India

Overweight *(no change)*

BFSI

Ears to the ground: Not for the faint hearted

- Our Karnataka visit shows a fresh wave of bad loans, estimated at high-single digit to early-teens, led by overleveraging, sub-lending, and a state ordinance.
- The higher focus on collections and new guard rails has restricted disbursements to only existing borrowers where the renewal rate is ~30-40%.
- Broad-based stress exists for all lenders, although seasoned players such as CREDAG and Ujjivan SFB are relatively better placed.

Karnataka: A melting pot of uncertainty

As microfinance institutions or MFIs are backtracking their steps to the present, we peeped into the Karnataka geography, leading to convoluted underserved borrowers. We visited a few MFI hotspots in the state (~10% of MFI universe's assets under management or AUM as of 3QFY25-end) and observed that there is a heightened sense of caution among lenders. Our interactions with customers indicated that their pecking order is based on higher ticket sizes and monthly collections.

Stress levels: A fresh wave of dust rising above the clouds

Karnataka was among the top performing states in terms of asset quality in 3QFY25, with a slow accretion in early delinquencies witnessed in the 30-90 days past due (DPD) bucket (Fig. 1). However, our on-the-ground check indicates that there is a tactical shift in 4QFY25, resulting in a spike in early-bucket delinquencies. We expect high-single to early-teen rise in bad loans to crop up in 4QFY25F. This will be largely led by the surfacing of sub-lending, overleveraging, and a recent state government ordinance. Collection efficiency in the X bucket has dropped from the Dec 2024 level and can be lower than expectations.

Looking inside the overdue bucket

On taking a deeper look at the proportion of overdue (OD) flows, we get a sense that a part of the OD flows are because of lack clarity among the borrowers after the ordinance, sub-lending, overleveraging and business as usual.

Disbursements moving in a measured stick

New customer addition has almost come to a standstill in Karnataka. Furthermore, the renewal rate in respect of existing customers has also reduced on account of stricter guard rails of 3+ lenders and the ticket size limit of Rs200,000. Disbursements by seasoned players are also restricted to ~30-40% of the portfolio. Despite restricted disbursements, there is no major surge in the overlap between MFI borrowers and gold loan borrowers, estimated at ~30%, which has been constant in the last two-to-three quarters.

Outlook and valuation

Among NBFC-MFI lenders, the largest lender, CreditAcess Grameen (CREDAG), with ~21% market share (Fig. 2), stood out with its weekly collections and gradually rising ticket size. The company enjoys vintage customers who are adhering to the repayment cycle, despite the overleveraging. These customers have survived through the Andhra Pradesh MFI crisis, demonetization and the Covid-19 pandemic, thus instilling a sense of financial discipline. Small finance banks or SFBs work with relatively higher ticket sizes and monthly collection models, which is the customer-preferred model. Among SFBs, Ujjivan SFB stood with its seasoned underwriting mechanism in place. We believe the dust will take another two quarters to settle before disbursements can take off with renewed vigour. Among our coverage stocks, we continue to have a HOLD rating on Spandana Sphoorty Financial with a stable target price of Rs360, valuing it at 0.8x FY26F BV.

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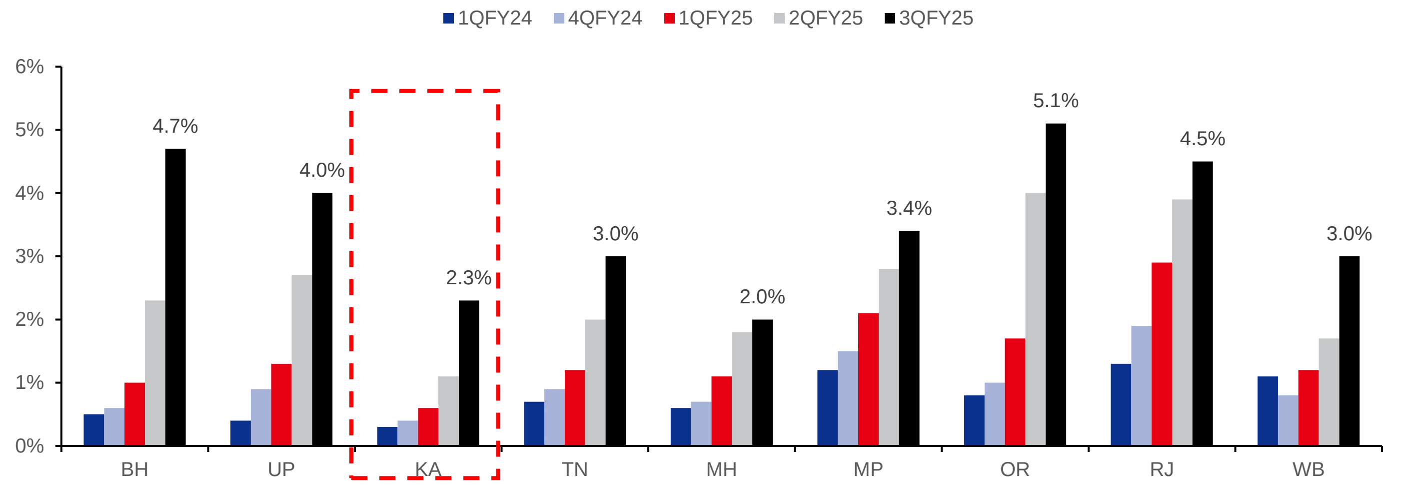
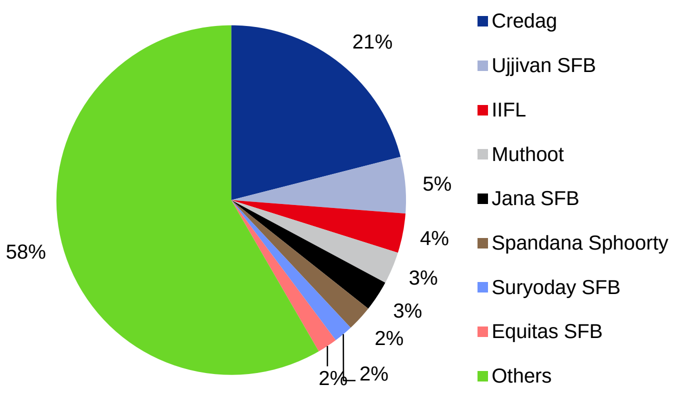
Figure 1: The rise in 30-60 DPD for our NBFC-MFI universe in major states indicates that the longer tail of the pain will stay



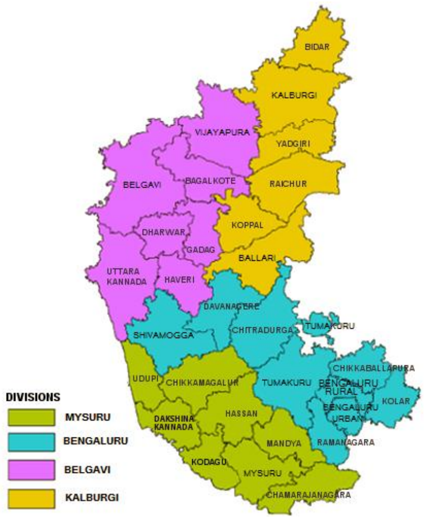
SOURCE: MFIN, INCRED RESEARCH, COMPANY REPORTS

Figure 2: MFI market shares as of 3QFY25-end



SOURCE: MFIN, INCRED RESEARCH, COMPANY REPORTS

Figure 3: Karnataka administrative districts



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Stock Ratings	Definition:
Add	The stock's total return is expected to exceed 10% over the next 12 months.
Hold	The stock's total return is expected to be between 0% and positive 10% over the next 12 months.
Reduce	The stock's total return is expected to fall below 0% or more over the next 12 months.

The total expected return of a stock is defined as the sum of the: (i) percentage difference between the target price and the current price and (ii) the forward net dividend yields of the stock. Stock price targets have an investment horizon of 12 months.

Sector Ratings	Definition:
Overweight	An Overweight rating means stocks in the sector have, on a market cap-weighted basis, a positive absolute recommendation.
Neutral	A Neutral rating means stocks in the sector have, on a market cap-weighted basis, a neutral absolute recommendation.
Underweight	An Underweight rating means stocks in the sector have, on a market cap-weighted basis, a negative absolute recommendation.

Country Ratings	Definition:
Overweight	An Overweight rating means investors should be positioned with an above-market weight in this country relative to benchmark.
Neutral	A Neutral rating means investors should be positioned with a neutral weight in this country relative to benchmark.
Underweight	An Underweight rating means investors should be positioned with a below-market weight in this country relative to benchmark.