ICRA

INDIAN MICROFINANCE SECTOR

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Good recovery though headwinds persist

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Executive Summary

HIGHLIGHTS

- Market size reaches Rs. 2.4 lakh crore; portfolio growth remained robust at 28% during the 12 months ended December 2018
- Geographical diversification improves; Bihar and Odisha fastest growing states in 9M FY2019
- Entity-level concentration of portfolio increases as smaller entities faced more challenges on fund raising, post the liquidity squeeze
- Ticket size growth outpaces client growth in 9M FY2019; significant increase in higher ticket-size loans
- Rising share of individual and consumption loans
- Asset quality and solvency improve, largely supported by write-offs; however, around 1.5% of the portfolio has remained in 0-90 dpd bucket
- Investors continued to support the industry with equity infusion of ~Rs. 4,350 crore in FY2019
- Liquidity position comfortable; MFI securitisation volumes picked up sharply in H2 FY2019
- Profitability improves, supported by lower credit costs

OVERVIEW

Despite the liquidity squeeze, post September 2018, which led to a dip in the growth of the non-banking financial company (NBFC) sector, portfolio growth for the microfinance sector saw a robust growth of 28% during the 12 months ended December 2018 (26% in FY2018), taking the overall market size (including the SHG Bank Linkage Programme*)* to Rs. 2.37 lakh crore as on December 31, 2018. While the overall pace of growth was good in 9M FY2019, a reversal in trend was observed with the growth in the ticket size outpacing the growth in the client base. While microfinance institutions (MFIs) continue to focus on expanding their reach and adding new clients, focus on client retention by offering higher ticket sizes and elimination of delinquent clients largely related to the demonetisation period has led to a moderate client growth for the sector. Further, since an individual may be the client of more than one MFI, the actual addition of new-to-credit clients could be even lower.

The geographical diversification has improved further in the industry at both the state and the district level. While Karnataka and Tamil Nadu remained the top two states (12.9% and 11.6% share in the industry, respectively), there has been an increased focus from the industry participants to expand their reach in the underpenetrated states of Bihar and Odisha. The asset quality indicators in these states remained benign even after demonetisation, and the share of these two states together increased to 19.5% as of December 2018 from 16.4% as of December 2017. However, some overcrowding was also observed in the district-level portfolio analysis with around 44 districts having more than 15 MFIs present in each district. Of these, 21 districts were in Bihar and Odisha.

The asset quality has improved with the 90+ dpd level declining to 3.9% in December 2018 from a peak of 11.6% in June 2017, supported by write-offs, some recoveries from delinquent contracts in affected areas, high portfolio growth, and robust collections in the portfolio originated post demonetisation (CY2017 onwards). However, excluding one large player with delinquencies that were significantly higher than that of the industry, the 90+ delinquencies were significantly lower at 1.4% as of December 2018 (peak of 7.6% as of June 2017). Also, around 1.5% of the portfolio has remained in the 0-90 dpd bucket for the past one year, much higher than what was seen before demonetisation. Some increase in the softer bucket delinquencies was also seen for MFIs with exposure to areas affected by the floods in Kerala and the Gaja cyclone in Tamil Nadu.

An analysis of the portfolio of the MFIs revealed that the ticket sizes and loan tenures are rising. Based on a portfolio-level study of over 35 MFIs and SFBs, around 12% of the portfolio was for ticket sizes greater than Rs. 40,000 as of December 2018. If we were to apply a factor here, assuming 30-40% of these borrowers had multiple loans, then around 5-6% of the portfolio could be at ticket sizes greater than Rs. 80,000 (higher than what is prescribed by the MFIN in the Mutually Agreed Code of Conduct (MACC)). Therefore, the risk of overleveraging has increased owing to the changing landscape of the sector with different types of participants, varying interpretation of RBI guidelines as well as some gaps in the credit bureau data.

While the growth prospects remain good and the industry is expected to grow at 20-22% in FY2020, MFIs need to conduct a more involved and thorough credit analysis/ assessment of the actual debt repayment capacity of the borrower. Further, the risk management policies of the lenders in the sector need to be aligned to ensure responsible and sustainable growth. On the positive side, the asset quality indicators should be supported by ensuring stringent group selection/elimination norms and adequate credit discipline at the borrower level by enforcing joint group liability (JGL), wherever applicable and required. Nevertheless, the segment shall always remain vulnerable to income shocks, political interference, and event risks. Accordingly, ICRA expects the credit costs for the sector to remain volatile with a mean level of 1.5-2.0% (annualised). The credit cost could vary among players and across cycles depending on the risk management practices and exposure to relatively overcrowded areas.

Investors continued to support the industry with equity infusion of ~Rs. 4,350 crore in FY2019 (~Rs. 4,100 crore in FY2018). However, more than 90% of the capital raised in FY2019 was by MFIs with assets under management (AUM) of more than Rs. 1,000 crore. This implies that larger entities have been able to attract capital while the smaller and less-diversified entities continue to struggle on this front. Given their growth targets of 25-30% p.a. over the next three years, in ICRA's opinion, MFIs and small finance banks (SFBs) together would need external capital of Rs. 3,500-4,700 crore during this period. There could also be a shift in the business model of the smaller MFIs, wherein these entities may originate more loans under the business correspondent (BC)/co-lending framework, as partners to large lenders, to conserve capital. Alternatively, there could be further consolidation in the industry with the smaller MFIs being acquired by larger NBFCs/banks.

The MFIs have been able to maintain a favourable asset liability maturity (ALM) profile, given the relatively short tenure of the advances. In addition to the capital flow, the liquidity profile is also supported by the priority sector benefit that the banks get for funding these entities, either through the on balance-sheet route or the off-balance sheet (largely assignments of microloans) route. However, MFIs with AUMs below Rs. 500 crore have faced challenges in raising funds (both equity capital and debt), as they are more dependent on larger NBFCs for funding, and these larger NBFCs had liquidity constraints of their own. In response to the liquidity squeeze, many of the smaller MFIs resorted to increased securitisation of their portfolios and further enhanced their BC relationships. However, incremental funding requirement for the MFIs is likely to remain a challenge, given the significant growth aspirations (and even for servicing the existing client requirements). At the same time, the cost of funds for the MFIs shall remain at elevated levels till the systemic liquidity improves.

At present, only a handful of lenders are offering microloans at an interest rate of less than 20% p.a. However, this is likely to change, going forward, as the market share of banks (including SFBs) in the sector goes up. As competition increases, the rate of interest could also be an important parameter for both client retention and mitigating the political risk. This underscores the need for MFIs to enhance their operating efficiencies for sustaining profitable growth in the long term. If the annualised credit costs remain at 1.5-2%, ICRA expects the sector to report a return on equity (RoE) of 13-15% in FY2020.

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- Provide intermediaries with a tool to improve efficiency in the funds raising process.

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