August 02, 2023

Unity Small Finance Bank Limited: Ratings reaffirmed; Ratings withdrawn for matured/redeemed instruments

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Issuer rating	-	-	[ICRA]A- (Stable); reaffirmed
Non-convertible debenture	10.00	-	[ICRA]A- (Stable); reaffirmed and withdrawn
Bank facilities (LT/ST – Fund based)	37.09	37.09	[ICRA]A- (Stable) reaffirmed/ [ICRA]A1 reaffirmed and withdrawn$
Bank facilities (LT/ST – Fund based)	96.01	-	[ICRA]A- (Stable)/[ICRA]A1; reaffirmed and withdrawn
Certificates of deposit	25.00	-	[ICRA]A1; reaffirmed and withdrawn
Total	**168.10**	**37.09**	

**Instrument details are provided in Annexure I; LT – Long term; ST – Short term; $ Short term rating has been reaffirmed and withdrawn*

Rationale

The ratings reaffirmation factors in the established presence of Unity Small Finance Bank Limited's (Unity SFB) promoter group in the financial services industry, the bank's healthy upfront capitalisation and the relaxations provided by the Reserve Bank of India (RBI) on priority sector lending (PSL) norms, the timeline for the initial public offering (IPO), etc. While reaffirming the ratings, ICRA continues to factor in the expectation of sub-optimal internal capital generation over the medium term, given the elevated operating expenses in the early stages of operations. Further, the accounting treatment of the fair valuation of the assets and liabilities of the erstwhile PMC Bank would continue to weigh down on capital build-up in the near to medium term. Thus, the bank is expected to require capital support to support its growth momentum in the near to medium term.

While Unity SFB's deposit base witnessed strong traction in the last year, its ability to continue building a granular deposit franchise at competitive rates would be critical for realising its growth plans and would remain important for its earnings trajectory. Its ability to scale up its operations while maintaining healthy asset quality would remain important for improving its operating leverage and earnings profile. The ratings also factor in the risks associated with the unsecured nature of microfinance loans, which is likely to remain a focus area for the bank for growth as well as to meet its PSL targets. ICRA also notes that while the reported gross non-performing assets (GNPAs) stood high as of March 31, 2023, on account of PMC Bank's stressed portfolio, these have been significantly provided for and the asset quality remains comfortable with net NPAs (NNPA) of 0.3%.

The Stable outlook on the long-term rating reflects ICRA's expectation that the bank will be able to grow its liability base, improve its scale of operations and report profitable operations (after fair value charges) after the next couple of years. The outlook also factors in the requisite capital-raising plans to offset the impact of the fair valuation of the erstwhile PMC Bank's liabilities on the capital and to fund the growth.

The outstanding ratings on the Rs. 96.01-crore bank facilities, Rs. 25.00 crore certificates of deposit, Rs. 10.00 crore non-convertible debentures and short-term fund based bank facilities have been reaffirmed and withdrawn as there is no amount outstanding against the same. The ratings have been withdrawn in accordance with ICRA's policy on the withdrawal of credit ratings (click here for the policy).

Key rating drivers and their description

Credit strengths

Established presence of promoters in financial services industry – Centrum Group, comprising Centrum Capital Limited (CCL; the holding company of the Group) and its subsidiaries, is a diversified financial services provider with a presence in fee-based businesses such as investment banking, broking, wealth management, insurance broking and asset management. The Group has an established position in debt capital markets with a clientele across public sector units, banks, state-level undertakings, private corporates and various provident funds. It ventured into the distribution of insurance products and the asset management business in FY2018. It also has a small equity broking operation under Centrum Broking Limited. In FY2019, the Group shifted its focus to grow its fund-based businesses and set up a non-banking financial company (NBFC; Centrum Financial Services Limited; CFSL), a housing finance company (Centrum Housing Finance Limited; CHFL) and a microfinance institution (Centrum Microcredit Limited; CML). Later, the lending portfolio of CFSL and CML were transferred to Unity SFB through a slump sale by the Centrum Group and CFSL became the promoter of Unity SFB with a 51% stake.

Resilient Innovations Private Limited (RIPL)/BharatPe, which is an investor with a 49% stake in Unity SFB, is a fintech company that provides services like payment solutions and financing solutions to small merchants and kirana store owners. It is expected to bring in technology support to help set up the platform for Unity SFB's digital bank plans.

Comfortable capital position, though weak profitability will drive growth-led requirements – Unity SFB commenced active operations from November 1, 2021, with an upfront equity base of Rs. 1,105.10 crore. Thereafter, PMC Bank was amalgamated with Unity SFB in accordance with the RBI's scheme for the recovery/resolution of the same. ICRA notes that the fair valuation of the liabilities has been accretive from a capital adequacy perspective. As on March 31, 2023, Unity SFB had a comfortable capitalisation profile with a Tier I ratio of 27.16% (38.77% as on March 31, 2022), comfortably above the regulatory requirement. The overall capital adequacy with a capital-to-risk weighted assets ratio (CRAR) of 48.99%, as on March 31, 2023, is supported by the relaxations provided by the RBI in terms of inclusion of certain restructured and fair-valued liabilities in the total CRAR. The liabilities will be marked up gradually to the face value over the coming years and would consequently have an adverse impact on the bank's net worth during this period. Further, considering the envisaged portfolio growth and low internal capital generation expected in the near term, Unity SFB will need growth capital for which the shareholders have committed to infuse Rs. 1,900 crore over the next few years.

Asset quality remains satisfactory with high provision on legacy stressed assets – As on March 31, 2023, the GNPA ratio stood high at 45.8% because of the legacy stressed assets of erstwhile PMC Bank. Excluding these, the GNPA stood at 3.2% as on March 31, 2023 (62.9% as on March 31, 2022). The NNPA ratio was comfortable at 0.3% (8.2% as on March 31, 2022) due to the high provision coverage on PMC Bank's legacy NPAs as well as the low net slippages on the freshly originated book (since November 2021). The bank's ability to incrementally maintain healthy asset quality in the portfolio to keep the credit costs under control would be critical, while any recoveries from PMC Bank's portfolio would be a positive. Unity SFB's ability to grow as well as diversify its portfolio and reduce geographical concentration would also be a key monitorable for its credit profile.

Credit challenges

Growing scale of operations; loan book expansion, while maintaining healthy asset quality, remains critical – As on March 31, 2023, Unity SFB's net loan book stood at Rs. 4,468 crore, up 85% YoY, with microfinance loans (MFI; inclusive banking) forming 28% of the overall net loan book and micro, small and medium enterprise (MSME) and supply chain finance loans (business banking) accounting for 66%. PMC Bank's legacy loan book declined to 6% of overall advances from 22% as on March 21, 2022, mainly on account of higher provisioning. Going forward, the bank would be focusing on MSME lending, inclusive banking, loan against property, unsecured business loans, supply chain finance, digital finance and working capital loans. BharatPe is also expected to play a transactional role in Unity SFB, which would help it scale up its loans and deposits.

As a sizeable portion of Unity SFB's portfolio comprises microfinance loans, the portfolio remains vulnerable to asset quality shocks as witnessed after demonetisation and during the Covid-19 pandemic. The microfinance industry is prone to socio-political, climatic and operational risks, which could negatively impact the bank's operations and its financial position. Moreover, risks associated with other segments, such as unsecured business loans, digital finance, etc, are relatively higher, given the marginal profile of the borrowers with limited ability to absorb income shocks. Unity SFB's ability to onboard borrowers with a good credit history, while scaling up its operations, would be key for managing high growth rates.

Profitability expected to remain sub-optimal in the near to medium term – Despite its low-cost restructured liabilities, the operating profitability remained sub-optimal at 1.97% of average total assets (ATA), partly due to the higher cost of incremental deposits and the elevated operating expenses incurred to revamp and scale up the branch network. Further, credit costs stood at 1.26% of ATA in FY2023 due to the higher provisioning on account of the management overlays in PMC Bank's legacy portfolio. Accordingly, Unity SFB reported a return on assets (RoA) of 0.35% in FY2023, before the impact of fair value charges of liabilities of erstwhile PMC Bank. In addition to the muted net profitability levels, the fair value charges on restructured liabilities, which are charged directly to the reserves, are expected to limit meaningful capital accretion in the medium term.

Unity SFB reported a net profit of Rs. 35 crore in FY2023, before fair value charges of Rs. 249 crore, leading to a net adverse impact of Rs. 214 crore on the net worth, against a charge of Rs. 150 crore to reserves in FY2022. The annual fair value charge to the net worth is expected to remain at a similar level of Rs. 250-280 crore in the coming years and the ability to generate sufficient profitability through core operations will be key for offsetting the impact of these charges on the net worth and to support future growth. Going forward, the bank's ability to improve its profitability levels would also depend on the scale-up of the loan book and the ability to raise deposits at competitive rates, thereby improving its operating profitability, while keeping slippages and credit costs at lower levels. This would remain a monitorable.

Critical to sustain granular deposit base growth and maintain improvement in liability profile – Unity SFB started its operations from November 1, 2021 and had 123 branches and 212 offices as on March 31, 2023. The bank witnessed meaningful traction in deposits in H2 FY2023, but on a relatively small base, with the same growing by 68% to Rs. 2,685 crore as on March 31, 2023. In the next three years, the management aims to increase the number of branches to 300, while adding a substantial number of touchpoints. To improve deposit traction, its interest rate proposition remains attractive for depositors, which could support its ability to build a granular current and savings account (CASA) base and retail fixed deposits. However, its ability to gradually improve the competitiveness of its funding would be critical for a sustained increase in its operating profitability and would thus remain important from a credit perspective.

Liquidity position: Strong

The depositor's settlement plan for erstwhile PMC Bank's liabilities has staggered the liabilities over a 10-year period, which supports Unity SFB's asset-liability management (ALM) profile to some extent. As per the scheme of amalgamation released by the RBI, deposits up to Rs. 5 lakh would be paid upfront to all eligible depositors and will be funded through the proceeds from Deposit Insurance and Credit Guarantee Corporation (DICGC). The bank received funds, aggregating Rs. 3,830 crore, from DICGC. This was settled with PMC Bank's depositors in FY2023, while the first tranche of subsequent payments to retail depositors, aggregating Rs. 148 crore, has also been paid out. The payout to DICGC is to be made over a 20-year period. This long maturity profile gives Unity SFB the flexibility to plan and phase the payments as per cash accruals.

Supported by the restructured longer-term liabilities, the bank's average liquidity coverage ratio for Q4 FY2023 was high at 767%, with statutory liquidity ratio (SLR) investments of Rs. 1,437 crore and non-SLR investments of Rs. 998 crore. Its structural liquidity statement (SLS), as on March 31, 2023, did not have negative cumulative mismatches in any bucket for up to one year. With growth in the loan book and deposits, the share of these long-term liabilities in the overall liability mix will keep declining. Hence, Unity SFB's ability to maintain high granularity and renewal rates for new deposits will be critical for its liquidity profile.

Rating sensitivities

Positive factors – ICRA could revise the outlook to Positive or upgrade the long-term rating if Unity SFB is able to sustain the build-up of the granular liability franchise while improving its funding cost and profitability. Diversifying the asset mix, while scaling up and maintaining the asset quality, and maintaining a prudent capitalisation profile will remain imperative.

Negative factors – The bank's ratings could be downgraded on account of a longer-than-expected path to generate meaningful growth capital, leading to pressure on the capitalisation profile. The weakening of the liquidity profile could also exert pressure on the ratings.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	[ICRA's Rating Methodology for Banks and Financial Institutions](#) [Policy on Withdrawal of Credit Ratings](#)
Parent/Group support	Not applicable
Consolidation/Standalone	Standalone

About the company

Unity SFB is the 12th small finance bank (SFB) in India, promoted by the consortium of Centrum Group and Resilient Innovations Private Limited. The RBI granted in-principle approval to CFSL, to set up an SFB under the general guidelines for the on-tap licensing of SFBs in the private sector, as a part of the revival/reconstruction of PMC Bank in June 2021. The licence to set up the SFB was issued in October 2021.

BharatPe acquired a 49% stake in Unity SFB while CFSL holds 51%. Further, as a part of this transaction, the entire business (assets and liabilities) of CFSL and CML was transferred to Unity SFB via a slump sale. CFSL serves as the holding company for Unity SFB with no other operations. Currently, Unity SFB primarily has the existing small and medium-sized enterprise (SME)/MSME/supply chain/microfinance asset base of CFSL and CML and receives digital platform and technology support from BharatPe. Unity SFB commenced active operations from November 1, 2021 with an upfront equity base of Rs. 1,105 crore. As the second leg of this transaction, PMC Bank was amalgamated with Unity SFB in accordance with the RBI's scheme for the recovery/resolution of the same. This was completed on January 24, 2022.

Key financial indicators (standalone)

	FY2022	FY2023
Net interest income	47	560
Profit before tax	-157	13*
Profit after tax	-150	35*
Net advances	2,419	4,468
Total assets	10,811	8,761
CET I	38.77%	27.16%
Tier I	38.77%	27.16%
CRAR	63.71%	48.99%
Net interest margin / ATA	1.05%	5.72%
PAT / ATA	-3.32%	0.35%
Return on average net worth	-18.66%	1.89%
Gross NPA %	62.9%	45.8%
Net NPA %	8.2%	0.3%
Provision coverage excl. technical write-offs	94.78%	99.59%
Net NPA / Core equity capital	13.35%	1.20%

*Source: Unity SFB, ICRA Research; All ratios as per ICRA's calculations; Amount in Rs. crore; * Before fair value charges of Rs. 249 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 Jul 17, 2023 (Rs. crore)	Date & Rating in FY2024	Date & Rating in FY2023			Date & Rating in FY2022			Date & Rating in FY2021
					Aug 02, 2023	Dec 08, 2022	Sep 09, 2022	Aug 05, 2022	Dec 29, 2021	Dec 17, 2021	Dec 14, 2021	-
1	Issuer rating	Long term	-	-	[ICRA]A-(Stable)	[ICRA]A-(Stable)	[ICRA]A-(Stable)	[ICRA]A-(Stable)	[ICRA]A- &	-	-	-
2	Non-convertible debenture	Long term	10.00	-	[ICRA]A-(Stable); withdrawn	[ICRA]A-(Stable)	[ICRA]A-(Stable)	[ICRA]A-(Stable)	[ICRA]A- &	[ICRA]A- &	[ICRA]A- &	-
3	Bank facilities (LT/ ST – Fund based)	Long/Short term	37.09	37.09	[ICRA]A-(Stable)/ [ICRA]A1; withdrawn$	[ICRA]A-(Stable)/ [ICRA]A1	[ICRA]A-(Stable)/ [ICRA]A1	[ICRA]A-(Stable)/ [ICRA]A1	[ICRA]A- &/ [ICRA]A1 &	-	-	-
4	Bank facilities (LT/ ST – Fund based)	Long/Short term	96.01	-	[ICRA]A-(Stable)/ [ICRA]A1; withdrawn	[ICRA]A-(Stable)/ [ICRA]A1	[ICRA]A-(Stable)/ [ICRA]A1	[ICRA]A-(Stable)/ [ICRA]A1	[ICRA]A- &/ [ICRA]A1 &	-	-	-
5	Certificate of deposit	Short term	25.00	-	[ICRA]A1; withdrawn	[ICRA]A1	[ICRA]A1	[ICRA]A1	[ICRA]A1 &	[ICRA]A1&	[ICRA]A1&	-
6	Commercial paper programme	Short term	-	-	-	-	-	-	[ICRA]A1+ (CE); withdrawn	[ICRA]A1+(CE)	-	-

& - Under Rating Watch with Developing Implications; $ Short term rating has been reaffirmed and withdrawn

Complexity level of the rated instruments

Instrument	Complexity Indicator
Certificate of deposit	Very Simple
Non-convertible debenture	Simple
Bank facilities (LT/ST – Fund based)	Simple
Issuer rating	Not Applicable

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
Not issued	**Certificate of deposit**	NA	NA	NA	25.00	[ICRA]A1; withdrawn
INE0J1607016	**NCD**	Jun 29, 2020	10.60%	Jun 29, 2023	10.00	[ICRA]A- (Stable); withdrawn
-	**Bank facilities (LT/ST – Fund based)**	-	-	-	37.09	[ICRA]A- (Stable)/ [ICRA]A1 withdrawn$
-	**Bank facilities (LT/ST – Fund based)**	-	-	-	96.01	[ICRA]A- (Stable)/[ICRA]A1; withdrawn
-	**Issuer rating**	-	-	-	-	[ICRA]A- (Stable)

Source: Unity SFB; NA – Not applicable; $ Short term rating has been reaffirmed and withdrawn

Please click here to view details of lender-wise facilities rated by ICRA

Annexure II: 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.

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