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Profitability of Non-Banking Financial Companies in India during Covid-19 Pandemic: A DuPont Analysis

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ABSTRACT

The Non-Banking Financial Companies (NBFCs) flourished in Indian landscape since 1980s and since then the sector has undergone various changes. The services provided by these Indian NBFCs are quite similar to those of banks. The uniqueness, however, lies in its credit extension to unbanked customers and customization of financial products. The global financial markets, including India have been severely hit by the COVID-19 pandemic. The present study takes a sample of 52 NBFCs-D (Non-Banking Financial Companies accepting Public Deposits) and 312 NBFCs-ND-SI (Systemically Important Non-Deposit Taking Non-Banking Financial Companies) currently registered with the Reserve Bank of India (RBI). The period of study spans over the financial years 2019-2020 and 2020-2021, during which Covid-19 Pandemic was prevalent. The three-step DuPont Analysis method was applied to analyze the profitability position of the select NBFCs during the years of Covid-19 pandemic. In this analysis, Return on Equity is disintegrated into Net Profit Margin (which measures the net profit generated as a percentage of net revenue), Total Asset Turnover (which measures the efficiency in utilization of assets in generating revenue) and Equity Multiplier (measures the proportion of assets financed by shareholders' equity),to report on profitability performance. The results of the analysis indicate the grim profitability position of Indian NBFCs during the Covid-19 Pandemic. During both the years of the pandemic, i.e., 2019-2020 and 2020-2021, the net profit generated by the select NBFCs was appreciably low. This was reflected in the value of Net Profit Margin for both the years. The revenue generated on utilizing the assets was also very low. This was indicated by the low value of Total Assets Turnover of the select NBFCs in both the years of pandemic. The Equity Multiplier ratio indicated the fact that, a high amount of debt was employed to finance the assets of the select NBFCs in 2019-2020 and 2020-2021.Debt is a cheaper source of finance in comparison to equity. However, incurrence of high amount of debt, when revenue generation is substantially low, leads to failure in servicing of debt. This is a financially risky situation. Along with that low profit indicates, that the low cost of debt did not yield any advantage as far as profit is concerned. The findings of the study indicate that the Indian NBFC sector was critically reeling under pressure with issues of, inadequate profit, fault in generating revenue from assets and inefficient allocation of own funds in assets.

Keywords: *Profitability; Net Profit Margin; Total Asset Turnover; Equity Multiplier; Return on Equity*

INTRODUCTION

According to the study by Makhijani (2014), Non-Banking Financial Companies (NBFCs) in India have taken up a complementary role to that of banks. Since the 1980s, when the banking sector was subjected to stringent regulations, the NBFC sector has grown slowly. In January 1997, changes in the RBI Act 1934 were made in the regulatory and supervisory structure of NBFCs. This was done to facilitate the smooth functioning of NBFCs. The systematic growth of NBFCs in India started to take root in 1997. According to Khan (2010), the NBFCs provide loans and advances to industry, agriculture, real estate, vehicle financing, hire purchase, lease, personal loans, working capital loans, loans against shares, investments, etc. They participate in the money market and are also involved in underwriting shares, stocks, etc. They are also engaged in providing specialized services such as portfolio management, asset management, and factoring services. The functioning of NBFCs in developing countries, involves a mix of banking and non-banking services. Another notable factor elaborated by Das and Ranjan (2019) relating to NBFCs in developing nations is, the diversity in the customer segments to which they cater. The NBFCs catering to Micro, Small and Medium Enterprises (MSMEs) have dominance in rural areas; the ones engaged in real estate, leasing and hire purchase are dominant in urban areas. The Reserve Bank of India brought the Indian NBFC sector under strict regulations and prudential norms. The capital adequacy and asset classification norms of the NBFC sector were made on par with the banking sector. The NBFC sector has added depth and dimension to the diversity of Indian Financial System over the years.

According to RBI, small and medium NBFCs have turned out to be the ones bearing the brunt in the wake of the Covid-19 outbreak. The large NBFCs have the advantage of raising money to pay back debt; it is the small and medium NBFCs that have to rely on reserves. The cash inflows in the Indian NBFC sector are showing signs of scarcity due to suspension of industrial operations. The liquidity crisis in the Indian NBFC sector, in 2018-2019, had already discouraged the suspicious banking sector to lend to NBFCs. The Covid-19 outbreak has further worsened the situation for Indian NBFCs. NBFCs had appealed to Reserve Bank of India to direct banks, to extend the benefit of three-month asset classification moratorium during the initial days of the pandemic. In response to it, such a moratorium had been provided from March to May 2020. A further extension till August 2020 was appealed by the NBFCs, as major business activities had remained shut in lockdown. The banks did provide loan moratorium, however in case of debt servicing the NBFCs had to rely mostly on their own reserves.

The Finance Industry Development Council, a representative body of assets and loan financing NBFCs, had urged RBI to consider a draw down from their reserves and an adjustment in Additional Expected Credit Losses provision requirement, in excess of the provisions calculated as per Normal Probability of Default. Such an adjustment can lead to comparative ease for the sector in accessing equity or debt when the situation normalizes over time. The NBFCs had further sought a one-time restructuring window till March 2021, for changing loan repayment schedule, restructuring installments, due to revised cash flows expected from customers. According to Impact Assessment of Covid-19 on Indian Agriculture and Rural Economy (2020), the most affected segments due to the pandemic are transport operators and MSMEs who form the bulk of customer base of the NBFCs. The NBFCs had further requested RBI to provide funds to Small Industries Development Bank of India (SIDBI) and National Bank for Agriculture and Rural Development (NABARD), so that they could provide long term loans to NBFCs.

LITERATURE REVIEW

There are various studies that have been undertaken based on different dimensions of the functioning of NBFCs. A number of studies have also been conducted on the impact of Covid-19 Pandemic on Indian economy. Of them some of the noted studies are elaborated below:

Bhole (2004) focussed on the problems,prospects and growth pattern of the NBFCs.He conducted a comparitive study between profitabiility of banks and NBFCs. Kantawala (2001) on analysing the performance of NBFCs in India from 1985-1995, found significant difference in profitability ratio, leverage ratio and liquidity ratio of various categories of NBFCs in India.In the study by Harihar (1998) and Machiraju (2010), overall performance of NBFCs with respect to cost of investment,cost of operations and profitability were taken into consideration.The study offered an insight into aggregate or overall performance of the NBFCs. Paul (2011) based on the analysis of some listed NBFCs had found out differences in their financial performances. Vadde (2011) on examining the performance of Indian NBFCs from 2008-2009 had found significant decrease in operating profit and profitability during the said period. Sowndharya and Shanmugham (2014) focussed on performance analysis of NBFCs taking into consideration efficiency and profitability.

Chaudhary, Sodani and Das (2020) assessed the disastrous impact of Covid-19 on Indian aviation, tourism, retail, capital markets, MSMEs and oil sectors.They focussed on the depreciation of rupee value and the loss of jobs of many migrant workers .They were of the opinion that India has to presently focus more on inclusive development. Das, Kumar and Patnaik (2020) stressed on the slowdown in

Indian domestic demand due to the pandemic.They have also discussed on the estimated drastic fall in Gross Domestic Growth rate of Indian economy as a consequence of Covid-19 pandemic. Dev and Sengupta(2020) has predicted long lasting damage to the Indian economy due to the pandemic.They have focussed on the need of the government to balance the income support especially of that of the poor,with the commensurate need. Agarwal and Singh (2020) has focussed on the wrecking of the Indian stock market for decline in consumption levels. The shortage in supply of raw materials for pharmaceuticals,automobiles, chemical products and electronics industries and the fall of Indian exports to China, is estimated to have a far reaching detrimental effect. Ramakumar and Kanitkar (2021) concluded that the government in India needs to focus more on the demand side revival and allocate budgetary funds for generation of employment opportunities.

The importance of NBFCs is increasing steadfastly with the gradual expanse in Indian economy. Various studies are unanimously indicating the distress of Indian economy during Covid-19 Pandemic. This paper studies and analyses the profitability position of the NBFCs in India during Covid-19 Pandemic. The effect of various significant ratios on overall profitability of a NBFC are examined,to cover multiple dimensions.

Objectives of the study

The study envisages on the path of the following objectives:

(a) To study the profitability position of NBFCs for first year of Covid-19 Pandemic,i.e,for the financial year 2019-2020.

(b) To study the profitability of position of NBFCs for second year of Covid-19 Pandemic,i.e, for the financial year 2020-2021.

METHODOLOGY

The present study has as sample 52 NBFCs-D (Non-Banking Financial Companies accepting Public Deposits) and 312 NBFCs-ND-SI (Systemically Important Non-Deposit Taking Non-Banking Financial Companies). This is the number of total NBFCs-D and NBFCs-ND-SI currently registered with the RBI, as per Report on Trends and Progress of Banking in India 2021. The period of study covers the financial years 2019-2020 and 2020-2021, during which the Covid-19 pandemic was prevalent. The study is based on secondary data collected from the reports on NBFCs available in Reserve Bank of India website. Along with that, different books, journal articles, annual reports and web-based materials have been consulted. The profitability of the RBI registered NBFCs (52 NBFCs-D and 312 NBFCs-ND-SI), taken as sample for the study, are examined with the help of three step DuPont Analysis. In this analysis, Return on Equity (ROE) is disintegrated into Net Profit Margin(measures the net profit generated as a percentage of net revenue),Total Asset Turnover(measures the efficiency in utilization of assets in generating revenue) and Equity Multiplier (measures the proportion of assets financed by shareholders' equity), to report on profitability performance. According to Philips (2015), this analysis was popularized by the American company DuPont de Nemours, Inc., in its internal efficiency report. The analysis takes into consideration both income statement data and balance sheet data. Saunders (2000), corroborated the fact that, the main ratio for performance evaluation in case of DuPont Analysis is Return on Equity, which measures profitability. Further Rogova (2014) in his study,seconded the fact that Return on Equity exhibited an advantageous position in profitability reporting , as it can be disintegrated into different profitability ratios. Jaffe *et al.* (2008),in their research work,concluded that Return on Equity measures profitability position of a firm by taking into consideration the return of the investors.

RESULTS

The Return on Equity and its disintegration into Net Profit Margin, Total Asset Turnover and Equity Multiplier for the selected sample of NBFCs-D and NBFCs-ND-SI for the first year of Covid-19 Pandemic, i.e,2019-2020,gives the following result:

Table 1: Return on equity, net profit margin,total asset turnover and equity multiplier of RBI registered NBFCs-D and NBFCs-ND-SI for financial year 2019-2020

Return on Equity	Net Profit Margin	Total Asset Turnover	Equity Multiplier
0.065259	0.114457	0.111066	5.019918

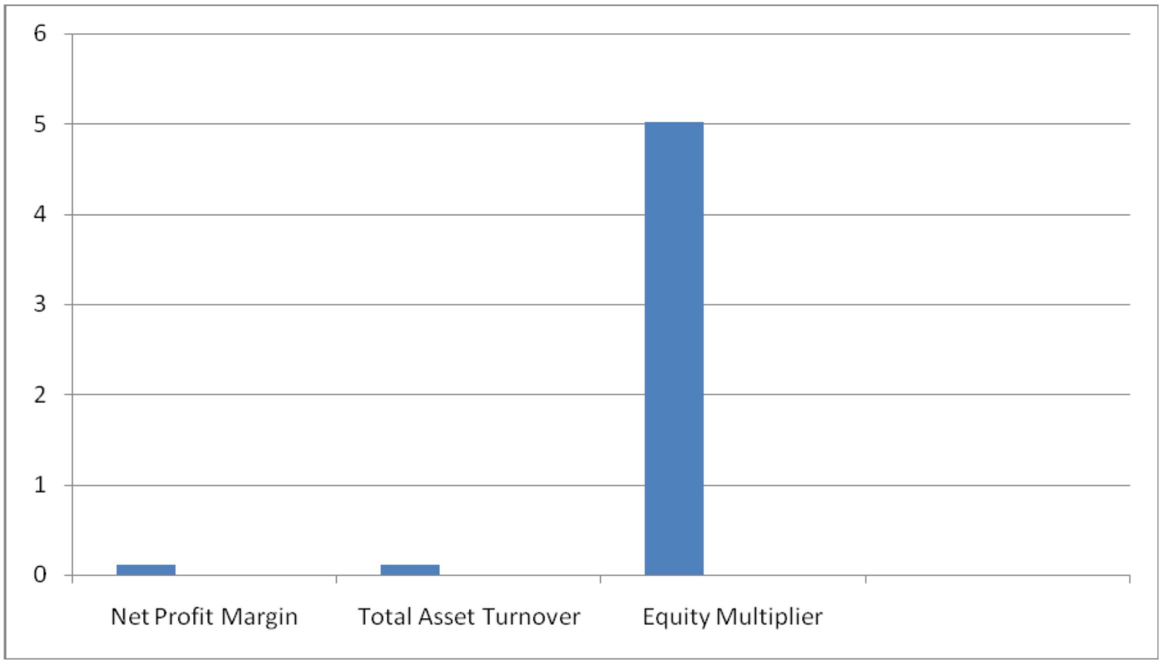

Figure 1: Graphical presentation of net profit margin,total asset turnover and equity multiplier of RBI registered NBFCs-D and NBFCs-ND-SI for financial year 2019-2020

In line with the first objective of the study, it can be observed that the value of the ratios Net Profit Margin and Total Asset Turnover is quite low for the select NBFCs, for the financial year 2019-2020. In comparison to their values, the value of Equity Multiplier is appreciably high at 5.019918. This presents a dismal situation as far as profitability is concerned. Net Profit Margin indicates the proportion of Net Profit earned to Net Revenue. Net Profit is obtained after deducting total cost (sum total of operating and non-operating cost) from total revenue (sum total of operating and non-operating revenue). A low value of Net Profit Margin means that a company has an ineffective total cost structure or poor pricing strategies or both. Thus, it points towards inadequate generation of profit. Total Asset Turnover indicates the efficiency in utilizing assets to generate revenue. A low value of Total Asset Turnover for the select NBFCs in 2019-2020, indicates that the NBFCs failed to generate adequate revenue utilizing its total assets. Equity Multiplier measures the portion of assets financed by the shareholders' equity. Hence, invariably the high value of Equity Multiplier for the select NBFCs, for the financial year 2019-2020, means that the NBFCs were relying more on debt, as its source of fund, to finance the assets. A high Equity Multiplier indicates high usage of debt. Using debt, as a source of capital, leads to incurrence of lower cost compared to using equity. This advantage of low-cost incurrence can only be viable when; the revenue generation is adequate to pay off the total debt, and when a company is able to generate substantial profit due to such low cost. But in 2019-2020, there was low revenue and profit generation by the NBFCs. In this situation a high burden of debt calls for a financially risky situation.

Table 2: Return on equity, net profit margin,total asset turnover and equity multiplier of RBI registered NBFCs-D and NBFCs-ND-SI for the financial year 2020-2021

Return on Equity	Net Profit Margin	Total Asset Turnover	Equity Multiplier
0.057617	0.126548	0.10169	4.47729

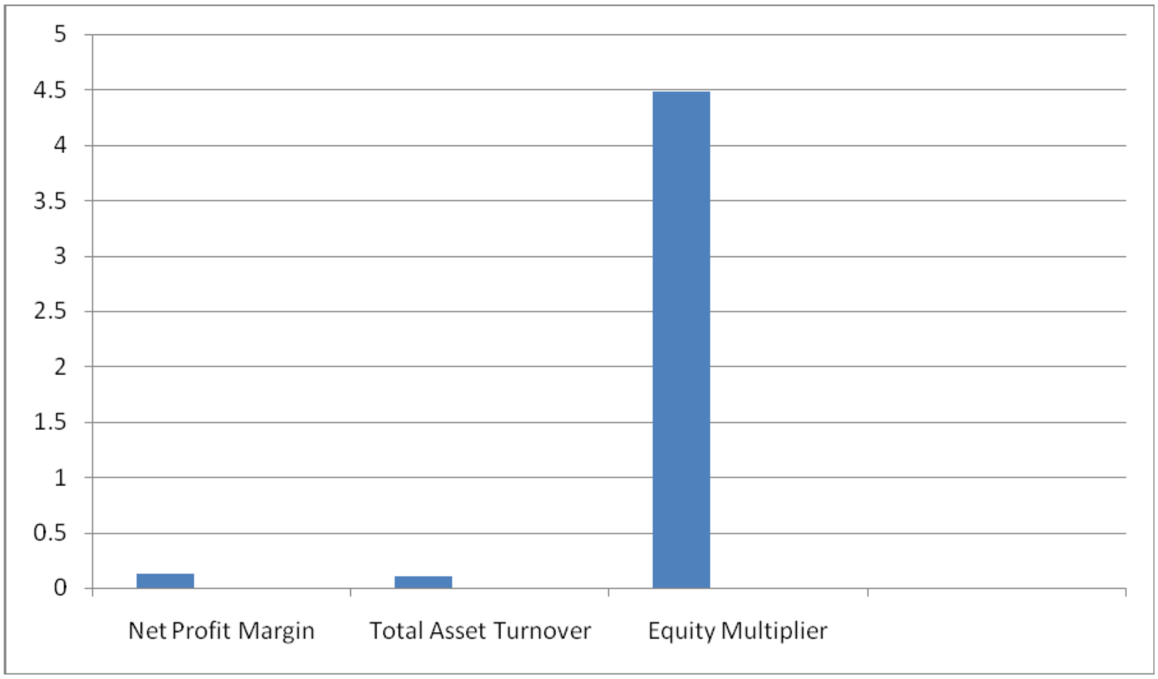

Figure 2: Graphical presentation of net profit margin,total asset turnover and equity multiplier of RBI registered NBFCs-D and NBFCs-ND-SI for financial year 2020-2021

In line with the second objective of the study, a number of important observations could be made. Net Profit Margin and Total Asset Turnover, of the select NBFCs for the financial year 2020-2021, had very low values. In comparison to their values, the value of Equity Multiplier is appreciably high. A low value of Net Profit Margin of the select NBFCs, in 2020-2021, means that the revenue earned with respect to total cost was inadequate, leading to low profit generation. A low value of Total Asset Turnover for the select NBFCs in 2020-2021, indicates failure on the part of the NBFCs to utilize its assets in generating adequate revenue. A proportionately very high value of Equity Multiplier for the select NBFCs, for the financial year 2020-2021, indicates that the NBFCs relied highly on debt financing, rather than its own funds, to build their assets. In other words, the select NBFCs were highly leveraged in 2020-2021. Incurring high debt to source funds, can be an effective business strategy when a company is able to generate adequate revenue to pay off the debts. It ensures efficient servicing of the high amount of debt. Debt is a cheaper source of finance compared to equity. Employment of high amount of debt can only be taken to be a successful strategy when a company is able to yield adequate profit. But in 2020-2021, there was low revenue and profit generation by the NBFCs. In such a situation a high leverage entails financial risk.

DISCUSSION

In the study conducted by Das (2016), the Return on Assets which measures the net income earned in proportion to total assets has been consistent at around 2% since 2008.This was higher than the Return on Assets of the banks. Kalra (2016) had concluded in her study that Total Assets, Deposits, Total Income and Total Expenditure significantly influenced profitability of Indian NBFCs. Total Assets which measure solvency of financial institutions turned out to be the most important factor in determining profitability position. The study also indicated that operating efficiency and total equity contributed significantly in increasing the profits of Indian NBFCs. In comparison to the present study, the similarity lies in the fact that Equity Multiplier, i.e., the ratio between total assets and total equity (5.019918 in 2019-2020 and 4.47729 in 2020-2021) is also seen to contribute most significantly to profitability of the NBFCs in India during Covid-19 pandemic. Hence total assets and total equity continue to affect profitability of Indian NBFCs both during pre and post covid-19 pandemic period.

From the study of Shanmuganandavadivel and Sasikala Devi (2018), the most important finding relating to profitability of Indian NBFCs was that the Return on Assets had declined for the sector from 2013-2014 to 2017-2018, due to poor asset quality. In comparison to that Return on Equity during the same time period was fairly high. As can be seen in the present study the asset quality of Indian NBFCs continue to be poor during pandemic period as in pre-pandemic period. This is indicated by the low values of Total Assets Turnover ratio (0.111066 in 2019-2020 and 0.10169 in 2020-2021) of Indian NBFCs during the two initial years of covid-19 pandemic. Girija and Faisal (2019) assessed the profitability positions of NBFCs-D and NBFCs-ND-SI during the period 2014-2015 to 2017-2018.In case of both the categories of NBFCs the net profit showed an increasing trend, however the profit of NBFC-ND–SI remained higher than NBFC-D over the time period, thus establishing the importance of the former. During covid-19 pandemic the net profit margin ratio (ratio between net profit and net sales) remained considerably low. However, the net profit margin ratio of the Indian NBFCs, did increase slightly from 2019-2020 to 2020-2021(from 0.114457 to 0.126548), when the government started to implement the policies to revive the worse hit NBFC sector during the pandemic. Rajsekaran and Premalatha (2020), inferred in their study that in terms of Return on Net Worth, Return on Capital Employed ,Price Earnings Ratio and Earnings per share the profitability position of ten NSE listed NBFCs was fairly good for the period 2014-2015 to 2019-2020.However in the present study, considering the total number of Indian NBFCs(both NBFCs-D and NBFCs-ND-SI),the profitability position had deteriorated significantly during 2019-2020 and 2020-2021 as is indicated by the significantly low values of Net Profit Margin .

A notable fact that could be observed is that profitability position of NBFCs in India suffered significantly in terms of net profit generation and total asset generation. The asset quality of NBFCs continued to be dismal also during the period of pandemic. However, total equity continued to contribute significantly to the profitability of Indian NBFCs even during the years of pandemic.

CONCLUSION

On analysis of the results, in line with the objectives of the study, the omnipotent fact that emerges is that the profitability position of Indian NBFCs was quite dismal during the Covid-19 Pandemic. During both the years of the pandemic, the profit generated remained low, as indicated by the low Net Profit Margin. Along with that, the revenue generated from utilizing assets also remained appreciably low. On the other hand, a high amount of debt was infused to finance the assets in 2019-2020 and 2020-2021. Low profit and revenue generation, coupled with the incurrence of a high amount of debt, indicates financial risk issues.

Profitability Analysis is a continuous management and planning procedure that covers all the revenue generating activities, asset and liability allocation issues of a financial institution. It serves one of the main purposes of financial management. Indian NBFCs have a deep-rooted problem in their basic operational and financial strategies with respect to profit generation. Such problems, coupled with the widespread economic distress prevalent in the Indian economy during the pandemic, have adversely affected the Indian NBFC sector immensely. The importance of the NBFC sector in a developing economy like India is significant. The cost management, balance sheet management, and operational strategies have to be corrected in detail and in time to improve the profitability of the Indian NBFC sector.

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