

**Simulated Finance Company Case Study**  
**Achankovil Financial Services Private Limited ("Achankovil")**  
**Pallathuruthy Bridge South, Alappuzha<sup>i</sup>, Kerala 688 001**

### **A Bad Start**

When B. Arunkumar ("Kumar") sauntered into the office on April 1<sup>st</sup>, a full half an hour late, he could sense that there was trouble brewing in the office and that he was at the centre of it. He was never late but he had gone out with his colleagues last night to celebrate the end of a good year in which both he and his company had done well. He had gone to bed late and had gotten delayed getting ready to get to office. None of his colleagues were prepared to make eye contact with him and when he got to his desk he saw why. His boss Ms. Akkamma Cherian<sup>ii</sup> had left a note on his table which read:

"Kumar: where the devil are you? Come to my office the minute you see this note."

People had seen the note and while nobody seemed to know what the issue was, the tone of the note was clear.

When he went into see Ms. Cherian she seemed pretty upset. She had received a call from the head of the AccuRate Rating Agency ("Accurate") first thing in the morning, giving her an informal feedback on the rating application that Achankovil had submitted to them based on provisional figures for the previous year. Based on a review of the figures, Accurate had informed Ms. Cherian that not only was Achankovil not going to get the "A" rating that they had hoped for but that the best that they could expect to get was a BB+ rating, not even a BBB.

She had been informed that to get a "A" rating for the bonds to be issued by Achankovil, they needed to convince Accurate that the one year default expectations would be no more than 1%, i.e., that Achankovil would not default on its obligations more than once in 100 years. Accurate had determined that Achankovil was nowhere near that expected default rate and instead had numbers closer to 20%, i.e., it was likely to experience failure over the next 5 years.

This was indeed devastating news and even Kumar was pretty upset when he came out of the office. He could not figure out what had gone so wrong.

### **Assets and Liabilities**

Kumar was a simple uncomplicated man and he liked to keep things simple and clear. Achankovil had closed the year with a Rs.100 crore balance sheet, with the following profile

1. Kumar had borrowed long-term money at 16% rate with a bullet maturity but quarterly interest payments. He had paid a little bit extra for it but he knew how hard it was to persuade lenders to give money to an unrated financial services company, that too with a rural focus, so when an offer of Rs.90 crore had come along, he had jumped at it. At the end of March 31<sup>st</sup> all his loans had a balance maturity of 5 years.
2. Achankovil had a capital base of Rs.10 crore and while he was not sure why he felt that way, in his view this was a good amount of capital and his investors expected to give them an annual return of 20% after all taxes – this was thus his most expensive source of money and he tried to rely on it to the minimum.

3. He had asked his branches to lend all this money out for a five to six year term with quarterly amortization schedules because Kumar knew liquidity was important and wanted to get money back from his clients as soon as possible so that he would not have to struggle for it when the time came to repay his lenders. The money he received he kept as a deposit with another much larger highly rated finance company who agreed to pay him the market rate for it, which at the moment was 16%, the same rate as the rate he borrowed money so he figured he was in good shape there.
4. At the end of March 31<sup>st</sup> all his loans, it turned out, had a balance maturity of exactly five years. They had been made to rural retailers who served the local backwaters tourist trade. This was a business Achankovil staff knew well so he, from his perch at the head-office, encouraged them to stick to only these borrowers. It is true there was steady attrition amongst these retailers as the tourist traded waxed and waned from year to year but he figured that on average only about 5 to 6% of the retailers went bust every year and could not pay anything back. The collateral that Achankovil held was largely inventories and by the time the staff got to it almost 70% of the inventory had disappeared.
5. To take care of all of these issues Kumar had required all his staff to charge a spread of 8% over the cost of funds and over and above any additional staff and other costs that they incurred – producing a lending rate of as high as 28%. This was high by urban market standards but Kumar felt that with an “A” rating at hand he could lower his cost of funds quite dramatically and, over time, would also have benefits of scale so that he could further reduce his operational costs.
6. He and Ms. Cherian both felt very strongly that serving clients like these, whom the larger banks were not prepared to touch, was the very purpose of the existence of Achankovil and that there was no question of starting to serve clients who had a lower risk of failure and moving away from the current remote rural focus.

### **What Had Gone Wrong?**

While this whole area of ratings was very new to him, he knew he was the inheritor of the great traditions of the famous Kerala School of Mathematics which had produced giants like Madhava of Sangamagrama (whose work on “Taylor” series expansions for example, pre-dated the work of Brook Taylor by over 200 years), and he set about understanding these issues in a very systematic manner. The questions he needed to answer were very clear:

1. Why did the Accurate think that Achankovil was worth only a BB+ rating?
2. Was Achankovil’s lending strategy or his own borrowing strategy somehow responsible?
3. What could he do about it so that the all-important “A” rating was possible?

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<sup>i</sup> Alappuzha is one of the most important tourist centres in the State of Kerala, with a large network of inland canals and is often referred to as the "Venice of the East". The name Alappuzha is derived from 'Aal (Sea) + Puzhai (River-mouth). The correct pronunciation of this name can be heard here: <http://upload.wikimedia.org/wikipedia/commons/2/26/Alappuzha.ogg>

<sup>ii</sup> Her parents had named her after the famous Kerala freedom fighter who Gandhiji referred to as the Jhansi Rani of Travancore.