Introduction

After graduating from IIM Ahmedabad, Rashesh Shah started working with ICICI in 1989. This is where he met Venkat Ramaswamy. Shah left ICICI in 1993 and joined Prime Securities as Head of Research and Investments. Around the same time Ramaswamy also left ICICI and joined Spartek Emerging Opportunities Fund as a fund manager. They were in the right place at the right time.

Indian capital markets opened up to foreign investors. Realizing the huge opportunity Shah called Ramaswamy and convinced him to start their own business. They wanted to apply for category one Merchant Banking License. The license would cost them 1 crore rupees. This is a lot of money in 1995. Shah convinced his father to mortgage their house. And Ramaswamy sold shares of Infosys. Edelweiss got incorporated in late 1995. How did their decision turn out? I will let the data to answer this question.

	1996	2016	CAGR
Market Capitalization (in crores)	₹1	₹8,000	57%
Book value per share	₹0.1	₹45.1	36%

Business

I had trouble pronouncing and remembering the name of the company. This is because I never understood the meaning of the word Edelweiss. It means — with no founder or family name attached to it. Edelweiss is one of the leading diversified financial services firm. It organizes its businesses into three different segments.

Diversified Mix of Businesses

CREDIT

Present across :

Wholesale
- Structured Collateralized Credit
- Distressed Assets Credit
- Wholesale Mortgage

Retail
- Retail Mortgage
- Agri & Rural Finance
- Loan Against Shares
- SME & Others

NON CREDIT

Strong product franchise serving diverse client needs:
- Capital Markets
- Wealth Management
- Asset Management
- Balance sheet Management Unit & Liquidity Management
- Agri Services & Others

INSURANCE

One of the fastest growing life insurance companies

Before digging into the details of each segment take a look at the table shown below. It shows the Revenue, Profits, and ROE for all three segments in FY16.

	FY16				
(in crores)	Capital Employed	Networth	Income	Profit after Tax	ROE
Credit	20014	2300	1200	300	17%
Non-Credit	11192	1100	1107	200	22%
Total Ex-Insurance	31206	3400	2307	500	18.6%
Insurance	1552	900	387	-100	-
Total	32758	4400	2694	400	12.9%

Credit Business

It lends money to both wholesale and retail customers. Around 45 percent of its revenue, net of finance costs, comes from this segment. The total credit book at

the end of FY16 is around 20,000 crore rupees. This segment generates an ROE of 17 percent. The breakdown of its credit book is given below.

Credit Type	**Description**	**% of Loan Book**
Structured Collateralized Credit	Customized credit solutions to corporate clients. The loans are adequately secured with 2x collateral cover.	35
Wholesale Mortgage	Funding residential real estate developers for housing projects. The wholesale credit market for residential real estate developers is about Rs. 100,000 to 120,000 crores. Edelweiss owns 5% of the market compared to HDFC: 40%, Indiabulls: 17%, and Piramal Enterprises: 14%.	27
Distressed Assets Credit	Largest Asset Reconstruction Company (ARC) in India with more than 7 years of history in distressed assets space. Banks get rid of their non performing assets to ARC by selling $1 for 40 - 50 cents. By doing this banks avoid the last 40 - 50% of provisioning. ARC makes money on fees. On top of that they make profits if they can sell the asset at a price greater than what they paid to the bank.	9
Retail Mortgage	Catering to retail home buyers and business owners.	13

Loan Against Shares	Caters to retail investors in the capital markets. Loan is offered against listed securities, to participate in IPOs, and exercise ESOPs.	6
SME & Others	Includes loans to small and medium enterprises for their business requirements by way of secured and unsecured loans.	6
Agri & Rural Financing	$10 billion unorganized market. Highly scalable, unoccupied by institutional players. Includes Micro Finance solutions to clients in Tier III/IV cities and rural areas.	4

Evolution: Baby Steps to Matured

I am a big fan of Rashesh Shah writings. The chairman letter he writes every year is a treat to read. His number sense is top notch. And backs his statements with data. If you haven't read his letters or listened to his conference calls then I would highly recommend it to you. In FY16 letter he captured the journey of Edelweiss in 4 year increments (contrast effects) and presented it brilliantly. The table given below captures the journey of Edelweiss. I have removed the period 1996-2000 on purpose to avoid the effects of small numbers.

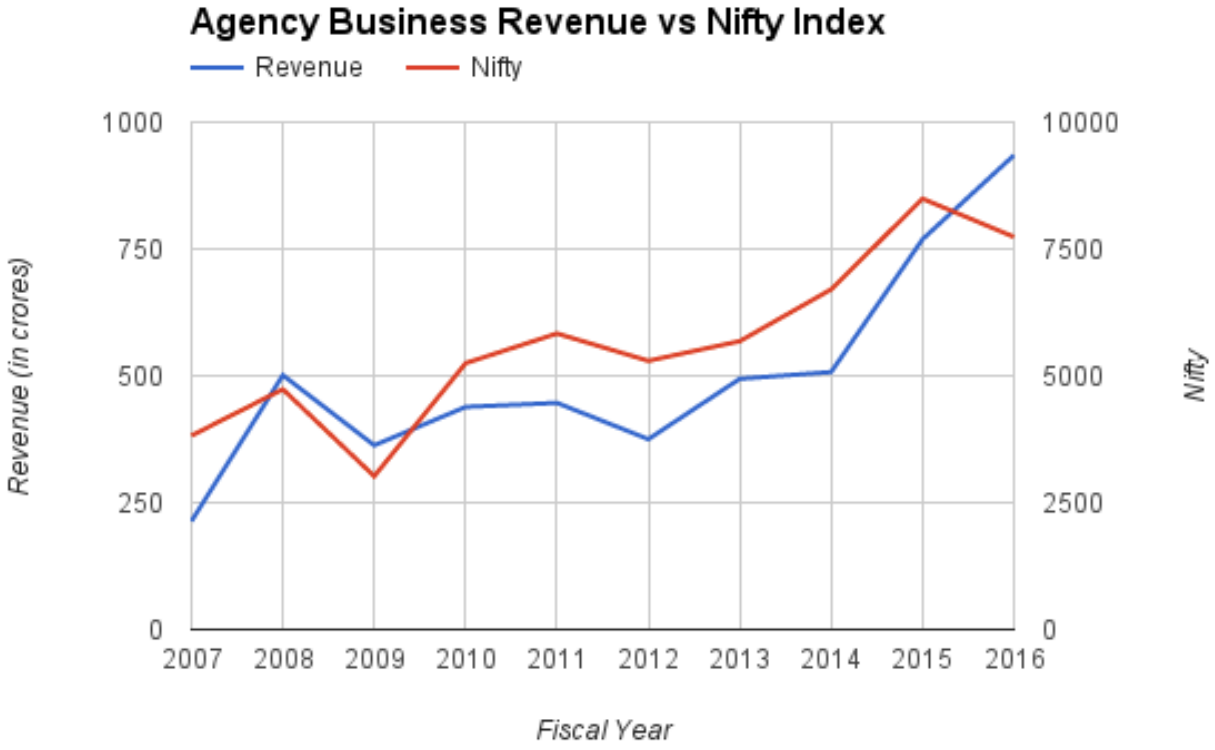
						Compounded Annual Growth Rate			
						Baby Steps	Joyful Hypergrowth	Painful Consolidation	Mature and Balanced Growth
(in crores)	2000	2004	2008	2012	2016	2000-2004	2004-2008	2008-2012	2012-2016
Revenues	8.5	28.1	1088.8	1670.7	5315.7	35%	149%	11%	34%
Profit after Tax	3.9	7.8	273.2	127.7	414.4	19%	143%	-17%	34%
# Employees	12	95	1621	3108	6227	68%	103%	18%	19%
Book Value per Share	0.4	0.9	24.7	34.8	45.1	22%	129%	9%	7%
Diluted Earnings per Share	0.2	0.2	4	1.7	4.9	10%	111%	-19%	30%

Edelweiss started its journey by providing investment banking and portfolio

advisory services. The Indian capital markets did really well from 2000-08 and Edelweiss got benefited immensely by surfing this wave. Revenue and Profits grew by over 70 percent and Earnings per Share compounded at 45 percent.

Rashesh Shah understood that Edelweiss was highly dependent on the capital markets. He is a big fan of Peter Drucker and his philosophy of exploring Adjacent Markets for growth. Credit business was something that he was thinking about entering. But he stayed away from it as he didn't understand it.

Take a look at the chart which shows the dependency of its Agency Businesses, which generates fee based income by providing brokerage, corporate advisory, wealth management, asset management, and other fee based services, with capital markets. This made Rashesh Shah to enter into the credit business. He setup the credit leadership team in 2007 and took the company public to raise capital to drive the credit business.



From 2008-12 Edelweiss went through a painful consolidation. Global financial crisis hit the domestic capital markets hard and this impacted Edelweiss wholesale capital market business. The company started building its credit business from 2008. Building a credit business from the ground up is not easy.

Why is that? Some of the challenges faced by Edelweiss is well explained by Rashesh Shah:

1. Your underwriting costs are the most important cost. What can kill you in a credit business is your credit cost. It is not going to be cost-to-income ratio or even your cost-of-funds. Before ramping up the loan book Edelweiss needs to understand the market deeply.
2. When it comes to lending, banks have a huge cost advantage due to CASA deposits. For example in Urban Salaried Home Loan, you are competing head-on with banks. That's why we are seeing a lot of the non-banks not able to do that. But in Distress Credit we are not competing with banks, we are on the other side of banks. We don't compete with banks on Structured Credit, Wholesale Real-estate, SME self-employed segment, and Agri Financing. The idea is to find things where you don't compete with banks but you collaborate with them.
3. While building the loan book you incur a lot of upfront operating costs. The ROE will be depressed in the short term. If you think long and do prudent lending then ROE will increase along with the loan book.

	2009	2012	2016
Loan Book (in crores)	550	3956	20014
Gross Non-Performing Assets	0%	0.57%	1.4%
Net Non-Performing Assets	0%	0.17%	0.47%
Return on Equity	9%	13%	17%

From the above table we can see that Edelweiss compounded its loan book at 67 percent. It was able to do that with a very low Non Performing Assets (NPA) under 1.5 percent. Its long term goal is to maintain NPA below 2 percent. Notice how the ROE went up from 9 to 17 percent. Also 80 percent of the current loan book is built during the 2nd half. From 2012-16 Edelweiss transitioned to mature and balanced growth.

Not only did Edelweiss diversify into credit business. It also became a multi liner by having a diversified credit portfolio. Companies like Repco and Gruh focus

on a particular segment (housing). They are called as mono lines. Building a multi line business is much harder than the mono lines as leadership breadth required to built a multi line is much higher. Multi liners can go after smaller opportunity size and they don't struggle a lot across cycles.

> If you look at the NBFC's history in India, monolines grow very fast but also struggle across cycles because if you are a housing finance company and you think there is a lot of irrational stuff going on the financial industry and people are under pricing, will you be able to scale back the business? It is very hard to do because how do you give up growth? No credit company will be ok with the shrinking book. So you will continue to grow hoping that I will be smarter than the others, but you will not be able to escape the irrationality of the industry. However, if you are a broad base firm, which what the banks are, you can keep on reallocating your portfolio. - Rashesh Shah

On average Edelweiss lends at 16.2 percent and borrows at 10.7 percent. This results in an interest spread of 5.5 percent. And it has a Net Interest Margin (NIM) of 6.8 percent. Click here to learn the difference between interest spread and NIM. On the wholesale book it maintains a high collateral cover of 2x. On the retail book its loan-to-value is 50 percent. This enables Edelweiss to have low NPAs like private banks.

	Banks	Edelweiss	NBFC
Non performing assets	1.3%	1.4%	3.2%

Write-offs

Edelweiss is in the business of giving loans to individuals and businesses. Some of its customers will neither pay interest nor principal for sometime due to tough business conditions. Edelweiss will classify these loans as non performing assets (NPAs). Once the condition improves the customers will pay back the interest and principal. But if the condition doesn't improve for the customer then he will default and the loan will be written off.

Edelweiss has to estimate how much loans will get defaulted and set aside some portions of its profits as provisions to cover for future losses. Lending companies can inflate their earnings by under provisioning. It's better for our health and wealth to look out for companies that over provisions. Did Edelweiss under or over provision?

(in crores)	2013	2014	2015	2016	Average
Gross NPAs	28.48	81.93	196.28	280.69	
Provision for NPAs	37.85	82.06	183.96	245.15	
Standard Assets	16.83	21.55	44.84	58.02	
Non-Standard Assets	21.02	60.51	139.12	187.13	
NPA Written Off	3.05	0	23.15	76.74	
Provision Coverage	133%	100%	94%	87%	104%
NPA Written Off / Provisions	8%	0%	13%	31%	13%

From the above table we can see that in FY16 Edelweiss has a very high provision coverage ratio of close to 90 percent. It wrote off only 30 percent of what it provisioned for. Also the total write offs during the last four years add up to 103 crore rupees. This is nothing compared to its current loan book of 20,000 crore rupees. From this we can conclude that Edelweiss is doing a fantastic job in provisioning.

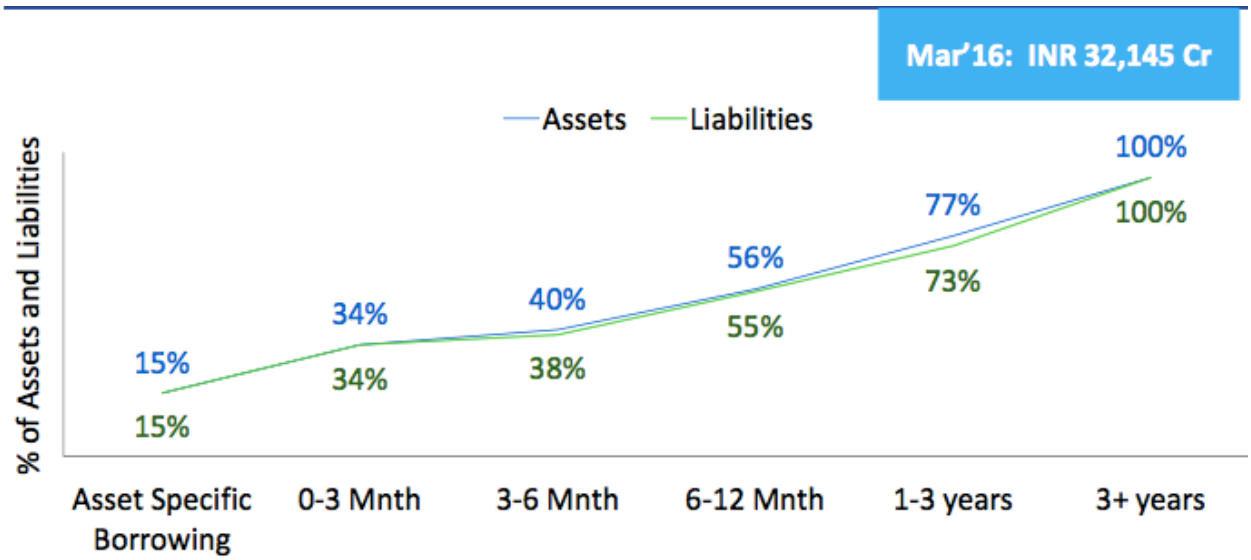
Asset Liability Mismatch

Edelweiss borrows money from 5 different sources. The details of the sources are given below. We can see that Edelweiss is reducing its dependency on short term sources like Money Markets. It's diversifying its borrowing sources by increasing Retail borrowings and they are long term in nature. Also by adding more loans from Banks it has increased the stability of its borrowing profile.

	Borrowings			
(in crores)	2011		2016	
Money Markets	3929	50%	9442.82	34%
Bank	2043.08	26%	8331.9	30%
Asset specific (CBLO)	1100.12	14%	4721.41	17%
Retail	392.9	5%	3888.22	14%
Others	392.9	5%	1388.65	5%
Total	**7858**	**100%**	**27773**	**100%**

Asset specific or Collateralized Borrowing and Lending Obligation (CBLO) borrowing is used to manage interest rate risk and asset liability mismatch risk. CBLO markets allows Edelweiss to borrow money by using Government Securities as collateral. Click here to learn more about CBLO Markets.

If Edelweiss uses short-term liabilities to fund long term assets, it could result in a liquidity crunch affecting its ability to service loans. In order to mitigate this it ensures that the short term and long term sources of funds are favorably matched with deployment. The chart below clearly shows that Edelweiss doesn't have asset liability mismatch risk.



Non Credit Business

Generates fee based income by providing brokerage, corporate advisory, wealth management, asset management, and other fee based services. Around 41 percent of its revenue comes from this segment. The revenue generated from this segment is volatile as it is highly dependent on the capital markets. Highly scaleable business with operating leverage resulting in profits growing faster than revenues. This segment generates an ROE of 22 percent. The details of various non-credit businesses are given below.

Non Credit Business	**Description**
Capital Markets	It has a wide range of corporate advisory services including IPOs, QIPs, Mergers & Acquisitions, and Fixed Income. It has one of the largest domestic institutional broking house with strong focus on research.
Wealth Management	Provide wealth management advice tailored to clients needs so that they can meet their financial goals. In FY16 its total asset under advice was 29,500 crore rupees.
Asset Management	Manage equity and debt focused assets through Mutual Funds, Portfolio Management Services, Alternative Investment Funds, and Asset Reconstruction Company. In FY16 its total asset under management was 32,100 crore rupees.
Balance Sheet & Liquidity Management	Strengthen its balance sheet by tapping into long-term liabilities and reducing the dependence of short-term borrowings. Liquidity management ensures that interest rate and asset liability mismatch risks are mitigated.

Agri Services & Others	It has a pan India network of 315 warehouses with a capacity of over 1.2 million metric tons. It offers various services ranging from procurement, quality assessment, warehousing, collateral management, and credit. The reason it is in the Agri Services is because it wants to build the agri credit business. Without an agri services arm it can't build an agri credit business as risk management is hard.

Given below is the revenue and profits for its non-credit businesses. Profits compounded at a much higher rate of 32 percent compared to revenue which compounded at 11 percent This could have happened due to business mix and operating leverage. Cost to income ratio is trending down which is good. The company is still in the investment mode. According to the management cost-to-income should come down to 50-60 percent in the long run.

(in crores)	2014	2015	2016
Net Revenue	893	1123	1107
Profit after Tax	104	134	182
Cost to income	80%	78%	76%
Return on Equity	19%	31%	22.3%

In the last couple of years the company started reporting the numbers for credit and non-credit businesses. Before that it used to segment it based on Agency and Non-Agency businesses. It's hard to compare the ROE differences between 2014-16. Consolidated view doesn't tell much about how the individual non-credit businesses are doing. I should read the subsidiary accounts to know the details.

Life Insurance

One of the fastest growing life insurance companies in India. This is a joint venture with Tokio Marine which provided 70% capital for 49% equity share. The remaining 51% equity is owned by Edelweiss. Around 14 percent of its revenue comes from this segment. Insurance segment is generating accounting losses as the business is in the investment phase.

(in crores)	2012	2013	2014	2015	2016
Income	53.21	98.2	159.8	283.9	387.5
Profit after Tax	-18.07	-64.7	67.8	-71.0	-154.8

In the last 5 years life insurance business generated losses adding up to 241 crore rupees. What is going on? Did Edelweiss make a mistake of entering the wrong business? To answer this question we need to look at the subsidiary accounts of Edelweiss Tokio Life Insurance Company. To keep things simple let's focus on fiscal years 2015 and 2016. From the table below we can see that insurance business is not bleeding on cashflows.

(in crores)	2015	2016	Total
Profit after Tax	-71.0	-154.8	-225.8
Cashflow from operations	-13.59	76.2	62.61

In order to sell a policy Edelweiss needs to set up a distribution channel so that prospective customers will know about its life insurance products. This will incur expenses in the form of commissions to brokers, agents, and other marketing expenses. These are called as underwriting expenses and when you compare this with earned premiums you get expense ratio. Expense ratio of 88

percent is very high. This is ok as the business is in the investment phase. We can already see that the expense ratio is coming down. Around 57 percent of sales happens through Agency channel. This channel is expensive in the short-term but works well in the long-term.

(in crores)	2015	2016
Premium earned-net	187	300
Operating expenses	205	264
Expense ratio	109.63%	88.00%

The largest portion of the premium goes towards paying for claims also known as losses. In life insurance claims often take years or decades to get reported and settled. This means that the insurance company is left with the choice of estimating the losses. So what we are seeing is not a true loss, but an estimated loss. Click here and here to learn more about life insurance business in India. Take a look at the table below showing the loss estimates along with actual benefits paid. What do you see?

(in crores)	2015	2016
Benefits Paid (actual)	7.71	18.35
Insurance Liabilities (estimates)		
Change in valuation of life insurance liabilities	139.49	255.49
Discount rate	7.8%	7.4%
Expected return on plan assets	not available	7.8%
Annual premium equivalent	99	146
Insurance Persistency	61%	70%

1. Insurance liability changes are the biggest item impacting profits and losses. They are provisions for future payments estimated by actuaries. The present value of this liability depends on three key factors: Mortality rate, Discount rate, and Expected return on plan assets. Mortality rate is a standard published by IRDA. You can find it here.
2. Insurance companies can reduce their liabilities artificially (read it as increase accounting profits) by increasing the discount rate and expected return on plan assets. Edelweiss discount rate of 7.4 and expected asset return of 7.8 percent for FY16 seems reasonable and it's inline with the current interest rate environment.
3. According to the management in life insurance business key inflection point happens when the total premium is about 6–7 times your first year new business premium. Currently 50 percent of the total premium is new premium and 50 percent is renewal premium. The business turns profitable when the new business premium at only about 14–15 percent of total premium.
4. For achieving 85 percent renewal premiums Edelweiss should ensure that already written policies stay intact without lapsing. Insurance Persistency measures this and higher the better. From the table we can see that Edelweiss persistency went up from 61 to 70 percent. Directionally things are looking ok.
5. Annual Premium Equivalent (APE) enables apples-apples comparison of insurance companies. APE 3-year CAGR for the industry is 2 percent. New insurance companies (peers) grew at 11 percent. Compared to the industry and peers, Edelweiss compounded at a much higher rate of 59 percent.

From all this we can conclude that the insurance business segment doing fine. It would take few more years for this segment to generate accounting profits. I agree with Edelweiss on reporting its ROE Ex-Insurance.

Management

Lending companies that knows how to evaluate and manage risks are going to be successful in the long term. We already saw that Edelweiss does a great job in maintaining high quality assets which resulted in low NPA and write-offs. On top of that it stayed out of broking at NSEL as they were selling spot contracts without any collateral. In spite of some customers being unhappy Edelweiss stayed with its decision.

In the end NSEL spot contracts turned out to be a Ponzi scheme and investors lost 5,500 crore rupees. To learn more about the NSEL scam read this and this. The decision to stay away from NSEL clearly shows that risk management is taken very seriously at Edelweiss. And it doesn't want to play around the edges to make additional profits.

> In fact, there was one client who was upset that we did not provide him with the opportunities to make good returns," an Edelweiss insider said, requesting anonymity. But Edelweiss chose to stay away. "We stayed out of broking at NSEL because we understood that on the warehouse side, risk management is the most critical. We prefer a situation where we manage the collateral and then fund it... As you have seen in every business that we head in, we are strongly focused on risk and compliance and we constantly oversee that, manage it. Our effort has always been to invest ahead of the curve in that. As you would have seen even the NSEL kind of crisis and all we had manage to stay away because a lot of that is focused on the kind of risk and compliance approach that we have. Still there is always a risk in any financial services business, risk and compliance is always an issue. You always have to be proactive about it, you have to be slightly paranoid about it, and you have to constantly focused on that. In our organization, the importance of that is never underestimated. - Rashesh Shah

Rashesh Shah imbibed three golden nuggets from Narayan Murthy, founder of Infosys. They are (1) Do not give equity cheap (2) Share benefits with your employees (3) Attempt to build a high-quality organization. The table given below clearly shows that Shah practices what he preaches.

Stocks issued other than ESOP and Bonus	0
Employee stock options issued from 2009	65,901,088
Shares outstanding end of FY16	814,036,630
% stock options issued on total outstanding	8%

In FY16 the remuneration for directors and key managerial personnel add up to 9 crore rupees. This is 1 percent compared to the total employee benefits of 882

crores. Shah and Ramaswamy didn't receive any stock options. I believe that the management is both able and honest.

If there's one thing I quibble about the management then it's there pledged shares. In FY16 around 55 percent of the promoter holdings is pledged. The trend of the pledged shares is coming down which is a good thing.

Valuation

If the actual rate of return on book exceeds the expected rate of return, then the intrinsic value of the asset should be worth more than the book. In FY16, after adjusting for non-provisioned NPA, the total book value comes to 4,334 crore rupees. Edelweiss earns around 20 percent ROE (ex-insurance) on its book.

If my expected rate of return is 12 percent then I should be willing to pay around 1.7 times book. In the last one month Edelweiss stock was trading between 83-99 rupees with a price-to-book ranging from 1.56 to 1.87. The current price looks reasonable. At this price we are not paying anything for growth.

Getting growth at zero cost for high quality financial companies is uncommon in the Indian stock market. Let's understand the growth opportunities existing in the Indian financial sector. The table below shows the Total Advances (money lent out) by the banks over time. I got this data from RBI website. What do you see?

(in trillions)	1998		2006		2016		CAGR	
							18 years	10 years
Total Advances - Banks	3.25	100.00%	15.17	100.00%	78.96	100.00%	19.40%	17.94%
Public Sector Banks	2.60	80.06%	11.06	72.94%	55.94	70.84%	18.59%	17.59%
Private Sector Banks	0.35	10.92%	3.13	20.63%	19.39	24.56%	24.90%	20.01%
Foreign Banks	0.29	9.02%	0.98	6.43%	3.64	4.60%	15.02%	14.06%

1. If the economy is growing, financial services normally grows 2.5 times of that and that means that if the economy grows at 8 percent, the average growth of a financial services entity is 20 percent [link]. In the last 18 years Indian economy grew at almost 9 percent. And the total advances in banks grew at 19.40 percent.

2. There is value migration happening from public to private banks. Currently public banks still holds 70 percent of advances. There is a lot of room for further value migration.
3. The total credit of all the non banks put together is only 8 trillion rupees. It is a smaller base, around 9 percent, and even within that there are the larger NBFCs who are mono lines focused on a particular segment. Out of 8 trillion rupees at least 4.5 to 5 trillion is housing finance. So the non housing finance is only 3 to 4 trillion in the non bank markets. So if you keep on slicing like that you can estimate that there is at least a fair amount of opportunities are still available [link].

Lending companies needn't worry about growth. It's there. To take advantage of this growth companies should first survive. For that they should keep their underwriting costs low. They should know how to evaluate and manage risks. Without that their heads will get chopped off. This reminds me of a scene from the movie Indiana Jones and The Last Crusade. Click here to watch that scene.

By being penitent Indiana Jones recovered the holy grail. To capture the growth (holy grail) lending companies should focus on asset quality (penitent) and not chase it. Here are some questions that an investor should ask before investing in Edelweiss.

1. Rashesh Shah played a huge role to nurture, grow, and shape the culture of Edelweiss. He is 54 years old. There is a key man risk. Will the company retain its culture without him?
2. On the consolidated balance sheet the leverage ratio is 6.3. This is definitely on the higher side. What happens if the NPA shoots up sharply?
3. Edelweiss is a complex financial entity. The total number of holding, subsidiary, and associate companies add up to 67. Including the consolidated annual report there are 68 annual reports in total. Do I really understand how their major subsidiary operates? Should I put this in a too hard pile?

Disclaimer: I have a small position in Edelweiss Financial Services. 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 industry. I am sharing it so that you can learn something from this.

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