June 29, 2021

Utkarsh Small Finance Bank Limited: Ratings reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Subordinated debt programme	200	200	[ICRA]A(Stable); reaffirmed
Certificate of deposit programme	1,000	1,000	[ICRA]A1+; reaffirmed
Total	**1,200**	**1,200**	

**Instrument details are provided in Annexure-1*

Rationale

The ratings factor in Utkarsh Small Finance Bank Limited's (USFB) experienced management team, strong investor base and adequate systems and processes, which have helped it scale up its operations. USFB registered a compound annual growth rate (CAGR) of around 60% in its portfolio during FY2017 to FY2020. However, the growth moderated to 26% in FY2021 owing to Covid-19-induced disruptions. As on March 31, 2021, USFB was catering to more than 26 lakh loan accounts through a network of 558 banking outlets spread across 18 states while managing a portfolio of Rs. 8,416 crore. The bank's funding profile remains well diversified with good traction in deposit mobilisation in FY2021. The total deposits increased by 43% in FY2021 to Rs. 7,508 crore as on March 31, 2021.

Further, the bank's capitalisation profile has improved with regular capital infusions (most recent infusion was Rs. 240 crore in FY2021). USFB's capital adequacy ratio of 21.88% (Tier I: 19.98%) as on March 31, 2021 was well above the regulatory requirement of 15.0% (Tier I: 7.5%). It is in the process of launching its initial public offering (IPO) to raise around Rs. 750 crore of primary equity capital[1] in FY2022. This would help bolster USFB's capitalisation profile while supporting its growth plans. The ratings continue to factor in the bank's strong liquidity profile and financial flexibility. The liquidity coverage ratio was healthy at 168% as on March 31, 2021 and 257% as on December 31, 2020 on a daily average basis for the respective quarters. The liquidity profile is also supported by the availability of lines from financial institutions (FIs) as well as the large share of non-callable deposits.

The industry has been facing many challenges following the spread of the Covid-19 pandemic throughout the country. These include the moderation in growth and the adverse impact on the asset quality as the borrowers' cash flows have been impacted severely. Given the challenges, the gross non-performing assets (GNPAs) and net NPAs (NNPAs) increased to 3.84% and 1.33%, respectively, as on March 31, 2021 from 0.71% and 0.18%, respectively, as on March 31, 2020. With the deterioration in the asset quality indicators, the bank's solvency (net NPAs/net worth) increased to 7.95% as on March 31, 2021 from 1.09% as on March 31, 2020. Further, USFB has restructured loans amounting to Rs. 284 crore[2] (3.4% of AUM as on March 31, 2021). While the bank's collection efficiency (excluding prepayments/foreclosures) had been improving in Q4 FY2021 and was reported at 97.6% for the month of March 2021 (91.1% for the month of December 2020), it is expected to have got impacted in Q1 FY2022 owing to the second wave of the pandemic. Consequently, the asset quality is expected to remain under stress in the near term.

Given the deterioration in the asset quality, the bank's profitability indicators were negatively impacted in FY2021. USFB reported a net profit of Rs. 112 crore in FY2021, translating into a return of 1.04% on average assets and 9.37% on the average net worth (Rs. 187 crore, 2.39% and 20.84%, respectively, in FY2020). The bank's ability to navigate through the adversity and

[1] As per Draft Red Herring Prospectus filed with Securities and Exchange Board of India

[2] As on March 31, 2021, loans amounting to Rs. 20.39 crore out of the Rs. 283.63 crore restructured loans have been pre-closed or classified as NPA

manage the impact on its business growth, client retention and asset quality would remain critical from a rating perspective, going forward.

The ratings remain constrained by the high share of the microfinance portfolio and the geographically concentrated nature of the same. With the commencement of banking operations, USFB launched various products such as loans to micro, small and medium enterprises (MSMEs), housing loans, construction equipment and commercial vehicles (CE/CV), etc. Despite increasing, the share of new products on the asset side, albeit improving, remained low at 16% as on March 31, 2021 (10% as on March 31, 2020). Further, the share of the microfinance portfolio in Bihar and Uttar Pradesh continues to remain high (47% and 28%, respectively, of the microfinance portfolio as on March 31, 2020). USFB's ability to successfully scale up its operations, while diversifying 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.

The Stable outlook on the [ICRA]A rating reflects ICRA's opinion that USFB will continue to benefit from its experienced management team, strong investor base, diversified funding profile and financial flexibility. In addition, ICRA expects the bank to improve its profitability metrics going forward, which had declined in FY2021 because of Covid-19-induced disruptions.

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; 89.50% stake as on March 31, 2021). CDC Group (formerly Commonwealth Development Corporation) is Utkarsh CoreInvest Limited's largest shareholder followed by Faering Capital and RBL Bank. Other shareholders include International Finance Corporation, Aavishkaar Goodwell, Norwegian Microfinance Initiative and ResponsAbility. The bank raised equity capital of Rs. 240 crore in FY2021 from various investors - Olympus ACF, resonsAbility, Aavishkaar, Triodos and Growth Catalyst Partners.

Diversified funding mix with good traction in deposit mobilisation – The total deposits increased by 43% in FY2021 to Rs. 7,508 crore as on March 31, 2021. USFB has been successfully diversifying its borrowing profile while increasing its deposits, which comprised 74% of the total funding as on March 31, 2021 (64% as on March 31, 2020). The concentration of deposits has improved as the top 20 deposits comprised 27% of the total deposits held by the bank as on March 31, 2021 (36% as on March 31, 2020). With healthy traction in deposit mobilisation, the share of funding from FIs through refinancing lines declined to 21% of the total borrowings as on March 31, 2021 from 27% as on March 31, 2020.

Capitalisation profile supported by regular capital infusions – The bank's capital adequacy ratio of 21.88% (Tier I: 19.98%) as on March 31, 2021 was well above the regulatory requirement of 15.0% (Tier I: 7.5%). The gearing remained on the higher side at 7.60 times as on March 31, 2021 (7.99 times as on March 31, 2020), given the excess liquidity being carried by the bank. While the pace of growth has been higher than the internal capital generation, USFB has been regularly raising equity capital to maintain its capitalisation profile. In FY2021, the bank raised equity capital of Rs. 240 crore from various investors. It is in the process of launching its IPO to raise around Rs. 750 crore of primary equity capital[3] in FY2022. This would help bolster USFB's capitalisation profile while supporting its growth plans.

Comfortable liquidity position and financial flexibility – The bank's liquidity profile is supported by its enhanced borrowing ability on account of its 'scheduled' status and the large portion of relatively shorter-tenor assets. The liquidity coverage ratio was healthy at 168% as on March 31, 2021 and 257% as on December 31, 2020 on a daily average basis for the respective quarters. The bank's structural liquidity statement as on March 31, 2021 did not have any cumulative mismatches for a period

[3] *As per Draft Red Herring Prospectus filed with Securities and Exchange Board of India*

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; further impact expected because of second wave of Covid-19 – The industry is facing many challenges following the spread of the pandemic throughout the country. These include the adverse impact on the growth and the asset quality as the borrowers' cash flows have deteriorated significantly. Given the challenges, the GNPAs and NNPAs increased to 3.8% and 1.3%, respectively, as on March 31, 2021 from 0.7% and 0.2%, respectively, as on March 31, 2020. With the deterioration in the asset quality indicators, the solvency deteriorated to 8.0% as on March 31, 2021 from 1.1% as on March 31, 2020. Further, the bank has restructured loans amounting to Rs. 284 crore[4] (3.4% of AUM as on March 31, 2021).

While USFB's collection efficiency (excluding prepayments/foreclosures) had been improving in Q4 FY2021 and was reported at 97.6% for the month of March 2021 (91.1% for the month of December 2020), it is expected to have got impacted in Q1 FY2022 owing to the second wave of the pandemic. The surge in Covid-19 infections in the last two-three months led to several states/Union Territories (UTs) imposing lockdowns or placing significant restrictions on gatherings and the movement of people, resulting in the disruption of economic activities and impacting the field operations as well as collections for the industry. Though gradual unlocking has started and the collections in the industry are expected to have witnessed some improvement in June 2021, the full recovery of the collection efficiency is expected to take some time. The bank's ability to navigate through the adversity and manage the impact on its business growth, client retention and asset quality would remain critical from a rating perspective, going forward.

Subdued profitability indicators – USFB reported a net profit of Rs. 112 crore in FY2021, translating into a return of 1.04% on average assets and 9.37% on the average net worth (Rs. 187 crore, 2.39% and 20.84%, respectively, in FY2020). The net interest margin (NIM) declined to 8.13% of average assets in FY2021 from 9.68% in FY2020, owing to negative carry of the excess on-book liquidity maintained, decline in business volumes and reversal of interest income in light of the increase in NPAs. The impact of the decline in NIM was offset to some extent by the moderation in operating expenses. The operating expenses moderated to 5.06% of average assets in FY2021 from 6.09% in FY2020 due to lower administrative expenses. However, given the deterioration in the asset quality indicators, the credit costs increased to 2.66% of average assets in FY2021 from 1.28% in FY2020. As the asset quality is expected to remain volatile in the near term, the bank's ability to control slippages and credit costs would be important from a profitability perspective.

Ability to diversify the product mix and increase the retail deposit base – USFB reported good traction in deposits in FY2021 while reporting a growth of 43%. However, the share of current account-savings account (CASA) remained low at 17% as on March 31, 2021, albeit improved from 13% as on March 31, 2020. Further, the share of new products on the asset side, albeit improving, remained low at 16% as on March 31, 2021 (10% as on March 31, 2020) 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 11 states through a network of 420 branches as on March 31, 2021. However, the share of the microfinance portfolio in Bihar and Uttar Pradesh continues to remain high[5]. 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 (84%[6] as on March 31, 2021), 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

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[4] *As on March 31, 2021, loans amounting to Rs. 20.39 crore out of the Rs. 283.63 crore restructured loans have been pre-closed or classified as NPA*

[5] *The share of microfinance portfolio in Bihar and Uttar Pradesh was 47% and 28%, respectively, as on March 31, 2020 and is not expected to have changed materially by March 31, 2021.*

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

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 168% as on March 31, 2021 and 257% as on December 31, 2020 on a daily average basis for the respective quarter. The bank's structural liquidity statement as on March 31, 2021 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, 2021, USFB was carrying on-book liquidity (including mandatory investments) of Rs. 3,484 crore. The bank's liquidity profile is supported by its enhanced 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 revise the outlook or upgrade the long-term rating if USFB is able to further scale up its portfolio, while diversifying its asset mix and improving the asset quality, maintain a prudent capitalisation profile and improve its retail deposit franchise.

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 with the return on average managed assets remaining below 1.5% on a sustained basis. 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 the small finance bank (SFB) licence from the Reserve Bank of India (RBI) in November 2016 and completed the conversion to a bank in January 2017. It is promoted by Mr. Govind Singh, who was earlier the business head of micro banking at ICICI Bank. Operating in 18 states as on March 31, 2021, the bank offers deposits, microfinance loans, MSME loans, affordable housing loans and corporate loans. USFB had a portfolio of Rs. 8,416 crore as on March 31, 2021, with microfinance loans accounting for 84%. As for liabilities, it had a deposit base of Rs. 7,508 crore as on March 31, 2021.

Key financial indicators (audited)

Utkarsh Small Finance Bank Limited	FY2020	FY2021
As per	IGAAP	IGAAP
Profit after tax (Rs. crore)	187	112
Net worth (Rs. crore)	1,020	1,368
Net Loan book (Rs. crore)	6,282	8,217
Total assets (Rs. crore)	9,404	12,138
Return on average assets (%)	2.39%	1.04%
Return on average net worth (%)	20.84%	9.37%
Gross NPA (%)	0.71%	3.84%
Net NPA (%)	0.18%	1.33%
Solvency (Net NPA/Net worth)	1.09%	7.95%
Gearing (times)	7.99	7.60
CRAR (%)	22.19%	21.88%

Gearing: (Total borrowings including deposits)/Net worth

Source: *Company, ICRA research; All ratios as per ICRA calculations*

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2022)				Chronology of Rating History for the Past 3 Years			
		Type	Amount Rated (Rs. crore)	Amount Outstanding as of May 31, 2021 (Rs. crore)	Date & Rating in FY2022	Date & Rating in FY2021	Date & Rating in FY2020		Date & Rating in FY2019
					Jun-29, 2021	Jun-15-2020	May-15-2019	Apr-11-2019	Dec-14-2018 Sep-12-2018
1	Subordinated Debt	Long Term	200	195	[ICRA]A(Stable)	[ICRA]A(Stable)	[ICRA]A(Stable)	-	-
2	Certificate of Deposit	Short Term	1,000	319	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1

Complexity level of the rated instruments

Instrument	Complexity Indicator
Subordinated debt	Simple
Certificate of deposit	Very Simple

Assuming the new instruments issued will be similar in terms of complexity as the previous subordinated debt raised; indicator will be changed once they are placed, if required

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(Stable)
NA	Subordinated debt – Yet to be issued	NA	NA	NA	5.00	[ICRA]A(Stable)
INE735W16304	Certificates of deposit	Dec-31-20	5.10%	Dec-27-21	48.61	[ICRA]A1+
INE735W16312	Certificates of deposit	Feb-22-21	5.40%	Feb-21-22	48.14	[ICRA]A1+
INE735W16320	Certificates of deposit	Mar-03-21	5.13%	Aug-30-21	98.77	[ICRA]A1+
INE735W16346	Certificates of deposit	Mar-15-21	4.75%	Jul-19-21	49.69	[ICRA]A1+
INE735W16338	Certificates of deposit	Mar-15-21	5.25%	Sep-08-21	49.31	[ICRA]A1+
INE735W16338	Certificates of deposit	Mar-30-21	5.10%	Sep-08-21	24.66	[ICRA]A1+
NA	Certificates of deposit	NA	NA	7-365 days	680.82	[ICRA]A1+

Source: *Company*

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

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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

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