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Non-Banking Financial Companies

SME Finance: Smaller players confront loan quality and earnings headwinds along with mounting competitive pressures

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Highlights

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Smaller NBFCs in SME financing face growth and asset quality headwinds in the near term.

Earnings performance of these players shall remain under pressure from margin compression and elevated credit cost in the near term.

Capital and liquidity profiles remain adequate and are the key factors bolstering their risk profiles.

SME credit* constitutes about 7% of the retail non-banking finance company (NBFC) loan book as of September 2024. Over the last six years (FY2019-FY2024), this segment grew at a CAGR of ~17%, higher than the 14% overall NBFC retail loan book growth. Healthy demand, access to better borrower information and seasoning, and scale-up by new entrants in this space have been the key growth drivers in the past.

In view of better business yields and competitive pressure from banks, large NBFCs are steadily increasing exposure to the lower ticket loans, which have been the focus segment of smaller players^ in the past. After registering a steady increase in their share over the last six years, the share of smaller players in the NBFC SME finance space dipped in H1 FY2025.

Smaller entities witnessed an uptick in their Gross Stage (GS) 3, with collections getting impacted in FY2025 because of the loan quality issues in the unsecured/consumption loan segment and slowdown in incremental credit to NBFCs in general. Entities, therefore, have tightened their credit policies during 9M FY2025.

ICRA expects NBFC SME loans to expand at 22-24% in the near term (FY2025-FY2026) vis-a-vis the 38% growth seen in FY2024. Smaller entities expanded at a much higher pace in the recent past. However, faced with elevated asset quality stress and their tightened policies, they are projected to register slower growth in the current fiscal vis-à-vis their past trends and expand close to overall segmental growth rates in the next fiscal.

Smaller players, considering their target risk profiles, would have a steady state credit loss of close to 4-6% in their SME loans. Entities have taken cover under the credit guarantee schemes – CGTMSE[1] and CGFMU[2] - in view of the credit risk in the segment; however, portfolio coverage is quite moderate at present.

Low provision cover in smaller entities vis-à-vis their past loan losses, coupled with the rise in loan quality risk is likely to impact their earnings performance. Further, regulatory actions, in general, on the NBFC sector, would limit their ability to adequately price their risk when competitive pressures from larger players are on the rise.

Earnings of smaller players are expected to remain under pressure in the near term, in view of the elevated credit cost, operating cost and, expected margin compression. Liquidity and capital, however, remain adequate, which support their risk profiles.

**SME Credit- Unsecured and quasi-secured loans (machinery, stock, etc.) offered to enterprises and individuals for business purposes*
^ Entities with overall Asset under management (AUM) of less than Rs.100 Billion ; 1 - CGTSME- Credit Guarantee Fund Trust for Micro and Small Enterprise; 2- CGFMU-Credit Guarantee Fund for Micro Units

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