Navigate

Case Study - I

Case Study - BestCredit

Welcome to BestCredit, an Organization which provides credit to people.

Following is a brief description of how the Organization works:

- The Organization gets its funds through various debt instruments, which costs company 4% p.a. in terms of interest
- The company then lends these funds in form of loans to its customers. To simplify, let us assume that the company offers loans to 2 kinds of customers:
  - The first kind of customers is customers with good credit history. They can get loans from various providers and are typically financially savvy. The best way to get these customers is to have simple, transparent and competitively priced products. BestCredit offers them loans at 6% p.a. Let us call these customers Highflyers.
  - The second kind of customers are the ones which have bad or impairing credit history. These customers are riskier and hence find it difficult to find loans at a competitive price. BestCredit offers them the loan at 15%. Let us call these customers Strugglers.
- Following are some more pieces of information BestCredit has provided:

	Highflyers	**Strugglers**
Loan interest rate	6%	15%
Typical loan amount (INR)	5,00,000	50,000
Charge-off rate	1%	10%
Number of loans underwritten (in last year)	100	1000
Operations cost	1%	1%

Please note that operations cost depends on multiple factors, most important of them being the scale of operations. Current estimates of 1% hold only at current scale.

In order to simplify the problem, let us assume that a very simple product, where the loan amount is lent to the customer and he has to return the amount along with interest at the end of 12 months. Also, charge-offs refer to the event when a customer fails in paying back the loan at end of 12 months.

Question:

Given the above information, do you think BestCredit is making profits or losses? Also, by what amount is the loss or profit being made?

Options:

1. Profit - 87,20,000
2. Profit - 32,20,000
3. Profit - 12,20,000
4. Loss - (- 7,80,000)(Correct answer)

Let's go through the calculation.

Equation:

Profit for BestCredit = Revenues - Expenses

= Interest earnings - Chargeoffs - Operational cost - Cost of capital

Interest earnings = 5,00,000 * 100 * (1 - 1%) * 6% + 50,000 * 1000 * (1 - 10%) * 15%

= 97,20,000

Chargeoffs = Total amount lent x charge-off rate

= 5,00,00,000 x 1% + 5,00,00,000 x 10%

= 55,00,000

Operational cost = Total amount lent x operationl cost %

= 5,00,00,000 x 1% + 5,00,00,000 x 1%

= 10,00,000

Cost of capital = Capital borrowed x rate of interest

= (5,00,00,000 + 5,00,00,000) * 4%

= 40,00,000

Hence,

Profit for BestCredit = Revenues - Expenses

= Interest earnings - Chargeoffs - Operational cost - Cost of capital

= 97,20,000 - 55,00,000 - 10,00,000 - 40,00,000

= -7,80,000

(content.php?topic_id=10&module_id=3&course=analytics101)
(content.php?topic_id=12&module_id=3&course=analytics101)