Learnings From India’s Mini-Lehman Crisis

This article is authored by MOI Global instructor Amey Kulkarni, Fund Manager at Candor Investing, based in Pune, India.

India had its mini-Lehman crisis when one of its infrastructure behemoths, IL&FS, defaulted on loans in early September 2018. Andy Mukherjee of Bloomberg termed the IL&FS default as India’s “Lehman moment”. It is estimated that IL&FS has a consolidated loan outstanding of more than $25 Bn. Not only have banks lent money to IL&FS, but also pension funds, mutual funds and even cash-rich corporates have lent to IL&FS.

A panic spread through India’s financial markets. Money markets froze and lending businesses found it difficult to not just raise additional money, but also roll over existing loans. Stock prices of most lending businesses fell anywhere between 20% to 90%.

Lending businesses are evaluated using the commonly accepted CAMEL model

- **C – Capital Adequacy Ratio**
- **A – Asset Quality**
  Asset Quality refers to the riskiness of the loan assets, the financial vulnerability of the counter-party. Eg personal loans are riskier than secured mortgage loans.
  Non-performing Assets (NPA) and its trend over several years is a good proxy indicator of the asset quality.
- **M – Management Quality**
  A conservative and capable management is important to success in a lending business because disbursing loans is easy, getting the money back in the difficult part.
- **E – Earnings/Return on Equity (ROE)**
  Lending businesses grow at a multiple to the GDP growth and growth is not a concern in a fast-developing economy like India.
  However, if the lending business grows faster than ROE, it needs to raise additional equity capital, thus diluting the existing investors. Though a higher ROE can be achieved by increasing the gearing ratio, reducing the cost-to-income ratio, operating in a segment where spreads are higher (eg. Gold loans, microfinance, SME lending etc.) are also safer/better ways of improving ROE.
- **L – Liquidity**
  All lending businesses borrow from one to lend to the other and hence maintaining an appropriate asset liability match is critical to the survival of the business. Ability to raise money especially under adverse conditions is critical to sustainability of the business.

Emphasis needs to be laid on the fact that growth is not an evaluation criterion since disbursing additional loans is a very easy thing, getting back the money is difficult.

Over the last 20 years, India has been home to several 100-bagger lending businesses. HDFC Bank, Kotak Mahindra Bank, Shriram Transport Finance, Manappuram Finance are just a few sample names. Investing in Indian lending businesses has been very rewarding for investors in the past and is likely to yield good returns in the future as well.

Let us analyze a representative sample of 12 lending businesses operating in India and derive some insights and lessons which will serve us well when picking stocks in the future.

We have specifically chosen 12 non-banking finance companies because though they come under the regulatory supervision of either the Reserve Bank of India (RBI) or National Housing Bank (NHB), the central bank of India does not act as the lender of last resort.

Lending Business	Change in stock price from 30th Aug-18
Piramal Enterprises	-17%
Gruh Finance	-22%
PNB Housing	-34%
Edelweiss	-41%
Shriram Transport	-8%
India Bulls Housing	-42%
DHFL	-78%
Muthoot Finance	39%
Manappuram	19%
Shriram City Union	-17%
L&T Finance	-23%
Bajaj Finance	-5%

Stock prices of three companies Edelweiss, Indiabulls Housing and DHFL fell by more than (40%) since Aug-18. Stock prices of most other companies fell with the exception of gold loan companies – Manappuram and Muthoot Finance which have given +ve returns.

Could the CAMEL model have predicted this? Are there some lead indicators which would helped us predict this outcome?

Lending Business	Change in stock price from 30th Aug-18	Gross NPA	Capital Adequacy	Return on Equity (5 yr avg)
Piramal Enterprises	-17%	1%	20%	17%
Gruh Finance	-22%	1%	19%	30%
PNB Housing	-34%	0%	17%	15%
Edelweiss	-41%	2%	16%	15%
Shriram Transport	-8%	9%	17%	12%
India Bulls Housing	-42%	1%	21%	28%
DHFL	-78%	1%	16%	17%
Muthoot Finance	39%	1%	26%	20%
Manappuram	19%	1%	26%	19%
Shriram City Union	-17%	9%	21%	12%
L&T Finance	-23%	7%	17%	12%
Bajaj Finance	-5%	1%	22%	21%

Note – There is no single parameter to judge management quality. However, consistent record on Return on Equity is a good approximation of management quality.

Minimum regulatory requirement for capital adequacy = 12%

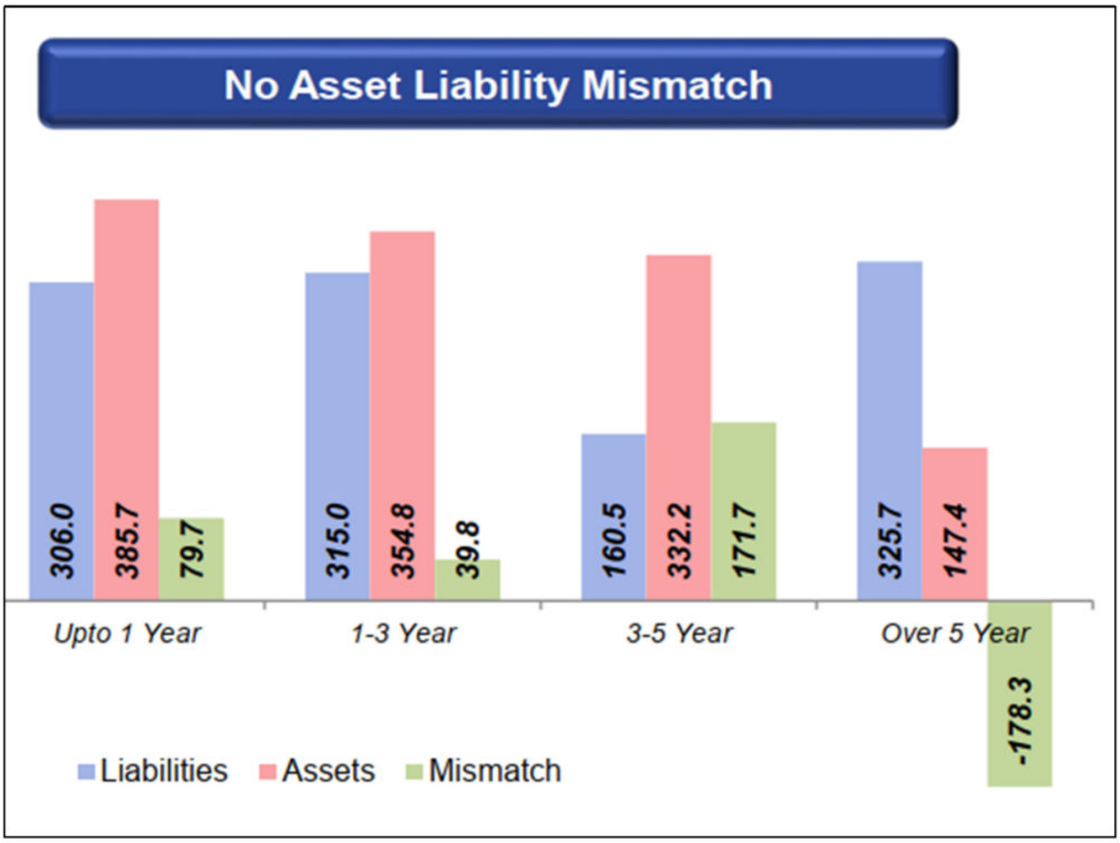
ROE (five-year avg) =20%+ vs. cost of borrowing of ~8%

If we carefully study the above table, we observe that companies with the maximum NPA (Shriram Transport, Shriram City Union, L&T Finance) have not been the biggest losers.

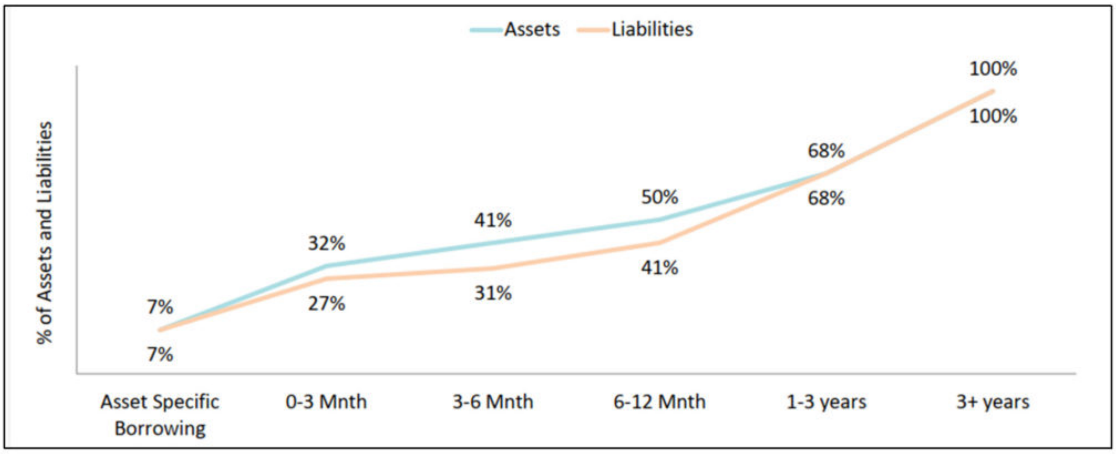
Also, companies with the lowest Return on Equity profile (Shriram Transport, Shriram City Union, L&T Finance) are not the biggest losers.
Again, all the companies have a healthy capital adequacy ratio (min 16%) which is comfortable and we could not have predicted the subsequent crash in stock prices of some of the lending businesses from this data.

Could we have predicted the laggard companies from asset-liability mismatch?

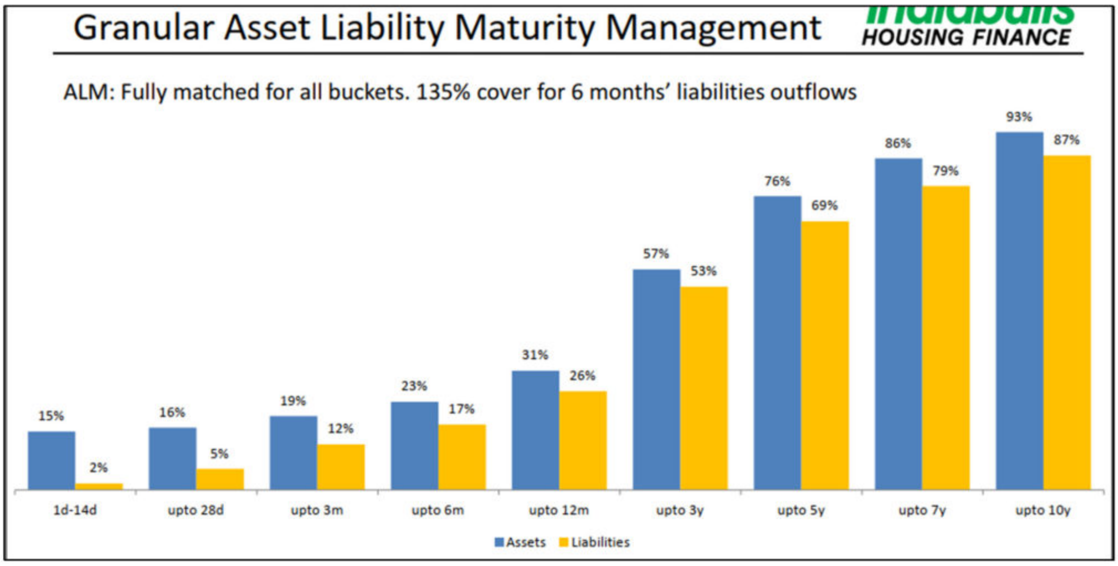
None of the laggards – Edelweiss, Indiabulls Housing or DHFL had an asset liability mismatch as of June 2018 before the default by IL&FS.



DHFL – No ALM mismatch



Edelweiss – No ALM mismatch



Indiabulls Housing – No ALM mismatch

Thus, analyzing the asset-liability position of the companies would not have given us any indication about which of the companies could be the worst hit. Did valuations play a part in the subsequent stock decline?

Lending Business	Change in stock price from 30th Aug-18	Valuation - P/B ratio (30-Aug-18)
Piramal Enterprises	-17%	2.2
Gruh Finance	-22%	15
PNB Housing	-34%	3.3
Edelweiss	-41%	3.5
Shriram Transport	-8%	2.1
India Bulls Housing	-42%	3.5
DHFL	-78%	2.0
Muthoot Finance	39%	1.9
Manappuram	19%	2.0
Shriram City Union	-17%	2.3
L&T Finance	-23%	3.0
Bajaj Finance	-5%	10

Paying more than 3x book value for a lending business that makes around 18-20% return in equity is in my opinion a rich valuation. Though the companies that were valued more than 3 times book value

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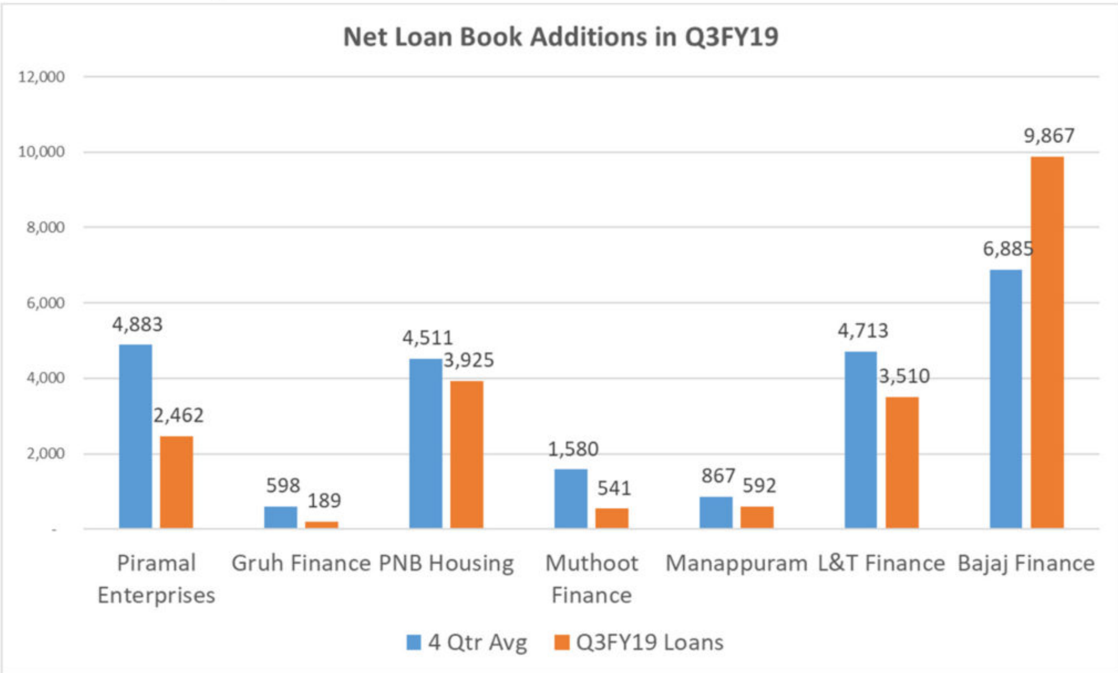
(India Bulls Housing, PNB Housing, Edelweiss, PNB Housing, L&T Finance) did fall substantially, Bajaj Finance (P/B of 10) and Gruh Finance (P/B of 15) did not fall as much.

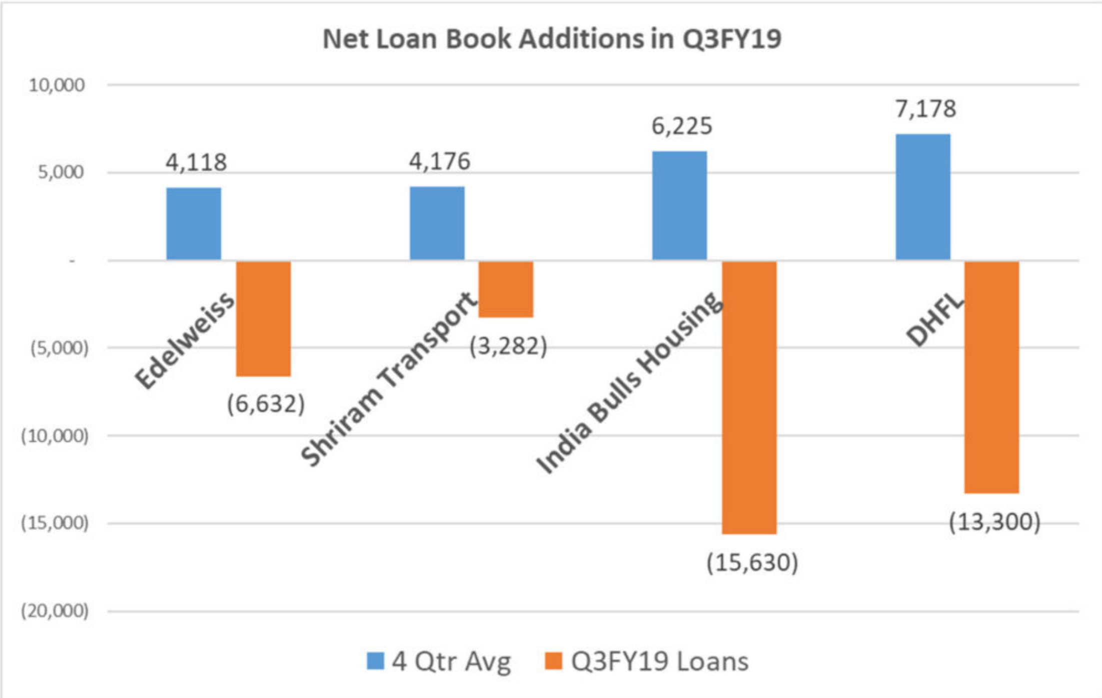
Thus, pure valuations would also not have been a lead indicator of the fall in stock prices.

Since our quest for a lead indicator is not yielding much, let us look at what happened after the default by IL&FS and derive what the learnings are. After the default by IL&FS, the short-term debt market virtually froze and refinancing the commercial papers (short-term loans < 1 yr.) became difficult for even good quality lending businesses. Borrowing more to lend it further to the customers became a huge challenge. In fact, lending businesses found it difficult to repay their old borrowings.

In this tight liquidity situation, have the lending businesses been able to grow their loan book?



The above chart compares the net additions to loan book (fresh loans – repayments) for CQ4 2018, with the average of the same numbers for the previous four quarters. The net loan addition for CQ4 2018 for most companies slowed down from their average for the previous four quarters. Bajaj Finance was the notable exception which actually managed to increase its loan book at a higher pace.



These companies saw a contraction in their loan books. They basically had to down-sell the loan book through securitization, thus reducing the on-balance sheet loans in CQ4 2018. Performance during such a crisis speaks volumes about the way the lending business is carried out. Financial Institutions that lend to these companies (banks/mutual funds etc.) will always know more about the lending practices of these companies than an average investor. The refusal of these financial institutions to make additional loans during the crisis times tells us about the confidence they have in these companies' business model.

Though the stock prices of almost all lending businesses fell in this period, the biggest fall was companies which saw a decline in their loan book. Shriram Transport Finance which already has 8% gross NPAs, mediocre ROE profile (12%) and moderate valuations (P/B of 2.1) did not fall much as the stock price was probably already depressed. Surprisingly, Muthoot Finance and Manappuram – both gold loan lending businesses have given +ve returns. Goal loan lenders are the safest lending business because the collateral – gold has a ready market and is already in possession of the lender. In case of default, the lender can easily and quickly sell the gold collateral and recover its money.

Sometimes, despite a lot of data analysis and good process, one can get stuck in bad stocks. A way to avoid this is study the history of the company. Liquidity crises keep recurring at frequent intervals and the performance of the lending business during such periods is the litmus test of separating below-par businesses from investable businesses. Unless they drastically change their way of conducting business, lending businesses that struggled during this liquidity crisis will probably repeat a similar performance in the next crisis.