Marcellus: Fooled by Probabilities and by NBFCs

There are plenty of cleverly crafted games in which you win most of the time and are rewarded with small payoffs. However, in such games there is always one scenario (which is not the base case scenario) where you get wiped out completely. Investing in NBFCs resembles these games of chance.

"When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done." **– J.M.Keynes in "The General Theory of Unemployment, Interest and Money" (1936)**

Would you gamble if the odds are stacked in your favour?
Imagine you walk into a casino in Monaco and are ushered towards a roulette wheel. The wheel has 37 numbers: the numbers 1 through to 36 and the number zero. You are told that if you bet $100 you will get an extra $3 if any non-zero number comes up. But if zero comes up, you will lose your $100. You swiftly do the maths in your head and realise that the odds are stacked in your favour. In fact, on average you expect to make 21.6 cents every time the wheel is spun [36/37 x 3 – 1/37 x 0]. Being a switched on Indian HNW you realise that you will lose money only 3% of the time (1/37).
The wheel is spun a few times and as expected you win repeatedly as

non-zero numbers come up. You then call up your bank in Switzerland and ask them to give you some margin funding so that you can wager larger amounts. As you sustain your sterling track record, you call up a Private Equity fund in Mumbai, spell out your track record of continuous profits and explain how they too can get a slice of the action if they take a stake in your enterprise. With debt from Swiss banks and equity from PE, you are now betting many multiples of $100. It is all going swimmingly until one day, the wheel stops on zero.

The financial model of an NBFC (in India and beyond)

The business model of a non-bank lender is and always has been straightforward. The lender has equity of $10 and borrows $90 (debt:equity of 9x) from the wholesale money market (say, at the rate of $45 every six months).

This $100 is then lent at a certain interest rate either to people who want to buy flats (20 year home loans) or to developer who want to construct residential housing blocks (5 year developer loans). Most of the interest collected from these borrowers goes to the wholesale money market participants who gave the NBFC the $90. Assuming a spread between the two interest rates of 3%, gives the NBFC a gross profit of $3 on the $100 it has lent. From that, the NBFC pays for its operating costs (assume 50 cents) and for bad debts (i.e. for borrowers who do not repay). Assuming it is a well-run NBFC, the bad debts could be as little 50 cents. That means that on $100 of loans (funded by a mere $10 of equity), the NBFC will make a profit of $2 (3 – 0.50 – 0.50). That results in a very impressive Return on Equity of 20% (2 / 10), enough to convince every PE house in town to seek a stake in the said NBFC.

Then one day, one of the developers (who has been lent, say, just $2)

says that he cannot repay. So the NBFC takes possession of the half constructed building that the developer has erected but can't find any buyers for the skeletal structure. That year the NBFC's profits go to zero as the normal operating profit of $2 is wiped out by the developer's default - the equivalent of the roulette wheel stopping on zero. Next month, the wholesale money market – unnerved by the NBFC's zero profits - refuses to extend its usual $45 to the NBFC; rather it coughs up only $25. This is not enough for the NBFC to rollover its existing debt.

Since the NBFC's shareholders' equity is only $10, the NBFC is now left insufficient funds. It can do one of two things: (1) raise more equity (which would heavily dilute the current shareholders but protect the wholesale money market lenders who have lent money to the NBFC); or (2) default on the monies that it owes the wholesale market (which completely wipes out the current shareholders and the wholesale money market lenders).

Investing in a NBFC is like playing European roulette

For the past couple of years we have told anyone who was willing to listen and any TV station that was willing to give us a pulpit that investing in NBFCs is like playing European roulette. You will make money most of the time – typically in large, free market economies NBFCs go bust once every decade or so. But then one day you will (yes, "will" is the apt word) lose everything you invested in the NBFC.

To cite a more prosaic game that most of us played as kids – investing in NBFCs is like playing Snakes & Ladders. There is that super long snake in the penultimate cell who brings you back to zero (although only a minority of the cells contain snakes). On the other hand, investing in clean, well-managed companies in the real world is like

playing Ludo – it is more laborious but we know where we are going and ultimately get there.

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Saurabh Mukherjea is the author of "The Unusual Billionaires and "Coffee Can Investing: the Low Risk Route to Stupendous Wealth". He's also the Founder of Marcellus Investment Managers.

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Saurabh Mukherjea can be reached on Saurabh@marcellus.in