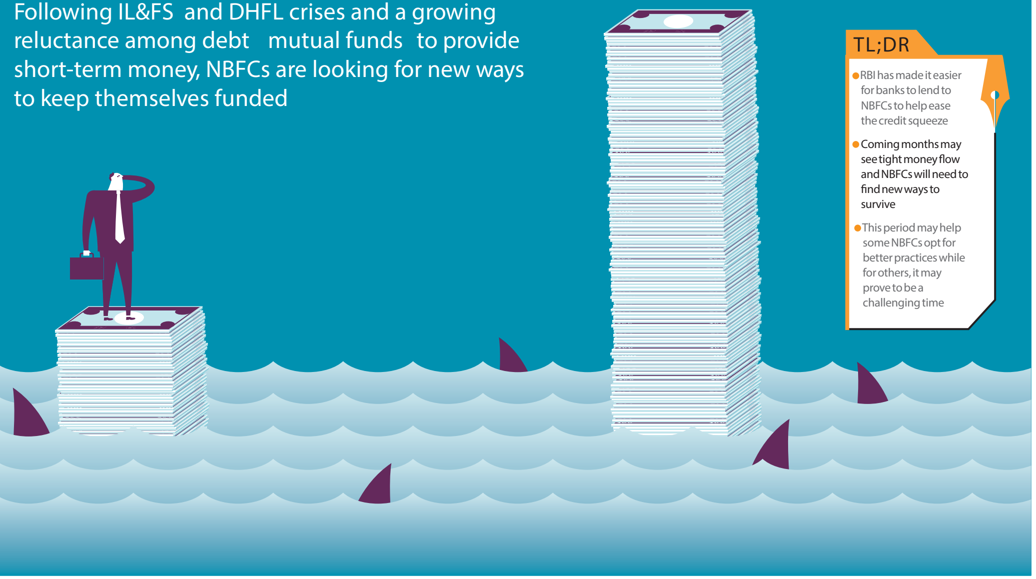
Credit Cautious

Following IL&FS and DHFL crises and a growing reluctance among debt mutual funds to provide short-term money, NBFCs are looking for new ways to keep themselves funded



TL;DR

- RBI has made it easier for banks to lend to NBFCs to help ease the credit squeeze
- Coming months may see tight money flow and NBFCs will need to find new ways to survive
- This period may help some NBFCs opt for better practices while for others, it may prove to be a challenging time

:: Suman Layak

Rashesh Shah is an avid marathoner and the 55-year-old chairman of Edelweiss Group often compares building a business to long-distance running. In a long race, it is important to pace oneself well and speed up, accelerate, and slow down as and when needed.

In the last quarter of 2018, Shah accelerated fund-raising at Edelweiss, bringing in nearly ` 8,800 crore through different instruments, including non-convertible debentures of ` 4090 crore. It was the highest fundraising by the group in a single quarter.

Shah had a clear goal — to quickly double liquid investments, raising liquidity from 10-12% to around 20%. This was the period after IL&FS, one of India's largest non-banking financial companies, defaulted on its repayment commitments on August 28, leading to widespread worry around the health of the NBFC sector.

Following the Il&FS crisis, funds availability to NBFCs went down. Mutual funds that lend to these entities through a short-term lending instrument called commercial papers turned off the tap.

NBFCs are known as India's shadow banking sector, a big source of credit to the country's small and medium enterprises, realtors, homebuyers and consumers.

As they reduced lending in the face of a cash squeeze, the government woke up and asked the Reserve Bank of India to help. Last week, a new RBI dispensation led by Governor Shaktikanta Das made it easier for banks to lend to NBFCs. But this move came only after the financial services industry got its second and third jolt in January and February this year.

Large entities such as Zee Group and Dewan Housing Finance Ltd plunged into crises creating worry for their lenders. Then Reliance Communications decided to file for bankruptcy and Anil Agarwal-promoted Vedanta got downgraded.

> The mismatch between borrowing and lending is not unusual. Problems cropped up when the tap of commercial paper was turned off

Edelweiss and other NBFCs of their size and risk management abilities have prepared well for another round of squeeze. But what about the smaller players? Can they survive more jolts?

Bitter Pill

Madan Sabnavis, chief economist at CARE Ratings, feels the situation can be a corrective phase for NBFCs. "If you look at the health of the larger NBFCs, there is no issue. But the smaller ones will have to change the way they borrow and look more at bonds and banks," he told ET Magazine .

Let us take a look at the nature of the anomaly now. In a report titled 'Second Wave', Credit Suisse pointed out that as on February 1, debt mutual funds had lent 30% of their money to NBFCs and housing finance companies (DHFL took a large share of that, including up to 30% of specific debt funds).

"Rising scrutiny of credit risk in debt funds is likely to keep flows to them volatile, constraining NBFC funding that still relies on mutual funds for 10-30% of their borrowings," the Credit Suisse report said.

Market sources acknowledge that large investors in debt mutual funds have instructed managers not to lend to specific entities. The Credit Suisse report points out that as compared to August, the mutual funds' lending to DHFL has fallen by 60%.

Sudip Bandyopadhyay, chairman of Inditrade Capital, says the environment has improved since October and November of last year, when there was panic all around. "The cost of funds are up, but money is there. Credit flow is still restricted for small NBFCs that were dependent on short term borrowings from mutual funds using commercial papers."

The convenient thing about commercial papers is that they are available at a lower rate of 6.9%, which make them more attractive to a buyer than the 6.5% returns from government bonds. While this was the rate at which NBFCs would borrow, they could lend at a little more than benchmark rates of around 8.5% set by large banks such as the State Bank of India.

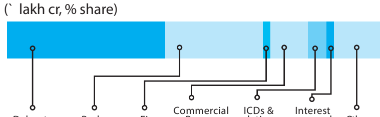
The problematic part of this model is that while lending by NBFCs is for a longer term, commercial papers are inherently a short-term instrument. So the NBFCs have to keep paying off and raise fresh rounds several times a year.

Liabilities of NBFCs
(` lakh cr)

Particulars	NBFC-ND-SI	NBFC-D
Share Capital	1.02	0.04
Reserves & Surplus	3.98	0.56
Total Borrowings	15.72	2.74
Secured Borrowings	7.76	-
Unsecured Borrowings	7.96	-
Current Liabilities	1.51	0.46
Total	22.22	3.80

NBFC-D can take deposits while NBFC-ND-SI are non-deposit taking systematically important entities with asset sizes in excess of ` 500 crore

Composition of Outstanding Borrowings for NBFC-ND-SI
(` lakh cr, % share)

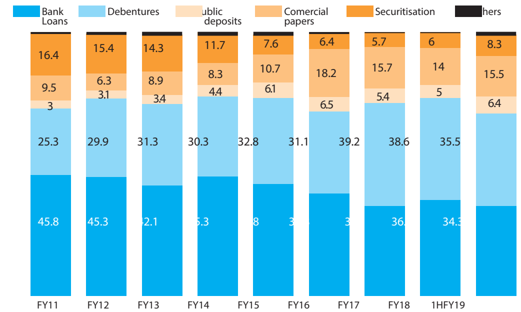


Source: RBI Trends and Progress of Banking in India/ CARE Ratings

"Smaller NBFCs will now have to change the way they borrow and look more at bonds and banks"

Madan Sabnavis, chief economist, CARE Ratings

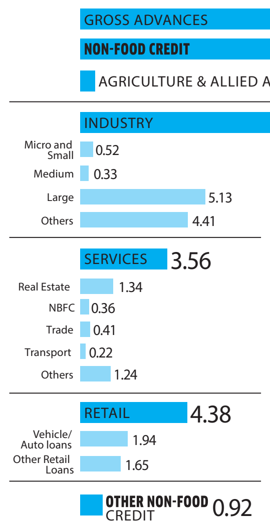
Rise in Short-Term Borrowings in NBFCs' Funding Mix
(%)



Source: Ind-Ra's analysis, company data

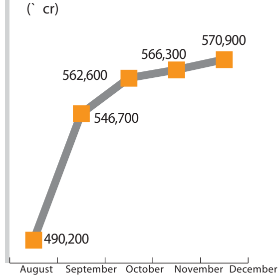
Sectoral Deployment of NBFC Credit
(as of September 2018)

Amount (` lakh cr)



RBI Trends and Progress of Banking/ CARE Ratings

Growth of Bank Credit to NBFCs
(` cr)



Source: RBI

This mismatch between borrowing (liabilities) and lending (assets) is not unusual. Housing finance companies that lend for long term like 20 years have to do it any way. Problems crop up when suddenly, the tap of commercial paper gets turned off as is happening now.

Some other funding taps may also run dry.

Pankaj Naik, associate director of India Ratings, points out that housing finance companies also take in behavioural factor into account – the fact that many home buyers prepay loans after 8 to 10 years. "When there is a financial crunch, these pre-payments also may not happen," he says.

Different Eggs, Different Baskets

So what is the way forward? In the short term, large NBFCs have been able to raise their level of liquidity to tide over the crisis.

While Shah of Edelweiss spoke of raising the liquidity to 20% from 10%, Naik points out that for most of the industry, liquid assets have gone down to as low as 8%. "It was high in 2014 after the last crisis of 2013. But it has gone down in the last four years."

Higher liquidity comes at a cost called negative carry, says Naik. It is the difference between interest earned on holding the money in liquid instruments and lending it out.

Shah says Edelweiss has learnt a lot from the crises of 2008 and 2013. The only way out is to diversify assets and liabilities -- borrow from diverse sources including abroad and lend to a wider range of sectors, he says.

The change of guard at the Reserve Bank also seems to have helped. Das took over on December 12 and delivered a rate cut last week, apart from making it easier for banks to lend more. However, Das has brought something more to the table.

Sumit Bali, CEO of IIFL Finance, attended a meeting with Das and NBFC representatives in the first half of January. He says the RBI is "far more consultative" now and eager to understand the problems of the sector. The RBI team, he says, took notes of what people from the NBFCs said.

IIFL too has just raised ` 1,100 crore through non-convertible debentures.

"As bad news continues to come, we stay liquid, diversifying our funding base and securitising our assets," Bali says.

It's a view Shah supports. He says the balance sheet of NBFCs needs to be efficient, and they should look at selling assets or churning them instead of looking at plain growth.

However, there are challenges beyond assets and liabilities and not every player can come out unscathed.

While the RBI action on rates is likely to help lower the cost of funds for the financial services industry, Naik points out that there is also the pressure on demand in specific segments such as high-tonnage commercial vehicles and real estate and even industries. He feels NBFCs with strong parentage are safe, like Tata Capital or L&T Finance or Mahindra Finance that can go and borrow from their parent groups. But Bali sees the problem at both ends of the spectrum. "NBFCs like us who are in the middle are safe. The large or the small ones need to be careful."

After all, it's a marathon and some are likely to quit running. ■

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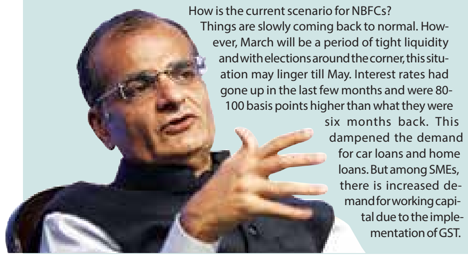
'NBFCs Need to Diversify Both Assets & Liabilities'

Rashesh Shah, chairman of Edelweiss Group, spoke to ET Magazine on how NBFCs can survive this challenging period. Edited excerpts:



How is the current scenario for NBFCs?

Things are slowly coming back to normal. However, March will be a period of tight liquidity and with elections around the corner, this situation may linger till May. Interest rates had gone up in the last few months and were 80-100 basis points higher than what they were six months back. This dampened the demand for car loans and home loans. But among SMEs, there is increased demand for working capital due to the implementation of GST.

Do NBFCs need to limit the size of their balance sheets?

The quality of the balance sheet will also a matter apart from its size. There is a need to be balance-sheet efficient. Indian NBFCs will have to diversify borrowings and bring in funds from newer sources. At the same time, assets will have to be diversified. The concentrated book approach won't work. If needed, NBFCs will have to sell assets and maintain balance sheet quality. Also, more assets should be liquid.

With mutual funds wary of lending to NBFCs, what can be the alternatives?

Different sources will have to be tapped like insurance companies, bond markets and even international banks.