Budget proposals will help NBFCs

But they are aimed at handling short-term liquidity issues. Solvency issues of the NBFCs still remain a worry.

by **Narendra Nathan**

Stocks of non-banking finance companies (NBFC) reacted enthusiastically to the recent Budget, which proposed to lend a helping hand to the cash-strapped NBFCs. The recognition of the systemically important NBFC sector by the Finance Minister also enthused the market. "By mentioning NBFC 18 times in the Budget speech, the Finance Minister accepted that NBFC is a very important part of the economy," says S. Krishnakumar, CIO, Equities, Sundaram Mutual Fund. Krishnan Sitaraman, Senior Director, Crisil Ratings concurs. "The finance minister's broad statement of support for the NBFC sector alone will give some confidence to the industry players."

Finance Minister Nirmala Sitharaman recognised that "NBFCs are playing an extremely important role in sustaining consumption demand as well as capital formation in the small and medium industrial segment". Besides providing working capital support to micro, small and medium enterprises, NBFCs have helped create consumption demand in several sectors—auto, consumer durable, etc.—by providing easy loans during the past few years. However, the payment default by IL&FS in September 2018 hit the NBFC hard. Due to increased fear, banks restricted their stop-gap funding arrangement with the NBFC sector and this liquidity crisis has adversely impacted other sectors. For instance, the recent slowdown in auto sales. This is why the Finance Minister chose to address this issue by announcing specific measures.

The most important measure was the provision to create ₹1 lakh crore securitisation facility with government guarantee. Public sector banks (PSBs) can participate in this scheme without fear because the government will be offering a one-time six-month partial credit guarantee to them for losses of up to 10%. While this government guarantee won't help clean the entire NBFC mess, it will provide immediate relief to the sector by restoring confidence among NBFCs. "Historically, securitised transaction has never seen more than 10% loss and this move is aimed at assuring PSU banks that they won't suffer losses," says Sitaraman of Crisil Ratings.

Strong NBFCs have high valuations

It does not seem prudent to invest in them at such high prices.

COMPANIES	STOCK PRICE (₹)	M-CAP (₹ CR)	PE	PBV	DIV. YIELD
Bajaj Finserv	7,587.50	1,20,747	37.51	38.20	0.02
Gruh Finance	282.05	20,700	46.31	10.94	0.58
Aavas Financiers	1,497.45	11,697	125.94	10.65	0.00
Bajaj Finance	3,414.75	1,98,021	49.57	10.12	0.12
HDFC	2,261.05	3,90,099	24.00	6.35	0.86

NBFCs available for cheap may be risky

Investors should not jump in simply because these are trading at low prices.

COMPANY	STOCK PRICE (₹)	M-CAP (₹ CR)	PE	PBV	DIV. YIELD
DHFL	77.75	2,440	1.63	0.28	7.07
IDFC	36.40	5,811	9.86	0.60	2.06
IRB InvIT Fund	65.50	3,802	19.21	0.64	4.58
PFC	127.45	33,648	4.84	0.84	6.12
REC	160.35	31,668	5.50	0.89	5.71

NBFCs ranked based on the PBV ratio. Data as on 8 July. Compiled by ETIG Database

Who will benefit?

The phrasing of this provision by the Finance Minister, "For the purchase of high-rated pooled assets of financially sound NBFCs," has raised some doubts about the kind of NBFCs the government is trying to support. One can reasonably believe that it is not aimed at top rung NBFCs such as HDFC or Bajaj Finance because they are not facing any liquidity issues right now. Due to government parentage, NBFCs such as Power Finance Corporation, LIC Housing Finance, etc., are also not facing any liquidity issues. So, it appears that the targeted beneficiaries of the proposed scheme are the middle-rung private sector NBFCs. The help these NBFCs need also depends on their asset liability management (ALM). Banks are comfortable extending short-term credit to NBFCs—short-term loans like micro finance, gold loan, small vehicle loans, etc.—because there is no ALM mismatch for them. However, NBFCs catering to the real estate and infrastructure sector give long term loans (10-30 years) and there is likely to be some ALM mismatch, if their loans are funded by short-term borrowings. "Medium NBFCs with ALM mismatch are facing liquidity problem now and the government's proposal is to help those who are financially sound," says Sitaraman.

Other measures

PSB recapitalisation of up to ₹70,000 crore was another important measure that was announced by the Finance Minister. "Better than expected recapitalisation proposal was basically to help PSU banks buy securitised bonds from NBFCs," says Arun Gopalan, Senior VP, Systematix Shares and Stocks. The Finance Minister also proposed bringing the housing finance companies (HFCs) directly under the RBI to strengthen the central bank's regulatory authority over all NBFCs. Currently, HFCs are regulated by the National Housing Bank, an RBI subsidiary. "These are critical measures because the exact amount of bad loans with NBFCs is still not clear and only regular asset quality review by the RBI will bring it out," says Shailendra Kumar, CIO, Narnolia Financial Advisors.

Don't ignore solvency issues

Other than ALM-linked liquidity issues, some NBFCs have also been facing solvency and regulatory issues. The solvency issue is more prominent with NBFCs associated with real estate or infrastructure projects because these sectors are still under duress. The Finance Minister has tried to revive the real estate sentiment by announcing an additional ₹1.5-lakh interest deduction on housing loans taken for buying affordable housing—where the house price is below ₹45 lakh. However, this may not be enough because this ₹45-lakh limit is too small and houses in this price will be available only in tier-3 cities, or far-flung suburbs of the big cities.

Don't jump in

The NBFC segment is now seeing extreme polarisation and fundamentally strong companies such as HDFC and Bajaj Finance are already trading at rich valuations. If we assume that the NBFCs books now are clean, DHFL seems like a must-buy because it is now trading at a PE of just 1.63 and PB of 0.28. But as mentioned earlier, investors should wait for the real non-performing assets (NPA) to be revealed before jumping to buy these stocks. Just like the NPA situation in PSU banks and corporate-facing private sector banks, it may take a few years to clean the system (after these NAPs come out in the open). So, it is best to wait and watch.

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It will soon be raining PSU stocks

The Budget proposals have increased the chances of an over supply of PSU stocks in the market.

by **Narendra Nathan**

There was much about PSUs in this Budget. The Finance Minister reiterated the government's decision to carry out strategic divestment in some PSUs. She also stated that caps in sectors like aviation would be liberalised. So what does it mean for investors? "Strategic divestment of companies is a positive step. By holding on to them, the government is destroying their value," says S. Krishnakumar, CIO, Equities, Sundaram AMC.

The next bold announcement was on giving full autonomy to PSU boards and making them accountable. "These are positive signs. Though the government may not give 100% autonomy, expect a marked improvement in management," says Shailendra Kumar, CIO, Narnolia Financial Advisors.

While these are positive steps for the long-term, chances of PSU stocks flooding the market in the short-term is high. The announcement to make the market more liquid and asking Sebi to bring down the maximum promoter shareholding from 75% to 65% has opened a Pandora's Box. Several PSUs have flouted the Sebi rule of 75% promoter holdings. There are companies where the government has 99% stake (*see chart*). The government stake in some PSU banks is over 90%. "The government holding in some PSU banks is actually increasing due to recapitalisation," says A. K. Sridhar, Director & CIO, IndiaFirst Life Insurance. Now there will be pressure on these PSUs to bring down the government stake to 75%. If they succeed, around ₹50,000 crore (based on current market capitalisation) will be made available.

However, the reduction of maximum promoter shareholding to 65% may not happen in a hurry, because a sudden change like this may result in unintended consequences (*see page 11*). But should it happen, it will amount to supply of another ₹50,000 crore. This is because there are several big PSUs where the government holding is between 65% and 75% (*see table*).

Among the Budget proposals related to PSUs, the most important one is the decision to change the way the 51% government stake is calculated. Unlike the current practice of counting only direct government holding, the promoter holding in PSU companies will now be counted considering the holding of all PSU entities, defined as companies where government holding is above 51%. This reclassification will allow the government to bring its direct holding to below 51%. The combined government holding has zoomed in some PSUs, giving it an opportunity to raise additional money through divestment. In some cases, the combined holding is above 75% and may force the government to go for immediate divestment to bring it down to the limit.

Many PSUs have flouted norms on promoter stake ceiling

Rules say promoter share should not exceed 75%.

Company	Govt stake (%)	CMP (₹)	M-cap (₹ cr)
KIOCL	99.06	124.55	7,746
United Bank of India	96.83	10.22	7,591
Scooters India	93.87	28.25	247
HMT	93.69	15.95	1,921
Corporation Bank	93.50	28.20	16,904

Sorted on the basis of govt holding

Govt holds between 65-75% stake in several large PSUs

Forced dilution may result in supply of ₹50,000 crore.

Company	Govt stake (%)	CMP (₹)	M-cap (₹ cr)
Coal India	70.96	232.45	1,43,253
Bank of Baroda	69.23	124.55	47,911
NMDC	72.28	106.90	32,731
NHPC	73.33	23.90	24,008
Canara Bank	70.62	269.55	20,304

Sorted on the basis of market cap

Combined govt holding is high in some PSUs

If stake of govt institutions are also considered, the govt stands to gain more.

Company	Govt stake (%)	LIC + others (%)	Total (%)
State Bank of India	57.13	9.25	66.38
Indian Oil Corporation *	52.18	29.80	81.98
NTPC	56.09	11.51	67.60
Power Grid Corporation of India	55.37	6.41	61.78
Bharat Petroleum Corporation *	53.93	15.21	69.14

* Others include cross holdings among oil PSUs + own investment trusts. Compiled by ETIG Database

Experts feel direct government holding going below 51% will be positive in the long term, as it may be a precursor to privatisation. "This move may lead to slow privatisation. The government is on the right path and its benefits will show in a few years," says Kumar of Narnolia.

Increased float and higher institutional interest is another benefit. "Bringing direct government control to below 51% will increase free float and may increase FPI interest in the counter," says Krishnakumar. With the reduction of direct government holding, index weights in these companies may also increase. However, this move could backfire. "If index makers decide to add the holding of PSU entities as government holding, weight of these companies may fall in the short-term," says Sridhar.

What should investors do now? Most experts earlier asked long-term investors to avoid PSUs due to uncertainties in the space. However, the picture has changed. "We have changed stance now due to increased board autonomy and chance of privatisation. Investors can park a small portion of their portfolio here," says Kumar. Some PSUs are giving good dividend yield and due to the recently increased buyback tax, they may give more dividends.

However, short-term pressure in these counters will increase due to enhanced supply. The government has increased its divestment target for the year to ₹1.05 lakh crore. To improve chances of divestment in the form of ETFs, the government is giving tax benefits under Section 80C to investors in PSU focussed ETFs. The CPSE ETFs are expected to hit the market soon. Investors need not rush to buy them there are better managed tax saving schemes on offer.

Divestment may happen directly in the form of offer for sale also. "Though short-term supply overhang will be there for all counters, it will be less for counters that are doing well. So investors can go for such companies," says Sridhar. Investors can decide on the basis of industry prospects as well. For example, NTPC is doing well and is expected to do well in future due to ever increasing demand for electricity. However, companies like SAIL are suffering due to a global steel glut and therefore, should be avoided.

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