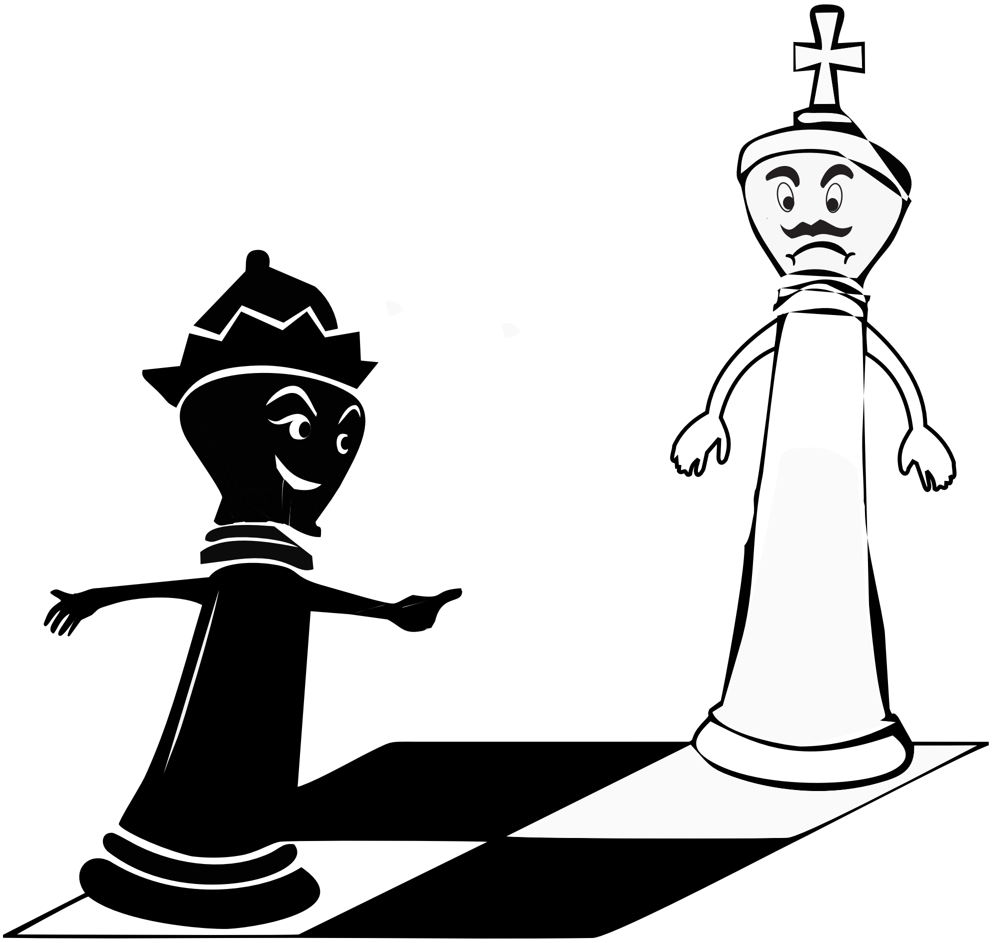
Your success is our success

BANKING & FINANCIAL SERVICES

July 14, 2015

Asset financiers / investors are looking forward to a cyclical upturn with renewed optimism. However, the regulatory and competitive landscape for NBFCs is changing significantly, in our view. We believe NBFCs are entering an era, where growing at a healthy pace while maintaining profitability will be an arduous task. We prefer to play the up cycle with niche / small NBFCs with potential to achieve profitable market share gains.

OLD GAME NEW RULES NEW WINNERS



Umang Shah
umang.shah@emkayglobal.com
+91 22 6624 2468

Sohail Halai
sohail.halai@emkayglobal.com
+91 22 6612 1336

Clyton Fernandes
clyton.fernandes@emkayglobal.com
+91 22 6612 1340

INDUSTRY REPORT

Contents

Companies

Your success is our success

Banking & Financial Services

Old game – New rules, New winners

Asset financiers / investors are looking forward to a cyclical upturn with renewed optimism. However, the regulatory and competitive landscape for NBFCs is changing significantly, in our view. We believe NBFCs are entering an era, where growing at a healthy pace while maintaining profitability will be an arduous task. We prefer to play the up cycle with niche / small NBFCs with potential to achieve profitable market share gains.

- **Growth prospects improving; But, do not expect fireworks:** Improving IIP growth, falling inflation, pick-up in mining activity, rising government spend on infrastructure and signs of pick-up in urban demand, point towards improving growth prospects for asset financiers. The freight-fuel index, which has a strong influence on M&HCV sales, has picked up too. However, weak rural demand, uncertainty over mid-season monsoon, flat-to-rising fuel costs and corporate deleveraging leading to delay in private capex cycle are certain offsetting factors, which can dampen the recovery process. Sustainability in some of these green shoots is essential for meaningful pick-up in growth. We expect a gradual recovery in asset growth for NBFCs.
- **Top private banks emerging as serious competitors:** Our analysis of the branch expansion strategy of the top five private banks in context of ~890 unique locations covered by top 3 NBFCs reveals- a) Over FY13-15, top 5 private banks aggressively opened branches in 31% of the locations covered by top 3 NBFCs, where they now command ~45% branch market share, b) Of this, in ~20% of total locations, none of the top 5 private banks were present earlier and they now enjoy ~38% branch market share, and c) Despite aggressive rural / semi urban branch rollout, none of the top 5 private banks are still present in ~37% of these locations. In our view, private banks are strategically penetrating the NBFC turf and could emerge as serious competitors. Market share of auto financing NBFCs appears to be stagnating. Increasing competition from private banks raises risk of market share loss for large NBFCs.
- **Regulatory noose tightened; No scope to cut corners:** Higher capital requirements, tighter securitization norms and a far more restrictive regulatory framework (similar to that of banks) clearly reflects RBI's intention to plug regulatory loopholes, which benefitted NBFCs earlier. Of the proposed changes, stringent NPL recognition norms are likely to impact the profitability of NBFCs. We believe, NBFCs with low provision coverage ratios and aggressive loan write-off policies are likely be most impacted.
- **Bet on niche / small players for profitable market share gains:** NBFCs have generally been preferred over banks for their superior growth and profitability. However, under the new regulatory framework, the profitability gap is likely to narrow. In such a scenario, we prefer niche / small NBFCs, where the visibility on growth as well as profitability remains relatively better (inducing profitable market share gains). Our preferred picks in this space are BAF (Initiate with ACCUMULATE rating), CIFC (Initiate with ACCUMULATE rating) and SCUF (Initiate with ACCUMULATE rating).

Bajaj Finance	ACCUMULATE
CMP*	Target Price
5,025	6,018

Cholamandalam Fin.	ACCUMULATE
CMP*	Target Price
721	825

Mahindra Finance	REDUCE
CMP*	Target Price
277	262

Shriram City Union Fin.	ACCUMULATE
CMP*	Target Price
1,684	2,013

Shriram Transport Fin.	SELL
CMP*	Target Price
940	771

** CMP and valuations as on 10th July 2015*

Financial Snapshot (Standalone)

	EPS		P/E		BV		P/BV	
	FY16E	FY17E	FY16E	FY17E	FY16E	FY17E	FY16E	FY17E
Bajaj Finance	212	263	23.7	19.1	1,400	1,625	3.6	3.1
Cholamandalam Fin.	35	45	20.4	16.0	234	273	3.1	2.6
Mahindra Finance	17	20	16.7	13.7	112	126	2.5	2.2
Shriram City Union Fin.	98	119	17.1	14.1	701	797	2.4	2.1
Shriram Transport Fin.	58	70	16.3	13.5	452	508	2.1	1.9

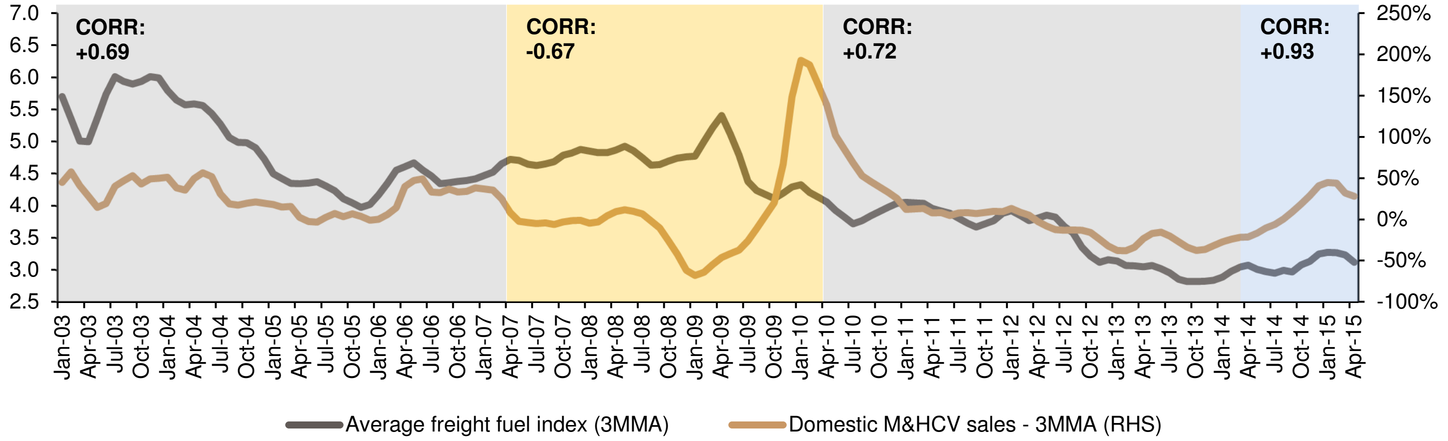
Umang Shah
umang.shah@emkayglobal.com
+91 22 6624 2468

Sohail Halai
sohail.halai@emkayglobal.com
+91 22 6612 1336

Clyton Fernandes
clyton.fernandes@emkayglobal.com
+91 22 6612 1340

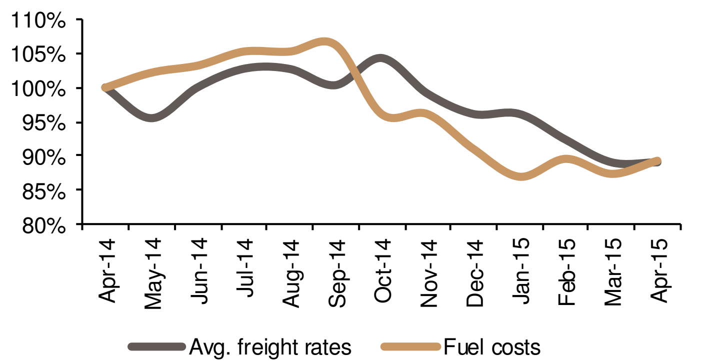
Key charts and tables

Exhibit 1: M&HCV sales highly correlated to the freight-fuel index; An uptick in industrial activity crucial for sustenance of M&HCV sales



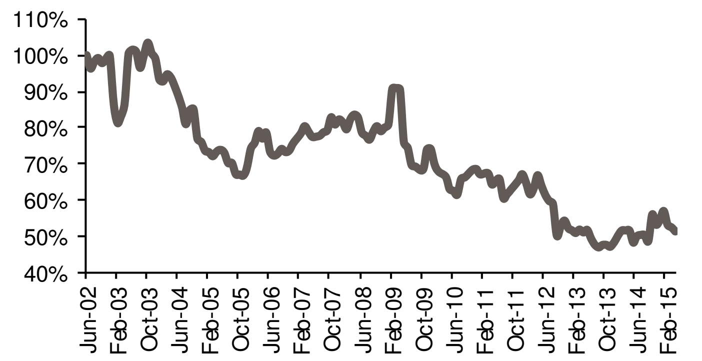
Source: CMIE, IFTRT, Emkay Research

Exhibit 2: Freight rates have fallen in tandem with fall in fuel costs



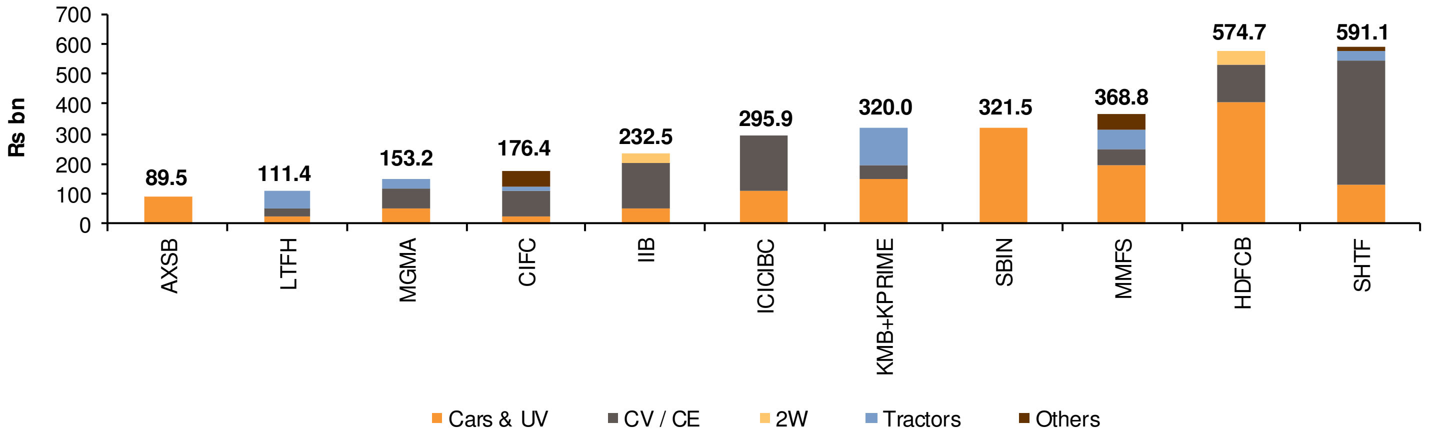
Source: CMIE, IFTRT, Emkay Research

Exhibit 3: Freight-fuel index has steadily come down reflecting the intense competition in the industry



Source: CMIE, IFTRT, Emkay Research

Exhibit 4: Product differentiation between private banks and NBFCs is blurring (Auto fin. AUM breakup as publicly disclosed)



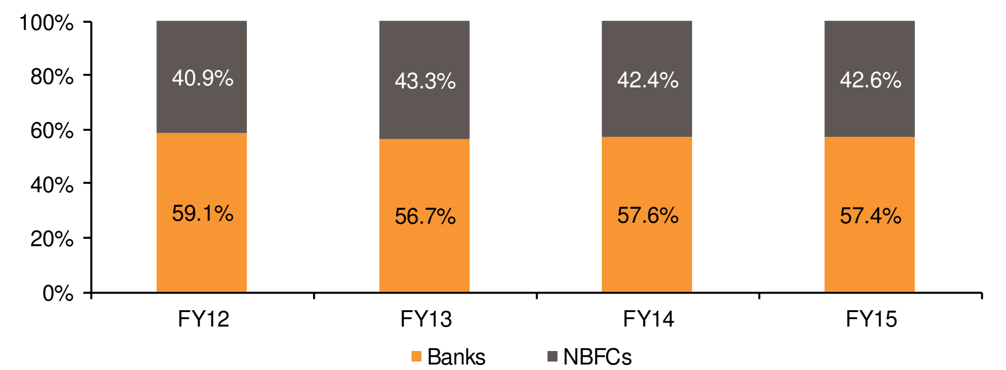
Source: Company, Emkay Research

Exhibit 5: Top 5 private banks aggressively penetrating into NBFC turf

	Top 3 AFCs	Top 5 Pvt. Banks	Comments
Total locations covered	890	564	Out of the total 890 unique locations dominated by top 3 AFCs, top 5 private banks are present in only 564 (63%) of such locations
Branches	1,581	1,956	No of branches across these locations of NBFCs and private banks
Of the above,			
Private banks further increased penetration in 278 locations during FY13-15			
Locations covered over FY13-15	278	278	No of locations, where top 5 pvt banks opened branches over FY13-15
% of total	31.2%	49.3%	
Branches	596	500	Penetrating deeper into the areas, where NBFCs have dominant position
% of total	37.7%	25.6%	
Branch mkt share (%)	**54.4%**	**45.6%**	
Of the above,			
New locations covered	176	176	No of locations, where none of the top 5 private banks were present earlier
% of total	19.8%	31.2%	
Branches	335	202	~38% branch market share in areas, where NBFCs were present solely, could hurt incumbent players
% of total	21.2%	10.3%	
Branch mkt share (%)	**62.4%**	**37.6%**	

Source: Company, RBI, Emkay Research *Note: The branch data for NBFCs has been collated and compiled from various websites.*

Exhibit 6: Market share of banks / NBFCs in auto financing space



Source: RBI, Company, Emkay Research

Exhibit 7: Credit costs under new regulatory norms may remain elevated for companies with aggressive write-off policy

	FY07-14				FY07-14		
As % of average on-BS loans	**AVG**	**MIN**	**MAX**	**As % of average on-BS loans**	**AVG**	**MIN**	**MAX**
Shriram Transport Finance				**Cholamandalam Finance**			
Net addition to GNPLs	0.9%	0.1%	1.5%	Net addition to GNPLs	1.0%	-2.6%	4.1%
Net loan loss provisions	0.6%	0.3%	1.0%	Net loan loss provisions	0.8%	-1.6%	4.7%
Bad debts & write-offs	**1.6%**	0.8%	2.3%	Bad debts & write-offs	**1.0%**	0.1%	3.3%
Gross NPL (%)	2.7%	**1.6%**	**4.0%**	Gross NPL (%)	3.0%	**0.7%**	**8.7%**
Provision coverage ratio (%)	68.3%	**43.1%**	**79.1%**	Provision coverage ratio (%)	69.8%	**40.0%**	**73.3%**
Mahindra Finance				**Sundaram Finance**			
Net addition to GNPLs	1.1%	-1.0%	3.1%	Net addition to GNPLs	0.3%	-0.3%	1.1%
Net loan loss provisions	0.6%	-0.5%	1.9%	Net loan loss provisions	0.1%	-0.3%	0.2%
Bad debts & write-offs	**1.5%**	0.8%	2.5%	Bad debts & write-offs	**0.3%**	0.2%	0.6%
Gross NPL (%)	5.7%	**3.0%**	**9.8%**	Gross NPL (%)	1.1%	**0.6%**	**1.6%**
Provision coverage ratio (%)	71.0%	**65.9%**	**71.9%**	Provision coverage ratio (%)	63.9%	**84.2%**	**54.5%**

Source: Company, Emkay Research *Note: Provision coverage ratio for MIN and MAX gross NPLs are for the corresponding periods*

Investment ideas

Bajaj Finance (BAF IN, Accumulate, TP: Rs6,018)

Bajaj Finance (BAF) has been an outlier among NBFCs, maintaining strong growth and healthy profitability, despite challenging environment and being proactive in adopting to the regulatory changes. We expect this healthy trend to continue and with the conclusion of its recent equity raising, BAF appears well positioned for its next growth phase. While valuations factor in most positives, we believe qualitative growth justifies premium valuations. We initiate coverage with an **Accumulate** rating and TP of Rs6,018.

Cholamandalam Finance (CIFC IN, Accumulate, TP: Rs825)

Cholamandalam Finance (CIFC) has developed a diversified and de-risked product portfolio, which has insulated it from the CV downcycle. With growth returning in the vehicle finance portfolio and the HE portfolio growing at a healthy pace, we believe, CIFC is better placed than its peers. The stock trades at a premium to peers, but, growth could surprise positively. We initiate coverage with an **Accumulate** rating and TP of Rs825.

Mahindra Finance (MMFS IN, Reduce, TP: Rs262)

MMFS has transformed itself from a captive financier to a multi-product auto financier, but it remains a strong play on rural India. As a result, the persistent slowdown in rural India continues to adversely impact MMFS' growth and asset quality. We expect this trend to continue in the near term. A turnaround in the rural demand remains a key catalyst for MMFS' earnings growth. We maintain our **Reduce** rating with a target price of Rs262.

Shriram City Union Finance (SCUF IN, Accumulate, TP: Rs2,013)

Shriram City Union Finance (SCUF) has developed a niche and diversified business model, focusing on the underserved and under penetrated SME segment in the rural and semi urban areas. With the uncertainty over the gold loan business behind it and its strong capital position, SCUF remains well poised for its next phase of growth. ROEs to improve gradually as leverage increases. ROAs likely to remain healthy despite elevated credit costs. We initiate coverage with an **Accumulate** rating and TP of Rs2,013.

Shriram Transport Finance (SHTF IN, Sell, TP: Rs771)

Multiple headwinds in the form of slower growth due to a large base, continued pressure on NIMs and elevated loan loss charges on the back of changing regulatory norms are likely to keep SHTF's earnings under pressure. Return ratios have come off on a sustainable basis and are unlikely to move up significantly in the near term. Valuations likely reflecting the same and hence, the scope for valuation re-rating appears limited. Earnings may disappoint; downside risks from current levels persist. We initiate coverage with a **Sell** rating and TP of Rs771.

Exhibit 8: NBFC scoring matrix

	Bajaj Finance	Cholamandalam Finance	Mahindra Finance	Shriram Transport Finance	Shriram City Union Finance
Asset growth	5	5	2	1	5
Regulatory impact	5	4	3	1	1
Capital adequacy	5	3	4	4	5
Execution capabilities	5	4	3	2	3
Pricing power	4	3	4	3	5
ROAs	4	3	3	2	5
Total Score	**28**	**22**	**19**	**13**	**24**

Source: Company, Emkay Research *Note: Scoring based on 5 being the highest and 1 being the lowest on a rating scale*

Exhibit 9: Key financials

	FY05	FY10	CAGR FY05-10	FY15	CAGR FY10-15	FY16E	FY17E	FY18E	CAGR FY15-18E
Bajaj Finance (BAF IN)									
AUM	12,487	40,320	26.4%	324,100	51.7%	425,022	542,502	676,444	27.8%
Networth	2,758	11,525	33.1%	47,998	33.0%	76,065	88,322	103,484	29.2%
Net operating income	1,342	7,145	39.7%	31,699	34.7%	41,762	51,849	63,943	26.4%
Pre-provision profit	823	3,949	36.8%	17,415	34.6%	23,474	28,694	35,616	26.9%
Adj. PAT	557	894	9.9%	8,979	58.6%	11,511	14,292	17,704	25.4%
ROAA	4.7%	2.3%		3.1%		3.0%	2.9%	2.9%	
ROAE	21.9%	8.0%		20.4%		18.6%	17.4%	18.5%	
Cholamandalam Finance (CIFC IN)									
AUM	19,640	68,505	28.4%	254,525	30.0%	300,137	368,711	466,347	22.4%
Networth	3,028	4,850	9.9%	26,733	40.7%	36,511	42,628	50,625	23.7%
Net operating income	1,302	4,259	26.8%	17,308	32.4%	19,928	23,933	29,645	19.6%
Pre-provision profit	746	2,256	24.8%	9,819	34.2%	11,517	14,201	18,207	22.9%
Adj. PAT	341	154	-14.7%	4,351	95.0%	5,508	7,030	9,092	27.8%
ROAA	0.0%	0.5%		11.2%		19.3%	23.7%	27.1%	
ROAE	0.0%	20.5%		14.2%		19.2%	22.8%	26.5%	
Mahindra Finance (MMFS IN)									
AUM	27,538	107,489	31.3%	368,780	28.0%	411,742	479,804	579,181	16.2%
Networth	3,556	17,274	37.2%	56,694	26.8%	63,060	71,152	81,415	12.8%
Net operating income	2,717	10,671	31.5%	30,855	23.7%	33,722	38,331	45,467	13.8%
Pre-provision profit	1,889	7,421	31.5%	20,787	22.9%	22,334	25,096	29,738	12.7%
Adj. PAT	823	3,444	33.1%	8,293	19.2%	9,336	11,392	14,223	19.7%
ROAA	3.2%	4.1%		2.5%		2.5%	2.6%	2.8%	
ROAE	27.1%	21.6%		15.4%		15.6%	17.0%	18.6%	
Shriram City Union Finance (SCUF IN)									
AUM	9,637	52,160	40.2%	167,170	26.2%	197,456	245,171	306,518	22.4%
Networth	702	10,000	70.1%	41,012	32.6%	46,192	52,526	60,564	13.9%
Net operating income	870	5,853	46.4%	21,885	30.2%	24,416	28,603	35,034	17.0%
Pre-provision profit	461	4,029	54.2%	12,949	26.3%	14,586	17,096	21,278	18.0%
Adj. PAT	231	1,943	53.1%	5,581	23.5%	6,491	7,876	9,967	21.3%
ROAA	3.0%	3.3%		3.2%		3.3%	3.2%	3.2%	
ROAE	32.9%	23.1%		15.9%		14.9%	16.0%	17.6%	
Shriram Transport Finance (SHTF IN)									
AUM	54,000	291,593	40.1%	591,083	15.2%	660,191	749,887	862,264	13.4%
Networth	1,971	38,348	81.1%	92,380	19.2%	102,509	115,167	130,813	12.3%
Net operating income	1,831	22,491	65.2%	41,836	13.2%	46,066	51,373	58,807	12.0%
Pre-provision profit	1,004	17,315	76.8%	31,054	12.4%	33,556	36,739	41,512	10.2%
Adj. PAT	493	8,732	77.7%	12,378	7.2%	13,049	15,844	19,098	15.6%
ROAA	3.0%	3.4%		2.3%		2.1%	2.2%	2.3%	
ROAE	32.5%	28.6%		14.1%		13.4%	14.6%	15.5%	

Source: Company, Emkay Research

Growth prospects for asset financiers improving; But, do not expect fireworks

FY15 witnessed turnaround in auto sales (ex-two wheelers). However, asset financiers had a challenging year characterized by slower growth, shrinking NIMs and deteriorating asset quality. Going forward, we expect a gradual recovery in growth for NBFCs, led by a host of factors:

- The recovery in the M&HCV segment has been sharp on the back of a low base and anticipation of revival in economic growth following a strong election mandate. The freight-fuel index (which has a strong co-relation with M&HCV sales) has moved up in the past year, indicating a demand recovery in the M&HCV segment and also, improving operator profitability due to fall in diesel prices.
- However, factors such as weak rural demand, uncertainty over mid-season monsoon, flat-to-rising fuel costs and corporate deleveraging leading to delay in private capex cycle are certain offsetting factors, which could delay the recovery process. Macro factors such as shrinking CAD, falling inflation, improving industrial production are aligning positively from growth perspective. Sustainability in these green shoots is essential for a sustained pickup in growth.
- We expect AUM growth for asset financing NBFCs to remain tepid in the near term and to gradually pick up in FY17-18.

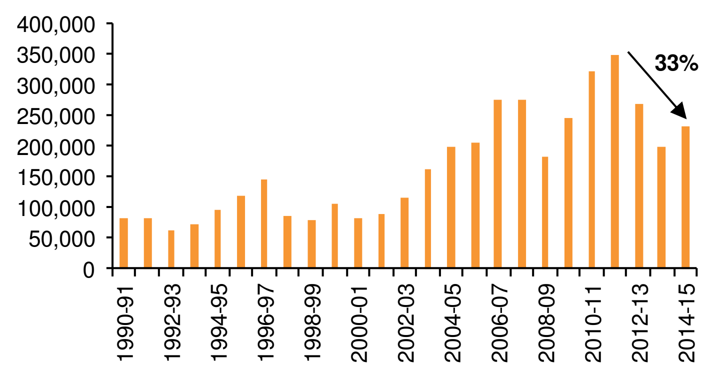
Moot point: Is the turnaround in vehicle sales sustainable?

Vehicle sales remained sluggish for over two years – with the CV segment witnessing one of the worst cycles in decades – before turning around in FY15. This turnaround in vehicle sales could be attributed to a host of factors such as 1) Hope of a quick turnaround in the economy, post the general elections outcome in May 2014, 2) Low base created by the decline in the past few years, 3) Pent up / replacement demand, 4) Steep manufacturer discounting, 5) Falling fuel prices, and 6) Cheaper / easy (higher LTV) availability of financing. However, the moot point remains – How sustainable is the current turnaround in vehicle sales? We have tried to address this by analyzing some of the key demand influencing factors and interacting with market participants to gauge the demand velocity going forward.

An uptick in industrial activity and agri output remain crucial for the M&HCV growth momentum to sustain

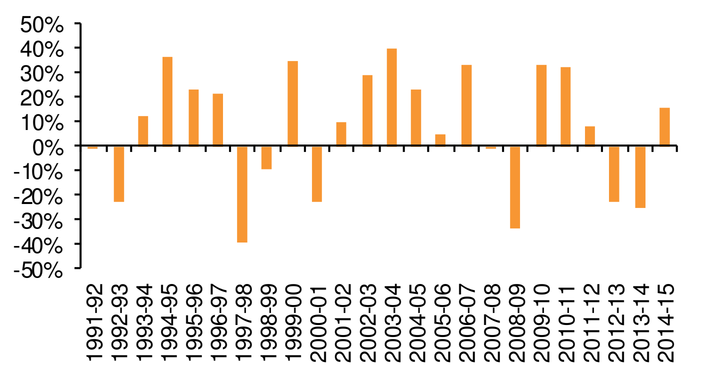
In FY15, domestic M&HCV sales grew 16% yoy, with growth largely back-ended during the year. The growth was largely driven by a 21% yoy growth in the M&HCV – goods segment, while the passenger segment witnessed a decline of 5% yoy. However, despite a 16% yoy increase in M&HCV sales, FY15 M&HCV volumes are still 33% lower than the peak volumes clocked by the industry in FY12 and about 15% lower than the sales clocked during FY07-08 *(refer exhibit 10, 11, 12, 13)*.

Exhibit 10: FY15 M&HCV volumes, still 33% lower than peak volumes



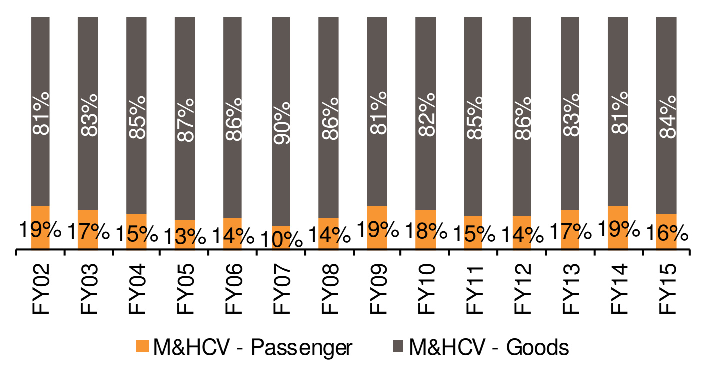
Source: CMIE, Emkay Research

Exhibit 11: FY15 M&HCV sales up 16% yoy



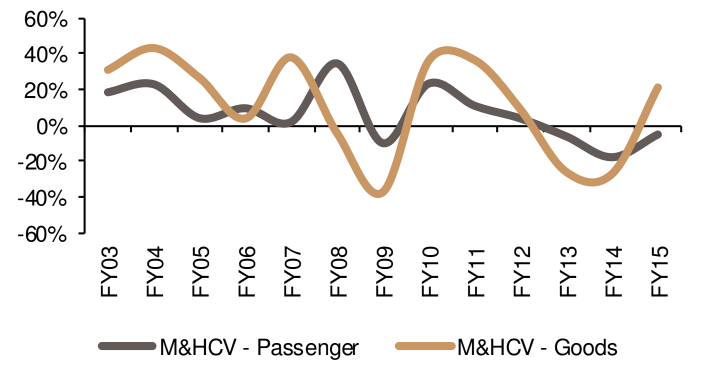
Source: CMIE, Emkay Research

Exhibit 12: Sales in M&HCV goods segment picked up in FY15



Source: CMIE, Emkay Research

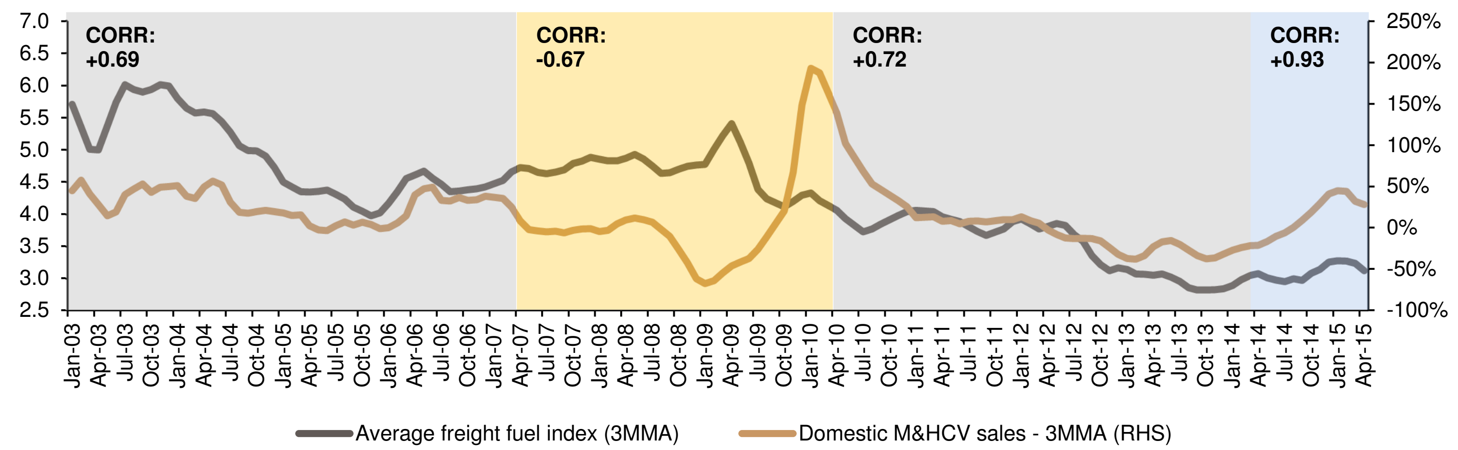
Exhibit 13: M&HCV – goods segment-driving sales growth (% yoy)



Source: CMIE, Emkay Research

Our analysis suggests that there is a high correlation between M&HCV sales and the freight-fuel index *(refer exhibit 14)*. The freight fuel index [calculated as average freight rate (per ton per km) / fuel price (Rs per ltr) * 100] clearly reflects upon the two most important aspects – 1) Demand buoyancy captured in freight availability and freight rates and 2) Operator profitability based on fuel price movement. These two factors remain the key determinants of demand for M&HCVs. It is pertinent to note that the index is also a reflection of the macro-economic developments.

Exhibit 14: M&HCV sales highly correlated to the freight-fuel index; An uptick in industrial activity crucial for sustained growth in M&HCV sales



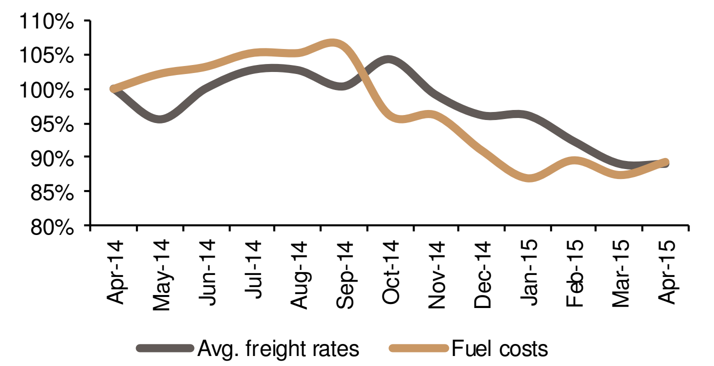
Source: CMIE, IFTRT, Emkay Research

Some of the key observations are as follows:

- **Jan-03 to Mar-07 and Mar-10 to Mar-14:** During this period, the M&HCV sales and freight fuel index has shown a positive correlation of about +0.7. During both these time periods, the M&HCV sales have mimicked the movement in the fright-fuel index, which in turn was driven largely by the economic conditions the prevailing, albeit with a marginal lead / lag.
- **Apr-07 to Mar-10:** During this period, the freight-fuel index and M&HCV sales showed correlation of -0.7. Note, this was the period of global financial crisis, followed by a sharp recovery led by a government stimulus.
  - During Apr-07 to Apr-09, the freight-fuel index headed north despite the global financial crisis, possibly due to a sharp correction in fuel prices, while the M&HCV sales kept falling due to weak macro-economic situation.
  - On the other hand, during Apr-09 to Mar-10, the index fell sharply and the M&HCV sales once again moved in the opposite direction. The fall in the index could be partially attributed to the increase in fuel costs, while the M&HCV sales were, most likely, driven by the government's fiscal stimulus to put the economy back on track.
- **Apr-14 to Apr-15**: During this period, both the variables have shown highest positive correlation +0.9. During this period, the freight-fuel index rose, led by stable / rising freight rates and falling fuel prices. Meanwhile, M&HCV sales saw a pick-up on the back of strong replacement demand and capacity build-up in anticipation of the expected turnaround in the economy.

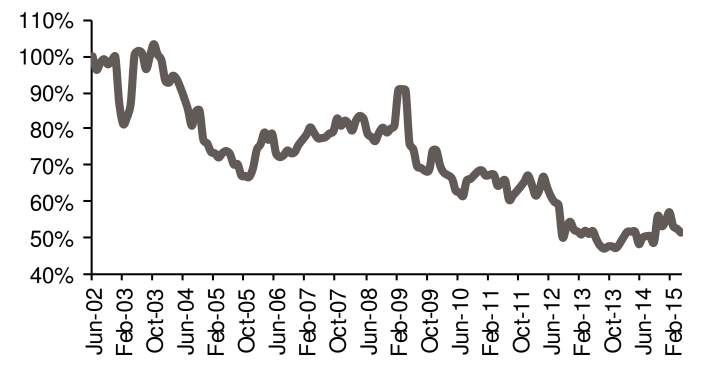
Going forward, we see certain downward risks to the freight-fuel index - 1) Likely rise in fuel prices, which can put pressure on operator profitability, and, 2) A highly competitive environment coupled with a weak demand scenario, leading to fall in freight rates despite rising fuel costs *(refer exhibits 15, 16)*. Hence, we believe an uptick in the industrial activity and agri output (major drivers for road freight movement) are crucial for sustained growth in the M&HCV segment.

Exhibit 15: Freight rates have fallen in tandem with fall in fuel costs



Source: Company, Emkay Research

Exhibit 16: Freight-fuel index has steadily come down reflecting the intense competition in the industry

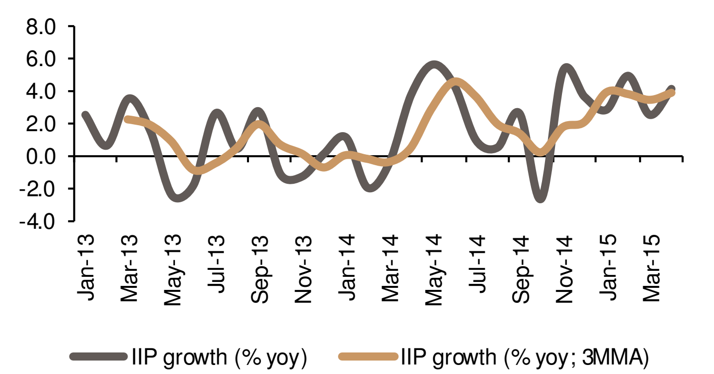


Source: Company, Emkay Research

Economic variables aligning for a gradual recovery

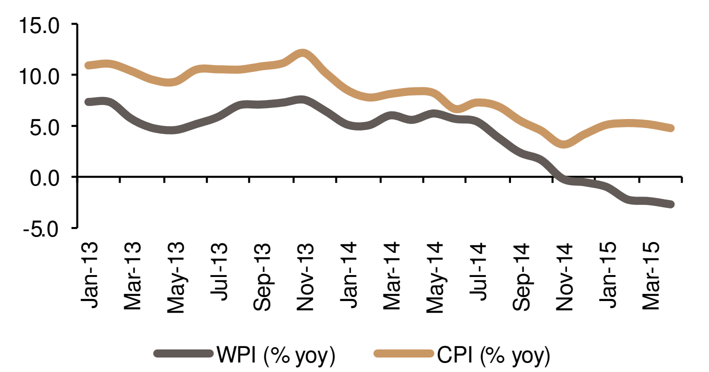
The economy is getting back on the growth path. While directionally, growth is likely to improve, the pace of growth remains debatable. In our view, the recovery process is likely to be gradual and contingent on the steps taken by the government to resolve various bottlenecks impeding growth across major sectors. Though the data as per the new GDP series does not paint a very grim picture, the ground realities reflect a very different scenario – weak order inflows, delayed payments for infrastructure contractors, stretched cash flows for fleet operators / farmers, lack of private capex etc. Note, inflation and IIP data are showing certain improvements and the RBI has started cutting interest rates *(refer exhibits 17, 18, 19)*. However, government action to revive capex cycle and monsoon would remain key catalysts for boosting growth.

Exhibit 17: Industrial activity is gradually picking up



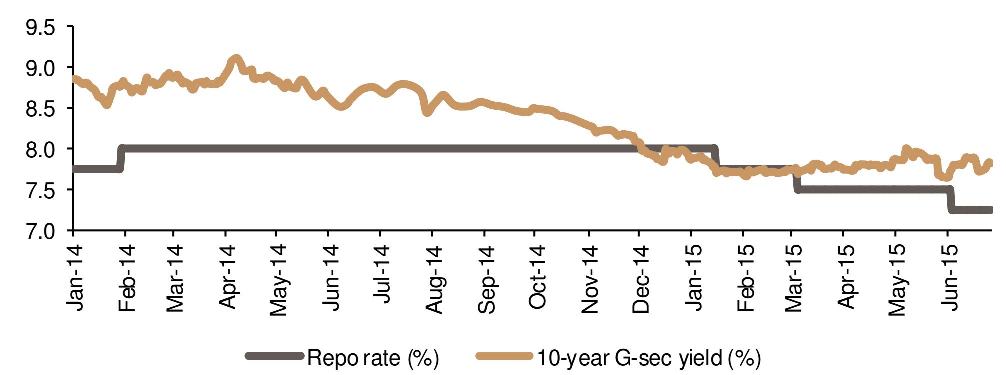
Source: CMIE, Emkay Research

Exhibit 18: Inflation is cooling off



Source: CMIE, Emkay Research

Exhibit 19: RBI has started cutting interest rates to support growth

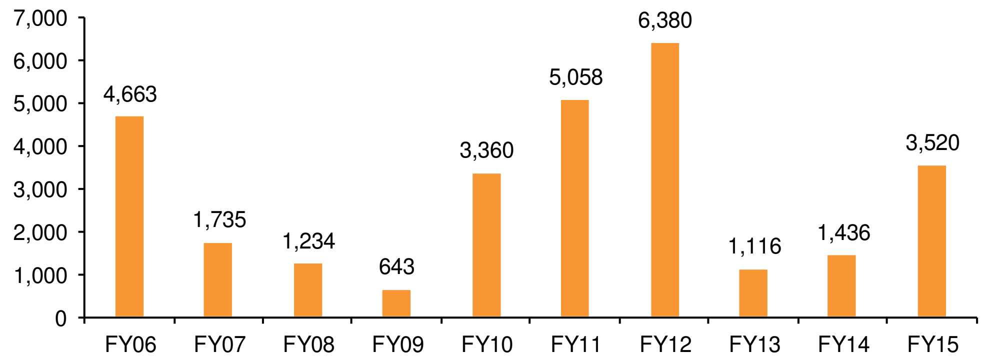


Source: RBI, Bloomberg, Emkay Research

Government action – Little done, lot more to be done

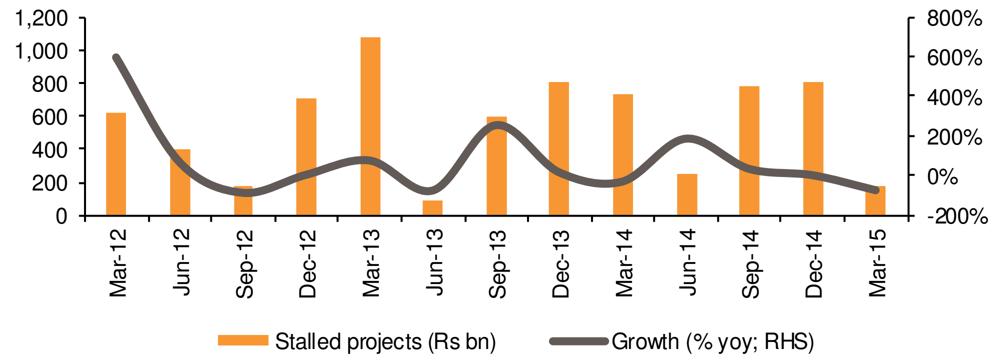
The government, in its first year along with the RBI, has done some legwork and as a result, the data suggests a gradual pick-up in economic activity. Some of the key near term triggers are a) ramp up in mining activity, as coal block auctions have commenced, b) road projects awarding has begun and the process is gathering pace *(refer exhibit 20)*, c) government spending has started at the onset of the current fiscal and d) the quantum of stalled projects is falling for three consecutive quarters *(refer exhibit 21)*; If it sustains and the public sector investments kick in, it can further build on the growth momentum. However, a lot more needs to be done by the government to kickstart the private capex cycle, which can further augment growth.

Exhibit 20: Road projects awarded by the NHAI have risen significantly (length awarded - km)



Source: NHAI, Emkay Research

Exhibit 21: Quantum of stalled projects has been falling (yoy) over the last three quarters

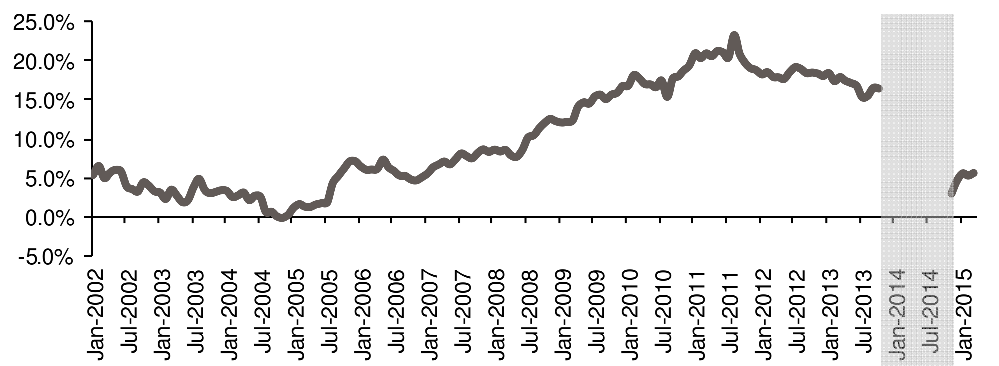


Source: CMIE, Emkay Research

Weak rural demand, –ve for UV/LCV; Uptick in urban demand, +ve for PV

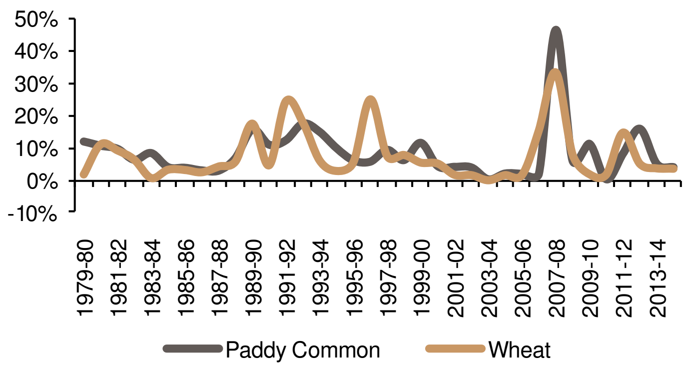
Rural consumption demand continues to remain weak, led by a combination of factors – a) Fall in growth of rural wages *(refer exhibit 22)*, b) Lower increase in MSPs to curb food inflation *(refer exhibit 23)*, c) Moderation in growth of average daily wages under NREGA *(refer exhibit 24)*, d) deficient monsoon last year, followed by unseasonal rains impacting farm yields, resulting in lower cash flows for farmers.

Exhibit 22: Growth in average daily rural wages is moderating



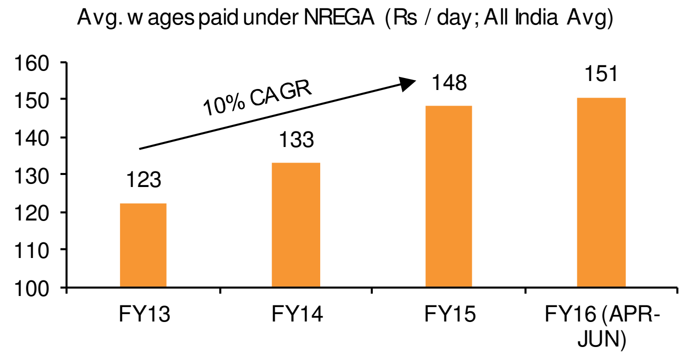
Source: RBI, Emkay Research Note: The base year has been shifted and hence the data between Nov-13 to Oct-14 has been removed for like-to-like comparisons.

Exhibit 23: MSP hikes are lower, in a bid to curb inflation



Source: CMIE, Emkay Research

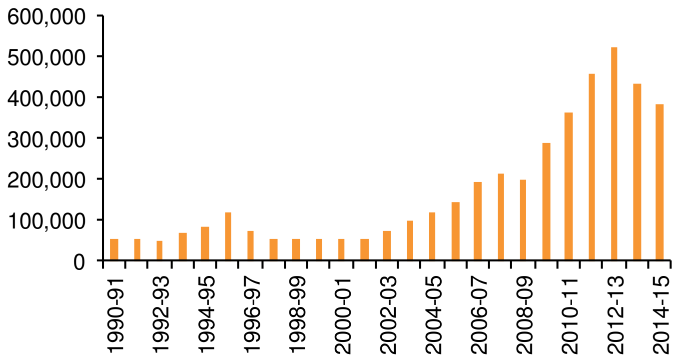
Exhibit 24: Average daily wages paid under MNREGA largely flat



Source: MNREGA, Emkay Research

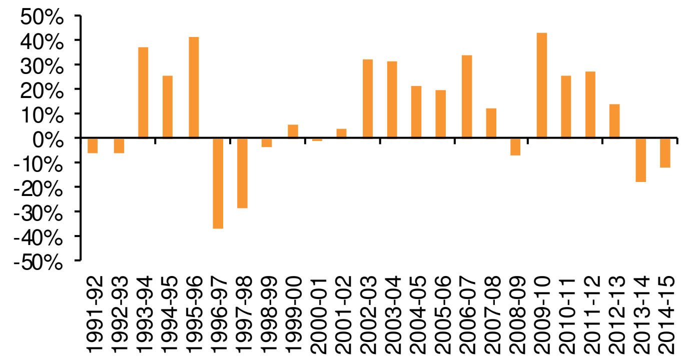
All these factors lead to a fall in rural disposable incomes. Hence the focus now shifts to monsoon and government spending on rural infrastructure. These factors would be the key catalysts in reviving rural demand and this is likely to have an impact on tractors, LCV, UV and PV sales in the rural segment. We expect the growth in the LCV segment to lag the growth in the M&HCV segment. We believe there could be continued weakness in LCV/UV sales in the near term.

Exhibit 25: LCV sales continued to decline in FY15



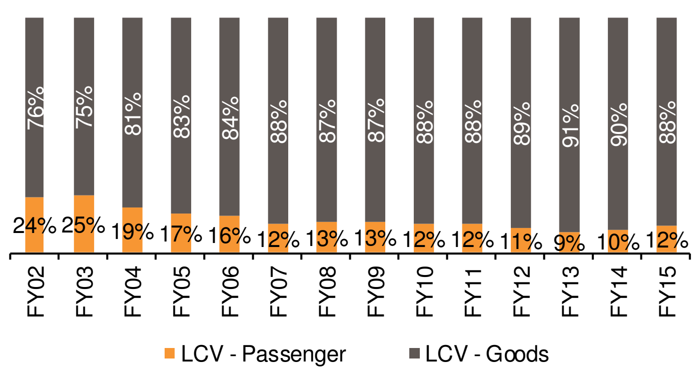
Source: CMIE, Emkay Research

Exhibit 26: Trend in LCV sales growth (% yoy)



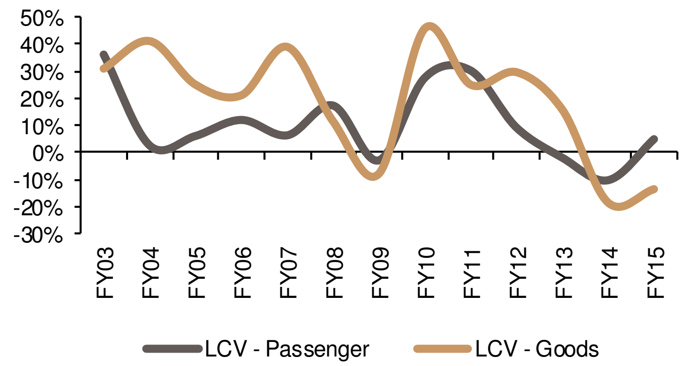
Source: CMIE, Emkay Research

Exhibit 27: LCV sales mix remained largely stable



Source: CMIE, Emkay Research

Exhibit 28: Trend in LCV segment-wise sales growth (% yoy)

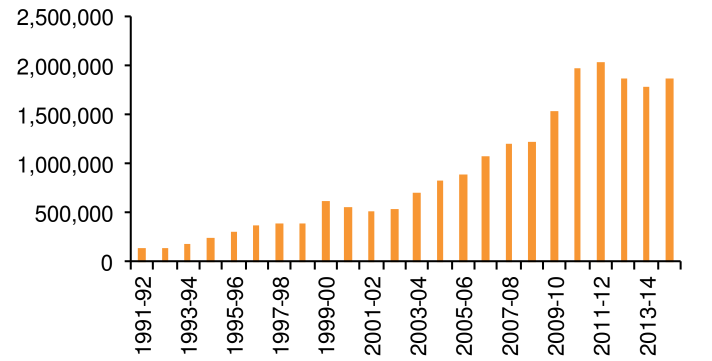


Source: CMIE, Emkay Research

Urban consumption trends are looking up

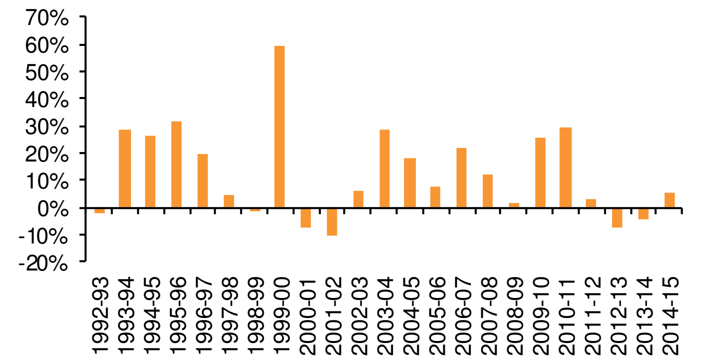
The overall consumption trends appear to have reversed, in favour of urban, compared to that witnessed in the past. While the rural markets are in stress, the urban market sentiments seem to be on an uptrend. This is also partially reflected in the passenger vehicle sales that grew marginally in FY15. Management commentaries of some of the leading PV manufacturers, indicate that urban demand is showing some strength (possibly due to pent-up demand of past few years), though rural continues to remain sluggish.

Exhibit 29: PV sales nearing peak scaled in FY12



Source: CMIE, Emkay Research

Exhibit 30: Trend in PV sales growth (% yoy)



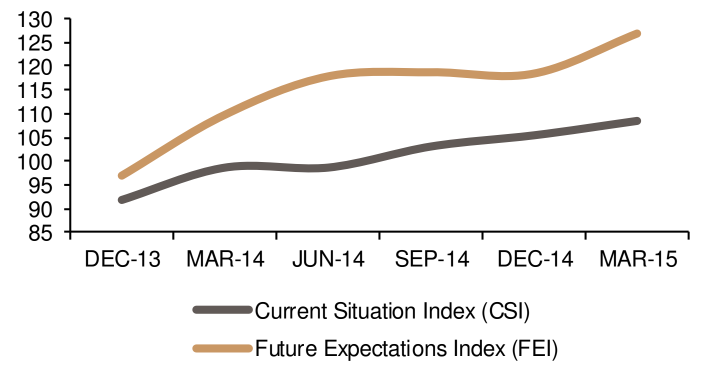
Source: CMIE, Emkay Research

Apart from that, some of the key data points that signal an urban recovery are as follows:

- As per the RBI's latest Consumer Confidence Survey (based on responses from 5,400 participants in top six metropolitan cities in India), the Current Situation Index (CSI) has improved every quarter for the past four quarters, and the Future Expectations Index (FEI) has improved in March quarter after remaining almost stagnant for the past three quarters *(refer exhibit 31)*.
- While 70% of the respondents are positive on their current spending, ~78% respondents expect an increase in their future spending in the next 1-year. On the flipside, respondents also expected inflation to rise over the corresponding period *(refer exhibit 32)*.
- As per the Naukri Jobspeak data (as on Apr-15), hiring in some of the large cities shows an uptick *(refer exhibits 33, 34)*. Moreover, media reports also suggest that IT and other companies are giving higher salaries to acquire and retain talent.

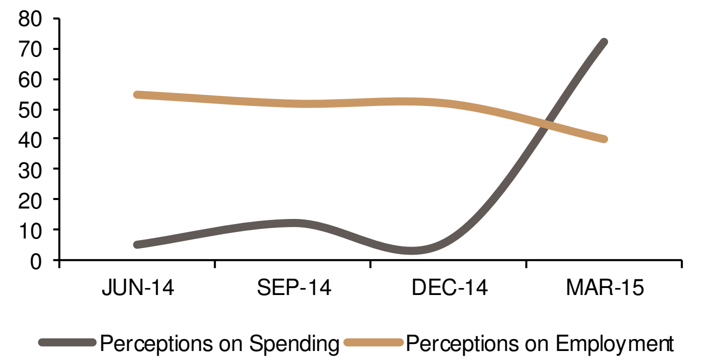
We believe, all these factors coupled with the pent-up demand of past few years, may lead to higher consumer spending in the auto / consumer durables segment, which augurs well for asset financing companies focused on the urban consumer.

Exhibit 31: Consumer Confidence Index is trending up



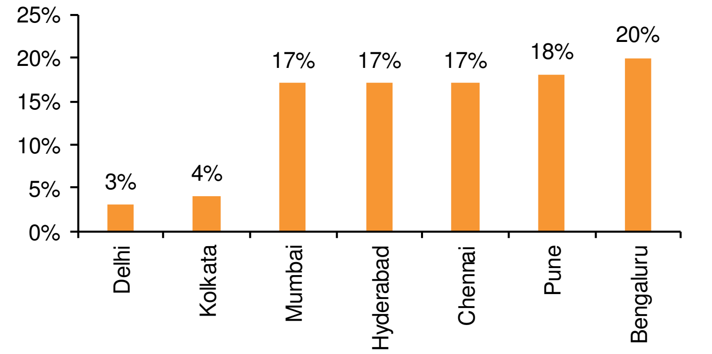
Source: RBI, Emkay Research

Exhibit 32: Trend in consumer confidence indices



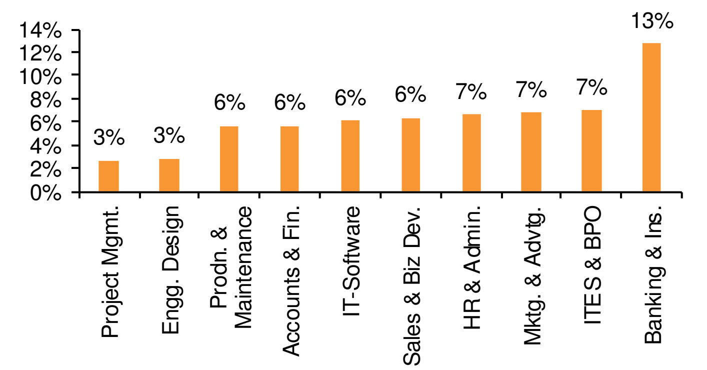
Source: RBI, Emkay Research

Exhibit 33: Hiring trends in key urban centres are healthy



Source: Naukri.com, Emkay Research

Exhibit 34: Hiring trends across some of the major industries



Source: Naukri.com, Emkay Research

Private banks expanding into NBFC turf; Market share of 'large' players at risk

Myth: Banks (PSU as well as private) are present where NBFCs are operating, but are not perceived as a major competitor / threat.

Myth-buster: Our analysis suggests a) In about 890 unique locations covered by top 3 NBFCs (SHTF + MMFS + CIFC), ~37% of locations are such, where none of the top 5 private banks (ICICIBC + HDFCB + AXSB + IIB + KMB-merged) are present as on Mar 2015, b) About 176 such unique locations (~20% of total) have been tapped by these banks during FY13-15, where none of them were present earlier, and c) Cumulatively, these five private banks now command 38% branch market share in those locations.

What does the branch expansion strategy of private banks reveal?

Based on the data available from the RBI and various company websites, we have tried to analyze the branch network of top 3 NBFCs (SHTF / MMFS / CIFC) and top 5 private banks (HDFCB, ICICIBC, AXSB, KMB-merged, IIB). Clearly, the top private banks (whose presence matters) are penetrating deeper into the rural and semi-urban regions, which otherwise, have been largely dominated by the NBFCs. Some of the key observations from the analysis are as follows:

- Of the total 890 unique locations covered by the top 3 NBFCs, the top five private banks are present in only 564 such locations (63% of total)
- Of the above 564 locations covered by private banks, 278 locations (49.3% of the total bank locations) have been such, where private banks have opened branches during FY13-15. The branch market share of private banks in such locations is now 45.6%.
- Of the above 278 locations, 176 locations (20% of total) are such, where none of the top five private banks were present earlier. About 202 new branches have been opened in such locations during FY13-15 and private banks enjoy 37.6% branch market share in such locations.

Exhibit 35: Top 5 private banks aggressively penetrating into NBFC turf

	Top 3 AFCs	Top 5 Pvt Banks	Comments
Total locations covered	890	564	Out of total 890 unique locations dominated by top 3 AFCs, top 5 pvt banks are present only in 564 (63%) of such locations
Branches	1,581	1,956	No of branches across these locations of NBFCs and private banks
Of the above,			
Pvt banks further increased penetration in 278 locations during FY13-15			
Locations covered over FY13-15	278	278	No of locations, where top 5 pvt banks opened branches over FY13-15
% of total	31.2%	49.3%	
Branches	596	500	Penetrating deeper into the areas, where NBFCs have dominant position
% of total	37.7%	25.6%	
Branch mkt share (%)	54.4%	45.6%	
Of the above,			
New locations covered	176	176	No of locations, where none of the top 5 pvt banks were present earlier
% of total	19.8%	31.2%	
Branches	335	202	~38% branch market share in areas, where NBFCs were present solely, could hurt incumbent players
% of total	21.2%	10.3%	
Branch mkt share (%)	62.4%	37.6%	

Source: Company, RBI, Emkay Research Note: The branch data for NBFCs has been collated and compiled from various websites.

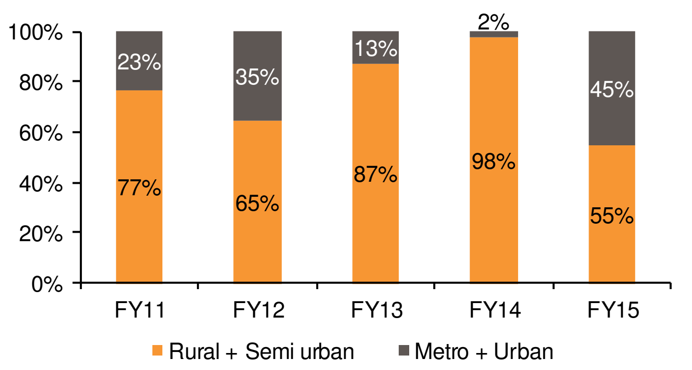
What is leading private banks to shift focus to rural / semi urban regions?

Change in regulations mandated banks to penetrate deeper

Most private banks, who have been urban focused, are now reaching out in the rural, semi urban regions. One of the reasons for expanding aggressively in rural areas was the change in RBI's branch authorization policy, which mandated banks to maintain a mix between rural and urban branches and asserted them to enter unbanked areas. As a result:

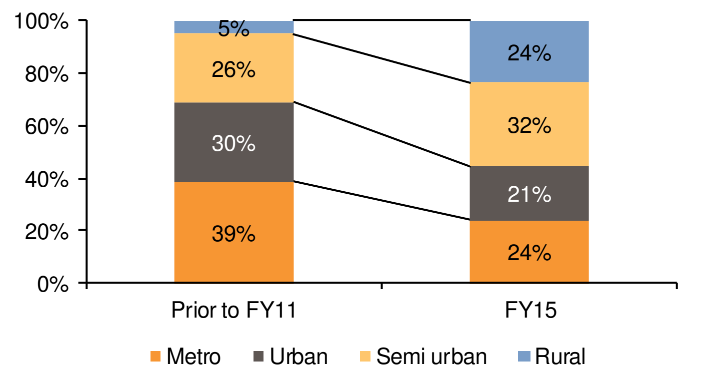
- Led by a significant ramp-up in the branch network in the rural / semi urban / unbanked / underbanked regions, the top three private banks (ICICIBC, HDFCB, AXSB) now have ~53% of their branches in the rural / semi urban regions vs. an average 30%+ in FY11.
- For HDFCB, AXSB, ICICIBC – average incremental branch addition in the rural + semi-urban regions during FY13-15 stood at 81%, 69% and 71% respectively.
- During this period, these three banks cumulatively added about 2,462 rural / semi urban branches, implying that roughly about 800 new locations have been entered into, even if we assume all three banks opened their branches at the same location.

Exhibit 36: HDFCB: Incremental branch addition



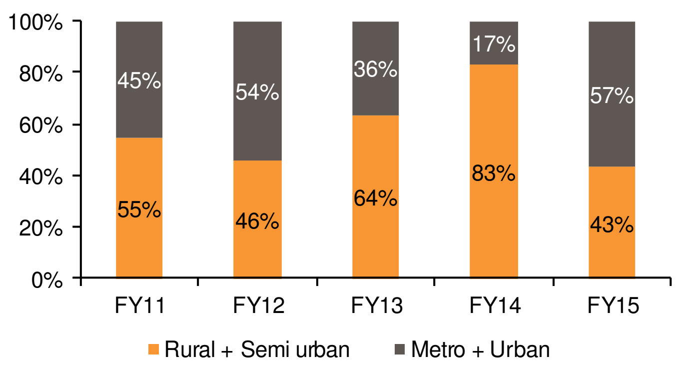
Source: RBI, Company, Emkay Research

Exhibit 37: HDFCB: Branch mix



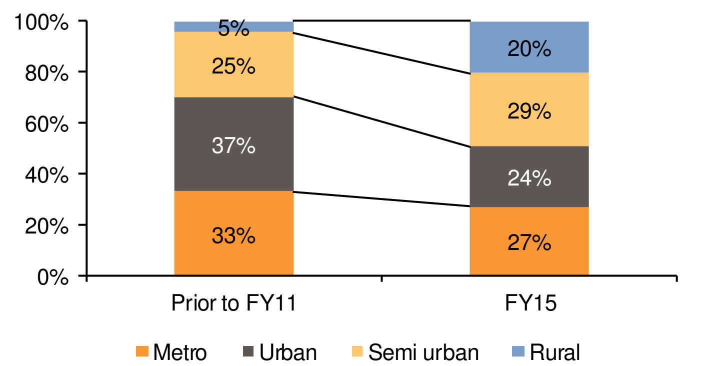
Source: RBI, Company, Emkay Research

Exhibit 38: AXSB: Incremental branch addition



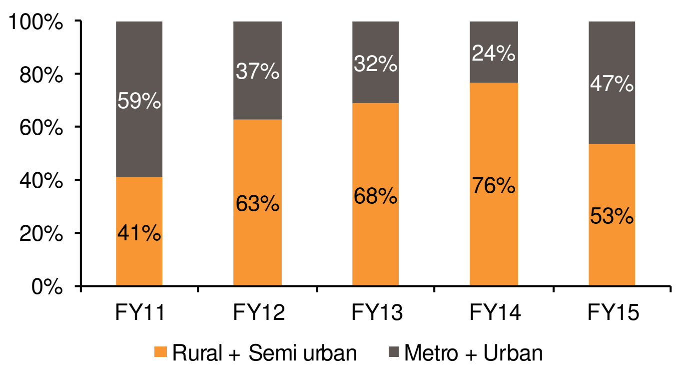
Source: RBI, Company, Emkay Research

Exhibit 39: AXSB: Branch mix



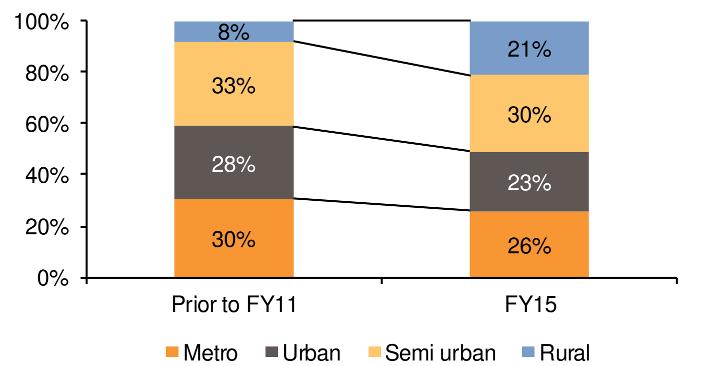
Source: RBI, Company, Emkay Research

Exhibit 40: ICICIBC: Incremental branch addition



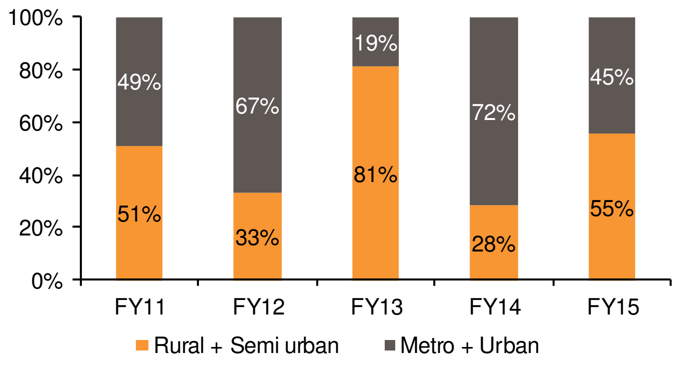
Source: RBI, Company, Emkay Research

Exhibit 41: ICICIBC: Branch mix



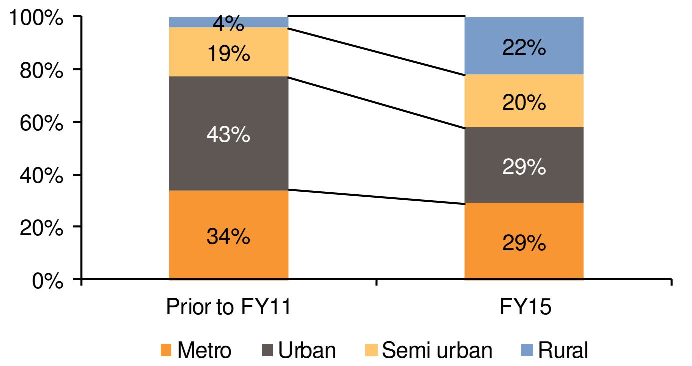
Source: RBI, Company, Emkay Research

Exhibit 42: IIB: Incremental branch addition



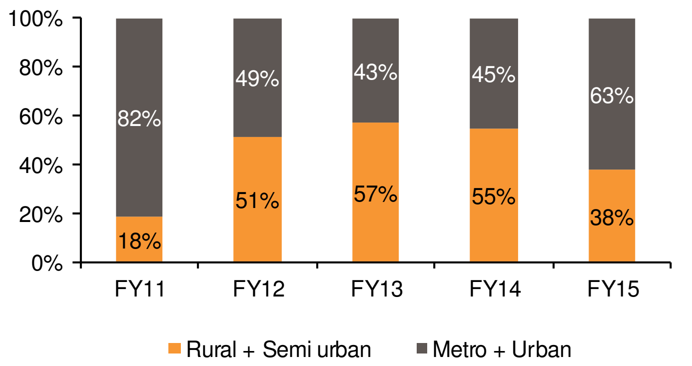
Source: RBI, Company, Emkay Research

Exhibit 43: IIB: Branch mix



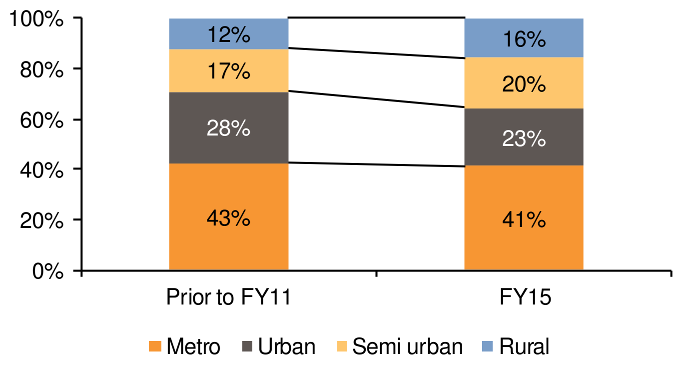
Source: RBI, Company, Emkay Research

Exhibit 44: KMB+VYSB: Incremental branch addition



Source: RBI, Company, Emkay Research

Exhibit 45: KMB+VYSB: Branch mix



Source: RBI, Company, Emkay Research

Huge untapped rural opportunity too, has attracted private banks

Apart from the regulatory compulsions, private banks are also attracted by the huge untapped potential this segment offers. Moreover, slowdown in corporate credit, search for an economically viable rural business model and relatively higher profitability are also some of the reasons for private banks looking at rural as a business opportunity.

Management commentaries of top private banks indicate that they are geared up to push forward the rural envelope:

Kotak Mahindra Bank

Excerpt from Kotak Bank FY14 Annual Report, Management Discussion –

“We have always built our business model as concentrated India, diversified financial services. Our India-Bharat banking model is based on an inclusive approach – borrowing from urban India and lending to middle India (smaller towns) and rural regions. In a country, where barely a third of its 1.2 billion people have a bank account, and is at the tipping point of a historic shift, I believe this model’s time has come. The time is now.”

“Our focus on Rural India (Bharat) has yielded positive results, with the overall portfolio growing by 22%. The quality of the portfolio has been healthy with delinquency under control. The Tractor and Farm Equipment (TFE) portfolio disbursements grew by 30% against industry growth rate of 20%. The Bank, during the year, continued to increase its geographical presence by opening new branches in rural India which will help its future growth in this sector.”

Axis Bank

Excerpt from Axis Bank FY14 Annual Report, Management Discussion –

“During the year, the Bank continued to expand its network, with increased focus on the semi-urban and rural areas. Both the Retail and SME segments continued to benefit from this network expansion and have justifiably remained the key growth drivers for the Bank during the year.”

HDFC Bank

Comments from Mr. Aditya Puri, Managing Director, HDFC Bank, on HDFC Bank's rural strategy, Feb 2015 –

"If you see 60 per cent of India lives in rural and semi-urban area, where the penetration of organized finance is only 8 per cent and the reason is that because it is difficult to come up with a profitable model here. We have been working out with our pilots in the last 3-4 years and only last year, we have managed to smoothen out everything whereby this is a major area for us."

http://www.business-standard.com/article/current-affairs/nobody-can-find-fault-with-the-prime-minister-s-execution-skills-aditya-puri-115022000043_1.html

Comments from Mr. Aditya Puri, Managing Director, HDFC Bank, on HDFC Bank's rural strategy, Jun 2015 –

"I want to own semi-urban and rural areas, where the penetration of organised banking and finance is only eight per cent at present. That is because there are cost issues, etc.…

… We also thought that initial pick-up (of digital banking) in semi-urban and rural areas will be low. But it is, in fact, 50 per cent higher than in urban areas. That's for the simple reason that if you want to buy something in rural areas, you have more options online, and it is cheaper than your neighbourhood store.

When I went to Sangla in Himachal Pradesh, I realised they took time to give loans in rural areas. Now, we are saying we will offer loans in 24 hours even for them. Shopkeeper loans will be made available in only three hours, personal loans in 10 seconds, auto loans in 30 minutes — that is a complete change. Sixty to sixty-five per cent of India lives in semi-urban areas. At least 60-70 per cent of them are technology savvy, so that's a huge market."

http://www.business-standard.com/article/finance/hdfc-bank-will-cut-base-rate-this-quarter-aditya-puri-115061001044_1.html

What does all this imply for NBFCs?

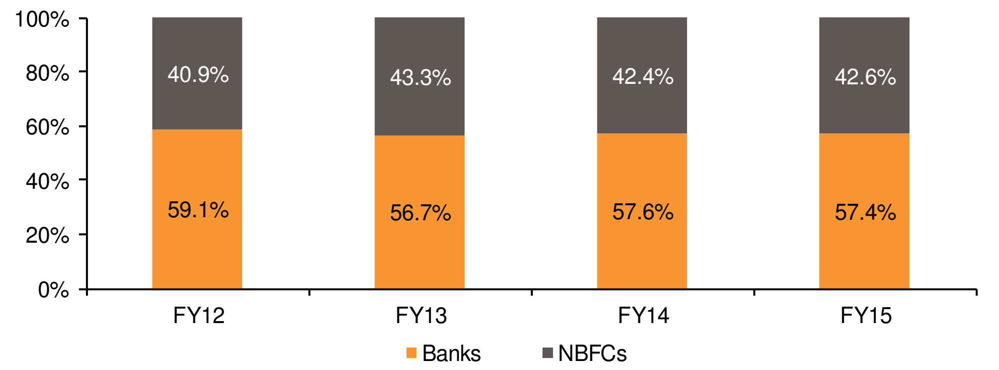
Lack of reach of the formal banking sector into rural / semi urban regions and inability of the public sector banks to bring large untapped rural populace under the banking channel, led NBFCs to emerge as the last mile channel to provide credit assistance. NBFCs since have been relatively lightly regulated and innovative business models have led to high profitability.

However, major private banks (whose presence matters) stepping up their rural presence and shifting their focus on rural as the next growth opportunity, makes us believe that some serious competition for NBFCs could be emerging. In our view, these private banks have gradually set up capacity during the down cycle, which should yield dividends during an upcycle. Some banks may have their rural models, which could be liability focused. However, going by the management commentary of HDFC Bank and Kotak Bank, their focus is to develop a profitable business model, encompassing the liability as well as asset side aspects. As a result, one of the major implications of this could be stagnation / loss in market share for NBFCs.

Market share of large NBFCs could be at risk

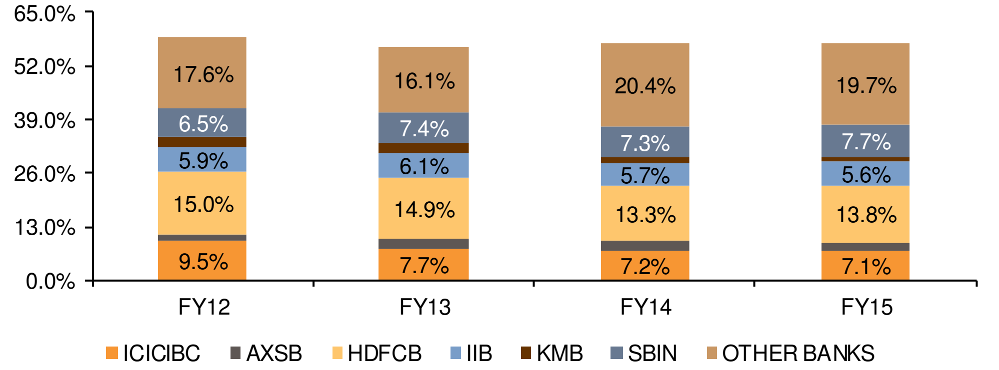
The market share data for auto / asset financing banks / NBFCs indicates that the market share of NBFCs (cumulative), within the overall auto financing space, has begun to stagnate. What is changing over the years is that the number of market participants are increasing. Hence, private banks and small NBFCs are able to gain market share, while some of the incumbent players in this business are able to just maintain their market shares or see it erode.

Exhibit 46: Market share of banks / NBFCs in auto financing space



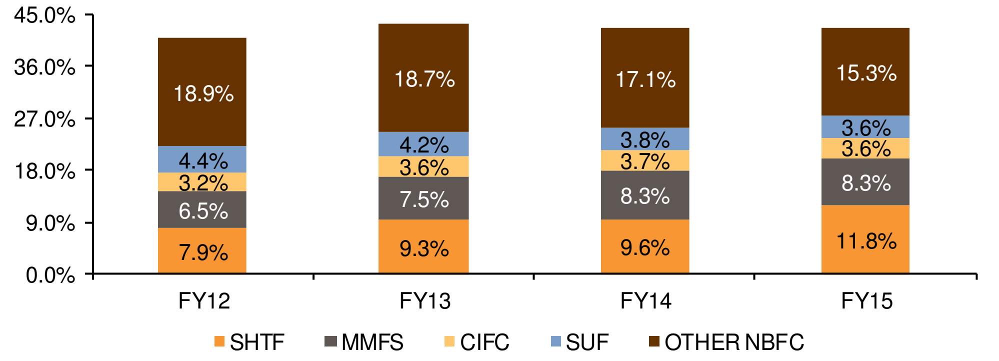
Source: RBI, Company, Emkay Research

Exhibit 47: Large banks are losing market share



Source: RBI, Company, Emkay Research

Exhibit 48: Overall NBFC market share is stagnating

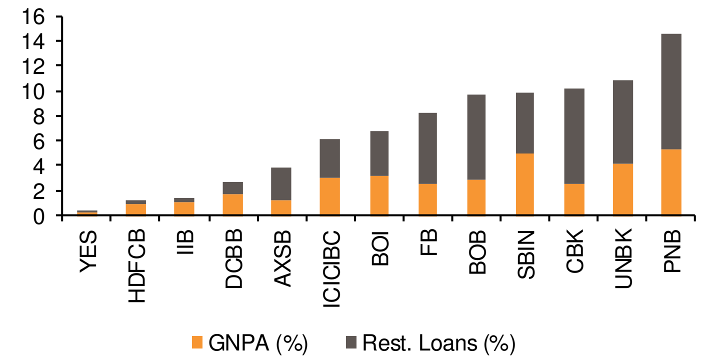


Source: RBI, Company, Emkay Research

Private Banks or NBFCs: Product differentiation is blurring

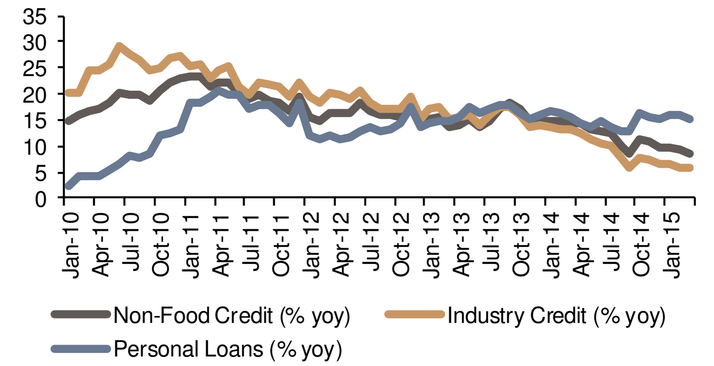
With corporates in deleveraging mode, corporate credit offtake at multi-year lows *(refer exhibit 50)* and banks reeling under asset quality pressure from their large corporate exposures *(refer exhibit 49)*, retail segment has been the most obvious choice for lenders – banks and NBFCs alike. Retail asset quality / demand in the current cycle has remained relatively stronger – thanks to the credit bureaus and the divergent consumer behaviors in the rural and urban pockets. Select product categories and customer segments have helped specialized financiers to combat slowdown.

Exhibit 49: Stressed assets of banks as at end-Mar 2015 (%)



Source: Company, Emkay Research

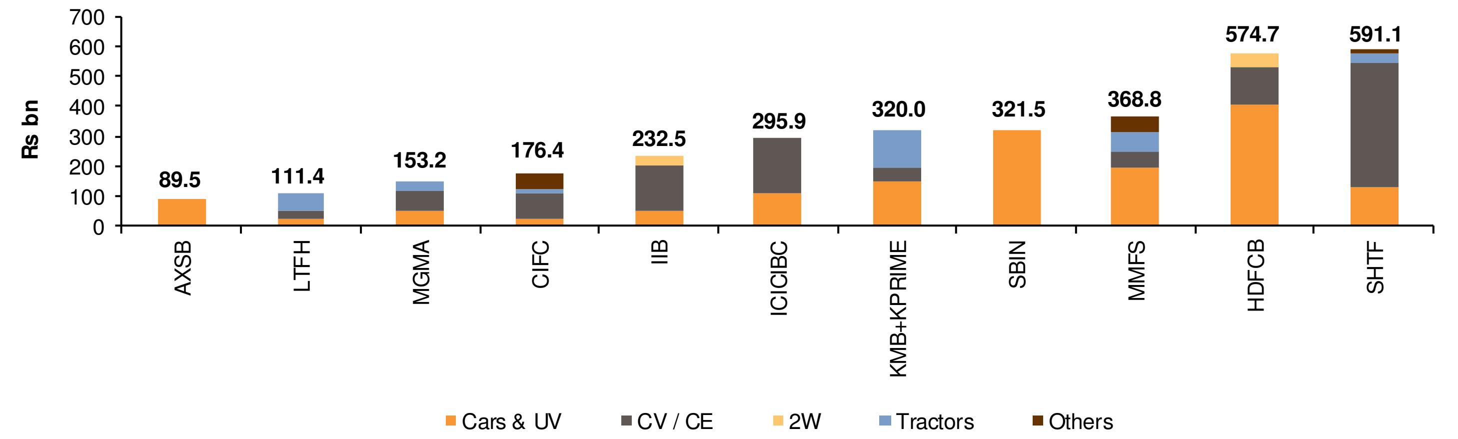
Exhibit 50: Credit growth is at multi-year lows



Source: RBI, Emkay Research

However, this has also attracted a lot of competition from new players entering the market or has led banks and NBFCs to enter into segments outside their core operating areas. As a fallout of this, most private banks and NBFCs have significantly expanded their retail product offerings in search of growth and the differentiation on the product front are blurring *(refer exhibit 51)*. For e.g. private banks are offering finance for pre-owned vehicles, loans against gold jewelry, loans against property, which used to be dominated by NBFCs or select banks in the past.

Exhibit 51: Product differentiation between private banks and NBFCs is blurring (auto financing AUM breakup as publicly disclosed)



Source: Company, Emkay Research

Increasing competition can put pressure on margins/growth or both

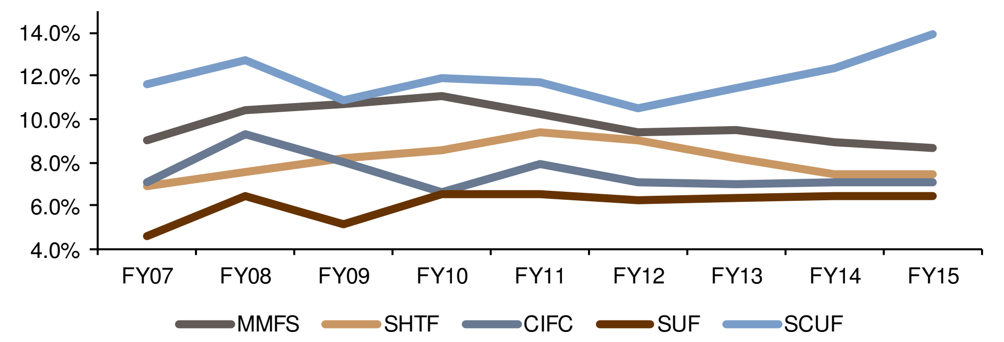
Ideally, competition brings out efficiencies among market participants, but it also puts pressure on growth / margins. Housing loans, SME loans, loan against property (LAP), unsecured personal loans for better (CIBIL) rated consumers, car loans, CV loans (mainly in the fleet segment), gold loans – all these products have seen immense competition and the product ROEs have structurally come off, due to stiff competition.

In areas, where the growth / profitability comes under pressure, heavy competition can also result in market disruptions. Instances of banks getting aggressive in the mortgages, auto loans segment or captive financiers aggressively pushing parent OEM's products have proven disruptive and impacts growth or yields for other active players in the market.

Niche NBFCs, have ventured into new product lines, which have not been their domain expertise. SHTF financing passenger vehicles, CIFC rapidly growing in tractor financing, L&T Finance goring aggressively into tractor financing and Bajaj Finance entering rural areas and doing vehicle financing are some of the examples. Most NBFCs are now offering finance against used vehicles and loan against property.

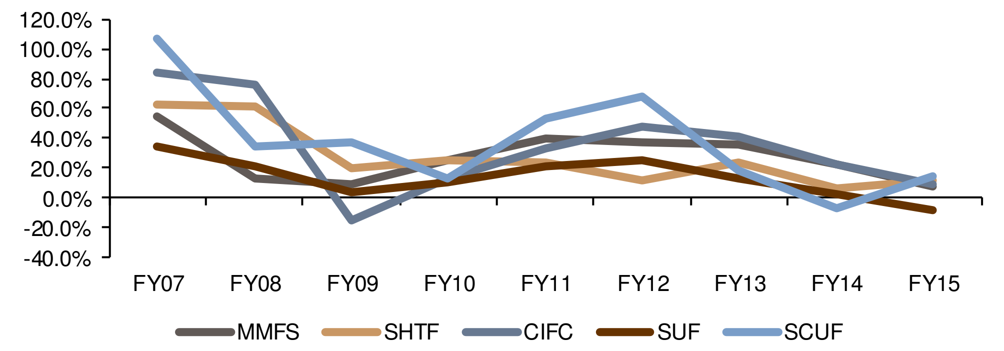
We believe all this could result in intense competition between banks and NBFCs in the retail segment – urban / rural alike. Besides, it is difficult to predict whether new players entering into new product segments (which have been dominated by niche NBFCs) will be able to do the business, as efficiently or better, than the incumbent players. However, they can cause disruptions in the market place and there are historical evidences of the same. Objectively, we believe strong niche players may continue to survive and thrive, while new players may find it difficult to sustain the momentum. However, in the interim, there can be disruption in the marketplace and market share loss for large players cannot be ruled out.

Exhibit 52: Trend in net operating margins of major NBFCs



Source: Company, Emkay Research Note: Net operating margins = Net operating income as % of average AUMs

Exhibit 53: Trend in AUM growth of major NBFCs



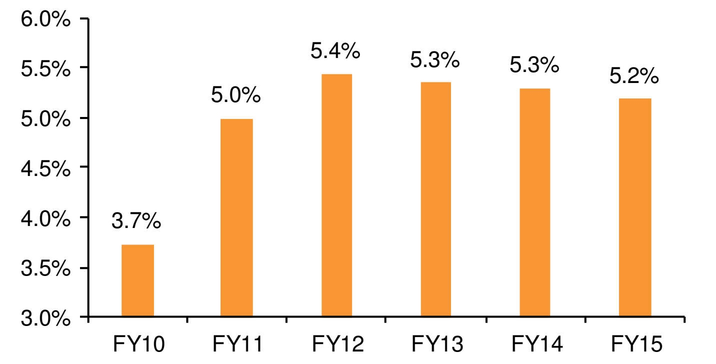
Source: Company, Emkay Research

Regulatory gap narrowing; near term profitability to remain under pressure

A relatively lighter regulatory framework compared to banks is one of the reasons for the lucrativeness of the NBFC business model. This, coupled with their niche business models, helped NBFCs deliver superior profitability compared to that of banks. However, the sector has become meaningful in terms of its size (let alone the sheer number of NBFCs). As per the Financial Stability Report, there were 11,842 NBFCs registered with the RBI. Of which, 220 are deposit taking NBFCs (NBFC-D) and 200 of them are classified as non-deposit accepting and systemically important (NBFC-ND-SI).

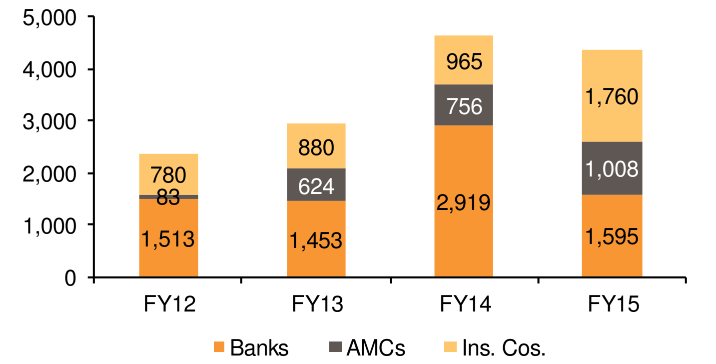
Our interactions with RBI officials suggested that the regulator intends to monitor these NBFCs closely as bulk of the business is done through these NBFCs. Also, the exposure *(refer exhibit 54, 56, 58)* of the sector in terms of handling public money and the interconnectedness *(refer exhibit 55)* has increased materially, which has also attracted regulator's attention. As a consequence, the RBI has completely overhauled the regulatory framework for NBFCs over the past few years and the regulatory gap with banks will be reduced to a great extent. This should impact the sustainable ROA / ROEs and keep near term profitability of NBFCs under pressure.

Exhibit 54: Bank credit to the NBFC sector (% of non-food credit)



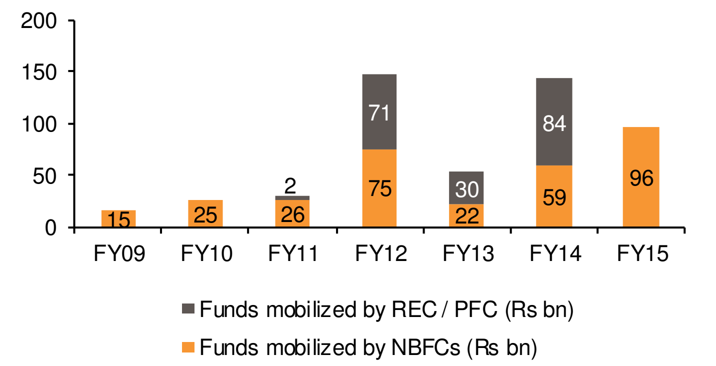
Source: RBI, Emkay Research

Exhibit 55: Investment by financial institutions in NBFCs (Rs bn)



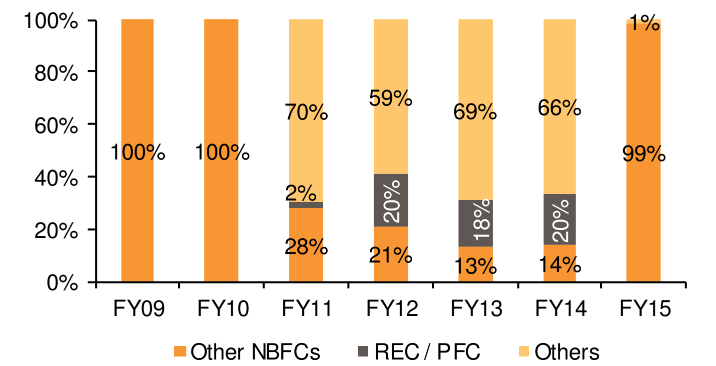
Source: RBI, Emkay Research

Exhibit 56: Funds mobilized by NBFCs through NCD route



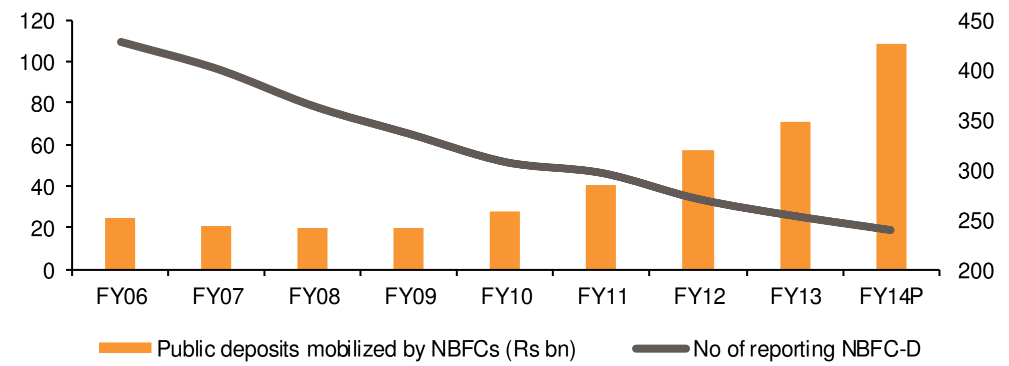
Source: SEBI, Emkay Research

Exhibit 57: Mix of funds raised through NCDs over the past few years



Source: SEBI, Emkay Research

Exhibit 58: Exposure of deposit taking NBFCs-D is increasing rapidly



Source: RBI, Emkay Research

Revised NPL recognition norms: a key deterrent to profitability

Under the revised regulatory framework *(refer exhibit 59)*, migration to 90-dpd NPL recognition will be a key challenge for NBFCs – both, in terms of operational issues and higher credit costs. While this does not change the ultimate loss given default, it does have earnings implications for NBFCs. De-recognition of interest income and higher loan loss charges are likely to impact ROAs / ROEs in the near term. However, NBFC's ability in passing on these regulatory costs and aligning their business models to the new regulations will be a key monitorable in the medium to long term.

Exhibit 59: Key changes under the revised regulatory framework for NBFCs

	Existing guidelines	Revised guidelines	Comments
Capital requirements	Minimum CRAR requirement of 15%, of which: ▪ tier-1 of not less than 7.5% for AFCs ▪ tier-1 of not less than 10% for Infrastructure Finance Companies (IFCs), ▪ tier-1 of not less than 12% for NBFCs engaged in lending against gold jewellery	NBFCs directed to maintain tier-1 capital of 10% by March 2017 ▪ 8.5% by end Mar 2016 ▪ 10% by end Mar 2017 Minimum tier-1 capital requirement for NBFCs engaged in lending against gold jewellery, unchanged at present. To be reviewed in future.	Higher capital requirement to lead to lower leverage and impact ROEs of AFCs. However, we believe most NBFCs used to keep excess capital from the credit rating standpoint and hence, maintaining higher capital should not be an issue
Asset classification norms	An asset is classified as NPA when it has remained overdue for a period of six months or more for loans; and overdue for twelve months or more, in case of lease rental and hire purchase installments	For all loan, hire purchase and lease rental assets, NPAs to be classified based on 90 days overdue basis in a phased manner by March 2018 ▪ 150 days overdue by Mar 2016 ▪ 120 days overdue by Mar 2017 ▪ 90 days overdue by Mar 2018 For existing loans, one-time adjustment of the repayment schedule, not amounting to restructuring will, however, be permitted	We believe this would lead to a sharp rise in NPAs for NBFCs and thereby, an increase in provisioning requirements. However, more importantly what kind of changes NBFCs bring in to their business models to keep NPAs under check has to be seen
Standard assets provisioning	Currently, NBFCs are required to make a standard assets provisions at 0.25% of the outstanding amount	Standard asset provisioning norms for NBFCs increased to 0.4% in phased manner and brought at par with banks ▪ 0.30% by end Mar 2016 ▪ 0.35% by end Mar 2017 ▪ 0.40% by end Mar 2018	We expect this to have some impact on earnings - although, not in a very meaningful way

Source: RBI, Emkay Research

Credit costs under the new norms likely to hurt P&L in the near term

As per the new regulatory framework, NBFCs will start migrating to the 90-dpd NPL recognition from 180-dpd NPL recognition method from FY16 onwards. Certain NBFCs have been conservative and have already been following NPL recognition and provisioning norms, which are more stringent than that of the RBI's. In our view, though the increase in NPLs under the new norms would be technical in nature, the profitability could likely come under strain due to:

- higher interest income de-recognition due to increased delinquencies, which could hurt net interest margins
- increased standard and loan loss provisioning requirement due to increased delinquencies

As evident in *exhibit 60*, NBFCs generally write-off loans aggressively as a part of their business model. In addition, the loan loss provisions move in tandem with the movement in fresh delinquencies. Under the new framework, NBFCs with higher provision coverage ratio are likely to benefit and would be relatively better placed. However, certain factors to watch out for are:

- Typical loan tenors for NBFCs range between 30-40 months. Hence, the provisioning policies followed by NBFCs ideally have to be stringent than that of the RBI's, assuming that the non-performing loans have to be written off during that period to keep NPLs under check and to reduce loan losses. As a result, certain level of provision cover has to be maintained by NBFCs and hence, they cannot fall beyond a particular level.
- Hence, a turnaround in the economy resulting in lower delinquencies and lower write-offs could possibly help NBFCs to offset the rising credit costs, which would otherwise hurt the earnings.

Exhibit 60: Trend in loan loss charges and delinquencies for major NBFCs

	FY07-14		
As % of average on-BS loans	**AVG**	**MIN**	**MAX**
Shriram Transport Finance			
Net addition to GNPLs	0.9%	0.1%	1.5%
Net loan loss provisions	0.6%	0.3%	1.0%
Bad debts & write-offs	**1.6%**	0.8%	2.3%
Gross NPL	2.7%	**1.6%**	**4.0%**
Provision coverage ratio	68.3%	**43.1%**	**79.1%**
Mahindra Finance			
Net addition to GNPLs	1.1%	-1.0%	3.1%
Net loan loss provisions	0.6%	-0.5%	1.9%
Bad debts & write-offs	**1.5%**	0.8%	2.5%
Gross NPL	5.7%	**3.0%**	**9.8%**
Provision coverage ratio	71.0%	**65.9%**	**71.9%**
Cholamandalam Finance			
Net addition to GNPLs	1.0%	-2.6%	4.1%
Net loan loss provisions	0.8%	-1.6%	4.7%
Bad debts & write-offs	**1.0%**	0.1%	3.3%
Gross NPL	3.0%	**0.7%**	**8.7%**
Provision coverage ratio	69.8%	**40.0%**	**73.3%**
Sundaram Finance			
Net addition to GNPLs	0.3%	-0.3%	1.1%
Net loan loss provisions	0.1%	-0.3%	0.2%
Bad debts & write-offs	**0.3%**	0.2%	0.6%
Gross NPL	1.1%	**0.6%**	**1.6%**
Provision coverage ratio	63.9%	**84.2%**	**54.5%**

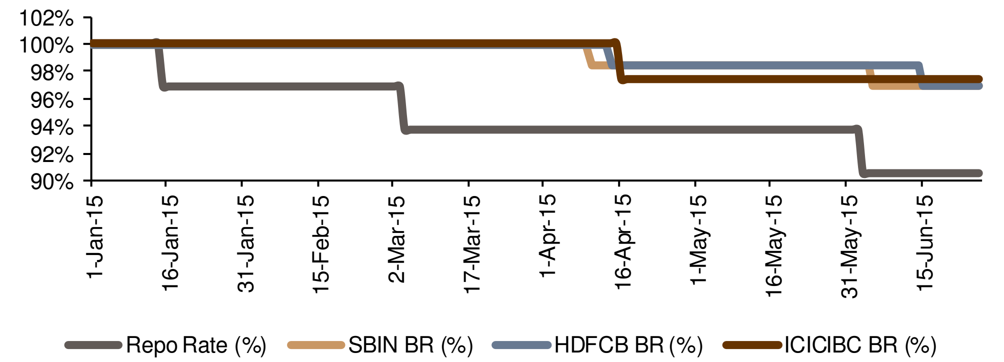
Source: Company, Emkay Research Note: Provision coverage ratio for MIN and MAX gross NPLs are for the corresponding periods

Benefits of falling interest rates likely to accrue, albeit with a lag

Ideally, NBFCs tend to benefit from falling interest rates, given their largely fixed rate lending and partially floating liabilities. As a result, NBFCs tend to outperform in a falling interest rate cycle. However, this time around, we believe the benefits may accrue with a lag.

- While the RBI has cut repo rate by 75bp so far in the current monetary easing cycle, the banks have passed on only about 15-30bp in the form of base rate cuts so far *(refer exhibit 61)*. Note, this is the first monetary easing cycle, since the base rate regime was implemented. That, is possibly, the reason for slower transmission of repo rate cuts into bank base rates as the deposit rates for banks have to fall ahead of lending rates. Our economist expects further maximum 25bp rate cut in CY15.

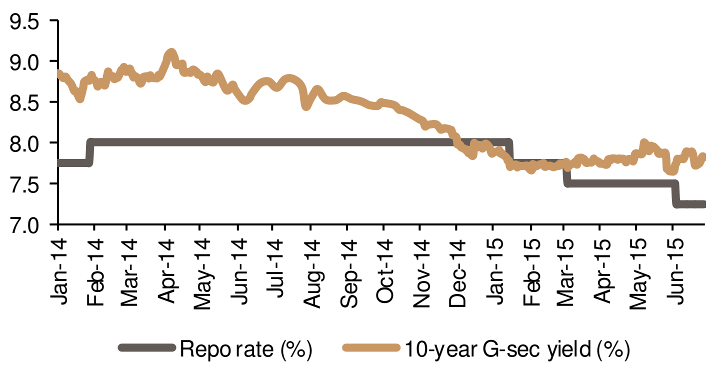
Exhibit 61: Bank base rates have lagged repo rate cuts



Source: Company, Bloomberg, Emkay Research

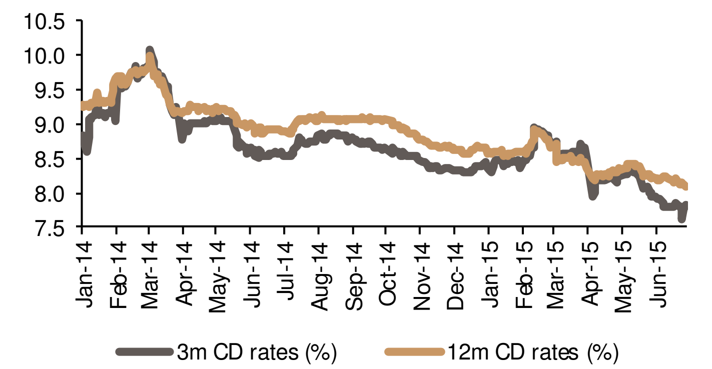
- Though market rates have reflected the decline in interest rates *(refer exhibits 62, 63)*, it is yet to meaningfully reflect in the net interest margins of NBFCs. This could be partially due to higher delinquencies leading to higher interest income reversals, and partially due to high competition, given the slower asset growth. We believe, players, who are not present in niche business segments (e.g. LAP, new vehicle financing, etc.), may continue to face pressure on NIMs as against their niche peers.

Exhibit 62: Trend in repo rate and 10-yr G-sec yields



Source: Bloomberg, RBI, Emkay Research

Exhibit 63: Market rates have fallen in line with policy rates



Source: Bloomberg, RBI, Emkay Research

Prefer betting on niche/small players for profitable market share gains

One of the key arguments in favour of NBFCs as an investment proposition is, stronger growth coupled with higher profitability, which eventually generates higher investor returns. However, the operating environment (from competition as well as regulatory standpoint) has undergone a radical change over the past few years, which would make it difficult for NBFCs to grow at a healthy pace while maintaining their profitability.

NBFCs have generally been preferred over banks for their superior growth and profitability. However, under the new regulatory framework, the profitability gap is likely to narrow. We take cognizance of the changing landscape under which NBFCs will operate. As a consequence, we stick to basics and objectively evaluate some of the key stocks to avoid valuation traps.

The key factors we watched for are:

- Visibility of high growth on the current base for large NBFCs
- Sustainability of profitable growth for companies enjoying niche advantages
- Impact of the new regulatory norms on the sustainable return ratios
- Execution track record of the management
- Niche / competitive edge
- Valuations in context of the sustainable return ratios

Exhibit 64: NBFC scoring matrix

	Bajaj Finance	Cholamandalam Finance	Mahindra Finance	Shriram Transport Finance	Shriram City Union Finance
Growth	5	5	2	1	5
Regulatory impact	5	4	3	1	1
Capital adequacy	5	3	4	4	5
Execution capabilities	5	4	3	2	3
Pricing power	4	3	4	3	5
ROAs	4	3	3	2	5
Total Score	**28**	**22**	**19**	**13**	**24**

Source: Company, Emkay Research *Note: Scoring based on 5 being the highest and 1 being the lowest on a rating scale*

We base our investment thesis on these parameters and would prefer niche / small NBFCs where the visibility over growth as well as profitability remains relatively better (inducing profitable market share gains) than some of their larger peers. Our preferred picks in the space are BAF (Initiate with ACCUMULATE rating), CIFC (Initiate with ACCUMULATE rating) and SCUF (Initiate with ACCUMULATE rating).

Exhibit 65: Key recommendations

	Reco	CMP (Rs)	TP (Rs)	+/- upside (%)
Bajaj Finance	Accumulate	5,025	6,018	20%
Cholamandalam Finance	Accumulate	721	825	14%
Mahindra Finance	Reduce	277	262	-5%
Shriram City Union Finance	Accumulate	1,684	2,013	20%
Shriram Transport Finance	Sell	940	771	-18%

Source: Company, Emkay Research

Exhibit 66: Key financials

	FY15	FY16E	FY17E	FY18E	CAGR (%)
Bajaj Finance					
ROAA	3.1%	3.0%	2.9%	2.9%	
ROAE	20.4%	18.6%	17.4%	18.5%	
EPS (Rs)	179.1	211.8	263.0	325.8	22.1%
P/E (x)	28.1	23.7	19.1	15.4	
BV (Rs)	957.3	1,400	1,625	1,904.4	25.8%
P/BV (x)	5.2	3.6	3.1	2.6	
ABV (Rs)	932.7	1,389.9	1,618.5	1,880.7	26.3%
P/ABV (x)	5.4	3.6	3.1	2.7	
Cholamandalam Finance					
ROAA	1.9%	2.1%	2.2%	2.3%	
ROAE	17.5%	17.4%	17.8%	19.5%	
EPS (Rs)	30.3	35	45	58.3	24.4%
P/E (x)	23.8	20.4	16.0	12.4	
BV (Rs)	186.0	234	273	324.5	20.4%
P/BV (x)	3.9	3.1	2.6	2.2	
ABV (Rs)	155.1	203.2	234.6	277.0	21.3%
P/ABV (x)	4.6	3.5	3.1	2.6	
Mahindra Finance					
ROAA	2.5%	2.5%	2.6%	2.8%	
ROAE	15.4%	15.6%	17.0%	18.6%	
EPS (Rs)	14.7	17	20	25.2	19.7%
P/E (x)	18.8	16.7	13.7	11.0	
BV (Rs)	100.5	112	126	144.3	12.8%
P/BV (x)	2.8	2.5	2.2	1.9	
ABV (Rs)	86.0	100.4	114.5	131.4	15.2%
P/ABV (x)	3.2	2.8	2.4	2.1	
Shriram City Union Finance					
ROAA	3.2%	3.3%	3.2%	3.2%	
ROAE	15.9%	14.9%	16.0%	17.6%	
EPS (Rs)	84.7	98	119	151.2	21.3%
P/E (x)	19.9	17.1	14.1	11.1	
BV (Rs)	622.2	701	797	918.9	13.9%
P/BV (x)	2.7	2.4	2.1	1.8	
ABV (Rs)	606.0	674.7	760.0	868.7	12.8%
P/ABV (x)	2.8	2.5	2.2	1.9	
Shriram Transport Finance					
ROAA	2.3%	2.1%	2.2%	2.3%	
ROAE	14.1%	13.4%	14.6%	15.5%	
EPS (Rs)	54.6	58	70	84.2	15.6%
P/E (x)	17.2	16.3	13.5	11.2	
BV (Rs)	407.1	452	508	576.5	12.3%
P/BV (x)	2.3	2.1	1.9	1.6	
ABV (Rs)	390.4	406.7	441.8	498.2	8.5%
P/ABV (x)	2.4	2.3	2.1	1.9	

Source: Company, Emkay Research

India Equity Research | Banking & Financial Services
July 14, 2015
Initiating Coverage

Emkay©
Your success is our success

Bajaj Finance

Racing ahead

CMP	Target Price
Rs5,025	Rs6,018 (▪)
Rating	**Upside**
ACCUMULATE (▪)	19.8 %

Bajaj Finance (BAF) has been an outlier among NBFCs, maintaining strong growth and healthy profitability, despite challenging environment and being proactive in adopting to the regulatory changes. We expect this healthy trend to continue and with the conclusion of its recent equity raising, BAF appears well positioned for its next growth phase. While valuations factor in most positives, we believe qualitative growth justifies premium valuations.

- **Uptick in urban demand to help augment growth:** Unlike in the past, consumer demand trends appear to be shifting in favour of urban. While rural demand continues to remain weak, the latest RBI data shows that urban consumer confidence is improving after a long time and so is the outlook on urban consumer spending. This, in our view, augurs well for Bajaj Finance and could help it maintain its healthy growth momentum. We have modeled in 28% CAGR in AUMs over FY15-18E.
- **Diversified product mix and wide distribution reach to aid new client acquisition:** As of end-Mar 2015, BAF has 28 active product lines (including loans and fee-based products), with a large part of them focusing on the retail consumer. BAF is now one of the leading players in consumer related businesses due to its steady introduction of new products and its strong cross sell platform. BAF distributes its products through a network of multiple channel partners and currently boasts of 16,000 touch points. BAF's diversified product portfolio helps in strong customer acquisition and an existing large customer base aids cross selling of products. New customers acquired in FY15 grew by 45% yoy.
- **Least impacted NBFC under the new regulatory framework:** BAF is the only NBFC which is almost fully compliant with the RBI's new regulatory framework ahead of its actual implementation. While under the new framework, NPLs are likely to rise, the impact of the provisioning costs are already taken into the P&L. BAF's internal provisioning policies are more stringent compared to that of RBI's. Hence, we expect migration to 90-dpd NPL recognition norms to have a negligible impact on BAF's P&L.
- **Recent capital raising to cushion NIMs:** BAF's NIMs have been on a downward trajectory led by a strong growth in the relatively low-yielding non-consumer segments. While we expect this trend to continue in the medium term, the recent equity capital raising of Rs18bn should cushion margins. The capital raising constitutes 37.5% of BAFs Mar-15 networth. Consequently, despite relatively faster growth in the non-consumer segments, BAF's NIMs may remain protected in the near term.
- **Valuation and view:** BAF has showcased superior execution skills despite challenging economic environment (FY11-15: 44%/38% AUM/PAT CAGR). Though new business lines have been introduced at regular intervals, the management has also been prudent in exiting non-profitable / riskier businesses in a timely manner. We expect healthy growth and profitability trends to sustain. The stock trades at 3.1x FY17E BV, reflecting its qualitative growth, better than peers returns profile and superior execution track record. We initiate coverage with an **Accumulate** rating and target price of Rs6,018 (based on residual income model).

Financial Snapshot (Standalone)

(Rs mn)	FY14	FY15	FY16E	FY17E	FY18E
Net income	25,001	31,699	41,762	51,849	63,943
Net profit	7,190	8,979	11,511	14,292	17,704
EPS (Rs)	143.4	179.1	211.8	263.0	325.8
ABV (Rs)	782.7	932.7	1,389.9	1,618.5	1,880.7
RoA (%)	3.4	3.1	3.0	2.9	2.9
RoE (%)	19.6	20.4	18.6	17.4	18.5
PE (x)	35.0	28.1	23.7	19.1	15.4

Source: Company, Emkay Research

Change in Estimates	
EPS Chg FY16E/FY17E (%)	NA/NA
Target Price change (%)	NA
Previous Reco	NA

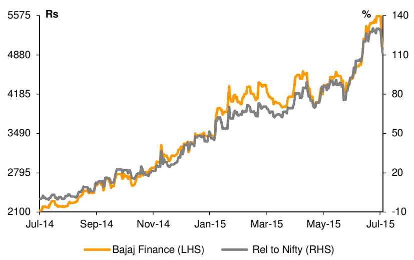
Emkay vs Consensus

EPS Estimates	FY16E	FY17E
Emkay	211.8	263.0
Consensus	217.8	271.0
Mean Consensus TP		Rs 4,990

Stock Details	
Bloomberg Code	BAF IN
Face Value (Rs)	10
Shares outstanding (mn)	54
52 Week H/L	5,660 / 2,124
M Cap (Rs bn/USD bn)	269 / 4.25
Daily Avg Volume (nos.)	104,751
Daily Avg Turnover (US$ mn)	8.6

Shareholding Pattern Mar '15	
Promoters	61.6%
FIIs	13.6%
DIIs	5.6%
Public and Others	19.2%

Relative price chart



Source: Bloomberg

Umang Shah
umang.shah@emkayglobal.com
+91 22 66242468

Sohail Halai
sohail.halai@emkayglobal.com
+91 22 66121336

Clyton Fernandes
clyton.fernandesi@emkayglobal.com
+91 22 66121340

Uptick in urban demand to help augment growth

Asset financiers have been long betting on rural demand to counter the slowdown in urban consumer demand. However, the demand appears to be shifting with urban consumer demand, showing signs of an uptick. While rural demand continues to remain weak, the latest RBI data shows that urban consumer confidence is improving after a long time and so is the outlook on urban consumer spending. This, in our view, should help BAF maintain its healthy growth momentum. We have modeled in 28% AUM CAGR over FY15-18E.

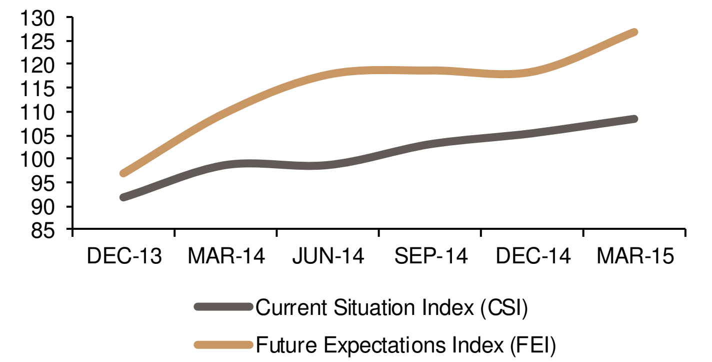
Urban consumption demand could be the next growth driver

Over the last few years, urban consumption had slowed down meaningfully, but was partially offset by buoyant rural demand. However, the overall consumption trends appear to have reversed in favour of urban, compared to the past. Though rural markets appear to be in stress, the urban market sentiments seem to be on an uptrend.

- As per RBI's latest Consumer Confidence Survey (based on responses from 5,400 participants in top six metropolitan cities in India), the Current Situation Index (CSI) has improved every quarter in the last four quarters and the Future Expectations Index (FEI) has improved in the March quarter after remaining almost stagnant for the past three quarters *(refer exhibit 67)*.
- While 70% of the respondents were positive on their current spending, nearly 78% respondents expected an increase in their future spending over the next 1-year period. On the flipside, respondents also expected inflation to rise over the corresponding period *(refer exhibit 68)*.
- As per the Naukri Jobspeak data, hiring in some of the large cities shows an uptick *(refer exhibit 69, 70)*. Moreover, media reports also suggest IT and other companies paying higher salaries to acquire and retain talent.

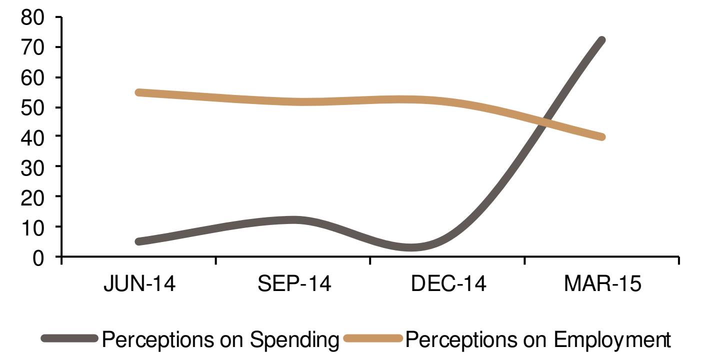
We believe all these factors coupled with the pent-up demand of past few years may lead to higher consumer spending in the auto / consumer durables segment, which augurs well for asset financing companies focused on the urban consumer.

Exhibit 67: Trend in the consumer confidence indices



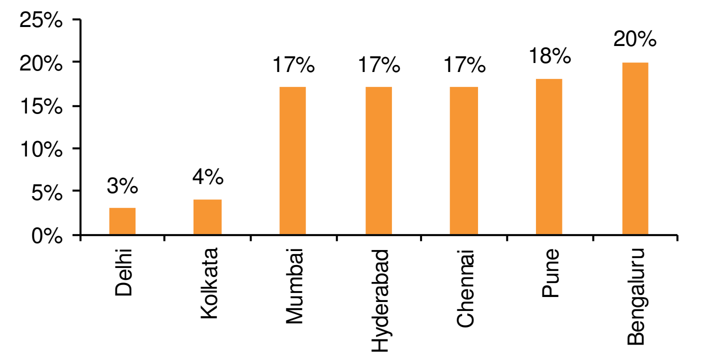
Source: RBI, Emkay Research

Exhibit 68: Trend in consumer confidence indices



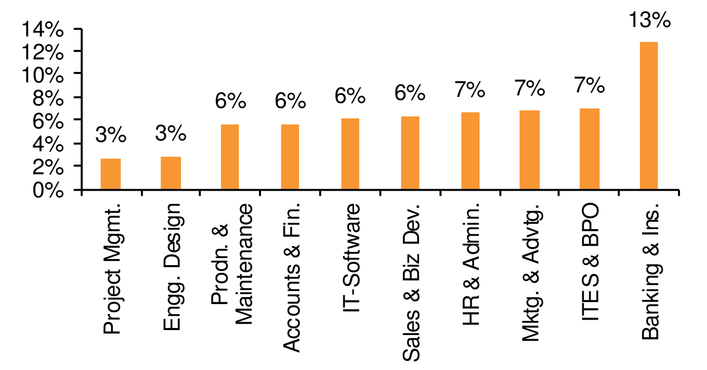
Source: RBI, Emkay Research

Exhibit 69: Hiring trends in key urban centres



Source: Naukri.com, Emkay Research

Exhibit 70: Hiring trends across some of the major industries

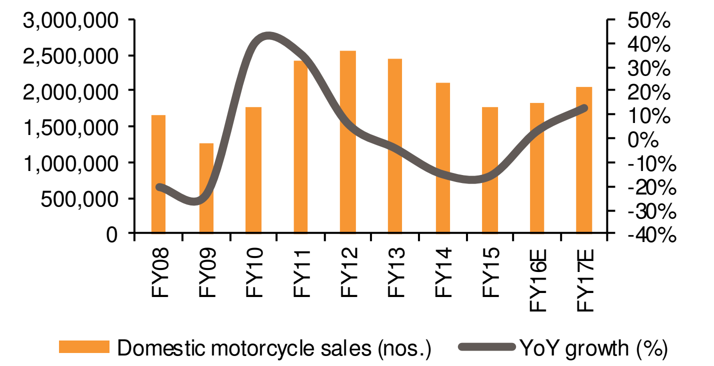


Source: Naukri.com, Emkay Research

Improving outlook for Bajaj Auto domestic sales could be credit, margin positive

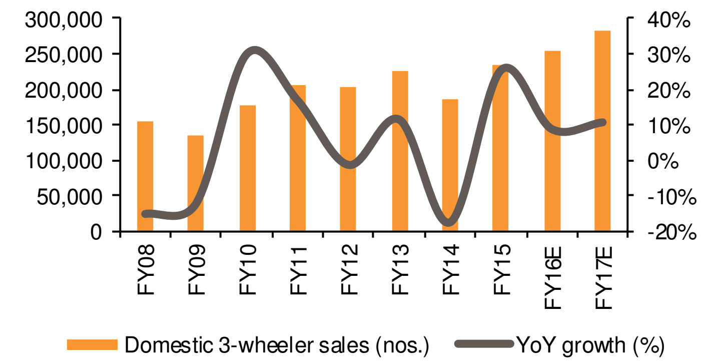
Apart from urban spending trends turning favourable, the outlook for Bajaj Auto domestic 2W/3W sales appears to be improving. After three consecutive years of volume contraction, our auto analyst expects Bajaj Auto's domestic motorcycle sales volumes to gradually pick up. Bajaj Auto's 3-wheeler sales turned around in FY15. Our auto analyst expects these positive trends to continue *(refer exhibit 71, 72)*. BAF's auto financing portfolio has remained largely stagnant for past three years. An uptick in Bajaj Auto domestic sales can aid growth for BAF. The improving sales outlook is not only credit positive for BAF, but also margin accretive. In FY15, BAF had 31% and 15% financing penetration in Bajaj Auto's domestic two-wheeler and three –wheeler sales respectively. The yields in the 2W/3W financing business remain high, which should help BAF in maintaining its margins.

Exhibit 71: Bajaj Auto domestic motorcycle sales set to improve



Source: Company, Emkay Research

Exhibit 72: Turnaround in Bajaj Auto 3-wheeler sales likely to sustain



Source: Company, Emkay Research

Diversified and consumer centric portfolio augurs well for client addition

As of Mar'2015, BAF has 28 active product lines (including loans and fee-based products), a large part of them focusing on the retail consumer *(refer exhibit 73)*. BAF has become one of the leading players in consumer related businesses due to its continuous introduction of new product lines and its strong cross sell business model.

BAF distributes its products through a network of multiple channel partners and currently has around 16,000 touch points *(refer exhibit 74)*. Its diversified product portfolio helps in strong customer acquisition and an existing large customer base aids cross selling of products. New customers acquired in FY15 grew by 45% yoy *(refer exhibit 76)*.

Exhibit 73: Diversified product portfolio – Mar-15

Consumer (41% of FY15 (1) AUM)	SME (53% of FY15 (1) AUM)	Commercial (5% of FY15 (1) AUM)	Rural (1% of FY15 (1) AUM)
Consumer Durable Financing	Loan Against Property	Vendor Financing – Term Loans & Purchase Order Financing	Consumer Durable Financing
Digital Product Financing	Home Loans – Self Employed	Large Value Lease Rental Discounting	Gold Loans
Lifestyle Product Financing	Loan Against Securities (Retail and Promoter)	Infrastructure Financing	Refinance
2 Wheeler & 3 Wheeler Financing	Unsecured Working Capital Loans		Personal Loan Cross sell
Personal Loan Cross sell	Loans to Professionals		Loans to Professionals
Salaried Personal Loans	SME Cross Sell (mortgage and unsecured working capital loans)		Working Capital Loans to MSME
Salaried Home Loan			Loan Against Property to MSME
EMI Card Business			

Source: Company, Emkay Research

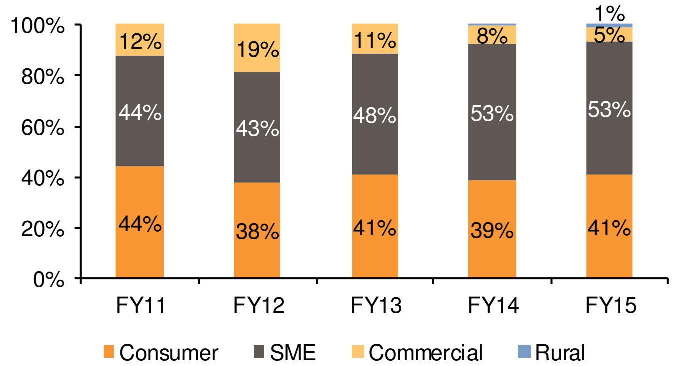
Exhibit 74: BAF has a widespread distribution reach led by its various channel partners

Distribution reach	Mar-15
Consumer durable product stores	7,000+
Lifestyle product stores	1,150+
Digital product stores	2,650+
2W–3W Dealer / ASCs /Sub-dealers	3,000+
SME – Direct sales agents	700+
Rural consumer durable product stores	1,500+

Source: Company, Emkay Research

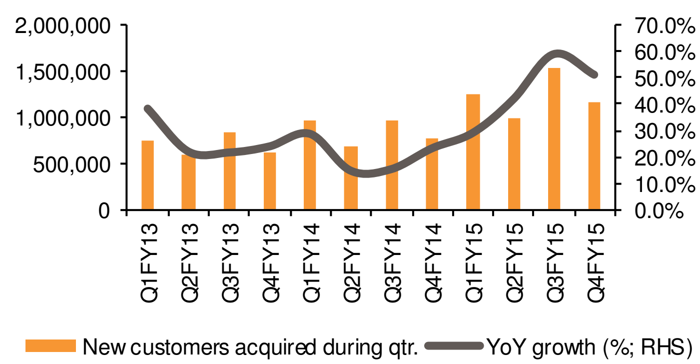
Despite strong growth in the SME / LAP segments, BAF has largely maintained the mix between consumer and non-consumer portfolio, which ensures superior profitability and stable portfolio quality to an extent *(refer exhibit 75)*. The management has also been prudent enough by slowing down or exiting some of the commercial business lines (like infrastructure lending) in the past to protect portfolio quality / profitability.

Exhibit 75: AUM Mix (%)



Source: Company, Emkay Research

Exhibit 76: New customer acquisition on an uptrend

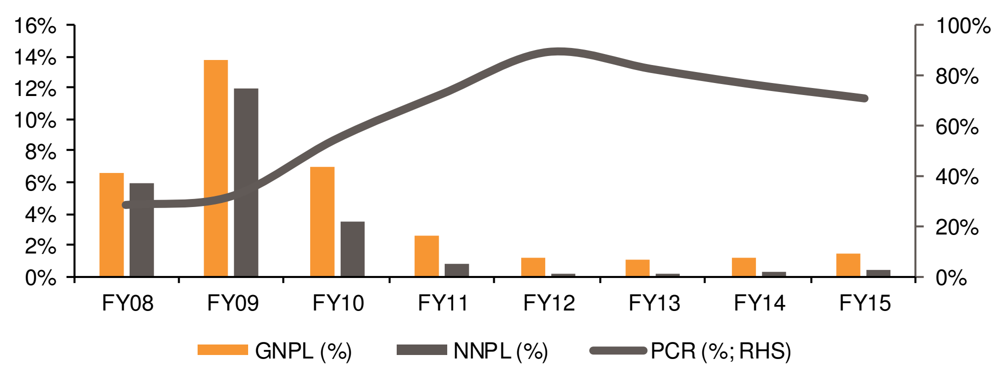


Source: Company, Emkay Research

Least impacted under the new regulatory framework

BAF is the only NBFC, which is almost fully compliant with the RBI's new regulatory framework ahead of its actual implementation. While under the new framework, NPLs are likely to rise, the impact of the provisioning costs are already taken into the P&L. BAF's internal provisioning policies are more stringent compared to the RBI stipulation *(refer exhibit 78)*. Hence, migration to the 90-dpd NPL recognition norms from 180-dpd, is likely to have a negligible impact on BAF's P&L. We believe this will give BAF an edge over its peers in the coming years, which may reel under the pressure of the higher provisioning costs.

Exhibit 77: BAF: Asset quality trends



Source: Company, Emkay Research

Exhibit 78: BAF: Provisioning policy much ahead of the RBI

Bajaj Finance Provides a general provision of 0.40% on all standard assets (0.5% on Mortgages) against RBI's requirement of 0.25% (from FY16 0.30%)

Bajaj Finance Provisioning

RBI Norms

For FY15

- 6 months and <= 24 months - 10%
- >24 months and <=36 months - 20% on secured & 100% on unsecured portion
- >36 months and <=60 months - 30% on secured & 100% on unsecured portion
- >60 months - 50% on secured & 100% on unsecured portion

For FY16

- 5 months and <= 21 months - 10%
- >21 months and <=33 months - 20% on secured & 100% on unsecured portion
- >33 months and <=57 months - 30% on secured & 100% on unsecured portion
- >57 months - 50% on secured & 100 on unsecured portion
- Loss assets – 100%

Consumer Lending provision coverage

Consumer Durables:

- 3 - 5 months overdue - 75%
- Above 5 months - 100%

2 and 3 Wheeler:

- 3-5 months 30%
- 6-12 months - 60%
- Above 12 months - 100%

Personal Loan Cross Sell:

- 3-5 months - 55%
- Above 5 months - 100%

Salaried Personal Loan:

- 3-5 months - 70%
- Above 5 months - 100%

SME Lending provision coverage

Home Loan/Loan against Property:

- 4-5 months - 15%
- 6-12 months - 25%
- 13-18 months - 40%
- 18-24 months - 60%
- Above 24 months - 100%

Working Capital Loans:

- 3-5 months - 70%
- Above 5 months - 100%

Loan against Securities:

- Above 5 months - 100%

Commercial Lending provision coverage

Construction Equipment Financing:

- 4-5 months - 15%
- 6-9 months - 30%
- 10-12 months - 60%
- Above 12 months - 100%

Auto Component Vendor Financing:

- 6-12 months - 10%
- 12-18 months - 20%
- 18-24 months - 30%
- Above 24 months - 100%
- Graded provision on secured portfolio

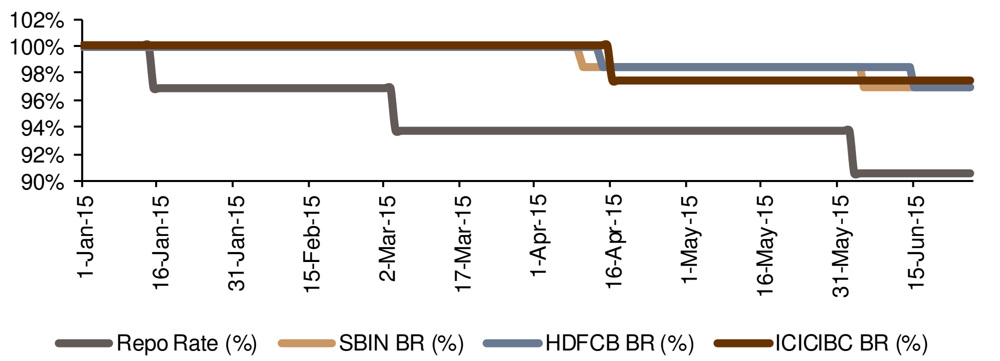
Source: Company, Emkay Research

Recent capital raising to cushion NIM downtrend

BAF's net interest margins have been on a downward trajectory led by a strong growth in the non-consumer segments. While the AUM mix has remained largely stable, the growth in the non-consumer segments has been in the low yielding LAP segment. We expect this trend to continue in the medium term. However, the company recently raised equity capital to the tune of Rs18bn through a combination of preferential issue to the promoters and institutional investors.

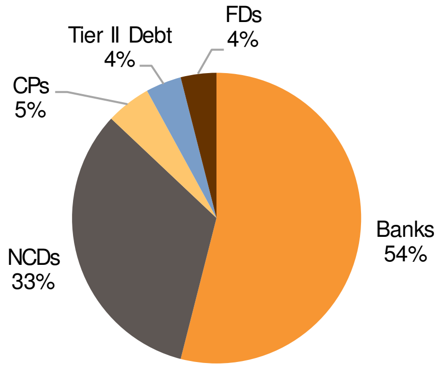
The raised capital constitutes 37.5% of BAF's Mar-15 networth. Besides, more than 50% of its borrowings are in the form of bank borrowings *(refer exhibit 80)*. We expect BAF to gradually benefit from the transmission of rate cuts by banks as and when they reduce base rates. We believe this should help BAF augment its net interest margins and thereby, cushion the fall in NIMs led by higher growth in the non-consumer segments *(refer exhibit 81)*.

Exhibit 79: Bank base rates have lagged repo rate cuts



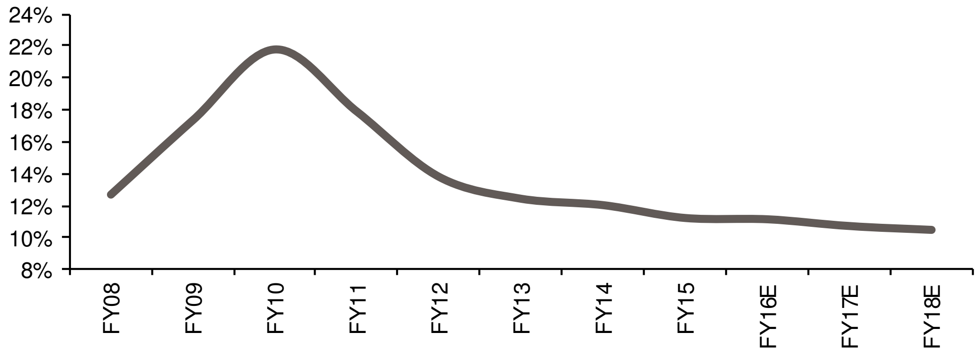
Source: Company, Bloomberg, RBI, Emkay Research

Exhibit 80: With bank borrowings forming large part of borrowings, costs could come down



Source: Company, Emkay Research

Exhibit 81: BAF: Calculated net operating income as % of average AUMs



Source: Company, Emkay Research

Valuation and outlook

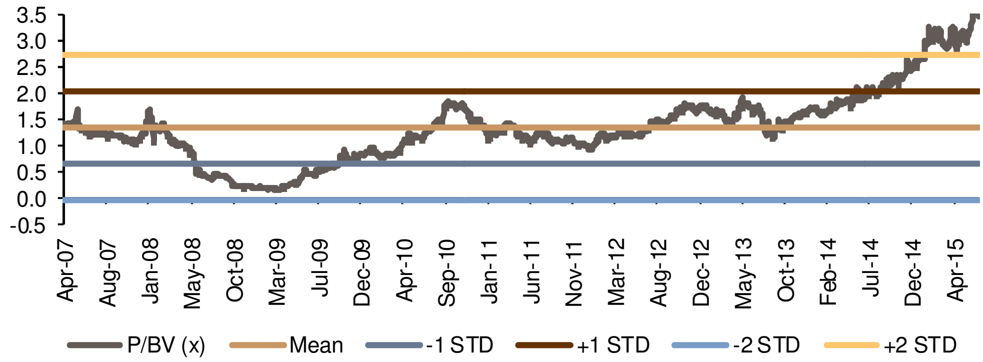
BAF has showcased superior execution skills, despite challenging economic environment (FY11-15: 44%/38% AUM/PAT CAGR). Though new business lines have been introduced at regular intervals, the management has also been prudent in exiting non-profitable / riskier businesses in a timely manner. We expect healthy growth and profitability trends to sustain. The stock trades at 3.1x FY17E BV, reflecting the qualitative growth, better than peers returns profile and superior execution track record. We initiate coverage with an **Accumulate** rating and target price of Rs6,018 (based on residual income model).

Exhibit 82: Key financials

Bajaj Finance	FY15	FY16E	FY17E	FY18E	CAGR (%)
ROAA	3.1%	3.0%	2.9%	2.9%	
ROAE	20.4%	18.6%	17.4%	18.5%	
EPS (Rs)	179.1	211.8	263.0	325.8	22.1%
P/E (x)	28.1	23.7	19.1	15.4	
BV (Rs)	957.3	1,399.8	1,625.4	1,904.4	25.8%
P/BV (x)	5.2	3.6	3.1	2.6	
ABV (Rs)	932.7	1,389.9	1,618.5	1,880.7	26.3%
P/ABV (x)	5.4	3.6	3.1	2.7	

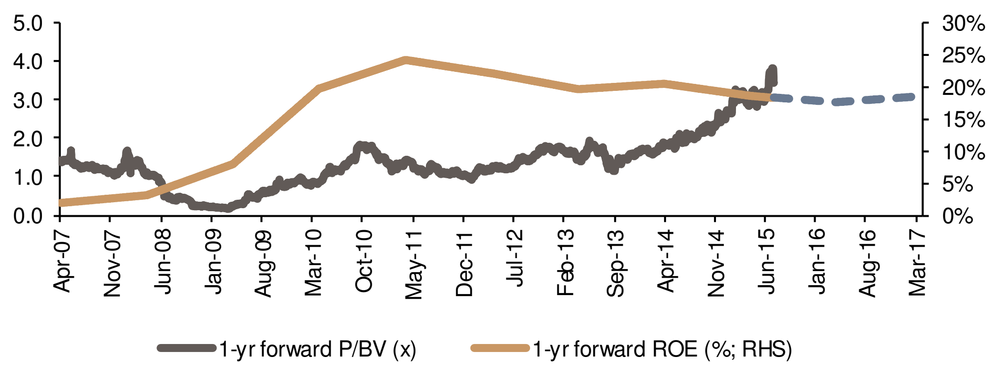
Source: Company, Emkay Research

Exhibit 83: BAF: 1-yr forward P/BV (x)



Source: Company, Bloomberg, Emkay Research

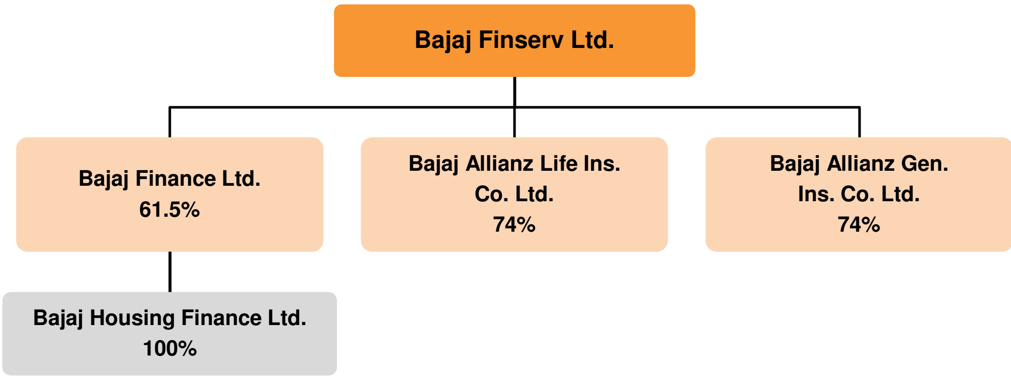
Exhibit 84: BAF: 1-yr forward P/BV (x) ROEs



Source: Company, Bloomberg, Emkay Research

Annexures

Exhibit 85: BAF: Company Structure (Mar-15)



Source: Company, Emkay Research Note: As per shareholding pattern before the capital raising

Exhibit 86: Key shareholders (Jun-15)

Name of the shareholder	% holding
Promoters & promoter group	57.8%
Maharashtra Scooters	3.6%
Govt. of Singapore	2.8%
HDFC MF	1.2%
Acacia Partners LP	1.1%
Pinebridge Investments	1.1%

Source: BSE filings, Emkay Research
Shareholding pattern as on 12th June 2015

Key Financials (Standalone)

Income Statement

Y/E Mar (Rs mn)	FY14	FY15	FY16E	FY17E	FY18E
Net interest income	**21,740**	**28,823**	**37,435**	**47,270**	**58,541**
Other income	**3,261**	**2,876**	**4,327**	**4,579**	**5,402**
Fee income	0	0	0	0	0
Net income	**25,001**	**31,699**	**41,762**	**51,849**	**63,943**
Operating expenses	11,511	14,284	18,288	23,155	28,328
Pre provision profit	**13,490**	**17,415**	**23,474**	**28,694**	**35,616**
PPP excl treasury	**13,490**	**17,415**	**23,474**	**28,694**	**35,616**
Provisions	2,578	3,846	6,033	7,039	8,791
Profit before tax	**10,912**	**13,569**	**17,441**	**21,655**	**26,825**
Tax	3,722	4,591	5,930	7,363	9,120
Tax rate	34	34	34	34	34
Profit after tax	**7,190**	**8,979**	**11,511**	**14,292**	**17,704**

Balance Sheet

Y/E Year End (Rs mn)	FY14	FY15	FY16E	FY17E	FY18E
Equity	501	501	543	543	543
Reserves	39,407	47,497	75,521	87,779	102,940
Net worth	**39,909**	**47,998**	**76,065**	**88,322**	**103,484**
Deposits	0	0	0	0	0
Borrowings	197,496	266,900	336,894	440,376	555,563
Total liabilities	**246,180**	**328,112**	**427,575**	**545,370**	**677,992**
Cash and bank	7,768	2,197	4,636	5,979	5,456
Investments	282	1,572	1,684	2,202	2,778
Loans	233,752	318,070	413,496	527,590	657,879
Others	2,179	3,781	4,644	5,705	7,012
Total assets	**246,180**	**328,112**	**427,575**	**545,370**	**677,992**

Key Ratios (%)

Y/E Year End	FY14	FY15	FY16E	FY17E	FY18E
NIM	10.5	10.2	10.0	9.8	9.6
RoA	3.4	3.1	3.0	2.9	2.9
RoAE	19.6	20.4	18.6	17.4	18.5
GNPA (%)	1.2	1.5	1.6	1.7	2.0
NNPA (%)	0.3	0.4	0.1	0.1	0.2

Per Share Data (Rs)	FY14	FY15	FY16E	FY17E	FY18E
EPS	143.4	179.1	211.8	263.0	325.8
BVPS	795.9	957.3	1,399.8	1,625.4	1,904.4
ABVPS	782.7	932.7	1,389.9	1,618.5	1,880.7
DPS	16.0	18.0	24.0	32.0	40.0

Valuations (x)	FY14	FY15	FY16E	FY17E	FY18E
PER	35.0	28.1	23.7	19.1	15.4
P/BV	6.3	5.2	3.6	3.1	2.6
P/ABV	6.4	5.4	3.6	3.1	2.7
Dividend Yield (%)	0.3	0.4	0.5	0.6	0.8

Growth (%)	FY14	FY15	FY16E	FY17E	FY18E
NII	29.3	32.6	29.9	26.3	23.8
PPOP	28.1	29.1	34.8	22.2	24.1
PAT	21.6	24.9	28.2	24.2	23.9
Loans	37.1	36.1	30.0	27.6	24.7

Quarterly (Rs mn)	Q4FY14	Q1FY15	Q2FY15	Q3FY15	Q4FY15
NII	6,258	7,440	6,878	8,842	8,176
NIM(%)	10.8	11.7	10.0	12.0	10.3
PPOP	3,399	4,035	3,788	5,009	4,583
PAT	1,821	2,114	1,972	2,584	2,310
EPS (Rs)	36.32	42.15	39.32	51.53	46.06

Shareholding Pattern (%)	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Promoters	61.6	61.6	61.6	61.6	61.6
FIIs	11.7	12.2	12.6	13.1	13.6
DIIs	7.6	7.1	6.9	6.3	5.6
Public and Others	19.1	19.1	18.9	19.0	19.2

Emkay
Your success is our success

Cholamandalam Finance

A play on recovery in CV cycle

CMP	**Target Price**
Rs721	Rs825 (▪)
Rating	**Upside**
ACCUMULATE (▪)	14.4 %

Cholamandalam Finance (CIFC) has developed a diversified and de-risked product portfolio, which has insulated it from the CV downcycle. With growth returning in the vehicle finance portfolio and the HE portfolio growing at a healthy pace, we believe, CIFC is better placed than its peers. The stock trades at a premium to peers, but, growth could surprise positively.

- **De-risked product portfolio to help CIFC outpace peers:** While vehicle financing remains the mainstay business of the company, CIFC de-risked itself by diversifying into the home equity (LAP) business in 2007. This helped CIFC to navigate through the cyclical downturn in the CV segment. In FY15, CIFC clocked ~10% AUM growth, mainly led by a 24% yoy growth in its HE portfolio. While the growth in the vehicle financing business could revive strongly, we expect HE portfolio to grow at a faster pace, leading to a healthy overall AUM growth. We expect CIFC to clock an AUM CAGR of 22% over FY15-18E and the share of the HE portfolio to go up to ~32% by FY18E from 29% currently.
- **Lower borrowing costs to likely aid NIMs:** CIFC witnessed margin expansion in FY15, despite higher delinquencies on account of moving to 150-dpd NPL recognition a year ahead of the RBI's implementation schedule. With banks constituting 64% of borrowings, we expect CIFC to benefit from falling interest rates as banks cut rates, albeit, with a lag. Besides, a rating upgrade and incremental lending in high yielding products should help maintain / improve margins.
- **Tight leash on expenses to help augment ROAs:** During FY11-14, CIFC more than doubled its branch network from 236 to 574 branches. After rapid branch addition and capacity building, the management is now looking at maintaining a tight leash on operating costs. In FY15, the company added just five branches (net basis), while it closed down about 45 gold loan branches, as the company decided to exit the gold loan business. In our view, there is ample scope for operating leverage to kick in as CIFC's AUMs per branch (including large ticket HE AUMs) compare with some of its larger peers. We believe, the benefits of operating leverage should help CIFC improve its return ratios.
- **Pressure on credit costs likely to be lower:** CIFC proactively moved to 150-dpd NPL recognition in FY15, a year ahead of the RBI's implementation schedule. This gives CIFC some headroom in terms of moving towards 90-dpd NPL recognition as per the RBI schedule. Besides, CIFC doesn't write-off loans as aggressively as some of its larger peers and hence, the pressure on credit costs is likely to remain lower.
- **Valuation and view:** During FY12-15, CIFC's PAT grew at a 36% CAGR as against 0%-10% CAGR delivered by some of its larger peers, which has led to a re-rating of the stock. We expect CIFC's healthy growth momentum to continue and it is likely to be a strong beneficiary of the recovery in the CV cycle and expect CIFC to gain profitable market share. We initiate coverage with an **Accumulate** rating and target price of Rs825 (based on the residual income model).

Financial Snapshot (Standalone)

(Rs mn)	FY14	FY15	FY16E	FY17E	FY18E
Net income	14,918	17,308	19,928	23,933	29,645
Net profit	3,640	4,351	5,508	7,030	9,092
EPS (Rs)	25.4	30.3	35.3	45.1	58.3
ABV (Rs)	148.1	155.1	203.2	234.6	277.0
RoA (%)	1.8	1.9	2.1	2.2	2.3
RoE (%)	17.1	17.5	17.4	17.8	19.5
PE (x)	28.4	23.8	20.4	16.0	12.4

Source: Company, Emkay Research

Change in Estimates

EPS Chg FY16E/FY17E (%)	NA/NA
Target Price change (%)	NA
Previous Reco	NA

Emkay vs Consensus

EPS Estimates	FY16E	FY17E
Emkay	35.3	45.1
Consensus	35.7	40.0
Mean Consensus TP		Rs 661

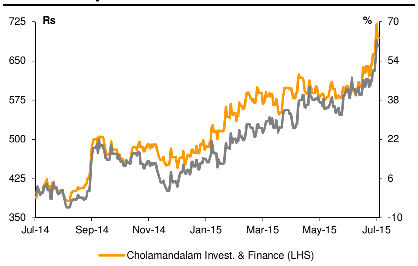
Stock Details

Bloomberg Code	CIFC IN
Face Value (Rs)	10
Shares outstanding (mn)	144
52 Week H/L	744 / 351
M Cap (Rs bn/USD bn)	104 / 1.64
Daily Avg Volume (nos.)	69,397
Daily Avg Turnover (US$ mn)	0.8

Shareholding Pattern Mar '15

Promoters	57.8%
FIIs	16.9%
DIIs	18.3%
Public and Others	7.1%

Relative price chart



Source: Bloomberg

Umang Shah
umang.shah@emkayglobal.com
+91 22 66242468

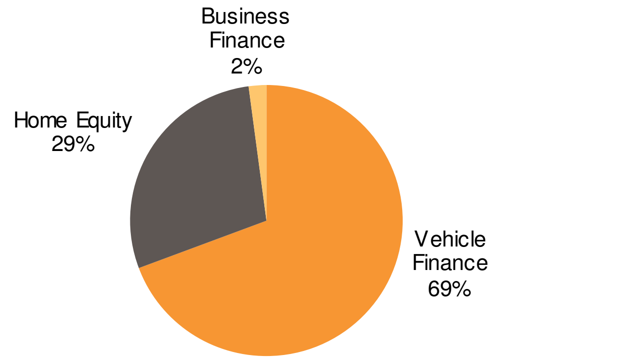
Sohail Halai
sohail.halai@emkayglobal.com
+91 22 66121336

Clyton Fernandes
clyton.fernandesi@emkayglobal.com
+91 22 66121340

De-risked product portfolio to help CIFC grow faster than peers

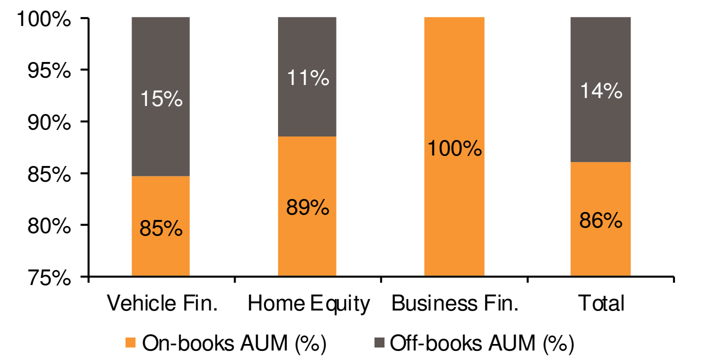
Unlike some of its competitors, CIFC has a well-diversified and de-risked product portfolio. While vehicle financing remains the mainstay business of the company, it also has home equity (LAP) business contributing meaningfully to its balance sheet as well as the P&L. As at end-Mar 2015, the vehicle finance portfolio constituted 69% of its AUMs and the home equity portfolio constituted 29%. Within the vehicle finance business too, the portfolio is well diversified with M&HCV, LCVs, PVs, tractors and used vehicles *(refer exhibit 87, 88)*.

Exhibit 87: AUM Mix as on Mar-15



Source: Company, Emkay Research

Exhibit 88: Mix between on-books and off-books AUMs

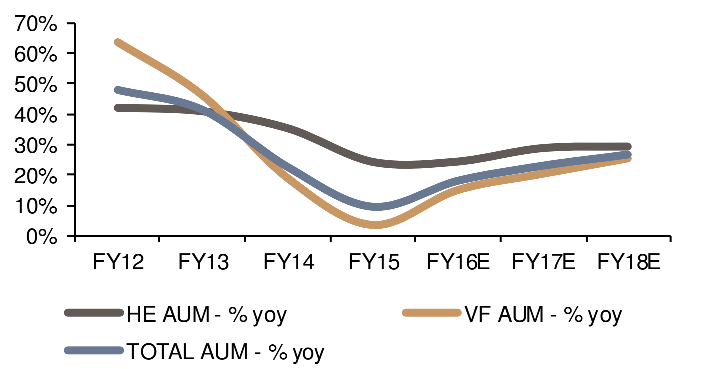


Source: Company, Emkay Research

CIFC, in the past, also ventured into some of the retail businesses viz. unsecured personal loans in JV with DBS and gold loans. However, CIFC has completely exited the unsecured personal loans segment, post the debacle during the global financial crisis. Also, CIFC has practically exited the gold loan business, post the regulatory overhaul. CIFC is now running pilots in the agri financing space – financing seeds, fertilizers and providing crop related loans – leveraging on the expertise and the distribution strength of its group companies. This also complements its tractor financing business.

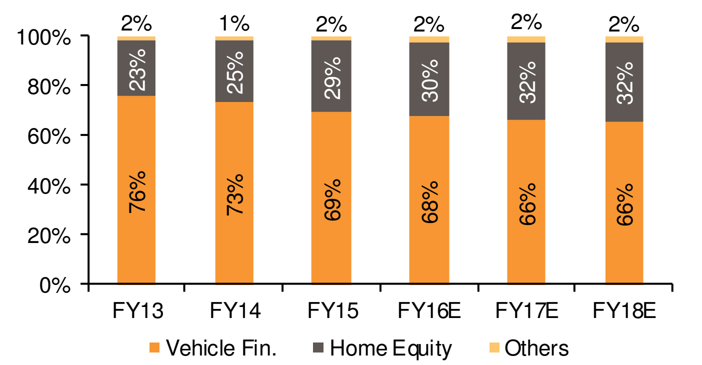
The diversification has helped the company during difficult times in maintaining its growth and profitability. Portfolio diversification also acts as a hedge for CIFC against the cyclicality of the vehicle financing business. We expect CIFC's AUMs to grow at a 22% CAGR during FY15-18E. The management expects the HE business to grow at a healthy pace, led by increasing penetration and its share increasing to ~35% in overall AUMs by FY17E. While the growth in the vehicle financing business could revive strongly, we expect HE portfolio to grow at a faster pace, leading to a healthy overall AUM growth. We expect the HE AUMs to continue to grow at a faster pace and expect its share to go ~32% by FY18E *(refer exhibits 89, 90, 91)*.

Exhibit 89: Growth in the VF business to pick up strongly



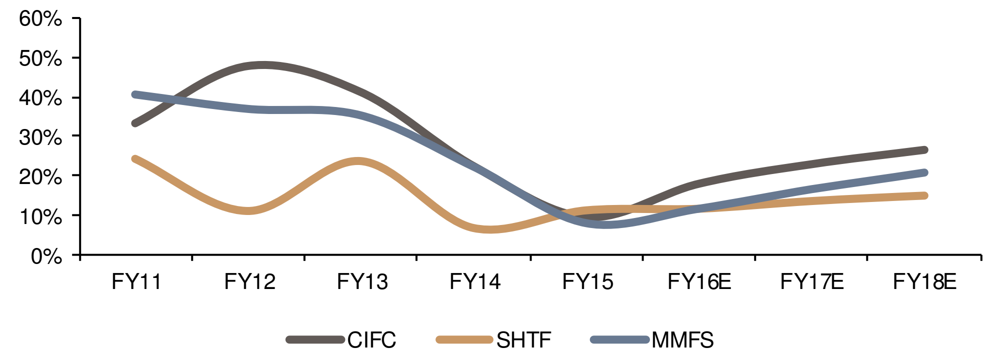
Source: Company, Emkay Research

Exhibit 90: Share of HE business to rise in the AUM mix



Source: Company, Emkay Research

Exhibit 91: CIFC's AUM growth likely to be faster than peers



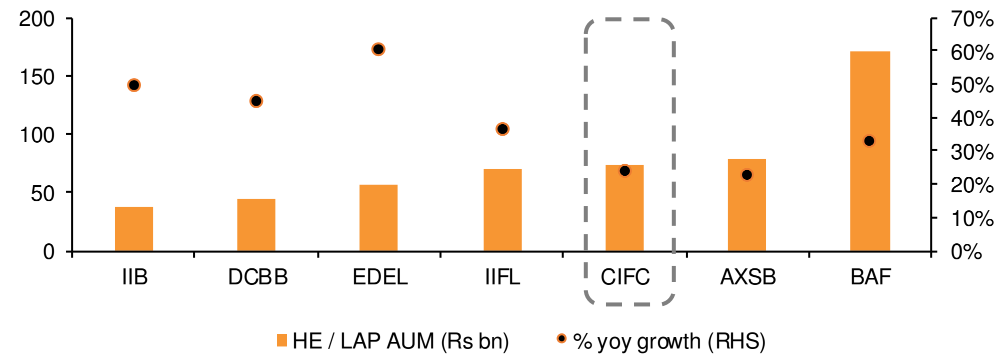
Source: Company, Emkay Research

HE / LAP portfolio: Growing slowly, but profitably, compared to peers

CIFC started its HE business in 2007. However, true to its nature, the company has remained conservative in this segment, unlike its peers. Over the past 2-3 years, this space has seen immense competition from private banks and NBFCs, due to lack of growth opportunities. As a result, the lending yields and ROEs in this business have dropped substantially.

Despite a relatively small base, CIFC's HE portfolio grew 24% yoy in FY15 and clocked a CAGR of 30% over FY13-15 *(refer exhibit 92)*. Some of the NBFCs with comparable portfolios have grown multi-fold during the same period. Importantly, CIFC's HE portfolio clocked a pre-tax ROA of 3.7% in FY15, which is better than some of its peers. We believe, CIFC's profitable growth approach would help it develop a sustainable long-term business model in this space.

Exhibit 92: CIFC is growing conservatively and profitably in the HE / LAP business (Mar-15)



Source: Company, Emkay Research

Shift towards high-yielding loans, lower borrowing costs to aid NIMs

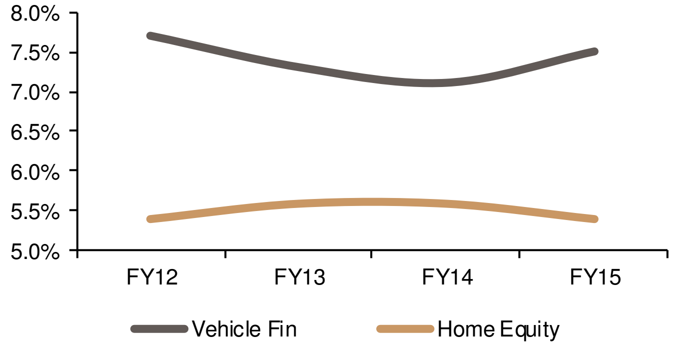
CIFC's net interest margins continued to improve in FY15 despite high interest rates and higher delinquencies, as the company moved to 150-dpd NPL recognition, a year ahead of the RBI's implementation schedule. This could be largely explained by the shift in the high-yielding segments in the VF business – namely tractor and used vehicle financing *(refer exhibit 7)*.

Going forward, some of the factors, which we believe, can aid margin expansion are:

- Continued shift towards high-yielding portfolios
- As on 31st March 2015, CIFC's borrowing mix constituted 64% in the form of bank borrowings. Banks have started to cut base rates and CIFC should benefit from the same, albeit with a lag *(refer exhibit 94)*.
- Recently, CRISIL has upgraded the rating for CIFC's long term debt instruments from CRISIL AA-/Positive to CRISIL AA/Stable, which could result in lower cost of borrowings.

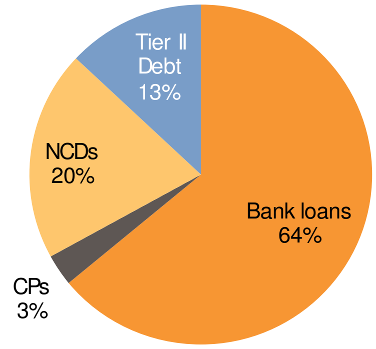
We believe, the only risk to margins could be increasing competition from private banks / NBFCs in the vehicle financing as well as home equity business. On the regulatory front, the company is compliant at least for FY16, which restricts the pressure on NIMs due to interest income reversal led by higher NPL recognition.

Exhibit 93: Margins in the VF business on an uptrend



Source: Company, Emkay Research

Exhibit 94: Borrowing mix skewed in favour of bank loans (Mar-15)



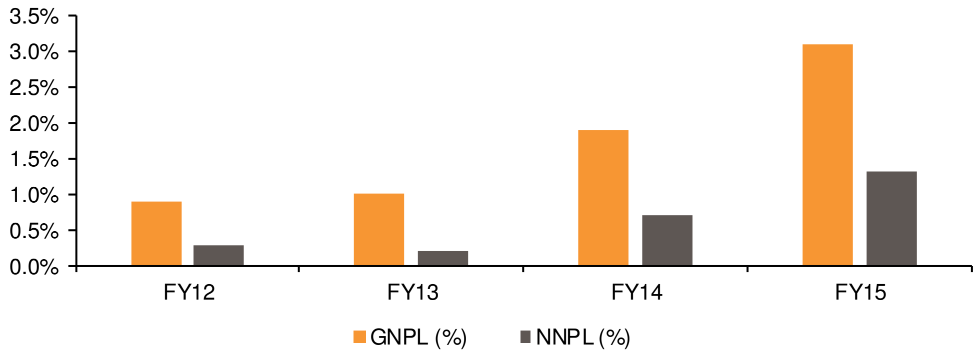
Source: Company, Emkay Research

Regulatory noose tightened; but pressure on credit costs could be lower

In 4QFY15, CIFC's asset quality improved sequentially on the back of improving collection efficiencies in the vehicle finance business. However, the management proactively moved from 180-dpd to 150-dpd NPL recognition. As a result, the company ended the year with gross and net NPL of 3.1% (2.4% on 180-dpd basis) and 2% (1.3% on 180-dpd basis). The company has also made standard asset provisions to the tune of 0.3% as against regulatory requirement of 0.4% *(refer exhibit 95)*.

In our view, the company's regulatory compliance, a year ahead of its implementation, makes it relatively comfortable for FY16. Secondly, CIFC doesn't follow an aggressive write off policy unlike some of its large peers. Hence despite lower provision coverage ratio the pressure on credit costs may remain lower in an improving credit cycle.

Exhibit 95: Gross NPLs rose in FY15 on moving to 150-dpd NPL recognition



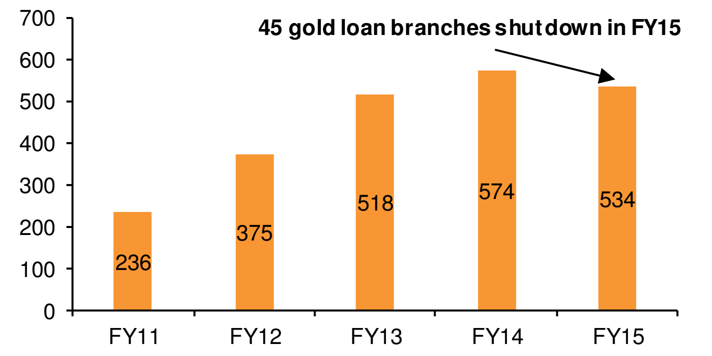
Source: Company, Emkay Research

Tight leash on expenses to help augment ROAs

During FY11-14, CIFC more than doubled its branch network from 236 to 574 branches. After rapid branch addition and capacity building, the management is now looking at maintaining a tight leash on operating costs to improve return ratios. In FY15, the company added just five branches (on a net basis), while it closed down about 45 gold loan branches, as the company decided to exit the gold loan business completely *(refer exhibit 96)*.

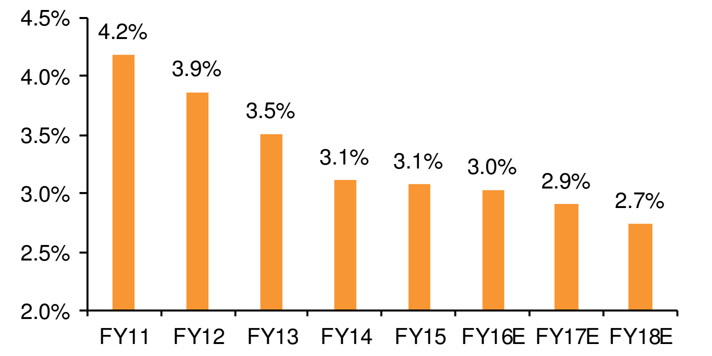
In our view, branch expansion in the near future is likely to be slower, as the recently opened branches scale up to their potential. As at end-Mar 2015, CIFC's AUM per branch is significantly lower compared to that of SHTF, while it is slightly higher compared to that of MMFS. This could also be attributed to the fact that the relatively big-ticket HE AUMs have grown at a faster pace, leaving ample scope for the company to scale up business without any capacity constraints *(refer exhibit 98)*. We believe, slower branch expansion and tight control on costs, should help improve ROAs. We expect the cost-to-assets ratio to fall from 3.1% in FY15 to about 2.7% in FY18E *(refer exhibit 97)*.

Exhibit 96: Pause after a rapid branch expansion



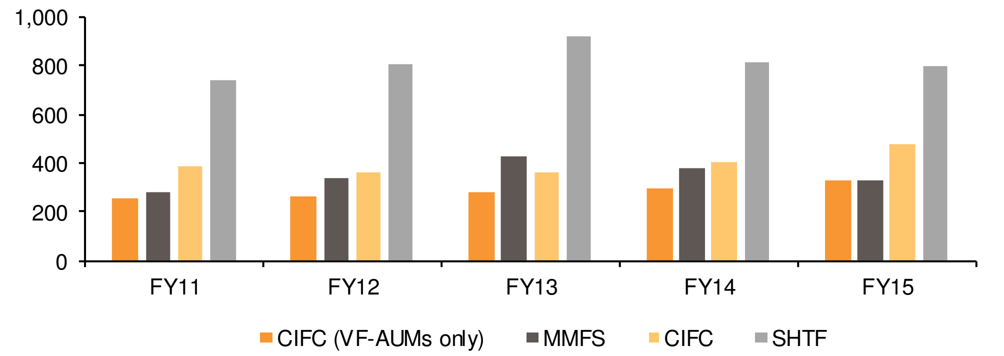
Source: Company, Emkay Research

Exhibit 97: Opex-to assets ratio likely to trend down



Source: Company, Emkay Research

Exhibit 98: AUM per branch for major NBFCs



Source: Company, Emkay Research

Subsidiaries

Cholamandalam Distribution Services Ltd

Cholamandalam Distribution Services Ltd offers wealth management services for mass affluent and affluent customer segments. It also does retail distribution of a wide range of products – Investments, Life Insurance, General Insurance, Home loan & Mortgage products. It operates through a network of 8 offices across the country. In FY15, the company recorded total income of Rs131m and PAT of Rs57m. Cholamandalam Distribution Services Ltd, has also applied for a Payments Bank license.

Cholamandalam Securities Ltd

Cholamandalam Securities Ltd offers broking services to HNI and institutional investors. The company has presence across 15 metros and mini metros. In FY15, the company recorded total income of Rs144m and PAT of Rs32m.

Valuations and outlook

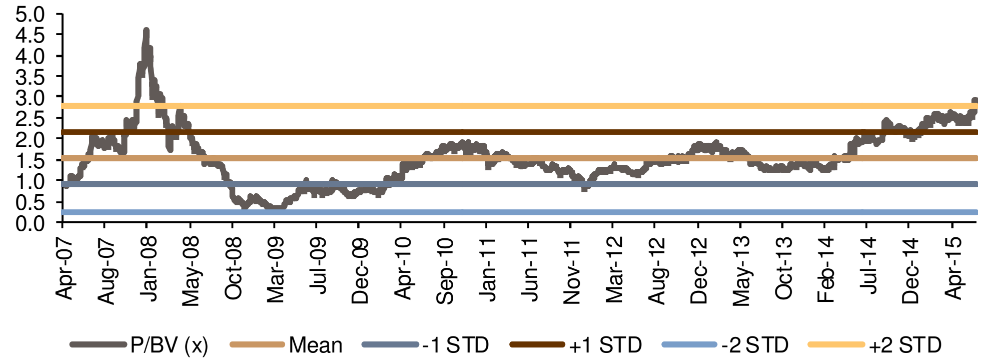
During FY12-15, CIFC's PAT grew at a 36% CAGR as against 0%-10% CAGR delivered by some of its larger peers, which has led to a re-rating of the stock. We expect CIFC's healthy growth momentum to continue and it is likely to be a strong beneficiary of the recovery in the CV cycle and expect CIFC to gain profitable market share. We initiate coverage with an **Accumulate** rating and target price of Rs825 (based on the residual income model).

Exhibit 99: Key financials

	FY15	FY16E	FY17E	FY18E	CAGR (%)
ROAA	1.9%	2.1%	2.2%	2.3%	
ROAE	17.5%	17.4%	17.8%	19.5%	
EPS (Rs)	30.3	35.3	45.1	58.3	24.4%
P/E (x)	23.8	20.4	16.0	12.4	
BV (Rs)	186.0	234.0	273.2	324.5	20.4%
P/BV (x)	3.9	3.1	2.6	2.2	
ABV (Rs)	155.1	203.2	234.6	277.0	21.3%
P/ABV (x)	4.6	3.5	3.1	2.6	

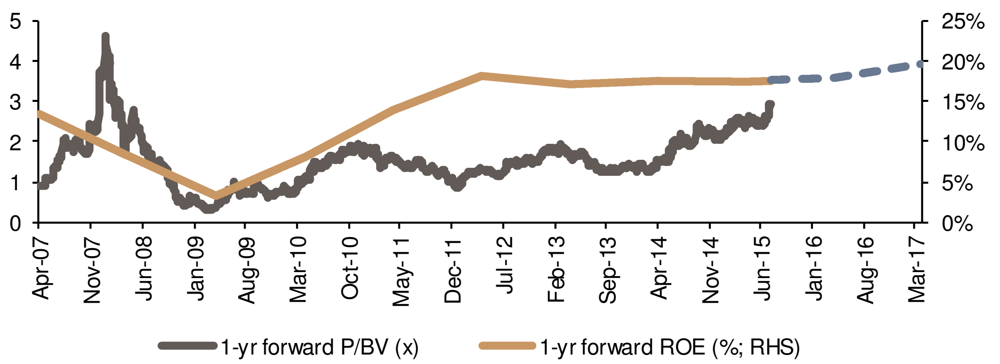
Source: Company, Emkay Research

Exhibit 100: CIFC: 1-yr forward P/BV (x)



Source: Company, Bloomberg, Emkay Research

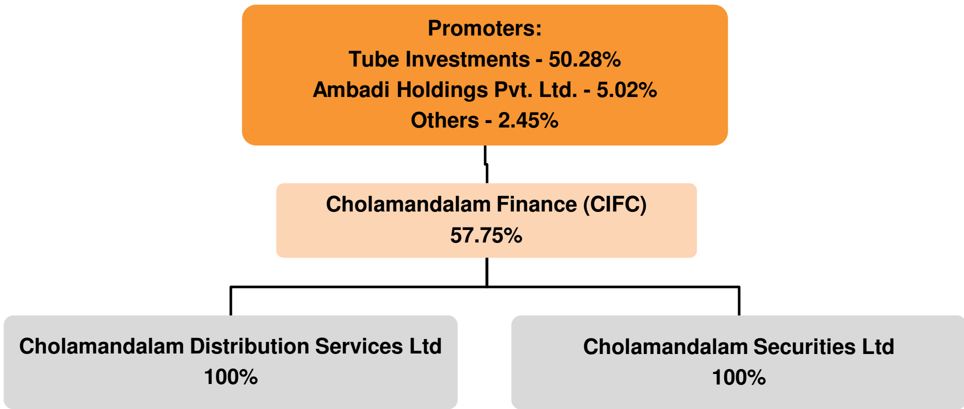
Exhibit 101: CIFC: 1-yr forward P/BV (x) vs. 1-yr forward ROE



Source: Company, Bloomberg, Emkay Research

Annexures

Exhibit 102: CIFC: Company holding structure



Source: Company, Emkay Research

Exhibit 103: CIFC: Key shareholders

Name of shareholder	% holding
Promoter and promoter group	57.8%
Norwest Venture Partners	4.9%
Creador LLC	4.6%
Amansa Holdings	4.3%
IFC	4.1%
HSBC	2.2%
Apax Partners	2.1%
HDFC MF	1.9%
Aquaris Investments	1.5%

Source: BSE filings, Emkay Research

Key Financials (Standalone)

Income Statement

Y/E Mar (Rs mn)	FY14	FY15	FY16E	FY17E	FY18E
Net interest income	**14,605**	**17,039**	**19,659**	**23,638**	**29,320**
Other income	**312**	**269**	**269**	**296**	**325**
Fee income	0	0	0	0	0
Net income	**14,918**	**17,308**	**19,928**	**23,933**	**29,645**
Operating expenses	6,582	7,489	8,411	9,733	11,438
Pre provision profit	**8,335**	**9,819**	**11,517**	**14,201**	**18,207**
PPP excl treasury	**8,335**	**9,819**	**11,517**	**14,201**	**18,207**
Provisions	2,833	3,247	3,173	3,549	4,431
Profit before tax	**5,502**	**6,572**	**8,345**	**10,652**	**13,776**
Tax	1,862	2,221	2,837	3,622	4,684
Tax rate	34	34	34	34	34
Profit after tax	**3,640**	**4,351**	**5,508**	**7,030**	**9,092**

Balance Sheet

Y/E Year End (Rs mn)	FY14	FY15	FY16E	FY17E	FY18E
Equity	1,433	1,437	1,560	1,560	1,560
Reserves	21,514	25,296	34,951	41,068	49,065
Net worth	**22,947**	**26,733**	**36,511**	**42,628**	**50,625**
Deposits	0	0	0	0	0
Borrowings	180,932	194,752	232,714	289,132	369,805
Total liabilities	**215,468**	**238,732**	**283,414**	**348,634**	**440,597**
Cash and bank	8,008	3,407	3,813	6,701	10,605
Investments	824	675	1,164	1,735	2,219
Loans	195,141	222,659	265,430	326,074	412,419
Others	10,765	11,309	12,256	13,298	14,444
Total assets	**215,468**	**238,732**	**283,414**	**348,634**	**440,597**

Key Ratios (%)

Y/E Year End	FY14	FY15	FY16E	FY17E	FY18E
NIM	7.1	7.1	7.2	7.2	7.1
RoA	1.8	1.9	2.1	2.2	2.3
RoAE	17.1	17.5	17.4	17.8	19.5
GNPA (%)	2.0	2.8	3.1	3.3	3.4
NNPA (%)	0.8	1.9	1.7	1.7	1.7

Per Share Data (Rs)	FY14	FY15	FY16E	FY17E	FY18E
EPS	25.4	30.3	35.3	45.1	58.3
BVPS	160.2	186.0	234.0	273.2	324.5
ABVPS	148.1	155.1	203.2	234.6	277.0
DPS	3.5	3.5	4.0	5.0	6.0

Valuations (x)	FY14	FY15	FY16E	FY17E	FY18E
PER	28.4	23.8	20.4	16.0	12.4
P/BV	4.5	3.9	3.1	2.6	2.2
P/ABV	4.9	4.7	3.6	3.1	2.6
Dividend Yield (%)	0.5	0.5	0.6	0.7	0.8

Growth (%)	FY14	FY15	FY16E	FY17E	FY18E
NII	31.9	16.7	15.4	20.2	24.0
PPOP	44.9	17.8	17.3	23.3	28.2
PAT	18.7	19.5	26.6	27.6	29.3
Loans	16.9	14.1	19.2	22.8	26.5

Quarterly (Rs mn)	Q4FY14	Q1FY15	Q2FY15	Q3FY15	Q4FY15
NII	3,847	3,844	4,113	4,584	4,498
NIM(%)	6.8	6.5	6.8	7.5	7.2
PPOP	2,218	2,216	2,305	2,684	2,615
PAT	907	931	951	1,113	1,356
EPS (Rs)	6.33	6.49	6.62	7.75	9.44

Shareholding Pattern (%)	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Promoters	57.8	57.8	57.7	57.7	57.8
FIIs	16.9	19.0	20.7	20.6	16.9
DIIs	9.8	8.2	12.9	13.0	18.3
Public and Others	15.4	15.0	8.7	8.7	7.1

Emkay
Your success is our success

Mahindra Finance

Wait for positive catalysts

CMP	Target Price
Rs277	Rs262 (▼)
Rating	**Upside**
REDUCE (▪)	(5.3) %

MMFS has transformed itself from a captive financier to a multi-product auto financier, but it remains a strong play on rural India. Consequently, the persistent slowdown in rural India continues to adversely impact MMFS' growth and asset quality. We expect this trend to continue in the near term. A turnaround in the rural demand remains a key catalyst for MMFS' earnings growth.

- **Lackluster rural demand to hurt growth:** Rural demand continues to weaken on the back of reduced rural disposable income due to low increase in MSPs, slower growth in rural wages (even under NREGA) and lower government spending on rural infrastructure. Moreover, a sub-par monsoon could only aggravate the situation. In our view, rural demand is likely to remain lackluster, thereby impacting MMFS' growth in the near term. A better than expected monsoon could be one of the key catalysts influencing rural demand. We model in 16% AUM CAGR over FY15-18E.
- **Asset quality challenges persist:** MMFS threw a positive surprise in 4QFY15 driven by strong recoveries. However, we believe sustaining such asset quality performance would be arduous for MMFS. Lower MSP hikes for the second consecutive year and lower procurement are some factors that can adversely impact the asset quality. Moreover, with uncertainty over rainfall, near term asset quality pressures likely to persist.
- **Regulatory noose tightened; Credit costs to remain high:** Under the new regulatory regime, MMFS is relatively better placed among its peers as it currently recognizes NPLs on a 150-dpd basis. Hence on an immediate basis, the company is compliant till Mar-16. However, we believe the impact of provisions on migration will be higher for MMFS as and when it migrates given its low provision cover and aggressive loan write-off policy. As on Mar-15, MMFS had a provision coverage ratio of 61%.
- **Rural housing finance – a long term opportunity:** Rural housing finance remains highly underpenetrated and has a great business potential, in our view. Mahindra Rural Housing Finance Ltd. (MRHFL) has grown its loans at 60% and profits at 49% CAGR during FY11-15. As at end FY15, the company had an outstanding loan book of Rs21bn (~5% of consolidated AUMs) and recorded PAT of Rs442mn, generating a ROA of ~2.6%. While we believe this business has strong long term growth potential, its contribution to consolidated profits is likely to remain limited.
- **Valuation and view:** MMFS trades at 2.2x FY17E BV, which is 1.s.d. above its long period average valuations. Despite a strong 4QFY15 performance, we believe there are multiple headwinds for MMFS in the near term – 1) uncertainty related to monsoon and demand uptick in the rural economy, 2) expected erosion in the sustainable returns profile of the company. While we like MMFS' rural focused niche business model, we would like to wait for positive catalysts to emerge. Maintain **Reduce** with a target price of Rs262

Financial Snapshot (Standalone)

(Rs mn)	FY14	FY15	FY16E	FY17E	FY18E
Net income	27,650	30,855	33,722	38,331	45,467
Net profit	8,872	8,293	9,336	11,392	14,223
EPS (Rs)	15.7	14.7	16.5	20.2	25.2
ABV (Rs)	80.2	86.0	100.4	114.5	131.4
RoA (%)	3.1	2.5	2.5	2.6	2.8
RoE (%)	18.6	15.4	15.6	17.0	18.6
PE (x)	17.6	18.8	16.7	13.7	11.0

Source: Company, Emkay Research

Change in Estimates

EPS Chg FY16E/FY17E (%)	(5.6)/(7.7)
Target Price change (%)	(2.2)
Previous Reco	REDUCE

Emkay vs Consensus

EPS Estimates		
	FY16E	FY17E
Emkay	16.5	20.2
Consensus	17.6	21.6
Mean Consensus TP		Rs 288

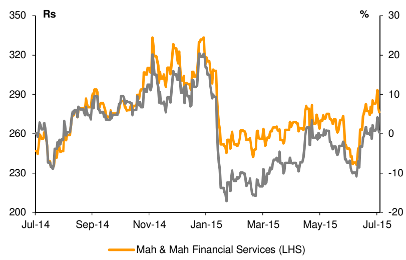
Stock Details

Bloomberg Code	MMFS IN
Face Value (Rs)	2
Shares outstanding (mn)	569
52 Week H/L	345 / 232
M Cap (Rs bn/USD bn)	157 / 2.48
Daily Avg Volume (nos.)	1,318,296
Daily Avg Turnover (US$ mn)	5.9

Shareholding Pattern Mar '15

Promoters	52.0%
FIIs	38.2%
DIIs	4.0%
Public and Others	5.9%

Relative price chart



Source: Bloomberg

Umang Shah
umang.shah@emkayglobal.com
+91 22 66242468

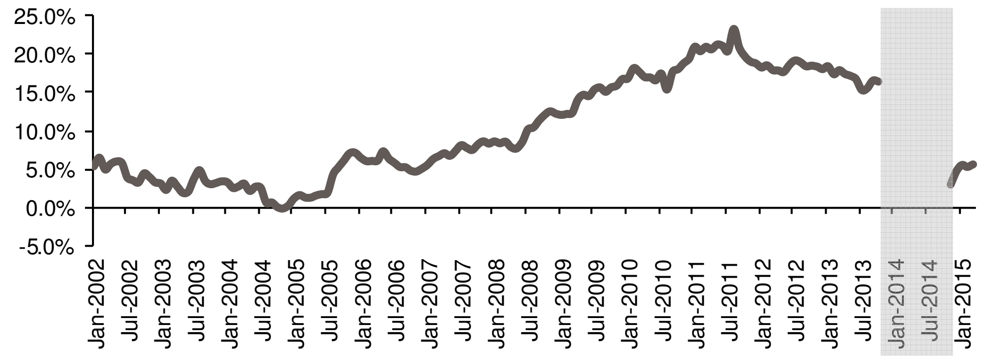
Sohail Halai
sohail.halai@emkayglobal.com
+91 22 66121336

Clyton Fernandes
clyton.fernandesi@emkayglobal.com
+91 22 66121340

Lackluster rural demand to hurt growth

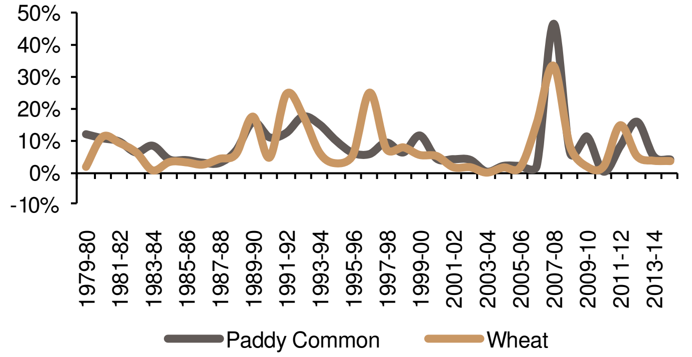
Rural demand has remained weak led by a host of factors such as- 1) low increase in MSPs and lower procurement by the FCI to curb food inflation *(refer exhibit 105)*, 2) slower growth in rural wages (also average daily wages under NREGA) *(refer exhibits 104, 106)* and 3) deficient monsoon last year followed by unseasonal rains impacting crops, resulting in to lower rural disposable incomes. Furthermore, a sub-par monsoon this year, if it pans out, could only aggravate the situation. The rural economy is highly monsoon contingent and better than expected monsoon can turn around the sentiments. We believe if the government starts spending on rural infrastructure, it could lead to a pickup in rural demand.

Exhibit 104: Growth in average daily wages for rural laborer is moderating



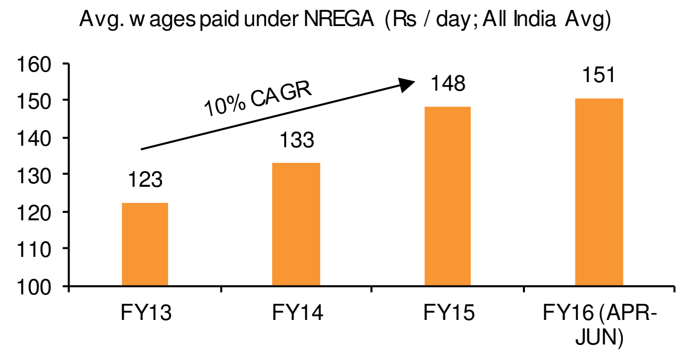
Source: MOSPI, Emkay Research Note: The base has been shifted and hence the data between Nov-13 to Oct-14 has been removed for comparative purposes.

Exhibit 105: Trend in MSP hikes for key agri commodities



Source: CMIE, Emkay Research

Exhibit 106: Growth in average daily wages under NREGA moderates

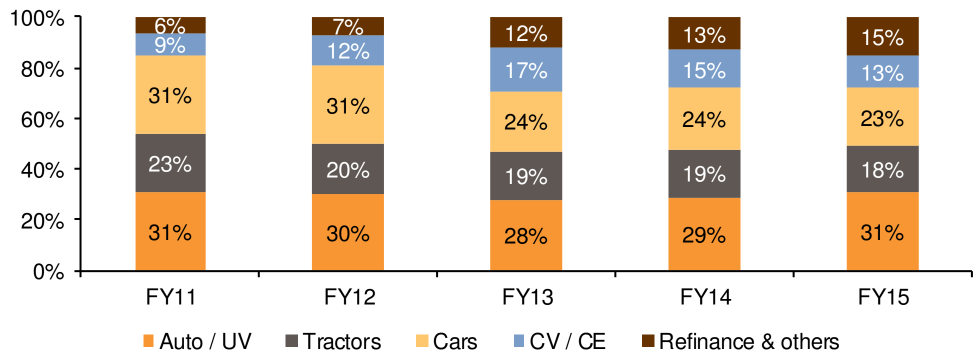


Source: MNREGA, Emkay Research

Well diversified product portfolio, but target market is rural

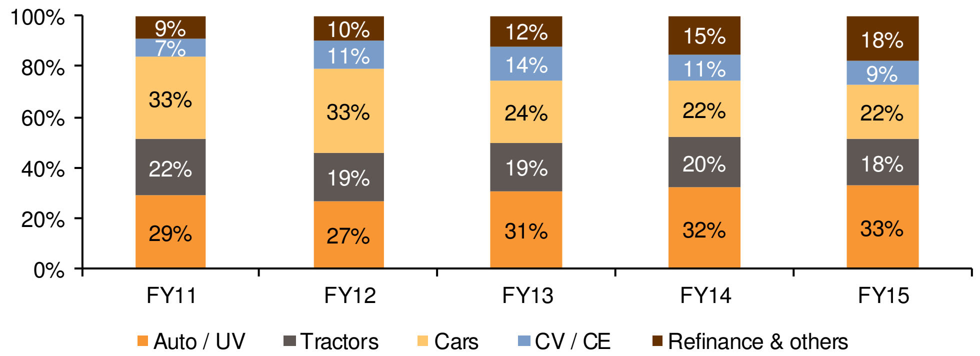
MMFS has transitioned from a captive financier to a diversified asset financing NBFC. Over the years, it has diversified not only from financing only M&M products but also from financing just tractors to various product categories. As at end Mar 2015, MMFS' product portfolio includes only 18% tractors and 31% UVs. The rest is dominated by cars (23%), CVs (13%) and pre-owned vehicles and others (15%) *(refer exhibits 107, 108)*. While the company has completely de-risked itself on the product side, its target market continues to remain completely rural.

Exhibit 107: AUM Mix (%) – Mar 2015



Source: Company, Emkay Research

Exhibit 108: Value of assets financed mix (%) – Mar 2015

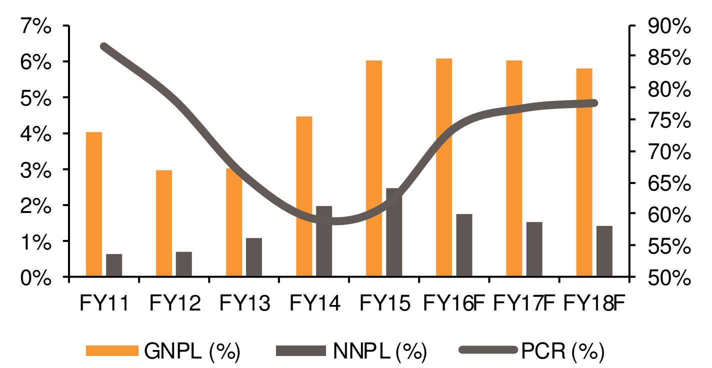


Source: Company, Emkay Research

Regulatory noose tightened; Credit costs to remain high

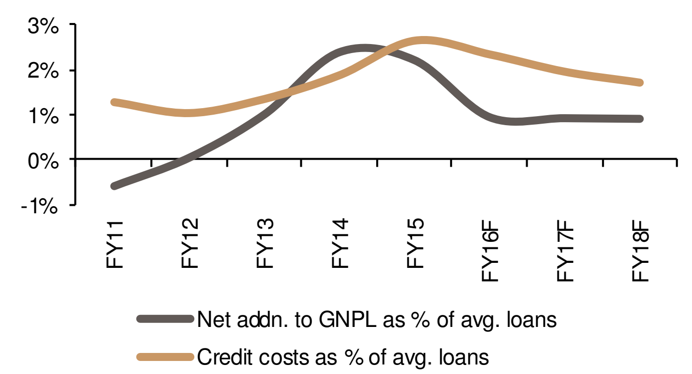
Under the new regulatory regime, MMFS is relatively better placed than its peers as it currently recognizes NPLs on a 150-dpd basis. Hence on an immediate basis, the company is compliant till Mar-16. However, we believe the impact of provisions on migration will be higher for MMFS as and when it migrates, given its low provision cover and aggressive loan write off policy *(refer exhibit 110)*. As on Mar-15, MMFS had a provision coverage ratio of 61%. A better than expected monsoon and sooner than expected revival in rural demand could be positive catalysts for MMFS, as it could lead to a sharp improvement in asset quality.

Exhibit 109: Asset quality trend



Source: Company, Emkay Research

Exhibit 110: Credit costs unlikely to fall sharply

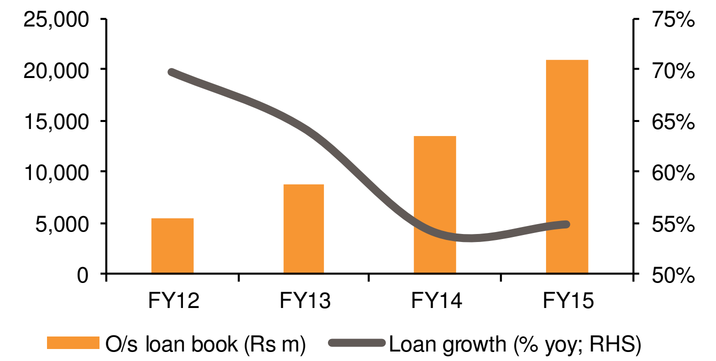


Source: Company, Emkay Research

Rural housing finance – a long term growth opportunity

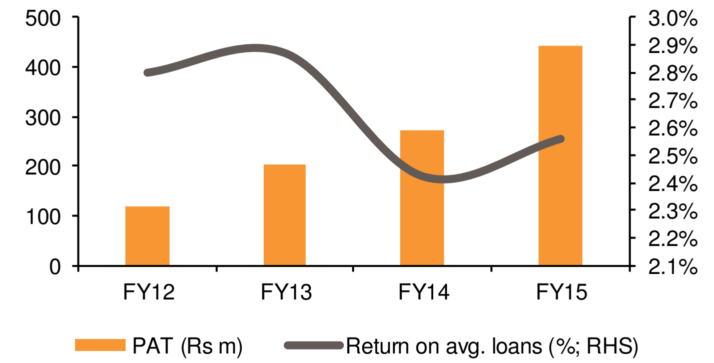
Rural housing finance remains one of the most underpenetrated business opportunities and has a great business potential, in our view. Mahindra Rural Housing Finance Ltd. (MRHFL) has grown its loans at 60% and profits at 49% CAGR during FY11-15 *(refer exhibits 111, 112)*. As at end FY15, the company had an outstanding loan book of Rs21bn (~5% of consolidated AUMs) and recorded PAT of Rs442m, generating a ROA of ~2.6% *(refer exhibit 113)*. While we believe this business has strong long term growth potential, its contribution to consolidated profits is likely to remain limited. We currently do not assign any value to the rural housing finance business in our valuations.

Exhibit 111: MRHFL: Loan growth remains healthy



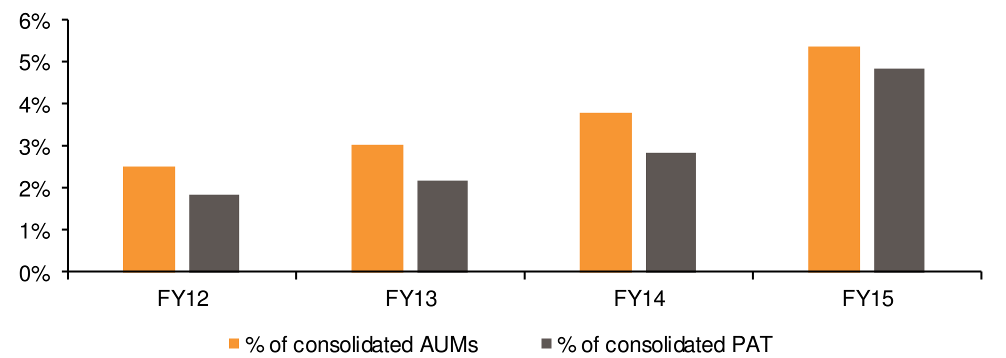
Source: Company, Emkay Research

Exhibit 112: MRHFL: Trend in profitability



Source: Company, Emkay Research

Exhibit 113: Contribution of MRHFL to consolidated AUM and PAT



Source: Company, Emkay Research

Valuation and outlook

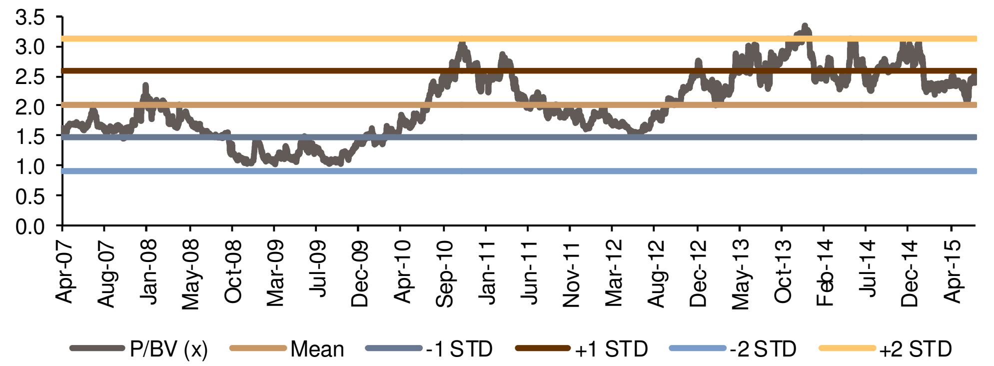
MMFS trades at 2.2x FY17E BV, which is 1.s.d. above its long period average valuations. Despite a strong 4QFY15 performance, we believe there are multiple headwinds for MMFS in the near term – 1) uncertainty related to monsoon and demand uptick in the rural economy, 2) expected erosion in the sustainable returns profile of the company. While we like MMFS' rural focused niche business model, we would like to wait for positive catalysts to emerge. Maintain **Reduce** with a target price of Rs262 (based on residual income model).

Exhibit 114: MMFS: Key financials

Mahindra Finance	FY15	FY16E	FY17E	FY18E	CAGR (%)
ROAA	2.5%	2.5%	2.6%	2.8%	
ROAE	15.4%	15.6%	17.0%	18.6%	
EPS (Rs)	14.7	16.5	20.2	25.2	19.7%
P/E (x)	18.8	16.7	13.7	11.0	
BV (Rs)	100.5	111.8	126.1	144.3	12.8%
P/BV (x)	2.8	2.5	2.2	1.9	
ABV (Rs)	86.0	100.4	114.5	131.4	15.2%
P/ABV (x)	3.2	2.8	2.4	2.1	

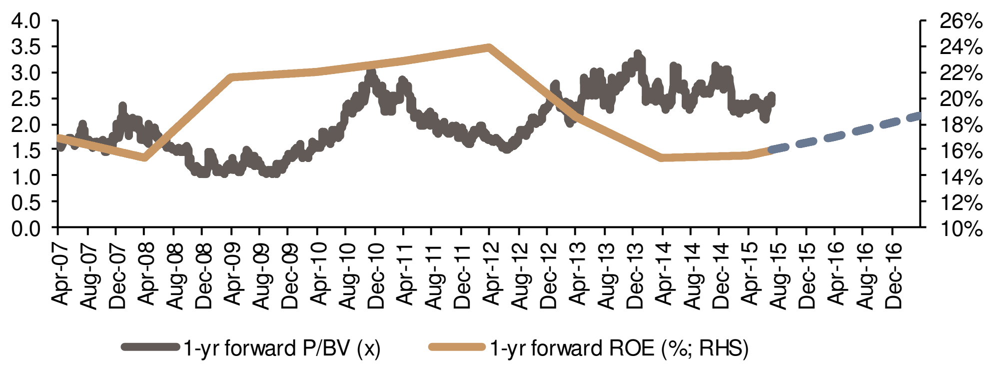
Source: Company, Emkay Research

Exhibit 115: MMFS: 1-yr forward P/BV (x)



Source: Company, Bloomberg, Emkay Research

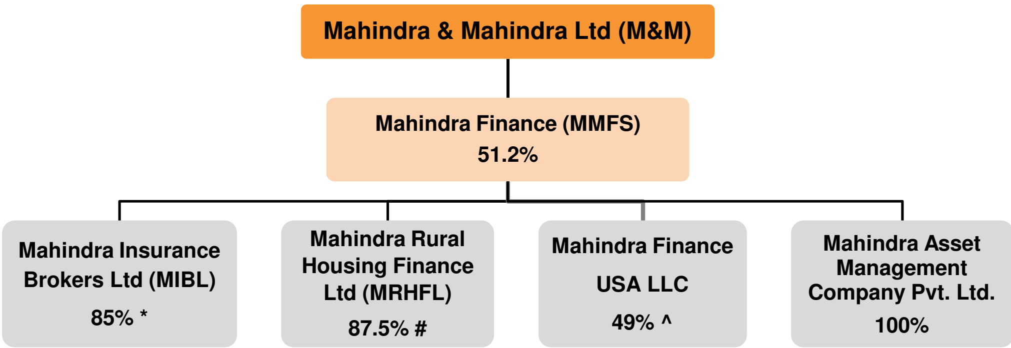
Exhibit 116: MMFS: 1-yr forward P/BV (x) vs 1-yr forward ROE (%)



Source: Company, Bloomberg, Emkay Research

Annexure

Exhibit 117: MMFS: Company structure



Source: Company, Emkay Research

** Balance 15% held by Inclusion Resources Pvt. Ltd., a subsidiary of Leapfrog Financial Inclusion Fund*

 # Balance 12.5% held by National Housing Bank (NHB)

^ JV with Rabobank Group subsidiary

Exhibit 118: MMFS: Key shareholders (as on Mar-15)

Name of the shareholder	% holding
Promoters & promoter group	52.01%
Aranda Investments	3.79%
Franklin Templeton	2.60%
Fidelity Funds	1.27%
JP Morgan	1.12%

Source: BSE filings, Emkay Research

Key Financials (Standalone)

Income Statement

Y/E Mar (Rs mn)	FY14	FY15	FY16E	FY17E	FY18E
Net interest income	**24,845**	**27,641**	**30,318**	**34,508**	**41,036**
Other income	**2,805**	**3,214**	**3,404**	**3,823**	**4,431**
Fee income	0	0	0	0	0
Net income	**27,650**	**30,855**	**33,722**	**38,331**	**45,467**
Operating expenses	9,134	10,068	11,388	13,235	15,729
Pre provision profit	**18,516**	**20,787**	**22,334**	**25,096**	**29,738**
PPP excl treasury	**18,516**	**20,787**	**22,334**	**25,096**	**29,738**
Provisions	5,058	8,275	8,188	7,836	8,187
Profit before tax	**13,458**	**12,512**	**14,146**	**17,260**	**21,551**
Tax	4,585	4,219	4,810	5,868	7,327
Tax rate	34	34	34	34	34
Profit after tax	**8,872**	**8,293**	**9,336**	**11,392**	**14,223**

Balance Sheet

Y/E Year End (Rs mn)	FY14	FY15	FY16E	FY17E	FY18E
Equity	1,127	1,128	1,128	1,128	1,128
Reserves	49,815	55,566	61,932	70,023	80,286
Net worth	**50,942**	**56,694**	**63,060**	**71,152**	**81,415**
Deposits	0	0	0	0	0
Borrowings	239,306	262,538	294,805	343,764	414,831
Total liabilities	**316,657**	**350,741**	**400,028**	**465,267**	**556,004**
Cash and bank	5,533	4,794	12,601	14,827	14,213
Investments	8,692	8,537	10,023	11,344	13,275
Loans	296,170	329,300	368,919	430,186	519,119
Others	5,068	7,013	7,164	7,325	7,496
Total assets	**316,657**	**350,744**	**400,028**	**465,267**	**556,004**

Key Ratios (%)

Y/E Year End	FY14	FY15	FY16E	FY17E	FY18E
NIM	8.9	8.7	8.6	8.6	8.6
RoA	3.1	2.5	2.5	2.6	2.8
RoAE	18.6	15.4	15.6	17.0	18.6
GNPA (%)	4.4	6.0	6.1	6.0	5.8
NNPA (%)	1.8	2.3	1.6	1.4	1.3

Per Share Data (Rs)	FY14	FY15	FY16E	FY17E	FY18E
EPS	15.7	14.7	16.5	20.2	25.2
BVPS	90.4	100.5	111.8	126.1	144.3
ABVPS	80.2	86.0	100.4	114.5	131.4
DPS	3.8	4.0	4.5	5.0	6.0

Valuations (x)	FY14	FY15	FY16E	FY17E	FY18E
PER	17.6	18.8	16.7	13.7	11.0
P/BV	3.1	2.8	2.5	2.2	1.9
P/ABV	3.5	3.2	2.8	2.4	2.1
Dividend Yield (%)	1.4	1.4	1.6	1.8	2.2

Growth (%)	FY14	FY15	FY16E	FY17E	FY18E
NII	22.9	11.3	9.7	13.8	18.9
PPOP	18.5	12.3	7.4	12.4	18.5
PAT	0.5	(6.5)	12.6	22.0	24.9
Loans	23.2	11.2	12.0	16.6	20.7

Quarterly (Rs mn)	Q4FY14	Q1FY15	Q2FY15	Q3FY15	Q4FY15
NII	7,627	6,802	7,369	7,388	8,834
NIM(%)	9.1	8.0	8.4	8.2	9.6
PPOP	5,439	4,611	5,000	4,771	6,429
PAT	3,107	1,549	2,071	1,364	3,334
EPS (Rs)	5.51	2.75	3.67	2.42	5.91

Shareholding Pattern (%)	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Promoters	52.1	52.1	52.1	52.0	52.0
FIIs	41.4	41.4	41.5	41.6	38.2
DIIs	1.4	1.3	1.1	1.7	4.0
Public and Others	5.1	5.2	5.3	4.6	5.9

Shriram City Union Finance

Small is beautiful

CMP	Target Price
Rs1,684	Rs2,013 (▪)
Rating	**Upside**
ACCUMULATE (▪)	19.5 %

Shriram City Union Finance (SCUF) has developed a niche and diversified business model, focusing on the underserved and under penetrated SME segment in the rural and semi urban areas. With the uncertainty over the gold loan business behind it and its strong capital position, SCUF remains well poised for its next phase of growth. ROEs to improve gradually as leverage increases. ROAs likely to remain healthy despite elevated credit costs.

- **Consolidation phase over; Focus back on growth:** After growing at a 44% CAGR over FY06-13, the company went into consolidation mode, given the challenging macro environment. The management scaled down growth and re-aligned its gold loan portfolio in light of the tightening regulations for gold loan companies and the sharp volatility in gold prices. As a result, AUMs remained largely flat during FY13-15 and the mix shifted in favour of small enterprises and two-wheeler loans. With the portfolio realignment largely done and strong CAR of ~29%, we expect SCUF to get back into growth mode on the back of strong growth opportunities in the SME and housing segments. We have modeled in 22% AUM CAGR over FY15-18E.
- **High CAR boosts NIMs; but, downside risks persist:** In FY15, Piramal Enterprises Ltd. picked up a 9.99% stake in Shriram City Union Finance, leading to a 400bp accretion to its tier-I ratio. As a result, SCUF's net operating margins improved by about 150bp in FY15. Going forward, we believe there are downward risks to margins, namely 1) Reduced benefits of capital infusion as the leverage increases, 2) Interest income de-recognition as the company migrates to 90-dpd NPL recognition from the current 180-dpd. While margins are likely to come off, we expect it to still remain healthy.
- **Credit costs likely to remain elevated:** SCUF currently recognizes NPLs based on 180-dpd basis. Under the new regulatory regime, the company will start migrating to 90-dpd NPL recognition from FY16 onwards. In our view, although fresh accretion to NPLs may start receding on the back of improving economic scenario, the credit costs may remain elevated due to migration to new regulations.
- **Valuation and view:** SCUF's niche business model offers high growth potential with strong profitability and low competition. The target customer segment and the small and mid-market business segments remain underserved by the formal banking channel and hence, offer huge growth potential. Despite some expected erosion in ROAs due to 1) fading effect of capital infusion and 2) high credit costs on migration to stricter NPL recognition norms, we expect SCUF's ROAs to be best in class. ROEs are likely to improve as leverage increases. We initiate coverage with an **Accumulate** rating and a target price of Rs2,013 (based on the residual income model).

Change in Estimates

EPS Chg FY16E/FY17E (%)	NA/NA
Target Price change (%)	NA
Previous Reco	NA

Emkay vs Consensus

EPS Estimates		
	FY16E	FY17E
Emkay	98.5	119.5
Consensus	105.0	128.1
Mean Consensus TP		Rs 2,197

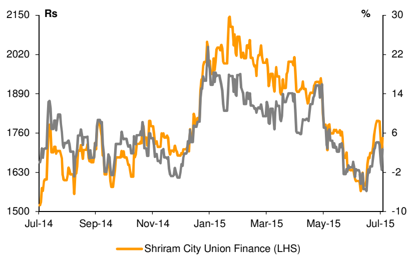
Stock Details

Bloomberg Code	SCUF IN
Face Value (Rs)	10
Shares outstanding (mn)	66
52 Week H/L	2,200 / 1,520
M Cap (Rs bn/USD bn)	111 / 1.75
Daily Avg Volume (nos.)	10,017
Daily Avg Turnover (US$ mn)	0.3

Shareholding Pattern Mar '15

Promoters	33.8%
FIIs	13.9%
DIIs	2.2%
Public and Others	50.1%

Relative price chart



Source: Bloomberg

Umang Shah
umang.shah@emkayglobal.com
+91 22 66242468

Sohail Halai
sohail.halai@emkayglobal.com
+91 22 66121336

Clyton Fernandes
clyton.fernandesi@emkayglobal.com
+91 22 66121340

Financial Snapshot (Standalone)

(Rs mn)	FY14	FY15	FY16E	FY17E	FY18E
Net income	18,879	21,885	24,416	28,603	35,034
Net profit	5,211	5,581	6,491	7,876	9,967
EPS (Rs)	87.9	84.7	98.5	119.5	151.2
ABV (Rs)	476.0	606.0	674.7	760.0	868.7
RoA (%)	3.2	3.2	3.3	3.2	3.2
RoE (%)	20.4	15.9	14.9	16.0	17.6
PE (x)	19.2	19.9	17.1	14.1	11.1

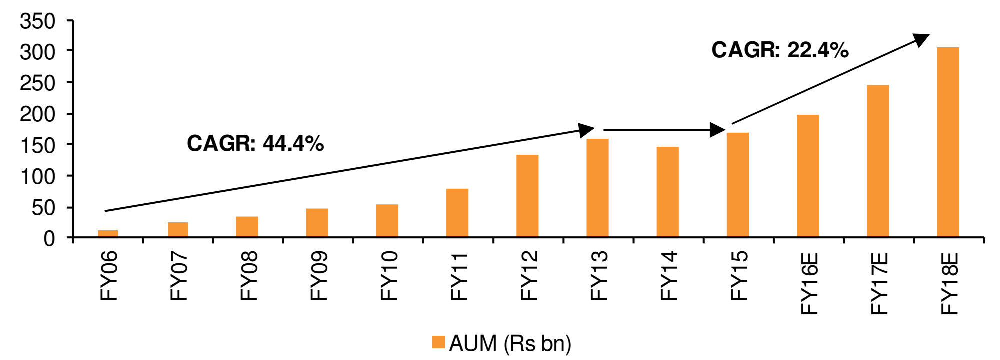
Source: Company, Emkay Research

Consolidation phase over; focus back on growth

SCUF has a niche business model focusing on small ticket loans, retail focused, relatively high risk and high ROA segments. Most business segments, in which SCUF operates (SME loans, gold loans, 2-wheeler loans) offer high growth potential. Note, its target customer segment too is niche, as most of its customers (in the SME segment) are Shriram Group's chit fund subscribers. The credit risk hence, is relatively low for SCUF, as prospective borrowers are thoroughly assessed for their repayment ability and track record with the chit fund companies.

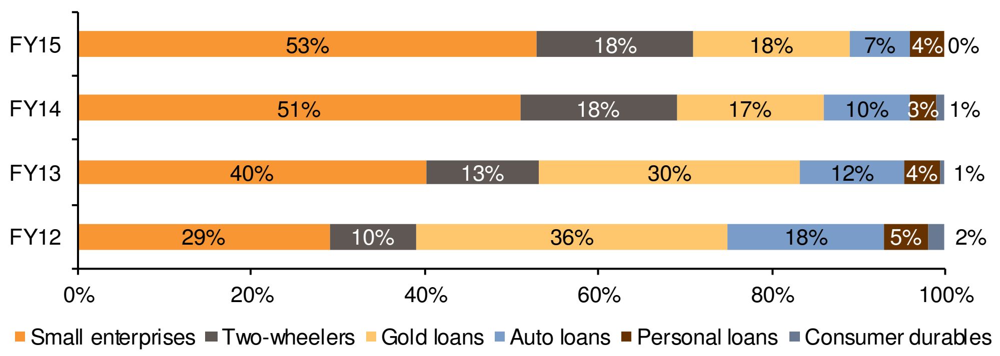
After growing at a 44% CAGR during FY06-13 period, the company went into consolidation mode, given the challenging macro environment *(refer exhibit 119)*. The management scaled down growth and re-aligned its gold loan portfolio in light of the tightening regulations for the gold loan companies and the sharp volatility in gold prices. As a result, the AUMs remained largely flat during FY13-15 and the AUM mix shifted in favour of small enterprises and two-wheeler loans. The share of gold loans reduced to 18% in FY15 from 36% in FY12 *(refer exhibit 120)*. We expect SCUF to get back into growth mode on the back of strong growth opportunities in the SME and housing segments. We have modeled in 22% AUM CAGR over FY15-18E.

Exhibit 119: AUM growth to pick up after a lull



Source: Company, Emkay Research

Exhibit 120: AUM mix shifts in favour of SME / 2W loans (%)



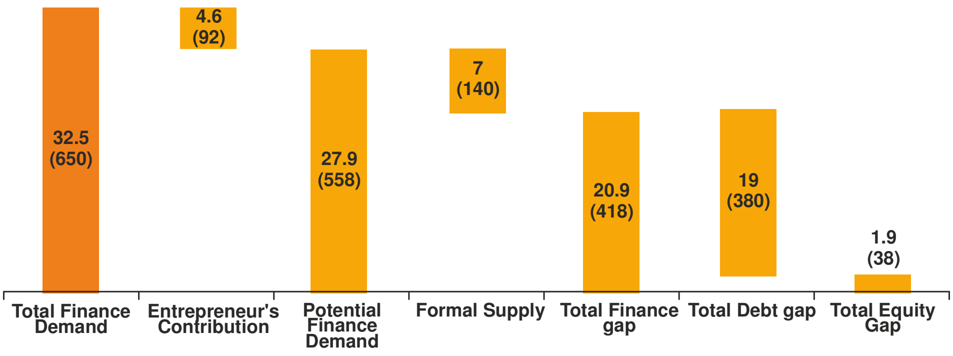
Source: Company, Emkay Research

SME segment offers huge growth potential

SCUF has developed its expertise in small loans – both retail and business loans. While the company continues to offer multiple products, small business loans (both against gold / property) remain a key focus area for the company. As at end-Mar 2015, it constituted 53% of SCUF's total AUMs. The MSME segment remains highly underserved and a large part of the borrowings for this segment come from the unorganized sector at usurious rates.

As per a study conducted by the International Finance Corporation (IFC), despite a significant contribution of the MSME sector to the economy, the flow of credit to this sector remains fairly low. Among others, the lack of adequate and timely access to finance has been seen as the biggest impediment to the growth of the sector. According to the findings of the study, financial institutions have limited their exposure to the sector due to a higher risk perception and limited access of MSMEs to immovable collateral *(refer exhibit 121)*.

Exhibit 121: Overall finance gap in the MSME sector (Rs trillion)

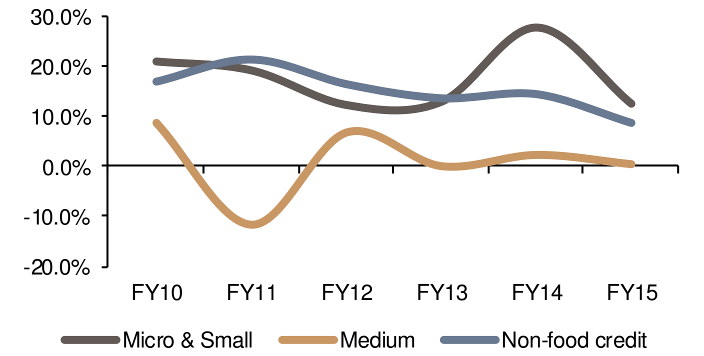


Source: MSME Census, RBI, SIDBI, Primary Research, IFC-Intellecap Analysis, Emkay Research
Note: Figures in bracket in USD bn; Based on the IFC study on demand for finance in the MSME sector, 2012

The RBI data suggests that banks have been reducing their exposure to medium enterprises due to risk aversion as they reel under economic slowdown pressures. During FY10-15, the outstanding bank credit to the medium enterprises have grown at -0.7% CAGR, while the same to the micro and small enterprises has grown at a CAGR of 16.6% vs. 14.7% CAGR in non-food credit. The banks' exposure to the micro and small enterprises has grown at a relatively rapid pace, as the exposure is classified as priority sector lending *(refer exhibits 122, 123)*.

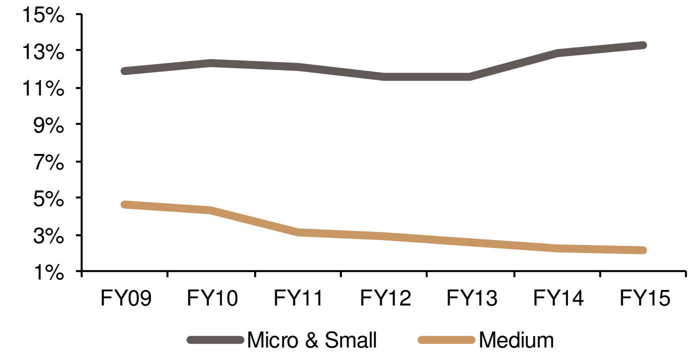
In our view, this is where it throws up growth opportunities for NBFC players. Proximity to the customer, strong domain and local area knowledge, ability to assess surrogate incomes, risk taking ability and ability to make finance available when needed with lowest possible turnaround time, make NBFCs a preferred choice for small and medium enterprises to address their finance needs.

Exhibit 122: Credit growth to medium enterprises lags non-food credit growth



Source: RBI, Emkay Research

Exhibit 123: Share of micro, small and medium enterprises (cumulative) has remained largely stagnant over the past few years



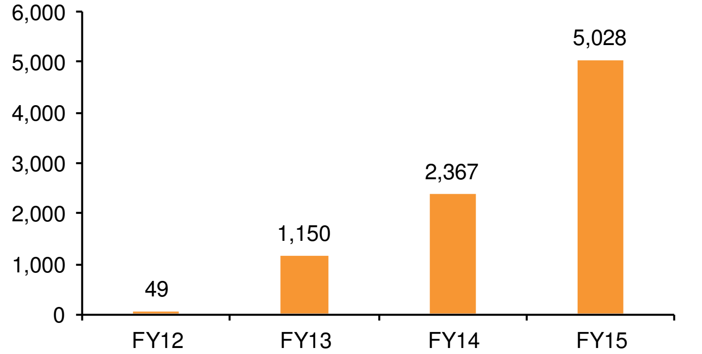
Source: RBI, Emkay Research

Housing is another potential 'high growth' segment

SCUF has further diversified and added housing finance to its product portfolio. The business is undertaken under a majority owned subsidiary Shriram Housing Finance (SHF - 77% owned by Shriram City Union Finance), focusing mainly on the self-employed category in the rural and semi-urban regions. As on Mar-15, the outstanding AUMs stood at Rs7.37bn (up 130% yoy). It recorded PAT of Rs202mn, with an ROA of 3.55% in FY15 *(refer exhibits 125, 126)*.

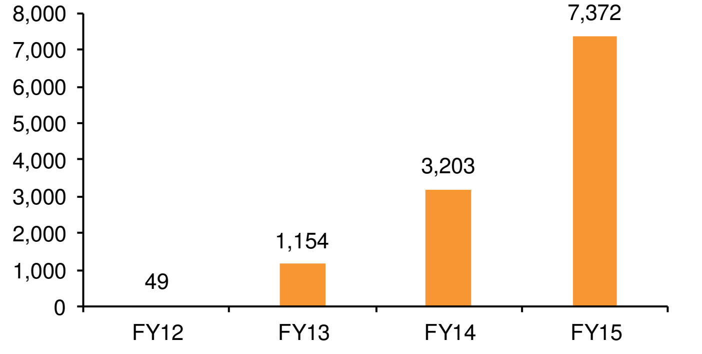
While Shriram Housing Finance currently contributes in a negligible way to the consolidated AUMs and profits, we believe the growth opportunity in this segment is immense. Moreover, the customer segment and the markets catered by Shriram Housing Finance, offer high profitability than the plain vanilla mortgage segment. We believe, over the next 3-5 years, this could start contributing meaningfully to SCUF's consolidated balance sheet.

Exhibit 124: Trend in disbursements growth of SHF



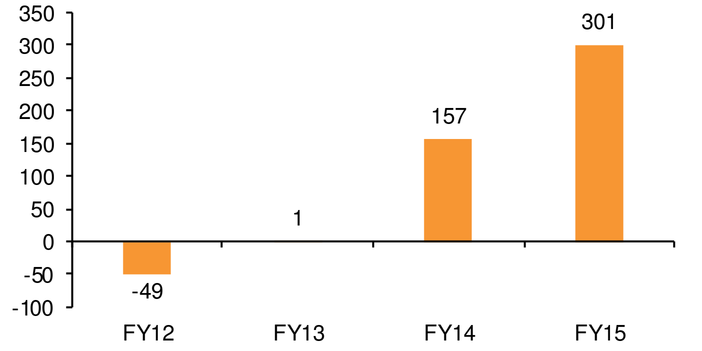
Source: Company, Emkay Research

Exhibit 125: Trend in AUM growth of SHF



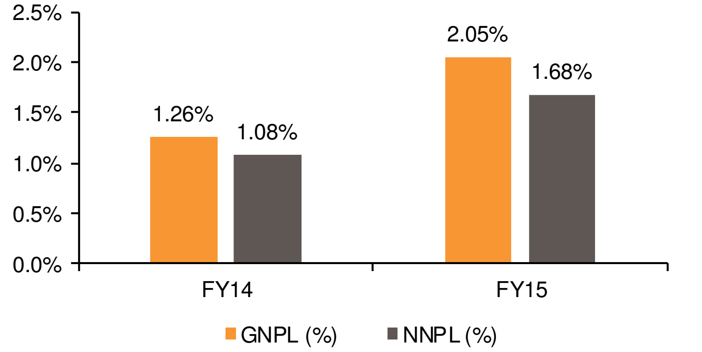
Source: Company, Emkay Research

Exhibit 126: Trend in PBT growth of SHF



Source: Company, Emkay Research

Exhibit 127: Asset quality trends of SHF



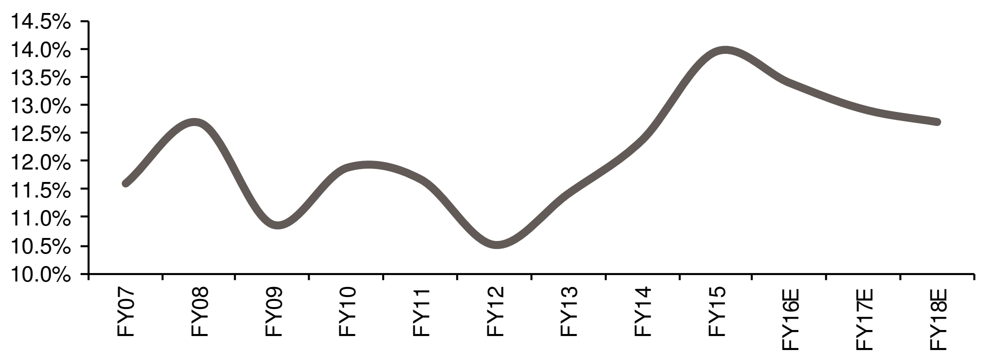
Source: Company, Emkay Research

High CAR boosts NIMs, but, downside risks persist

In early FY15, Piramal Enterprises Ltd. picked up 9.99% stake in Shriram City Union Finance at a consideration of Rs7.9bn. As a consequence of this capital infusion, the Tier-I capital adequacy ratio of the company improved by about 400bp. As at end-Mar 2015, SCUF's capital adequacy ratio stood at 29%, with Tier-I capital ratio of about 24%. In FY15, SCUF's net operating margins improved by about 150bp, which helped SCUF cushion some increase in its credit costs *(refer exhibit 128)*.

Going forward, we believe there are downward risks to margins - 1) Reduced benefits of capital infusion as the leverage increases, 2) Interest income de-recognition as the company migrates to 90-dpd NPL recognition from the current 180-dpd. Although the margins are likely to come off from its peak levels, we expect it to remain healthy.

Exhibit 128: Net operating margins (as % of average AUMs) likely to trend downwards

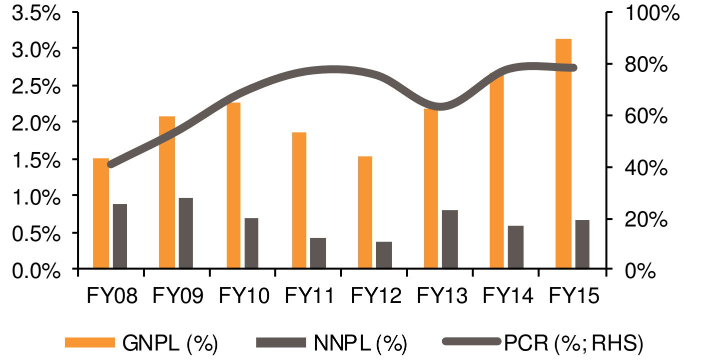


Source: Company, Emkay Research

Credit costs likely to remain elevated under new regulatory norms

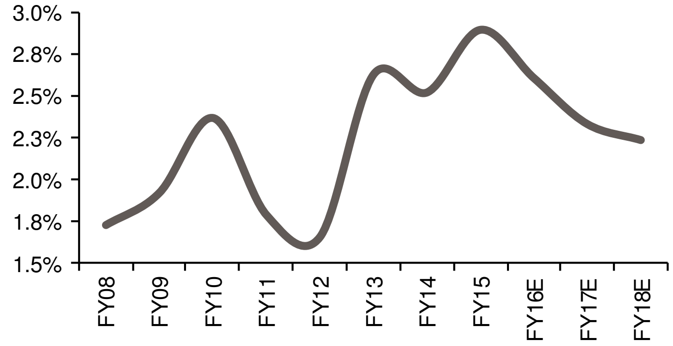
SCUF currently recognizes NPLs based on 180-dpd basis. Under the new regulatory regime, the company will start migrating to 90-dpd NPL recognition from FY16 onwards. In our view, although the fresh accretion to NPLs may start receding on the back of improving economic scenario, the credit costs may remain elevated due to migration to new regulations *(refer exhibits 129, 130)*.

Exhibit 129: NPLs have risen, so has provision cover



Source: Company, Emkay Research

Exhibit 130: Credit costs as % of avg. AUMs likely to remain elevated



Source: Company, Emkay Research

Valuation and outlook

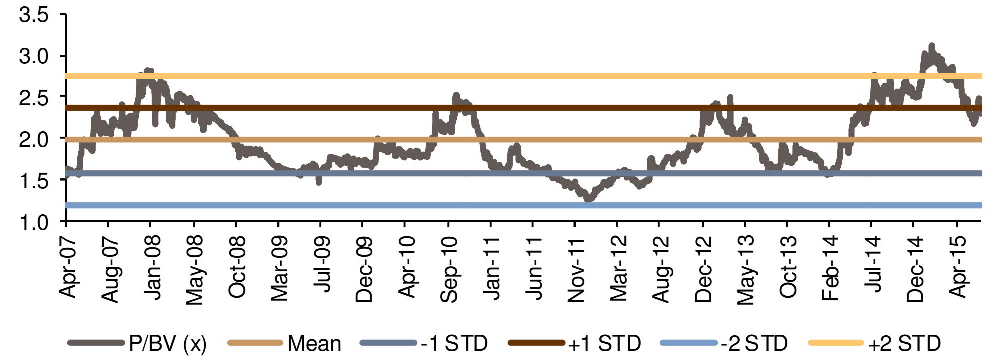
SCUF has a niche business model, which offers high growth potential with strong profitability and low competition. The target customer segment and the small and mid-market business segments remain underserved by the formal banking channel and hence, offer huge growth potential. Despite some expected erosion in ROAs due to 1) fading effect of capital infusion and 2) high credit costs on migration to stricter NPL recognition norms, we expect SCUF's ROAs to be best in class. ROEs are likely to improve as leverage increases. We initiate coverage with an **Accumulate** rating and a target price of Rs2,013 (based on the residual income model).

Exhibit 131: Key financials

Shriram City Union Finance	FY15	FY16E	FY17E	FY18E	CAGR (%)
ROAA	3.2%	3.3%	3.2%	3.2%	
ROAE	15.9%	14.9%	16.0%	17.6%	
EPS (Rs)	84.7	98.5	119.5	151.2	21.3%
P/E (x)	19.9	17.1	14.1	11.1	
BV (Rs)	622.2	700.8	796.9	918.9	13.9%
P/BV (x)	2.7	2.4	2.1	1.8	
ABV (Rs)	606.0	674.7	760.0	868.7	12.8%
P/ABV (x)	2.8	2.5	2.2	1.9	

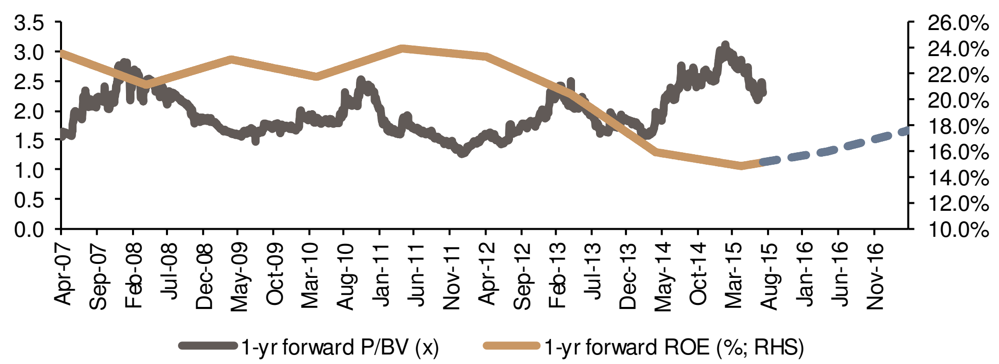
Source: Company, Emkay Research

Exhibit 132: SCUF: 1-yr forward P/BV (x)



Source: Company, Bloomberg, Emkay Research

Exhibit 133: SCUF: 1-yr forward P/BV (x) vs. 1-yr forward ROE (%)



Source: Company, Bloomberg, Emkay Research

Key Financials (Standalone)

Income Statement

Y/E Mar (Rs mn)	FY14	FY15	FY16E	FY17E	FY18E
Net interest income	**18,228**	**21,168**	**23,628**	**27,736**	**34,081**
Other income	**651**	**716**	**788**	**867**	**954**
Fee income	0	0	0	0	0
Net income	**18,879**	**21,885**	**24,416**	**28,603**	**35,034**
Operating expenses	7,239	8,936	9,829	11,507	13,757
Pre provision profit	**11,641**	**12,949**	**14,586**	**17,096**	**21,278**
PPP excl treasury	**11,641**	**12,949**	**14,586**	**17,096**	**21,278**
Provisions	3,842	4,538	4,751	5,162	6,176
Profit before tax	**7,799**	**8,411**	**9,835**	**11,934**	**15,101**
Tax	2,587	2,830	3,344	4,057	5,134
Tax rate	33	34	34	34	34
Profit after tax	**5,211**	**5,581**	**6,491**	**7,876**	**9,967**

Balance Sheet

Y/E Mar (Rs mn)	FY14	FY15	FY16E	FY17E	FY18E
Equity	593	659	659	659	659
Reserves	28,390	40,352	45,533	51,867	59,905
Net worth	**28,983**	**41,012**	**46,192**	**52,526**	**60,564**
Deposits	0	0	0	0	0
Borrowings	120,491	124,020	152,030	195,759	256,396
Total liabilities	**163,831**	**180,380**	**216,547**	**270,177**	**343,237**
Cash and bank	24,729	7,814	16,700	21,940	32,637
Investments	6,275	9,817	7,601	9,788	12,820
Loans	128,535	158,903	187,691	233,046	291,360
Others	3,278	3,024	3,566	4,218	4,999
Total assets	**163,831**	**180,380**	**216,547**	**270,177**	**343,237**

Key Ratios (%)

Y/E Mar	FY14	FY15	FY16E	FY17E	FY18E
NIM	12.4	13.9	13.4	12.9	12.7
RoA	3.2	3.2	3.3	3.2	3.2
RoAE	20.4	15.9	14.9	16.0	17.6
GNPA (%)	2.1	2.7	3.4	3.7	4.0
NNPA (%)	0.5	0.6	0.8	0.9	1.0

Per Share Data (Rs)	FY14	FY15	FY16E	FY17E	FY18E
EPS	87.9	84.7	98.5	119.5	151.2
BVPS	488.9	622.2	700.8	796.9	918.9
ABVPS	476.0	606.0	674.7	760.0	868.7
DPS	10.0	15.0	17.0	20.0	25.0

Valuations (x)	FY14	FY15	FY16E	FY17E	FY18E
PER	19.2	19.9	17.1	14.1	11.1
P/BV	3.4	2.7	2.4	2.1	1.8
P/ABV	3.5	2.8	2.5	2.2	1.9
Dividend Yield (%)	0.6	0.9	1.0	1.2	1.5

Growth (%)	FY14	FY15	FY16E	FY17E	FY18E
NII	9.7	16.1	11.6	17.4	22.9
PPOP	10.9	11.2	12.6	17.2	24.5
PAT	15.9	7.1	16.3	21.3	26.5
Loans	(5.0)	23.6	18.1	24.2	25.0

Shareholding Pattern (%)	Jun-14	Jun-14	Sep-14	Dec-14	Mar-15
Promoters	33.8	33.8	33.8	33.8	33.8
FIIs	23.5	23.8	24.8	14.4	13.9
DIIs	2.9	2.9	2.4	2.2	2.2
Public and Others	39.8	39.5	39.0	49.6	50.1

Initiating Coverage

Emkay©
Your success is our success

Shriram Transport Finance

On a wing and a prayer

CMP	Target Price
Rs940	Rs771 (▪)
Rating	**Upside**
SELL (▪)	(18.0) %

Multiple headwinds in the form of slower growth due to a large base, continued pressure on NIMs and elevated loan loss charges on the back of changing regulatory norms are likely to keep SHTF's earnings under pressure. Return ratios have come off on a sustainable basis and are unlikely to move up significantly in the near term. Valuations are most likely reflecting the same, offering limited scope for a re-rating. Earnings may disappoint; Downside risks from current levels persist.

- **Growth likely to be constrained by a large base:** With assets under management to the tune of Rs591bn, SHTF is now the largest asset financing NBFC, despite the moderation in AUM growth over the past few years. As at end-Mar 2015, SHTF's on-balance sheet AUMs at Rs492bn compare with the outstanding auto loans of Rs532bn of HDFC Bank and Rs307bn of SBI. Despite a turnaround in the CV cycle and favourable auto sales, we expect SHTF's pace of asset growth to be slower than its historical average (lagging its peers) and which should be the new normal for the company. We model in 14% AUM CAGR over FY15-18E.
- **Multiple headwinds to NIMs persist:** Over the past few quarters, SHTF's reported NIMs have shown qoq improvement. However, we believe that the improvement may not be sustainable despite falling interest rates due to 1) increase in interest income de-recognition as the company migrates to 90-dpd NPL recognition and 2) 93% of its disbursements in FY15 being in the high-yielding used vehicles segment. As the disbursement share of low-yielding new CVs picks up, NIMs could be under pressure.
- **Regulatory changes to keep credit costs elevated:** SHTF's gross NPLs have grown at a CQGR of 8.7% over the past 12 quarters, but %GNPL rose from 3.2% to 3.8% in FY15. This was due to cumulative loan write-offs of over 6% during the same period. Under the new regulatory framework, we expect fresh delinquencies to rise as SHTF migrates from 180-dpd to 90-dpd NPL recognition. While the provision coverage ratio at 80% may provide some cushion, with aggressive write-off policy, we expect credit costs to remain elevated during FY15-18E period.
- **SEF merger to act as an overhang:** SHTF board has approved the merger of Shriram Equipment Finance (SEF, a wholly owned equipment financing subsidiary), with itself for better control over the business, which is reeling under severe asset quality pressure. In our view, though SEF constitutes <5% of SHTF's consolidated AUMs, the asset quality issues in the SEF business may act as an overhang on the stock.
- **Valuation and view:** SHTF trades at 1.8x FY17E BV, 1s.d. close to its long period average valuations. However, we believe SHTF's valuation re-rating back to earlier levels looks challenging given the return ratios are likely to remain subdued led by pressure on NIMs and high credit costs. We initiate coverage with a SELL rating and target price of Rs771 (based on residual income model).

Financial Snapshot (Standalone)

(Rs mn)	FY14	FY15	FY16E	FY17E	FY18E
Net income	38,410	41,836	46,066	51,373	58,807
Net profit	12,642	12,378	13,049	15,844	19,098
EPS (Rs)	55.7	54.6	57.5	69.8	84.2
ABV (Rs)	351.3	390.4	406.7	441.8	498.2
RoA (%)	2.7	2.3	2.1	2.2	2.3
RoE (%)	16.3	14.1	13.4	14.6	15.5
PE (x)	16.9	17.2	16.3	13.5	11.2

Source: Company, Emkay Research

Change in Estimates	
EPS Chg FY16E/FY17E (%)	NA/NA
Target Price change (%)	NA
Previous Reco	NA

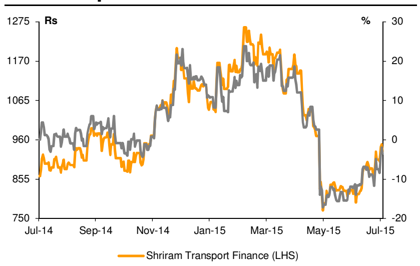
Emkay vs Consensus

EPS Estimates	FY16E	FY17E
Emkay	57.5	69.8
Consensus	65.3	80.7
Mean Consensus TP		Rs 1,060

Stock Details	
Bloomberg Code	SHTF IN
Face Value (Rs)	10
Shares outstanding (mn)	227
52 Week H/L	1,288 / 761
M Cap (Rs bn/USD bn)	213 / 3.36
Daily Avg Volume (nos.)	716,296
Daily Avg Turnover (US$ mn)	10.5

Shareholding Pattern Mar '15	
Promoters	26.1%
FIIs	51.2%
DIIs	4.2%
Public and Others	18.6%

Relative price chart



Source: Bloomberg

Umang Shah
umang.shah@emkayglobal.com
+91 22 66242468

Sohail Halai
sohail.halai@emkayglobal.com
+91 22 66121336

Clyton Fernandes
clyton.fernandesi@emkayglobal.com
+91 22 66121340

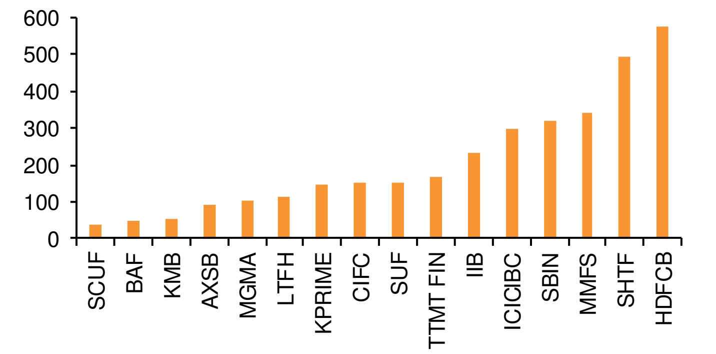
Asset growth likely to remain constrained by a large base

Barring the housing finance companies, Shriram Transport Finance (SHTF) has by far emerged as the largest asset financing NBFC in the country. In FY15, its disbursements stood at Rs338bn, up 18% yoy and assets under management stood at Rs591bn, up 11% yoy. Note, SHTF's on-balance sheet AUMs of Rs492bn as at Mar-15 compares with the outstanding auto loan portfolio of Rs532bn of HDFC Bank and Rs307bn of SBI *(refer exhibit 134)*.

In our view, despite the turnaround in the CV cycle and a favourable auto cycle, SHTF's growth pace is likely be slower than its own historical performance, given its large base now. We believe the growth clocked by SHTF in the past is unlikely to repeat and it could be slower than some of its peers.

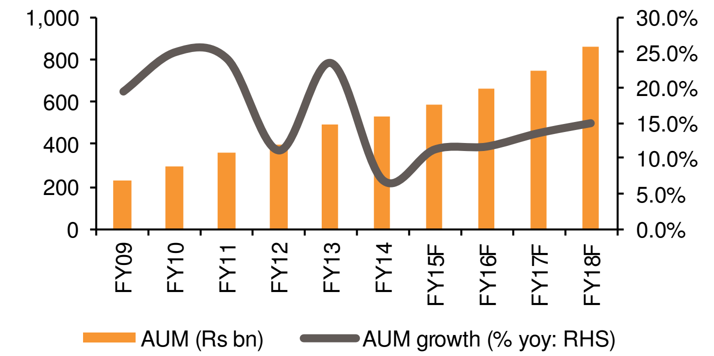
On the contrary, if SHTF has to grow aggressively to gain market share it may have to enter segments outside its niche of used CV financing, where it's pricing power is low. As a result it may adversely impact its net interest margins in our view. Consequently, we model in 14% CAGR in AUMs during FY15-18E *(refer exhibit 135)*.

Exhibit 134: Auto fin. AUMs (on-BS) of banks and NBFCs (Mar 2015)



Source: Company, Emkay Research

Exhibit 135: AUM growth for SHTF to see moderate pick up

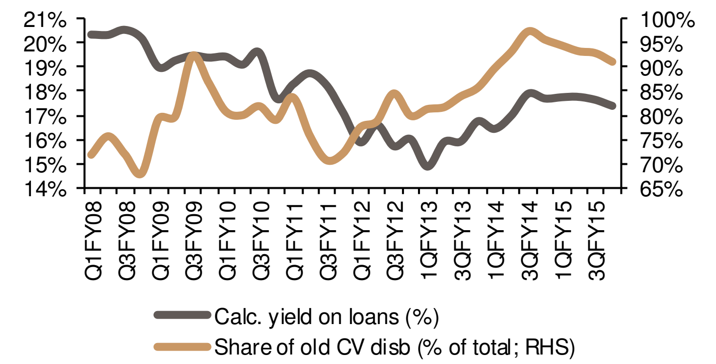


Source: Company, Emkay Research

Multiple headwinds to NIMs persist

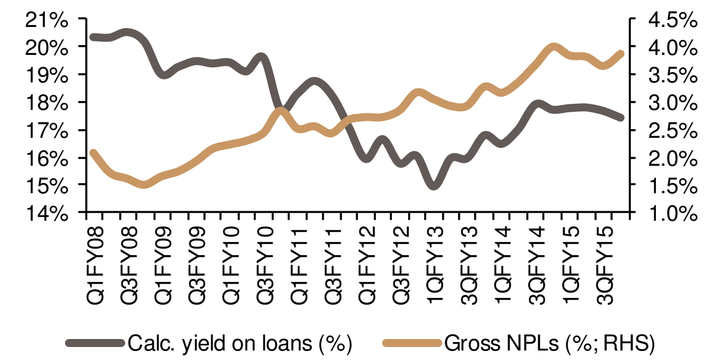
Over the past few quarters, SHTF's reported NIMs have shown qoq improvement as it cumulatively expanded by 21bp in 4QFY15 over the quarter a year ago. This could be on the back of stabilization in securitization spreads and more than 90% of incremental disbursements in the high-yielding used CV segment. However, the improvement may not be sustainable in our view, despite falling interest rates, as 1) increase in interest income de-recognition as the company migrates to 90-dpd NPL recognition *(refer exhibit 137)* and 2) about 93% of disbursements in FY15 were in the high-yielding used vehicles segment, which is at a historical high *(refer exhibit 136)*. As the share of new CVs in the disbursements starts picking up there could be downward pressure on margins. The recent rating upgrade by CRISIL should provide some cushion to margins, but in our view, SHTF may find it challenging to maintain a fine balance between growth and margins.

Exhibit 136: Movement in loan yields vs. disbursements in used CVs



Source: Company, Emkay Research

Exhibit 137: Movement in loan yields vs. gross NPLs

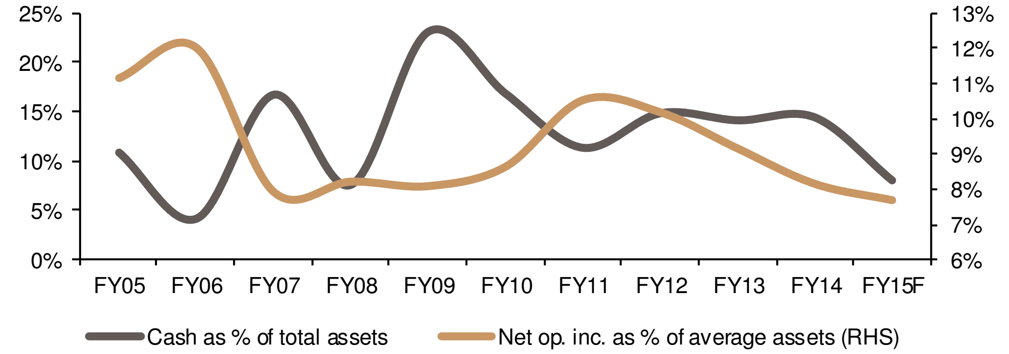


Source: Company, Emkay Research

Cash balance on balance sheet at multi-year lows

Besides this, SHTF's NIMs are also affected by the liquidity it maintains on its balance sheet. Historically, SHTF has maintained higher cash balances on its balance sheet due to higher share of securitized (off-balance sheet) loans. However, post the revised securitization norms, the share of off-BS AUMs has fallen and so have the cash balances. We believe this too is one of the factors impacting its NIMs *(refer exhibit 138)*.

Exhibit 138: Movement in net operating margins vs. cash balances on balance sheet



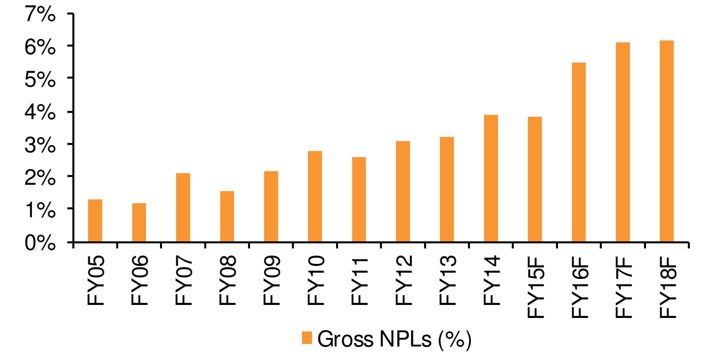
Source: Company, Emkay Research

Regulatory changes to keep credit costs at elevated levels

Over the past 12 quarters, SHTF's gross NPLs have grown at a CQGR of 8.7%, but %GNPL rose from 3.2% to 3.8% during the same period. This was due to cumulative loan write-offs of over 6% during the same period. This could be mainly attributed to the fact that the NBFCs aggressively write-off bad loans and this is a part of their business model.

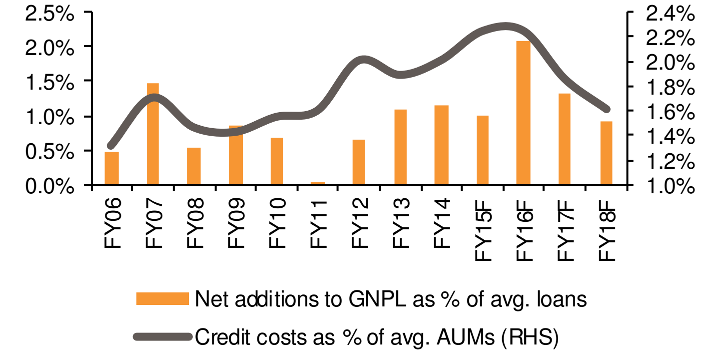
Under the new regulatory framework, we expect fresh delinquencies to rise as SHTF migrates from 180-dpd to 90-dpd NPL recognition. While the provision coverage ratio at 80% may provide some cushion, with aggressive write-off policy, we expect credit costs to remain elevated during FY15-18E period *(refer exhibits 139, 140)*.

Exhibit 139: Gross NPLs likely to rise under new regulatory regime



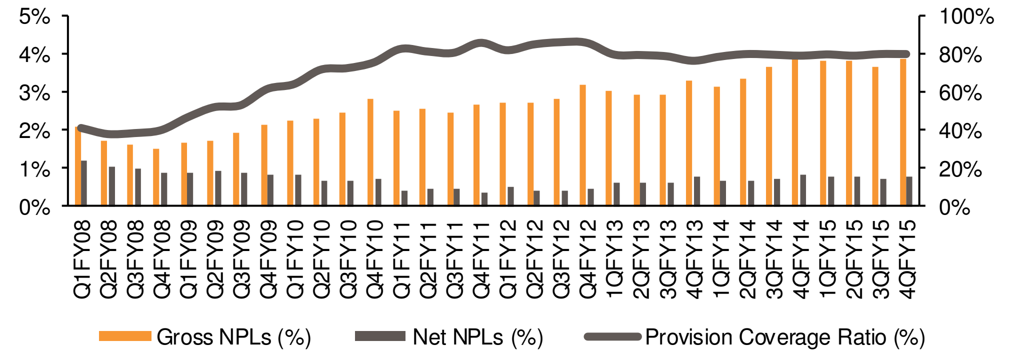
Source: Company, Emkay Research

Exhibit 140: Credit costs likely to remain at elevated levels



Source: Company, Emkay Research

Exhibit 141: Trend in non-performing loans and provision coverage ratio (%)



Source: Company, Emkay Research

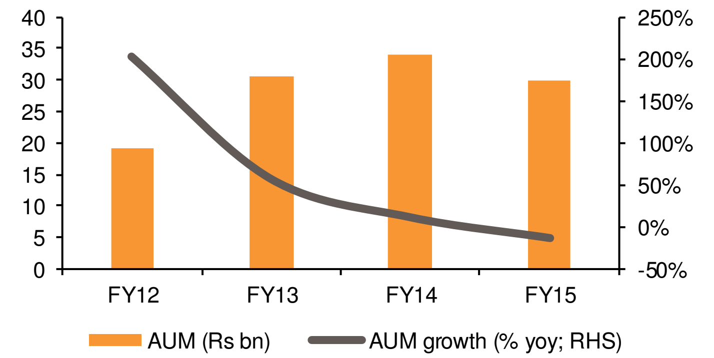
SEF merger to remain an overhang

In a surprising move, SHTF board approved the merger of Shriram Equipment Finance (SEF), a wholly owned equipment financing subsidiary, with itself. The rationale for the merger was better control over the business, which is reeling under severe asset quality pressure. In 4QFY15, SEF witnessed a sharp jump in its NPLs as gross NPLs stood at ~15% levels *(refer exhibit 143)*. The spike in asset quality was unexpected and is worrisome. Besides the management guided for additional Rs4bn worth loans turning bad in 1QFY16, provided it were to migrate to the 150-dpd NPL recognition.

In our view, though SEF constitutes <5% of SHTF's consolidated AUMs *(refer exhibit 142)*, the asset quality issues may act as an overhang on the stock. The recovery process in this business is likely to remain slow, given slower activity on the ground as indicated by the management and also based on our interactions with the industry participants.

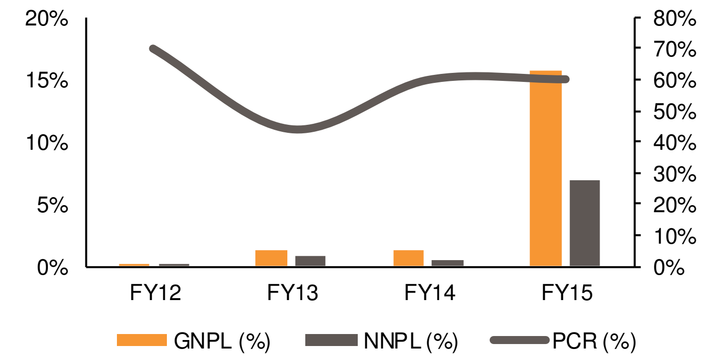
We currently do not factor in any impact of the merger in our estimates.

Exhibit 142: AUM growth in SEF has moderated sharply



Source: Company, Emkay Research

Exhibit 143: Asset quality trend for SEF



Source: Company, Emkay Research

Valuation and outlook

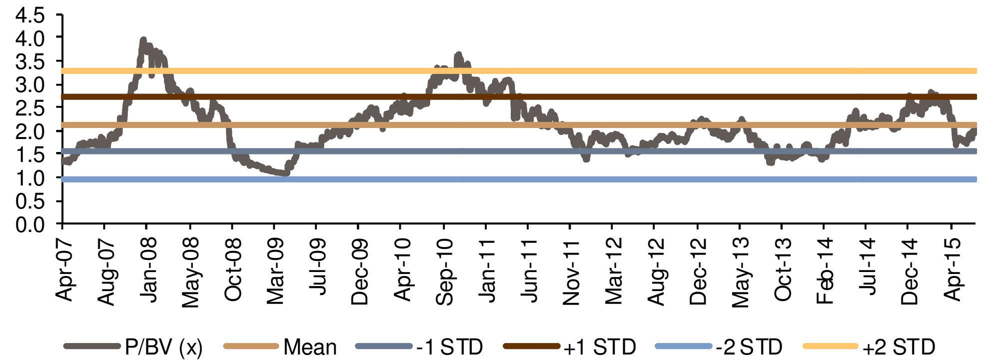
SHTF trades at 1.8x FY17E BV, close to its long period average valuations. However, we believe SHTF's valuation re-rating back to earlier levels looks challenging given 1) the return ratios are likely to remain subdued, led by pressure on NIMs and high credit costs and 2) looming uncertainty over the SEF issue. We initiate coverage with a SELL rating and target price of Rs771 (based on the residual income model). As at end-Mar 2015, SEF constituted 4.8% of SHTF's consolidated AUMs and negatively contributed to FY15 consolidated earnings. We currently do not factor in the impact of merger into our estimates.

Exhibit 144: Key financials

Shriram Transport Finance	FY15	FY16E	FY17E	FY18E	CAGR (%)
ROAA	2.3%	2.1%	2.2%	2.3%	
ROAE	14.1%	13.4%	14.6%	15.5%	
EPS (Rs)	54.6	57.5	69.8	84.2	15.6%
P/E (x)	17.2	16.3	13.5	11.2	
BV (Rs)	407.1	451.8	507.5	576.5	12.3%
P/BV (x)	2.3	2.1	1.9	1.6	
ABV (Rs)	390.4	406.7	441.8	498.2	8.5%
P/ABV (x)	2.4	2.3	2.1	1.9	

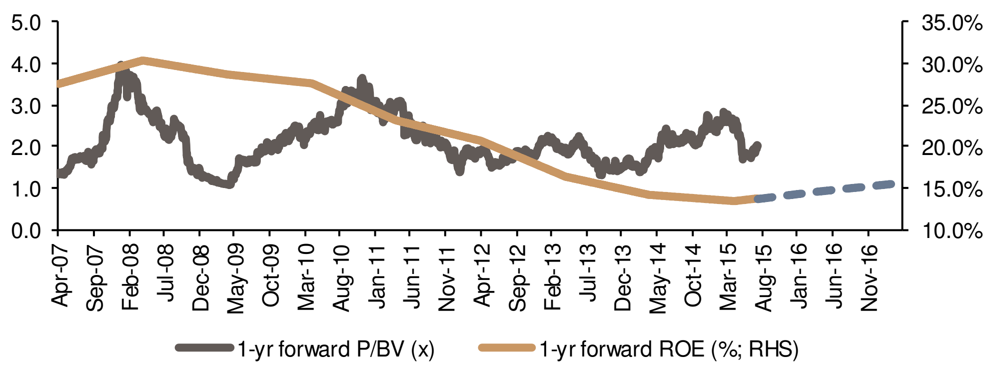
Source: Company, Emkay Research

Exhibit 145: SHTF: 1-yr forward P/BV (x)



Source: Company, Bloomberg, Emkay Research

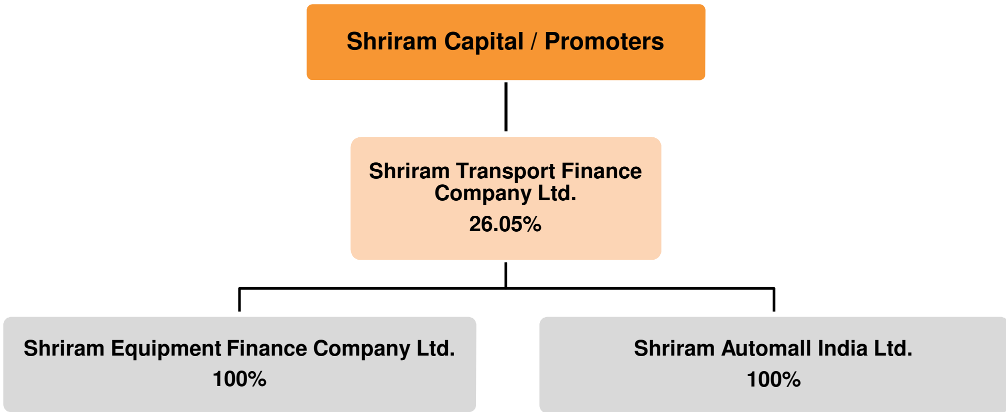
Exhibit 146: SHTF: 1-yr forward P/BV (x) vs. 1-yr forward ROE (%)



Source: Company, Bloomberg, Emkay Research

Annexure

Exhibit 147: SHTF: Company structure



Source: Company, Emkay Research

Exhibit 148: SHTF: Key shareholders (as on Mar-15)

Name of the shareholder	% holding
Promoters & promoter group	26.1%
PHL Capital	10.0%
Sanlam Life Insurance	3.0%
Centaura Investments	2.0%
Stichting Pensioen fonds	1.8%
Small Cap World Fund	1.6%
Ontario Teacher's Pension Fund	1.2%
Govemment Of Singapore	1.1%
Vanguard	1.0%
Abu Dhabi Investment Authority	1.0%
Merrill Lynch Capital	1.0%

Source: BSE filings, Emkay Research

Key Financials (Standalone)

Income Statement

Y/E Mar (Rs mn)	FY14	FY15	FY16E	FY17E	FY18E
Net interest income	**33,759**	**37,439**	**41,494**	**46,344**	**52,983**
Other income	**4,651**	**4,397**	**4,572**	**5,029**	**5,824**
Fee income	0	0	0	0	0
Net income	**38,410**	**41,836**	**46,066**	**51,373**	**58,807**
Operating expenses	9,789	10,783	12,510	14,633	17,295
Pre provision profit	**28,621**	**31,054**	**33,556**	**36,739**	**41,512**
PPP excl treasury	**28,621**	**31,054**	**33,556**	**36,739**	**41,512**
Provisions	10,340	12,630	14,080	13,092	13,007
Profit before tax	**18,280**	**18,424**	**19,476**	**23,647**	**28,505**
Tax	5,638	6,046	6,427	7,804	9,407
Tax rate	31	33	33	33	33
Profit after tax	**12,642**	**12,378**	**13,049**	**15,844**	**19,098**

Balance Sheet

Y/E Mar (Rs mn)	FY14	FY15	FY16E	FY17E	FY18E
Equity	2,269	2,269	2,269	2,269	2,269
Reserves	80,463	90,111	100,239	112,897	128,544
Net worth	**82,732**	**92,380**	**102,509**	**115,167**	**130,813**
Deposits	0	0	0	0	0
Borrowings	359,246	442,800	497,781	564,527	649,716
Total liabilities	**492,257**	**593,272**	**669,771**	**759,309**	**871,767**
Cash and bank	70,860	47,234	64,801	72,147	80,029
Investments	27,253	33,272	39,823	45,162	51,977
Loans	388,882	492,271	541,067	613,616	706,213
Others	4,256	19,487	22,872	26,933	31,807
Total assets	**492,257**	**593,272**	**669,771**	**759,309**	**871,767**

Key Ratios (%)

Y/E Year End	FY14	FY15	FY16E	FY17E	FY18E
NIM	6.6	6.7	6.6	6.6	6.6
RoA	2.7	2.3	2.1	2.2	2.3
RoAE	16.3	14.1	13.4	14.6	15.5
GNPA (%)	3.7	3.8	5.5	6.1	6.2
NNPA (%)	0.8	0.8	1.9	2.4	2.5

Per Share Data (Rs)	FY14	FY15	FY16E	FY17E	FY18E
EPS	55.7	54.6	57.5	69.8	84.2
BVPS	364.6	407.1	451.8	507.5	576.5
ABVPS	351.3	390.4	406.7	441.8	498.2
DPS	7.0	10.0	11.0	12.0	13.0

Valuations (x)	FY14	FY15	FY16E	FY17E	FY18E
PER	16.9	17.2	16.3	13.5	11.2
P/BV	2.6	2.3	2.1	1.9	1.6
P/ABV	2.7	2.4	2.3	2.1	1.9
Dividend Yield (%)	0.7	1.1	1.2	1.3	1.4

Growth (%)	FY14	FY15	FY16E	FY17E	FY18E
NII	(2.4)	10.9	10.8	11.7	14.3
PPOP	(0.2)	8.5	8.1	9.5	13.0
PAT	(7.1)	(2.1)	5.4	21.4	20.5
Loans	13.2	26.6	9.9	13.4	15.1

Quarterly (Rs mn)	Q4FY14	Q1FY15	Q2FY15	Q3FY15	Q4FY15
NII	9,205	9,676	10,072	10,528	10,854
NIM(%)	6.9	7.2	7.3	7.5	7.5
PPOP	6,900	7,398	7,660	7,973	8,023
PAT	2,950	3,064	3,022	3,125	3,167
EPS (Rs)	13.00	13.50	13.32	13.77	13.96

Shareholding Pattern (%)	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Promoters	26.1	26.1	26.1	26.1	26.1
FIIs	53.9	53.2	52.4	51.1	51.2
DIIs	1.0	2.0	3.4	4.3	4.2
Public and Others	19.0	18.7	18.3	18.6	18.6

Emkay Rating Distribution

BUY	Expected total return (%) (Stock price appreciation and dividend yield) of over 25% within the next 12-18 months.
ACCUMULATE	Expected total return (%) (Stock price appreciation and dividend yield) of over 10% within the next 12-18 months.
HOLD	Expected total return (%) (Stock price appreciation and dividend yield) of upto 10% within the next 12-18 months.
REDUCE	Expected total return (%) (Stock price depreciation) of upto (-) 10% within the next 12-18 months.
SELL	The stock is believed to underperform the broad market indices or its related universe within the next 12-18 months.

Emkay Global Financial Services Ltd.
CIN - L67120MH1995PLC084899
7th Floor, The Ruby, Senapati Bapat Marg, Dadar - West, Mumbai - 400028. India
Tel: +91 22 66121212 Fax: +91 22 66121299 Web: www.emkayglobal.com