Financial Sector Case Study

"Santy, Can't you go out and play?", shouted Mr. Pai at his 4 year old son, while continuing to furiously work on his laptop. Santy was shocked as he had never heard his father shout like that at him (or for that matter) anybody and started crying. Pai heard his wife cajoling Santy and asking Pai to leave his work at office when he comes home, but he did not respond.

Pai, the CEO at Easy Money (EM) had a big day at work the next day as he had to present his business performance review and also ask the promoters, Easy Bank Limited (EBL) bank for urgent liquidity support to the extent of Rs 6.50 billion in addition to more capital as well to meet regulatory requirements. He had to be well prepared as his job too was at stake. He knew that tomorrow the promoters were also going to evaluate various options including a) continuing to support EM and let it continue as a standalone entity, b) merge EM with itself either fully or acquire all the assets and leverage the network to increase the groups retail presence to generate fee income c) sell EM to "Lucky PE", a private equity player that has evinced interest last week or d) acquire EM's credit book but sell its NBFC license, branch networks and staff to China Auto Company (CAC), a Chinese Auto Manufacturer, that is planning to commence selling its products in the Indian market from January 2009.

About EBL

EBL is a financial super house with presence in the entire gamut of financial services in the country. It has a presence in banking, life and general insurance, domestic asset management, private equity, merchant banking & advisory, capital market operations. It does not have an international presence as of now but the group is currently exploring opportunities to acquire a bank in the overseas market to mark its entry as an international player. The consolidated net worth of EBL is around Rs 170 billion as on March 2008 and had an asset base of Rs 1,200 billion. EBL has reported strong growth in business volumes aided by a benign environment in India in the last few years. On a standalone basis, EBL had a net worth of Rs 130 billion and an asset base of Rs1,000 billion as on March 2008. Apart from the bank, the NBFC and the insurance companies, none of the other business requires further capital. EBL is one of the few players that has not yet roped in a JV partner for the insurance business which is into its 3rd year of operations. EBL had a 65% stake in EM and the rest were held by FIIs, institutions and public.

Pai was an old timer at EM having spent the last 8 years in the organization in various roles. EM has been among the better run NBFCs operating in India for the last 10 years. Backed by fairly strong promoters with deep pockets and shareholders ever willing to infuse more capital as the stocks (EBL and EM) were amongst the "must haves" based on research reports. The senior management was relatively more stable with hands on experience in secured asset lending model provided EM with an enviable edge over its peers. This was true till about 9 months back. Some of the senior members quit to start on their own while a few retired, leading to a relatively new team at the helm.

In fact, Pai took on his current role as the CEO just 2 months back. Pai has worked in various roles of Business origination, collections, credit and treasury in his entire career of over 20 years. In addition, the global credit crisis and its impact on India added to his woes. The fact that the economy is showing signs of slowing down, falling stock markets coupled with rise in delinquency levels has been giving Pai jitters so some time now. He was left pondering - where did we so drastically go wrong that we are in such a deep mess?

EM was a strong NBFC with a pan India presence in the business of vehicle financing. Over the last few years especially during 2000-2005, the Indian economic environment was quite benign and EM was growing its business at a brisk pace. The business model was in place and was being adhered to and funding lines were not an issue at all. The top line and bottom line were growing at over 25% p.a. in the last few years keeping all stakeholders – shareholders, management team, lenders and customers happy. The business had been built over a period of 15 years and had a nationwide branch network of 125 branches across 75 cities. Strong and strategic tie-ups with manufacturers give it access to leads at their counters to increase the business volumes. Notwithstanding the competition from peers, faster turn around time, decentralized operations with appropriate delegation of powers and fine pricing terms in addition to good relationship management with manufacturer and dealers helped EM grow its business volumes significantly in the last few years. The current year is witnessing a slowdown in the growth rates on account of lower auto sales in the country and also higher interest rates.

Brief on the Indian Financial Sector Space

The vast potential offered by the Indian consumption needs and the relatively low borrowing levels of the individuals presented the entities in the financial sector space to expand their scale of operations. Over the last few years, Indian financial sector has seen several new entities enter the NBFC space in order to build on the regulatory arbitrage (minimum capitalization requirements levels, no CRR, limited SLR and no restrictions on expanding branch network) present in the Indian financial system. Consequently, not only did foreign entities enter the Indian financial space but existing banks too increased their presence in the retail credit segment in order to improve their profitability as this segment offered better yields as compared to the corporate credit. However, in the recent past, the RBI has been tightening the norms for NBFCs in terms of capitalization levels, higher disclosure levels, tighter monitoring and shutting some of the avenues for mobilizing funds, thereby partially reducing the arbitrage opportunities.

Pai's thoughts took him few years back wherein EM had adopted a bold business plan to get larger and more profitable than Best Financiers Limted (BFL), an entity considered to be amongst the best in the industry in terms of credit underwriting and systems. EM had taken many decisions regarding aggressive growth paths while maintaining asset quality, alternative and cheap funding sources, undercutting competition and raising capital at appropriate time. In the last few years, EM reported better financial performance than BFL on almost all counts, a fact that is also reflected in the rise in share price. In terms of profit and business levels, EM are now at similar levels but still lenders and shareholders seem more comfortable with BFL than with us. Pai could not fathom the reason for the same. He though that they EM managed to achieve its business plans but the stock took a severe beating in the last 2 months. This is despite EM not doing any unsecured lending that is currently witnessing sharp rise in delinquencies and defaults. While the stock markets too have crashed (sensex by 60%), EM has suffered severely with the current price nearly 10% of is 52 week high.

He continued to murmur, what luck? It had to happen just after I am promoted as the CEO. He continued to pen his thoughts on the recent strategies undertaken in the last few quarters – in hindsight, everything seemed to have backfired.

When interest rates started moving up, EM, which till then had a fairly match ALM profile ventured to higher proportion of shorter term loans for funding assets with a medium term maturity. In the first few quarters, it helped the company protect its margins as the market sources prevented it from increasing the lending rates. In the recent past, while it was able to increase the lending rates as well to protect the margins, it continued to rely on short term funds to maintain its interest spreads. However since the last quarter, the Indian market began to see an inverted yield curve (of course at higher levels) and banks and mutual funds refused to lend funds for more than one year. Thus EM had to continue borrowing on the short term at totally unattractive rates. As it historically maintained fewer banking relationships, it was getting more and more difficult to avail of fresh lines from the banks at short notice. While EM has been able to rollover / repay the debts that have fallen due till date, it continues to have a negative ALM of Rs 6 billion for the next 20 days (15% of the balance sheet size), factoring in the repayments and assuming no incremental lending.

Market rumors that EM is in a fix on liquidity front have already spread in the market and lenders are wary of extending support. Adding to the misery is rumours about the parent bank as well on account of credit quality concerns on its corporate loan book. General concerns on retail asset quality have deterred purchasers from acquiring retail asset portfolio from NBFCs.

A snapshot comparison between EM and BFL is as under

Comparison	EM	BFL
Demographics	Pan India	Pan India
Asset Class	Largely Cars / MUVs/ CV	Largely Cars / MUVs / CV
Unsecured Lending business	Nil	10% of the portfolio
Track Record	Over 10 years	Over 10 years
Promoter Shareholding	65%	80%
Asset Base	Rs 40 billion	Rs 40 billion
Gearing	6X	5X
Borrowing Sources	Banks / MFs	Banks/ MF / Public Deposits
Market Share in Vehicle finance market	Increased from 1% to 6% in the last 5 years	Increased form 5% to 6% in the 5 year period
Portfolio mix on New : Used vehicles	80:20	85:15
Credit Underwriting	Partly Outsourced	Fully In house
Credit Rejection Rate	~ 65%	~ 40%
Dependence on bank funding	~ 30%	~ 50%
ALM mismatch (1 year bucket)	-15%	-5%
Return on Average Assets (PAT/Avg. Total Assets)	~ 2.5%	~ 1.5%
Return on Net Worth (RoNW)	~ 15%	~ 8%
Gross NPA	~ 4%	~ 3%
Net NPA	~ 2%	~ 1%
Solvency Indicators (Net NPA/ Net Worth)	20%	10%

About "Lucky PE"

This is a Private Equity entity promoted by Indian entrepreneurs out of Singapore. They have been investing in India for the last 5 years and are more focused in the financial sector space. The firm has 3 funds as on date and the total assets under management for the firm are just under US$ 2.5 billion, out of which nearly US$ 500 million is yet to be deployed. Notwithstanding the current meltdown in the stock markets, the funds still have an annualised returns of over 25%

About "China Auto Company"
This entity is among the larger Chinese manufacturers that has set up shop in India 2 years back. It has invested nearly US$ 2 billion as on date and the commercial production is likely to start by February 2009. CC has set up manufacturing facilities for Commercial vehicles, tractors and small cars. CAC has tied up with 4 financiers as on date to finance the purchasers of their products. Given the lower off-take of auto in the last few months, CAC is contemplating an option to have a captive financing subsidiary to boost their sales in the current market.

References

- RBI website – specifically RBI Annual reports, RBI report on Trends & Progress and Master circulars on Prudential Guidelines
- Various Bank and finance companies Annual Reports
- Society of Indian Automobiles Manufacturers (SIAM) Reports

Questions

- Given the scenario of tightening regulatory norms in the country, what should the parent (EBL) do – Continue to support the NBFC or should it merge it with itself or exit from the NBFC?
- What are the strengths and weakness of business models followed by EM and BFL and which in your view is better?
- What are the key differences between a captive financing company and a conventional NBFC financing auto sales and which is a better business model?

Annexure 1. Past Financials of EBL

(in Rs. million)	Mar-08	Mar-07	Mar-06	Mar-05	Mar-04
SUMMARY PROFIT & LOSS ACCOUNT					
Interest Income	79,900	62,216	53,081	49,115	46,548
Interest Expenses	(47,158)	(35,019)	(29,799)	(29,326)	(30,194)
Net Interest Income	32,741	27,197	23,282	19,789	16,354
Commission, Exchange & Brokerage	5,351	4,290	3,499	3,089	2,809
Net Profit on Exchange Transactions	694	816	741	653	630
Other (including dividend) income	2,843	3,009	2,063	1,579	1,201
Total Fee Based Income	8,889	8,115	6,303	5,321	4,640
Operating Income	41,630	35,312	29,586	25,110	20,994
Employee expenses	(12,534)	(11,625)	(10,935)	(9,927)	(9,015)
Other Operating expenses	(6,775)	(6,578)	(5,547)	(4,665)	(3,872)
Total Operating Expenses	(19,309)	(18,203)	(16,482)	(14,592)	(12,887)
Operating Profits	22,321	17,109	13,104	10,517	8,108
Provisions including NPA provisions	8	8	8	8	8
Operating profits after Provisions	22,329	17,117	13,112	10,525	8,116
Net profit on sale of securities & Assets	(748)	2,033	4,173	8,085	5,760
Profits Before Tax	21,581	19,150	17,285	18,610	13,876
Tax	(734)	(2,061)	(2,274)	(3,331)	(2,443)
Profits After Tax	20,847	17,089	15,011	15,280	11,432
Preference dividend	0	0	0	0	0
Equity dividend	(2,092)	(1,664)	(1,493)	(1,407)	(713)
Accretion to reserves	18,754	15,425	13,518	13,873	10,719
SUMMARY ASSETS					
Term Loans	347,942	250,811	169,697	109,960	79,324
CC and Loan Repayable on Demand	230,292	184,196	135,936	106,888	100,989
Bills Purchased & Discounted	26,408	23,894	20,343	17,055	15,070
Total Advances	604,641	458,902	325,977	233,902	195,383
Govt. Securities incl. approved securities	253,070	246,340	233,973	189,144	147,664
Shares	2,908	1,889	1,381	1,049	1,047
Debentures Bonds	20,403	22,594	25,120	24,624	23,655
Others	16,633	9,336	6,064	6,383	5,838
Total Investments	293,014	280,159	266,537	221,200	178,204
Current Assets incl. cash and CRR	84,557	71,174	61,376	45,017	33,479
Owned fixed assets	4,191	4,238	3,390	2,701	2,202
Deferred Tax Assets	219	354	269	318	214
Other Assets	35,599	46,128	33,607	21,195	13,025
Total assets	1,022,222	860,954	691,156	524,333	422,506
SUMMARY LIABILITIES					
Equity share capital	19,372	19,372	12,273	12,273	12,273
Reserves	110,021	91,266	24,715	27,275	13,402
Net worth	129,393	110,638	53,065	39,548	25,675
Rupee Borrowings	9,543	4,106	4,364	1,272	2,654
Sub Debt	9,443	7,516	4,456	3,041	2,798
Foreign Exchange Borrowings	5,752	9,067	7,799	6,672	2,609
Demand Deposits	67,572	55,882	45,841	38,385	32,372
Saving Deposits	74,877	68,716	46,741	27,005	24,877
Term Deposits	679,166	567,021	492,713	369,145	298,244
Total Deposits	821,615	691,620	585,295	434,536	355,493
Deferred Tax Liability	0	0	0	0	0

Current liabilities	46,476	38,008	36,176	39,265	33,278
Total Liabilities	1,022,222	860,955	691,156	524,333	422,506
SUMMARY CONTINGENT LIABILITIES					
On Foreign Exchange contracts	99,626	89,150	63,249	51,925	42,643
On Guarantees	21,712	16,590	12,914	9,974	8,560
On Acceptances / endorsements	18,433	14,906	14,674	10,331	7,049
Others	8,034	3,737	2,085	1,846	2,407
Total Contingent Liabilities	147,805	124,382	92,921	74,076	60,659

Annexure 2. Past Financials of EM

(in Rs. million)	Mar-08	Mar-07	Mar-06	Mar-05
SUMMARY PROFIT & LOSS ACCOUNT				
Interest Income	5,002	3,187	2,641	1,123
Interest Expenses	3,827	2,478	2,232	865
Net Interest Income	1,175	708	409	258
Fee Income	185	163	122	56
Operating Income	1,360	871	531	315
Employee expenses	98	78	46	38
Other Operating expenses	149	109	76	83
Total Operating Expenses	247	187	121	122
Operating Profits	1,112	684	410	193
Provisions including NPA provisions	50	59	89	53
Operating profits after Provisions	1,062	625	321	140
Net profit on sale of securities & Assets	252	223	92	41
Profits Before Tax	1,314	848	413	181
Tax	389	263	120	52
Profits After Tax	925	585	293	129
Preference dividend	-	-	-	-
Equity dividend	123	110	87	74
Accretion to reserves	802	475	206	55
SUMMARY ASSETS				
Loans & Advances	40,723	31,357	24,755	20,409
Investments	106	35	122	72
Current Assets incl. cash	347	548	228	146
Owned fixed assets	414	246	192	172
Deferred Tax Assets	-	-	-	-
Total assets	41,590	32,185	25,297	20,799
SUMMARY LIABILITIES				
Equity share capital	1,389	1,389	840	840
Reserves	4,244	3,442	1,754	1,548
Net worth	5,632	4,830	2,594	2,388
Borrowings	34,869	26,976	22,467	18,194
Deferred Tax Liability	272	-	-	-
Current liabilities	817	379	236	217
Total Liabilities	41,590	32,185	25,297	20,799

Annexure 3. Residual Maturity Profile of assets and liabilities for EM

As on (in Rs million)	**Mar-08**	**Mar-07**	**Mar-06**
Loans			
0-1 yr	8,145	6,271	4,951
1-2 yr	12,217	9,407	7,426

2-3 yr	12,217	9,407	7,426
>3 yr	8,145	6,271	4,951
Total	**40,723**	**31,357**	**24,755**
Borrowings			
0-1 yr	18,502	10,791	5,617
1-2 yr	10,473	8,093	7,639
2-3 yr	5,236	5.395	2,247
>3 yr	698	2,698	6,965
Total	**34,909**	**26,976**	**22,293**