Lending financial services (lenders)

Companies in India that offer lending financial services, or lenders in short, include banks and non-banks like housing finance companies (HFCs) and all other non-bank financial companies (NBFCs). Lenders form an important part of any capitalistic economy and hence are critical to track for investors to be “macro aware”. Lenders also make up a large part of the listed universe, whether it be by number (10-20% of top 200-1000 stocks) and more so by value (25-35% weightage in major indices). Moreover, a small number of these listed lenders, of different sizes and business models, have been large and consistent wealth creators over time in India and investors, expectedly, are always on the look out to discover a smaller version of these businesses. Lenders also have an outsized presence in the financial press because there is usually some exaggerated (many a time temporary) winner or loser that is “revealed” from amongst these companies every year.

Naturally, one of the most common questions that most investors are asked (including us) is what do you think about lenders.

Our answer, which may be a little unconventional and surprising, but hopefully consistent, is that most lenders are not high-quality businesses.

Where do most lenders fail on the “People, Returns and Growth” framework that we have previously described? Firstly, 30-35% of lenders are majority owned by the Gov’t, also called PSU lenders, which fail our “People” filter because our experience suggests that in such institutions, there is a secondary objective of “national service” that often overrides interests of minority shareholders. We wish to avoid such misalignment, irrespective of the sector. Secondly, and more importantly, we think that most lenders, even private lenders that are not owned by the Gov’t, will be unable to deliver >15% *sustainable* ROE to pass the “Medium” requirement for our “Returns” filter.

Why is it difficult for most lenders to earn >15% sustainable ROE? Our three key reasons for this =

(1) Lenders are leveraged entities (with total assets usually 5-10x shareholder’s equity), where you can be right 9 times out of 10 and still lose a lot (not unlike how any string of numbers multiplied by 0 is still 0). In distress, your ownership in such entities often gets diluted, by forced disadvantageous capital infusions, leading to permanent losses that could be >50%.

(2) Lenders are exposed to a number of overlapping macroeconomic cycles, like growth, interest rates, asset quality, liquidity and regulations. Thus, destinies of lenders are much less within their control compared to most other businesses, which are usually (much) less cyclically affected. It takes years, often decades, for management teams to learn how to handle such cycles, especially to handle times when multiple cycles worsen together.

(3) In spite of the above two points, and the sobering long-term statistics on sector’s survivability (leave alone profitability), entry barriers are reasonably low, and hence lending competition for most assets remains very high, most of the time. This behaviour of new promoters, and minority shareholders, is likely driven by greed and, more so, envy of the exaggerated (even if ephemeral) success stories.

This is not to say that there are no lenders that we would want to own. We think that 5%, or at most 10% as in most other sectors, which would be 5-10 of the entire ~100 lenders within our investible universe, are potential high-quality businesses that we would be happy to own. Stated this way, our initial assertion that most lenders are not high-quality businesses sounds much more reasonable. It is merely less optimistic than the consensus wisdom that a larger number of lenders, especially private lenders, are great businesses. We think that consensus may be waylaid by the few aforementioned consistent wealth creators or enamoured by the high growth that is common in lenders, especially in

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the early stages of their lending journey. Neither of this is enough for us - if anything, we are put off by very high growth!

So, what attributes do we look for in a lender? As in any other company, we search for sustainable competitive advantages and in lending, we think that these are mostly around low costs:

(1) Low cost of liabilities: Liabilities are the “raw materials” in a lending business and hence low cost of liabilities is akin to low “raw material costs” in normal businesses. More often than not, deposits are the lowest cost of liabilities and hence banks usually have lower “raw material costs” than non-banks. Customers’ reluctance to change banks, depositors’ perception of convenience or safety and perceived high pedigree of parent company or group can all lead to such an advantage. Such competitive advantages can be categorized as either “high switching costs” or “special assets”.

(2) Low cost of underwriting: Underwriting of loans, which is largely the assessment of risk, is key to a lending business. When risks emerge (as they inevitably do), loans become non-performing, leading to credit costs, or loan loss provisions, which lenders obviously try to minimize. Two important attributes of a good underwriter are (1) understanding all the risk exposures (both odds and impact of each risk exposure) of a loan portfolio and (2) ability to walk away when the price (loan yield) is not adequate. Such skill and behaviour are usually developed over time based on process, experience and culture. This competitive advantage is best thought of as a “special asset”, and is rare. Side-note: most of this paragraph is as true for lending as it is for insurance… and investing!

(3) Low cost of operations: Operating costs are all expenses that are neither a cost of liabilities nor a cost of underwriting. These operating costs are usually a function of the above two points, i.e. liability mobilization and loan underwriting, and hence it is best to consider them in the context of different business models and underlying types of loans. Normally, the business with the largest size has the lowest cost of operations compared on a like-to-like basis, benefitting from economies of scale. Sometimes a disciplined mono-line lender may be able to be more efficient than a diversified lender due to higher focus. In our experience, the low cost of operations is usually less important than the first two points.

Note that the more important competitive advantages mentioned in the first two points above can be classified as “high switching costs” or “special assets”, both of which are largely intangible. Thus, we think that historical track-record is the single most important way to identify high-quality lenders (note that track-record is important in our analysis of all companies). For this reason, we primarily consider companies that have been operating with the same business model and lending within the same asset class for at least a decade, and usually multiple decades, since their survival itself is a sign of some skill. While we don’t outright dismiss companies that have been lending for <10 years, we remain very wary, and would much prefer to wait to see their decadal performance before investing.

Before we end, there is a unique piece of the puzzle regarding Indian lenders that we think is less understood. This is the uniqueness, and weirdness, of capital raises. Lenders, especially private lenders, regularly raise capital for growing faster than their internal accruals will allow. If such capital is raised at >1x price-to-book (P/B), as they usually are, they will be book-accretive i.e., will cause the book value per share (BVPS) to increase (the extent of the increase would depend on the P/B valuation and the amount raised relative to the book value). Some private lenders have almost perfected the art of raising capital every 3-5 years and in effect, have caused their BVPS to compound much faster than their ROEs would imply. While capital raises are individually better understood, what seems to be less understood is the cumulative impact of such capital raises. We estimate that capital raises have contributed to 50-70% of BVPS growth over the last ten years for most private lenders. This adds an

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additional complexity, specifically reflexivity, to the evaluations (and valuations!) of lenders. Also, if all of this understanding is right, at some point in the future, when these private lenders have grown large enough to compete mostly amongst themselves, and when the incremental opportunity for growth reduces, their BVPS growth will fall in line with their ROE (less dividends), which, while being healthy, will lead to slower growth than the past. This is likely to have a concomitant impact on valuations too. All of this is likely not as well appreciated today but we suspect will become a more important topic for the lending sector in the next 5-10 years.

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