ICRA

Medium & Small Non-Banking Financial Companies

Slowdown in credit growth as asset quality concerns emerge

November 2024

Highlights

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AUM growth of M&S NBFC expected to moderate to 18-20% in FY2025.

Asset quality expected to be under pressure in the near term, especially in the unsecured segments, viz., MFI, SME and PL/CL.

This report assesses the performance of medium and small (M&S) non-banking financial company (NBFC), defined as entities[1] with assets under management (AUM) of less than Rs. 150 bn as of March 2024.

M&S NBFCs constituted about 16% of the overall NBFC (excluding infrastructure financiers) AUM as of March 2024, up from about 14% as of March 2023. In this note, their performance is being assessed in relation to other larger NBFCs[2], which constituted about 83% of the industry AUM.

These NBFCs have grown at a faster pace (5-year CAGR of 28%) compared to other larger NBFCs (5-year CAGR of 11%), given their smaller base and larger share of presence in high growth segments, viz., affordable housing, microfinance, secured business loans (LAP), and other unsecured business (SME) and personal/consumption (PL/CL) loans

AUM growth of M&S NBFCs is expected to slow down to about 18-20% in FY2025 (vis-à-vis 37% in FY2024) on the back of headwinds on asset quality, funding and regulatory tightening. Especially, growth in unsecured segments is expected to be impacted more than the secured segments.

Gross stage 3 (GS3) of M&S NBFCs entities have steadily declined and stood low in relation to the recent times; GS3 of M&S NBFCs have typically been in line with those of their larger peers. M&S entities are expected to face asset quality pressures in the near term, on the back of seasoning impact and specific issues in certain asset segments such as MFIs, PL/CL, etc.

Given that the loan provisions had been drawn down steadily since the pandemic, entities may require increased provisioning, which would result in higher credit costs in the near term.

[1]*based on ICRA sample of 117 M&S NBFCs which are largely constituted by entities rated AA- or lower*
[2]*based on ICRA sample of 40 large NBFCs*
CAGR- Cumulative Annual Growth Rate

Highlights

Overall profitability of M&S NBFCs to remain healthy at 1.9-2.1% in FY2025, notwithstanding the decline vis-à-vis the previous year.

Some entities in unsecured segments, viz., MFI, SME and PL/CL would require capital raises in the near term to shore up their solvency.

M&S NBFCs are likely to witness a decline in margins by 50-70 bps overall in FY2025, though it may be skewed more towards the unsecured segments, which have higher business yields. The entities are under pressure to cut lending rates, given the regulator nudge against 'usurious' lending rates. Cost of funds may also increase by 30-50 bps in FY2025, given the tight funding conditions.

As M&S NBFCs face margin contraction and increased credit & provision costs in unsecured and MFIs in the near term, the net profitability is expected to reduce to 1.9-2.1% in FY2025 from the 2.7% witnessed in FY2024. Notwithstanding the reduction, the profitability would remain at healthy levels. Upfront income on account of securitisation and co-lending bolster earnings for entities in this space. Improving operating efficiencies going forward, will remain the key for steady state earnings.

The capital position of M&S NBFCs remains adequate in the near term. While growth is expected to moderate in the near term, some entities in segments which come under asset quality pressures, viz, MFI, SME and PL/CL would require capital raises to shore up their solvency position. Over the past few years, capitalisation was supported by regular and sizeable capital raises. Investors – both private equity (PE) participants and retail investors - viewed the segment favourably, with some entities witnessing majority stake purchase by PEs and some listing at the stock exchanges.

M&S NBFCs carry higher liquidity vis-à-vis their larger peers; however, entities have steadily moderated their on-b/s liquidity over the last few years as they emerged out of the pandemic. The tightening funding conditions over the last few quarters also added to the pressure on the on-b/s liquidity maintained by entities.

Incrementally, with the tightening of credit flows to NBFCs from the banking sector in FY2025, M&S NBFCs are expected to be disproportionately impacted vis-à-vis their larger peers. As a result, the reliance on other sources of funding, including NCDs, securitisation, ECBs, etc. would increase in the near term. Incrementally, co-lending could also become a key funding source over the near to medium term.

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Thank You!