a healthy growth in its scale since starting operations as a small finance bank (SFB). It witnessed a compound annual growth rate (CAGR) of around 46% in its portfolio during FY2017 to FY2022. While the growth rate has been moderating since the onset of the pandemic owing to Covid-19-induced disruptions, the same remained healthy at 24% (annualised) in 9M FY2023. As on December 31, 2022, USFB was managing a portfolio of Rs. 12,543 crore (Rs. 10,631 crore as on March 31, 2022) with operations in 24 states through a network of 794 branches. Further, it has been reporting a healthy traction in deposit mobilisation and was able to reduce its net advances-to-deposit ratio to 95% as on December 31, 2022 from 102% as on March 31, 2022 (109% as on March 31, 2021). ICRA expects the trend to continue with the bank gradually improving the diversification in its portfolio and the granularity of its deposits.

Improving asset quality and earnings profile[3] – The bank's overall asset quality indicators have been improving, aided by write-offs and gradually declining slippages. It reported gross NPAs of 3.6% and net NPAs of 0.7% as on December 31, 2022 compared to 6.1% and 2.3%, respectively, as on March 31, 2022. Further, the standard restructured portfolio has been declining and was reported at 0.3% of the portfolio as on December 31, 2022 (1.3% as on March 31, 2022). Nevertheless, the asset quality remains a monitorable, given the high share of microfinance and the limited seasoning of the non-microfinance portfolio.

With the improvement in the asset quality, the credit costs are also gradually reducing, aiding an improvement in USFB's overall profitability. The bank reported credit costs at 2.2% of ATA in 9M FY2023 compared to 3.2% in FY2022. The net interest margin also improved to 9.0% of ATA in 9M FY2023 (7.8% in FY2022), aided by lower reversal of interest income on NPAs and higher yield in the portfolio, especially the microfinance portfolio. Nevertheless, operating expenses increased to 5.8% of ATA in 9M FY2023 from 5.4% in FY2022 due to capacity building and increasing administrative costs. With the improvement in margins and reduction in credit costs, the overall profitability indicators improved in 9M FY2023 with USFB reporting a net profit of Rs. 271 crore in 9M FY2023, translating to a return of 2.2% on ATA (Rs. 61 crore and 0.5%, respectively, in FY2022). ICRA expects the bank to maintain a healthy earnings profile, going forward.

Adequate capitalisation – The bank's capital adequacy ratio of 20.4% as on December 31, 2022 (21.6% (Tier I: 18.1%) as on March 31, 2022) was well above the regulatory requirement of 15% (Tier I: 7.5%). While the pace of growth has been higher than the internal capital generation, USFB has been raising equity capital regularly to maintain its capitalisation profile. It raised Rs. 150-crore equity capital in FY2022 from various investors (Rs. 240 crore in FY2021), though the gearing remained high at 8.2 times as on December 31, 2022 (8.3 times as on March 31, 2022; 7.6 times as on March 31, 2021). The high gearing level can be partly attributed to the excess liquidity being carried by the bank. ICRA expects the bank to remain adequately capitalised, given its plan to raise primary equity capital in the near term and healthy internal capital generation. While USFB is in the process of listing its shares on the stock exchange to meet the regulatory requirement and raise primary equity capital, ICRA takes note of the delay in completing the same and will continue to monitor further developments.

Credit challenges

Geographically concentrated portfolio with high share of microfinance – As on December 31, 2022, USFB had a presence in 24 states through a network of 794 branches. However, the share of Bihar and Uttar Pradesh remained high at 34% and 26%, respectively, in the portfolio as on December 31, 2022, despite declining gradually. Further, the share of the microfinance portfolio, albeit declining, remained high at 71% as on December 31, 2022 (77% as on March 31, 2022). 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., and plans to increase their share in the portfolio. Going

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[3] *Ratios for 9M FY2023 are annualised over March 2022; All ratios are as per ICRA calculations*

forward, the bank's ability to diversify its operations geographically and reduce the share of microfinance, as it scales up its operations, will remain important from a credit perspective.

Ability to improve granularity of deposit base further – The total deposits increased by 34% in FY2022 and by 37% (annualised) in 9M FY2023 to Rs. 12,847 crore as on December 31, 2022. The concentration of deposits has also declined as the top 20 deposits comprised 22% of the total deposits held by the bank as on December 31, 2022 (29% as on March 31, 2022; 27% as on March 31, 2021). The share of CASA in total deposits declined to 21.0% as on December 31, 2022 from 22.4% as on March 31, 2022 (17.7% as on March 31, 2021), in line with industry trends. Going forward, USFB's ability to further improve the granularity of its deposits while sustainably increasing the share of CASA will be important from a credit perspective.

Ability to manage political, communal and other risks, given the marginal borrower profile – As microfinance continues to account for a large portion of the bank's portfolio (71% as on December 31, 2022), it 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 339% as on December 31, 2022 (214% as on September 30, 2022; 186% as on June 30, 2022; 173% as on March 31, 2022) on a daily average basis for the respective quarter. The bank's structural liquidity statement, as on January 31, 2023, did not have any cumulative mismatches for a period of one year, even under the stressed scenario of 80% collection efficiency on advances. USFB'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 profile is also supported by the availability of funding lines from financial institutions (FIs).

Rating sensitivities

Positive factors – ICRA could upgrade the long-term rating if the bank is able to significantly scale up its operations profitably with diversification in the asset mix and sustainably improve the granularity in its deposit base, while maintaining a prudent capitalisation profile.

Negative factors – Pressure on the ratings could arise on a deterioration in the asset quality or in the operational efficiency, which could affect the profitability with the return on assets falling below 1% on a sustained basis. Deterioration in the capitalisation profile or weakening of the liquidity profile could also exert pressure on the ratings.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	Rating Methodology – Banks and Financial Institutions
Parent/Group support	Not Applicable
Consolidation/Standalone	Standalone

About the company

Incorporated in 2009, Utkarsh Micro Finance Limited received a small finance bank (SFB) licence from the Reserve Bank of India (RBI) in November 2016 and completed the conversion to an SFB in January 2017. The bank is headed by Mr. Govind Singh, who was earlier the business head of micro banking at ICICI Bank Limited. Operating in 24 states as on December 31, 2022, USFB offers deposits, microfinance loans, micro, small and medium enterprise (MSME) loans, affordable housing loans and corporate loans, among other products. It had a portfolio of Rs. 12,543 crore as on December 31, 2022, with microfinance loans {including microfinance loans sourced by business correspondents (BCs)} comprising 72% (77% as on March 31, 2022) of the same. As for liabilities, USFB had a deposit base of Rs. 12,847 crore as on December 31, 2022, with term deposits accounting for 79% (78% as on March 31, 2022).

Key financial indicators (audited)

Utkarsh Small Finance Bank Limited	FY2021	FY2022	9M FY2023
Net interest income	839	1,061	1,119
Profit after tax	112	61	271
Net advances	8,217	10,228	12,254
Total assets	12,138	15,064	18,079
Tier I	20.0%	18.1%	17.9%
CRAR	21.9%	21.6%	20.4%
Net interest margin	7.8%	7.8%	9.0%
PAT / ATA	1.0%	0.5%	2.2%
Return on closing net worth	8.2%	3.9%	19.4%
Gross NPAs	3.8%	6.1%	3.6%
Net NPAs	1.3%	2.3%	0.7%
Provision coverage on NPAs	65.5%	63.6%	80.5%
Net NPA / Net worth	8.0%	15.0%	4.7%

Source: Company, ICRA Research; All ratios as per ICRA's calculations; Amount in Rs. crore

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current rating (FY2024)				Chronology of rating history for the past 3 years		
		Type	Amount rated (Rs. crore)	Amount outstanding as of Mar 31, 2023 (Rs. crore)*	Date & rating in FY2024	Date & rating in FY2023	Date & rating in FY2022	Date & rating in FY2021
					Apr 13, 2023	Jun 28, 2022	Jun 29, 2021	Jun 15, 2020
1	Subordinated debt programme	Long term	200.00	195	[ICRA]A+ (Stable)	[ICRA]A (Positive)	[ICRA]A (Stable)	[ICRA]A (Stable)
2	Certificate of deposit programme	Short term	1,000.00	--	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+

**Source: USFB*

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: [Click Here]

Annexure I: Instrument details

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

Source: USFB

Annexure II: List of entities considered for consolidated analysis – Not applicable

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About ICRA Limited:

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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.

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