Microfinance Industry Beats Covid Blues, Likely to Grow by 28% in FY24

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Overview

The Microfinance industry (MFI) experienced a growth spurt in FY23, expanding at a rate of 37% Y-o-Y due to a favourable macroeconomic climate and renewed demand, which has led to a surge in disbursements over the past few quarters. Consequently, NBFC-MFIs have surpassed banks in the overall microfinancing landscape, constituting approximately 40% of the total outstanding microfinance loans as of March 31, 2023, compared to 34% for banks.

CareEdge Ratings anticipates growth momentum to continue, with the portfolio of NBFC-MFIs expected to grow at a rate of 28% y-o-y in FY 2024. However, increasing customer indebtedness, rising average ticket size and a gradual shift from the Joint Liability Group (JLG) model to individual loans pose the risk of overleveraging for the industry. Also, considering the inherent nature of its asset class, NBFC MFIs are highly prone to event-based risks, such as political, geographical uncertainty and susceptibility to natural calamities. Moreover, the evolving global macroeconomic environment and the continuation of support from impact funds and PE investors at the same pace will also be critical and needs to be closely monitored.

The removal of the lending rate cap by the Reserve Bank of India (RBI) has enabled MFIs to engage in risk-based pricing, which has boosted net interest margins (NIMs) and, in turn, increased returns on total assets (RoTA). Credit costs have declined from their peak in FY 2021 but remain higher than pre-Covid levels, with a portion of the restructured book slipping into NPA. CareEdge Ratings expect NIMs to continue improving, resulting in RoTA rising to approximately 3.8% for FY 2024, aided by controlled credit costs of approximately 2.5% for the same year.

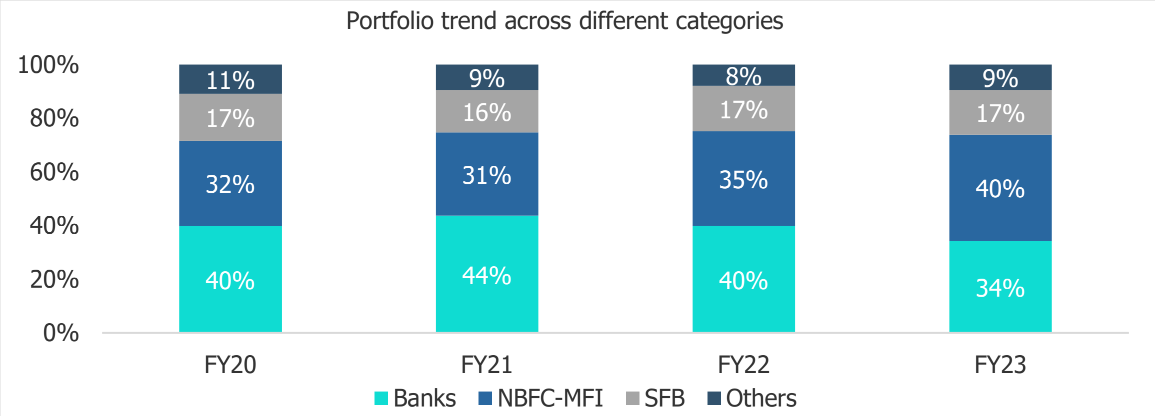
Asset quality, although on an improving trend, still remains moderate as compared to the pre-Covid level owing to additional slippages arising from the restructured portfolio. The MFI sector has taken the cumulative impact on the credit cost of around 19% of the portfolio, as on March 31, 2020, from FY21 to FY23 due to Covid-19. However, with an improving collection efficiency trend, GNPA is expected to improve to 2.0% in FY24 from a peak of 6.26% for FY22.

In terms of capital structure, NBFC-MFIs have managed to raise around ₹3,000 crore of equity in FY23, compared to around ₹1,500 crore and ₹1,430 crore in FY2021 and FY2022, respectively, indicating a renewed interest from investors. Nevertheless, due to the current global turbulence, investors are likely to exercise greater caution and selectivity in the future. Additionally, with increased support from investors and rising disbursement levels, the gearing level was 3.7x and 3.8x as of March 31, 2022, and March 31, 2023, respectively. The gearing level for the MFI sector is however envisaged to moderately increase to around 4.1x by March 31, 2024.

NBFC-MFIs Outpace Banks

The microfinance industry has experienced a shift in market share, with NBFC-MFIs overtaking banks for the first time in four years. While banks held a dominant position during the Covid-19 period, the growth rate of NBFC-MFIs has now surpassed that of banks, resulting in NBFC-MFIs commanding a higher market share in the overall microfinance sector. As of 31st March 2023, NBFC-MFIs contributed around 40% to the outstanding overall microfinance loans, compared to banks' 34%. With a growth rate of around 37% during FY23, NBFC-MFIs are currently leading the industry.

Figure 1: Portfolio Trends Across Categories



Source: Data from CareEdge Ratings sample of NBFC-MFIs/MFIN/RBI;

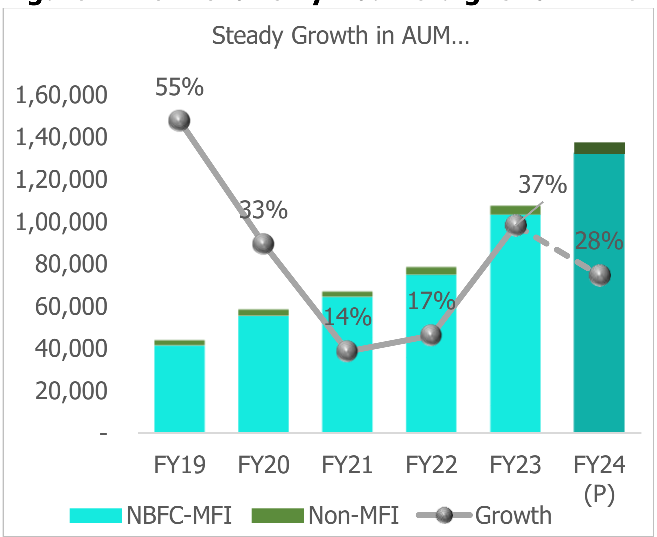
NBFC-MFIs Expected to Grow at 28% in fiscal year 2024

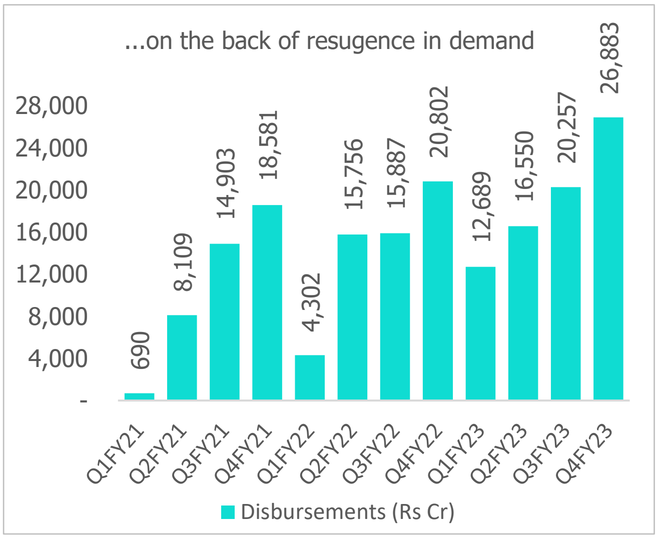
The microfinance industry experienced a slowdown in growth in FY21 due to the challenges posed by the Covid-19 pandemic. However, growth rebounded in FY22 & FY23, with NBFC-MFIs growing at 17% and 37% Y-o-Y, supported by improving macro-economic environment. This growth momentum is expected to continue, with CareEdge Ratings projecting a healthy loan growth of around 28% in FY24 for NBFC-MFIs.

Bihar, Tamil Nadu, Uttar Pradesh, Karnataka and West Bengal remain the top five states in terms of assets under management with Bihar leading the sector with around 15% market share as on December 31, 2022

In terms of product profile, Joint liability group (JLG) loans currently dominate the portfolio mix. However, with the new RBI guidelines, we are increasingly witnessing a shift towards individual lending. Further, RBI's new regulation of increasing household income to ₹3 lakh has given NBFC-MFIs an opportunity to expand their target market. Now, NBFC-MFIs can lend to the Non-MFI sector up to 25% of their total assets which was 15% of the loan book earlier.

Figure 2: AUM Grows by Double-digits for NBFC-MFIs as Demand Rises





Source: Data from CareEdge Ratings sample of NBFC-MFIs

Profitability Indicators Improve with NIMs Expansion, Still Below Pre-Covid Levels

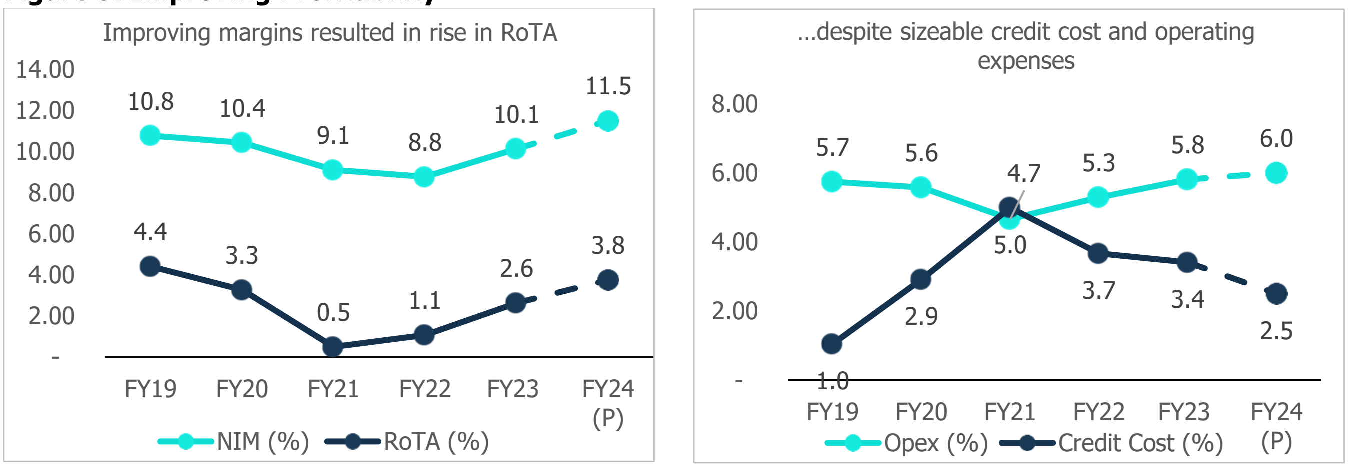
The NBFC-MFIs have demonstrated an enhancement in net interest margins (NIMs), registering approximately 10.1% during FY23, as opposed to the 9% recorded in both FY21 and FY22. This upswing can be attributed to the abolition of the lending rate cap regime in the revised RBI regulations and reduced interest income reversals due to the improved asset quality. While the comprehensive influence of the revised regulations is yet to fully materialize, the projection from CareEdge Ratings foresees a further escalation of NIMs in the forthcoming FY24.

Notably, the ratio of operating expenses to average assets has sustained a relatively elevated level of approximately 5.8% throughout FY23. This trend is propelled by the rapid expansion of branches, augmented technological advancements, and escalated compliance in alignment with the revised regulatory framework outlined by the RBI. Looking ahead, CareEdge Ratings anticipates a moderation in the rate of operational expense increment, concurrent with the realisation of operational efficiencies.

Evidently, the credit cost experienced a substantial rise, accounting for 4.7% of average assets in FY21. However, it demonstrated a marginal reduction to 3.7% in FY22 and further ameliorated to 3.4% in FY23. Supported by an improving macroeconomic milieu, the trajectory of the credit cost to average assets ratio is expected to undergo a further descent, projecting a reduction to 2.5% by FY2024. Nonetheless, it is noteworthy that this figure will persist at a higher level than the pre-Covid benchmarks.The improvement in margins along with the reduced credit cost has led to an improvement in profitability indicators, with a return on average assets of 2.6% in FY23 (vs 1.1% in FY22).

Looking ahead, profitability is expected to improve further with higher margins, reduced credit costs, and improved collection efficiency. However, it is likely to remain lower than the pre-covid level in FY24.

Figure 3: Improving Profitability



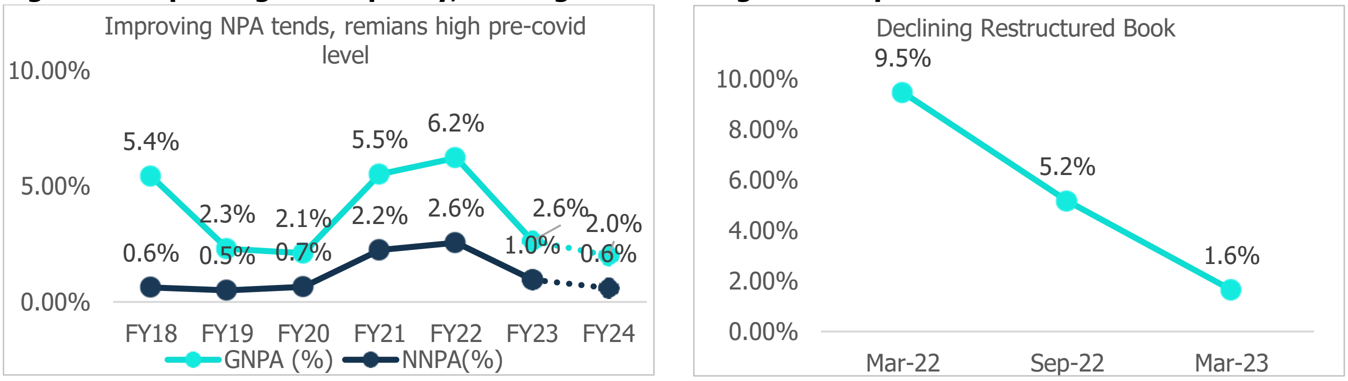
Source: CareEdge Ratings

Asset Quality Improving

In the wake of the escalating impact of the Covid-19 pandemic on the income profiles of lower-income segments within the economy, coupled with the ensuing rise in debt servicing delays among end borrowers, the sector witnessed a notable surge in asset quality stress. The Gross Non-Performing Asset (GNPA) Ratio reached a zenith at 6.2% as of March 31, 2022, in stark contrast to the 2.05% recorded on March 31, 2020, primarily attributed to a significant upswing in slippages. However, marked by enhanced collection efficiency buoyed by an ameliorating macroeconomic landscape and substantial write-offs, an encouraging shift in the NPA trend is discernible, even though the GNPA ratio persists at elevated levels relative to the pre-Covid era. Moreover, a discernible reduction in the restructured loan portfolio is evident, with the book contracting from 9.5% as of March 31, 2022, to 5.1% as of September 30, 2022, and further to 1.6% as of March 31, 2023.

Going forward, CareEdge Ratings expects the collection efficiency to remain high leading to improvement in asset quality metrics with GNPA ratio reducing to 2% as on March 31, 2024.

Figure 4: Improving Asset quality, although remains higher than pre-covid levels



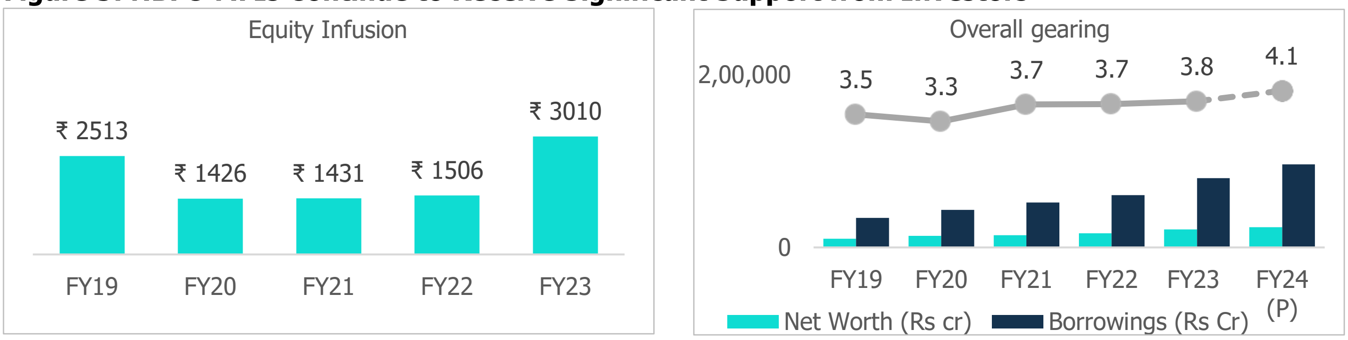
Source: CareEdge Ratings

Capital Structure Likely to Remain Comfortable

Amid the pandemic, the NBFC-MFI sector encountered subdued profitability and a dearth of substantial equity infusion, consequently driving gearing to approximately 3.7 times during FY21 and FY22. This elevation occurred despite the loan book growth demonstrating relative restraint during the same period. Conversely, FY23 witnessed a marked surge in disbursements. However, propelled by an enhanced profitability profile fostering robust internal accruals and a revitalized investor faith in the sector, the gearing structure remained predominantly stable. The sector garnered ₹3,010 crore in FY23, a notable increase from ₹1,506 crore in FY22 and ₹1,431 crore in FY21. While larger microfinance institutions successfully secured equity through initial public offerings (IPOs) and existing investors, mid and small-scale MFIs leaned more heavily on bank funding, consequently elevating their total borrowings. For the larger MFIs, the cost of debt funds spanned between 8% to 13% per annum, whereas for mid-sized MFIs, the cost of funds hovered close to 15% per annum.

Given the ongoing global upheaval, investor caution and selectivity are poised to intensify in subsequent times. In the broader perspective, we envisage the microfinance sector's gearing level to sustain a moderate stance at 4.1 times over the ensuing 12 months. Bearing in mind the inherent asset class attributes, any notable surge in gearing beyond the 4x threshold remains a pivotal aspect warranting oversight.

Figure 5: NBFC-MFIs Continue to Receive Significant Support from Investors



Source: CareEdge Ratings

CareEdge View

CareEdge Ratings foresees the growth trajectory within the Microfinance Institution (MFI) sector to sustain, projecting a year-on-year growth rate of approximately 28% for FY24. This impetus will be propelled by consistent disbursement expansion and an increasingly favourable macroeconomic landscape. A corresponding alleviation of asset quality strain is also anticipated, with the Gross Non-Performing Asset ratio projected to diminish to 2% by the conclusion of FY 2024, albeit remaining elevated in comparison to pre-Covid benchmarks.

The expected upturn in the Return on Average Assets to approximately 3.8% during FY24 is underpinned by judiciously managed credit costs and ameliorating Net Interest Margins. However, it is imperative to acknowledge key risk factors. The burgeoning customer indebtedness in conjunction with a burgeoning average ticket size poses the peril of overleveraging for the sector. Given the intrinsic characteristics of the asset class, NBFC MFIs are notably susceptible to event-based risks, encompassing political vicissitudes, geographical uncertainties, and susceptibility to natural adversities. Moreover, the evolving global macroeconomic milieu, as well as the sustainability of support from impact funds and Private Equity (PE) investors, necessitates vigilant monitoring.

Furthermore, the underwriting framework is undergoing a fundamental shift, transitioning from Joint Liability Group (JLG) lending to individual lending. The concurrent challenge is managing growth alongside credit quality, which warrants meticulous observation.

Contact

Sanjay Aggarwal	Senior Director	sanjay.agarwal@careedge.in	+91 - 22 - 6754 3582/ 8108007676
Gaurav Dixit	Director	gaurav.dixit@careedge.in	+91 - 120- 4452002/ 9717070079
Neha Kadiyan	Associate Director	neha.kadiyan@careedge.in	+91 - 120- 4452022/ 8130340369
Prabhjyot Kaur	Lead Analyst	Prabhjyot.kaur@careedge.in	+91 - 120- 4452031/ 9540705783
Mradul Mishra	Media Relations	mradul.mishra@careedge.in	+91 - 22 - 6754 3596/ 9833070317

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

Connect:

Locations: Ahmedabad | Andheri-Mumbai | Bengaluru | Chennai | Coimbatore | Hyderabad | Kolkata | Noida | Pune

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