NBFCs Crisis: *Critical Takeaways for Personal Finance*

"One who fails to plan, plans to fail." – Benjamin Franklin

Before understanding what happened in Non Banking Financial Companies (NBFCs) crisis we need to understand the basis of a company balance sheet in details:
What is a balance sheet?
A balance sheet is a financial statement that lists an organisation's assets and liabilities.

DUMMY BALANCE SHEET OF ABC LTD.
AS AT 31ST MARCH, 2019

Liabilities (sources)	Amount	Assets (Uses)	Amount
Long Term Sources: - Owner Capital/Equity - Reserve & Surplus - Long term loans		**Long Term Uses/Fixed Assets:** - Purchase of fixed assets like land & building, machinery, furniture & office equipments - Investment in other securities	
Short Term Sources/Current Liabilities: - Creditors - Short term loans like bank overdraft		**Short Term Uses/Current assets:** - Debtors - Inventory - Cash & Cash Equivalent	
Total		**Total**	

Liabilities: Liabilities constitute what the organisation owes, that is, what it has borrowed and what are its shareholders' funds.
Money is the basic need of a business and whenever the business needs money it borrows, in the first place the borrowing happens from the owners of the business which is known as capital. Secondly, it borrows from the lenders for long term & short term in the form of debenture/bonds & commercial papers respectively. Thirdly, borrowing can also be in the form of goods instead of money. It is usually a credit extended by the supplier marked as the term 'creditors' in the books of account.

Assets: Assets, on the other hand, represent what a business owns and all it has purchased with the money that is borrowed. The Company invests long term money in fixed assets like land, building, machinery, and equipment & short term money in current assets like cash, account receivable and inventories. It is very important to know that fixed assets are not frequently converted into cash during the life of the business whereas current assets are converted into cash during the operating cycle of the business.
Business needs to invest their money in such a way that its assets will generate an inflow of funds before liabilities demand an outflow. But in the worst-case scenario wherein the situation gets reverse we need to check the liquidity & solvency position of the firm.

In order to determine whether or not the company is "liquid"&" solvent", we need to study the financial structure of a company, Simply, it is the way in which the assets (fixed & current) are financed by the long term funds and short term funds.
The enterprise is liquid if it can meet its current liabilities out of current assets. It is solvent if assets are greater than outsider liabilities (Total liabilities minus owner's capital).
On the basis of liquidity & solvency, a **balance sheet can be categorized into three types:**

Type A:

Balance sheet –A(Ideal case, but very rare)

Liabilities (sources)	Amount	Assets (Uses)	Amount
Long term sources	**60**	Long term assets	**60**
Short term sources	**40**	Short term assets	**40**
Total	100	Total	100

A balance sheet is type A
when the long term sources and the long term uses match
when the short term sources and short term uses also match.
Though it seems an ideal balance sheet, because long term assets are acquired from long term sources and short term assets from short term sources, when you review short term assets you find it includes cash, debtors, and inventory. At the time of trouble, business may pay its creditors from debtors by efficient management of timings through bank overdrafts. But it will face serious problems to repay its creditors from inventory. In case emergency inventory is the least liquid assets & cannot be converted at the right pricing. Consequently, the company may face liquidity problem & to remain solvent it may need to sell long term assets to repay short term liabilities. When an organisation is forced to sell its long term assets in order to meet its short term liabilities, it represents the beginning of the end of that organisation.

Type B:

Balance sheet –B(Risky case)

Liabilities (sources)	Amount	Assets (Uses)	Amount
Long term sources	**50**	Long term assets	**60**
Short term sources	**50**	Short term assets	**40**
Total	100	Total	100

A balance sheet is type B
when the long term sources are less than the long term uses
when the short term sources are more than the short term uses
This indicates that the long term assets are financed from long term sources to an extent & partly from short term sources and this becomes a case of asset-liability

mismatch. Company is one which we need to avoid at any cost because it is guilty of financing its long term assets from short term sources. At the time of emergency, company needs to sell its long term assets for repayment of short term loans. Maximum business failures fall into this category. And exactly the same thing happened with NBFCs like ILFS & DHFL last year, which we discuss below.

Type C:

Balance sheet –C (Great!)

Liabilities (sources)	Amount	Assets (Uses)	Amount
Long term sources	**70**	Long term assets	**60**
Short term sources	**30**	Short term assets	**40**
Total	100	Total	100

A balance sheet is type C
when the long term sources are more than the long term uses
when the short term sources are less than the short term uses
This indicates that all long term assets are acquired from long term sources & surplus funds from long term sources are allocated to short term assets.
Type C is the most liquid & solvent one. Because company has surplus assets to repay its short term liabilities.

Anil Lamba, in "Romancing the Balance Sheet", says that a healthy Organisation is one which always follows below rules:

- Should use long term funds for long term purposes and short term funds for short-term purposes.
- May use, or rather should use, some long term funds for short-term purposes.
- But should NEVER use short-term funds for long term purposes.

NBFC Crisis:

"Bankers are people who lend you their umbrella in good weather, but who want to have it back as soon as it starts raining" - Mark Twain

NBFCs are financial institutions also known as India's shadow banking sector, a big source of credit to the country's small and medium enterprises, realtors, homebuyers and consumers. Unlike the formal banking sector, they cannot accept deposits from the public; they borrow money from banks or sell commercial papers to mutual funds to raise money. Gold loans, consumer durable loans, two-wheeler loans, vehicle finance and loan against property are the segments where NBFCs have a very strong presence across the country.

Asset Liability Mismatch?

"Companies with large debts often assume that these obligations can be refinanced as they mature."
-Warren Buffett

From the above balance sheet illustrations, we understood that for a sound company needs to have higher long term sources than long term assets & higher short term assets than short term liabilities.

But when you check the NBFC business model, you will find that they borrow money from short term sources like commercial paper for lending long term projects like house loans, real estate project financing & commercial vehicle loans. For example, an NBFC raises money by selling 9-month debt papers and on-lends this as a house loan with tenure of 15 years. This leads to a situation where the NBFC has to roll over (or renew) the 9-month debt paper or raise fresh loans to repay the debt paper. In good times, this happens as a matter of course. But when times are tough, this cycle is broken.

This is the scenario which has played out for many NBFCs including IL&FS, DHFL and is called an asset-liability mismatch.

IL&FS Crisis:

Let's look at the balance sheet of IL&FS in the above-stated format:

ILFS: Infrastructure Leasing & Financial Services Limited (IL&FS) is an Indian infrastructure development and finance company. It operates through more than 302 entities including IL & FS Investment managers, IL & FS financial services and IL & FS Transportation Networks India Limited.

CONSOLIDATED BALANCE SHEET OF INFRASTRUCTURE LEASING & FINANCIAL SERVICES LIMITED as on 31st March 2018					
Liabilities (sources)	Amount (in crs)	% age of liability	Assets (Uses)	Amount (in crs)	% age of assets
Long term sources	78725	68	Long term Assets	82556	71
Short term sources	37089	32	Short term Assets	33258	29
	115815	100		115815	100

Source: IL&FS 2018 Annual Report

As on 31st March 2018, it's long term assets (71%) are financed from long term sources (68%) to an extent and remaining from short term sources (3%). It seems equal to the Type B balance sheet which was guilty of financing long term assets from short term sources.

When you check the maturity profile of assets & liabilities of the firm in the following table, you will find a serious gap (negative red values in the last column). Henceforth, in September 2018, a group company defaulted in payment obligation of bank loans, term & short term deposits and failed to meet the commercial paper redemption obligation due on September 14. On September 15, it defaulted on inter-corporate deposits & later it's credit rating downgraded by credit rating agency ICRA. At the time of default, IL&FS total outstanding debt was Rs 91,000 cr.

Maturity Pattern of Certain Items of Assets and Liabilities as at March 31, 2018									
Particulars	**1 day to 30/31 days**	**Over 1 month to 2 months**	**Over 2 months to 3 months**	**Over 3 months to 6 months**	**Over 6 months to 1 year**	**Over 1 year to 3 years**	**Over 3 years to 5 years**	**Over 5 years**	**Total**
Liabilities (in cr)									
Borrowings from banks	40.0	-	82.5	275.0	554.7	1,108.3	228.3	-	2,288.8
Market Borrowings	822.3	499.5	280.5	1,495.3	1,706.7	3,250.0	2,367.3	3,225.1	13,646.6
Total Liabilities	862.3	499.5	363.0	1,770.3	2,261.3	4,358.3	2,595.7	3,225.1	15,935.4
Assets (in cr)									
Loans & Advances	2,625.9	861.3	198.9	103.7	148.0	1,534.5	154.1	598.5	6,224.9
Investments	1,574.0	-	68.4	42.9	296.8	3.6	1,673.2	10,381.0	14,039.9
Total Assets	4,199.9	861.3	267.3	146.6	444.8	1,538.1	1,827.3	10,979.4	20,264.7
GAP (Assets -Liabilities)	3,337.6	361.8	-95.7	-1,623.7	-1,816.5	-2,820.3	-768.4	7,754.4	4,329.3

Source: IL&FS 2018 Annual Report

DHFL Crisis:

Same is the case with DHFL. Now let's look at the balance sheet of DHFL

Dewan Housing Finance Corporation's main business is of providing loans to Retail customers for purchase or construction of residential property & loans against property.

CONSOLIDATED BALANCE SHEET OF DEWAN HOUSING FINANCE CORPORATION LTD. as on 31st March 2018					
Liabilities (sources)	Amount (in crs)	% age of liability	Assets (Uses)	Amount (in crs)	% age of assets
Long term sources	80374	75	Long term Assets	89489	83
Short term sources	27254	25	Short term Assets	18138	17
	107627	100		107627	100

Source: DHFL 2018 Annual Report

As on 31st March 2018, its long term assets (83%) are financed from long term sources (75%) to an extent and remaining from short term sources (8%). So this is also an example of Type B Balance Sheet where chances of problem creeping are somewhat on higher side.

When you check the maturity profile of assets & liabilities of the firm in the following table, you will find a serious gap (negative red values in the last column). DHFL's problem started after IL&FS default on September 2018, When DSP mutual fund had to sell DHFL paper at a steep discount. When the news published it became visible to everyone that the company is guilty of financing its long term assets from short term sources. Subsequently, the stock dropped by more than 50% in the day itself. To combat the situation DHFL sold its insurance & mutual fund business to pay the lenders. But the situation got even worse. Finally, in June 2019 DHFL defaulted in all its debt payments. In quarter 1 2019-20 the company has reported a loss of more than its value as an entity i.e 2223 cr.

Assets Liability Management (Maturity pattern of certain items of Assets Liabilities)											
Particulars	**Upto 30/31 days (one month)**	**Over 1 month & up to 2 month**	**Over 2 month & up to 3 month**	**Over 3 month & up to 6 month**	**Over 6 month & up to 12 month**	**Over 1 Year & up to 3 Years**	**Over 3 Year & up to 5 Years**	**Over 5 Year & up to 7 Years**	**Over 7 Year & up to 10 Years**	**Over 10 Years**	**Total (in cr)**
Liabilities (in cr)											
Deposits	107	299	661	1,377	2,238	4,720	742	57	134	4	10,339
Borrowings from Bank	2,499	363	792	1,545	3,106	14,030	10,795	5,475	2,989	455	42,049
Market Borrowing	197	4,142	2,054	1,254	1,378	11,083	3,156	7,011	5,905	1,183	37,362
Foreign Currency Liabilities	-	-	-	148	148	1,314	1,355	-		-	2,965
Total Liabilities	2,803	4,804	3,507	4,325	6,871	31,146	16,048	12,543	9,027	1,641	92,715
Assets (in cr)											
Advance	1,701	459	462	1,410	2,918	12,373	14,095	10,656	9,651	38,209	91,932
Investments	6,879	-	-	-	173	-	-	-	665	359	8,077
Foreign Currency Assets	-	-	-	-	-	-	-	-	-	-	-
Total Assets	8,580	459	462	1,410	3,091	12,373	14,095	10,656	10,316	38,568	1,00,009
GAP (Assets -Liabilities)	5,776.9	-4,345.7	-3,044.4	-2,914.7	-3,779.7	-18,773.2	-1,953.6	-1,887.5	1,288.6	36,926.6	7,293.4

Source: DHFL 2018 Annual Report

Post ILFS default, there were fears that this would turn out to be a contagion. Banks, mutual funds and investors were afraid that more such entities would default. As this fear took hold, many institutions refused to give money to NBFCs. The cost of funds rose for NBFCs & shares of NBFCs dropped drastically.

NBFC	Pre crisis (31-08-2018)	Post crisis (03-08-2019)	% fall
DHFL	664.58	46.65	-93%
Piramal Enterprises	3122.43	1748	-44%
Edelweiss	278.78	149.7	-46%
India Bulls Housing	1275.74	489.64	-62%
Shriram Transport	1344.16	978.45	-27%
Shriram City Union	2010.06	1412	-30%
PNB Housing	1388.48	714.15	-49%
Muthoot Finance	409.55	621.3	52%
Manappuram Finance	100.52	113	12%
Gruh Finance	335.4	244.7	-27%
Bajaj Finance	2930.44	3238	10%

Some well-managed balance sheet company merged stronger. This is not the first time the NBFC crisis occurred. The same problem happened in 2008, 2013, at the time of demonetization.

Personal Finance; Co-correlation with NBFCs Crisis

"The surest way to ruin a man who does not know how to handle money is to give him some."
- George Bernard Shaw

If you are thinking why am I discussing all this with you & how is this important to you?
Below is the dummy income statement & balance sheet of Mr. Mohan. Income statement consists his income or inflow of money from all sources like salary, rent from house property, gain on shares, mutual fund or real estate, income from business & profession, income from interest on deposits.
Expenses consist of his outflow of money on various heads like taxes, household expenses, utility expenses, loan EMIs, Insurance premium & other expenses.
After deducting total expenses from income, whatever left is your saving. Now you can invest this in various avenues like recurring deposit, debt mutual fund, equity mutual fund & fixed deposits.

DUMMY INCOME STATEMENT OF MR. MOHAN
FOR THE YEAR ENDED 31st MARCH, 2019

Particular	**Amount**
1. Income Sources: A) Income from salary B) Income from house property C) Income from capital gain D) Income from business & profession E) Income from other sources Gross Total Income (A+B+C+D+E)	
2. Expenses: A) Tax B) Household expenses C) Utility expenses D) Loan EMIs E) Insurance Premiums F) Other expenses Total Expenses(A+B+C+D)	
Savings(Income-Expenses) - SIP in liquid mutual fund - SIP in ultra short bond fund - SIP in Equity mutual fund - Investment in PPF/EPF/NPS - Investment in RD - Balance in saving accounts	

Balance Sheet:
A balance sheet represents that your assets & your liabilities on a particular date.

"Rich people acquire assets. The poor and middle class acquire liabilities that they think are assets."
- Robert Kiyosaki

Liabilities: Liabilities constitute what you owe, that is, what you have borrowed.
Liabilities can be classified into two distinct categories:
Long term liabilities: Long term liabilities are which you have to repay after a year or so, it includes long term borrowing like, home loan, car loan, etc.
Short term liabilities: Short term liabilities are those you have to repay within a year like credit card bills, income tax.

Assets: Assets, on the other hand, represent what you own, be it from your savings or from your borrowings.
Assets can be classified into three distinct categories:

- Fixed Assets: Fixed assets include things like houses, cars, furniture.
- Investments: Investments include stocks, equity mutual funds and real estate, long term bonds, long term debt funds, PPF.
- Current Assets: Current assets are those assets that can be converted into cash within a year. These include cash, saving accounts, liquid funds, and Ultra short bond funds.

All assets are recorded only on their present market value.

Net worth: Your net worth is the difference between what you own and what you owe.

Net worth = Assets – Long term liabilities – Short term liabilities

If you have a negative net worth, this means that you owe more than you own.
Two ways to increase your net worth are to increase your assets or decrease your liabilities. You can increase assets by increasing your cash or increasing the value of any asset you own. One note of caution: make sure you don't increase your liabilities along with your assets. For example, your assets will increase if you buy a house, but if you take out a mortgage on that house your liabilities will also increase. Increasing your net worth through an asset increase will only work if the increase in assets is greater than the increase in liabilities. The same goes for trying to decrease liabilities. A decrease in what you owe has to be greater than a reduction in assets.

DUMMY BALANCE SHEET OF MR. MOHAN
AS AT 31ST MARCH, 2019

Liabilities (Sources)	Amount	Assets (Uses)	Amount
Long Term Sources: A) Net Worth(Total assets-Long term loans – Short term Loans)		**Long Term Uses/Fixed Assets:** - Primary Residence (Home) - Furniture & Appliances - Vehicle	

B) Long term loans - Outstanding Home Loan - Outstanding Vehicle Loan - Outstanding Consumer Loan		- Investment in securities like PPF, equity mutual fund, fixed deposit, real estate, life insurance, gold & other investment	
Short Term Sources/Current Liabilities: - Outstanding Credit Card Loan - Tax Payable		**Short Term Uses/Current assets:** - Cash - Saving account/Liquid fund - Short term debt funds - Others receivables	
Total		**Total**	

Let's evaluate the personal finance balance sheets as per the "Three Type of Balance Sheets":

Type A:

Balance sheet –A(Ideal case, but very rare)

Liabilities(Sources)	Amount	Assets(Uses)	Amount
Long term Sources - Net Worth 10 - Long term debt 70	80	Long term assets	80
Short term sources	20	Short term assets	20
Total	100	**Total**	100

A balance sheet is type A when you build your long term assets like house, car from long term mortgages & short term assets like an investment in short term debt funds from short term sources like a credit card. Though it seems an ideal balance sheet but it is probable to have liquidity issues. As the value of short term liabilities is fixed, therefore any delay in monetising short term assets is likely to create liquidity issues.

Type B:

Balance sheet –B (Risky case)

Liabilities(Sources)	Amount	Assets(Uses)	Amount
Long term Sources - Net Worth 20 - Long term debt 40	60	Long term assets	80
Short term sources	40	Short term assets	20
Total	100	**Total**	100

A balance sheet is type B when long term assets are financed from long term sources to an extent & partly from short term sources and this becomes a case of asset-liability mismatch similar to ILFS & DHFL. When your current liabilities exceed current assets results in liquidity issues and failing to handle the same, it turns out to be solvency issue. For example, you have long term assets like a house which is sources from house loan & a car, free from debt. You have short term liabilities like a credit card which are greater than your short term liquid assets. To timely repay your short term liabilities you will need to sell off your car.

Type C:

Balance sheet –C (Great!)

Liabilities(Sources)	Amount	Assets(Uses)	Amount
Long term Sources - Net Worth 70 - Long term debt 20	90	Long term assets	80
Short term sources	10	Short term assets	20
Total	100	**Total**	100

Type C balance sheet tells us that the long term assets are more than the long-term liabilities and subsequently the short-term assets are more than the short-term liabilities. This type of balance sheet is most liquid as well as solvent & can handle any emergency.

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My role as an advisor is that my investor will have Type C Balance sheet before investing money in equity & will maintain Type C Balance sheet during their investment in equity. Equity is a long term asset that gives returns in cycles. At the time of bear market, when your portfolio is down, you have sufficient reserves to maintain your short term liabilities & able to handle the downside.

Below is the performance summary of Warren Buffett company: Berkshire Hathaway. Share price of his company fell more than 35%, 4 times in 53 years of history. Despite this underperformance, over the long period (1965-2018), company generated a compounded return of 20.5% p.a. If you were the investor in his company at those downtimes & had type c balance sheet you wouldn't have panicked. But if you had type A & B balance sheets you would not had much option except exiting.

"The market can stay Irrational longer than you can stay solvent."
- John Maynard Keynes

Berkshire Hathaway Share Price (in USD)

Short Term Price Movements

Period	High	Low	Percentage Decrease
March 1973-January 1975	93	38	(59.1%)
10/2/87-10/27/87	4,250	2,675	(37.1%)
6/19/98-3/10/2000	80,900	41,300	(48.9%)
9/19/08-3/5/09	147,000	72,400	(50.7%)

Long Term Value Appreciation

Compounded Annual Gain – 1965-2018	**20.5%**
Overall Gain – 1964-2018	**2,472,627%**

Source: Warren Buffett's letters; 2017 & 2018

Benjamin Graham: In the short run, the market is a voting machine but in the long run, it is a weighing machine.

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