



FairConnect Business Advisors Private Limited

FairConnect Comment

Demonetization: Specialized monitoring required to help investors safeguard the 'Double Bottom Line Investments'

NBFC-MFI (NBFC-Micro Finance Institutions) sector which provides door-step credit to low-income individuals and have a client base of close to 33 million is playing extremely critical role in providing credit to un-served population in the country. The sector also employs close to 0.1 million people across its branch network of close to 9,900 across the country¹.

Rs. 550 billion NBFC-MFIs are going through a crucial phase 'post demonetization' a phase during which collection efficiencies dipped significantly, from 99% to around 80-85% in the month of November and December 2016. The internal efforts at MFIs, efforts of Self-Regulatory Organizations (SROs) as well as the maturity of investors and credit rating agencies will determine the trajectory for future progress of these last mile financial inclusion providers post this difficult phase.

FairConnect has developed an in-house framework to segregate the MFIs based on their unique challenges and strengths and can advise the lenders and investors in preserving their portfolio quality as well as relationships with the investee companies.

Based on the advice, investors can fine tune their strategy, devise the key monitorable and revamp default related covenants. Developmental Financial institutions can step up equity and debt allocations for sector to maintain continuity and resilience for better performing companies.

¹ Source: MFIN; The clients number here is the aggregate of clients of member MFIs. Given some degree of overlaps, it does not reflect the number of 'unique' clients

Collection efficiencies were severely impacted, but are on improvement trajectory

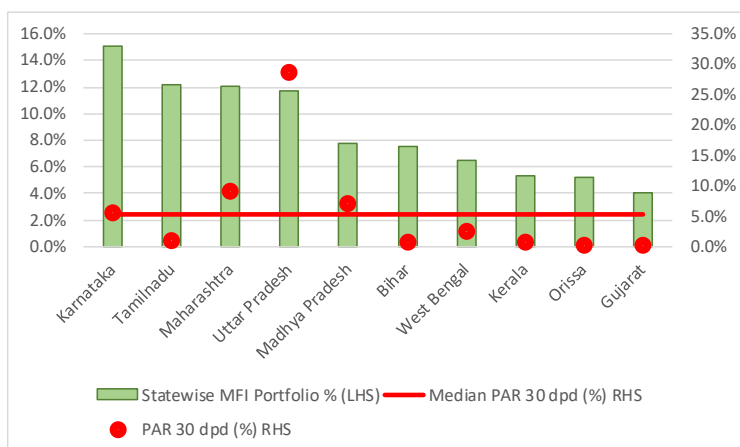
Table-1: Movement in Collection Efficiency % for listed MFI players

Name of Entity	Up to Nov	Up to Dec	Upto Jan ()
Bharat Financial Inclusion			
Collections against November dues	91.0%	96.8%	97.5% (19th Jan)
Collections against December dues		88.8%	92.5% (19th Jan)
Satin Creditcare Network			
Collections against November dues	65.3%	81.2%	88.1% (25th Jan)
Collections against December dues		57.9%	77.6% (25th Jan)
Ujjivan Financial Services			
Collections against November dues	90.6%	93.7%	95.4% (18th Jan)
Collections against December dues		88.2%	91.1% (18th Jan)
Equitas Small Finance Bank			
Collections against November dues	96.8%	99.3%	99.3% (26th Jan)
Collections against December dues		96.3%	96.6% (26th Jan)
Average of above entities			
Collections against November dues	85.9%	92.8%	95.1%
Collections against December dues		82.8%	89.5%

Source: Investor Presentation of Companies

As seen from table 1, collection efficiency got impacted quite severely in November 2016, but the adverse impact of demonetization on collection efficiency is waning as seen in improvement in collection efficiency for all players in January 2017 from low levels of November 2016. Impact was lesser for companies with better geographical diversity and for the small finance bank (as it could continue to accept old currency).

Chart-1: State wise MFI 'Portfolio %' vs Portfolio at Risk% as on December 31, 2016



Source: MFIN, FairConnect

From risk perspective, learnings are quite evident from the table-1 & chart-1. Local issues can have a more pronounced impact on collection efficiencies. For instance, the Karnataka state (which has 15 % of overall MFI portfolio) saw its 30+ delinquencies rising to 5.7%; while UP, which also has a sizeable share in overall microfinance credit at 11.7 %, saw its 30+ delinquencies rising to 28.7 %. The local level issues

may be rather complex and difficult to predict. **In light of this, Geographical diversity adds to resilience as seen in Bharat Financial Inclusion collection performances.**

Further, political risk remains one of key residual risks, despite the phenomenal efforts of MFIs and SROs, collection efficiencies in western UP is significantly inferior compared to any other geography in India.

Banks, end up getting better regulatory treatment vis a vis NBFCs. Therefore, better regulatory supervision, oversight and differential superior support from RBI for banks, is likely to reduce the risk for MFIs getting converted into banks.

Earnings to get hit in FY2018, digital movement to be structurally positive over long term

Deeper issues such as loss of income and increase in informal indebtedness during November and December 2016 and worsening of credit culture issues may continue to keep collection efficiencies low in FY2018 vs. levels seen in pre-demonetization. As a result of this, some MFIs may need to provide for significantly higher credit losses, leading to lower profits / losses in FY2018.

Over long term, while the adoption of digital payments and availability of currency post demonetization can remove the constraints of currency availability leading to an improvement in collection efficiency from low level of November and December 2016.

However, impact on credit profiles may not be uniform over Long Term

However, the extent of damage and therefore damage control will be unique for each entity due to geographical and product diversification, differential cost structures, capital structure and access to liquidity and equity. While one NBFI may make loss in the short term, but may remain solvent and return

to normal levels of business; another may remain profitable in the short but could be precarious over longer term due to structural weaknesses.

Therefore, it would be important to understand the unique position of each entity, as well as its strategy to mitigate the current and future risks to maintain resilient profitable operations.

Appreciation of differences and support of Investors required for MFIs to come back on track post demonetization

While companies undergo this learning phase, it would be equally important for investors and rating agencies to appreciate these nuances so that liquidity profile of the MFIs (who have minimal long term credit issues) is maintained and the companies do not end up folding up due to temporary issues. One such concern is the presence of stricter financial covenants (for instance 30+ days past due or DPD not to exceed 5-10%, this covenant may get breached for some MFIs). It would be important that investors do not mechanically apply such triggers, as this may trigger a liquidity event and default crystallization for all the investors.

It would be critical for MFIs (with temporary issues) to continue accessing funds for supporting the growth in asset base. Borderline MFIs would need equity infusion and those with weaker capital structure, limited management bandwidth and limited scale may be better off merging with the stronger ones.

Case 1: Company with Temporary Issues - Financial performance of company post demonetization (6-month period post demonetization)

Numbers in Rs. Crore			
Net worth	50.0		
Loan Book	360		
Cash & bank balances	40		
Borrowings	350.0		
		Collection efficiency post demon	
Collection Efficiency	99%	85%	85%
Key Financial Numbers (for 6 months)	Pre demonetization	Post Demonetization	
		Company 1: making 25% Provisions on 'loans in default'	Company 2: making 40% Provisions on 'loans in default'
NIMs	9.5%	8.8%	8.4%
Credit Provisions (assuming adequate Provisioning)	0.3%	3.8%	6.0%
Profitability (PBT Level)	3.0%	-1.2%	-3.9%
Profitability (PAT Level)	2.0%	-1.2%	-3.9%
ROE	16.1%	-9.3%	-31.0%

Refer annexure-1 for detailed analysis

Merely looking at the financials the “company 2” seems to be headed for a disaster and hence the lender may seem to be better off recalling the loan, so that the one who recalls the loan first is curtailing its loss given default.

However, going by the credit nuances the company's financials over next 12 months (post six months of stress periods) may look like as follows:

Key Financial Numbers	Post demonetisation			
	Company 1: making 25% Provisions on 'loans in default' in first 6 months and 40% thereafter		Company 2: making 40% Provisions on 'loans in default'	
	First 6 months	Next 12 months	First 6 months	Next 12 months
Collection efficiency assumed	85%	95%	85%	95%
NIMs (at target gearing)	8.8%	9.2%	8.4%	9.1%
Credit Provisions	3.8%	3.1%	6.0%	2.0%
Incremental profitability (PBT Level)	-1.2%	-0.5%	-3.9%	0.5%
Incremental profitability (PAT Level)	-1.2%	-0.5%	-3.9%	0.3%
ROE (annualized)	-9.3%	-3.7%	-31.0%	2.7%

Refer annexure-2 for detailed analysis

Clearly the company 2 will come back to normal after 12- 18-month phase, provided there is no liquidity event and the company continues to get debt fund to support growth. At the same time, Company 1 may take longer to catch up as it created lower provisions to begin with.

Lender's pro activeness may be crucial to support the liquidity profile of the MFIs as well as the growth prospects

While the MFIs may finally emerge stronger from this crucial phase, their ability to do so and continue contributing towards the financial inclusion would be critically dependent on maturity and patience shown by the investors (both debt and equity).

In this crucial phase, a large number of lenders / investors may see their triggers (which are defined at as low as 30+ delinquencies hitting 5% for an unsecured lender) getting breached, therefore

giving the lenders a right to recall the loan / investment. The only practical option left with the investors would be to relax the stringent covenants temporarily for a large number of investments, else they could end up in a self-inflicting default led by the liquidity crunch at the NBFC.

It may be worthwhile to have revamp at some of the covenants, by aligning them to market realities and incorporating the mitigating factors to ensure safety of investors' funds by factoring in the excess interest or capital cushions available while avoiding invocation of triggers too frequently. This phase also calls for close monitoring for key credit parameters, increase due diligence in troubled centers.

Lenders/Investors can fine tune their monitoring and strategy and as default covenants

Based on extensive experience of the team, FairConnect has developed an in-house framework to segregate the MFIs based on their unique challenges and strengths and can advise the lenders and investors in preserving their portfolio quality as well as relationships with the investee companies.

Based on the advice, investors can fine tune their strategy, redefine some of the default related covenants and devise the key monitorable. Developmental Financial institutions can step up these equity and debt allocations for sector to maintain continuity and resilience for better performing companies.

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Annexure-1: Company with Temporary Issues - Financial performance of company post demon (next 6 month)

Numbers in Rs. Crore			
Net worth	50.0		
Loan Book	360		
Cash & bank balances	40		
Borrowings	350.0		
Lending yield	22.50%		
Collection Efficiency	99%	85%	85%
Key Financial Numbers (for 6 months)	Pre-demonetization	Post Demonetization	
		Assuming credit cost of 25% of shortfall in recovery	Assuming credit cost of 40% of shortfall in recovery
Yield on loans	22.4%	21.7%	21.2%
Cost of funds	12.8%	12.8%	12.8%
Interest spread	7.9%	7.2%	6.8%
NIMs (at target gearing)	9.5%	8.8%	8.4%
Processing fees	0.8%	0.8%	0.8%
Operating costs	7.0%	7.0%	7.0%
Operating profitability	3.3%	2.6%	2.1%
Credit Provisions (assuming adequate Provisioning)	0.4%	3.8%	6.0%
Profitability (PBT Level)	2.9%	-1.2%	-3.9%
Profitability (PAT Level)	1.9%	-1.2%	-3.9%
ROE	15.1%	-9.3%	-31.0%

Annexure-2: Company with Temporary Issues - Financial performance of company post demon (next 6 month)

Key Financial Numbers	Post demonetisation			
	Assuming credit cost of 25% of shortfall in recovery in first 6 months and 40% thereafter		Assuming credit cost of 40% of shortfall in recovery	
	First 6 months	Next 12 months	First 6 months	Next 12 months
Collection efficiency assumed	85%	95%	85%	95%
Yield on loans	21.7%	22.1%	21.2%	22.1%
Cost of funds	12.8%	12.8%	12.8%	12.8%
Interest spread	7.2%	7.6%	6.8%	7.6%
NIMs (at target gearing)	8.8%	9.2%	8.4%	9.1%
Processing fees	0.8%	0.8%	0.8%	0.8%
Operating costs	7.0%	7.4%	7.0%	7.4%
Operating profitability	2.6%	2.6%	2.1%	2.5%
Credit Provisions	3.8%	3.1%	6.0%	2.0%
Incremental profitability (PBT Level)	-1.2%	-0.5%	-3.9%	0.5%
Incremental profitability (PAT Level)	-1.2%	-0.5%	-3.9%	0.3%
ROE (annualized)	-9.3%	-3.7%	-31.0%	2.7%