MSME AUM for NBFCs to cross Rs 5.3 lakh crore by FY26

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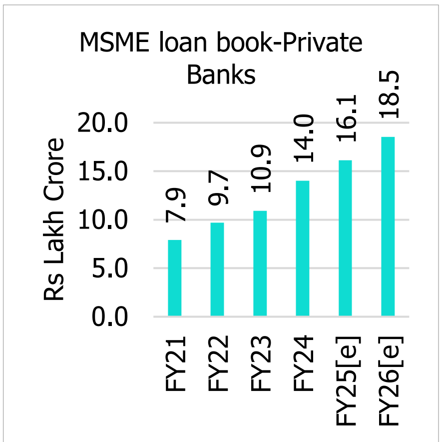
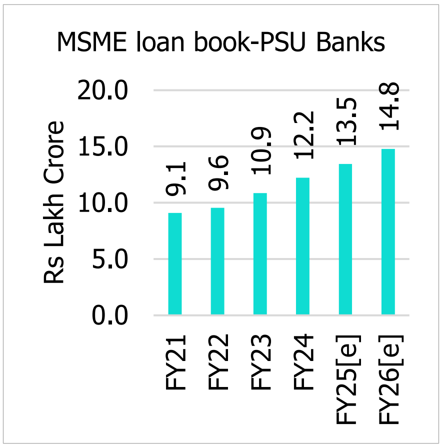
Synopsis

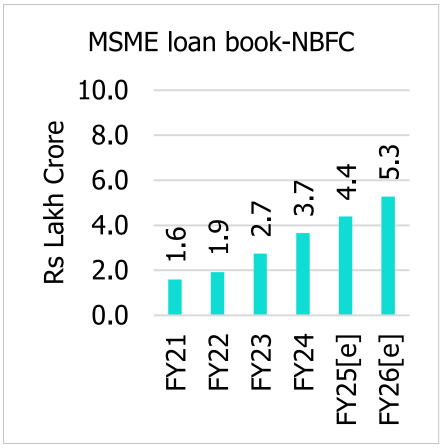
- India's MSME sector, comprising ~63 million enterprises, presents a credit opportunity of more than Rs 18 lakh crore.
- NBFCs are emerging as key players in MSME lending, recording a 32% CAGR from FY21 to FY24, outpacing growth rates of private banks (20.9%) and public sector banks (10.4%).
- The share of MSME loans in NBFCs' total loan portfolio increased from 5.9% in FY21 to 9.1%. We expect growth of 20% for NBFCs, 15% for private banks, and 10% for public sector banks in FY25.
- In micro-LAP (<Rs 10 lakh ticket size), NBFCs continue to dominate with more than 45% market share, followed by private banks 26% and PSU banks 11%
- CareEdge-rated NBFCs in the micro-lap segment grew at 38.6% CAGR from FY20 to FY24. While growth remains healthy, profitability metrics are expected to slightly moderate due to compression in Net Interest Margins (NIMs) and an increase in credit costs.

Overall MSME Credit

MSME lending has witnessed robust growth in recent years, with Non-Banking Financial Companies (NBFCs) emerging as the front-runners, outpacing the growth rates of both private and public sector banks. Between FY21 and FY24, NBFCs recorded a 32% compound annual growth rate (CAGR) in MSME lending, albeit on a smaller base, compared to 20.9% for private banks and 10.4% for public sector banks. The share of MSME credit in NBFCs' overall loan portfolio rose from 5.9% in FY21 to 9.1% in H1 FY25, an increase of over 50%. The banks maintained relatively stable MSME exposure, ranging from 16.2% to 16.9% over the same period. The Private sector banks have been gradually gaining market share from public sector peers. In FY24 alone, private banks expanded their MSME loan book by Rs 3.1 lakh crore, representing a 29% year-on-year increase, primarily driven by a 35% growth in micro-enterprise lending. This expansion has been underpinned by a supportive ecosystem, including initiatives such as Udyam registration, GST Sahay, TREDS, and the development of digital public infrastructure, alongside enabling policy measures and credit guarantee schemes. Looking ahead, this growth trajectory is expected to persist, with NBFCs projected to grow at 20%, private banks at 15%, and public sector banks at 10% during FY25 and FY26.







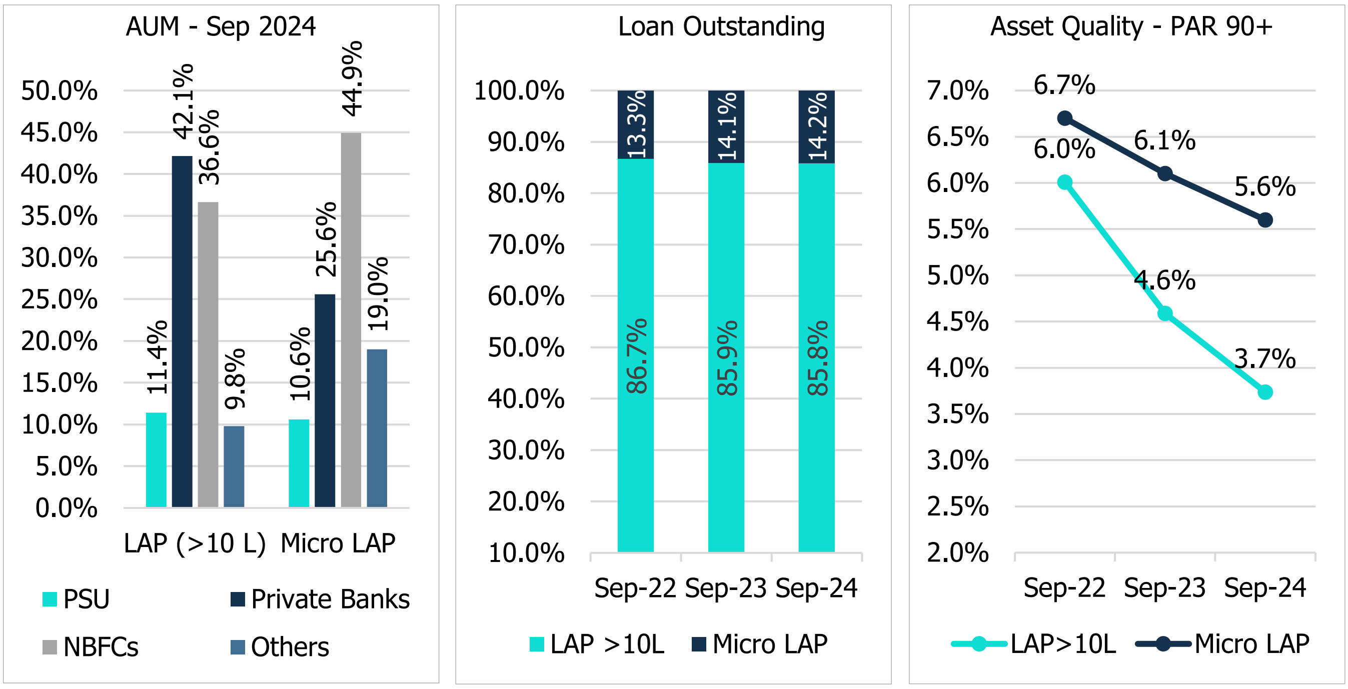
Source: RBI, CareEdge Estimates

Large opportunity for lending institutions

India's MSME sector, comprising nearly 63 million enterprises, presents a significant growth opportunity for formal lending. The total debt demand is estimated at Rs 95.6 lakh crore, of which Rs 50.7 lakh crore is deemed addressable through formal lending channels, particularly by banks and NBFCs. As of H1 FY25, the formal credit supply stood at only Rs 32.4 lakh crore, leaving a credit gap of Rs 18.3 lakh crore. With the ongoing formalisation of the economy and increasing adoption of digital technologies, a growing share of currently informal demand is expected to transition into the formal financial system.

NBFC dominate the micro-LAP segment

The secured MSME loan segment, particularly Micro-LAP with high-yield loans, presents significant growth opportunities to bridge the credit gap for underserved borrowers. Without access to SARFAESI, NBFCs encounter asset quality risks, while increasing competition and volatile cash flows further pressure their margins. The MSME Loan Against Property (LAP) market has seen remarkable growth, expanding from Rs 7.5 lakh crore to Rs 11.3 lakh crore over the two years ending September 2024—a 50% increase. Within this market, the Micro LAP segment experienced even higher growth, rising by 60% from Rs 1 lakh crore to Rs 1.6 lakh crore during the same period.

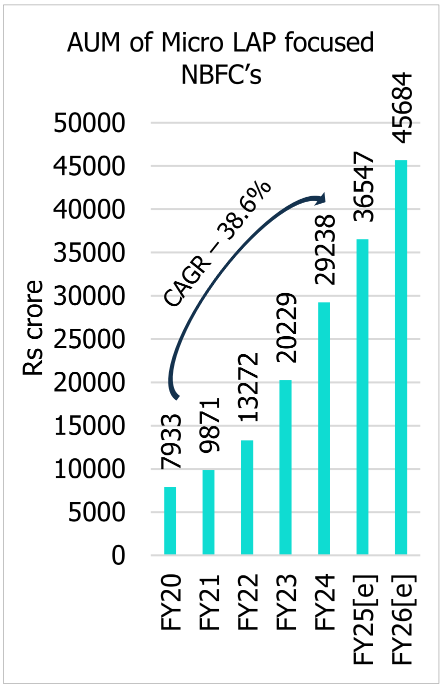


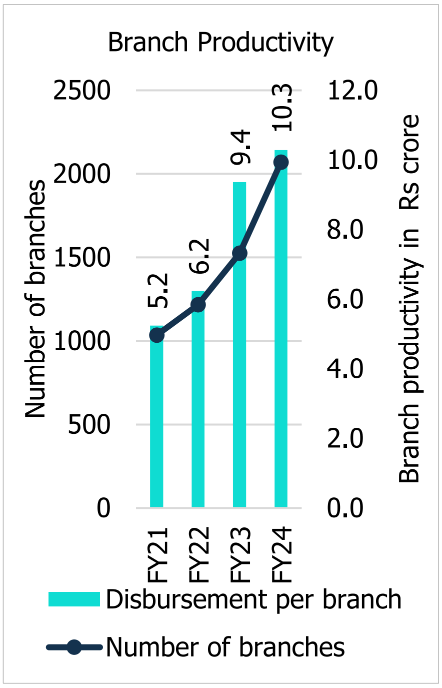
Source: CRIF Highmark

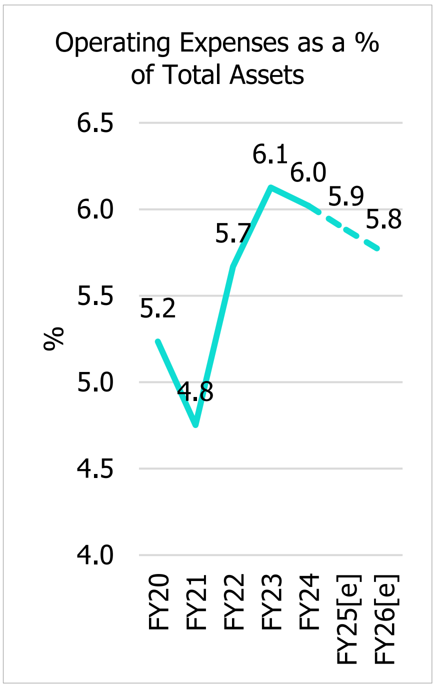
NBFCs dominate the Micro LAP (<10 lakh ticket size) segment with a 45% market share, well ahead of private banks at just over 25%. In contrast, private banks lead the Rs 10 lakh+ LAP segment with a 42% share, while NBFCs hold a 37% share. This reflects NBFCs' strong role in the micro-LAP space and the competitive MSME LAP market. Asset quality data indicate higher PAR90+ levels in Micro LAP compared to LAPS above Rs 10 lakh, although both have shown improvement. PAR90+ for Rs 10 lakh+ LAP decreased from 6.0% in September 2022 to 3.7% in September 2024, while Micro LAP dropped from 6.7% to 5.6%. Micro LAP tends to have higher delinquency rates due to several factors: a higher proportion of "new to credit" customers, reliance on credit evaluations based on assessed income, and borrowers' limited ability to manage cash flow mismatches.

Care Rated MSME Micro LAP-focused NBFCs

NBFCs, specialising in MSME Micro LAP lending, have experienced a 38.6% compound annual growth rate (CAGR) since FY20 till FY24, driven by their focus on underserved segments, government support, regulatory reforms, and technological advancements, such as Udyam registration. Their adoption of tech-based underwriting and data collection has enhanced outreach, while partnerships with traditional banks have further fuelled growth. By serving MSMEs that do not qualify for credit, these NBFCs address a crucial market gap. CareEdge projects that their AUM will grow by 25% in FY25 and FY26, highlighting their increasing role in MSME financing and financial inclusion. Care-rated Micro LAP-focused NBFCs have doubled their branches from approximately 1,000 in FY21 to over 2,000 in FY24, supported by improved productivity, with the average disbursement per branch increasing from Rs 5.2 crore to Rs 10.3 crore. This expansion has resulted in higher initial operating expenses, with stabilisation expected to occur from FY24 onward.



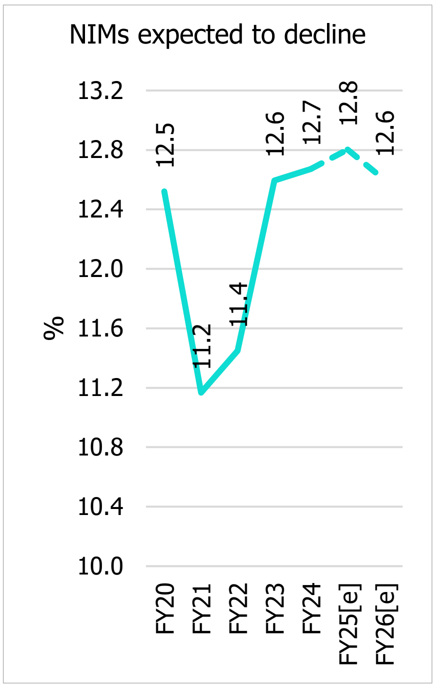


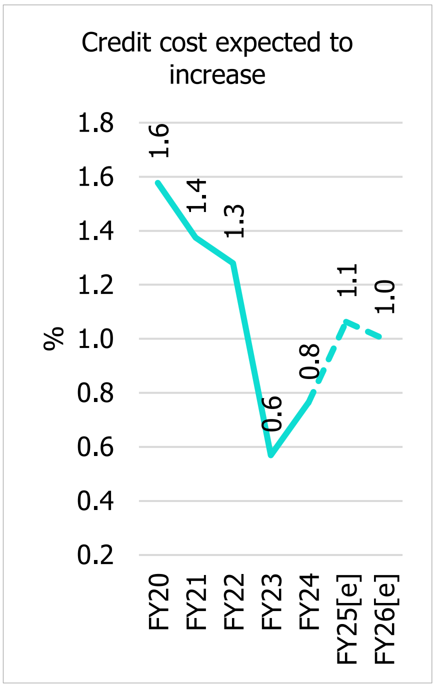


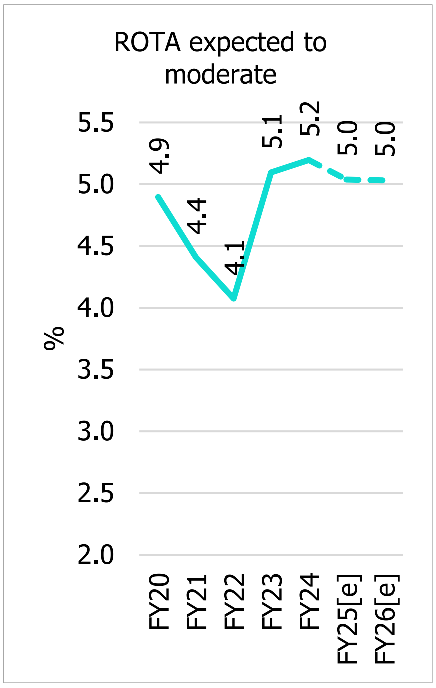
Source: CareEdge Estimates

Expected Slight moderation in profitability metrics

Going forward, rising competition and pricing pressures are expected to moderate Net Interest Margins (NIMs), while anticipated rate cuts may ease tight liquidity and reduce borrowing costs. Maturing AUM and an expanding micro-loan customer base are likely to increase credit costs, particularly amid stress in the microfinance sector, which could affect Micro LAP delinquency rates. Consequently, a slight decline in Return on Average Assets (ROTA) is projected for FY25 and FY26. Effective credit portfolio management and robust risk frameworks will be crucial, although improving liquidity may provide some relief. The majority of borrowers rely on a single income source, making them vulnerable to economic downturns. With an estimated 15–20% borrower overlap in the microfinance sector, close monitoring of borrower leverage is essential to mitigate default risk.







Source: CareEdge Estimates

In the webinar by CareEdge Ratings titled "Exploring MSME Growth and the Evolving Micro LAP Landscape," industry experts shared their opinions about the credit growth trajectory for MSMEs, Micro LAP, and asset quality, among other topics.

Mr Aseem Dhru, Managing Director and CEO of SBFC Finance Limited, emphasised that the MSME lending sector benefits from increased digitisation, particularly UPI, which has shifted cash-based transactions into formal banking, providing richer customer data. This shift has made previously underserved segments more lendable and is expected to sustain long-term growth despite occasional lending bubbles. However, MSMEs face challenges like unpredictable cash flows exacerbated by health issues, family emergencies, and economic slowdowns.

Additionally, small businesses are increasingly facing competitive pressures due to changing consumer habits, with quick commerce companies redirecting traditional sales. He noted that banks typically find MSME lending challenging, making specialized NBFCs necessary due to their expertise in managing these complexities. Furthermore, although loans in this sector often require collateral, these securities — usually self-occupied residential properties in rural areas — are difficult to liquidate, making enforcement of the security time-consuming and challenging, which warrants higher lending rates in this segment.

D. Arulmany, Founder, MD, and CEO of Veritas Finance Limited, noted that most micro-LAP customers often operate in cash, remain below GST thresholds, are prone to erratic cash flow, and live "hand to mouth," making their loan repayment challenging during difficult times. However, despite concerns that the stress in unsecured lending may impact secured micro-LAPS, recent trends indicate stability. Borrowers seem to distinguish between secured and unsecured loans, prioritising and maintaining repayment discipline for secured debt. While urban markets face stress from fintech-based unsecured loans leading to over-leveraging, rural markets remain relatively stable. Mr Arulmany highlighted substantial growth opportunities in the sector, with lending margins and pricing staying stable due to the complexity and risks involved despite increased competition.

Mr Mohit Sahney, Founder, Managing Director, and CEO of Finova Capital Private Limited, highlighted the resilience of the micro LAP sector, which has grown robustly despite challenges such as demonetisation, GST, liquidity crises, COVID-19, geopolitical tensions, and interest rate hikes. He expects sustained growth of around 25% in the medium term, driven by strong fundamentals. Mr Sahney stressed the importance of robust credit underwriting and effective collection practices, noting that smaller loans often suffer from relaxed scrutiny. In comparison, larger loans face challenges in cash-flow assessment. Effective customer engagement and proactive management are critical for portfolio health. He also pointed out that over-leveraging in microfinance affects broader credit behaviour, leading to repayment pressures. Additionally, household spending patterns have shifted, with non-food expenses surpassing food costs, indicating a growing demand for credit. Banks are increasingly focusing on higher-ticket MSME loans (ranging from Rs 15-20 lakh), which are expected to face minimal challenges due to operational efficiency and strategic growth objectives.

Vineet Jain, Senior Director at CareEdge Ratings, believes that with better quality data from digital sources, banks will now be able to offer more competitive pricing to customers who fall into a lower risk profile. MSME and Micro-LAP NBFC lenders often serving new-to-credit customers need to leverage data and analytics to understand borrowers better to price risk and detect early warning signals accurately."

CareEdge Ratings View

- The MSME book is projected to grow at approximately 14% in FY25 and FY26, while the Micro-LAP book is expected to grow more than 25% during the same period.
- There is an anticipated slight spillover of stress from the Microfinance Institution (MFI) sector and unsecured loans to the micro-LAP segment. Consequently, credit costs are expected to rise marginally in FY25 before slightly reducing in FY26.
- Operating leverage is expected to come into play alongside a compression in NIMs and an increase in credit costs, leading to a slight moderation in profitability.
- For Micro-LAP focused NBFCs, several opportunities are on the horizon. These include deeper branch penetration, digital transformation, co-lending initiatives, and continued access to equity funding, all of which are expected to drive growth in lending.
- The government's ongoing focus on employment generation is anticipated to support MSME lending. Additionally, this focus will enhance access to formal credit for New-to-Credit (NTC) customers, thereby facilitating the formalisation of the economy.

Contact

Sanjay Agarwal	Senior Director	sanjay.agarwal@careedge.in	+91 - 22 - 6754 3582 / +91 - 81080 07676
Vineet Jain	Senior Director	vineet.jain@careedge.in	+91 - 22 - 6754 3623 / +91 - 99876 88674
Jitendra Meghrajani	Assistant Director	jitendra.meghrajani@careedge.in	+91 - 22 - 6754 3422 / +91 – 77188 22054
Sudeeksha Rathi	Analyst	sudeeksha.rathi@careedge.in	+91 – 22 – 6754 3456 / +91 – 9893242344
Mradul Mishra	Media Relations	mradul.mishra@careedge.in	+91 - 22 - 6754 3596

CARE Ratings Limited
Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022
Phone : +91 - 22 - 6754 3456 | CIN: L67190MH1993PLC071691

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