



FairConnect Business Advisors Private Limited

FairConnect Comment

Loan Against Property (LAP): LAP 'A Long-Term Capital Lifeline for MSMEs'

'Loan against Property' (LAP) market estimated close to Rs. 3 trillion is quite sizeable in relation to overall Indian banking credit to the MSMEs at Rs.8.4 trillion¹ as on March 31, 2016. Further, this market is growing at a much faster pace compared to the overall MSME pie and has significantly lower credit losses.

The level of attraction for the LAP market for lenders can only match the criticism level of analysts. While the market has expanded at an impressive 25%+ annualized pace over the past 3-5 years, caution and criticism from the analyst has remained strong and steady.

We have analysed some of the frequently asked questions on the segment in this blog:

- 1) Can this segment maintain the growth momentum?
- 2) Will credit costs go out of control?
- 3) How do the Loan takeovers impact the credit costs?
- 4) Does the type of property financed impact the credit costs?
- 5) Can one expect double digit Return on Equity?
- 6) How can low risk appetite investors participate in the high growth LAP market?

From the perspective of sustenance in growth, asset quality and earnings, it is important to evaluate the reasons for growth in the market and the risk factors to the lenders.

1. Can this segment maintain the growth momentum?

Key reasons for buoyancy in the 'LAP' segment are the funds through this channel:

- It fulfils a dire need for long term capital for MSME
- It eases the liquidity pressure for MSMEs
- It enhances MSMEs capacity to scale up

For MSMEs, it is rather difficult to get long term loans from banks owing to low income reporting (by the MSMEs) as well as high margin requirement specified by the banks. Getting equity from capital markets is even more difficult owing to challenges on reported income and lack of adequate investor appetite.

However, a large number of lenders in LAP market go beyond reported income to assess the repayment capacity, basis which these lenders are able to extend loans fairly efficiently and thus 'LAP' becomes the Long-Term Capital Lifeline' for MSMEs. Additionally, the underlying property gives visibility on recovery

¹ Extended by SCBs, as per RBI monthly credit data

to the lenders, should the assessed income trajectory go awry, enabling them to extend the loans for longer tenures, which could be 10-15 years.

Long term nature of the product reduces the pressure on liquidity or may help the MSME to scale up business as much as 2.5 times owing to lower debt servicing burden. Reduction in liquidity pressures can lead to systemic stability in credit profiles, as liquidity remains a key reason for credit rating downgrades (35% for CRISIL rated companies in CY 2017 and over 20% for ICRA rated companies in FY 2017).

Debt burden of a 10-year LAP loan is only 30 – 40% of a short-term loan as seen from the table below:

Table 1: Debt Servicing Burden for LAP vs. Term Loan

	Loan Against Property	3-year Tenure Loan
Loan Amount in Rs. Million	2	2
Rate Of interest	12.5%	12.5%
Tenure	10 years	3 years
Debt Servicing Burden for a quarter (in Rs.)	87,826	229,167
Debt Servicing Burden for LAP in relation to 3-year Term Loan	38%	

Therefore, the growth in LAP market which is catered to by the NBFCs, Banks and housing finance companies should be seen as filling in the source for funding gap for long term finances as well as part replacement of MSME loans (for both term loans and working capital loans), where the lenders have been cautious after suffering significant losses.

Overall from demand perspective, considering the size and diversity of Indian MSMEs, better economic prospects, limited development of long term fund market and the ease of financing in LAP segment, strong growth prospects for LAP market over next 3-5 years seem pretty much in place.

2. Will credit costs go out of control?

Credit costs in the segment are linked to the

- 1) Risks associated with the borrowers' ability to pay
- 2) Level of Frauds
- 3) Severity of loss in case of auction in a severe stress scenario

We focus on the first and third factor, as some risk of fraud may remain in the system, although the risks may reduce once lenders start effective utilization of Central Registry of Securitisation Asset Reconstruction and Security Interest.

1) Risks associated with the borrowers' ability to pay

These risks are a function of the following:

- Business and Financial Risks, which typically manifest in the form of:
 - Overestimation of demand

- Excessive competition
- Change in business dynamics
- Stress in liquidity
- Overleveraging
- Diversion of funds: if the funds are diverted for non-business purposes or unrelated or speculative businesses with unpredictable cash flows

Clearly if the funds are not diverted for speculative purposes, the underlying risks in the LAP segment are no different from any other form of MSME lending. As per CIBIL, NPAs in MSME segment have reached 8.7% as on March 31, 2016. However, NPAs in LAP are less than a third of this for most players owing to better credit assessment and the underlying collateral, which could be lowering the propensity to default.

Going forward as well, understanding of businesses, good credit underwriting, good risk policies ensuring the diversity are key mitigants against any significant risk.

Over and above the primary risk mitigants, build-up of equity with amortization provides an additional layer of protection.

2) Severity of loss in case of auction in a severe stress scenario

Given the nature of product and likely borrower profile, 90 day delinquencies at around 2% - 5% may be inevitable in a normal scenario. However, in a stress scenario, debt servicing capability of MSMEs could get impacted leading to significant rise in delinquencies.

While some of these delinquent accounts may get cured, overall severity of loss on the balance would be a function of the following:

- LTV of the loan at the time of auction, which in turn would be a function of the following:
 - Original LTV
 - Amortization of the loan
 - Decline / increase in property prices
- Distress discount on the value of property auctioned
- Time taken to repossess, sell and realize the money (which may be a function of value and type of property)
- Legal Expenses incurred on the recovery

Original LTV and decline in property prices can have a significant impact on the severity of loss as seen from the table below:

Table 2: Severity of loss for Loans disbursed at various LTVs, if the default crystalizes one year after the disbursal²

Loss in relation to Loan amount in the following Scenarios			
Original LTV	Normal Scenario	Moderate Stress	Severe Stress
50%	0%	0%	1%
55%	0%	0%	11%
65%	0%	10%	28%
75%	14%	25%	41%
85%	26%	36%	50%
95%	36%	45%	57%

As seen from the table, in a normal scenario a lender may have negligible credit costs for loans up to 65% LTV. However, in a severe stress scenario, the lender may have to incur 28% loss. However, for higher LTV loans (more than 75% LTV), severity of loss in case of default may be as high as 14% in a normal scenario and may increase to over 40% in a stress scenario.

It would be interesting to construct a hypothetical portfolio on the basis of LTV and estimate the overall life time credit losses on the basis of this portfolio

Table 3: Life time credit losses for a hypothetical portfolio

LTV Range	Proportion of the book	Loss in relation to Loan amount in the following Scenarios		
		Normal Scenario	Moderate Stress	Severe Stress
Less than 50%	25%	0%	0%	1%
50%-60%	30%	0%	0%	11%
60%-70%	40%	0%	10%	28%
70%-80%	5%	5%	16%	34%
80%-90%		26%	36%	50%
90%-100%		36%	45%	57%
Weighted Average life time loss for the Portfolio		0.2%	4.7%	16.5%

As seen from the table, life time credit losses could rise multifold, if there are defaults in the high LTV bucket in a stress scenario. Therefore, it might be worthwhile for lenders not to have excessive reliance the property as security even when LTVs are low at 50-60% and also to price the risk appropriately for loans more than 50% LTV.

² Assuming distress sale haircut at 20% and recovery expenses at 7-8% of loan amount, recovery period of 18 months from the date of default

As seen from the table, life time credit costs may rise to 4.7% in a moderate stress scenario, which may translate into annual credit cost of 90 – 100 basis points.

If the lenders can avoid excessive LTVs and ensure proper cash flow assessment, the delinquencies may not rise significantly as economic activity is expected to improve. Secured nature of product, with build-up of equity with amortization of the loans, increasing coverage of CIBIL, and effectiveness of SAFAESI are additional mitigants against the rise in delinquencies. **In light of this, annual credit costs (including standard asset provisioning) may not increase substantially from current levels (0.7%-1%).**

3. How do the Loan takeovers impact credit costs?

Loan takeovers (whereby the loan from old lender is prepaid by taking a new loan from a new lender against the same property) are a common practice in the industry. Typically loan takeovers are also accompanied by top ups (additional loan funding post the takeover).

The top ups may be a sign of stress in the account especially when the additional loan is taken without commensurate increase in business. As in this situation, the cash flows may not be sufficient to repay even the existing loan and the with the increase in loan quantum, debt servicing burden could only increase further.

Further, in case such takeovers are accompanied with increase in the LTV, severity of loss could go also up.

However, if the entrepreneur is getting the loan refinanced to support increased business volumes and the cash flows can support the debt servicing, within a reasonable LTV, delinquencies and therefore credit costs may not go up.

Further, if the loan has amortized significantly, and the entrepreneur is shifting the loan to a new lender to reduce the debt burden by increasing the loan tenure or is shifting to get the benefit of lower interest rates, the credit costs may not go up.

Loan takeovers, if done in cash flow stress situation may lead to a rise in credit costs. However, if the underwriting discipline is maintained, takeovers may not necessarily mean higher risk.

4. Does the type of property financed impact the credit costs?

Type of property financed influences the following:

- Likelihood of default
- Time period taken to auction the property
- Legal expenses incurred on recovery

If the underlying property financed is 'Self-occupied Residential Property' likelihood of default may be lower, although once the loan becomes delinquent, expected recovery may be lower as the time taken to repossess, sell and realize the money may be longer. **However, on overall basis credit costs on a Lap**

against self-occupied residential property is likely to be lower than a similar sized other type of property (commercial building, industrial building or a piece of land)

At the same time, size of property could influence the ease of auction of the property (larger properties are more difficult to sell) as well as legal expenses (legal expenses in % terms may be disproportionately high in relation to a small loan).

Liquidity could be an issue for a large property, increasing the time to auction, further the lender may end up with a larger haircut on the property. Therefore, it may be prudent to either have more conservative LTVs for larger tickets loans or better pricing to compensate for likely higher credit costs.

For very small loans (less than Rs. 20 lakh), legal costs may reduce the overall recovery percentage. As legal costs, may range from 5 – 10% for such loans.

Overall, self-occupied residential property of the size of Rs. 5-7.5 million at less than 60% LTV may have very low credit costs, any deviation on the size and type of property may increase the credit costs.

5. Can one expect double digit Return on Equity?

Landers's ability to translate high growth and low credit costs in ROEs would be linked to the discipline followed by the lenders in pricing the loans as well as effective origination costs.

Some lenders may end up spending significant on customer acquisition (1-2%) for a 10-15-year loan, whose effective life may get reduced to half because of high customer attrition rates. Further, for some of these loans lending spreads are so thin especially in Tier 1 cities that the return on equity could drop to single digit.

Lenders with minimal reliance on outsourced model, geographical spread in Tier II and Tier III towns and superior service levels may have low DSA payouts and longer effective tenure of the loans. This may lead to resilient double digit returns on the product. Lower rated issuers can enhance the return on equity through improving capital efficiency through securitization route.

6. How can low risk appetite investors participate in the high growth market?

There are very few monoline players operating in the segment, therefore in case low risk appetite investors want to participate only in LAP market, securitization offers that channel.

Investors can avoid taking the risk on balance sheet of the lender by investing in pass through certificates. Careful selection of the originator based on the quality of appraisals and systems as well as of the pool, along with the credit enhancements can help the low risk appetite investors to participate in the high growth market.

Objective of this could be to build priority sector portfolio or high quality book at reasonable net interest margins.

Although participation of FPIs has been very limited so far, given the size, good performance of the underlying pools, and the attractive alpha (150-200 basis points over govt securities for AA rated papers), the prospects for investments in the segment seem good.

To sum it up

- **Growth Prospects Remain Strong:** 'Loan against Property' is likely to maintain a growth trajectory given it fulfils a basic need for long term funds for MSMEs.
- **Credit costs may not rise significantly:** At the same time, secured nature of product, increasing coverage of CIBIL, and effectiveness of SAFAESI do give the enabling platform to the lenders. Thus, build-up of equity with amortization of the loans and a pick-up in economic activity is likely to ensure less than moderately low credit losses for the lenders.
- **Loan takeovers may not necessarily mean higher credit risk:** Loan takeovers, if done in cash flow stress situation may lead to a rise in credit costs. However, if the underwriting discipline is maintained, takeovers may not necessarily mean higher risk.
- **Type and size of property do influence the credit costs:** Type of property does have a bearing on propensity to default and recovery post default. **For instance, self-occupied residential** property of the size of Rs. 5-7.5 million at less than 60% LTV may have very low credit costs, any deviation on the size and type of property may increase the credit costs.
- **Double digit Return on Equity are possible:** Landers's ability to translate high growth and low credit costs in ROEs would be linked to the discipline followed by the lenders in pricing the loans as well as effective origination costs.

Securitization can facilitate participation of low risk appetite investors: Securitization can lower the credit risk by suitable credit enhancements. Careful selection the originator based on the quality of appraisals and systems as well as of the pool, along with the credit enhancements can help the low risk appetite investors to participate in the high growth market.

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