Bajaj Finance

Sometimes being late to a party might workout very well in your favor. Indian economy grew at a high rate of 9.5 percent from 2005 to 2007. Money was cheap and inflation was low. Millions of aspiring Indians took personal and credit card loans. Private banks like ICICI and foreign banks like Citibank grew their retail loan book aggressively.

Global financial crisis showed its ugly face in 2008, and it impacted every economy including ours. Customers defaulted on personal and credit loans. These loans were non collateralized, and the banks did a massive write offs on their loans. Many players exited the retail loan segment.

Bajaj Finance entered the consumer loan business in late 2007. It too got affected by the slowdown. Being a late entrant to the consumer loan business, it was able to survive the cyclical stress without getting its head chopped. It cleaned up its books, invested in technology, strengthened the risk management process, and emerged as a market leader in retail loans.

(in crores)	FY09	FY17	CAGR
Gross NPA	16.6%	1.68%	
Asset under management	2,539	60,194	49%
Profit after tax	34	1,837	65%
Share price	7	1,714	99%

Few Basics

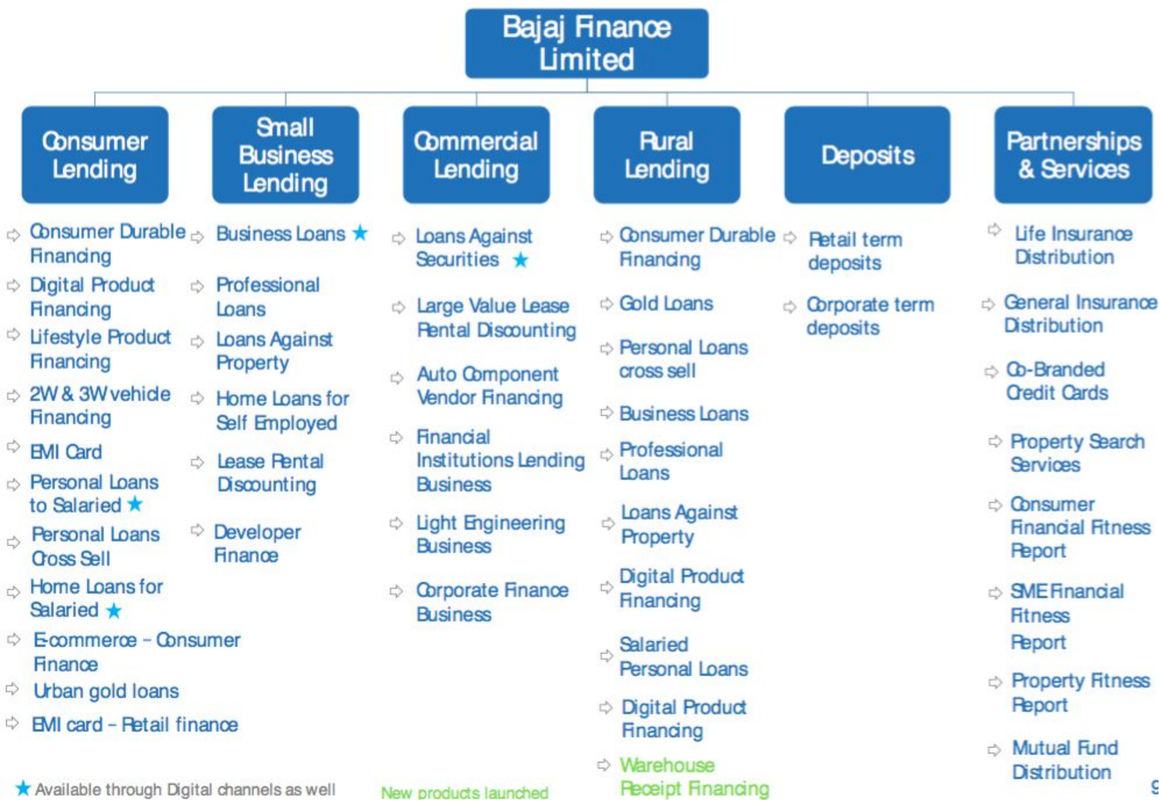
Bajaj Finance Limited (BFL) is a 29 year old non bank finance company (NBFC). Its lending activities is organized into six different verticals: consumer, small business, commercial, rural, deposits, and partnership & services.

Want to buy a fridge, tv, bike, clothes, home, or furniture? Are you short on funds? No problem. BFL is there to lend you. BFL runs a super profitable business, with disciplined underwriting and without exposing itself to lot of risks. Here are some key business metrics.

1. Return on equity of 21 percent and Return on assets of 3.5 percent. For a $1 in equity it controls $6 in advances. The leverage is reasonable and it is doing it without any asset liability mismatches.

2. Capital-to-risk weighted assets ratio (CRAR) ratio of 20 percent is well above the RBI norms. It lends at 17 percent and borrows at 8 percent. This results in a spread of 9 percent, and NIM is around 10 percent. To learn more about spread and NIM: link.

3. Gross NPA is 1.68 percent and Net NPA is 0.44 percent. It has a decent provision coverage of 74 percent. Around 21 percent of its loan book is exposed to the real estate sector. Most of them are residential mortgages.



BFL grew its loan book by 36 percent in the last one year. Consumer loans constitute 45 percent of the total loans and it is growing faster than the overall loan book. SME loans constitutes a decent share of 37 percent. The remaining 18 percent is made up of commercial and rural loans. It is aggressively growing its rural loan book.

(in crores)	2016		2017		Growth
Consumer	18,996	43%	27,159	45%	43%
SME	18,692	42%	22,082	37%	18%
Commercial	5,202	12%	7,881	13%	51%
Rural	1,339	3%	3,072	5%	129%
	44,229	100%	60,194	100%	36%

BFL has a well diversified borrowing profile. Bank loans and non-convertible debentures (NCD) make up 75 percent of total borrowings. NCD and Commercial paper borrowings are growing at higher rates.

(in crores)	2016		2017		Growth
Banks	16,565	37%	17,060	35%	3%
NCD	16,765	38%	19,785	40%	18%
Subordinate debt	3,338	7%	3,338	7%	0%
Deposits	3,901	9%	4,128	8%	6%
Commercial paper	3,462	8%	4,589	9%	33%
CBLO	500	1%	350	1%	-30%
	44,531	100%	49,250	100%	11%

Evolution

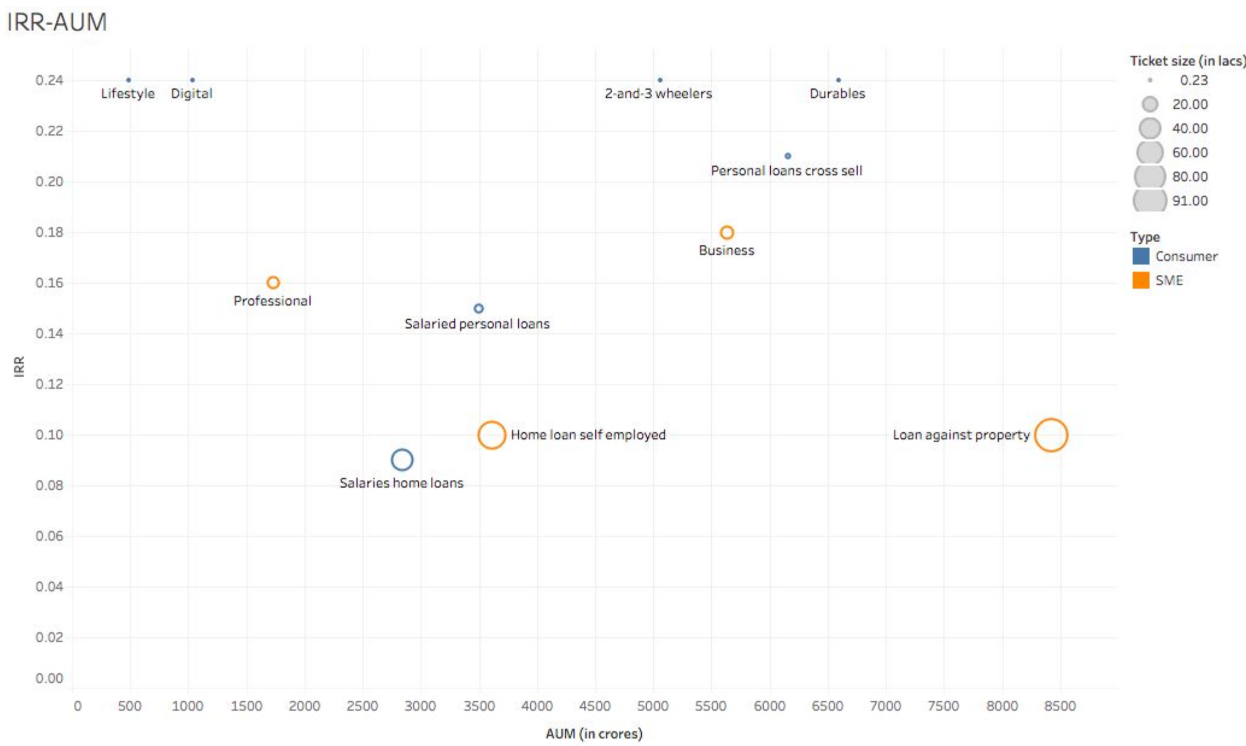
The best way to study a business is to look at it as an evolving movie, and not as a still photograph. Any intelligent analysis should have time as a key dimension. I looked at BFL over the last 8 years, and studied the strategic actions of management. Here are some important points that stood out.

					CAGR	
(in crores)	2009	2013	2014	2017	2009-2013	2014-2017
AUM	2,539	17,517	24,061	60,194	62%	36%
Net Interest Income	435	1,904	2,500	6,200	45%	35%
PAT	34	591	719	1,837	104%	37%
EPS	0.93	13.57	14.48	34.01	95%	33%

Innovate or Die: Lending is a commodity business. Customers will borrow from someone who offers low interest rates. How is BFL able to generate a superior NIM of 10+ percent? Ticket size on consumer durable loan is very small. On a 30k rupees loan an extra 200 basis points add up to 600 rupees on interest. This is nothing due to [contrast effects](). Customers are willing to pay the premium, if someone can approve the loans instantaneously.

In 2010 less than 10 percent of consumer durables happened on financing, and 40 percent came from credit cards, and the rest was cash transactions. BFL invested in technology automated the backend systems and approved loans in under 5 minutes. This enabled it to compete with credit cards, and customers happily paid the premium.

The visualization below shows information on 4 variables: AUM on x-axis, IRR on y-axis, loan type by color, and ticket size by bubble size. Spend some time to study it carefully. What do you see?



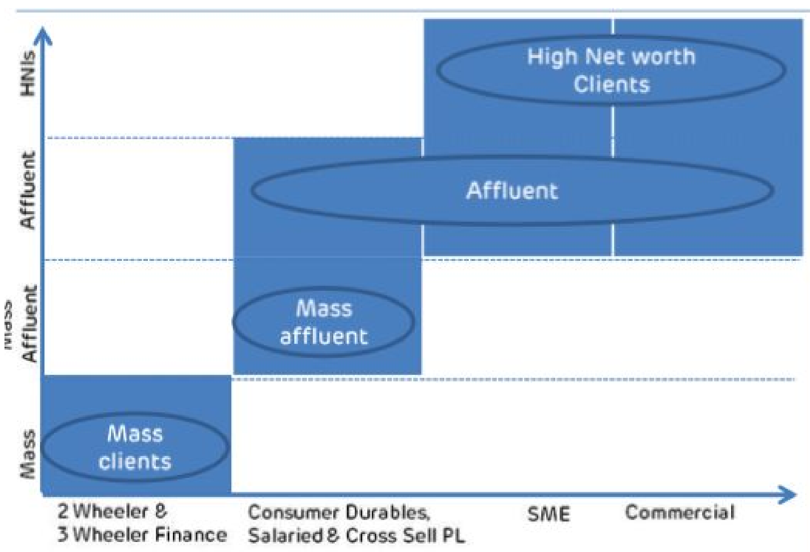
Most of the consumer loans have smaller ticket size with high IRR. Ticket size on SME loans are higher with small IRR. This makes sense as customers prefer paying lower interest rates on a 5 crore loan compared to a 30k loan.

Existing Member Identification (EMI) card is a hell of an innovation. At the time of the first consumer durable loan, customers can apply for an EMI card. For all incremental consumer durable loans, the customer will be able to swipe the card and purchase the product. This reduced the acquisition cost on future loans and increases cross selling.

Analytics, Cross-selling, and Affluent: Next generation lending companies need to leverage technology. BFL does its loan origination on salesforce, and it tracks all purchases and loan repayments of its customers. It invests a lot in data warehouse and risk analytics technology platform.

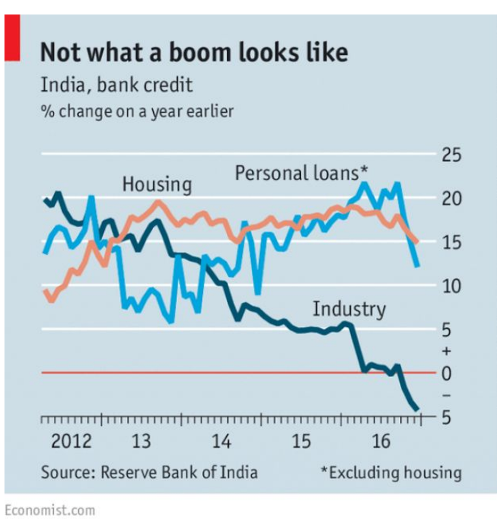
This enables BFL to know its creditworthy customers, and cross sell more loan products to them. It developed a real-time machine learning based fraud analytics model. This has replaced the traditional score based model and uses machine learning algorithms to detect frauds. It outsourced its technology needs to TCS, and has a team to oversee and work closely with TCS.

Ticket size on business loans are high. Avoiding defaults is more important than IRR. BFL strategy is to focus on affluent small businessmen and knows its clients really well. On the rural lending it stuck with its strategy of lending money to affluent customers. The chart below clearly shows its strategy of sticking with affluent customers.



Delayed Gratification: Most companies were not interested in investing in consumer durables, which is low ticket and high volume loans. Competition was benign due to the high up-front investments required in distribution, technology and processes to compete in this relatively low ticket size, high volume business.

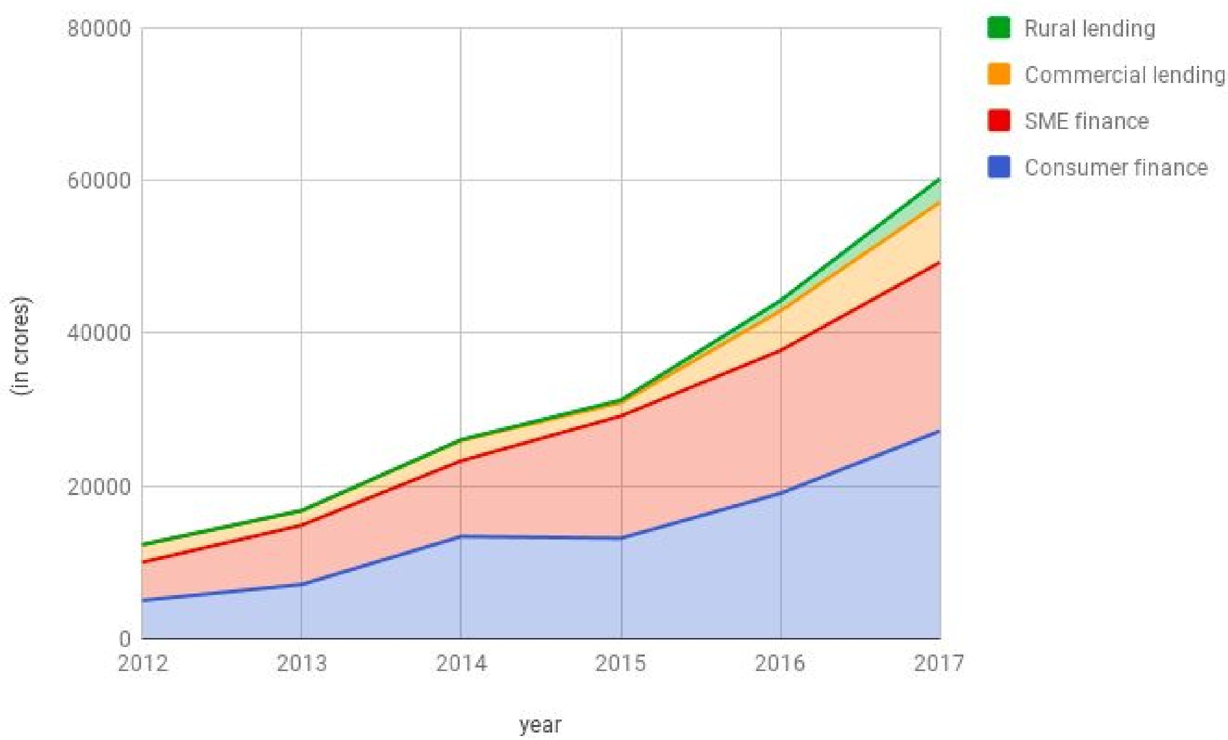
Cat that sat on a hot lid never sat on any lid. Retail loans did very badly in 2008. Many players exited the retail loan segment. BFL survived and took the pain of setting up the infrastructure needed. Delayed gratification is a competitive advantage. This enabled BFL to capitalize and surf the retail lending wave since 2012.



Fail Fast: DNA of the company is to innovate. In a lending business, innovation is a double edged sword. It can kill you if you're not mindful of asset quality. It is ok to fail, but the key is to fail fast and learn from it. BFL had a couple of failures, identified it early, and fixed it. Loan book compounding at 36%, and diversifying without blowing up is an amazing feat

1. BFL got the license to sell wealth management products to common man. The entire commision structure of mutual funds industry crashed. The business was no longer viable and shut it down. BFL moved the team to another division to cross sell other products to its customers. It found success from failure.

2. BFL entered construction and infrastructure finance. With 15 months of launching it saw issues with asset quality. It immediately stopped issuing new loans and shrunk its loan book. This experience taught BFL to do sensitivity analysis during good and bad times. Other players like Shriram Transport Finance took another 2 years to see the trouble and blew up badly. Hats off to BFL management for spotting this and exiting the segment.



Future

Skate to where the puck is going, not where it has been. What drives BFL future value? The total advances lent out by the organized finance industry in FY17 is around 96 trillion rupees. BFL asset under management is 0.63% of that. If we visualize BFL as a machine, here are the most important levers that will drive its future value.

1. **AUM Growth:** Credit growth drives economic growth. The ratio of economy growth to credit growth is 1 : 2.5. How fast can its AUM grow? Here is a simple thought experiment. Let's assume that over the next 5 years credit growth in the economy is 20 percent, and BFL grows at 30 percent. AUM of BFL will still be under 1 percent of overall advances. Can it grow its AUM off-balance sheet via platform play?

2. **NIM:** BFL has a NIM between 10 to 11 percent. Is this high or low? To answer this question, let us compare it with averages. From the table, we can see that BFL has 2x NIM of the highest group. Over the next 5 years, would BFL be able to protect its NIM?

	NIMs
Public sector banks	2.12%
Private banks	3.38%
Foreign banks	3.41%
Small finance banks	5.08%
Bajaj Finance	10%

3. **Expense Ratio:** BFL reduced its expense ratio by 1,000 basis points in the last 9 years. The current expense ratio is 41 percent. Can it reduce its expense ratio further by leveraging technology? If yes, it has some room to operate on lower NIMs. Reflect on the last point.

4. **Underwriting costs:** BFL has a gross npa of 1.68 percent. Can it reduce this in future by leveraging analytics?

Having a deep understanding of the above four levers should enable one to calculate the intrinsic value of BFL. And estimate the IRR it would generate by holding it over the next 5 years. I will leave this as an exercise to the reader.

References

1. Bajaj Finance: Annual Report, Presentations, Conference call transcripts
2. Bajaj Finance: Building scale with profitability
3. Sanjiv Bajaj Interview: link and link
4. Indian Banks: Lay of the land

Disclaimer: I own shares of Bajaj Finance. This is not a recommendation to buy, sell, or hold. I am not a SEBI registered analyst. I wrote this document to organize my thoughts and deepen my understanding about the company and lending industry. I am sharing it so that you can learn something from this.

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