Arman Financial Services Ltd.

"Arman Financial Services Limited Q3 FY22 Earnings Conference Call"

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ARMAN FINANCIAL SERVICES LTD.

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MANAGEMENT: **MR. AALOK PATEL - JOINT MANAGING DIRECTOR - ARMAN FINANCIAL SERVICES LIMITED**
MR. VIVEK MODI, GROUP CFO - ARMAN FINANCIAL SERVICES LIMITED

MODERATOR: **MR. MANJITH NAIR - EMKAY GLOBAL FINANCIAL SERVICES LIMITED**

Moderator: Ladies and gentlemen, good day, and welcome to Arman Financial Services Limited Q3 FY22 Earnings Conference Call, hosted by Emkay Global Financial Services Limited.

We have with us today, Mr. Jayendra Patel, Vice Chairman and Managing Director; Mr. Aalok Patel, Joint Managing Director; and Mr. Vivek Modi, Group CFO.

As a reminder, all participant lines will be in the listen only mode, and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal and operator by pressing '*' then '0'on your touchtone phone. Please note that this conference is being recorded.

I now hand the conference over to Mr. Manjith Nair from Emkay Global Financial Service. Thank you, and over to Mr. Nair.

Manjith Nair: Hi, this is Manjith here. Good evening, everyone. I would like to welcome the management team of Arman Financial and thank them for this opportunity. I shall now hand over the call to the management for the opening remarks. Over to you, sir.

Aalok Patel: Thank you so much. This is Aalok Patel here, and a very good evening to everyone. It's a pleasure to connect with all of you once again and thanks for joining in. The purpose of this call is to discuss our financial performance for the third quarter and nine months ended FY '22. And to also attempt to answer any questions that you may have. We have issued a detailed press release and investor presentation as always for the quarter, and I hope you had a chance to review it. I'll start with a brief overview of the industry and the business during the last quarter. And then we'll move to our financial performance.

During the quarter due to the newly evolved Omicron variant of COVID-19, there were very minor disruptions, which were thankfully very limited and had a very small impact on our overall operations. Although, the number of infections were high, the severity was much less and there was no major impact on the business and the cash flows of our borrowers. The government, RBI and other regulatory bodies are also fully supporting the banks and the NBFCs in all possible ways.

This includes unchanged interest rates, also includes RBI accommodative stance and its decision to allow relaxation to the lenders until September 2022, to comply with the new regulations for upgrading their NPAs, which as you know, which stated that an

NPA can only become standard post clearing all their dues. The budget announcements to increase infrastructure and other spending should also make sure that the positive growth momentum for the economy continues. So, the overall picture today definitely looks positive or at least much more positive than I imagined it to be a year and a half ago.

Now, I will give a brief overview on our financial performance for the third quarter and post that will touch upon liquidity, disbursements, and collections in more details. On the performance for the quarter, it gives me immense pleasure to inform all of you that our consolidated loan book, as on 31st December 2021, crossed the INR 1,000 crore milestone, reaching INR 1,045 crore. This was a milestone that was delayed for over a year due to the ongoing COVID crisis. But thanks to all the support received by our stakeholders, we have managed to cross this very important milestone. And with your continues support, we hope to cross many more milestones in the years to come.

We registered a growth of 45% year-on-year, led by the addition of more than 35,000 new customers with branches reaching optimal disbursement levels, along with the increase in average ticket size in the second cycle borrowers in the micro finance segment. Segmented AUM for micro finance stood at INR 856 crore up by 56% year-over-year, and the AUM for MSME stood at INR 139 crore, which is higher by almost 20%. For the two-wheeler segment, our AUM stood at INR 49 crore, unfortunately, down by 9% year-over-year.

Consolidated loan disbursements during Q3 FY22 stood at INR 296 crore, up by 63% year-over-year. The total MSME and two-wheeler disbursements in Q3 were INR 38 crore and INR 16 crore, respectively. While micro finance disbursement stood at INR 242 crore, higher by 64% year-over-year. This encouraging performance was mainly due to better penetration, the addition of new customers combined with an improved macro-economic environment. I would like to highlight here that while we grew our disbursements, our core focus still lies on maintaining the quality of our assets and on enhancing profitability.

Our repayment rate of the portfolio created post the first lockdown that is the portfolio created post September 2020, 18 months ago, is still hovering above 99% despite having the second and third waves in between. The gross total income during Q3 FY ‘22 stood at INR 59 crore, up by 23% year-over-year. The net total income increased by 9% year-over-year to INR 33 crore. The profit after taxes increased by 140% year-over-year to INR 7 crore, aided by the lower provisioning requirements due to better asset quality of the loans disbursed post COVID-19 since September 2020.

Consolidated GNPA stood at 5% and NPA stood at 1.1% for December 2021. The company has steadily created adequate provisions to take care of the unprecedented impact of the COVID pandemic. And I feel that the worst is definitely behind us in terms of NPA provisioning. Loan impairment costs for the quarter reduced to INR 6.6 crore. The company prudently created extra provisioning of INR 1.9 crore and took an aggressive write off INR 4.6 crore in this quarter.

Cumulative loan provisioning stood at INR 64 crore as on 31st December 2021, covering 6.1% of the on-book AUM. Overall provisioning reduced due to the better asset quality and aggressive write-offs aimed at reducing the NPA burden of pre-COVID doubtful assets.

The company enjoys a healthy liquidity position with INR 126 crore in cash and in bank balance, liquid investments, and undrawn CC limits. The consolidated debt to equity ratio stands at approximately 4.35x as on 31st December. And shareholders' equity stood at approximately INR 202 crore.

We are pleased to inform that the company has closed an INR 100 crore direct assignment transaction with SBI in January, which represents the largest DA transaction in the company's history. The ALM continues to remain positive, and the company continues to have access to new sources of funds due to the company's robust balance sheet and prudently lending practices.

Coming to the collections, collections across segments continue to improve since the last two quarters with overall collection efficiency of 94% in January 2022. Microfinance collections picked up with the repayment rates reaching 93% in January '22, despite the minor impact of the third wave. Two-wheeler and MSME collections continue to be well-north of 95% during January '22. As mentioned earlier, post-COVID disbursement loan book collection efficiency stands at 99%. While the collection seems to be getting back on track, we anticipate that they should return to pre-COVID levels mostly by Q1 of FY '23., if there are no further disruptions due to the pandemic.

Our branch expansion plan is going well on track, and we have opened 24 new branches during the month of December, January, and February till date. Our total branch network is expected to reach around 280 to 290 branches by March '22. By expanding our branch network, we will improve our penetration capabilities in geographies that we are already present in along with expanding our reach into the new geographies, such as Bihar.

Going by our asset light business model, the Capex required for each brand expansion was fairly minimal, allowing us to reach branch level breakeven quite quickly. The overall picture looks quite positive in terms of better collection efficiencies, ease liquidities, pick up in the credit demand across segments, better asset quality. Nevertheless, there's definitely some scope for improvement, which we'll be seeing in the coming few months and quarters.

I strongly believe that our strong borrower base, our resilient business model, continuous customer engagement, growing reach, robust balance sheet, passionate on ground workforce, and experienced management team will ensure sustainable and profitable growth going forward without compromising on our asset quality.

And finally, to conclude, I would like to express my sincerest gratitude to all of our stakeholders for their continued support during these very difficult times. And of course, a special note of appreciation for the company's field staffs who continue to show perseverance during these difficult times. That seems to keep on coming.

I would like to request the operator now to open the floor for the question-and-answer session. Thank you very much.

Moderator: Thank you very much. We'll now begin the question-and-answer session. Anyone who wishes to ask a question, we will '*' and '1' on their touchtone telephone. If you wish to remove yourself from the question queue, you may press '*' and '2'. Participants are requested to use handsets while asking a question. Ladies and gentlemen, even wait for a moment while the question queue assembles. Participants, you may '*' and '1' to ask the question. The first question is from the line of Anish Goyal from Goyal Services. Please go ahead.

Anish Goyal: Sir, I have noticed that percentage cost of funds has increased as compared to previous quarters, can you please give the reason for same?

Aalok Patel: I'm sorry, I didn't understand what has increased you said?

Anish Goyal: Sir, percentage cost of funds has increased compared to the previous quarter.

Aalok Patel: Percentage cost of funds have increased from the last quarter.

Anish Goyal: Definitely.

Aalok Patel: The weighted average cost of borrowing you're referring to?

Anish Goyal: Yes, yes.

Aalok Patel: So, that has overall decline, sir. I think what you might be noticing is timing differences of uploading of certain processing fees and things like that, of the increased borrowing that might get recognized right away. But overall weighted average cost of borrowing is decreasing. But if you compare quarter-to-quarter, there might be some timing differences here and there, which is making it appear to increase.

Anish Goyal: Okay. Sir our microfinance yield is also falling, what are the reasons for the same?

Aalok Patel: Microfinance…

Anish Goyal: I have noticed that…

Aalok Patel: Yes, yes, you're right about that part, microfinance yields are falling simply because of government regulations. So, two reasons actually, number one, the interest rates have been falling in the market, and there is a cap of what interest rates that we can charge to our customers, and for the benefit of others. I've just mentioned what that is, that is either 10% of our overall cost of borrowing or 2.75x of the average base rate of the top five PSU banks. So, the latter number has been continuously falling for the last five or six quarters. And the second fact is that we have accepted a lot of funds under the corporate guaranteed scheme.

Aalok Patel: Which was extended to microfinance institutions, which provides basically a guarantee to banks in case of an MFI default. However, the caveat for accepting those funds is that it must be done 2% lower than the lowest base rate by RBI. So, in our case, we'll have to do it about 19.8%. So that's what you're seeing there. That's why the yields are declining along with overall interest expense as well. So, the margin remains somewhat consistent. However, this is just kind of a little bit of a side note here.

Overall, we are sort of anxiously awaiting the new RBI white paper to convert over into an actual regulation for the MFIs. And that will remove all kinds of margin caps. So, there's fingers crossed that it comes out soon. And we can take advantage of that, not only in terms of the increase in margins, but penetration into other areas of operations and, of course, better competitive environment, with the removal of regulatory arbitrage, with other MFI players such as SSDs. A lot of other benefits as well.

Anish Goyal: Yes, yes. Any update on opening of new branches, as you have earlier mentioned in your con calls that December or January you will be opening new branches?

Aalok Patel: Yes, as I mentioned, we have opened about 24 new branches, mostly in UP, Bihar and Rajasthan.

Anish Goyal: Okay.

Aalok Patel: The plan is to open at least another 15 more branches by the month end. And of course, Bihar we have very recently expanded just about a month and a half ago. So, now we are operating in eight states

Anish Goyal: Okay. And any sir update from the equity infusion from QIP because you have mentioned, after 1,200 AUM you will be looking at QIP. So, AUM already closed 1,050. So, any update on that?

Aalok Patel: No, no, unfortunately, no update on that. I think I'm waiting until this new RBI circular comes out.

Anish Goyal: Okay.

Anish Goyal: So, by then you will be looking at debt to raise funds.

Aalok Patel: Yes, I mean, of course, debt raising is a continuous process for us.

Anish Goyal: Okay.

Aalok Patel: I think even right now, we'll have at least INR 300 - 400 crores in the pipeline.

Vivek Modi: So, I mean, from a debt, equity side, yes, the leverage has increased and that actually is to be concerned…

Anish Goyal: Yes.

Vivek Modi: To approximately 4.3 or something,

Vivek Modi: For us to be absolutely comfortable on our CRAR and continue to further leverage. And then Aalok just informed that we've already done INR 100 crore of off-balance sheet transactions with SBI wherein we have sold off a portfolio of INR 100 crore. So, while the equity market might take some time, I mean, whatever is required to be done to ensure that the debt continues to flow and there is no problem to accumulate for branch expansion to be well taken care of.

Moderator: Thank you. Participants, you may press '*' and '1' to ask a question. The next question is from the line of Savi Jain from 2Point2 Capital Advisors LLP. Please go ahead.

Savi Jain: Yes, hi Aalok. So, Pre-Provisioning Operating Profit growth was negative. So, obviously, there are a few reasons for that. But if you could just again, summarize, what are the various reasons why, despite of 40 plus percent AUM growth, we had a negative PPOP growth?

Aalok Patel: Pre-provisioning, I mean, you talking about pre-provisioning profits?

Savi Jain: Operating profit, yes.

Aalok Patel: So, that's a combination, as I mentioned to the gentleman earlier, the margins have been kind of falling down. So, we are at about legally 21.8% cap, which is, at least 3%, lower than what it was about a year and a half ago or a year ago. And on top of that, we are incurring a lot of operating costs for the branch expansions. Believe it or not, collecting money is also quite an expensive endeavor, as you can imagine, with all the COVID-related stuff going on.

So yes, there's pressure on both sides on the income side and on the expensive side as well. But I think what you will notice is, I'm not even sure if I can say this, but probably by next quarter, all of those things would have been a little bit streamlined. And I think Q4 should be slightly better, at least in terms of both aspects about the income side and the expense side.

Savi Jain: But you should be operating at those yields because of the absence of that RBI notification, which still hasn't come?

Aalok Patel: Even if the RBI circular does come out tomorrow, there is not going to be any magic want unfortunately, all the assets which I have already created on my books are at the lower yield.

Savi Jain: Correct, sir.

Aalok Patel: The weighted average will start to increase of course, but that will still take some time or a few quarters putting real impact on the P&L. So Vivek, anything to add?

Vivek Modi: So, on the pre-provisioning side, what also happens is, as the gentlemen earlier was to an extent there is a pressure on the NIM, because of the lower yields that we have to do on MFI. But alongside, the funding within this quarter has in particular gone up, and the overall finance cost has gone up for that reason. And overall, as the portfolio growth continues, the yield and the revenues should start kind of going north.

Savi Jain: Yes. So, this RBI thing, will it be like, again, a draft paper or will it be a final notification?

Vivek Modi: No, it will be a final notification.

Savi Jain: And it will be effective immediately?

Aalok Patel: I wish we could address that.

Savi Jain: Based on earlier circulars, which have come for the industry, what do you anticipate?

Aalok Patel: I think, it would not be immediately, I think if it comes today, it might be effective from 1st April or something like that.

Savi Jain: Okay. Yes, I mean, I think a lot of players that were talking about this coming through in the last quarter, December quarter, and we are in February, and it still not come.

Vivek Modi: So, every industry gets glued to the budget for some of the other reason Aalok and I were glued to the budget speech for this one only.

Aalok Patel: Yes.

Savi Jain: I think the government had more important things to take care of.

Vivek Modi: Mostly, I was watching to the governor's Monetary policy, I thought, maybe something will be announced.

Savi Jain: On that, they don't discuss this, as speaking to the management of credit access, they being the largest player anticipating this, and they said maybe after this policy meet is when they're finally going to discuss this. So, let's see.

Vivek Modi: Again, this is pure speculation. But I believe that the go ahead has been received by the governor. And now it's just awaiting some final touches. But that was about a month ago. So, there's only many touches that somebody can give to something. Let's see.

Savi Jain: In terms of provisioning for the back book, is there something still left you mentioned from FY '23 maybe you will start -- it will start normalizing. So, do we expect another quarter of higher provisioning?

Vivek Modi: So, the Arman book is completely provided for, in fact, more provided for then so there were like, write backs and stuff also as in written off assets were somewhat collected in the last quarter. In the micro side, I think, as I said, the worst is definitely behind us. There might be some minor level of provisioning, which comes in and as the portfolio keeps growing, anyway you have to provide for 1% of standard assets for provision. So, it's not like the provisions will stop. But the COVID provisions have slowed down quite a bit. And I think they will continue to slow down as it keeps going. But yes, I think I was mentioning about repayment rate, we are expecting the repayment rate to normalize by Q1 of FY '23. So, coming up in another four and a half odd months, unless something drastic happens, and I keep glinting it by saying that, but something or other always comes up. But after the third wave, there was a little bit of a very negligible impact of customers and staff members that were sick for three, four days.

So, the collection might have come in a little late or something, but nothing crazy happened. I think people are used to it by now, my staff and members and all of us are just kind of used to these minor COVID-related disruptions and they take it in stride. So, I think after a year and a half of this or almost two years of this, people can get used to anything and I guess we are used to it by now.

Savi Jain: And this daily stamping of NPA that notification did not have an impact on the financials this quarter.

Vivek Modi: Savi, generally, what happens is since largely our loans are unsecured loans. If a customer manages or flows down into the third or the fourth bucket and becomes an NPA even historically, we've seen that 9 in 10 cases never comes back to a pre-NPA, or less than 90 days DPD, they continue to be in more than 90 DPD. Because they might come back and pay us one instalment regularly, but that doesn't make them move anywhere into the 60 DPD bucket. So, overall impact, of the kind of profile of the customer is not really very, very impactful, but still in the longer run, we feel that it could have an impact, at least to the extent of increasing the NPAs in a standard, stable kind of condition by about half a percent.

Aalok Patel: See, as far as we are concerned, the largest chunk of NPAs is in the old pre-COVID assets, right. So those were already valued over the 90 plus DPDs. Or the newer assets, which were created, as you heard, we have not been facing too many issues. So, the overall impact anyway is not going to be very, very large. Now there is a new regulation, which I think that they have delayed it until September, the implementation of it. But yes, as Vivek said, maybe about 40 bps, 50 bps at the very most.

Savi Jain: Okay. Just a couple of more questions. One is, are we still doing group meetings? Are we now moved to like, stop giving JLG loan and doing more of individual loans? What is it?

Aalok Patel: No, we're still doing JLG, we are doing individual loans as well. I believe that in the MSME side, we are doing about INR 15 crore to INR 16 crore. In the micro side, we are doing about INR 4 crore or INR 5 crore, almost INR 20 crore of disbursements, we are doing in the individual lending business in a month. But rest of them is JLG.

Savi Jain: So, yes, the JLG is becoming a smaller proportion of the overall book, is it?

Vivek Modi: No, no, no way. I think, what probably Aalok is trying to say is that MSME is anyway, an individual lending book. In microfinance, as during the last call, we kind of said that you've already started looking at a pilot model of individual lending book, there we're seeing about INR 3 crore, INR 4 crore of disbursements on monthly basis.

Savi Jain: But are we doing group meetings? Is it I mean, in this kind of…?

Aalok Patel: Yes, yes, for JLG absolutely, we are doing group meetings, we are doing the whole JLG thing, yes, it's not completely out of fashion or anything.

Vivek Modi: No, no, it still continues to be bread, butter, and cheese everything.

Aalok Patel: Yes, bread, butter, cheese, jam, whatever you want to call it, there is…

Vivek Modi: Microfinance, we'll continue that.

Aalok Patel: When I say get the individual loan in the future, what I typically mean is I'm talking about five years down the road. Today's scenario, I mean JLG is still the king.

Savi Jain: Right. And lastly, Maharashtra are we still lending there, or is going to become smaller in terms of bookings?

Aalok Patel: The book is shrinking; we are actually lending it to the branches which are not that badly impacted. Other branches, we are not. Overall, it's declining, but yes, we are dispersing in Maharashtra not as much as it was pre-COVID, but we are.

Savi Jain: To these new states like, for example, Bihar is kind of slightly, maybe a riskier state based on experience with of other players. So, obviously diversification is good, and we are already quite diversified now with five states being large part of the book. So, is it really necessary to get into some of these other states, which might be slightly riskier and obviously costlier, also, because operating expenses will be higher?

Aalok Patel: No, I've been considering opening in Bihar for at least three, four years, five years. The outside perception is risky. But I think if you look at the data, the hard data, the numbers from both demon and COVID, it will appear that Bihar is one of the best states to operate in India. So that's what really allowed me to pull the trigger on a small way to, okay, let's open in. Now there are of course, fair share of issues, law and order issues and whatnot, which are there in Bihar.

But as far as the quality of the customers go, at least on the numbers, I mean, it's much better than even Gujarat or it's much better than even in Madhya Pradesh or any other place. And it's a little bit crowded there. It seems that, I'm not the only one who can read numbers. So, there are a lot of other players also moving in. So, we'll have to do it carefully. We are expanding from the border regions of UP through our existing branch network in UP and that is what we typically do. But I think, it's as microfinance matures, either you make headways into new places, or you will be left behind. So…

Savi Jain: Couldn't we tackle that by getting into newer products, rather than newer geographies? So, just to...

Aalok Patel: We are doing both, we are trying to get into newer products.

Savi Jain: But in terms of new products, two wheelers, maybe you did a tweak with that rural. Otherwise, for the last few years, I think you've not really piloted a new product per se, maybe something like micro-housing or something which…

Aalok Patel: It's not the right time to get into new things. I understand what you're trying to say. And of course…

Savi Jain: Just to draw parallel, for example, we had these two small finance banks Ujjivan and Equitas, so one went to that entire geographical diversification, and one went to the entire product diversification. And in hindsight, Equitas seem to have done a much better job as compared to say, Ujjivan. So just keeping that playbook in mind, I was just asking whether it is better to also look at more products rather than new geographies.

Aalok Patel: In my experience, I think you need a little bit of both. But as far as doing product diversification, which is related to what you know already, that is safer to do in a time like this, because I mean, like all companies and all people, you have limited resources. And my management force and everybody's busy, kind of trying to take care of COVID-related issues at this point, right. And with so much kind of unexpected stuff into the future, I don't want to get into something, which I don't know exactly how to do.

During good times, when you have a lot of profit and things are on auto mode, you have a lot of time to concentrate on newer things, right now is not the right time, according to me to get into something completely new. Individual loans, all of those things that are distant cousins of what I'm already doing. So that's not really that big of a deal. But this affordable housing is a completely different segment.

Moderator: Thank you. Participants you may press '*' and '1' to ask a question. The next question is from the line of Balkrushna from Axanoun Investment Management. Please go ahead.

Balkrushna Vaghasia: Good evening, sir. Many congratulations for crossing INR 1,000 crore AUM.

Aalok Patel: Thank you.

Balkrushna Vaghasia: So, I have a couple of questions. Every industry in MFI, like if I consider the period of pre-COVID and the post-COVID period that is going to be afterward, let's say from 2022. So, do you see any fundamental changes in the NPA trend that were in pre-COVID period and from the period 2022 onwards, I mean, is there any fundamental shift in the industry, – is the average going to be higher than pre-COVID?

Aalok Patel: So, if I understand your question correctly, what you are asking about is the comparation of pre-COVID and post COVID. So, let's forget about COVID -related losses. But as the regular operations resumes the NPA will be on a steady state higher or lower or same than what they were pre-COVID, is that your question?

Balkrushna Vaghasia: Exactly.

Aalok Patel: They will be higher, very frankly speaking would not buy a very large amount. But they'll be slightly higher as the ticket size continues to increase and as microfinance continues to penetrate deeper and deeper. The lower hanging fruits kind of go away and you're taking slightly higher risk on other customers. And I think people are getting used to credit, they have a lot of different areas to get credits from. So, as competition increases, it's natural that the NPA will probably increase likely as well.

But I mean, I've said this often then back that, we were in a golden age for like, good seven, eight years in MFI where loan losses were less than 1%. I mean, those unless you are doing gold loan or something like that. It's unheard of right even in the secure business, even in two-wheeler it was never the case. So as an industry rather than probably lying to we, things have been good in the past, and they will continue to be good in the future. It's better to be mentally prepared for something a little worse than it was in the past. But if it's the same or slightly less, nobody will be happier than I will be.

Balkrushna Vaghasia: Okay. And my second question, do we do any percentage of loan that we disburse in cash?

Aalok Patel: No, no, we are 100% cashless in all segments.

Vivek Modi: And almost for four years now.

Vivek Modi: Single rupee of cash that goes out has gone out the last four years.

Balkrushna Vaghasia: Okay, okay. And it is also mentioned in the investor presentation, that collection efficiency of your loan book post COVID loan book is around 99%, okay? So, when I look at the disbursement of last five quarters, so it is around INR 1,140 crore and total loans outstanding on your balance sheet is around INR 965 crore. So, I'm not able to understand the math here, because you say your overall collection efficiency is between 92 to 95%. And your post-COVID loan book collection efficiency is 99%.

Aalok Patel: Yes, correct. So, what, yes, please?

Balkrushna Vaghasia: You go ahead.

Aalok Patel: No, I mean, that's just the way the math works out. It's just that whatever is left. Now, that is pre-COVID, right? I mean, that has much lower collection efficiency, because the stuff that was good has already been paid off to an extent, and that INR 1,100 crore that you mentioned, I'm sure it's correct. I don't know what the disbursement has been in the last five quarters. But that also gets repaid, right? So, you can't really compare that I mean, since inception, I've disbursed maybe INR 5,000 crore, but that doesn't mean, even the good portfolio continues to repay. So, that will bring down their overall weightage in the repayment calculation.

Balkrushna Vaghasia: So, what you are saying, is that a good portion of INR 1,140 crore, okay? So, you are saying that a lot of loans that you disbursed after September 2020, got repaid before the loan you disbursed pre-September 2020, right? So, is that a very big?

Aalok Patel: Imagine, I lend you INR 100 today, right? And you pay me as of INR 2 tomorrow, your outstanding will become INR 98, right?

Balkrushna Vaghasia: Yes.

Aalok Patel: Now, that same INR 100 if I gave it to you two years ago, your outstanding might be let’s say INR 15, and you pay me INR 2 that will become 13. So, I mean the overall portfolio weightages will be different than the repayment weightages because, both EMIs are INR 2, right? But the portfolio is very different, one is INR 98 the other will be INR 13.

Balkrushna Vaghasia: Yes, so, basically there are quite a couple of scenarios, right? So, wherein the loans you disbursed post-COVID are of shorter period and the earlier loans would be for the longer period and the second scenario you mentioned would be something of that sort?

Vivek Modi: Let's look at this way.

Vivek Modi: INR 1,100 crore, the outstanding of the INR 1,100 crore let's say out of that INR 10,045 crore of total AUM. We start approximately 70% of the AUM. So, out of INR 1,100 crore about 25% - 35% - 40% would have run off in a regular course of something which has been disbursed. One and half years ago in September, would have repaid about 15 instalments already.

Aalok Patel: And something which was disbursed in February and March of 2020 with the moratorium would be almost close to being run-off for now. But still, there'll be like a few months left on it, but the EMIs will be the same. Anyway, well probably let us move to your next question. Maybe you can call Vivek for the mathematical understanding of this.

Balkrushna Vaghasia: Yes, all right, all right. So, basically, can you tell me- on your consolidated balance sheet, there is a loan of around INR 965 crore. So, what would be the percentage of pre-COVID and post-COVID loan book in this INR 965 crore?

Aalok Patel: What is it Vivek, about 25% or something would be pre-COVID, about 75% would be post-COVID. Roughly speaking, Vivek can probably give you a better answer.

Vivek Modi: But about 75% was post-COVID, the pre-COVID is less than half.

Aalok Patel: But the repayment will be probably higher than that and again this is math.

Vivek Modi: Again, a case in point would be like say for example NPA cases, out of my 3.8% of NPA, there would be hardly a case which is a post-COVID disbursement, the entire NPA would be pre-COVID.

Balkrushna Vaghasia: Right, correct.

Vivek Modi: So, where even collections demand is there, the collections are not happening.

Vivek Modi: Or less than let say 30%.

Moderator: Thank you. Participants, you may press '*' and '1' to ask a question. The next question is from line of V Srinath from Bellwether Capital. Please go ahead.

V Srinath: Can you just take me through plans for MSME, what are the growth outlook disbursements have somewhat kind of come back to pre-COVID. So where are we standing? And then there was a particular line in the presentation that said that you have tightened the cash flow requirements, and COVID impact layer, can you kind of explain that too? And, again, given that we are coming out and if there are customers who have clear credit screen in the last two years, and not defaulted? Wouldn't it be better at least leaving the norms as is? Because, you would already have kind of clean data coming from the Bureaus. So yes, just wanted to understand broadly, how are you seeing MSME over 12 to 18 months kind of time horizon?

Aalok Patel: No, I mean, we love MSME. It's a great business to be in. The returns are great. The losses if you compare it with microfinance are probably say more less. As I said, Arman, we are already out, and we had a situation that we are writing back. So, it's a great business, but it takes a very specific kind of customer to find that customer and of course, the kind of volumes and the volume games that you can expect from the microfinance side, at least post-COVID, it's been difficult to keep that up, because it takes. you and your team to find that specific kind of customer who can afford the rates and you can evaluate their cash flows. So, the rejection rates continue to be high. But that being said, I think the disbursement levels are increasing. We are continuing to open branches in that segment as well. So, plan is to open about 10 - 12 branches. We have already opened about three branches in the last couple of months.

Vivek Modi: Geographically, we went to Rajasthan.

Aalok Patel: So, geographically we have expanded into Rajasthan at areas we found to be good for doing this kind of a business. So, overall, I mean, I'm quite bullish on it, but it's going to take some time, COVID did have a setback, I mean, we tightened underwriting norms and it was very difficult to evaluate the cash flows. So, as I said, it takes a very specific set of circumstances to disperse the loan to the MSME customer, but we are working on it. But otherwise, I mean, I love the business there's absolutely nothing wrong with the business. What was your second question?

V Srinath: So, do you expect a ramp up there also in disbursements to start in a quarter or two, similar to MFI we have now crossed, looks like we are firmly on a growth path there. Do you expect MSME also to hit a growth path in a quarter or two? How are you seeing it?

Aalok Patel: Absolutely, absolutely. All our efforts are going towards that only. So, if we didn't go to that path, then clearly, I mean, we have not succeeded but our efforts are going towards that path as you say.

V Srinath: Perfect. One final housekeeping question on MSMEs. For MSME book also, the loans given post the April are they like 10% collection efficiency similar to MFI is the trend similar?

Vivek Modi: Oh, yes, absolutely. It is 99% plus collections. Yes.

V Srinath: Okay. And the last one, we've seen two-wheeler kind of ramp up from INR 7 crore to INR 16 crore disbursement, did this ramp up coming from rural to wheeler or the erstwhile business that we had that we were looking to kind of ramp down?

Vivek Modi: So that the cyclical kind of benefit because October and November of this quarter are supposed to be the best month for two-wheeler sales, Diwali sales. So, both…

V Srinath: What is the two-wheeler contribution on the INR 16 crore?

Vivek Modi: I think maybe about INR 5 crore, INR 6 crore in the rural and INR 10 crore in the urban.

V Srinath: Got it. So, that is scaling up at a slow pace, but it's scaling up.

Vivek Modi: Yes, actually in terms of disbursements, especially in the festive season, it would have been upwards of 25% of the overall two wheelers sales, which kind of is now reflecting on the overall growth of the portfolio itself. But again, as I said, to large extent, quarter two to quarter three growth, is about the festive season also in the two wheelers segment.

Moderator: Thank you. Participants you may press '*' and '1' to ask the question. The next question is from Sachin Motwani from Param Capital Research. Please go ahead.

Sachin Motwani: My first question is on the MFI business, like in your presentation, you mentioned 35,000 average ticket size, but you have been hovering around 22,000, 23,000 for many years now. Like, I think you were at 20,000, 21,000 average ticket size, it's now 23,000, something. So, this and the other rate of AUM per branch, we've been at around INR 4 crore AUM per branch for quite some time now. So, why are we not able to scale these numbers? I just wanting to get your thoughts on that. That was my first question.

Aalok Patel: So, on the average ticket size, I think, pre-COVID, we were at probably around 28,000 or 26,500…

Vivek Modi: 28,000 or so which has gone up to 35,000. And, I mean, there are no better excuse than to say that's where the trend of the market is going. In the micro finance segment, you don't really compete too much on the interest rates and things of that sort. What you are competing a lot on is on ticket size and turnaround time and things of that sort. So, the trend towards the market is going towards increasing the ticket sizes.

Sachin Motwani: Yes.

Aalok Patel: To give you a little bit of more comfort around that, it seems that higher ticket sizes are only in the future cycles that largely speaking is on the second cycle, third cycle and so on and so forth.

Sachin Motwani: Right.

Aalok Patel: Now, when we are lending money, I would say at least 15 odd percent of the microfinance customers for now have been kind of taken away from the market because we are not lending money to anybody who has defaulted during COVID. Right. So, even if they didn't pay for four, five months during COVID and now are doing okay, we're still erring on the side of caution and saying that okay, we will not lend money to them.

But the customers who are left are like the cream customers right even for us. So, these are customers who have continued to pay us without any kind of difficulty or any problems during COVID, during first, second, third wave whatever it may be. So, I am comfortable taking a slightly higher risk on them? Yes, maybe. I mean, I think it would be fair to say yes. So, a lot of these customers which we are giving higher ticket amounts have been through, like, the worst test that you can imagine, COVID. And they've proved themselves. So, I think it should be okay.

As far as the branches are concern, I think, overall, the branches AUMs continue to increase, but we have a policy that splits a branch once it approaches a certain AUM. So, once it crosses INR 5 crore to INR 6 crore AUM, we split that branch into a new branch because that's part of our risk mitigation side. So, you will see that as a new branch, but our policy will not allow an average branch to be more than a certain AUM.

Sachin Motwani: Understood. And how is the competitive intensity because you mentioned that 15% of MFI customers are now touching and the 85% are cream customers. So, is the competitive intensity regrettably lesser benign, especially post-COVID now or during COVID times?

Aalok Patel: No, it's honestly as competitive, I mean, it kind of ebbs and flows in that sense, like, during the waves and stuff nobody's lending anything. And then everybody remembers that, oh, we have targets, and everybody starts disbursing left and right. So, it's kind of all over the place, if you look at it throughout the year. But let's say today, like, for example, February or January, I mean, the competition is just as high as it was pre-COVID. I don't see any relief from that and that is fine, competition is okay. We can manage competition.

Sachin Motwani: For you, you see it more from the SFB side or MFIs or the universal banks?

Aalok Patel: It is more from the MFI side, I mean, probably this might be a better question to ask my Chief Operating Officer, but based on my knowledge, it is not so much on the SFB side because SFBs are facing their own issues, at least in the areas that we operate in. I could be wrong on this, but the MFIs are also, see there's a lot of funds available. Let me tell you that much also.

So, people are not facing so much of a liquidity issue, as it seems to me. Again, I don't have numbers to back this, but based on different CGS schemes as I mentioned and other schemes that the government's been running and the overall availability of liquidity in the market, along with PSL guidelines and things like that the MFIs have -- the good MFI or at least a decent MFIs have a good supply of money flowing in. So, that has not been an issue.

Sachin Motwani: Okay, got it. Next question I have was on this direct assignment with SBI. So, –what would be your broader terms that you would be earning 10% spread your margins would be similar as the current business?

Aalok Patel: So, how DA works is can we take the assets that we own and sell it. So, there are no like margins to worry about.

Sachin Motwani: Yes.

Aalok Patel: The deal we did was somewhere around 10%, I mean, it's kind of a complex thing, right. But all in cost would be somewhere around 11% for us, after considering the processing fee and the other requirements, the stamp duties, and things of that sort. The published rate would be somewhere around 10%.

Vivek Modi: Generally, generally a DA could work in favor of increasing the NII and that addresses the…

Aalok Patel: Yes, so there is no margin requirement on DA, which is what I always said through the years that is if it allows you to get a little bit better margin, then I'm all for doing off book transactions. And this was such an example.

Sachin Motwani: Got it. Just one correction on a slide actually on your slide number 13, your reported cost to income is 28%, which I think you've taken the cost to income as a percentage from a total gross income instead of the NII plus other income.

Aalok Patel: Absolutely possible. Thank you so much.

Moderator: Thank you. The next question is from line of Rupesh Tatiya from IntelSense Capital. Please go ahead.

Rupesh Tatiya: Okay. So, my first question Aalok is you are at INR 300 crore roughly disbursement in Q3, in quarter four of next financial year we are all set to reach let's say INR 500 crore kind of disbursement quarterly run rate?

Aalok Patel: INR 500 crore a quarter…

Rupesh Tatiya: In quarter four of '23.

Aalok Patel: That seems a little bit out there but let us say, somewhere in the neighborhood of about INR 450 crore should be doable. Might be touching INR 500 crore I don't want to over promise anything. INR 450 crore kind of per quarter seems quite doable by Q4 of next year. Disclaimer always is to let us see what further disruptions are coming due to COVID.

Rupesh Tatiya: Okay. And then my second question in terms of business design so to say, cost of funds and you have always maintained that MFI is not a cost of funds business it's more of distribution business and you add lines in finding first time borrowers or rural borrowers and kind of areas where competition will take some time to come back in that is kind of your add back. Whatever, I have observed your business for so many years now.

But you are also saying that two things are happening, right, the penetration is going to increase with this RBI circular also the penetration is going to increase, and the ticket sizes are on an increasing thing. These are the two trends in the industry. So how long do you see that the cost of funds won't matter to you? Like, are you okay, for let's say next five years that cost of funds won't become bottleneck in terms of business design?

Aalok Patel: Cost mattering as soon as this new idea circular comes out, because once you remove the margin caps, see today, whatever cost savings I get from my borrowing costs, I have to by law, pass it on to my customers, right, at least on a weighted average. So, once that is removed, I have to worry about three things instead of two things, right, I have to worry about my top line, I have to worry about my interest cost, and I have to worry about my operating costs. So, all three of those things will matter to the bottom line and it will be a balance of those three which will, so we are in a place right now where it's going to start mattering very soon and hopefully sooner rather than later.

Rupesh Tatiya: But I mean that is about 10% cap, right? That probably everybody is looking at as an increased bottom line and more distribution I think the industry players like you're looking at that margin capital removal in this way?

Aalok Patel: No, this margin cap will get removed. So, if I'm able to save 1% on my borrowing costs or if I'm able to charge 1% more to my customer, then that will directly impact my bottom line by that percent.

Rupesh Tatiya: Yes, that way you are looking, but my question is our cost of funds disadvantage over let's say, SFGs or someone like Bandhan Bank is really huge, right? And we have been kind of smart to pick this rural pocket, sustain those rural pockets and get kind of yields that we get, but I mean, how long that can continue?

Aalok Patel: Sir, let me tell you a couple of things here. So, my cost of borrowing disadvantage so to speak is far from huge now. It used to be quite huge, today I am at a place and at a scale where I'm able to attract funds at a lower cost. So, that's why our rating is A minus at this point as well. So, while there is a little bit of a disadvantage, I'm not going to disregard that. But I have other advantages that SFBs don't like my operating cost structure. And in fact, a lot of them are not making very much money with their scale or a lot of them are making losses, I have not made a loss in any quarter.

So, let us put aside the differences between an NBFC, MFI structure and an SFB structure because I've always said these are two different like they are apples and oranges. They might be fruits, but they are different kinds of fruits. As far as the other MFIs go, I mean, there are a few MFIs that have a distinct advantage over us maybe credit access or somebody like that, but there are companies which are much-much larger than ours and I have managed borrowing at a lower cost. So, it's not just as a function of scale I think your vintage matters, your rating matters. Your overall profitability, your governance, and lot of other factors play into what rates that you borrow from.

But yes, I don't disagree with you that our core competency has always gone out to find the new customers and get into the niche areas where there is not a lot of competition, and we can service these customers in a way. Slowly, slowly that might be going away not by choice, but because the market is expanding and there are a lot of players and players are expanding and everybody's opening new branches. So, that is the reality of competition I think we've done a good job with the places we were good at. And I think we'll continue to do a good job hopefully, as the market environment keeps changing.

Rupesh Tatiya: Okay. And sorry to harp on this, but how about ticket size and let's say, if you want to lend really good customer at 50,000-60,000 else your business decision kind of prevented because of your cost of funds? I mean, how does cost of funds impact your ticket size say in terms of good customer or in terms of risk to portfolio?

Aalok Patel: Cost of borrowing is not going to really impact my ticket sizes. Cost of borrowing has two advantages. One is it increases your portfolios faster and thereby, your potential interest income that you can earn. And the second thing is it reduces your overall cost or operating costs as a percentage of your portfolio. But it comes with the risk that if you're giving a lot of money to somebody who can't afford it, your loan losses might increase to that aspect. So, this is a continuous balance that needs to take place.

I personally, don't like large ticket sizes. If it is forced due to competition and stuff like that, of course, I have to run a business and I have to consider practical applications. But in the long-term, I mean, there are players right now which I'll not name that are doing INR 75,000 micro finance JLG loans, second cycle loans, and INR 60,000 first cycle loans. I mean, that's absolutely ridiculous. I would not do that at all.

I mean, if you want to do INR 60,000, INR 75,000, do an individual model, go down to their cash flows, try to understand their business, try to understand what they're doing and lend them a lakh and a half if they deserve it, there's no problem. But if you're trying to give a larger ticket size under the facade of joint liability, which is getting diluted day by day as we speak, then I think fundamentally, there's something wrong with that business model.

Now, I'll be happily proven wrong maybe. Maybe their asset size will be completely okay and two, three years, four years down the road there'll be somebody that tells me that, oh, you should have done the same thing. look at that guy across the street, he made a buttload of money doing that, which is fine, I'll have to make my peace with it if that happens. But today, I think I have to go by my instincts which says that you cannot do such a large ticket size under the JLG model, you will have to do it under a MSME or an individual role model, where you are actually going down and trying to do a little bit more underwriting.

Rupesh Tatiya: Okay. Okay. And then my last question, any balance transfer out, kind of data in MFI in MSME maybe balance transfer probably not the right term, but you understand right, I mean, if customers going to a different borrower due to better service, better rate whatever, better repayment terms.

Aalok Patel: So, you're saying somebody getting re-financing from somebody else, and they come with a cheque of another finance company, and somebody takes over. That doesn't happen in microfinance. That might happen unofficially, where they borrow money from somebody and repay my money. Payments do happen all the time, but no, I mean, I don't have a single instance to share where somebody has bought over debt because I mean, that doesn't make sense in unsecured right. Bandhan was trying to do it years ago, and I think I said it, how do you do that in an unsecured because what's stopping him from borrowing someplace else, right?

Vivek Modi: We might see prepayments happening for obvious reasons that somebody might be getting a lakh for a housing loan and want to repay the higher interest or because the housing company might have said that your EMI servicing is very high, and you will not be able to get a higher loan and you repay this. So, that kind of thing leads to prepayments every now and then. I mean, it wouldn't be very large, but that does tend to happen. But that trend has not started yet where people are like officially refinancing and they get a demand draft of some finance company to close their loans out.

Moderator: Thanks. Next question is from line of Savi Jain from 2Point2 Capital Advisors. Please go ahead.

Savi Jain: Yes, hi. So, I just began slide number 18, which talks about your liabilities. So, I was just struggling to understand some parts of the pie chart. So, there is a 1% direct assignment in the pie chart. Am I right? What have you mentioned as DA?

Aalok Patel: Yes. So, if you are talking about the SBI DA transaction that is in January. So…

Savi Jain: No, that I understand, what I'm asking is that you have separately written in the left chart that there is an INR 581 million direct assignment, whereas in the graph, it is only 2%.

Aalok Patel: INR 581 million and INR 72 million, INR 7.2 crore. So, there's a note in the bottom, I believe.

Aalok Patel: Is there some typo, is that what you're saying, Savi?

Savi Jain: No, no, I'm not able to understand if it is INR 581 million, then it is actually much higher than 2%, which is shown in the chart. So…

Aalok Patel: Yes, that's possible. And let us look into that.

Savi Jain: I mean, I'm not too sure I'm going a bit color blind as well on this one because…

Vivek Modi: No, no, it is that only because after green, there is DA which is purple.

Aalok Patel: If it was 58 divided by 766. He's saying it should be 7.5% and not 2%, FY'21 he's talking about on the left side.

Savi Jain: Even on the FY '21. Similarly, on the right one also, which was 1%. That is still quite close, not that different. But yes, that could be still correct. But anyway, my question is that what you're saying is as to you remember offhand is that your direct assignment was like very small earlier, it was to the tune of INR 5 crore, INR 10 crore?

Aalok Patel: We do a lot of PTCs but after IND AS direct assignment definition has changed to completely without recourse. So, while pre-IND AS something was off balance sheet, we had to re-recognize back on the balance sheet, if it had recourse, Vivek correct me if I'm wrong, in getting the accounting terms right. So, if you try to compare, let's say, pre-IND AS and post-IND AS, it will be a little hard to compare. But we haven't done a lot of DA transactions, the SBI one, which we just did has been the largest. A lot of the DAs have run off also, because the max DAs that we can do is maybe about 19 or 20 months because they require, three-month vintage and then another month or so for the rating and everything to be the pool to be rated and everything like that. So, the average tenure you will be left with will be 17-18 months. So, since COVID, we have not done a lot of DA transactions.

Vivek Modi: SBI is the first done.

Aalok Patel: So, this one seemed right to me. It will be about 0.8%.

Vivek Modi: No, no, no. Let me correct to everybody hearing this, I think the footnote there is incorrect\. The total DA outstanding would have been about INR 12.5 crore at the beginning of the financial year March '21, which was kind of close to whatever 1% or 2% rounded.

Savi Jain: So, all of this credit risk is assumed by the bank? You have no credit enhancement that we have provided to the bank?

Aalok Patel: No, DA structure as per the RBI policy does not allow any credit enhancement.

Savi Jain: But do you need to keep capital on this?

Aalok Patel: No, there's no cash collateral if that's what you mean.

Savi Jain: So, basically this goes out of your book, right?

Aalok Patel: Yes. That's what exactly this is.

Savi Jain: Is it like a profitable given that now you have these limitations on spreads, does it make sense to do it at 10%, do you make money ROE on this transaction?

Aalok Patel: It makes absolute sense to do it. The only problem is that the profit you have to recognize on it right away. So, your profit for that quarter might appear to be inflated, well, not inflated, that's the wrong term. But while the operating expenses of servicing this loan might be over a period of two financial years, the profit from the same has to be recognized right away.

Savi Jain: So, basically, next quarter, there will be a normal jump in profitability, because of this transaction?

Vivek Modi: No, I didn't mean that. I am talking only accounting side not that we want to kind of say anything regarding the…

Savi Jain: No, that I understand. I'm saying we need to take it as an extraordinary income when the right to do would be to amortize it over the period of the loan.

Aalok Patel: I agree with you. In fact, amortization is but IND AS is quite weird. Savi, what happens is we'll have to go by what the accounting standards and…

Savi Jain: Correct. So, the same is not true for securitization and where does PTC appear on this?

Aalok Patel: So, DA is securitization which is a true sale. PTC will appear on balance sheet in this. PTC is actually by India standards not off-balance sheet. And in that case, you amortize the overall cost and the…

Savi Jain: So, in this graph where does it appear?

Vivek Modi: So, in this graph, it will be bundled up in the bank or the FI, wherever, there is securitization, the blue one.

Aalok Patel: The blue one.

Savi Jain: The blue one will have it; PTC and securitization are one of the same things?

Vivek Modi: Maybe for nomenclature let understand in our presentation, the securitization here means the PTC and the DA is direct assignment, which is a true sale and does not have any recourse to the investor. Hence, off-balance sheet. Would that also include the PLI also?

Aalok Patel: No, PLI is not there.

Savi Jain: So, securitization what is the trading enhancement that you provide to the lender?

Vivek Modi: That depends on contract to contract, that will be too specific to address at this level, but largely speaking, there would be second loss credit enhancement that could happen through subordination and there could be cash collateral, and there is over collateralization, as well. So, generally, the recourse kind of thing available to the investor could be anywhere between 12% to 25%, depending on the overall structuring.

Savi Jain: Oh, that's quite a lot actually. So, basically, they don't really ever see any NPA on that because your low credit losses would be less than whatever 6%-7% even in the worst-case scenario. So…

Aalok Patel: In the cases where the company completely flat out defaults only in that case. But normal asset losses on an ongoing basis, typically, they would not see any losses.

Savi Jain: So, there the cost would be lower?

Vivek Modi: Higher.

Vivek Modi: The coupons are really lower, but the overall cost will go up because you will have a cash collateral, you will have a subordination that might happen through second loss guarantee coming in. And the overall legal opinion, the initial setup costs generally is high. So, that's what the bank's books, PTC is a treasure instrument, a DA transaction, it goes directly into their balance sheet as a retail loan or whatever it may be. So, there are a lot of differences that took us a while to also get used to these instruments. And every instrument has first, second, third loss, kind of a work. Some of them come with guarantees. I'm talking about the PTC specifically. And so, the overall coupon to the bank might be lower. But the cost will go up because there'll be a negative carry might be on the cash collateral. There'll be a guaranteed fee maybe that you've to provide for the secondary losses, so stuff like that.

Moderator: Thank you very much. Sir, the line for the participant dropped. Ladies and gentlemen, that was our last question for today. On behalf of Emkay Global Financial Service, that concludes this conference. Thank you for joining us. You may now disconnect your lines. Thank you.

Aalok Patel: Thank you so much.

Vivek Modi: Thank you.