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Values that bind

India NBFC Sector
March 2015

CV lenders: Gearing up for a joyride

– BUY SHTF, CIFC, SCUF

25 March 2015

India NBFCs

CV lenders: Gearing up for a joyride

We believe that the worst cycle for CV/CE lenders in the last 20 years is coming to an end. A strong cyclical upturn coupled with lower fuel and funding costs could turn FY17 into a bumper year. SHTF is our top pick in the sector; we also initiate coverage on CIFC and SCUF with BUY ratings. We believe rural/semi-urban auto (ex-CV) lenders are in mid-downcycle and their profitability is likely to remain under pressure – maintain HOLD on MMFS.

- **FY17 a potential bumper year for CV/CE lenders:** We believe the cyclical upturn in the CV industry has already begun and will last for another 3-4 years. Recovery in demand, asset quality and margins could be sharper for NBFCs this time around given that CV volumes were severely affected in the last 2-3 years. As the CV recovery gathers pace, we expect FY17 to be a bumper year for CV/CE (commercial vehicle/construction equipment) lenders.

  Disbursement growth is likely to be much higher than volume growth as we expect a gradual reduction in discounts, increase in LTVs and higher churning of older vehicles over the next 2-3 years (refer chart alongside). Further, we expect steady improvement in margins and credit cost for the next 3-4 years, which will support high profit growth for CV/CE lenders (SHTF and CIFC).

- **NBFCs to benefit from lower fuel & funding costs:** In FY13 and FY14, CV utilisation levels dropped by 30-40%, resulting in a sharp reduction in freight rate at a time when fuel cost (~50% of operating cost) was going up. Fuel cost has declined by ~15% in the last six months. Benign fuel cost will benefit CV operators as and when utilisation levels start improving. This apart, the cost of borrowings through the wholesale market is already down by ~150bps. We expect banks to cut lending rates in FY16, thereby reducing the cost of funds further for NBFCs (banks account for 40-45% of NBFC borrowings) and aiding margins.

- **NBFCs with strong NPA coverage to sail through regulatory changes:** Our coverage NBFCs are well above the proposed tier 1 capital requirement of 10% under the new RBI norms. NBFCs have also been given considerable time to comply with 90-DPD norms. We believe that these companies will lower their coverage ratio without taking a hit on profitability. Despite a lower coverage ratio, we will continue to ascribe target price multiples on book value as there will be no change in cash flow and overall profitability on this account.

- **How to play the sector?** SHTF is our top pick (BUY, TP Rs 1,500) due to its strong presence in the high-margin used CV market, robust capitalisation and high NPA coverage. We also initiate coverage on CIFC (TP Rs 775) and SCUF (TP Rs 2,300) with BUY ratings. Maintain HOLD on MMFS (TP Rs 250) due to cyclical pressure in the medium term and expensive valuations.

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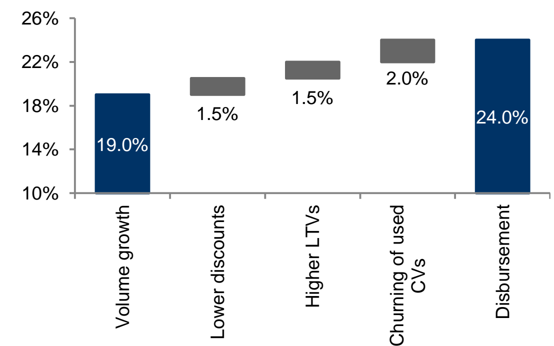
COMPANY	TICKER	CMP (Rs)	TP (Rs)	REC
Shriram Transport	SHTF IN	1,161	1,500	BUY
Mahindra Finance	MMFS IN	263	250	HOLD
Chola Finance	CIFC IN	571	775	BUY
Shriram City Union	SCUF IN	1,887	2,300	BUY
SREI Infrastructure	SREI IN	43	NA	NR

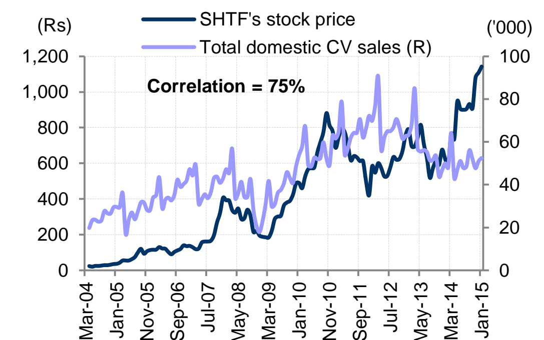
NR – Not Rated

Disbursement growth will be 500bps higher than volume growth over FY15-FY18E



Source: RCML Research

Strong correlation of SHTF with CV sales



Source: SIAM, Bloomberg, RCML Research

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Valuation and Financial snapshot

Fig 1 - Valuations

Companies	CMP (Rs)	TP (Rs)	Upside (%)	EPS (Rs)			BV (Rs)			PE (x)			PBV (x)		
				FY15E	FY16E	FY17E	FY15E	FY16E	FY17E	FY15E	FY16E	FY17E	FY15E	FY16E	FY17E
Shriram Transport Finance	1,161	1,500	29.2	59.1	76.3	100.0	415.4	479.4	563.4	19.7	15.2	11.6	2.8	2.4	2.1
Mahindra Finance	263	250	(4.8)	15.1	17.8	21.4	105.6	119.3	135.8	17.3	14.7	12.3	2.5	2.2	1.9
Chola Finance	571	775	35.7	28.7	35.3	47.3	184.5	232.7	275.0	19.9	16.2	12.1	3.1	2.5	2.1
Shriram City Union	1,887	2,300	21.9	90.8	111.7	132.3	634.5	734.5	855.1	20.8	16.9	14.3	3.0	2.6	2.2

Source: Company, RCML Research

Fig 2 - Key ratios

Companies	EPS growth (%)			NIM (%)			RoA (%)			RoE (%)		
	FY15E	FY16E	FY17E	FY15E	FY16E	FY17E	FY15E	FY16E	FY17E	FY15E	FY16E	FY17E
Shriram Transport Finance	6.0	29.1	31.1	6.5	6.9	6.9	2.5	2.8	3.3	15.1	17.0	19.2
Mahindra Finance	(10.6)	17.7	20.0	8.4	8.5	8.7	2.4	2.6	2.9	15.2	15.8	16.8
Chola Finance	13.1	22.9	33.8	6.9	7.1	7.4	1.8	2.1	2.4	16.7	17.5	18.6
Shriram City Union	0.0	23.0	18.5	13.1	13.7	13.6	3.2	3.6	3.7	16.1	16.3	16.6

Source: Company, RCML Research

India NBFCs

CV lenders: Gearing up for a joyride

Sector Report

INDIA

NBFC

Worst cycle ever drawing to an end

We believe that the worst cycle for CV/CE lenders in the last 20 years is coming to an end. Our Auto analyst expects a robust ~20% CAGR in CV volumes over FY15-FY17 given (1) the ongoing macro recovery, (2) the cyclical nature of CV demand where sales dip sharply (dropping more than the automobile industry) during an economic slowdown and pick up swiftly during the ensuing cyclical recovery, (3) a softer interest rate environment (90-100% of CV purchases are financed, per our dealer check), (4) the recent lifting of mining restrictions along with stricter safety norms which will lead to an increase in transport loads and (5) GST implementation which will support demand for newer, faster vehicles.

We expect 20% CAGR in M&HCV volumes in FY15-FY17 as the economy gathers steam

(Read our recent CV report – India Automobiles: Wheels of fortune – BUY AL, TTMT)

Massive decline in CV volumes in FY13/FY14

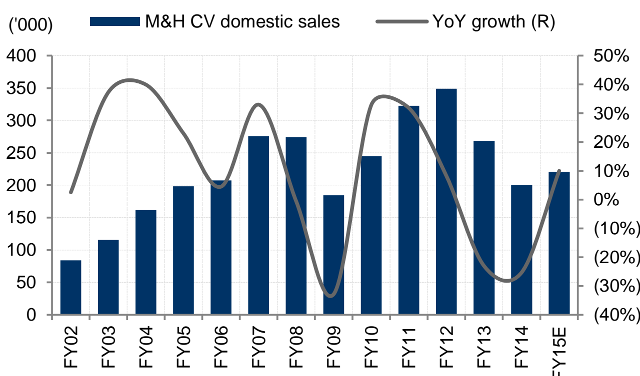
In FY10 and FY11, M&HCV volumes (domestic) grew at a healthy rate of ~32%. M&HCVs grew a further 10% in FY12 on the higher base of FY11. This created a lot of latent capacity in the industry in the hope of a strong investment climate, robust GDP growth and better manufacturing activities.

But India's economy failed to deliver and M&HCV sales dropped 23% in FY13 and 25% in FY14 – two consecutive years of sharp decline seen for the first time since FY01. This was mainly because players created excessive capacity in anticipation of robust GDP/ manufacturing activity. Our Auto analyst (Mihir Jhaveri) expects a recovery to ~10% growth in FY15 led by the lower base of last year and higher sales to large fleet operators.

LCV volumes (domestic) grew at a better rate in FY12/FY13, primarily led by consumption demand and a buoyant rural economy. Thereafter, with a slowdown in the overall economy, LCV volumes too dropped 18% in FY14 and are likely to register a decline of ~12% in FY15. Future prospects are brighter with many operators now expecting LCV volumes to follow the M&HCV path and show improvement from H2FY16 onwards.

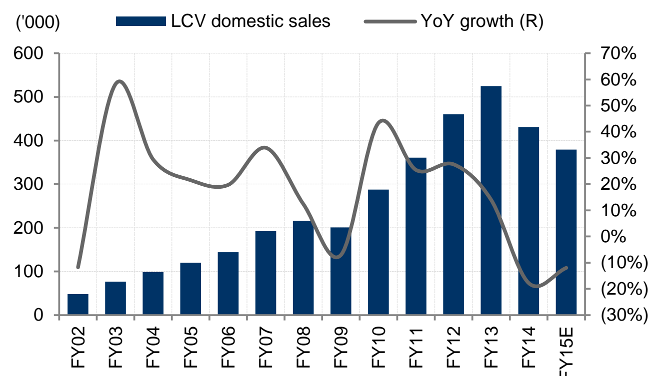
CV volumes were down sharply in FY12-FY14 on weak economic growth

Fig 3 - M&HCV sales down sharply in FY13/FY14



Source: SIAM, RCML Research

Fig 4 - LCV volumes declined in FY14/FY15E



Source: SIAM, RCML Research

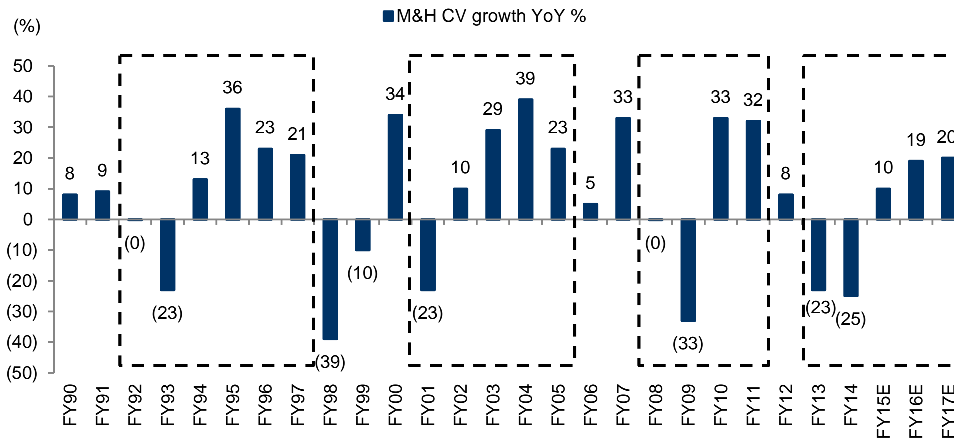
We believe a demand recovery in the LCV segment, which is currently affected by low transportation tonnage, vehicle over-capacity and a constrained financing environment, will follow through as the macro recovery deepens and demand for overall cargo improves. While FY15 will remain depressed for the segment (~12% volume decline), our Auto analyst is modeling for 14%/16% growth in FY16/FY17.

Cyclical nature of demand suggests recovery ahead

CV volume growth being cyclical in nature has historically exhibited sharp demand growth and decline patterns. A year (or two) of decline is generally followed by high double-digit growth in the segment. Accordingly, following the steep 43% correction in MHCV volumes over FY12-FY14 (~25% drop each in FY13 & FY14), we expect a sharp recovery in the segment over FY15-FY17.

Demand slump in CVs is typically followed by high double-digit growth as pent-up demand unwinds

Fig 5 - Periods of steep decline in MHCV vols. are generally followed by sharp pickup

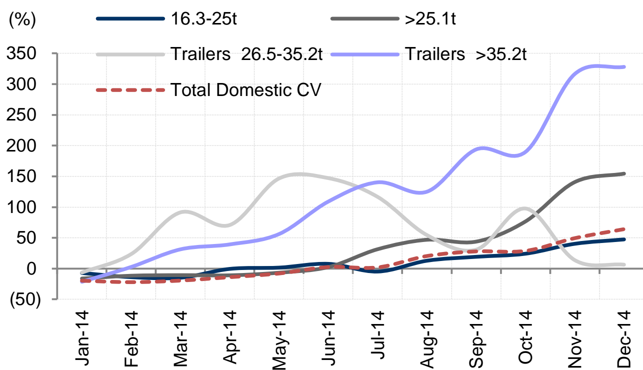


Source: SIAM, RCML Research

Higher tonnage MHCVs taking the lead, reflecting increased industrial activity

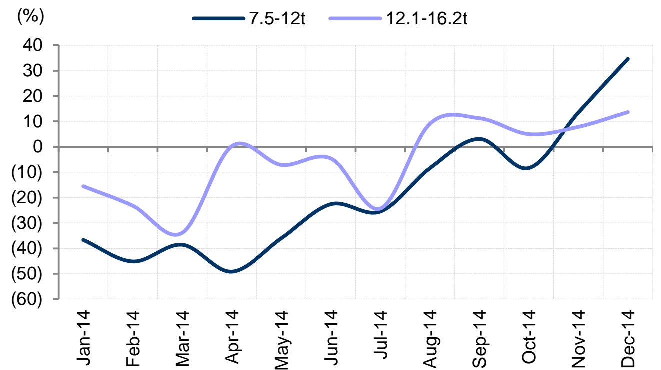
Early trends suggest that volumes in the higher tonnage segment have rebooted sharply. Our dealer interactions indicate that this can be attributed to a pick-up in the construction segment (mainly roads), where higher tonnage vehicles are used. This also possibly reflects the shift in demand over the last few years from 12-16t vehicles to >25t multi-axle vehicles (MAV) – MAV trailers are preferred for transporting heavy capital goods and automobiles, among others, while tippers are used for the mining industry.

Fig 6 - Domestic MHCV growth led by higher tonnage (>16t) segment…



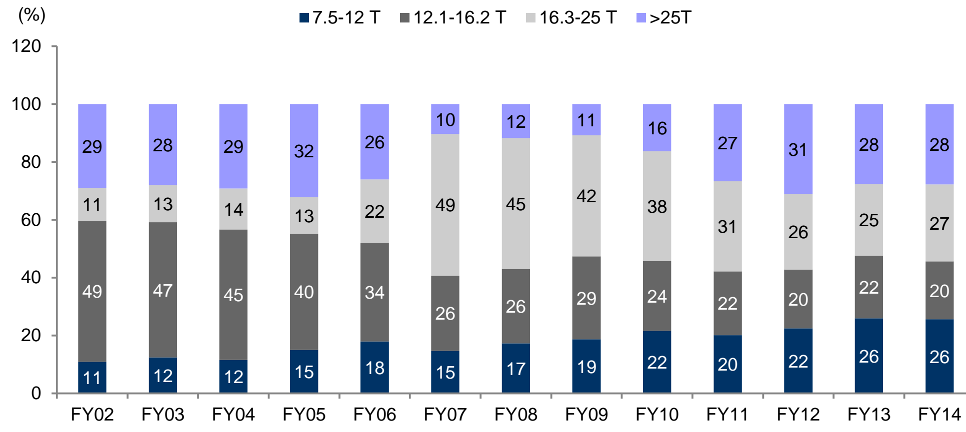
Source: SIAM, RCML Research

Fig 7 - …growth in lower tonnage (<16t) segments also following suit



Source: SIAM, RCML Research

Fig 8 - Share of >25t segment has increased over the past 4-5 years



Segment	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
>25T	29	28	29	32	26	10	12	11	16	27	31	28	28
16.3-25 T	11	13	14	13	22	49	45	42	38	31	26	25	27
12.1-16.2 T	49	47	45	40	34	26	26	29	24	22	20	22	20
7.5-12 T	11	12	12	15	18	15	17	19	22	20	22	26	26

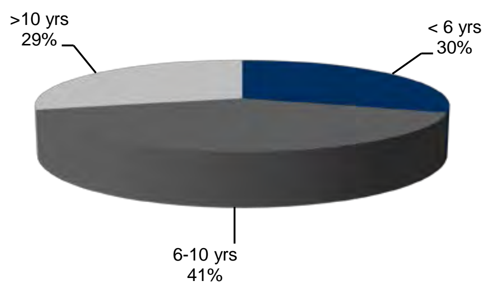
Source: SIAM, RCML Research

Plenty of pent-up replacement demand

We believe replacement demand will provide a kicker to volume growth as the number of CVs sold in the last two years is only a tenth of those running on road – our Auto analyst's rough cut analysis suggests that there are ~4.5mn CVs running in India and if we consider a 15-year lifecycle, then ~0.29mn vehicles should be replaced per year. Over the last two years, CV sales averaged only 0.23mn, reflecting massive pent-up demand in the replacement market. Dealer checks also suggest that the on-ground improvement in demand has indeed been from the replacement side. We believe this trend will only strengthen and will also slowly percolate into the lower tonnage and LCV segments as industrial activity moves up.

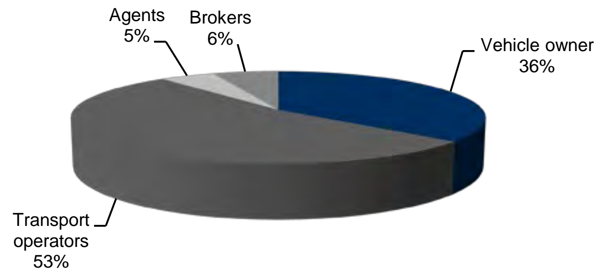
CVs sold in the last 2-3 years only a tenth of those running on road, reflecting high replacement potential

Fig 9 - Vehicle age for the trucking industry



Source: Ministry of Road, Transport, Highway (2010 report), RCML Research

Fig 10 - Organisational structure in terms of ownership



Source: Ministry of Road, Transport, Highway (2010 report),RCML Research

Restrictions on truck overloading, vehicle age to create incremental demand

Both central and state governments have started to become more stringent about adherence to cargo load restrictions, which should lead to the sale of more vehicles. Fleet operators normally overload trucks in order to improve the profitability per trip (even though this reduces the efficiency/mileage of the vehicle, hurting profitability in the long run). Strict government oversight on truck overloading will force operators to run more vehicles for the same cargo load, and thus create incremental demand.

In line with the government's focus on increased road safety, we could see the implementation of norms on maximum vehicle age. Currently, CVs older than 8 years are not allowed to run in the four metro cities of Mumbai, Delhi, Kolkata and Chennai. There are virtually no norms in other states and fleet operators continue to run their vehicles for as long as 30 years. Any vehicle age regulations in non-metros would lead to a surge in replacement demand.

GST implementation could add a new dimension to demand

After innumerable delays, the new Modi Govt. has indicated its firm intent to implement GST (goods & service tax) by Apr'16. GST implementation would result in removal of individual state tax, octroi and toll checkposts, thereby raising the turnaround time of transport vehicles and increasing demand for newer, faster vehicles to enhance efficiency. The overall faster movement of vehicles (to an estimated 350km per day from 250km now) will also result in a shorter replacement cycle as wear and tear increases.

NBFC consolidation phase to take 6-9 months

Although a turnaround in the CV industry has begun, it will take some time for CV lenders, especially NBFCs, to start benefiting from the same. Fleet operators, dealers and CV lenders (NBFCs) are indicating that volumes/asset quality trends have bottomed out in the last 5-6 months and are largely stable currently. This is mainly due to expectations of a GDP recovery in the next one year. However, the improvement is not broad-based enough to help NBFCs which largely cater to First Time Users (FTU) and Single Road Transport Operators (SRTO).

Disbursement trends for FTUs/SRTOs still very sluggish

Many dealers/financiers in Southern India are doing a third of their peak capacity in sales/disbursements currently. In Western India (especially Goa), volumes are down by 40-50%. Disbursement trends are unlikely to improve meaningfully in the next 6-9 months due to the absence of demand from many industries. At best, disbursement may pick up materially only post Q2FY16 if the government announces new road/port projects and private sector capex picks up by Q2/Q3FY16.

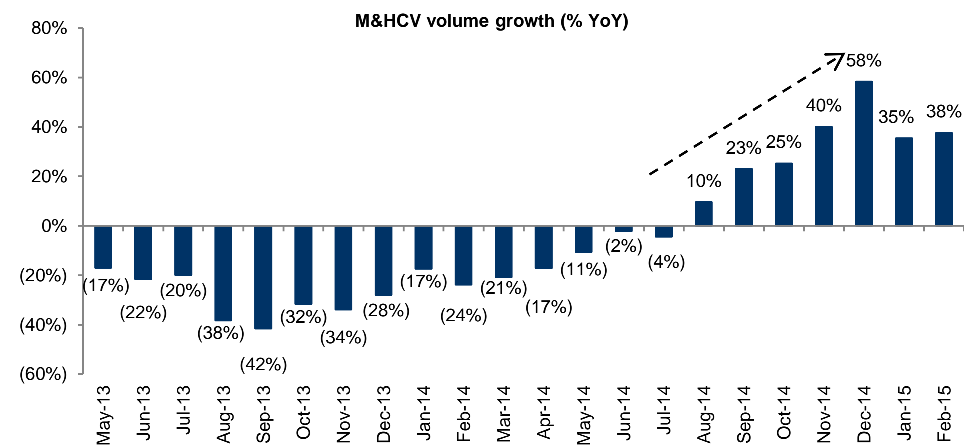
Recent uptick in M&HCV sales is not broad-based

M&HCV sales have risen 30-40%+ YoY in the last four months on a very low base of last year. However, dealers and operators suggest that sales are highly skewed in favour of large fleet operators, rather than FTUs or SRTOs. These operators are buying due to multiple reasons, mainly:

1. Demand from specific sectors such as cement and auto (particularly Maruti Suzuki) is very strong. Large cement and auto companies don't give business to fleet operators if the fleet used for transportation is very old. Therefore, large fleet operators are adding capacity as the business pipeline from cement/auto players remains strong.

2. There is a general belief in the market that discounts will narrow in coming months as sales improve and therefore price-sensitive buying by large cash-rich operators is also being seen.

Fig 11 - Recent surge in M&HCV demand is highly skewed towards large fleet operators

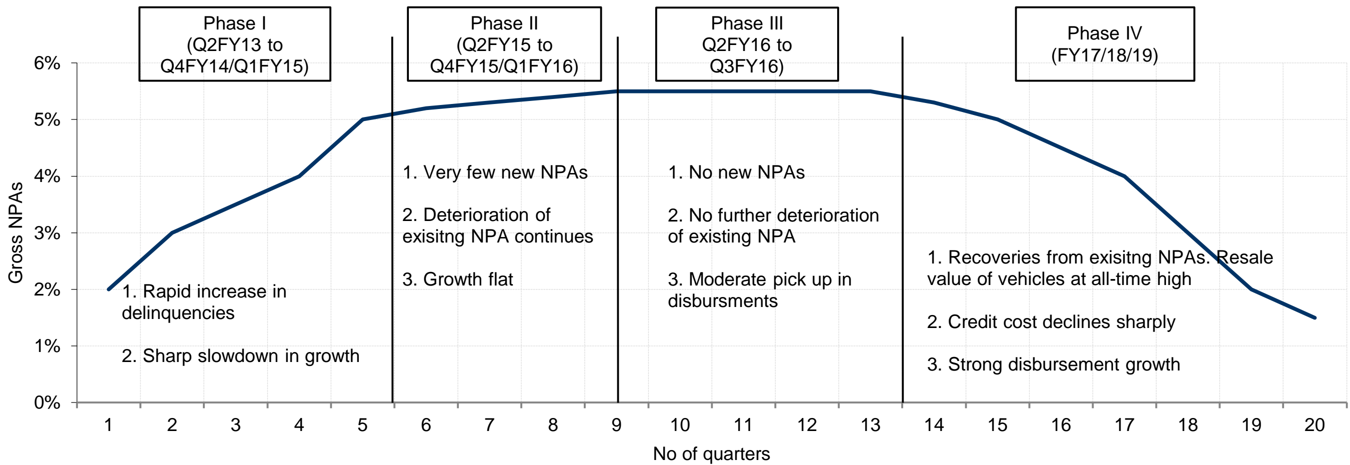


Source: SIAM, RCML Research

FTUs/SRTOs aren't participating in the market yet as recovery is not broad-based

FTUs and SRTOs are not buying currently due to idle capacity. Fleet operators generally borrow from the top 2-3 private sector banks in India and therefore the recent uptick is unlikely to show in the disbursement numbers of NBFCs. Industry players (operators, branch managers of NBFCs, dealers) indicate that HDFC Bank is doing very well with large fleet operators in terms of incremental disbursements and asset quality.

Fig 12 - Consolidation phase will last till Q2-Q3FY16



Source: Company, RCML Research

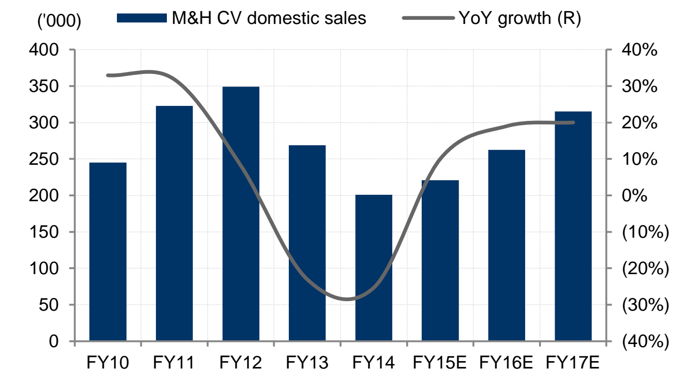
Players pointed out that FTUs/SRTOs do not buy vehicles on sentiment and tend to be more cautious at the beginning of any upward cycle (more so due to recent losses). So far, all we've seen are announcements and intentions proffered by the new government – while these are positive they do not translate into buying decisions as CV operators are still awaiting concrete contracts/orders (revenue visibility for at least 1-2 years).

Consolidation phase for CV operators and lenders to last till Q2-Q3FY16

FY17 a potential bumper year for CV/CE lenders

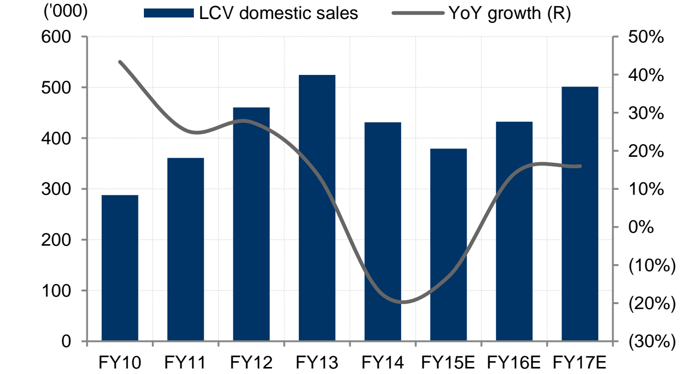
We expect the CV recovery to gather pace over the next two years, with a sharp rebound in late FY16/FY17. Recovery in demand, asset quality and margins could be sharper for NBFCs this time around given that CV volumes were severely affected in the last 2-3 years. Disbursement growth is likely to be much higher than volume growth as we expect a gradual reduction in discounts, increase in LTVs and higher churning of older vehicles over the next 2-3 years.

Fig 13 - M&HCVs likely to grow at ~20% in FY16/FY17



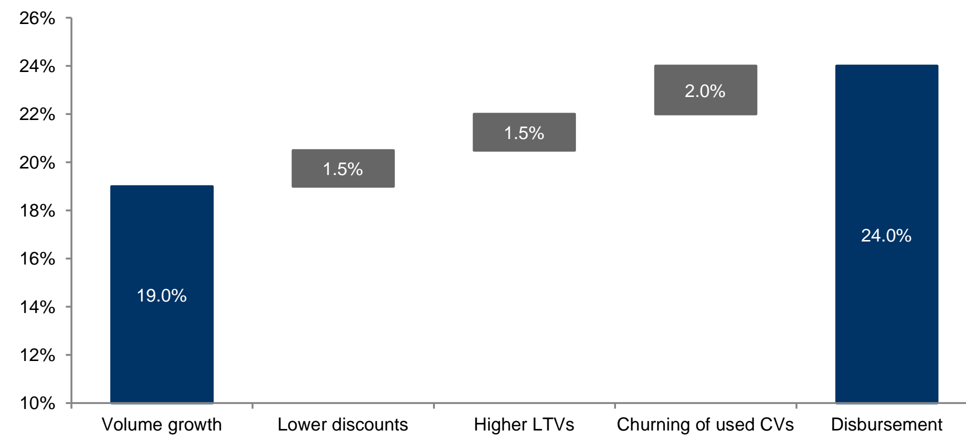
Source: SIAM, RCML Research

Fig 14 - LCV volumes likely to grow at 14-16% in FY16/FY17



Source: SIAM, RCML Research

Fig 15 - NBFC disbursements to grow at 24% CAGR over FY15-FY18



Source: RCML Research, Company

Overall disbursement growth is likely to be ~500bps higher than CV volume growth

NBFC disbursal growth to outpace new CV volume growth

- **Higher volumes to support ~19% CAGR for NBFCs over FY15-FY17E:** Our Auto analyst expects new LCV and M&HCV sales to register 15% and 20% growth respectively over FY15-FY17. This will be directly reflected in disbursements of CV lenders. On an average, M&HCV value (price) is ~5 times higher than LCV value. In addition, our coverage NBFCs have a higher share in M&HCV volumes while LCV loans in the market are dominated by captive financiers. Therefore, a 20% CAGR in M&HCV volumes and 16% in LCV volumes (as projected by our Auto analyst) can translate into ~19% CAGR in for NBFCs.

- **Pricing to improve by ~5% as discounts narrow:** Currently, CV manufacturers are offering high discounts to push sales and therefore disbursements on a like-to-like basis (same volume numbers) have declined. Regional/branch offices of CV lenders indicate that they have lost 5-7% of disbursements (~10% since the peak of the last

cycle in FY08) in the last two years due to high discounts. We don't expect discounts to disappear completely but a reduction in discounts can support a 5% increase in disbursements over the next three years.

- **LTV can increase with economic recovery:** Large and experienced lenders have cut their LTV by 5-7% in the last two years in order to check increasing delinquencies. We expect LTVs to increase gradually from FY16 onwards which in turn will support disbursement growth.

- **Higher churning and better pricing of older vehicles to support disbursement further:** Resale prices of vehicles have corrected sharply in the last two years due to idle capacity. Younger vintage vehicles are at a steep discount to newer vehicles. The resale market is dominated by brokers and prices are determined by factors such as urgency to close loans, fear of further deterioration in prices, and availability versus demand for vehicles. Prices are generally more depressed in an economic downturn and recover rapidly once there is a broad-based recovery.

  In addition, many SRTOs are holding back their replacement demand as revenue visibility is still very poor. Players indicate that they are stretching the use of existing vehicles even though these require replacement. Such buyers are likely to come back in a big way once recovery gathers pace from Q3-Q4FY16 onwards. We expect higher churning of used vehicles will support a further 2% rise in disbursement for the next three years (taking incremental disbursals up 6-8% including the discount impact).

Higher churning and lower discounts could take incremental disbursals up 6-8% by FY17/18

Benefits from lower fuel and funding cost

Fuel cost has fallen ~15% in the last six months which will benefit CV operators as and when utilisation levels start improving. This apart, the cost of wholesale market borrowings is already down by ~150bps. We expect banks to cut lending rates in FY16, thereby further reducing the cost of funds for NBFCs.

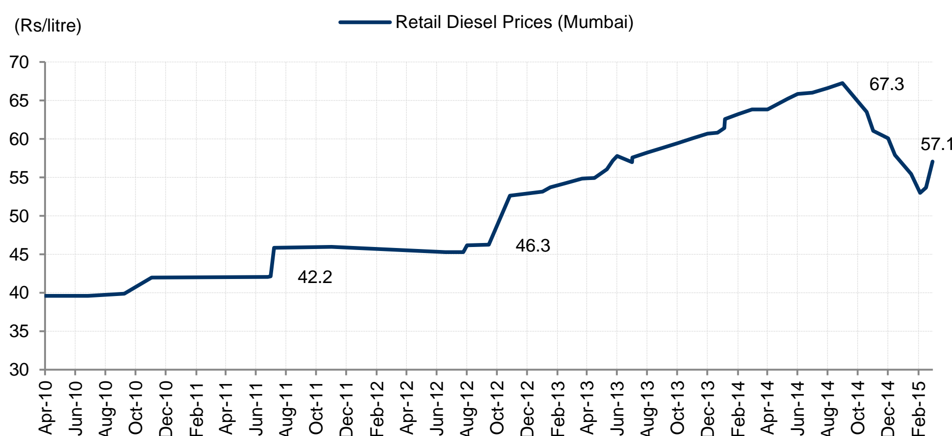
Lower fuel cost to benefit CV operators

Diesel prices went up by 21% in FY13 and 16% in FY14. During this period, CV utilisation levels dropped by 30-40%, resulting in a sharp reduction in freight rate at a time when the fuel cost (~50% of operating cost) was going up. In the last six months fuel cost has declined by ~15% due to diesel price deregulation.

Although freight rates have also come off partially as there is plenty of excess capacity, benign fuel costs will definitely help CV operators as and when utilisation levels start to improve.

Lower fuel cost will benefit CV operators as and when utilisation picks up

Fig 16 - Fuel cost for CV operators has declined by ~15% in the last six months



Source: IOCL (diesel prices – Mumbai) RCML Research

We note that there is a very limited correlation between CV utilisation rate and fuel cost. CV utilisation is instead correlated with industrial activity and GDP growth. We are expecting GDP growth and industrial activity to pick up going forward. At this time, lower fuel cost will reduce operating costs for CV operators and thus improve their profitability.

CV operators have stated that if freight rates don't correct further, then M&HCV operators could benefit in the range of Rs 12k-15k a month, which will help them pay their monthly loan installments. Players have also indicated that freight rates will recover sharply when utilisation levels improve, as rates in many segments are unduly low, mainly due to undercutting by SRTOs. This is especially true in the mining belt.

Cheaper funding costs to boost NBFC margins from FY16 onward

Upside risk to FY16 margins for NBFCs due to lower cost funds, interest reversal and higher securitisation

The cost of borrowing through the wholesale market is already down by ~150bps in FY15 and this trend is expected to continue. We expect banks to cut their lending rates in FY16, thereby further reducing the cost of funds for NBFCs (banks account for 40-45% of total NBFC borrowings). Securitisation volumes are likely to decline by 30-40% in FY15 but we expect steady pick up from FY16 onwards, thereby aiding NBFC margins. The delinquency rate is also expected to drop considerably in FY16 and therefore interest reversal will be very low, supporting yields.

Short-term interest rates are headed south

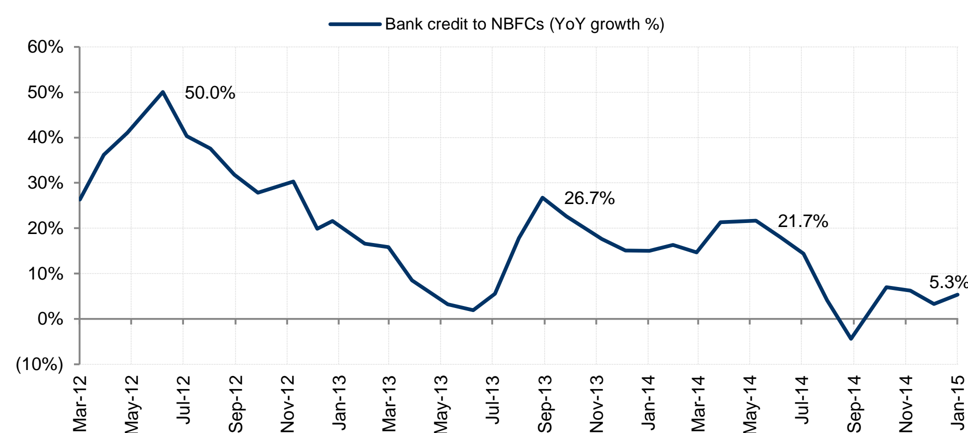
Retail NBFCs in India borrow for a maximum 4-5 year tenure (duration of loans is a maximum of 5 years). NBFCs borrow heavily from the bond market when short-term interest rates are benign, predictable and lower.

In Jul'13, the RBI tightened liquidity to curb rupee volatility which resulted in a sharp increase in short-term rates. Three-month CP rates touched a record high of 12.4% by the end of Aug'13. Despite an increase in banks' lending rates in FY14, bank funding was cheaper for a considerable part of the year (FY14). As against this, interest rates in the bond market were high and volatile. During this period NBFCs/HFCs stayed away from the bond market and changed their borrowing mix in favour of bank loans.

NBFCs now increasingly borrowing through bond market

CP rates are down by ~150bps in the last one year and are unlikely to be very volatile in FY15/FY16. Investor appetite for bonds has improved in the last six months as directionally interest rates are headed downwards (demand for bonds usually improves when interest rates are declining as it is a fixed-rate product). NBFCs have started paying off their bank loans and relying heavily on bond funds in the last 3-4 months.

Fig 17 - NBFC borrowings from banks declining

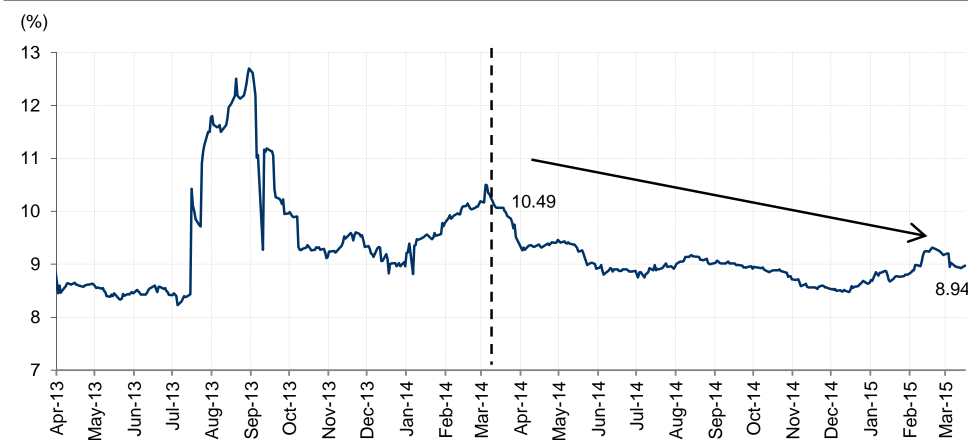


Source: RBI, RCML Research

NBFCs have indicated that fund raising through the wholesale market is now 50-75bps cheaper than bank loans (base rate at 10.25-10.5%). Many NBFCs are funding entire incremental requirements through the bond market instead of banks.

NBFCs are borrowing more through the wholesale debt market as interest rates have softened

Fig 18 - Short-term interest rates (3M – CP rates) have corrected by ~150bps



Source: Bloomberg, RCML Research

Expect banks to cut lending rates in FY16

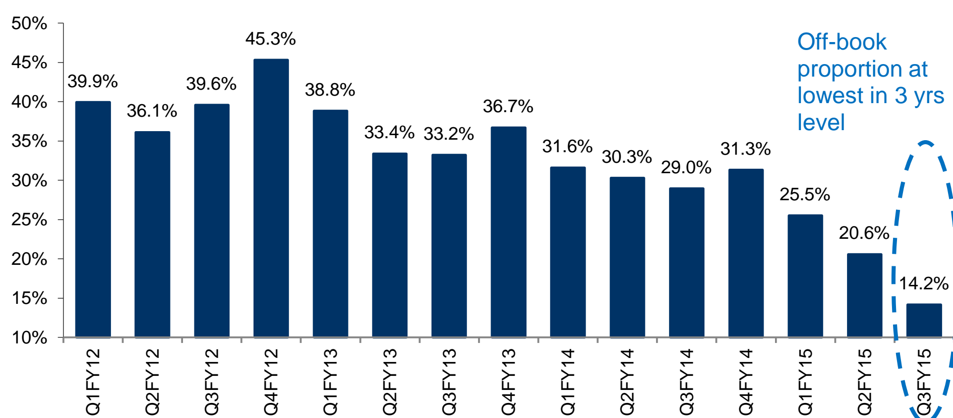
We expect short-term interest rates to remain low in FY16, aiding NBFC margins (in FY15, the benefit will be limited only to incremental funding in H2FY15). We expect banks to cut lending rates in FY16. NBFC borrowings through banks constitute 40-45% of total funding and, unlike wholesale market borrowings, are floating in nature. Therefore, entire borrowings from banks will get re-priced immediately. NBFCs have indicated that they may not pass the entire benefit in cost of funds to borrowers, leading to better margins.

Securitisation activities to pick up gradually in FY16, lowering cost of funds

Securitisation activities are at record low due to one-time regulatory impact, lower demand from banks

We expect a 30-40% drop in fresh sell-down to banks by leading NBFCs in FY15. Our interactions with rating agencies confirm our view that demand from banks for priority sector buyouts and NBFC loans is likely to remain low in FY15. For example, the proportion of off-book loans is at a record low of 14% as of Q3FY15 for SHTF.

Fig 19 - SHTF - Off-book proportion is at lowest level since last three years



Source: Shriram Transport Finance, RCML Research

Demand from banks is low due to changes in the treatment of investments in RIDF (rural infrastructure development fund) bonds and low bank credit growth. As per the latest RBI circular, banks will be allowed to consider outstanding balances of investments in RIDF and other funds for computation of priority sector lending requirements. The total outstanding amount of RIDF and other funds stood at Rs 1,150bn as on FY13, as per NABARD. This will reduce banks' dependence on securitisation to meet shortfalls in FY15. In addition, bank credit growth is likely to remain low this year, further reducing the demand from banks.

Qualifying assets for sell-downs are also lower from the NBFC side as loans need to be seasoned for at least six months (without a single default in EMI). Due to slower disbursements and higher defaults, fewer loans are qualifying for sell-down.

Priority sector lending certificates (PSLC): a potential game-changer for NBFCs

PSLCs will enable NBFCs to sell loans efficiently at a better rate, aiding their profitability

The working group of the RBI constituted especially to look into priority sector lending (PSL) targets and classifications has recommended the introduction of PSLCs to enable banks to meet their PSL targets and/or leverage on over achievements. These papers will be traded on an electronic platform and will allow the most efficient lender to provide funding access to the poor. There will not be any transfer of underlying credit risk.

Currently, Scheduled Commercial Banks (SCB), Regional Rural Banks (RRB), Local Area Banks (LAB), and Urban Cooperative Banks (UCB) who have are allowed to participate. In future, Small Finance Banks would also be allowed to participate. We believe the RBI will gradually allow NBFCs to participate through this route as well, rather than selling down or securitising loans through SPVs which is much more cumbersome as these papers require ratings and transfer of risk. This will also bring transparency in off-book transactions.

Interest reversals will be lower in FY16

NBFCs have lost 30-50bps of margins in FY14/FY15 due to interest reversal on account of slippages

Our estimates suggest that SHTF and MMFS are likely to lose 40-50bps and 30-40bps in margins respectively due to interest reversal on NPAs in FY14/15. We expect the delinquency rate to decline considerably in FY16, leading to low interest reversal. This is likely to support yield on loans in FY16. In addition, any recovery from written-off interest accrual can boost margins for CV lenders.

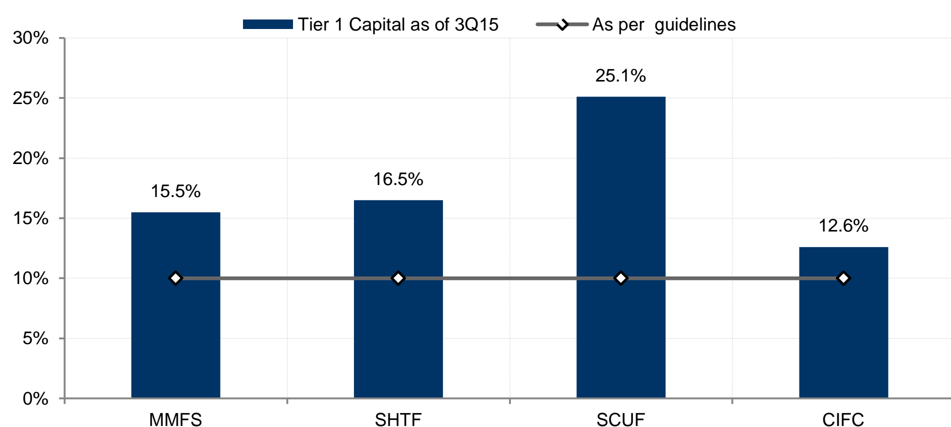
NBFCs with high NPA cover to sail through new norms

Our coverage NBFCs are well above the proposed tier 1 capital requirement of 10% under the new RBI norms. NBFCs have also been given considerable time to comply with 90-DPD (days past due) norms for NPA classification. We believe that these companies will lower their coverage ratio without taking a hit on profitability. Lower NPA coverage is not much of a concern as cash flows/profitability remain intact.

Tier 1 requirement of 10%

As per new RBI guidelines, retail NBFCs must maintain 10% tier 1 capital (total CAR at 15%). NBFCs have been given two-and-a-half years to comply with this rule (8.5% by FY16 and 10% by FY17). NBFCs under our coverage are well above the new tier 1 requirement of 10% and hence will not be affected in the short term. Long-term leverage for NBFCs may decline as rating agencies require them to maintain tier 1 at 100-150bps above the regulatory requirement. However, this is unlikely to affect them materially as profitability could increase due to better credit ratings (led by low leverage) and higher ROA.

Fig 20 - Tier 1 well above RBI requirement for our coverage universe



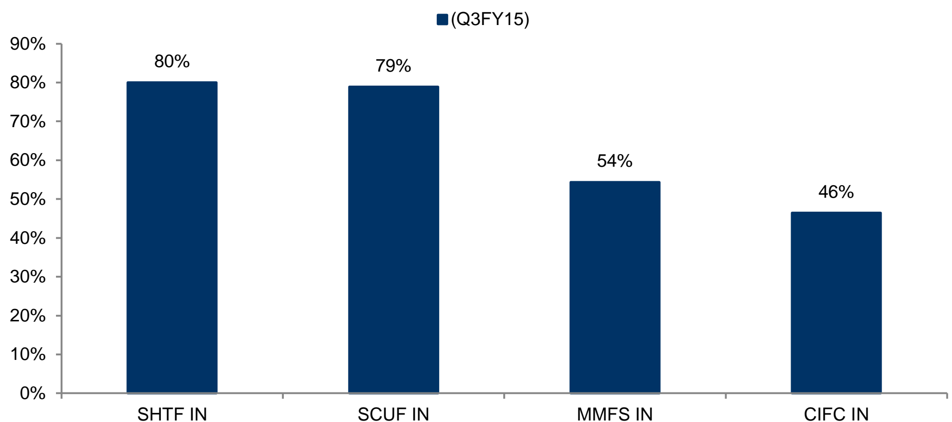
Source: RBI, RCML Research, Company

All our coverage NBFCs are well above mandatory tier 1 requirement

Stringent prudential norms – NPA classification on 90 DPD

The RBI has hiked standard asset provision norms for NBFCs to 40bps from 25bps currently. All NBFCs have to comply with this by end-FY18 (5bps every year). In addition, NPA classification norms will be made exactly in line with that of banks by FY18. The central bank has given NBFCs more than three years to comply with these norms, which we think is adequate and will reduce the impact in FY16/FY17. The RBI has also allowed one-time restructuring of existing loans and therefore only incremental loans will have to comply with the new norms, which will further lower the impact on overall profitability. Most NBFCs have indicated that gross NPAs will go up by 2-2.2x of current NPAs as the business cycle is weak currently and NPAs are higher in the shorter duration brackets.

Fig 21 - NPA coverage ratio across NBFCs



Source: Company

Impact of new norms will be much lower on NBFCs with strong coverage ratio (SHTF, CIFC and SCUF)

NBFCs have two options to comply with these norms:

1. **Allow coverage ratio to drop:** NBFCs have indicated that they may allow their coverage ratio to drop as NPAs are likely to double. This is mainly because there will be a change in reporting only and ultimate cash flows will remain intact. NBFCs like SHTF which have ~80% coverage ratio can do this easily.

2. **Increase provisions:** NBFCs may decide to take a hit on profitability by maintaining the provision coverage ratio at current levels. We believe this is very unlikely as there will be a significant drawdown of profits.

Most NBFCs have room to reduce coverage ratios in order to avoid a hit on profits

We don't rule out a combination of these two options, viz. partly reducing the coverage ratio and increasing provision charge. It is difficult to assess the exact financial impact (under option 2) for NBFCs under our coverage universe as it will depend on the underlying state of the economy, assets under each brackets and recovery efforts put in by the companies.

Fig 22 - Drop in coverage ratio post 90-DPD norms

Company	Q3FY15	Increase in NPA by 1.5x	Increase in NPA by 2x
Shriram Transport Finance			
Gross NPAs	17,797	26,696	35,595
Net NPAs	3,561	12,460	21,359
Provisions	14,236	14,236	14,236
Provision coverage	80.0%	53.3%	40.0%
Mahindra & Mahindra Finance			
Gross NPAs	24,991	37,487	49,982
Net NPAs	11,426	23,922	36,417
Provisions	13,565	13,565	13,565
Provision coverage	54.3%	36.2%	27.1%

Source: Company, RCML Research

We believe the impact on provision coverage ratio is likely to be lower for SHTF than MMFS. In addition, we expect SHTF's credit quality to improve and MMFS's to decline going forward, thereby lowering/raising the negative impact of regulatory change on SHTF/MMFS respectively.

Investors unlikely to penalise NBFCs for lower coverage ratio

Change in reporting only; cash flows intact

Cash flows are likely to remain intact and lower coverage ratios would imply only a change in accounting/reporting methodology. Book value adjusted for net NPA (adj. BV) is of no consequence here, as a large part of the adjustment is technical in nature and there is no loss in underlying value. Profitability remains unchanged. Credit costs are more important for NBFCs than reported NPAs due to the low tenure of underlying assets (at <4 years).

How to play the sector?

SHTF is our top pick (BUY, TP Rs 1,500) due to its strong presence in the used CV market, robust capitalisation and NPA coverage. We also initiate coverage on CIFC (TP Rs 775) and SCUF (TP Rs 2,300) with BUY ratings. Maintain HOLD on MMFS (TP Rs 250) due to cyclical pressure in the medium term and expensive valuations

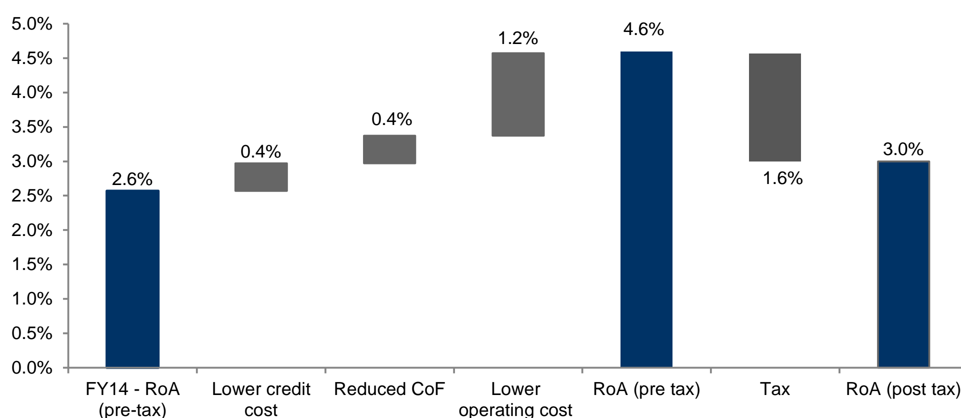
SHTF our top pick in the sector

Structural BUYs – CIFC and SCUF

- **Chola Finance (CIFC) – Structural improvement in profitability underway:** We are initiating coverage on CIFC with a Mar'16 TP of Rs 775 (36% upside). We believe multiple drivers are at play for steady improvement in the company's profitability and expect ROA to rise gradually from 1.8% reported in FY14 to ~2.2% by FY17 and ~3% by FY19.

  We have valued the stock using the two-stage dividend discount model (DDM), assuming ROE of 20.5%, COE of 13% and perpetual growth rate of 5%. Our target price is based on 2.8x FY17E P/B.

Fig 23 - CIFC expected to move steadily towards 3% ROA levels



Source: Company, RCML Research

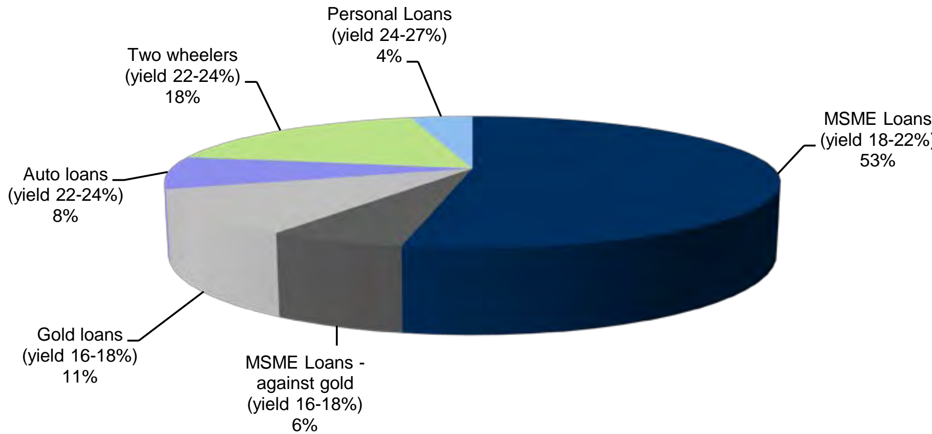
Structural improvement expected to continue till FY19 for CIFC

- **Shriram City Union (SCUF) – Unique combination of high growth and strong profitability:** We initiate coverage on SCUF with a BUY rating and a Mar'16 TP of Rs 2,300 (22% upside). We believe that SCUF is a structural play on increasing organised credit penetration in India. Small enterprise loans constitute ~50% of the company's total loan book and growth rates are likely to be much stronger given the fact that the segment is highly underpenetrated and credit starved.

  We use the two-stage DDM valuation method with assumptions for ROE at 20%, COE at 13% and perpetual growth rate at 5%. Our target price for the stock is based on 2.7x FY17E P/B.

SCUF's growth rate and profitability (ROE) expected to remain superior to peers

Fig 24 - SCUF is present in high growth and high ROE segments



Source: Company

Upward cycle has begun for SHTF; MMFS still mid-downcycle

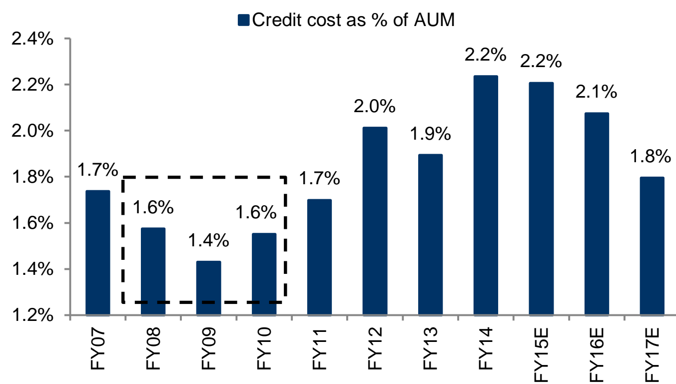
Potential upside/downside risk to estimates for SHTF/MMFS

Credit cost assumption conservative for SHTF and aggressive for MMFS

We believe that consensus is underestimating the upside potential in SHTF's earnings. Recovery in the CV cycle is likely to be much steeper this time around and, in our view, the stock can register a 33% CAGR in net profits over FY15-FY18 (note that consensus is estimating a 25% CAGR over FY15-FY17). We are assuming credit cost of 1.8% in FY17 as compared to the last 10-year average of 1.7%. Credit cost can be much lower than our estimates.

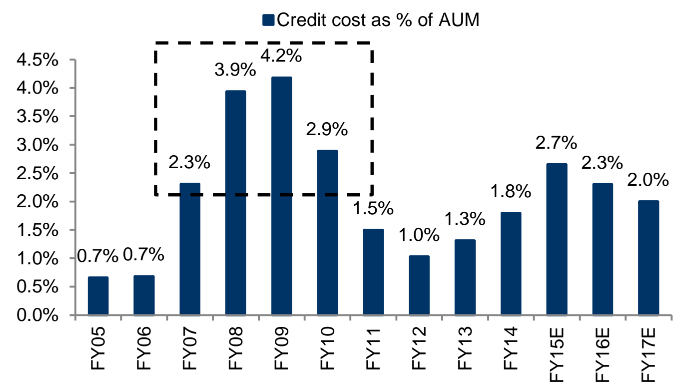
Credit cost for MMFS is likely to touch 2.7% in FY15 (1.8% in FY14 and 1.3% in FY13). We are assuming some moderation in credit cost in FY16 and FY17; however if rural demand does not improve and the cycle worsens, then costs may remain elevated. We note that credit cost in the last down cycle was ~3.7% on average for three years (FY08-FY10).

Fig 25 - SHTF – upside risk from credit cost



Source: Company, RCML Research

Fig 26 - MMFS – downside risk from credit cost



Source: Company, RCML Research

Fig 27 - SHTF – we are ~10% ahead of consensus for FY17

	FY15	FY16	FY17
Consensus			
EPS	58.2	73	90
YoY growth (%)		25%	24%
Religare			
EPS	59.1	76.3	100.0
YoY growth (%)		29%	31%
Religare vs. Consensus			
EPS	1.5%	5.0%	11.1%

Source: RCML Research, Bloomberg

Fig 28 - MMFS – we are 12-15% lower than consensus for FY16-FY17

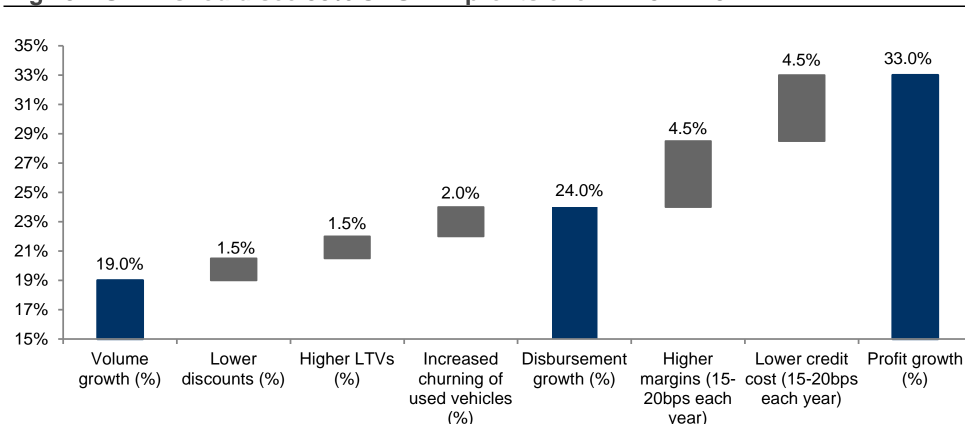
	FY15	FY16	FY17
Consensus			
EPS	15.4	20.2	25.3
YoY growth (%)		31.7%	25.0%
Religare			
EPS	15.1	17.8	21.4
YoY growth (%)		17.7%	20.0%
Religare vs. Consensus			
EPS	(1.4%)	(11.9%)	(15.4%)

Source: RCML Research, Bloomberg

- **Shriram Transport Finance – Well worth the long haul:** The stock has a high correlation with GDP/IIP and we expect sharp improvement in loan growth, margins and credit cost as the economic recovery gathers pace. SHTF is the best stock to play a CV cycle recovery (+75% correlation). We expect a 33% earnings CAGR in this upward cycle which is likely to last till FY19.

  We assume coverage of SHTF with a BUY rating and a Mar'16 TP of Rs 1,500 (29% upside). We have used two-stage DDM to value the stock with the following assumptions: ROE of 21%, COE of 13% and perpetual growth rate of 4%. We have valued the construction equipment finance subsidiary separately using the same assumptions. Our target price is based on 2.6x FY17E P/B.

Fig 29 - SHTF should see 33% CAGR in profits over FY15-FY18



Source: Company, RCML Research

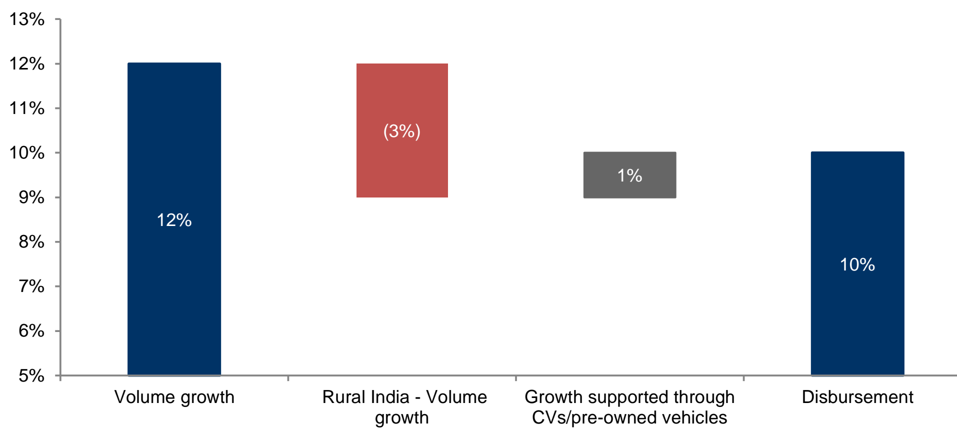
We expect strong CAGR in profits due to recovery in loan growth, margins and credit cost

- **Mahindra Finance – The worst is yet to come:** We believe that MMFS is in the middle of a downward cycle and is likely to register its weakest growth and profitability in the last five years for the FY15-FY17 period. AUM growth will be poor due to a slowdown in rural income and increased discounts offered by manufacturers. NPA coverage is at a record low and credit cost is likely to remain elevated due to higher slippages and transition to 90-DPD norms.

  We assume coverage of MMFS with a HOLD rating and a Mar'16 TP of Rs 250 (4.8% downside). Our target price is based on 2.17x FY17E P/B and arrived at using a two-stage DDM with assumptions for ROE at 19%, COE at 14% and perpetual growth rate at 5%.

MMFS likely to post weakest profitability in the last 5-7 years

Fig 30 - MMFS's disbursement growth to be weaker than overall volume growth



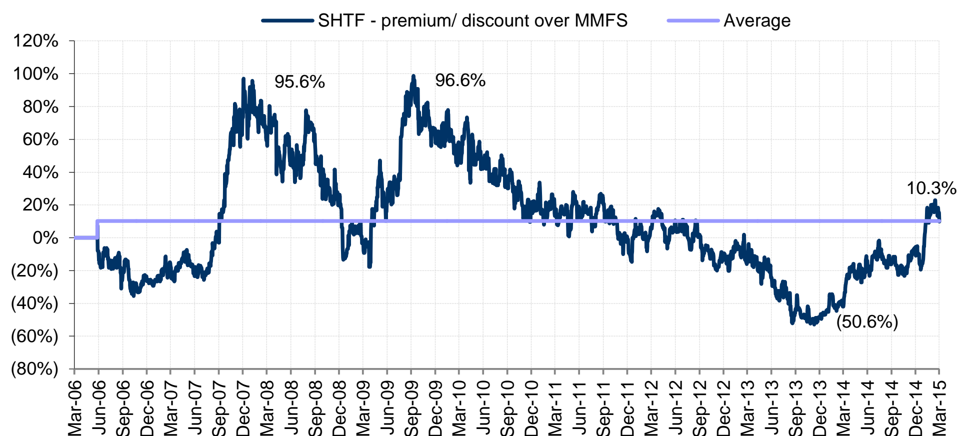
Source: Company, RCML Research

SHTF can trade at significant premium to MMFS

SHTF is currently trading at ~10% premium to MMFS (one-year forward P/B). Past trends show that this premium widens significantly when the CV cycle is favourable – for instance, in FY08 and FY11, when CV volume growth was very strong, SHTF traded at ~100% premium to MMFS. We thus expect the valuation gap between the two stocks to widen further as the CV recovery gathers pace.

SHTF's valuation premium to MMFS typically widens during a CV upcycle

Fig 31 - SHTF premium/discount to MMFS (one-year forward P/B)



Source: Company, RCML Research, Bloomberg

Companies

25 March 2015

BUY

TP: INR 1,500.00
▲ 29.2%

Shriram Transport Finance

SHTF IN

Well worth the long haul

We believe SHTF is the best stock to play the CV recovery. Though growth will be modest till H1FY16, we expect a sharp improvement in disbursement, margins and credit cost once we hit the middle of the CV upcycle in late-FY16 or early-FY17, led by (1) stronger CV replacement demand, (2) a higher churn rate in used vehicles (SHTF's stronghold), and (3) lower delinquencies. We model for a 30% earnings CAGR over FY15-FY17 and retain our BUY rating on the stock with a revised Mar'16 TP of Rs 1,500.

- **Loan growth to improve materially from FY17:** Our Auto analyst expects M&HCV volumes to grow by ~20% in FY16/FY17. We believe SHTF's disbursement growth will outpace M&HCV volume growth due to narrowing vehicle discounts (currently 5-7%), an increase in LTVs (down 5-7% since FY11 peak) and higher churning of older vehicles (>5yrs) where SHTF has a dominant position.

- **Multiple drivers at play for margin improvement:** Margins have declined by ~200bps since FY11 and are expected to recover gradually from FY16 driven by lower interest reversal (due to lower delinquencies), a change in loan mix towards older vehicles, higher securitisation and lower cost of funds as rates soften. The proportion of off-book loans is at a record low of 14% (Q3FY15). A sell-down will reduce SHTF's cost of funds by 100-150bps, which will flow into margins once securitisation gathers steam.

- **Credit cost stabilising:** Credit costs have been running at Rs 3bn per quarter for the last one year and we expect the trend to continue for the next 2-3 quarters. We conservatively estimate a 20bps decline in credit cost as a percentage of AUM each in FY16 and FY17.

- **Strong earnings growth ahead:** We are 10% ahead of consensus on FY17 earnings and expect a 33% earnings CAGR in this upward cycle which is likely to last till FY19. We have a new Mar'16 TP of Rs 1,500 (from Rs 1,250) for SHTF set at 2.6x FY17E P/B.

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PRICE CLOSE (24 Mar 15)
INR 1,160.75

MARKET CAP
INR 263.4 bln
USD 4.2 bln

SHARES O/S
226.3 mln

FREE FLOAT
74.0%

3M AVG DAILY VOLUME/VALUE
0.5 mln / USD 9.5 mln

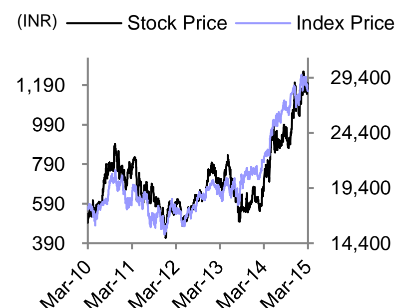
52 WK HIGH
INR 1,287.70

52 WK LOW
INR 665.05

Financial Highlights

Y/E 31 Mar	FY13A	FY14A	FY15E	FY16E	FY17E
Net interest income (INR mln)	35,264	34,961	37,456	43,920	52,102
Net revenues (INR mln)	36,932	39,557	42,971	50,814	60,719
Pre-provision profits (INR mln)	28,670	29,768	31,562	37,811	45,879
Adj. PAT (INR mln)	13,606	12,642	13,400	17,302	22,683
Adj. EPS (INR)	60.0	55.7	59.1	76.3	100.0
ROE (%)	20.6	16.3	15.1	17.0	19.2
ROA (%)	3.4	2.7	2.5	2.8	3.3
Gross NPA (%)	3.2	3.9	3.7	3.9	4.0
CAR (%)	17.9	20.4	20.7	21.1	21.0
P/BV (x)	3.7	3.2	2.8	2.4	2.1
P/E (x)	19.4	20.8	19.7	15.2	11.6

Source: Company, Bloomberg, RCML Research



Recovery will be steeper this time around

Expect 33% CAGR in PAT over FY15-FY18E

- **Volume growth of 19%+:** Industry-wide M&HCV volumes have plunged 23-25% in both FY13 and FY14 and are likely to register a modest increase of ~10% in FY15. Our Auto analyst, Mihir Jhaveri, expects M&HCV volumes to grow by 19%/20% in FY16/FY17, and LCVs to pick up with a lag at a 15% CAGR over FY15-FY17.

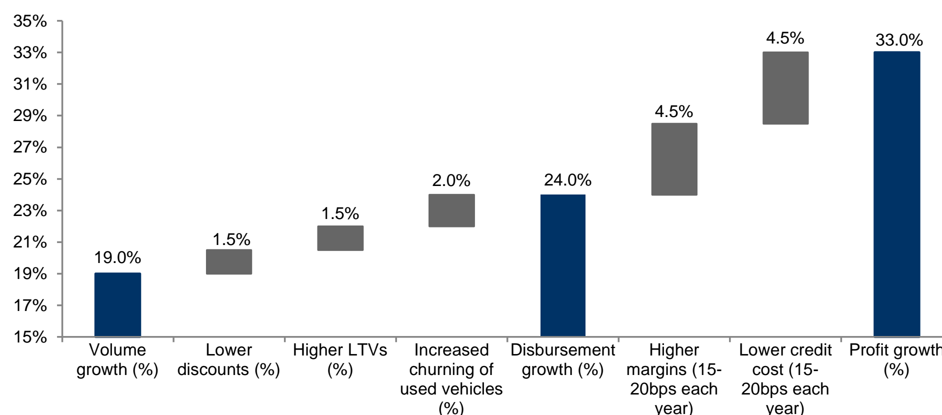
- **Lower discounts, higher LTVs to drive 3% additional loan growth each year:** We expect SHTF's disbursement growth to be much higher than M&HCV volume growth due to a likely narrowing of discounts (currently 5-7%) and an increase in LTVs (down ~5% since the FY11 peak). We model for discounts to reduce and LTVs to increase by 1.5% each per year, driving an additional 3% disbursement growth for the company over our forecast period.

- **Higher disbursements to used vehicles:** Our channel checks with industry players (CV fleet operators, lenders and dealers) suggest that churning of vehicles that are over 5-7 years old has stopped due to poor market conditions; we expect the scenario to improve going forward. Note that SHTF has a dominant position in this high-margin segment, which should support loan growth by 2% every year.

- **Margin improvement, lower credit costs to add 8-9% to earnings:** We expect 15-20bps NIM improvement and a drop of 15-20bps in credit costs each year over FY15-FY18, driving 8-9% additional earnings growth for the company during this period. As such, margins in this upcycle are likely to be lower than the earlier cycle due to changes in securitisation guidelines and a higher share of loans to younger vehicles (<5yrs old) and LCVs.

- **We remain conservative on credit costs:** Despite assuming ~20bps decline in credit costs in FY16 and FY17 each, our FY17 estimate stands at 1.8% vs. the last 10-year average of 1.7%. We see upside risks to our credit cost estimates if the economic situation improves considerably.

Fig 1 - SHTF should see 33% CAGR in profits over FY15-FY18E



Source: RCML Research

Expect 33% PAT CAGR over FY15-FY18 driven by higher loan growth, better margins and benign credit costs

- **We are ~10% ahead of consensus for FY17:** We expect a 30% PAT CAGR for SHTF over FY15-FY17 as the economic recovery gathers pace. The company's strong earnings profile backed by a 24% loan growth CAGR, lower credit costs and improving margins should support a re-rating to ~2.6x FY17E P/B (from current valuations of 2.1x FY17E P/B), in our view.

Fig 2 - Religare vs. consensus

	FY15	FY16	FY17
Consensus			
EPS (Rs)	58.2	73	90
YoY growth (%)		25%	24%
Religare	**FY15**	**FY16**	**FY17**
EPS (Rs)	59.1	76.3	100.0
YoY growth (%)		29%	31%
Religare vs. consensus	**FY15**	**FY16**	**FY17**
EPS (Rs)	**1.5%**	**5.0%**	**11.1%**

Source: Company, Bloomberg, RCML Research

We are 10% above consensus for FY17 EPS

Sharp recovery in loan growth from H2FY16/FY17

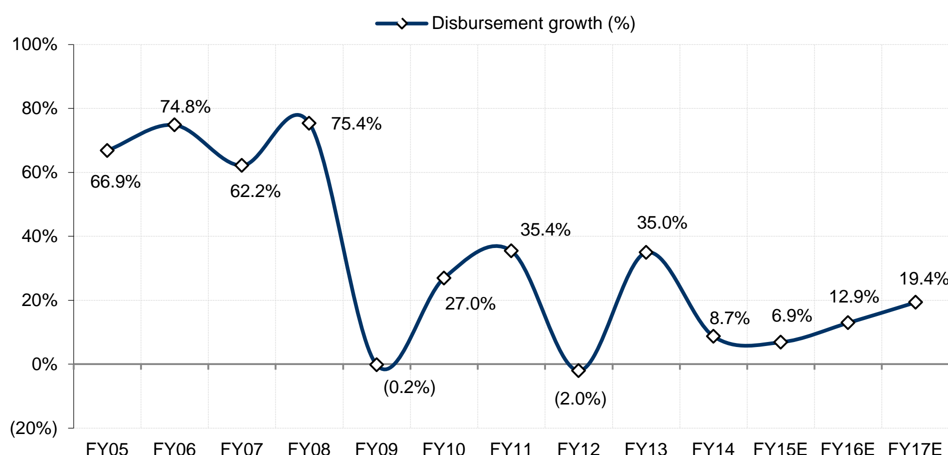
We note that SHTF has gained significant market share in the recent downturn, and therefore incremental growth would be limited to that extent (lower than overall disbursement growth for the industry) when the cycle begins to turn positive.

Participation from FTUs and SRTOs to increase considerably from FY17

Thereafter, we believe disbursements would rebound significantly for SHTF once we are in the middle of the upcycle (late-FY16 or early-FY17), as replacement demand kicks in. Vehicle replacements have been low over the last two years due to the uncertain macro conditions and we expect a pick-up from Q2FY16 onwards (typically 25% of vehicles come up for replacement every year when the economy is doing well). Many small road transport operators (SRTO) are holding back their purchases currently, as they are typically late entrants into the market due to their stretched cash flow situation.

We expect strong disbursement growth for SHTF from FY17 onwards due to a higher churning rate of used vehicles (mainly +5-year-old vehicles), a segment where SHTF enjoys a dominant position.

Fig 3 - Disbursement growth to start improving meaningfully from FY17 onwards

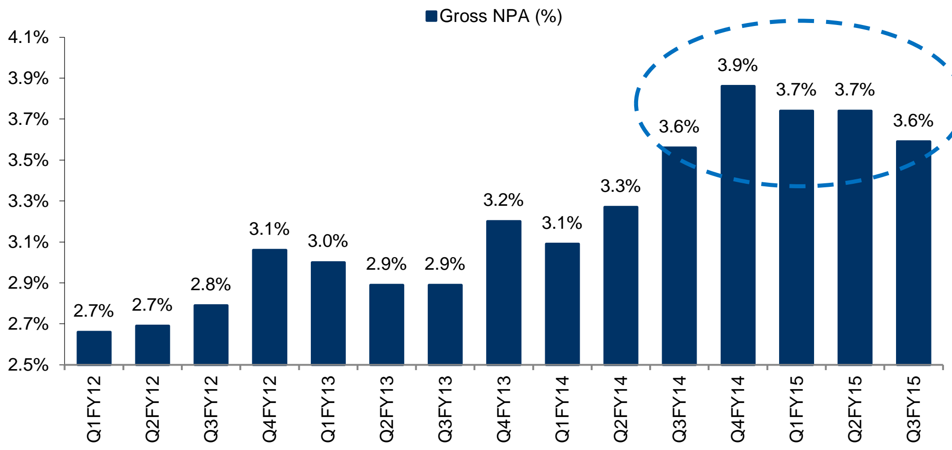


Source: RCML Research, Company

Credit cost and margins are stabilising

Gross NPAs have risen by ~100bps since FY12. However, the company has maintained its NPA coverage and net NPA levels, which is encouraging in our view. NPA coverage is at ~80% with net NPA of 0.7% as of Q3FY15. Credit cost for the last 3-4 quarters has remained in the range of 2.2-2.4%.

Fig 4 - Gross NPAs have stabilised in last 4-5 quarters



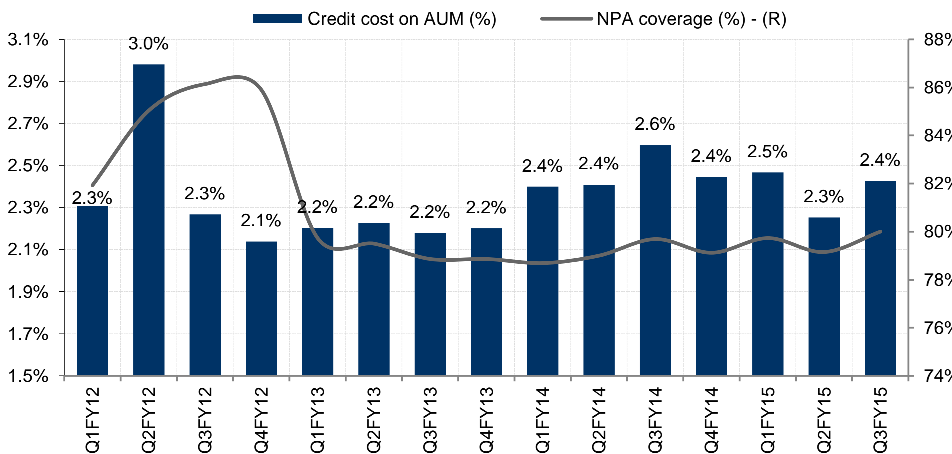
Source: Company

Credit costs have been running at Rs 3bn per quarter for the last one year and we expect the trend to continue for the next 2-3 quarters. Credit cost as a percentage of AUM is likely to fall by ~40bps over FY15-FY17.

SHTF took a hit on its profits in Q1/Q2FY12 due to its mining-related exposure. Currently, ~1% of its loan book is exposed to mining-related activities (all operational currently).

Fig 5 - Credit cost stabilising and NPA coverage robust at 80%

Robust NPA coverage at 80% gives us significant comfort



Source: Company

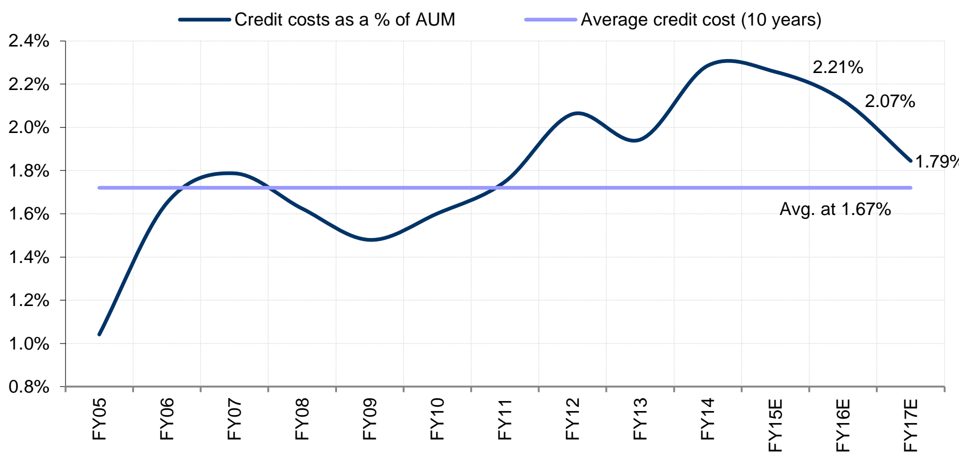
Expect credit costs to moderate going forward

We believe SHTF has adequately provided for lost and delinquent assets, and therefore the company's credit costs should decline at a faster pace when the cycle improves. Also, credit costs as a percentage of AUM are likely to drop by ~40bps over FY15-FY17 as the economy improves and manufacturing & infrastructure-related activities gather steam.

While we expect FY17 credit costs, at 1.8%, to remain marginally higher than the last 10-year average of 1.7%, we see upside risks to our estimates if economic growth and outlook remains strong.

Upside risk from credit cost does exist

Fig 6 - Credit cost to decline steadily



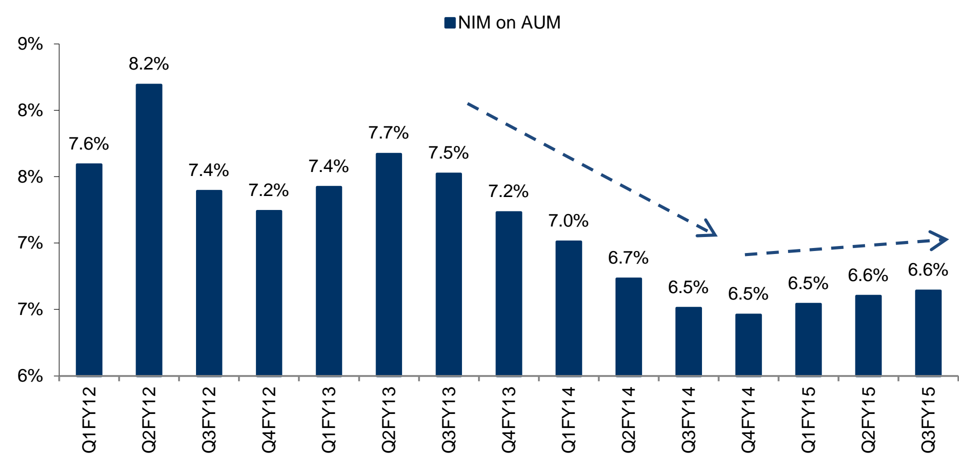
Source: Company, RCML Research

Multiple factors to drive up margins

NIMs have declined by 100bps from 7.7% in Q2FY13 to 6.6% in Q2FY15 (lowest in the last three years) due to interest reversals on high delinquencies and changes in the loan mix. However, margins have stabilised in the last 3-4 quarters and appear to have bottomed out.

While NIMs have corrected by ~120bps in FY13/FY14, they have stabilised in the last 3-4 quarters

Fig 7 - NIMs are stabilising at 6.5-6.6%

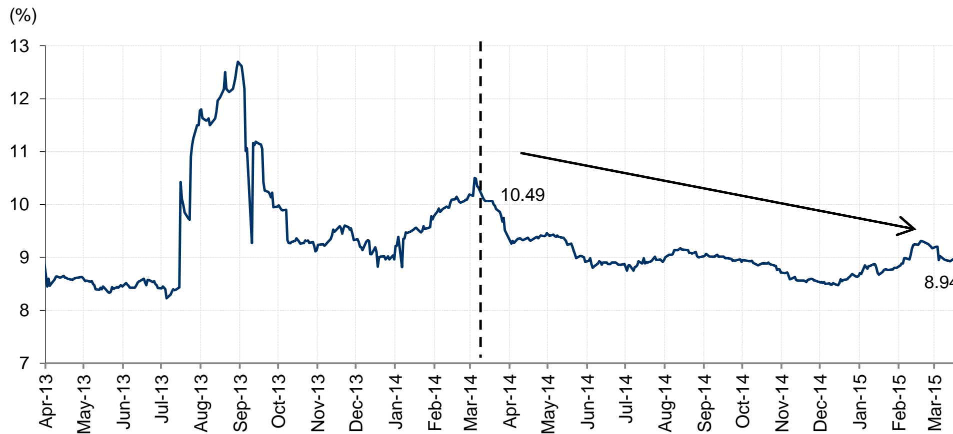


Source: Company

We model for ~40bps improvement in NIMs over FY15-FY17 given multiple triggers for steady margin expansion in the next 2-3 years.

- **Cost of funds to decline gradually:** Cost of borrowings through the wholesale market is already down ~150bps since FY14, with the trend expected to continue. We expect banks to cut their lending rates in FY16, thus reducing the cost of borrowings from banks.

Fig 8 - Wholesale cost of funds down ~150bps since FY14

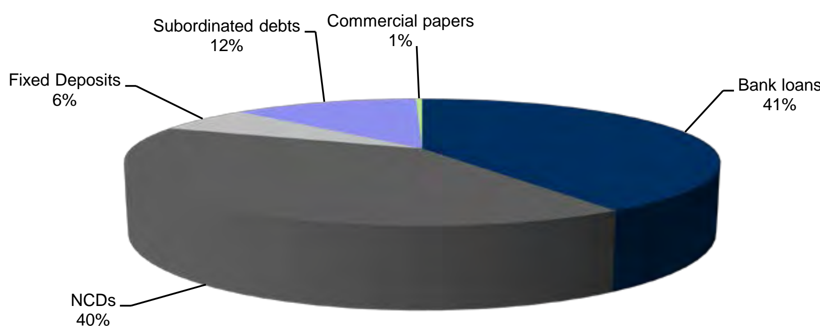


Source: Bloomberg, RCML Research

- **ALM structure offers benefits in a declining rate scenario:** For SHTF, nearly the entire loan book carries a fixed rate of interest, whereas 40% of its borrowings are floating in nature (bank borrowings). This kind of ALM structure will help the company in a softening rate environment, as a reduction in bank and wholesale rates would lower the company's overall cost of funds. In addition, SHTF may look at reducing dependence on banks as the cost of wholesale borrowings is lower, which would support margins further.

Fig 9 - Break-up of borrowings for the company

Cyclical tailwinds to help as lending book is fixed in nature

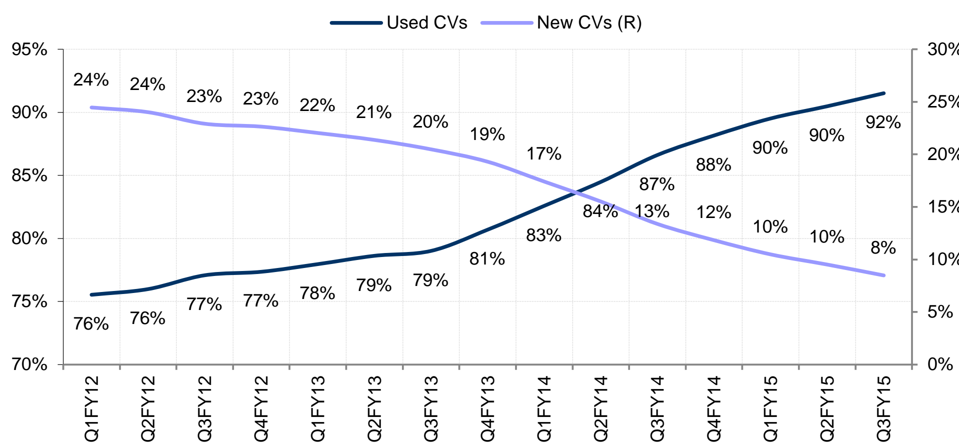


Source: Company

- **AUM mix to change in favour of high-yielding loans as macro improves:** The proportion of LCVs in SHTF's overall AUM (~10%) has gone up in the last 1-2 years as LCV volumes have declined at a much lower rate than other CV segments. Also, the proportion of low-yielding, sub-5-year-old CVs has gone up significantly over the years and now stands at 15-18% of overall AUM. We believe these changes in AUM mix (which have hit company margins in the last 2-3 years) can be attributed to industry trends, as demand for newer used CVs (mainly 1-3-year-old vehicles) was created due to a slowdown in investment-related/manufacturing activities in the last two years.

  We expect this trend to reverse and the AUM mix to slowly move towards high-yielding, older vehicles (>5yrs), which in turn would support margins.

Fig 10 - AUM mix has changed dramatically in the last three years

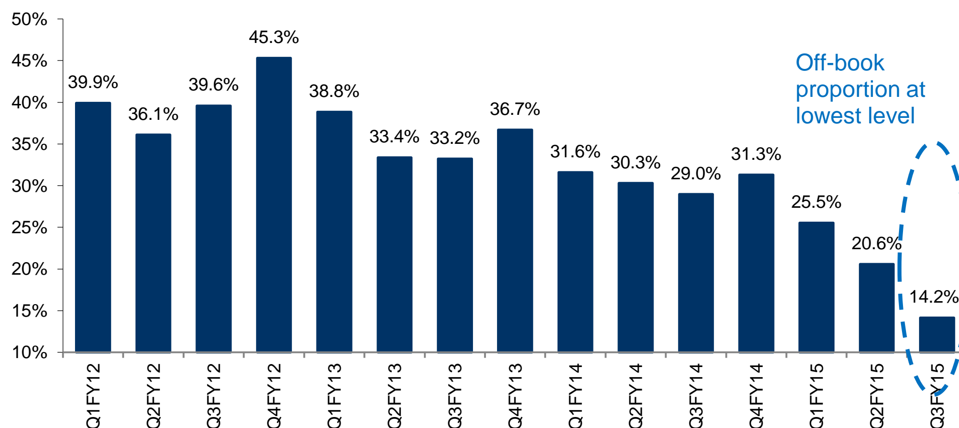


Source: Company

Proportion of very old vehicles (+5 years) expected to increase, aiding profitability

- **Securitisation volumes to pick up from FY16 onwards:** SHTF's off-book loan proportion is at a record low of 21% as of Q2FY15 due to lower demand from banks and changes in RBI regulations. We expect securitisation volumes to pick up from FY16 onwards and touch 33-35% of AUM by FY17-end. The cost-of-funds advantage in a sell-down is 100-150bps, which should flow into SHTF's margins in FY16/FY17.

Fig 11 - Off-book loan proportion at lowest level



Source: Company, RCML Research

Securitisation volumes are at a record low and should improve from FY16 onwards

PSLCs will enable NBFCs to sell loans efficiently at a better rate, thereby aiding their profitability

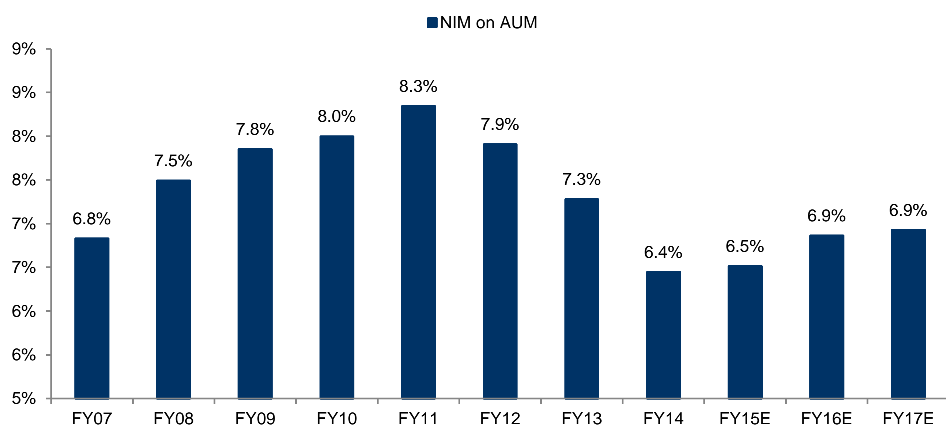
- **Priority sector lending certificates (PSLC) – a potential game-changer for SHTF:** The working group of the RBI, especially constituted to look into priority sector targets and classifications, has recommended the introduction of PSLCs to enable banks to meet their PSL targets and/or leverage on over-achievements. These papers will be traded on electronic platforms and will allow the most efficient lender to provide access to the poor. There will not be any transfer of underlying credit risk.

  Currently, Scheduled Commercial Banks (SCB), Regional Rural Banks (RRB), Local Area Banks (LAB), and Urban Cooperative Banks (UCB) who have originated PSL eligible category loans are allowed to participate. In future, Small Finance Banks would also be allowed to participate.

  While the RBI currently does not permit NBFCs to participate in PSLCs, we think it would gradually allow them to use this route, rather than selling down or securitising loans through SPVs which is a much more cumbersome method as these papers require ratings and transfer of risk. This will also bring transparency into off-book transactions.

- **Interest reversals to be lower in FY16:** Our estimates suggest that SHTF has lost 40-50bps in margins due to interest reversals on NPAs in FY15. We expect the delinquency rate to decline considerably in FY16, leading to lower interest reversals and supporting the yield on loans. In addition, any recovery from written-off interest accruals would boost margins for SHTF.

Fig 12 - We expect ~40bps improvement in margins from FY15-FY17



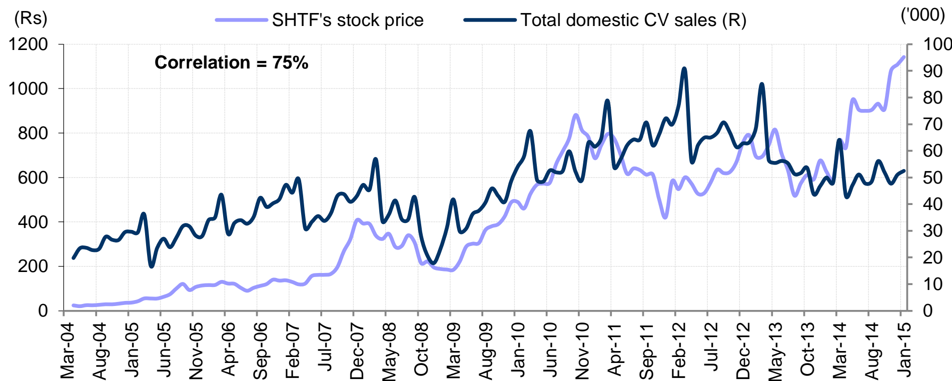
Source: Company, RCML Research

SHTF the best stock to play CV cycle recovery

SHTF's stock price has a strong correlation with CV sales (+75%) and we expect a re-rating ahead amid an upward CV cycle. Using the two-stage dividend discount model, we have a Mar'16 TP of Rs 1,500 for the stock, which offers ~29% upside from current levels.

Fig 13 - SHTF stock price has ~75% correlation with CV sales

SHTF's stock price has strong correlation with CV sales



Source: SIAM, Bloomberg, RCML Research

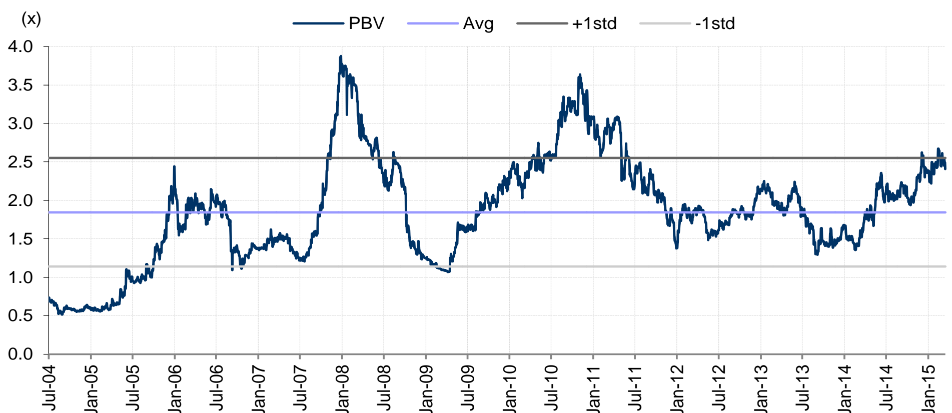
Fig 14 - Valuation summary

Particulars	
ROE	21%
g (initial growth)	18%
r (COE)	13%
gn (perpetual growth rate)	4%
n (initial growth period, yrs)	5
payout1	15%
payoutn	80%
K1	0.85
K2	11.26
P/BV	2.58x
Value of SHTF	1,409
Value of Shriram Equipment Finance	88
TP (rounded off)	1,500

Source: RCML Research

The stock is currently trading at +1 SD forward P/B. We expect a steady re-rating as the CV cycle improves further.

Fig 15 - One-year forward P/B



Source: Bloomberg, RCML Research, Company

Disbursements

Y/E 31 Mar (INR mln)	FY13A	FY14A	FY15E	FY16E	FY17E
Disbursements	2,62,531	2,85,950	3,05,618	3,45,166	4,11,961
Growth (%)	34.7	8.9	6.9	12.9	19.4
AUM/Sanctions	4,96,760	5,31,021	5,69,411	6,58,342	7,91,104
Growth (%)	23.5	6.9	7.2	15.6	20.2

Per Share Data

Y/E 31 Mar (INR)	FY13A	FY14A	FY15E	FY16E	FY17E
Reported EPS	60.0	55.7	59.1	76.3	100.0
Adjusted EPS	60.0	55.7	59.1	76.3	100.0
DPS	7.0	7.0	8.3	12.2	16.0
Book value	317.1	364.6	415.4	479.4	563.4
Adjusted book value	306.5	351.3	407.2	473.6	557.7

Valuation Ratios

Y/E 31 Mar (x)	FY13A	FY14A	FY15E	FY16E	FY17E
P/E	19.4	20.8	19.7	15.2	11.6
P/BV	3.7	3.2	2.8	2.4	2.1
P/ABV	3.8	3.3	2.9	2.5	2.1

Financial Ratios

Y/E 31 Mar (%)	FY13A	FY14A	FY15E	FY16E	FY17E
Spread Analysis					
Interest spreads	4.7	4.9	6.8	7.0	7.2
Yield on advances	15.0	16.5	16.9	17.0	17.1
Yield on assets	13.2	13.7	14.4	14.7	14.5
Cost of funds	11.5	12.3	11.3	11.0	10.9
NIMs	7.3	6.4	6.5	6.9	6.9
Operating Ratios					
Operating cost to income	22.4	24.7	26.6	25.6	24.4
Operating expenses / Avg assets	2.8	2.6	2.4	2.5	2.4
Asset Quality and Capital					
Gross NPA	3.2	3.9	3.7	3.9	4.0
Net NPA	0.8	0.8	0.4	0.3	0.2
CAR	17.9	20.4	20.7	21.1	21.0
Growth Ratios					
Net interest income	36.8	30.6	21.3	23.8	14.9
Non-interest income	64.6	175.4	20.0	25.0	25.0
Pre-provisioning profit	8.2	3.8	6.0	19.8	21.3
Net profit	8.2	(7.1)	6.0	29.1	31.1
Assets	25.5	9.8	17.2	12.0	15.6
Advances	23.5	6.9	7.2	15.6	20.2
Book value	19.7	15.0	13.9	15.4	17.5
EPS	7.9	(7.1)	6.0	29.1	31.1

DuPont Analysis

Y/E 31 Mar (%)	FY13A	FY14A	FY15E	FY16E	FY17E
Net interest income / Assets	8.8	7.4	7.0	7.2	7.5
Non-interest income / Assets	0.4	1.0	1.0	1.1	1.2
Operating expenses / Assets	2.1	2.1	2.1	2.1	2.1
Provisions / Assets	2.1	2.4	2.3	2.1	1.9
Taxes / Assets	2.4	2.1	2.0	2.1	2.2
ROA	3.4	2.7	2.5	2.8	3.3
Equity / Assets	6.1	6.1	6.0	6.0	5.9
ROAE	**20.6**	**16.3**	**15.1**	**17.0**	**19.2**

Income Statement

Y/E 31 Mar (INR mln)	FY13A	FY14A	FY15E	FY16E	FY17E
Interest income	63,967	74,287	83,086	94,033	1,09,215
Interest expense	(28,703)	(39,325)	(45,630)	(50,112)	(57,113)
Net interest income	35,264	34,961	37,456	43,920	52,102
Non-interest income	1,669	4,596	5,515	6,894	8,617
Net revenue	36,932	39,557	42,971	50,814	60,719
Operating expenses	(8,262)	(9,789)	(11,409)	(13,002)	(14,840)
Pre-provisioning profits	28,670	29,768	31,562	37,811	45,879
Provisions & contingencies	(8,508)	(11,488)	(12,142)	(12,736)	(13,006)
PBT	20,162	18,280	19,420	25,075	32,873
Extraordinaries	-	-	-	-	-
Income tax	(6,556)	(5,638)	(6,020)	(7,773)	(10,191)
Reported PAT	13,606	12,642	13,400	17,302	22,683
Adj. net profit	**13,606**	**12,642**	**13,400**	**17,302**	**22,683**

Balance Sheet

Y/E 31 Mar (INR mln)	FY13A	FY14A	FY15E	FY16E	FY17E
Advances	3,14,438	3,64,737	4,33,276	4,83,814	5,61,943
Investments	35,689	27,253	28,470	29,748	31,090
Current assets	94,766	96,749	1,11,095	1,28,294	1,48,912
Net block (inc CWIP)	601	1,007	1,107	1,218	1,340
Goodwill	-	-	-	-	-
Other assets					
Total Assets	**4,45,493**	**4,89,745**	**5,73,949**	**6,43,074**	**7,43,286**
Share capital	2,269	2,269	2,269	2,269	2,269
Options/warrants/others	-	-	-	-	-
Reserves & surplus	69,679	80,463	91,987	1,06,520	1,25,574
Net worth	71,947	82,732	94,256	1,08,790	1,27,843
Total borrowings	2,31,999	3,59,246	3,95,171	4,52,074	5,24,949
Current liabilities	1,26,430	34,626	70,849	67,992	75,717
Provisions	17,955	15,653	16,436	17,257	18,120
Deferred tax liabilities	(2,838)	(2,512)	(2,763)	(3,039)	(3,343)
Other liabilities					
Total Equity & Liabilities	**4,45,493**	**4,89,745**	**5,73,949**	**6,43,074**	**7,43,286**

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Values that bind

Company Update
INDIA
NBFC

25 March 2015

HOLD
TP: INR 250.00
▼ 4.8%

Mahindra & Mahindra Fin Secs

MMFS IN

The worst is yet to come

We believe MMFS is in the middle of a downward cycle which will see the company registering its weakest growth and profitability in the last five years during FY15-FY17. Valuations at 2.2x FY17E P/ABV appear expensive given a likely 300bps drop in ROE through FY17E amid cyclical pressure on AUM growth (10% CAGR), record-low NPA coverage (~50%) and high credit costs in the medium term – maintain HOLD with a revised Mar'16 TP of Rs 250.

- **Single-digit growth likely in FY16:** In the last 3-4 years, auto sales in rural India have outpaced volumes in urban India, resulting in robust loan growth for MMFS due to its focus on rural markets. Now, given a slowdown in rural areas and high pent-up demand in urban India, we expect urban sales to move into the lead for the next 1-2 years. MMFS' disbursal trend in rural India has been weak over the last 4-5 quarters and could remain 200-300bps lower than overall auto industry growth. Our Auto analyst expects auto/tractor volume growth of just 10%/11% in FY16/FY17. With high discounts and low resale prices of older vehicles, we expect MMFS' overall AUM growth to drop to sub-10% in FY16 – the weakest since FY10.

- **NPA coverage at record low; credit cost to remain elevated:** MMFS has not provided adequately for credit cost since the beginning of this downward cycle (FY12) and hence its coverage ratio has dropped to a record low of ~50% (86% in FY11). Transition to 90-DPD norms is likely to double its NPAs. We expect credit cost to remain elevated in FY15-FY17 as there is no room to lower coverage further.

- **FY16 margin gains to have little earnings impact:** The cost of wholesale market borrowings has corrected sharply in the last one year and banks too are likely to cut their base rate in FY16. We believe MMFS' FY16/FY17 margins will be 30-40bps higher than FY15, but earnings gains will be offset by credit cost and growth pressures.

- **Maintain HOLD:** Given medium-term cyclical pressure and expensive valuations, we maintain HOLD. Our new Mar'16 TP of Rs 250 (from Rs 325) is set at 2.1x FY17E P/ABV.

Financial Highlights

Y/E 31 Mar	FY13A	FY14A	FY15E	FY16E	FY17E
Net interest income (INR mln)	22,238	27,681	31,206	34,340	38,433
Net revenues (INR mln)	24,424	30,196	33,851	37,514	42,398
Pre-provision profits (INR mln)	16,103	19,805	21,948	23,740	26,443
Adj. PAT (INR mln)	9,270	9,544	8,532	10,042	12,049
Adj. EPS (INR)	16.5	16.9	15.1	17.8	21.4
ROE (%)	24.4	19.3	15.2	15.8	16.8
ROA (%)	4.0	3.1	2.4	2.6	2.9
Gross NPA (%)	2.9	3.5	7.0	7.1	7.0
CAR (%)	17.5	16.2	16.4	16.9	17.2
P/BV (x)	3.2	2.8	2.5	2.2	1.9
P/E (x)	15.9	15.5	17.3	14.7	12.3

Source: Company, Bloomberg, RCML Research

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PRICE CLOSE (24 Mar 15)
INR 262.50

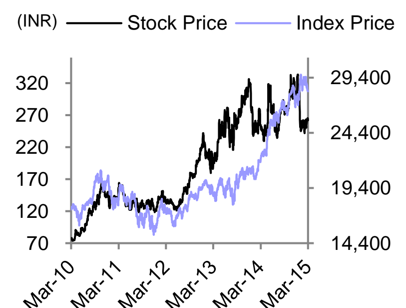
MARKET CAP
INR 149.3 bln
USD 2.4 bln

SHARES O/S
601.8 mln

FREE FLOAT
50.0%

3M AVG DAILY VOLUME/VALUE
2.6 mln / USD 10.9 mln

52 WK HIGH	52 WK LOW
INR 344.90	INR 229.25



Midway through a downward cycle

We believe MMFS is still mid-downcycle and likely to register its weakest growth and profitability in the last five years during FY15-FY17. Falling AUM growth, elevated credit cost, record-low NPA coverage and sustained earnings pressure make us cautious on the stock.

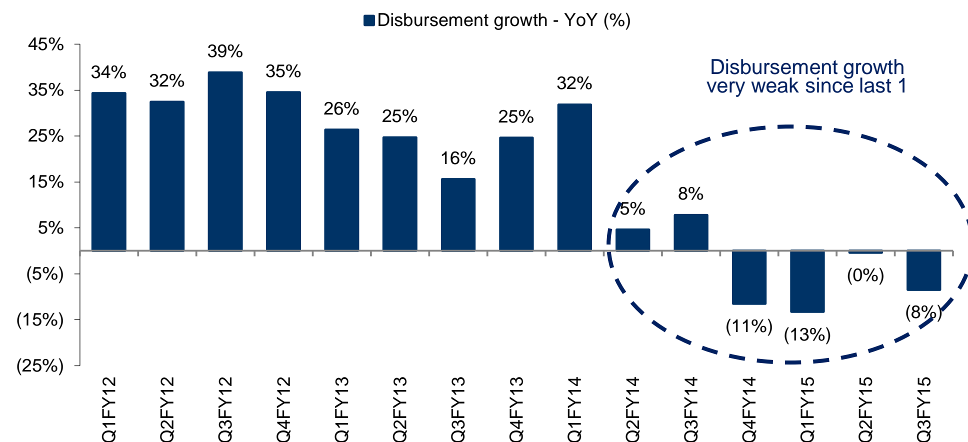
Sub-10% AUM growth ahead

Disbursement growth remains weak

MMFS' disbursements declined by 8% YoY to Rs 67bn in Q3FY15 with weakness across categories and especially in the CV/CE portfolio which registered the steepest decline of 25% YoY. The car (non-M&M, parent) and tractor (M&M) segments which constitute more than 40% of total AUM declined by 13% and 17% YoY respectively during the quarter.

As shown in the chart below, MMFS' disbursements have dropped sharply over the last 5-6 quarters. Management attributes this to slower growth in industry-wide auto sales and higher discounts offered by auto manufacturers across various products. We expect this trend to continue, leading to lower disbursement growth for the pre-owned vehicle segment (~15% of total AUM) in FY16. Note that the company's overall AUM growth is currently being maintained at 10-11% (3Q15) due to robust growth in the pre-owned vehicles segment (15% of AUM), where disbursements are up 10% YoY (on a higher base) and total loans are up 85% YoY.

Fig 1 - Disbursement growth very weak in last six quarters



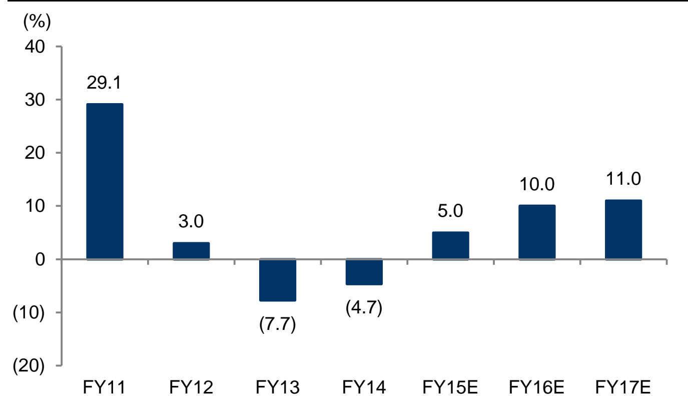
Source: Company

Weak disbursement trend will translate into sluggish AUM growth in FY16/FY17

Rural auto sales likely to lag urban sales in the next 1-2 years

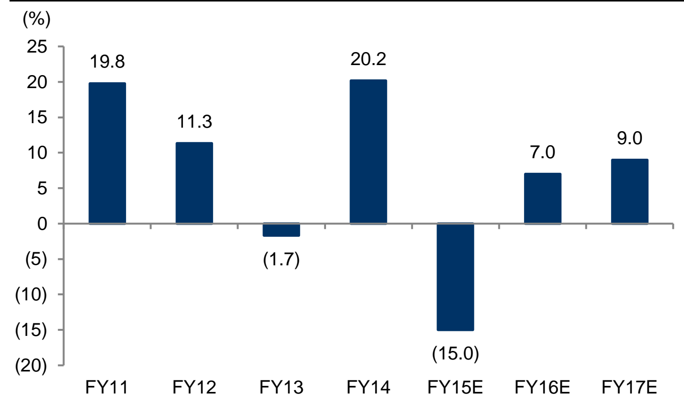
Our Auto analyst expects auto volume growth of 10%/11% in FY16/FY17 and tractor sales growth of 7%/9%. Rural auto sales are likely to be lower than urban sales. Unless auto volumes in rural India pick up meaningfully in FY16 (unlikely in our view), MMFS' AUM growth would fall below 10% for the fiscal.

Fig 2 - Auto sales to grow at ~10% in FY16/FY17



Source: SIAM, RCML Research

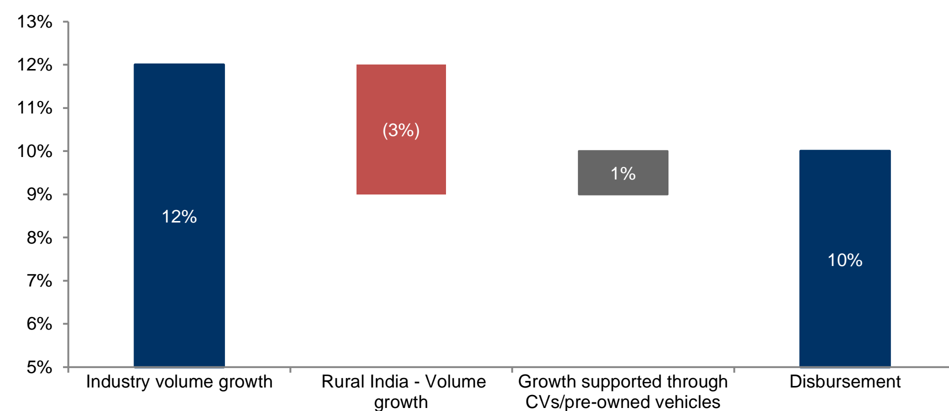
Fig 3 - Modest improvement in tractor volumes



Source: SIAM, RCML Research

In the last 4-5 years, auto sales in rural India have accelerated ahead of urban India due to structural changes in the rural economy (higher outlay for irrigation projects, higher cash flow with rural populations, higher spending under government schemes). However, for the next 1-2 years, we expect the tables to turn with urban sales likely to outpace rural offtake due to high pent-up demand in urban India. MMFS operates in rural and semi-urban markets and therefore its disbursement growth could remain 200-300bps lower than overall industry volume growth.

Fig 4 - Disbursement growth will be much lower than industry volume growth in FY16/17



Source: RCML Research

Higher discounts and lower vehicle resale prices to subdue disbursements

For FY15, urban auto sales are estimated to have increased 2-4% despite the weak economy, while rural/semi-urban demand has likely declined – accordingly, the company expects disbursements for the year to remain flat or decline marginally. In FY16 as well, disbursements could be lower than auto sales numbers due to higher discounts offered by manufacturers and a drop in vehicle resale price. We expect discounts to remain high at least till the end of H1FY16. MMFS is trying to support growth by focusing on its SME finance book as well as loans given under the Mahindra ecosystem – not a healthy sign.

Fig 5 - Management guidance on loan growth

Segments	Proportion in overall AUM	Projected disbursement growth (FY16)	Comments
Tractors	18%	10%	M&M's tractor portfolio has posted negative growth YTD and the same will be reflected in MMFS's disbursement numbers in 9MFY15 and FY15.
			Tractors in rural areas are now regarded as multipurpose vehicles (used for infrastructure and transport). Therefore, with improvement in GDP growth and IIP next year, tractors may register 8-10% growth in FY16.
			If the monsoon is good next year, it may lead to a minor increase in growth (2-3%).
Auto / Utility Vehicle (M&M)	29%	8-10%	Parent company M&M commands 50%+ market share.
			In the last 1-1.5 years, M&M faced very high competition in the urban market and its urban volumes are likely to decline in FY15.
			However, vehicles in the pick-up segment are doing well in rural areas and volumes are expected to remain flat/show marginal growth (2-3%) in FY15.
			UVs in rural areas are need/economy-based and are therefore expected to register 8-10% growth in FY16.
Cars & Others (non-M&M)	23%	8-10%	Industry players expect 5-7% volume growth in FY16. Maruti Suzuki is the only exception with guidance of ~15% growth. However, Maruti is offering discounts and therefore disbursements will be much lower than 15%.
			Sales mix for many players is likely to change in favour of urban areas in the next 1-2 years.
Commercial Vehicles & Construction Equipment	14%	10-12%	MMFS had completely exited heavy commercial vehicles due to the slowdown in Q3/Q4FY14. LCV/CE volumes also slowed down considerably in Q1FY15.
			M&HCV volumes declined significantly in the last two years and therefore the base is very low.
			In the last 2-3 months, M&HCV volumes have increased considerably but demand is highly skewed in favour of fleet operators.
			Fleet operators are buying vehicles as demand from sectors like cement and auto manufacturers are showing good traction. Many fleet operators are also buying due to high discounts and prices are likely to go up next year.
			CV volumes may improve in FY16 and the industry is likely to register ~15% growth. MMFS may be able to grow its book by 10-12%.
Used Vehicles & Other Finance	16%	15-20%+	The company highlighted that its used vehicle portfolio is ~9% of AUM and the remaining portion has dealer financing, SME and TW (Two wheelers) loans.
			Used vehicle financing is likely to registered better growth as demand for used vehicles is generally strong when new vehicle sales are lower.
			However, it is unlikely to support overall AUM growth meaningfully as typically loans are given for 2 years and the average duration for repayment is 12-13 months.

Source: RCML Research, Company

NPA coverage at record low; credit cost to remain elevated

Steady rise in gross NPAs in the last two years

MMFS' gross NPAs have consistently gone up in the last two years due to poor monsoons, adverse climatic conditions and a slowing rural economy. Currently, gross NPA is at a multi-year high of 7%.

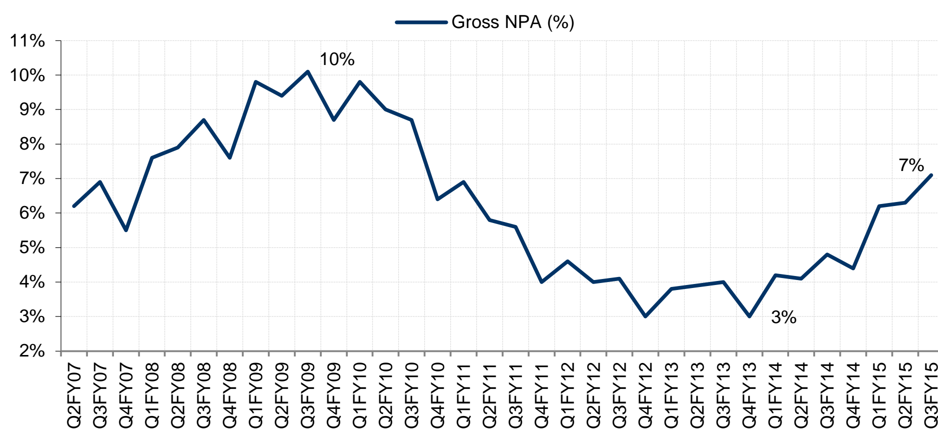
Middle of the NPL cycle; credit cost is expected to remain elevated

We have seen no meaningful improvement in ground realities over the last 2-3 quarters despite government efforts. Collections improved in the last quarter, but this is in no way indicative of a trend reversal. Further, as seen in 9MFY15, pressure on resale prices of vehicles (due to manufacturer discounts on new vehicles) is likely to push up losses from defaults for the company.

Higher NPLs in southern markets

MMFS stated that contrary to earlier trends, southern states were showing a marked deterioration in asset quality. The southern market constitutes 35% of MMFS' AUM and their contribution to NPLs is much higher.

Fig 6 - Gross NPA up steadily since FY13



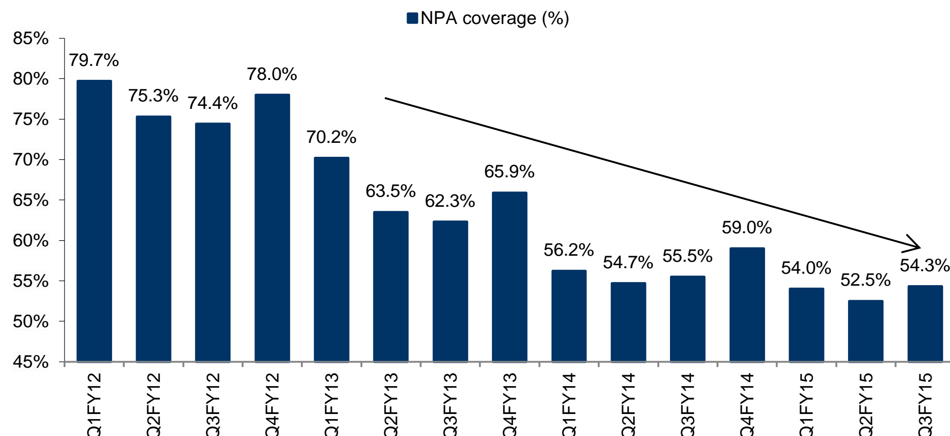
Source: Company

Poor coverage and transition to 90-DPD norms to keep credit cost high

MMFS has not provided adequately for credit cost since the beginning of this downward cycle (FY12), thereby failing to buffer against further deterioration in asset quality. A key concern is the steady decline in NPA coverage ratio from 86% in Q4FY11 to ~52% in Q2FY15, with only a marginal increase of ~200bps in Q3FY15 to 54%. Credit cost is expected to remain elevated in FY16-FY17 as we do not expect the company to drop coverage below 50%.

Coverage ratio at multi-year low of ~50% which will keep credit cost very high

Fig 7 - NPA coverage ratio near 50%



Source: Company

Transition to 90-DPD norms will double NPA and credit cost will increase due to poor coverage ratio

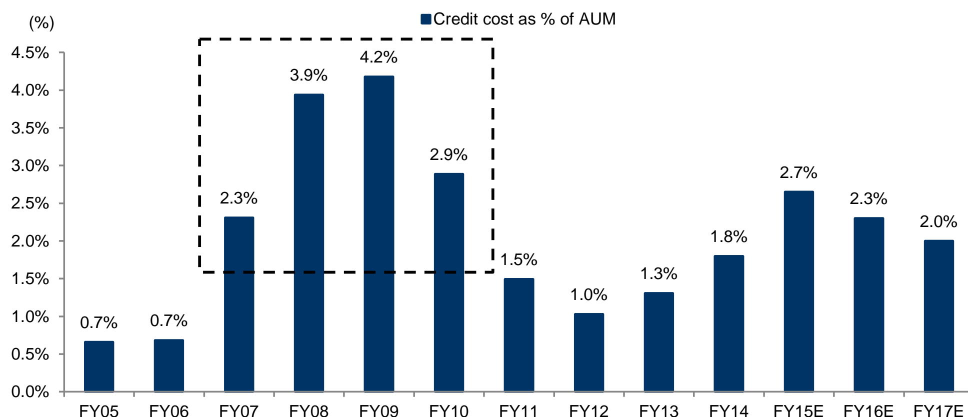
MMFS is currently following 150-DPD norms for NPA. In FY12, when the Usha Thorat Committee recommendations were out, management was guiding for a 50% increase in NPAs, i.e. from 4% to 6%. However, the company has now highlighted that due to poor asset quality trends, the overdue accounts in each day-bracket between 90 and 150 days have gone up in the last 1-1.5 years. We estimate that NPLs are likely to double due to new norms over FY15-FY18.

MMFS has not yet finalised the strategy for transition to 90-DPD NPA norms. If the company decides to maintain its coverage ratio at 50%, credit cost will increase meaningfully. On the other hand, if credit costs are maintained at current levels (2.5-2.7% in FY15-18), the coverage ratio will drop to 30-35%.

Downside risk from credit cost persists

We expect MMFS' credit cost to touch 2.7% in FY15 (from 1.8% in FY14 and 1.3% in FY13). We are assuming credit cost moderation in FY16 and FY17, though a sustained slowdown in rural demand could keep costs much higher than our estimates. We note that credit cost in the last cycle was ~3.7% on average for three years (FY08-FY10).

Fig 8 - MMFS – downside risk from credit cost



Source: Company, RCML Research

Possible upside to margins in FY16…

Lower wholesale cost of funds and cut in banks' base rate will aid margins

The cost of borrowings in the wholesale market has corrected sharply in the last six months. MMFS is not borrowing incremental funds from banks and has instead shifted to the wholesale debt market. The company's credit rating was recently upgraded to AAA by CARE and Fitch, which should enable it to place NCDs with pension funds and insurance companies. Management expects a marginal benefit on cost of funds in FY16 due to the rating upgrade. Also, if banks cut their base rate in FY16, then the benefit will directly flow into MMFS' margins as 45% of the company's borrowings are still sourced from banks.

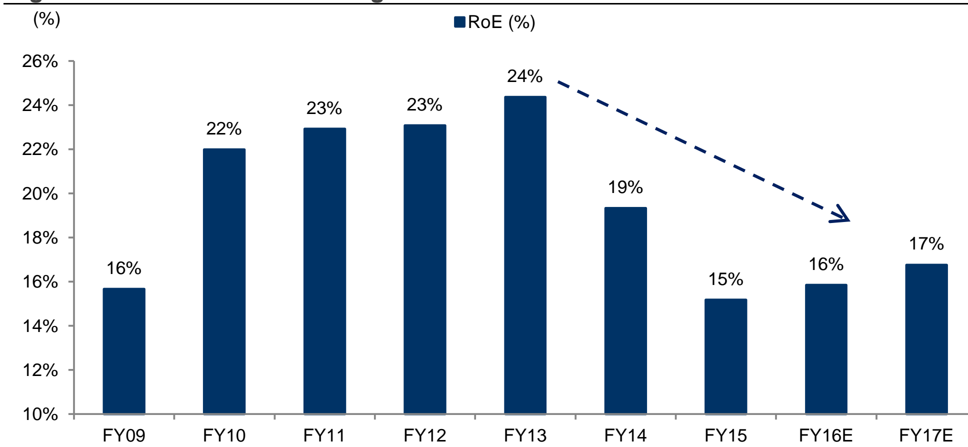
Management highlighted that MMFS is likely to lose 30-40bps of margins in FY15 due to interest reversals (higher NPAs). In addition, the company may have to cut lending rates if competitors do so. Overall, we see a possible 30-40bps upside to margins in FY16 over FY15 though the earnings impact will be minimal given credit cost and loan growth pressures.

…but profitability to remain under pressure; maintain HOLD

ROE to remain much lower than FY10-FY14 levels, limiting re-rating potential

We expect ROE to decline by ~300bps over FY15/FY16 due to slower loan growth and higher credit costs. Current valuations at 2.3x FY17E P/ABV are above the historical average and expensive given the pressure on profitability (we are using adj. P/B mainly because of the company's low coverage ratio). We maintain HOLD with a revised Mar'16 TP of Rs 250, set at 2.1x FY17E P/ABV (from Rs 325 earlier).

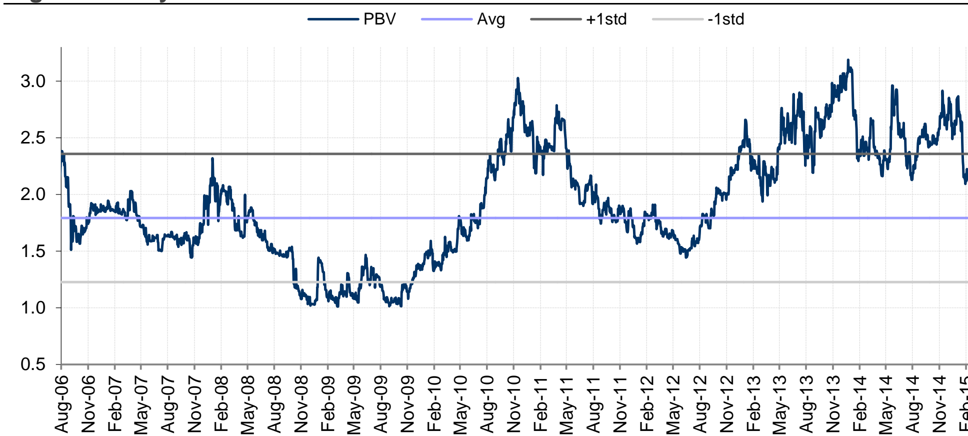
Fig 9 - ROE to remain in the range of 15-16% – much lower than FY10-FY14 levels



Source: RCML Research, Company

Fig 10 - One-year forward P/B for MMFS

Stock is trading above historical average – expensive in our view



Source: Company, RCML Research, Bloomberg

Disbursements

Y/E 31 Mar (INR mln)	FY13A	FY14A	FY15E	FY16E	FY17E
Disbursements	1,62,102	1,72,720	1,81,356	1,99,492	2,27,420
Growth (%)	22.2	6.5	5.0	10.0	14.0
AUM/Sanctions	2,83,000	3,46,986	3,76,652	4,10,094	4,57,732
Growth (%)	36.6	22.6	8.5	8.9	11.6

Per Share Data

Y/E 31 Mar (INR)	FY13A	FY14A	FY15E	FY16E	FY17E
Reported EPS	16.5	16.9	15.1	17.8	21.4
Adjusted EPS	16.5	16.9	15.1	17.8	21.4
DPS	3.6	3.7	3.5	4.1	4.9
Book value	81.3	93.9	105.6	119.3	135.8
Adjusted book value	76.7	85.0	86.0	102.0	116.1

Valuation Ratios

Y/E 31 Mar (x)	FY13A	FY14A	FY15E	FY16E	FY17E
P/E	15.9	15.5	17.3	14.7	12.3
P/BV	3.2	2.8	2.5	2.2	1.9
P/ABV	3.4	3.1	3.1	2.6	2.3

Financial Ratios

Y/E 31 Mar (%)	FY13A	FY14A	FY15E	FY16E	FY17E
Spread Analysis					
Interest spreads	6.7	6.4	6.5	6.8	7.1
Yield on advances	16.6	16.5	16.5	16.55	16.65
Yield on assets	16.3	16.3	16.3	16.4	16.5
Cost of funds	9.6	9.9	9.8	9.6	9.4
NIMs	8.9	8.6	8.5	8.6	8.7
Operating Ratios					
Operating cost to income	34.1	34.4	35.2	36.7	37.6
Operating expenses / Avg assets	3.6	3.4	3.4	3.6	3.8
Asset Quality and Capital					
Gross NPA	2.9	3.5	7.0	7.1	7.0
Net NPA	1.0	1.6	3.2	2.6	2.6
CAR	17.5	16.2	16.4	16.9	17.2
Growth Ratios					
Net interest income	41.5	24.5	12.7	10.0	11.9
Non-interest income	9.8	15.1	5.2	20.0	24.9
Pre-provisioning profit	43.6	23.0	10.8	8.2	11.4
Net profit	44.1	3.0	-10.6	17.7	20.0
Assets	39.4	25.8	8.0	8.1	11.1
Advances	39.7	25.0	8.5	8.3	11.3
Book value	37.8	15.5	12.4	13.0	13.8
EPS	31.4	2.9	-10.6	17.7	20.0

DuPont Analysis

Y/E 31 Mar (%)	FY13A	FY14A	FY15E	FY16E	FY17E
Net interest income / Assets	9.6	9.1	8.8	9.0	9.2
Non-interest income / Assets	0.9	0.8	0.7	0.8	0.9
Operating expenses / Assets	3.6	3.4	3.4	3.6	3.8
Provisions / Assets	1.2	1.7	2.5	2.2	1.9
Taxes / Assets	1.8	1.7	1.2	1.4	1.5
ROA	3.9	3.1	2.4	2.6	2.9
Equity / Assets	6.1	6.2	6.3	6.0	5.8
ROAE	**23.6**	**19.3**	**15.4**	**15.8**	**16.8**

Income Statement

Y/E 31 Mar (INR mln)	FY13A	FY14A	FY15E	FY16E	FY17E
Interest income	38,944	50,491	58,027	63,314	70,193
Interest expense	(16,706)	(22,810)	(26,821)	(28,974)	(31,760)
Net interest income	22,238	27,681	31,206	34,340	38,433
Non-interest income	2,186	2,515	2,645	3,174	3,966
Net revenue	24,424	30,196	33,851	37,514	42,398
Operating expenses	(8,321)	(10,391)	(11,903)	(13,774)	(15,955)
Pre-provisioning profits	16,103	19,805	21,948	23,740	26,443
Provisions & contingencies	(2,882)	(5,190)	(8,870)	(8,343)	(7,969)
PBT	13,221	14,615	13,078	15,397	18,474
Extraordinaries					
Income tax	(4,561)	(5,071)	(4,547)	(5,355)	(6,425)
Reported PAT	17,783	19,686	17,625	20,752	24,900
Adj. net profit	17,783	19,686	17,625	20,752	24,900

Balance Sheet

Y/E 31 Mar (INR mln)	FY13A	FY14A	FY15E	FY16E	FY17E
Advances	2,56,800	3,21,105	3,48,331	3,77,140	4,19,762
Investments	4,575	7,219	6,571	6,836	7,168
Current assets	8,209	10,978	11,679	12,434	13,421
Net block (inc CWIP)	1,123	1,273	1,400	1,540	1,694
Goodwill	-	-	-	-	-
Other assets					
Total Assets	**2,70,708**	**3,40,575**	**3,67,981**	**3,97,951**	**4,42,045**
Share capital	1,126	1,127	1,127	1,127	1,127
Options/warrants/others	-	-	-	-	-
Reserves & surplus	44,670	51,810	58,379	66,112	75,389
Net worth	45,796	52,937	59,506	67,239	76,516
Total borrowings	2,01,525	2,59,953	2,87,618	3,18,892	3,59,590
Current liabilities & Provisions	23,151	27,320	20,454	11,378	5,452
Deferred tax liabilities	-	-	-	-	-
Other liabilities	237	365	402	442	486
Total Equity & Liabilities	**2,70,708**	**3,40,575**	**3,67,981**	**3,97,951**	**4,42,045**

RELIGARE INSTITUTIONAL RESEARCH
Values that bind

Company Initiation
INDIA
NBFC

25 March 2015

BUY
TP: INR 775.00
▲ 35.7%

Cholamandalam Investment and Finance

CIFC IN

Structural growth ahead – initiate with BUY

We initiate coverage on CIFC with BUY and a Mar'16 TP of Rs 775 (~35% upside). We expect moderating credit costs, higher NIMs and rising operating efficiency to support ~100bps expansion in ROA to 3% over five years. CIFC's loan growth would also remain ahead of peers led by expansion across geographies and products. The stock trades at 2.1x FY17E P/B and we expect a re-rating given the structural improvement in profitability ahead.

- **Five-year journey towards 3% RoA:** We expect CIFC's ROA to improve from 1.8% in FY14 to ~2.4% by FY17 and ~3% by FY19 led by better margins, stronger operating ratios and lower credit costs. Credit costs (~1.5% of avg. assets in FY15) are at a cyclical high and should moderate to a cyclical average of ~1.3% by FY17/18. Also, a shift in funding mix towards fixed-rate products over the next 2-3 years and higher capital adequacy would lower the cost of funds and reduce margin volatility.
- **CV/auto cycle recovery augurs well for growth:** We expect CIFC to continue posting stronger loan growth than peers (at ~20% CAGR over FY15-FY18) given the ongoing revival in the CV/auto cycle, its pan-India presence (~600 branches in FY15E from 170 in FY10), and market share gains in new products (tractors, used vehicles). Recent capital infusion via a US$ 83mn CCPS issue should ensure adequate capital for growth.
- **Strong promoter profile:** CIFC is a part of the Murugappa group, a leading business conglomerate founded in 1900. The promoter has stood by the company during difficult times, with a buyback of DBS' 37.5% stake in CIFC for Rs 3.8bn in FY10 when profitability hit a record low and staunch support during top management churn.
- **Initiate with BUY:** We value CIFC based on the two-stage Gordon growth model and arrive at a Mar'16 TP of Rs 775. We think current valuations (2.1x FY17E PBV) are cheap and earnings growth (~30% CAGR over FY15-FY17E) should support a re-rating.

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PRICE CLOSE (24 Mar 15)
INR 570.95

MARKET CAP
INR 82.0 bln
USD 1.3 bln

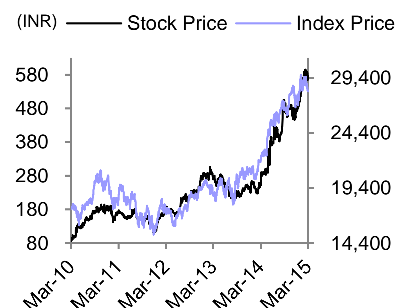
SHARES O/S
143.3 mln

FREE FLOAT
42.3%

3M AVG DAILY VOLUME/VALUE
0.2 mln / USD 1.9 mln

52 WK HIGH
INR 618.00

52 WK LOW
INR 248.50



Financial Highlights

Y/E 31 Mar	FY13A	FY14A	FY15E	FY16E	FY17E
Net interest income (INR mln)	11,074	14,605	16,920	20,544	25,101
Net revenues (INR mln)	11,447	14,918	17,275	20,960	25,590
Pre-provision profits (INR mln)	5,751	8,335	9,894	12,764	16,191
Adj. PAT (INR mln)	3,065	3,640	4,119	5,494	7,353
Adj. EPS (INR)	21.4	25.4	28.7	35.3	47.3
ROE (%)	18.1	17.1	16.7	17.5	18.6
ROA (%)	1.9	1.8	1.8	2.1	2.4
Gross NPA (%)	1.2	1.9	2.7	2.5	2.3
CAR (%)	19.0	17.2	17.3	19.2	19.4
P/BV (x)	4.2	3.6	3.1	2.5	2.1
P/E (x)	26.7	22.5	19.9	16.2	12.1

Source: Company, Bloomberg, RCML Research

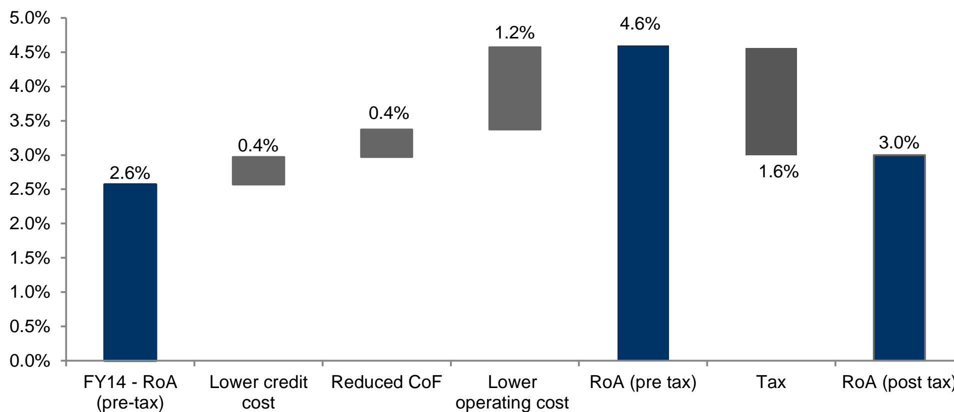
Investment rationale

Five-year journey towards 3% ROA

Gradual improvement in margins, credit costs and operating ratios to drive ROA to 3% by FY19

We expect CIFC's ROA to expand gradually from 1.8% in FY14 to ~2.4% by FY17 and ~3% by FY19 led by steady improvement in margins, credit costs and operating ratios. Credit costs (~1.5% of avg. assets in FY15) are at a cyclical high and should moderate to a cyclical average of ~1.3% over FY15-FY18 (albeit still much higher than the 0.2-0.8% in FY12/FY13 – strong years for the company). CIFC's cost of funds is also expected to moderate with a more granular asset mix and higher capital adequacy. We expect margins to improve gradually from FY16 onwards. Increased operating efficiency should lead to ~100bps improvement in ROA over the next five years.

Fig 1 - Structural improvement in ROA underway



Source: Company, RCML Research

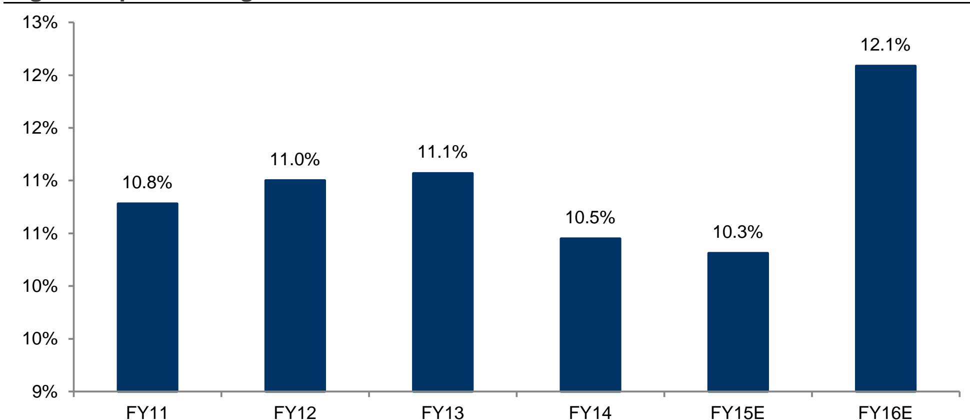
Higher tier 1, cyclical tailwinds to aid margins

Tier 1 to improve by ~180bps in FY16

Recent stake sale to boost tier 1 capital – precursor for a better credit rating

Over the last one-and-a-half years, CIFC's tier 1 capital has remained lower at 10-10.5% than comparable peers (12%+). Lower capital adequacy has hurt the company's credit rating, in turn forcing it to borrow at marginally higher rates. However, the recent fund raising by CIFC is likely to increase its tier 1 capital by ~180bps. Global PE firm Apax Partners has invested ~US$ 83mn for an 8% equity stake in CIFC by subscribing to 50mn compulsorily convertible preference shares (CCPS) at a face value of Rs 100/sh. The CCPS will convert into equity shares at Rs 407 each, translating into an issue of 12.2mn shares by Jul'15, thereby boosting the company's tier 1 capital adequacy ratio.

Fig 2 - Capital raising to boost tier 1 in FY16



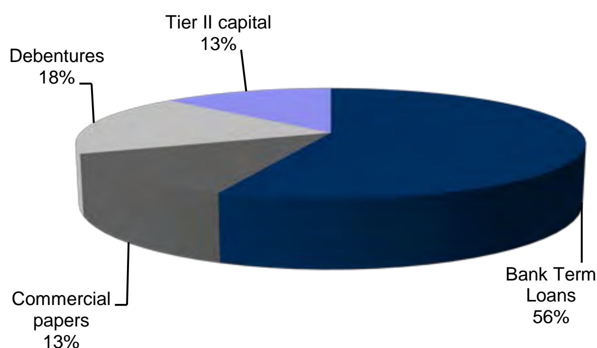
Source: Company, RCML Research

Cyclical tailwinds to support margins in medium term

ALM structure will result in better margins when rates are falling

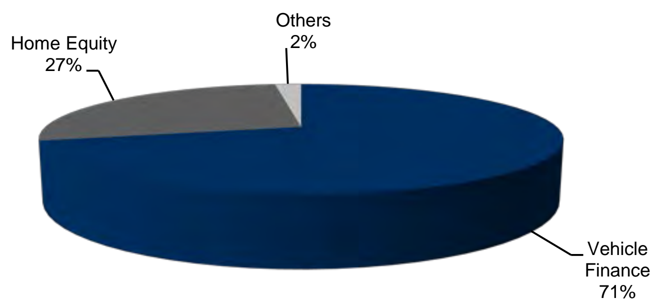
CIFC's vehicle loan portfolio (~71% of total loans) carries a fixed rate of interest. In comparison, ~58% of its borrowings are floating in nature. In addition, the company issues short-duration commercial papers (13% of the total) typically with 6-month average maturity and therefore these do reflect floating interest rates from a longer-term (2-3 year) perspective. While this ALM structure gives CIFC limited ability to pass on any increase in interest rate, the company does benefit when rates are falling. In the current softening rate environment, CIFC's ALM structure would result in better margins as a reduction in wholesale cost of funds and banks' base rate will bring down the company's cost of borrowings while keeping yield on advances stable.

Fig 3 - Funding mix (Dec'14)



Source: Company

Fig 4 - Asset mix (Dec'14)

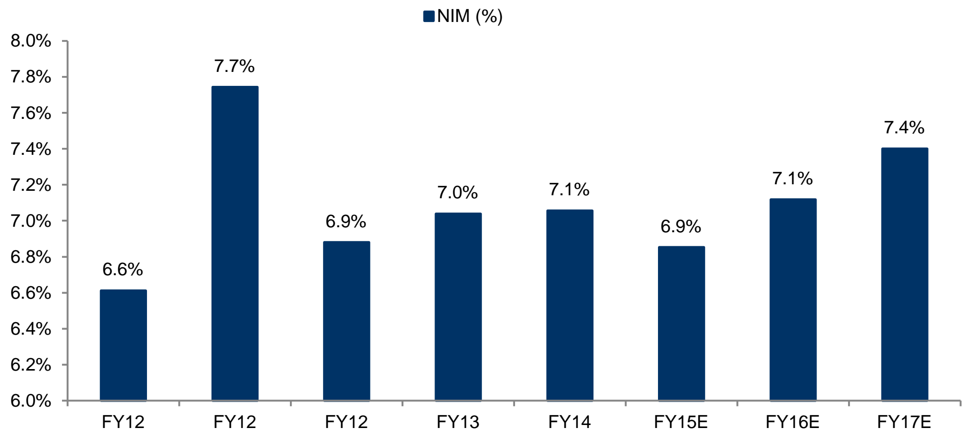


Source: Company

Better funding mix to reduce margin volatility in long term

CIFC has an AA credit rating from CARE Ltd. With better capital adequacy and a diversified loan book, the company could see a rating upgrade in the next 1-2 years. This would enable CIFC to diversify its funding mix through wholesale market borrowings (insurance/pension companies and mutual funds). We expect to see a shift in funding mix towards fixed-rate products over the next 2-3 years, which would lower the company's cost of funds and temper margin volatility. Margins are likely to improve from FY15 onwards and we are modeling for 20-30bps expansion over FY15-FY17.

Fig 5 - We expect steady improvement in margins over FY15-17



Source: Company, RCML Research

Credit costs to moderate gradually

NPAs and credit costs at cyclical peaks and should moderate going forward

Expected to normalise at 1.2-1.3% levels

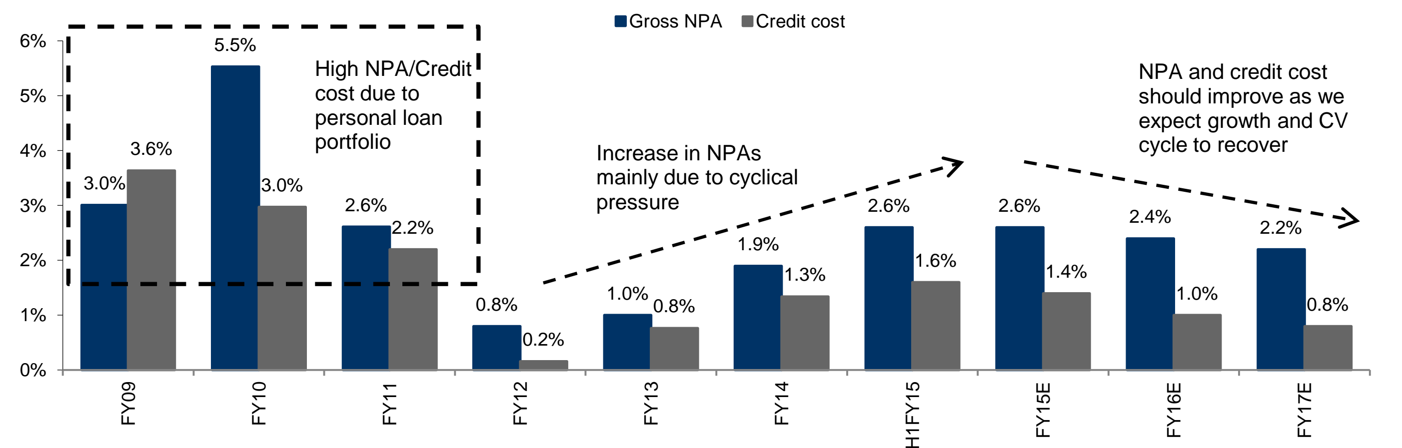
CIFC along with its DBS JV started a personal loans business in FY06, but discontinued it after incurring heavy losses in Sep'08. These losses were the biggest drag on the company's profitability over FY08-FY11, and accounted for 80% of the credit costs during this period. With the company now focusing on its traditional secured lending portfolio, credit costs are likely to be lower than the earlier cycle.

At present, CIFC's NPAs and credit costs are high due to the CV cycle downturn and economic growth slowdown. Gross NPAs have increased from 0.8% in FY12 to 2.8% in 9MFY15, and credit costs from 0.2-0.3% in FY12 (lowest ever) to 1.7% currently. We expect this trend to continue for at least 2-3 quarters.

Upside risks to ROA from further reduction in credit costs

Thereafter, CIFC's credit costs may fall sharply if there is a strong pick-up in growth led by improvement in the CV cycle. Adjusted for the cyclical skew, we expect credit costs to average at 1.2-1.3% over FY15-FY17 as the company lends to riskier segments in semi-urban and rural India.

Fig 6 - Trend in gross NPAs and credit costs: Expect modest recovery FY16 onwards



Source: Company, RCML Research

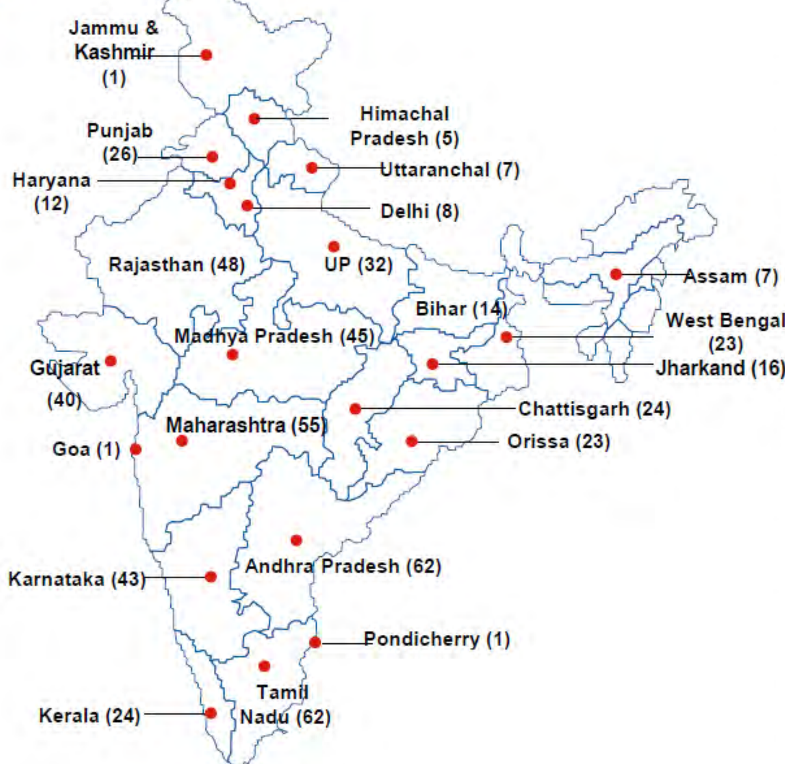
Improved productivity and cross-selling to reduce operating costs

Rapid branch expansion over last 3-4 years

CIFC has invested heavily towards building its branch network in the last 3-4 years, growing at a 35% CAGR over FY10-FY14 to ~600 branches (90% in semi-urban and rural areas) from 171 in FY10. With the company now penetrating most markets across India, the pace of expansion would likely be slower, as the focus shifts towards scaling up existing branches and introducing more products to boost productivity.

CIFC has expanded rapidly across India in the last 3-4 years

Fig 7 - CIFC's pan-India presence

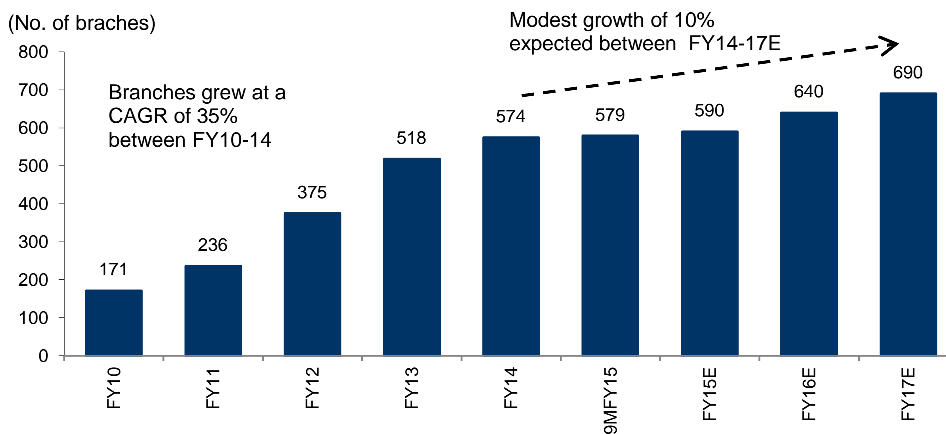


Source: Company

We expect CIFC to open 50 branches each year over FY14-FY17, which translates to less than 10% growth.

Expect modest growth in branches over FY14-FY17 (10% vs. 35% in FY10-FY14)

Fig 8 - Rapid branch expansion between FY10-FY14



Source: Company, RCML Research

Technology investments to reap benefits in coming years

CIFC has invested heavily in technology for loan generation, disbursements and collections, which has helped bring down the loan turnaround time from 6-7 days over the last 2-3 years to 1-2 days at present. Standardised procedures would improve operating efficiency, enabling the company to reduce loan processing/collection costs going forward.

New businesses to bring in operating efficiencies

Economies of scale from new business initiatives

- **Home (equity) business:** We note that the average tenure for a home loan is ~10 years (vs. 3.5-4 years for auto loans) and operating costs are lower than vehicle financing because of higher ticket sizes (~Rs 0.5mn as against Rs 500k for vehicle loans). Thus, the cost of sourcing/collections for home loans is lower and since these loans are sticky, they can grow in line with the promoters' (borrowers') existing business without incremental sourcing costs.

  The company currently operates this business through fewer than 100 branches, but plans to rope in the remaining branches in future. The cost of generating home loans through the existing branch setup will be much lower going forward. An increasing proportion of higher-ticket and longer-duration home equity loans (up from 23% of CIFC's total AUM in FY13 to 28% in Q3FY15) should bring in operating efficiencies for the company in coming years.

- **Home loan (mortgage) business:** Given the success of its LAP product (loans against property), CIFC has started offering pure home loan products for non-salaried and non-professional customers, garnering a good response in many locations. The company's current mortgage portfolio stands at Rs 800mn, with a yield of 16% and potentially strong return ratios. CIFC plans to ramp up this business without compromising on profitability and is likely to offer these loans through its existing branch setup given a largely similar customer profile concentrated in semi-urban and rural India.

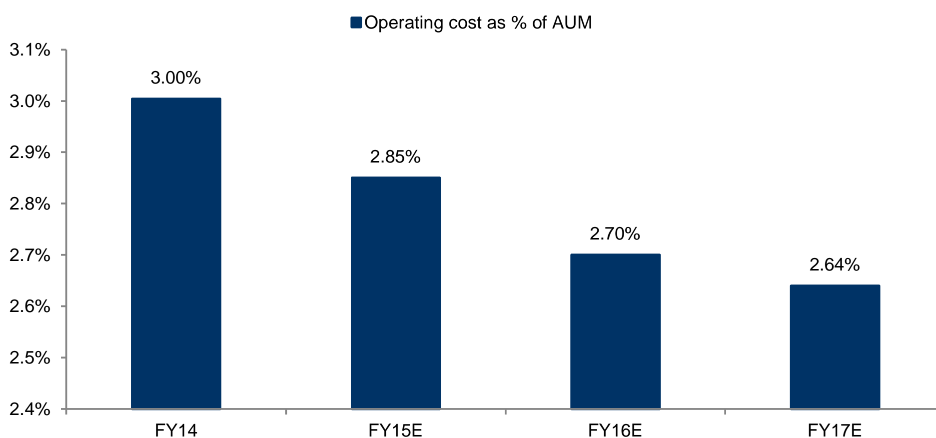
- **Gold loans/SME and small agriculture loans:** CIFC plans to cross-sell small loans to customers of group companies. The cost of sourcing these loans will be lower.

Operating cost as proportion of average AUM to decline

As new businesses bring in operating efficiency, the company's operating cost as a percentage of total AUM is likely to decline by ~40bps to ~2.6% over FY14-FY17.

Rising efficiency to shave 100bps off operating cost by FY19

Fig 9 - Operating cost as a percentage of total AUM to decline gradually



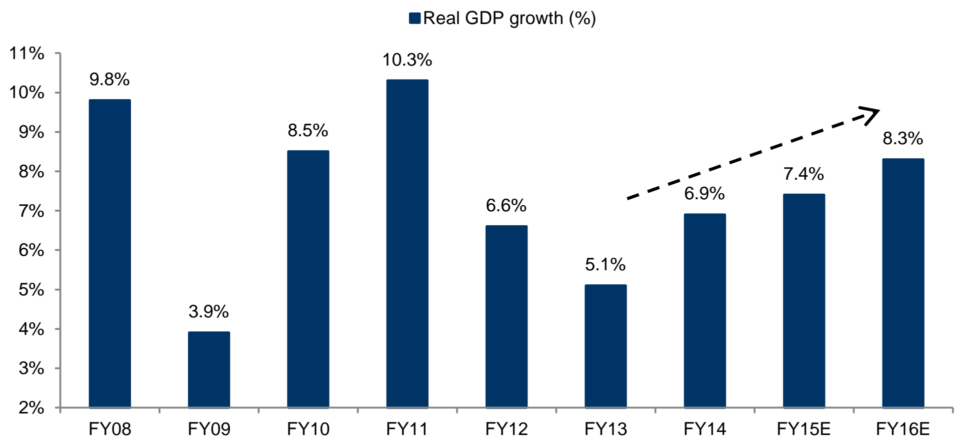
Source: Company, RCML Research

CV/auto cycle recovery augurs well for growth

India's economic growth to improve steadily…

We believe the Indian economy is at an inflection point. Our economist Prerna Singhvi expects India's GDP growth to pick up from 6.9% in FY14 to 7.4% and 8.3% in FY15 and FY16 respectively.

Fig 10 - Expect steady recovery in GDP growth

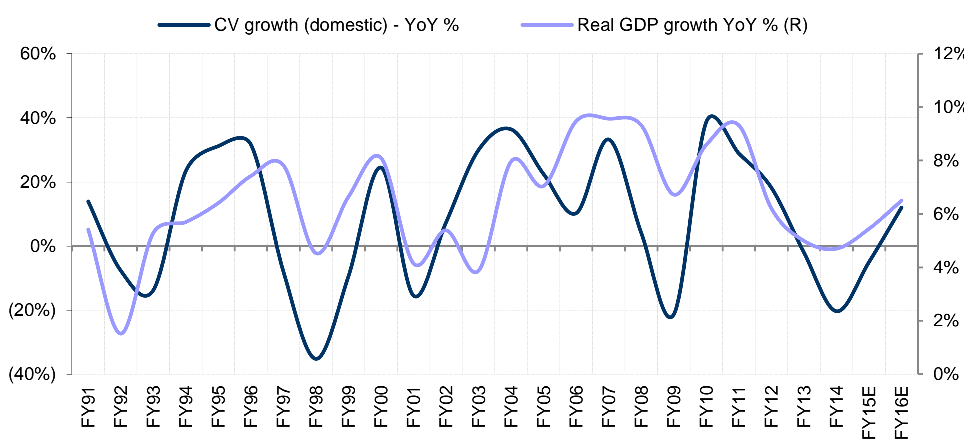


Source: RBI, RCML Research, Bloomberg

…leading to a pick-up in CV volumes from FY16 onwards

CV sales and utilisation levels have a high correlation with GDP growth and economic cycles, while M&HCV sales are closely linked with IIP growth. CVs account for ~50% of CIFC's total auto loans (including small CVs and three-wheelers). With a recovery in the CV cycle, we expect the company's loan growth to pick up meaningfully from H2FY16/FY17 onwards.

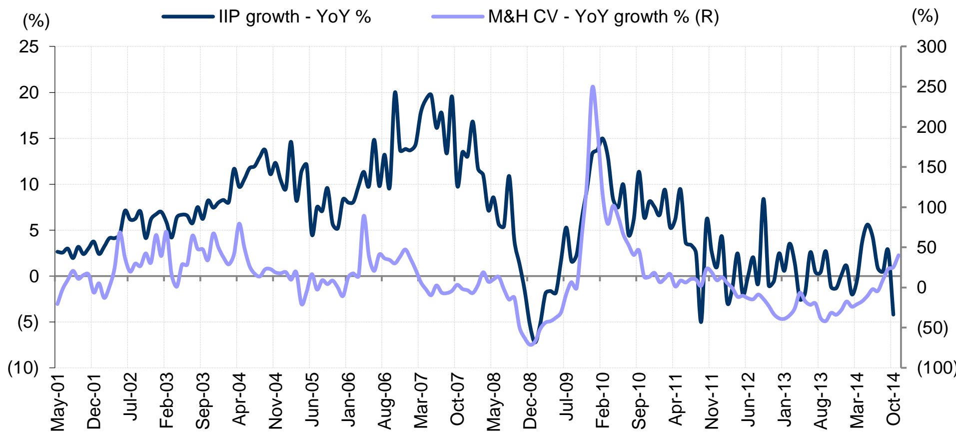
Fig 11 - Long-term trend for CV sales and GDP growth



Source: RBI, Bloomberg, RCML Research

Correlation between GDP and CV volume growth remains high

Fig 12 - Strong correlation between IIP growth and M&HCV growth

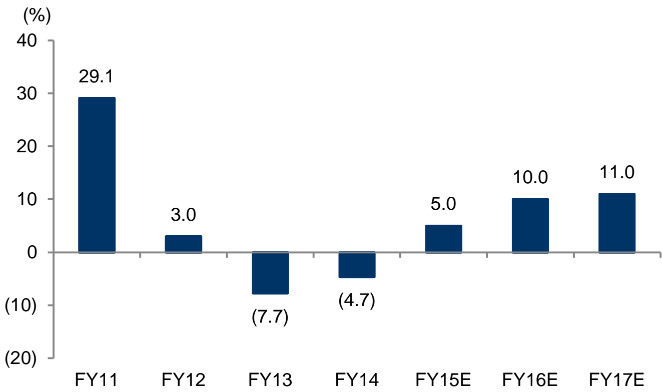


Source: RBI, Bloomberg, RCML Research

Our Auto analyst, Mihir Jhaveri, expects domestic CV volumes to recover from FY16 onwards and forecasts LCV/M&HCV volume growth of 14%/19% in FY16 and 16%/20% in FY17. Industry auto volumes are expected to grow 10%/11% in FY16/FY17 while tractor sales revive from a 15% decline in FY15 to 7%/9% growth in FY16/FY17. Since CIFC does not offer tractor loans from all its branches, overall growth in its tractor portfolio is likely to be higher than industry due to the base effect.

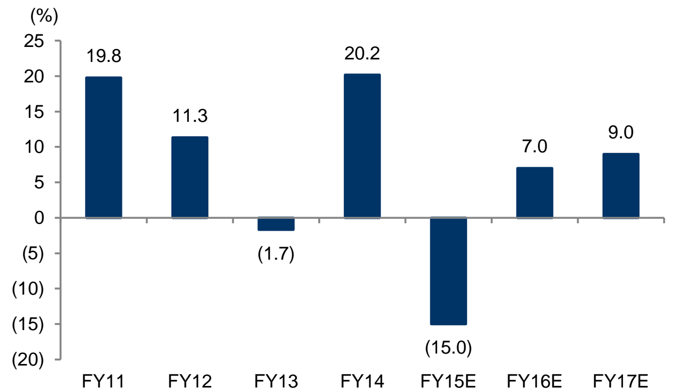
Auto and tractor sales to revive from FY16, which will boost loan disbursals

Fig 13 - Auto industry volumes to grow by ~10% in FY16/17



Source: SIAM, RCML Research

Fig 14 - Tractor volumes to revive modestly in FY16/17



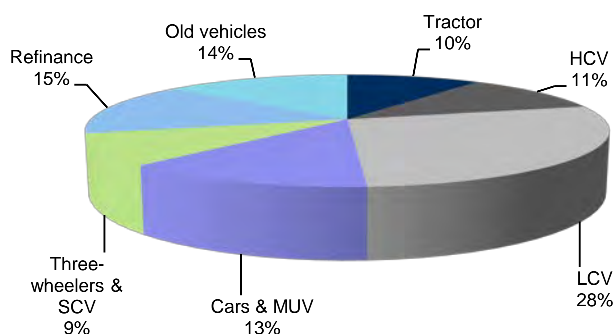
Source: SIAM, RCML Research

Diversified portfolio across products and geographies

CIFC has expanded its footprint aggressively in the last 3-4 years, raising the number of branches from 171 in FY09 to ~580 as of Dec'14. The company now has a pan-India presence with a well-diversified loan book across regions. Branches take 2-2.5 years to achieve initially targeted business. Therefore, we expect the growth rate to remain high despite the company opening fewer branches in FY16/FY17E.

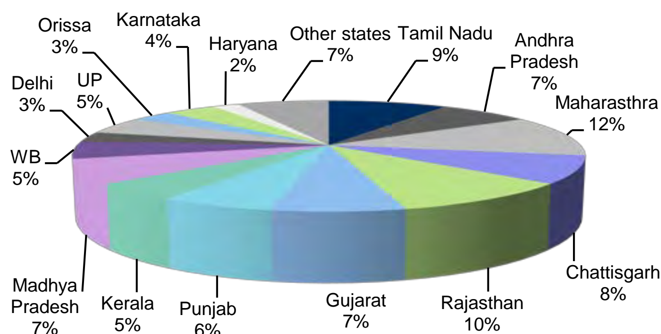
Diversified loan book augurs well for balanced growth

Fig 15 - Balanced portfolio across product lines (3Q15)



Source: Company

Fig 16 - Well-diversified book across regions (3Q15)



Source: Company

CIFC introduced tractor financing in FY12, with the portfolio now constituting ~10% of its total disbursements. We expect growth in this segment to remain high going forward. The company is also likely to see healthy growth in used vehicles (~15% of its total vehicle loans) – we expect the used vehicles market to outpace growth in the new vehicles segment as it is highly underpenetrated and currently dominated by unorganised players, especially in rural and semi-urban areas.

The company currently operates home loan equity business through fewer than 100 branches, but plans to rope in the remaining branches in future which is likely to support growth.

CIFC has started offering pure home loan products for non-salaried and non-professional customers, garnering a good response in many locations. This segment has a huge potential and support loan growth in coming years.

CIFC is planning to enter into SME loans and gold loans mainly for group company customers which will drive further improvement in loan growth.

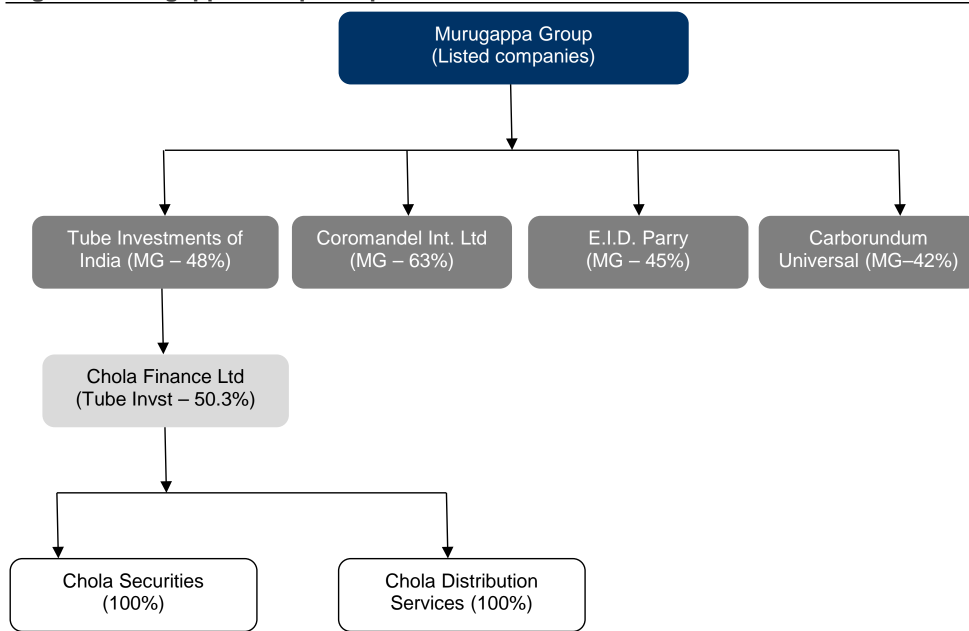
Strong promoter backing

Murugappa group: Background and history

Strong and reputed promoter enhances market credibility

CIFC is a part of the Murugappa Group which was founded in 1900 and is one of India's leading business conglomerates, with 28 businesses including 11 listed companies and a workforce of 32,000 employees. The group, with a wide geographical presence spanning 13 states in India and five continents, has forged strong alliances with leading international companies such as Groupe Chimique Tunisien, Foskor, Mitsui Sumitomo, Morgan Crucible and Sociedad Química y Minera de Chile (SQM).

Fig 17 - Murugappa Group: Corporate structure



Source: Company

The group is a market leader in several businesses, with the key listed businesses as under:

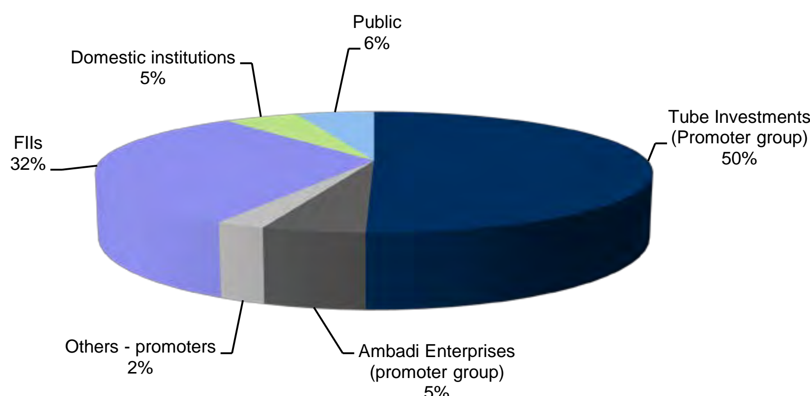
- **Fertilizer:** Coromandel International (market cap of ~US$ 1.3bn; the group owns 63%+ stake) is one of India's leading phosphatic fertilizer companies, with a production capacity of 2.9mt of phosphatic fertilizers.
- **Engineering products:** Tube Investments of India (market cap of ~US$ 1bn; the group owns 48%+ stake) offers a wide range of engineering products such as steel tubes, chains and car-door frames, apart from e-scooters, fitness equipment and cycles.
- **Sugar and bio products**: EID Parry India (market cap of ~US$ 560mn, the group owns 45%+ stake) offers a wide range of agro products such as sugar, microalgal health supplements and bio products, with a capacity to crush 32,500 tonnes of cane per day (tcd).
- **Abrasives/electro minerals and industrial ceramics:** Carborundum Universal (market cap of ~US$ 500mn; the group owns 42%+ stake) is a pioneer in coated and bonded abrasives, super re-factories, electro minerals and industrial ceramics. The company currently has a presence in Australia, South Africa, Russia, Canada and the Middle East.

Key unlisted businesses are:

- **Parry Agro:** Parry Agro has tea plantation factories both in South and North-east India, and between the two regions, the company produces ~17mn kg of tea.
- **General Insurance:** Cholamandalam MS General Insurance Company is a JV between Murugappa Group and Mitsui Sumitomo Insurance Group of Japan, operating through 93 branches and over 7,500 agents India. Cholamandalam MS offers a wide range of products that include accident, engineering, health, liability, marine, motor, property, travel and rural insurance for individuals and corporates. The company achieved a GWP of Rs 13bn in FY12.

Cholamandalam Finance (CIFC) was established in 1978 as an equipment financing company and later diversified into vehicle loans, gold loans, home equity and business finance. The company is primarily focused on semi-urban and rural customers who do not get bank finance easily. The Murugappa Group owns 57.7% in the company through its subsidiaries – Tube Investments (50.3%), Ambadi Enterprises (5%) and others group companies (2.4%).

Fig 18 - Shareholding pattern as on Dec'14



Source: Company, Bloomberg

Promoters supportive during difficult times

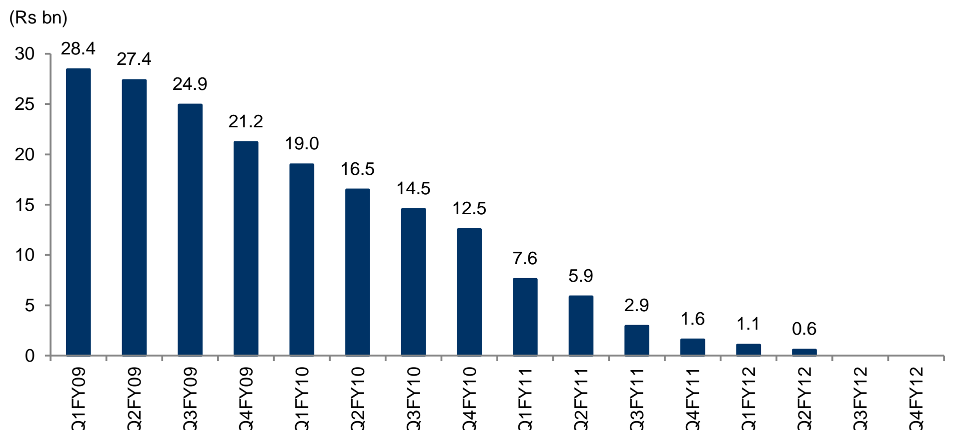
CIFC entered into a JV with Development Bank of Singapore (DBS) in Jun'05, with DBS taking a 37.5% stake in the company. Disbursement growth was robust in FY07/FY08 at +80% CAGR as the company grew its personal loan (PL) portfolio aggressively. However, due to a sharp slowdown in global and domestic loan growth in FY08/FY09, the company suffered significant delinquencies and heavy losses in the small-ticket PL segment.

Gross NPAs in the PL segment jumped to ~10% in FY09 from 1.5% in FY08, leading CIFC to exit the PL business in Sep'08. Due to the sharp slowdown, segment NPAs touched a record high of 32% in FY10. After discontinuing the unsecured loan business (1/3rd of total loan book), CIFC gradually brought down the exposure through effective collections, high NPA provisions, and sell-down of assets on an assignment basis from FY10-FY12. The company had a loan book of ~Rs 14bn in FY09 which was fully recovered/provided for by FY12.

Promoters bought back DBS' stake in CIFC despite record low profits

The JV was originally formed to leverage on DBS' expertise in the personal loan business. However, since CIFC was exiting the business, the promoters decided to buy out DBS' stake in the JV. In FY10-end, the Murugappa group bought DBS' 37.5% stake in CIFC for Rs 3.8bn (Rs 91/sh), signalling strong promoter support despite low profitability at the time.

Fig 19 - Run-down of CIFC's personal loan portfolio

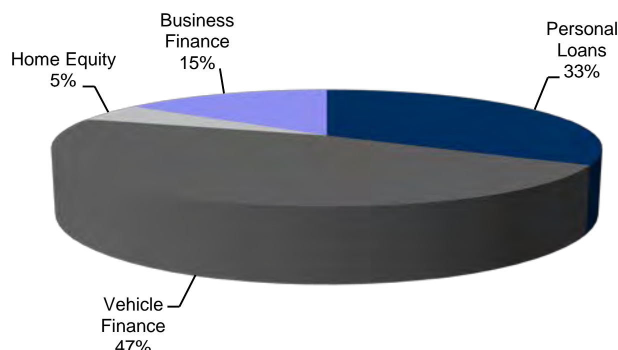


Source: Company

After exiting the unsecured personal loans business, the company focused solely on the productive/secured end of the segment, including its core competency in vehicle finance (two decades of operating experience). It introduced the home equity business in 2001 and is growing it slowly (GNPA at manageable levels, credit costs benign).

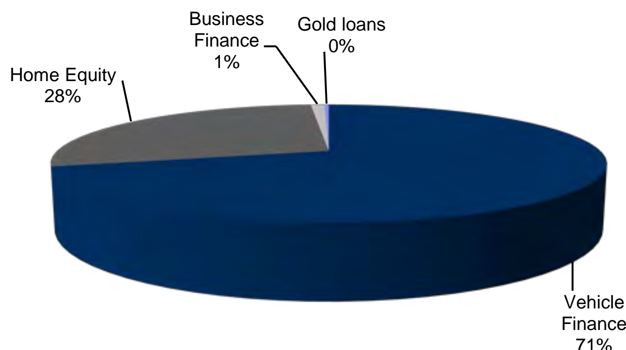
Business mix has changed drastically in favour of secured/productive segments

Fig 20 - Business mix – FY08



Source: Company

Fig 21 - Business mix – Q3FY15



Source: Company

Senior management

Experienced team heading various verticals

Mr. Vellayan Subbiah, Managing Director

Mr. Subbiah was the Managing Director at Laser Words, Chennai, from January'07 to August'10. He is currently director on the boards of SRF and some other Murugappa group companies. His professional experience includes six years at McKinsey and Company, Chicago, and associations with 24/7 Customer Inc., Las Gatos and The Carlyle Group, San Francisco. He is a Bachelor of Technology in Civil Engineering from IIT Madras and a Masters in Business Administration from the University of Michigan.

Mr. Arul Selvan, Sr. Vice President & CFO

Mr. Selvan is a CA from the Institute of Chartered Accountants of India and an MBA from Open University (UK). With over 20 years of experience in finance and accounts, he heads CIFC's finance function as the CFO. Mr. Selvan has spent 19 years with the Murugappa group, with stints at Tube Investments of India, the corporate strategic planning division of the Murugappa Group, Cholamandalam Mitsui Sumitomo General Insurance and the group corporate finance division of the Murugappa Group.

Mr. Kaushik Banerjee – President, Strategies & Corporate Affairs
Mr. Banerjee has been in the asset finance business for close to 25 years. He began his career in financial services with ITC Classic Finance (an ITC subsidiary) and has headed the west & east operations of Esanda Finanz (a subsidiary of ANZ Grindlays Bank) where he worked for seven years. He joined CIFC in 2001 and took over as Senior Vice President of the vehicle finance vertical in 2006. The division enjoys a strong reputation as one of the largest financiers of CVs in the country with a robust portfolio quality.

Mr. Rohit Phadke, Sr. VP & Business Head – Home Equity
Mr. Phadke has 20+ years of experience in asset financing. His last assignment was with Apple Finance as regional manager. He has been with the company for over 10 years and had led the west zone of the vehicle finance business with distinction. He established the home equity business in 2006, and has successfully built a significant franchisee in the mortgage space, recording both profits and growth from the time of commencement of business.

Valuations

Initiate coverage with BUY, TP Rs 775

Since we expect CIFC to continue to post strong earnings growth, we use the two-stage Gordon growth model to set our target price, as it captures valuations in a high-growth stage.

Fig 22 - CIFC – valuation methodology

Components of two-stage model	Our assumptions
ROE	20%
COE	13%
g (initial growth)	16%
r (COE)	13%
gn (perpetual growth rate)	5%
n (initial growth period, yrs)	5
payout1	20%
Payoutn	80%
K1	1.10
K2	13.05
P/BV	2.83x
FY17 – BV	275
TP (rounded off)	775

Source: RCML Research

CIFC is currently trading at 2.1x FY17E PBV, a 10% discount to SHTF/MMFS which we think is unjustified given higher loan growth versus peers and the structural improvement in profitability ahead. We believe strong earnings growth would eventually lead to a stock re-rating. Initiate with BUY.

Key risks

Slower-than-anticipated loan growth

We expect CIFC's loan growth to remain strong and better than industry at a 22% CAGR for the next three years. Any sharp deviation from our expectation could pose a risk to our investment thesis.

Risk from new geographies/product lines

CIFC has added new loan products into its portfolio over the last few years and is planning to scale up products like home loans, SME and gold loans. There is a downside risk to growth as well as asset quality in these new loan segments as the company does not have a demonstrated track record in managing these business lines.

Similarly, CIFC has ventured into new geographies in the last 2-3 years. Growth and asset quality dynamics are different across geographies, especially in rural and semi-urban areas.

Increase in asset quality pressures

Our earnings estimates incorporate credit costs of ~140bps over the next three years (FY15-FY17E). Gross and net NPA ratios are likely to decline by 25-30bps every year for the next three years. Any sharp deterioration in asset quality could see credit costs rising sharply, thereby adversely affecting our earnings forecasts.

Tightness in money markets and higher bank lending rates

Past trends show that NBFCs and wholesale funded banks tend to de-rate sharply whenever there is a steep rise in rates in a short span of time, as occurred during the Oct'08–Feb'09 and Oct'10–Mar'11 periods.

We have assumed a benign interest rate environment and cut in banks' lending rate in FY16/FY17, leading to a decline in cost of funds for the company and resulting in higher spreads and margins. Any adverse trend in money markets and liquidity poses a downside risk to our margin assumptions.

Regulatory changes

The RBI has changed capital requirement and NPA recognition norms (from 180-day to 90-day NPA recognition). Due to recent dilution, CIFC's tier 1 capital (12.1% in FY16E) is comfortable and well above the RBI requirement of 10%. We expect gross NPA for CIFC to go up over the next few years due to the new norms, which may lead to an increase in credit cost. However, the impact will be lower than peers.

The RBI wants to bridge the gap between regulations pertaining to banks and NBFCs. Any further tightening of regulations by the RBI (like changes in priority sector norms and liquidity requirements) can affect CIFC.

Appendix

Q&A with business heads

Our interaction with two of CIFC's key business heads, Rohit Padke – Business Head, Home Equity and Kaushik Banerjee – President, Strategies & Corporate Affairs, validates our confidence in the company's ability to deliver higher-than-industry growth with a tight leash on operating cost and asset quality.

Rohit Padke – Business Head, Home Equity

Why did CIFC start the loans against property (LAP) business? This is in sharp contrast to other leading NBFCs which have concentrated only on vehicle finance and related areas?

CIFC is looking for balanced growth in home equity with focus on profitability and asset quality

- CIFC has not added on this business segment merely to show higher growth and increase its balance sheet size. It launched this business in FY01 and has created a niche for itself by understanding the market well. CIFC has been a pioneer in many businesses such as three-wheeler finance and LCV finance, and LAP is another product that will evolve over time.
- The main purpose of this business is to provide credit to the MSME sector which is neglected by banks due to lower disclosed incomes. Therefore, the target segment for the company is non-salaried and non-professional customers – these customers don't have income proof (to justify higher loan disbursement) and therefore find it difficult to secure loans from banks.

Unlike auto finance, isn't lending against property risky? Customers are highly leveraged as borrowing against property is the last resort, coming generally after term loans and working capital lending limits are exhausted?

Competes with reputed private sector banks; lending is based on assessment of cash flow

- Though the product is known in the market as 'loan against property', loans are given for business purposes and the property acts solely as collateral. Many well-known private sector banks including HDFC Bank and Yes Bank are engaged in this business and have sizeable portfolios. Both banks together have an estimated portfolio of Rs 75bn under this category in southern regions.
- Loans are granted on assessment of the cash flow-generating ability of the underlying business, the borrowers' future plans, the industry in which the company operates, and nature of the business (safe, volatile, cyclical or structural). The company does not grant loans to a customer who is overleveraged and wants to service existing debt.

Since CIFC is an NBFC and therefore not covered under the SARFEASI Act, how do you recover loans as it is not easy to repossess and sell property (compared to vehicles)?

- The SARFEASI Act allows lenders to repossess the underlying asset without going to court, but borrowers can always go to court and ask for a stay order. Therefore, it isn't easy to repossess and sell the property even if lenders are covered under the Act.
- CIFC has various options including filing a complaint under the Negotiable Instrument Act for bounced cheques – this is a simple and effective law and a bounced cheque is a punishable offence. In addition, the company can opt for arbitration in the court of law – in this case, the borrowers will have to appoint a lawyer wherever the company is registered (in Chennai for CIFC), which they find time consuming and costly. CIFC can also obtain relief u/s 9 of the Companies Act, under which the court will attach the property and the borrower cannot sell/dispose of it without the lender's permission.

- Credit checks, analysis of borrower capacity/business and proper documentation are key to success rather than recovery. More than 90% of CIFC's defaults in the past were mainly due to business-related problems and fraud cases were negligible. To date, the company has written off only Rs 430mn of its portfolio.
- In addition, the government has recently announced in the budget that NBFCs will be included in the SARFEASI Act – this isn't a game-changer but will help keep credit quality in check.

What checks do you follow when granting a home loan?

Detailed check on property/mortgage records, understanding of client business/economic conditions

- **Property/mortgage records:** Better analysis and understanding of property law is the key as property and mortgage laws differ from state to state in India. Even land and property records are not easily available in some states. Studying the history of property that is being used as collateral is essential in order to avoid fraud. Proper documentation and creating a first charge on the business is crucial.
- **Understanding the business/sector and geographies in which the borrower operates:** Cash flow for repayment of loans and interest will come from the underlying business and therefore the credit team should be well aware of the underlying business dynamics in each region.
- CIFC's business is divided into three verticals: sales, credit and collections. The management's goal of building a clean loan book is clear. Every employee in each of these divisions has 30% of their KPI linked to other verticals, which in turn helps ensure a quality loan book.

What are the growth opportunities and your targets for the business?

- Although opportunities are immense, the company is looking at balanced growth. This is because each category, customer segment and geography is different and rapid expansion can bring with it asset quality risk in future. The company is looking at growing the home equity lending business in the range of 20-25% going forward.
- Based on the success of its LAP product, CIFC has started offering pure home loans to non-salaried and non-professional customers as well. The product has garnered a good response in many geographies, reaching a portfolio size of Rs 800mn with 16% yields. ROA/ROE too are likely to be strong. CIFC plans to ramp up this business without compromising on profitability.

What are the margins and sustainable profit ratios in the home equity lending business?

Home equity lending is very profitable if done sensibly; ROA in the range of 3.5-4%

- Average yield for the home equity business ranges between 12-13.5% (depending upon the market interest rate) and margins are in the range of 3.5-4%. Notably, the average tenure for home loans is ~10 years (vs. 3.5-4 years for auto loans) and operating cost is lower than vehicle financing because of the higher ticket size (~Rs 0.5mn on average for LAP vs. Rs 500k for auto loans). Apart from lower costs of sourcing/collection, these loans are sticky and hence can grow in line with the promoters' existing business without added sourcing cost. ROA is expected to stay in the range of 3-3.5%.

What are the challenges going forward?

- The biggest challenge is manpower. CIFC needs people with a solid understanding of property laws and also credit risk. The company has managed this well so far. Churning of employees at the mid and senior level is low and the team is very stable.

Kaushik Banerjee – President, Strategies & Corporate Affairs

What is your outlook on the CV cycle? Have you seen any improvement on the ground and in asset quality since the new government came into power?

Situation is grim and consolidation phase for lenders is expected to last for another 6-9 months

- There is no material improvement on the ground and datapoints like utilisation rates, resale prices, discounts offered by manufacturers and delinquency rates remain poor.
- The M&HCV segment which caters to long distance transportation is closely linked to manufacturing and investment-related activities in the country (IIP growth). We need to see some improvement in these parameters.
- At the same time, one of the worst cycles in the last 20 years is coming to an end. The consolidation phase for lenders will last for one more year before we see an improvement in growth.
- In the goods segment, typically 25% of vehicles come up for replacement every year. However, over the last 1-1.5 years, replacement demand was weak due to the uncertain market conditions. This demand is likely to come back in a big way once we have clarity on growth.

Do you think operators will benefit from the recent correction in fuel price?

SRTOs will benefit from lower fuel cost once cycle turnaround begins

- Diesel prices went up in FY13/FY14. During this period, utilisation levels dropped by 20-30%, resulting in a sharp reduction in freight rate when fuel cost (~50% of operating cost) was going up.
- Fuel cost has declined in the last six months. Although freight rates have also come off partially due to excess capacity, benign fuel cost will definitely help CV operators as and when utilisation levels start improving.
- CV operators have stated that if freight rates don't correct further, then M&HCV operators could benefit in the range of Rs 12k-15k a month which will help them pay their loan EMI.

What is your view on the pick-up in CV sales in the last 2-3 months?

- CV sales are higher mainly due to the low base effect. In addition, only large fleet operators are in the market and they are buying vehicles to fulfill standardised contracts or specific applications. SRTOs are absent and will come back only when they see actual improvement on the ground.
- Higher sales in the last 3-4 months will benefit large private sector banks such as HDFC Bank and Axis Bank as fleet operators generally don't take loans from NBFCs. Year-on-year growth for these top banks will look better as they have curtailed their operations heavily due to poor market conditions.

Have you seen any improvement in vehicle resale prices in the last 6-9 months?

- Resale prices of vehicles have come off dramatically in this cycle. Younger vintage vehicles are at a steep discount to newer vehicles. Some fleet operators are also buying these vehicles as discounts are high.
- However, resale volumes have recently increased at some organised auctions and the trend suggests that operators are buying vehicles in anticipation of good economic conditions ahead. This is positive for the sector.

Why have LCV volumes declined less than M&HCVs (lower negative impact on CIFC's books as well)?

LCV volumes expected to rebound from H2FY16 onwards

- LCVs/mini LCVs primarily cater to consumption or retail demand. They can switch products and segments easily and therefore are not affected by an investment-related slowdown if retail products are growing at a healthy rate.
- However, consumption-related demand is also witnessing some slowdown as overall GDP growth has halved, and this is reflected in LCV volumes.
- Lower CPI inflation going forward will bring LCVs back into the limelight as higher disposable incomes will drive demand for comfort goods among the low-to-mid income groups.

What is your outlook on the tractor business?

Tractor lending helps de-risk CIFC's business

- Tractor lending is a good product to de-risk CIFC's business as it is largely disassociated with the CV cycle. It has good yields and is very profitable if risks are managed adequately.
- The company is focusing on the profitability of this product and has adopted the strategy of a balanced portfolio across geographies. A tight check on recovery ensures NPLs are manageable. In addition, the tractor portfolio offers a good securitisation opportunity as it qualifies under priority sector lending.

What is your view on GST implementation and its impact on CV volumes?

- A key upshot of the goods and services tax (GST) will be that the price to consumer will come down in the long run, which will benefit all players by way of higher demand.
- Movement of goods will be much easier and therefore it will bring efficiency in overall operations, leading to lower delinquencies and better asset quality.
- Higher efficiencies will also reduce the waiting time at checkpoints and can reduce the overall demand for vehicles. However, the impact will be staggered over 4-5 years and only state-to-state traffic movement will improve. Many states have already abolished octroi duty and the impact on traffic movement will not be material.

Disbursements

Y/E 31 Mar (INR mln)	FY13A	FY14A	FY15E	FY16E	FY17E
Disbursements	1,21,183	1,31,142	1,48,190	1,71,901	2,02,843
Growth (%)	36.3	8.2	13.0	16.0	18.0
AUM/Sanctions	1,89,980	2,32,530	2,71,431	3,17,117	3,74,086
Growth (%)	41.0	22.4	16.7	16.8	18.0

Per Share Data

Y/E 31 Mar (INR)	FY13A	FY14A	FY15E	FY16E	FY17E
Reported EPS	21.4	25.4	28.7	35.3	47.3
Adjusted EPS	21.4	25.4	28.7	35.3	47.3
DPS	3.9	4.1	4.4	4.7	5.0
Book value	137.2	160.2	184.5	232.7	275.0
Adjusted book value	134.9	150.7	162.6	216.2	259.6

Valuation Ratios

Y/E 31 Mar (x)	FY13A	FY14A	FY15E	FY16E	FY17E
P/E	26.7	22.5	19.9	16.2	12.1
P/BV	4.2	3.6	3.1	2.5	2.1
P/ABV	4.2	3.8	3.5	2.6	2.2

Financial Ratios

Y/E 31 Mar (%)	FY13A	FY14A	FY15E	FY16E	FY17E
Spread Analysis					
Interest spreads	6.7	7.1	7.2	7.6	8.0
Yield on advances	17.3	17.9	17.6	17.9	18.2
Yield on assets	15.5	15.3	14.7	14.7	14.8
Cost of funds	10.4	10.6	10.4	10.3	10.2
NIMs	7.5	8.0	8.0	8.5	8.9
Operating Ratios					
Operating cost to income	49.8	44.1	42.7	39.1	36.7
Operating expenses / Avg assets	3.6	3.3	3.2	3.1	3.0
Asset Quality and Capital					
Gross NPA	1.2	1.9	2.7	2.5	2.3
Net NPA	0.2	0.7	1.4	1.0	0.8
CAR	19.0	17.2	17.3	19.2	19.4
Growth Ratios					
Net interest income	52.3	31.9	15.8	21.4	22.2
Non-interest income	(27.3)	(16.3)	13.9	16.8	17.8
Pre-provisioning profit	68.3	44.9	18.7	29.0	26.8
Net profit	77.7	18.7	13.1	33.4	33.8
Assets	35.5	18.5	14.2	16.7	16.3
Advances	34.6	17.5	16.1	14.3	16.3
Book value	28.4	16.7	15.2	26.1	18.2
EPS	64.6	18.7	13.1	22.9	33.8

DuPont Analysis

Y/E 31 Mar (%)	FY13A	FY14A	FY15E	FY16E	FY17E
Net interest income / Assets	7.0	7.4	7.3	7.7	8.1
Non-interest income / Assets	0.2	0.2	0.2	0.2	0.2
Operating expenses / Assets	3.6	3.3	3.2	3.1	3.0
Provisions / Assets	0.8	1.4	1.6	1.7	1.6
Taxes / Assets	0.9	0.9	0.9	1.1	1.2
ROA	1.9	1.8	1.8	2.1	2.4
Equity / Assets	12.4	11.6	11.5	13.6	13.8
ROAE	**18.1**	**17.1**	**16.7**	**17.5**	**18.6**

Income Statement

Y/E 31 Mar (INR mln)	FY13A	FY14A	FY15E	FY16E	FY17E
Interest income	25,184	32,316	37,041	43,258	50,976
Interest expense	(14,110)	(17,711)	(20,121)	(22,714)	(25,876)
Net interest income	11,074	14,605	16,920	20,544	25,101
Non-interest income	373	312	356	415	489
Net revenue	11,447	14,918	17,275	20,960	25,590
Operating expenses	(5,696)	(6,582)	(7,381)	(8,195)	(9,399)
Pre-provisioning profits	5,751	8,335	9,894	12,764	16,191
Provisions & contingencies	(1,243)	(2,833)	(3,654)	(4,440)	(5,050)
PBT	4,508	5,502	6,240	8,325	11,141
Extraordinaries	0	0	0	0	0
Income tax	(1,443)	(1,862)	(2,122)	(2,830)	(3,788)
Reported PAT	3,065	3,640	4,119	5,494	7,353
Adj. net profit	**3,065**	**3,640**	**4,119**	**5,494**	**7,353**

Balance Sheet

Y/E 31 Mar (INR mln)	FY13A	FY14A	FY15E	FY16E	FY17E
Advances	1,66,926	1,95,141	2,24,935	2,58,037	3,00,652
Investments	2,245	824	962	1,124	1,326
Current assets	6,708	11,355	10,566	16,758	18,668
Net block (inc CWIP)	707	729	851	994	1,173
Goodwill	0	0	0	0	0
Other assets	5,262	7,418	8,659	10,117	11,934
Total Assets	**1,81,848**	**2,15,468**	**2,45,973**	**2,87,031**	**3,33,753**
Share capital	1,432	1,433	1,433	1,555	1,555
Options/warrants/others	0	0	0	0	0
Reserves & surplus	18,216	21,515	24,996	34,640	41,219
Net worth	19,648	22,947	26,429	36,195	42,774
Total borrowings	1,53,375	1,81,258	2,06,397	2,35,476	2,72,859
Current liabilities	77,847	92,760	1,04,565	1,21,968	1,38,893
Provisions	2,415	3,515	4,103	4,794	5,655
Deferred tax liabilities	0	0	0	0	0
Other liabilities	6,411	7,748	9,044	10,566	12,464
Total Equity & Liabilities	**1,81,848**	**2,15,468**	**2,45,973**	**2,87,031**	**3,33,753**

RELIGARE INSTITUTIONAL RESEARCH
Values that bind

Company Initiation
INDIA
NBFC

25 March 2015

BUY
TP: INR 2,300.00
▲ 21.9%

Shriram City Union

SCUF IN

Unique combination of high growth & high profitability

We initiate coverage on SCUF with BUY and a Mar'16 TP of Rs 2,300. SCUF has developed a robust business model over the last two decades and largely caters to the under-served rural and semi-urban areas. Its niche expertise in MSME lending (~50% of loan book) and large customer base sourced from group companies supports high growth along with superior profitability. In our view, significant under-penetration in key businesses – MSME lending, housing finance & pre-owned vehicle loans – should sustain a structural ROE of +20%.

- **Niche presence in scalable business:** SCUF is well placed in MSME financing (~50% of its total AUM) due to niche experience gained over the last two decades and a large customer base of group companies. This segment is highly underpenetrated and hence growth rates are likely to remain strong with superior profitability. SCUF is able to achieve high margins and low credit costs due to its strong connect with customers and robust labour-intensive business model.
- **Near-term ROE subdued but ROA healthy:** We expect gross spreads to remain protected at ~11% and credit cost to decline with the expected improvement in the economy. Loan growth is likely to revive from FY16 onwards. While tier 1 capital at 25% (dilution via 10% stake sale to Piramal Enterprises in May'14) is likely to be a drag on ROE in the near term, we are confident that SCUF can generate sustainable ROA of 3-3.2% (ROE of 21-23% with leverage of 7x) in the medium-to-long term.
- **Immense growth potential in rural housing finance:** Shriram Housing, SCUF's housing finance subsidiary (77% stake), primarily targets under-served segments in tier II and tier III cities and towns. It currently has 61 branches across 17 states, with an AUM of ~Rs 6bn and a target to reach Rs 20bn by FY17.
- **Initiate with BUY:** Current valuations are 2.2x FY17E P/B. We have a Mar'16 TP of Rs 2,300, based on 2.7x FY17E P/B.

Financial Highlights

Y/E 31 Mar	FY13A	FY14A	FY15E	FY16E	FY17E
Net interest income (INR mln)	16,326	17,848	21,505	26,175	30,460
Net revenues (INR mln)	16,725	18,879	22,021	26,783	31,190
Pre-provision profits (INR mln)	10,497	11,641	13,148	16,325	18,856
Adj. PAT (INR mln)	4,496	5,211	5,684	7,356	8,714
Adj. EPS (INR)	83.4	90.9	90.8	111.7	132.3
ROE (%)	22.5	20.2	16.1	16.3	16.6
ROA (%)	3.1	3.2	3.2	3.6	3.7
Gross NPA (%)	2.2	2.7	3.0	3.2	3.3
CAR (%)	18.6	26.1	30.5	30.1	29.5
P/BV (x)	4.6	3.8	3.0	2.6	2.2
P/E (x)	22.5	20.7	20.7	16.8	14.2

Source: Company, Bloomberg, RCML Research

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PRICE CLOSE (24 Mar 15)
INR 1,887.15

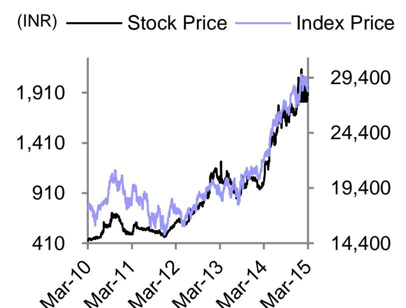
MARKET CAP
INR 124.4 bln
USD 2.0 bln

SHARES O/S
59.3 mln

FREE FLOAT
66.2%

3M AVG DAILY VOLUME/VALUE
0.1 mln / USD 1.7 mln

52 WK HIGH	52 WK LOW
INR 2,200.00	INR 1,020.05



Investment rationale

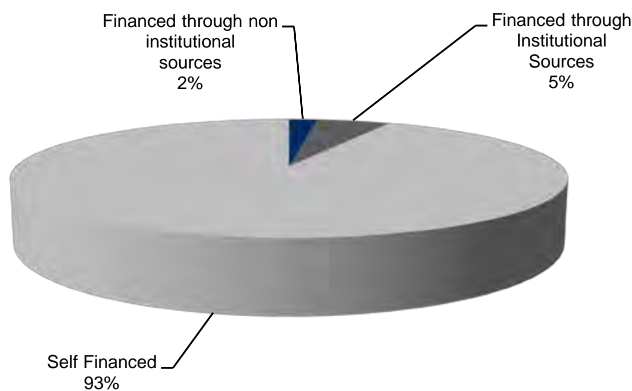
MSME segment highly underpenetrated

Demand outstrips supply

There is a significant gap in credit allocation to the MSME (micro small medium enterprise) sector in India – as per the RBI's working group recommendation on priority sectors, supply of credit to the sector in FY13 has been short of total demand by ~59%. The average gap for the entire period of the 12th five year plan (2012-17) has been ~52%.

Supply of credit to MSME sector has been short of demand by 52% during the 12th five year plan

Fig 1 - Credit penetration is very low for MSME sector (12th five year plan)



Source: RBI, Company

RBI data reveals that only 5.18% of MSME units (both registered and unregistered) had availed of finance through institutional sources, 2.05% received finance from non-institutional sources and a majority of the units, i.e. 92.77% had not availed any external finance or depended on self-finance. This under-penetration of credit hampers the growth potential of the MSME sector as a whole.

SCUF in a sweet spot to gain from MSME opportunity

We believe that SCUF has an edge over banks in terms of financing MSME credit needs, as banks follow a restrictive funding approach with heavy dependence on a standardised credit policy and statutory certified information. We note that only a small portion of MSMEs route their day-to-day transactions through the banking system as many entrepreneurs find it difficult to comply with banks' paperwork.

Banks' current business model is not suitable for MSME customers

Banks need to alter their lending model in terms of appraisal process, collection and decentralisation of decision-making if they want to serve these categories of customers. With such structural changes unlikely to materialise anytime soon in the banking sector, we think SCUF has immense growth potential in the under-served MSME market.

Group company Shriram Chits has a large client base

SCUF sources 30-35% of its loans through group company Shriram Chits. In addition, 20-25% of loans are through chit referrals and the remaining 40-50% are sourced largely through SCUF's own branch network. Shriram Chits has a large customer base totaling 40mn clients of which 1.2mn are currently active – SCUF targets both active and non-active (past) clients.

Large client base of Shriram Chits helps the company cross-sell MSME credit

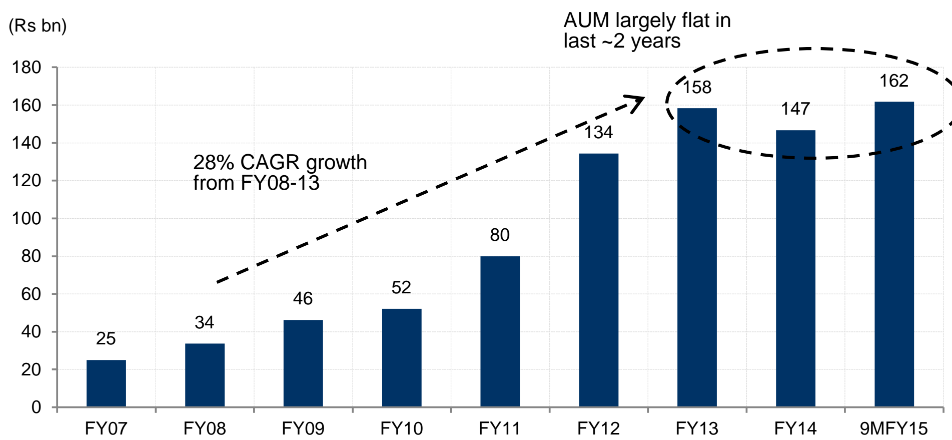
SCUF is also expanding its MSME loan book through its own branches and reliance on Shriram Chits has come off gradually. Management highlighted that the MSME loan book

sourced through chit members is growing slowly (~5% growth in the last 2-3 years) and it is expanding largely through own branches. Growth is picking up in areas not covered by Shriram Chits, such as in the states of Madhya Pradesh, Chhattisgarh, Maharashtra and Northern India.

Conscious slowdown in AUM growth in the last two years

Management stated that it has consciously slowed down AUM growth over the last year and a half due to poor economic conditions. This strategy has paid off in terms of lower delinquencies and better asset quality performance than peers. In the gold loan segment for instance, due to regulatory challenges and volatility in gold prices, SCUF has consciously stayed away the segment. Ownership verification of jewellery can be difficult since there is no clarity on the documents/methods to be used for purchase. The company chose to lower the LTV on gold products to 50-55%, which resulted in ~50% YoY decline in gold loans in FY13/FY14.

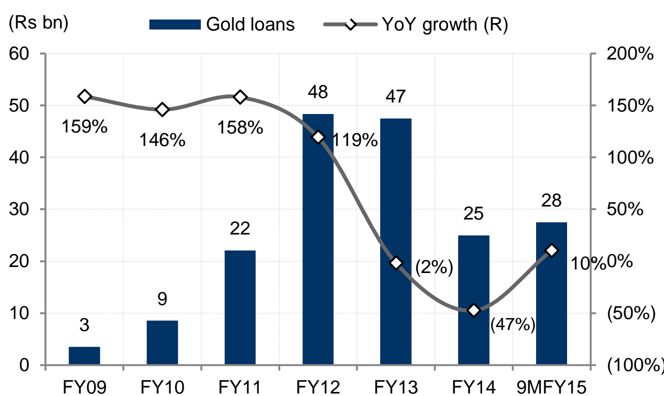
Fig 2 - AUM growth largely muted in the last two years



Source: Company

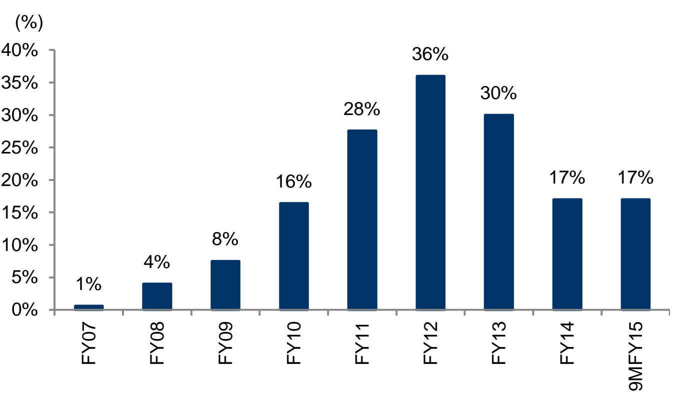
AUM remained largely flat in the last two years due to the economic slowdown

Fig 3 - Gold loans declined by 50% YoY in FY14



Source: Company

Fig 4 - Gold loan proportion in AUM has come off from 36% in FY12 to 17% currently



Source: Company

In the two-wheeler space, SCUF is financing ~60k two-wheelers a month. The company is the third largest player after HDFC Bank and IndusInd Bank. Bajaj Finance is the fourth largest player. Growth opportunities are expanding as customers in semi-urban and rural areas are moving from cash to cheque purchases and showing greater willingness to take loans. However, this process will be gradual – the two-wheeler segment is still a cash-heavy market and loans are taken for private vehicles rather than business use.

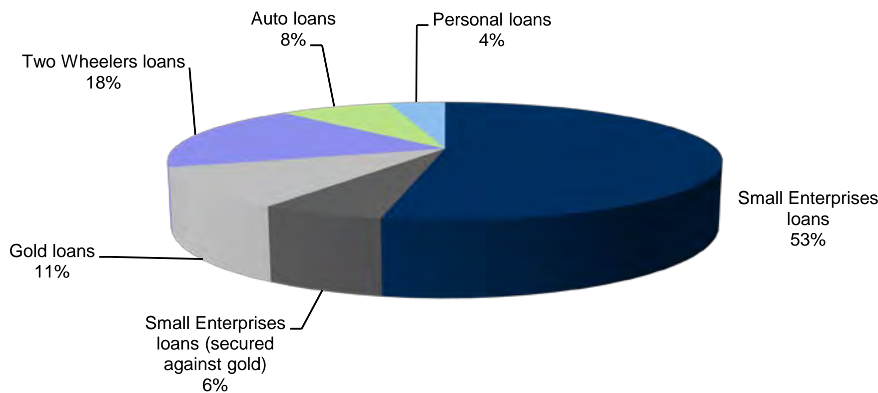
In auto finance, SCUF finances mainly second-hand vehicles (cars, tractors, CVs and three-wheelers), which are more than 12 years old. Capital/residual value is low and lending is based on the borrower's profile and product end use.

AUM to clock 19% CAGR over FY15-FY17

We expect growth to revive as the slowdown due to the gold loan portfolio is already behind us and with revival in economic activities, MSME lending (+50% of portfolio) should gather momentum.

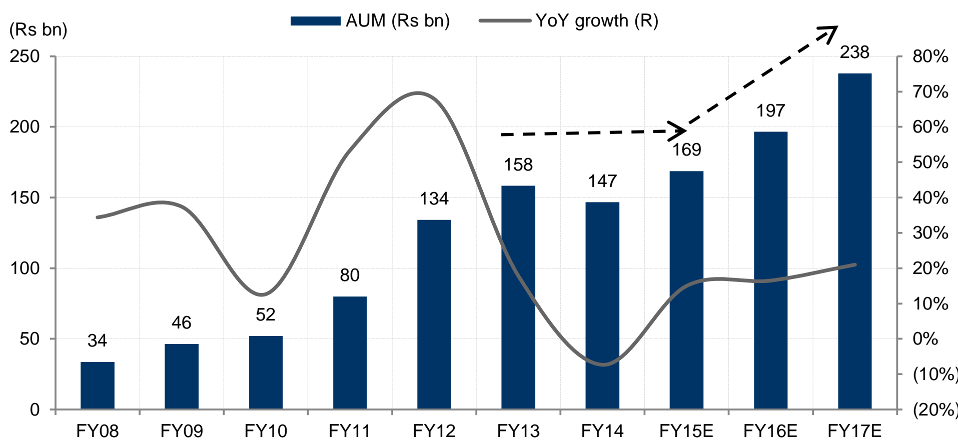
AUM expected to grow at 19% led by all verticals

Fig 5 - AUM break-up (Dec'14)



Source: Company

Fig 6 - Growth to revive after two years of flat AUM



Source: Company, RCML Research

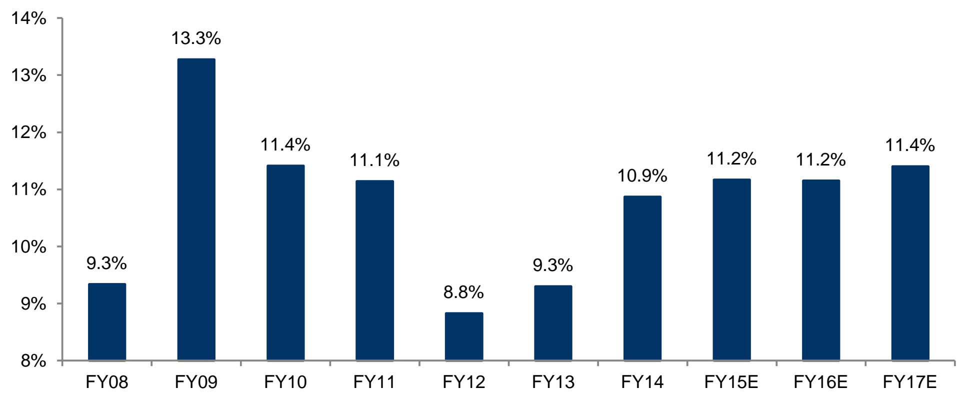
Excess capital to subdue near-term ROE but ROA set to expand

Margins largely protected at current levels

Despite lower cost of funds, spreads to remain at current levels due to high interest reversal & lower securitisation

We expect gross spreads (calculated) to remain in the range of 11-11.5% over FY15-FY17. SCUF expects some benefits due to a reduced cost of funds in the wholesale market and a likely cut in base rates (bank funding) in FY16. However, interest reversals are expected to go up as the company moves toward the RBI's new 90-DPD norms from 180-DPD currently. In addition, securitisation volumes will be lower in FY15/FY16 compared to earlier years due to slower growth in bank credit and relaxation of RIDF rules by the RBI.

Fig 7 - Gross spread to remain in the range of 11-11.5%



Source: Company, RCML Research

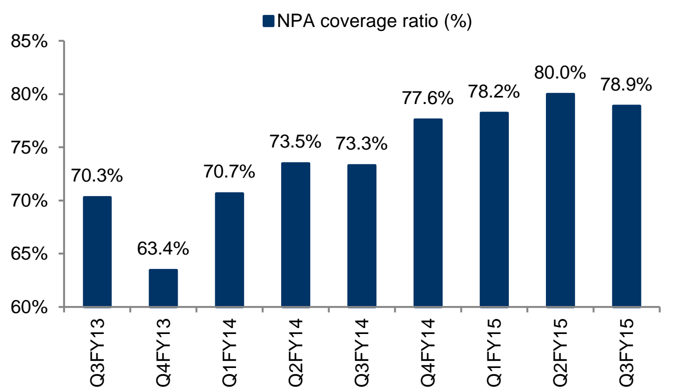
Credit costs expected to decline marginally

Managing the portfolio well with high margins and low credit costs

Despite slower economic growth over the past year and a half, SCUF has managed its asset quality well. Gross NPA is in the range of 1.5-1.8% in the MSME segment and ~4% in the vehicle finance book. The company is following 180-DPD norms for NPA classification and currently has a gross NPA ratio of ~3%. Management pointed out that under the new 90-DPD norms, gross NPAs would be 5-6%.

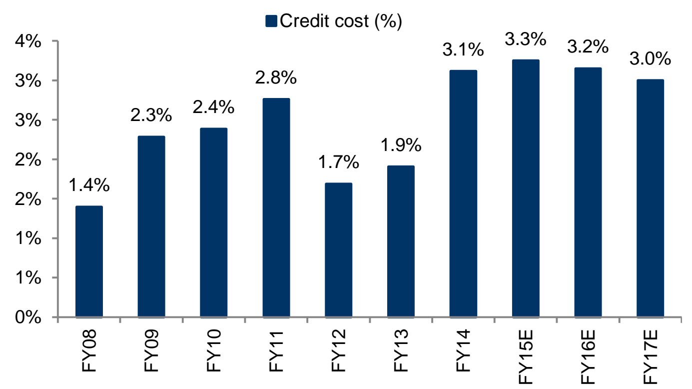
We believe that credit cost is unlikely to increase materially due to transition to 90-DPD norms as the company has maintained a robust provision coverage ratio of ~80%. SCUF is not likely to change its business model and will bring down its provision coverage ratio to comply with regulatory changes. Credit cost has increased steadily in the last 4-6 quarters and is expected to moderate by ~10bps each in FY16/FY17 due to the improvement in economic activity.

Fig 8 - Robust NPA coverage lends comfort



Source: Company, RCML Research

Fig 9 - Credit cost to decline by 10bps each in FY16/17



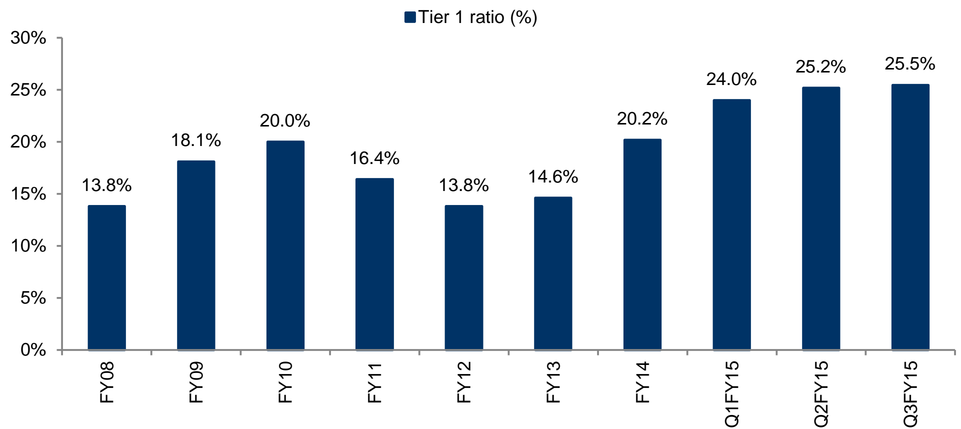
Source: Company, RCML Research

High tier 1 capital

Loan growth was virtually flat over FY13-FY15 due to poor economic conditions – the lower capital burn led to an increase in tier 1 capital. In addition, in May'14, Piramal Enterprises took ~10% stake in the company at Rs 1,200/sh. This has increased tier 1 to 25%. Though ROA is expected to remain strong, ROE may be lower than earlier years due to lower growth (and in turn low leverage). The company needs to grow at a much faster rate in order to attain +20% ROE which looks difficult, at least till FY17-end.

Lower capital burn led to an increase in tier 1 capital

Fig 10 - Excess capital due to slower loan growth in FY14/15 and equity raising



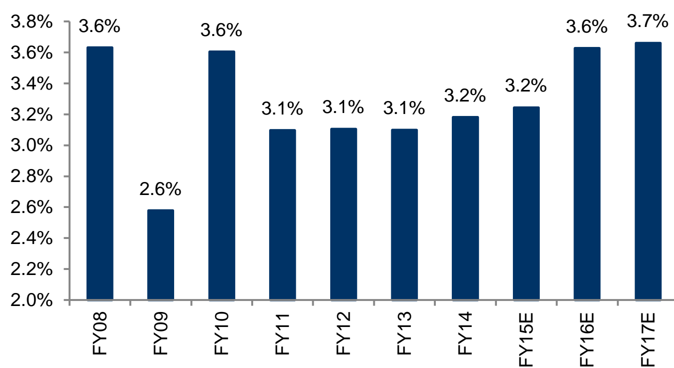
Source: Company, RCML Research

ROA to expand 50bps through FY17

We expect ROA to expand by 50bps over FY15-FY17 due to a revival in loan growth, higher margins, declining credit cost and lower leverage. ROE is likely to remain within the 16-17% range as compared to +20% during FY08-FY14 due to low leverage.

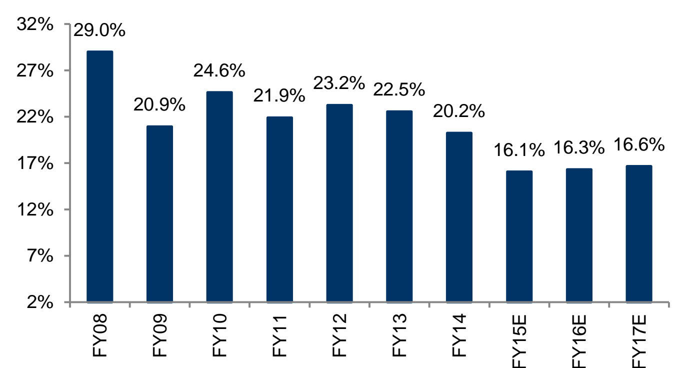
Since growth prospects are strong in the segments in which SCUF operates, the company is likely to consume higher capital once the economic recovery gathers pace. We strongly believe that low ROE is only a near-term phenomena and long-term sustainable profitability remains intact with ROE of 20%+.

Fig 11 - ROA to expand by 50bps over FY15-FY17E



Source: Company, RCML Research

Fig 12 - ROE to remain low due to lower leverage



Source: Company, RCML Research

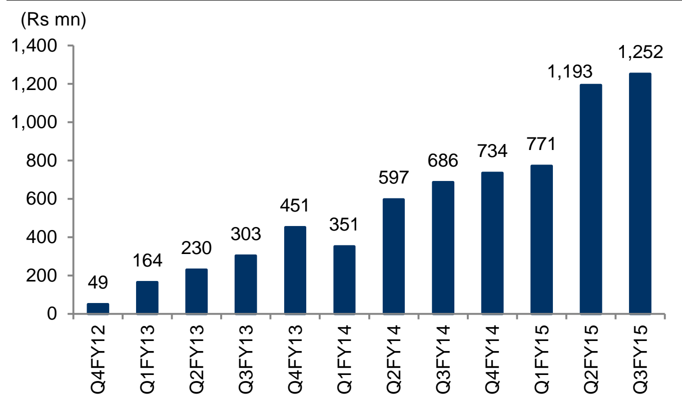
Immense growth potential in housing finance subsidiary

ROE in the housing finance business to remain in the range of 18-20%

SCUF owns a 77% stake in Shriram Housing Finance (PE investor Valiant Partners owns the balance 23%), which primarily lends to under-served segments in tier II and tier III cities and towns, via 61 branches across 17 states.

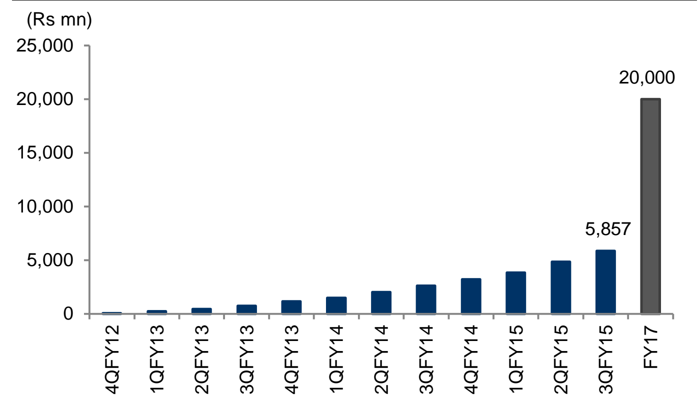
The company currently has a loan book of Rs 6bn of which ~50% comes from rural and semi-urban customers. Self-employed customers account for ~65% of the total loan book. The housing arm is planning to reach Rs 20bn in AUM by FY17 and we expect growth thereafter to be in line with the industry. Credit quality risks are low in this business as average LTV is ~54% and ROE is expected to remain in the range of 18-20%.

Fig 13 - Disbursement growth strong



Source: Company, RCML Research

Fig 14 - Management targeting Rs 20bn in AUM by FY17



Source: Company, RCML Research

Valuations

Initiate coverage with BUY and TP of Rs 2,300

Our TP of Rs 2,300 is based on the two-stage Gordon growth model

Since we expect SCUF's earnings growth profile to remain strong, we use the two-stage Gordon growth model to set our target price, as it captures higher valuations emanating from a high-growth stage.

Fig 15 - Shriram City Union Finance – Valuation methodology

Components of two stage model	Our Assumptions
ROE	20%
COE	13%
g (initial growth)	16%
r (COE)	13%
gn (perpetual growth rate)	5%
n (initial growth period, yrs)	5
payout1	20%
payoutn	80%
K1	1.09
K2	12.14
P/BV	2.70x
FY17 - BV	855
TP (rounded off)	2,300

Source: Company, RCML Research

Key risks to our investment thesis

Slower-than-anticipated loan growth

We expect loan growth to remain strong and better than industry. Any sharp deviation from our expectations could pose a risk to our investment thesis.

Increase in asset quality pressures

We expect asset quality pressures to ease going forward. Conversely, any further deterioration in asset quality could see credit costs increasing, adversely affecting our earnings forecasts.

Regulatory changes

The RBI has changed capital requirement and NPA recognition norms (from 180-day to 90-day NPA recognition). We expect SCUF's gross NPA to go up over the next few years which may lead to an increase in credit cost. However, the impact will be lower than peers.

Disbursements

Y/E 31 Mar (INR mln)	FY13A	FY14A	FY15E	FY16E	FY17E
Loan book	1,35,241	1,28,535	1,58,561	1,80,793	2,09,249
Growth (%)	26.1	(5.0)	23.4	14.0	15.7
AUM	1,58,280	1,46,680	1,68,682	1,96,515	2,37,783
Growth (%)	17.8	(7.3)	15.0	16.5	21.0

Per Share Data

Y/E 31 Mar (INR)	FY13A	FY14A	FY15E	FY16E	FY17E
Reported EPS	83.4	90.9	90.8	111.7	132.3
Adjusted EPS	83.4	90.9	90.8	111.7	132.3
DPS	8.4	10.3	10.0	10.0	10.0
Book value	406.5	488.9	634.5	734.5	855.1
Adjusted book value	393.5	480.3	623.1	724.8	847.4

Valuation Ratios

Y/E 31 Mar (x)	FY13A	FY14A	FY15E	FY16E	FY17E
P/E	22.6	20.8	20.8	16.9	14.3
P/BV	4.6	3.9	3.0	2.6	2.2
P/ABV	4.8	3.9	3.0	2.6	2.2

Financial Ratios

Y/E 31 Mar (%)	FY13A	FY14A	FY15E	FY16E	FY17E
Spread Analysis					
Interest spreads	9.3	10.9	11.2	11.2	11.4
Yield on advances	21.9	21.8	22.1	21.9	22.0
Yield on assets	11.3	10.9	12.3	12.9	12.8
Cost of funds	12.6	10.9	10.9	10.8	10.6
NIMs	11.8	11.5	13.1	13.7	13.6
Operating Ratios					
Operating cost to income	37.2	38.3	40.3	39.0	39.5
Operating expenses / Avg assets	4.3	4.4	5.1	5.2	5.2
Asset Quality and Capital					
Gross NPA	2.2	2.7	3.0	3.2	3.3
Net NPA	0.8	0.6	0.7	0.5	0.4
CAR	18.6	26.1	30.5	30.1	29.5
Growth Ratios					
Net interest income	47.8	9.3	20.5	21.7	16.4
Non-interest income	73.8	158.4	-50.0	18.0	20.0
Pre-provisioning profit	49.4	10.9	13.0	24.2	15.5
Net profit	31.3	15.9	9.1	29.4	18.5
Assets	29.4	0.1	13.9	17.4	17.3
Advances	26.1	-5.0	23.4	14.0	15.7
Book value	22.7	20.3	29.8	15.8	16.4
EPS	24.1	8.9	0.0	23.0	18.5

DuPont Analysis

Y/E 31 Mar (%)	FY13A	FY14A	FY15E	FY16E	FY17E
Net interest income / Assets	11.3	10.9	12.3	12.9	12.8
Non-interest income / Assets	0.3	0.6	0.3	0.3	0.3
Operating expenses / Assets	4.3	4.4	5.1	5.2	5.2
Provisions / Assets	2.6	2.3	2.7	2.6	2.5
Taxes / Assets	1.5	1.6	1.6	1.8	1.8
ROA	3.1	3.2	3.2	3.6	3.7
Equity / Assets	6.4	5.7	4.2	4.2	4.2
ROAE	**22.5**	**20.2**	**16.1**	**16.3**	**16.6**

Income Statement

Y/E 31 Mar (INR mln)	FY13A	FY14A	FY15E	FY16E	FY17E
Interest income	30,431	31,355	34,985	40,961	47,467
Interest expense	(14,105)	(13,507)	(13,480)	(14,787)	(17,007)
Net interest income	16,326	17,848	21,505	26,175	30,460
Non-interest income	399	1,031	515	608	730
Net revenue	16,725	18,879	22,021	26,783	31,190
Operating expenses	(6,229)	(7,239)	(8,873)	(10,458)	(12,334)
Pre-provisioning profits	10,497	11,641	13,148	16,325	18,856
Provisions & contingencies	(3,840)	(3,842)	(4,665)	(5,345)	(5,851)
PBT	6,657	7,799	8,483	10,980	13,006
Extraordinaries	-	-	-	-	-
Income tax	(2,160)	(2,587)	(2,799)	(3,623)	(4,292)
Reported PAT	4,496	5,211	5,684	7,356	8,714
Adj. net profit	**4,496**	**5,211**	**5,684**	**7,356**	**8,714**

Balance Sheet

Y/E 31 Mar (INR mln)	FY13A	FY14A	FY15E	FY16E	FY17E
Advances	1,35,241	1,28,535	1,58,561	1,80,793	2,09,249
Investments	730	6,276	6,903	7,593	8,353
Current assets	24,137	26,571	18,427	27,709	36,129
Net block (inc CWIP)	884	1,014	1,116	1,227	1,350
Goodwill					
Other assets	2,742	1,436	1,580	1,738	1,912
Total Assets	**1,63,734**	**1,63,831**	**1,86,587**	**2,19,061**	**2,56,992**
Share capital	554	593	659	659	659
Options/warrants/others	-	-	-	-	-
Reserves & surplus	21,974	28,390	41,133	47,719	55,662
Net worth	22,528	28,983	41,791	48,377	56,321
Total borrowings	1,27,287	1,20,491	1,26,849	1,48,251	1,72,630
Current liabilities	13,534	13,790	17,237	21,546	26,933
Provisions	385	568	710	887	1,109
Deferred tax liabilities	-	-	-	-	-
Other liabilities	-	-	-	-	-
Total Equity & Liabilities	**1,63,734**	**1,63,831**	**1,86,587**	**2,19,061**	**2,56,992**

25 March 2015

SREI Infrastructure Finance

CE lending industry still not out of the woods

We interacted with the top management as well as several regional/state heads at SREI to discuss the company's construction equipment (CE) lending business. Given lacklustre manufacturing and infrastructure activities in India, SREI's slippages/credit costs are likely to stay elevated while growth would remain sluggish in the near term. SREI is not facing pricing pressure and is incrementally focusing on retail customers to improve profitability. We do not have a rating on the stock.

- **Market leader in CE financing:** SREI started operations in 1989 and currently has a 50:50 JV with BNP Paribas for infrastructure equipment finance. The SREI-BNP JV is a market leader in equipment financing with 30% market share and a presence across the value chain of infrastructure equipment. The JV has interests in QUIPPO (India's largest equipment rental company) and an 18% stake in VIOM networks (independent tower company with +40K towers). It also lends to infrastructure projects and has equity interest in eight road assets.

- **Credit costs likely to remain elevated in FY15/Q1FY16:** Management stated that it has seen no improvement on the ground over the last one year, as industrial production (IIP), infrastructure spending (especially on roads) and mining activity remain lacklustre. Slippages are expected to remain elevated and credit cost high in the next 2-3 quarters. SREI is looking to improve its provision coverage ratio in coming quarters. Gross/net NPA on 90-DPD stood at 4.8%/3.6% as at end-Q3FY15.

- **Disbursement growth to remain sluggish:** SREI's experience over the last two decades suggests that recovery in the CE cycle always precedes growth. However, there are no clear signs of recovery and utilisation levels for equipment are still poor. Many of the company's regional branches are achieving only a third of their peak capacity (FY08-FY10) disbursements. Therefore, a meaningful recovery in loan growth is still some time away. If there is a broad-based recovery in FY16, management expects 10-15% growth.

- **Strategically focusing on retail customers to improve profitability:** SREI currently has ~60% of its portfolio concentrated with corporate clients. Yields are lower and risk of NPA is high as the equipment cannot be used for alternate purposes. The company plans to increase the share of retail loans in coming years, which will help improve profitability. Management is targeting an improvement in ROE band from 12-18% currently to 14-20% over the next 2-3 years.

- **No pricing pressure; cost of funds to ease going forward:** Despite weak disbursement trends, management is not seeing any pressure on lending rates (yields). This is mainly because business is concentrated among a few large players (small/inexperienced players have exited in the last two years). Currently, the major source of funding is bank borrowings (working capital at 52% and term loan from banks at 20%), while debentures constitute 7% of total loans (up from 3% in Q2FY15). The company is exploring new avenues to reduce the cost of funds, including higher NCD issuances.

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PRICE CLOSE (24 Mar 15)
INR 43.00

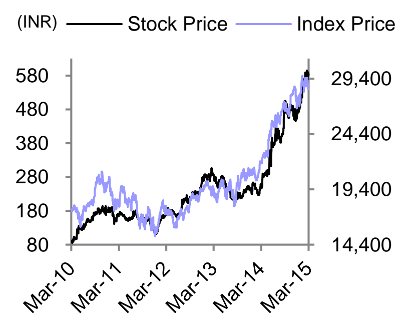
MARKET CAP
INR 21.6 bln
USD 348.9 mln

SHARES O/S
503.0 mln

FREE FLOAT
50.7%

3M AVG DAILY VOLUME/VALUE
0.1 mln / USD 1.1 mln

52 WK HIGH	52 WK LOW
INR 57.55	INR 24.9



Region and state-wise trends

We met SREI's CFO (Sanjeev Sancheti) and Investor Relations head (Amit Agarwal). In addition, we interacted with several regional and state heads at SREI to discuss the company's construction equipment (CE) lending business. Our findings suggest that given weak manufacturing and infrastructure activity in India, SREI's slippages and credit costs are likely to stay elevated while growth remains sluggish in the near term.

Slippages still high, disbursements sluggish

Western region – Rajasthan and Gujarat better off; mixed trends in Maharashtra

Trends are better in Gujarat and Rajasthan due to higher spending by the state on infrastructure projects

- Infrastructure activities in Rajasthan and Gujarat are driven mainly by their respective state governments and the EPC model is used for most projects. Therefore, asset quality disturbances have been lower in these states in the last 1-1.5 years.
- In terms of loan/disbursement growth as well, these two states have posted a better performance than the rest of India.
- In Maharashtra, the corporate business has been sluggish for the last 2-3 years as fewer new projects have come up. Companies are hopeful that with the strong government in place in the state, infrastructure activities will pick up.
- Disbursement and asset quality trends for the CV/CE segment in Maharashtra are not materially different from the rest of India. The sand mining ban in the Konkan region's eco-sensitive zones has affected freight rates and demand for CVs. However, demand for sand mining is likely to improve as the ban was lifted by the new government in Dec'14.

Goa – slow, gradual recovery

Mining ban and economic slowdown have hit the region badly and improvement will be very slow

- Goa had 70-80 working mines which were shut down in Sep'12 post a Supreme Court (SC) order pertaining to allegations of illegal mining activity. The SC thereafter cleared 27 mines and the state government is likely to frame rules for operating these mines in the next 1-2 months.
- Mining activities are likely to start in April or October next year (no mining during the monsoons). Companies believe that the SC will allow other mines to open up separately in a gradual manner (as it did with Karnataka).
- Mining in Goa is concentrated with 5-6 large players – given substantial underutilised capacity with these miners, disbursements will take time to pick up. CV operators have been badly affected as their work is on contract basis and vehicles are lying idle. Resumption of mining loads will help these small CV operators.
- Asset quality should improve gradually from Q1FY16 onwards while disbursements in the state may pick up from late FY16 only. We believe it will take 2-3 years to reach disbursement levels achieved in FY08/FY09.

Southern India – disturbing trends

Southern India showing highest asset quality deterioration as compared to other regions

- Players have indicated that the southern market typically enjoys better growth and asset quality trends than the rest of India. However, in this cycle, delinquencies have been higher in southern India even as disbursements remain poor.
- Operators indicate that a lot of work done by public works departments (PWD) has stopped in Tamil Nadu and Kerala. The real estate sector has also slowed down considerably and this is exacting a toll on CV/CE players.
- In Tamil Nadu, state government interest in the infrastructure/industrial sectors has dwindled and current disbursements by CV/CE lenders are only 25% of the FY08/FY09 numbers. Also, 90-DPD customers have increased to 20-22% of total loans compared to 6-8% in FY08 in some branches in Tamil Nadu.
- In Andhra Pradesh, disbursement and asset quality have taken a severe hit due to political turbulence (the Telangana divide) over the last two years. Many large infrastructure companies are facing a financial crunch as government departments are not clearing their dues. Fleet operators are also defaulting on loans.
- Players are hopeful that with a new government at the centre and state, infrastructure activities will pick up going forward. However, meaningful improvement is still a year away, in our view.

Eastern India – trends mimic rest of India

- CV/CE demand mainly comes from road, mining and urban development – all sectors that remain largely under-developed in India's eastern markets and hence this region contributes only ~20% of the industry loan book.

Things are stabilising and mining activities are expected to improve from Q1/Q2FY16

- Roads and mining activities have been embroiled in environmental/legal hurdles for the last year and a half and disbursements are only 20-25% of FY08/FY09 levels. Coal India's coal production was down 20-22% in the last year which affected CV/CE utilisation rates. In Orissa, due to the SC order, only 7-8 mines are operational (the others will start with a lag).
- Many NBFCs and unorganised players have exited the market in the last one year and hence pricing has improved. Companies are getting better collaterals and loan disbursements are earning higher yields.
- CV lenders indicate that forward-flow delinquencies have stabilised in the last 2-3 months and bucket movements (from say 30-DPD to 60-DPD, or 60-DPD to 90-DPD) for NPL accounts have ceased.
- Improvement in mining activities (recent coal auctions) and revival in the road sector will drive growth going forward. We expect the pick-up to be slow in the next 2-3 quarters but thereafter momentum will improve led by new projects expected to be announced in Q1/Q2FY16.

SREI Infrastructure Finance

CE lending industry still not out of the woods

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SREI a market leader in CE financing

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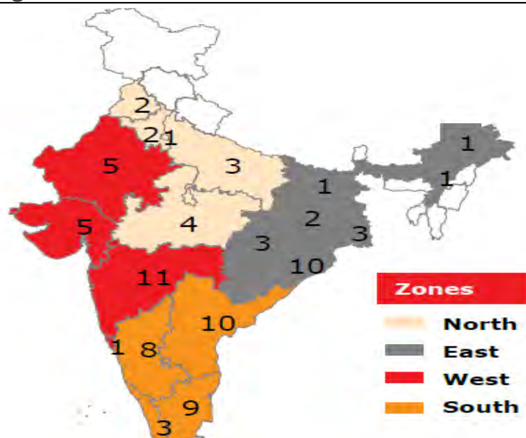
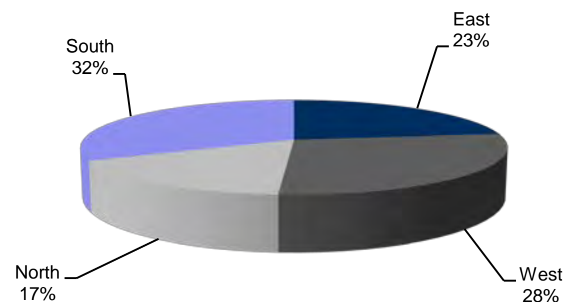
SREI-BNP JV holds 30% market share in equipment finance

Fig 1 - Branch network across India



Source: Company

Fig 2 - South and West India account for 60% of branches



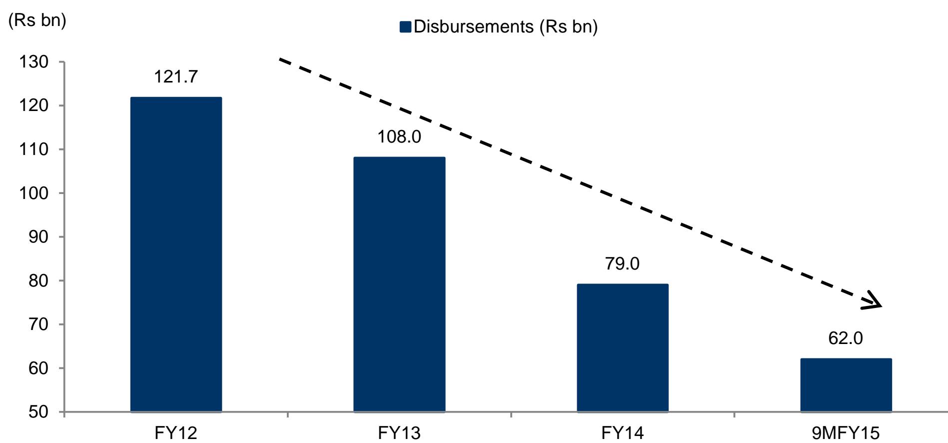
Source: Company

Disbursement growth to remain sluggish

SREI's experience over the last two decades suggests that recovery in the CE cycle always precedes growth. However, there are no clear signs of recovery and utilisation levels for equipment are still poor. Many of the company's regional branches are achieving only a third of their peak capacity (FY08-FY10) disbursements. Therefore, a meaningful recovery in loan growth is still some time away. If there is a broad-based recovery in FY16, management expects 10-15% growth.

Many branches achieving only a third of their peak capacity disbursement

Fig 3 - Considerable slowdown in disbursement



Source: Company

SREI Infrastructure Finance

CE lending industry still not out of the woods

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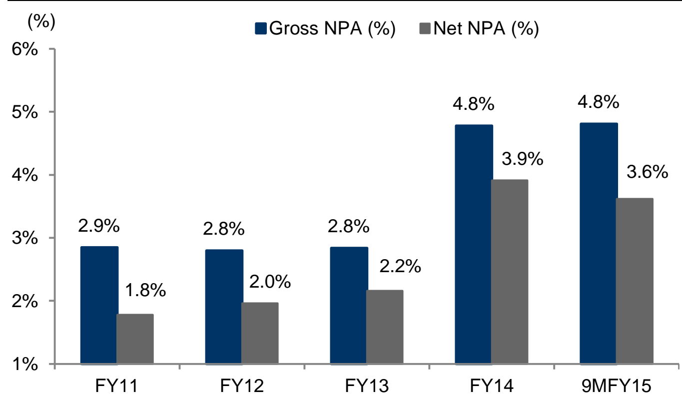
Credit costs likely to remain elevated in FY15/Q1FY16

Management stated that it has seen no improvement on the ground over the last one year, as industrial production (IIP), infrastructure spending (especially on roads) and mining activity remain lacklustre. Slippages are expected to remain elevated and credit cost high in the next 2-3 quarters. SREI is looking to improve its provision coverage ratio in coming quarters. Gross/net NPA on 90-DPD stood at 4.8%/3.6% as at end-Q3FY15.

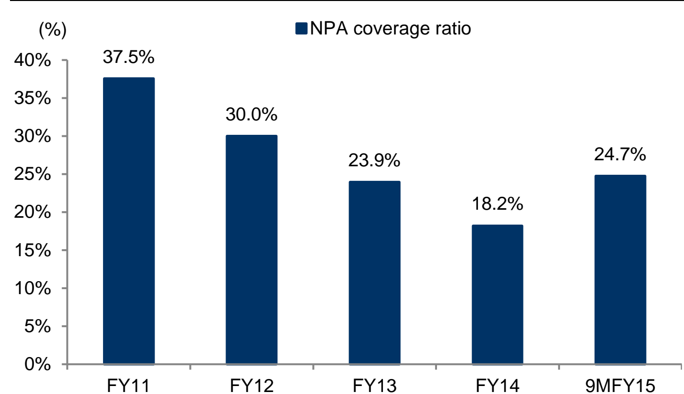
No improvement on the ground over the last one year

Fig 4 - NPA increased amid poor economic growth



Source: Company

Fig 5 - Low coverage ratio to keep credit cost high



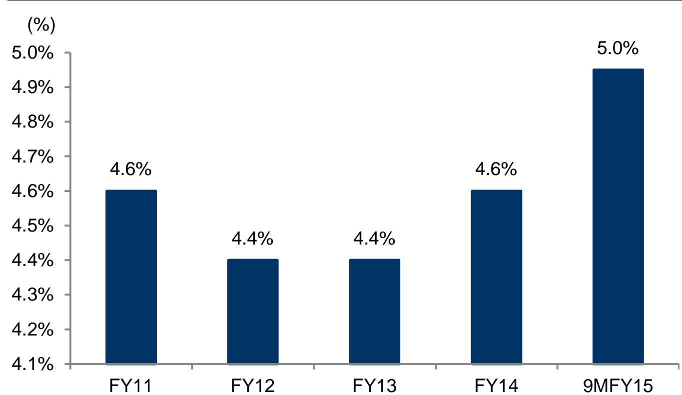
Source: Company

No pricing pressure; cost of funds to ease going forward

Despite weak disbursement trends, management is not seeing any pressure on lending rate (yields) as the business is rather concentrated with only a few large players. Currently, the major source of funding is bank borrowings (working capital at 52% and term loan from banks at 20%), while debentures constitute 7% of total loans (up from 3% in Q2FY15). The company is exploring new avenues to reduce the cost of funds, including higher NCD issuances.

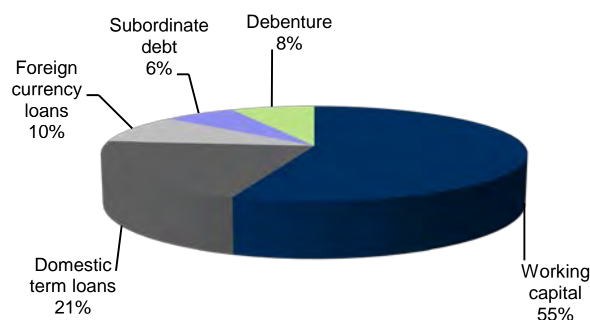
Exploring new avenues to reduce cost of funds, including higher NCD issuances

Fig 6 - NIM to remain in the range of 4.5-5%



Source: Company

Fig 7 - Borrowing profile highly skewed towards banks (Q3FY15)



Source: Company

Fig 8 - SREI Infra – P&L statement

Income Statement (Rs mn)	FY11	FY12	FY13	FY14
Disbursement (Rs bn)	100	122	108	79
Income from finance activities	11,161	16,661	21,470	23,800
Finance charges (excl Forex Impact)	6,552	10,263	13,578	15,324
Net interest Income	**4,610**	**6,398**	**7,892**	**8,477**
Other Income	32	7	89	14
Total Income	4,641	6,405	7,981	8,491
Operating Expenditure	1,525	2,144	2,407	2,316
Operating Profits	**3,116**	**4,262**	**5,574**	**6,175**
NPA Provision & Write off	782	1,004	1,366	2,592
Provision on Standard Asset	200	36	86	2
Forex M2M	1	176	88	5
Profit before tax	2,133	3,046	4,035	3,576
Taxes	825	1,074	1,336	1,322
PAT	**1,308**	**1,972**	**2,699**	**2,254**

Source: Company

Fig 9 - SREI Infra – Key financial ratios

(%)	FY11	FY12	FY13	FY14
Yield on Avg. Funds	13.8	14.7	14.8	14.6
Cost of Funds	9.7	10.6	10.9	11.2
Interest Spreads	4.1	3.9	3.8	3.5
NIM	4.6	4.4	4.4	4.6
Gross NPA	2.9	2.8	2.8	4.8
Net NPA	1.8	2.0	2.2	3.9
Return on Avg. Net Worth	12.6	15.3	16.5	11.3
Return on Avg. Assets on Books	1.6	1.7	1.8	1.3
Return on Avg. Capital Empl.	12.0	12.0	12.0	12.0
Leverage	7.0	7.4	7.2	6.2
CAR	15.8	16.9	16.2	17.1

Source: Company

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Hold	Between 15% and –5%
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