Banks vs. NBFCs

An Investment Case

At a broader level, banks as a group performed less compared to NBFCs. Hence, the verdict is clear. But one needs a bit closer look and must do research on the universe of NBFCs and identify those companies with good governance principles, solid franchise, risk management and sound business model.

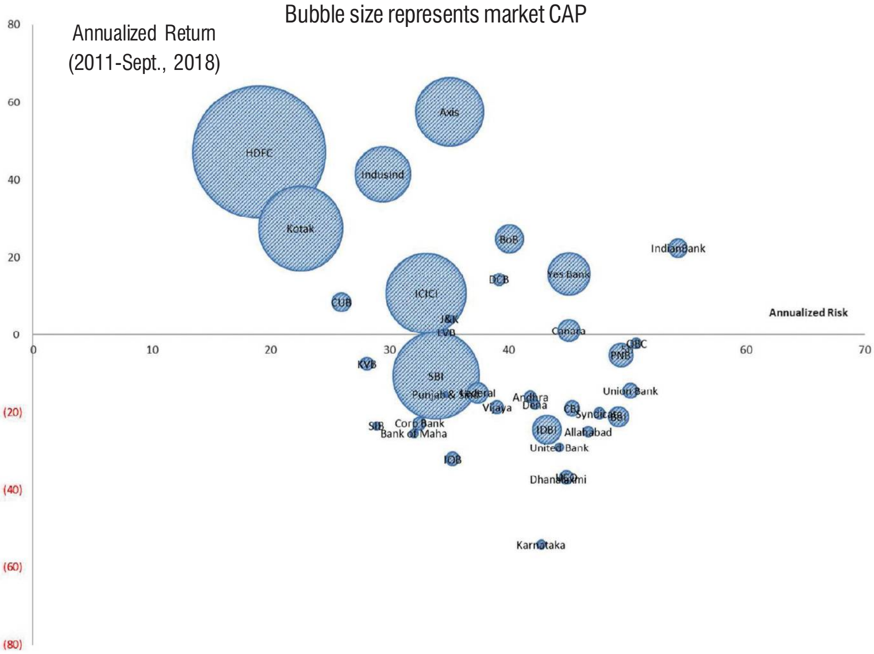
M R Raghu
CFA, FRM, FCMA, Head of Research,
Kuwait Financial Center

Investing in NBFCs is like playing European roulette. Investing in NBFCs is like playing Snakes & Ladders. There is that super long snake in the penultimate cell who brings you back to zero.

Saurabh Mukherjea,
Marcellus Investment Managers

There are 36 banks and 19 NBFCs that are listed on Indian stock exchanges. Both of these important sectors have been embroiled in some controversy or the other recently. While Non-Performing Assets (NPAs) have always been a major cause of concern with banks, the recent cases of ICICI Bank and Punjab National Bank do no good to the sector as a whole. In fact, even NBFCs are now in the eye of a storm as the NPA crisis deepens. Nonetheless, despite the negative publicity, of late, it is true that the financial services sector has immense growth potential and can be a major growth driver, going forward. But the debate is: where should you bet your shirt on? Banks or Non-Banks. Not an easy question, but definitely an interesting one,

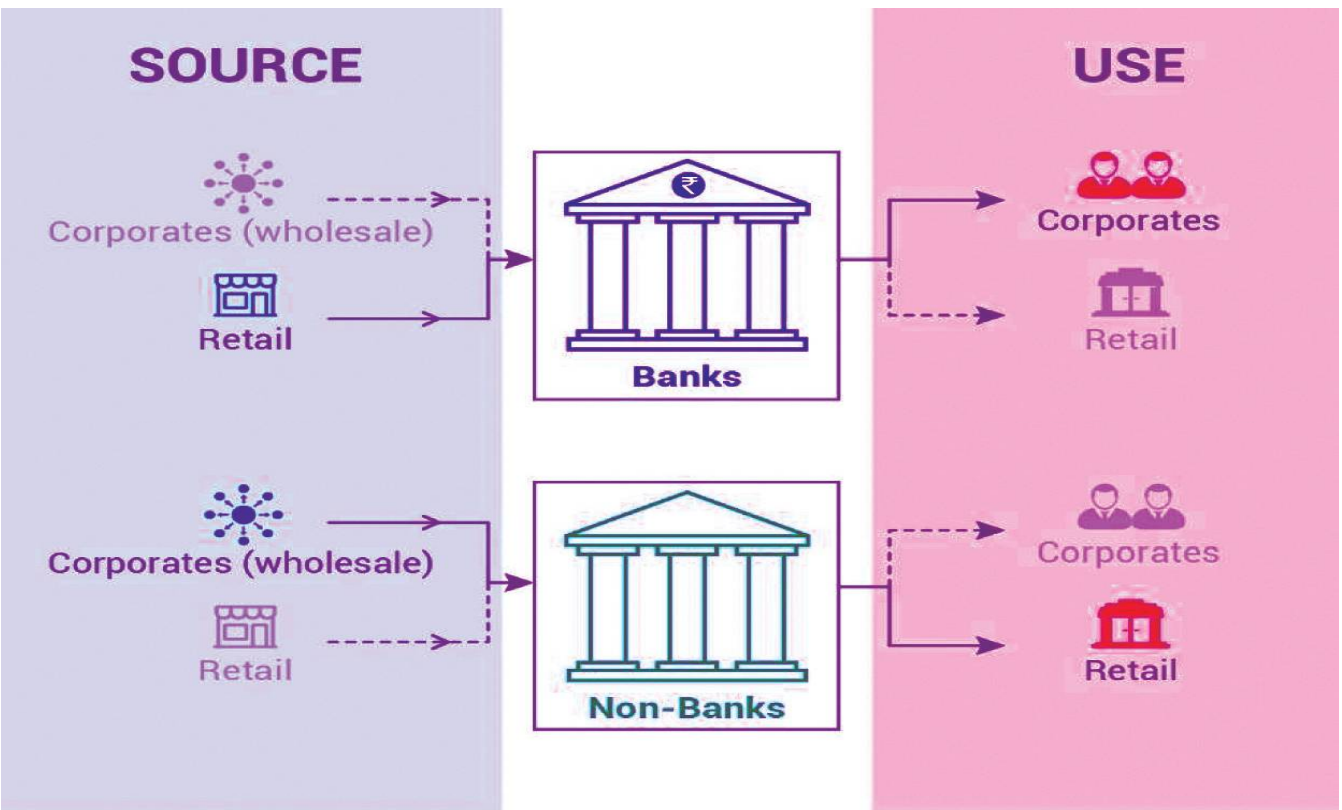
Indian Banks Performance



Source: Reuters

at least from the investment management perspective.

As a group, banks are certainly larger than NBFCs whichever way you look at it. However, on performance metrics (return on equity and return on assets), NBFCs have a clear edge over banks. This is also reflected in share price performance of banks and NBFCs. Banks, as a group, provided an annualized return of 21% during the past five years, while NBFCs have provided a whopping annualized return of 46%. Looking a bit closer at the share price performance chart of Indian banks, it is clear that bigger private banks like HDFC Bank, Axis, Kotak and IndusInd have generated appreciable long-term returns for shareholders. However, the chart is also plotted with several mid-sized and small-sized public and private sector banks delivering sub-par/negative returns to shareholders since 2011. This has caused the overall sector performance metrics to be lower. A similar look at NBFCs presents a contrasting picture. Unlike banks, most of the NBFCs have managed to create good shareholder value on the back of strong performance metrics. For example, the Return on Equity (ROE) for NBFCs at 9.2% is nearly twice that of banks. It is similar in case of return on assets. However, with the exception of Bajaj Finance, none of them enjoy size and are very small, especially if we look at the median market capitalization.



Comparative Performance Banks Versus NBFCs

	Banks	NBFCs
Number	36	19
M Cap ($ bn) (Sept. 2018)	235	66
Median M Cap ($ mn)	870	2.7
RoE (2014-2018)	5.3	9.2
RoA (2014-2018)	1.05	2.6
Annualized Share Price Performance (2014-2018)	21%	46%

Source: Reuters

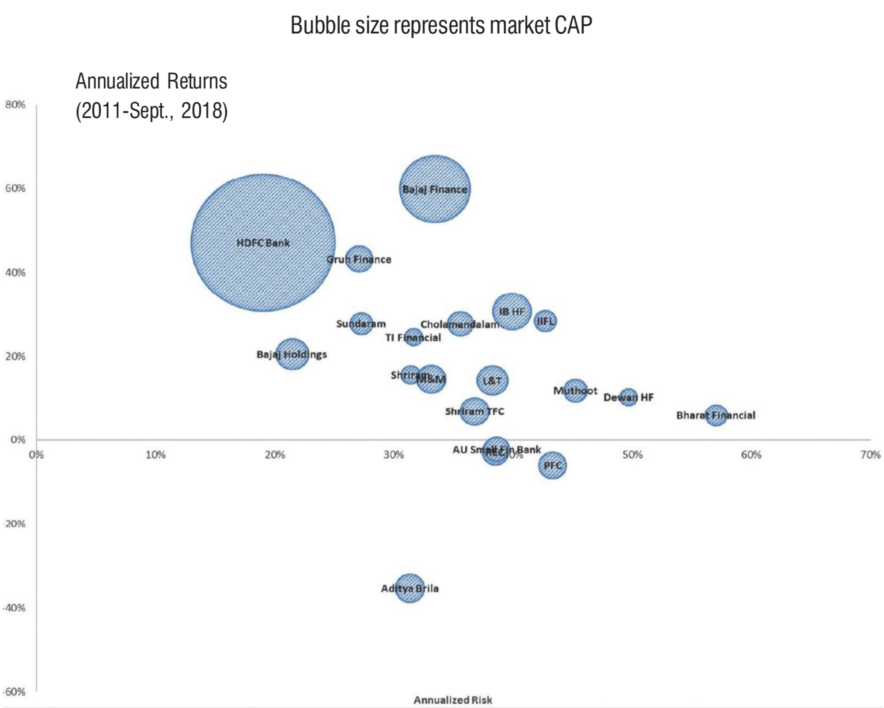
Let us now see as to what differentiates the business model for banks and NBFCs. Both of them are in the business of financial intermediation in that they obtain their funding and deploy them with a margin. The segregation of corporates and retail applies on both sides, i.e., sources and deployment. Here is where there is a key difference that is emerging. While banks depend to a great extent on retail sources of funding through deposits, NBFCs depend on wholesale sources. However, when it comes to deployment, banks predominantly lend to corporates, while NBFCs focus on retail. At the heart of this diversity lies the asset liability mismatch leading to non-performing loans, scams and scandals. The one with lower amount of NPAs, scams, and scandals will emerge the winner.

NPAs have been building up in the banking sector for quite some time, thanks to this structure of obtaining funds through retail and lending them to wholesale. In such a case, high profile defaults (remember Vijay Mallya, Nirav Modi, etc.) will inflict greater pain on the whole sector with loss of money, followed by loss of confidence. On the other hand, NBFCs are somewhat in a safer territory since their lending is mainly to retail (consumer loan, mortgage, gold loan, etc.) and whose NPAs can be controlled. An out of context example in the form of microfinance will be apt here. Microfinance companies mostly lend to rural women with a 95% recovery rate. Retail customers are certainly low-risk compared to corporate bigwigs, especially when they enjoy political clout! The retail focus of NBFCs needs them to build on franchise value more than banks. This is not to say that banks need not have franchise value. But it is more at play for NBFCs than banks.

A key factor that can explain the performance differentials of banks versus NBFCs could be the presence and dominance of public sector in the banking space. Nearly, half of the listed banks are from the public sector domain, though they constitute only 25% of the market cap. However, the fact is that the presence of public sector will inhibit nimbleness and can cause governance issues leading to NPAs. Though, I think governance can be an issue even with private sector banks when they become too big in size.

Moving on, at a broader level, banks as a group performed less compared to NBFCs. Hence, the verdict is clear. However, there are sharp differences in underlying performance of constituent companies. Banks like HDFC Bank, Axis, IndusInd and Kotak have produced outsized shareholder wealth compared to other small and medium-sized banks. The same holds true for NBFCs where the performance of Bajaj Finance has almost dwarfed most other rivals in the game. In hindsight, it looks like the names mentioned above would form good candidates for portfolio inclusion. However, one needs a bit closer look and must do research on the universe of NBFCs and identify those companies with good governance principles, solid franchise, risk management and sound business model. When looked at through this prism, NBFCs have a clear edge over banks, going ahead. Happy Investing! ■

NBFCs' Share Price Performance



Source: Reuters

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