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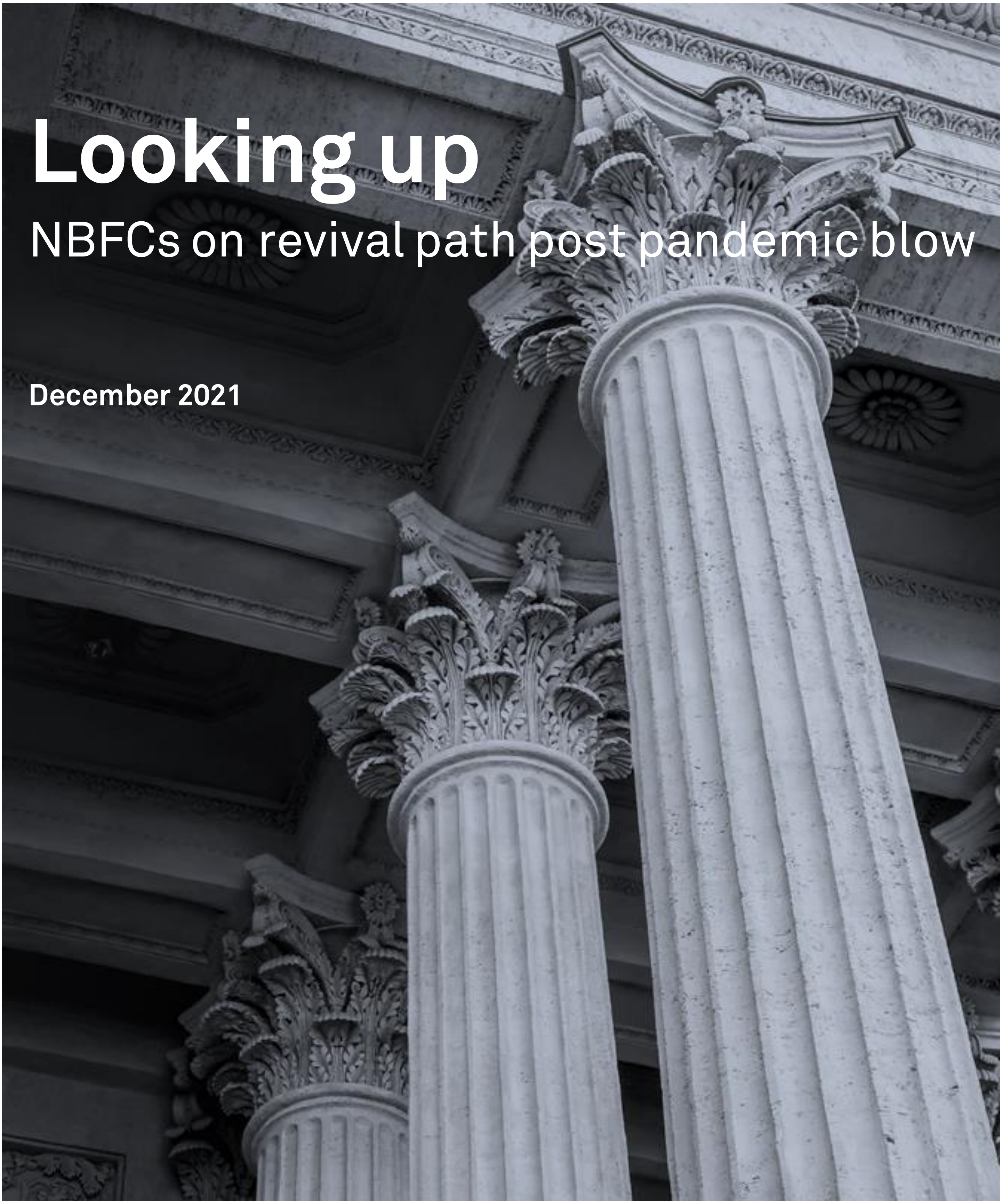
Looking up

NBFCs on revival path post pandemic blow

December 2021



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Executive summary

After weathering multiple challenges over the past three fiscals, made worse by the Covid-19 pandemic, non-banking financial companies (NBFCs)[1] in the private sector are expected to see their assets under management (AUM) grow 8-10% next fiscal, compared with an estimated 6-8% in the current fiscal and 2% in the last. The upturn will ride on two tailwinds — improving economic activity and strengthened balance sheet buffers.

NBFCs have navigated the challenges in the past couple of years by focusing on higher liquidity, capital and provisioning buffers. These, combined with improving economic activity, have put the sector in a comfortable position to capitalise on growth opportunities.

That said, NBFCs are facing three headwinds. First, intensifying competition from banks that, flush with liquidity, have sharpened focus on retail loans, which are the mainstay of NBFCs. Second, gross non-performing assets (GNPAs) are expected to increase, mostly because of the recent regulatory clarification in recognition norms and, to some extent, due to slippages from the restructured book. And third, funding access is yet to fully normalise for some of the players.

Net-net, growth will be driven by NBFCs with strong parentage and better funding access in the two largest segments — home loans and vehicle finance.

Organic consolidation is also underway, with larger NBFCs gaining share. In the three fiscals through 2021, the market share of the top 5 NBFCs has risen 600 basis points (bps; 100bps = 1%) to 46%. The ability to identify niches that cater to the relatively difficult-to-address customer segments and asset classes will fuel long-term growth for the sector.

Asset quality performance will drive the sector's fortunes going forward.

The recent regulatory clarification in NPA recognition norm to a daily due date basis instead of the month-end will have implications as NBFCs ramp up collection activity between the due date and the month-end — the reason their overdue reduces by the end of the month. However, this flexibility is no longer available.

Also, bounce rates in the 60-90 days bucket are estimated at 25-35%. Consequently, a significant proportion of loans in the 60-90 days bucket may slip into the >90 days overdue bucket and will have to be recognised as NPAs.

However, the increase in GNPAs because of the regulatory clarification in recognition norms will be largely an accounting impact because, given the improving economy, the credit profiles of borrowers are not expected to deteriorate. Consequently, ultimate credit losses are not expected to change significantly.

What also bears watching is the performance of the restructured book. While the monthly collection efficiency ratio[2] of NBFCs has seen an improvement across segments in the quarter ended September, the quantum of restructuring done under the RBI Resolution Framework 2.0 is more than that logged last year. The performance of this book after moratorium is monitorable as it mostly involved offering moratorium.

In the milieu, additional disclosures by NBFCs around underlying delinquency profiles and collection efficiencies can help allay any apprehensions around rising reported GNPAs. Players with low leverage, high liquidity and strong parentage are expected to benefit from better funding access at optimal rates. For the rest — especially mid-sized and smaller players — co-lending, securitisation, or other partnerships with banks will facilitate a funding-light business model.

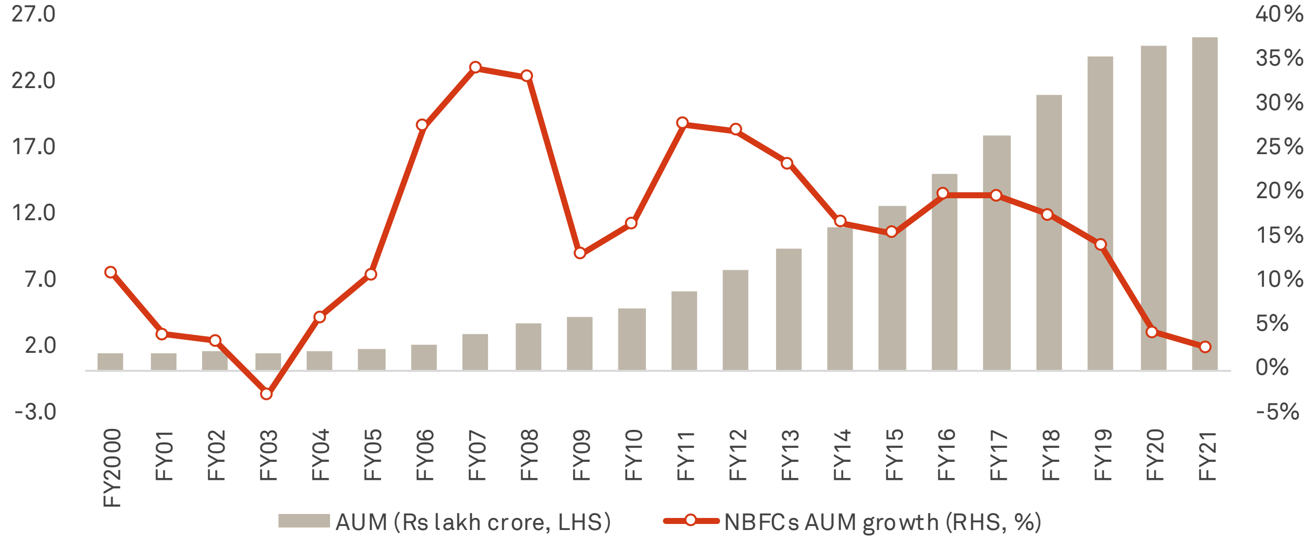
[1] Comprising both non-banking finance companies and housing finance companies in private sector; excludes government-owned entities
[2] Monthly collection efficiency = Total collections (excluding foreclosures)/ scheduled billing (unadjusted for moratorium)

NBFCs a key pillar of the Indian financial ecosystem

Non-banking financial companies (NBFCs) — along with public sector banks, private banks and financial institutions — form one of the four broad constituents of the credit ecosystem of the Indian financial sector. Over the last few decades, NBFCs have navigated several storms, some of them unprecedented, especially in the past three years. They have braved through the wholesale asset quality crisis, the global financial crisis, taper tantrum, funding challenges post September 2018, and the Covid-19 pandemic.

These ups and downs notwithstanding, assets under management (AUM) have increased from less than Rs 2 lakh crore at the turn of the century to over Rs 25 lakh crore now.

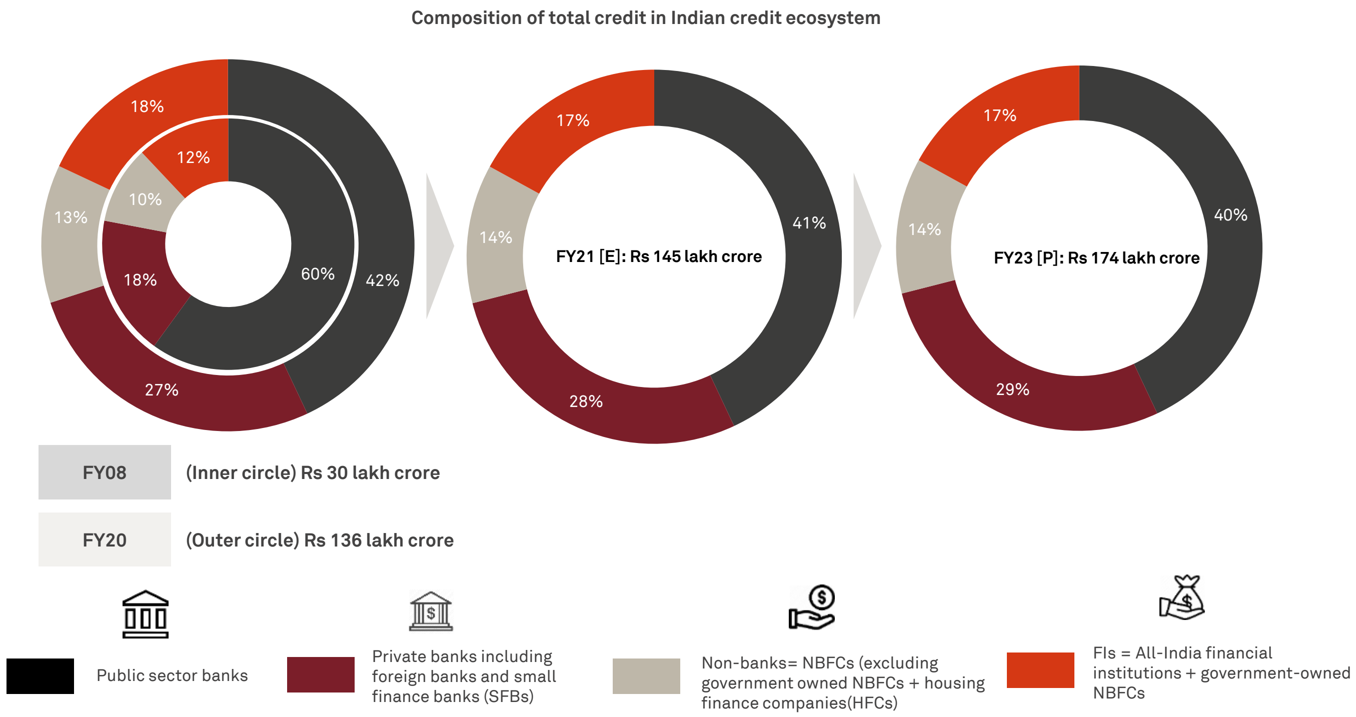
Substantial growth in NBFC AUM over the past two decades



Source: CRISIL Ratings, company data

The share of NBFCs in the overall credit pie increased to 18% as of March 2020 from 12% as of March 2008. Public sector banks lost share—from 60% to 42%—which was picked up by private banks and NBFCs. However, the share of NBFCs slipped to a still-significant 17% last fiscal, because of multiple challenges in the recent past. We expect it to hold steady at this level, with growth picking up this fiscal and the next.

NBFCs to retain share in the Indian financial ecosystem

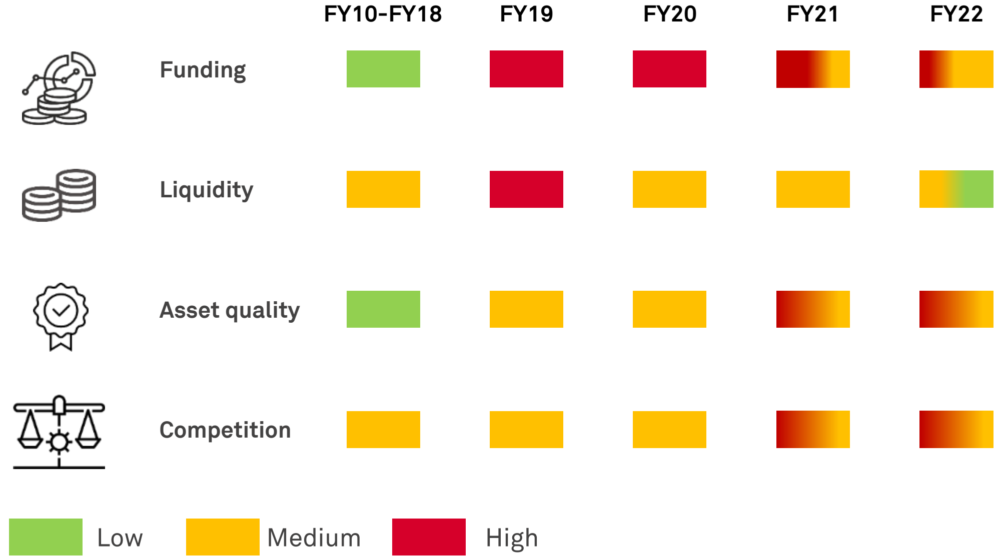


Source: CRISIL Ratings, company data

The NBFC sector has weathered many a storm

NBFCs have faced four key challenges over the past decade: funding, liquidity, asset quality and competition. A relatively calm period between fiscals 2010 and 2018 helped the sector grow substantially, even as banks reeled under asset quality pressure. However, funding and liquidity issues cropped up post September 2018 — an inflection point for the sector. These too were just about subsiding, when Covid-19 struck. Over time, while the funding and liquidity situation has improved, increasing competition and potential asset quality challenges are now key monitorables for the sector.

Dynamics of evolving challenges for NBFCs over the past decade



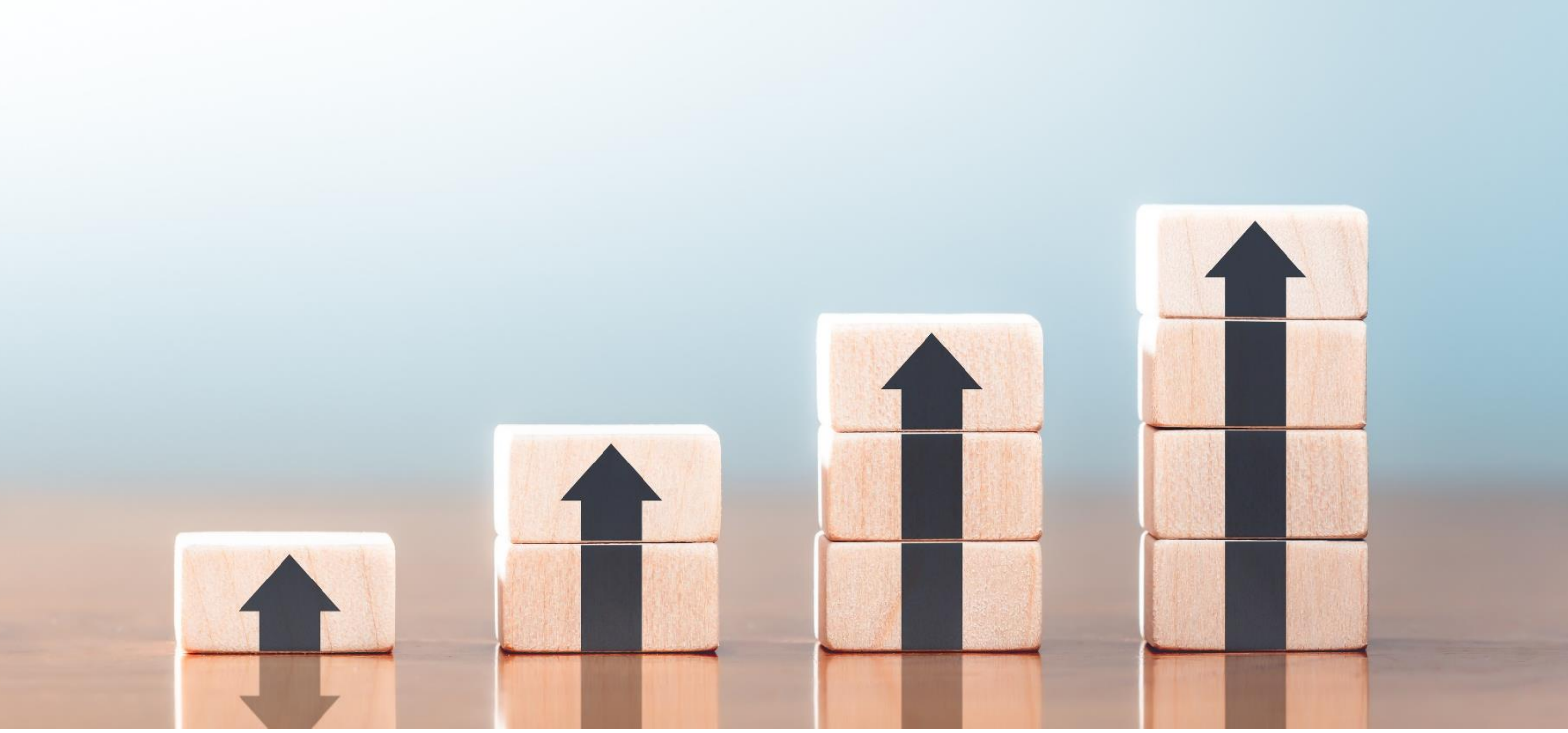
Source: CRISIL Ratings

Many NBFCs have, however, demonstrated admirable resilience by adopting the three-pronged formula of enhancing liquidity, provisioning cover, and capitalisation to strengthen their balance sheets. Liquidity cover[3] of NBFCs rated by CRISIL Ratings has improved substantially over the last one-and-a-half years, acting as a crucial offset to asset quality pressure amid the pandemic. The most stressful period from a liquidity perspective was April-May 2020, when the first Covid-19 wave was at its peak. At that time, 23% of the NBFCs rated by CRISIL Ratings had a liquidity cover of less than one time over a three-month horizon. However, the situation has eased since, and the latest analysis indicates that only 3% of the rated NBFCs now fall under this category. Moreover, these are mainly the better-rated ones with good collections and fund-raising ability.

In contrast, the capital raising momentum has held strong in the past two-and-a-half years, with NBFCs raising more than Rs 60,000 crore, well above what we have seen in the past. This has brought down leverage levels, especially in the context of subdued growth.

Equally pertinent is the build-up in the provisioning cover across segments, especially in the past one-and-a-half years, and following the Covid-19 additional overlay. This has allowed a floating provisioning buffer which will help weather future surprises, and provide cushion against significant impact on profitability due to asset quality challenges.

[3] Measured as: (cash available with NBFCs + unutilised bank lines+ estimated collections)/debt falling due over a three-month horizon

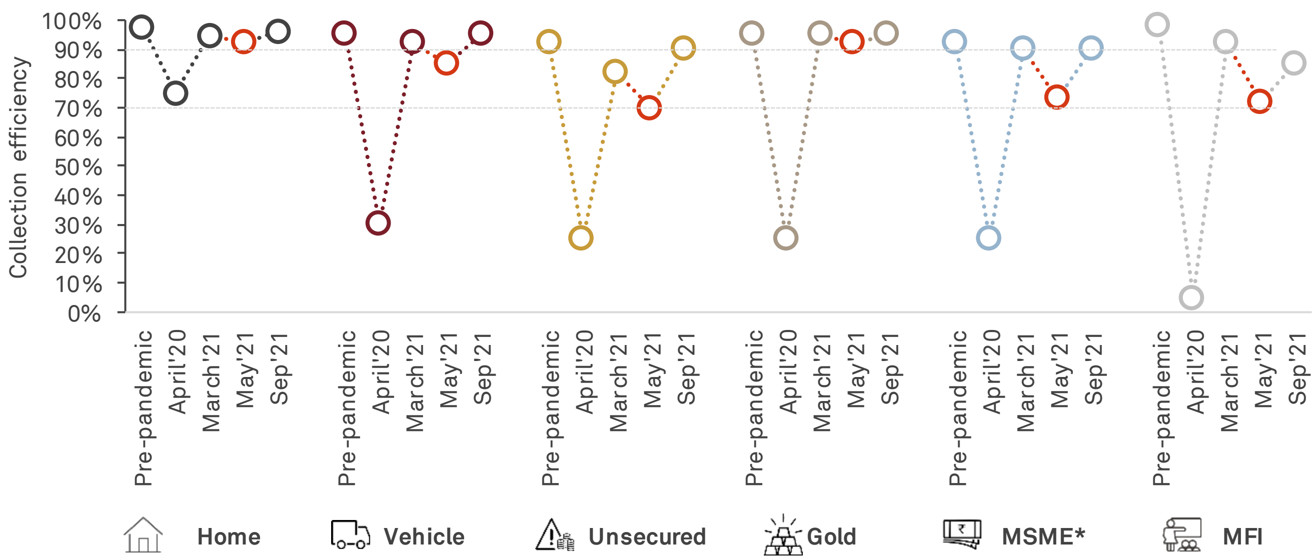


Collections rebound, but asset quality pressure persists

The intensified focus on collections, even at the cost of growth, has yielded higher numbers across segments. NBFCs have strengthened collection infrastructure, including through addition of modes of equated monthly instalment, or EMI, payments. As a result, collection efficiency is nearly back to pre-Covid levels for most segments. This, along with an improvement in the macroeconomic environment, bodes well for the sector.

Interestingly, the drop in collections during the second Covid-19 wave was not as severe as what was seen during the first wave. This may be partly because of the starker uncertainties and the complete nationwide lockdown last year. In contrast, the lockdowns were localised and some business activities continued this year.

Collection efficiency has improved across segments



Source: CRISIL Ratings, company data

That said, four factors will determine asset quality of NBFCs over the medium term:

- **A third Covid-19 wave** (including the omicron variant) and any material disruption in asset quality on account of it, hitherto not factored in
- **OTR**[4] or the restructured portfolio and slippages therefrom
- **Recognition of non-performing assets (NPA) norms**, as revised recently to a daily due-date basis from the month-end basis typically followed by NBFCs until now, in addition to greater stringency regarding upgrade of NPAs
- **Economic growth momentum**, a tailwind that would limit the rise in NPAs caused by the other factors

The Reserve Bank of India (RBI) recently provided clarifications on the income recognition, asset classification and provisioning (IRACP) norms, which will eventually lead to a movement towards daily recognition of NPAs and add a layer of restriction on upgrades of NPA accounts unless all overdues are cleared. Given that the prevalent industry practice was month-end recognition of NPAs, we expect an increase in reported GNPAs, which would vary according to the area of operation.

CRISIL Ratings expects NPAs to rise anywhere between 25-300 bps on account of the revised norms.

As has been the case traditionally, home loans and gold loans will be least impacted while unsecured and micro, small, and medium enterprise (MSME) loans may be hit the most. However, the higher reported NPAs will not necessarily imply materially higher pressure on asset quality as only the yardstick of reporting NPAs will change and not the inherent creditworthiness of the borrower, so the ultimate credit losses will not be impacted. The underlying borrower cash flows will also be supported by the improving macroeconomic environment.

This leads to the conclusion that while regulatory clarifications may lead to higher reported gross NPAs (GNPAs), the underlying fundamentals of the borrowers is not expected to change. In that case, the performance of the restructured portfolios assumes greater importance in determining asset quality.

It is interesting to note here that the trends in restructuring have been divergent across asset classes, and given the inherent borrower profile, collections have been divergent too.

Table: Divergent trends in restructured portfolios across asset classes as on September 30, 2021

Segment	Restructuring range	Median restructuring
Home loans	0-10%	2-3%
Vehicle finance	0-13%	4-5%
Gold loans	0-7%	1-2%
Unsecured	1-40%	10-11%
MSME finance*	2-25%	6-7%
Wholesale finance**	3-35%	7-8%
MFI	2-15%	7-8%

*Includes loans against property and unsecured business loans
**Includes DCCO extension accorded by RBI to real estate lenders
Source: CRISIL Ratings

[4] One-time restructuring

We also note that restructuring increased substantially post the second Covid-19 wave compared with what was seen last fiscal. Home loans and gold loans have typically seen 0-10% and 0-7%, respectively, of their AUMs restructured, while MSME finance has seen restructuring of 2-25%. The expected slippages vary, too, depending on how collections have shaped up so far in these portfolios. The maximum slippages from the restructured portfolios are expected in the unsecured and MFI segments (to the extent of 60% of their portfolios) while slippages will be more controlled for the other segments. How the restructured portfolios perform remains a key monitorable.

In effect, while the fundamental asset quality metrics are expected to actually improve, driven by the economic environment, the recent regulatory clarifications on NPA recognition norms will lead to an increase in the reported GNPAs. At the same time, any slippages from the restructured portfolio as the book comes out of moratorium will keep delinquencies elevated.

Earnings may be impacted in the near term; normalisation of funding will be key to growth

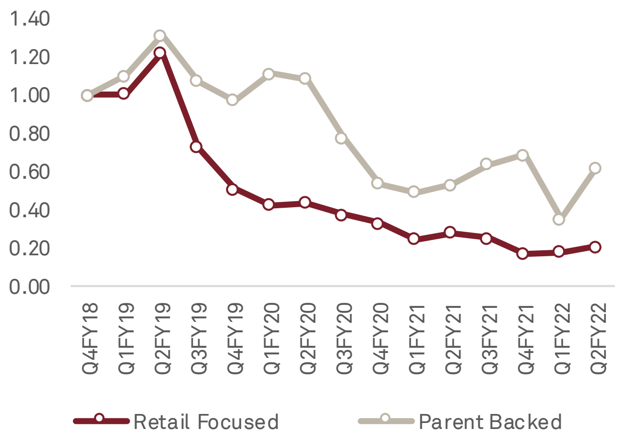
Return on assets (RoA) will be subdued this fiscal due to the impact of higher provisioning requirements amid elevated slippages and recent regulatory clarifications on NPA recognition norms. However, earnings should improve across segments with improvement in economic activity and the support it will provide to business operations.

Another dynamic that will determine growth of NBFCs is the normalisation of funding access. Though access to capital market borrowings for NBFCs is still disproportionately skewed towards large and parent-backed NBFCs, we have seen green shoots emerging in funding access for NBFCs.

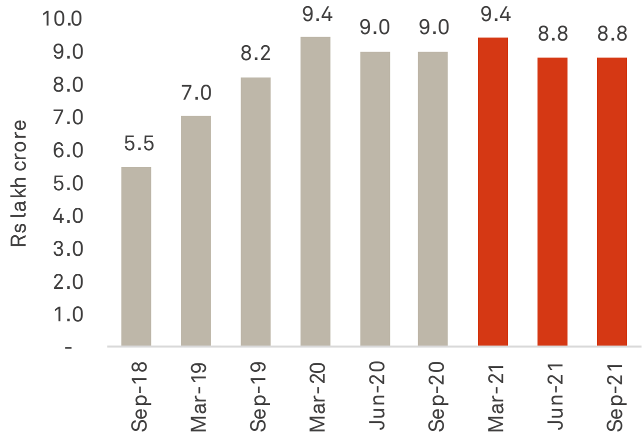
On the debt capital markets front, fund mobilisation still remains below the peak achieved in the fourth quarter of fiscal 2018. At the same time, bank funding to NBFCs has improved, with exposure of the banking system to NBFCs currently at well above September 2018 levels.

NBFCs on their part are also focusing on diversifying their funding avenues with a number of them looking closely at co-lending and securitisation as well as retail borrowings. NBFCs with deposit-taking licences are also focusing on increasing the share of retail deposits in their liability mix as it is a relatively source of funding. This will be the theme for future growth.

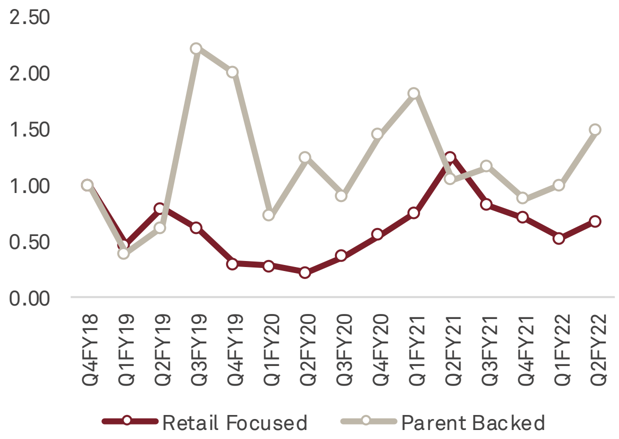
CP issuances have started to pick up



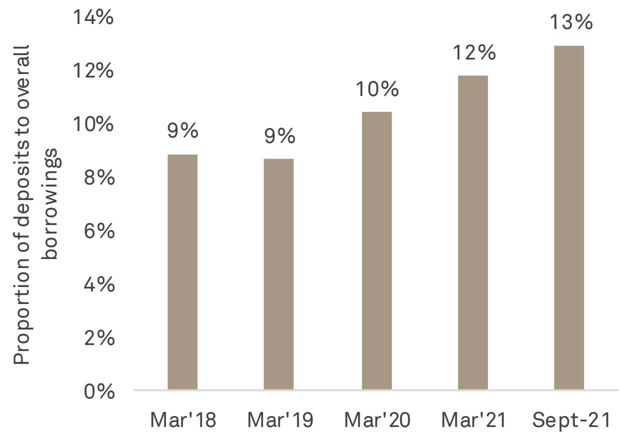
Bank funding continues support (outstanding sector credit)



Bond issuances have also risen



NBFCs have ramped up on deposits, too



Bond and commercial paper data indexed to 1 for issuances during Q4FY18; CP issuances exclude IPO financing

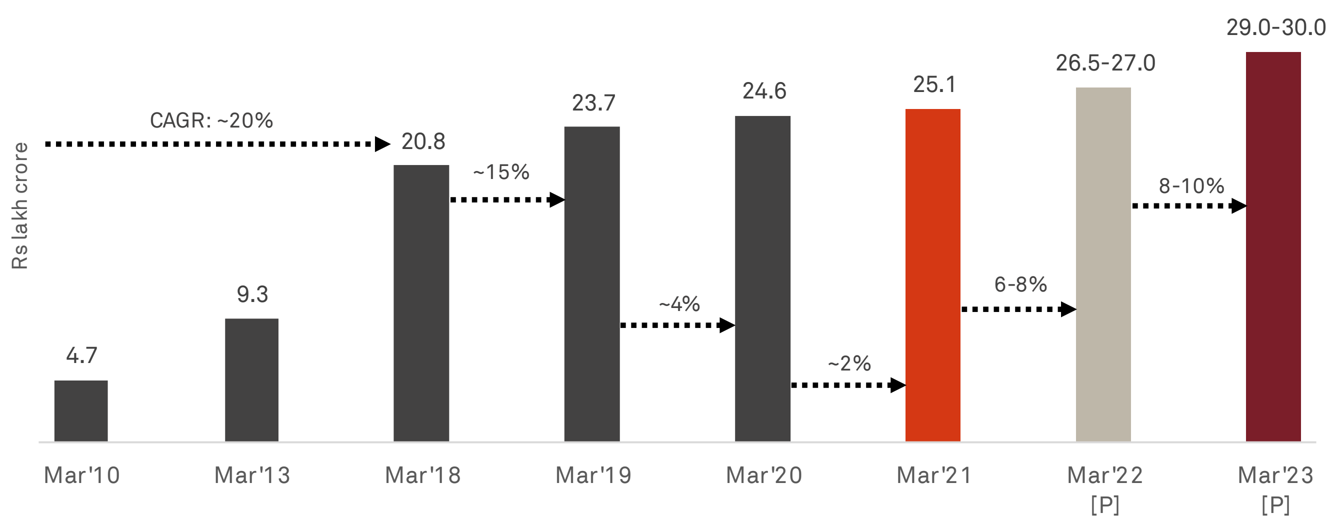
Source: SEBI, RBI, Prime database, FTRAC, Company data; CRISIL Ratings

Growth set to revive for NBFCs, could potentially touch double digits

Growth to revive but stay lower than before

The NBFC sector saw AUM growth plunge to decadal lows of 4% and 2% in fiscals 2020 and 2021, respectively, because of funding access and asset quality challenges. However, green shoots should drive up growth to 6-8% this fiscal and 8-10% in the next. An interesting trend is the organic consolidation in the sector with larger NBFCs gaining share in the overall AUM — the top five NBFCs raised their share from 40% to 46% between March 2018 and March 2021.

AUM growth for NBFCs could potentially touch double digits in the next 1.5 years



Source: CRISIL Ratings, company data

With elevated delinquencies, NBFCs will likely continue to focus on traditional and safer asset classes in the near term, such as home loans, vehicle finance and gold loans, for growth. While these segments will see better growth on-year, they will remain lower than the pre-Covid levels. Intensified competition from banks will also be a factor that NBFCs will have to contend with.

On the other hand, wholesale finance, which was a key growth driver for the sector in the past, has been declining lately on account of the funding access challenges. Over time, many players have scaled down this business and shifted focus towards granularisation of portfolios. Some players are also looking to fill the gap and grow their books in this segment. However, a majority of the incremental funding towards this space is expected to be led by alternative investment funds (AIFs), challenges from an asset liability maturity management perspective will be much less and access to patient capital is higher.

A key monitorable will also be the performance of the unsecured loan portfolio. This is generally a short-tenure portfolio, and therefore, has a higher run down in the book. That said, this segment too faced headwinds last year, given the economic environment and asset quality concerns. However, an improvement in high frequency indicators signifying better consumption should drive growth, as also higher yields, even as competition from banks in the traditional segments keep yields low in the salaried and prime borrower segments.

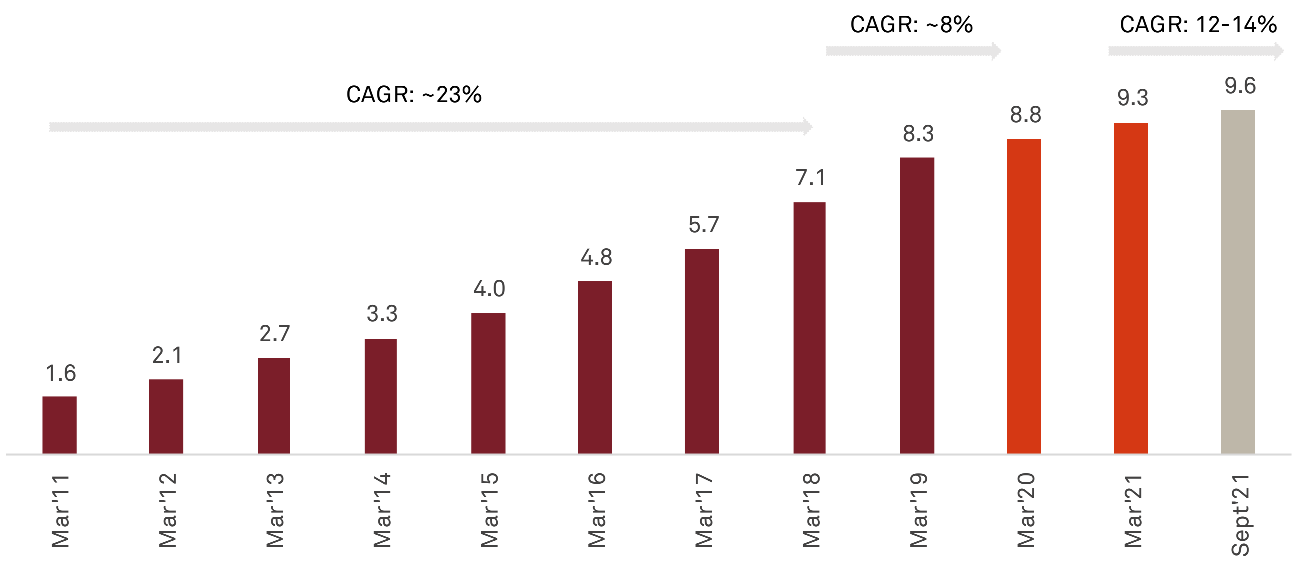
Going forward, we expect to see NBFCs continuing to play a key role in Indian financial ecosystem. On growth, larger players and traditional asset segments will dominate, with partnerships aiding mid-sized and emerging players. We expect digitalisation, tech-enablement of business processes and use of data analytics gaining momentum, which should help on both asset quality and growth fronts. And the focus on maintaining higher capital and liquidity levels will continue for some more time to provide stakeholder confidence and progress towards normalisation of funding access.

Home loans: Rebuilding brick by brick

Home loans, which have the largest share (over 35% as on September 30, 2021) in the NBFC AUM pie, will likely drive the next leg of growth for the sector. It must be noted that the dominance of this portfolio stems from a few large players and that increased interest in the segment, not just from NBFCs but also banks, in recent years is changing the dynamics of the industry. There have also been several new entrants focused on affordable housing where the borrower profiles are distinctly different.

The AUM of NBFCs in the home loan segment rose at a compound annual growth rate of 23% from March 2011 till March 2019. The growth rate dropped to 8% during March 2019-March 2021 because of Covid-19 linked challenges. Intensified focus on the segment should revive the growth momentum to 12-14% driven by improving sales, better affordability, and increased preference among consumers towards home ownership.

Home loan growth to revive to 12-14%

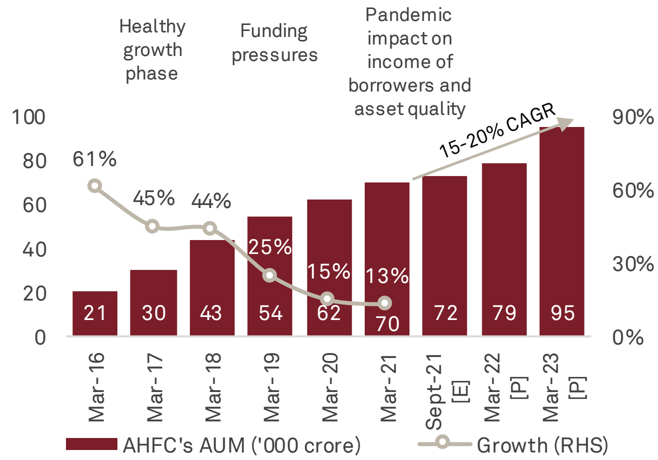


Source: CRISIL Ratings, company data

However, the growth will not reach the earlier level with banks, too, focusing on retail assets, especially home loans for salaried segments. Moreover, there is clear organic consolidation among HFCs—given the intense competition and fine rates offered on traditional home loans, it's mainly the larger players with strong credit profiles that are able to compete effectively with banks and therefore, the share of these large players will continue to increase.

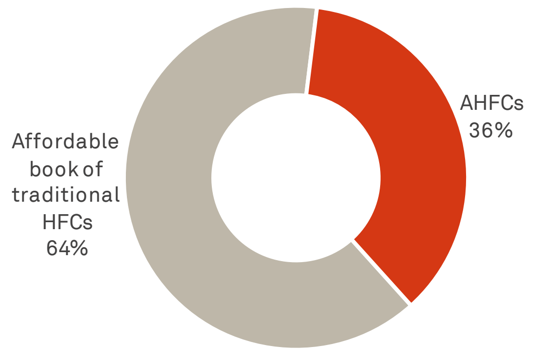
The share of affordable housing remains low in the overall ecosystem, though there has been strong growth in this space with several new entrants targeting this segment. Consequently, growth in affordable housing has been higher compared with traditional home loans. Of the total affordable housing[5] AUM of almost Rs 2 lakh crore as on March 21, specialised affordable HFCs (AHFCs) constituted about 36% and have increased their share over time backed by healthy growth. These entities were fairly small even just five years back and have grown rapidly on a low base. CRISIL Ratings defines affordable housing entities with average ticket size of Rs 15 lakh or less.

Affordable housing finance AUM ('000 crore)



Source: CRISIL Ratings, company data

Share of AHFCs in affordable housing finance AUM, Mar-21



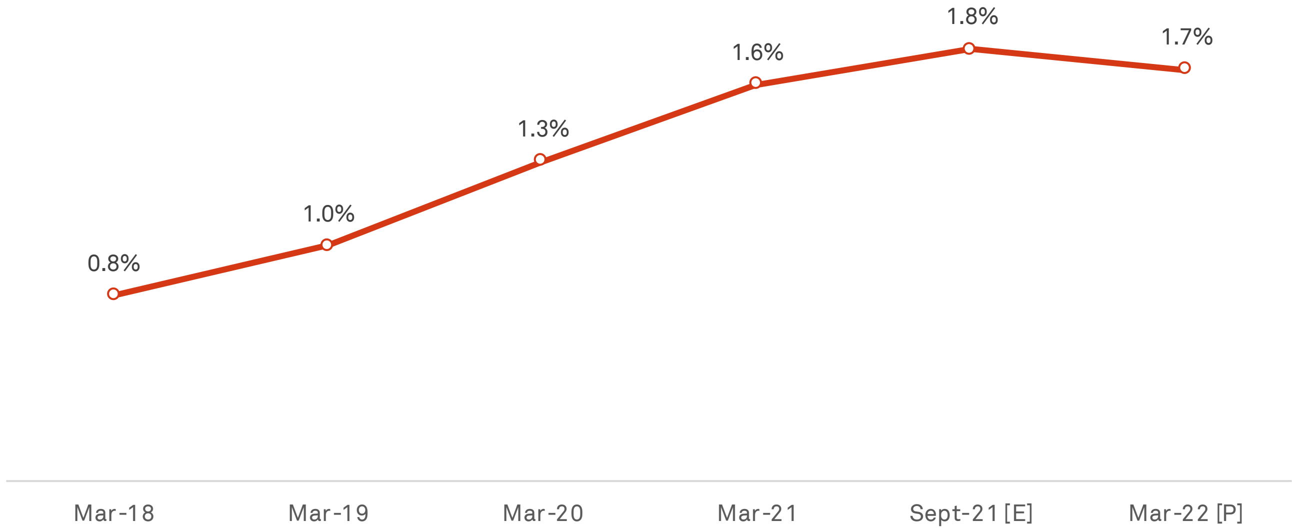
Source: CRISIL Ratings, company data

While growth in the affordable housing space also slowed between fiscals 2019 and 2021, it was higher compared with most other asset classes. This segment should grow 15-20% over the medium term driven by the large opportunity available and the supportive policy and regulatory environment. The competitive environment however is evolving and will bear watching, both with traditional HFCs turning their focusing on this segment and many affordable HFCs looking to expand outside their core states.

Asset quality metrics have held steady amid the strong growth. Home loans are considered to be among the safest asset classes, as is reflected in in the portfolio performance over time. With the portfolio skewed towards salaried customer segments (almost 70% of the AUM), the asset quality metrics remain under control. Asset quality metrics for the self-employed portfolio, though weaker, remain comfortable. While the recent regulatory clarification on NPA recognition norms will push up reported GNPAs, the home loan segment will be among the least impacted by the development.

[5] The details are based on overall AUM trend for specialised affordable housing finance companies (AHFCs)

Asset quality remains under control for home loans

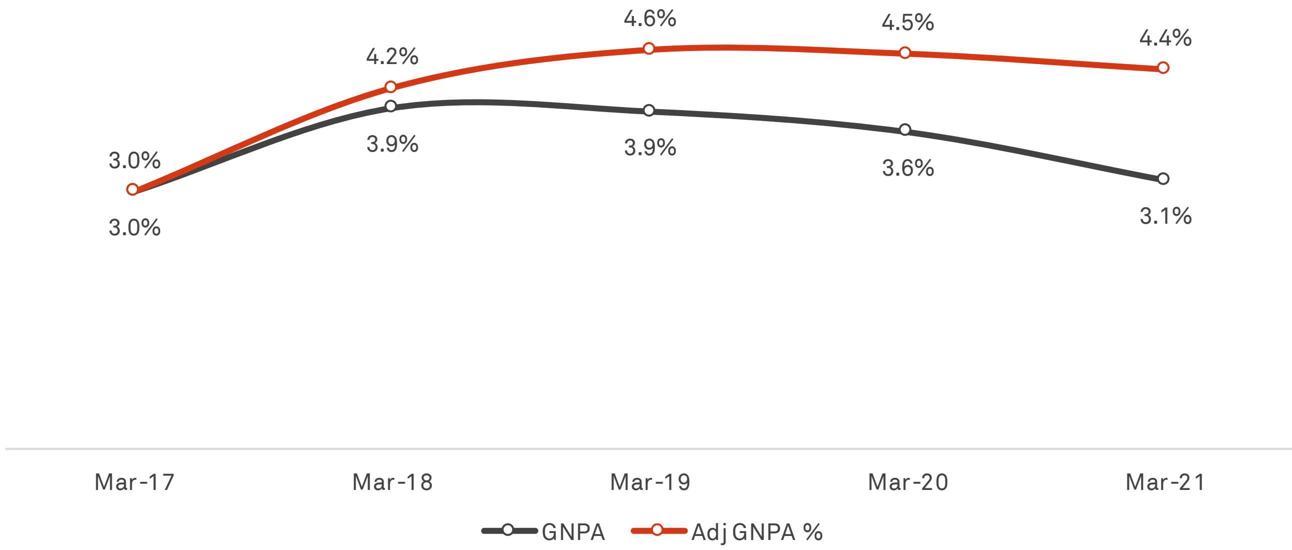


Source: CRISIL Ratings, company data

Performance of the restructured portfolio will be a differentiating factor going forward among HFCs. With restructuring diverging widely among players (0-10% of AUM), each player's performance can differ. CRISIL Ratings expects slippages from the restructured book to be limited to 5-10% for the overall home loan portfolio, but will be at a higher level for the affordable housing finance segment.

HFCs in the affordable housing space cater primarily to borrowers who are self-employed or do not have formal salaries, and therefore, the portfolio has distinct characteristics from traditional home loans. These borrowers have limited financial flexibility which could cause volatility in cash flow during emergencies. This is reflected in the delinquency metrics in this segment.

Trend in affordable housing delinquencies



Source: CRISIL Ratings, company data

That said, given the inherently riskier borrower profiles, this segment also has higher write-offs or sales to asset reconstruction companies (ARCs) because of accounts becoming delinquent, contrary to the negligible write-offs/sales to ARCs in the traditional home loans space. Adjusted for these, the affordable housing GNPAs were at 4.4% as on March 31, 2021—2.8 times of that in the traditional home loans space. Even on an early delinquency basis, the increase post-Covid was higher for AHFCs. However, the improving macroeconomic environment has led to better early bucket delinquencies in recent months. Higher yields and comfortable capital position of players provide further cushion against asset side risks. Gearing is comfortable with affordable housing financiers having raised close to Rs 12,000 crore of capital in the past five years.

Way forward for HFCs

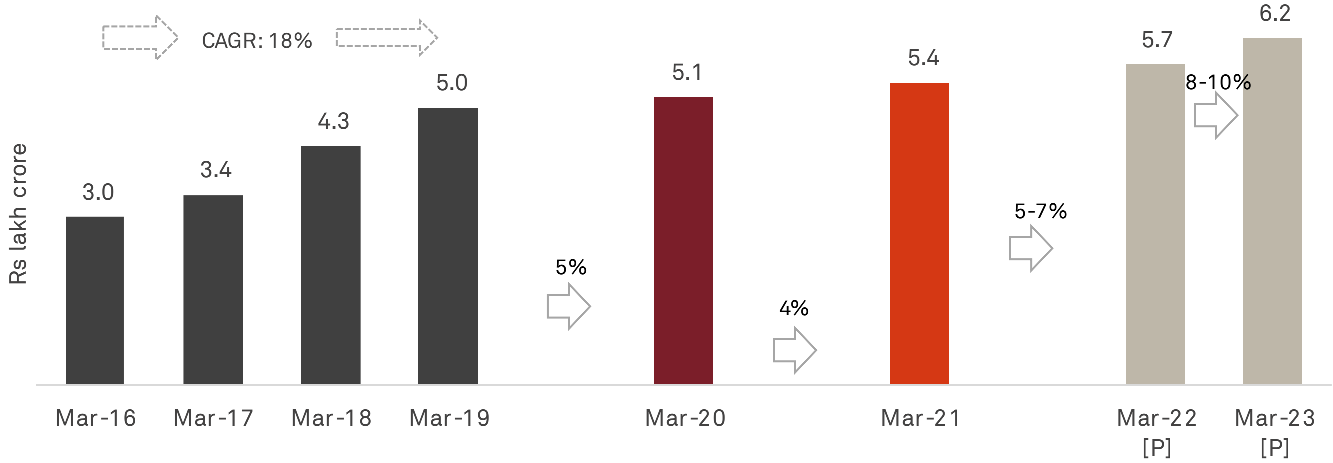
Overall, we expect growth to revive for HFCs in the days ahead. This will be driven by a pick-up in real estate sales, which will be the primary tailwind. Higher affordability and low interest rates will support this trend. But competition is also set to intensify further in the segment. This is true not only of traditional lenders but also affordable housing financiers.

On the funding side, partnerships and co-lending with larger players are key themes we see gaining momentum for small/ mid-size HFCs. The regulatory environment continues to evolve and would entail short-term adjustment costs, but should structurally strengthen the sector over the long term. Finally, and absolutely fundamental to the HFC business will be effective asset-liability maturity management, which will remain crucial for sustainable growth.

Evolving trends in vehicle finance

Vehicle loans, which hold the second-largest share (~20%) in the NBFC AUM pie, saw a sharp reduction in growth in the past two fiscals. But this fiscal, it is gaining traction on the back of the improving macroeconomic environment and rise in automotive sales. Vehicle finance AUM is expected to pick up to 5-7% this fiscal and 8-10% in the next, crossing Rs 6 lakh crore by March 2023.

Trend in vehicle finance AUM for NBFCs



Source: CRISIL Ratings, company data

To be sure, the pandemic-led contraction in the economy impacted original equipment manufacturer (OEM) sales. The chip shortage and increasing fuel prices also played their part.

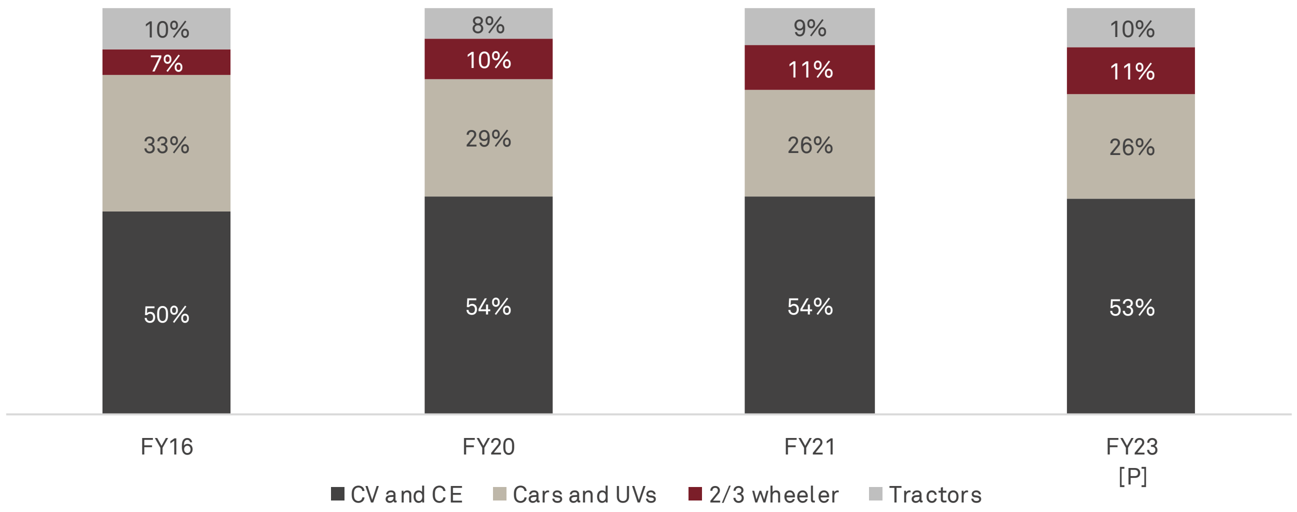
But opportunities lie ahead. The government's focus on infrastructure investment will support commercial vehicle (CV) and construction equipment (CE) sales. Also, the launch of the vehicle scrappage policy or voluntary vehicle modernisation programme (VVMP) is expected to give a fillip to incremental sales, especially in the CV segment.

After declining in fiscal 2021, sales of cars, utility vehicles (UVs) and CVs are expected to recover this fiscal. Two/three-wheeler and tractor sales are expected to stay subdued, but likely grow in the next fiscal.

It must be noted that AUM growth is not directly proportional to growth in vehicle sales, but disbursement is. Growth in the outstanding portfolio also factors in elements like repayments, prepayments, as well as loan tenure. Therefore, AUM growth differs from sales growth and the extent of difference will depend on the specific asset segment.

Overall AUM growth will likely be driven by an increase in the CV AUM by 5-7% this fiscal and 8-10% in the next, with cars and UVs growing at a similar pace. Two/three-wheeler and tractor financing will stay on course, too. However, growth across these segments will be lower than that in the past, as competition from banks remains strong.

Trend in vehicle finance AUM for NBFCs



Source: CRISIL Ratings, company data

The share of cars and UVs in the NBFC AUM has steadily fallen, even as that of CVs and two-wheelers have gained. CVs, cars and UVs will continue to constitute around 80% of the NBFC vehicle finance AUM.

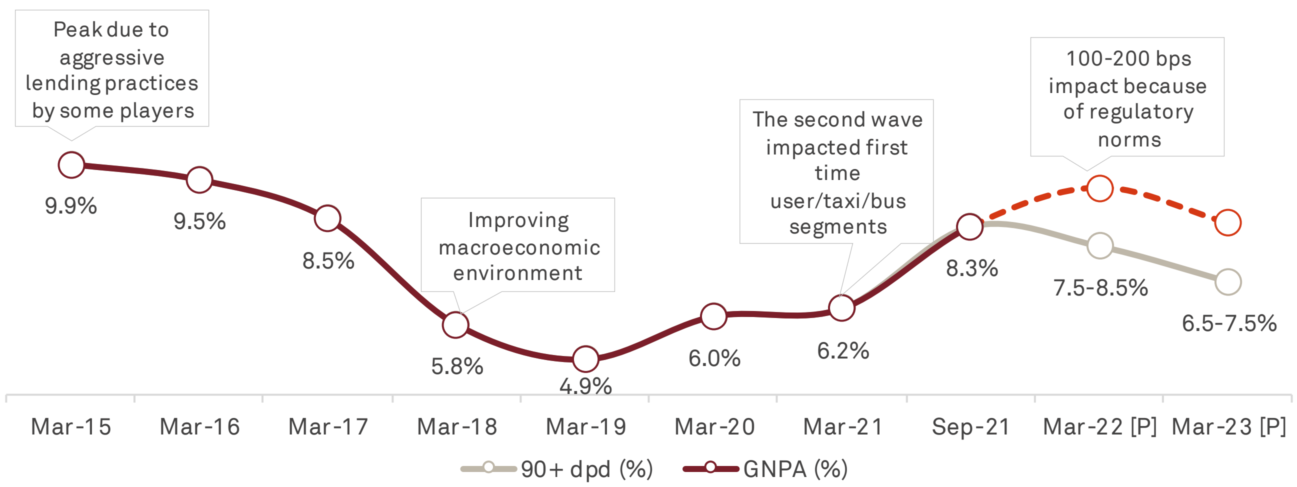
Competitive pressure from banks has increased lately, especially in the cars, UV and new CV finance segments. Banks have steadily gained a dominant share in the car/UV space (around 70% in 2021 compared with 58% in 2014), largely on account of lower yields.

However, NBFCs are likely to maintain their dominance in the CV space. Specifically, segments such as light CVs and used car finance will remain a domain of NBFCs, as these segments are typically dominated by small transport road operators, first-time users and first-time buyers, which are better serviced and catered to by NBFCs.

An improvement in the economic environment will support the fundamental asset quality of vehicle financiers, though reported NPAs will likely rise given the recent regulatory clarification on NPA recognition norms. The high frequency indicators show an improvement and toll collections are rising from the lows witnessed during the first wave of Covid-19. While the second wave led to a dip, the rebound has been fairly strong. E-way bills — both for inter-state and intra state movement of goods — followed a similar trajectory.

Consequently, collection efficiency has improved, thus supporting the fundamental asset quality for vehicle financiers. In fact, collection efficiency has almost reached the pre-Covid level in recent months.

Trend in 90+ days past due (dpd) for vehicle financiers



Source: CRISIL Ratings, company data

Baseline GNPAs were earlier expected to gradually improve to 6.5-7.5% by March 2023 from 8-8.5% in September 2021. But given the recent regulatory clarifications on NPA recognition norms, GNPA are now envisaged to be 100-200 bps higher. It should be noted that even in light of the pandemic, 90+ dpd as of September 2021 was well below the peak witnessed in March 2015. While the revised regulations will push up reported NPAs for the overall sector by 100-200 bps, the range for individual NBFCs could be broader. The impact will largely be on the accounting side rather than economic, as the underlying customer profile will not change and, hence, ultimate credit losses are not likely to change materially.

As with the other NBFC segments, performance of the restructured portfolio will be key. There is high divergence in restructuring among players in the vehicle finance sector. While restructuring at the industry level is estimated at 4-5%, it ranges from negligible to 13% for the 15 NBFCs considered in our analysis. In light of the extensive restructuring, it would be important to see how this portfolio performs, and to get a sense of any early indicators. Also, performance of some of the most impacted sub-segments, such as school/tourist buses and commercial car operators, where restructuring levels are higher, will be a key monitorable.

Overall slippages from the restructured book for vehicle financiers are expected at 15-25%.

Way forward

As vehicle financing NBFCs tweak their business strategies while charting a revival post the pandemic, the fundamentals are in place for a revival for them, but competition also remains intense, especially in cars and UV financing. To manage this, we see sharper focus on the used vehicle segment by NBFCs as a risk-return strategy.

The regulatory environment continues to evolve and would entail short-term adjustments, but should structurally strengthen the sector over the long term. As during the transition to 90+ NPA recognition, we see players once again re-orientating their collection team structures and taking initiatives to educate customers to limit the impact of the recent regulatory clarifications in NPA recognition. So, while reported NPAs would increase, and this would also have an impact on near term profitability, credit profiles of most CRISIL-rated NBFCs are supported strong capital and liquidity buffers.

Over the long term, niche positioning across customer/ asset segments will ensure NBFCs continue to play a critical role in overall vehicle financing space.

Infrastructure finance: Private players carving out a niche

Infrastructure, as a sector, has seen among the highest credit demand over the years. Lenders, however, have been cautious towards it as the extended gestation period of many infrastructure projects means funds are locked up for long. This is accentuated by concerns regarding inherent mismatches in the asset liability maturity profiles, because of limited access to long tenure borrowings in India.

To be sure, credit quality of many projects has been suspect in the past, given a number of instances of time and cost overruns which have put pressure on project cash flows. This, in turn, has affected the ability to repay lenders on time, resulting in an increase in NPAs in the sector.

At the same time, there is no denying the fact that infrastructure is one of the most important sectors influencing economic growth and overall development. Recognising this, the government has taken steps to promote infrastructure development and facilitate access to credit. These include not only significant industry specific measures, and the announcement of the National Infrastructure Pipeline (NIP), but also the setting up of specialised government-promoted financial institutions to address funding needs. In fact, such institutions and banks have done much of the heavy lifting in terms of financing the infrastructure sector. Whereas, the private sector, including NBFCs, has played a relatively subdued role, given the risks entailed.

That said, the role of private sector NBFCs in extending credit to the infrastructure sector has evolved over time. Here, we outline their growth trajectory, and discuss trends in asset quality and the way forward.

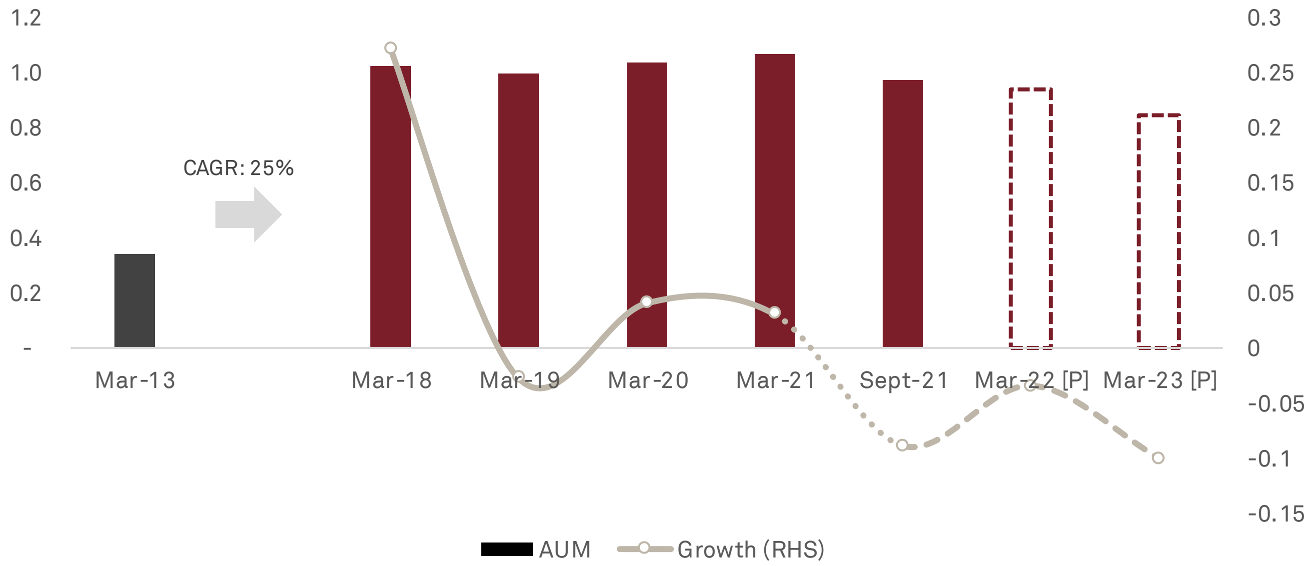
The evolving role of private sector NBFCs in infrastructure financing

Though infrastructure finance in India has been dominated by specialised financial institutions and banks, private sector NBFCs have established themselves in niche spaces. For instance, NBFC-infrastructure debt funds (NBFC-IDFs), which entered the fray in 2013, have played an increasing role in financing operational infrastructure projects, even as they operate within their defined categories and risk spectrum.

However, the growth of NBFCs in this segment has been impacted post September 2018, as the default by a large infrastructure financier and the consequent caution by lenders and investors towards extending credit to such NBFCs has constrained their ability to lend.

These funding challenges faced by wholesale financiers and the weak macroeconomic environment amid Covid-19 in the past two years has also affected the infrastructure portfolios of NBFCs.

Trend in infrastructure finance[6] AUM of NBFCs



Source: CRISIL Ratings, company data

The AUM of private sector NBFCs in infrastructure financing is estimated at ~Rs 1.0 lakh crore as on September 30, 2021. This constitutes ~4% of the overall NBFC AUM pie (if government-owned NBFCs were included in the mix, the AUM would be several times that amount).

However, growth in this sector is expected to remain subdued as another large infrastructure financier has recently faced credit quality challenges and has been referred to the resolution framework.

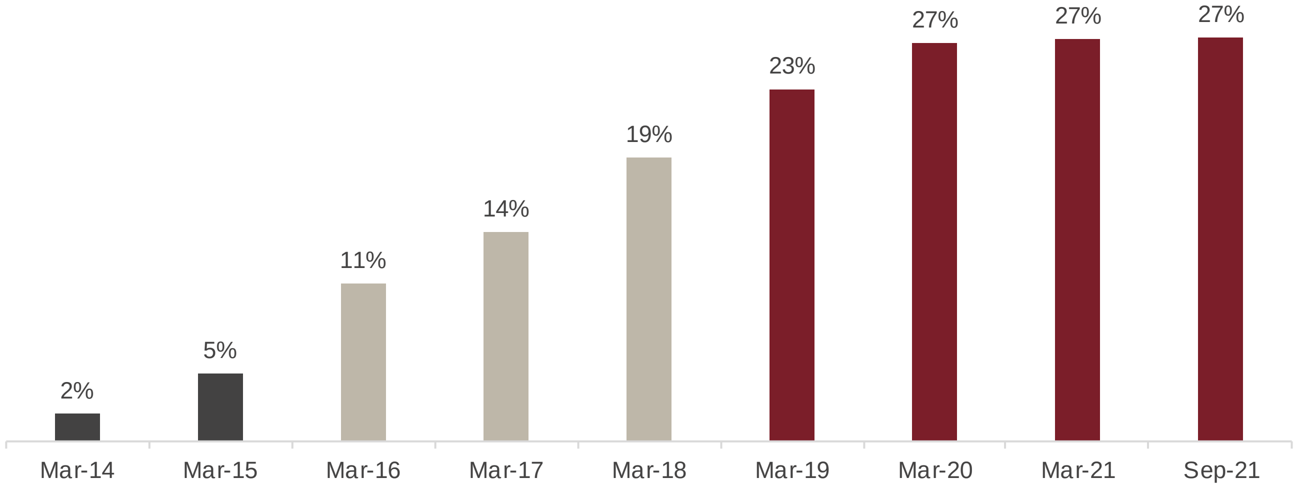
NBFC-IDFs growing at a faster clip

A key trend in the infrastructure financing space in the past decade has been the emergence of NBFC-IDFs. It has been heartening to see them grow despite challenges. The share of NBFC-IDFs in the overall infrastructure finance portfolio for NBFCs has increased consistently — from a mere 2% as of March 31, 2014, to 27% as of September 30, 2021 — and outpaced growth in the overall portfolio.

What separates NBFC-IDFs from other infrastructure financiers is their focus on operational infrastructure projects with a demonstrated track record and solid risk management processes. By doing so, they bypass the project risk emanating during the construction period faced by other infrastructure lenders. Hence, their asset quality has historically been strong with very low NPAs.

[6] Excludes government-owned NBFCs

Trend in share of NBFC-IDFs in the infrastructure finance AUM of NBFCs

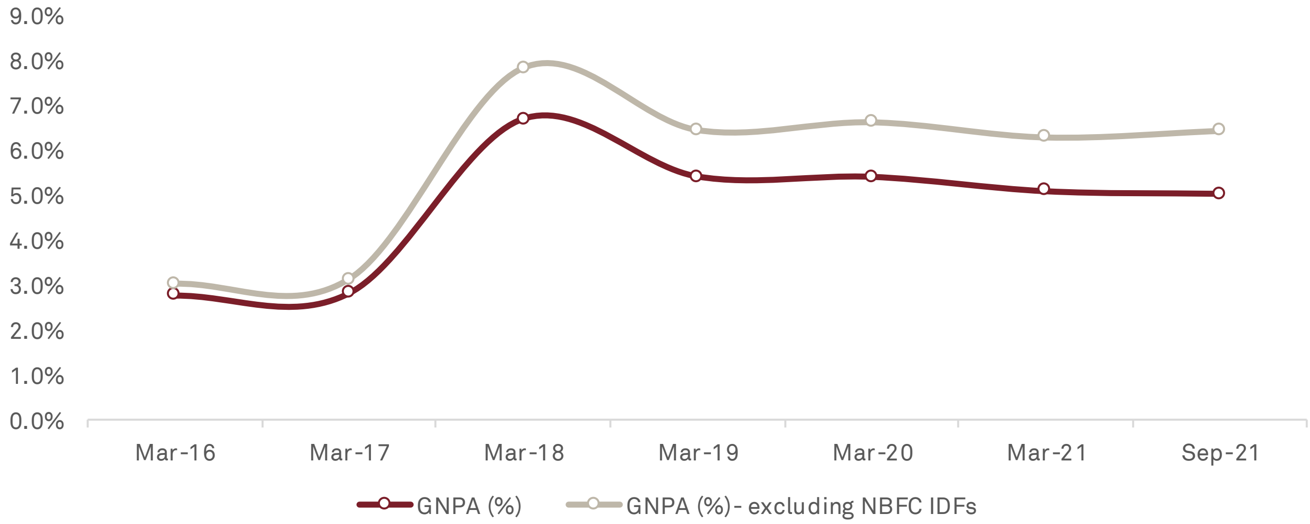


Source: CRISIL Ratings, company data

Asset quality remains a concern, but NBFCs faring better than banks

Asset quality pressures for infrastructure financing NBFCs peaked in March 2018 as they did for banks. This was on account of exposures to a number of projects turning delinquent due to time and cost overruns as well as slippages in past restructured assets. That said, NBFCs did not see as steep a rise in NPAs as banks did.

Trend in GNPAs for infrastructure finance portfolio of NBFCs

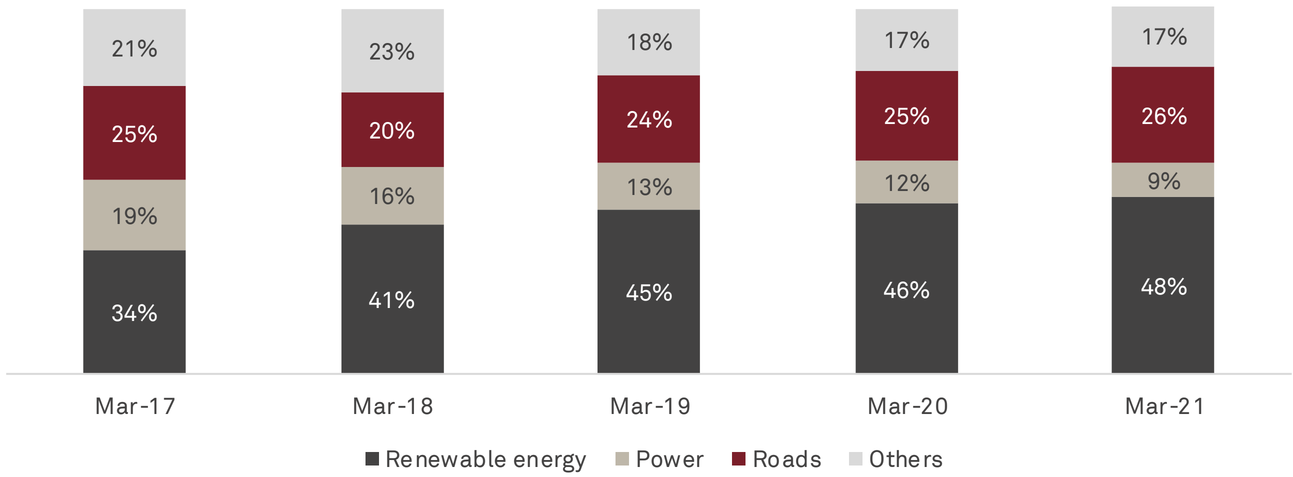


Note: The above figures are based on details of NBFCs with infrastructure finance portfolios

Source: CRISIL Ratings, company data

A key reason for NBFCs faring better than banks in terms of asset quality performance has been their focus on diversification. In the power sector instance, NBFCs have been focusing less on thermal projects which have caused considerable asset quality challenges for banks in the past. Rather, their infrastructure finance portfolios primarily comprise renewable energy and road projects, where asset quality metrics have been better so far. So even if NBFCs have seen delinquencies increase due to legacy thermal power project exposure, their overall asset quality metrics have fared better than that for banks.

Trend in constituents of infrastructure portfolios at NBFCs



Source: CRISIL Ratings, company data

NBFC-IDFs' focus on operational projects has kept asset quality metrics under control. Recent trends in terms of asset quality resolutions for some large assets support an improving trajectory in GNPAs for infrastructure finance portfolios. Nevertheless, this sector has its own share of challenges, the biggest being the viability of some projects within the renewables space and viability of tariffs. There are also concerns regarding the executed power purchase agreements (PPAs) with some state power distribution companies (discoms). Steps are being taken to address some of these issues, including by the government. The upshot is, control on asset quality metrics is crucial for sustainable growth in infrastructure finance, which makes it imperative to be selective about the projects being funded.

The way forward

Fundamentally, demand for credit from the infrastructure sector is expected to stay elevated in the coming days, given the government thrust on development of infrastructure projects and pickup in the macroeconomic environment. The NIP has a target of Rs 111 lakh crore of investments between fiscals 2020 and 2025 — more than twice of what was achieved from fiscals 2014 to 2019. While there are several market participants to channel this growth, there is space for NBFCs, too.

For NBFCs to be able to position themselves well in key infrastructure segments such as roads, renewables and transmission, they will need to leverage their core strengths of strong customer relationships, adaptability, local knowledge, innovation, responsiveness and reach.

Strong risk management systems and ability to manage credit quality will be critical for sustained growth. So will be building a strong liability franchise with access to funding over relatively longer time frames. And, demonstrating a strong asset quality track record and a solid capital base will be important to build stakeholder confidence.

As far as asset quality concerns go, many NBFCs focused on infrastructure finance have strengthened their balance sheets with higher capitalisation, provisioning cover and liquidity. This bodes well for them, as it will support their credit profiles if there are any large unanticipated slippages in asset quality.

Conclusion

After two bleak years staring at decadal lows, NBFCs should ride on the tailwinds of improved macroeconomic fundamentals and strengthened balance sheets. We expect NBFCs to grow 6-8% this fiscal and 8-10% in the next.

Moreover, this growth is expected to be broad-based across retail segments, though the focus will be on traditional asset classes such as home loans, vehicle finance and gold loans. Despite increasing competition from banks, NBFCs have carved a niche in these segments, which, clubbed with their inherent strengths, bodes well for them.

By size, large NBFCs are consolidating their share in the overall AUM pie. Co-lending/partnerships will play a critical role in supporting small and mid-sized NBFCs over the medium term.

As the economic environment improves, we do not see the fundamentals of asset quality being drastically altered. However, the recent regulatory clarifications on NPA recognition will increase reported GNPAs. That said, slippages from the restructured portfolios remains a key monitorable and will drive asset quality performance over the medium term. Nevertheless, we expect a strong capital base, increased provisioning coverage, and healthy liquidity to support NBFCs over the medium term.

In all this, a third Covid-19 wave (including omicron) remains a key risk factor. The extent of spread and intensity and its implications will need monitoring.

All said, NBFCs have shown remarkable resilience and gained importance in the financial sector ecosystem, growing from less than Rs 2 lakh crore AUM at the turn of the century to Rs 25 lakh crore at present. Their share in the overall credit pie has risen from 12% in fiscal 2008 to 17% in fiscal 2021. We believe they will remain a force to reckon with in the Indian credit landscape, given their inherent strength of providing last-mile funding and catering to customer segments that are difficult to address.

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ASSOCHAM derives its strength from its Promoter Chambers and other Industry/ Regional Chambers/Associations spread all over the country.

It was established in 1920 by promoter Chambers, representing all regions of India.

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As a representative organ of Corporate India, ASSOCHAM articulates the genuine, legitimate needs and interests of its members. Its mission is to impact the policy and legislative environment so as to foster balanced economic, industrial and social development. We believe education, IT, BT, Health, Corporate Social responsibility and environment to be the critical success factors.

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