MSME AUM for NBFCs to Cross ₹4.2 lakh crore by FY25

June 20, 2024 l Ratings

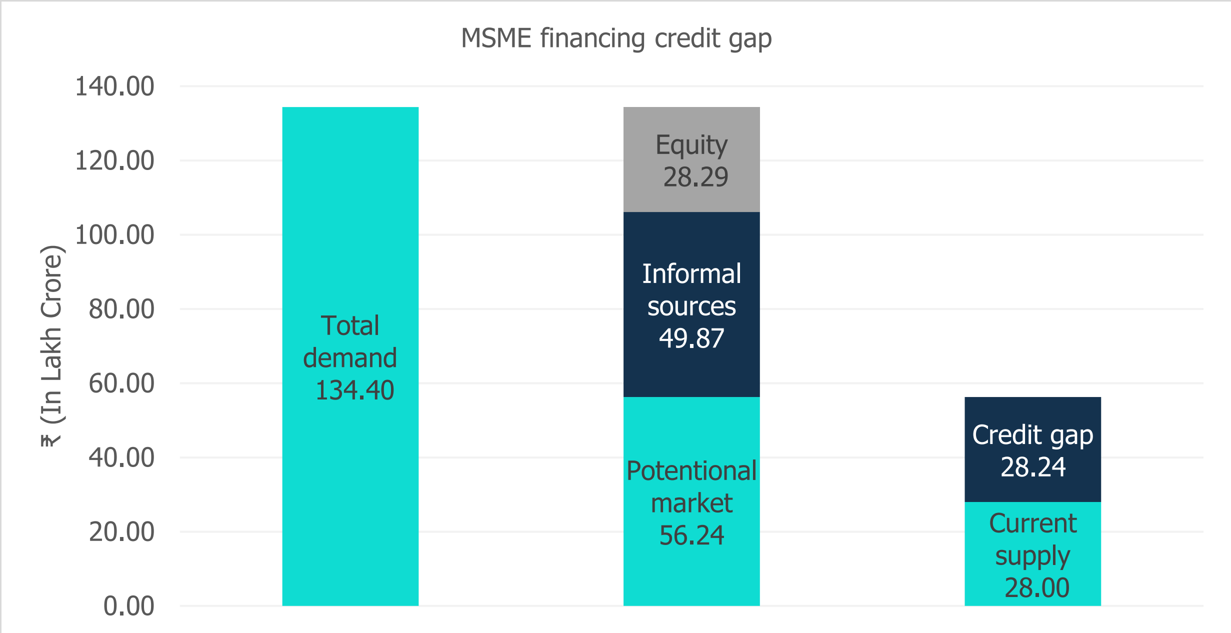
Synopsis

- Estimated credit gap of approximately ₹28 lakh crore, indicating substantial lending opportunity within the micro, small, and medium enterprises (MSME) sector.
- Policy-level initiatives by the Government of India (GoI), Reserve Bank of India (RBI) and all other stakeholders to facilitate easier credit access have been instrumental to the MSME sector's overall growth.
- Non-banking financial companies (NBFCs) are emerging as an important player in MSME lending exhibiting 3x y-o-y growth in FY23, surpassing both public sector banks (PSUs) and private sector banks (PVBs). This growth trajectory is expected to continue, with NBFCs, private sector banks and public sector banks projected to achieve growth rates of 25%, 15%, and 10%, respectively, in FY24 and FY25.
- The overall asset quality within the MSME portfolio has steadily improved across all categories of lenders and all sub-segments of MSME.
- CareEdge-selected sample of small ticket-size MSME-focused NBFCs have experienced a notable uptick in their loan portfolio, demonstrating a CAGR growth of 36% from FY19 to FY23.
- Profitability metrics for NBFCs with a focus on small ticket-size MSMEs are expected to moderate due to compression in Net Interest Margins (NIMs) and heightened credit costs stemming from new-to-credit (NTC) clients and predominantly unsecured microloans.

With more than 64 million MSMEs in India, the sector has encountered significant challenges due to events such as demonetisation, COVID-19, and the Goods and Services Tax (GST) implementation. Despite these obstacles, MSMEs are increasingly adopting digital channels, which in turn facilitates smoother identity verification and underwriting processes for lenders. However, MSME lending still faces notable barriers, including a lack of comprehensive data, collateral, documentation, and the absence of formal credit histories. "Information" emerging as the new collateral, facilitated by "India Stack" and other digital solutions, thereby improving access to funds for MSMEs to meet their various financial requirements.

Huge lending opportunity for MSME sector

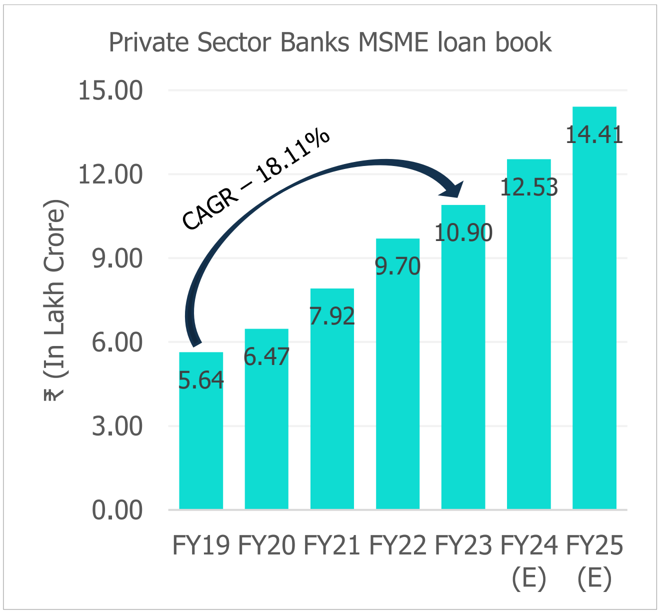
With about 64 million MSMEs in India overall, the total funding requirement for the sector is projected to reach ₹134.40 lakh crore. Of this, total debt demand is estimated at ₹106.11 lakh crore, of which ₹56.24 lakh crore or 53% is anticipated to be the potential market size addressable through formal funding sources such as banks and NBFCs. Considering the existing supply of ₹28.00 lakh crore (based on FY24 projections), the credit gap is estimated at approximately ₹28.24 lakh crore. Moreover, as the economy formalizes, unaddressed demand currently met through informal funding sources is anticipated to transition towards institutionalized channels over the long term, resulting in a potential credit gap of ₹78.13 lakh crore.

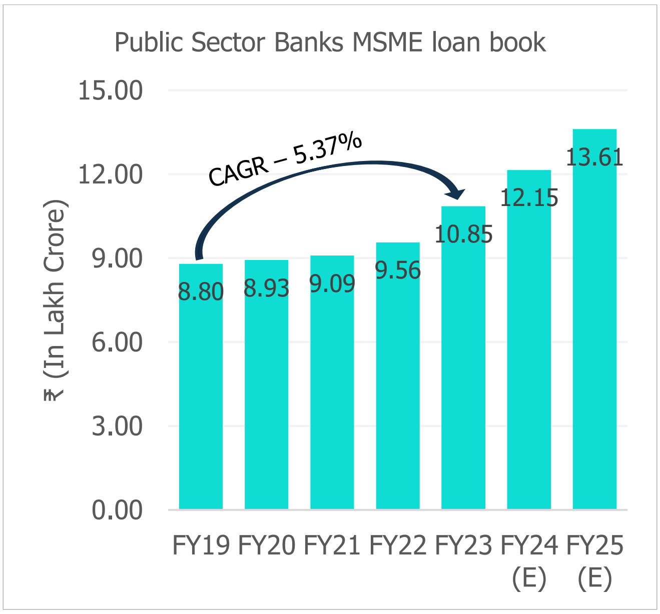


Source: IFC Report, CareEdge estimates.

NBFCs emerging as an important player in MSME lending

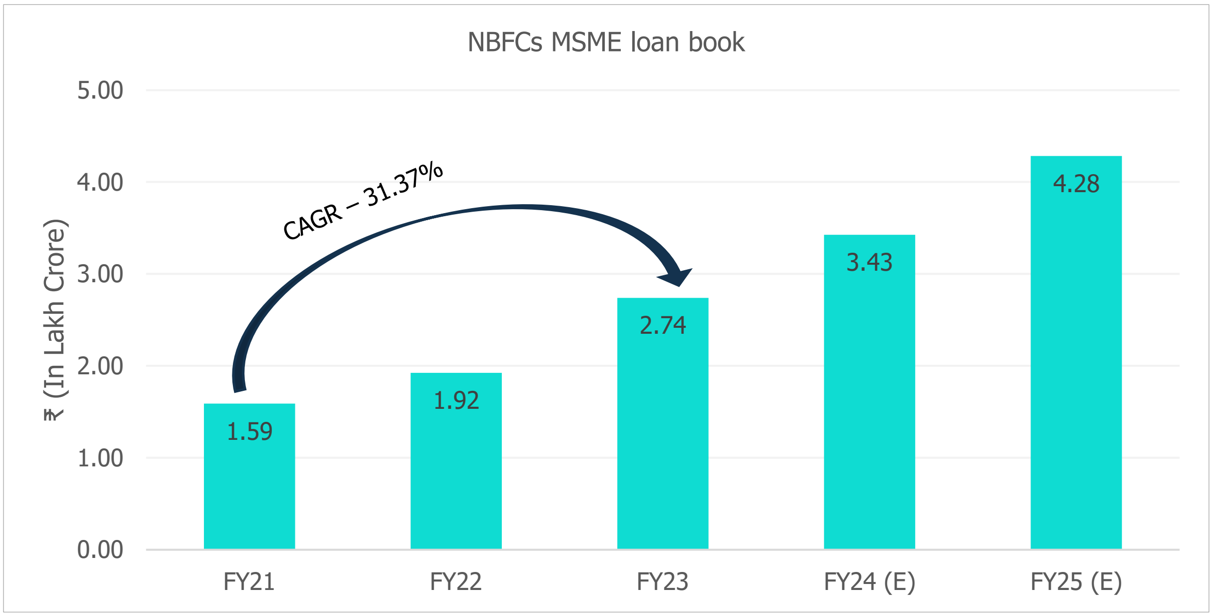
Lending to MSMEs has garnered increasing attention not only from banks but also NBFCs. Over the past five fiscal years, PVBs have demonstrated a compounded annual growth rate (CAGR) of approximately 18%, whereas PSBs have recorded a CAGR of about 5%. The pursuit of better yields and improving asset quality have led to PVBs increasing their focus on MSME lending, with PSBs ceding their share to PVBs.





Source: Reserve Bank of India.

NBFCs have reported approximately 31% CAGR growth in the last three fiscals. Notably, these entities have seen the substantial percentage increase in their share of MSME lending, also reflected in their loan book growth compared to banks, with NBFCs reporting more than 3x growth in FY23 y-o-y compared to both PSBs and PVBs.



Source: Reserve Bank of India.

Growth in the MSME segment reflects strong ecosystem development, including Udyam registration, digitalisation, and efficient underwriting processes. This growth is bolstered by the concerted efforts of government and regulatory bodies to promote credit guarantee schemes. The momentum is expected to continue across all financial institutions, with NBFC growth projected at 25%, followed by private banks at 15%, and public sector banks at 10% in both FY24 and FY25.

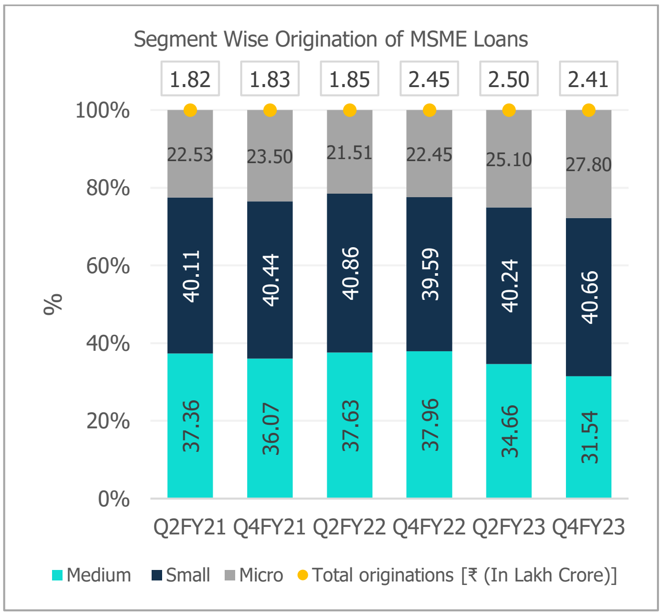
Sanjay Agarwal, CEO & Whole Time Director, Ambit Finvest Private Limited, while explaining the scope of collaboration between NBFCs and banks and financial technology (fintech) companies said, "This is a one-time opportunity. After waiting for decades, a business opportunity such as this is created due to the favourable economic environment, given that Indian GDP is growing by more than 7%, the government is stable, and entrepreneurs are in a position to raise funds due to the robust capital markets."

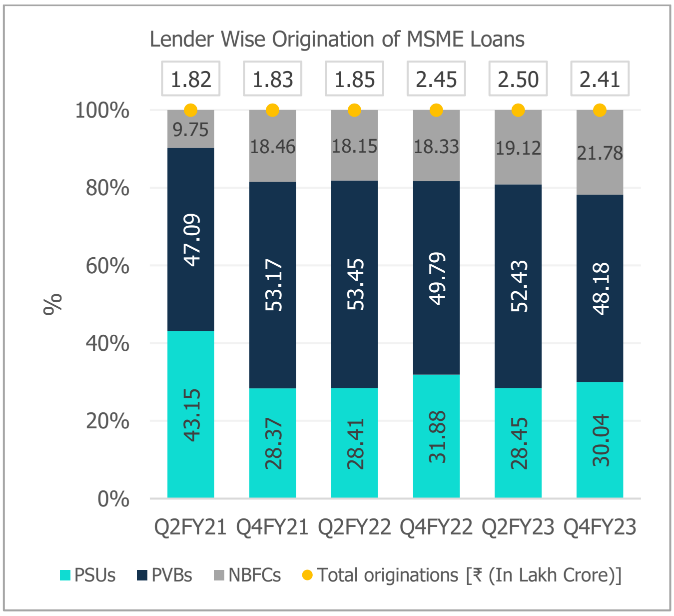
Recent trends in originations and credit bureau score

As per recent trends, originations to micro-enterprises are increasing at a faster pace compared to small and medium enterprises (SMEs), with the share of micro-enterprises increasing from 22.53% in Q2FY21 to 27.80% Q4FY23. Regarding lender-wise originations, NBFCs are rapidly extending the share with a considerable increase from 9.75% in Q2FY21 to 21.78% in Q4FY23. PVBs remain at the forefront with the highest share in overall originations. While PSBs are leading credit suppliers to micro-enterprises, PVBs are leading suppliers to small and medium enterprises.

Among borrowers with a credit history, there is an increase in the share of highly creditworthy borrowers (with CIBIL MSME Rank [CMR] 1-3) across MSME segments. The increase in the share of the CMR 1-3 segment signifies an enhanced borrower profile at origination. While micro-segment originations are primarily dominated by borrowers with a CMR score of 4-6, small and medium segment originations are dominated by borrowers with a CMR score of 1-3. The share of borrowers with high-risk credit history [CMR 7-10] is declining across all segments.[1]

[1] Source: SIDBI and TransUnion CIBIL MSME Pulse (February 2024 edition)



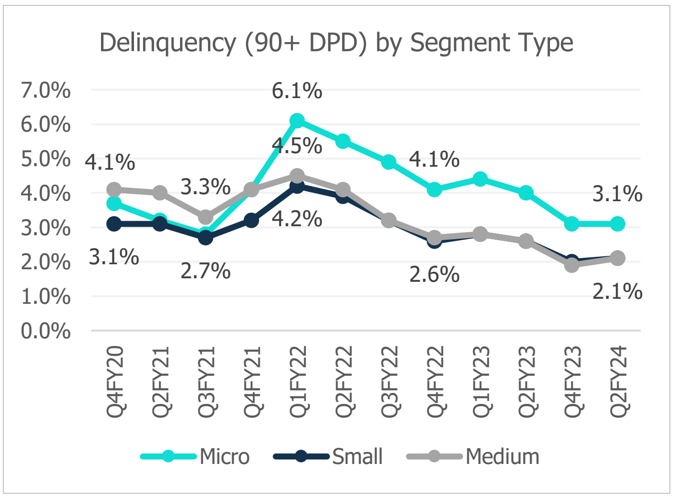


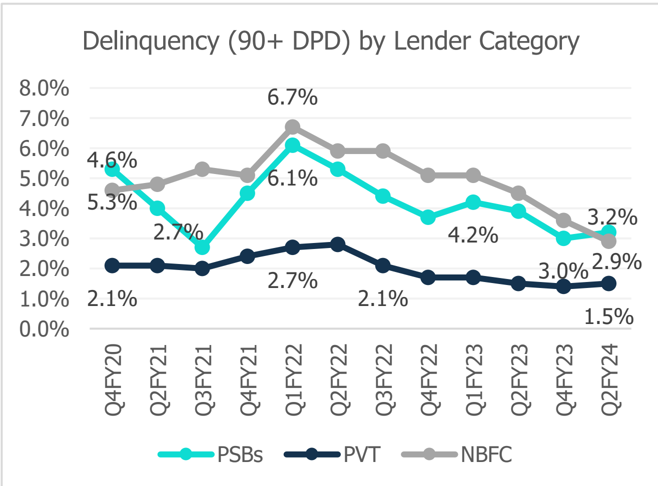
Sources: SIDBI and TransUnion CIBIL MSME Pulse (March 2023 and August 2023 editions).

Improving asset quality

There is a significant improvement in overall delinquencies since the height of the pandemic's impact. The decline from 4.4% in Q2FY22 to 2.3% in Q2FY24 indicates a positive shift, driven by various factors like better macro-economic conditions, enhanced underwriting mechanisms, improved data availability and a tech-driven approach. This improvement isn't just limited to one category of lenders or specific sub-segments of MSME but seems to be a broader trend across the industry. It's a testament to the resilience of the financial sector and the adaptability it has shown in response to challenging circumstances.

As of September 2023, the data indicates that micro-enterprises have reported the highest 90+ days past due (dpd) rate at 3.1%. However, both small and medium enterprises have shown lower delinquency rates, around 2.1%.





Sources: SIDBI and TransUnion CIBIL MSME Pulse (March 2023, August 2023, and February 2024 editions).

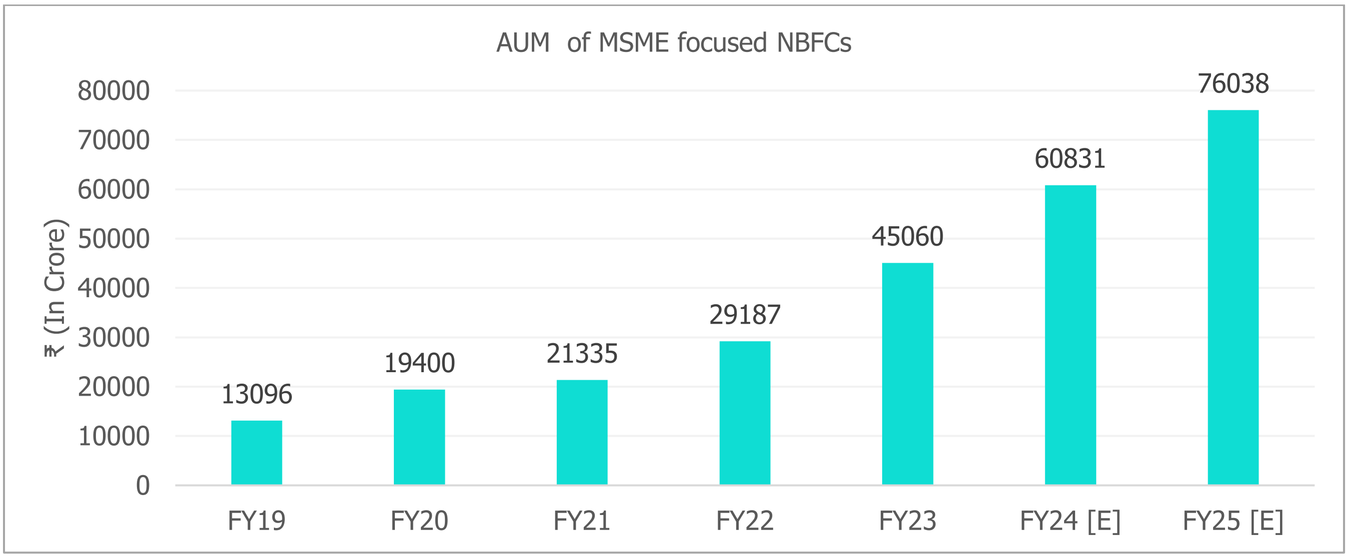
Across lender categories, PSBs have registered the highest delinquency levels, standing at 3.2% in Q2FY24. In contrast, PVBs are experiencing the lowest levels of non-performing assets (NPAs), with a rate of 1.5%. This nuanced breakdown provides insight into the varying delinquency trends within different segments and lender categories.

Small ticket size MSME-focused NBFCs

The growth trajectory of NBFCs focused on MSME lending, especially those targeting small-ticket sizes, has been remarkable, with a reported CAGR of 36.19% since FY19, even amid the challenging years of the COVID-19 pandemic. This growth can be attributed to various factors, including their focus on an underserved market segment, government support, regulatory reforms, and advancements in the ecosystem such as Udyam registration. Additionally, their adeptness in utilising technology-driven data collection and underwriting processes has enhanced their ability to reach out to underserved MSMEs.

Collaborations with traditional banks have also emerged as a viable avenue for financing MSMEs, further bolstering the growth of these NBFCs. These competencies enable NBFCs to effectively cater to MSMEs that may not meet pricing demands for prime credit, thereby filling a crucial gap in the market.

Considering these factors, CareEdge anticipates that the AUM of small-ticket MSME-focused NBFCs will continue to grow, with a projected growth rate of 35% in FY24 and an additional 25% in FY25. This forecast highlights the increasing importance of NBFCs in meeting the financing needs of the MSME sector and their potential to drive economic growth and financial inclusion.



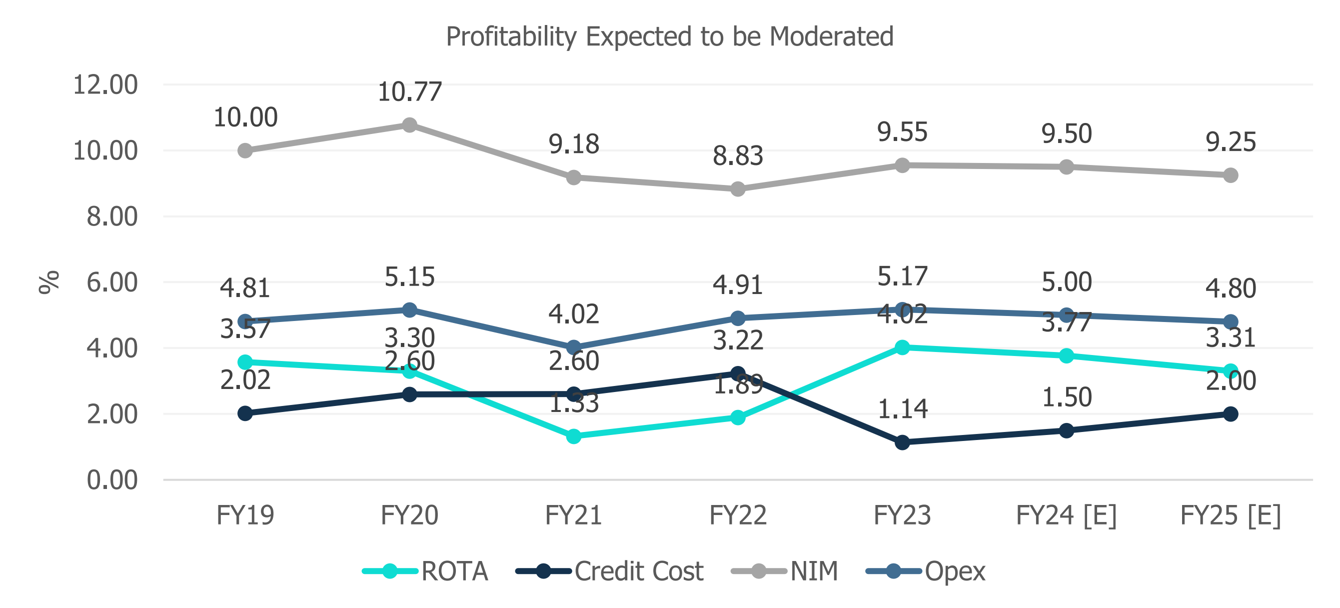
Source: CareEdge-selected samples with MSME lending >70%.

Expected moderation in profitability metrics

In FY23, NIMs for small ticket size MSME-focused NBFCs improved, primarily because of the rapid repricing of loans in anticipation of increased interest rates. The proportion of high-yielding microloans also saw an uptick in FY23, further contributing to NIMs expansion during this period. Going forward, NIMs are expected to decline due to increasing competition among lenders vying to address the credit gap.

Operating leverage will be driven by better absorption of fixed expenses and slower growth of employee expenses in comparison to the AUM. Due to robust asset quality metrics and higher-than-expected write-backs, credit cost has significantly reduced in FY23. Going forward, credit costs are expected to increase due to an increase in new-to-credit customers and microloans that are primarily unsecured.

Considering the expected higher credit costs and NIMs contraction, alongside a slight decrease in operating expenses, the return on total assets (RoTA) is projected to moderate to 3.77% in FY24 and further to 3.31% in FY25, down from 4.02% in FY23.



Source: CareEdge, basis data set of small ticket-size NBFCs with MSME lending >70%.

Evolving landscape of MSME lending market

The MSME lending market is constantly evolving to meet with the ever-rising demand for credit in the sector. Central to this evolution is digitalisation, which serves as the primary driver. Digitalisation has revolutionised the lending process, enabling faster loan originations and consequently boosting business for banks and NBFCs. It has also streamlined underwriting processes and facilitated cashless collections, thereby enhancing asset quality for lenders. This digital transformation has been made possible through various components such as the GST ecosystem, credit bureaus, bank statements, access to account aggregators, e-KYC, among others.

Secondly, banks and NBFCs are increasingly turning to co-lending arrangements, which have emerged as a crucial strategy for fostering growth in the underserved segment. It is a capital-efficient avenue for NBFCs in the sector. Notably, technologically driven NBFCs are preferred over others in such arrangements.

Recent origination trends highlight an increase in new-to-credit customers, particularly in the micro segment of borrowers. In Q4FY23, micro new-to-credit customers comprised 61% of the total new-to-credit originations, underscoring their significance as a key target segment for all lenders in the sector.

Rahul Priyadarshi, Chief General Manager, Small Industries Development Bank of India (SIDBI), interacting at a CareEdge webinar emphasizes, "I do not perceive new-to-credit (NTC) as a risk. No reason to be skeptical about lending to NTC customers and then seeing that this may turn the edges of NPA levels. There may be some incremental value, but I don't think this trend is going to reverse NPA levels."

Narayan Barasia, Chief Financial Office, SBFC Finance Limited, says, "New-to-credit (NTC) is bound to happen when 50% of customers are unserved today. So, there is nothing to worry about NTC so far as the formal data like Income Tax returns (ITR), GST returns, and bank statements are available."

Rahul Priyadarshi referring to the importance of incentivising environmental, social and governance (ESG) for the MSME segment said, "For ESG to become successful, some amount of incentivisation has to be done to MSMEs. When they (MSMEs) are part of a global supply chain, ESG is going to become a big factor for their existence."

Initiatives taken by stakeholders

Initiatives by the Government of India (GoI), RBI and other stakeholders have brought in policy-level initiatives for bridging the credit gap and bringing in sustainable credit availability solutions for the MSME sector. From the perspective of credit funding, schemes such as Pradhan Mantri MUDRA Yojana (PMMY), Emergency Credit Line Guarantee Scheme (ECLGS), Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) and Credit Linked Capital Subsidy Scheme (CLCSS) have been introduced by the government.

To further strengthen the process, ecosystem developments were made in the form of Udyam registration, and GST Sahay, among others, with certain regulatory initiatives such as revised reclassification of MSMEs. Collectively, these stakeholder initiatives are playing a crucial role in facilitating the growth of the MSME sector, consequently leading to an increasing demand for credit in the sector.

In the webinar conducted by CareEdge titled "Navigating the MSME Financing Landscape: Trends, Challenges, and Road Ahead", industry experts shared their opinions other than mentioned before in the report about the credit growth trajectory for MSMEs, co-lending, asset quality, among others.

Rahul Priyadarshi, emphasizes, "Faceless lending does not work beyond a certain point. There is an element of faceless for unsecured lending personal loans and others but for MSME lending or other types of lending, you need to have a personal connect with the borrower. Technology will enable the MSME growth trajectory and is expected to grow at 35% y-o-y."

Prabakaran S, Executive Vice-President, RBL Bank Limited, while opining on the delay in implementation of the 45-day payment tax rule to MSMEs says, "It is only a temporary flip. In the long term, this 45-day rule is going to be good for at least lending institutions. If MSMEs are dealing with corporates, it will ensure they at least receive payment within 45 days of invoice. I think this is a positive."

Prabakaran S, while explaining developments that banks have made in MSME lending, says, "With better quality data from digital sources, banks will now be able to charge slightly less to customers who fall under the better risk profile, allowing banks to not only achieve credit growth but also fulfil its PSL targets and to do other cross-sell, including liabilities to make up the shortfall in interest income."

Narayan Barasia explained prevailing challenges on catering to customers in the micro segment. He states, "To make sure that MSME really grows and thrives in India, what we need to do is look at the bottom of the pyramid and see whether Tier-IV vendors can actually get credit. From a digitization perspective, more and more income tax filings are happening, more and more GST filings are happening. It is actually becoming relatively easy for a bank or NBFC to assess the customer." He adds, "The challenge is as the cost of borrowing is increasing, the ability of tier 4 vendors to absorb the costs and pass on incremental costs to its customers gets restricted."

Sanjay Agarwal, Senior Director, CareEdge Ratings, further emphasizes that "Credit growth momentum along with improving delinquencies level across all segments signifies an improvement in financial health of MSMEs. As more NTC customers enter the market, lenders need to leverage data and analytics to understand borrowers better. This will help ensure steady growth while maintaining a stable asset quality."

CareEdge Ratings View

- Small-ticket-size MSME-focused NBFCs are expected to maintain an upward growth trajectory, with a projected increase of 35% in Assets Under Management (AUM) for NBFCs in FY24 and a further 25% in FY25.
- Asset quality is expected to be stable, despite inherent risks in the space of microloans.
- Operating leverage is expected to come into play, alongside a compression in NIMs and an increase in credit costs, leading to a moderation in profitability.
- The rise in co-lending collaborations and the RBI's cautious approach to unsecured consumer and personal loans creates a favourable environment for the expansion of MSME lending.
- Key risks to MSME lending include regulatory uncertainties, unfavourable macroeconomic conditions, and the rise of new-to-credit clientele.

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