Microfinance – Upcycle set to get stronger!

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Microfinance (MFI) & 2W finance were the worst impacted amongst the various segments of BFSI sector. While 2W finance is still struggling to recover, the recovery in MFI sector started sometime in mid of 2022 and the Q3FY23 results & commentaries of various players suggest that the momentum is set to get stronger. The current macro & micro set-up for the MFI sector can be termed as the "goldilocks situation" due to the following reasons:

1. Lower loan losses: Pandemic pain for most players is about to get over. Since we are in the early stages of the cycle, most of the analyst estimates suggest losses of less than 2% for FY24 vs. 3-5% seen over the pandemic years.

2. Explosion in the "income" line item: Post the revised RBI guidelines, most MFIs have hiked theirlending rates by 200-350bps. Also, in absence of fresh NPAs, there will no interest income reversals. Thus, after a long time, MFIs will earn "full card rate" on the entire portfolio.

3. Strong loan book growth: After a long time, loan book is set to grow by 25-40% in FY24 for various players. In the near term, growth creates its own virtuous cycle in terms of operating leverage and the repayment behavior of clients, both of which adds to the bottom-line.

How long can the upcycle last?

While most of the reasons stated above are well known & talked about, the biggest unknown is the length of the upcycle. If one looks at all the past cycles, it appears that the cycles are getting shorter. May be because the sector is far more penetrated & matured than a decade ago. Or may be the sector has grown faster than inherent capabilities of the underlying borrower.

	Period	Length	Sector size at start (cr)	Lending rates (large players)	Reasons for ending
Upcycle 1	2006-10	5 years	6,000	28-30%	AP crisis
Upcycle 2	2013-16	4 years	30,000	20-25%	Demonetization
Upcycle 3	2018-20	3 years	1,35,000	18-20%	Problems in East & Covid

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Upcycle 4	2022-?	?	3,00,000	21-23%	?

*Source: MFIN Micrometer, company drhp, Greenedge Research

Are there any major unseen risks?
Another aspect which makes us circumspect about the length of the cycle beyond FY24 is the 200-350bps lending rate hike taken by various players. These hikes are larger than warranted by rise in borrowing costs. Post the AP crisis, the large MFIs developed a view that lending rates below 20% significantly reduces the risk of political interference. To that regard, lending rates of large MFIs like SKS, Bandhan, Ujjivan, Credit access remained in the 18-20% band over 2016-20.

But so deep were the covid losses, that MFIs have raised lending rates by 200-350bps to repair their balance sheets and we are once again in the 22% range. This despite the 10x increase in size and manifold increase in technology usage over the last 8 years. It tells us about how difficult the segment is and that one cannot write-off the soft political risks. As equity investors, the best we can do is not to assign peak valuations to peak earnings of FY24.

Company section
Despite the different regulatory structures i.e. NBFC-MFI, SFBs or NBFCs, microfinance sector has generally been homogeneous – most players follow some form of JLG model, they grow fast in an upcycle and they lose a good amount in downcycle. But beyond this, there are subtle differences like geographic diversification, process diligence, ability to manage large number of employees, and leverage. For a good player, all of the above factors culminate into relatively lower credit losses in bad cycles. Below is list of losses suffered by major listed players.

Credit losses of MFI players

INR cr	Total provisions (FY20 – FY23e)	MFI book (as on Mar'20)	% Loss
Bandhan Bank	17,098	46,190	37%
Ujjivan SFB	2,128	10,377	21%
Suryoday SFB	905	3,014	30%
CreditAccess	2,034	11,996	17%
Spandana	1,846	6,829	27%
Fusion	829	3,607	23%
Arman	134	860	16%

*Source: Company presentations; (assumes that all provisions relate to MFI loan book that was existing just when covid hit)

Bandhan Bank (CMP = 230; Mcap = 36,500cr)

Long term assessment: It is India's largest MFI and stands out for being the worst impacted as well.Apart from the pandemic generated pain, company specific factors include lack of geographic diversification (>50% of MFI book in West Bengal & Assam), overleveraging its customers under the garb of warding-off competition (average ticket size was 2-3x of industry) and extreme under-investments in non-MFI businesses (branches, sales, technology, brand).

Until as late as Sep'21, management attributed most of the problems to the pandemic. The deep losses even after the huge write-offs in FY22 has probably forced to change track and talk about asset & geographic diversification. Even if the intent is whole hearted, it will take years of investments in tech, people and processes to build a good bank (which means much higher opex). Till then, earnings will continue to be extremely cyclical with huge dominance of microfinance on the asset side and highly interest rate sensitive customers on the liability side.

Short term assessment: The benign macro cycle offers some hope in the interim. If most of write-offs are genuinely over in FY23, Bandhan can report a big jump in profits in FY24 courtesy the 200-250bps lending rate hike, improvement in % of assets that will earn interest (reduction in stressed portfolio) and sharp reduction in loan losses.

INR cr	FY20	FY21	FY22	FY23e	FY24e	Comments
Loan book	71,850	87,040	99,340	1,06,790	1,30,904	Good growth possible
Net income	7,873	9,585	11,537	11,206	14,838	250bps higher lending rates
Provisions	1,393	3,820	7,885	4,000	1,188	Benign cycle & end of NPAs
PAT	3,024	2,205	124	2,019	6,015	Big jump in profits
RoA	4.3%	2.2%	0.1%	1.5%	3.8%	Avg across cycle = 2.5%
RoE	23%	14%	1%	11%	26%	Avg across cycle = 15%

Source: Company presentations; (projections are just for illustrative purpose)

Valuation: Despite trading 50% below the pre-pandemic levels, current valuations at 1.9x on Mar'23
aren't exactly cheap, given the deeply cyclical nature of its business. If FY24 is indeed a good year for earnings, the stock can give 20-30% returns, in-line with the increase in its networth. Anything beyond this should be contingent on the management's ability to reduce the cyclicality of its business model.

Ujjivan SFB (CMP = 27; Mcap = 5,200cr)

Long term assessment: Apart from being one of the well-run MFIs, Ujjivan had the distinction of being the most geographically diversified MFI as well. However, things changed post conversion to small bank. Their initial strategy around branches & liabilities misfired. They then tried to rope in a banker CEO, but that strategy too failed. The old founder re-took control of the management in late 2021.

Amidst all this, Ujjivan still remains a well-run MFI. But its banking piece continues to struggle. Despite spending 1,000s of crores in opex, its liability franchise as well as fee income (non-lending related) franchise remains weak. It is indicative of two things – that banking franchise is extremely tough to build despite throwing lot of money on it and that the MFI mindset still reigns supreme within the company. 70% loan book and 90%+ of profits still come from the MFI business which is deeply cyclical. Any change in this will be very gradual.

Short term assessment: Ujjivan is already reporting an upswing in FY23 earnings due to early recognition of losses (9MFY23 losses are close to zero) and having raised lending rates from 19% to 21% in May'22. It may not be easy to grow earnings at double digit rate over the base of FY23 since Ujjivan will have to contend with rising deposit costs & normalization of credit losses in FY24.

INR cr	FY20	FY21	FY22	FY23e	FY24e	Comments
Loan book	14,153	15,140	18,162	21,895	27,644	Good growth possible
Net income	1,956	2,040	2,087	3,103	3,751	Impact of rising deposit rates
Provisions	171	799	1,118	40	310	Normalization of credit costs
PAT	350	8	-415	985	901	Big jump in profits
RoA	2.4%	0.0%	-2.1%	3.9%	2.8%	Avg across cycle = 1.4%
RoE	15%	0%	-15%	28%	19%	Avg across cycle = 9.6%

Source: Company presentations; (projections are just for illustrative purpose)

Valuation: Stock trades at 1.25x on FY23 book value, which isn't expensive. But given that cross-cycle RoEs are around 10% or close to cost-of-capital, it's not easy to build a case for permanent improvement in valuations. Stock can give 20-30% upside in next 12 months purely based on book value compounding. Returns beyond that depends on the length of MFI cycle and ability to reduce cyclicality of earnings.

Despite much higher MFI losses, Bandhan has higher RoAs & RoEs compared to Ujjivan. This is because Ujjivan has spent much more than Bandhan in trying to build a banking franchise. It's a different matter that both remain heavily dependent on MFI sector and have to offer high rates to attract depositors.

Suryoday SFB (CMP = 99; Mcap = 1,050cr) It is the smallest among listed SFBs. In many areas of life, small can be beautiful. But this is surely not true in the banking domain, where scale becomes very important to success. The small scale of operations doesn't allow Suryoday to spend much on banking franchise (CASA = 9% of borrowings) and its not possible to scale profitably without spending. It's more like a chicken and egg problem.The pandemic performance of its MFI book (~65% of total loans) puts it in mid-tier amongst the MFIs. While the cyclical upturn will lift all boats including Suryoday, small size is going to remain an impediment for times to come. Valuations at 0.7x current book is the only comforting factor.

Credit Access Grameen (CMP = 990; Mcap = 15,500cr)

Long term assessment: CAG is India's largest NBFC-MFI and also one of the best run MFIs, visible in the lowest credit losses during the pandemic and the fastest return to profitability. This despite having acquired a mid-sized MFI just before the start of pandemic speaks volumes about the management ability. Operating in rural areas and following the best practices in terms of collections & customer leveraging, Credit Access is the cleanest play in the NBFC-MFI space.

Short term assessment: Upswing in earnings has already started in Q3FY23. With good growth,higher lending rates and cyclically low credit costs, FY24 will witness 5%+ RoAs.

INR cr	FY20	FY21	FY22	FY23e	FY24e	Comments
Loan book	11,996	13,587	16,599	20,749	25,313	Good growth on anvil
Net income	1,127	1,537	1,766	2,300	2,944	Lending rates increased
Provisions	237	771	597	429	368	Normalization of credit costs
PAT	328	131	357	728	1,140	Big jump in profits
RoA	3.4%	1.0%	2.4%	3.9%	5.0%	Avg across cycle = 3.1%
RoE	13%	4%	9%	17%	22%	Avg across cycle = 13%

Source: Company presentations; (projections are just for illustrative purpose)

Valuations: Current valuations at 3.3x on FY23 book adequately reflect the relatively lower cyclicality in earnings and management pedigree. Expecting valuation expansion from here isn't a good idea since we have seen in the past two down cycles (demon & covid) that even the best players suffercyclicality in this sector. Thus, the best case here should be book value compounding or 15-25% returns in FY24.

One point to note here is that well run NBFC-MFIs trade at higher valuations v/s Bank-MFIs. Part of the reason is NBFCs don't have to spend huge money on building a banking franchise (and we have seen poor outcomes from most SFBs except Equitas & AU) and there is always an option value interms of a large bank acquiring the NBFC-MFI.

Fusion MFI (CMP = 400; Mcap = 4,000cr)

Long term assessment: Fusion MFI has been one of the fastest growing MFIs in the past 7 years and also among the better geographically diversified. Ability to continuously raise equity capital at the right time has enabled it to grow through demonetization as well as pandemic. The credit losses look optically low due to the high growth, but when one looks at static pool analysis, Fusion's asset quality performance is mid-tier (23% losses on Mar'20 portfolio).

Fusion's loan book has grown by 12x in past 7 years or 45% CAGR, which is almost 2x of the sector growth. Generally speaking, MFI business is very operations intensive in terms of getting the right staff & establishing right processes. Pulling off such high growth without any lose ends will be a sort of miracle (but miracles do happen). Not to mention that over the past few years, there were disputes between the original founders, private equity investors & SIBDI (details available in drhp) and the founder promoter has less than 5% equity left in the company.

Short term assessment: We have already seen two good quarters post the IPO. The fund raise andthe benign macro will ensure this continues for FY24 as well.

INR cr	FY20	FY21	FY22	FY23e	FY24e	Comments
Loan book	3,607	4,637	6,786	8,822	11,027	Good growth on anvil
Net income	NA	498	705	1,088	1,409	Lending rates increased
Provisions	73	221	369	167	202	Normalization of credit costs
PAT	70	44	22	376	506	Big jump in profits
RoA	1.9%	0.9%	0.3%	4.3%	4.6%	Avg RoA across cycle = 2.4%
RoE	8%	4%	2%	21%	20%	Avg RoE across cycle = 11%

Source: Company presentations; (projections are just for illustrative purpose)

Valuations: Current valuations at 1.8x on FY23 book look reasonable when compared to well-run MFIs like CreditAccess and Arman. May be the market is adequately building in for risks-factors like large un-seasoned book, low promoter stake and average RoEs across cycle of ~11%.

Spandan Sphoorty (CMP = 600; Mcap = 4,260cr)

Long term assessment: Spandana has crossed many critical milestones – survived AP crisis, emerged out of CDR, withered the pandemic storm and stabilized after the bitter fight between ex-founder and current promoter. After all this, the balance sheet still remains well capitalized and the new management is in place and working towards re-establishing the building blocks i.e. people, processes & raw material. If the execution is good, FY24 can be the first significant year of profits.

Short term assessment: Borrowing costs are slated to go up, since Spandana is re-starting its relationship with lenders. But that will more than adequately be off-set by increase in lending rates (200bps higher than competitors). FY24 can be the first year of mid-teen RoEs. However, Spandana will have to moderate its strategy of higher borrowing & lending rates, once things stabilize.

INR cr	FY20	FY21	FY22	FY23e	FY24e	Comments
Loan book	6,829	8,157	6,089	6,698	8,372	Good growth on anvil
Provisions	274	644	481	448	151	Normalization of credit costs
PAT	337	129	70	144	480	Big jump in profits
RoA	6.0%	1.7%	1.0%	2.3%	6.4%	Avg across cycle = 3.5%
RoE	15%	5%	2%	5%	14%	Avg across cycle = 8%

Source: Company presentations; (projections are just for illustrative purpose)

Valuations: Current valuations at 1.3x on FY23 reflect the chequered past and a modest future. If the management is able to demonstrate good growth and profitability, there is some scope for improvement in valuations.

Arman (CMP = 1405; Mcap = 1,193cr)

Long term assessment: Arman is small but well-run MFI. It ticks many boxes including good geographic diversification, highly profitable operations, lowest credit losses during demonetization & pandemic, and highest shareholding by founder-promoter. High involvement of the founders and adequate risk management should ensure that Arman will continue to be better than the sector in years to come.

INR cr	FY20	FY21	FY22	FY23e	FY24e	Comments
Loan book	860	814	1,233	1,726	2,417	Good growth on anvil
Provisions	20	55	37	22	36	Normalization of credit costs
PAT	42	11	32	83	105	Big jump in profits
RoA	5.4%	1.3%	3.1%	5.6%	5.1%	Avg across cycle = 4.1%
RoE	28%	6%	16%	30%	26%	Avg across cycle = 21%

Valuations: Current valuations at 3.4x on FY23 book adequately reflect the "better than sector" long term performance. Investors can continue to expect book value compounding for the years to come.

Investor strategy – Create a barbel!

Given the high certainty in the near term and the usual uncertainty in the long term, investors are better off playing the barbel strategy i.e. to own a combination of well-run MFI (which will at least ensure book value compounding) and a turning around MFI (which can give higher returns IF the turnaround happens)!

- **Barbel 1:**CreditAccess, Arman
- **Barbel 2:**Bandhan, Ujjivan, Spandana

For those who do not like investing in deeply cyclical sectors, they can invest in short duration bonds of some of the MFIs. Balance sheets are well capitalized, macro cycle is benign and micro looks strong for FY24. Many of these bonds offer yields in the range of 11-12% and are a part of GreenEdge Wealth's high yield bond baskets.

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