CAPITAL FIRST

Opportune transition

India Equity Research| Banking and Financial Services

Capital First (CAFL) has emerged stronger post structurally transforming its business model by prudently focusing on high-growth retail financing and downsizing wholesale book post FY10. The company has clocked commendable >40% CAGR in retail financing over FY12-16. Though subdued returns (<10% RoE) is a natural corollary of inevitable investments for retail transition, we perceive minimal scalability risk to the business model given strategic diversification in potent opportunity space and highly process-driven model driving expansion. We anticipate an optimal product strategy anchored by stringent risk mitigants to fuel a smart J-shaped surge in return ratios—RoA/RoE of 1.9%/18-19% by FY19E. Initiate coverage with 'BUY' and target price of INR767.

Sharpening retail focus: Potent NIM booster

CAFL has not only rationalised its wholesale book (to sub-15% of AUM), but also sharpened focus on retail segments entailing humungous growth opportunities. To further strengthen the retail narrative, it has prudently shifted strategy—post initial focus on relatively low-risk secured SME lending, it invested in building processes, systems and infrastructure to make inroads in high-growth, high-yield consumer durables, 2-wheeler and unsecured business loan (BL) segments, which will aid NIM improvement. Ergo, we estimate AUM CAGR of >23% and NIM (calc) of >8.0% by FY19.

At inflection point; RoE poised for exponential growth

The company has now developed an enduring as well as self-perpetuating model. With end of investment phase, further scale up of businesses will enhance operating leverage. Though shift to high-yield consumer durable and 2-wheeler loans will entail higher opex and credit cost, net-net it will be RoA accretive. With appropriate levers in place, we estimate a J-shaped recovery in CAFL's RoA/RoE to 1.9%/18-19% by FY19.

Outlook and valuations: Re-rating on cards; initiate with 'BUY'

CAFL's earnings are poised to post 40% CAGR over FY16-19E riding healthy AUM CAGR, prudent product shift strategy, operating leverage benefits, controlled credit cost and higher cross-sell opportunities. Though valuation of 2.8x FY18E P/ABV appears expensive considering historical RoE, given the sustainable growth phase and sharp RoE recovery, we expect it to re-rate further as earnings and visibility improve. We initiate with '**BUY/Sector Outperformer**' recommendation/rating and target price of INR767 (assigning it a multiple of 3.5x on FY18 adjusted BV).

Financials (Standalone) (INR mn)

Year to March	FY16	FY17E	FY18E	FY19E
Net revenue	9,719	14,114	18,499	23,738
Net profit	1,569	2,379	3,234	4,276
Diluted EPS (INR)	17.2	26.1	35.4	46.9
Adj book value (INR)	176.6	194.9	219.1	252.9
P/ABV (x)	3.5	3.1	2.8	2.4
RoAE (%)	9.8	13.5	16.3	18.6

EDELWEISS 4D RATINGS

Absolute Rating	**BUY**
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Overweight

MARKET DATA *(R: CAPF.BO, B: CAFL IN)*

CMP	INR 612
Target Price	INR 767
52-week range (INR)	630 / 320
Share in issue (mn)	91.2
M cap (INR bn/USD mn)	56 / 826
Avg. Daily Vol.BSE/NSE('000)	16.1

SHARE HOLDING PATTERN (%)

	Current	Q3FY16	Q2FY16
Promoters *	65.2	65.2	65.3
MF's, FI's & BK's	9.9	10.4	10.3
FII's	7.3	2.5	7.7
Others	17.8	21.9	16.7

** Promoters pledged shares (% of share in issue) : NIL*

RELATIVE PERFORMANCE (%)

	Sensex	Stock	Stock over Sensex
1 month	5.4	7.2	1.8
3 months	8.5	36.5	28.0
12 months	(0.4)	41.6	42.0

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Chart 1:Smooth transition from wholesale to retail book with further granularity emerging towards high yielding products

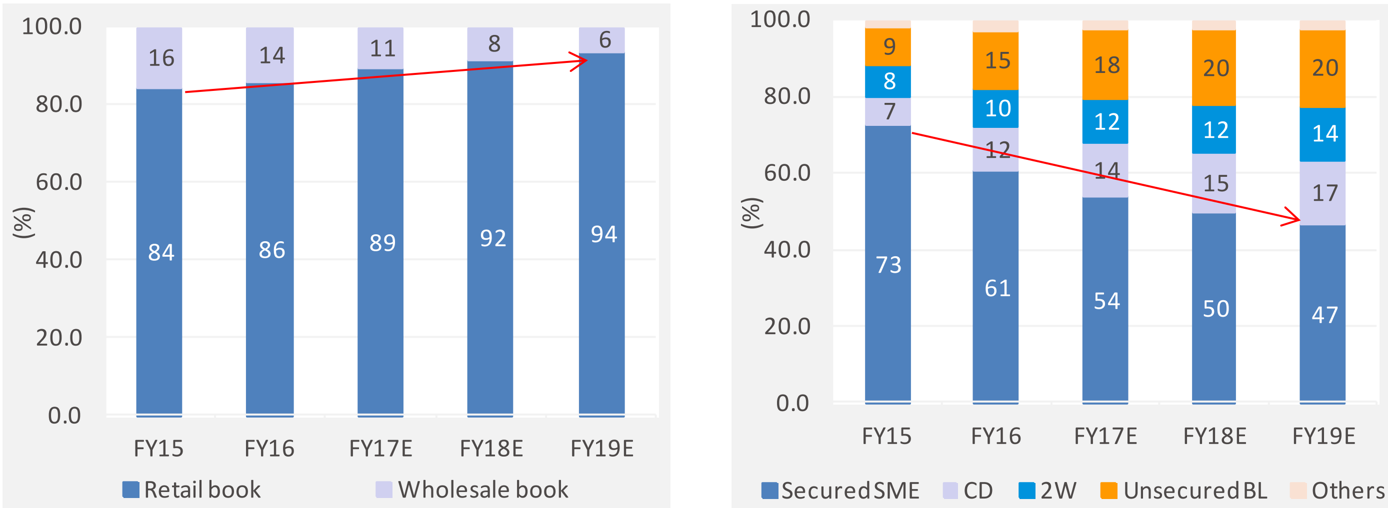


Chart 2:Cost/income ratio to improve to 45%; GNPLs/credit cost to rise with product shift but will be net-net RoA accretive

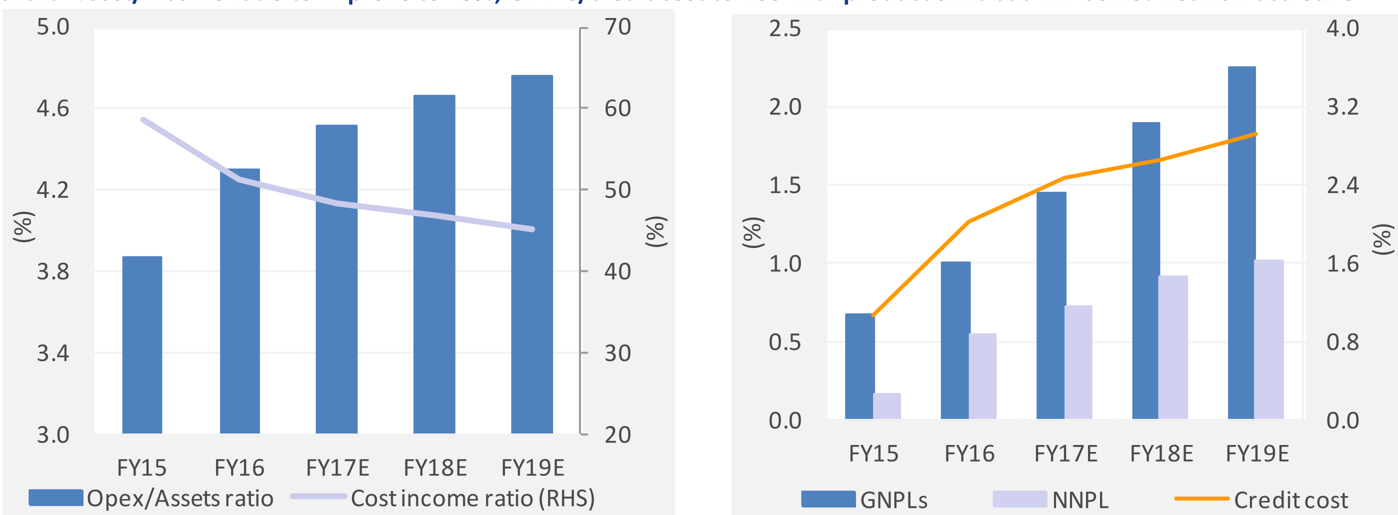
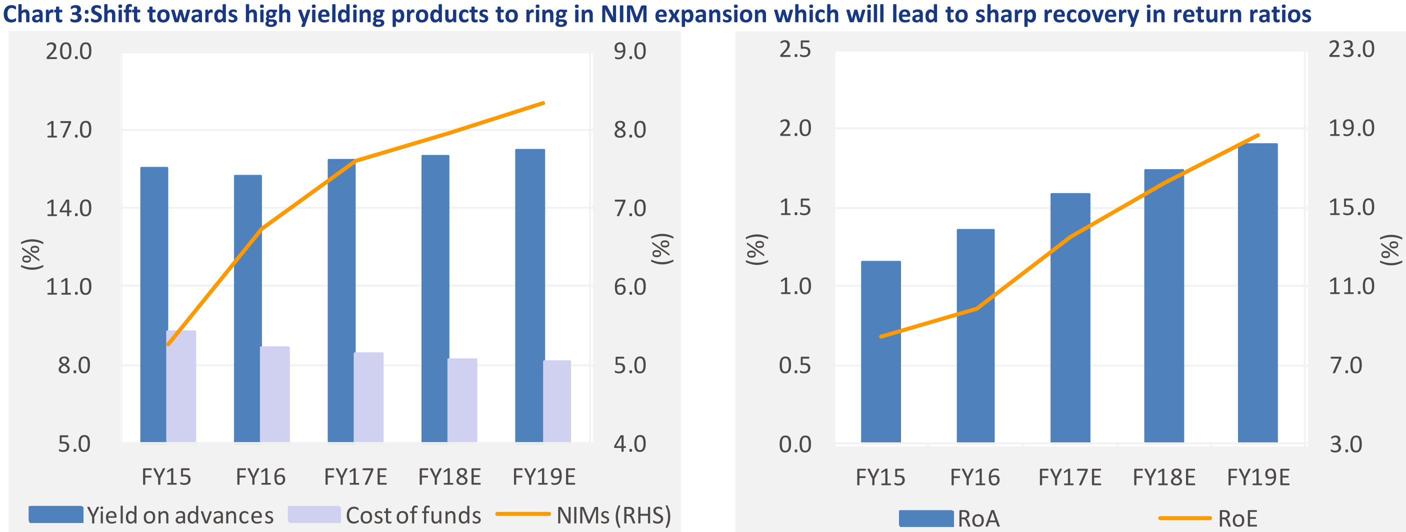


Chart 3:Shift towards high yielding products to ring in NIM expansion which will lead to sharp recovery in return ratios



Source: Company, Edelweiss research

Investment Rationale

Prudent shift to retail segment with an eye on superior yield

- CAFL, from FY11, sharpened focus on the retail financing segment and has seamlessly emerged much stronger and dominant—retail portfolio clocked >40% CAGR over FY12-16 to INR137bn
- Unwavering focus on rationalising its wholesale financing book through selective lending, curtailing its proportion to as low as <15% in FY16 from 70% plus in FY11.
- Invested in building processes, systems and infrastructure to make inroads into high-growth, high-yielding segments

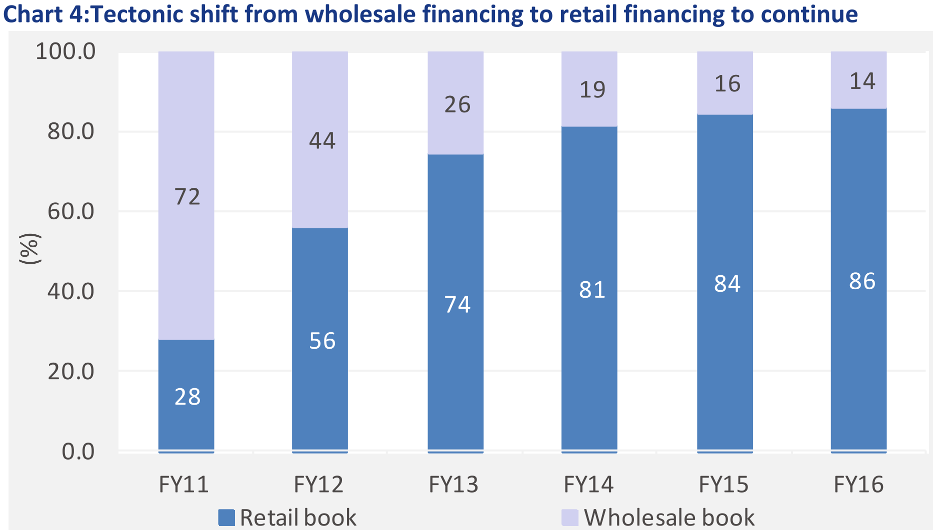
"The theme with which company was founded is that of financing India's 50mn MSMEs and its fast-emerging middle class, with a differentiated model, based on new technologies, provides a large and unique opportunity"

– Mr. V. Vaidyanathan (Chairman & Managing Director) Annual Report 2016

CAFL, under the current management's aegis, has structurally transformed its business model. The company has trained an unwavering focus on rationalising its wholesale financing book through selective lending, curtailing its proportion to as low as <15% in FY16 from 70% plus in FY11. Leveraging on management's DNA, CAFL, from FY11, sharpened focus on the retail financing segment and has seamlessly emerged much stronger and dominant—retail portfolio clocked >40% CAGR over FY12-16 to INR137bn.

To further strengthen its retail narrative, the company prudently shifted strategy—post initial focus on relatively low-risk secured SME lending segment (~INR41bn book by FY13), it invested in building processes, systems and infrastructure to make inroads into high-growth, high-yielding segments—consumer durables (CD), 2-wheeler and unsecured BL—with retail finance portfolio becoming much granular now.

Chart 4:Tectonic shift from wholesale financing to retail financing to continue



Source: Company

Chart 5:Retail AUM grew at faster pace than overall AUM

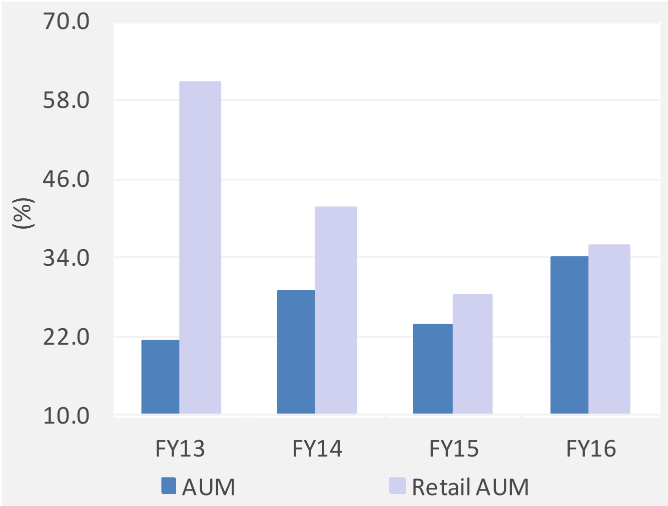
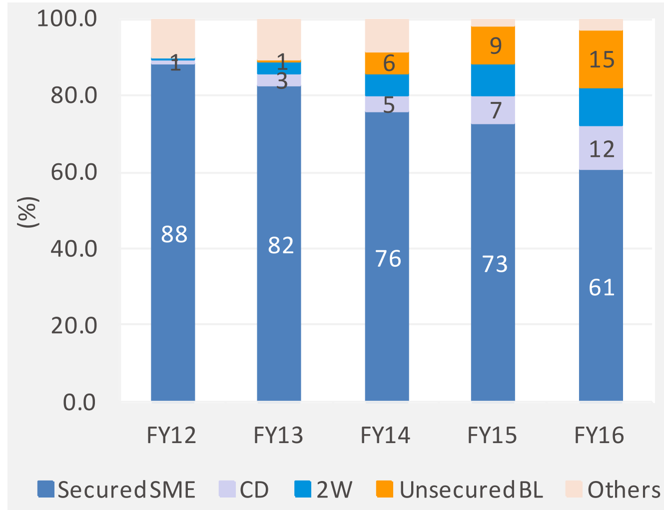


Chart 6: Within retail, book becoming more granular



Source: Company

I. At an inflection point; RoE poised to grow exponentially

- Shift to retailisation with stringent credit filters has invariably entailed extra costs, keeping return ratios subdued (RoE <10%).
- CAFL has consciously shifted from low-yielding secured SME to high- yielding high-growth CDs, 2-wheeler financing and unsecured BL, which is bound to boost overall yield: NIMs (calc) to improve to 8% plus by FY19 from 6.7% currently.
- With scale up in the book, operating leverage benefit will come to the fore; cost-income ratio estimated to settle at ~45% by FY19 from 51% in FY16.
- From a credit cost perspective, though shift to high-yielding CDs and 2-wheelers will obviously come at a cost, net-net it will be RoA accretive.
- All these vectors when seen in conjunction should boost CAFL's RoA/RoE to 1.9/18-19% in FY19E from 1.4/9.8% in FY16.
- It has also maintained capital adequacy significantly higher than regulatory requirement over the years (~20-24% all through FY13-FY16).

In our view, the Street's scepticism on CAFL generating sub-10% RoEs over the past 5 years is unwarranted as return ratios are bound to be depressed at a time when the company is investing in people, processes and technology for retail transition. The company's RoE has remained sub-optimal owing to 2 primary reasons: (i) relatively lower NIMs; and (ii) higher cost income ratio.

NIMs lower on wholesale lending products skew

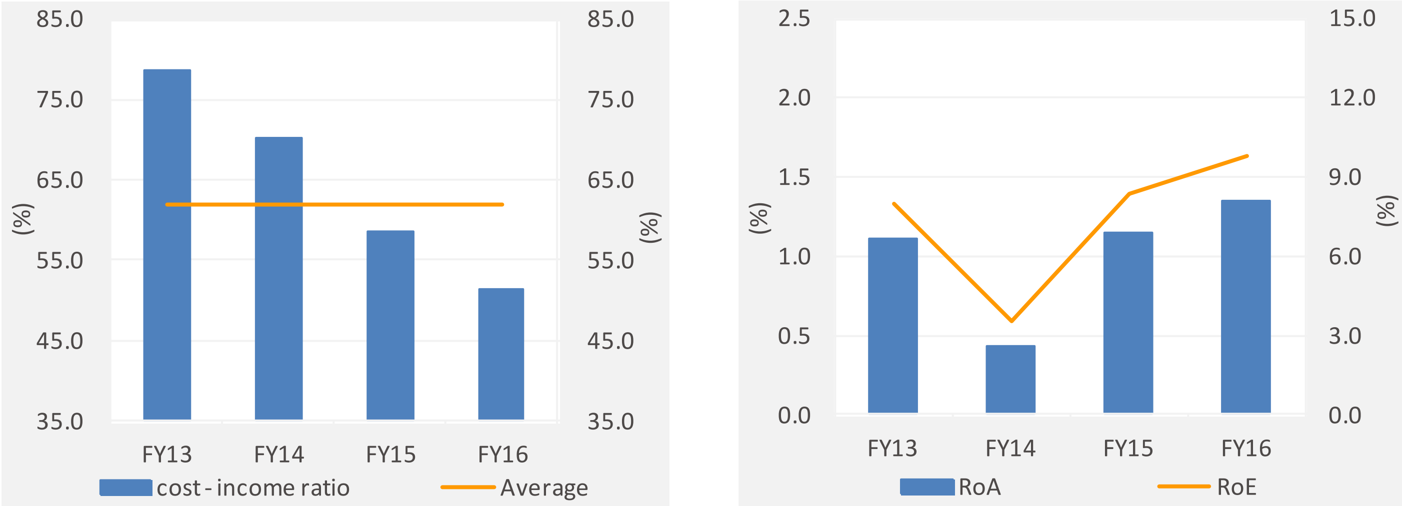
Until FY13, >25% of CAFL's book was skewed towards wholesale lending. Even within retail, >75% of the book emanated from secured SME, yields wherein are lower—12-13%. Cumulatively, the company's credit rating till FY12 was at AA- and only in FY13 it was upgraded to AA+, benefit of which is envisaged with a lag. Ergo, NIMs (calc) hovered in the 3.9-5.3% range between FY12 and FY15.

Higher opex/AUM and cost/income ratio natural corollary of busines transition phase

CAFL's cost/income ratio during the transition and investment phase i.e., FY13 / FY14, was as high as ~70-80%. This was a natural corollary of the company shifting gears—moving from wholesale to retail book—wherein incremental expenditure towards employee ramp up, training, processes, systems, technology, etc., was imperative.

Ergo, with limited margin cushion and high cost structure, the company's RoA and RoE, albeit trending higher, continued to remain at sub-1.4% and 10% levels, respectively. However, gaining from operational efficiencies and shift towards higher-yielding book, CAFL's NIMs have inched up to 6.7% with cost/income ratio steadily declining to ~50% in FY16. This, we believe, is just the beginning of a turnaround.

Chart 7:With operational efficiencies, cost / income ratio declines thereby providing a leg up to RoA/RoE's

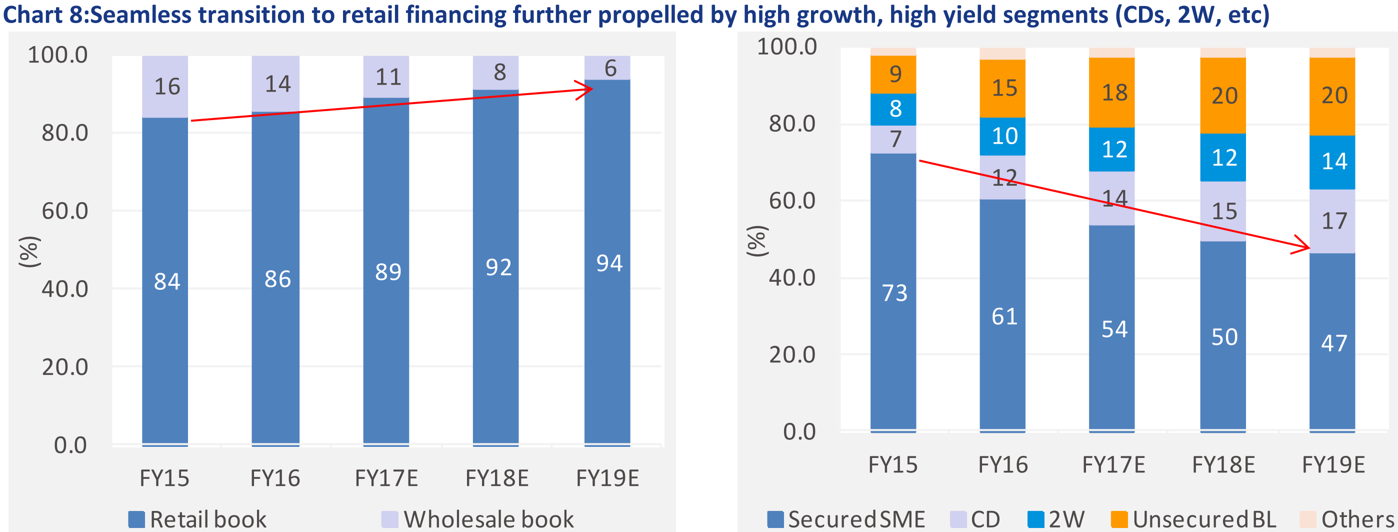


Source: Company

So what will change now?

i. Within the retail finance book, CAFL has consciously shifted from low-yielding secured SME to high-yielding high-growth CD, 2-wheeler financing and unsecured BL, which is bound to boost overall yield despite rising competition and falling interest rates. This, coupled with funding cost benefit as it tactically shifts borrowing in favour of debt market riding anticipated credit rating upgrade, will significantly boost margin. **<u>We estimate NIMs to improve to 8% plus by FY19 from 6.7% currently.</u>**

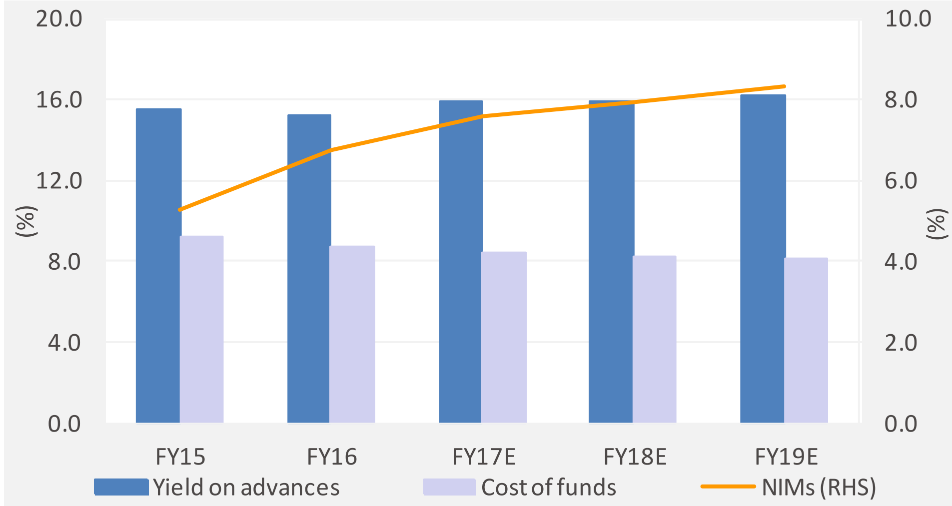
Chart 8:Seamless transition to retail financing further propelled by high growth, high yield segments (CDs, 2W, etc)



Source: Company, Edelweiss research

Shift in product mix to high yielding segments will help lift NIMs from 6.7% in FY16 to 8%+ by FY19E

Chart 9: All levers in place to take NIMs to 8% plus from 6.7% as at FY16



Source: Company, Edelweiss research

ii. On the cost front, CAFL has invested heavily into processes, systems, people, tie ups and technology, particularly for CD financing (which was posting losses in initial phase, though they have reduced and current fiscal onwards profitability will improve). The objective was to build a system that can run predictive analytics, score cards, etc., which will strengthen credit appraisal filters and also reduce turn-around time. **With scale up in the book, operating leverage benefit will come to the fore and we estimate CAFL's cost-income ratio to settle at ~45% by FY19 from 51% in FY16**.

iii. From a credit cost perspective, though shift to high-yielding CDs and 2-wheelers will obviously come at a cost, net-net it will be RoA accretive. The past few years indicate that CAFL has delivered best-in-class credit costs—sub 2%, inspite of making provisions on 90dpd plus basis. However, we do concede that the company has not yet seen a complete economic cycle within its retail financing book and has been in growth phase as well. Here, we believe stringent credit filters and analytics/score card driven processes will help it sail through a potential economic downturn with minimal impact. On the existing retail book where ~70-75% is secured (excluding CDs) with a collateral of ~1.5-2.0x, the likelihood of credit cost shocks is minimal.

All these vectors when seen in conjunction should boost CAFL's RoA/RoE to 1.9/18-19% in FY19E from 1.4/9.8% in FY16. Based on our industry analysis through interaction with industry participants and experts, we have chalked out RoE decomposition metrics for various retail product segments. Super-imposing this industry-wide RoE metrics on CAFL's structural change in portfolio mix provides some idea about delta that can be expected for the company across various operating parameters. To quantitatively elucidate the analysis, we believe there is a case for >100bps improvement in yields and >250bps spurt in net revenue which offset by 70-75bps jump in cost structure and ~70bps higher credit cost requirement should ideally result in ~80bps improvement in RoAs (post-tax) due to change in product mix in favour of CDs, 2-wheeler financing and unsecured BL.

Table 1: Portfolio mix change makes a case for ~80bps expansion in RoAs (%)

	FY16		FY19E			
	On-book AUM Prop (%)	RoA	On-book AUM Prop (%)	RoA	FY16	FY19E
--Secured SME	40.3	1.3	29.0	1.3	0.5	0.4
--CD	12.7	(0.3)	20.4	2.9	(0.0)	0.6
--2W	11.2	2.2	16.9	3.2	0.2	0.5
--Unsecured BL	14.5	2.4	23.4	2.5	0.3	0.6
--Wholesale loans	18.2	1.5	7.9	1.2	0.3	0.1
- Others	3.2	1.4	2.5	1.5	0.0	0.0
Consolidated RoA					**1.4**	**2.2**

Table 2: ...led by >250bps expansion in net revenues (%)

	FY16		FY19E			
	On-book AUM Prop (%)	Net revenue	On-book AUM Prop (%)	Net revenue	FY16	FY19E
--Secured SME	40.3	4.3	29.0	4.3	1.7	1.2
--CD	12.7	16.6	20.4	18.8	2.1	3.8
--2W	11.2	16.3	16.9	16.4	1.8	2.8
--Unsecured BL	14.5	11.1	23.4	11.3	1.6	2.6
--Wholesale loans	18.2	5.8	7.9	5.8	1.1	0.5
- Others	3.2	1.4	2.5	1.5	0.0	0.0
Consolidated Net revenues					**8.3**	**11.0**

Table 3: Sourcing cost of CD and 2-wheeler financing will be high (%)

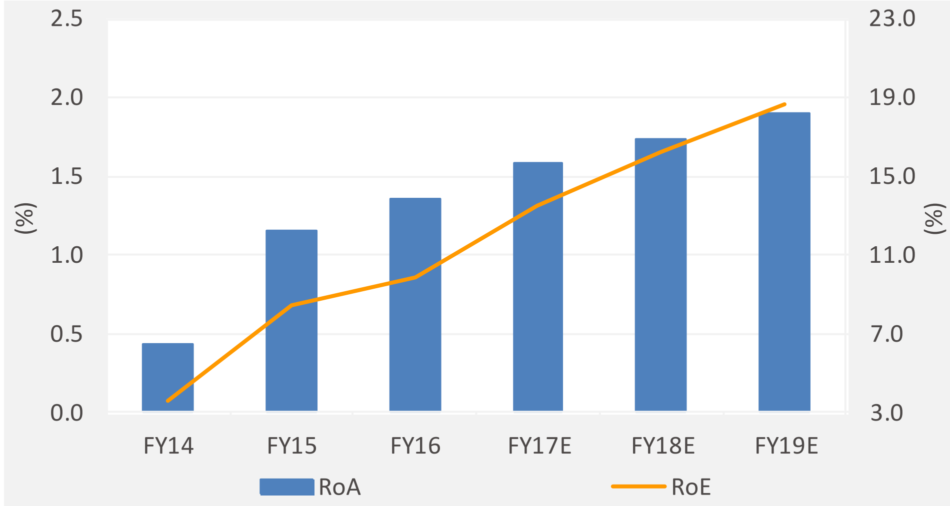
	FY16		FY19E			
	On-book AUM Prop (%)	Opex	On-book AUM Prop (%)	Opex	FY16	FY19E
--Secured SME	40.3	1.0	29.0	0.8	0.4	0.2
--CD	12.7	11.0	20.4	9.0	1.4	1.8
--2W	11.2	10.0	16.9	8.0	1.1	1.3
--Unsecured BL	14.5	5.0	23.4	4.5	0.7	1.1
--Wholesale loans	18.2	1.0	7.9	1.0	0.2	0.1
- Others	3.2	1.4	2.5	1.5	0.0	0.0
Consolidated Opex					**3.9**	**4.6**

Table 4: Shiftying towards high yielding products will come at higher credit cost (%)

	FY16		FY19E			
	On-book AUM Prop (%)	Prov.	On-book AUM Prop (%)	Prov.	FY16	FY19E
--Secured SME	40.3	1.3	29.0	1.6	0.5	0.5
--CD	12.7	6.0	20.4	5.5	0.8	1.1
--2W	11.2	3.0	16.9	3.5	0.3	0.6
--Unsecured BL	14.5	2.5	23.4	3.0	0.4	0.7
--Wholesale loans	18.2	2.5	7.9	3.0	0.5	0.2
- Others	3.2	1.4	2.5	1.5	0.0	0.0
Consolidated Credit cost					**2.5**	**3.2**

Source: Industry experts, Edelweiss research

Chart 10: Imposing industry-wide metrics, CAFL's RoA/RoE set to reach 1.9/18-19%



Source: Edelweiss research

Humungous growth opportunities portend business scalability

- With rising presence and humongous unmet credit opportunities, we anticipate >40% CAGR over FY16-19 in CD, 2-wheeler financing and unsecured BL.
- **Consumer durable financing:** Gaining dominance; investments to reap benefits; growth not a challenge; opportunities exist in e-commerce, lifestyle financing.
- **2-wheeler financing**: Presence at >1,400 dealerships in Tier 1-3 cities catering to low / middle income customers generating robust yields of 22-23%. Strong underwriting skills lowers chances of asset quality strain.
- **Secured SME lending:** Growth to moderate to sub-20% (compared to >25% CAGR over FY12-16). Return ratios will be flattish to declining for on-book AUM, though it can be shored up relying more on securitization.

Each of the financing streams in which CAFL is present provides immense potential with limited scalability risk. Table below reflects the company's rising market dominance in its product verticals. **With rising presence and humongous unmet credit opportunities, we anticipate CAFL's AUM to clock >23% CAGR over FY16-19.**

Table 5:CAFL's product segments and growth potential, at a glance

Products	Features	AUMs - FY16 (INR bn)	AUMs - FY19 (INR bn)	AUM CAGR % (FY16-19)	% AUM (FY16)	% AUM (FY19)	Avg ticket size ('000)	Avg tenor (mths)	Avg LTV (%)
Secured SME (including home loan)	Provides long term loans to MSMEs after proper evaluation of cash flows; Backed by collateral of residential / commercial property	83	132	16.6	51.9	43.7	9,600	60.0	42.0
Two wheeler loans	Financing to salaried & self employed individuals for purchase of new two-wheelers	14	40	41.5	8.7	13.2	44	24.0	70.0
Consumer durable loans	Financing to salaried & self employed individuals for purchase of white goods	16	48	44.6	9.9	15.9	30	8.0	76.0
Unsecured BL	Provides unsecured short term working capital loans to MSMEs;	20	57	40.9	12.7	19.0			

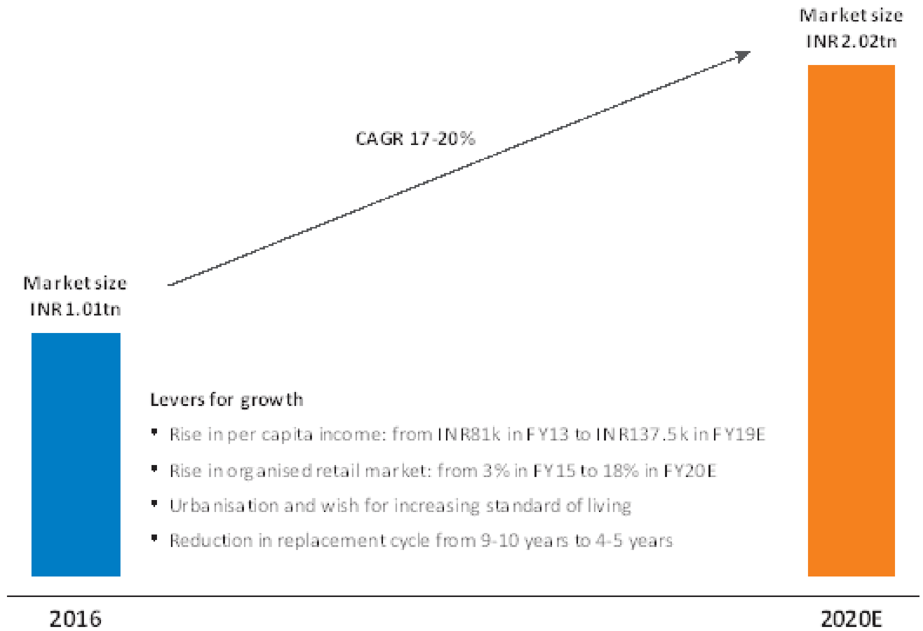
Source: Edelweiss research

1. Consumer durable: Gaining dominance; investments to reap benefits

Growth not a challenge; estimate ~45% CAGR over FY16-19.

- The Indian market for consumer durable products is expected to reach a market of ~INR2.02tn by FY20E from INR1.1bn in FY16. This growth will be ably supported by sub-par penetration levels (growing demand in rural markets), rise in disposable incomes (per capita income is expected to increase from INR81k to INR137.5k by FY19E), rise in share of organised retail (to 15-18% from ~3-5% currently), product innovation, etc (EY Study on Indian electronics and consumer durables segment).

Fig. 1: Multiple levers to expand consumer durable market segment



Source: EY study on Indian electronics and consumer durables

- Recognising this huge opportunity, CAFL has marked its presence by being a dominant player in consumer durable financing by virtue of investing heavily in cutting-edge technology, predictive analytics, entering into tie ups with manufacturers & dealers, increasing physical presence across stores (>3,000 by FY16) and quick turnaround time. These have facilitated the company's entry in an otherwise monopolistic market and it is now a dominant financier in various stores. Our channel checks through personal visits at various stores, interactions with dealers, shop floor staff and observation of customer pattern/behaviour indicate that CAFL has gained significant dominance in many stores (accounts for more than 30% of financing demand) and is not a fringe player in this segment.

- In order to ramp up its consumer durable business, CAFL is incrementally focussing on increasing counters (i.e., warm bodies) at various dealers. Apart from tieing up with large dealers with pan-India presence, the company has also been incrementally tieing up with neighbourhood mom & pop electronic stores where CAFL has a monopoly in offering financing options. Besides this, we believe there is a huge uptapped opportunity for CAFL by leveraging on the potential available in digital financing, lifestyle financing and e-commerce.

Developed proprietary systems for credit appraisal and faster turnaround time

- CAFL has also developed a proprietary credit scoring system, which based on CIBIL score and other demographic parameters such as age, employment criteria, residental status, etc., runs millions of combinations and permutations and arrives at a scientific score card, enabling it to take credit decisions within few minutes of customer approach.

- In order to ensure healthy asset quality and realising that consumer durable financing is an unsecured lending business with neglibigle possibility of repossessing the goods financed, based on real time monitoring of asses quality trends CAFL withdraws its

presence from stores / geographies where either delinquencies on a trend basis have been higher or where incremental business generated does not justify the cost.

Cross-sell to drive return ratios up

- CAFL has also started issuing an Easy Buy Card (EBC) which enables customer loyalty who do not have to pay processing fees for subsequent loans. Once the client is onboard, the company benefits by cross-selling its other finanicng and insurance products. Return from such cross-sell is critical for CAFL to increase its RoA/RoE.
- The gestation period is quite high in consumer durable financing and it has been almost 4 years since the company invested in technology, processes, people etc. CAFL is close to break even as losses have been dipping incrementally and from the current fiscal onwards profitability is likely to improve. Further, operating leverage will kick in, which will lead to a smart surge (J-curve) in return ratios.

Table 6: Estimated return ratios for CD financing from inception to matured stage

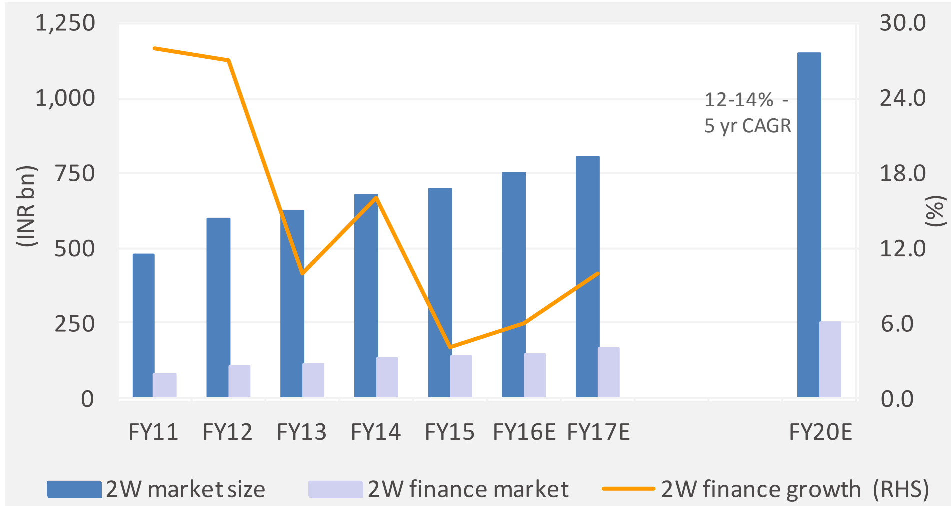
(%)	FY16	FY19E
Yield on advances	24.5	24.0
Cross sell & fee income	0.8	3.0
Total income	25.3	27.0
Cost of funds	8.7	8.2
Net revenue	16.6	18.8
Operating expense	11.0	9.0
Credit cost	6.0	5.5
RoA (pre tax)	(0.4)	4.3
RoA (post tax)	**(0.3)**	**2.9**
Leverage (x)	6.5	6.5
RoE (post tax)	**(2.0)**	**18.7**

Source: Industry experts, Edelweiss research

2. 2 wheeler: Set for smooth ride

- 2-wheeler market is poised to grow from ~INR750bn to INR1.2tn over FY16-20E, 11-13% CAGR. With regards to financing opportunities, with the advent of specialised NBFCs, penetration of 2-wheeler financing has seen continuous uptick—to ~26% in FY16 from ~23% in FY10 and is expected to jump ~28% by FY20. Thus, clearly, the 2-wheeler financing market opportunity is set to go catapult to INR250bn from ~INR150bn, 12-14% CAGR over FY16-20E.

Chart 11: Growth in two-wheeler finance disbursements



Source: CRISIL

- In order to penetrate further into the burgeoning retail high-growth high-yield segment, CAFL ventured into the 2-wheeler financing space in FY12 and has built a book of INR14bn as at FY16. The company offers 2-wheeler financing to salaried as well as self employed. Loans are offered at an LTV of 70% with an average ticket size of INR44k for 24-36 months' tenor.
- From a risk and technology perspective, CAFL adopts the same score card mechanism for 2-wheeler financing with some additional manual/physical checks wherever required. This also enables it to charge interest rates commensurate to the risk that it undertakes.
- CAFL is present across >1,400 dealer outlets in Tier 1-3 cities. Since CAFL provides 2-wheeler loans to low / middle income customers, yields in this segment are stronger at 22-23%. Further, with strong underwriting skills backed by predictive analytics and strong technology platform, chances of asset quality strain emerging are also low. This, when seen in conjunction with fee and cross-sell income (~2-3%) that it generates, translates into heathy return ratios for the company. **We estimate RoA of 2-wheeler financing business to jump from 2% in FY16 to >3% in FY19.**

Table 7: Operating leverage benefit with scale can boost 2-wheeler business RoE

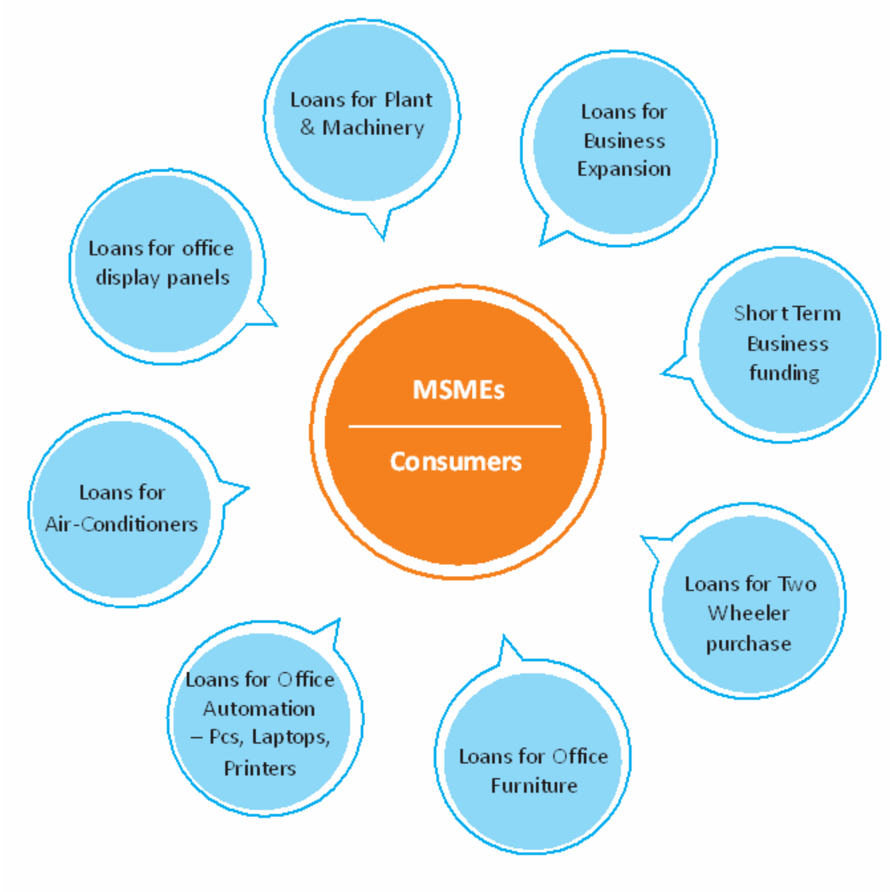
(%)	FY16	FY19E
Yield on advances	22.5	21.8
Fee income	2.5	2.8
Total income	25.0	24.6
Cost of funds	8.7	8.2
Net revenue	16.3	16.4
Operating expense	10.0	8.0
Credit cost	3.0	3.5
RoA (pre tax)	3.3	4.9
RoA (post tax)	**2.2**	**3.2**
Leverage (x)	6.5	6.5
RoE (post tax)	**14.4**	**21.1**

Source: Industry experts, Edelweiss research

3. Secured SME and Unsecured BL: CAFL's forte

Under SME segment, the company provides a wide range of customised products to cater to varying demands and requirements of borrowers.

Fig. 2: Stream of product offerings for MSME and Self Employed Customers



Source: Company

Based on loan use, the company ascertains the ticket size which is also in sync with its overall credit and risk management policy.

Table 8:Typical ticket size and customer profile of CAFL's secured SME and unsecured BL business

Typical ticket size	Typical customer profile
INR5mn - INR20mn	SME financing based on customised cash flow analysis and references from the SME's customers, vendors, suppliers
INR100k - INR 5mn	Small Entrepreneurs/ partnership firms in need of immediate funds, for say, purchase of additional inventory for an unexpected large order.
INR15k - INR100k	Micro business owners and consumers for purchase of office PC, office furniture, Tablets, Two-Wheeler, etc.

Source: Company

With wide experience, CAFL has created a niche positioning for itself in SME / LAP financing market

A. **Secured SME loans**

With an AUM of INR76.5bn (48% of AUM), secured SME loans have been the predominant business segment for CAFL sourced from 222 locations. However, over the past 1 year, the Street is incrementally getting apprehensive about players who have grown their secured SME books given the evolving industry dynamics. The space has become extremely competitive, leading to over-heating with increased focus of NBFCs/HFCs as well as banks on gaining market share.

What is CAFL's sweet spot and how does it differentiate?

- CAFL, by virtue of being in LAP segment for >5 years, has created a niche in mid-size loans with sweet spot between INR7-10mn as average ticket size and up to INR100mn. The competition in this segment is relatively low with focus of only few NBFCs. However, with continued modest real estate sentiments, CAFL is now incrementally de-focused on ticket size beyond INR50mn.
- CAFL does LAP financing solely backed by cash flows of the borrower's business. Further, company lends only against owned residential (~60-65%) or commercial property (~35-40%, limited to commercial offices only, not against warehouse, factories, land, plant & machinery etc) as a collateral.
- For business evaluation and customer credit assessment, it has a team of ~150 professionals (including MBAs, CAs, etc).
- Further, as a matter of credit prudence, the company provides LAP funding only to customers with adequate credit track record; this partly helps deal with credit uncertainties.
- With respect to computation of LTV, it has maintained conservative stance of sanctioning loans—even if the property value is high, LTV is determined by the lower of the cash flow assessed eligibility or property value based eligibility.

Table 9: Ticket size of various LAP players signifying limited competition

(INR mn)	FY15	FY16	*YoY change (%)*	Avg ticket size
Indiabulls	138,591	178,576	*28.9*	INR5-15mn
LICHF	49,738	110,152	*121.5*	INR1-2.5mn
Dewan	91,871	98,840	*7.6*	INR1.5-4mn
Cholamandalam	72,799	90,140	*23.8*	INR3-7.5mn
Bajaj Finance	82,320	83,320	*1.2*	INR10-25mn
HDFC	62,500	81,000	*29.6*	
Capital First	66,478	76,543	*15.1*	INR7.5-20mn
Reliance Cap	36,955	45,952	*24.3*	INR2-5mn
L&T Finance	16,000	23,000	*43.8*	
Repco	11,545	15,228	*31.9*	INR1-5mn
Total	**642,830**	**822,016**	***27.9***	

Source: Company, Edelweiss research

Are return ratios sustainable for LAP/SME segment?

With rising competition in the LAP segment, yields are structurally coming off for all players and incremental loans in this segment are being disbursed at ~12%. However, the company is focused on sustaining yields in its target segment. Also, boost to RoE in this segment is provided by actively resorting to securitization of its PSL compliant SME book (~35-40%) to PSU as well as private banks on which it generates a spread/securitisation income of ~3%.

Another characteristic of this product segment is that it is largely sourced through DSAs (75-80% of CAFL's loans originate from DSAs). Our channel checks indicate that players try to grab market share via higher DSA payouts; CAFL's payout to DSAs ranges between 1.0% and 1.5%, of which it tries to recover 60-70% from customers via processing fees.

Going forward, we believe the company will grow this segment at sub-20% (compared to >25% CAGR reported over FY12-16). Return ratios in this product segment will be flattish to marginal declining for on-book AUM, though it can be shored up relying more on securitization.

Table 10: Secured SME lending business RoA to be largely flattish

(%)	FY16	FY19E
Yield on advances	12.5	11.8
Cost of funds	8.7	8.2
Net interest margins	3.8	3.6
Securitization income	0.5	0.8
Operating expense	1.0	0.8
Credit cost	1.3	1.6
RoA (pre tax)	2.0	1.9
RoA (post tax)	**1.3**	**1.3**
Leverage (x)	12.0	12.0
RoE (post tax)	**15.7**	**15.3**

Source: Industry experts, Edelweiss research

B. Unsecured business loans

CAFL's unsecured BL portfolio commenced ~3 years ago and it has already clocked an AUM of INR19.3bn by FY16. Similar to LAP, BL is also majorly sourced (~75-80%) via DSAs. This book is lucrative with yields ranging between 18% and 19% given the nature of no or less collateral. We anticipate BL to post >40% AUM growth over FY16-19. If managed well across cycles, we believe this segment has the potential to clock >15% RoE given its higher yield profile.

Table 11: Business loans are high yielding; managing credit cost key to RoE accretion

(%)	FY16	FY19E
Yield on advances	18.5	18.0
Fee income	1.3	1.5
Cost of funds	8.7	8.2
Net revenue	11.1	11.3
Operating expense	5.0	4.5
Credit cost	2.5	3.0
RoA (pre tax)	3.6	3.8
RoA (post tax)	**2.4**	**2.5**
Leverage (x)	6.5	6.5
RoE (post tax)	**15.5**	**16.5**

Source: Industry experts, Edelweiss research

Stringent risk mitigants in place to tackle cyclical downturn

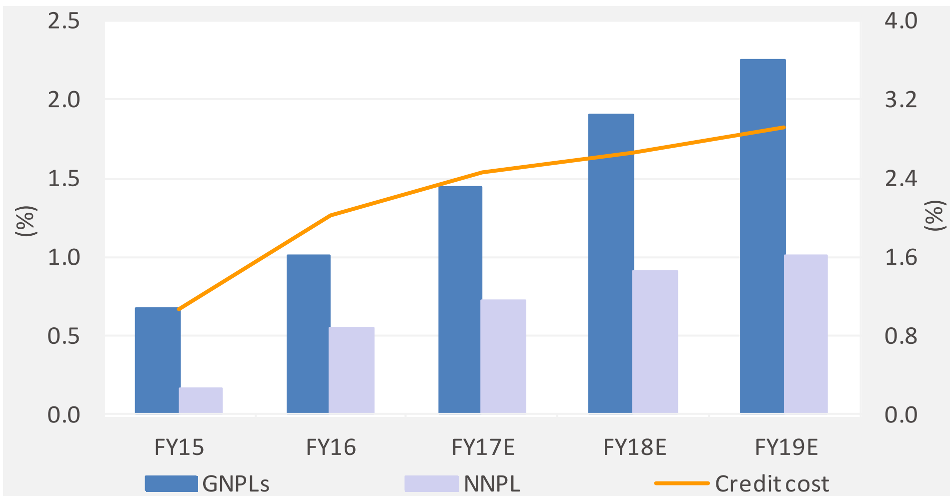
- Over a period of time, CAFL has invested in business analytics, cutting-edge technology and contemporary score cards.
- Inherent checks and balances for effective risk management, decentralised risk management process , rigorous underwriting, cash flow based lending, score card based evaluation eliminating subjectivity suggests there is no cause for concern of any huge negative surprise if the consumption cycle turns.
- The fact remains that the book is yet to see an economic down cycle. Also growing high yielding segments will call for higher provisioning. We are buidling in rise in GNPLs to 2.25% in FY19 and anticipate credit cost of 290bps till FY19

Well contained credit cost; product mix shift to boost it

We are cognizant of the fact that CAFL has built its retail book only over the past 5–6 years (40% plus CAGR over FY12-16). To that extent, the fact remains that the book is yet to see an economic down cycle. We, therefore, extensively analysed the company's credit checks and processes and arrived at the conclusion that there is no cause for concern of any huge negative surprise if the consumption cycle turns.

Positivity emerges from the fact that CAFL has, over a period of time, invested in business analytics, cutting-edge technology and competent score cards. This, along with decentralised risk management model, enables the company to identify stress built up early in the cycle. Besides this, it follows aggressive provisioning norms, which will keep future credit cost under control (unlike other NBFCs who will be hit during transition to the 90dpd recognition norm). Evolving granularity in retail portfolio will also help diversify the risk. However, since CAFL is also growing its retail portfolio in favour of high yielding segments such as consumer durables, 2-wheeler financing and unsecured business loans, it will call for higher risk and higher provisioning. **To that extent, we are buidling in rise in GNPLs from 1.07% in FY16 to 2.25% in FY19 and anticipate credit cost of 290bps till FY19.**

Chart 12: Portfolo mix shift to lead to rise in credit cost



Source: Company, Edelweiss research

Table 12: Aggressive provisioning practices, yet unelevated credit cost

(%)	LAP	BIL	CD	2W
90+ dpd	10.0	25.0	50.0	25.0
120+ dpd		50.0	100.0	50.0
150+ dpd		100.0		100.0
180+ dpd	33.0			
360+ dpd	100.0			

Source: Company

Note: 100% provisioning on cross-sell of Personal Loans to CD and 2W customers on 90 dpd+ basis

Aggressive provisioning and write off policy ensures no asset quality shocks

So, what different is CAFL doing in order to keep its credit cost under check

(1) Inherent checks and balances for effective risk management

For its various lending products, CAFL has developed an in-house robust risk management platform with adequate checks and balances in place. These rigorous credit filters act as a cornerstone for all its lending practices.

(2) Decentralised risk management process

CAFL's credit process is decentralised with segregation of authority and responsibility across business origination, credit underwriting, risk, operations and collections/monitoring functions to ensure inherent checks and balances and avoid any conflict of interest. Further, the company uses a robust technology platform which helps it run various scoring and monitoring mechanism, thereby raising a red flag on real-time basis.

Fig. 3: Decentralised processe ensures robust checks and balances

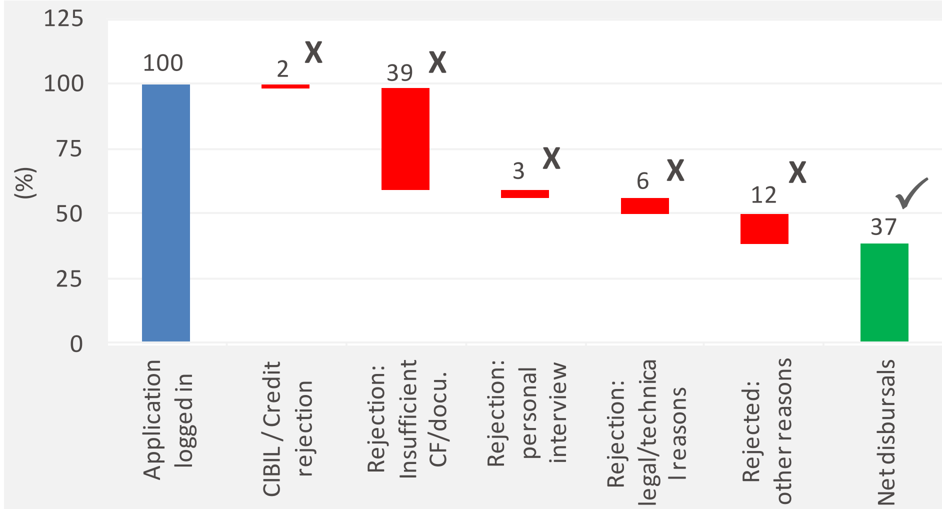
Source: Company

(3) Rigorous underwriting

Although the SME Financing businesses, both secured and unsecured, are predominantly DSA originated, their role ends post referring the customer. It is CAFL which then individually assesses the customer's cash flows in light of his business / profession, overall industry scenario and geograhy presence. For secured SME financing, in order to ensure appropriate discipline in credit assessment and underwrting standards, the company has built a team of 140 plus professionals (mostly CAs & MBAs) on pan-India basis. Owing to such stringent underwriting standards and based on a study undertaken by the company, ~39% of overall secured SME loans against property applications are rejected by the credit underwriting team owing to insufficient cash flow or documentation, and only ~37% of total applicantions translate into disbursed loans once the application passes through several levels of scrutiny and checks.

Strong credit underwriting resulting into only 37% of all applications logged in getting disbursed

Chart 13: Strong credit underwriting process at play for Secured SME LAP



Source: Company

(4) Cash flow based lending

Apart from the strong underwritng standards, CAFL has set its LTV on a very conservative basis—LTV is decided by the lower of the cash flow assessed eligibility or property value based eligibility—resulting in LTV of 42% against industry norm of ~60-70%.

(5) Score card based applicant evaluation eliminates subjectivity

Based on various predictive analytics (modified and updated based on years of industry knowledge), the system automatically prepares a score card for each applicant. Based on the score card and upon satisfying pre-defined conditions, the loan is approved or rejected with no manual intervention and zero subjectivity. In 2-wheeler loans too CAFL adopts the same score card based approach coupled with a little more detailed check, viz., apart from identify proof, address proof and CIBIL score, the company also verifies if the borrower is self employed or salaried, age, nature of industry, number of dependents, marital status, etc. After collecting the required information, the company runs its analytics / systems to generate a credit score, based on which the lending rate is ascertained. This helps the company charge an interest rate which is commensurate with the risk undertaken.

Valuations

- Earnings are poised to post >40% CAGR through FY19 riding healthy AUM growth, operating leverage benefits, controlled credit cost and higher cross-sell opportunities.
- We are convinvced that an optimal product strategy with stringent risk mitigants equip CAFL adequately to post a smart J-shaped surge in return ratios—RoA and RoE of 1.9% and 18-19% plus, respectively.
- We expect it to re-rate further as earnings trajectory and visibility improve.

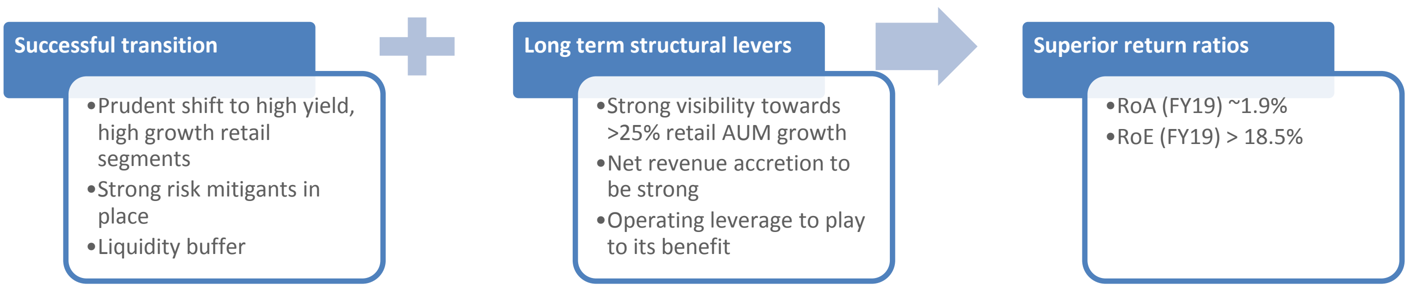
Right product mix

- **Right time right shift:** CAFL has structurally transformed its business model and emerged stronger after down-sizing the wholesale book post FY10. Company has at the right time shifted its lending strategy to retail products. Even within retail, CAFL has got the pulse right by tapping the relatively low risk, high growth high yield segments viz. CDs, 2W, unsecured BL, etc.
- **Adequate liquidity buffers:** In keeping with its conservative strategy, CAFL has consistently maintained CAR at >300 bps over the regulatory threshold levels to avoid volatility in funding costs.

Structural levers in place to help retain mojo

- **23% AUM CAGR & 27% retail AUM CAGR over FY16-19E on conservative basis:** We believe company is nicely poised to embrace the next leg of growth surging within retail lending space. CAFL's advantage is its presence in segments where typically it faces limited competition. We expect company to on a conservative basis clock ~23% overall AUM CAGR over FY16-19E, primarily led by strong >27% AUM CAGR within retail book.
- **Asset quality:** Albeit we concur that CAFL has not yet seen an economic downcycle within its retail book, positivity emerges from the investment that CAFL has done in sharp analytics, cutting edge technology as well as contemporary score cards.

Fig. 4: Strong AUM and earnings growth along with best-in-class productivity leads to superior return ratios



Source: Edelweiss research

CAFL is trading at a discount of >35% compared with BAF, which we believe should narrow down. Further, with earnings trajectory the stock should re-rate further

Superior return ratios to sustain

CAFL's RoA and RoE as at FY16 were at 1.4% and <10%, respectively. Shift to retailisation with stringent credit filters in place has invariably entailed extra costs, keeping return ratios subdued (RoE <10%). We are convinvced that an optimal product strategy (shift to high growth high yield products translating to much higher NIMs) with stringent risk mitigants equip CAFL adequately to post a smart J-shaped surge in return ratios—RoA and RoE of 1.9% and 18-19% plus, respectively.

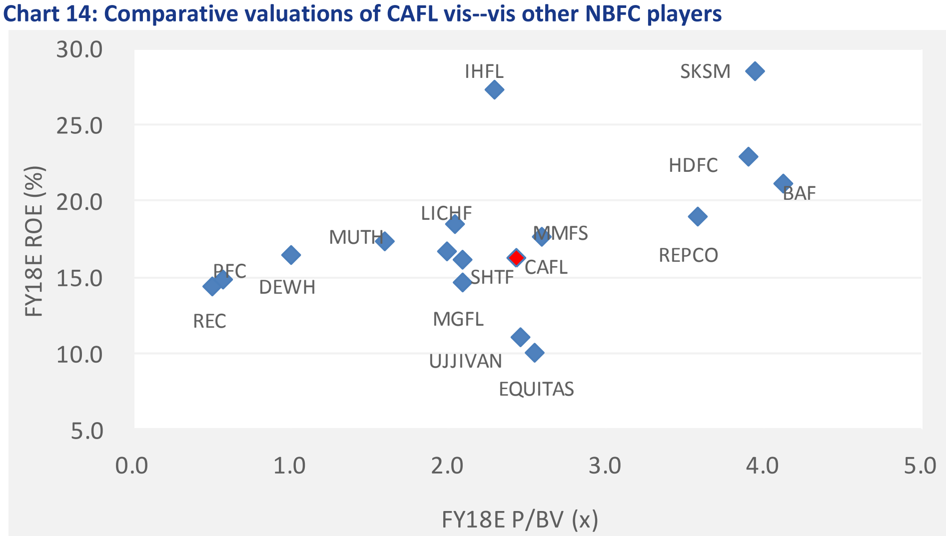
Table 13: CAFL's valuation compared to BAF

	CAFL			BAF		
	FY16	FY17E	FY18E	FY16	FY17E	FY18E
Diluted EPS (INR)	17	26	35	239	303	372
Adj. book value (INR)	177	194	219	1,371	1,681	1,996
Diluted P/E (x)	35.4	23.4	17.2	35.9	28.3	23.1
P/BV (X)	3.4	3.1	2.8	6.3	5.1	4.3
RoA (%)	1.4	1.6	1.7	3.4	3.3	3.3
RoE (%)	9.8	13.5	16.3	20.9	19.8	20.0

Source: Edelweiss research

From a valuation perspective, CAFL is trading at a discount of >35% when compared with BAF. This discount will narrow down considering that both the companies are expected to clock an AUM CAGR of ~25% over next 2-3 years with sharp RoE progreesion of CAFL towards 18-19% by FY19. The company's earnings are poised to grow ~40% CAGR through FY16-19E riding healthy AUM growth, operating leverage benefits, controlled credit cost and higher cross-sell opportunities. We expect it to re-rate further as earnings trajectory and visibility improve. Hence, we initiate coverage on CAFL with **'BUY/SO'** recommendation/rating and target price of INR767 assigning 3.5x FY18E ABV.

Chart 14: Comparative valuations of CAFL vis--vis other NBFC players



Source: Bloomberg, Edelweiss research

CAFL's valuation when mapped with other NBFC players, clearly reinstates our faith the street is ready to pay premium to stocks where there is a niche, strong growth and earnings potential

Key Risks

High growth phase poses a risk if cycle turns

CAFL has built the retail book only over the past 5-6 years registering 40% plus CAGR over FY12-16. Ergo, the fact remains that the book is yet to face an economic down cycle. High growth phase generally poses risk of a negative surprise if the consumption cycle turns tide.

Slowdown in real estate sector could impact major product segment

Any slowdown in the real estate sector may adversely hit the secured SME portfolio's growth as CAFL will have to be careful on valuation for future disbursements. This may also impact recoverability in the event of a default through sell-off of the property which has been kept as security. However, 45% LTV at origination provides a lot of cushion to price drop.

Competition may pressurise yields

Secured SME and unsecured BL financing is a highly competitive and over-heated segment. There is perceived risk in terms of deterioration of underwriting practices, LTV dilution etc. Further, emergence of small finance banks which were erstwhile microfinance companies may pose increasing competition by diversifying their portfolios into 2-wheeler finance, business loans, etc. Moreover, the growth potential and high yields can attract banks/NBFCs to technology based CD financing. All these may lead to pricing pressure in CAFL's high yield business viz. 2-wheeler, consumer durable and business loans.

Adverse revision in manufacturers' subvention

With respect to consumer durable financing, manufacturers' subvention is a key source of return to the company. Any adverse tweaking of subvention to consumer durable financing companies due to slowdown in growth or emergence of new players will affect CAFL's margin.

Regulatory risk

Adverse regulatory changes such as increase in risk weights, securitization norms, capital adequacy requirement etc., can impact CAFL's growth and profitability.

Operating leverage benefit key to RoE improvement thesis

We are estimating higher RoA and RoE riding improved margin and operating leverage benefit. However, if origination and monitoring cost is higher in key growth products, the advantage of operating leverage may not play out.

Company Description

Granular retail focused NBFC in high-growth high-yielding segments

Mr. Vaidyanathan, with financial backing from Warburg Pincus', bought out majority shareholders of an existing NBFC which was primarily into wholesale financing and the brand Capital First was born. Post that, Mr. Vaidyanathan changed the key constituents of the company: (a) majority and minority shareholding was changed through buyout and open offer to public; (b) fresh INR1bn capital was infused; (c) Board of Directors was reconstituted; and (d) business was changed from wholesale to retail lending.

CAFL's retail lending business has clocked a commendable growth from AUM of INR35bn (~56% of AUM in FY12) to INR138bn (86% of AUM in FY16). Within the retail book as well, the company has built a granular book with incremental focus on high-growth high-yield segments such as consumer durable, 2-wheeler loans, etc. Although the proportion of secured SME continues to remain at ~>60%, it is likely to fall to ~47% by FY19E due to the sharpening focus on consumer durable and 2-wheeler loans.

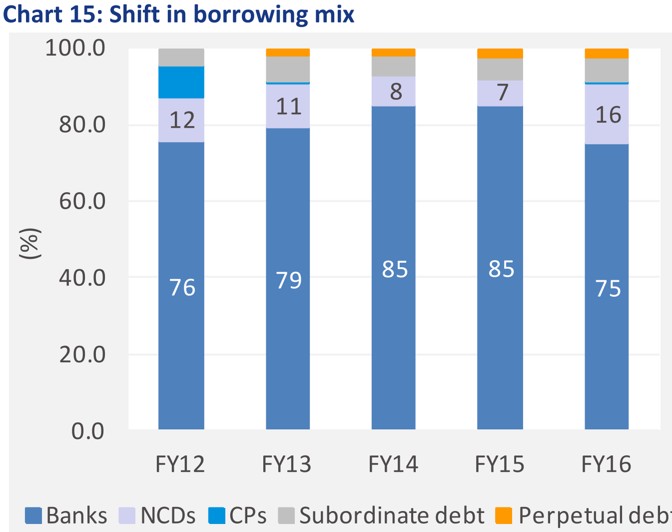
Strong credit rating

CAFL's long-term credit rating has been inching up—from A+ in FY10 to AA+ in FY13—a commendable and rare feat for a finance company. The company also has a good short-term rating of A1+, highest in the industry. Such strong credit rating speaks volumes about the comfortable capitalization levels, robust business model, reasonable asset quality, healthy liquidity position, experienced management team, credible promoters and reputed institutional shareholders. The strong credit rating enables CAFL raise funds at competitive rates. With a strong credit rating, the company has also been able to diversify its borrowing mix, gradually moving away from bank borrowings to other cheaper sources such as NCDs, sub-ordinated debt, etc. This has pruned its overall cost of funds—down to 8.7% in FY16 from 11.1% in FY12.

Table 14: Steady credit ratings upgrade by CARE & Brickwork

Year	Long term credit rating	Upgrade
FY10	A+	
FY11	A+	
FY12	AA-	√
FY13	AA+	√
FY14	AA+	
FY15	AA+	
FY16	AA+	

Chart 15: Shift in borrowing mix



Source: Company

Capital raising history

CAFL's every endeavour to raise funds from the market has received owerwhelming response, with all fund raising closed successfully by investments from marquee investors. Moreover, all follow-on fund raisings have been at a price higher than the previous issue price.

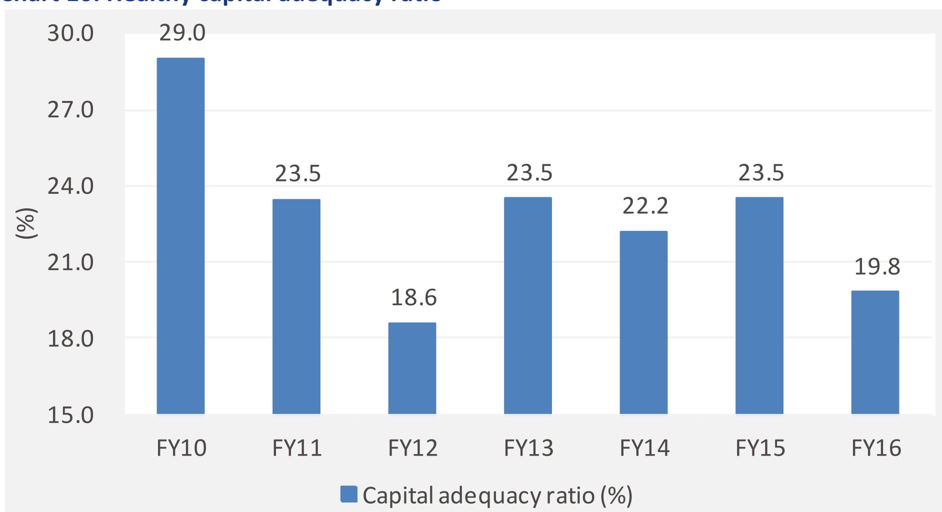
Table 15: Historical fund raising

Date	Issuance	INR mn	INR
Mar-15	QIP	3,000	390
Mar-14	Warburg Pincus	1,300	154
Mar-14	HDFC Standard Life	500	154
Mar-14	Warburg Pincus - Primary equity capital	1,000	

Source: Company

Historically, the company has always maintained an extremely comfortable capital adequacy ratio (CAR) of atleast 300bps above the regulatory requirement of 15%.

Chart 16: Healthy capital adequacy ratio



Source: Company

Added lever from CAFL's housing finance subsidiary

CAFL also has a wholly owned subsidiary, Capital First Home Finance (CFHF), through which it has been undertaking housing financing business from FY14. Over past 3 years (FY14-16), the loan book has scaled up to INR4bn. With the increasing Government's focus towards housing for All scheme, CFHF is primed to see healthy growth with a tilt towards affordable housing segment.

Striding ahead with strong management pedigree

Mr. V. Vaidyanathan (currently Executive Chairman) founded CAFL by first acquiring equity stake in an NBFC and then securing equity backing of INR8.1bn in FY12 from one of the largest PE, Warburg Pincus. Once Mr. Vaidyanathan took over the reins of CAFL all key constituents of the company were changed: (a) majority and minority shareholding was changed via buyout and open offer to public; (b) fresh capital of INR1bn was infused into the company; (c) Board of Directors was reconstituted; and (d) business strategy was changed from wholesale to retail lending.

Mr. Vaidyanathan has been a strong name in the retail financing space. He was earlier with ICICI (when it was a domestic financial institution) where he helped the insitutuion transition into an universal bank. He was also the pioneer in launching retail banking for ICICI Bank, wherein he built a retail loan book of >INR1.35tn. Mr. Vaidyanathan also spearheaded the bank's SME and rural banking business. It was under his helmsmanship that the bank transitioned and became a strong retail banking player.

Mr. Vaidyanathan has a knack of venturing into and capturing high growth high yielding retail segments, which is backed by one of the most renowned PE player, Warbug Pincus. CAFL has till date successfully completed 3 rounds of fund raising wherein marquee investors have subscribed at each stage of fund raising.

It was under Vaidyanath's leadership, amply supported by core management team that CAFL has been able to transition from a wholesale financier to retail financier. CAFL has also been able to achieve granularity in its retail lending business which has helped CAFL scale up its operation, control credit cost and steadily built retrun ratios for the company and shareholders.

Majority of the Board members are Indepenent by nature and come from diverse backgrounds across Banking, Consulting, etc each with >15-20 years of work experience.

Management Overview

CAPITAL FIRST

Board of Directors

Mr. V. Vaidyanathan, Executive-Chairman

Previously was with ICICI Bank where he built retail & SME banking & managed rural banking
He was also appointed as ED of ICICI Bank, MD & CEO of ICICI Personal Financial Services, ICICI Prudential Life, Chairman of ICICI Home Finance & board member of ICICI Lombard
He is an alumnus of Birla Institute of Technology and Harvard Business School

Mr. Vishal Mahadevia, Non-Executive Director

MD & co-Head, Warburg Pincus India with >20 years experience
Previously, he worked with Greenbriar equity group, Three cities research Inc & Mckinsey & Company
He is B.S. in Economics & B.S. in Electrical Engineering from Wharton

Narendra Ostawal, Non-Executive Director

MD of Warburg Pincus India with >13 years experience in consulting & private equity
Previously, he has worked with 3i and Mckinsey & Company
He holds a CA degree from ICAI and MBA from IIM, Bangalore

Apul Nayyar, Executive Director

Head-Retail & Director with CAFL's housing finance business
He has also led CAFL's foray into affordable housing segment
Previously, he has worked in leadership positions with IIFL, Merrill Lynch and Citigroup

Nihal Desai, Executive Director

Handles Risk, IT and Operations; Over 20 years experience including 16 years with ICICI Bank where he was instrumental in bank's retail foray
Previously, he worked with Serco India as MD
He holds Engineering degree in Computer science, PGDM and has been part of various trainings from Wharton & IIM-Ahmedabad

N.C. Singhal, Independent Director

Former vice chairman & MD of SCICI
Awarded UNDP fellowship for Advanced Studies in Project Formulation and Evaluation
Holds post graduate qualifications in Economics, Statistics and Administration

Hemang Raja, Independent Director

Former Managing Director & CEO of IL&FS Investsmart
Served on committee of NSE & on corp. governance committee of BSE

M S SundaraRajan, Independent Director

Former Chairman & Managing Director of Indian Bank
Has a total experience of about 40 years in the banking industry
Post graduate in Economics from university of Madras with specialisation in Mathematica Economics, National Income and Social Accounting

Dr.Brinda Jagirdar, Independent Director

Former Chief Economist of SBI with >35 years experience in banking industry
Independent consulting Economist with specialisation in areas relating to Indian econom and financial intermediation
She is a Ph.D in Economics, M.S., Economics, M.A., Economics

Dinesh Kanabar, Independent Director

Former Dy CEO & Chairman Tax, KPMG India. Presently, CEO of Dhruva Advisors LLP
Handled some of the biggest tax controversies and advised on complex structures for both inbound and outbound investments
He is a fellow member of the ICAI

Source: Company

Industry Overview

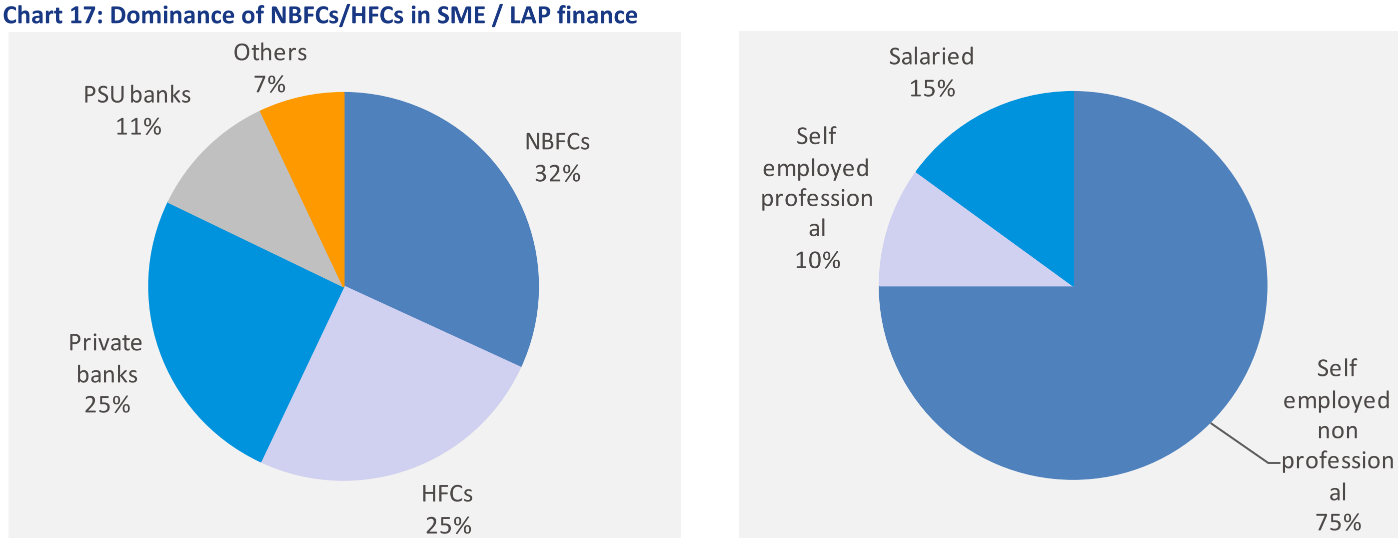
LAP / SME and business loans: Ready to be lapped

According to a NSSO Survey 2013, there are approximately 57.7mn small and medium business units (MSME) which run manufacturing, trading or services activities. However, the MSME sector, especially unorganized micro and small enterprises, find it difficult to tap adequate finance in a timely manner owing to insufficient credit information.

As per an IFC report (2012), total viable and addressable debt within the MSME sector is INR26tn, of which immediately addressable demand is ~INR9.9tn. Of this, the banking system is likely meet upto INR6.4tn demand and balance i.e., INR3.5tn, will need to be met by other channels such as NBFCs, etc.

Over the past 2-3 years, secured SME / loan against property (LAP) has gained flavour and has been hard sold by banks as well as NBFCs. With banks' corporate portfolios facing asset quality issues, they have been incrementally focussing on gaining traction in their retail portfolios. This traction was partially achieved by focussing on lending towards SME / LAP segment. NBFCs' penetration in SME / LAP financing too is on the rise which they offer as a primary product. Apart from this, other parameters such as giving filip to NBFC's SME financing book are: (i) Given funding cost disadvantage and huge untapped business potential, NBFCs/HFCs have ventured into high-yield asset class such as LAP to maintain profitability; (ii) Compared to <40% market share in mortgages, NBFCs/HFCs account for more than 52% of SME / LAP market; (iii) self employed customers account for almost 85% of LAP disbursements, of which 75% are non-professionals and 10% professionals. Salaried class account for only 15%; and (iv) Businesses' increasing funding requirement and accessibility to financiers have prompted more customers to opt for LAP / SME financing.

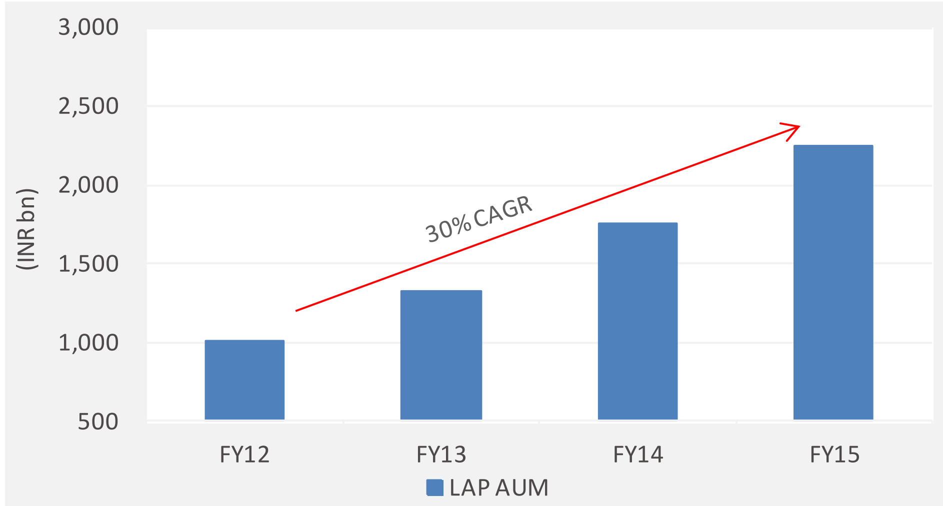
Chart 17: Dominance of NBFCs/HFCs in SME / LAP finance



Source: CRISIL

With an increasing awareness amongst borrowers, the secured SME / LAP segment has posted strong growth over FY12-15. Having said this, with deeper penetration and rising customer awareness, CRISIL believes that LAP / SME financing has further legs to continue to grow at ~20% over FY16-18E.

Chart 18: Historically strong growth to sustain within LAP segment

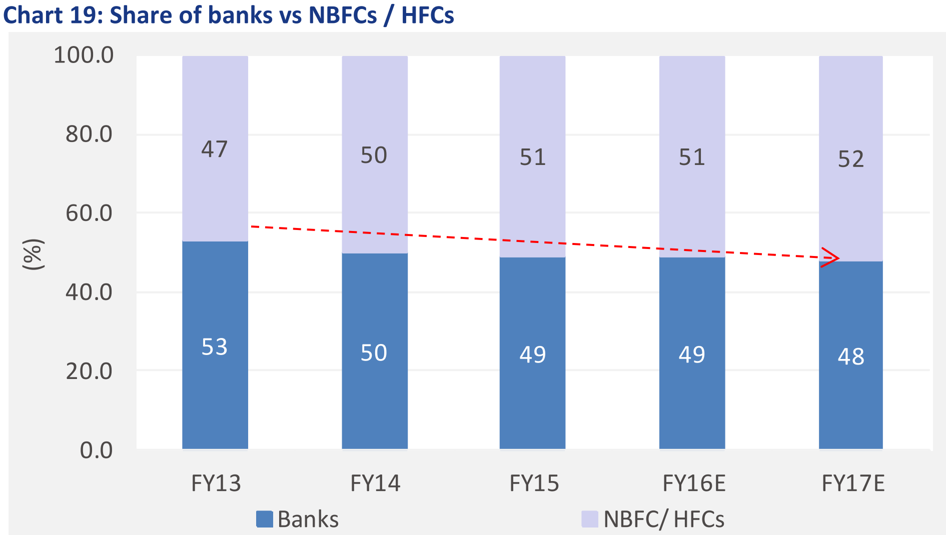


Source: CRISIL

NBFC's SME / LAP financing market size is expected to catapult—to INR1.8tn in FY17E from INR1.1bn in FY15

People with negligible credit history faced a dearth of financing avenues since banks shied away from lending to them. It was NBFCs which stepped in and created a niche by lending to such customer segments. Further, with a strong link to the grassroots, expertise in specific asset classes and deeper penetration in rural & unbanked markets render NBFCs a critical cog in catering to this segment's requirements. Over time and as NBFCs developed customised products and brand identity, even customer segments with credit histories (SMEs, partnership firms, etc) have been shifting from banks to NBFCs. Even CRISIL in its LAP / SME report has acknowledged the rising proportion of NBFCs/HFCs within the LAP / SME financing segment—share has jumped to 51% in FY15 from 47% in FY13. With an increasing pie of LAP market and rising share of NBFCs, overall latter's share is estimated to catapult—to INR1.8tn in FY17E from INR1.1bn in FY15, >25% AUM CAGR.

Chart 19: Share of banks vs NBFCs / HFCs



Source: CRISIL

Based on our interaction with DSAs as well as NBFCs we understand that some market participants have been increasingly slowing their LAP portfolios with deteriorating underwriting practices. Factors which make us believe that players are incrementally relaxing their underwriting practices are:

i. Incrementally credit appraisal is being skewed more towards asset value rather than being underwritten on cash-flows

ii. Even with property as collateral, financing is rising against non-residential property

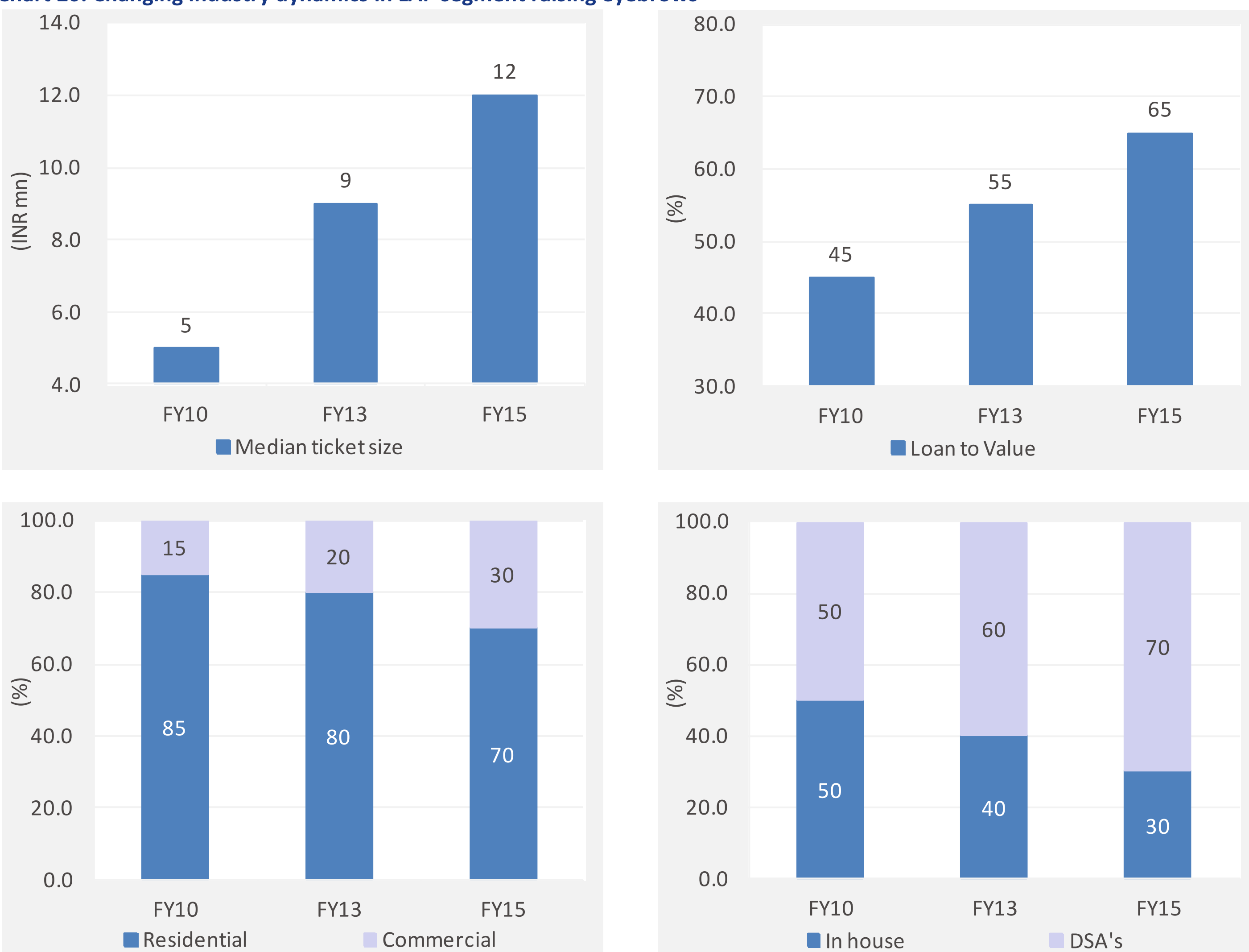
iii. Ticket sizes are increasing

iv. LTV's are rising

v. Large volume of balance transfer masks true delinquency

vi. Pricing is under pressure: Lending rates have fallen by 2% points

Chart 20: Changing industry dynamics in LAP segment raising eyebrows



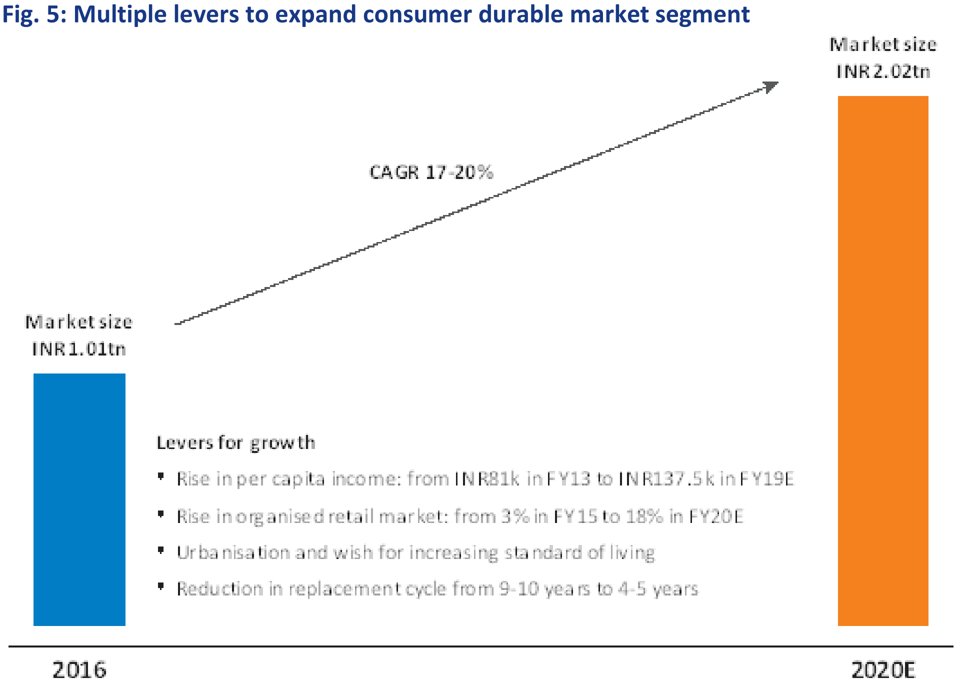
Source: Industry experts

While CAFL has also been focussing on building a granular LAP / SME financing book, we believe that with deepening penetration (outside of Top 7 cities) the company has immense potential to achieve 20-25% growth over the next 2-3 years while maintaining its asset quality.

Consumer durable financing: Oligopolistic market

India's consumption story is undisputably one of the strongest in the world. Within that, the consumer durable story is a burgeoning opportunity with market size expected to catapult to INR2.02tn by FY20E from INR1.01tn in FY16. Such strong growth potential will be led by not only rise in per capital incomes, but also shift from unorganised to organised market, urbanisation, increase in the standard of living and reduction of replacement cycle. This analysis is also well corroborated with increasing proportion of consumer expenditure towards consumer durables *(durables plus semi-durables)* to 11.5% in FY15 from 10.8% in FY13. With rising urbanisation and break down of joint families into nuclear families, the proportion of consumer durables bought under financing arrangements is bound to surge.

Fig. 5: Multiple levers to expand consumer durable market segment



Source: EY study on India's electronics and consumer durable

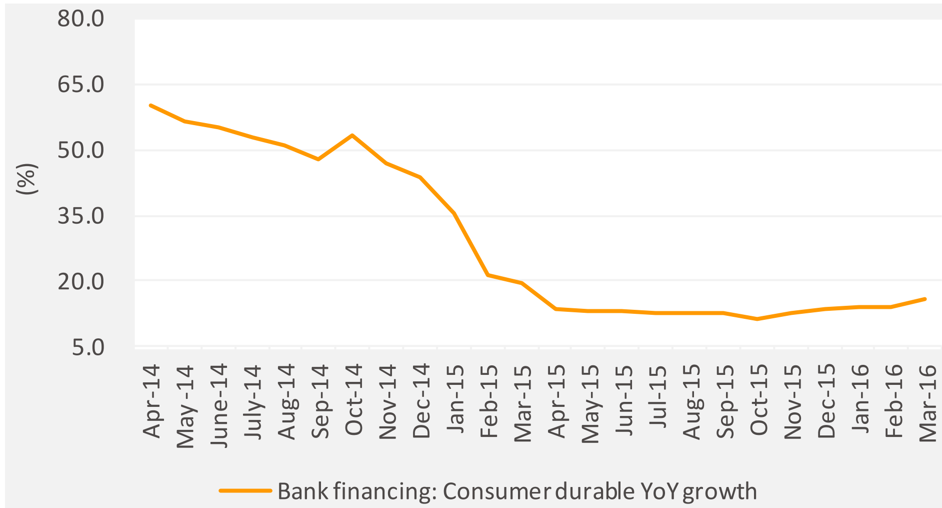
Such financing arrangements are offered by banks through their debit card or credit card model as well as NBFCs through additional credit. However, the latter, primarily Bajaj Finance and Capital First, have made their mark by penetrating deeper and tying up with manufacturers as well as dealers, making it almost an oligopolistic market. This is also reflected in slower growth in banks' lending to the consumer durable segment.

Considering limited market participants, there will be increasing room for niche NBFC's- fuelled with capital, deeper penetration, and technologies in place, to capture the increasing overall consumer durable financing pie.

Table 16: Almost oligopolistic situation, a beneficial spot for CAFL

	(INRbn)
CAFL	15.8
BAF	55.6
Banks	177.5

Chart 21: Bank financing to consumer durable segment has been declining to stable

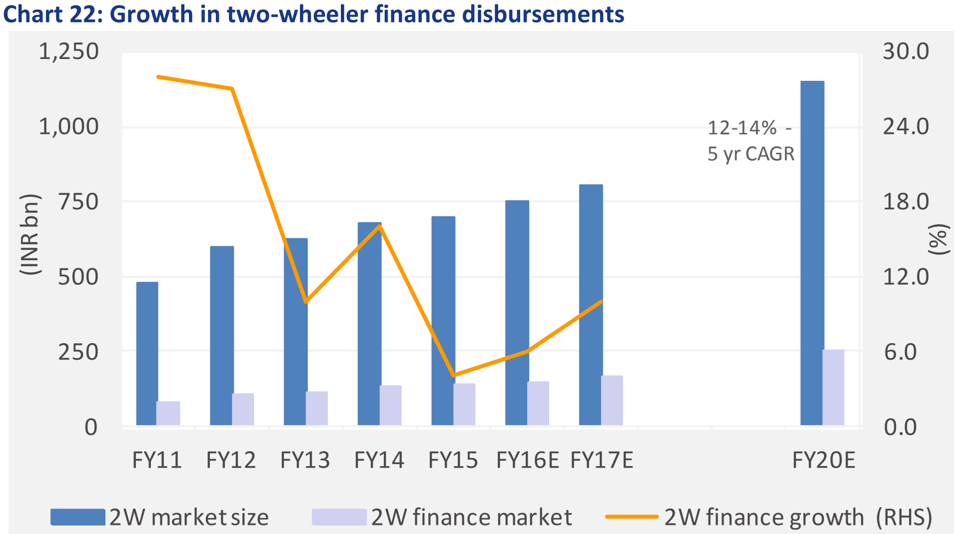


Source: RBI, Company, Bajaj Finance

2-wheeler financing: Get set to ride

Overall 2-wheeler sales remained muted in FY16 (grew 6-8%), but with increasing disposable incomes, urbanisation coupeld with an economic tail wind, the overall 2-wheeler market is poised to grow from ~INR700bn to INR1.2tn over FY16-20E, 11-13% CAGR.

Chart 22: Growth in two-wheeler finance disbursements



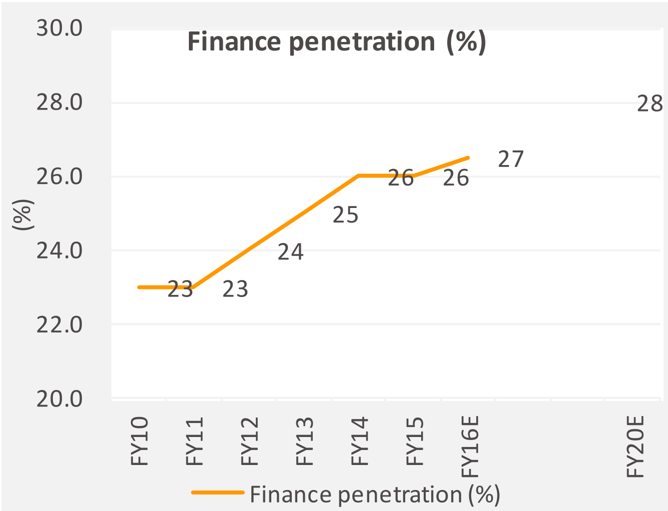
Source: RBI, Company, Bajaj Finance

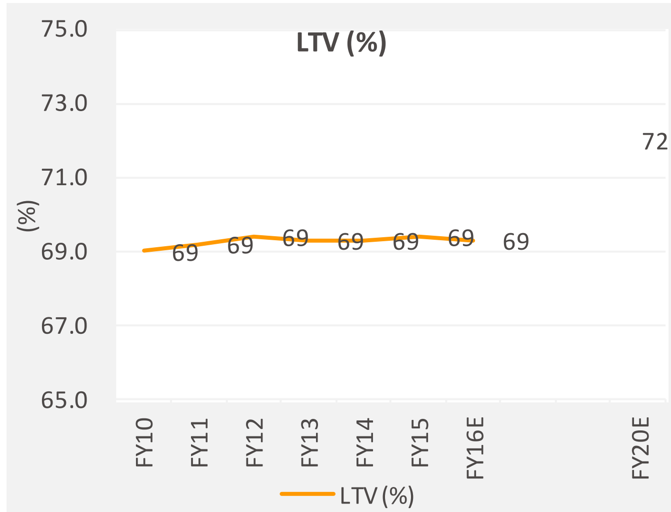
With respect to finance penetration within the segment, after falling to less than 25% in FY10, overall penetration has improved gradually. With banks pruning their exposure post the global financial crisis, niche NBFCs such as Shriram City Union, CAFL, Fullerton, etc., have grabbed market share and steadily built their portfolios. Further, 2-wheeler companies have also started their own captive NBFCs (Hero Credit, Tata Capital, TVS Credit, etc) for 2-wheeler lending business.

Table 17: Each player's pie within the overall 2W financing space

	Pvt banks	Captive NBFCs	Other NBFCs
Market share (%)	41-45	27-31	26-30
Key players	HDFC Bank	Bajaj Auto Finance	Shriram City Union
	IndusInd Bank	TVS Credit	Capital First
	ICICI Bank	Hero Fincorp	Fullerton
	Axis Bank		Muthoot Capital

Chart 23: Increasing finance penetration together with increasing LTV's to increase 2W finance market





Source: CRISIL

With availability of credit, improving credit quality and increasing LTVs, disbursements should grow at 12-14% over FY15-20E with greater share grabbed by NBFCs which are ready to penetrate deeper and provide quick turn around riding predictive analytics, score card rating method, etc.

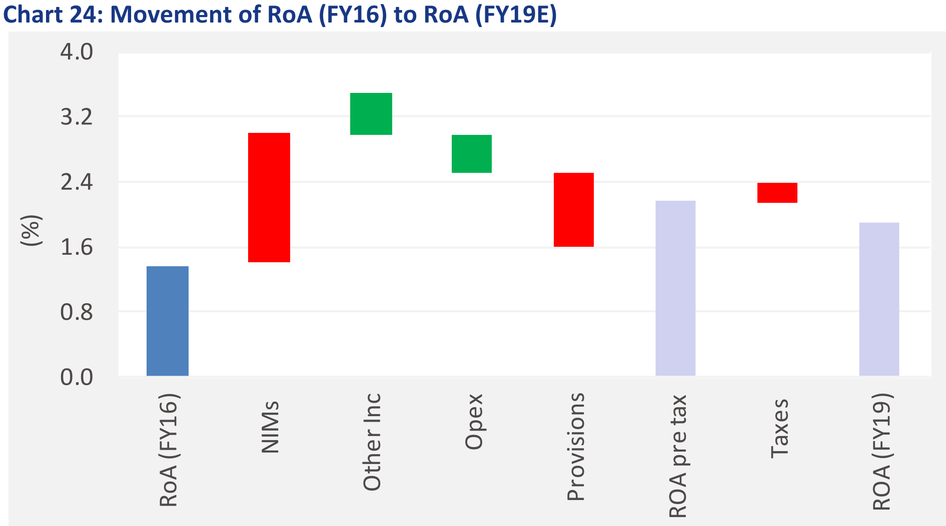
Financial Outlook

- We estimate the company to post ~23% AUM CAGR over FY16-19 primarily led by consumer durable, 2-wheeler and BL clocking >40% loan growth and LAP tracking broadly overall ~20-25% AUM growth.
- We anticipate ~100bps improvement in yields due to portfolio shift which coupled with dip of ~55bps in funding cost will lead to significant improvement in margin to 8.4% by FY19 from 6.7% currently.
- With scale up in the book, operating leverage benefit will come to fore and we expect cost-income ratio to settle at 45% by FY19E from 51% in FY16.
- From a credit cost perspective, transitioning to high-yield CDs and 2 wheelers will obviously come with a cost, but will be net-net accretive for RoA.

Change in portfolio mix, operating leverage to drive superior returns

With all the right ingredients—vibrant product portfolio, investment in franchise, technological set up and management acumen—in place, CAFL is set to make sizeable in roads in high-growth high-yield retail products. We estimate the company to post ~23% AUM CAGR over FY16-19 primarily led by consumer durable, 2-wheeler and BL clocking >40% loan growth and LAP tracking broadly overall ~20-25% AUM growth. Such shift in AUM mix will help CAFL post healthy yields as well. With opex growing at 29% and credit cost contained (at sub 300bps), we envisge return ratios to post a J-shaped recovery with RoA of 1.9% and RoE of 18-19% by FY19E.

Chart 24: Movement of RoA (FY16) to RoA (FY19E)



Source: Edelweiss research

Loan book to clock an impressive 20-25% CAGR over FY16-19E

CAFL is poised to sustain the stellar loan growth seen over FY12-16 even over FY16-19E. We estimate further rationalization of the wholesale book and the proportion to dip from 14% in FY16 to <10% of the overall AUM over the next 2-3 years. Going forward, retail lending will remain CAFL's forte contributing as high as ~90-95% by FY19E. Key growth drivers will be:

- **Market penetration and enhanced presence:** In order to ramp up its consumer durable business, CAFL is incrementally focussing on increasing counters (i.e., warm bodies) at various dealers. Apart from tiying up with large dealers with pan-India presence, the company has also been incrementally tieing up with neighbourhood mom & pop electronic stores where CAFL has a monopoly in offering financing options. Likewise, even for its 2-wheeler financing, the company has been increasing tie ups with dealers to set warm bodies in Tier II and III cities. Within secured SME and unsecured BL segments, due to over-heating of competition and >70-75% loans being sourced via DSAs, CAFL has strengthened the credit filters and proportion of balance transfer cases moving out for CAFL are also low.

- **Increasing awareness within customer segments:** With increasing awareness of possibility of leveraging self occupied property, the next delta will come from virgin customers joining the LAP / BL wagon. Moreover, financing penetration in the consumer durable segment is rising with easy accessibility to finance, increasing awareness and push from financiers.

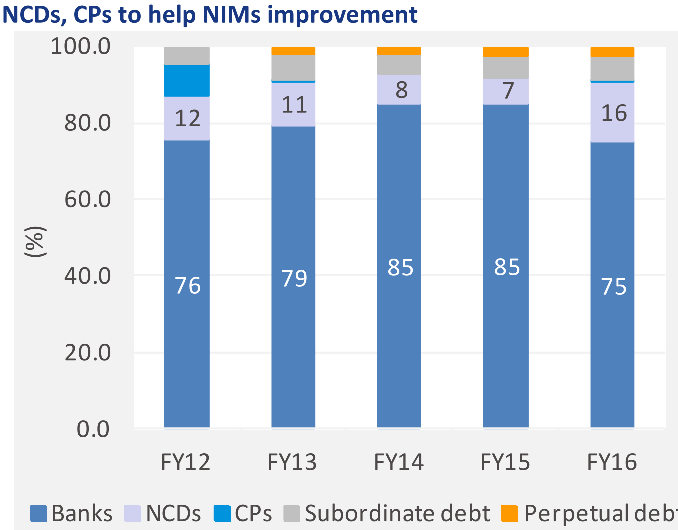
NIMs on the rise despite falling interest rates

- Even within the retail finance book, CAFL will consciously shift from low-yielding LAP to high-yielding high-growth consumer durables and 2-wheeler financing which will help improve yield amidst competition and falling interest rate scenatio. We anticipate ~100bps improvement in yields due to portfolio shift even after factoring 100-120bps decline in card rate for various products.

- Riding balance sheet strength, improving business model and able promoters, CAFL's ratings have improved consitently—long- term credit rating of AA+ and short-term credit rating of A1+. Amongst-the-best credit ratings enable CAFL to borrow at competitive rates. This will aid in tactically tilting borrowings towards NCDs and CPs moving away from relatively high-cost bank borrowings. Ergo, we estimate the funding cost to dip ~55bps leading to significant improvement in margin to 8.4% by FY19 from of 6.7% currently.

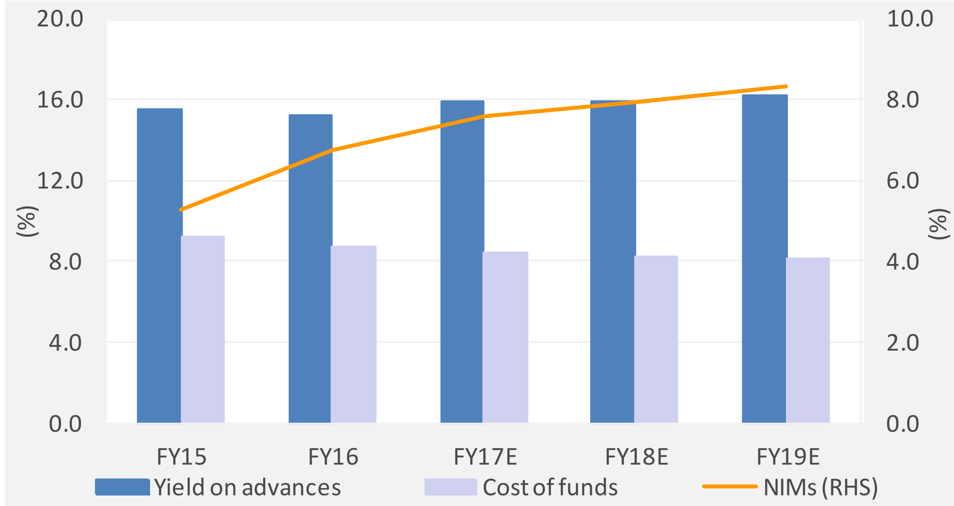
Chart 25: Consistent rating upgrades and increasing proportion of NCDs, CPs to help NIMs improvement

Year	Long term credit rating	Upgrade
FY10	A+	
FY11	A+	
FY12	AA-	√
FY13	AA+	√
FY14	AA+	
FY15	AA+	
FY16	AA+	



Source: Company

Chart 26: Rising yield and diversified borrowings to lead to best-in-class NIMs



Source: Edelweiss research

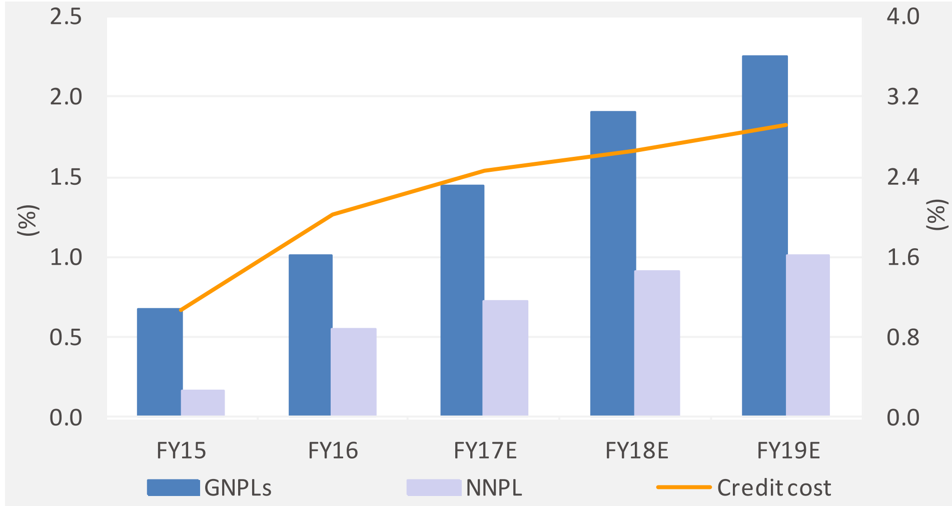
Operating leverage benefit to come to fore

On the cost front, CAFL has invested heavily into processes, systems, people, tie ups and technology, particularly for CD financing (which has been running into losses in initial phase). The objective was to build a system that can run analytics, score cards, etc., which would strengthen credit appraisal filters and also reduce turn-around time. With scale up in the book, operating leverage benefit will come to fore and we expect cost-income ratio to settle at 45% by FY19E from 51% in FY16.

Credit cost to rise with portfolio shift, but no major shocks anticipated

From a credit cost perspective, transitioning to high-yield CDs and 2 wheelers will obviously come with a cost, but will be net-net accretive for RoA. The past few years indicate that CAFL has delivered best-in-class credit costs (it rose to 2% in FY16, inspite of making provisions on 90dpd plus basis). However, we are mindful of the fact that the company has not yet seen a economic downcycle within its retail financing book and has been in a growth phase as well. Here, we believe stringent credit filters and analytics/scorecard driven processes will help it sail through an economic downturn with minimal impact.

Chart 27: Buidling higher credit cost due to portfolio shift; no major shocks expected



Source: Edelweiss research

Financial Statements (Standalone)

Income statement (INR mn)

Year to March	FY16	FY17E	FY18E	FY19E
Interest income	16,570	22,763	28,547	35,326
Interest charges	8,759	11,286	13,713	16,511
Net interest income	7,811	11,477	14,834	18,815
Fee & other income	1,908	2,638	3,665	4,923
Net revenues	9,719	14,114	18,499	23,738
Operating expense	4,986	6,814	8,687	10,736
- Employee exp	1,755	2,599	3,321	4,016
- Depreciation /amortisation	100	110	128	154
- Other opex	3,131	4,105	5,238	6,566
Preprovision profit	4,733	7,300	9,811	13,002
Provisions	2,347	3,723	4,948	6,572
PBT	2,386	3,577	4,863	6,430
Taxes	817	1,198	1,629	2,154
PAT	1,569	2,379	3,234	4,276
Extraordinaries	0	0	0	0
Reported PAT	1,569	2,379	3,234	4,276
Basic number of shares (mn)	91.2	91.2	91.2	91.2
Basic EPS (INR)	17.2	26.1	35.4	46.9
Diluted number of shares (mn)	91.2	91.2	91.2	91.2
Diluted EPS (INR)	17.2	26.1	35.4	46.9
DPS (INR)	2.4	3.9	5.3	7.0
Payout ratio (%)	14.0	15.0	15.0	15.0

Growth ratios (%)

Year to March	FY16	FY17E	FY18E	FY19E
NII growth	52.3	46.9	29.3	26.8
Net revenues growth	51.2	45.2	31.1	28.3
Opex growth	32.2	36.7	27.5	23.6
PPP growth	78.1	54.2	34.4	32.5
Provisions growth	124.8	58.6	32.9	32.8
PAT growth	40.1	51.6	35.9	32.2

Operating ratios (%)

Year to March	FY16	FY17E	FY18E	FY19E
Yield on advances	15.2	15.9	16.0	16.3
Cost of funds	8.7	8.4	8.2	8.1
Spread	6.5	7.5	7.8	8.1
Net interest margins	6.7	7.6	8.0	8.4
Cost-income	51.3	48.3	47.0	45.2
Tax rate	34.2	33.5	33.5	33.5

Balance sheet (INR mn)

As on 31st March	FY16	FY17E	FY18E	FY19E
Liabilities				
Equity capital	912	912	912	912
Reserves	15,685	17,644	20,306	23,827
Net worth	16,597	18,556	21,219	24,739
Secured loans	109,275	139,408	170,929	205,957
Unsecured loans	8,596	10,967	13,447	16,202
Total borrowings	117,871	150,375	184,375	222,160
Total liabilities	**134,468**	**168,931**	**205,594**	**246,899**
Assets				
Loans	126,443	160,193	197,235	237,315
Investments	2,542	2,642	2,742	2,742
Current assets	*10,614*	*12,788*	*14,126*	*17,455*
Current liabilities	*6,066*	*7,657*	*9,466*	*11,507*
Net current assets	4,548	5,131	4,660	5,948
Fixed assets (net block)	292	383	455	501
Deferred tax asset	644	584	502	395
Total assets	**134,469**	**168,931**	**205,594**	**246,899**
Earning assets	133,533	167,965	204,637	246,004
AUMs	160,409	203,224	250,217	301,063
Balance sheet ratios (%)				
Loan growth	38.3	26.7	23.1	20.3
EA growth	35.8	25.8	21.8	20.2
Gross NPA ratio	1.0	1.5	1.9	2.3
Net NPA ratio	0.6	0.7	0.9	1.0
Provision coverage	45.5	50.0	52.0	55.0

RoE decomposition (%)

Year to March	FY16	FY17E	FY18E	FY19E
Net interest income/Assets	6.7	7.6	8.0	8.4
Other Income/Assets	1.6	1.7	2.0	2.2
Net revenues/Assets	8.4	9.4	9.9	10.5
Operating expense/Assets	4.30	4.52	4.66	4.76
Provisions/Assets	2.02	2.5	2.7	2.92
Taxes/Assets	0.7	0.8	0.9	1.0
Total costs/Assets	7.0	7.8	8.2	8.6
ROA	1.4	1.58	1.74	1.90
Equity/Assets	13.8	11.7	10.7	10.2
ROAE	9.8	13.5	16.3	18.6

Valuation metrics

Year to March	FY16	FY17E	FY18E	FY19E
Diluted EPS (INR)	17.2	26.1	35.4	46.9
EPS growth (%)	*33.8*	*51.6*	*35.9*	*32.2*
Book value per share (INR)	181.9	203.4	232.6	271.2
Adj. Book value per share (INR)	176.6	194.9	219.1	252.9
Diluted P/E (x)	35.6	23.5	17.3	13.0
Price/ BV (x)	3.4	3.0	2.6	2.3
Price/ ABV (x)	3.5	3.1	2.8	2.4

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
Allahabad Bank	HOLD	SU	M	Axis Bank	BUY	SO	M
Bajaj Finserv	BUY	SP	L	Bank of Baroda	BUY	SP	M
DCB Bank	REDUCE	SU	M	Dewan Housing Finance	BUY	SO	M
Federal Bank	BUY	SP	L	HDFC	BUY	SP	L
HDFC Bank	BUY	SO	L	ICICI Bank	BUY	SO	L
IDFC Bank	BUY	SP	L	Indiabulls Housing Finance	BUY	SO	M
IndusInd Bank	BUY	SP	L	Karnataka Bank	BUY	SP	M
Kotak Mahindra Bank	HOLD	SP	M	LIC Housing Finance	BUY	SP	M
Magma Fincorp	BUY	SP	M	Mahindra & Mahindra Financial Services	HOLD	SU	M
Manappuram General Finance	BUY	SP	H	Max India	BUY	SO	L
Multi Commodity Exchange of India	BUY	SP	M	Muthoot Finance	BUY	SO	M
Oriental Bank Of Commerce	HOLD	SP	L	Power Finance Corp	HOLD	SP	M
Punjab National Bank	BUY	SP	M	Reliance Capital	BUY	SP	M
Repco Home Finance	BUY	SO	M	Rural Electrification Corporation	HOLD	SU	M
Shriram City Union Finance	BUY	SO	M	Shriram Transport Finance	BUY	SO	L
SKS Microfinance	BUY	SO	M	South Indian Bank	BUY	SP	M
State Bank of India	BUY	SP	L	Union Bank Of India	HOLD	SP	M
Yes Bank	BUY	SO	M				

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

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Coverage group(s) of stocks by primary analyst(s): Banking and Financial Services

Allahabad Bank, Axis Bank, Bajaj Finserv, Bank of Baroda, DCB Bank, Dewan Housing Finance, Federal Bank, HDFC, HDFC Bank, ICICI Bank, IDFC, Indiabulls Housing Finance, IndusInd Bank, Karnataka Bank, Kotak Mahindra Bank, LIC Housing Finance, Max India, Multi Commodity Exchange of India, Manappuram General Finance, Magma Fincorp, Mahindra & Mahindra Financial Services, Muthoot Finance, Oriental Bank Of Commerce, Punjab National Bank, Power Finance Corp, Reliance Capital, Rural Electrification Corporation, Repco Home Finance, State Bank of India, Shriram City Union Finance, Shriram Transport Finance, South Indian Bank, Union Bank Of India, Yes Bank

Recent Research

Date	Company	Title	Price (INR)	Recos
12-Jul-16	**Satin Creditcare Network**	Catch it young, watch it grow; *Visit Note*	495	Not Rated
11-Jul-16	**IndusInd Bank**	En-route to deliver Phase III targets; *Result Update*	1,124	Buy
11-Jul-16	**South Indian Bank**	Incremental stress lower; retail focus sustains; *Result Update*	23	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

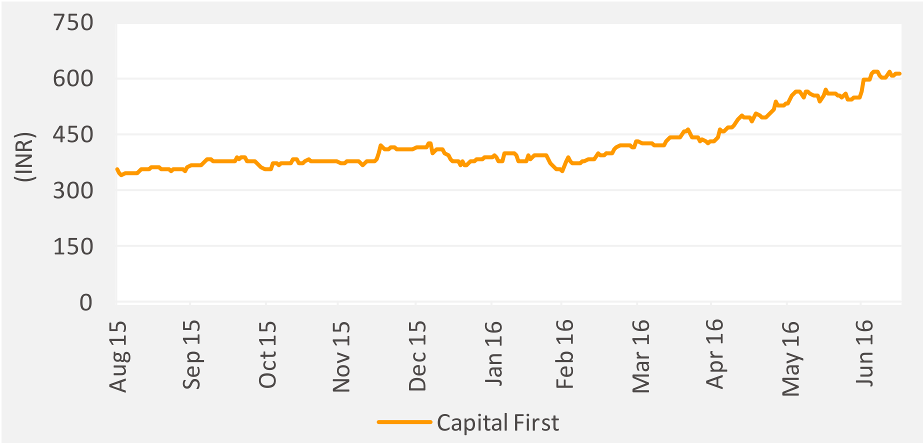
	Buy	Hold	Reduce	Total
Rating Distribution* * - stocks under review	158	59	12	229

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	156	62	11

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

One year price chart



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