Arman Financials

Investment Case – Ajit Agrawal

Microfinance co. with a rare combination of Growth and Conservatism

Arman Financial Services Ltd. (Arman) is a **diversified Gujarat based NBFC that is focused on Microfinance, 2W & MSME** lending. Gujarat accounts for ~50% of the Rs722cr AUM, while MP, UP & Maharashtra account for the rest.

It was founded in '92 as a leasing NBFC and moved into the 2W segment in '98. It formed its MFI subsidiary (Namra) in '10, which **provides loans under Joint Liability Group model (JLG)**. Recently the company has ventured into MSME financing.

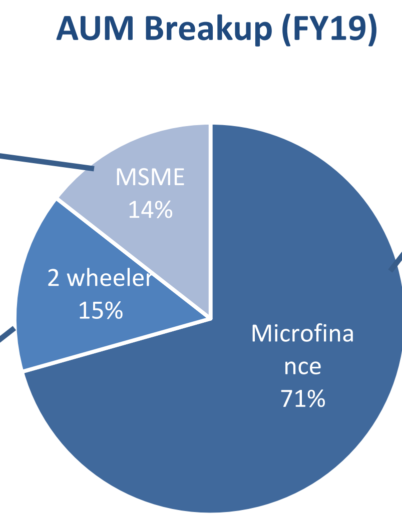
Arman's **target segment is mostly the unorganized & underserviced segment** of the economy & mostly in niche markets. 89% of Arman's customers are women of which, 84% are located in rural areas and are using the loans for income generating activities to increase household income.

It has received a Investment Grade Rating of BBB+ and **MFI-2+ Grading (one step below highest possible MFI rating)**

Significant investment in process improvement: 100% Cashless Disbursement Model will reduce cost and risk; Moved towards ERP based system with mobile based support, Geo-location based tracking leading to Efficient route tracking, etc.

These are non-salaried individual non-group unsecured loans, providing financial support to SMEs operating in rural India deprived of formal funding options;
MSME model is much similar to MFI model with door step delivery & small ticket size of loans;
Newest vertical, holds the potential to emerge as an important business and profitability driver;

Oldest business vertical & concentrated in Gujarat;
Urban centric business, and under pressure due to huge competition and higher borrowing cost of company. Thus started focusing more on rural 2w financing



MFI business is through its wholly-owned subsidiary Namra Finance
Unsecured loans exclusively for income generating activities to women of economically poor and socially neglected communities
Follows the JLG model with a 16 member group & focuses largely on rural lending.
Average ticket size is ~Rs 21,000.

Microfinance Industry

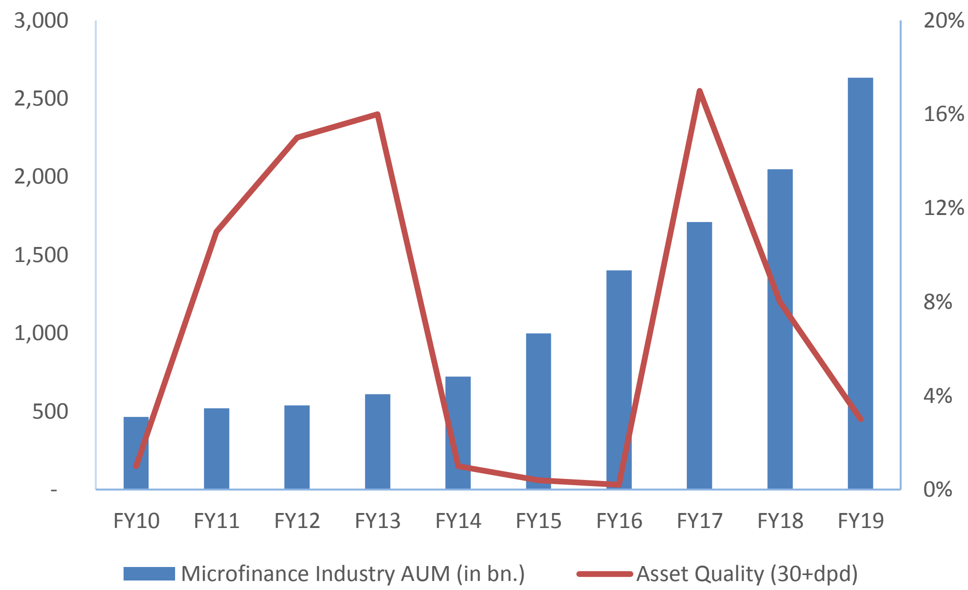
- Rural Areas account for half the GDP but less than 20% of banking credit
- Microfinance Loan has grown at 30%+ in the last 5 years, still credit penetration in rural areas remains low (MFI Loans-GDP ratio is just 0.59% in India)
- Characteristics of Microfinance: Lending to women by forming a Joint Liability group, Not price sensitive, Manpower Intensive, Loans qualifies for PSL for Banks
- Consolidations in MFI space: 1) Kotak - BSS Microfinance Merger; IndusInd - BFIL; DCB – Annapurna
  2) Bandhan – Banking license; Ujjivan, Equitas, AU – Small Finance Bank license
- Highly regulated following AP crisis: 10% margin cap; ticket size cap of 60,000; no collateral can be taken;
- Microfinance seems risky and cyclical, but default risk depends on geography and credit practice of the MFI (currently stress building up in West Bengal and north east)

MFI sector is characterized by stress events occurring every 5-6 years:

2008: National farm loans waiver, that let to confusion and moral hazard among borrowers impacting MFI loans

2011: AP Crisis - AP had built excess exposure to micro loans due to huge competition. Following several incidents of wrongful recovery practices, the state government came out with hard regulations with respect to MFI practices, impacting the AP MFIs negatively. This, in turn, led huge write-offs.

2017: Demonetization – Inadequate currency supply and political interferences in some states impacted collection efficiencies

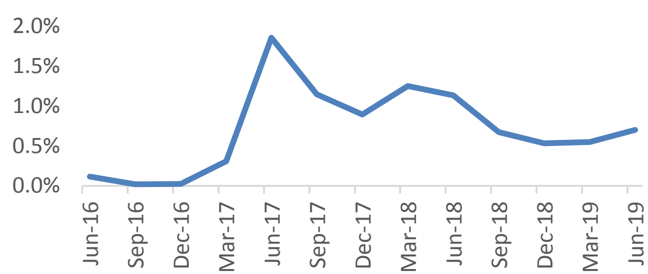


Two Evaluation Parameter: Asset Quality & Liability Franchise

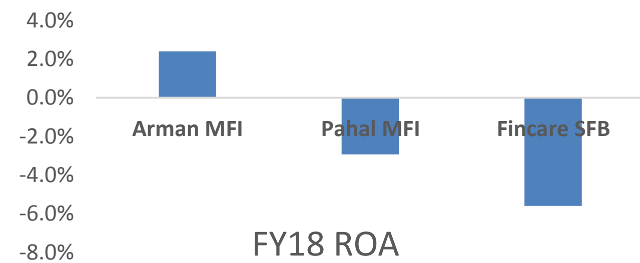
Asset Quality – tested during Demon

- One of the best asset quality in MFI industry with GNPA being 0.55% for FY19 for MFI loans.
- Robust Credit Appraisal Quality with high rejection rates & lower NPAs
- MFI Industry was severely impacted during Demon, Industry repayment rates reduced from 99% to 70%
- Arman held off on disbursements for 4 months, resulting in decline in AUM. Managed to end up with PAR60 of 4.3% in FY17 vs 9.8% for the industry
- After stabilizing the assets, Arman entered new states of UP & Maharashtra to capture space vacated by other players (such as Satin);

Arman's NPA during Demon Period



Post-demon comparison with other MFI in Gujarat



Liability Franchise – tested during IL&FS crisis

- Adequately capitalised with a conservative leverage ratio of 6.3x, after raising funds from SAIF partners.
- Raised adequate funds due to the long term relationship, despite significant headwinds following LI&FS crisis
- No ALM mismatch as focus is on low ticket size loans
- New sources of funding: Multi-originator securitization transactions, foreign NCD transaction,
- Conservatively maintains 2months extra cash reserves, which despite being a negative carry is a prudent measure for adverse market condition

Investment Rationale

Huge Growth Runway Ahead:	AUM/PAT growth of 59%/39% for the last 3yrs even after Demon & liquidity crisis; Strong growth runway ahead due to: low base, low rural credit penetration, growth from new segments (MSME financing & rural 2w financing)
Robust Profitability:	ARFL has maintained high NIMs of 12-13% and decent ROAs of ~5%. Going forward, this returns will be supported by AUM growth and improving operating leverage.
Industry's best asset quality:	Company has showcase excellent risk management during downcycle by sacrificing growth for risk, which was seen during demon. Amidst volatile asset quality and high delinquencies in the BFSI sector, Arman has built its portfolio on a prudent basis reflected in its stable asset quality (10Y avgNPA <1%)
Geographically Well Place:	West and North India are most underpenetrated regions for MFI loans. Enjoys a strong position in Gujarat - Top3 Player, strong brand name and 20 yrs of presence. Rural Focus rather than focusing on Urban customer by other NBFCs.
Great Capital Allocation Track record:	Good track record of Capital Allocation, by exiting segments where the co. has felt their competitive edge is weakening or if the sector is likely to face headwinds (lease financing, 3w financing). Their overall approach is focused on responsible growth, which is a rare trait in the MFI industry.
MSME segment is promising:	This segment shares broadly common customer profile with MFI segment but with higher NIM & RoAs. Focus is to establish presence in areas that are un-served/unpenetrated market with low competition.
Efficiency with increase in scale:	With increase in scale, the AUM/branch & Ticket Size will improve adding to margins. Robust systems are already in place: Cashless disbursements, centralized credit checks, Geo-location based tracking

Key Risk

- Competition from Small Finance Banks, FINTECH disruption and Jan Dhan overdraft loan facilities
- Risks from regulatory changes & geographical expansion (expanding rapidly into UP, Maharashtra)

Financial Analysis and Projections

Operating Parameter	FY17	FY18	FY19	FY20E	FY21E	FY22E	Comments
AUM (in mn.)	**1,839**	**4,233**	**6,869**	**10,199**	**14,227**	**18,966**	AUM is expected to grow at 40% for the next 3 years led by growth in MSME segment
growth (%)	7%	130%	62%	48%	39%	33%	
Microfinance (% of total)	56%	68%	71%	69%	67%	65%	MFI share in total portfolio will decline, as MSME portfolio is growing rapidly
2 wheeler (% of total)	41%	21%	15%	12%	10%	8%	
MSME (% of total)	3%	11%	14%	19%	24%	27%	
AUM Growth	*7%*	*130%*	*62%*	*48%*	*39%*	*33%*	Around 1/3 of the growth in AUM is contributed by increse in Ticket Size; This trend is likely to contnue as Avg ticket size is still lower than Industy's average of 25,000
MFI Customers	102,716	198,751	273,071				
MFI Avg Ticket Size	10,049	14,463	17,767				
Profitability							
Interest Yield (%)	*29%*	*25%*	*24%*	*25%*	*24%*	*24%*	Yields to remain stable led by higher MSME yields
Cost of Borrowing (%)	*15%*	*13%*	*13%*	*14%*	*14%*	*14%*	100bps increase in Borrowing cost post IL&FS crisis
NIM (%)	*17%*	*13%*	*13%*	*13%*	*13%*	*12%*	
Net Interest Income	294	397	723	1,147	1,564	1,977	
PAT	63	73	213	367	527	657	PAT will improve let by operating efficiency and lower credit costs
RoAUM	3.6%	2.4%	3.8%	4.3%	4.3%	4.0%	
RoE	13%	14%	23%	25%	27%	25%	
Operating Efficiency							
Cost to Income (%)	57%	60%	50%	49%	47%	47%	Stable due to expainsion into new branches; in the LT this will decrease
Employee Cost/ AUM	5.7%	5.4%	4.7%	4.6%	4.2%	4.0%	Declining due to: maturing branches, increasing ticket size & inv. in IT
Loan per MFI Branch	13.6	18.3	28.2				Still scope of Improvement (Industry Avg. is 5cr loan per Branch)
Asset Quality							
GNPA (%)	1.4%	1.7%	1.0%				
NNPA (%)	1.1%	1.6%	0.9%				
Credit Cost (%)	1.9%	2.5%	1.5%	1.5%	1.5%	1.4%	Cost were elevated in FY17-18 due to impact of Demon

Valuation vs. peers

MFI Peers	FY19 AUM	3Y AUM growth	GNPA	Cost-Inc Ratio	ROA	ROE	Mkt. Cap (in mn.)	Price/Book		P/E		FY19 P/AUM
								FY19	FY21E	FY19	FY21E	
Arman Financial	6,869	59%	0.6%	50%	3.8%	23%	4,547	3.5	1.7	21.3	7.1	0.7
Satin Creditcare	70,680	29%	2.9%	54%	3.1%	20%	13,320	1.1	NA	6.2	NA	0.2
Spandhana Sphoorty	44,373	54%	0.1%	25%	8.2%	19%	68,670	3.6	NA	17.8	NA	1.5
CreditAccess Grameen	71,590	41%	0.6%	34%	5.0%	16%	90,700	3.9	NA	27.2	NA	1.3
Bharat Financial Inc.	173,940	31%	0.8%	39%	5.7%	27%	125,948	3.0	1.9	13.0	9.3	0.7
Bandhan Bank	447,800	42%	2.0%	33%	4.2%	19%	667,370	6.0	4.4	34.2	20.6	1.5

Note: Data for Arman is after adjusting conv. debentures and class ‘A’ shares; Source: Bloomberg, Company data; Data as on FY19

Arman Scores comparatively better in almost all the parameters against its peers, except on Cost-Income ratio which is understandable given small size of the company.

With a long term track record of superior risk management, the potential to grow its loan book north of 40% over the medium term and a management with the right approach to capital allocation, valuations of ~1.7x FY21E B/V is attractive.