FairConnect Business Advisors Private Limited

FairConnect Comment

Retail Credit: 'High Growth and Reasonable Risk Adjusted Return' Segment

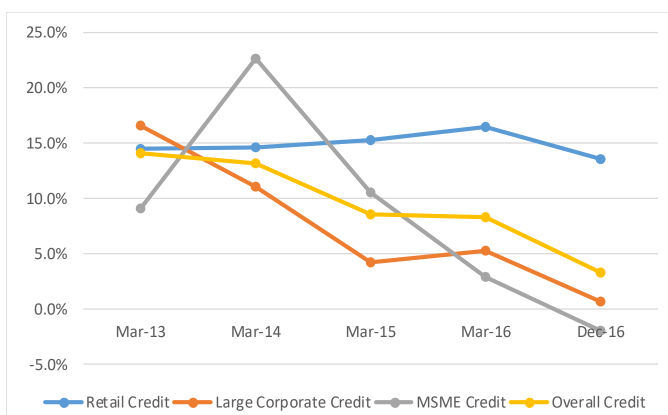
Credit penetration in India continues to grow at a record pace, especially in under-served areas of low to medium income borrowers and medium to small businesses. This is being fueled by NBFCs, housing finance and micro finance companies. Several of these small-medium size NBFCs are well managed with good corporate governance practices, have access to equity from private equity investors. Some of these have improved their credit profiles on the strength of demonstrated track record in scaling up while managing good asset quality and improving on earnings.

However, still several of these companies continue to rely primarily on funding from banks and struggle to access credit especially via the route of fixed income markets, despite offering reasonable credit risk profile. This note focusses the performance of retail credit segment and the opportunities it offers to bond market investors to generate reasonable risk adjusted returns.

Retail Credit focused on low income / affordable segment to grow at close 20% annualized rate

Retail loans segment continue to witness reasonable growth (~15% CAGR over last 3 years) while growth in corporate loan segment remain muted (~7% over last 3 years)[1].

Chart-1: Banks' Trend in Credit Growth



Source: RBI, FairConnect

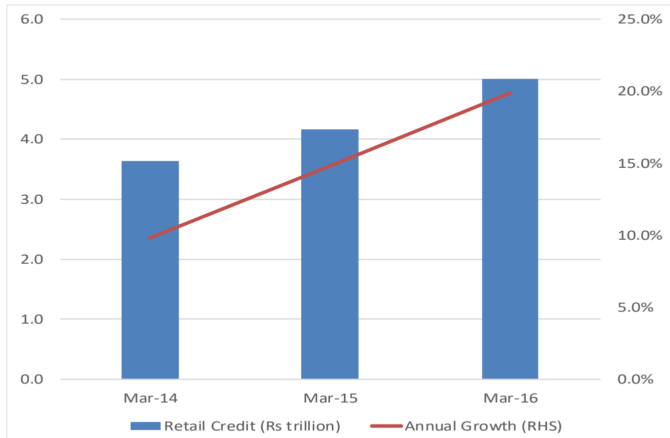
As chart 1 brings out, banks, in particular, witnessed significant difference in growth dynamics across retail and non-retail segment. Banks registered a y-o-y growth of 13.5% as on December 2016 in retail loan segment, despite the negative impact of demonetization vs 0.7% growth rate in large corporate loan segment. Banks'

[1] Retail credit growth is for banks and retail focused NBFCs, corporate credit growth is for banks

retail loan segment growth was 16.4% as on March 2016 and in large corporate loan growth was much lower at 5.3%. Banks' credit growth in MSME segment also was much lower, vs. retail loans, at 3.0% and -1.9% as on March 2016 and December 2016 respectively.

In line with trend in banks' retail loan book growth, retail focused NBFCs also registered a healthy growth rate of 19.8% in FY16 (13.5% in FY15). Housing Finance Companies (HFCs) registered a credit growth of around 20-22% in FY16. Source: ICRA

Chart-2: Retail Focused NBFCs Credit Size & Growth



Source: ICRA, FairConnect

In our estimate, Rs. 6 trillion Indian self-employed / affordable retail finance market[2] is expected to grow at around 20% annual rate provided GDP growth rate is in excess of 6%. India's retail credit penetration as % of GDP remains relatively low at 18% as on March 31, 2016.

While mainstream retail borrows are well served by the large banks and large NBFCs / HFCs. A large number of Indians do not have formal income proof and therefore find it difficult to access credit from the larger institutions. Smaller NBFCs, HFCs (more specifically in affordable housing finance segment) and MFIs are catering to this demand.

Retail focused NBFCs are nimble footed and better placed to provide credit to borrowers which do not have formal income proof

While mainstream retail borrows are well served by the large banks and large NBFCs. A large number of Indians do not have formal income proof and therefore find it difficult to access credit from the larger institutions. Smaller NBFCs, HFCs (more specifically in affordable housing finance segment) and MFIs are catering to this demand; these entities are better placed in this segment on the back of their knowledge of local area, nimble footed structure, lower operating costs vs. mainstream banks and ability to assess credit profile without formal income proof.

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[2] Retail focused NBFCs and HFCs in affordable housing finance segment; size of overall retail finance market (including banks, HFCs and NBFCs) is estimated at around Rs 25 trillion as on March 31, 2016 however most of this is catered by banks / large HFCs / NBFCs.

Better asset quality, lower credit cost support the business proposition for retail loan segment

As table 1 brings out, retail loan segment exhibit good asset quality in banks' loan book (retail NPAs at low levels of <2%) while their overall asset quality taken a significant toll and NPAs risen to multi-year high levels as on December 2016.

Table-1: Retail NPAs & Corporate NPAs for two large banks as on December 2016

	NPAs as on Dec-16		Estimated Annualized Credit cost (9MFY17)[3]	
Name of the Bank	**Retail**	**Overall**	Retail	Overall
State Bank of India	**0.7%**	**7.2%**	0.2%	2.1%
ICICI Bank	**1.8%**	**7.2%**	0.9%	3.7%

Source: Investor Presentation of Banks, FairConnect

Although the gross NPAs and credit costs in the affordable finance segment are likely to be higher than seen for the larger banks. Considering the focused approach, proximity to the customer, delinquencies and eventual losses are likely to allow for good risk adjusted returns for efficient NBFCs / HFCs.

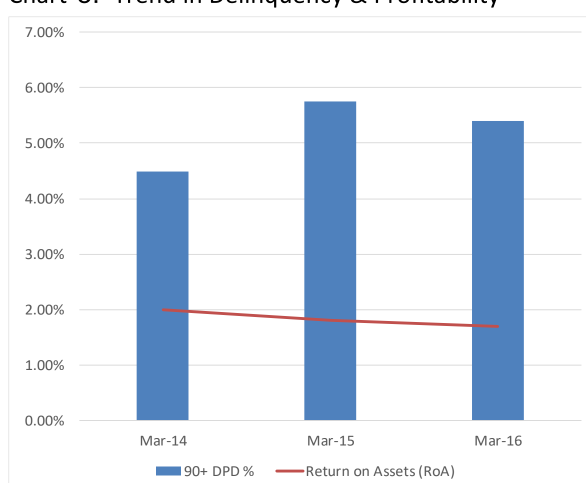
Credit profiles of retail focused NBFCs could continue to improve

As is the case with banks, retail focused NBFCs also have been able to maintain good asset quality profile.

Retail focused NBFCs have maintained healthy & stable profitability too as reflected in Return on Assets (RoA) of 1.7%- 2.0% over last three years. Capitalizations profile of these entities remain comfortable at 15% (net worth in relation to managed loan book), Source: ICRA.

Credit profiles of smaller NBFCs, HFCs in affordable housing finance segment and MFIs have been stable. Several of these entities have witnessed credit rating upgrades over last few years.

Chart-3: Trend in Delinquency & Profitability



Source: ICRA, FairConnect

[3] Overall credit cost is calculated as credit provision in relation to average advances; retail credit cost is calculated as: overall credit cost / overall NPAs * NPAs in retail segment

Considering the business prospects, granularity of the book, stengthening of systrems and proceses as well as access to equity, credit prolifes of retail finance playes could continue to improve.

Demonetization could lead to some stress in short-term, however prudent selection of investments to mitigate the risk

In the aftermath of demonetization, inadequate currency supply, political interference in some states, and disruption in borrowers' cash flows led to a drop in collection efficiencies of entities which lend to small business / entrepreneurs / microfinance.

More specifically for MFIs, as per ICRA, median 0+ dpd[4] for MFIs have increased to 19% as on December 31, 2016 vs. share of overdue loans of less than 1% in MFIs loan book as on September 30, 2016.

Demonetization could also impact growth prospects of entities which do disbursements in cash in H2 FY17. However, in our view, portfolio growth of these entities likely to return to normal levels in FY18.

Overall, demonetization could remain a stress point in short term, however as the economy gets remonetized, withdrawals limits from banking channels are lifted and some transactions move to non-cash modes, environment is expected to improve. RBI's additional 90-day dispensation for NBFCs for classifying accounts as non-performing would provide temporary relief in asset classification and profitability.

Furthermore, prudent selection of investments, via focusing on entities which have comfortable liquidity profile, and adequate profitability and capitalization cushion to withstand short term concerns is likely to mitigate the risk emerging from demonetization.

Retail focused entities to offer good risk adjusted returns for bond market investors; pooled vehicle could serve the purpose more efficiently

So far most of retail focused small-medium size NBFCs are largely dependent on banks for their funding needs. As these entities enjoy reasonable credit profiles (credit ratings of BBB / A category), appear good on financial discipline, and are offering good risk adjusted returns (some of the recent private placement listed debt by these entities were raised at 11.5-13.8% interest rate) and hence may be a good investment avenue for bond market investors. While there are some foreign portfolio investors like ResponsAbility, Blue Orchard, Symbiotics among others, who are active investors in this segment, still most of retail

[4] Days past due (DPD) or overdue loans

focused small-medium size NBFCs continue to struggle to access credit especially via the route of fixed income markets.

However, the purpose could be served well if there is a pooled vehicle where the management team has good understanding of credit profile of these entities, depth knowledge of these sectors and set out strong risk management and monitoring systems.

FairConnect's management team has long experience of assessing credit and business profile of small to medium size retail focused NBFCs and undertaking due diligence on operations of these entities.

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