

BUY ARMAN CMP : 227



Arman Financial Services Ltd.

STOCK DATA

Market Cap(Rs. cr)	157
P/E	20
P/B	4.06
EPS	11.27
Promoters Holding	28.81%
52 week high/low	264.50/121
Shares outstanding (in cr)	0.69

KEY FINANCIALS(Rs. in cr)

Y/E March	2013	2014	2015	2016
AUM	71	91	115	172
Debt/Equity	1.68	2.22	1.64	1.58
Operating Inc	17	24.5	29.6	41.6
ROE (%)	11.15	13.35	17	18
ROA (%)	4.55	4.64	6	5.57
GNPA*	0.56	0.72	0.83	NA
NNPA*	0.51	0.64	0.65	NA

*consolidated basis

VALUATION : The Company its Trading at 14 Times FY 2017 Earning and 10 times FY 2018 Earning. We believe the company can double its profit in the next two years and maintain ROE of 16-18%.

Arman Financial Services

Thesis – ‘EVERY DOG HAS HIS DAY – TODAY IS MY DAY’ – MANAGEMENT ON CONCALL

Arman Financial is a small NBFC in Micro finance space & two wheeler financing space. We are overall extremely bullish on Micro finance sector as a whole. Arman Financial is a small Gujarat based NBFC with presence in Gujarat and Madhya Pradesh. They operate in two areas i.e. Micro-Finance (Namra finance) and Two-wheeler finance (Standalone Arman). The major revenue comes from Micro-finance(68%). The company’s niche lies in its business model and its location presence (present in low penetrated markets).

There is a double value mitigation happening in microfinance space

- 1) From Banks to Microfinance
- 2) From unorganized money-lenders to Organized Microfinance companies

The total AUM of the company has grown by 50% in FY16 to 172.31 cr and we believe that this growth is sustainable going forward as well. Arman entered the microfinance space in 2009 and has reached an AUM of 117 Cr. in 2016. We believe there will be exponential growth of 50% plus for next 3 years in Microfinance divisions. Arman in the last quarter has raised bank debt from SBI worth 25Cr at 11.8% last quarter which is the rate at which larger players like Ujjivan and Equitas raise debt. Before raising this debt the cost of capital was 15.5% for its microfinance Division suggesting the benefit of size has started getting realized in Arman.

Why We like Arman:

- Industry growing at 30-40%
- Huge opportunity size

- Expanding to new geographies (Risk Management)
- Dividend Payment for Last 6 Years
- Lower Capital Cost Going Forward
- Small Base hence Easier Growth
- Better ROA than Larger Players

About the company

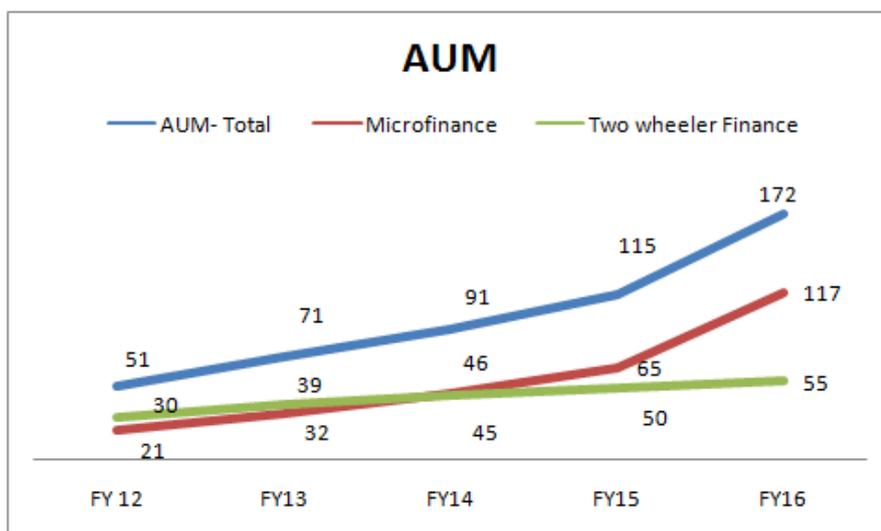
Arman Financial Services is an Non-Banking Finance Company(NBFC) active in 2-wheeler finance business. It also operates a wholly owned subsidiary, Namra Finance Ltd. exclusively for its microfinance operations. It operates mostly in unorganized and underserved segment of the economy and mostly serve niche markets in Gujarat and Madhya Pradesh. The Company Plans to Mitigate its location Risk (Political Risk) by Diversifying in Uttar Pradesh and Maharashtra after successful Diversification in Madhya Pradesh. Madhya Pradesh has huge growth potential as 72% of the total population resides in rural India where most people don't have access to financing.

They serve areas and clients where it is simply not possible for banks to provide financial services under the current market scenario.

As on 31st March 2016 the total AUM of the company stood at 172 crores with micro finance contributing 68% of the total AUM (i.e. 117 cr) rest being Two- wheeler finance.It has total 60 operational branches (55 microfinance and 5 two-wheeler).The company now has 18 branches operational in Madhya Pradesh and 37 branches in Gujarat for the Microfinance business. Promoters hold 28.81% of the total share capital and 24.99% is solely held by one foreign investor which is a Private Equity Fund named RIF NORTHWEST II.

Why Arman?

Robust growth in AUM



Micro-finance is the major business revenue stream for the company and it has grown a lot faster in the last few years. AUM for the micro-finance business has increased by 79.62% YOY and the disbursement in the same year has increased by 55.58%. The management has given a guidance of similar growth in the next financial year which we believe is achievable. **We believe that by FY19 they will reach 500 cr from the current 174 cr.**

Good Asset Quality

In the microfinance segment the net NPA in the Q4FY16 was at 0.18%.

	Q1FY16	Q2FY16	Q3FY16	Q4FY16
Gross /Net NPA (in cr.)	0.02	0.02	0.01	0.22
NNPA (%)	0.03%	0.02%	0.01%	0.18%

Arman works on Joint liability Group (JLG) model where a group of women living in near vicinity borrow money and they are jointly held liable. So if one member defaults the other members are force to pay. Ticket size of such loans usually is around Rs. 17,500. Advantage of this model is that the no. of defaults are usually less due to social pressure and not only are the interest spreads higher than any other type of loans but also the tenure of the loan is less than a year. Moreover the company gives loans only for purpose of buying income generating assets like sewing machine, cattle etc and not for consumption purpose.

ROA-Highest among the peers

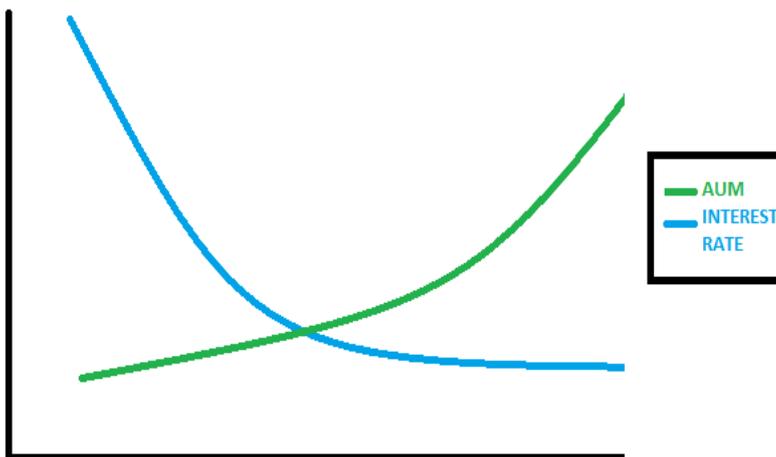
	ROA (%)
Ujjivan Financial	3.65%
Equitas Holdings	2.95%
SKS Microfinance	4.2%
Janlakshmi	2.57% - FY15
Satin Credit care	2.2%
Arman Financial	5.57%

Peer Comparison: Arman has the potential to scale up

	AUM	P/E	ROE
Ujjivan Financial	5064	21	18.3%
Equitas Holdings	6125	29	13.31%
SKS Microfinance	7677*	29	25.1%
Satin Credit care	3271	25	22.1%
Arman Financial	172	21	18%

Arman is small company with the lowest AUM as compared to others. Our research Indicates that historically the speed to growth increases as soon as the company crosses the 100 crore AUM as many banks start offering loans as competitive prices to Arman. We believe that the growth can be 1.5-2x faster than the Industry growth for the 3 years atleast with lower cost of borrowing and more efficiency. SBI has given loan to Arman at 11.8% of Rs. 25 Cr. whereas IDBI has given a loan of 12 crores at 12.2 %.(confirmed by management on Concall). In FY 2016 the cost of debt for the microfinance business was 15.5% we believe between 2017 and 2018 there will be atleast a drop of 300bps in cost of borrowing for the company.

AUM VS COST OF CAPITAL



‘Today we are in the position to tell banks that if you don’t offer us competitive prices, we will go to the bank across the Street’– Management on Concall.

History of other Microfinance businesses has proven that once a microfinance company crosses 100 crore of AUM, not only does the cost of capital reduces drastically (due to bank funding), but the speed to growth increases exponentially.

Operational and Financial Performance

Going forward, the microfinance company is expected to contribute the growth. In the last four years, the company’s Microfinance has grown at a CAGR of 54% and two wheeler finance has grown at a CAGR 16% only.

(Please note, below forecast are definitely going to be wrong, we at Stallion Asset Hate forecasting but this was made just for understanding purpose only)

	FY 12	FY13	FY14	FY15	FY16	FY17E	FY18E	FY19E
AUM- Total	51	71	91	115	172	259	358	508
Microfinance	21	32	46	65	117	199	298	448
Two wheeler Finance	30	39	45	50	55	60	60	60

Contribution of Business: Declining share of Two Wheeler Business

	FY 12	FY13	FY14	FY15	FY16	FY17E	FY18E	FY19E
Two wheeler Finance	58.82%	54.93%	49.45%	43.48%	31.98%	23.17%	16.76%	88.19%
Microfinance	41.18%	45.07%	50.55%	56.52%	68.02%	76.83%	83.24%	11.81%

Company has reduced its exposure to two wheeler finance considerably thus increasing the share of micro-finance which is a high growth and sustainable business. According to us, we would be happy if the management exits the 2 wheeler business due to lower return on capital employed.

Microfinance Industry

- 70% of India's population is rural and 59% of India's population earns Rs. 100 a day. These people don't have banking facilities and they end up getting trapped in the hand of local moneylenders. Arman's focus is to lend small sums of money to such rural poor so that generate income for themselves with the help of these loans.
- Government has actively supported and promoted "Financial Inclusion" so that everyone comes under the banking system and get the organised banking facilities.
- NBFC's account for 9.4% of the total credit in India in 2005-06, increasing to 12.1% in 2014-15 and a projected 17.1% by 2018-19.
- Micro finance companies are back on the growth track after a setback in 2011 due to Andhra Pradesh crises.

To know more about Microfinance Industry and how it works, read our prior report on Ujjivan Financial or Satin Creditcare.

Dividend Payout

The Management has Paid out dividend every year to its Shareholders for last 7 Years suggesting good corporate governance for a company of this size.

	2010	2011	2012	2013	2014	2015	2016
Div. Per Share	0.6	0.8	0.8	0.8	1	1.2	1.4
EPS	1.93	4.45	7.51	5.92	6.54	8.89	11.27
Payout Ratio	31.1%	18.0%	10.7%	13.5%	15.3%	13.5%	12.4%

Risks

There are certain risks and concerns associated with this business which we would like to highlight.

- **As per RBI guidelines, MFI with AUMs below 100 crore, need to have an interest cap of 12% above their cost of borrowings. For e.g., if their cost of borrowing is 14.5%, they cannot lend above 26.50%. However, once the AUM crosses 100 crore, the interest cap reduces to 10%. Only Last Quarter the company has crossed the 100 crore Benchmark and impact needs to be seen in the coming quarters.** This might bring down the NIMs. However, reduction in Op. Exp/Avg Assets might not affect the overall profitability. The management can increase processing fees of the loan or sell more value added services like life insurance themselves to maintain NIMs (larger players like SKS Microfinance do it).

- **Declining growth in Two-Wheeler Finance Business**

Two-wheeler finance business is slowing down in form of de-growth in operating income and rising NPA's mainly due to a) sluggish two-wheeler demand in rural India and b) This space is very competitive as most of the two-wheeler companies have their own finance branch or tie ups with other finance companies and they provide better terms on loans so that their customers do not go outside for borrowing money. They have only 5 branches for two-wheeler finance out of total 60 branches. Since this business segment contributes a small portion of the total AUM, the profitability of the consolidated company will not be affected in a big way.

NPA Analysis (2 Wheeler Finance)

	Q4 (Jan-Mar)	Q1 (Apr – Jun)	Q2 (Jul – Sep)	Q3 (Oct-Dec)	Q4 (Jan-Mar)
2 Wheeler Finance (Rs. Cr.)	FY 2014-15	FY 2015-16	FY 2015-16	FY 2015-16	FY 2015-16
Gross NPA	0.79	0.96	1.31	1.15	1.80
Provisions	0.09	0.09	0.13	0.15	0.18
Net NPA	0.7	0.87	1.18	1.00	1.62
Net NPA Percentage	Rising NPA's 1.09%	1.52%	2.34%	1.80%	2.92%

- **Competitive Industry:** Micro finance industry is very competitive as many players have entered in this space. Recently RBI has also given small bank licence to 10 NBFC's. But we believe that the whole micro-finance sector as a whole is set to grow and hence these regional players have enough room to scale themselves up.

Valuation –

The company has a benefit of size and lower Interest cost from next year onwards.

We have Divided the company in 2 part i.e. Microfinance business and 2 Wheeler Business

(in Cr)	Market Cap	Profit FY 16	PE	ROE
Full Business	157	8	20	18
2 Wheeler	32	2.5	13	7
Microfinance	125	5.5	23	39

We actually don't know what arman could look like in the next 2 years but we know the margin of safety. Below is our worst Case Scenario for this company. Even if the Arman's microfinance divisions Grows at Industry rate of 35% v/s Management Guidance of 70% ,there is decrease of Return on Asset of 25%, and there is Valuation drop of 35% we will still not lose any money in the next two years. But on the upside, if Arman's Management does what it promises we believe it will be an amazing Investment with massive re-rating.

Worse Case	FY16	FY17E	FY18E	Comment
Microfinance (AUM)	117	163.8	221.13	35% Growth (expected Growth of Very Large Players)
ROA (ending)	4.7%	4%	3.6%	25% Decrease in ROA
Profit (in Cr.)	5.5	6.6	8.0	
PE	22.8	18.0	15.0	35% Decrease in Valuations
Micro Finance Market Cap	125.4	117.9	119.4	
2 Wheeler Market Cap	32.0	32.0	32.0	
Total Market Cap	157.4	149.9	151.4	
Expected Returns	0.0%	-4.7%	-3.8%	

Investing is a Game of Risk Adjusted Probabilities where the idea has to be Heads you win, Tails you don't lose much. Our Historical Research on biggest wealth creators suggest that the Sector In-play trades well above its fair value for a long period of time before reverting to mean. We believe in this bull cycle NBFC are In-play and will trade well above fair value in times to come.

Conclusion

Most PSU Banks who are more on the rural side are not in the good shape to lend hence we certainly believe that the next 3-4 years are clear runs for NBFC where they have their niche. There is a large value mitigation happening from the unorganized money lender to organized microfinance company. We love the microfinance and the MSME Finance area in NBFC's. The company will have to raise equity going forward to maintain the growth which will lead to dilution probably sometime in 2017. We have seen large jumps in AUM historically once the company crosses 100 Crore AUM and gets access to bank funding. Arman is at inflection point in its growth journey; but we will have to review the performance of the company quarterly for due risky nature of its business. The company's two wheeler business is a drag on the balance sheet, We would be happier if they discard that business and stick to microfinance only.

We have increased our weight in Microfinance with Addition of Arman in the portfolio as we remain extremely bullish on this sector. We always concentrate our investments in 3 sectors and NBFC space is definitely a space to be in for the next 2 years.

Disclosure: Amit Jeswani & Family have no positions

Analyst Disclosures: No positions

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