Arman Financial: Conservatism in its roots

Before we start talking about Arman Financial Services, let's have a brief look at the story of Bandhan Bank. There is an interesting story shared in the book "*Bandhan: The Making of A Bank*", where they share the Eureka Moment of Mr. Chandra Shekhar Ghosh.

It started when one day he was walking in the market and he saw a guy coming on Royal Enfield giving out Rs.500 to a bunch of women waiting there, and in return they were immediately paying him Rs.5 back. Later that evening the guy came to the same place and those women returned the principal amount. When Mr.Ghosh asked why they were paying 1% interest for the duration of half a day, which if seen annually would be an interest of 730%, they replied that it is just like offering tea to the moneylender. Plus the banks would not lend them as they don't have proper documentation.

This incident was the eureka moment of Mr.Ghosh where he came up with the idea of setting up Bandhan.

The story above summarizes the foundation of any Microfinance business in India and why people are ready to pay high interest.

About the company

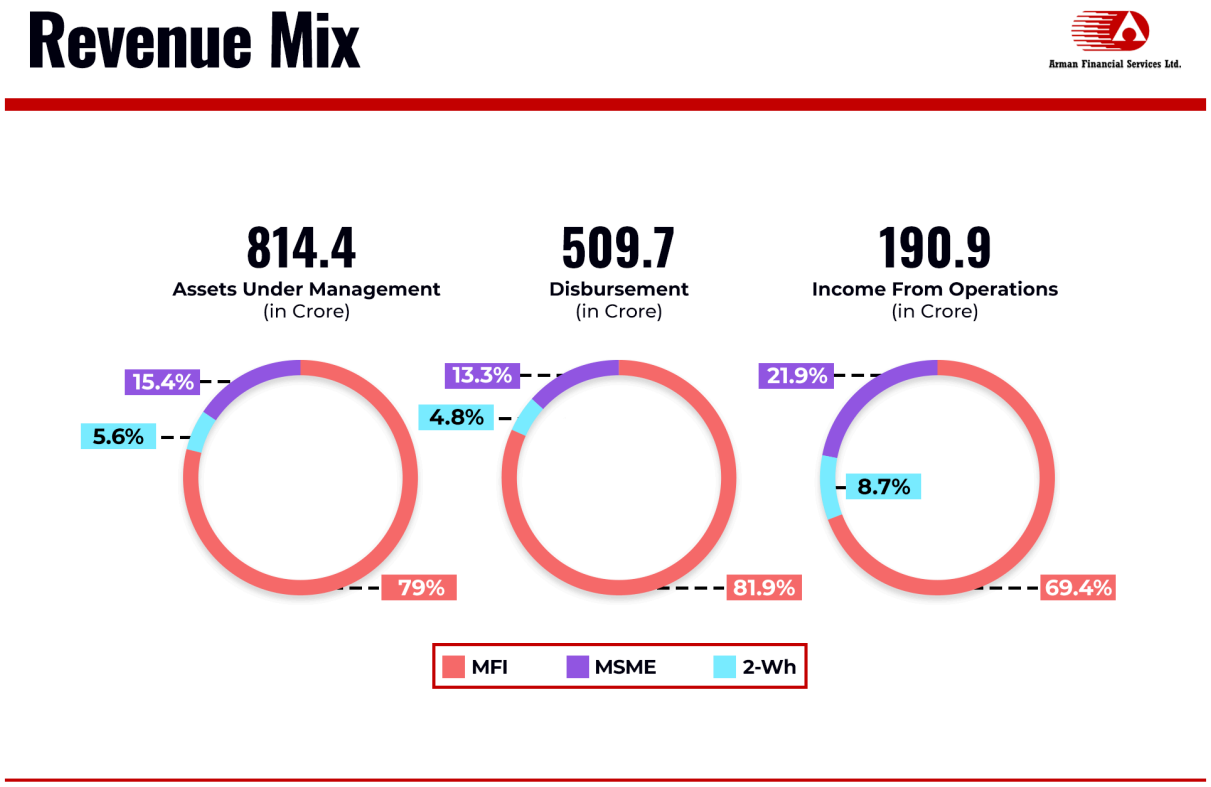
Arman Financial Services Ltd is an Non-Banking Financial Company (NBFC) mainly focusing on Microfinancing which represents around 80% of their portfolio, 15% is Micro, Small, and Medium Enterprises (MSME) Loans, and 5% is into 2 Wheeler loans as of FY21.

Jayendra B. Patel is the founder of the company who incorporated it in 1992. Now the business is mostly handled by his son Alok J. Patel. Mr. Alok has done his education from the U.S.A and holds a master's degree in Accountancy & Finance. He

is also a licensed Certified Public Accountant (CPA) and has worked as an independent auditor for KPMG for 4 years and also at John Deere Credit.

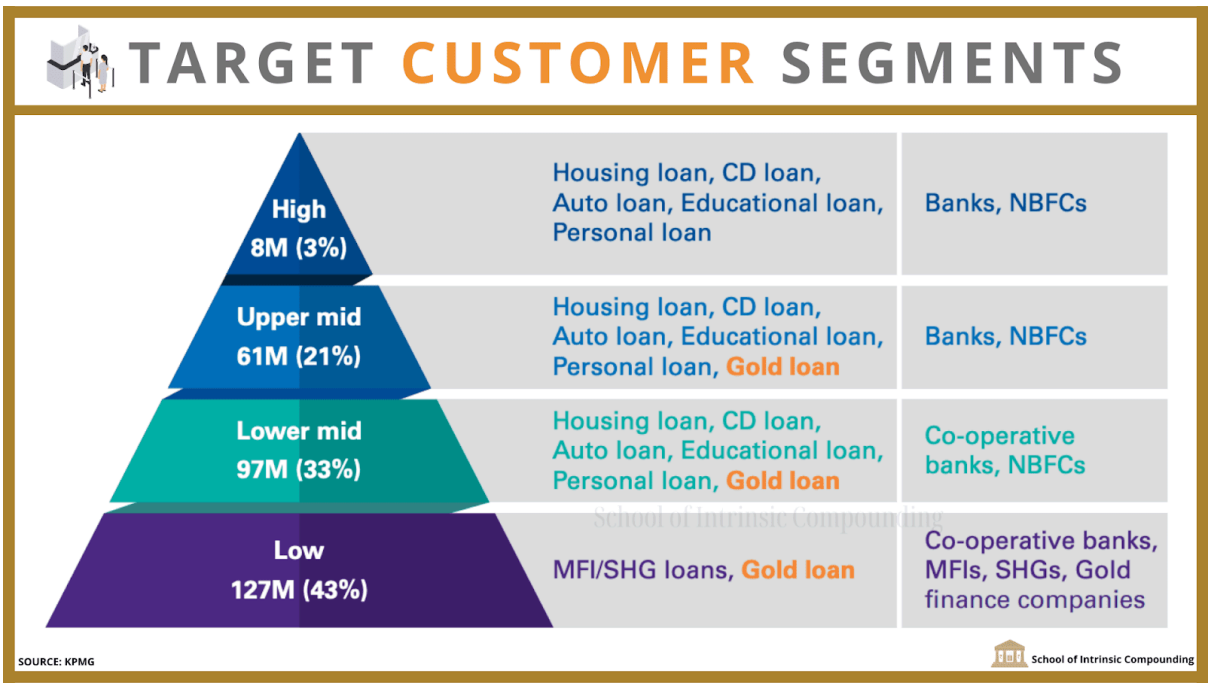
Currently they operate in 7 states with 239 branches and 3.74 lakh customers with Asset Under Management (AUM) of Rs.814 cr as of FY21.

Business Segments



Microfinance Institution (MFI) Segment

Microfinancing is providing micro-sized unsecured loans to the unbanked segment of our country's population. The customers are from the lowest segment of the economy in terms of earning capacity, as portrayed in the image below.



One question that comes to mind instantly when you read an ***unsecured*** loan is that "*what if the customer doesn't pay or runs away?*". Well, fortunately that is not the case.

The best way to overcome this fear is through reading the book, "*Banker to the Poor*" which is about the story of Nobel prize winner Muhammad Yunus, founder of Grameen Bank. The book came to my notice when Prof. Sanjay Bakshi had recommended it to me. If you want to develop insights on MFI business this book is a must read.

The passage below shows that these people borrowed money for their living and if they don't pay back they won't get the credit the next day and it would end up making their life miserable.

Banker To The Poor

Arman Financial Services Ltd.



Muhammad Yunus

They don't have any collateral," said the branch manager, expecting that this would put an end to our discussion.

"Why do you need collateral as long as you get the money back? That is what you really want, isn't it?"

"Yes, we want our money back," explained the manager. "But at the same time we need collateral. That is our guarantee."

"To me, it doesn't make sense. The poorest of the poor work twelve hours a day. They need to sell and earn income to eat. They have every reason to pay you back, just to take another loan and live another day! That is the best security you can have—their life."

The manager shook his head. "You are an idealist, Professor. You live with books and theories." "But if you are certain that the money will be repaid, why do you need collateral?"

"That is our bank rule." "So only those who have collateral can borrow?" "Yes." "It's a silly rule. It means only the rich can borrow."

CHAPTER FOUR - The Stool Makers of Jobra Village

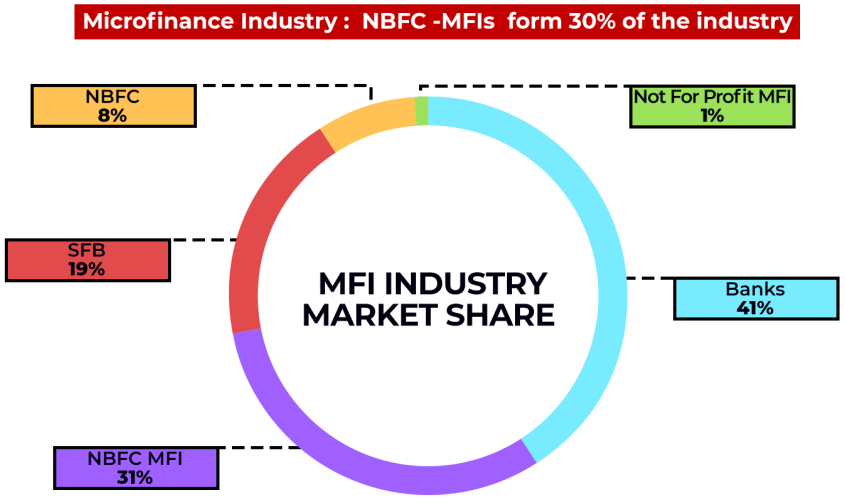
School Of Intrinsic Compounding

Arman Financial's management has a similar mindset where they believe that, ***"agar chote bandhe ko finance diya jaye toh wo paise jaroor se time par vapas aatha hai"*** (If people who belong to lower segment of the economy are provided loans, then the money is always paid on time.)

If you have read our analysis of Manappuram Finance, there we had written about MFI **size opportunity being around 4 lakh crores as per research of CRISIL and MCRIL** (Currently we are at 1 lakh crore).

Industry Structure

Arman Financial Services Ltd.



School Of Intrinsic Compounding

Source : RBI, CLSA

Further we have also covered the two business models that are Joint Liability Group (JLG) and Self Help Group (SHG) which are used by MFIs, so to understand that you can refer to the blog.

Arman Financial follows the JLG model and operates their MFI business via their subsidiary, Namra Finance, where they have centre meetings - they take attendance of the members, and it happens every 14 days that is bi-weekly and they keep collecting money from 1st to 12th of every month. The customers are only women who indulge in income generating activities like Kirana stores, diary related activities (representing 40% of the loan book), etc. with the average ticket size of Rs.33,000-35,000. Arman Financial also does Loan Utilization Check (LUC) to verify whether the money taken as loan is being utilized for the said purpose or not. Here is a video to understand the process.

Loan Utilization Check (LUC)

Arman Financial Services Ltd.

Avinash Tanawade: What percentage of people are doing income generating activity in MFI loans?

Aalok J. Patel: 100%, we only loan money for income generating activities, that said sometimes you lend for income generating activities and it gets put into discretionary use, if I can place sure that it would reduce as much as possible but otherwise it is very difficult to track sometimes whether the money has gone, there are LUCs in place, what we call loan utilization checks in place, but something that they bought like cattle, it might be easy to verify. If it is a working capital loan for a kirana store it is hard to tell whether the money actually went into income generating activities, but when you talk in a micro level, the way I like to explain it is that these guys do not have different pockets for home use, personal use, or business use right, they have some quantity of money and whether it is for an education or food or for business, it is coming out of the same pocket, so on a micro level it is not like they are keeping balance sheet and stuff like that in place and keeping an absolute difference, this is for business use and this is for home use, so it just kind of gets mixed in.

Source : Q1FY21 Con call

Management has **most of their branches in rural areas** which helps in avoiding competition, but they never enter a new district without other players testing out the market first.

They have **100% cashless disbursal** (not collection) and fall under a **centralized disbursal process**, where the final approval is taken from the head office after all the checks. Even though this would lead to delay in disbursal compared to peers, such a process **ensures quality of the loan book**.

The MFI segment acts as a **"turf testing tool"** as the management calls it. This segment provides them information about the economic health of the area and helps in building a brand. Once they believe that the area is capable of higher ticket size loans they move few customers from MFI to MSME.

One characteristic of MFI business which we covered in our Manappuram analysis too is that it requires discipline from the side of customers. As it is difficult to manage the lowest customer segment as shown in the pyramid.

Con Call Extract - Q3 FY21

Arman Financial Services Ltd.

Aalok Patel: In fact the entire restructuring philosophy is behind that model only that given the kind of pandemic situation and wherein it has almost extended to nine months now and if you get them a breather there is definitely a probability that they might want to fall in line over a period of time because microfinance funding has been there for, factual source of funding so they would definitely want to fall in line once their incomes kind of replenish over a period of time. So, the hard part is in micro is of course losing that discipline, so you constantly have to deal with that, but from this at least 1.5% to 2% of our customers and who were to be found as and their house is locked and they are what we call absconding in our terms. Those EMIs are very difficult to recover. I mean we cannot even find the customer. They have migrated from their selves so I do not know what exactly the situation is so those will be amongst the 4%, 4.5% which have not started here because we cannot even find them.

School Of Intrinsic Compounding

If customers behave in discipline, then they can be shifted to individual loans or even to MSME loans but only if customers need the loan amount. Management would do analysis of their business and understand why they would be needing more loans and not give it just because the person has completed 2-3 cycles. As of Q1FY21, 20% of their customers had experienced 3-4 cycles and 20-30% of their customers would be unique to them.

Filter For Next Loan Cycle

Arman Financial Services Ltd.

Aalok Patel: Any customer that is let us say; a customer in the microfinance side so I am talking about only microfinance right now. Out of a 100 customers who have finished their loans last quarter we lend money to about 40 of them so that is about 40%. Now in many aspects that is on the lower side but we have to consider a lot of aspects so the first part is see, does the customer want a loan maybe they dont need a loan, so right there, there is a dropout there. The second part is based on its performance do we want to lend in the money. We track his attendance, we track he has defaulted or a bit late or overdue for a few days whatever it is so that is a second level of filtering that goes there. The third level is the credit bureau so automatically if he has overleveraged with some other banks or financial institutions right there and then you either by my own underwriting or through RBI policy, I have to reject the customer down. So once you get through all of those filtering we are left with about 40% the idea is to increase it as much as 100% because if it is a good customer why would I let him go I mean that is a no-brainer but that basically the formula that has worked out at least in the last quarter. let us see what we can do to increase that number but right now given the underwriting and the filter that we have that is what the number is coming to for better or for worst.

School Of Intrinsic Compounding

Source : Q1FY19 Con call

Further management also has plans to have **individual loans under the MFI segment too**. They already have one under MSME segment (which we will discuss later), but having the same could help the company retain more clients as the customer could shift to a different lender who is offering individual loans under the MFI segment and management does not want to lose a good-disciplined customer. Going forward that is in the next 3-5 years management believes that a large part of their **loan book would be mitigating to individual loans**. Like the one they are doing under the MSME segment.

V Srinath: I think it is in the sort of piloting can you give some insights on that?

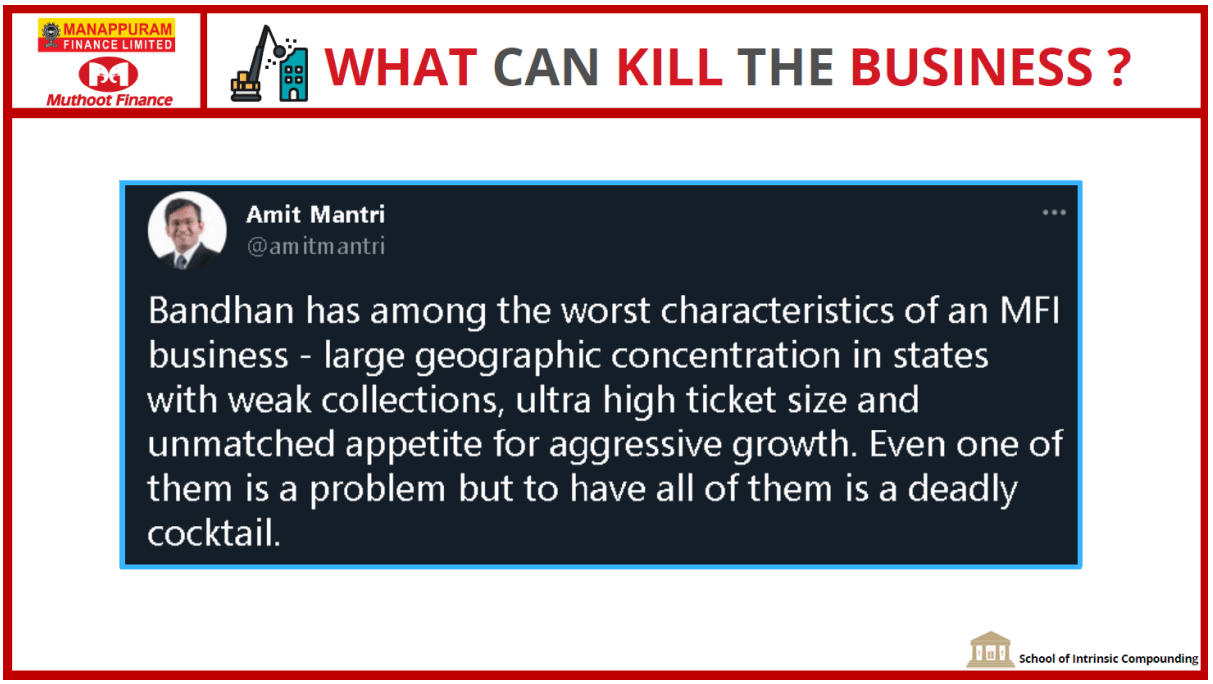
Aalok Patel: We have already started the pilot in the microfinance side. I think we already have some 44 odd customers and probably going to increase that by another 100 customers this month and the IEIs in that case as we are trying a cashless model of collections. We are still using the income assessments but for the customers who deal with us for three or four cycles at least for the last five to six years, if there are matured enough to a point where we can assess their incomes a little bit better or at least estimate their income similar to what we are doing for MSME and if we are in a industry that we understand well then we are disbursing money on an individual basis on a pilot basis through a MFI segment alone and we are attempting that we recover the money at least majority of it through cashless model so right now we are doing e-NACSH, we are trying couple of other things as well like auto UPIs and things which are coming up, there are numerous different methods to get it on a cashless way. I think pulling it out of their bank account will be better than waiting for them to transfer it like using the UPI apps and things like that but that being said I think the important thing is that they should have money in their bank account I mean all these cashless models of payment will rely on them having some cash in their bank account which the rural segment does not seen very, very enthusiastic to give up easily but we have to give it time.

Currently they cherry pick the best customers from the MFI segment and shift them to individual lending in the MSME segment. This is not an alarming thing because the quality of their loan book is quite good which can also be seen through the behaviour of their customers during COVID, where some customers didn't take moratorium rather were paying two installments together.

Currently management is also planning to expand in three areas: Haryana, Madhya Pradesh, and Rajasthan. They have decided not to further expand in Maharashtra for next one year.

What can kill this business?

Similar to last time with the filter we used for Belstar (Muthoot Finance) and Asirvad (Manappuram Finance), let's do it for Arman Financial.



Three characteristics that would kill an MFI business:

1. **Large geographic concentration**: Their MFI business operates in 7 states and has around 198 branches with 310,000+ customer base. **This is the filter Arman fails.** If we compare this with Manappuram they are one of the most diversified MFI with presence in 24 States with around 23 lakh customers.
2. **Ultra-High-Ticket Size**: Current average ticket size is around Rs.33,000-35,000 where average ticket size stands at Rs34,900. Therefore, one can conclude **Arman's ticket size is not ULTRA high.** Bandhan has ticket size of around Rs.50,000-60,000.

3. **Aggressive growth**: Arman Financial's AUM grew at 35% CAGR from Rs.176cr in FY17 to Rs.814cr in FY21 and they guided to hit Rs.1000cr mark in FY22. Looking at it on an **absolute basis the growth looks aggressive but when comparing it with peers the growth rate doesn't seem very aggressive.** For example Manappuram grew their AUM at the rate of 35% CAGR from FY17 to FY21, SPANDANA grew their AUM CAGR of 77% during FY17-1HFY20, and CreditAccess Grameen: AUM CAGR of 51% over FY14-1HFY20.

Micro, Small, and Medium Enterprises (MSME) Loans Segment

If you can recall the pyramid image shown in earlier part of the article, MSME customers are generally from lower middle segment and these customers for Arman Financial are the ones which have survived a few cycles of MFI segment and after shift to MSME segment only after going through the underwriting filtering process which ensures the quality for larger ticket sized unsecured loan.

The loans under this segment are **focused towards individual loans or small business** working capital loans. They operate with 35 branches which are spread across Gujarat (23), Madhya Pradesh (8), and Maharashtra (4).

The purpose of starting this segment is to provide higher ticket size loans when compared with MFI to businesses or individuals who fall above the lowest customer segment. **The ticket size is usually from Rs.50,000 to Rs.1,50,000/- (Average is Rs.70,000-75,000/-).** Management describes this segment as **Microfinance Plus** because you take the **best practices of MFI segment with greater underwriting process which was not allowed in MFI segment.** Plus, this is their highest yield product with yield being as high as 35% and the average tenure of such loan is 24 months.

The customers for this segment are generally large Kirana stores, machine and tyre shops, small highway stores, etc. More than 80-90% of their portfolio is from rural areas and all these loans are unsecured as the model itself is operational heavy.

Getting assets for secured lending would just bring in too many inefficiencies. Rather, they go the unsecured way with high quality MFI customers. 70% of their customers have outstanding loans with other institutions as well but management also has a **70% rejection rate** in this segment with **credit bureau checks of both the borrower and their spouse**, which maintains asset quality.

The customer selection for their MSME segment is that the customer should have completed 3-5 cycles with them and have always made the payment even during the COVID times. Such criteria provide management the confidence to lend such customers higher ticket size loans. This is the reason that they have low NPAs which is in the range of 1-1.5% for such a business (removing the COVID period) but management guides that this to be around 2% in the long run.

But just because the customer has gone through various cycles doesn't qualify them for higher ticket loan, they still have to undergo the underwriting process as per the standard of their MSME segment.

Con Call Extract - Q4 FY19

Arman Financial Services Ltd.

Aalok Patel: We have been trying to target the larger loans. Originally, I had anticipated that the average loan size will be around the Rs. 1 lakh range, turns out it is closer to about Rs. 70,000 at this point and I don't really want to push the higher ticket loans if the absorption capacity is not there in the rural side. So, we are pretty conservative as far as our loan sizes go, we do a pretty thorough cash flow analysis and then we arrive at a loan amount for any individual customer. So, it is not the same as some of the other competitors are doing that is relying on their Microfinance customers and if they have crossed a certain cycle, third cycle, fourth cycle, automatically they bound them up to a Rs. 1 lakh loan or something like that. So, I don't really believe in doing that. I feel anything over Rs 50,000 requires a much better underwriting or a much superior underwriting, then what you would do for Microfinance and I think I have said this before that just because somebody has paid you Rs 30K to 40K loan for 3 years in a row or 3 cycles in a row that does not mean necessarily that they will be able to pay you Rs. 1 lakh on time in the fourth year. So, I think hopefully that answers your question.

Arman Financial provides a doorstep collection facility which is appreciated by their customers because most of their branches are in rural areas where even bank branches are not present. **Compared to banks they have a faster turnaround time, and they would have better asset quality because they get on the ground level to assess the cash flows of the customer.** Furthermore, not many are doing unsecured loans under MSME segment and most of them follow Loan Against Property (LAP) which leads to higher cost and longer turnaround time.

Con Call Extract - Q2 FY20

Arman Financial Services Ltd.

Avinash Tanawade: Why are these customers not going to the microfinance and coming to us because some microfinance companies like Bandhan, for instance, is giving loans of up to Rs 1 lakh or more even Rs 2 lakh or Rs 3 lakhs. So why they are coming to us rather than going for them because if I remember correctly, then Bandhan is providing loans at 18% to 19% yields.

Aalok Patel: I mean, that is a good question. But I can ask the same thing that why somebody is going to Bandhan at 18% or 19% when they can go to SBI for 12% or 14% or they can go to Japan for 4%. So, it has to do with my service model number one. So, with a lot of lending firms, they do not provide door-step collections. I provide door-step collections in cash which a lot of people appreciate because there might not be bank branches in that area, where they have to go and deposit the money on a month-to-month basis. There are other factors as well, like for example, I provide a very quick turnaround. I get down to the ground level and try to assess their cash flow, and if we are not comfortable with their cash flows, then we reject the customer as well and that is hard to estimate for, I mean you need some level of local knowledge and some level of experience with the different occupations. The other fact is also that our loans are unsecured. When you are talking about an Rs.4 to Rs.5 lakh loan in MSME, very few people are doing it on an unsecured basis, it is mostly some level of LAP loan or something like that. So, that also has not only a higher cost but a higher hassle and a higher turnaround time, and frankly speaking at the micro level when you are talking about loans of this size our customers are not very price sensitive. For us, if you are talking about a large loan in crores even a 5 basis points should make a difference right, but when you are talking about an Rs.70,000 loan, yes I mean 5% will make a difference in the installment but maybe by only Rs.100 to Rs.200 or something of that sort. So, a lot of people do not care about that as long as they get it in time and with the least amount of hassle as possible.

Yields are very attractive in this business and **currently business doesn't have any competitive pressure to lower the rate but they are open to if required and focus on reducing operational cost**.

Doorstep collection is the "secret sauce" of their MSME segment which helps in building relationships and indirectly maintains the asset quality (as it helps in

maintaining discipline). Currently they consider Fullerton as their biggest competition as they follow a similar model.

Secret Sauce: Doorstep Collection

Arman Financial Services Ltd.

Aalok Patel: That is an excellent question. In fact, post demonetization what happened was everybody had projects in place to move towards the cashless disbursements. I think what is going to happen is post this COVID people are going to move towards the cashless collection as well. So, we already have projects in the place to start using UPI and QR and all of these fancy things in place to start collecting digitally. However, it will have to be done very carefully, because the reason our repayment rates are so good in microfinance compared to personal loans or stuff in urban areas, is because of the high touch model. Even in our MSME business, we go to the doorstep to collect the money, and that high touch kind of model creates the right pressure points to make sure that people continue to pay on time, so we do not want to lose that. At least I would not risk losing it until we do a lot of piloting and a lot of other analysis. So, what we will probably come up with is some hybrid model where the collection is electronic if somebody chooses to pay electronically, but we don't lose that high touch center meeting kind of model so we will see. A lot of people are doing some great innovative kind of thinking right now including us, but it will take time. I think that to move towards 100% cashless is not going to be possible in a year or two, it will take at least two to three years.

Source : Q4 FY20 Con call

But then comes the problem of logistics as doorstep collection makes the business operational heavy.

Con Call Extract - Q2 FY20

Arman Financial Services Ltd.

Amit Mantri: Because there is a high degree of cash collection that happens even in the MSME segment, how do you manage the risk of fraud, be it on the customer side or on the employee side. How are you managing those risks?

Aalok Patel: Well, that is why we are all sitting here. The hard part of this business is managing the logistics on the ground and managing the operations. So, it is a very operations intensive business. We have lots of checks and balances with lots of layers, almost like a casino to an extent, where everybody has to watch everybody else. We also have daily reporting structures that, if something does go wrong, we know about it on the same day. Even then, you cannot prevent somebody who has Rs 50,000 to Rs 60,000 in his pocket from running away. So that does tend to happen on rare occasions, but it is not a very large amount and we have ensured to cover even those kinds of small thefts or whatever you call it, but our systems are set up in a way where we do not typically run into a very large-scale fraud or anything like that.

MSME vs MFI

The key differences between MFI and MSME segments are:

1. **Ticket size**: MFI has lower ticket size with average being around Rs.33-35,000/- plus the disbursement is done in a group-based model which includes only women. Whereas in MSME there is no such policy rather it is individual lending focused with average ticket size being Rs.70,000.
2. **Customer segment**: Customers in MFI belong to the lowest category of the pyramid whereas MSME customers are lower middle.
3. **Yield**: MFI yields around 24% and MSME around 30-35%.

4. **Rejection Rate**: MFI has rejection rate of 40-50% (during COVID it went up to 65%) and MSME has it at 70-75%
5. **Retention Rate**: We don't have the exact figures for MSME retention rate but logically speaking MSME has very low repeat customers because once they are done with higher ticket size loans such customers hardly need that similar amount of loan again. But in MFI the loans are for their daily income generating activities, which leads to retention rate of around 55-60%, hence retention rates are relatively high.

Two-Wheeler Loans

Two-wheeler segment is not the most profitable segment which they have, plus the NPA they get here are relatively higher but still the management is interested in this business because it **helps in operating leverage** and in mitigating risk as during demonetization it was the only segment that was functioning. They have already burnt their hands in the used two-wheeler market earlier, so management has decided to stay away from it.

This segment is **only present in Gujarat** where their sales people sit at dealerships and as of now they have a reach of 55+ dealerships with AUM of Rs.45cr. Earlier they were only into the Urban side but now they have started Rural 2W loans too which have higher yields (Urban at 21-23% vs Rural at 26-28%). This is a **secured loan segment** where the **Loan to Value is around 60-85%** with **average ticket size from Rs.30,000-50,000/-**

Loan Against Property (Planned)

Management had planned to start a new segment that is Loan Against Property around 2018-2019 but didn't execute the plan as they wanted to enter with a better understanding of the market but then in 2020 COVID hit, and all the plans have been

delayed now. The ticket size would have been around Rs.2 lakh to Rs.5 lakhs and customer profile would be one step above MSME segment.

Conservative Management



The above quotes represent management's long-term thinking and understanding towards the crisis. They have realized that **crisis/scams are an inherent part of the NBFC sector**, and **one should expect it to happen every 5-6 years** but still the company like Arman Financial would do good in the long run.

Now, let's look at the reasons behind the title, "*Conservatism in its roots*".

Management is **never the first mover in any district** for their MFI segment and not in a hurry to enter any segment like they were planning for 2 years to enter the housing segment, but still did not as they believe they are yet to understand the market properly.

Further, whenever a crisis strikes, they are **among the first companies to stop disbursement** be it demonetization or COVID.

Safety Over Growth

Arman Financial Services Ltd.

"We have implemented a hiring freeze till conditions settle and put all expansion plans on hold. Disbursements have also been put on hold until repayments are on track. Going forward, we will maintain a strict vigil on our 'operating expenses' and look to implement steps to improve operational efficiency. Collections will remain our top priority for the next 2 quarters."

- April 2020 – COVID 19 Business update

"It is just that we are not concentrating on the repayment as far as the field is concerned. Otherwise, we can push it. There is plenty of demand in the market for funds."

- Q1FY22 Con call

Source : Q1FY22 Con call

Quality over Growth

Arman Financial Services Ltd.

Aalok Patel: We are disbursing but see there is a different form of strategies you have to use as far as disbursement goes during times like this that we do not want to pressure your people, you do not want to give them hard targets and things like that. As I said in my speech, it is very imperative that we have at least microfinance there is not a lot of paperwork available to formulize a system about cash flows and things like that. So I think it is very imperative that you do not push your people too hard and you tell them you can do less business but make sure whatever we are doing is of a higher quality, much more emphasis on collections also is what we are telling our people so that gives them little less time for disbursement. That being said we are expecting this month around the disbursement of maybe about Rs.50 Crores in the microfinance book and maybe around Rs.12 odd Crores in the other books, so total Rs.62 to Rs.65 Crores somewhere

Source : Q4 FY21 Con call

Due to their practice of choosing asset quality over growth, management has survived all the crises and performed better than industry in terms of collection efficiency. **During the time of demonetization and the COVID pandemic the company was able to get 90-95% collection efficiency with industry being around 60-70%,** which represents their asset quality and customer base.

Management has also being conversative and provided extra provisioning whenever they feel trouble where it is 2017 or 2021 they have also provided extra so as to create cushion for the business. The reason behind such nature is the history of Mr.Aalok Patel who has spent some time in the USA while he was completing his studies and has witnessed the 2008 financial crisis there.

It is very easy to lose patience in this lending business. There is **no problem of growth as demand will always be there** but asset quality if not maintained the

business could get into trouble. Plus, management believes that sometimes there can be genuine issues and when dealing with people from the lower pyramid therefore, they must show sympathy (Management won't hesitate to restructure a loan for such cases).

Con Call Extract - Q1 FY21

Arman Financial Services Ltd.

Jayendra B. Patel: May be his question was this, how are you getting in touch with this kind of people, it is at field level and we are calling people who has regularly calling them you so and so, nowhere and I mean nowhere in the conversation you want to do anything like a strict language or anything, all you want to find out is how is the family and has everything been okay, and only in one sentence you want to tell them that there has been a little delay in your payment and that is about it, under no circumstances you want to do any kind of harsh words, so that is my input on this.

Aalok J. Patel: You have to be sympathetic, I do not think this is a situation where muscle flexing is going to go anywhere and I think it will lead to a very disastrous situation both for us and the customer, and you have to be very sympathetic, I mean these are not willful defaulters right, they have had their life come crashing down, they have to worry about feeding their family and taking care of their life functions before they start paying the installments and I think that is fair enough, so I hold no ill will against these customers, but at the end of the day I run a business so I will have to make sure that somehow or other I get them restarted as many of them as I can.

Management has completed the capex for 30 branches, but they have stopped the work on it because they want their team to focus on repayment rather than bringing in new business.

As mentioned at the start of this section, management has said that one should expect a crisis every 5-6 years in between saw issues which come up specific to the district are manageable; the problem only gets serious when it becomes an industry level issue.

Con Call Extract - Q2 FY19

Arman Financial Services Ltd.

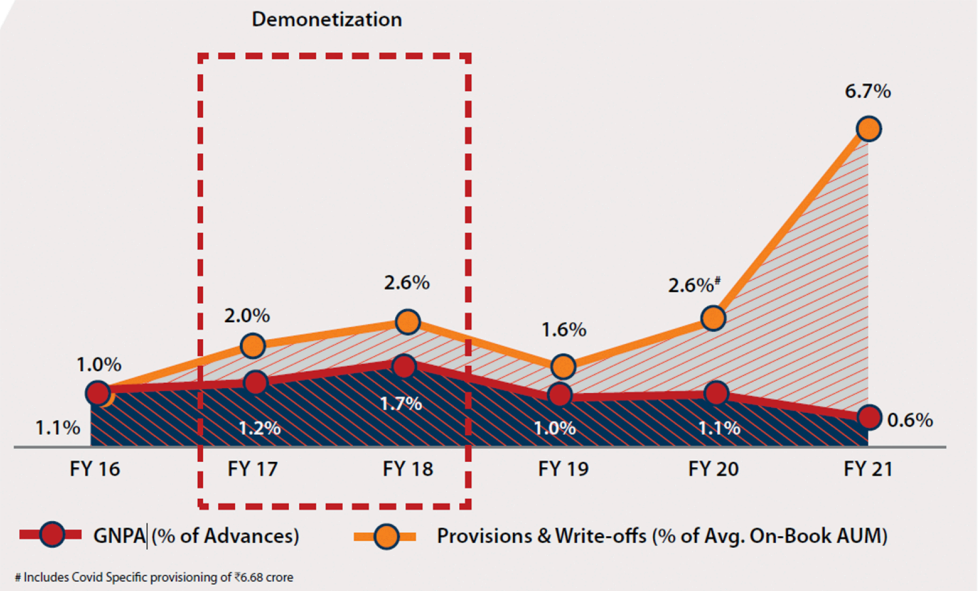
Aalok Patel: Sure Digant. So first of all you are right. So let me just give you a little bit of background from when the problems arise in microfinance how they come. So when people typically say 1% cost or 1% NPA or whatever, those are usually caused by certain hot pockets in one district on other, if it is a bad year it could be one state or another natural disaster and yes you are hearing about some heating up, which is happening in Odisha. I am hearing about some heating that is also happening in the Northeast or Eastern side of India as well. So these things do happen from time-to-time. In our case also, like if you look at -- what happens is in microfinance when the problems come in a certain area, they come with a battalion and when there is good weather in a certain area then you have no problems. I still have plenty of branches, over half of my branches, which completely have zero overdue, they are absolutely not even Rs.1 of overdue and there are certain branches which might have 10%, 15% also. So by average it will come to 1%. The fact is after doing this for so many years you can handle these kinds of situations whenever they do come up while demonetization was such a unique event because it happened country wide, so you were fighting one fire fight but you were fighting 150 places or if you have 150 branches. So those kinds of events are quite difficult to manage, but as far as the localized fires or wild fires that erupt from now and occasionally I think we have all MFIs are well suited to deal with those. As far as Arman's portfolio or especially the MFI book portfolio is concerned, so earlier on I think about a year and a half ago maybe a little more than that almost 80% of our portfolio was in Gujarat, about two years ago.

Another way to judge the conservative nature of the management is through numbers, that is to see the difference in the GNPA and NNPA.

Net Non-Performing Asset formula is GNPA - provisioning = NNPA, which means **higher the difference between both the numbers more the provisions management has made in their books**.

Asset Quality

Arman Financial Services Ltd.



School Of Intrinsic Compounding

Good banks/NBFCs generally maintain a 70% coverage ratio. Arman Financial made a total of Rs.36.67cr as provisions and GNPA were Rs.26.36cr which leads to 139% of provision coverage ratio.

Well, the care is not limited to customers only as at the end of the day employees are the assets of the company who also require help in times of crisis. They do not do layoffs during crises, rather they provide incentive to retain the talent. Even though they care about their employees they still can't afford to pay them hefty salaries to retain talent and the maximum they can do is provide ESOPs. The reason being NBFCs advantage over Banks is that they **can operate in a low-cost model even though borrowing cost would be high, operational cost can provide NBFCs advantage over banks**. If NBFC start providing hefty salaries, then it would take away the low-cost advantage.

Few measures management takes to mitigate risk

1. **Branch**: To reduce the measure of a black swan event management **does not allow** a **district** to have **more than 5% exposure** and if a branch reaches a loan book of Rs.5cr they would split the branch.
2. **Preference to old customers**: They prefer providing new loans to their **old customers who have maintained the discipline** but we all know that this strategy doesn't work for long and companies have to start getting new customers on board who bring in additional risk.
3. **Avoid few businesses**: Management avoids lending to some kinds of businesses like direct agriculture business or roadside restaurant during COVID as they believe there the risk to reward ratio is not suitable.

Top-up Loans

Top Up Loans

Arman Financial Services Ltd.



**The author of the tweet meant 2016*

School Of Intrinsic Compounding

Link: https://twitter.com/amitmantri/status/1381851904934703104

Evergreening/top-up loans are those loans which are given to existing customers to repay the initial loan they had taken. Such loans are dangerous because this will lead to **customers falling into a vicious circle** which would at the end affect the lender themselves. Management is totally against evergreening of loans. They believe that it

disrupts the discipline one builds among their customers and it's an easy way out to cover your losses.

Top-Up Loans

Arman Financial Services Ltd.

Aalok Patel: No, I do not think it has reached to that level, I do not think it has become a systemic issue or anything like that. Let us say in the case of Arman as well now if we borrow from SBI and have a repayment for Kotak this month, then does that mean we have borrowed money from SBI to pay off Kotak, of course it does right, that is our business, nobody says anything wrong about it, so there are right ways to do it and wrong ways to do it number one. Number two it is not like I have anything against top up loans, off course I am not a big fan of them, but top up loans done in the right way although I do not know exactly how to distinguish what is the right way or wrong way, , but you know if you fully disclose it that you are doing top up loans then you have a certain level of criteria for doing it where at least the management level of a certain company feels it is the right thing to do and the underwriting standards are adequate and finally the positives outweigh the negatives then go ahead and do it. Only thing I am against, is that you use it to cover up your losses and kind of hide your problems, so that is the main issue that I have with the top ups, otherwise there are companies who have always been **doing this for the last couple of years**, so we have been against top up personally.

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Source : Q2 FY21 Con call

RBI's Consultative Paper

The current regulation for Net Interest Margin (NIM) , that is, how much the company charges on their product is 10% over the cost of borrowing. Arman Financial has their cost of borrowing at 12-13% which means the maximum they could charge on their MFI products would be 22-23%.

On SOIC channel we had mentioned about the structural changes the MFI industry is going to witness because of RBI's consultative paper on new regulation norms.

The new regulation is going to bring in the following three major changes in the industry:

1. **Removal of pricing cap**: this could lead to **increase in ROE** (net income/shareholder equity) as they would be **able to charge more** on their products leading to increase in net income. Further this i**ncreased the size of the addressable market** for the industry because earlier companies used to avoid riskier borrowers because due to cap on interest rates the risk to reward ratio was not attractive.
2. **Change in upper limit**: After the removal of cap now the limit for loans would be based on 50% of total household income, which means there is **no individual borrower limit**. Before this the cap was at Rs.1.25 lakhs.
3. **Definition of household income**: The requirement for a customer to avail MFI loan is that their household income should not exceed Rs 1.25 lakh (Rural) and Rs 2 lakh (Urban). This definition would now also apply to banks, earlier it was restricted to NBFCs.

Management believes that this paper is going to be a game changer for the MFI industry.

This white paper is exactly what the management wanted earlier, and analysts used to discuss about.

Con Call Extract - Q2 FY21

Arman Financial Services Ltd.

Savi Jain: You have lesser interest because from the heydays of 28%, 29%, 30% now the bigger banks are lending at 19%, so it has already come down to a very respectable level?

Aalok Patel: In my experience, a lot of the government officials do not understand the nitty-gritty, operational issues of microfinance or how expensive it is to do what we do and you know as you say every two, three years there might be a zero ROE kind of a year. I have met many government officials in my career and you know when you explain to them that what you do, they love the story you are helping the women and all other stuff. But inevitably the question will come up that how much you charge and the second 24% or 23% comes out of your mouth you have lost half the battle, it does not matter how much you try to justify to them about operational cost and credit cost and the last mile delivery and all of that stuff, in their minds you are taking unfair advantage of the poor people. So we have come a long way, I think, the central and most of the higher state level officials understand what we do and why it is necessary to have these rates; however, anyway we can always try, there is nothing wrong in asking, it is just that in my opinion when you are asking them to increase rates, they do not want a newspaper article saying that RBI allows charging poor people an extra 2% right, it is a nightmare form them so I do not think they will allow that.

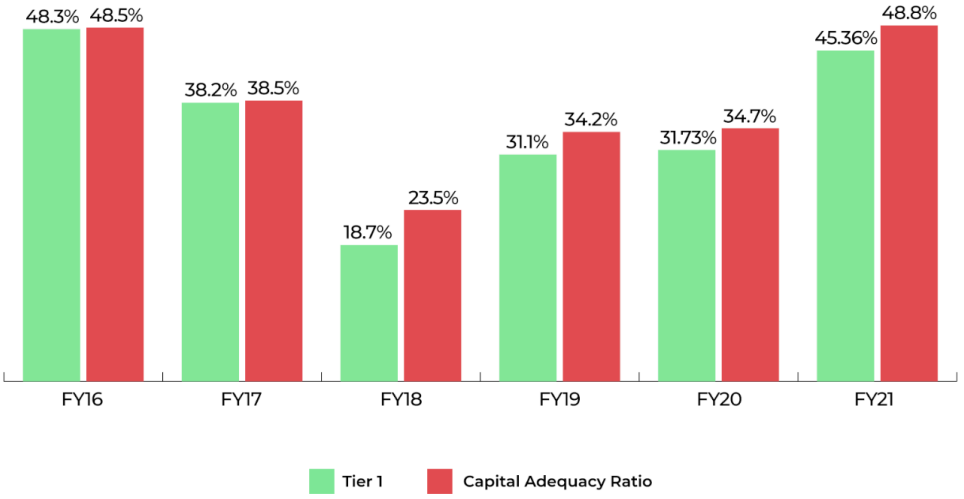
Please note this is a consultative paper, even though management is positive it will eventually be implemented **but there is a risk involved here.**

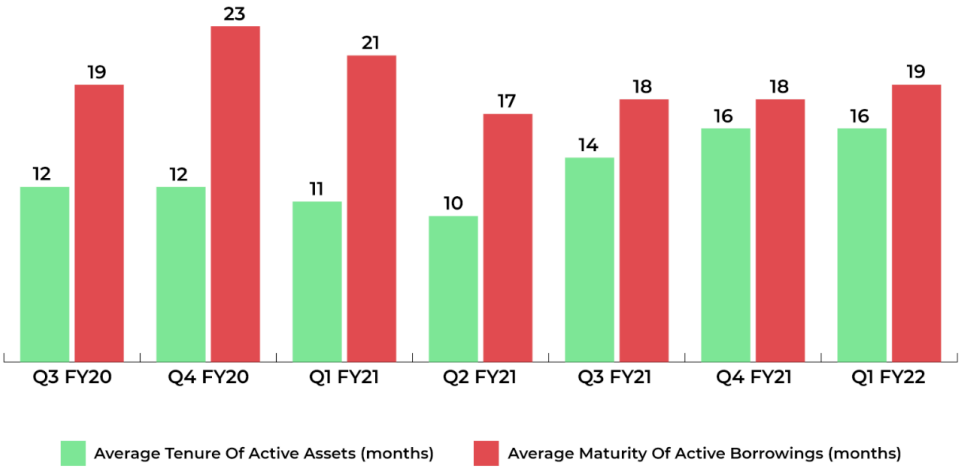
Cost/Liability Side

On the liability side the company looks fine as there is **no asset liability mismatch** which makes a lending business fragile. Average loan tenor of loans on the assets side stands at 16 months whereas average period of borrowings on the liability side is at 19 months.

Cost/Liability Side

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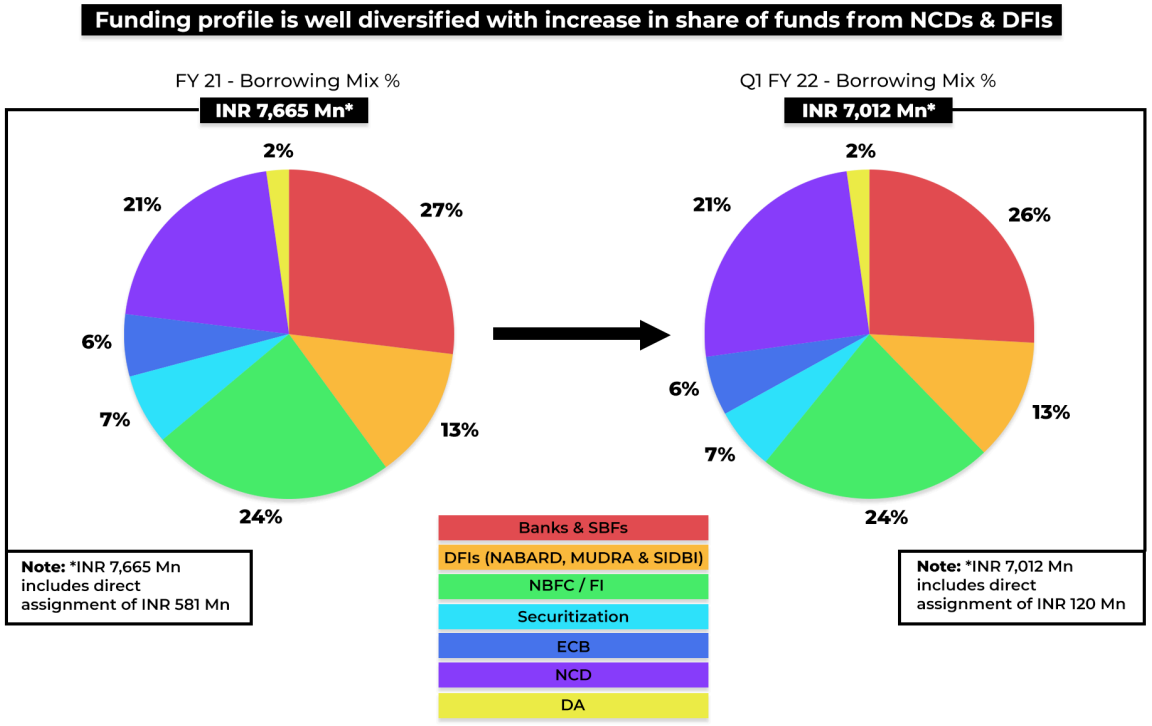


Source : Company, JMFS Research

As long as the period of borrowings is longer than tenor of loans disbursed, there is nothing to worry about.

Borrowing Mix

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Source : Investor Presentation

As of Q4FY21 their cost of borrowing was at 12.25% and margin for MFI products was around 9.25-9.5% (limit is at 10% until RBI paper is approved). Management believes there is less probability of costs of funds going down. **The only lever for reducing cost now left is improving efficiency.**

Branches and Cost

As most of the business of Arman Financial happens in rural areas the **expenditure of opening a branch is not huge** and for them to break even MFI branches require 500-700 customers and MSME is little lower at around 450 customers. Total capex for

a branch is around Rs.2.5-3 lakh the reason for it being cheap is rural locality. Therefore, opening a branch is not an issue running it efficiently can be.

Con Call Extract - Q1 FY22

Arman Financial Services Ltd.

Aalok Patel: Our structure is different. There are many factors as far as AUM per branch. Number one you have to consider what is the average ticket size of the loan. Let us say if my case average ticket size is Rs.30,000 and the guy across the street from me is Rs.36,000 so apples to apples there should be a 20% difference in the AUM per branch. The number of clients might be the same. The second thing is about how the vintage of the branches so how old is the branch. The third is that what your strategy as far as branch expansion is. Are you going after the lowest handing fruits where there a lot of population but lot of competition? Ahmedabad for example are you venturing it out into places where there is low density of population and it will take you a while but there is low competition and in general better kind of credit discipline. Are your rural versus urban. Urban tend to have a much, much larger branches. Rural do not. There are many factors to consider and of course let us say I had just opened 13 new branches. Those branches will have no customers and they will basically pull down the average for the rest of.

Vivek Modi: The normal branch will take at least three quarters to four quarters to reach the standard benchmark for the branch.

Aalok Patel: I think typically we reached a breakeven point between 500 to 700 kind of customers so we will try to get there at least in six months or so typically speaking and after that I will not call smooth sailing but once you reach that critical mass the growth you do not have to push so much for the growth of the branches.

Small Finance/Banks vs NBFCs

Competition from small finance banks is real but **not alarming.** Most banks indulge in the MFI segment (unless they are laser focused like Bandhan) to increase their yield. Further similar gold loan 5-10% difference on small ticket loans doesn't make a huge difference, rather customers would look for comfort.

Con Call Extract - Q2 FY19

Arman Financial Services Ltd.

Amit Mantri: Sure. So in your microfinance business, you have a fair bit of competition from the small finance banks which in the commentary said that since they do not have any liquidity issues and the smaller MFIs are facing liquidity challenges which should mean that there will be market share gains by the small finance banks and the banks themselves in comparison to smaller MFIs. So what does this mean for the future of both the MFIs and Arman as well?

Aalok Patel: See first of all, I am not completely sure that all asset base are not facing liquidity issues. Some of them are facing liquidity issues and as far as my market knowledge is concerned many of them have slowed down disbursements. So while there are some of them that are taking advantage of the situation who are well capitalized or have sufficient liquidity available, there are others who are slowing down or pulling back as well. So I do not foresee too much of an issue from the SFB. That being said competition is very real in the market and certainly we tried to combat that by being at the right place, at the right time, providing better service and all of the other stuffs, which I am sure you are hearing time and time again.

The other part to note is India is a very large country and the application that we serve is again enormous. So just to kind of give you a little background that when I started in microfinance the expectation was that all the money lenders or the informal segments will go out of business in the question of two or three years. If you go to the ground level that is not the case. They are still doing business along with the Shroffs and the moneylenders and everybody. So, there is enough room for everybody to operate because the market is broad enough.

Valuation

As discussed various times at SOIC, **investing is a game of probabilities so having scenarios set in mind is a good way to value a business**. Let's first look at what can happen in the next 2 years.

If we assume 35% growth rate for FY22 assuming no COVID third wave and management guidance of 40% growth once the dust settles and then 25% growth rate for FY23, the book value would reach to Rs.295 in FY22 and Rs.370 in FY23.

Bear case: During downfall of economy the P to BV multiple Arman gets is around 2 times leading to stock price in FY23 could be at Rs.740.

Base case: In a stable economy it gets 3-3.5 times multiple leading to stock price of Rs.1110-1295 in FY23.

Bull case: In a no COVID world and good economic conditions the multiple reaches to 5-6 times which implies a stock price of Rs.1850-Rs.2,220 in FY23.

Note: If we don't include the FY21 numbers as due to COVID management had stopped disbursement and started focusing on safety rather than growth, the book value has grown at 35% between FY18-FY20. Further, these numbers are just rough estimates for creating probabilistic scenarios, **don't take them to precision**.

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