

ANALYSIS

Was the NBFC meltdown waiting to happen?

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Growth & asset quality challenges, difficulty in raising funds, post IL&FS episode, and frothy valuations suggest just that

Stocks of non-banking finance companies (NBFCs) have been in a free fall, rattling investors over the past few days. What began as a singular event, with one of the big names – IL&FS failing to repay its commercial paper dues – has blown into a possible liquidity crisis for the entire NBFC universe. Is the sharp fall in NBFC stocks justified?

Frothy valuations, difficulty in raising funds from the bond market after the IL&FS episode, and existing growth and asset-quality challenges in some players suggest that some of the concerns are warranted and are unlikely to wane in the near term.

Many of these stocks may continue to feel the heat, which can worsen, if liquidity concerns of the sector are not addressed. Given the rising concerns over liquidity crunch, players with unfavourable asset-liability mismatch are best avoided.

Why the fear?

The massive sell-off has been triggered by the news that DSP Mutual Fund sold the commercial papers of Dewan Housing Finance Company (DHFL) at a higher yield in the secondary market – essentially at a sharp discount. This has raised a much wider concern over the liquidity problem at NBFCs.

Frothy valuations were long due for a correction

Price to book (times)*	Jan-16	Jan-18	Current
HDFC	5.5	6.7	4.6
Sundaram Finance	4.7	5.2	4.2
Can Fin Homes	3.4	5.3	2.7
Shriram Transport Finance	1.9	2.8	2.1
Dewan Housing Finance	1.2	2.2	1.4
Cholamandalam Investment & Finance	2.6	4.4	3.6
GRUH Finance	11.3	15.7	16.9
Bajaj Finserv	4.0	6.6	7.9
LIC Housing Finance	2.7	2.4	1.7
Mahindra & Mahindra Fin Services	2.0	3.4	2.6
RepcO Home Finance	4.5	3.5	2.0
Indiabulls Housing Finance	2.1	4.2	3.3
L&T Finance Holdings	2.6	7.2	3.4

*12-month trailing

In practice, banks and NBFCs can run into liquidity issues, mainly because of asset-liability mismatches. That is, their loans and borrowings do not come up for payment at the same time. Mismatches in the up to six months to one-year bucket often provide early warning signals of impending liquidity problems.

Sifting through the annual report disclosures from NBFCs for 2017-18 reveal that some players have a wide mismatch, with deposits and borrowings in the up to six-month bucket coming up for payment faster than their loans in the same tenure.

For Can Fin Homes, for instance, 18 per cent of its total liabilities (including bank borrowings and market borrowings) are maturing within six months, while only 5 per cent of its assets (advances and investments) are in the less than six-month bucket. For Dewan Housing Finance, its liabilities up to six months are 17 per cent of total liabilities, while the proportion of assets in the up to six-month bucket are 11 per cent.

The mismatch is wider if market borrowings on the liabilities side and advances on the assets side alone are considered (20 per cent market borrowings versus 4 per cent assets maturing within six months). Repco is another player that has a wide mismatch — 30 per cent liabilities versus 3.5 per cent assets maturing within six months.

Even if a full-fledged liquidity crisis does not unfold, the recent events hitting market sentiment will make it difficult for NBFC players to raise money from the bond market. With short-term rates increasing, the cost of funds of these companies will also increase, impacting profitability.

Most of the HFCs and NBFCs have been able to sport stellar growth in the last two-to-three years, sufficiently funded by market borrowings and bank loans. Banks' credit to NBFCs grew by 27 per cent in FY18, up from 11 per cent in the previous year. Market borrowings for most NBFC players are 40-50 per cent of their total liabilities.

Wide asset-liability mismatches for few players

	HDFC	Sundaram Finance	Can Fin Homes	Dewan Housing	Gruh Finance	Indiabulls Housing	Repc Home Fin	Mahindra Finance	Bajaj Finance
% of total liabilities maturing <6 months	9.8	19.3	18.6	16.7	7.4	16.4	30	22.6	17.4
% of assets maturing <6 months	10.3	23.4	4.9	10.9	3	16.4	3.5	24.6	29

Hence, inability to raise funds from the market or banks will impact growth, hurting earnings estimates. Players such as Indiabulls Housing Finance and Dewan Housing have delivered 20-30 per cent CAGR in loans over the past three years.

Frothy valuations

While growth has been robust for NBFC players, the sharp rise in valuations in the past two years has been overdone. Stocks such as Can Fin, Shriram Transport Finance, Cholamandalam Investment and Finance, Gruh Finance, and Mahindra & Mahindra Financial Services doubled since the rally began in 2016 till the beginning of this year. Dewan Housing Finance nearly trebled during this period.

But some stocks such as Can Fin, Repco, LIC Housing Finance and Shriram Transport Finance have been taking a hit since January this year on the back of slowdown in growth and rising delinquencies. These stocks lost 18-35 per cent in value from January until last week (before the mayhem began), and have fallen by another 10-15 per cent in the past two-to-three days.

Given that the recent turmoil in the secondary bond market is specific to papers issued by Dewan Housing, the stock has fallen by a steeper 50 per cent in the past few days. Interestingly, the stock had gained 4-odd per cent since the start of the year when other NBFC stocks were already plummeting.

Hence, while the recent events have exacerbated investors' concerns over the sector, some of these stocks were already correcting in view of growth challenges and rising risks.

Given the intensifying competition in the space, rising interest rates in the economy and risks emanating from the LAP portfolio for HFCs, many players have been facing earnings pressure in recent times. Recent events on the liquidity front will only add more pressure on NBFCs and housing finance companies.

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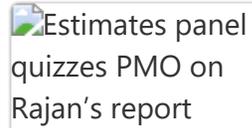
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