India

Overweight *(no change)*

Highlighted Companies

Bajaj Finance Ltd

ADD, TP Rs9000, Rs5829 close

Bajaj Finance's pricing power and the ability to pass on the rise in cost of funds to end-customers, in our view, will drive margins.

Cholamandalam Investment and Finance Company

ADD, TP Rs900, Rs829 close

CIFC's AUM diversity and its management's dynamic focus on creating a longer-tenure ecosystem will, in our view, drive a rerating.

Mahindra & Mahindra Finance

ADD, TP Rs350, Rs251 close

MMFS is our high-conviction stock idea due to its attractive risk-reward and improving return ratios.

NBFC

Time to ride the tide

- We expect the margin paradox in favour of NBFCs whereby their margins outperform bank margins by 50-75bp in a stable monetary policy scenario.
- We expect credit growth for NBFCs to remain superior compared to banks due to a favourable asset mix, aggressive sales approach & improving penetration.
- NBFCs outperform banks during the soft monetary policy phase amid superior growth and margins. We prefer MMFS, CIFC, BAF & Spandana Sphoorty.

Time to play margin paradox: NBFCs better placed on margin front

We expect the margin paradox to play out in the coming quarters whereby NBFCs will be able to hold on to superior margins vs. banks. In a rising interest rate scenario, NBFCs faced steep margin pressure due to rising cost of funds (mainly borrowed from banks via benchmark-led rates) and relatively slower transmission (due to fixed-rate lending profile). However, with stagnant or else easing policy rates for NBFCs, with the cost of funds being capped due to stabilizing benchmark rates and a rise in yields due to gradual pass-on of previous rate hikes, the margin trajectory for NBFCs will be relatively better vs. banks.

Expect NBFC margins to outperform bank margins by ~50-75bp

In the current monetary tightening cycle since May 2022, banks under our coverage universe have witnessed ~85bp rise in yields as against ~45bp rise in the cost of funds, resulting in margin expansion of ~40bp. On the contrary, NBFCs witnessed ~70bp surge in the cost of funds against ~40bp improvement in yields. This resulted in margin compression of ~45bp. Going ahead, we expect banks to witness a surge in deposit cost by ~50-100bp with stagnant yields (being benchmarked to external rates) whereas NBFCs are already witnessing a yield surge of ~75-100bp but the cost of funds is expected to remain flat. This will result in net interest margin or NIM expansion by ~50-75bp for NBFCs and banks' NIM to compress by ~25-50bp in the coming ~12-18 months.

Credit growth favourable for NBFCs due to asset mix, penetration

We expect system credit demand in the coming quarters to ease amid tighter liquidity and elevated interest rates, but overall credit growth to remain sporadic with a few players performing better. The slowdown would be severe in case of rate-sensitive segments like mortgage whereas auto financing, unsecured SME/MSME, and personal loan, being low rate-sensitive, are expected to perform better. As NBFCs primarily cater to these segments, the growth prospects for NBFCs look encouraging compared to banks.

Lower credit cost will continue to support overall profitability

We continue to remain comfortable on the asset quality profile of all lenders with the lower credit cost trend continuing at least till 2HFY24F. Collection efficiency for most NBFCs has witnessed a gradual improvement over time, which provides comfort.

Forced conversion of large NBFCs into banks unlikely for now

We believe the RBI is comfortable with the NBFC structure and prefers them to float in their current condition with an aim to increase credit penetration in India as well as to improve overall financial inclusion. The central bank has already implemented various regulations, especially on asset quality and disclosure norms, which have brought NBFCs at par with banks on the business front. Lastly, most large NBFCs are promoted by corporate houses where the RBI remains uncomfortable over issuing licences, reiterating our view further.

MMFS & Spandana are high-conviction bets along with BAF & CIFC

We prefer diversified NBFCs with a pan-India presence and strong liability profile. Bajaj Finance (ADD, TP of Rs9,000) and Cholamandalam Finance (ADD, TP of Rs900) are those names where we are confident of profitable growth management with the ability to hold a steady asset quality profile. Mahindra Finance (ADD, TP of Rs350) and Spandana Sphoorty (ADD, TP of Rs750) are turnaround stories where we remain confident of improving profitability and return ratios, which are available at a favourable risk-reward.

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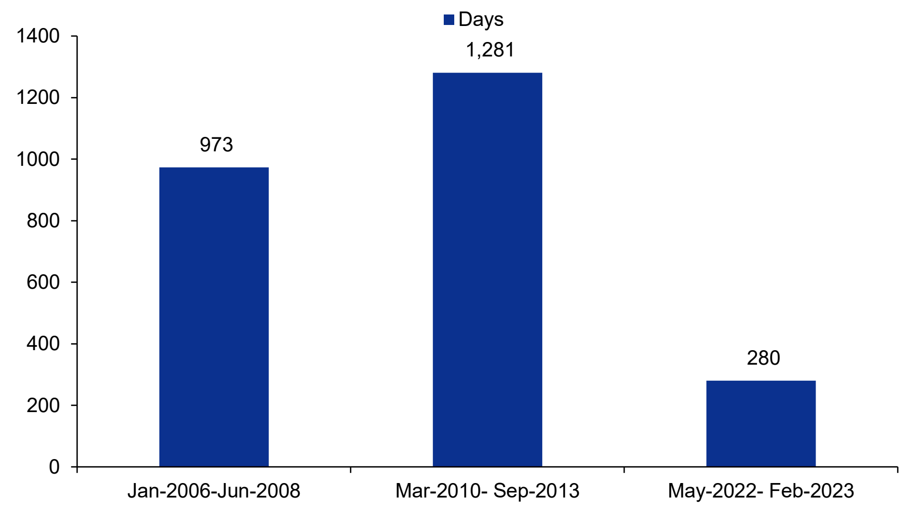
Margin paradox: NBFCs to outperform banks

The recent pause in monetary policy rates was a relatively unexpected move from the Reserve Bank of India or RBI but considering the recent cooling off in domestic inflation data, we remain hopeful of policy rates being close to their peak. We believe the withdrawal of policy tightening is an ideal opportunity to play margin paradox whereby NBFCs will deliver superior margins compared to banks. This is exactly the opposite of the rate tightening cycle, which is advantageous for banks.

Current rate tightening cycle has been sharpest in past decade

We have observed that the current monetary tightening cycle has been sharper compared to the previous two cycles, resulting in a steep rise in benchmark rates.

Figure 1: Days taken for 250bp repo rate hike in different rate hike cycles



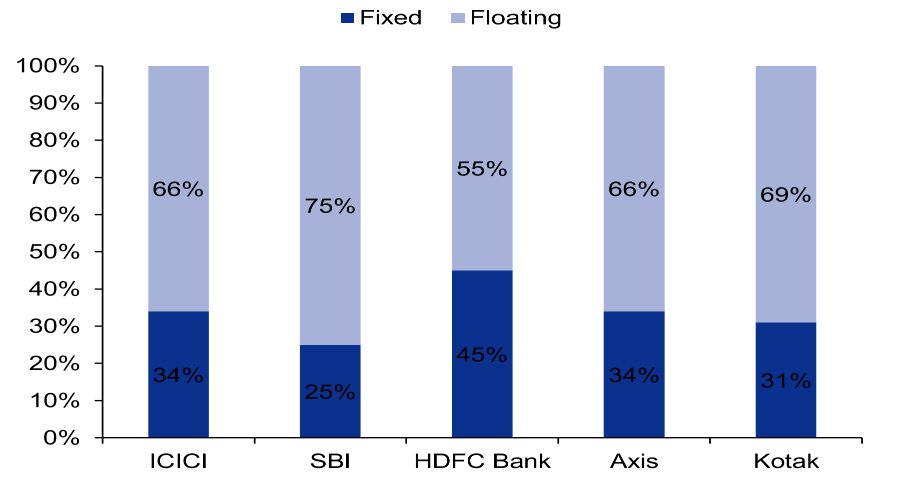
Margins favoured banks over NBFCs during rate tightening

During the current monetary tightening cycle since May 2022, banks under our coverage universe witnessed ~85bp rise in yields against ~45bp rise in the cost of funds, resulting in margin expansion of ~40bp during the past. On the contrary, NBFCs witnessed ~70bp surge in the cost of funds against ~40bp improvement in yields. This resulted in margin compression of ~45bp.

Elevated share of variable rate loans supported bank yields

Banks managed to witness a consistent yield improvement during the current monetary tightening due to an elevated share of benchmark- linked lending products. Thus, any rise in the repo rate was passed on to end- customers.

Figure 2: Banks have a higher share of floating rate loans

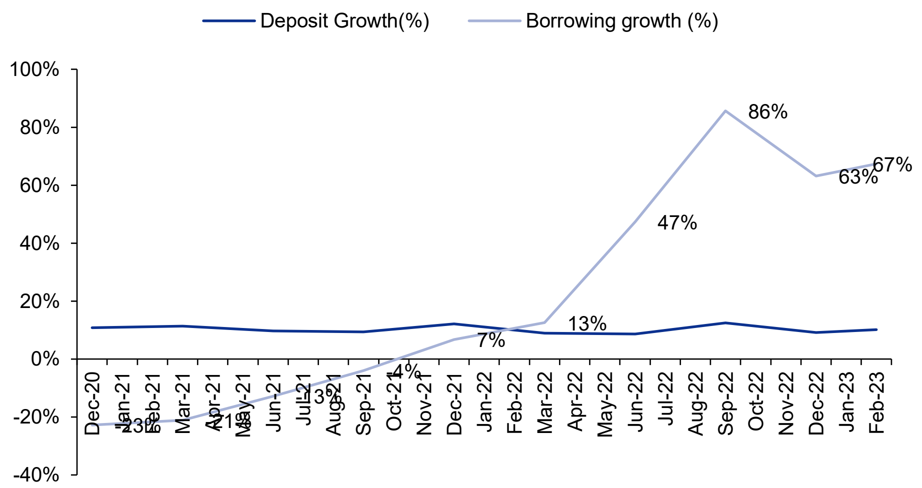


SOURCE: INCRED RESEARCH, BLOOMBERG

Banks' focus on borrowing/treasuries kept cost of funds low

During the Covid-19 pandemic phase of 2020-22, most banks were sitting on excess liquidity because of low demand. Additionally, banks also raised money through borrowing, which was available cheap, instead of the traditional pattern of deposits which generally remains costlier. This kept the cost of funds lower.

Figure 3: Borrowing surpassing deposit growth aided margins

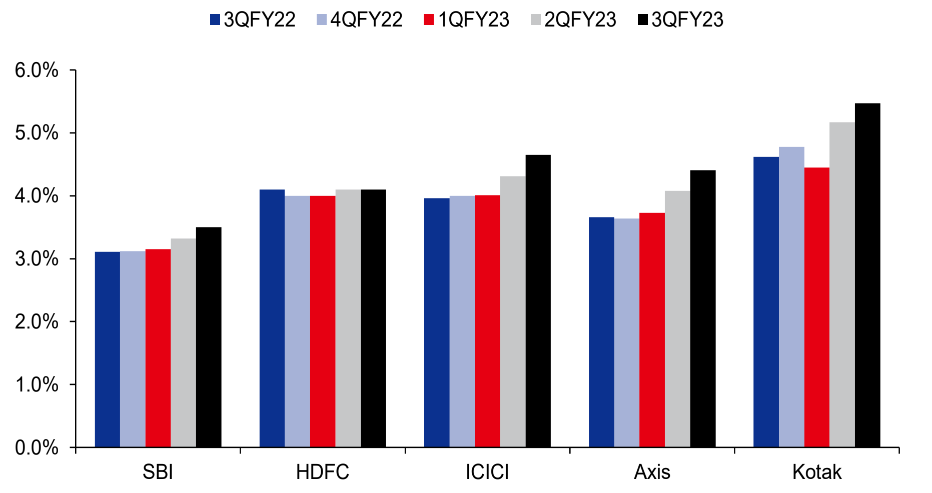


SOURCE: INCRED RESEARCH, BLOOMBERG, COMPANY REPORTS

A combination of these led to superior margins for banks

The sharp surge in yields coupled with a slower-than-expected rise in the cost of funds resulted in a superior margin profile for most banks in India. The margin trend remained healthy in the past despite consistent policy tightening.

Figure 4: Banks' margins witnessed a surge despite the hike in repo rate

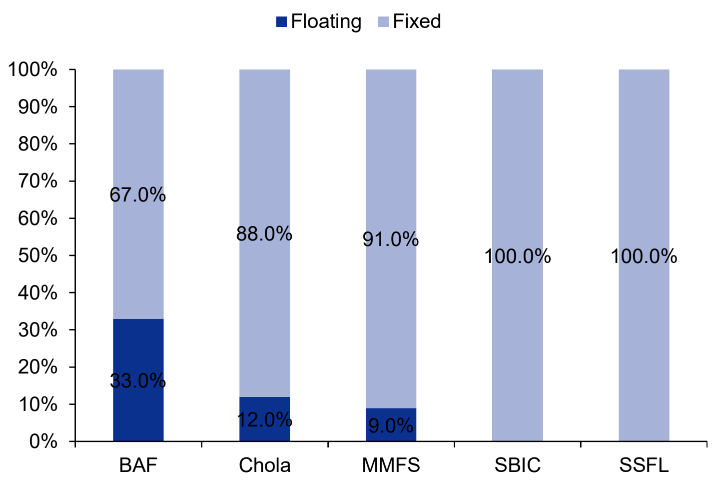


SOURCE: INCRED RESEARCH, COMPANY REPORTS

On the contrary, fixed-rate lending and floating-rate borrowing created adversity for NBFCs' margins

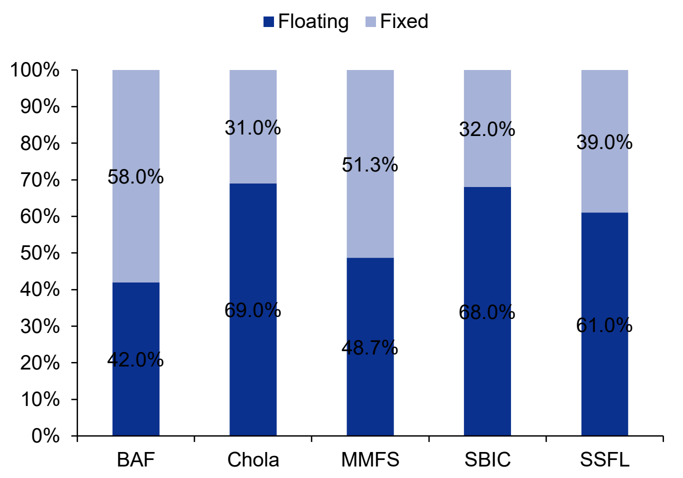
Non-banking finance companies or NBFCs are primarily engaged in fixed-rate lending profiles such as vehicle financing, SME/MSME financing etc. Their ability to pass on the rate hike comes with a lag effect. However, the rise in cost of funds is immediate due to the higher portfolio of floating rate loans, mainly from banks.

Figure 5: Lending book breakup of large NBFCs as of Dec 2022



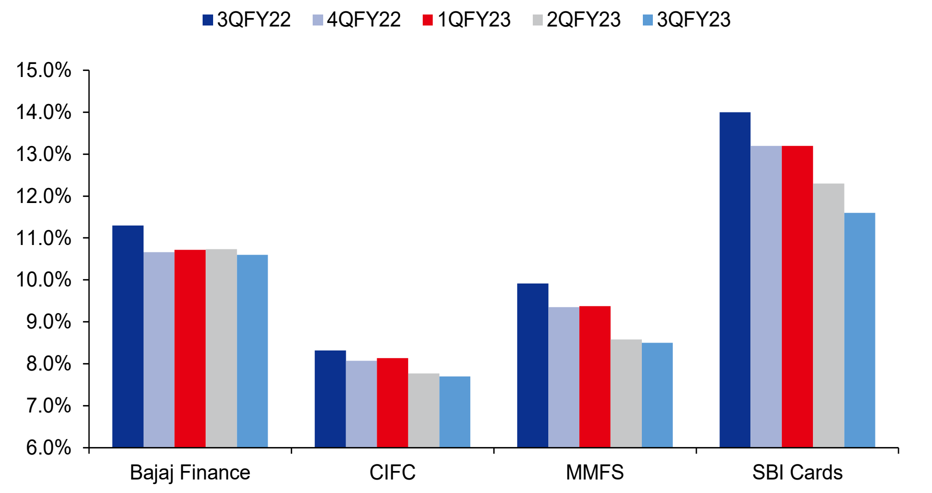
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 6: Borrowing breakup of large NBFCs as of Dec 2022



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 7: NBFCs' margins have been on a falling spree since the past few quarters



SOURCE: INCRED RESEARCH, COMPANY REPORTS

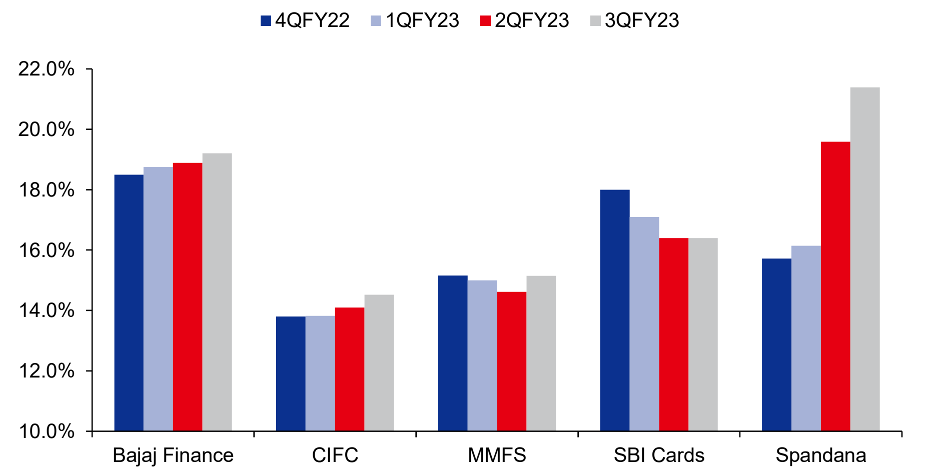
Margin paradox: Margins of NBFCs to outperform

We expect a margin paradox whereby NBFCs will be able to deliver superior margins compared to banks, at least in the initial couple of quarters. Although uncertainty prevails, considering the recent cooling off in domestic inflation data, we remain hopeful of policy rates peaking or being close to their peak. During the tightening of monetary policy, the advantage of banks will turn into a disadvantage, but turn into an advantage for NBFCs.

Banks' yields to decline immediately, NBFCs' yields are sticky

With the rise in repo rate, bank lending rates started moving up, resulting in a surge in margins. However, with benchmark lending rates (repo) saturating, a further rise in lending rates also gets capped. On the contrary, most NBFCs have increased their benchmark lending rates in the past few quarters, and the advantage of the same should stay due to the fixed-rate lending profile of NBFCs.

Figure 8: Yield on advances for NBFCs has moved up gradually

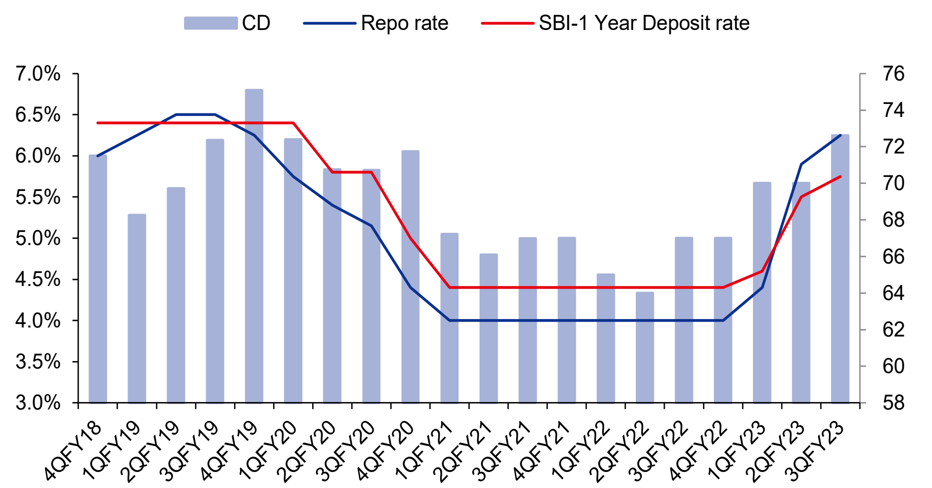


SOURCE: INCRED RESEARCH, COMPANY REPORTS

Repricing of deposits to keep cost of funds elevated for banks

On the contrary, overall cost of funds will continue to move up because of the repricing of deposits, which happen with a lag effect and so the surge in cost of funds for banks may continue for at least a couple of quarters despite benchmark repricing stopping for banks.

Figure 9: High CD ratio to keep deposit rates elevated for some time



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Being funded by banks, NBFCs' cost of funds to remain stagnant

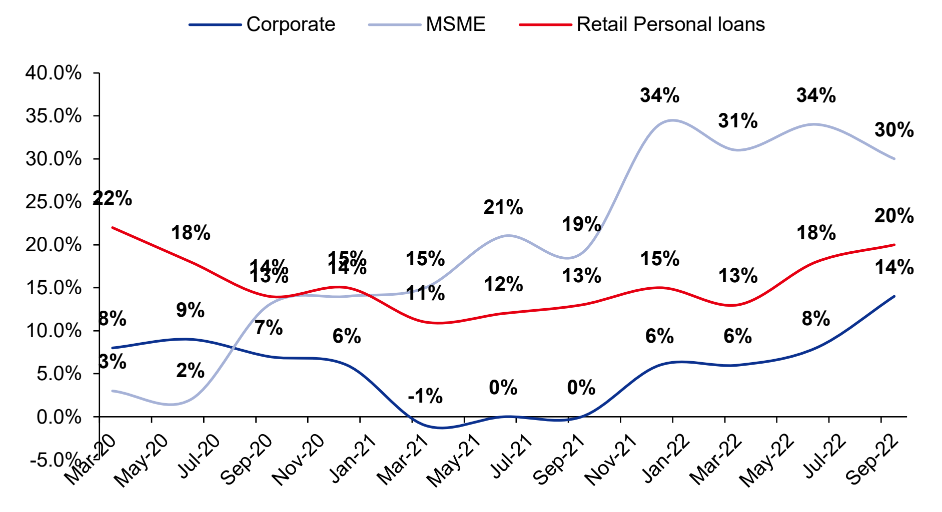
Assuming benchmark rate (repo rate) has already peaked out or nearly at peak level, the surge in cost of funds for NBFCs would be limited or capped considering that ~60% of the sourcing (borrowing) happens through the banking channel which is any how linked to benchmark rate or external rate which will stabilize once the repo rate hike matures.

Going ahead, we expect banks to witness a surge in deposit cost by ~50-100bp with stagnant yields (being benchmarked to external rates) whereas NBFCs are already witnessing a yield surge of ~75-100 bp but the cost of funds is expected to remain flat. This will result in NIM expansion by ~50-75bp and banks' NIM to compress by ~25-50bp in FY24F. Thus, we believe NBFCs' margins to outperform banks' margins relatively by 50-75bp.

Credit momentum favourable for NBFCs

India's financial sector witnessed a superior credit demand environment post Covid-19 pandemic, since the past few quarters amid various reasons including but not restricted to the change in customer spending pattern, improved data availability, lower interest rates, easy availability of finance, etc. Interestingly, India witnessed credit spurt in retail and SME/MSME segments whereas corporate credit is mostly restricted to demand for working capital loans. Despite the steep rise in rates, the overall momentum (especially in unsecured retail and SME segments) continued.

Figure 10: System credit growth is mainly led by retail and SME/MSME segments

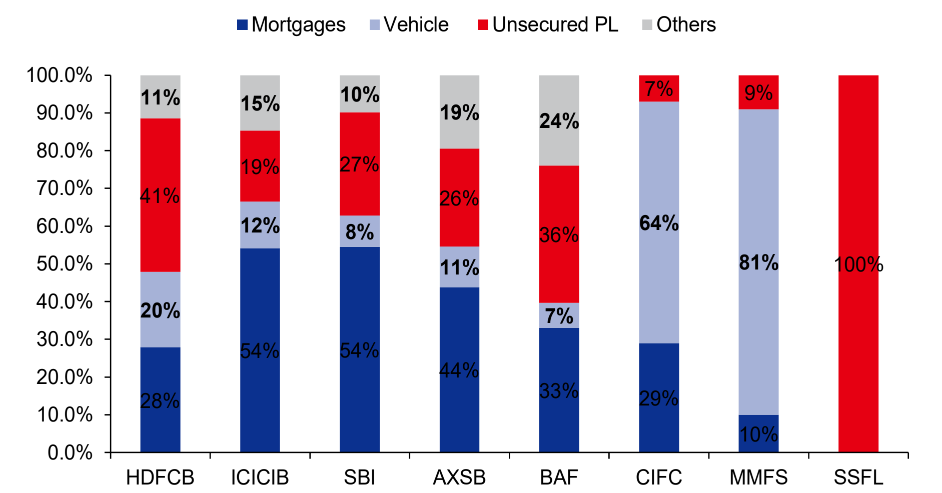


SOURCE: RBI, INCRED RESEARCH

NBFCs have a limited presence in rate-sensitive segments

Going ahead, we expect the credit momentum to witness a slowdown amid tighter liquidity and elevated interest rates. The high base of last year will also have an impact. However, we believe the impact would be more severe in case of rate-sensitive retail lending segments like mortgage whereas segments such as auto loan, unsecured SME/MSME, personal loan, etc. which are less rate-sensitive are expected to perform relatively better. As NBFCs primarily cater to these segments, it will ensure relatively superior credit growth compared to banks.

Figure 11: Banks are exposed to rate-sensitive mortgage loans contrary to NBFCs

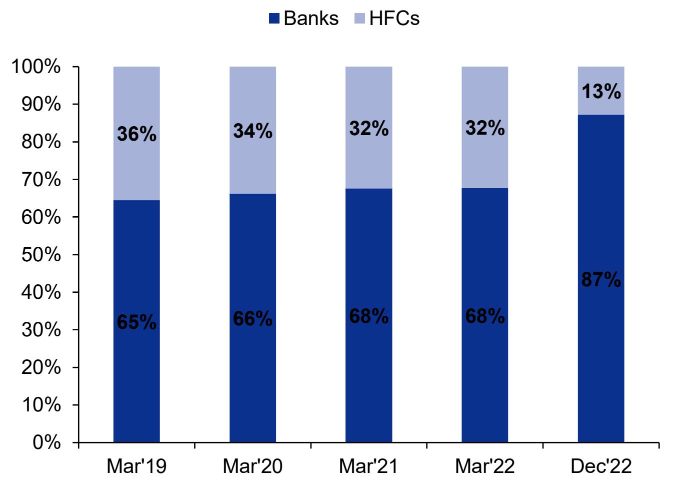


SOURCE: INCRED RESEARCH, COMPANY REPORTS
*DATA AS OF DEC 2022-END

Market share in mortgage & auto loans reiterates our view

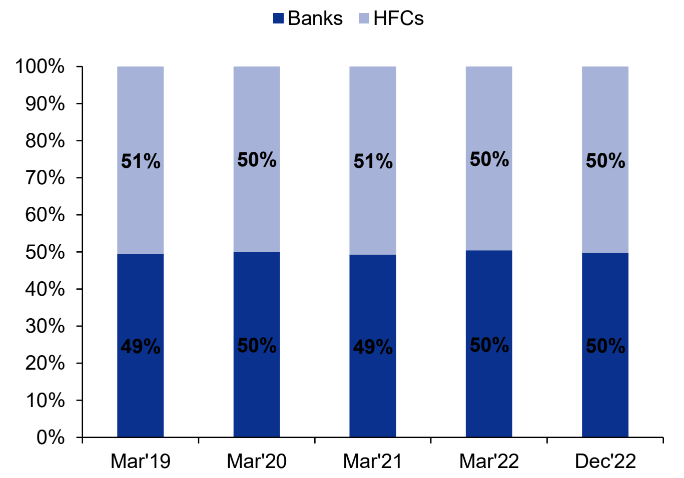
Our analysis of market share movement for mortgage and vehicle finance segments also indicates that rate-sensitive segments like individual housing have now been completely dominated by banks whereas in case of vehicle finance, NBFCs still manage to maintain their dominance.

Figure 12: Banks have a rising dominance in mortgage business



SOURCE RBI, INCRED RESEARCH
NOTE: FOR DEC 2022 HDFC LTD MERGED WITH HDFC BANK:

Figure 13: NBFCs held on to auto-lending market share over the years

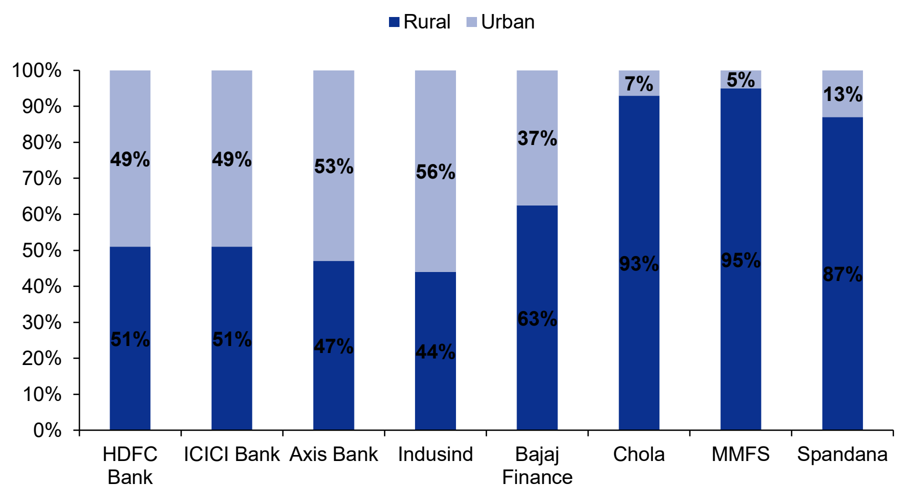


SOURCE: RBI, INCRED RESEARCH

Deep market penetration is another key advantage for NBFCs

Apart from generic credit demand arising out of urban and semi-urban customers, most lenders are witnessing a rise in credit demand supported by deepening penetration into new geographies. Rise in digitalization has accelerated credit penetration for most lenders but NBFCs are more prone to such a customer base compared to banks because of their flexible lending practices, higher feet on street and relatively smooth underwriting standards (higher income deviation, etc) which, we believe, will further support growth amid elevated lending rates.

Figure 14: NBFCs have deep geographic penetration to support their growth



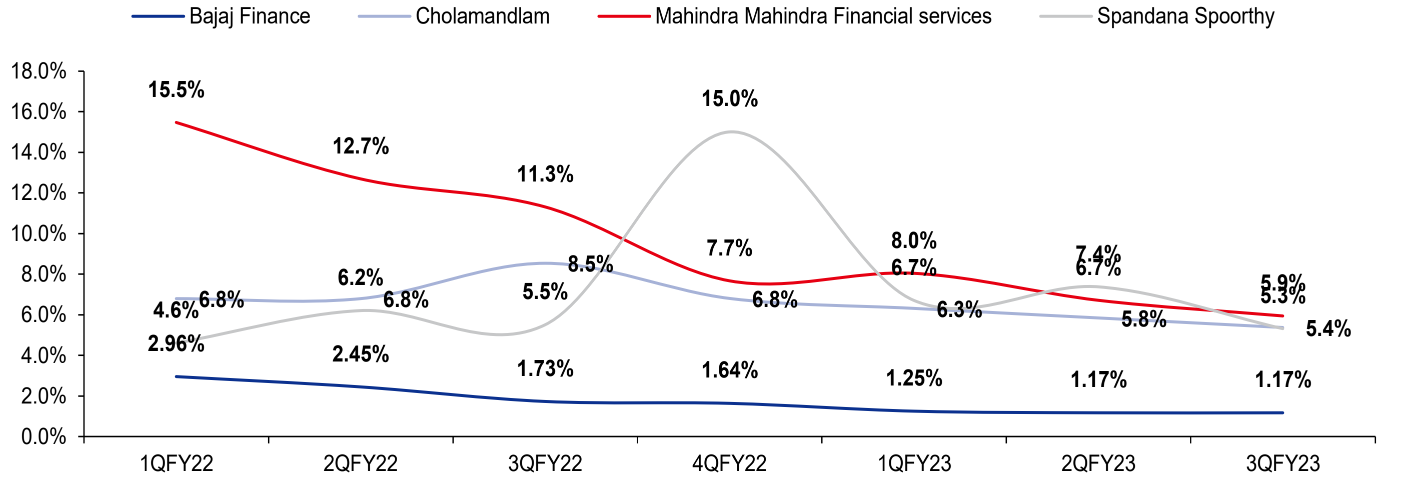
SOURCE: INCRED RESEARCH, COMPANY REPORTS

To conclude, although we believe that recent monetary and liquidity tightening will impact system credit demand, the overall growth trend to remain sporadic with a few players performing better. We also believe that rate-sensitive sectors are more vulnerable to slowdown. As NBFCs are more focused on low interest rate-sensitive and has a deeper penetration, they will be relatively better placed on the growth front compared to banks.

We remain comfortable over asset quality

India's financial sector is witnessing an improving asset quality trend post-pandemic as most wilful defaulters have been recognised during the Covid era. The incremental customer had a superior borrower profile which kept the overall trend in fresh slippage under check. This, coupled with improved recovery mechanism and significant buffer provisions built during the pandemic times, supported the consistent decline in credit cost, resulting in a surge in profitability.

Figure 15: NBFCs have witnessed a gradual improvement in headline NPA ratios (even after adapting IRAC norms)

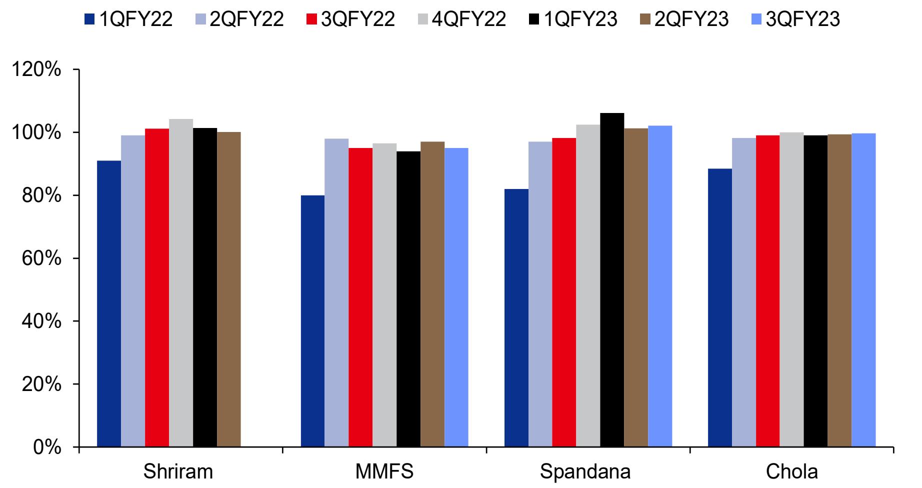


SOURCE: INCRED RESEARCH, COMPANY REPORTS

Improving collection efficiency provides further comfort

We have seen the banking system report sequentially lower slippage ratio and credit cost and that trend should continue going ahead. Meanwhile, NBFCs have adopted income recognition, asset classification and provisioning norms for non-performing asset or NPA recognition which has resulted in a spike, but the overall trend is normalizing over time. Collection efficiency of most NBFCs has witnessed a gradual improvement and remained healthy, which provides necessary comfort.

Figure 16: Collection efficiency held on well since the past few quarters



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Going ahead, we remain comfortable on the asset quality trend and lower credit cost, at least till 2HFY24F. This is because a large portion of incremental credit is to small-ticket retail/SME customers, which will avoid chunkier slippages. Also, overall recoveries and collections have improved due to excessive digitalization adopted by most lenders.

Conversion into bank is unlikely in near term

Post ILFS crisis, the NBFC sector has witnessed significant consolidation with many weak players already out of the business. We do not factor in the risk of conversion into banks for most NBFCs under our coverage universe, despite their balance sheet size and level of operations. The RBI has already implemented various regulations, especially on asset quality and disclosure norms, which has brought NBFCs at par with banks on the business front.

Figure 17: Comparison of major regulations for banks vs NBFCs

Regulation	Norms of NBFCs	Norms for Banks	Remark
Asset quality classification	IRAC norms	IRAC norms	NBFCs at par with banks
CET-1	9% of RWA for Upper layer NBFC	5.5% of RWA	Tighter for NBFCs
Disclosure for loan book break-up between agri, industry, service and personal loan and NPAs	Loan book break-up to be disclosed	Loan book break-up to be disclosed	NBFCs at par with banks
Disclosure of capital market exposure	Exposure to capital market entities to be disclosed	NA	Tighter for NBFCs
Disclosure of real estate sector	Direct and indirect exposure to be disclosed	Direct and indirect exposures to be disclosed	NBFCs at par with banks
Disclosure of large exposure	Individual exposure more than 10% of Tier-1 capital to be disclosed	NA	Tighter for NBFCs
Divergence in asset classification	To be disclosed if divergence exceeds 5%	To be disclosed if divergence exceeds 5%	NBFCs at par with banks
Group exposure	25% of eligible capital base	25% of eligible capital base	NBFCs at par with banks
Provisioning	As per expected credit loss methodology	IRAC norms (likely shift towards expected credit loss methodology)	Tighter for NBFCs
Single exposure	20% of eligible capital base	20% of eligible capital base	NBFCs at par with banks

SOURCE: RBI, INCRED RESEARCH

NBFC structure creates lower risk to public deposits

On analysing the credit mechanism in India, we observed that there are primarily three structures of lenders in India.

- The first round of organized credit is being provided by micro finance institutions (MFIs) which are mostly funded by private equity Investors. They cater to new-to-credit customers and are responsible for bringing credit discipline among borrowers. The loan ticket size and tenure are highly restricted. Many fintech companies have also entered this segment which again is funded by private equity investors. A few banks are present in MFI lending, but they generally cater to existing liability customers or customers driven through government schemes.
- Once a customer graduates from MFI, the customer becomes targeted customer of NBFCs. These NBFCs are promoted by corporate houses. NBFCs increase the loan ticket size along with relatively superior product diversity. NBFCs are anyhow indirectly funded by banks (through lending or else securitization), but the preliminary risk lies with NBFC equity holders. More recently, banks have tied up with NBFCs for co-lending. However, generally, the first credit loss is guaranteed by NBFCs.
- Finally, organized banks comes into the picture who cater to a relatively superior set of customers with a decent credit history. Banks can be approached by any customer for liability management, but for loans, the process is being filtered out.

Being promoted by a corporate house further limits conversion

Most large NBFCs in India are promoted by some large corporate houses with strong balance sheets and can infuse capital as and when required. However, the RBI has a clear thought process of not allocating banking licence to corporate houses, which remains intact even now. This further reiterates our view over limited probability of NBFCs getting converted into banks, at least in the near term.

Figure 18: Promoter holdings of NBFCs

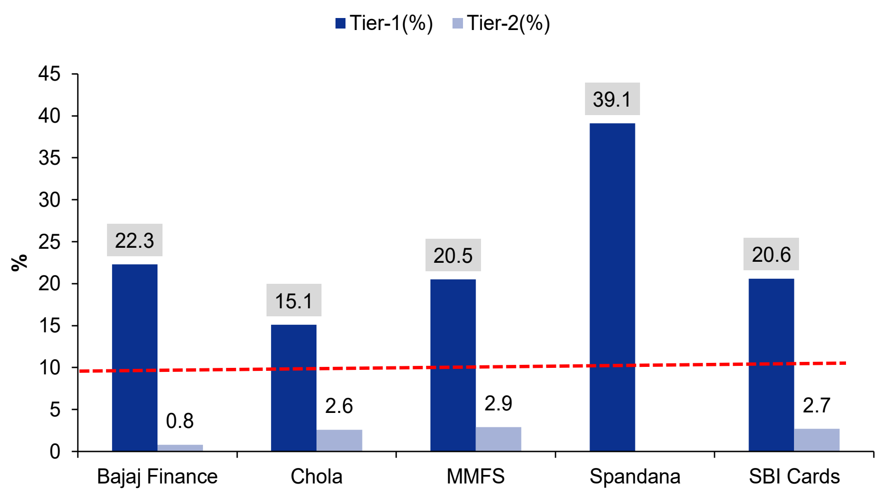
	Promoter	Promoter Holding
Bajaj Finance	Bajaj Group	56.0%
CIFC	Murgappa group	51.5%
MMFS	Mahindra & Mahindra	52.2%
LT Finance	L&T	66.2%
Spandana	Kedaara Capital	48.2%

SOURCE: INCRED RESEARCH, COMPANY REPORTS

Most NBFCs are better placed on capital adequacy norms

As highlighted earlier, NBFCs have relatively stricter capital adequacy norms compared to banks with a Tier-1 requirement of ~10%. Post-pandemic, we have observed that most large NBFCs are well capitalized, which can aid growth. Also, being promoted by a large corporate house, raising the capital is generally less complicated.

Figure 19: NBFCs are well placed on the capital adequacy front as of Dec 2022-end



SOURCE: INCRED RESEARCH, COMPANY REPORTS

We believe the RBI is comfortable with the NBFC structure and prefers them to float in the current condition with an aim to increase credit penetration in India as well as to improve overall financial inclusion. As banks deal with public deposits, the filtration of MFI and NBFCs is necessary. We are of the opinion that banks prefer only NBFCs to venture into new businesses and geographies and opt to participate through securitization or the assignment route.

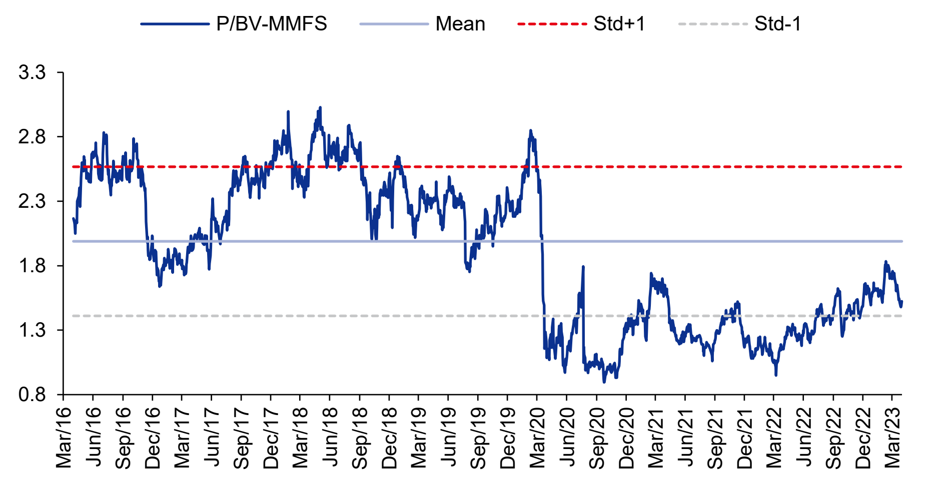
What we like about NBFCs

We prefer diversified NBFCs with a pan-India presence and a strong liability profile. Bajaj Finance and Cholamandalam Finance are such names where we are confident of profitable growth management with an ability to hold a steady asset quality profile. Mahindra Finance and Spandana Sphoorty are turnaround stories where we are confident of improving profitability and return ratios, which are available at favourable risk-reward ratio.

Mahindra Finance (ADD, TP Rs350)

MMFS is our high-conviction stock idea due to its attractive risk-reward (trading at ~1.6x FY24F BV) and improving return ratios (RoE at 16.2% by FY25F). We retain our ADD rating on MMFS with a higher target price of Rs350 or ~2.5x FY24F ABV. Downside risks: Slow growth, steep rise in cost of funds, and deterioration in asset quality.

Figure 20: MMFS is trading below its mean level

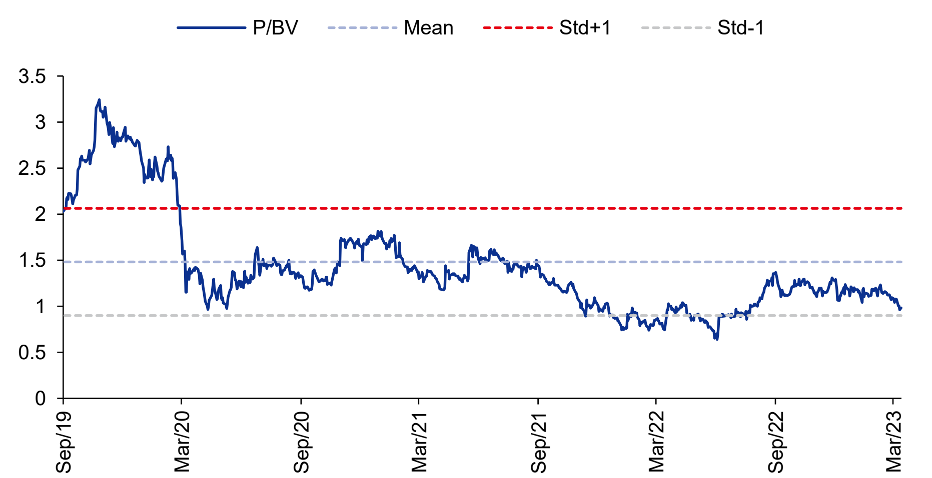


SOURCES: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG

Spandana Sphoorty (ADD, TP Rs750)

Spandana Sphoorty Financial (SSFL) is our high-conviction stock idea with an ADD rating and a target price of Rs750 or ~1.6x P/BV and ~17.4x P/E on Mar 2024F. We remain confident of its new management's ability to turn around the company through a process-driven approach and diversified growth methodology. Rise in fresh slippage, and resurgence of tussle with the old promoter are key downside risks.

Figure 21: Spandana Sphoorty is trading near -1 standard deviation

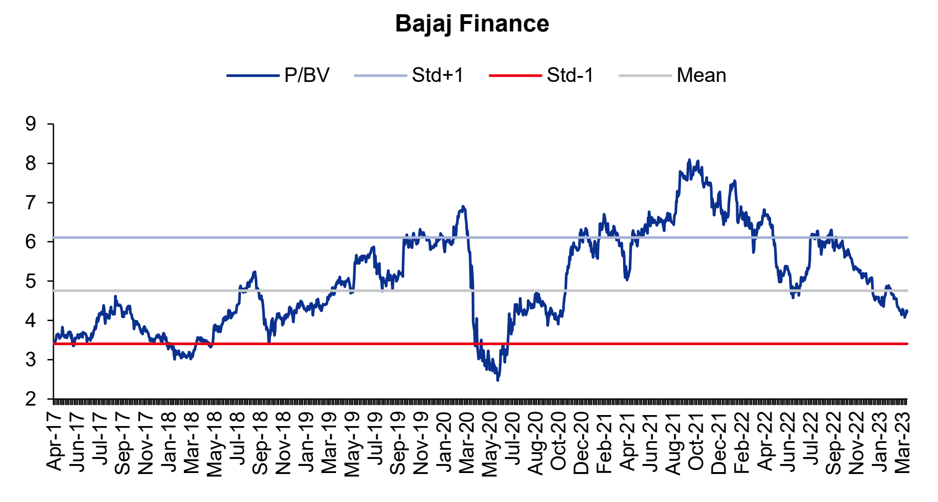


SOURCE: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG

Bajaj Finance (ADD, TP Rs9,000)

We are building in RoA of ~4.5% and RoE of ~25% for FY24F/25F, which justify the valuation premium. We maintain ADD rating on the stock with a target price of Rs9,000 or ~40x FY24F EPS. Slowing consumption and any further delay in digitalization are key downside risks.

Figure 22: Bajaj Finance is trading below its mean level

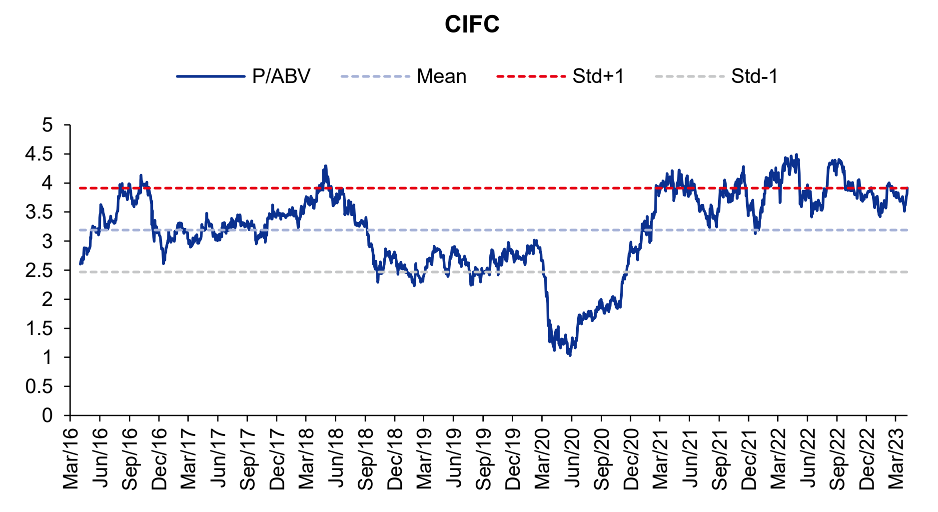


SOURCE: INCRED RESEARCH, BLOOMBERG, COMPANY REPORTS

Cholamandalam Finance (ADD, TP Rs900)

CIFC has remained a fine play on revival in India automobile demand, but we are more optimistic on rising assets under management or AUM diversity and management's dynamic focus on creating a longer-tenure ecosystem. We retain our ADD rating on CIFC with an unchanged target price of Rs900 or ~4.4x FY24F BV. Downside risks: Slowing growth, and a steeper rise in the cost of funds.

Figure 23: CIFC is trading near 1+ standard deviation



SOURCE: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG

Coverage universe

Figure 24: Valuation of NBFCs

				P/BV(x)			ROA (%)			ROE (%)		
Company	Rating	CMP(INR)	TP(INR)	FY23F	FY24F	FY25F	FY23F	FY24F	FY25F	FY23F	FY24F	FY25F
Bajaj Finance	ADD	5,759	9,000	6.5	5.3	4.2	4.7%	4.7%	4.8%	23.4%	24.1%	24.6%
Cholamandalam	ADD	779	900	4.6	3.8	3.1	2.6%	2.7%	2.6%	19.7%	21.3%	21.0%
SBI Cards	ADD	739	950	7.1	5.6	4.5	5.5%	5.6%	6.0%	24.9%	23.8%	23.8%
Aavas	ADD	1,670	3,000	4.9	4.2	3.6	3.5%	3.5%	3.6%	14.1%	15.1%	16.8%
Home First	ADD	722	1,200	3.3	2.8	2.5	3.9%	3.8%	3.7%	13.4%	14.9%	16.3%
Spandana	ADD	531	750	1.2	1.1	0.9	0.3%	3.2%	4.1%	0.7%	10.1%	14.8%
MMFS	ADD	240	350	1.7	1.6	1.5	2.3%	2.2%	2.3%	11.9%	12.8%	14.8%

SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 25: Valuation of banks

				P/BV(x)			ROA (%)			ROE (%)		
Company	Rating	CMP(INR)	TP(INR)	FY23F	FY24F	FY25F	FY23F	FY24F	FY25F	FY23F	FY24F	FY25F
SBI	ADD	523	800	1.5	1.3	1.1	0.9%	1.0%	1.1%	16.5%	17.0%	17.3%
HDFC Bank	HOLD	1,654	1,650	3.3	2.7	2.4	2.0%	1.9%	2.0%	17.4%	15.5%	15.6%
ICICI Bank	ADD	885	1,080	3.2	2.8	2.4	2.1%	2.1%	2.2%	17.3%	17.4%	18.0%
Axis Bank	ADD	860	1,100	2.2	1.9	1.6	1.5%	1.8%	1.8%	16.1%	18.4%	18.7%
IndusInd Bank	ADD	1,231	1,400	3.2	2.8	2.4	2.1%	2.1%	2.2%	17.3%	17.4%	18.0%

SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 26: Valuation of AMCs

				P/E(x)			Return on AUM (%)			ROE (%)		
Company	Rating	CMP(INR)	TP(INR)	FY23F	FY24F	FY25F	FY23F	FY24F	FY25F	FY23F	FY24F	FY25F
Nippon AMC	ADD	219	250	19.4	24.0	21.2	0.29%	0.24%	0.18%	21%	17%	19%
Aditya Birla AMC	ADD	338	390	15.2	18.0	15.3	0.21%	0.17%	0.18%	27%	21%	23%
HDFC AMC	ADD	1,746	1,950	26.0	27.7	24.1	0.35%	0.34%	0.29%	24%	21%	23%
UTI AMC	ADD	659	750	17.8	19.6	14.8	0.20%	0.17%	0.19%	13%	11%	14%

SOURCE: INCRED RESEARCH, COMPANY REPORTS

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