ICRA

NBFC-Retail Credit Trends

AUM growth of Retail-NBFCs set to improve to pre-pandemic levels; risk profile supported by improved asset quality and adequate capital

NOVEMBER 2022

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NBFC-RETAIL OUTLOOK – STABLE

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NBFC-Retail AUM growth estimated at 12-14% for FY2023; access to commensurate funding key for growth

The assets under management (AUM) of non-banking financial companies-Retail (NBFC-Retail; excluding housing finance companies or HFCs) grew at a healthy pace of 16.4% year-on-year (YoY) in Q1 FY2023, supported by demand spilling over from the previous quarter, i.e., Q4 FY2022. The healthy growth during Q1 FY2023 was also recorded on the back of a subdued performance witnessed in the first quarter of the previous year, given the severe impact of the second wave of the Covid-19 pandemic. With the demand scenario remaining favourable, ICRA expects the NBFC-Retail segment to achieve its best growth since the onset of the pandemic. Accordingly, ICRA has raised its AUM growth estimate for the NBFC-Retail segment to 12-14% for FY2023. The segments that drove growth in the last fiscal, namely microfinance and personal credit[1], are expected to remain the key growth drivers in the current fiscal as well, while the other key segments, i.e. vehicle finance and business loans, are expected to witness an improvement in their performance compared to the previous two fiscals.

The asset quality continued to improve in Q1 FY2023. This was supported by an improving operating environment for NBFCs and healthy collections, supported by the tightening of the collection processes by entities in view of the stringent Income Recognition, Asset Classification and Provision (IRAC) norms applicable from October 2022. However, some asset classes are expected to continue facing a divergence between the reported stage 3 numbers as per Ind-AS and the non-performing advances (NPAs) as per the revised IRAC norms.

The impact of the inflationary pressures on borrower cashflows, and consequently, the performance of the restructured book, would be monitorable. However, comfort can be drawn from the provisions maintained by the entities, which remain reasonably higher than the pre-Covid level, with the headline asset quality numbers declining to near pre-Covid levels.

The pressure on margins, given the increasing cost of funds, is expected to be more pronounced from H2 FY2023. However, this is expected to be largely 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 12-14% in FY2023:** NBFC-Retail AUM growth continued to be healthy in Q1 FY2023 with disbursements remaining on of the best in the last four years, despite declining sequentially from Q4 FY2022. With demand expected to hold up during the remainder of the year, ICRA expects the NBFC-Retail AUM to grow by about 12-14% in the current fiscal.

  The AUM growth in Q1 FY2023 was largely driven by the unsecured loan segments, namely personal credit and microfinance, while gold loans and vehicle loans were more subdued than the overall industry average. On a year-on-year (YoY) basis, the microfinance segment

[1] *Personal credit – Unsecured personal loans, consumer loans, education loans, etc*

Asset quality continued to improve in Q1 FY2023; headwinds remain in view of inflationary pressure impacting borrower cashflows and performance of the restructured book

Margin pressure, with the increase in the cost of funds, is expected to be more pronounced in H2 FY2023; expected to be offset by relatively lower credit costs, thereby resulting in net profitability remaining similar to the last fiscal

(including NBFC-MFI[2] and microfinance book of other NBFCs) grew by about 30% in Q1 FY2023, while the personal credit segment (unsecured personal loans, education loans, consumer loans, credit cards, etc) grew by about 43%; this was, to a large extent, on account of the growth in the previous year being affected by the second wave of the pandemic. While the growth in the gold segment is expected to be under pressure in FY2023, the key vehicle segments (CV/PV/2W[3]) are likely to perform better than the previous year.

- **Asset quality continued to improve in Q1 FY2023, but headwinds remain:** The overdues continued to decline in Q1 FY2023 on the back of the improved operating environment for NBFCs, with the AUM remaining on a growth trend, and entities augmenting their collections in view of the tighter IRAC norms, which are applicable from October 2022. In addition, the write-offs, while lower than the previous year, remain elevated, supporting a further reduction in the overdues to an extent. Segments, which witnessed a sharp increase in overdues on account of the pandemic, like 2W, microfinance, etc, continued to witness a moderation as collections improved and entities undertook write-offs to clear sticky overdues from their books. Overall, the 90+ days past due (dpd) of the NBFC-Retail segment improved to 4.0% as of June 2022 from a peak of 5.6% as of June 2021.

  The performance of the restructured book would remain monitorable in the near term, with most of the restructured accounts coming out of the moratorium in Q1 FY2023, considering the stress remaining at the borrower level for a portion of these restructured accounts and the ballooning repayment schedule of some of the restructured loans. The impact of the high inflationary pressures on the borrower-level cashflows also 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 level, even with the headline asset quality numbers approaching the pre-Covid levels.

- **Margin pressure expected in H2 FY2023; 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. With the Reserve Bank of India (RBI) commencing the tightening of policy rates from May 2022, the incremental cost of funds for the NBFC sector has started to move up. However, the impact on the average cost of funds was relatively modest in H1 FY2023, as most entities were able to lock in a sizeable portion of their funding through long-term borrowings at lower rates. The impact is expected to be more pronounced from H2 FY2023 and could lead to some margin pressure amidst the increasingly competitive environment. Further, with the provisions being carried by the entities remaining relatively higher than the pre-Covid level, the credit costs are expected to decline. As such, lower credit costs could offset the impact of the expected margin pressure in H2 FY2023 and result in the net profitability (return on average assets; RoMA) remaining similar to the last fiscal.

- **Adequate capital and liquidity profile:** The capital profile of NBFCs and HFCs remained stable in Q1 FY2023 on the back of healthy quarter-

[2] *NBFC-MFI – NBFC- microfinance institution*
[3] *CV – Commercial vehicle, PV – Passenger vehicle, 2W – Two-wheelers*

Liquidity and capital remain adequate

on-quarter (QoQ) growth, supported by an improving return on capital (12-15%). This follows the steady improvement witnessed over the prior 2+ years as growth slowed down but the return on capital was not significantly impacted (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-balance sheet (on-B/s) + sanctioned credit lines), adequately covering the repayments for the next three months. As the operating environment stabilises, entities may choose to reduce their on-B/S liquidity.

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ABOUT ICRA

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

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