In 2009, when the monsoon was less than 20% of its long-term average, Mahindra Finance was debating whether to stay true to its business model. The gross non-performing assets (GNPA) had touched 9%. For the company, which derives close to 85% of its business from rural and semi-rural markets, keeping bad loans in check was proving difficult.

It had to live through that again as GNPAs rose from 4.4% in FY14 to 8% in FY16. The drought had impacted the cash flows of its customers. It's not like Mahindra Finance was alone. Peers Shriram Finance and Cholamandalam Finance, too, saw a sharp uptick in their bad loans. For Mahindra though, patience was running thin as it was desperately looking to reduce volatility and keep asset pressure under check. "Our customers didn't have any CIBIL scores. So , we had to predict cash flows. That combination posed a challenge. But we took some measures to ease the strain without diluting the focus on rural and semi-rural markets," says V Ravi, CFO, Mahindra Finance.

For starters, Mahindra increased its reach. Most of that geographical expansion has come in the past year – penetration now stands at about 44% from 37% in FY15. Today, the NBFC is present in about 286,000 villages, with plans to add one lakh more villages in the next 18 months. It has ramped up its dealer network from 6,000-odd dealers about three years ago, to over 14,000 now, and has doubled its branches to 1,167 during the same period. The new branches are also to tap growth as Ravi expects "rural recovery to happen as a result of good monsoon in the coming months."

"New branches will ensure that we do not have significant exposure to a particular region or market, because poor agriculture conditions affect profitability," adds Ravi. A lot of it has also to do with the recovery of loans. For instance, large part of Mahindra Finance's asset quality issues have cropped up from the South, with the region logging GNPAs of 9% compared to 6% for the rest of India. And while Tamil Nadu, Karnataka, Kerala and Andhra Pradesh account for 30% of its loan book, they together have a share of 40% when it comes to GNPAs.

BEYOND THE FARM

Over the past few years, though, growth has been slow, admits Ramesh Iyer, vice chairman and managing director, Mahindra Finance. "Initially, our book size used to double every two years, then it became three. Now, it takes five years," he says.

Given the constraints of the rural segment, this is hardly surprising. But has the NBFC done enough to address the overhang? "Post the 2009 crisis, in our board meetings, we used to have extensive discus-

“ Our customers didn't have any CIBIL scores. So, we had to predict cash flows; that combination was challenging

–V Ravi

CFO, Mahindra Finance

fallen 140 basis points from 17.7% in FY12 to 16.3% currently.

"These businesses can use the existing infrastructure and branch network, and without any additional operating cost, directly add to the bottom-line. Since they generate higher yields, over the next few years, they will have a substantial impact on return ratios, which are today depressed because of the pressure on the core portfolio," says Ravi.

In FY16, the NBFC made a return on equity (RoE) of around 11%, which was its lowest in the last 10 years. "There may be few exceptional years, but ultimately we hope to have a RoE of around 18% in the years to come," he adds.

GAINING GROUND

Diversification is indeed helping. For instance, change in provisioning norms from 150 days to 120 days for its core business saw its standalone net profit drop 20% to ₹673 crore in FY16. But other verticals such as home loans, insurance and the mutual fund business reported a 22% growth in profit, limiting the impact on consolidated earnings. (*See: Steady support*)

Mahindra Finance started housing finance in 2013 with the same intent — to keep its rural focus whilst developing products that are backed by assets. "Our ticket size is

"Some of the past provisions will witness a reversal as a result of recovery, helping Mahindra improve return ratios

—Pradeep Agrawal, analyst, PhillipCapital

about ₹1.5 lakh to ₹1.7 lakh. These are usually loans for constructing an additional wall or room, etc; there is a huge market," says Iyer.

Today, housing finance is a ₹3,500 crore business. In FY16, it made a profit of ₹63 crore on an equity of ₹276 crore, making a return of almost 22%. It's a business that is leveraged almost 8x, with a yield of close to 17%. Yet, it's a secured business as it is reliant on mortgage of property.

Similarly, the company entered insurance broking and it launched its own mutual fund. By leveraging 158 branches across 23 states, it has already garnered assets of ₹1,700 crore, reaching out to some 50,000 customers. Together, the three businesses logged a net profit of close to ₹110 crore in FY16, on an invested equity of about ₹500 crore.

Iyer has ambitious plans. "Today, housing finance is about ₹3,500 crore. We intend to take it to ₹12,000 crore by the end of 2020. SME, which we started in 2015, has got a book size of ₹2,000 crore and we could take it to ₹10,000 crore by the end of 2020. There is great potential for the mutual fund and insurance distribution business as well, considering our large pool of customers," he says.

For now, frequent write-offs are taking a toll on Mahindra Finance's return ratios. A player like Bajaj Finance boasts of a RoE of 21% and a RoA of 3.2%. However, Mahindra and Shriram Finance's RoE has been less than 12% despite a net interest margin of about 7%. The stark difference is because compared to GNPAs of 6-8%, in the case of Mahindra and Shriram, it is 1.3% for Bajaj. Even the most efficient player in this space, Cholamandalam, with over 90% exposure to the rural and semi-urban markets, has GNPAs of close to 4%.

To turn this around, Mahindra Finance's strategy is to leverage its customer base and offer them financial products that are counter-cyclical. In the meanwhile, the cyclical upturn could bring in its own benefits, too. If poor monsoon, over the last three years, impacted the cash flows of rural India and dented Mahindra Finance's asset quality, with above average monsoon this year, there is high likelihood that cash flows and rural incomes will improve, bolstering demand and facilitating recovery. "We might see some of the past provisions actually witnessing a reversal as a result of recovery, helping Mahindra Finance improve return ratios," says Pradeep Agrawal, analyst, PhillipCapital. That seasonal bounty could be the harbinger of a better future.

Steady support

The insurance and home loans businesses have improved cash flow