February 20, 2024

Sonata Finance Private Limited: Continues on Rating Watch with Positive Implications; Rating withdrawn for Rs. 40-crore NCD programme

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Long-term bank facilities – Term loan	500	500	[ICRA]BBB; continues on Rating Watch with Positive Implications
Non-convertible debentures	20	-	[ICRA]BBB; continues on Rating Watch with Positive Implications & withdrawn
Non-convertible debentures	20	-	[ICRA]BBB; continues on Rating Watch with Positive Implications & withdrawn
Total	**540.00**	**500.00**	

**Instrument details are provided in Annexure I*

Rationale

Sonata Finance Private Limited's (SFPL) rating continues to remain on Watch with Positive Implications due to the announcement, dated February 10, 2023, regarding its share purchase agreements with Kotak Mahindra Bank Limited {Bank; rated [ICRA]AAA (Stable)} and the existing shareholders of the company. The bank will acquire 2,64,53,256 equity shares (face value of Rs. 10 each fully paid up), constituting 100% of SFPL's issued and paid-up capital, for a total consideration of approximately Rs. 537 crore. The rating watch factors in the expected implication of the change in the shareholding with the company becoming a wholly-owned subsidiary of the bank. ICRA expects this to improve SFPL's financial flexibility and fund-raising ability. ICRA is given to understand that the requisite regulatory approvals are in place with the transaction expected to be completed in the near future.

The rating continues to factor in SFPL's established track record of operations and its fairly diversified funding profile. The company was operating in 10 states through a network of 549 branches with assets under management (AUM) of ~Rs. 2,632 crore (before IND AS adjustment) as on December 31, 2023. Its funding profile is fairly diversified with funding relationships with more than 40 lenders, comprising a good mix of public sector banks, private banks, non-banking financial companies (NBFCs) and financial institutions (FIs). The rating also takes into consideration SFPL's improving profitability indicators with the company reporting a net profit of Rs. 54 crore in 9M FY2024, translating into an annualised return of 2.4% on average managed assets (AMA) and 19.5% on average net worth, compared to Rs. 42 crore, 1.6% and 12.9%, respectively, in FY2023.

The rating also factors in the company's continued exposure to regional concentration risk as the majority of the portfolio was in Uttar Pradesh (51%), followed by Bihar (24%) and Madhya Pradesh (16%) as on December 31, 2023. The asset quality indicators remain moderate with gross non-performing assets (GNPAs) at 4.0% as on December 31, 2023 (2.7% as on March 31, 2023; 4.6% as on March 31, 2022). Further, the company's capital adequacy ratio of 16.0% (Tier I: 15.7%), as on December 31, 2023, was near the regulatory threshold while the gearing remains high. The rating continues 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.

ICRA has withdrawn the rating outstanding for the Rs. 40 crore non-convertible debenture (NCD) programme as the instrument has matured/been redeemed/yet to be issued and there is no amount outstanding against the same. The rating has been withdrawn in accordance with ICRA's policy on the withdrawal of credit ratings, at the company's request.

Key rating drivers and their description

Credit strengths

Fairly diversified funding profile – SFPL's borrowing profile is relatively well-diversified, comprising funding relationships with more than 40 lenders as on December 31, 2023, with a good mix of public sector banks, private banks, NBFCs and FIs. The funding profile comprised loans from banks (38%), NBFC/FIs (22%), debentures (14%), external commercial borrowings (ECBs; 7%), sub-debt (1%) and off-book (17%) as on December 31, 2023. Going forward, SFPL's ability to maintain a diversified debt profile and continue raising funds at competitive rates would be important for scaling up its operations.

Improving profitability – The company's profitability indicators are gradually improving on the back of higher yields and interest margins. The net interest margin (NIM) improved to 10.5% of AMA in 9M FY2024 from 7.6% in FY2023 (6.9% in FY2022) due to the revision in SFPL's lending rates in light of the revised microfinance regulations. While the operating expenses increased on account of branch expansion and employee expenses, credit costs were elevated due to the deterioration in the asset quality. Nevertheless, higher margins helped the company improve its profitability in FY2023 as well as 9M FY2024. SFPL reported an improvement in its overall profitability with a net profit of Rs. 54 crore in 9M FY2024, translating into an annualised return of 2.4% on AMA and 19.5% on average net worth, compared to Rs. 42 crore, 1.6% and 12.9%, respectively, in FY2023. ICRA expects the trend to continue, provided the company is able to control its credit costs.

Credit challenges

Geographically concentrated portfolio – Lucknow (Uttar Pradesh) based SFPL commenced microfinance operations in 2006 and has been able to scale up its operations over the years. While it had a presence in 10 states as on December 31, 2023, it remains exposed to regional concentration risks given the high share of the top 3 states of Uttar Pradesh (51%), Bihar (24%) and Madhya Pradesh (16%). Further, the top 10 and top 20 districts accounted for 22% and 36%, respectively, of the AUM as on December 31, 2023. ICRA notes the company's efforts to diversify its operations geographically, which is important from a credit perspective.

Moderate asset quality – SFPL's asset quality indicators deteriorated with the GNPAs increasing to 4.0% as on December 31, 2023 from 2.7% as on March 31, 2023 (4.6% on March 31, 2022) on account of the higher slippages in 9M FY2024. While the company has been making recoveries from overdue accounts, including written-off accounts, its ability to contain further slippages and improve its asset quality metrics would be important from a credit perspective.

Moderate capitalisation profile – SFPL's capital adequacy ratio has been declining as it continues to scale up its on-book portfolio even though it has not raised any material equity capital in the last three years to support its growth plans. The capital adequacy of 16.0% (Tier I: 15.7%), as on December 31, 2023, was near the regulatory threshold while the leverage remains high. Although the gearing has declined in the current fiscal with the reduction in on-book liquidity, it remained high at 5.4 times as on December 31, 2023 (6.0 times as on March 31, 2023). The company's ability to maintain a prudent capitalisation profile with sufficient cushion over the regulatory capital adequacy ratio requirement will be important from a credit perspective.

Political, communal, and other risks in microfinance sector, given the marginal borrower profile – Microfinance remains susceptible to 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. Further, political and operational risks associated with microfinance may result in high volatility in the asset quality indicators. The microfinance industry is prone to socio-political, climatic and operational risks, which could negatively impact its operations. SFPL's ability to onboard borrowers with a good credit history, recruit and retain employees as well as improve the geographical diversity of its operations would be the key for managing growth while maintaining its credit profile.

Liquidity position: Adequate

As on December 31, 2023, the company reported unencumbered on-book liquidity of ~Rs. 231 crore and had scheduled inflows from advances (excluding interest) of ~Rs. 1,530 crore against scheduled debt repayments (excluding interest) of ~Rs. 1,407 crore during January 01, 2024 to December 31, 2024. Factoring in the expected collections from advances, the liquidity profile is adequate for meeting the debt obligations in a timely manner. As per the asset-liability management (ALM) profile as on December 31, 2023, SFPL had no cumulative mismatches for at least one year. The presence of ~Rs. 350 crore of sanctioned unavailed funding lines also supports the company's liquidity profile.

Rating sensitivities

Positive factors – The completion of the acquisition by the bank and clarity on the support to be provided by the bank could positively impact the rating. Sustained improvement in the company's profitability while scaling up the operations further and maintaining a prudent capitalisation profile could also positively impact the rating.

Negative factors – Pressure on the company's rating could arise if there is a further deterioration in its asset quality, affecting the profitability. A significant deterioration in the capitalisation profile or a weakening in the liquidity profile could also exert pressure on the rating.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	Rating Methodology for Non-banking Finance Companies ICRA's Policy on Withdrawal of Credit Ratings
Parent/Group support	Not Applicable
Consolidation/Standalone	Standalone

About the company

Sonata Finance Private Limited (SFPL) is a non-banking financial company – microfinance institution (NBFC-MFI) registered with the Reserve Bank of India (RBI). Incorporated in 1995, the company's microfinance operations commenced in 2006. SFPL's registered office is in Lucknow. While the company offers a gamut of loans including loans for home improvement, utility, sanitation, etc., its focus product is the income-generating group loan (IGL) using the joint liability group lending (JLG) model. As on December 31, 2023, SFPL was managing a portfolio of Rs. 2,632 crore (before IND AS adjustment) through a network of 549 branches spread across 151 districts in 10 states of India.

On February 10, 2023, SFPL announced that it has entered into share purchase agreements with Kotak Mahindra Bank Limited {rated [ICRA]AAA (Stable)} and the existing shareholders of the company. The bank will acquire 2,64,53,256 equity shares (face value of Rs. 10 each fully paid up), constituting 100% of SFPL's issued and paid-up capital, for approximately Rs. 537 crore.

Key financial indicators

Sonata Finance Private Limited	FY2022	FY2023	9M FY2024*
Total income	300	392	448
PAT	14	42	54
Total managed assets	2,251	2,928	3,050
Return on average managed assets	0.6%	1.6%	2.4%
Reported gearing (times)	4.7	6.0	5.4
Gross NPA	4.6%	2.7%	4.0%
CRAR	21.69%	16.55%	16.03%

*Source: Company, ICRA Research; *Provisional; 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 December 2023 (Rs. crore)	Date & Rating in FY2024	Date & Rating in FY2023			Date & Rating in FY2022	Date & Rating in FY2021	
					Feb 20, 2024	Feb 21, 2023	Oct 27, 2022	May 06, 2022	Mar 25, 2022	Mar 26, 2021	Aug 31, 2020
1	Long-term bank facilities – Term loan	Long term	500	243.675	[ICRA]BBB %	[ICRA]BBB %	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)
2	Non-convertible debentures	Long term	20.00	-	[ICRA]BBB %; withdrawn	[ICRA]BBB %	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)
3	Non-convertible debentures	Long term	20.00	-	[ICRA]BBB %; withdrawn	[ICRA]BBB %	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)
4	Non-convertible debentures	Long term	-	-	-	[ICRA]BBB (Stable); withdrawn	[ICRA]BBB (Stable)	[ICRA]BBB (Stable); withdrawn	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)
5	Non-convertible debentures	Long term	-	-	-	-	-	[ICRA]BBB (Stable); withdrawn	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)
6	Subordinated debt	Long term	-	-	-	-	-	[ICRA]BBB (Stable); withdrawn	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)

%-Rating on Watch with Positive Implications

Complexity level of the rated instrument

Instrument Name	Complexity Indicator
Long-term bank facilities – Term loan	Simple
Non-convertible debentures	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 / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	**Long-term bank facilities**	Sep 28, 2016 to Dec 31, 2019	10.60% - 13.50%	Mar 25, 2023 to Mar 31, 2025	500.00	[ICRA]BBB; Rating Watch with Positive Implications
INE509M07170	**Non-convertible debentures**	December 7, 2018	14.20%	March 31, 2023	20.00	[ICRA]BBB; Rating Watch with Positive Implications and withdrawn
Yet to be placed	**Non-convertible debentures**	-	-	-	20.00	[ICRA]BBB; Rating Watch with Positive Implications and withdrawn

Source: Company

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

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About ICRA Limited:

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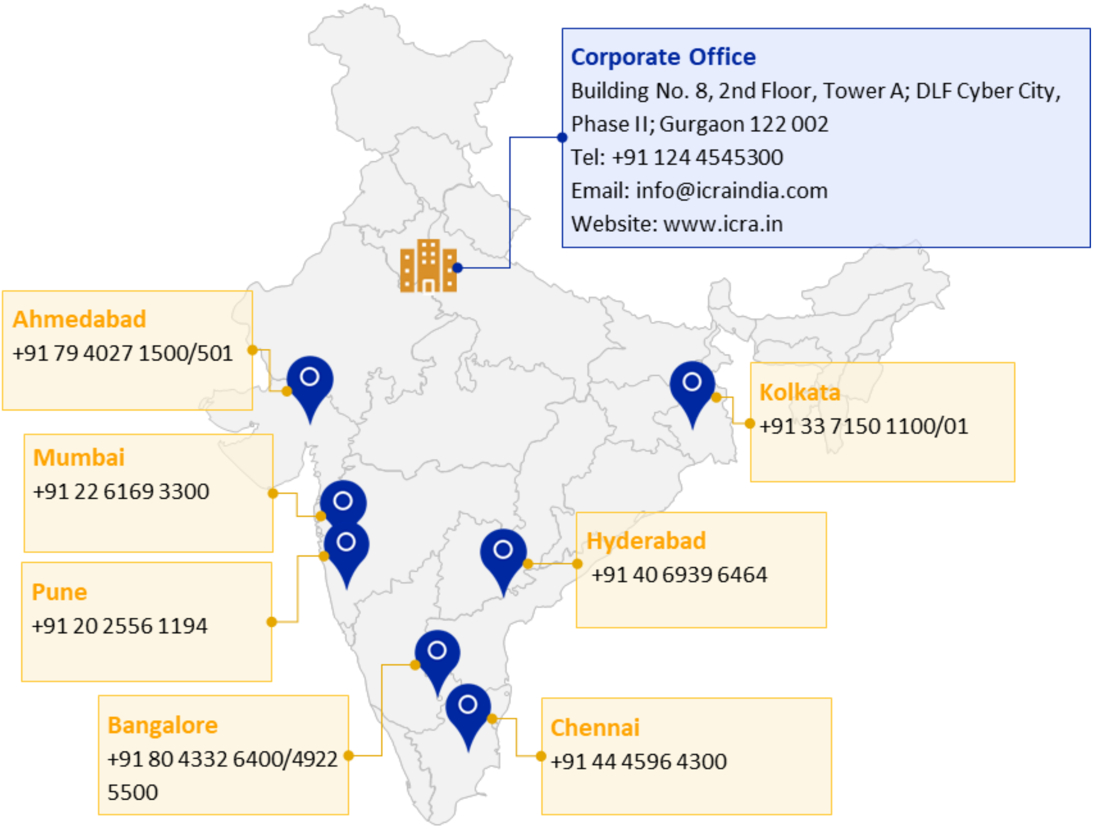

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