# NBFC-Retail Credit Trends

## Access to commensurate funding key for growth; risk profile supported by improved asset quality and adequate capital

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Karthik Srinivasan
+91 22 61143444
karthiks@icraindia.com

A M Karthik
+91 44 45964308
a.karthik@icraindia.com

R Srinivasan
+91 44 45964315
r.srinivasan@icraindia.com

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# NBFC-RETAIL OUTLOOK – STABLE

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*Asset quality improved sharply in Q4 FY2022, but headwinds remain in view of inflationary pressure impacting borrower cash flows and performance of the restructured book*

*Margin pressure, with the increase in the cost of funds, could be offset by relatively lower credit costs, thereby resulting in net profitability similar to the last fiscal*

*Liquidity and capital remain adequate*

**The assets under management (AUM) of non-banking financial companies-Retail (NBFC-Retail; excluding housing finance companies or HFCs) grew 8.5% year-on-year (YoY) in FY2022, which was higher than expected and largely driven by the strong growth witnessed in the last two quarters. The segments that drove growth in the last fiscal, namely microfinance and personal credit[1], are expected to be the key growth drivers in the current fiscal as well, while the other key segments, i.e. vehicle finance and business loans, would witness some revival in their performance compared to the last two fiscals. The NBFC-Retail AUM growth is estimated at 9-11% for FY2023.**

**The asset quality improved sharply in Q4 FY2022 supported by healthy collections, which improved with the tightening of the collections processes by entities in view of the stringent Income Recognition, Asset Classification and Provision (IRAC) norms applicable from October 2022 onwards. The impact on borrower cashflows and the performance of the restructured book, considering the high inflationary and subdued macroeconomic/operating environment, are monitorable. However, comfort can be drawn by the provisions maintained by the entities, which remain reasonably higher than the pre-Covid levels, with the headline asset quality numbers nearing the pre-Covid levels.**

**The pressure on margins given the increasing cost of funds, could be partially offset by the likely moderation in the credit cost, thus resulting in the net profitability being similar to the last fiscal. Access to commensurate funding would be key for AUM growth, which can provide upside to the estimated range. Entities continue to maintain adequate liquidity while capitalisation is expected to remain comfortable in relation to the growth expectations for FY2023. The outlook on the sector remains Stable.**

- **AUM growth expected to improve to 9-11% in FY2023:** NBFC-Retail AUM growth revived as disbursements picked up in Q2 FY2022 and the uptrend continued for the rest of the last financial year. Muted disbursements and the rundown in the existing portfolio due to repayments had led to a relatively sharper YoY fall in the AUM in Q1 FY2022. Collections in Q1 FY2022 were relatively less impacted vis-à-vis Q1 FY2021 when borrowers also had the option of availing a moratorium. As disbursements picked up from Q2, supported to an extent by pent-up demand, the AUM grew by 2-4% each quarter, improving on a quarter-on-quarter (QoQ) basis. ICRA estimates the AUM growth for the sector to have been at 8.5% for FY2022 vis-à-vis our previous expectation of 5-7%. We expect the growth to improve to 9-11% in FY2023 on the back of two years of low growth, assuming there are no further disruptions that would impact businesses.

  The AUM growth in FY2022 was largely driven by the unsecured personal credit segment, while gold loans and tractor loans grew at a higher pace than the overall industry average. The microfinance segment (including NBFC-MFI[2] and microfinance book of other NBFCs) grew by about 13% while the personal credit segment (unsecured personal loans, education loans, consumer loans, etc) grew by about 31%. The gold and tractor segments grew by about 9-10% during the year. The key vehicle segments (CV/PV/2W[3]) continued to face

*[1] Personal credit – Unsecured personal loans, consumer loans, education loans, etc*
*[2] NBFC-MFI – NBFC- microfinance institution*
*[3] CV – Commercial vehicle, PV – Passenger vehicle, 2W – Two-wheelers*

pressure, in line with the fall in the sales volume in view of the Covid-19 pandemic. Growth in FY2023 is also expected to be driven by the unsecured personal credit and rural credit as growth in the vehicle finance segment is expected to remain moderate vis-à-vis the pre-Covid level.

- **Asset quality improved sharply in Q4 FY2022, but headwinds remain:** The overdues moderated sharply in Q4 as the impact of the Omicron variant of Covid-19 was minimal, slippage from the restructured book was lower than expected, and entities augmented their collections in view of the tighter IRAC norms, which are applicable from October 2022. NBFC write-offs remained elevated and marginally higher than the last fiscal. Overdues had increased significantly, by about 150 basis points (bps), in Q1 FY2022, the sharpest in the recent past. While the overall overdues were expected to reduce steadily from the June 2021 level, RBI's November 12, 2021 circular and the consequent alignment of gross stage 3 (GS3) reporting, in line with this circular, by many entities led to a stable headline asset quality number between September 2021 and December 2021. The RBI, vide its circular of February 15, 2022, provided some relaxation to the implementation of the tightened IRAC norms. However, as expected, most of the entities which had already aligned their GS3 reporting with the tighter IRAC norms *(entities can continue reporting GS3 as per IndAS, i.e. 90 days past due (dpd) basis, and non-performing advances (NPAs) as per IRAC, if they choose to)* continued to focus on collections and did not avail the deferment provided by the RBI. Higher focus on collecting from the 30-90 overdue bucket, vis-à-vis the 60-90/90+ bucket in the past, supported the asset quality.

  Slippages from the restructured book were lower than expected in H2FY2022, which also contributed favourably to the asset quality performance. The standard restructured books of NBFCs stood at 2.7-3.0%, as of March 2022, down from the peak of 4.5% in September 2021. The asset quality performance in general and, the restructured book in particular, would remain a monitorable, considering the weakening macroeconomic/operating environment and the balloon repayment schedule of some of the restructured loans. The impact of the high inflationary pressures on the borrower-level cashflows remains to be seen, which would be another factor affecting the asset quality. However, comfort can be drawn from the provisions maintained by the entities, which remain reasonably higher than the pre-Covid levels, even with the headline asset quality numbers approaching pre-Covid levels.

- **Margin pressure expected; net earnings likely to remain similar to the last fiscal:** The profitability of the players during the pandemic was supported by the favourable cost of funds, even though they faced a growth slowdown, had higher on-balance sheet (on-B/s) liquidity leading to negative carry, built up their provisions in view of the uncertainties around the pandemic and undertook sizeable write-offs. While the asset quality related headwinds waned to some extent, entities are currently facing an increase in their borrowing rates. NBFCs have higher flexibility in terms of their products and target segments (secured/unsecured; salaried/self-employed; high ticket/low ticket; used vehicle/new vehicle, etc) and are therefore better positioned to pass-on their rate hikes to their borrowers incrementally. However, as their existing loan books typically comprise fixed rate loans, pressure on the margins is expected in the near term. ICRA expects the NBFC margins to be impacted by 50-70 bps in the current fiscal. Nevertheless, lower credit costs could offset the impact and result in the net profitability (return on average assets; RoMA) remaining similar to the last fiscal; this would, however, be lower than our previous expectation, which was modelled on a more gradual increase in the cost of funds.

- **Adequate capital and liquidity profile:** The capital profile of NBFC-Retail has improved consistently over the last 2+ years as growth slowed down (around 5% in FY2021 and 8.5% in FY2022) but the return on capital was higher (10-11%). Further, some entities raised capital over the last two years in view of the pandemic-related uncertainties. The capital profile of this segment is currently adequate, considering the growth outlook, and ICRA does not expect significant capital requirement for the segment over the near term. Entities continue to maintain a liquidity buffer (on-B/S + sanctioned credit lines) adequately covering the repayments for the next three months. As the operating environment stabilises, the entities may choose to reduce their on-B/S liquidity.

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## Business Contacts


Mr. L. Shivakumar
E-mail: shivakumar@icraindia.com
+91 22 6114 3406 / +91 98210 86490

Mr. Jayanta Chatterjee
E-mail: Jayantac@icraindia.com
Tel: +91 80 4332 6401/ +91 98450 22459


## Media and Public Relations


Ms. Naznin Prodhani
E-mail: Communications@icraindia.com
Tel: +91 124 4545 860


### Registered Office

B-710, Statesman House 148,
Barakhamba Road
New Delhi-110001
Tel: +91 11 23357940-45

### Corporate Office

Building No. 8, 2nd Floor,
Tower A, DLF Cyber City, Phase II,
Gurgaon - 122 002
Tel: +91-124-4545300

### Ahmedabad

1809-1811, Shapath V,
Opp: Karnavati Club,
S.G.Highway, Ahmedabad - 380015
Tel: +91 79 4027 1500/501

### Bengaluru 1

'The Millenia', Tower B Unit No. 1004,
10th Floor, 1 & 2 Murphy Road,
Bengaluru - 560 008
Tel: +91 80 4332 6400

### Bengaluru 2

2nd Floor, Vayudooth Chamber
15-16, Trinity Circle, M.G. Road,
Bengaluru - 560 001
Tel: +91 80 4922 5500

### Chennai

5th Floor, Karumuttu Centre
634, Anna Salai, Nandanam
Chennai - 600 035
Tel: +91 44 4596 4300

### Hyderabad 1

4th Floor, 'Shoban'
6-3-927/A&B. Somajiguda
Raj Bhavan Road,
Hyderabad - 500 082
Tel: +91 40 4067 6500

### Hyderabad 2

No. 7-1-58, 301, 3rd Floor, 'Concourse',
Above SBI-HPS Branch, Ameerpet,
Hyderabad - 500 016
Tel: +91 40 4920 0200

### Kolkata

A-10 & 11, 3rd Floor,
FMC Fortuna 234/3A,
A.J.C. Bose Road,
Kolkata -700 020
Tel: +91 33 7150 1100/01

### Mumbai

3rd Floor, Electric Mansion
Appasaheb Marathe Marg,
Prabhadevi,
Mumbai - 400 025
Tel: +91 22 6169 3300

### Pune

5A, 5th Floor, Symphony, S. No. 210
CTS 3202 Range Hills Road,
Shivajinagar, Pune - 411 020
Tel: +91 20 2556 1194

**Email:** Info@icraindia.com
**Helpdesk:** 9354738909
**Website:** www.icra.in/ www.Icraresearch.in