

India Ratings Places Sonata Finance's NCDs on Rating Watch with Positive Implications

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India Ratings and Research (Ind-Ra) has taken the following rating actions on Sonata Finance Private Limited's (Sonata) debt instruments:

Instrument Type	Date of Issuance	Coupon Rate	Maturity Date	Size of Issue (million)	Rating/Rating Watch	Rating Action
Non-convertible debentures (NCDs) [^]	-	-	-	INR2,000	IND BBB+/Rating Watch with Positive Implications	Placed on Rating Watch with Positive Implications
NCDs [#]	-	-	-	INR1,150	IND BBB+/Rating Watch with Positive Implications	Placed on Rating Watch with Positive Implications
Long-term bank loan				INR2,000	IND BBB+/Rating Watch with Positive Implications	Placed on Rating Watch with Positive Implications

[^] To be issued

[#] Details in Annexure

On 10 February 2023, Sonata entered into share purchase agreements with Kotak Mahindra Bank Limited ('[IND AAA/Stable](#)'; the bank), under which the bank will acquire 100% of the issued and paid-up capital of Sonata for INR5.37 billion. The transaction has been approved by the company's board of directors and has received necessary consent from its investors. The transaction is subject to the receipt of requisite regulatory approvals, including that of the Reserve Bank Of India.

The rating action factors in the likely improvement in the credit profile of Sonata, given the likely support it would receive from a strong parent like Kotak Mahindra Bank post completion of the acquisition.

Ind-Ra believes there are many steps and developments that might potentially need to be considered and approved by regulators before the acquisition comes into effect. The rating watch will be resolved once there is adequate progress on the receipt of requisite approvals for the acquisition.

Key Rating Drivers

Successful Completion of Acquisition to Support Business Growth: Ind-Ra believes the equity infusion is essential for the company to meet its near-to-medium term growth objectives while preserving its capital buffers. If the acquisition is successfully completed, Sonata might be able to operate at the existing high leverage levels, given the support of a strong parent while maintaining business growth. The adjusted leverage ratio (debt/tangible equity) increased to 5.58x at 9MFYE23 (FYE22: 4.98x, FYE21: 4.64x) on account of a 14% growth in the loan book to INR15.4 billion. The reported leverage (debt/reported equity) was 4.98x at FYE22 (FYE21: 4.64x).

Sonata's shareholding is diversified, with promotor shareholding at 7.1% at 9MFYE23. Its primary investors include global social and impact-investing entities such as Creation Investment Social Venture Funds (9MFY23: 27.95% stake), Societe De Promotion Et De Participation Pour La Cooperation Economique (15.03%), and Triodos Investment Management (15.03%). The company raised an equity capital of INR1.05 billion over FY15-FY22; this, along with internal accruals, led to a tangible net worth of INR2.98 billion at 9MFYE23 (FYE22: 2.78 billion, FYE21: INR2.55 billion, FYE20: INR2.43 billion).

Long Track Record with Experienced Management: Established in 2006, Sonata has been operational for 17 years in microfinance lending and seen various cycles and multiple credit events. The company is promoted by Anup Kumar Singh (managing director and chief executive officer), who has over two decades of experience in the microfinance industry. Prior to Sonata, he was with CASHPOR Micro Credit for eight years. Moreover, Sonata has seen a limited churn in its senior management and most of them have seen the company navigate through major credit events such as demonetisation and the COVID-19 outbreak. This could be especially useful because of its exposure to the western part of Uttar Pradesh (UP), where the credit discipline of borrowers is believed to be weaker than that in the rest of the state. While all the senior management positions, such as the chief risk officer, have not been filled formally yet, there is a group of advisors consisting of senior ex-bankers that advises Sonata on a range of matters on a full-time basis. The board has three independent directors, one executive director, and four non-executive directors. The chairman of the board is an independent director. The five non-executive directors are nominated by various social and impact investing funds with shareholding in Sonata.

Modest Profitability; Improvement Likely over Medium Term: Based on its learnings from demonetisation, which had impacted its profitability, Sonata had created incremental provisions on account of COVID-19 in FY20. The company's provisions amounted to INR499 million at 9MFYE23 (FYE22: INR572 million; FYE21: INR669 million, FYE20: INR606 million). The return on assets (RoA; 9MFY23: 1.26% (annualised); FY22: 0.9%, FY21: 0.3%, FY20: 1%) has remained moderate on account of higher credit cost (a percentage of loan assets) from the COVID-19 related provisions (3.23% (not annualised), 3.4%, 2.5%, 7.2%), of which INR499 million was unutilised at 9MFYE23. The RoA improved in 9MFY23 due to an increase in the yield on average loan assets (9MFY23: 23.25%, FY22: 20.2%, FY21: 19.5%) and a stabilisation in the cost of borrowings (9MFY23: 11.62%, FY22: 11.4%). The operating expense (opex to loan assets; 9MFY23: 8.6%, FY22: 7.8%, FY21: 6.6%) has increased on account of incremental branch addition.

Sonata holds adequate provisions, and the need for incremental credit cost is low in the event of moderate incremental stress. Furthermore, the increase in yields due to the easing of pricing restriction will improve the RoA and support its pre-provisioning operating profit to credit cost buffers (9MFY23: 1.3x, FYE22: 1.4x, FYE21: 1.2x).

Diversified Funding Sources: Sonata borrows from around 42 lenders/investors, with term loans from banks comprising 43% of the borrowings at 9MFYE23; 23% is through NCDs, 2% is through direct assignments, 13% is through external commercial borrowings, 18% business correspondents and 1% is sub-debt. Sonata was able to raise INR6.4 billion and INR9.1 billion in FY21 and FY22, respectively, when the impact of pandemic was at its peak and many mid- and small-sized microfinance institutions (MFIs) had found it difficult to raise funds. This is because of its diversity in lenders and vintage of its relationships with them. The company raised funding of INR9.64 billion in 9MFY23. Sonata also taps off-balance sheet funding through direct assignments and securitisation, which further supports its liquidity and bolsters funding diversity. The direct assignments and passthrough certificates transactions typically account for 3%-5% of the

overall gross loan portfolio.

Liquidity Profile - Adequate: As per Sonata's asset liability statement at 9MFY23, the cumulative inflow exceeded the cumulative outflows in the up-to-one-year bucket by 42%. As on 31 December 2022, the company had a cash bank balance of INR4.08 billion, which is adequate to meet three months debt obligations of INR3.05 billion, assuming nil collections and disbursements. As a practice, Sonata maintains on-balance sheet liquidity to cover at least three months of debt servicing.

Asset Quality Monitorable: In line with the industry, Sonata's asset quality also deteriorated over FY21-FY22, due to the elongated impact of the COVID-19 pandemic on borrowers' cash flows. The company's gross non-performing assets stood at 3.2% at 9MFY23 (FY22: 4.7%, FYE21: 6.2%; FYE20: 1.0%). The company maintained a healthy provision coverage of 77.75% in 9MFY23 (FY22: 71%, FY21: 72%). This, in the agency's opinion, is adequate, based on the recovery expectation from the delinquent portfolio. Furthermore, the company's collections, which had been impacted by the second wave of COVID-19, have recovered and stabilised (December 2022: 99.6%, March 2022: 99.7%; February 2022: 99.7%; January 2022: 99.1%; June 2021: 88.1%). In 9MFY23, the collections in the restructured book (December 2022 outstanding: INR154 million) remained low at 72%, in line with Ind-Ra's expectations, resulting in continued elevated credit costs. With stability in collections, healthy provisions and higher yield on assets, Ind-Ra believes the asset quality impact on credit cost for FY24 will be manageable.

Improving Outlook on MFIs: Ind-Ra revised its outlook on the microfinance sector to improving for FY24 from neutral while maintaining the rating outlook at Stable. The agency has maintained that the new regulations are positive for the sector and provide all microfinance practitioners with the ability to price in risks while providing a level playing field for non-bank financial companies-MFIs in terms of applicable regulations. However, the agency also expects the impact of elections in key states in FY24 on the sector to be a key monitorable. Also, there is increasing exposure per borrower in an inflationary environment with a possibly non-commensurate increase in income levels and this aspect would also be a key monitorable.

Rating Sensitivities

The Rating Watch with Positive Implications indicates that the ratings may either be upgraded or affirmed upon completion of the acquisition. The agency will continue to monitor the steps and developments, and necessary approvals pertaining to the acquisition. The agency expects that rating could be upgraded multi-notch, if the contour of the transaction is in line with the agency's expectations.

ESG Issues

ESG Factors Minimally Relevant to Rating: Unless otherwise disclosed in this section, the ESG issues are credit neutral or have only a minimal credit impact on Sonata, due to either their nature or the way in which they are being managed by the entity. For more information on Ind-Ra's ESG Relevance Disclosures, please click [here](#). For answers to frequently asked questions regarding ESG Relevance Disclosures and their impact on ratings, please click [here](#).

Company Profile

Sonata was incorporated under the Companies Act, 1956 and registered as non-deposit taking non-bank MFI with the Reserve Bank of India to carry on the microfinance business. Established in January 2006, the company is engaged in financial inclusion and economic empowerment of women and underprivileged sections of the society. Sonata is backed by global social and impact-investing funds. The company provides loans to joint liability groups as well as individuals for a range of income-generating activities. It caters to more than 822,916 clients mostly in

rural and semi-urban areas. It operates in the northern part of the country, with operations across 147 districts in ten states, namely Uttar Pradesh, Madhya Pradesh, Jharkhand, Maharashtra, Uttarakhand, Punjab, Haryana, Bihar, Rajasthan and Chhattisgarh.

FINANCIAL SUMMARY

Particulars (INR million)	FY22	FY21
Total tangible assets	16,985.0	14,930.5
Total tangible networkth	2,782.7	2,545.5
Net profit	136.2	43.8
Return on average assets (%)	0.85	0.29
Tangible equity / Tangible assets (%)	16.38	17.05
Source: Sonata, Ind-Ra adjustments		

Solicitation Disclosures

Additional information is available at www.indiaratings.co.in. The ratings above were solicited by, or on behalf of, the issuer, and therefore, India Ratings has been compensated for the provision of the ratings.

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Rating History

Instrument Type	Current Rating/Rating Watch			Historical Rating/Outlook		
	Rating Type	Rated Limits (million)	Rating	23 June 2022	16 December 2021	
NCDs	Long-term	INR3,150	IND BBB+/Rating Watch with Positive Implications	IND BBB+/Stable	IND BBB+/Stable	BI
Bank loans	Long-term	INR2,000	IND BBB+/Rating Watch with Positive Implications	IND BBB+/Stable	IND BBB+/Stable	BI

Annexure

ISIN	Instrument	Date of Issue	Coupon Rate	Maturity Date	Issue Size (million)	Rating/Rating Watch
INE509M07295	NCD	10 December 2021	11.77%	10 December 2026	INR400	IND BBB+/Rating Watch with Positive Implications
INE509M07303	NCD	23 December 2021	12.30%	23 December 2024	INR750	IND BBB+/Rating Watch with Positive Implications
	Total Unutilised				INR2,000	IND BBB+/Rating Watch with Positive Implications

	Total				INR3,150	
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Bank wise Facilities Details

[Click here to see the details](#)

Complexity Level of Instruments

Instrument Type	Complexity Indicator
NCDs	Low
Long-term bank loans	Low

For details on the complexity level of the instruments, please visit <https://www.indiaratings.co.in/complexity-indicators>.

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APPLICABLE CRITERIA

Financial Institutions Rating Criteria

Non-Bank Finance Companies Criteria

Evaluating Corporate Governance

The Rating Process

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