Initiating Coverage

Shriram City Union Finance Ltd.

IIFL India Private Clients

Profitable franchise geared for growth

What's fascinating about SCUF?

- Shriram City Union Finance (SCUF), part of the well-known Shriram Group, has successfully evolved as a mid-sized diversified lender over the past decade. FY08-14 AUM CAGR stands at 29% and RoA averaged 3%.
- In-depth penetration, deep local knowledge and access to the 'Shriram Ecosystem' lend uniqueness to the business which is nearly improbable to replicate. Strong pricing power manifested in high asset yield of 21-22%.
- The core focus of the company remains small enterprise loans (SEL) where it has a leading market share of 40%+. SEL's contribution in AUM is estimated to rise from current 52% to 60% by end of FY17.
- 2w financing book (18% of AUM) is growing faster than industry. Growth and asset quality headwinds in gold loans portfolio (18% of AUM) are largely behind.
- Gross NPL levels in SEL portfolio are at healthy 1.8%. Other products exhibiting 'priced-in' level of stress.
- Ongoing product mix shift is lowering inherent risk of the business while elevating profitability structurally.
- Acceleration in asset growth (18% CAGR over FY14-17E) to drive substantial cost leverage. Decline in borrowing cost and product mix shift to improve NIMs further.
- Thus, despite transition to 120dpd NPL classification by FY17, RoA would materially expand to 3.7%. Sustainable RoE at 18-20%.

Room for valuation to go higher

Trading at 2.2x FY17 P/ABV, SCUF's valuation is attractive in the context of its niche, profitable and high growth business. Relatively, company deserves to trade at premium to peers due to its superior profitability profile. We believe valuation will re-rate towards 3x FY17 P/ABV in the medium term. Initiate coverage with a BUY rating and 12-month price target of Rs2,325.

Financial summary

Y/e 31 Mar (Rs m)	FY14	FY15E	FY16E	FY17E
Total operating income	18,879	21,781	25,712	30,987
Yoy growth (%)	12.9	15.4	18.0	20.5
Operating profit (pre-provisions)	11,641	13,349	16,014	19,737
Net profit	5,212	5,945	7,079	8,828
yoy growth (%)	15.9	14.1	19.1	24.7
EPS (Rs)	87.9	90.3	107.5	134.0
Adj. BVPS (Rs)	476.1	623.7	705.2	807.9
P/E (x)	20.3	19.8	16.6	13.3
P/Adj.BV (x)	3.7	2.9	2.5	2.2
ROE (%)	20.2	16.8	15.7	17.1
ROA (%)	3.2	3.4	3.6	3.7
CAR (%)	26.1	32.7	32.2	30.6

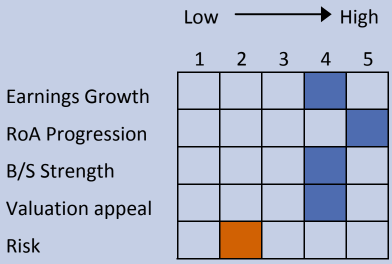
Source: Company, India Infoline Research

Rating:	**BUY**
Target (12-month):	**Rs2,325**
CMP:	**Rs1,807**
Upside:	**28.7%**

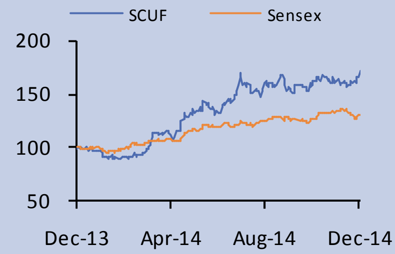
Sector:	**Financials**
Sector view:	**Positive**
Sensex:	27211
52 Week h/l (Rs):	1,870/935
Market cap (Rscr) :	11,910
6m Avg vol ('000Nos):	24
Bloomberg code:	SCUF IN
BSE code:	532498
NSE code:	SHRIRAMCIT
FV (Rs):	10

Price as on Dec 26, 2014

Company rating grid



Share price trend



Share holding pattern

(%)	Mar-14	Jun-14	Sep-14
Promoter	37.6	33.8	33.8
Insti	28.7	26.5	27.2
Others	33.7	39.7	39.0

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December 29, 2014

Company Report

Shriram City Union Finance - A robust business franchise!

Shriram City Union Finance (SCUF), part of the well-known Shriram Group, has successfully evolved as a multi-product lender over the past decade. The core focus of the company remains small enterprise loans (SEL) where it has a leading market share. Like other group companies, SCUF has a well-entrenched business focused on southern and western parts of India. Access to the 'Shriram Ecosystem', deep local knowledge and in-depth penetration through ~960 branches and 22000+ feet on streets lend uniqueness to the business, nearly improbable to replicate.

Core focus is on small entp loans where it has a leading market share

A unique business model difficult to replicate

Through a diversified product portfolio comprising of small enterprise loans, 2w financing, gold loans, auto loans, personal loans and housing loans (offered by subsidiary Shriram Housing Finance), SCUF addresses diverse credit needs of its customers across income generation, consumption and basic needs like housing. About 80% of the branch network is in under penetrated semi-urban India which has a huge potential for growth supported by improving consumption levels driven by rising incomes. Andhra Pradesh, Tamil Nadu and Maharashtra contribute 83% to company's AUM. SCUF has robust in-house credit appraisal and risk management capabilities which are further emboldened by access to customers' credit history from the group ecosystem.

Diversified product portfolio catering to diverse credit needs of customers

AP, Tamil Nadu and Maharashtra contribute 83% to AUM

The business is highly localized and therefore manpower oriented. The field force has strong domain knowledge and personal knowledge of customers and are responsible for the quality of portfolio they originate. While the broad policy formulation is centralized, loan related decision making is decentralized thereby underpinning prompt approval and disbursals. The company follows conservative lending practices across products with offered LTVs being lower or equal to the industry average.

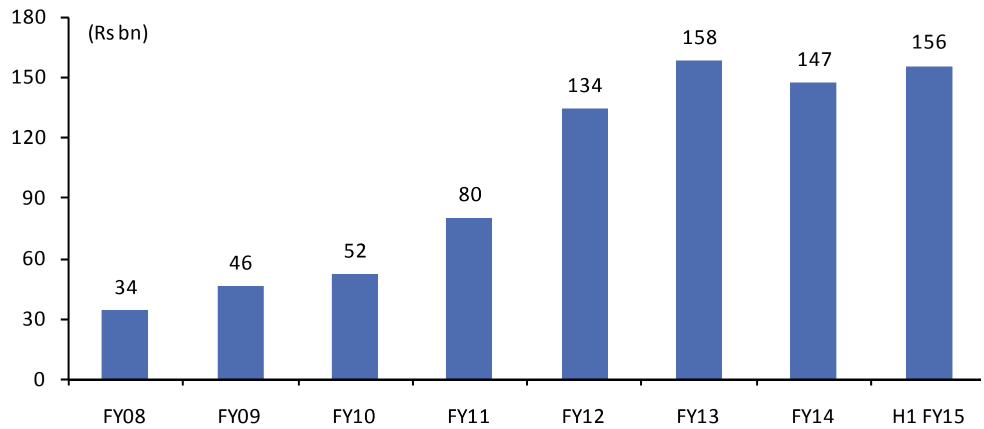
Highly localized business which is manpower oriented

SCUF follows conservative lending practices across products

SCUF's enviable competitive position and robust business policies are manifested in strong AUM growth and profitability track record. Over FY08-14, company's AUM grew at the rate of 28% pa and average RoA during the period was at impressive 3%. However, a proactive portfolio adjustment (reducing the share of gold loans) and added conservatism in small enterprise loan segment due to economic slowdown pulled down AUM growth in recent quarters. However, now the asset growth in set to accelerate with the management having eased its stance on the above mentioned strategies.

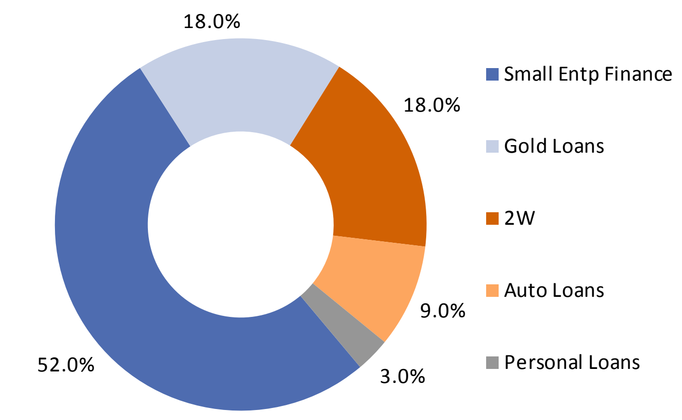
Strong AUM growth and profitability track record

AUM has witnessed a 28% CAGR over FY08-14

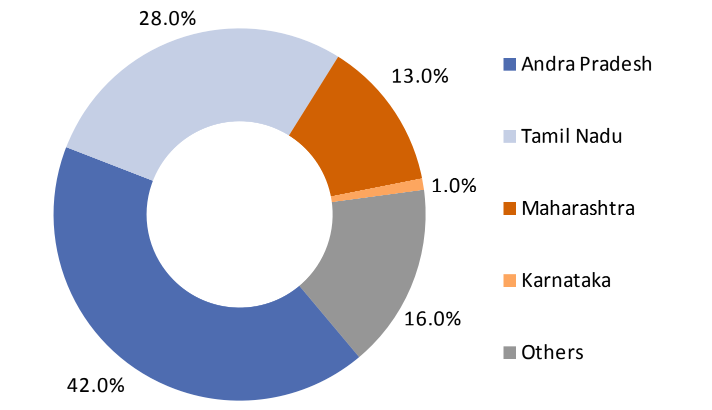


Source: Company, India Infoline Research

Product mix - Small Entp Loans is more than 50%

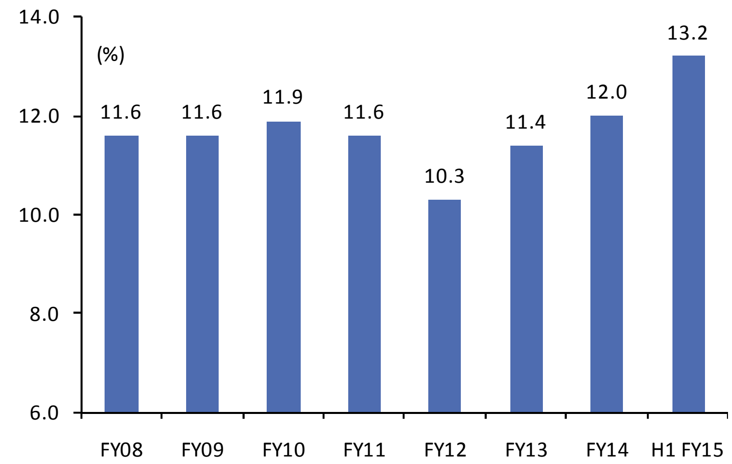


Regional AUM Mix - strong focus on South India

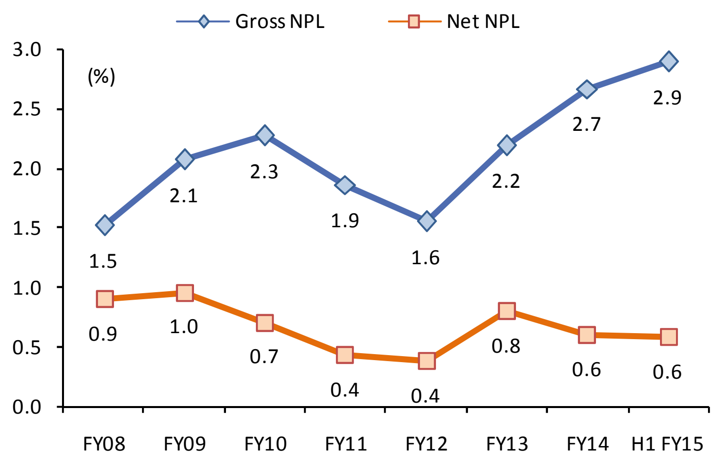


Source: Company, India Infoline Research

NIM has improved substantially in recent years

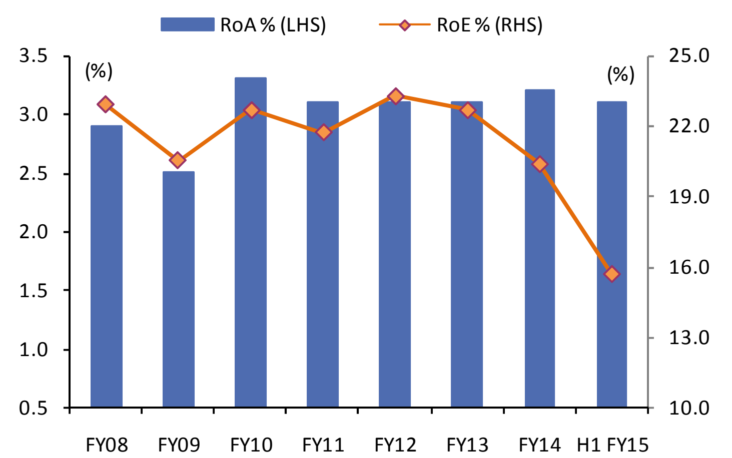


Gross NPLs have spiked but Net NPLs under control

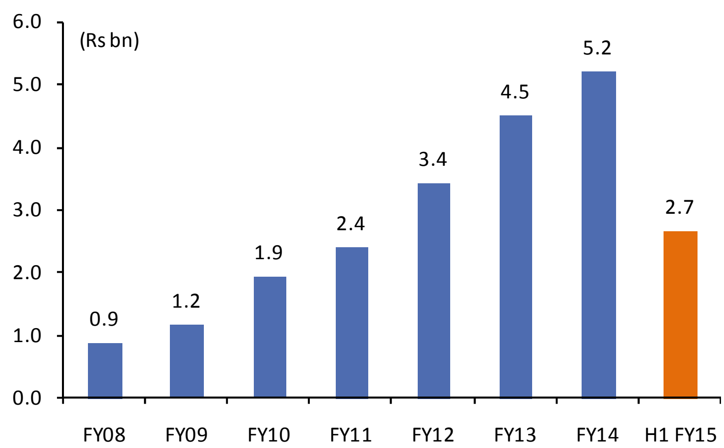


Source: Company, India Infoline Research

RoA sustained at 3%+; RoE dipped due to reduced leverage



Unhindered PAT growth



Diversified product portfolio

Two Wheelers	Auto Loans	Small Enterprise Finance	Personal Loans	Loan Against Gold	Home Loans
Started in Dec 2002	Started in Dec 2005	Started in Dec 2005	Started in Jan 2006	Started in Oct 2006	Started in Dec 2011
Average Tenor: **24 Months**	Average Tenor: **30 Months**	Average Tenor: **36 Months**	Average Tenor: **30 Months**	Average Tenor: **4 Months**	Average Tenor: **15 Years**
Average Yield: **22%-24%**	Average Yield: **22%-24%**	Average Yield: **18%-22%**	Average Yield: **24%-27%**	Average Yield: **16%-18%**	Average Yield: **15%**
Average Ticket Size: **INR 35,000**	Average Ticket Size: **INR 150,000**	Average Ticket Size: **INR 500,000**	Average Ticket Size: **INR 75,000**	Average Ticket Size: **INR 40,000**	Average Ticket Size: **INR 100,000**
Loan To Value: **Average 70%**	Loan To Value: **Average 60%**	Loan To Value: **NA**	Loan To Value: **NA**	Loan To Value: **upto 70%**	Loan To Value: **upto 70%**

Source: Company, India Infoline Research

Small enterprise loans to remain the mainstay product

From the products perspective, small enterprise loans (SEL) is the key differentiator for SCUF. With presence of nearly a decade, company has played a pioneering role in the development of this segment thus enjoying a dominant market share of more than 40% (as per a Frost & Sullivan report in 2013). In this product which is characterized by small ticket loans generally ranging between Rs0.1-1mn to local businesses (shopkeepers, traders, enterprises, etc), SCUF faces low competition thus commanding a strong pricing power. The lending yield ranges between 18-22% with average ticket size of ~Rs0.5mn and average duration of loans at ~36 months.

Small enterprise loans is the key differentiator for SCUF; enjoys market share of 40%+

SCUF has a strong pulse of the SEL market in its focused geographies of AP, TN and Maharashtra given long and deep presence. Rich local knowledge through its large field force and the Shriram ecosystem underpins company's strong credit appraisal and risk management framework. Though on most occasions the collateral is the residential property of the borrower, the loan exposure is based on the business requirement which is evaluated by a capable field personnel through analysis of the underlying utilization economics and future cash flows. As a conservative approach, SCUF has a policy of funding only businesses with minimum 3-4 years of track record and not start-ups. In its history of small enterprise loans, the company has never had to repossess and liquidate customers' property even once thus highlighting its robust underwriting standards.

Company has strong pulse of SEL market in its focused geographies given long and deep presence

Policy of funding only businesses with minimum 3-4 years of track record and not start-ups

Since initiation of the product, SCUF has effectively leveraged its group company, Shriram Chits, for building scale. Shriram Chits, established in 1974, is one of the most trusted brands in the chits business in the country with a customer base of over 3mn. Till 2013, SCUF had a channel partnership with Shriram Chits for sourcing and servicing small enterprise loans. In the middle of FY13, the employees involved in this activity were transferred to SCUF and the arrangement was dissolved. The chit entity, however, continues to provide large number of references both of its existing and erstwhile customers. So far, SCUF has tapped less than 10% of the addressable chit base. A detailed credit history of chit members is available with Shriram Chits which helps SCUF in credit evaluation.

Till 2013, SCUF had a channel partnership with Shriram Chits for sourcing and servicing small entp loans

Chit entity continues to provide references both of its existing and erstwhile customers

Over the past few years, SCUF has been focusing on developing business beyond the chit base. It has significantly lowered its dependence on chit business by establishing presence in the non-chit regions and taking non-chit customer referrals from the chit borrowers. The portfolio share of chit base has declined to around 50% from 70-75% about four years back. The non-chit portfolio is expected to grow at a faster pace in the future also with improving throughput from business units located in the non-chit regions of Maharashtra, Gujarat, Madhya Pradesh, Chhattisgarh, Rajasthan, UP and West Bengal. Company has been also pricing the product more competitively in these areas at 17-20% as compared to 20-22% in chit regions. Further, the credit quality of this portfolio has been marginally better than chit borrowers so far.

SCUF has been focused on developing business beyond the chit base

Portfolio share of chit base has declined to around 50% from 70-75% about four years back

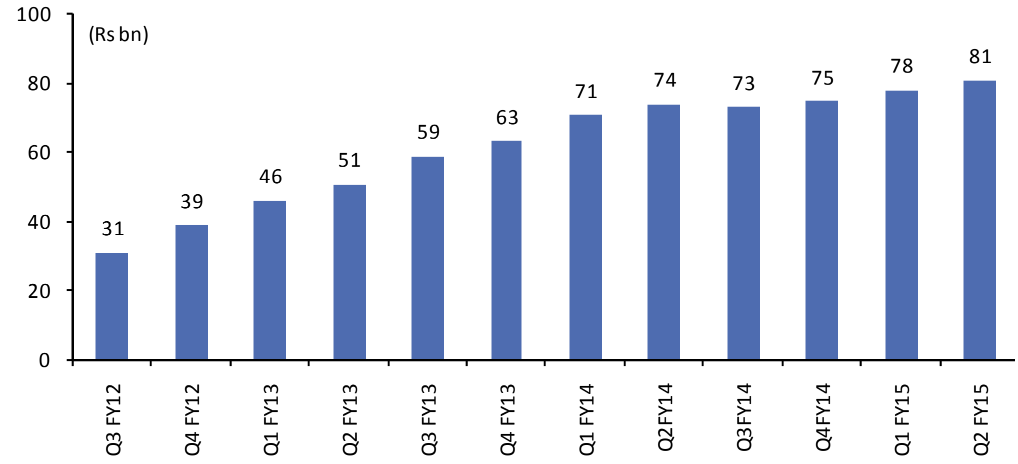
The SEL portfolio has witnessed robust growth of 39% over FY12-14, much higher than the overall AUM, thereby increasing its share in assets from 29% to 51%. In the recent quarters, the SEL book has witnessed a steep deceleration in growth due to conservative steps taken by the management such as lowering of ticket sizes and curtailing duration of loans in the wake of a sharp economic slowdown. However, with business sentiment in its key regions (especially in AP where the political uncertainty is behind) having witnessed a marked improvement, the company has reverted to its earlier policies of doing business which should aid medium term growth recovery. For FY15, the portfolio is likely to grow by 20% with disbursements in H2 expected to pick-up. In the coming years too, SEL portfolio would grow much faster than overall AUM given enormous growth opportunity and SCUF's supreme competitive position. We estimate the product's share in the AUM to increase to 60% by FY17.

SEL portfolio has witnessed robust CAGR of 39% over FY12-14; increasing its share in assets to 51%

Recent deceleration in growth due to conservative steps taken such as curtailing ticket sizes and loan duration

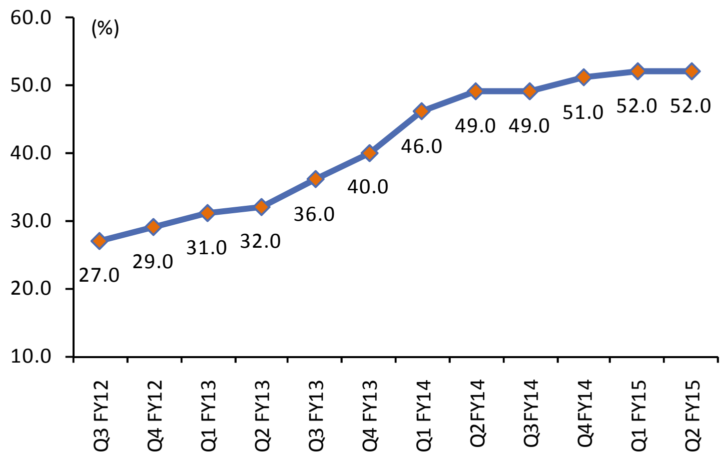
In FY15, portfolio is likely to grow by 20%; product's share in AUM to increase to 60% by FY17

SEL portfolio has witnessed robust 39% CAGR between FY12-14

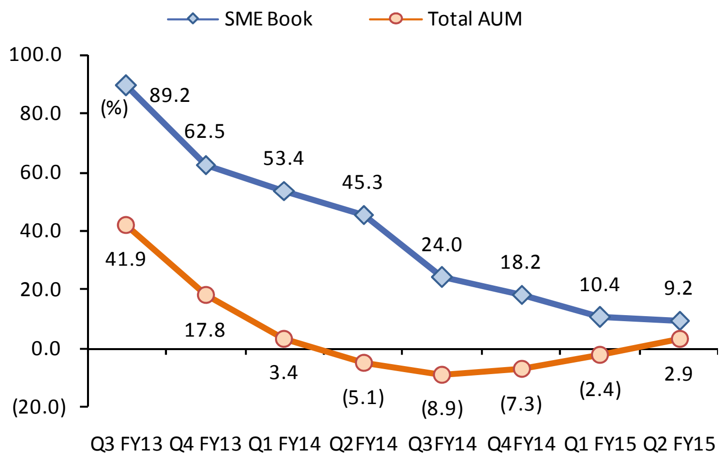


Source: Company, India Infoline Research

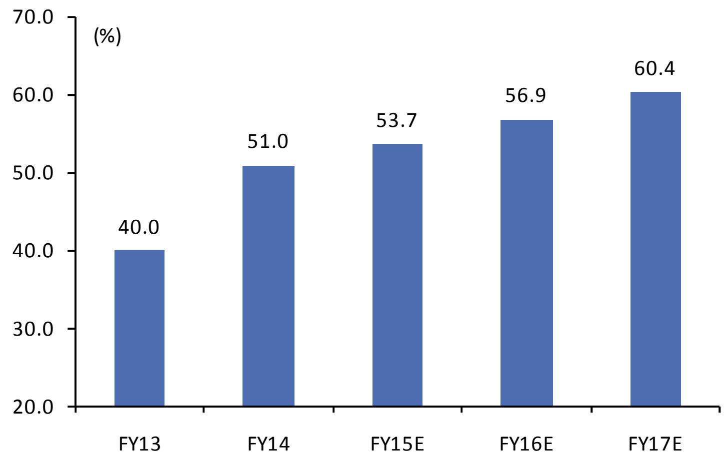
Share in AUM has increased significantly



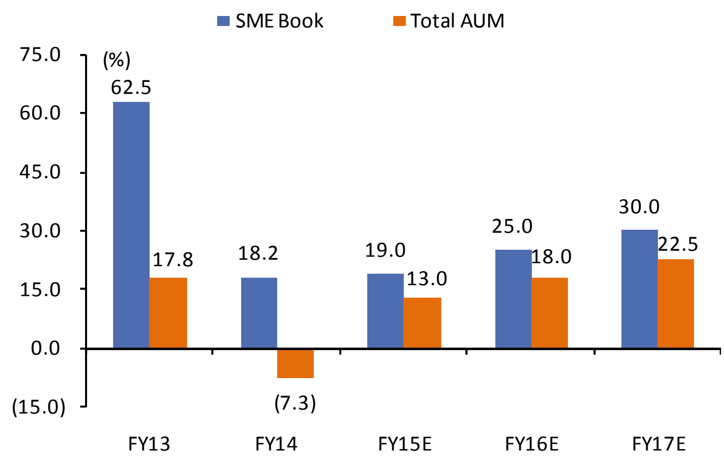
SEL portfolio has consistently grown at faster pace than overall AUM



Share in AUM to increase to 60% by end FY17



SEL book to drive the recovery in AUM growth



Source: Company, India Infoline Research

Gold loans portfolio has stabilized

Gold loans portfolio has started to stabilize after witnessing substantial contraction in the past couple of years. The decline in the portfolio was driven more by risk mitigation approach adopted by the company than due to tighter regulations and fall in the gold price. Driven by the relatively ease in origination, the share of gold loans in the overall AUM had rapidly climbed to 40% by H1 FY13 thus making it the largest contributor (SME was 32% then). Though SCUF was doing this business at more conservative terms (offering lower LTVs of 60-65% and consequently lower pricing), it was not comfortable with such high portfolio share of gold loans, a product which lacks differentiation. The management decided to lower the contribution by making LTV/rates more conservative (started offering 50-55% exposure at 14-16%) thus making the product unattractive for many of its borrowers. Consequently, the size of the gold loan book shrunk by nearly 60% between Q2 FY13-Q4 FY14 and its contribution in the overall AUM dipped to 17%.

Share of gold loans in overall AUM had rapidly climbed to 40% by H1 FY13 despite conservative LTVs/rates

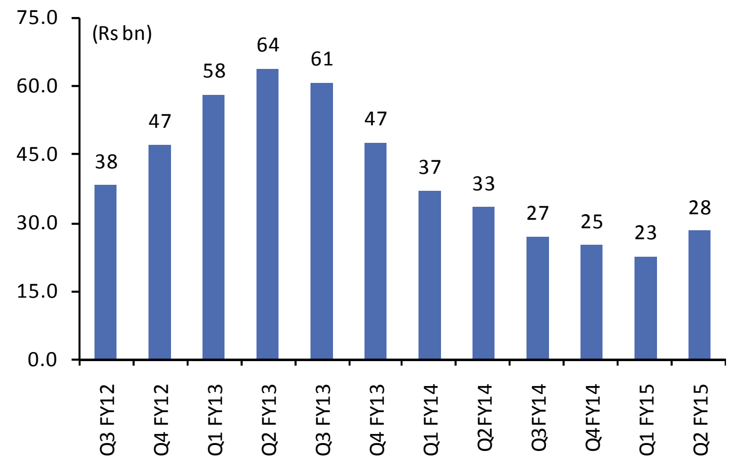
Not comfortable with such high portfolio share of gold loans, Co further lowered LTV and rates

However, since the start of the current fiscal, SCUF has started offering 60-65% LTVs with RBI raising the maximum LTV limit to 75% for the industry and gold prices stabilizing somewhat. Such higher LTVs are being offered only to select customers and that too for shorter tenors (3-6 months) to mitigate the price risk. For loans originated at 50-55% LTVs, the tenor offered is as long as 1 year. The blended duration of the portfolio is near 5 months, the average ticket of loans is about Rs40,000 and portfolio yield is at 15-16% (rates offered between 14-18% based on LTVs). The disbursement traction has improved significantly in H1 FY15 and the portfolio has started to grow after witnessing a secular fall over the past seven quarters. Though the management is unlikely to turn aggressive in this segment, the portfolio could grow in line with the overall AUM driven by widening distribution (currently offered in only ~350 of total ~960 branches).

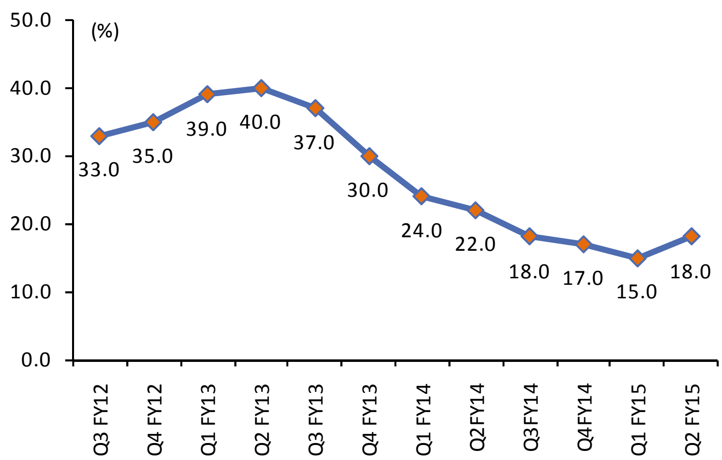
However, since the start of current fiscal, SCUF has reverted to offering 60-65% LTVs but to select customers

Disbursement traction has improved significantly in H1 FY15 and the portfolio has started to grow

Gold loan AUM has shrunk dramatically



Share in the total AUM has declined to 18%



Source: Company, India Infoline Research

2-wheeler loan portfolio growing ahead of the industry; auto loans portfolio has shrunk

Amongst the current product portfolio, 2-wheeler loans is the oldest offering of SCUF with commercial launch dating back to 2004. Underpinned by its long existence and wide reach, company is currently the third largest organized financier in this segment behind HDFC Bank and Indusind Bank. SCUF shares strong relationship with more than 6000 dealers across various geographies. Apart from presence at dealer locations, the company offers 2-wheeler loans at almost all its ~960 branches. SCUF mainly focuses on the self-employed customers unlike its larger competitors who target the salaried class. The average ticket size of loans is Rs35,000-40,000, tenor is 2-3 years and lending rate is in the range of 22-24%.

SCUF is the third largest organized financier in 2-wheeler segment

Mainly focusing on self-employed customers, company offers 2-wheeler loans at almost all its ~960 branches

The 2-wheeler loan portfolio of the company has grown at an impressive pace of 26% pa over the past couple of years defying the steep slowdown in the underlying industry volume growth. This suggests that SCUF has gained market share in this product segment. As per the management, the relatively newer branches opened in the North and West regions are seeing improved traction while the older branches in the South region continue to do well. The share of 2-wheeler loans in AUM has increased to 18% from 11% at the end of Q3 FY13.

Portfolio has grown at an impressive pace defying the steep slowdown in underlying industry

2w loans share in AUM has increased to 18%

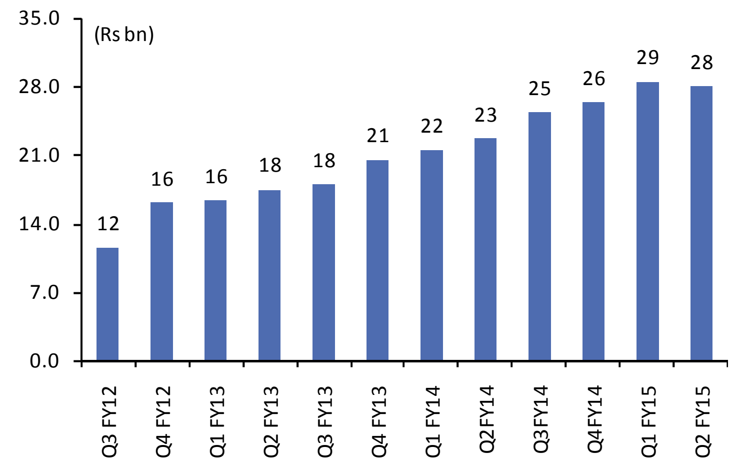
SCUF's auto loans portfolio represents used CVs, cars and 3W financing. With a non-compete arrangement with group company Shriram Transport Finance, SCUF is only into financing of more than 12-year old LCVs. This segment is more of an extension of SEL segment with many of the customers having earlier been a small loan borrower of the company. Financing of vintage LCVs mean that average ticket size is low at Rs0.15mn while lending rates are as high as 24-26%. The sharp slowdown in industrial and mining activity over the past three years has significantly impacted this portfolio; it has contracted from Rs27bn at end-Q3 FY12 to Rs14bn at end-Q3 FY15. The portfolio's share in overall AUM has declined substantially from 23% to 9% during the aforesaid period. Given sustained weakness in LCV demand, growth outlook of this segment could remain uncertain in the near term.

Auto loans portfolio largely represents financing of more than 12-year old LCVs

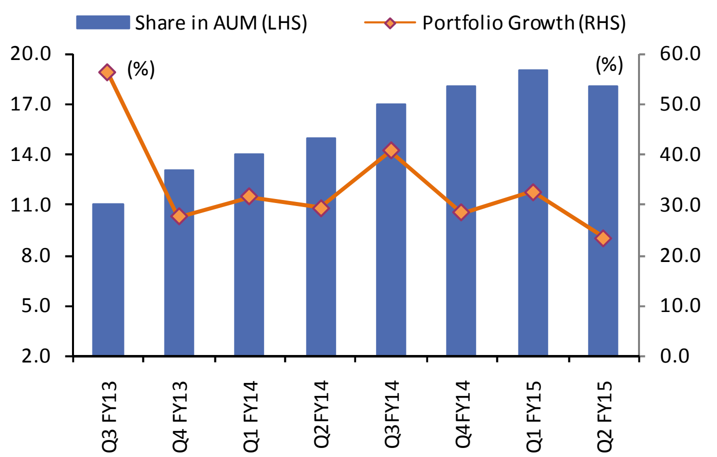
Sharp slowdown in industrial and mining activity has driven significant contraction of the portfolio

Portfolio's share in AUM has declined to 9%

2w loan portfolio has substantially grown in size

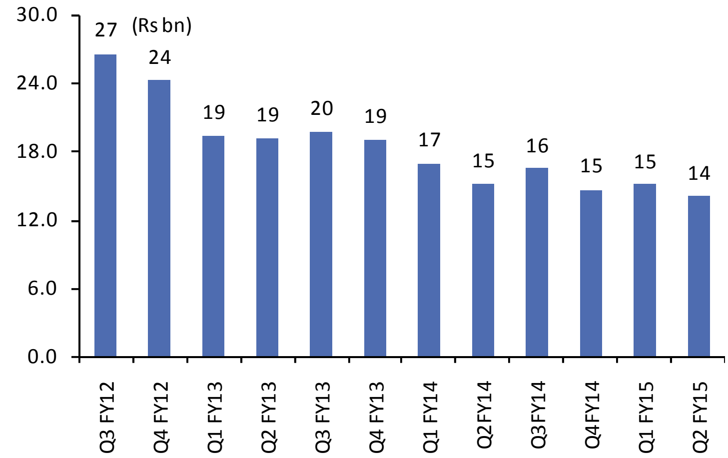


Share in total AUM has risen to 18%

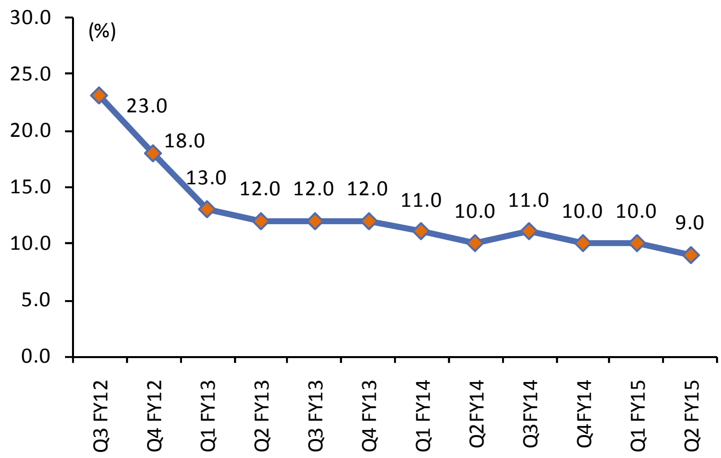


Source: Company, India Infoline Research

Auto loans portfolio has seen a steep contraction



Share in overall AUM has fallen to 9%



Source: Company, India Infoline Research

AUM growth to accelerate materially from current suppressed levels

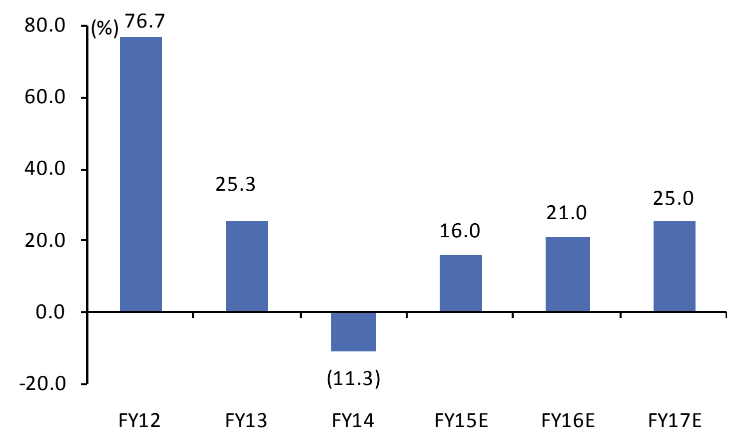
A combination of self-imposed caution across the product portfolio, deterioration in the demand environment and a larger base led to a steep deceleration in SCUF's asset growth from 60% yoy at the end of Q2 FY13 to just 3% at end-Q2 FY15. Product-wise, it was led by gold loans and auto loans where the portfolios have substantially shrunk in size. The share of the two combined has fallen from 52% to 27% in the aforesaid period. While the gold loan portfolio seems to have stabilized and would contribute to overall asset growth in the coming quarters, revival in auto loans is likely some time away. With economic activity especially in SCUF's key states (AP, TN and Maharashtra) improving at the margin, disbursements have already started to pick-up additionally supported by managements' eased lending approach in SME and Gold loans. In H1 FY15, disbursements have witnessed a healthy growth of 17% yoy as compared to a de-growth of 11% in FY14. As per SCUF, the momentum is expected to sustain in H2 FY15 and strengthen further over the coming years as the operating environment improves. The revival in disbursement momentum is estimated to pull AUM growth to 13% yoy by the end of the current fiscal. Over FY15-17, we expect loan assets to witness a CAGR of 20%.

Asset growth decelerated sharply over FY12-14 led by contraction in gold and auto loans portfolio

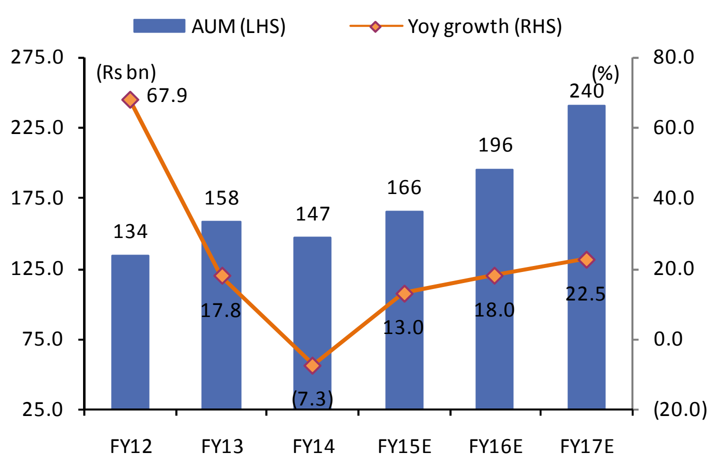
With economic activity in SCUF's key states improving at the margin, disbursements have started to pick-up

Disbursements expected to grow by 17% in FY15 thus pulling up AUM growth to 13%

Disbursement growth has started reviving



AUM growth to follow suit



Source: Company, India Infoline Research

NIM will further improve in the medium term

Being a deposit-taking NBFC and having a robust NCD franchise (courtesy group's strong brand equity in the main operating regions), SCUF's funding profile is more diversified and stronger when compared to many other NBFCs. Company's reliance on bank borrowings is comparatively lower at 53%. A fairly stable history of spread across rate cycles is testimony of company's deft management of interest rate and ALM risks. While all assets are at fixed rate (blended tenor not very long at 18 months), the borrowings are nearly equally split between fixed and floating rate (having a blended tenor of 23 months). Further, due to a niche and highly profitable business model, SCUF has traditionally enjoyed a high credit rating. Recently, company's long term rating was upgraded by CARE to AA+ and by India Ratings to AA which should enable SCUF in raising funds at more competitive rates in future.

SCUF's funding profile is more diversified and stronger than many other NBFCs

All assets are at fixed rate, while 52% of borrowings are at floating rates

SCUF has traditionally enjoyed a high credit rating

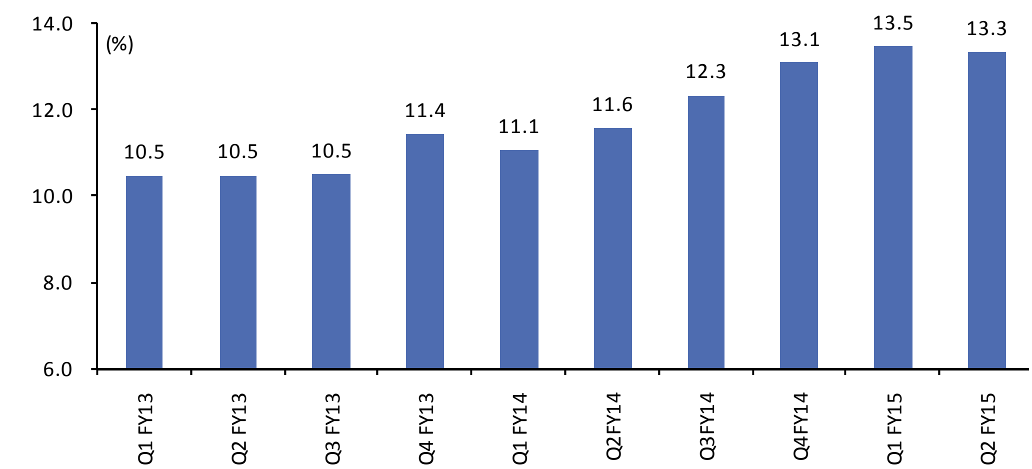
In spite of hardening of interest rate across maturities over the past three years, SCUF's cost of borrowing has remained largely stable. On the other side, portfolio yield has improved significantly driven by the change in product mix viz sharp decline in share of lower yielding gold loans and increase in contribution of much higher yielding small enterprise and 2w loans. Consequently, the NIM (computed on AUM) has improved substantially from 10.3% in FY12 to 13.4% in H1 FY15. Given company's strong competitive position in key products/regions, it enjoys a strong pricing power which enables it to comfortably pass on higher borrowing cost while retaining benefits in an easing funding cost environment. Longer term NIM outlook remains encouraging with the cost of borrowings expected to soften aided by 1) rationalization of spreads over base rate 2) base rate reduction by banks which is on the anvil with deposits rates already being reduced and 3) lower cost of incremental bond funding driven by the recent upgrade in credit rating and a general decline in rates. SCUF intends to largely retain the expected gains from softening of borrowing cost to overcome the higher provisioning requirement which would emanate from shifting NPL recognition to 90dpd by FY18. Therefore, we expect further improvement in NIM to 13.8% by mid-FY16.

NIM has improved substantially on the back of uptick in portfolio yield which was driven by product mix changes

SCUF's strong competitive position in key products/regions gives it a strong pricing power

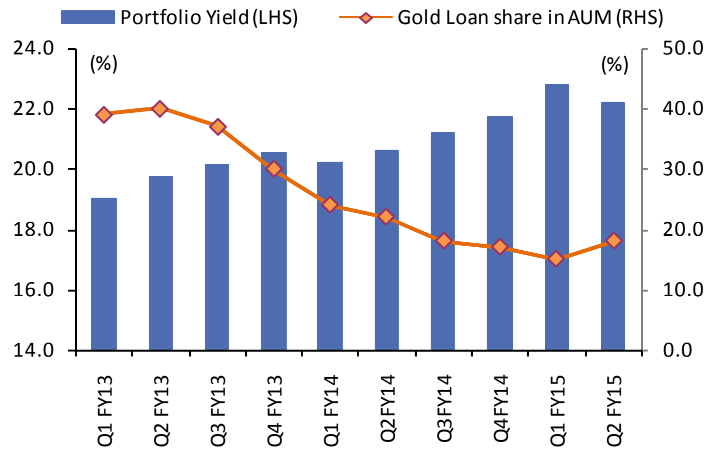
Longer term NIM outlook remains encouraging with the cost of borrowings expected to soften

NIM has seen smart expansion due to sharp uptick in portfolio yield

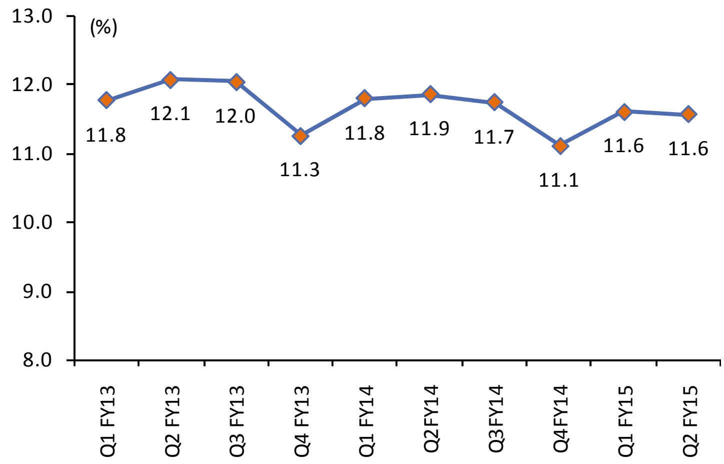


Source: Company, India Infoline Research

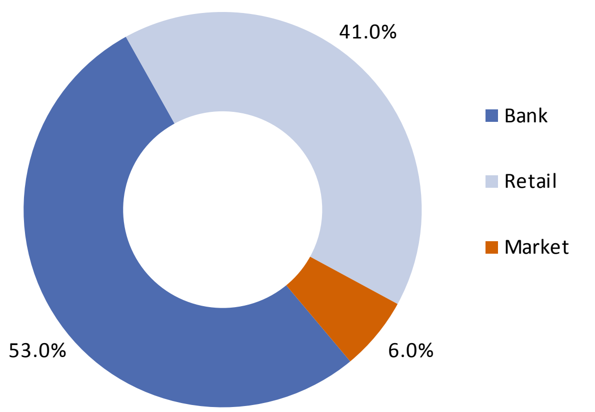
Portfolio yield has improved substantially on account of product mix change



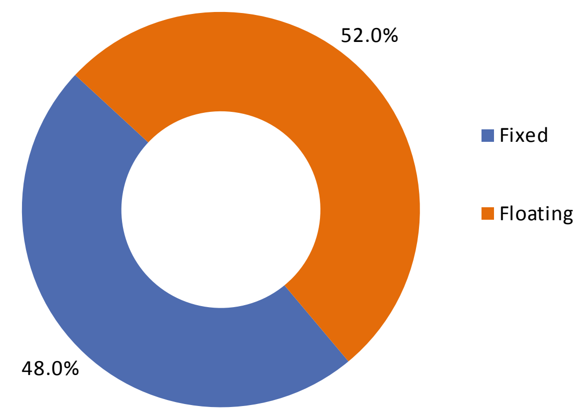
Cost of borrowing has been largely stable despite hardening of rates in general



Borrowing mix is better than most peers

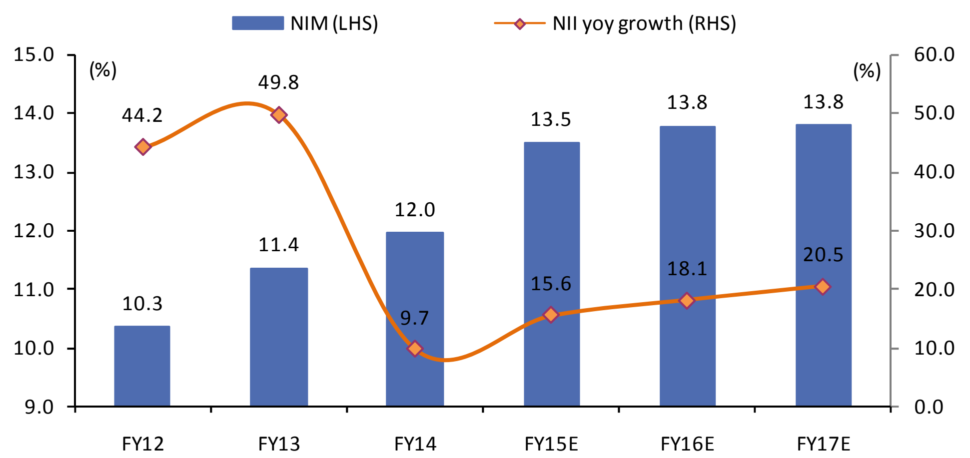


Liabilities equally split between fixed and floating



Source: Company, India Infoline Research

NIM to improve further and push NII growth above asset growth



Source: Company, India Infoline Research

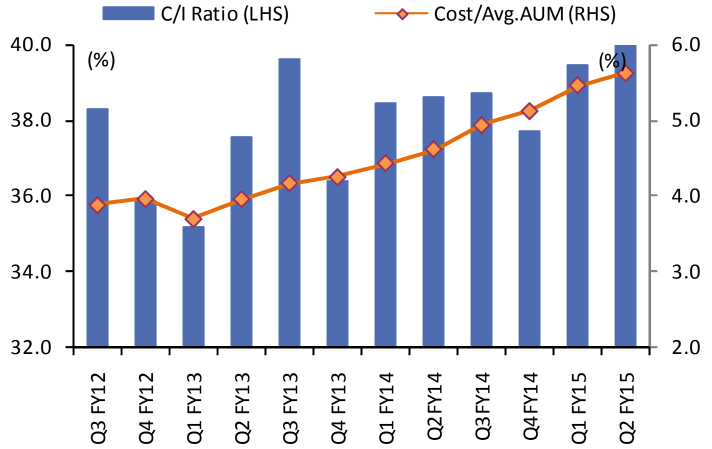
Cost metric to improve as growth returns and NIM expands

SCUF's cost metric has deteriorated materially over the past eight quarters driven by 1) transfer of around 7,000 employees in mid- FY13 from the chit business who were already involved in developing SCUF's business among chit customers 2) sharp slowdown in asset growth leading to under utilization of resources and 3) recent investments in resources and network. The cost/avg.AUM ratio increased significantly from 3.9% in Q2 FY13 to 5.6% in Q2 FY15 and the cost/income ratio touched a multi-quarter high of 40.5%. This is likely to start reversing in the coming quarters as AUM growth accelerates largely driven by improving productivity of existing resources and branches. We believe that business investments are already in place to push growth in an improving operating environment. While company has plans to test new geographies, it intends to execute in a calibrated way thus not pressuring cost. We estimate cost/avg.AUM ratio to improve to near 5% and cost/income ratio (additionally supported by NIM expansion) to retreat to near 36% by FY17.

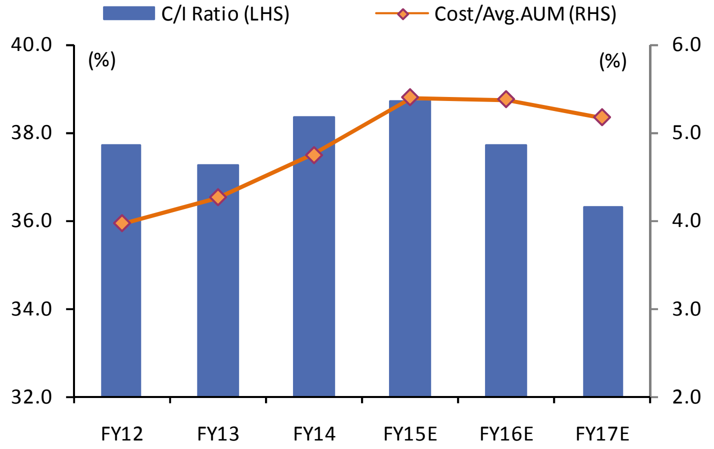
Cost/avg.AUM ratio has increased from 3.9% in Q2 FY13 to 5.6% in Q2 FY15

Cost metric to improve as AUM growth accelerates; estimate cost/avg.AUM ratio to improve to 5% by FY17

Marked deterioration in cost productivity over the past eight quarters



Growth recovery to drive an improvement in cost ratios



Asset quality stress has stabilized, but shift to 90dpd would keep credit cost high

A material uptick in stress in gold loan portfolio triggered by correction in gold prices has largely driven a significant increase in SCUF's gross NPL ratio from 1.4% in Q2 FY13 to 2.9% in Q2 FY15. Though entrenched macro slowdown and AP crisis had an impact on credit quality of other products, it still remains at healthy levels. For instance, gross NPLs in the SEL portfolio stand at impressive 1.8% reflecting SCUF's robust underwriting skills which are underpinned by close knowledge of the borrower's business. In 2w financing and auto loans, gross NPL ratios are just above 4% which is a steady-state level in the business and therefore well priced-in. Even in the gold loan business, SCUF due to its conservative lending policies has come out safely when compared to much aggressive dedicated gold loan companies. It did not have to resort to large scale auctioning nor it had to take a principal loss in any of the case. A notable positive in the reported performance of the company has been higher provisioning against fresh delinquencies which has led to a sharp improvement in provisioning coverage ratio which currently stands at 80%.

Stress in gold loan portfolio largely behind significant increase in SCUF's gross NPL ratio

Gross NPLs in SEL portfolio are at healthy 1.8% reflecting SCUF's robust underwriting skills

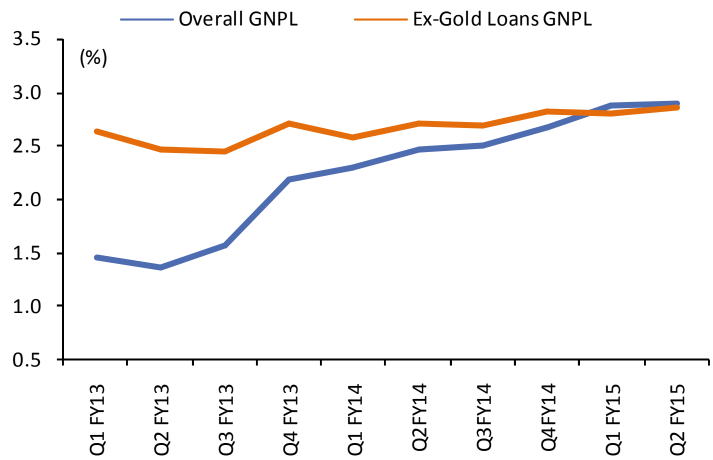
Higher provisioning against fresh delinquencies reflected in the sharp PCR improvement to 80%.

With company having rationalized the gold loan portfolio through added prudence and conservatism, the asset quality in the segment is expected to stabilize soon. On the other side, the resolution of AP crisis and improving activity in the region bodes well for other products. Even the management believes that overall stress should moderate and asset quality could marginally improve by the fiscal end. In the subsequent years, though cyclical improvement in credit environment will ease pressure, the reported NPLs would increase as SCUF shifts to 90dpd NPL classification by FY18 from current 180dpd. Therefore, credit cost is expected to remain elevated at near 3%. Net NPLs would rise to more than 1% of advances.

Asset quality in gold loan portfolio is stabilizing; resolution of AP crisis bodes well for other products

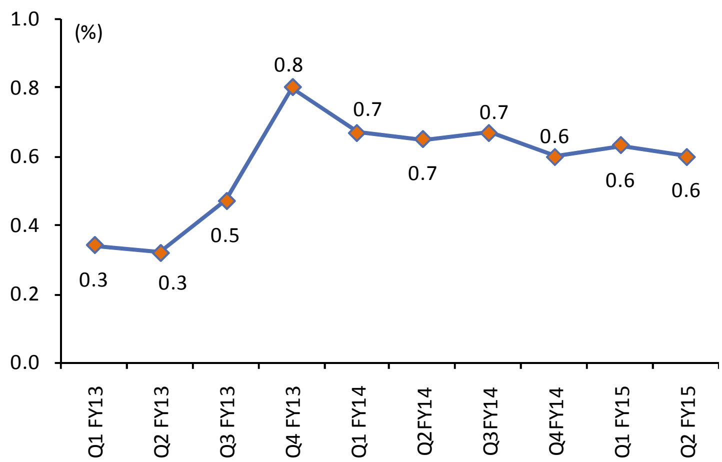
However, reported NPLs would increase as NPL classification shifts to 90dpd by FY18

Uptick in Gross NPLs largely driven by significant stress in gold loan segment

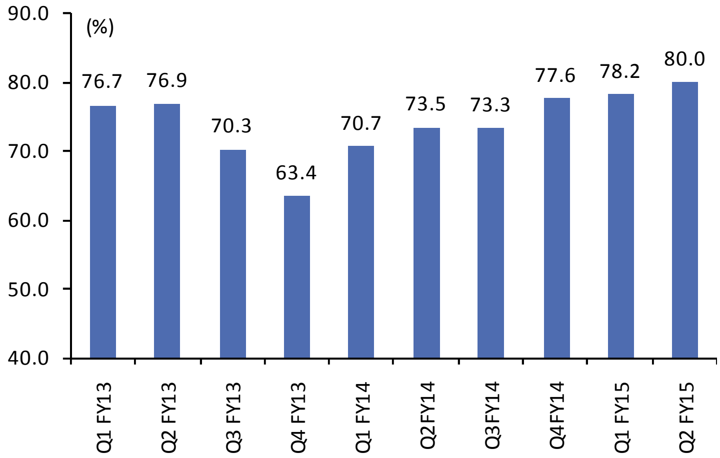


Credit cost has increased in response

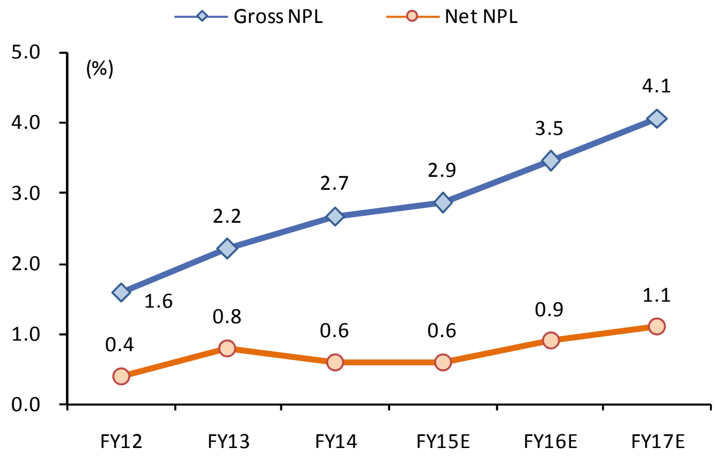
Conservative provisioning has kept Net NPLs in check



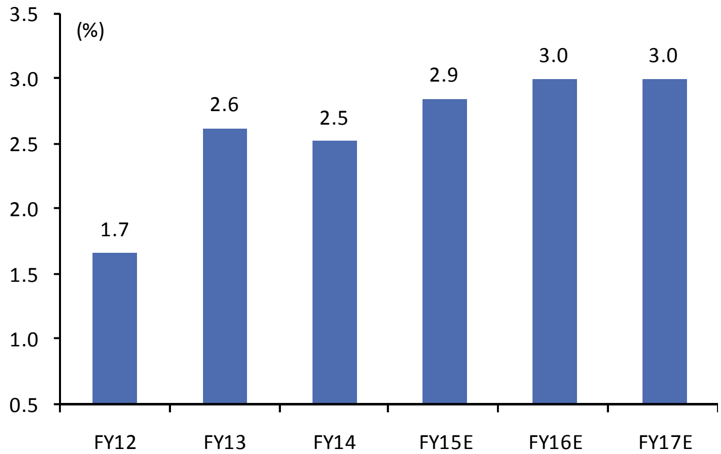
PCR has significantly improved to 80%



GNPL level to rise further as recognition shifts to 150dpd in FY16 and 120dpd in FY17



Therefore, annual credit cost to remain elevated



RoA to improve, low leverage to limit RoE expansion

The strength of company's business model is reflected in the delivery of steady 3%+ RoA over FY10-14, a period which experienced both benign and tough credit environment and rate down/up cycles accompanied with high volatility. We believe that shift in the product mix away from gold loans and in favour of small enterprise loans over the past two years has lowered inherent risk of the business while elevating the profitability structurally. This would be more visible in the coming years as RoA improves to above 3.5% despite persistence of high credit cost.

Shift in the product mix in favour of SEL has lowered inherent risk of the business while elevating profitability

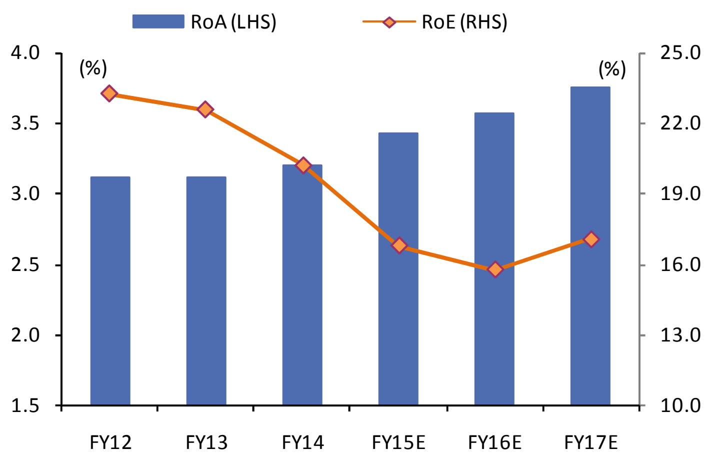
RoA to cross 3.5% in FY16/17 despite high credit cost

SCUF is very well capitalized for a reasonably strong asset growth recovery with Tier-1 capital at 25%. During Q1 FY15, company's capital adequacy was bolstered by a preferential allotment of equity worth Rs7.9bn to Piramal Enterprises. With the consequent reduction in the balance sheet leverage, RoE has declined to near 16% for H1 FY15. Notwithstanding the estimated expansion in RoA over the next couple of years, RoE improvement is likely to be restricted by continuance of low leverage levels (average assets growth is estimated to trail RoE till FY17).

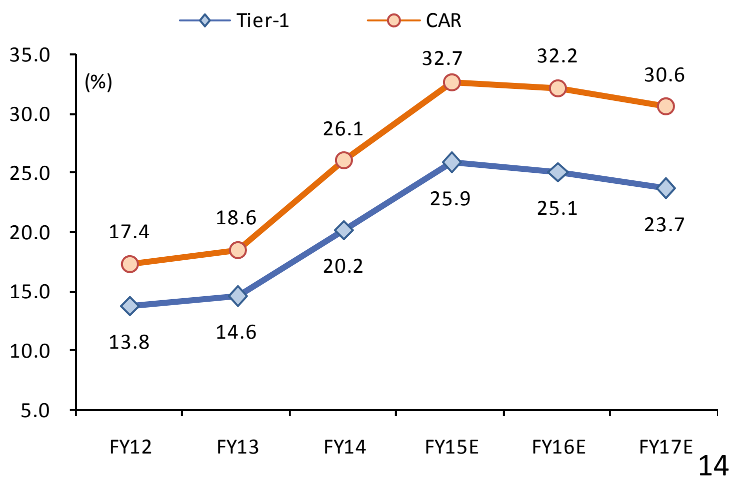
SCUF is well capitalized for strong asset growth with Tier-1 capital at 25%

RoE improvement to be restricted by continuance of low leverage levels

RoA to move in higher orbit; RoE improvement warrants a robust growth recovery



Company to remain well-capitalized for the coming three years at least



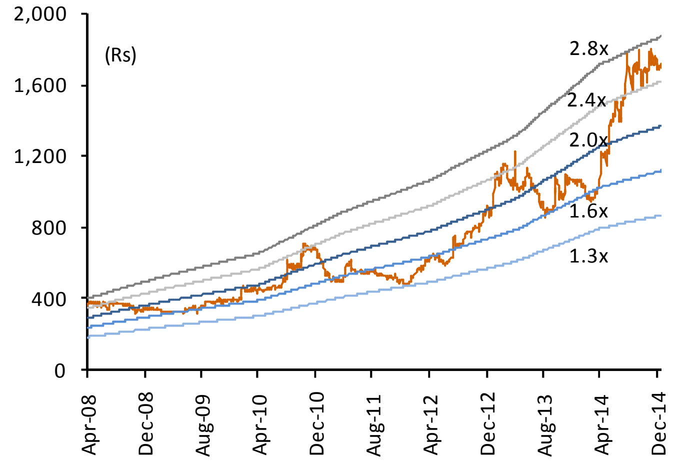
Valuation attractive both on absolute and relative basis; initiate coverage with 12m target of Rs2,325

We believe that SCUF's current valuation of 2.2x FY17 P/ABV is attractive in the context of 1) niche franchise; high entry barriers for new players in small enterprise loans segment 2) highly profitable business underpinned by strong pricing power; RoA to average 3.6-3.7% during FY16-17 3) expected significant acceleration in earnings growth and 4) healthy performance track record during the challenging period of FY12-14. On relative basis also, we believe that company deserves to trade at premium valuation due to its superior profitability ratios. We initiate coverage on SCUF with a BUY rating and 12-month price target of Rs2,325 implying an upside of 29% from current levels.

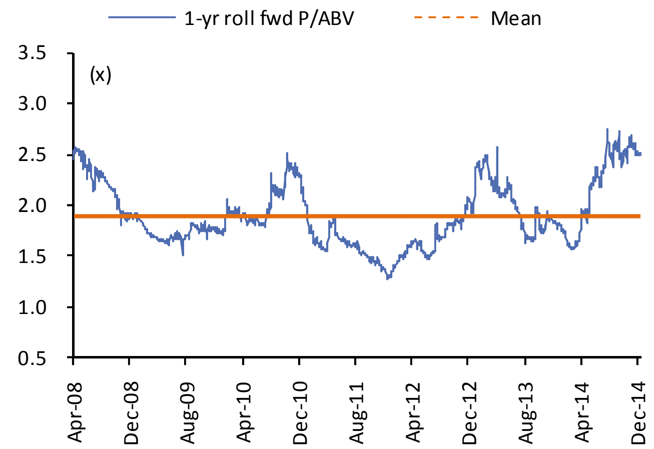
Valuation attractive at 2.2x FY17 P/ABV given niche business, robust profitability and improving growth

SCUF deserves to trade at premium to peers due to superior profitability ratios

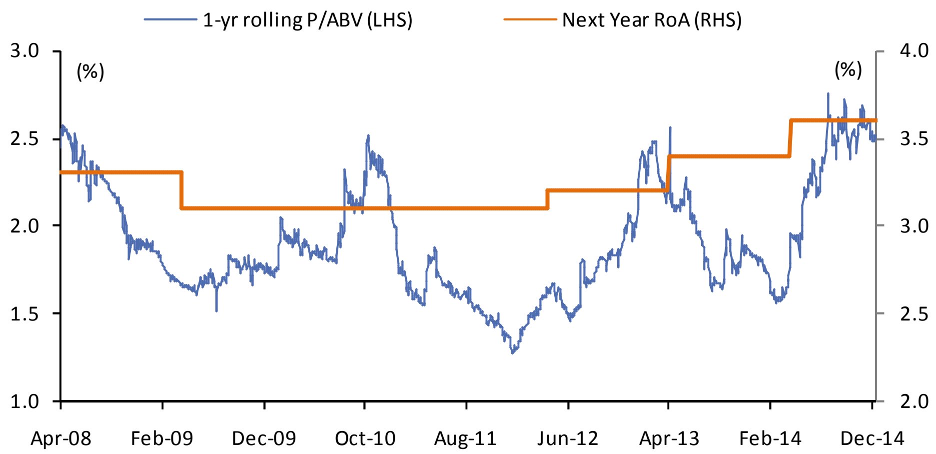
Trading at the higher end of historic 1-yr rolling P/ABV band



Incremental re-rating expected; 1-yr rolling P/ABV to cross 3x in the medium term



Valuation enrichment to be driven by higher RoA delivery



Source: Company, India Infoline Research

Financials

Income statement

Y/e 31 Mar (Rs mn)	FY14	FY15E	FY16E	FY17E
Income from Operatns	31,735	34,387	39,227	46,591
Interest expense	(13,507)	(13,322)	(14,339)	(16,592)
Net interest income	**18,228**	**21,065**	**24,888**	**29,998**
Non-interest income	651	716	824	989
Total op income	**18,879**	**21,781**	**25,712**	**30,987**
Total op expenses	(7,239)	(8,433)	(9,698)	(11,249)
Op profit (pre-prov)	**11,641**	**13,349**	**16,014**	**19,737**
Provisions	(3,842)	(4,452)	(5,420)	(6,528)
Exceptional Items	0	0	0	0
Profit before tax	**7,799**	**8,896**	**10,594**	**13,210**
Taxes	(2,587)	(2,951)	(3,515)	(4,382)
Net profit	**5,212**	**5,945**	**7,079**	**8,828**

Balance sheet

Y/e 31 Mar (Rs mn)	FY14	FY15E	FY16E	FY17E
Equity Capital	593	659	659	659
Reserves	28,390	41,317	47,356	54,874
Shareholder's funds	**28,983**	**41,976**	**48,015**	**55,533**
Long-term borrow	89,304	92,876	109,129	133,137
Other long-term liabi	3,723	4,282	5,138	6,166
Long term provi	568	634	740	892
Total non-curr liab	**93,595**	**97,791**	**115,008**	**140,195**
Short Term Borrow	3,836	3,989	4,687	5,718
Other current liab	34,239	35,609	41,840	51,045
Short term prov	3,179	3,549	4,147	4,996
Total current liab	**41,254**	**43,147**	**50,674**	**61,760**
Equity + Liab	**163,831**	**182,914**	**213,697**	**257,488**
Fixed Assets	1,014	1,166	1,341	1,542
Non-current inv	1,685	1,853	2,038	2,242
Deferred tax assets	180	180	180	180
Long-term loans/adv	42,257	49,043	57,227	69,316
Other non-curr asset	1,256	1,444	1,661	1,910
Total non-curr asset	**46,392**	**53,686**	**62,448**	**75,191**
Curr Investments	4,591	5,050	5,808	6,969
Cash & equivalents	24,729	21,929	26,058	30,755
Short-term loan/adv	86,277	100,131	116,842	141,523
Other current assets	1,842	2,118	2,542	3,050
Total Current assets	**117,439**	**129,228**	**151,249**	**182,297**
Total Assets	**163,831**	**182,914**	**213,697**	**257,487**

Key ratios

Y/e 31 Mar	FY14	FY15E	FY16E	FY17E
Growth matrix (%)				
Net interest income	9.7	15.6	18.1	20.5
Total op income	12.9	15.4	18.0	20.5
Op profit (pre-prov)	10.9	14.7	20.0	23.3
Net profit	15.9	14.1	19.1	24.7
Advances	(3.8)	16.1	16.7	21.1
Borrowings	(5.1)	4.0	17.5	22.0
Total assets	1.2	11.6	16.8	20.5
Profitability Ratios (%)				
NIM	12.0	13.5	13.8	13.8
Return on Avg Equity	3.2	3.4	3.6	3.7
Return on Avg Assets	20.2	16.8	15.7	17.1
Per share ratios (Rs)				
EPS	87.9	90.3	107.5	134.0
Adj.BVPS	476.1	623.7	705.2	807.9
DPS	10.0	11.0	13.5	17.0
Valuation ratios (x)				
P/E	20.3	19.8	16.6	13.3
P/Adj.BVPS	3.7	2.9	2.5	2.2
Other key ratios (%)				
Loans/Borrowings	100.9	112.6	111.8	111.0
Cost/Income	38.3	38.7	37.7	36.3
CAR	26.1	32.7	32.2	30.6
Tier-I capital	20.2	25.9	25.1	23.7
Gross NPLs/Loans	2.7	2.9	3.5	4.1
Credit Cost	2.5	2.9	3.0	3.0
Net NPLs/Net loans	0.6	0.6	0.9	1.1
Tax rate	33.2	33.2	33.2	33.2
Dividend yield	0.6	0.6	0.8	1.0

'Best Broker of the Year' – by Zee Business for contribution to broking

Nirmal Jain, Chairman, IIFL, received the award for The Best Broker of the Year (for contribution to broking in India) at India's Best Market Analyst Awards 2014 organised by the Zee Business in Mumbai. The award was presented by the guest of Honour Amit Shah, president of the Bharatiya Janata Party and Piyush Goel, Minister of state with independent charge for power, coal new and renewable energy.

'Best Equity Broker of the Year' – Bloomberg UTV, 2011

IIFL was awarded the 'Best Equity Broker of the Year' at the recently held Bloomberg UTV Financial Leadership Award, 2011. The award presented by the Hon'ble Finance Minister of India, Shri Pranab Mukherjee. The Bloomberg UTV Financial Leadership Awards acknowledge the extraordinary contribution of India's financial leaders and visionaries from January 2010 to January 2011.

'Best Broker in India' – Finance Asia, 2011

IIFL has been awarded the 'Best Broker in India' by Finance Asia. The award is the result of Finance Asia's annual quest for the best financial services firms across Asia, which culminated in the Country Awards 2011

Other awards

Recommendation parameters for fundamental reports:

Buy – Absolute return of over +15%

Accumulate – Absolute return between 0% to +15%

Reduce – Absolute return between 0% to -10%

Sell – Absolute return below -10%

Call Failure - In case of a Buy report, if the stock falls 20% below the recommended price on a closing basis, unless otherwise specified by the analyst; or, in case of a Sell report, if the stock rises 20% above the recommended price on a closing basis, unless otherwise specified by the analyst

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