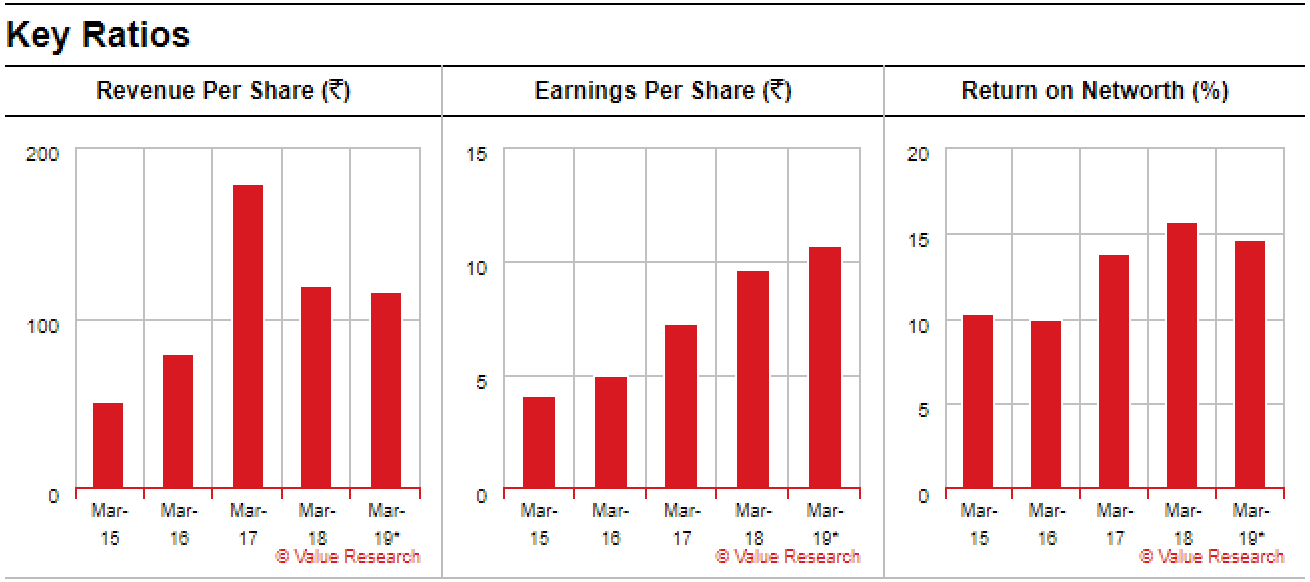
Edelweiss

Analysis and Valuation

Disclaimers

- No current holdings in Edelweiss as of 16-June-2019
- This is not a BUY / SELL / HOLD recommendation
- I am a hobbyist not a SEBI Registered Advisor
- Views are personal

Edelweiss – A well run, agile but complicated NBFC



Credit
- Retail Credit
- Corporate Credit
- Distressed Credit

Franchise & Advisory
- Wealth Management
- Asset Management
- Capital Markets

Insurance
- Life Insurance

For Investment Case

- Existing businesses are de-risking and becoming more efficient
- Growth businesses yet to fire
- Diversified with countercyclical businesses (no business line contribution more than 20%)
- Management quality

Against Investment Case

- Unknown stress in existing businesses
- Liquidity, ALM, Credit Quality challenges
- Loss making insurance business
- Cost/Income higher than peers (LT Fin, Piramal)
- Increasing funding costs and deleveraging
- Exposure to all risks (currency, credit, liquidity, market, policy etc.)

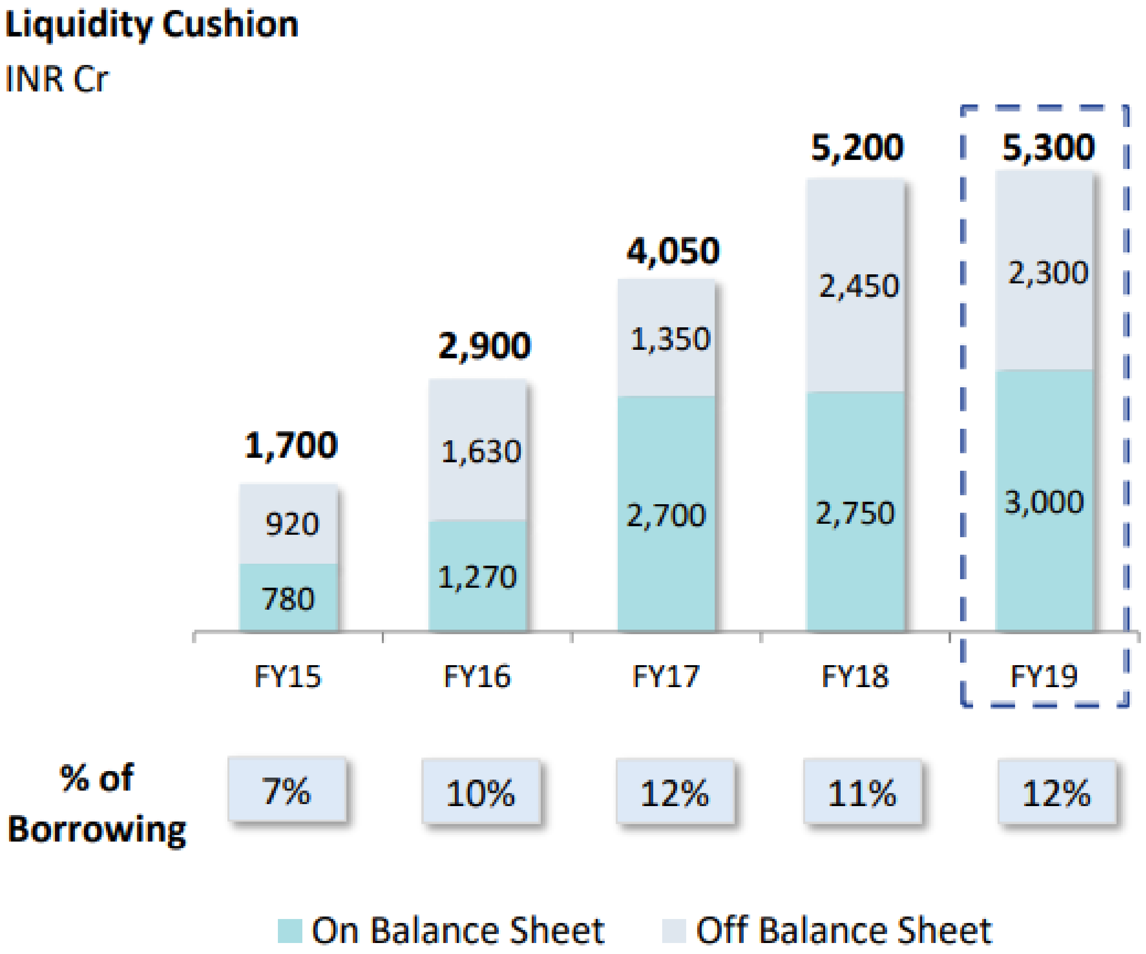
But things have changed ..

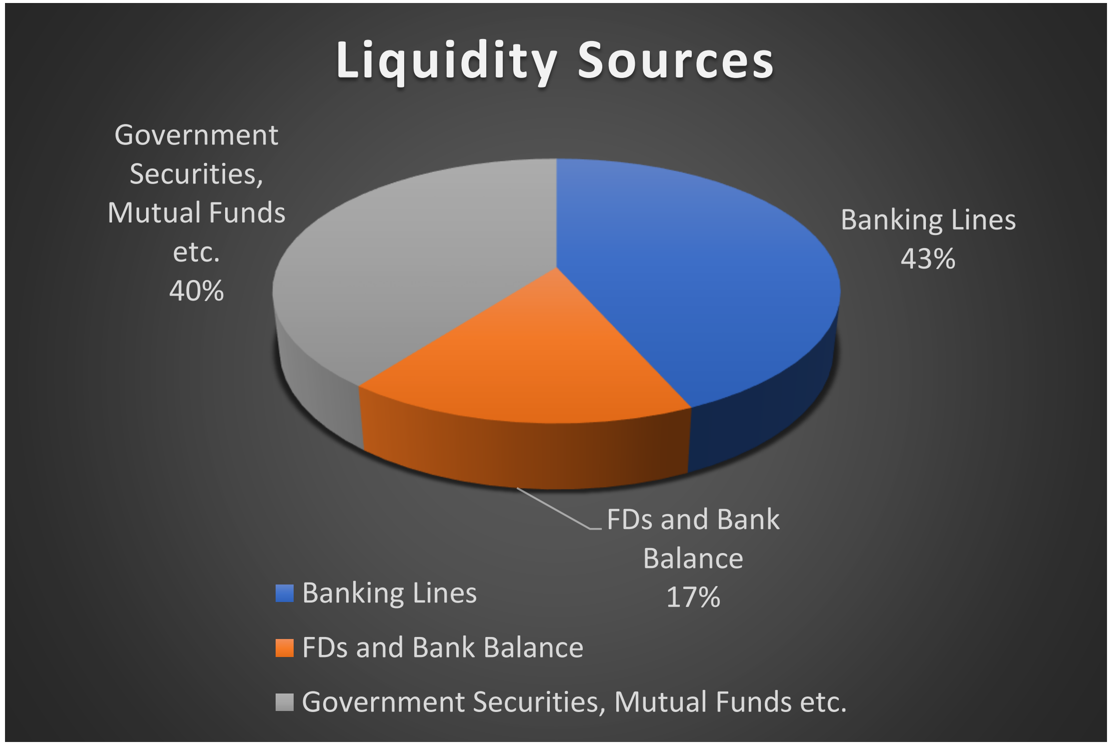
2017 Plans ☹ ☹

We are now focused on scaling up existing businesses

Liquidity = Liquidity cushion + HQLA (liquid assets)

Liquidity Cushion is 12% of borrowings





... Avg Mutual Fund contribution to funding mix of NBFCs is roughly 17%

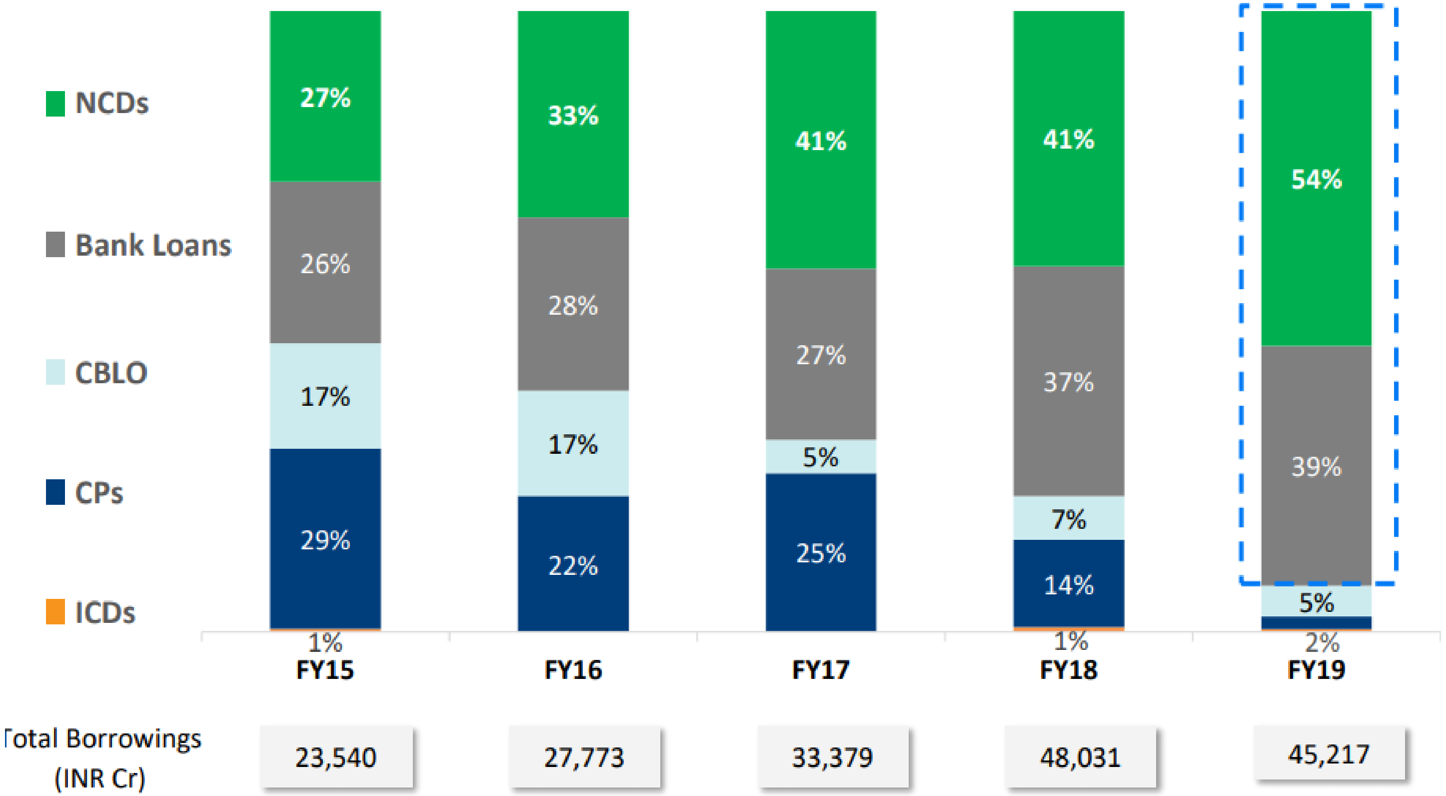
Liquidity = Liquidity cushion + **HQLA (liquid assets)**

As on 31st March'19 (INR Cr)

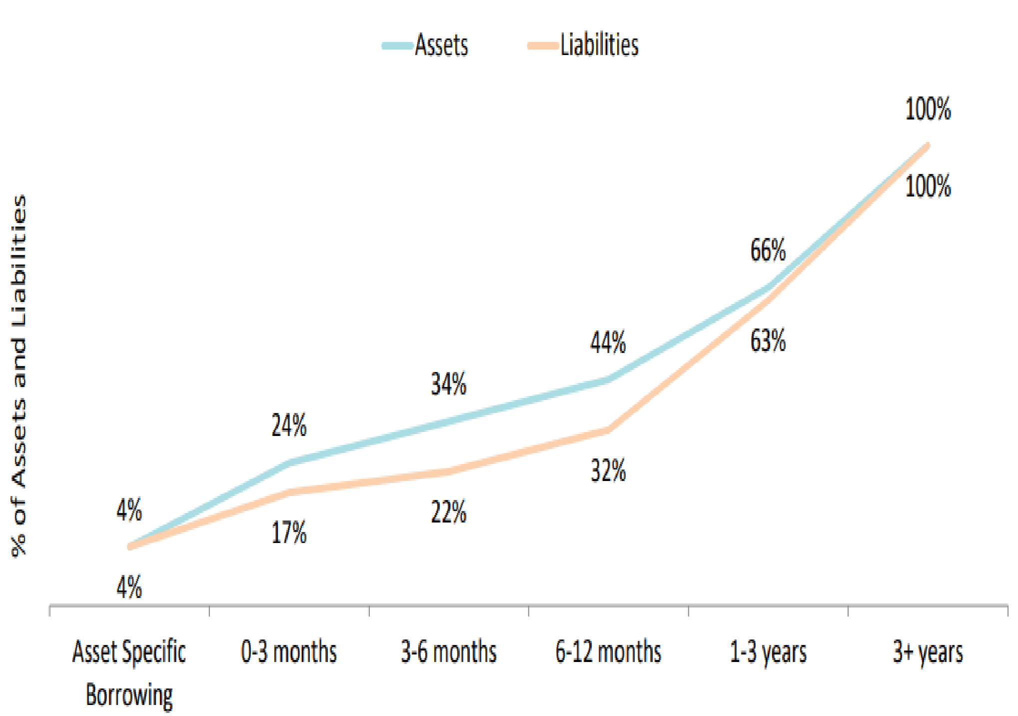
Overnight Liquidity	5,300
Assets Liquid-able in less than 120 days	4,750
Total	**10,050**

- Total Liquidity = 10050 + 5300 = 15,350 crores (35% of total Loan Book of 43000 cr)
- AMPLE LIQUIDITY !!

ALM situations looks good…



93% of borrowings are from NCDs and Bank Loans; Reduced reliance on CPs



Only 32% liabilities have tenor of less than an year…

- All in all, Long Term Assets matched by a Long Term Borrowing profile
- 45% borrowing comes from banking relationships
- “We never used Commercial Paper for ALM arbitrage.” – Rashesh Shah, Q2FY19 concall

Rising Rates? Only 15 bps hit on lending margins..

Renish Bhuva: Why I am asking is because given our outlook that the first half FY20 would be slightly muted in terms of the credit growth and we are sitting pretty high in borrowing book as of now. So, do we expect margin to decline or will we be able to pass it on if there is a negative carry on the borrowing side, how do you see the scenario?

Rashesh Shah: I think it is an important question. We have seen our cost of funding on an average go up by about 100 basis points in H2 versus H1. In a way it is very ironical because H2 is the one RBI has cut rates, so your repo rate has come down, your average funding cost depending on players have gone up. Our experience has been an increase in cost of almost about 100 basis points in H2. 100 basis points increase in cost of incremental borrowing translates to about 35 basis points on average cost of funding. It was only about a third of your resources are getting repriced because about two-thirds of our borrowing is also more than one year. So, in any year about a third of our borrowings will get repriced. So, if you pay 100 basis points higher cost on new borrowing, your average cost of funding should go by about 35 basis points. Out of that I think around 20 basis points we have been able to pass it on to our customers. We have also repriced some of the assets and the loans we have and we are continuously evaluating given the market conditions and competitive expectations. We continue to try and see whether there is any repricing opportunity available. We have already passed on almost about 20 basis points out of the 35 basis points change in funding on the assets side and we have in the second half

Price elasticity

Of 100 BPS incremental increase in borrowing cost,

35 BPS gross impact on margins, of which 25 BPS passed on to borrower

i.e. only 15 BPS net impact on margins

Real Risk #1 – Wholesale Real Estate Exposure

Expert take: Why loss given default is a better measure of banking stress

A high GNPA ratio is an indicator of the deficiencies in loan approval and underwri

ET CONTRIBUTORS | Updated: May 23, 2017, 08.28 AM IST

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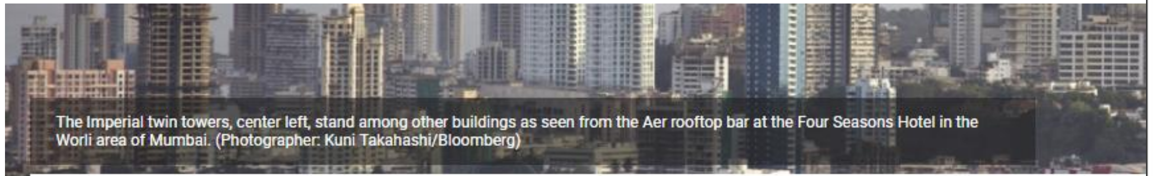
0 Comments

By Rashesh Shah



The Imperial twin towers, center left, stand among other buildings as seen from the Aer rooftop bar at the Four Seasons Hotel in the Worli area of Mumbai. (Photographer: Kuni Takahashi/Bloomberg)

Megacity Mumbai Records Back-to-Back Home Price Declines in 2018

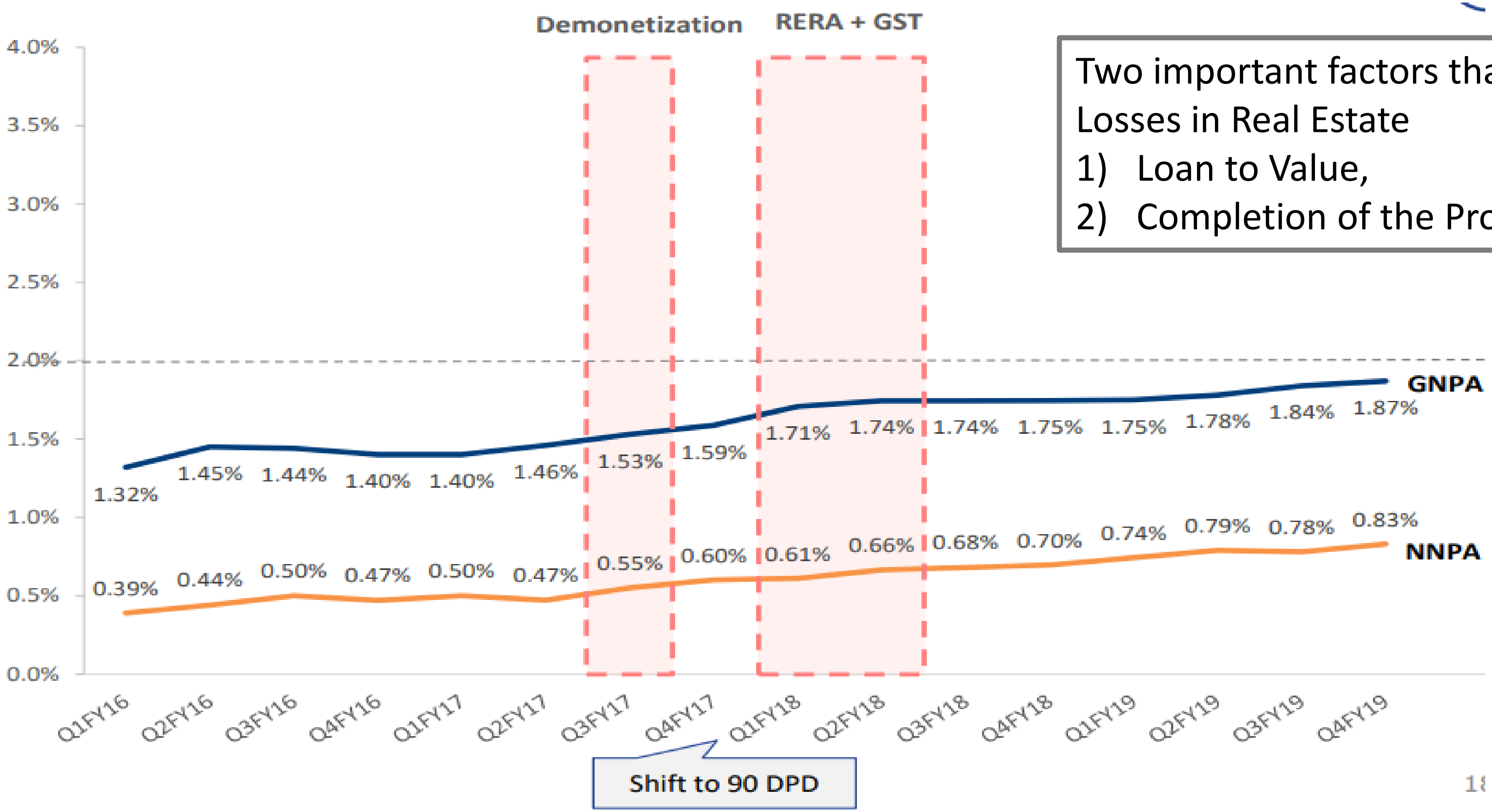
Sameer Baisiwala: And we should be comfortable that there would not be any impediments coming from any court order, BMC or any government bodies?

Vikas Oberoi: So government bodies have cleared it so I hope they don't, but one can never predict so we are keeping our figures crossed and we are working towards what we want to build. All this is very uncertain in India, anything can happen on any project. We bought Mulund land from Glaxo, title certified by a reputed law firm and then somebody tells us that this is forest even though there was a factory running for the last 50 years, so anything can happen. I am only going to pray and hope that nothing happens.

- Gross NPA is a measure of underwriting quality
- Net NPA is roughly = Gross NPA – Provisioning expenses, trouble here is Provisioning expenses can seriously underestimate losses
- Loss Given Default calculations are far from perfect –> as real estate collateral is often not recoverable or enforceable

Prima Facie Provisioning/LGD seems adequate…

- Rather than write off the bad loans, as they occur, banks/nbfcs usually create provisions for losses that average out losses over time and charge this amount against earnings every year
- But if provisioning fails to meet shortfall upon a real loss –> there will be loss incurred in the same year
- A lot collateral and real estate appraisal and valuation is based on PSEUDO Cash flows



Two important factors that determine Losses in Real Estate
1) Loan to Value,
2) Completion of the Project

Prima Facie Provisioning/LGD seems adequate…

UBS

Global Research

7 July 2015

YES Bank

Rising credit costs not priced in; downgrade to Sell

Loans approved to potentially stressed companies up 300% in three years

YES Bank has outperformed its peers in the corporate banking space, with impaired assets of 1.2% (compared to 5-16% for SOE banks, ICICI and Axis). However, our study indicates that loans approved to potentially stressed companies have increased significantly (up 3x) in FY12-15—these loans could be at risk given a gradual economic recovery and continued stress in sectors such as steel, power and construction. Loan approvals to our sample set of companies are estimated at 125% of net worth and 19% of outstanding loans.

Concentration on large groups have risen significantly in three years

Equities

India

Banks, Ex-S&L

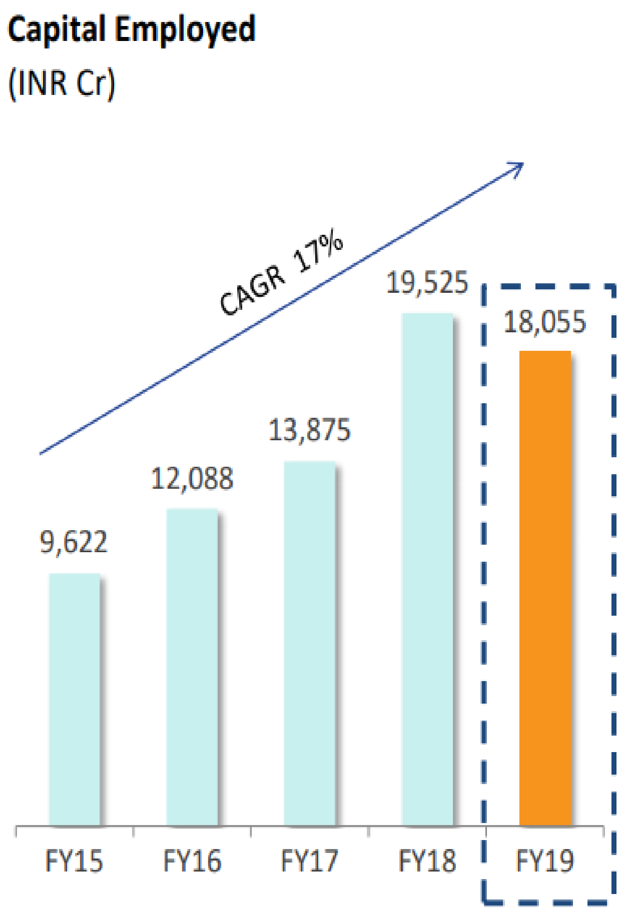
12-month rating	**Sell**
	Prior: Buy
12m price target	**Rs740.00**
	Prior: Rs1,000.00
Price	**Rs869.70**
RIC: YESB.BO **BBG:** YES IB	

Trading data and key metrics

52-wk range	Rs883.35-509.95
Market cap.	Rs361bn/US$5.68bn

Wholesale Book – De-risking but is it enough?

- About 60% of Lending Book is wholesale
- Concentration risk: 10 largest loans constitute 18-20% of the portfolio & there are 65 real estate accounts
- 50% exposure in wholesale book is to real estate assets – collateral here is land (LTV is 50-60%)
- About 1/3rd of the exposure is to MMR, Mumbai and Pune



Corporate Credit	Cr	
Structured Collateralized Credit	6,456	Customized credit solutions with robust risk management systems. **Recovery rates are high**
Wholesale Mortgage	**11,599**	Developer financing for primarily residential properties

- Historically, < 20% Loss Given Default in wholesale book
- Real-estate crisis: Assuming 20% of accounts default (~2400 crore)
- 50% LGD for entire developer loan book (i.e. 1200 crore)
- That's 1200 crore LOSS or Money Never Recovered – rest 50% will be recovered slowly after re-structuring and arbitration (recognized only on CASH BASIS only)
- Provisioning is currently only 1.5% of total loan book while losses can be 15% (0.3 x 0.5), i.e. 10 times

Impact of Real Estate defaults

	Wholesale Mortgage	H1FY19	H2FY19
1	Loan Book	INR 11,758 Cr	INR 11,599 Cr
2	Stage 3 Accounts	5 accounts amounting to INR 346 Cr	3 accounts amounting to INR 208 Cr
3	Historical recovery on default cases	84% cash recovery and rest in other assets	84% cash recovery and rest in other assets
4	Provisions on the books (voluntary provisions)	INR 242 Cr	INR 163 Cr

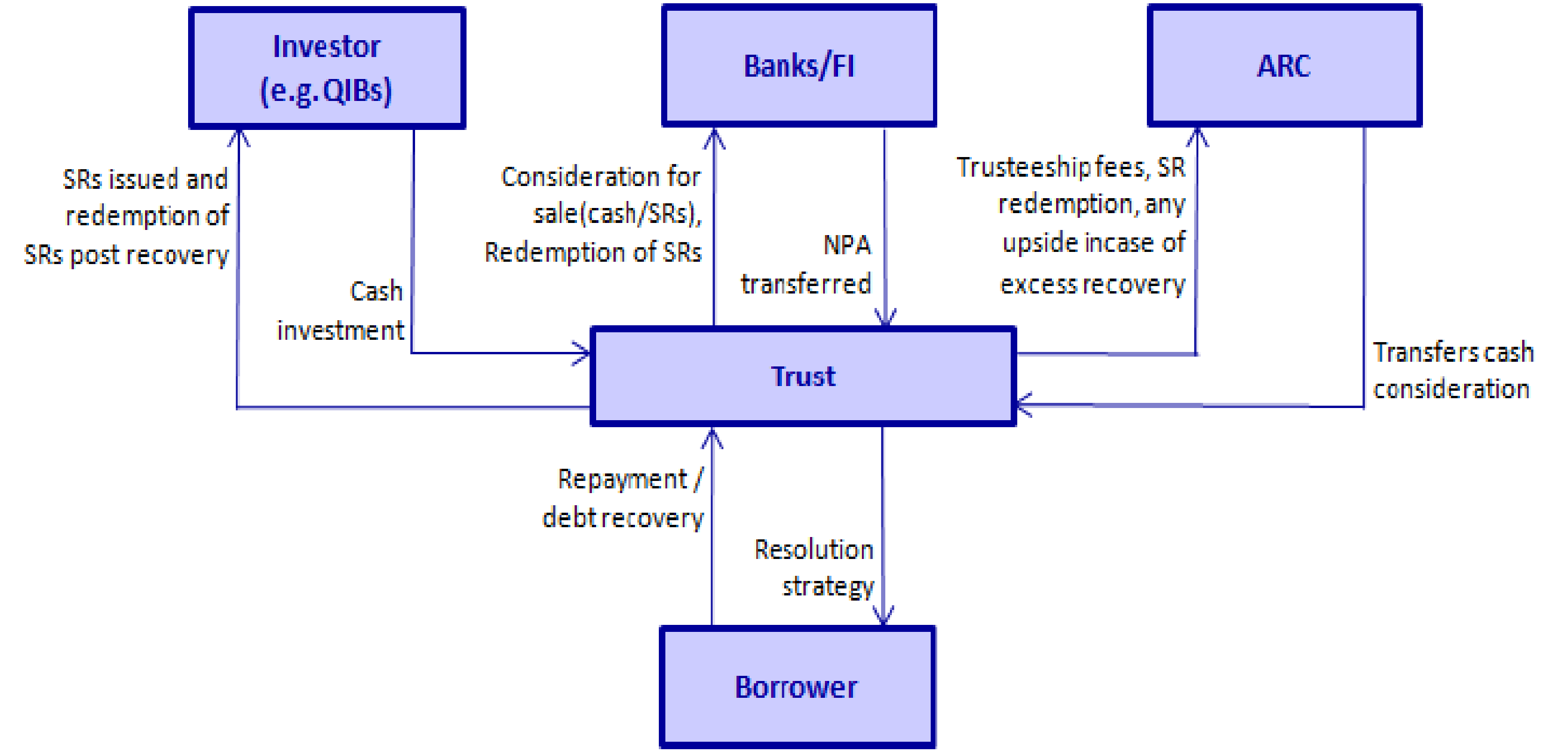
"Our industry interactions indicate that 15-**20**% of real estate debt may be stressed. Signs of stress should be visible from 1HF20 onwards as liquidity gets tighter."

- CLSA

- Only 1.5% voluntary provisioning as percentage of wholesale mortgage book
- 1200 crores in write down will not be covered by provisioning
- If FY 20 profits are 1200 crore (1100 crore in FY19), company will make no profit
- Collections and funding will be impacted as foreclosure and settlement in real estate is a long term process

Real Risk #2 – Off Balance Sheet sensitive to Macros

Exhibit 7: Typical sale process in the form of cash and security receipts



Source: MOSL, ARCIL

- 39000 crore of distressed assets held via Trusts/SPVs
- What is the consideration/control of Edelweiss in 39k crore of AUMs under Trusts/SPVs? What portion of these assets are consolidated on balance sheet?
- If economy goes bad, no management fee, only bad assets? (charity business instead of lottery business?)

Real Risk #2 – Off Balance Sheet sensitive to Macros

As on 31st March'19 (rounded off to nearest 100)	INR Cr	YoY Growth
Customer Assets	**2,00,900**	**19%**
Assets Under Advice (Wealth Management)	*1,06,000*	*18%*
Distressed Credit (ARC Assets)	*39,200*	*4%*
Funds under Management (Asset Management)	*35,800*	*26%*
Assets under Custody & Clearing	*19,900*	*56%*
Balance Sheet Assets	**53,900**	**(3%)**

- Balance Sheet Assets are de-growing, while AUA/AUM based business is growing
- Edelweiss is primarily an Agency business and not a Capital business

Risks Summarized

Provisioning losses:

- Write offs will cause Edelweiss to be downgraded – but even assuming no more funding from MFs or off-balance sheet High Quality Liquid Assets of 10,000 crore should be sufficient to meet near term requirements
- Risks therefore are not of liquidity or solvency but of losses and deterioration of the credit book
- Makes sense to value based with no growth basis (EPS growth has already fallen from 50% yoy to 15% yoy)
- Makes sense to value at adjusted book value (Adjusted for impairment)

Increasing costs:

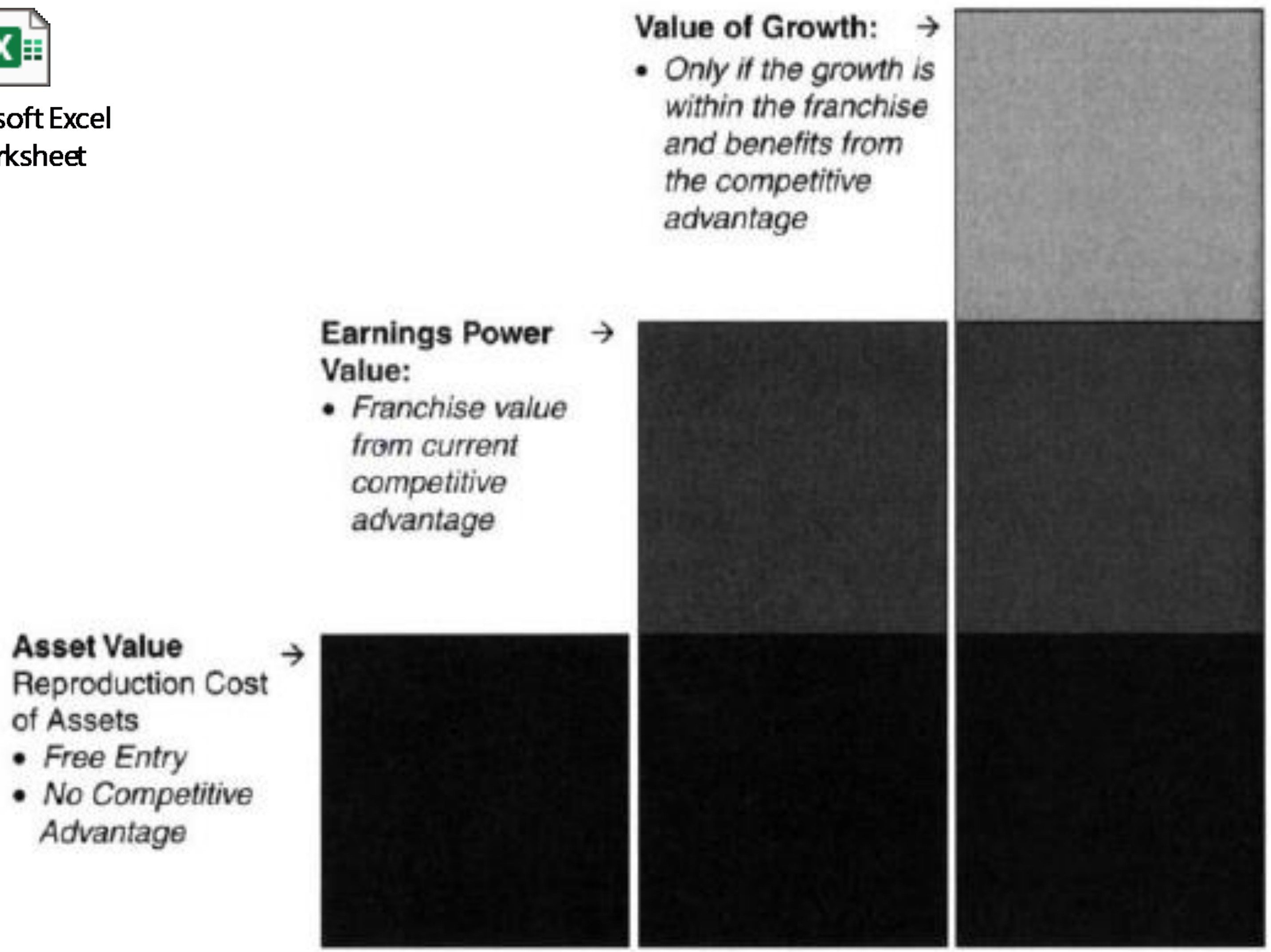
- Operating costs are already high (C/I ratio has increased), Interest costs on Capital business may also add to it
- Already high Cost to Income ratio will shoot up with recovery costs in case of rising NPAs and defaults
- Interest costs may keep on increasing for NBFCs
- 100 crore cost and investment per year into General Insurance subsidiary

ARC assets and related party risk:

- Economic stress can trigger ARC assets owned by Edelweiss turning into liabilities. Liquidity of 15k crore and Regulatory Capital of 10k crore may prove inadequate to cover 76 crores of assets (36 + 40)
- Assets under Management including ARC are 4x the Balance Sheet
- ARC structures may hide complex intercompany relationships and risks (more on this later….)

Valuation

Microsoft Excel Worksheet



- Wealth Management, Alternate Investment
- M&A, Capital Markets Advisory
- **(Low capital employed, High ROE)**

- Mutual Fund
- ARC
- **(High risk, High ROE)**

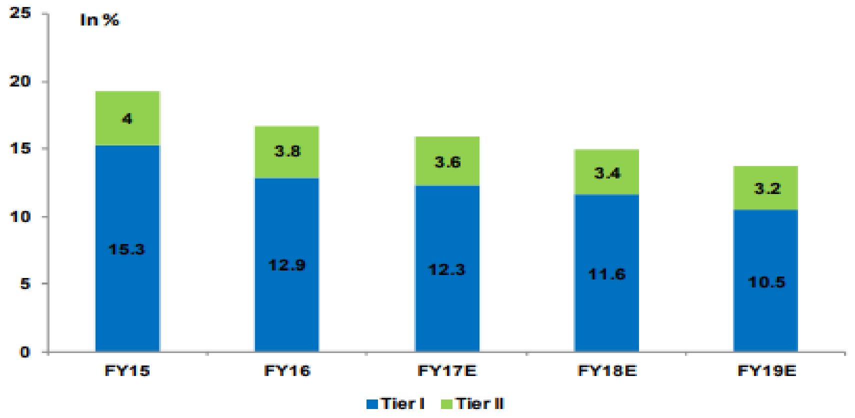
Book/Asset Value or; Regulatory Capital

Management Quality – Meets and Exceeds Expectations

Wholesale book share to dwindle to 53% on the back of faster growth of retail book

Meeting targets : Ventura projection in 2017 of changing loan book composition (currently Wholesale book share is around 53%)

High Capital Adequacy to drive future growth

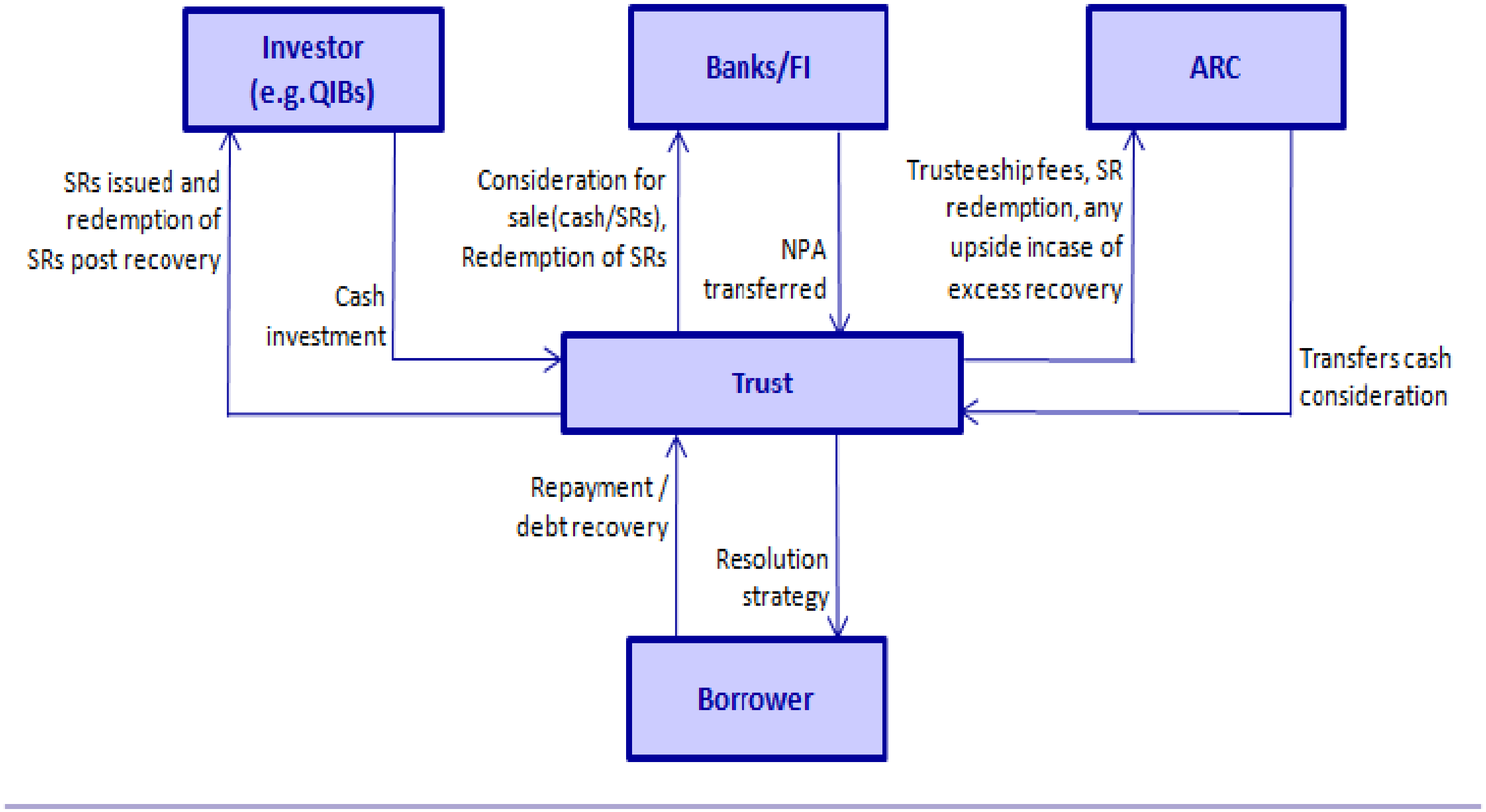


Source: EFSL, Ventura Research

Exceeds Targets: Regulatory Capital is 18%, way above expected 14% projected for 2019

Asset Reconstruction Company

Exhibit 7: Typical sale process in the form of cash and security receipts



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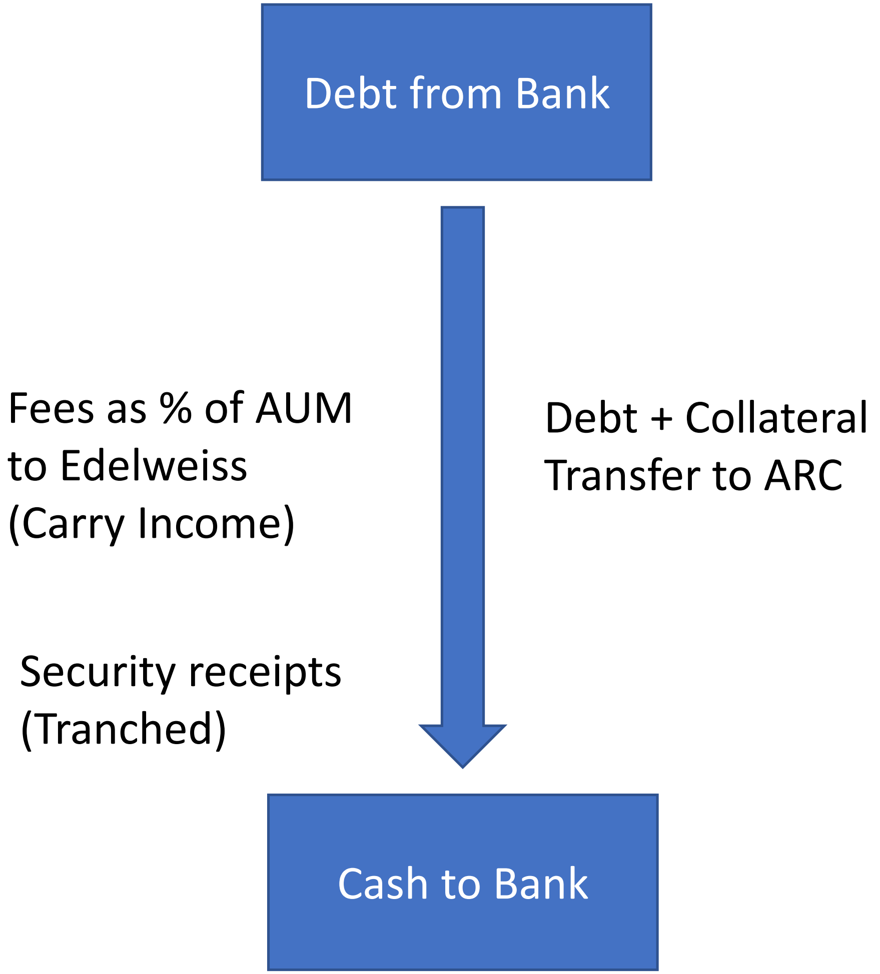

- Vega City Mall (Banerghatta road)
- Essar Steel, Binani Cement etc.

Asset Reconstruction Company

1.3 Revenue recognition

1. Management fee: The Company receives management fee from trusts declared by it for acquisition of financial assets and the same is accounted for on accrual basis (net of Good and Service Tax / Service Tax) as per terms of the relevant trust deeds and offer document issued by the Trust. In accordance with the Guidelines, recognition of management fee is discontinued and such unrealised fee is reversed on earlier of the following situations:

   (i) If the fee remains unrealised after the expiry of 180 days from the end of planning period, wherever applicable or from the date of recognition, in other cases.

   (ii) If Net Assets Value (NAV) of the Security Receipts falls below 50% of the face value of Security Receipts.

   Such unrecognised fee is recognised only after realisation of outstanding fees.

2. Upside sharing: Share in excess realization over acquisition price is accounted for as per terms of the relevant trust deed/offer document. For acquisitions on or after 23rd April, 2014, upside income is recognized only after full redemption of Security Receipts

3. Other fee net of (Good and Service Tax / Service Tax) is recognized on accrual basis as per contractual terms.

4. Income by way of yield on Security Receipt is accounted for as and when the same is realized. For acquisitions on or after 23rd April, 2014, yield is recognised only after the full redemption of the entire principal amount of Security Receipts.

Fees Income

Interest and Upside on Security Receipts

ARC: How it works - Vega City Mall

1. Distressed debt (NPA) of Rs 313 crore purchased from SBI and Bank of India in 2014
2. Collateral also transferred (Vega City Mall)
3. Structure 5:95, 5% paid upfront to banks, 95% as security receipts payable over 5-7 years (Regulatory norms now require atleast 15:85 ratio)
4. Mall space leased out to PVR etc.
5. Mall became profitable, banks receive Rs 400 crore in security receipts – write-back loans
6. Receipts can be sold or converted into equity
7. WIN WIN for ALL

ARC - **Risks**

Distressed Asset Business – Not Distressed Debt (heads I win, tails I don't lose much)

- Distressed AUM: 42000 Crore – held under ECL Finance. **How are they doing?**

- Edelweiss ARC will also have to redeem a large number of security receipts (SRs) to banks for the 600-odd portfolio companies

- Once the company goes to NCLT, the stressed company is out of control of ARC or lenders

- No steep discount: As per RBI guidelines, banks are required to sell NPA at a reserve price, which should generally be not lesser than NAV based on the estimated net realization from the account. This leaves very less margin of safety for ARCs

- **A large part of Security Receipt redemption will be due in the next two-three years as bulk of the assets were acquired after 2014 (5-7 year period)**

ARC – **Risks (continued..)**

- Complex structure (300 Different Trusts) and Inter-party transactions (i.e. Trust borrowings from and NCDs held by loss-making Edelweiss Tokio Life & ECL Finance)

	Balance with related parties			
24	Interest expense accrued and not due on borrowings from	Edelweiss Tokio Life Insurance Company Limited	3.27	3.09
		Edelweiss Commodities Services Limited	-	0.39
25	Receivable from	Edelweiss Financial Services Limited	0.01	0.01
		Edel Commodities Limited@@	0.00	-
		Edelweiss Alternative Asset Advisors Limited@@@	0.00	-
		Edelweiss Commodities Services Limited@@@@	0.00	-
		Edelweiss Finance & Investments Limited@@@@@	0.00	-
		Edelweiss Agri Value Chain Limited	0.03	-
		Edelweiss Securities Limited	-	0.06
		ECL Finance Limited	31.27	0.19
		Asset Reconstruction trusts - managed by the Company as trustee	593.70	997.94
26	Payable to	Edelweiss Multi Strategy Funds Management pvt Ltd	0.07	0.07
		Edelweiss Alternative Asset Advisors Limited	44.43	1.68
		Edel Finance Company Ltd@@@@@@	0.00	-
		ECL Finance Limited	0.19	-
		Edelweiss Financial Services Limited	16.27	-
		Edelweiss Business Services Limited	36.01	0.14
		Ecap Equities Limited	-	0.53
		Edelweiss Broking Limited	-	0.63
		Edelweiss Tokio Life Insurance Company Limited	0.11	-
		Edelweiss Commodities Services Limited	7.13	-
27	Non-convertible debentures held by	Edelweiss Tokio Life Insurance Company Limited	300.00	300.00
		EFSL Comtrade Limited	1,500.00	1,500.00
		Edelweiss Commodities Services Limited	4,840.62	2,381.00
		ECap Equities Limited	256.00	-
28	Short term loan including ICD payable to	Edelweiss Commodities Services Limited	3,600.00	8,449.76
29	Long term loan payable to	Edel Commodities Limited	4,870.00	4,870.00
		Edelweiss Commodities Services Limited	4,989.26	-

ECL Finance – Non-current investments

Investments in securitisation trust securities			
- EARC Trust SC 7	654.34	104,500	94.40
- EARC Trust SC 9	1	71,487	92.19
- EARC Trust SC 102	352.44	768,570	277.20
- EARC Trust SC 104	-	-	-
- EARC Trust SC 223	419.05	2,337,500	979.54
- EARC Trust SC 251	1,000	1,700,000	1,700.00
- EARC Trust SC 263	709.21	1,360,000	964.52
- EARC Trust SC 283	1.00	850,000	0.85
- EARC Trust SC 308	533.57	240,550	128.35
- EARC Trust SC 314	1,000	71,400	71.40
- EARC Trust SC 329	1,000	288,000	288.00
- EARC Trust SC 297	1,000	518,470	518.47
- EARC Trust SC 331	1,000	396,720	396.72
Less : Provision for diminution in value of investments			(49.45)
Investments in units of fund			
Edelweiss Stressed and Troubled Assets Revival Fund	10,000	25,000	206.37
			5,668.56
			6,668.56
Aggregate of unquoted investment			
- **At carrying value**			6,668.56
- **Aggregate Provision for diminution in value of investments**			49.45

ARC – Triggers and Opportunities

- RBI norms for NPA resolution require mandatory creation of Resolution Plan (RP), which banks outsource to ARCs
- Distressed investing usually involves greater risk than turnaround investing, but can also offer higher returns
- IBC and arbitration laws
- Market for Security Receipts will deepen
- Strategic shift from Distressed to Stressed Assets
- Auctions don’t find takers in down cycle – e.g. VR Mall
- Oaktree has earned 17% IRR since inception in 1995

Edelweiss - Competitive Advantage

- ARC: High barriers to entry due to nature of structure and payoff. 140 people in ARC team (need large teams)
- High ROE, low Capital Agency and Advisory businesses
- Balance Sheet Management team and its expertise
- Counter-cyclic, Diversified NBFC: No business contributes more than 20%

Next Steps – FY22 Outlook

- Double Credit Book (Focus on Retail)
- Retail book from 50:50 to 70:30
- ARC and Wealth Management growth targeted at 25% per annum
- Growth opportunities: Home Loan book < 10,000 crore. SME Book < 4000 crore.

Key Questions for a Growth Investor

- ARC – Cash Cow or Growth business? Fees + Carry income on existing AUM or upside on consideration in Trusts?
- Further equity dilutions for fund raising to maintain gearing ratio?
- Banking License?
- Possible listing of subsidiaries (Edelweiss Home Lending?) will unlock value?

Appendix

Edelweiss's credit business mix as at end December 18		
Rs crore	**Amount**	**Share of total book**
Retail credit (A)	**17,756**	
Retail mortgage	8,468	20%
SME and business loans	3,967	9%
Loan against securities*	4,738	11%
Agri	583	1%
Corporate credit (B)	**17,798**	
Structured collateralised credit	7,022	17%
Wholesale mortgage	10,776	25%
Distressed Credit* (C)	**6,826**	**16%**
Total credit book (A+B+C)	**42,380**	**100%**

Corporate Structure

* Edelweiss Capital Limited has 100% holding in its subsidiaries unless specifically mentioned in parenthesis, as on 30th September 2010.

Thank you

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