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FORESIGHTS

UNSECURED LENDING: OPPORTUNITY FOR GROWTH OR LOOMING RISK?

The overall credit combined for Banks and NBFCs saw a CAGR of 12% during FY17 to FY23 and stood at Rs.170.5 lakh crore as of March 2023.

During the same period, the personal loan book (including all retail for NBFCs) growth stood higher with a CAGR of 19%. In absolute terms, personal loan credit by banks and NBFCs has almost tripled in the past six years. But is this remarkable growth also a potential risk? CareEdge Ratings does a deep dive.

GDP Growth Surprises on the Upside at 7.6% in Q2 FY24

Diagnostic Sector to See Stable Double-digit Growth in Medium Term

Proposed ECL Framework Likely to Have Moderate Impact on Banks

NOTE FROM
SACHIN GUPTA
Chief Rating Officer & Executive Director

In recent weeks, three significant developments have unfolded, shaping India's economic and political landscape. Firstly, the release of the Q2 (July-September 2023) GDP figures showcased a robust growth rate of 7.6%, surpassing general expectations. Secondly, the Reserve Bank of India (RBI) heightened the capital requirement for banks and Non-Banking Financial Companies (NBFCs) concerning their exposure to personal loans. The regulatory adjustment reflects concerns about the accelerated growth in consumer lending, prompting measures to mitigate risks. Thirdly, the recent elections across all five states yielded decisive political mandates. The outcomes underscore the nation's political landscape's stability, lending confidence to investors.

Let us go look into these developments in further detail.

The release of Q2 (July-September 2023) GDP figures revealed a robust growth rate of 7.6%, surpassing general expectations. This growth shift is particularly notable as Manufacturing contributed significantly as against the earlier quarters where Services dominated. This signals a pivot towards 'investment' - driven growth from the previous reliance on 'consumption' - oriented progress.

However, amidst this economic momentum, the RBI introduced heightened capital requirements for banks and NBFCs regarding their exposure to personal loans. This action, while indicative of a thriving economy, also underscores the RBI's cautious approach to the rapid surge in consumer credit growth. The RBI's concern stems from the substantial increase in banks and NBFCs' exposure to consumer credit, which has surged approximately 25%-30% year-on-year over the last several quarters. Despite relatively low delinquencies and Non-Performing Assets (NPAs) in this segment, the RBI is wary of the undisclosed end use of these borrowed funds.

The RBI's decision to elevate the risk weight on banks' lending to NBFCs will have a tangible cost impact, estimated at around 0.4% for banks, to be transferred to the NBFCs. Beyond increased borrowing costs, NBFCs might confront challenges in accessing bank loans if financial institutions heed the RBI's guidance and curtail their exposure to NBFCs. This scenario could substantially impact lower-rated NBFCs, highly reliant on banks and other NBFCs for funding. Conversely, higher-rated NBFCs are anticipated to pivot towards more active engagement with bond markets and may opt to issue Pass-Through Certificates (PTCs) by securitising their unsecured loans.

Simultaneously, the decisive electoral mandates witnessed across all five states in recent weeks hold profound implications for India's economic landscape. Beyond just confirming the political trajectory, these elections pave the way for a continuity of stable governance, a crucial factor for businesses and investors alike. Corporations, both domestic and international, are more inclined to channel resources into capacity expansions, technological advancements, and innovative ventures. The robust support from a stable administration emboldens corporations to pursue growth strategies. The ripple effect of increased private sector investments spans various sectors, ranging from infrastructure and manufacturing to technology and services. These investments have the potential to revitalise regional economies, stimulate job creation, and enhance productivity, thereby contributing to the nation's GDP.

These multifaceted developments in India's economic and political spheres warrant a close examination, reflecting not only growth but also a cautious approach to financial risk and a promising outlook for investment and stability.

NOTE FROM
RAJANI SINHA
Chief Economist

In the December monetary policy meeting, the MPC opted to keep the policy repo rate unchanged at 6.5% and retained its stance of 'withdrawal of accommodation.' Notably, the tone of the policy statement exhibited a lesser hawkish undertone compared to the preceding statement. The RBI conveyed a sense of optimism regarding the growth trajectory, evident in its upward revision of the FY24 growth forecast to 7%, higher than the earlier projection of 6.5%.

Several favourable developments have contributed to an improved economic landscape. The upward surprise in Q2 GDP growth, core inflation easing closer to the RBI's target of 4%, softening of U.S. Treasury yields, and moderation in Brent crude oil prices to around USD 75/bbl. High-frequency data underscores brighter economic prospects, supported by the strong growth in eight core sectors, capacity utilisation levels exceeding long-term averages, growing GST collections and heightened festive demand. Public capex has also remained strong and monthly services exports have sustained above USD 27 billion, demonstrating resilience despite a global slowdown. However, there are some underlying factors that could pose economic headwinds. Following the projected contraction in Kharif production, careful monitoring of progress in rabi sowing is imperative, amid lower reservoir levels in some regions. Reduced agricultural output not only poses a risk to rural demand but may also contribute to food inflation. Moreover, the fragile state of the global economy and the contraction in global trade may have spillover effects on the domestic economy. Consequently, the governor's statement adopted a cautious tone, acknowledging these considerations.

The RBI has retained its inflation projections for FY24 at 5.4%. Softer core inflation, contracting WPI, correction in global food prices and moderating Brent crude oil prices will help ease domestic inflationary pressures. However, the risks stem from volatility in food prices. The recent sequential increase in prices of key vegetables can keep headline inflation elevated in the near term.

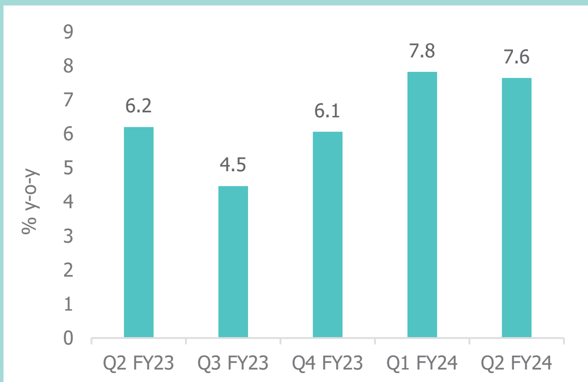
The current liquidity conditions align with the monetary policy stance. Currency leakage during the festive season, robust government cash balances, and the RBI's market operations have collectively contributed to a significant tightening of liquidity conditions, reducing the necessity for Open Market Operations (OMO) sales. Notably, the absence of any mention of future OMO sales in the governor's statement provides reassurance to the bond market. However, it's noteworthy that the RBI has been conducting small-value OMO sales in the secondary market. The RBI continued its focus on financial stability, especially given the robust growth in certain segments of personal loans.

The RBI is expected to adopt a nimble approach, implementing liquidity management operations as and when necessary to support money market conditions. Looking forward, the central bank remains committed to supporting growth while exercising caution in the face of evolving macroeconomic headwinds. Tight liquidity conditions are expected to persist, and the likelihood of a rate cut is anticipated after the first quarter of the next fiscal year, aligning with a period when quarterly inflation is projected to approach the 4% target.

GDP GROWTH SURPRISES ON THE UPSIDE AT 7.6% IN Q2 FY24

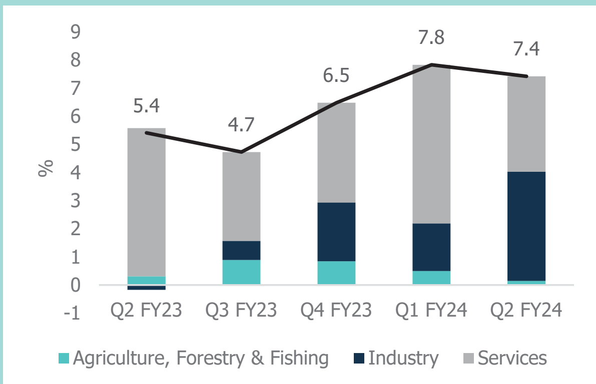
Economy maintained momentum in the second quarter (July-September) of FY24 with GDP growth at 7.6% following a 7.8% growth in the first quarter. The growth was much higher than expected, mainly driven by investments and government consumption. However, private consumption remained muted due to weak rural demand and some moderation in urban demand amid elevated inflationary pressures in Q2. On the supply side, a significant improvement in manufacturing and construction activities supported growth. Services sector lost momentum which could indicate normalisation of discretionary spending by the urban consumers. For the first half of the fiscal, economy expanded by 7.7% compared with 5.3% in H2 of FY23.

Quarterly GDP Growth



Source: MOSPI

Sectoral Contribution in GVA Growth



Source: MOSPI

GDP by Expenditure – Investment Accelerates, Private Consumption Muted
Investment demand grew by 11% compared with 8% growth in the first quarter. Investment rate (GFCF as % of GDP) inched higher to 35.3% compared with 34.2% a year ago. This was supported by higher capital expenditure at both Central and state government level. The Centre's capex was nearly 26% higher in Q2, while state's capex grew by more than 40% in Q2 FY24.

Private consumption growth faltered in Q2 to 3.1% from 6.0% growth in Q1 FY24. Despite a robust growth in high-frequency indicators such as GST collections, retail credit, PV sales etc., weakness in rural demand impacted overall consumption growth. A confluence of factors such as weak monsoon and high food inflation have been weighing on rural demand sentiments. Going ahead, the outlook on rural demand remains mixed. The uncertainty surrounding agricultural prospects and elevated prices of certain essential food items will continue to bite. However, government relief measures ahead of the elections such as reduction in LPG prices, extension of Prime Minister Garib Kalyan Yojana (PMGKAY) for another five years till 2029 etc. will provide some cushion. Government consumption jumped sharply in Q2 by 12.4%. It was the highest rate of expansion in 2.5 years.

Net exports continued to widen and contributed negatively to the growth as imports growth outpaced exports growth in Q2. It fell to negative Rs 2.8 lakh crore in Q2 FY24 from negative Rs 2.6 lakh crore in the previous quarter and negative Rs 1.5 lakh crore a year ago.

Growth in Consumption and Investment (% y-o-y)

	Q2 FY23	Q2 FY23	Q3 FY23	Q1 FY24	Q2 FY24
Government Final Consumption Expenditure (GFCE)	-4.1	-0.6	2.3	-0.7	12.4
Private Final Consumption Expenditure (PFCE)	8.3	2.2	2.8	6.0	3.1
Gross Fixed Capital Formation (GFCF)	9.6	8.0	8.9	8.0	11.0
GDP (at constant prices)	**6.2**	**4.5**	**6.1**	**7.8**	**7.6**

Source: MOSPI

Sectoral Performance in Q2 FY24 – Industry Shines, Agri Struggles
Industrial sector picked up momentum with manufacturing and construction activities witnessing significant acceleration. The sector grew by 13.2%, up from 5.5% growth a quarter ago. A positive business optimism and strong growth in new orders supported manufacturing output with net sentiments on profit margin turning positive during Q2 FY24 (RBI's Industrial Outlook Survey for Q2 FY24).

Manufacturing sector growth accelerated to 13.9% in Q2 led by industries such as motor vehicle, trailers, metals, minerals and petroleum, pharma, and chemicals etc. Construction sector (13% growth in Q2) benefited from a poor rainfall during August and September and higher implementation of infrastructure projects. This was reflected in robust cement and steel production and power demand during the quarter.

Services sector growth in Q2 moderated to 5.8% from 10.3% a quarter ago partly due to normalisation of base effect and possibly some dilution in discretionary demand. Consequently, the sector's contribution to GVA growth fell to 46% from 72% a quarter ago.

Agricultural sector growth faltered to 1.2% in Q2 FY24 from 3.5% in the previous quarter. It was the slowest growth seen in 4.5 years due to erratic rainfall this year. India experienced weakest monsoon in 2023 since 2018 cause by development El Nino conditions. Lower rainfall not only impacted sowing of some major Kharif crops such as pulses, oilseeds but also led to lower reservoir levels. The first advance estimate of Kharif output reinforces the concerns surrounding production of rice, pulses and oilseeds.

Way Forward
The strong growth in the first half of FY24 has been driven by resilience in urban demand and front loading of government's capital expenditure. While festive cheer will support urban demand in Q3, the outlook for rural demand revival remains clouded amid monsoon deficiency and likely hit to the agricultural production. The recent announcements of various relief measures such as LPG price reduction and extension of PMGKAY are expected to provide some cushion. So far investment demand has remained robust, however, there could be some moderation in H2 as both government and private sector may restrain their capital spending ahead of the general elections. Despite some expected moderation in the second half, India's overall GDP growth for FY24 will remain on a firm footing.

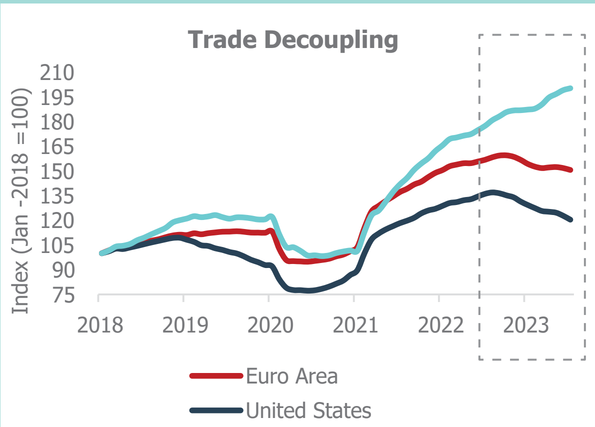
GLOBAL TRADE DECOUPLING AND INDIA

Trade Decoupling: Chinese Trade on with Western World on Decline
Against the backdrop of escalating tensions between the United States and China, terms such as supply chain resilience, reshoring, nearshoring, and deglobalization have gained significant traction. The initial impetus for trade decoupling emerged from the broader US trade deficit with China, resulting in the trade war of 2018-2019. However, this trend gained further momentum during the pandemic era due to supply chain vulnerabilities and geopolitical concerns. Western economies began actively seeking reliable and resilient supply chains.

Russia plays a notable role. This shift reflects a potential reorientation in global trade dynamics, with China actively diversifying its economic partnerships amid evolving geopolitical and economic landscapes.

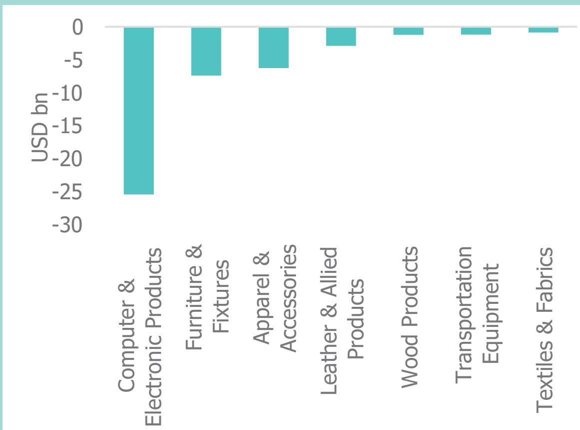
China is the Largest Major Non-Sanctioned Country to Witness a Contraction in Exports to the US
Upon closer examination of trade data, a notable pattern emerges. While total US merchandise imports witnessed a growth of USD 706 billion between 2018 and 2022, Chinese exports to the US experienced a nominal contraction of approximately USD 4 billion. It's worth noting that this contraction

Figure 1: Chinese Total Trade with the Western World on Decline



Source: IMF. Data represents total merchandise trade value (export+imports), 12 month rolling total indexed to January 2018 =100.

Figure 2: Contraction in US imports from China by Products Since 2018



Source: International Trade Administration, U.S. Department of Commerce.

A recent trend indicates the potential emergence of trade decoupling, evident in the declining trajectory of total merchandise trade between China and both the United States and the Eurozone. Simultaneously, China seems to be strategically pivoting by bolstering its trade relations with emerging markets, particularly in emerging Europe, where collaboration with

occurred despite the high inflationary environment in the post-pandemic period, which would have cushioned the nominal decrease in trade to some extent. Among the major trading partners of the US, China stands as the third highest in terms of import contraction, trailing behind sanctioned countries such as Venezuela and Russia.

Breaking down the data by product categories reveals that the most significant contraction in Chinese exports to the US occurred in computer and electronic products, with a total reduction of USD 26 billion from 2018 to 2022. This contraction aligns with the strategic nature of the sector, and government measures such as the US Chips and Science Act are anticipated to further accentuate this trend. On one hand while, US imports from China have contracted in the past five years, major EMs like Mexico (+USD 111 billion), Vietnam (+ USD 78 billion) and India (+ USD 31 billion) have managed to increase their exports to US. The increase in the export of these countries to the US can be attributed to both trade creation as well as trade diversion.

Electronics Export to the US: Both Vietnam and India witnessed similar growth but the former benefitted from the first-mover advantage.

In the computers and electronics exports to the US, Vietnam, India, and Taiwan have witnessed steep growth with a Compound Annual Growth Rates (CAGR) of 42%, 38%, and 27%, respectively over the past five years. However, India's electronics exports to the US have been substantially smaller in absolute terms, amounting to just USD 2.9 billion compared to Vietnam's USD 35 billion. This discrepancy can be attributed to Vietnam's advantageous position as a pioneer in electronics manufacturing, securing a first-mover advantage.

	CAGR of US Imports of Computers and Electronics between 2018-2022	Absolute Gain in Import Value (USD billion)
Vietnam	42%	35.0
India	38%	2.9
Taiwan	27%	27.2
Indonesia	17%	1.0
Israel	17%	2.1
Thailand	15%	9.6
Switzerland	12%	2.8
Ireland	12%	1.6
Italy	10%	0.7
South Korea	9%	6.5

Source: International Trade Administration, U.S. Department of Commerce.

The current export value of computers and electronics products from India to the US mirrors Vietnam's 2013 export of the same to the US. Vietnam's electronics exports to the US gained momentum after 2008, following the implementation of the US-Vietnam Trade and Investment Framework and Agreement (TIFA). Conversely, India's surge in electronics exports to the US started to gather momentum post-2018. Similar to Vietnam, other Asian countries like Taiwan, Malaysia, Thailand, South Korea and Japan already have a larger footprint in the US in terms of electronics export. However, even with a slow start, India stands to benefit from the trade diversions emerging from the decoupling of the US and Chinese economies.

India's Export to US and Newer Headwinds

While the computer and electronics sector demonstrated robust growth, other product categories such as electrical appliances, machinery, plastic and rubber products, metals, and chemicals have also experienced double-digit annualized growth over the past few years. Government initiatives, such as the Production Linked Incentives (PLIs), coupled with increased interest from foreign firms establishing manufacturing units in India, position the country to broaden its trade footprint. Notably, India has achieved recent success in mobile phone manufacturing, becoming one of the largest producers.

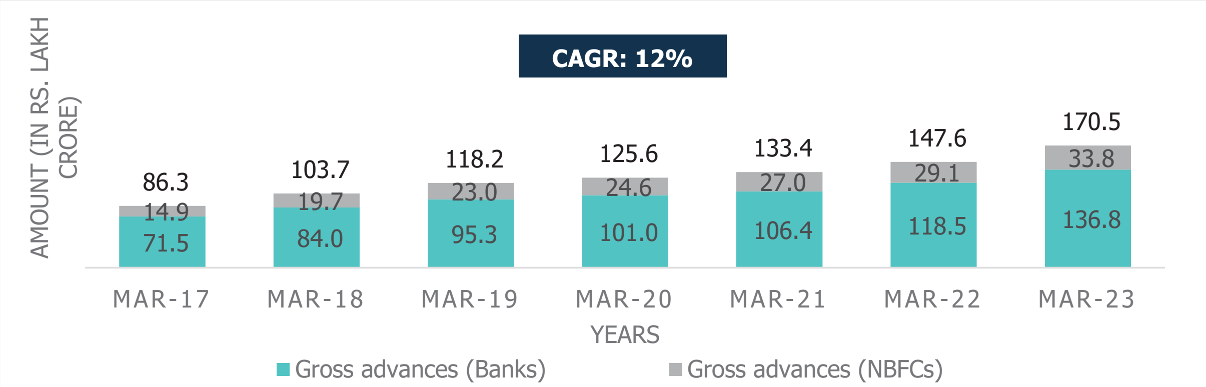
Despite these advancements, challenges persist in India's electronic exports, particularly in achieving higher domestic value addition, in contrast to the current scenario where most of the growth is driven by local assembly units. Moreover, export promotion schemes like the Advance Authorisation Scheme (AAS), Export Promotion Capital Goods Scheme (EPCGS), Duty Drawback Scheme (DDS), and the Remission of Duties and Taxes on Exported Products (RoDTEP) are perceived by Western nations as subsidies under the WTO framework. Consequently, countervailing duties imposed by the EU and the US curtail the benefits from these schemes to domestic manufacturers. Furthermore, emerging environmental regulations, such as the EU's proposed Carbon Border Adjustment Mechanism (CBAM), pose potential penalties for Indian exporters in the future. Navigating these complexities will be crucial for sustaining and expanding India's success in the global trade landscape.

In conclusion, India's global trade trajectory reflects dynamic growth, benefiting from trade diversion from China. However, compared to peer nations in the South Asian region, India has not fully capitalized on the advantages of trade decoupling. Persistent challenges, especially amidst evolving global trade regulations, highlight the imperative for India to enhance domestic value addition to establish itself as a formidable export hub. As the country continues its ascent in the global trade arena, achieving a delicate balance between fostering competitiveness and addressing international concerns becomes paramount. Navigating these challenges is essential for sustaining and amplifying India's positive trajectory in the continually evolving landscape of international trade. India is also currently negotiating FTAs with trade partners such as the United Kingdom (UK) and the European Union (EU). However, we need to be cautious as in the past India's trade deficit with important FTA partners like Japan, South Korea, and ASEAN widened after entering into the trade agreements.

UNSECURED LENDING: OPPORTUNITY FOR GROWTH OR LOOMING RISK?

The overall credit combined for Banks and NBFCs saw a CAGR of 12% during FY17 to FY23 and stood at Rs.170.5 lakh crore as of March 2023. During the same period, the personal loan book (including all retail for NBFCs) growth stood higher with a CAGR of 19%. In absolute terms, personal loan credit by banks and NBFCs has almost tripled in the past six years and stood at Rs.51.7 lakh crore forming 30.3% of the overall loan book as of March 31, 2023, as against Rs. 18.6 lakh crore or 21.5% of the overall loan book as on March 31, 2017. Thus, the rate of growth of personal loan books (which typically signifies consumption loans) is almost double that of the rest of the banking sector lending (business lending).

Overall Credit Market Size (Credit of Banks+ NBFCs)



Source: Financial Stability Report: RBI

The growth of unsecured personal loans (including Credit card receivables, Consumer durable loans and Other personal loans) in banks from March 2017 to March 2023 stood at CAGR – 21.0 % outpacing the personal loan growth which exhibited a CAGR of 19% during the same period. Unsecured personal loans account for almost 1/3rd of overall bank's personal loan credit of ~Rs. 41 lakh crores as of March 31, 2023.

Several factors have contributed to the substantial increase in the demand for unsecured personal loans, encompassing demographic shifts, the formalization of the economy, elevated purchasing power, the evolution and prominence of FinTechs, widespread access to the Internet/broadband and feature phones, the adoption of digital payment systems, the influence of India stack and information collateral, and broader coverage of credit bureaus, etc. The convergence of technology and finance has reshaped the lending landscape in India, making personal loans more accessible and convenient for a larger segment of the population, thereby contributing to the growth of the personal loan market. Furthermore, with higher coverage from credit bureaus and the availability of such data, the credit engines of the lenders are expected to work more efficiently and utilise machine learning to improve the credit performance of the pools so originated.

Despite some concerns about the high growth rate, leveraging technology and employing people with the right expertise has played a pivotal role in managing associated risks effectively. Regulatory measures such as the Digital Lending Guidelines and the Privacy Bill have strengthened customer confidence and have provided a clear framework for all stakeholders in the market. The entire industry has undergone substantial evolution, marked by increased regulatory clarity, transforming it into a more mature and stable market.

The borrower count has exhibited a pronounced rebound, experiencing a notable increase across various lender segments following a decline in the first year of the pandemic, with the majority of incremental volumes originating from NBFCs. The volume share of Non-Banking Financial Companies (NBFCs) has consistently risen, particularly in the post-Covid period, witnessing a significant upsurge in loan originations by volume. The advent of Fintechs targeting a younger demographic and individuals new to credit has resulted in the origination of low ticket-size loans, consequently contributing to a consistent decrease in the average ticket size of NBFC loans.

Loans with a ticket size below Rs. 1 lakh constituted over 85% of loan originations by volume in FY23. Loans with ticket size below Rs. 50,000 hold the majority share in origination volume, witnessing a more than two-fold increase in origination value in this segment over the last two fiscals that ended March 2023.

However, it may be noted that despite the lower share of originations volume, originations value share is dominated by Banks owing to the higher ticket size loans catered to by them. Private sector banks have also witnessed a decline in average ticket size over the years similar to the trend witnessed in NBFCs. On the other hand, it's pertinent to note that the PSBs have witnessed growth in average origination ticket size during the same period. PSU Banks continue to lead in terms of originated loan value share.

Unsecured Retail Asset Quality Remains Robust

Lending to any category of asset comes with inherent risks in the form of asset quality. The percentage of retail non-performing assets (NPAs) excluding secured asset classes of housing, auto as well and education for both Public and Private sector banks have shown a gradual decline in the percentage of NPAs over time. Further, the percentage of below-prime borrowers (bureau score of less than 730) across the lender categories has been declining over the past 3 years. This suggests that efforts are being undertaken by the lenders to manage risk and the overall financial landscape is moving towards healthier lending practices.

The Special Mention Account categories (SMA), i.e., SMA 0, SMA1 and SMA 2, of public sector banks stood higher with an SMA of 9.9% in unsecured personal advances as compared to 4.0% for private banks for unsecured retail loans category as on March 31, 2023. At an aggregate level, banks have ~7% of their unsecured retail loans in the SMA-0, 1 and 2 categories. Interestingly, even the SMA share of secured retail advances also lies in the range of 7% as of March 31, 2023.

Fintech NBFCs Most Vulnerable in Unsecured Personal Loans, CareEdge Ratings' Poll Reveals

CareEdge Ratings conducted a poll assessing the potential impact on various lender categories in the event of unsecured personal loans turning sour. According to the responses, Fintech NBFCs emerge as the most susceptible, with private sector banks, public sector banks, and other NBFCs following in decreasing order of potential impact. This underscores the need for a vigilant approach to risk management, especially for Fintech NBFCs, in navigating the challenges associated with the unsecured personal loan segment.

Regulatory Concerns

RBI has issued a notification to all lenders for inter alia an increase in risk weights by 25% on unsecured consumer credit (excluding housing, education, vehicle and gold loans), an increase in risk weights by 25% of bank credit to NBFCs assigned for the AAA-A rated portfolio, excluding PSL-compliant loans and HFCs and review/include sectoral limits for such loans. The personal loans as well as advances to NBFCs have been growing strongly and have been the primary driver of incremental bank credit. We see this as a strong signalling impact to deter growth in the unsecured space while lenders are well-capitalised to manage a decrease in CRAR which is anticipated to be around 25-45 bps. Meanwhile, bank lending to larger NBFCs could be pared down as they approach the capital market, while the aggregate dependence of mid-sized NBFCs on the banking sector for funding is likely to remain high despite an anticipated increase in lending cost by 25-30 bps. This could incentivize securitisation as a liability source for NBFCs.

RBI's Regulatory Action

- RBI had been indicating its concerns over the growth in unsecured loan space in anticipation of a potential risk buildup. As a logical next step, RBI has now hiked the risk weights to the segment, especially the unsecured loans segment.
- Risk weight of consumer credit exposure (outstanding as well as new) hiked by 25% for banks, while housing, education, vehicle and gold and gold jewellery loans have been excluded,
- Risk weight of consumer credit exposure (outstanding as well as new) hiked by 25% for NBFCs, microfinance/SHG loans along with the above segments have been excluded.
- Credit card receivables risk weights increased by 25% to 150%/125% for SCBs/NBFCs respectively.
- Risk weight of bank credit to NBFCs also increased by 25% for NBFCs rated between AAA-A, while BBB and below which have a risk weighting of 100% or more not face an increase in risk weights. Loans to HFCs and PSL-compliant loans will not attract higher risk weights.
- Additionally, all lending institutions would have to review and put in place sectoral /sub-segment exposure limits for consumer credit as part of prudent risk management. Unsecured consumer credit exposure limits would have to be strictly adhered to and monitored on an ongoing basis by the Risk Management Committee.

Outlook

Supported by a multitude of factors, some of which have led to structural changes, the growth trajectory of the Unsecured personal loan segment, particularly in the small ticket size category, with an increasing number of lenders embracing technology for loan origination. Stakeholders are progressively recognizing the importance of enhancing credit quality by avoiding the adverse selection of customers and refining collection practices. Further, regulatory clarity on essential aspects such as the business model, default loss guarantee, disclosure norms, KYC norms, and fair practices are anticipated to draw more participants and capital into the segment. Achieving attractive returns for equity capital providers will depend largely on managing credit costs and operational expenses. However, RBI's move, aimed at deterring consumer credit growth, is expected to impact the momentum in growth in the immediate to near term.

DIAGNOSTIC SECTOR TO SEE STABLE **DOUBLE-DIGIT GROWTH IN MEDIUM TERM**

Healthcare is one of the key sectors in India in terms of both revenue and employment. India's public budgeted expenditure on healthcare touched 2.1% and 2.2% of gross domestic product (GDP) in FY23 and FY22, against 1.6% in FY21, as per the Economic Survey 2022-23. The share of expenditure on health with respect to the total expenditure on social services, has increased from 21% in FY19 to 26% in FY23 (BE). Diagnostic forms a very essential part of the industry and is usually the first step towards treating diseases, starting from the detection of the disease to prognosis and determination of treatment regime to post-treatment monitoring of the patient. The Indian diagnostic services market was valued at USD 14.57 billion in 2022 and USD 16.23 billion in 2023 and is forecasted to reach USD 43.57 billion by FY32 (as per a report published by Polaris Market Research in March 2023). SPER market research predicts the Indian diagnostic lab market to reach USD 44.92 billion by 2032. The growth in the diagnostic sector is supported by an increase in healthcare spending by an ageing population, rising income levels, rising awareness for preventive testing, advanced healthcare diagnostic tests offerings, market penetration of healthcare insurance and healthcare measures by the central government.

Diagnostic services are classified into pathology testing services and imaging diagnostic services, wherein the former accounts for approximately 60% of the market share while imaging tests account for the rest. The radiology market is growing rapidly due to the increasing demand for imaging services, while the pathology testing services market is also expanding due to the growing number of people undergoing preventive health check-ups. Overall, the diagnostic services industry in India is poised for continued growth in the coming years. The market share of diagnostic services is divided into unorganised/local standalone labs, hospital-based labs, and organised players. A major part of the diagnostic business is driven by doctor recommendations. For the precise prescription for the patients, doctors are conducting diagnostic tests for most of the patients before prescribing the medication, which was not the case earlier.

Key Characteristics and Trends

India's approach towards preventive healthcare has undergone a change post the Covid-19 pandemic. Individuals are now more inclined towards preventive healthcare than curative healthcare. The increasing income levels of people, as reflected in the increase in GDP per capita to over US $2,388 in 2022 from US $1,958 in 2017 (as per the World Bank data) have also backed the paradigm shift in this inclination. The diagnostics companies would benefit from this shift, and growth of around 12%-14% in the revenue of the diagnostic companies is expected in the medium to long term.

Owing to the sedentary lifestyle, chronic diseases like obesity, diabetes, hypertension etc. have been on the increasing trend. The graph above captures the data on the increase in the number of people suffering from non-communicable diseases which is expected to jump from 19% in 2008 to 28% in 2030. Chronic diseases have been a major reason for mortality in the country. Owing to a sustained increase in the patient pool, growth has been witnessed in the healthcare market and it is thus a key driver for growth in the healthcare and diagnostics segments.

Furthermore, as per the report of the technical group on population projections, Ministry of Health and Family Welfare, there has been an increase in the age group above 45 years in the Indian population. The same was supported by an increase in life expectancy and the availability of better medical facilities. However, ageing causes a decrease in immunity levels and consequently higher need for diagnostic services. Thus, the increase in the ageing population is positively correlated to the growth in the diagnostic sector. India's appeal as a cost-effective destination for high-quality medical treatments and advanced healthcare facilities has resulted in sequential improvement in international patient footfalls in the healthcare sector which also augured well for the growth in the diagnostic sector in India.

The diagnostic industry is highly fragmented with the organised players contributing only 17% of the market share. Of this share of 17%, PAN-India diagnostic chains have a market share of about 35% and the regional chains have a market share of approximately 65%. The four largest players, viz., Dr. Lal PathLabs, Metropolis Healthcare, SRL Diagnostics and Thyrocare Technologies have only about 6% market share. Local players enjoy a market share of approximately 46% fragmenting the market followed by hospital-based labs with a market share of about 37%. Low barriers to entry, low capital requirements for asset-light business models and the absence of stringent regulations are the key reasons leading to the highly granulated nature of the industry.

Owing to the highly fragmented nature of the industry, the companies in the sector are employing inorganic growth strategies as a move towards consolidation apart from the organic growth measures being used for expansion. The companies are setting up new centres in untapped geographies majorly based on the franchisee model for organic growth. For example, Dr Lal Path Labs, which is a leading player in the northern and eastern parts of India, is expanding its presence in the west as well as central India by the acquisition of Suburban Diagnostics India Private Limited. Metropolis, a leading brand in the Mumbai Metropolitan Region is considering creating a presence in north and south India. Thyrocare, having a strong presence in the south, has set up a central laboratory in Delhi-NCR. The large players are using inorganic strategies acquiring small players to expand their presence in the new territories. Furthermore, owing to the strong balance sheet of major listed players, supported by a high level of cash profits along with a strong liquidity position and low reliance on debt, CareEdge Ratings expects the momentum of inorganic growth by major players to continue in the medium term.

Analysis of Top Six Listed Entities in Organised Diagnostic Sector

The total operating income of the diagnostic companies had increased significantly in FY21 and FY22 on account of revenue from Covid-19 and allied testing. However, the non-Covid-19 revenue continues to increase in FY23 on account of the increased inclination among people towards preventive healthcare which has led to an increase in the sales of wellness packages (bundles). This revenue also increased on account of the inorganic growth of the large, organised players. The PBILDT margin was higher in FY21 and FY22 due to an increase in the utilisation levels due to Covid-19. The margins, however, got corrected to pre-Covid-19 levels in FY23. The PBILDT margin for major organised players operating in pathological diagnostics is expected to be in the range of 23-25%, going forward. The operating margins are expected to be above 40% for entities engaged in imaging diagnostics services.

The major players in the diagnostic industry have focused on reinventing by integrating technology and digitisation. Increasing demand for testing post-pandemic along with the need for faster results and accurate diagnosis, has compelled the diagnostic companies to focus on a customer-centric approach. The companies are largely focusing on the home visit segment and are looking to provide service at par with the lab visit walk-ins. The strategy is to digitise the end-to-end home visit segment by employing various artificial intelligence/ machine learning techniques since the customers now look for omni channel presence for better service. The digitisation has also led to the entry of new startups in the diagnostic ecosystem which is primarily focused on home visit diagnostic services like Tata 1mg, PharmEasy, Healthians, Orange Health, etc. Apart from this, the companies are also focusing on geographical network expansion by considering penetrating Tier-2 and Tier-3 cities.

PROPOSED ECL FRAMEWORK LIKELY TO HAVE MODERATE IMPACT ON BANKS

The proposed transition to the 'Expected Credit Loss (ECL)' framework from the current incurred loss approach is a step forward for the Indian banks towards the Indian Accounting Standards (Ind AS). The transition to the ECL framework would have a one-time impact on the profitability and capital levels. Currently, it is difficult for market participants to quantify the impact due to a lack of public data and banks awaiting a detailed framework. Based on limited disclosures in analyst calls as well as management interaction with select banks, as of now, the likely impact is estimated to be up to 2.5% (subject to deferred tax benefit) on the capitalisation levels.

The impact on private sector banks, mainly the frontline ones, is likely to be lower due to contingency provisions maintained during Covid-19 time as well as better historical asset quality parameters. For a few public sector banks, the impact would be lower considering the contingency provisions made. Also, a significant improvement in slippages is further likely to improve the probability of default (PD) multiples thereby reducing the ECL estimates.

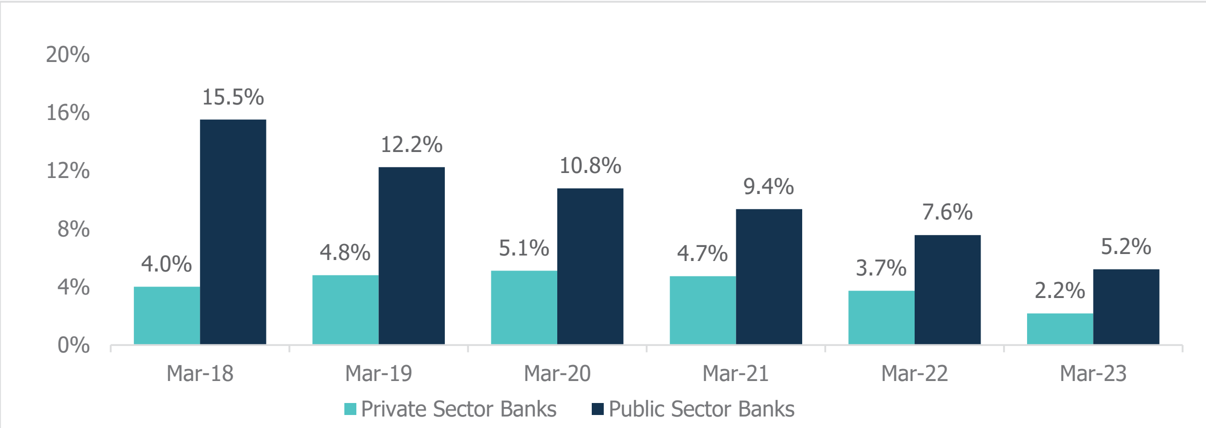
While the RBI has proposed a maximum time frame of five years after the date of implementation for spreading out these provisions, it is expected that most of the banks would manage the impact of the transition much earlier.

RBI came out with a discussion paper on 'Expected Credit Loss (ECL)-based approach for loan loss provisioning by Banks on January 16, 2023, and on October 4, 2023, a committee was formed which constituted an external working group on Expected Credit Loss (ECL) based Framework for Provisions by Banks. The working group is chaired by R Narayanaswamy, former Professor, IIM Bangalore and includes experts from industry and academia. The panel is expected to come up with recommendations that the Indian Banks should consider while making a transition to ECL based provisioning method.

Under the proposed transition, banks would be seeing a paradigm shift from the current provisioning method based on 'incurred loss' approach to a more proactive 'expected loss' approach. Under the incurred loss approach, the recognition of the credit loss happens much later as compared to ECL approach, wherein the loss is recognised and provided for at an earlier point in time based on forward looking estimates. The delay in making provisions, required the banks, when faced with increased defaults, to make unusually higher provisions which led to reduction in capital base of the banks.

The aggregate Gross NPA ratio for the entire sector has declined to 3.76% as on March 31, 2023, from 8.66% as on March 31, 2020, and 11.85% on March 31, 2018. This has been accompanied by a significant reduction in other stressed asset categories such as SMA 0-2 and restructured assets. Notably, most of the NPAs and stressed assets pertained to the corporate loan book. This class of banking assets has seen significant improvement in asset quality even as its proportion in overall banking assets has decreased substantially.

Gross NPA (%)



Source: RBI

The proposed approach is to formulate principle-based guidelines supplemented by regulatory backstops. Banks would be required to develop their own model for measuring expected credit losses for the purpose of estimating loss provisioning in line with the proposed principles.

Based on the models, banks would be required to categorise their financial assets (including loans and investments) into one of the three categories Stage 1, Stage 2 and Stage 3 depending upon the assessment of credit losses on the assets, at the time of initial recognition and each subsequent reporting date and make provisions accordingly.

Asset Quality of Banks

Banks saw a rise in NPAs post the asset quality review (AQR) during 2015-2016, which was largely in the corporate segments. This increased the level of provisioning and write-offs and a general shift of banks towards retail lending. Over the last three years, notwithstanding the stress during the Covid-19 period, the banking system has seen significant improvement in NPA ratios.

The entire banking sector has been making provisioning resulting in an aggregate provision coverage ratio (PCR) of 76.3% and a Net NPA ratio of 0.95% for the sector as on March 31, 2023.

Capital Position of Banks

Over the last three years, the capitalisation levels of banks have improved due to capital raise and improvement in profitability. Private sector banks raised equity capital in anticipation of expected losses during Covid-19 and were supported with internal accruals while the public sector banks saw infusion by the Government of India (GoI) as well as equity capital raise from capital markets apart from accretion of profits.

CareEdge RATINGS

HEAT MAP AND PROJECTION TABLE

		Oct-22	Nov-22	Dec-22	Jan-23	Feb-23	Mar-23	Apr-23	May-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23	Nov-23
PMI-M	Unit	55.3	55.7	57.8	55.4	55.3	56.4	57.2	58.7	57.8	57.7	58.6	57.5	55.5	56.0
PMI-S	Unit	55.1	56.4	58.5	57.2	59.4	57.8	62.0	61.2	58.5	62.3	60.1	61.0	58.4	56.9
GST Collections	Rs lakh crore	1.5	1.5	1.5	1.6	1.5	1.6	1.9	1.6	1.6	1.7	1.6	1.6	1.7	1.7
E-Way Bill	Crore	7.7	8.1	8.4	8.2	8.2	9.1	8.4	8.8	8.6	8.8	9.3	9.2	10.0	8.8
Air Passenger Traffic	Crore	2.7	2.8	3.1	3.1	2.9	3.1	3.1	3.2	3.0	3.0	3.0	3.0	3.1	
Railways Passenger Traffic	Crore	55.2	57.0	56.3	57.5	53.7	58.3	54.8	58.9	56.3	56.9	59.1	57.0	59.9	
PV Sales	Lakh	3.4	3.3	3.0	3.5	3.4	3.6	3.3	3.4	3.4	3.6	3.8	3.8	4.0	
2-3 Wheeler Sales	Lakh	19.5	16.0	13.8	14.8	14.3	16.1	16.6	18.1	16.8	16.7	19.5	21.6	22.9	
Tractor Sales	Lakh	1.3	0.8	0.7	0.7	0.7	0.9	0.9	0.9	1.1	0.7	0.6	1.1	1.3	
IIP	y-o-y%	-4.1	7.6	5.1	5.8	6.0	1.9	4.6	5.7	4.0	6.0	10.3	5.8		
Core Sector	y-o-y%	0.7	5.7	8.3	9.7	7.4	4.2	4.6	5.2	8.4	8.5	12.5	9.2	12.1	
Power Consumption	y-o-y%	0.5	12.3	9.8	12.0	7.7	-2.1	-1.8	-0.4	4.3	8.3	16.3	10.3	20.9	6.1
Petroleum Consumption	y-o-y%	5.7	14.3	3.4	4.3	6.6	8.7	1.4	12.6	5.2	3.1	8.1	8.2	3.7	-2.0
Outstanding Bank Credit - Total	y-o-y%	16.6	16.0	14.9	16.3	15.5	15.0	15.9	15.4	16.2	19.7	19.8	20.0	19.7	
Capital Goods Import	y-o-y%	8.8	14.5	9.9	-3.6	5.0	-2.2	0.3	14.1	3.1	10.9	13.3	-4.9	9.4	
Merchandise Exports	y-o-y%	-11.6	9.8	-3.1	1.6	-0.5	-6.0	-12.8	-10.3	-18.8	-10.0	3.8	-2.7	6.3	

*Bank credit data since July 2023 includes the impact of the merger of a non-bank with a bank

Indicator	FY18	FY19	FY20	FY21	FY22	FY23	FY24 Forecast
Gross Domestic Product (y-o-y%)	6.8	6.5	3.9	-5.8	9.1	7.2	6.8
CPI Inflation (y-o-y%)	3.6	3.4	4.8	6.2	5.5	6.7	5.4
Fiscal Deficit (As % of GDP)	3.5	3.4	4.6	9.2	6.8	6.4	5.9
Current Account Balance (As % of GDP)*	-1.8	-2.1	-0.9	0.9	-1.2	-2.0	-1.8
Rupee (USD/INR) (Fiscal year-end)	65.0	69.2	75.4	73.5	75.8	82.2	82-84
10-Year G-Sec Yield (%) (Fiscal year-end)	7.3	7.5	6.1	6.3	6.8	7.3	7-7.2

* Note: (-) Deficit / (+) Surplus; Fiscal deficit to GDP ratio data for FY24 are Budget Estimates (BE)

Corporate Office:

CARE Ratings Limited: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400022.
Phone : +91-22-6754 3456 | E-mail: corp.comm@careedge.in | CIN - L67190MH1993PLC071691

Other Offices:
Ahmedabad I Andheri-Mumbai I Bengaluru I Chennai I Coimbatore I Hyderabad I Kolkata I Noida I Pune

Media Contact

Mradul Mishra I mradul.mishra@careedge.in I +91-22-6754 3596