Initiating Coverage – 27 January 2015

Equity Research

NIRMAL BANG
a relationship beyond broking

Muthoot Finance Ltd

Recommendation	BUY
CMP (23/01/2015)	Rs. 222
Target Price	Rs. 292
Sector	NBFC

Stock Details	
BSE Code	533398
NSE Code	MUTHOOTFIN
Bloomberg Code	MUTH IN
Market Cap (Rs cr)	8827
Free Float (%)	25%
52- wk HI/Lo (Rs)	235/120
Avg. volume BSE +NSE (Quarterly)	496,280
Face Value (Rs)	10.0
Dividend (FY 14)	50%
Shares o/s (Crs)	39.71

Relative Performance	1Mth	3Mth	1Yr
Muthoot	16.6%	19.5%	70.3%
Sensex	7.6%	9.0%	37.0%

Shareholding Pattern	31st Dec 14
Promoters Holding	75.0%
Institutional (Incl. FII)	16.85%
Corporate Bodies	1.04%
Public & others	7.11%

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All set to embark on new journey

Muthoot Finance Ltd (MFL), headquartered in Kochi (Kerala) is 75% owned by the Muthoot family and is the largest gold financing NBFC in India with total AUM of Rs 22,088 cr as on Dec-14. MFL is engaged in the business of providing personal loans and business loans against used household jewellery.

MFL saw consolidation period for past couple of years, marked by de-growth in AUM (from Rs 26,000cr in FY13 to 21,500 levels in Q1FY15), to & fro shifts in regulatory stance and sharp correction in gold prices. Combination of the above factors led to volatility in the earnings (FY14 RoA at 3.2% from avg. of 4.2% over FY06-13). Hence, valuation too took a knock (from avg. 1.9.x level over FY12-13 vs. to now at 1.5x FY17E).

We believe that MFL is now all set to embark on growth momentum (Q2/Q3FY15 saw growth coming back, albeit at lower pace) given better macro-economic conditions and restoration of LTV back to 75% from 60% earlier. Further, lower volatility trend in gold prices has also led to renewed enthusiasm within the industry. With better conditions for gold financing NBFCs and MFL being the undisputed leader of the industry, we expect MFL's AUM growth to pick up pace in near term and substantially gain momentum in medium to long term. We build in loan growth of 13.3% CAGR FY14-17E.

We expect MFL's RoA to increase to ~3.6% by FY17E led by:

- **Pick-up in core earnings:**
  We expect core earnings to grow at ~10% CAGR (vs. mere 3% CAGR FY12-14) over FY14-17E driven by uptick in business growth and improving trend in margins (avg. 9.6% in FY15-17E vs. avg. 9.2% in FY13-14)
- **Operational leverage- key RoA driver**
  MFL is all set to milk its strong branch network of 4256; incremental cost will be substantially lower (opex CAGR of 10.0% FY14-17E vs. 46.2% CAGR in FY09-14) and thus we expect C-I ratio to fall to 46.5% FY17E vs. 51.3% in FY15E leading to RoA of 3.6% in FY17E vs. 3.03% in FY15E.
- **Gradual healing of asset quality:**
  MFL's performance in FY13-15E was marred by spikes in NPL level in turn leading to higher credit costs. With easing regulatory hurdles and lower volatility trend in gold prices, we expect asset quality to improve (GNPA/NNPA of 1.7/1.2% in FY17E vs. 2.0/1.7% in FY14).

Volatility in gold prices remains the key risk, but we believe that demand for gold will remain strong thereby expect churning in good loan book for the industry. ***At CMP of Rs 222, MFL trades at 1.73x and 1.52x its FY16E and FY17E BV and 10.38x and 8.35x its FY16E and FY17E EPS respectively. We believe that Muthoot being the market leader is best positioned to benefit from improving business sentiment in the gold loan industry as asset quality concerns are likely to abate. We initiate coverage on the stock with a BUY rating on the stock and a target price of Rs 292 (2.0x FY17E ABV) implying a 32% upside.***

Year	NII (Rs cr)	Growth (%)	PBP (Rs cr)	Growth (%)	PAT (Rs cr)	EPS (Rs)	PE (x)	Adj BVPS (Rs)	P/ABV (x)	RoE
FY 14A	2,302	-9.4%	1,248	-21.0%	780	20.99	10.58	105.5	2.10	19.5%
FY 15E	2,247	-2.8%	1,094	-12.3%	685	17.26	12.87	114.7	1.94	14.9%
FY 16E	2,635	17.5%	1,329	22.8%	849	21.38	10.38	128.4	1.73	16.3%
FY 17E	3,068	16.3%	1,640	24.3%	1055	26.58	8.35	145.8	1.52	18.1%

Investment Rationale

Worst is behind

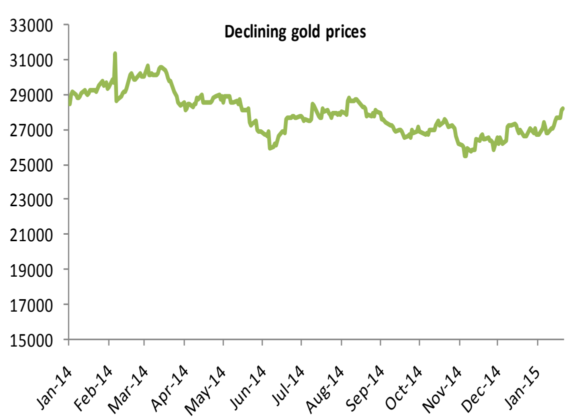
Gold loan NBFCs faced multiple headwinds over last couple of years and MFL being the leader of the industry bear the brunt which resulted in decline in company's AUM driven by sharp slowdown in disbursements. Industry as a whole at that point of time was facing difficulties viz decline in gold prices, to & fro in regulatory stance and general slowdown in macro.

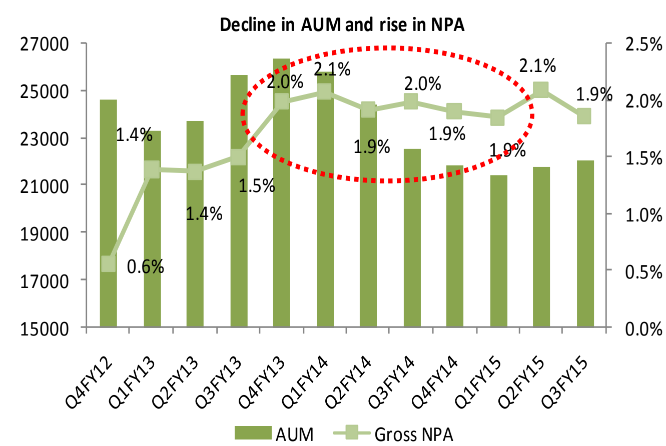
Issues which plagued the gold loan industry in the last couple of years

The gold loan industry started to face headwinds from March 2012. To begin with issues like
(1) tightening of regulations by the RBI – lowering the LTV to 60% during
(2) gold prices began to retreat from its highs
Both the above factors resulted in

- Decline in AUM
- Increasing cases of loss given defaults.

Pure gold loan financiers like Muthoot Finance and Manappuram faced severe asset quality pressure for the above reasons.





Source: Company data, Nirmal Bang Research

However, since January 2014, the LTV which was being capped at 60% (during March 2012-Sep 2013) was relaxed to 75%. Now the guidelines for gold loan NBFCs are almost at par with most of the other NBFCs. Gold loan NBFCs still have to adhere to higher capital adequacy ratio with Tier I of 12% (higher than other NBFCs). The revised guidelines are as under:

Specifications	Earlier guidelines	Current guidelines
LTV	No LTV cap	75% LTV cap
Valuation of jewellery	On gold value	On 22 karat gold jewellery
Base for calculating gold price in LTV	Three months average price of 22 karat gold	30 day average price taken from the Bombay Bullion Association
Cash transaction	Not defined	Loans below Rs 1 lakh only in cash and above must that to be disbursed in cheque only
Safe deposit vault	Not defined	NBFCs having more than 50% of AUM in gold loans must have minimum level of physical infrastructure

Source: Company data, Nirmal Bang Research

All set to embark on new journey

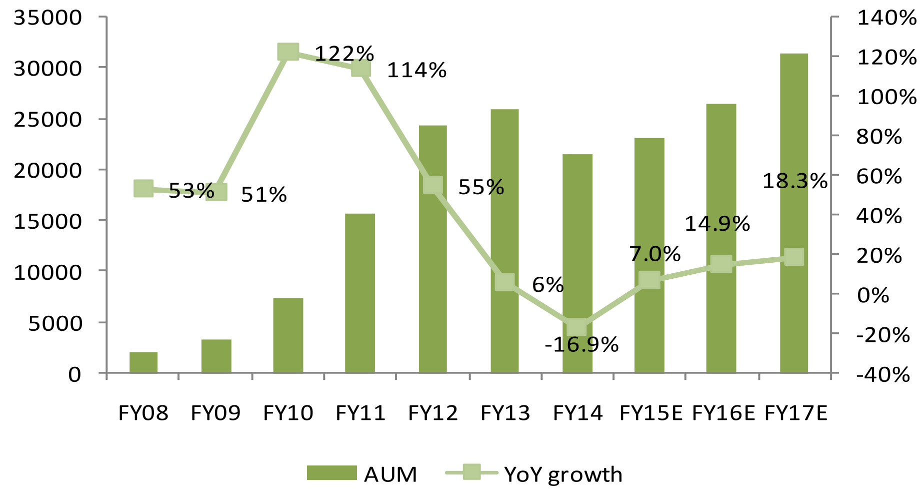
Growth set to pick up after consolidation

During FY08-12, MFL witnessed sharp increase of 83% CAGR in its AUM driven by increase in gold volumes and higher gold prices. However, due to unfavorable conditions, MFL resorted to consolidation. AUM witnessed de-growth of 17% in FY14. After witnessing decline for the last 5 quarters, we saw a QoQ uptick in growth in Q2/Q3FY15 which is expected to gain momentum going ahead.

Going ahead, management expects traction in its AUM on account of new product launches, lower auctions as compared to FY14 levels and stabilising gold prices and expects to witness ~12-15% AUM growth over the next 12 months.

Though the growth rate is likely to remain modest in FY15E, we are of the view that pickup in growth will be largely seen in FY16/17E. We believe that an increase in the client base over the long term would be a key driver of AUM growth,
(1) as the penetration of organised finance will increase and
(2) gold loans availed by customers are based on for funding requirements rather than gold prices.

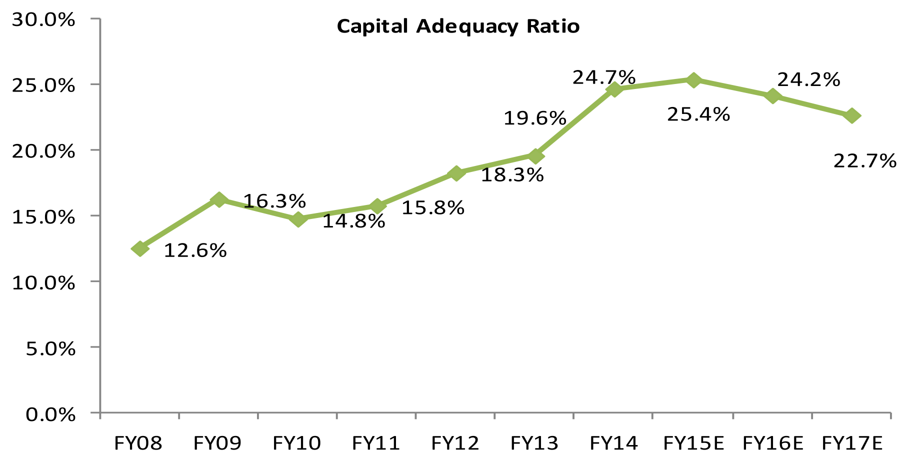
Thus stability in gold prices, stable regulatory regime and revival in overall economic scenario is likely to drive the AUM growth going forward. We expect a pickup in AUM growth from 7% in FY15E to ~15% in FY16E and ~18% in FY17E.



Source: Company data, Nirmal Bang Research

Strong capital position augurs well for high growth

Healthy capital adequacy ratio has been an advantage for the company to enable it to grow its loan book at significant pace in tough times. Muthoot had raised Rs420 cr through the IPP route in May 2014 at Rs165 per share. Post the capital raising Muthoot had a capital adequacy of 26.3% with Tier I ratio of 20.7% in Dec 2014 and a lower leverage of ~4.9x which will enable it to grow at healthy pace going forward with an improvement in economy.

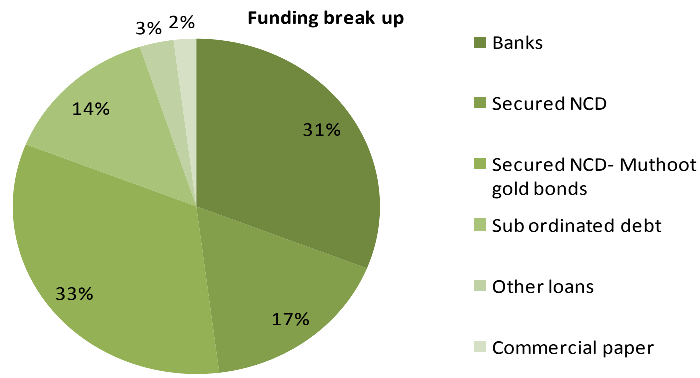


Source: Company data, Nirmal Bang Research

Margins to witness expansion

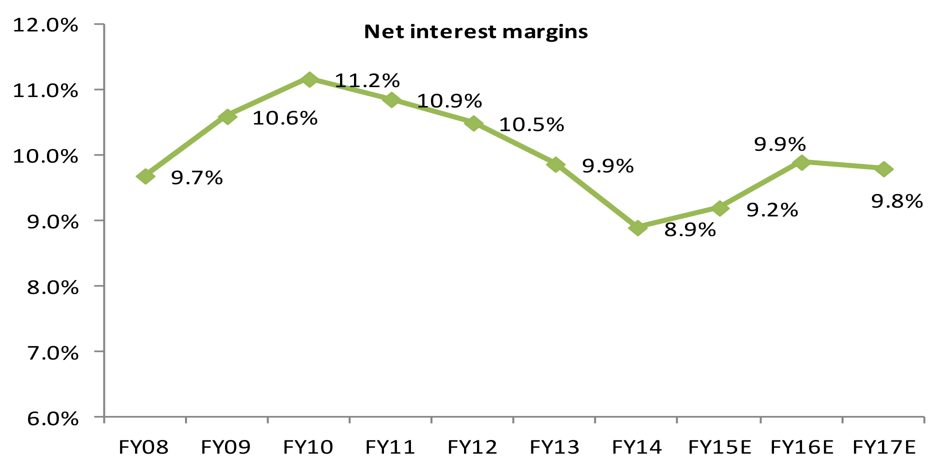
MFL witnessed CAGR of 50.7% in its Net interest income over FY09-FY14 reflecting strong AUM growth and higher yields. Post the regulatory issues impacting the overall business environment, growth in NII came down to as low as 17% in FY13 and witnessed de growth of 9.4% in FY14. MFL's NIMs have been gradually trending lower from 11% in FY11 to 9% in FY14 due to focus on low margin yielding products and lower realisations on auctions. Moreover, higher funding costs also impacted the margins of the company.

Going forward, with lower interest rate regime, we believe that the funding cost of MFL will benefit as 84% of the funding comes from bonds and banks. In addition, growth in AUM and considerably stable asset quality will also lead to improvement in yields. Consequently, we expect NII to witness CAGR of 9.9% over FY14-FY17E after declining marginally by 2.8% in FY15E.



Source: Company data, Nirmal Bang Research

With decline in borrowing costs and improvement in yields (improved LTV) the spreads of the company are likely to improve going forward.

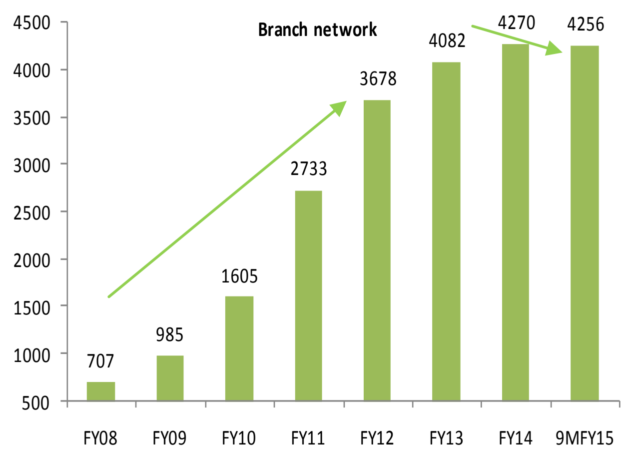


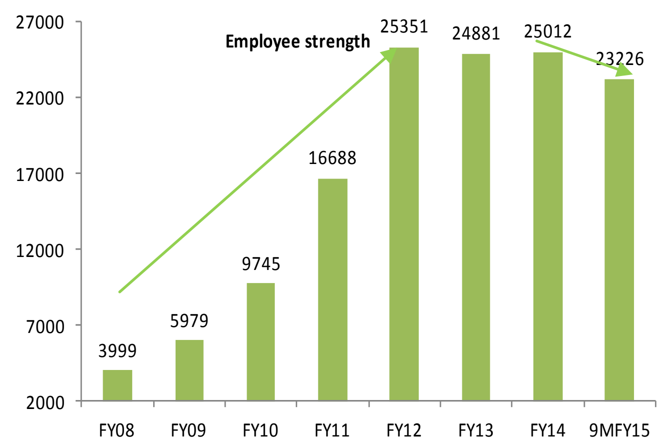
Source: Company data, Nirmal Bang Research

Operating leverage, key RoA diver

While the overall industry scenario was not conducive for growth, MFL adopted the strategy of curtailing costs in order to maintain its profitability. During FY08-FY14, the branch network has increased at a CAGR of 43%. However, in FY15E the bank closed down 15 branches as compared to significant expansion taken in the past. We believe that management will place more emphasis on increasing efficiency of the existing branches rather than extensive branch expansion. Thus, we have factored in moderate branch expansion of ~22-23 in both FY16E and FY17E. Further, MFL intends to increase its presence in North India, as management hinted of very low competition.

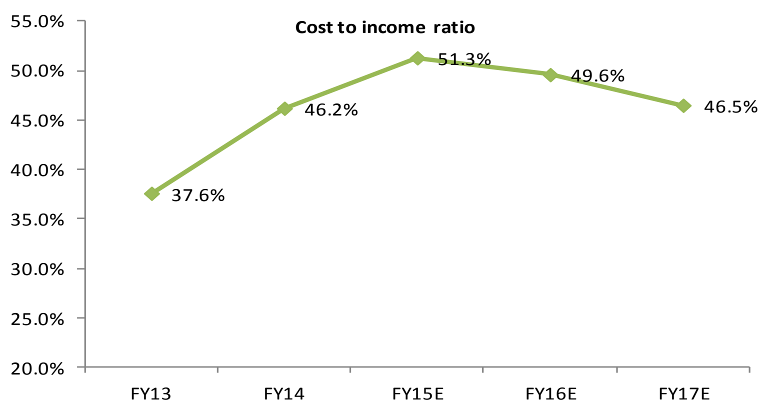
At the same time, after reaching a high of 25,684 employees in Q2FY14, Muthoot has slowed the pace of fresh recruitment which is visible from decline in employee head counts to 23,226 in Q3FY15.





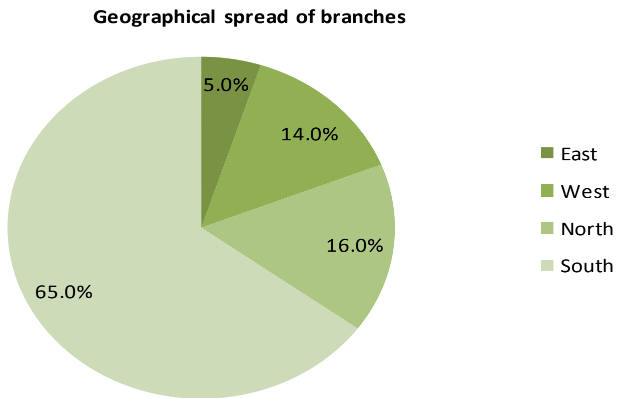
Source: Company data, Nirmal Bang Research

Despite sharp reduction in employees, cost to income ratio for the company increased from 37.6% in FY13 to 46.2% in FY14 and is further expected to increase in FY15E at 51.3% primarily due to slow growth in total income. Moreover, as most of the branches continued to remain operational, the fixed cost continued to remain on the higher end. Going forward, with most of the fixed cost in place, growth in income would lead to a sharp improvement in the cost to income ratio. We believe that management will place more emphasis on increasing efficiency of the existing branches and employees which will result in better productivity and thereby lower cost to income ratio. We expect cost to income ratio to improve to 46.5% as compared to 51.3% in FY15E.



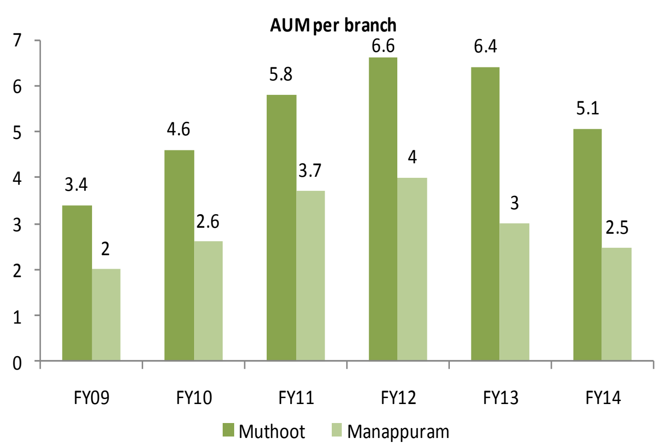
Source: Company data, Nirmal Bang Research

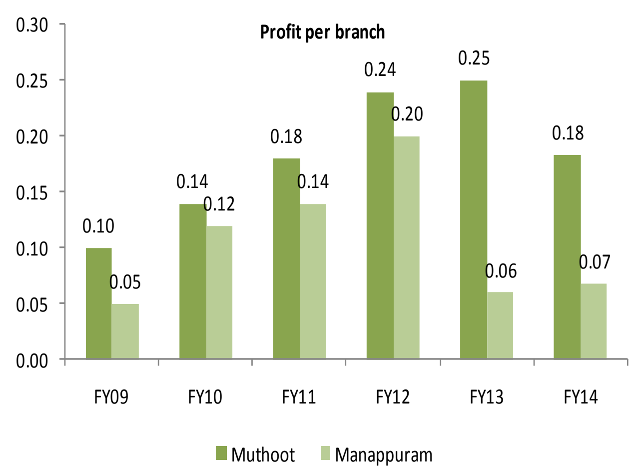
Moreover, MFL is improving its branch penetration and exploring new regions. After expanding aggressively in western India, the company is looking to expand in other regions like North and East. This strong expansion strategy will help the company to grow more robustly and maintain leadership position.



Source: Company data, Nirmal Bang Research

As MFL is the market leader with strong branch network, the profit per branch as well as AUM per branch is higher for Muthoot Finance as compared to its peer Manappuram Finance Ltd.

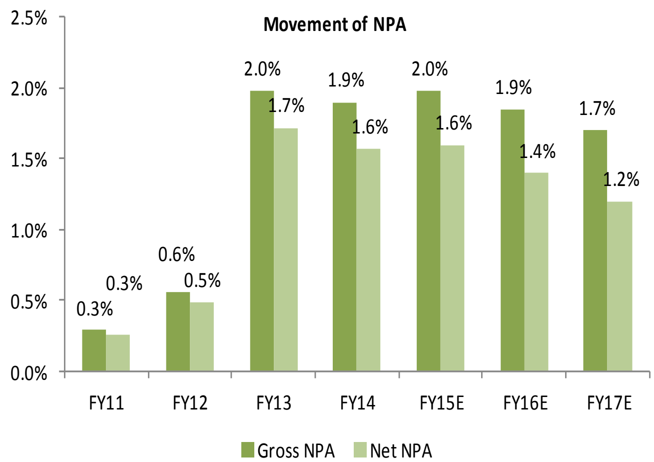


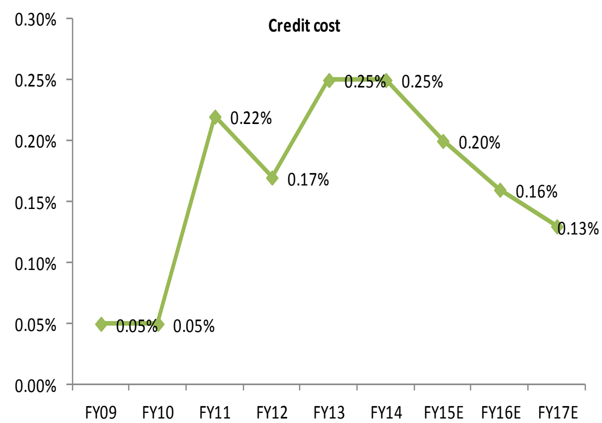


Source: Company data, Nirmal Bang Research

Asset quality on the mend

The Gross NPAs remained on the higher end owing to sudden sharp decline in gold prices which increased the risk of defaults in the company's legacy portfolio. After correcting sharply, gold prices have broadly stabilized at levels of Rs 2700-2800 per gram indicating that defaults are likely to be much lower in coming period as compared to previous quarters thereby improving asset quality. Moreover, the reduced LTV in the last two years and continuous efforts on collections will also enable the company to keep asset quality under check. The company provides 0.46% on standard loans as against the RBI requirement of 0.25%.





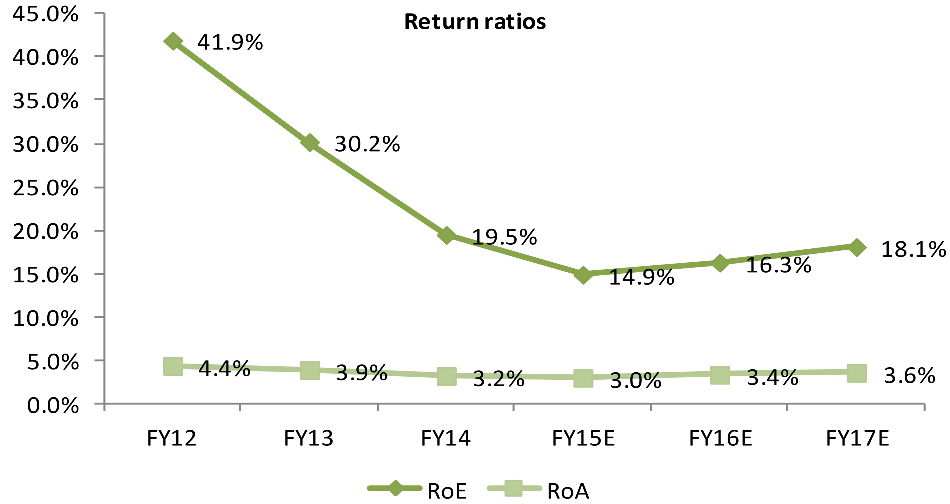
Source: Company data, Nirmal Bang Research

RoA to inch up towards 3.6%

Muthoot Finance has always enjoyed superior return ratios (higher than most of the NBFC's) despite the significant challenges faced by the company. RoE remained as high as 19.5% with RoA of 3.2% in FY14. In FY15E return ratios are expected to moderate owing to the dilution in earning (the company had raised capital in May 2014). However, we expect return ratios to improve in FY17E as compared to FY15E levels. We expect an improvement in the business parameters of the company led by:

- Uptick in business growth
- Improvement in NIMs
- Operational efficiency
- Stable asset quality

We expect MFL's core earnings to improve leading to an improvement in return ratios. We expect the company to witness a PAT CAGR of 10.6% over FY14-FY17E leading to a RoE of 18.1% and RoA of 3.6% in FY17E.



Source: Company data, Nirmal Bang Research

Strategic initiatives taken by the company

In the last one month, the company has taken many strategic initiatives which will further enhance the performance of the company in long term.

- Acquired 51% stake in Asia Asset Finance PLC for Rs 30 cr, Sri Lanka as the company intends to capitalise on the growing opportunities in the Sri Lankan market.
- Muthoot has entered into an agreement with YES Bank to act as its business correspondent through its 4,256 branches and becoming the first NBFC to enter into business correspondent segment.

We believe that these efforts will not only enhance the growth opportunities for the company but will also provide an avenue for expansion of its noncore income which in turn will improve the return ratios of the company.

Quarterly Result Analysis

Particulars (Rs in cr)	Q3FY15	Q3FY14	YoY	Q2FY15	QoQ
Interest income	1052.2	1046.8	*0.5%*	1185.6	*(11.2%)*
Finance cost	529.2	508.4	*4.1%*	627.7	*(15.7%)*
Net Interest Income	**523.0**	**538.4**	*(2.9%)*	**557.8**	***(6.2%)***
Other income	17.0	14.7	*15.5%*	15.2	*11.9%*
Total income	**540.0**	**553.1**	*(2.4%)*	**573.0**	*(5.8%)*
Employee costs	162.7	157.6	*3.2%*	149.0	*9.2%*
Depreciation	21.7	21.1	*2.6%*	12.4	*75.3%*
Advertisement	19.7	14.4	*36.7%*	11.7	*68.3%*
Other expenses	94.8	95.9	*(1.1%)*	92.7	*2.3%*
Total expense	**298.9**	**289.1**	***3.4%***	**265.7**	***12.5%***
Cost to income	*55.4%*	*52.3%*		*46.4%*	
PBP	241.1	264.0	*(8.7%)*	307.3	*(21.5%)*
Provisions	3.5	4.1	*(13.7%)*	9.1	*(61.4%)*
PBT	**237.6**	**260.0**	***(8.6%)***	**298.2**	***(20.3%)***
Tax expenses	83.2	89.2	*(6.8%)*	104.0	*(20.0%)*
PAT	**154.4**	**170.7**	***(9.6%)***	**194.2**	***(20.5%)***
EPS	3.9	4.3		5.2	
Gross NPA	1.9%	2.0%		2.1%	
Net NPA	1.5%	1.7%		1.8%	

Source: Company data, Nirmal Bang Research

- Net Interest income declined 2.9% YoY and 6.2% QoQ and stood at Rs 523 cr owing to focus on low yielding products.
- Muthoot reported 12.5% QoQ growth in operating expenses to Rs 298.9 cr led by increased advertising expenditure on acquiring new customers.
- Cost to income ratio witnessed sharp deterioration owing to slower income growth and high growth in expenses. Cost to income ratio stood at 55.4% vs. 46.4% in Q2FY15 and 52.3% in Q3FY14.
- Provisions declined 13.7% YoY and 61.4% QoQ
- Gross NPA improved by 20 bps on QoQ basis and stood at 1.9%.

Company description

Muthoot Finance Ltd (MFL) is the largest gold loan NBFC in India in terms of loan portfolio and provides personal and business loans secured by gold jewellery, or Gold Loans, primarily to individuals. It has the highest branch network among gold loan NBFCs in India at 4265 branches with a Gold Loan portfolio of Rs 22011.7 cr as on 31st December 2014.

MFL has ~7 million customers with an average ticket size of ~Rs40, 000. The typical tenure of these loans are 12 months, however most of these loans are repaid within six months. The customers generally take loans against gold to meet various short term demands. The interest rate ranges from 14-22% depending on the Loan to Value of the loan (LTV). Higher the LTV, greater will be the interest rates charged.

In addition to gold loan business, MFL also provides money transfer services through its branches as sub-agents of various registered money transfer agencies, and recently has commenced providing collection agency services as well. Its other recent initiatives include sale of gold coins and insurance products amongst various other services.

Risk Concerns

- Increasing competition from public sector banks and other NBFCs in the same line of business
- Volatility in gold prices.

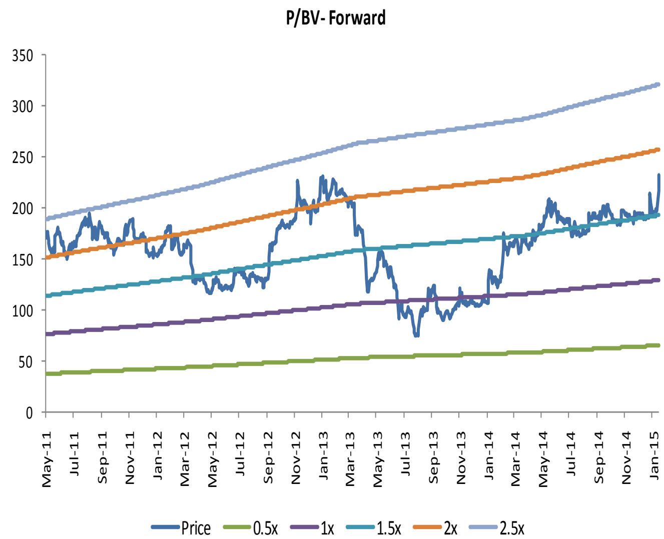
Peer Valuation

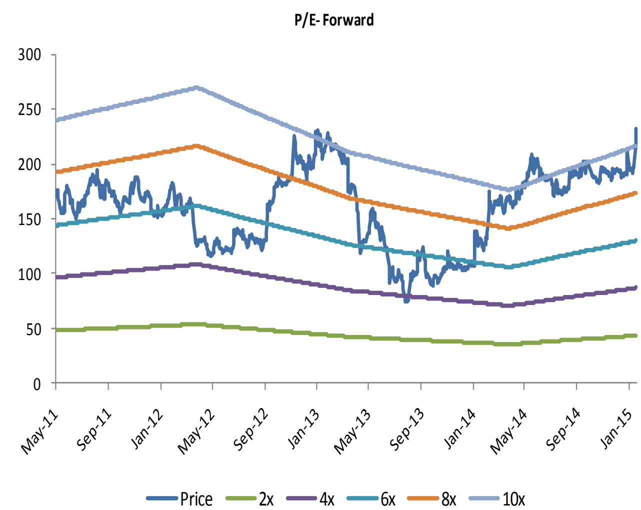
Company	CMP	Market cap (Rs cr)	P/E			P/BV			RoE		
			FY15E	FY16E	FY17E	FY15E	FY16E	FY17E	FY15E	FY16E	FY17E
LIC Housing	486	24509	17.94	15.14	12.95	2.97	2.55	2.19	16.9%	17.4%	17.5%
M&M Financial Services	251	14310	19.62	14.37	11.45	2.92	2.61	2.28	13.3%	16.6%	19.0%
Shriram Transport Finance*	1095	24687	18.36	14.61	11.82	2.64	2.29	1.97	15.3%	16.7%	17.8%
Bajaj Finance	3858	19347	21.76	16.84	13.14	4.21	3.47	2.81	20.2%	21.6%	22.6%
Cholamandalam	515	7397	18.13	14.40	12.10	2.72	2.27	1.98	15.8%	16.7%	17.7%
Manappuram*	33.2	2793	11.06	8.62	7.72	1.06	0.99	0.92	11.3%	11.6%	11.8%
Muthoot Finance	222	8827	12.87	10.38	8.35	1.94	1.73	1.52	14.9%	16.3%	18.1%

Source: Company data, Nirmal Bang Research
** Based on Bloomberg estimates*

Valuation and Recommendation

MFL had suffered in the past two years owing to various regulatory pressures and uncertain macro-economic environment. We believe that worst is now over for the company and MFL is set to embark on a new growth path. MFL being the market leader ***is best positioned to benefit from improving business sentiment in the gold loan industry as asset quality concerns are likely to abate. At CMP of Rs 222, MFL trades at 1.73x and 1.52x its FY16E and FY17E BV and 10.38x and 8.35x its FY16E and FY17E EPS respectively. We initiate coverage on the stock with a BUY rating on the stock and a target price of Rs 292 (2.0x FY17E ABV) implying a 32% upside.***





Financials

Profitability (Rs. Crs)	FY13	FY14	FY15E	FY16E	FY17E
Interest earned	5,359	4,928	4,342	4,954	5,812
Interest expended	2,819	2,626	2,105	2,327	2,755
Net interest income	**2,539**	**2,302**	**2,236**	**2,627**	**3,056**
Other income	28	20	11	9	12
Total income from operations	**2,568**	**2,321**	**2,247**	**2,635**	**3,068**
Employee cost	545	592	643	719	782
Other expenses	421	481	510	587	645
Total expenses	967	1,073	1,153	1,306	1,428
Profit before prov	1,601	1,248	1,094	1,329	1,640
Provisions	90	55	47	43	41
Profit before tax	**1,511**	**1,194**	**1,047**	**1,286**	**1,599**
Tax	507	413	362	437	544
PAT	**1,004**	**780**	**685**	**849**	**1,055**

Balance Sheet (Rs. Crs)	FY13	FY14	FY15E	FY16E	FY17E
Equity capital	372	372	397	397	397
Reserves and surplus	3,364	3,893	4,536	5,083	5,790
Net worth	**3,736**	**4,265**	**4,933**	**5,480**	**6,187**
Total Borrowings	24,089	19,484	19,726	22,873	27,123
Other liab	1,572	1,641	1,823	2,052	2,518
Total liab and equity	**29,397**	**25,389**	**26,482**	**30,405**	**35,828**
Cash and bank bal	1,342	2,049	1,365	1,586	1,866
Investments	83	35	40	45	50
Loans	26,518	21,862	23,399	26,884	31,784
Fixed assets	303	327	368	414	466
Net current assets	1,152	1,165	1,311	1,476	1,661
Total assets	**29,397**	**25,438**	**26,482**	**30,405**	**35,828**

Quarterly (Rs. Crs)	Sep.14	Mar.14	June.14	Sep.14	Dec.14
Net interest income	568	586	552	550	538
Non interest income	5	7	4	3	2
Total income	573	593	557	553	540
Operating expenses	266	296	276	289	299
Operating profit	307	297	281	264	241
Provisions	9	18	8	4	3
Profit before tax	298	278	273	260	238
Taxes	104	97	93	89	83
Net profit	**194**	**181**	**180**	**171**	**154**

Key Ratios	FY13	FY14	FY15E	FY16E	FY17E
Yield Ratios					
Avg Yield on Loans	20.9%	20.4%	19.2%	19.7%	19.8%
Cost of Borrowing	13.0%	12.1%	10.7%	10.9%	11.0%
Net interest spread	8.0%	8.3%	8.4%	8.8%	8.8%
Net interest margin	9.5%	8.9%	9.2%	9.9%	9.8%
Gross NPA	2.0%	1.9%	2.0%	1.9%	1.7%
Net NPA	1.7%	1.6%	1.6%	1.4%	1.2%
Capital adequacy ratio	19.6%	24.7%	25.4%	24.2%	22.7%
Prov coverage ratio	13.3%	17.4%	18.3%	23.1%	25.4%
Gross NPA	525	416	463	497	531
Net NPA	455	344	378	382	396

Profitability Ratios	FY13	FY14	FY15E	FY16E	FY17E
Cost / Income Ratio	37.6%	46.2%	51.3%	49.6%	46.5%
Net profit margin	18.6%	15.8%	15.7%	17.1%	18.1%
RONW	30.2%	19.5%	14.9%	16.3%	18.1%
Return on Assets	3.92%	3.23%	3.03%	3.38%	3.60%

Per share data	FY13	FY14	FY15E	FY16E	FY17E
EPS	27.02	20.99	17.26	21.38	26.58
BVPS	100.5	114.7	124.2	138.0	155.8
Adj BVPS	88.3	105.5	114.7	128.4	145.8
DPS	4.5	5.0	5.5	6.5	7.5
Dividend yield	2.0%	2.3%	2.5%	2.9%	3.4%

Growth Ratios	FY13	FY14	FY15E	FY16E	FY17E
Advances growth	23.5%	-17.6%	7.0%	14.9%	18.2%
Borrowing growth	24.3%	-19.1%	1.2%	15.9%	18.6%
NII growth	17.2%	-9.4%	-2.8%	17.5%	16.3%
PAT growth	12.6%	-22.3%	-12.2%	23.9%	24.3%
Pre prov profit growth	13.5%	-21.0%	-12.3%	22.8%	24.3%
Non interest inc growth	17.8%	-9.6%	-3.2%	17.3%	16.4%

Valuation Ratios	FY13	FY14	FY15E	FY16E	FY17E
P/E	8.22	10.58	12.87	10.38	8.35
P/BV	2.21	1.94	1.79	1.61	1.42
P/ABV	2.52	2.10	1.94	1.73	1.52

Source: Company data, Nirmal Bang Research

NOTES

Disclaimer:

Nirmal Bang Research (Division of Nirmal Bang Securities PVT LTD)

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