Banking, Financial Services & Insurance

August 26, 2011

Magma Fincorp

Bloomberg: MGMA IN EQUITY
Reuters: MAGM.BO

BUY

Accounting: AMBER ☺
Predictability: GREEN ☺
Earnings momentum: GREEN ☺

Changing Gears

Whilst rising systemwide rates, slowing economy and regulatory changes could impact Magma's earnings in the near term, Magma's strong credit quality and inexpensive valuation of 1.2x FY12 P/B limit the downside possibilities. The increased focus on high-yield products, improved operational efficiency, stable credit quality and decreased leverage on the balance sheet are likely to expand RoA and hence should drive a rerating of this stock. We initiate with BUY.

Competitive position: MODERATE **Changes to this position: STABLE**

Despite best in class asset quality trends, reasonable growth in the loan portfolio and improving RoA and RoE over the last three years, Magma trades at a discount to peers on both P/BV and market cap:loan assets metrics. This discount, we believe, is driven by its comparatively low RoA and historically high leverage on the balance sheet versus peers. However, going forward we expect RoA to expand from 1.1% in FY2011 to 1.6% in FY2013 driven by:

- **NIMs expanding due to higher yields:** Whilst we expect the interest rate spreads of the company to contract in the near term due to rising systemwide rates, over the medium term, we expect spreads to expand as the proportion of higher yield products (tractors, used commercial vehicles and SMEs) increase in the loan book from 14% in FY2011 to 26% in FY2013 (yields on these products are up to 500bps higher v/s the new commercial vehicles (CVs), construction equipment and passenger cars).
- **Operational efficiency to improve:** As the company leverages its current branch network and employee base, leading to 24% CAGR in the loan book over FY11-13, we expect opex as a percentage of average assets to come down from 3.2% in FY2011 to 2.8% in FY2013.
- **Lower leverage to expand NIMs:** The recent capital infusion (US$100mn invested by KKR and IFC) should also help Magma expand NIMs by ~50bps and RoA by ~35bps in FY12 as its interest expenses fall. Moreover, the reduction in leverage from 20x to 10x also decreases the balance sheet risk for the company.

Valuation: Our excess return valuation method gives a fair value of Rs91 per share (27% upside) implying 1.5x FY12 P/BV. The stock is currently trading at 1.2x FY12 P/BV which is at a 30% discount to the average valuation commanded by Indian NBFCs.

Catalysts: Consistent improvement in RoA over the next two years would be the key valuation catalyst in the medium term. A reversal in the interest rate cycle is the obvious near-term catalyst; while credit quality slippage and an adverse ruling from the RBI on securitisation are the key downside risks.

Exhibit 1: Key financials

Year to March	FY09	FY10	FY11	FY12E	FY13E
Net Revenues (Rs mn)	3,431	3,980	5,217	5,166	8,394
Operating Profits (Rs mn)	1,026	1,513	2,177	1,904	4,417
Net Profits (Rs mn)	328	630	1,089	707	2,265
EPS (Rs)	3.0	5.8	8.4	4.0	11.7
RoA (%)	0.5%	0.7%	1.1%	0.6%	1.6%
ROE (%)	11.4%	19.4%	23.3%	8.2%	18.3%
P/B (x)	2.6	2.2	1.6	1.2	1.0

Source: Company, Ambit Capital research

INITIATING COVERAGE

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Recommendation

CMP:	Rs72
Target Price (12 months):	**Rs91**
Previous TP:	*NA*
Upside (%)	*27%*
EPS (FY13):	Rs11.7
Change from previous (%)	*NA*
Variance from consensus (%)	*-15%*

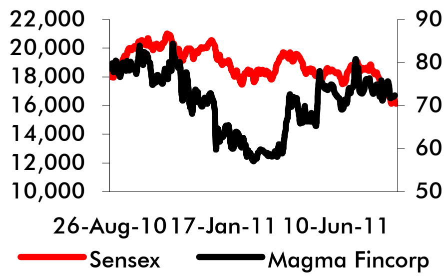
Stock Information

Mkt cap:	Rs13bn/US283mn
52-wk H/L:	Rs88/56
3M ADV:	Rs18.8mn/US$0.4mn
Beta:	0.9x
BSE Sensex:	16,146
Nifty:	4,840

Stock Performance (%)

	1M	3M	12M	YTD
Absolute	-5.2	-3.3	-9.9	-0.3
Rel. to Sensex	9.3	6.2	1.3	21.0

Performance (%)



1-year forward P/BV

Due to lack of reliable historical forward estimates for the stock, we do not have historical P/BV profile for the company.

Source: Bloomberg, Ambit Capital research

Company Financial Snapshot

Consolidated Income statement (Rs. Mn)

	FY11	FY12E	FY13E
Net Interest Income	4,667	4,515	7,587
Other Income	550	651	808
Total Income	**5,217**	**5,166**	**8,394**
Operating Expenditure	3,040	3,262	3,977
Operating Profit	**2,177**	**1,904**	**4,417**
Write-offs & Provisions	356	691	895
PBT	**1,822**	**1,214**	**3,522**
Tax	601	395	1,145
PAT	**1,221**	**819**	**2,377**
Adjusted PAT	**1,089**	**707**	**2,265**
Ratios			
EPS (Rs)	8.4	4.0	11.7
BVPS(Rs)	45	60	71
Net Interest Margin (%)	6.0%	6.7%	7.0%
Opex (% of Assets)	3.2%	2.8%	2.8%
Write-Off (% of AUM)	0.27%	0.57%	0.62%
ROA (%)	1.1%	0.6%	1.6%
ROE (%)	23.3%	8.2%	18.3%
P/E (X)	8.6	18.1	6.1
P/B (X)	1.6	1.2	1.0

Company Background

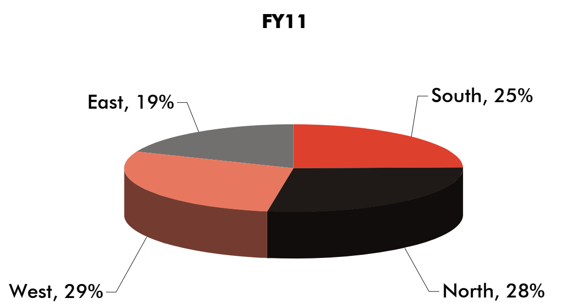
Magma Fincorp is a mid-sized non-bank auto financier with a sizeable presence in the financing of cars, utility vehicles, commercial vehicles, construction equipment and tractors primarily in rural and semi-urban areas.

Year	Event
1989	Company started by first generation entrepreneurs Mr. Sanjay Chamria and Mr. Mayank Poddar.
1994	Listed on the NSE
1996	Entered into the business of financing vehicles and construction equipment.
1999	Acquired north India based NBFC, Consortium Finance which strengthened company's presence in North India
2006	Rolled out used vehicle and big-ticket construction equipment financing.
2007	Merged with East India-based Shrachi Infrastructure Finance owned by the Todi family. The Todis became joint promoters of the company. Entered into a tie-up with Maruti Udyog Ltd to finance Maruti cars.
2008	Entered into a JV with International Tractors Ltd (ITL) to finance tractors manufactured by ITL.
2009	Entered into a JV with German insurer, HDI Gerling, to start the general insurance business.
2010	Issued a QIP of Rs1.2bn
2011	KKR and IFC infuse Rs4.4bn for a 28% stake in the company. Mr. Sanjay Chamria and Mr. Mayank Poddar bought out the Todi's 5.6% stake in Magma. The promoters now own 30% of Magma.

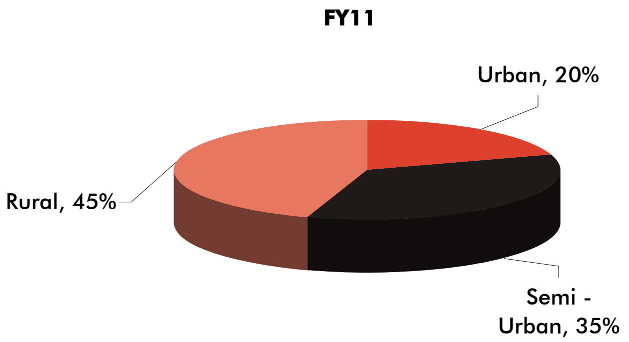
Consolidated Balance Sheet (Rs mn)

	FY11	FY12E	FY13E
Sources of funds:			
Equity	5,847	11,349	13,463
Debt	96,072	112,673	140,432
Preference Shares	1,469	1,469	1,469
Total	**103,487**	**125,560**	**155,584**
Application of funds:			
Fixed Assets	1,871	1,845	1,865
Loan book	95,672	118,345	147,046
Net Working Capital	5,944	5,370	6,672
Total	**103,487**	**125,560**	**155,584**

Geographical well diversified portfolio



Rural and Semi urban focused business



Shareholding Pattern

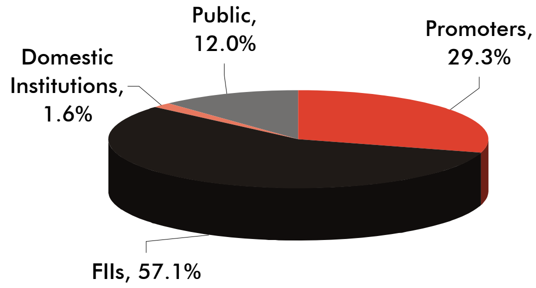


Exhibit 2: Magma Fincorp: SWOT analysis

Strengths	Weaknesses
▪ Strong loan origination and appraisal processes which had ensured quick turnaround time without compromising on quality of assets. ▪ A geographically well diversified portfolio with no region having more than 30% share in the portfolio and no single state comprising more than 13% of the loan portfolio. ▪ A relatively diversified portfolio in terms of product categories with a strong presence in cars, utility vehicles, commercial vehicles and construction equipment. ▪ Strong recovery processes that ensure best-in-class credit quality for the company.	▪ Lack of broad-based funding base - heavy dependence on banks for funding. ▪ Relatively weaker presence in western and southern India. ▪ Weaker presence in higher yield products like used commercial vehicles and tractors leading to lower yields and hence lower RoAs.
Opportunities	**Threats**
▪ Opportunity to grow at a rapid pace by leveraging the existing infrastructure and increasing its presence in southern and western India. ▪ Opportunity to broad base the liability profile by raising funds from different sources such as Retail Bonds, NCDs etc. ▪ Opportunity to increase operational efficiency (currently operating cost:income is 58.3%) by optimally utilising the branch network and employees' strengths. ▪ Opportunity to successfully scale up used CV, tractors and the SME loan portfolio to increase RoA.	▪ Regulatory changes in terms of removal of priority sector status on securitisation deals and/or significant changes in securitisation guidelines could increase the company's capital requirement and increase cost of funds for the company. ▪ Inability to contain NPAs in the riskier segments like tractors, used CVs and SME loans could erode the RoA of the company.

Source: Ambit Capital research

The valuation disconnect

Magma is one of biggest asset financing companies in India with Rs98.7bn of loan assets and an RoE of ~23% in FY11. However, despite its reasonable size, healthy RoE and healthy growth (FY06-FY11 loan assets CAGR of 22%), the company is trading at a significant discount to other asset financing companies both on P/B and market cap:loan assets metrics.

Exhibit 3: Market cap of Magma is lower in proportion to the size of the company

Loan product	Major products	Market cap (Rs bn)	Loan assets (Rs bn)	Market cap as a % of loan assets	FY12E RoE* (%)	FY12E* (P/BV)	5-yr CAGR in loan portfolio
Magma Fincorp	**Cars, UVs, commercial vehicles, construction equipment**	**13**	**98.7**	**0.14**	**24.2%**	**1.3**	**22%**
Shriram Transport Finance	Old and new commercial vehicles	135	370.0	0.37	26.3%	2.2	37%
M&M Finance	Cars, UVs, tractors, commercial vehicles	69	150.9	0.46	21.2%	2.0	23%
Sundaram Finance	New CVs	30	125.0	0.24	22.0%	1.7	18%
Cholamandalam Finance	Old and new CVs, loan against property and loan against shares	16	101.0	0.16	18.2%	1.6	35%

*Source: Company, Bloomberg, Ambit Capital research. * FY12 RoE and P/BV are consensus estimates from Bloomberg.*

Magma's valuation discount appears in part to be driven by investors' concerns with respect to its relatively lower RoAs and highly leveraged balance sheet – Magma's historical leverage is in the range of 20x-25x.

Exhibit 4: Lower RoA is leading to a lower valuation multiple for Magma

Company	Market cap as a % of loan assets	FY12E P/BV (x)	FY11 return on assets (%)
Magma Fincorp	0.14	**1.2**	1.1
Shriram Transport Finance	0.37	2.2	3.4
M&M Finance	0.46	2.0	4.0
Sundaram Finance	0.24	1.7	2.2
Cholamandalam Finance	0.16	1.6	0.7

Source: Company filings, Bloomberg; Ambit Capital research. We have calculated RoA based on FY11 loan assets.

The RoA breakup of Magma relative to two other major asset financing companies — Shriram Transport (SHTF) and Mahindra and Mahindra Finance (MMFS) — shows that despite superior credit quality, Magma's lower RoA is driven by comparatively: **(i)** lower interest yield; **(ii)** higher opex:loan assets; and **(iii)** higher leverage on the balance sheet leading to interest expenses as a percentage of assets being higher versus peers. The table below quantifies these comparisons.

Exhibit 5: Lower yields, higher opex and higher leverage are the major drivers of lower RoA at Magma

As a % of average loan assets* (%) in FY11	Magma	SHTF	MMFS
Yield on loans	13.2	18.4	17.7
Cost of funds	8.2	11.5	8.2
Gross spreads	**5.0**	**6.9**	**9.5**
Operating expenses	3.4	2.2	4.0
Provisions and write-offs	0.	1.7	1.3
Net spreads	**1.3**	**3.0**	**4.2**
Impact of equity funding, working capital management and accounting treatment of securitisation income**	0.5	2.0	1.9
Pre tax RoA	**1.8**	**5.0**	**6.1**
Taxes, preference dividends etc.	0.7	1.6	2.1
RoA	**1.1**	**3.4**	**4.0**
Leverage (x)	20	8.5	5.5
RoE	**23.3**	**29.5**	**22.0**

Source: Company filings, Ambit Capital research Including securitised/assigned assets. **MMFS and Magma book upfront income on securitisation whilst SHTF amortises it over the tenure of the loans.*

However, going forward we expect Magma's RoA to expand from 1.1% in FY2011 to 1.6% in FY2013 driven by: **(i)** an increase in lending yields due to a higher proportion of higher-yield products in the loan assets (used CVs, tractors and SME loans to rise from 14% in FY11 to 26% in FY13), **(ii)** opex as a percentage of average assets coming down from 3.2% in FY11 to 2.8% in FY13 as Magma leverages its existing branch and employee base; and **(iii)** leverage on the balance sheet (due to the recent US$100mn equity infusion) falling from 20x at FY11 to 11x at FY12 leading to NIM expansion. In the section below we have described these drivers in detail.

Robust loan growth with increase share of higher yield products

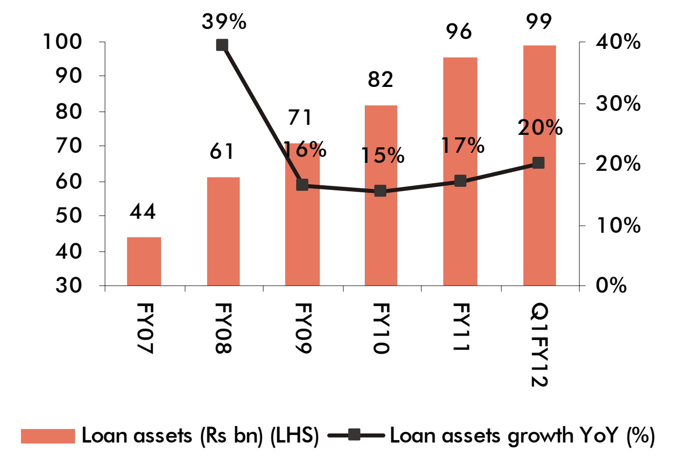
Magma's loan book has grown at a CAGR of ~22% between FY07-FY11 driven by 21% CAGR in loan disbursals. The passenger car segment has been the key driver of growth for Magma between FY07-FY11 with disbursements growing at a CAGR of 24%. Higher-yield products like tractors and SME loans have also shown strong disbursement growth with tractors growing at 217% CAGR between FY08-FY11 and SME loans growing at a 63% CAGR between FY09-FY11.

Exhibit 6: Deconstructing Magma's portfolio

Loan product	As a % of Magma's portfolio	Net IRR* portfolio (%)	Credit costs** on the product (%)	Loan disbursements %CAGR (FY07-11)***	Major competitors	Market size (Rs bn)
New commercial vehicles	38	12.6	1.0	14	Sundaram Finance, Shriram Transport, Kotak Mahindra, Indusind	~600
Cars and utility vehicles	25	14.0	1.0	24	M&M Finance, Kotak Mahindra, HDFC Bank	~585
Construction equipment	22	12.6	1.0	15	L&T Finance, SREI Infra, Tata Finance	~155
Tractors	8	19.9	3.0	217	Mahindra Finance, Kotak Mahindra	~125
Used commercial vehicles	4	18.7	3.0	6	Shriram Transport, Unorganised financiers	~360
SME loans	4	17.0	2.0	63	Banks, Reliance Capital, Religare, India Infoline	~60
Overall	**100**	**15.0**	**1.3**	**21**		

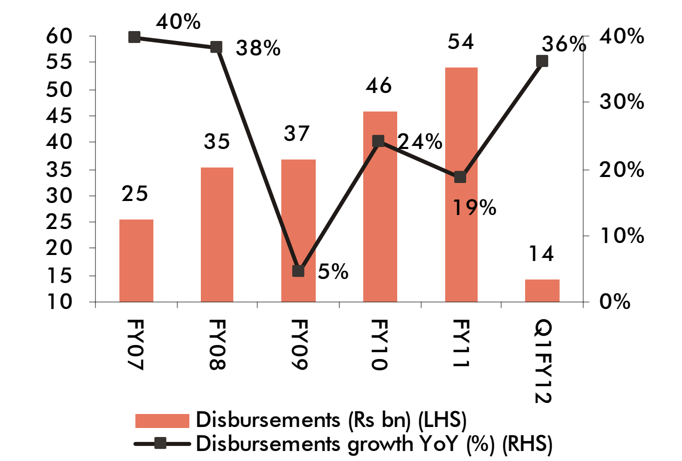
*Source: Company, Ambit Capital research. *IRR in 1QFY12- net of commission paid to brokers. ** The credit costs are credit charges in each product spread over the tenure of the loan. ***Loan disbursement growth CAGR for tractors is for FY08-11 and for SME loans it is between FY09-11.*

Exhibit 7: Moderate loan assets growth …



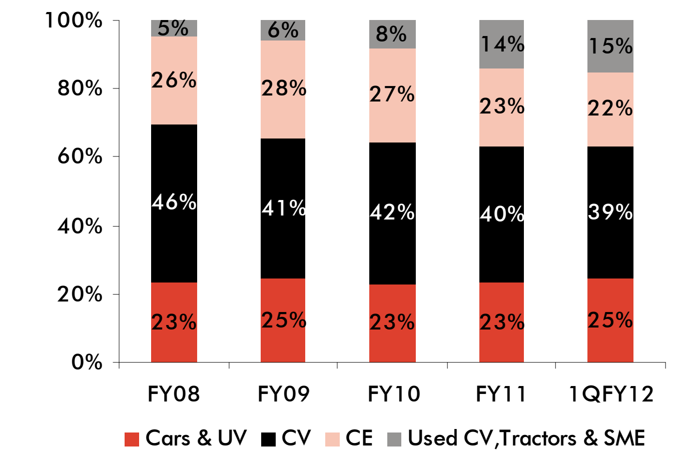
Source: Company, Ambit Capital research.

Exhibit 8: … driven by moderate disbursements growth



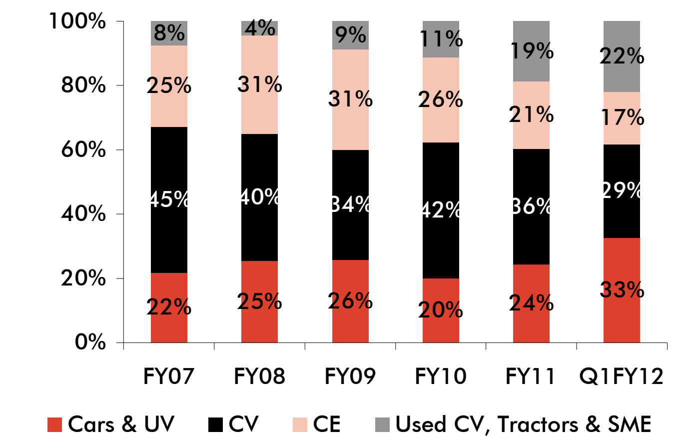
Source: Company, Ambit Capital research

Exhibit 9: Increasing proportion of high-yield products in the loan portfolio



Source: Company, Ambit Capital research

Exhibit 10: Driven by increasing proportion of high-yield products in new disbursals



Source: Company, Ambit Capital research

Going forward management is guiding towards a 40% CAGR in loan disbursals over FY11-FY13 driven primarily by strong growth in passenger vehicles, tractors, used CVs and SME loans.

However, given our expectation of a slowdown in auto sales growth in India (due to the broader economic slowdown), we are being conservative in our estimates. We are building in 27% CAGR in disbursals over FY11-FY13. This translates to a CAGR of 24% in the loan assets of the company over FY11-FY13. Our estimate of 27% CAGR in loan disbursals for Magma (v/s our estimate of 15% CAGR in auto sales in India over the same period) is driven by the following factors:

(i) **Demand** for passenger vehicles is still very robust in semi-urban and rural areas where the economy is more resilient. A majority of Magma's business comes from the branches situated in these areas. Another NBFC, M&M Finance, which also has a leading presence in rural areas, is continuing to see strong credit demand.

(ii) Addition of ~50 new **branches** over the next two years taking the total branch count for Magma to about 220 by FY13.

(iii) **Introduction of the full range of existing products** to additional branches, as most of the products are still not offered across all branches.

Eg. Tractor financing which was offered in ~100 branches in FY2011 will be offered in more than 150 branches in FY2012.

(iv) **Higher growth in new products** such as used CVs, tractors and SME loans wherein Magma is still a marginal player and where the company is yet to roll out these products in additional geographies.

Higher yields should support spreads

Historically Magma has clocked interest spreads in the range 3.5%-5.0% (significantly lower than competitors — SHTF and MMFS). Part of the reason for this has been that most of Magma's portfolio is concentrated in new CVs, construction equipment and cars where lending yields are ~5% lower than tractors, utility vehicles and used CVs (which are the leading products for MMFS and SHTF respectively).

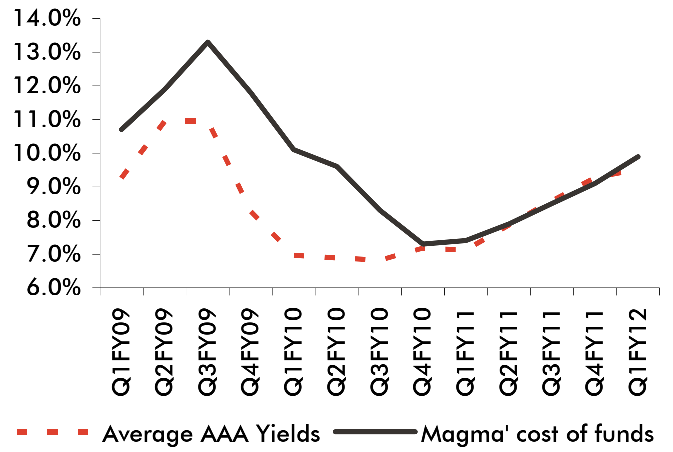
Whilst we expect Magma's cost of funds to rise by 240bps in FY12 v/s FY11 due to rising systemwide rates (as ~28% of total borrowings of the company are short term working capital and commercial paper borrowings) and lower borrowings through the securitisation route (currently 43% of the borrowing which management intends to bring down), we expect incremental interest rate spreads for Magma to: (a) **Contract** by 50bps to 4.5% in FY12; and (b) **Expand** again to 5.0% in FY13 as the proportion of higher-yield products (used CVs, tractors and SME loans) increases in the disbursals from 19% in FY11 to 27% in FY13 and the cost of funds decreases due to a reversal in the interest rate cycle. This will lead to 28% CAGR in NII over FY11-FY13.

Exhibit 11: Incremental spreads to remain stable going forward

Product	FY11		FY12E		FY13E	
	As a % of disbursals	IRR (%)	As a % of disbursals	IRR (%)	As a % of disbursals	IRR (%)
Cars	24	13.0	28	14.8	27	14.3
CVs	36	11.6	30	13.4	28	12.9
Constr. Equipment	21	11	17	13.4	16	12.9
Used CVs	5	18.2	6	19.4	7	18.9
Tractors	9	19.6	13	20.6	15	20.1
SME Loans	6	16.2	6	17.8	7	17.3
Blended IRR		**13.2**		**15.1**		**15.0**
Cost of Funds		**8.2**		**10.6**		**10.0**
Spreads		**5.0**		**4.5**		**5.0**

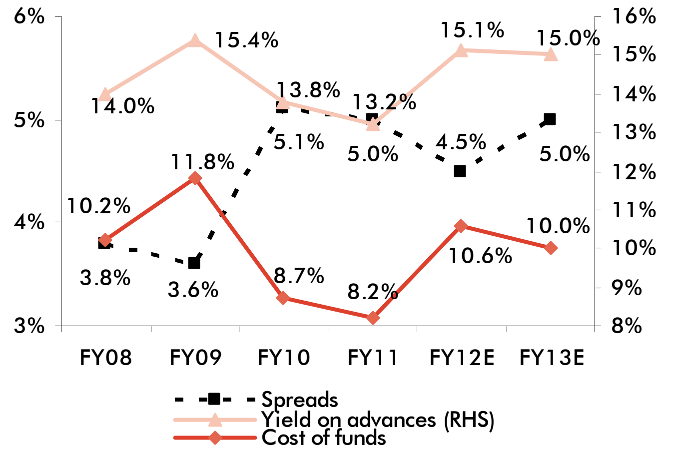
Source: Company, Ambit Capital research. The IRRs above are net of commission paid to brokers.

Exhibit 12: Magma's cost of funds rises with AAA bond yields



Source: Company, Bloomberg, Ambit Capital research. AAA yields are average of quarterly average yields on1-month, 3-month, 6-month, 1-year, 3-year, 5-year and 10-year AAA bonds.

Exhibit 13: However, higher yields could help Magma maintain incremental spreads



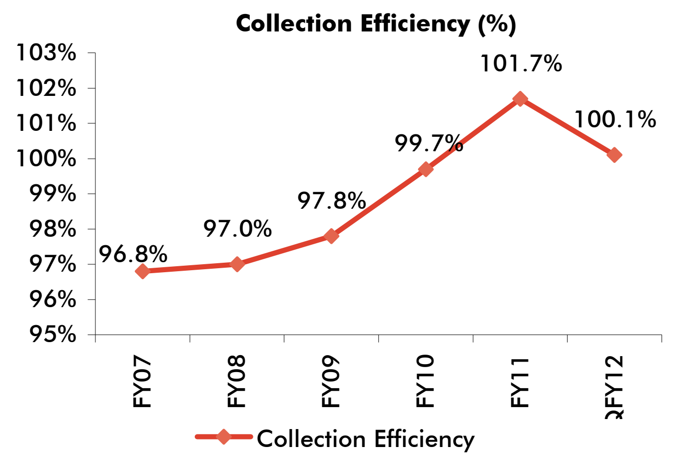
Source: Company, Ambit Capital research.

Credit costs to increase marginally

Historically, Magma has displayed among the strongest asset quality trends in the industry with credit costs being in the range 0.2%-0.8% of loan assets over the last five years. Even in the FY09 credit crisis, the credit costs for the company remained at just 0.8% of average assets. Magma's superior asset quality has been driven by:

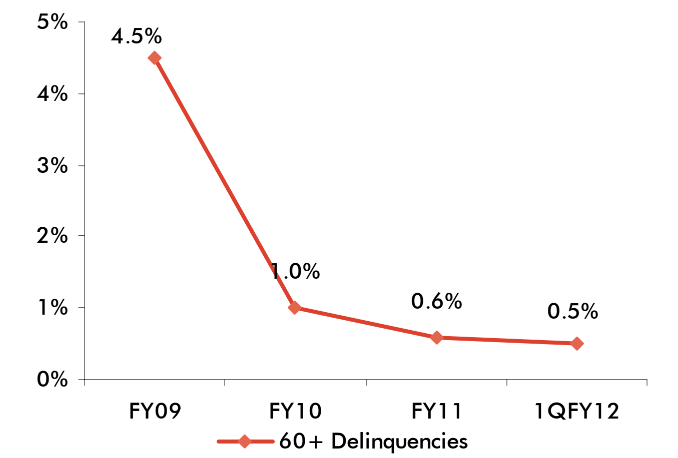
- A **unique business model** where credit origination, credit underwriting and recovery are three separate verticals (even at the branch level) thereby minimising any conflict of interest between different verticals.
- More than one-thirds the **compensation** of the credit underwriting team is based on the asset quality of the loans originated by the team.
- The underwriting team is responsible for **recoveries** in the first 15 months of loan origination when the chances of default are at the highest.
- No part of the credit origination and recovery process is **outsourced** apart from repossession of the vehicles.
- An **independent audit firm** has been hired to conduct random checks of documents and information submitted by the employees to minimize employee and customer fraud.
- The **delinquent loans** are categorized in different buckets based on the length of the delinquency; and each bucket has a dedicated recovery team.

Exhibit 14: Improving collection efficiency*



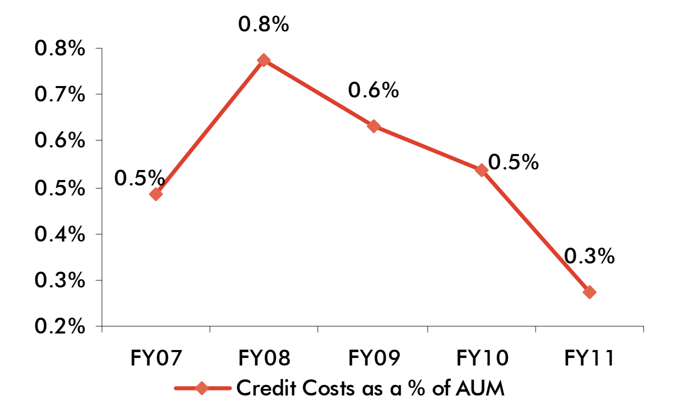
*Source: Company, Ambit Capital research. * Defined as amount collected as a % of amount due from borrowers*

Exhibit 15: Declining delinquencies (60+DPD*)



*Source: Company, Ambit Capital research * Defined as amount due after 60 days of scheduled payment as a % of total outstanding*

Exhibit 16: Declining credit costs



Source: Company, Ambit Capital research

Exhibit 17: Magma's credit costs are the lowest in the industry (write-offs and provisions as % of loan assets)

Company	FY08	FY09	FY10	FY11
M&M Finance	3.5%	3.7%	2.5%	1.3%
Shriram Transport	1.6%	1.4%	1.6%	1.7%
Magma Fincorp	**0.8%**	**0.6%**	**0.5%**	**0.3%**
Sundaram Finance	0.4%	0.5%	0.6%	0.3%
Cholamandalam Finance	2.3%	5.1%	5.4%	2.7%

Source: Company filings, Ambit Capital research

The improvement in Magma's credit quality is visible from the: (i) improved delinquency trends in the securitised loan pools sold by the company to banks; and (ii) decrease in credit enhancement required on these pools over FY08-2010.

Exhibit 18: Delinquency and credit enhancement requirement for the securitised loans pools originated by Magma

Year of origination of the pools	Median 12-month past securitisation 90 day+ delinquencies (%)	Median 24-month past securitisation 90 day+ delinquencies (%)	Median credit enhancement on the pools (%)
CY08	6.7	4.7	17.5
CY09	1.4	1.8	18.1
CY10	1.3	NA *	13.4

*Source: Crisil, Ambit Capital research. *Loans originated in 2010 have still not aged 24 months*

However, going forward we expect credit costs for Magma to rise to **57bps of the average loan assets** in FY12 and to **62bps in FY13**. Our expectation of higher credit costs are based on: **(i)** slight deterioration in credit quality in the CVs, cars and construction equipment segments due to adverse macroeconomic factors; **(ii)** higher proportion of tractors, used CVs and SME loans in the loan book, where historically credit costs have been relatively higher.

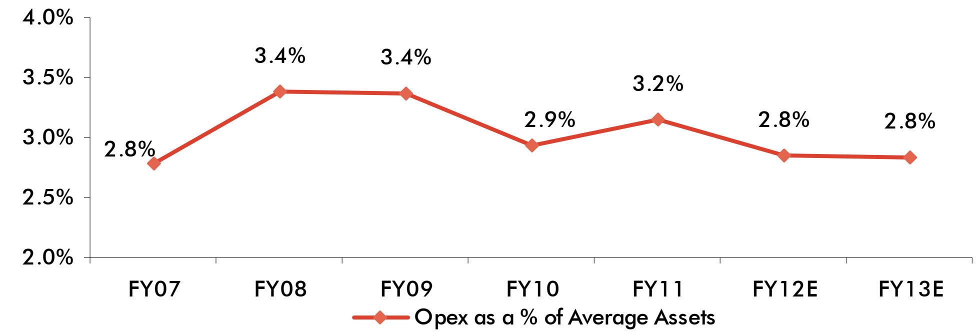
Operational efficiency to increase with scale

Operating expenses as a percentage of loan assets has ranged between 2.8%-3.4% over FY08-FY11 as the company has been continuously invested in its processes and manpower over the last four years (resulting in excellent asset quality despite rapid growth in the portfolio). However, going forward we believe that this ratio could come down to 2.8% of loan assets by FY2013 as:

- In the past year the company has invested in manpower in its recovery, back office and operations verticals keeping in mind future business expansion. Moreover, the company has also hired most of the relatively expensive middle management required for the new products such as tractors, used commercial vehicles and SME loans. The remaining hires needed to man new branches and expand the sales force for new products should not add meaningfully to employee expenses.
- The company has opened 20 new branches in the past year (~13% of overall branches) which are still not fully utilized.

As the company fully utilizes its branch network and its manpower, the operating expenses would be spread over a much larger asset base leading to decline in opex:loan assets ratio.

Exhibit 19: Operating efficiency to improve further with scale



Source: Company, Ambit Capital research

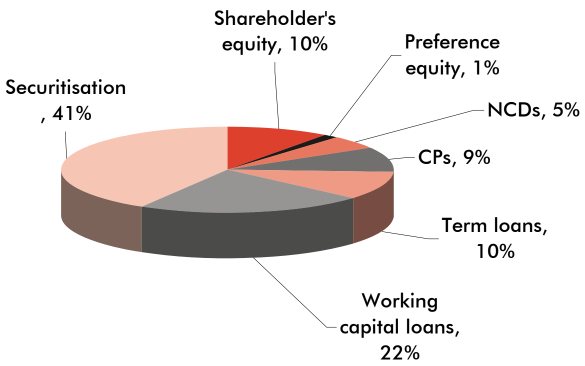
Capital raise should help expand NIM

The recent capital infusion by KKR and IFC of Rs4.4bn in 1QFY12 has enhanced Magma's net worth by 75% to Rs10.4bn and lifted its tier 1 ratio to 16.4% from 11.3%. This will also enhance Magma's NIMs by ~50bps and RoA by ~35bps due to lower interest expenses.

However, the leverage on the company's balance sheet is still relatively high at ~10x (compared with other NBFCs under our coverage universe which have a leverage in the range 4-8x). In spite of high leverage on the balance sheet, the healthy regulatory capital ratios of the company are driven by:

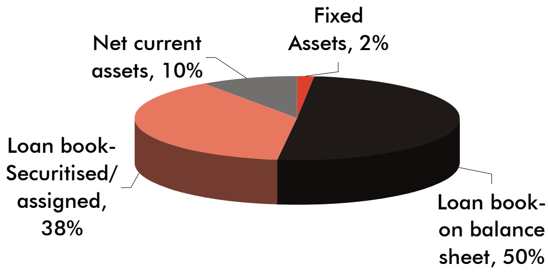
- 43% of Magma's loan assets are off its books (assigned or securitised to banks) and on these loans Magma does not provide any risk capital though the first loss risk on the portfolio assigned still lies with the company (note that this accounting treatment is not unique to Magma; all NBFCs follow the same practice)
- "subordinated unsecured non-convertible perpetual debentures" constitutes ~9% of the tier 1 capital of the company.

Exhibit 20: Magma Fincorp: Liability profile



Source: Company, Ambit Capital research.

Exhibit 21: Magma Fincorp: Asset profile



Source: Company, Ambit Capital research

Management is of the view that the company has adequate equity capital that should help it grow for the next two years. However, we believe that the company could need another infusion of equity capital in the next 12 months if there are regulatory changes in the priority sector status of securitisation/assignment deals and/or changes in the securitisation/assignment guidelines which could:

- Either **bring down** the amount of assets the company could securitise (eg. minimum holding period requirement before securitisation)
- Or **increase** the equity capital requirement for securitised/assigned assets (eg. bringing treatment of credit enhancement on assignments on a par with securitisation deals or deduction of credit enhancement from tier 1 capital etc).

However, we are not building in further capital infusion in our estimates as the company can maintain its regulatory capital ratios by issuing more perpetual debt instruments to maintain its tier 1 capital if required.

Key risks to our investment thesis

Change in securitisation guidelines: Historically Magma has dependent heavily on securitisation/portfolio assignments (where the company benefits from a cheaper source of funds and from a lower capital requirement) for its borrowing requirement. Currently ~41% of Magma's funding comes via the securitisation. Hence any regulatory changes related to securitisation could increase the cost of funds for the company by ~50bps and capital infusion might be required in early FY2013 to meet regulatory capital ratios. Whilst we are factoring nil securitisation going forward for our assumptions on the cost of funds for Magma, we have not factored in equity dilution in our estimates.

Higher-than-anticipated NPAs on the higher-yield portfolio: Our BUY argument on the stock hinges on the assumption that higher growth in higher yield portfolio (tractors, used CVs and SME loans) will not only increase the blended yields but would also bring down the opex to loan assets ratio with limited increase in the credit costs. Our expectation is that this sequence of events will lead to RoA enhancement for the company. However, if the delinquency levels in these high-yield segments go back to historical levels (60+ delinquencies were 9.7% for tractors and 6.9% for used CVs in March 2009), the impact of higher yields could be nullified by higher credit costs leading to no expansion in RoA going forward.

However, the comforting factors are: **(i)** Magma has already been through one credit cycle in the tractors and used CV segments and hence we believe should have altered its credit appraisal processes to contain higher NPA risk and; **(ii)** the yields on higher-yield segments are ~5% higher versus the existing products of Magma and hence deterioration in credit quality has to be significant for these products to be RoA dilutive for Magma.

Exhibit 22: Explanation for our flags on the cover page

Segment	Score	Comments
Accounting	AMBER	**What we like** Magma's NPA provisioning policy is amongst the best seen for NBFCs wherein the company writes off all 180+ days delinquent loans. From FY12 onwards the company has moved to a more conservative accounting norm and will amortise securitisation income over the life the securitised portfolio v/s the earlier practice of upfront booking of income. Our back-of-the-envelope calculation shows that reported net profits would be 35% below the earnings that the company would have had, had it continued with its earlier accounting policy. **What we don't like** The company is moving to more aggressive accounting policy in terms of expensing upfront commissions to third parties and will amortise the expense over the life of the asset irrespective of whether the asset is securitised or not. The company has not made provisions for the premium it will pay over face value while redeeming the preferential equity shares. However, the **book value of the company would be down by only 2%** if we deduct present value of future redemption premium it will pay for preference shares.
Predictability	GREEN	The recent past does not show any negative surprises from the company in terms of corporate governance, treatment of minority shareholders and earnings.
Earnings Momentum	GREEN	Whilst the net profits of the company will decrease in FY12 due to the accounting change mentioned above (i.e. scrapping the upfront booking of securitisation income), we expect the earnings of the company to grow at a CAGR of 44% of between FY11-FY13.

Source: Ambit Capital research

Key assumptions & estimates

Exhibit 23: Key assumptions and estimates for Magma (all figures in Rsmn unless otherwise mentioned)

	FY09	FY10	FY11	FY12E	FY13E	Comments
Assumptions						
YoY loan assets growth (%)	16	15	17	24	24	Loan assets to grow at a CAGR of 24% between FY11-FY13 driven by the company opening additional branches, rolling out existing products to additional branches and increased penetration in new products such as used CVs, tractors and SME loans.
Incremental spreads	3.6%	5.1%	5.0%	4.5%	5.0%	We expect spreads to fall in FY12 due to rising interest costs. However, we expect spreads to increase again to 5% due to the higher proportion of the higher yield portfolio in the loan book and lower funding costs in FY13.
Opex as a % average assets	3.4%	2.9%	3.2%	2.8%	2.8%	We expect operational efficiency to improve going forward as Magma has already invested in manpower and infrastructure which can support a much larger loan portfolio.
Credit costs as a % of average loan assets	0.63%	0.53%	0.27%	0.57%	0.62%	We expect an increase in credit costs going forward due to proportion of riskier assets increasing on the books in FY12 and a slight increase in credit costs in mature products due to deterioration in credit quality.
Key output (Rs mn)						
Net revenues	3,431	3,980	5,217	5,166	8,394	FY11-13 CAGR of 27% v/s FY09-11 CAGR of 23%
Operating profit	1,026	1,513	2,177	1,904	4,417	FY11-13 CAGR of 42% v/s FY09-11 CAGR of 46%
Profit after tax	328	630	1,089	707	2,265	FY11-13 CAGR of 44% v/s FY09-11 CAGR of 82%
Diluted EPS (Rs)	3.0	5.8	8.4	4.0	11.7	FY11-13 CAGR of 18% v/s FY09-11 CAGR of 67%

Source: Company, Ambit Capital research

Ambit v/s Consensus

Exhibit 24: Ambit v/s consensus

(Rs mn)	Consensus	Ambit	% difference
Net revenues			
FY12E	6,608	5,166	-22%
FY13E	9,201	8,394	-9%
Net profits			
FY12E	1,599	707	-56%
FY13E	2,391	2,265	-5%

Source: Bloomberg, Ambit Capital research

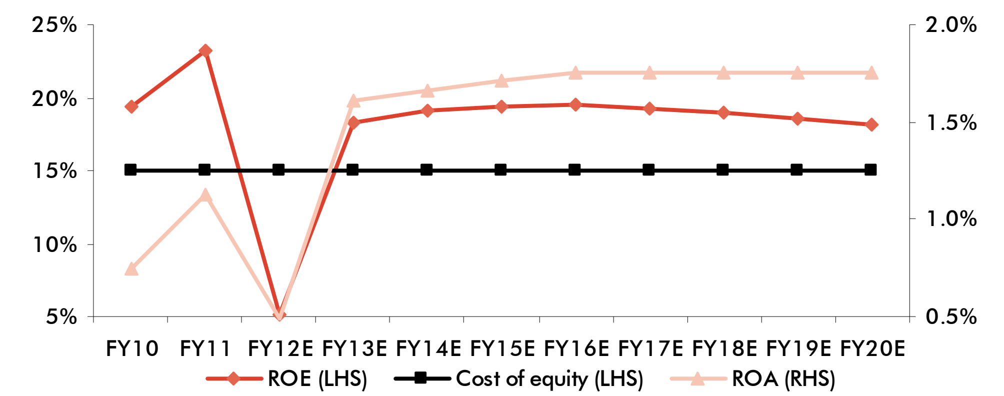
Our FY2012 estimates for revenue at 22% and for net profit at 56% are below consensus estimates respectively driven by our lower loan growth and lower interest rate spreads v/s consensus. However, the consensus estimates from Bloomberg contains data from only three brokers and hence might not be a true representative of the overall market expectations on company's earnings.

Valuation

We have valued Magma using the excess return to equity model which is *'net profits – (cost of equity x average net worth)'* for all the future years discounted back to the present using cost of equity and added to current networth.

- We have explicitly forecasted net profits for FY2012 and FY2013 based on the assumptions in exhibit 23.
- Between FY13-FY16 we have assumed a 20% CAGR in loan growth and have faded it to 15% by FY2021.
- We have assumed RoA expansion by 5bps every year from FY13-FY16 to 1.75% by FY16 and have assumed 1.75% as sustainable RoA for the company.
- We have assumed that the company will not raise any capital and will use internal accruals to maintain its capital adequacy ratio.
- We have assumed cost of equity of 15% and terminal growth of 4%

Exhibit 25: RoA and RoE profile of Magma



Source: Company, Ambit Capital research

Based on these assumptions our excess return model values Magma at **Rs91 per share (implied FY13 P/B of 1.3x and FY13 P/E of 7.7x)**, implying 27% upside from current levels.

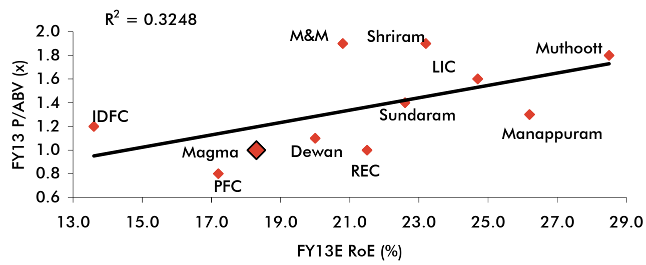
Exhibit 26: Magma trades at a discount to peers

	Price (local currency)	Market cap (US$ bn)	ROA (%) FY12E	ROA (%) FY13E	ROE (%) FY12E	ROE (%) FY13E	P/BV (x) FY12E	P/BV (x) FY13E	P/E (x) FY12E	P/E (x) FY13E
NBFC peer group (Bloomberg ticker)										
Power Finance Corporation (POWF IN)	143	4.3	2.7	2.7	17.5	17.2	0.9	0.8	5.9	4.9
REC (REC IN)	178	3.8	3.1	3.1	21.3	21.5	1.2	1.0	6.0	5.1
IDFC (IDFC IN)	109	3.6	2.8	2.7	12.4	13.6	1.4	1.2	12.0	10.0
Dewan Housing Finance (DEWH IN)	217	0.5	1.7	1.7	18.0	20.0	1.3	1.1	7.5	5.8
LIC Housing Finance (LICHF IN)	200	2.2	1.9	1.9	24.0	24.7	1.9	1.6	8.5	6.9
Shriram Transport Finance (SHTF IN)	607	3.0	3.0	3.0	24.1	23.2	2.3	1.9	10.4	8.9
M&M Finance (MMFS IN)	619	1.4	3.6	3.6	20.1	20.8	2.2	1.9	11.9	9.8
Manappuram Finance	47	0.9	4.6	4.7	22.9	26.2	1.7	1.3	8.2	5.6
Muthoot Finance (MUTH IN)	179	1.5	3.3	3.4	33.2	28.5	2.4	1.8	9.9	7.1
Sundaram Finance (SUF IN)	525	0.6	2.4	2.5	22.0	22.6	1.7	1.4	9.2	7.8
Average of the above			**2.9**	**2.9**	**21.5**	**21.8**	**1.7**	**1.4**	**8.9**	**7.2**
Magma Fincorp (MGMA IN)	72	0.3	0.5	1.6	5.2	18.3	1.2	1.0	18.0	6.2
Premium (discount) to above			**-83%**	**-45%**	**-76%**	**-16%**	**-29%**	**-29%**	**101%**	**-14%**

Source: Bloomberg, Ambit Capital. The forward estimates for IDFC, Shriram Transport, M&M Finance, Manappuram and Magma are based on Ambit estimates

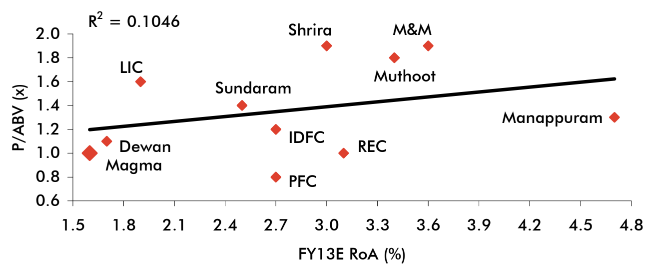
At 1.2x FY13 P/BV, Magma is trading at 29% discount to peers on FY13 P/BV despite the RoE being just 16% below that of peers'. However, as explained earlier the discount is probably driven by comparatively lower RoAs of Magma v/s peers. As explained in the earlier section, Magma's expected RoA expansion should drive the rerating of the stock going forward.

Exhibit 27: Magma is trading at a discount on the RoE/PB metric …



Source: Bloomberg, Ambit Capital research. RoE and BVPS estimates for IDFC, Shriram Transport, M&M Finance, Manappuram and Magma are based on Ambit estimates

Exhibit 28: … and the discount appears to be driven by lower RoA



Source: Bloomberg, Ambit Capital research. RoA and BVPS estimates for IDFC, Shriram Transport, M&M Finance, Manappuram and Magma are based on Ambit estimates

Balance sheet

Year to March (Rs mn)	FY09	FY10	FY11	FY12E	FY13E
Sources of funds					
Shareholders' funds	**2,965**	**3,522**	**5,847**	**11,349**	**13,463**
Preference equity	1,161	1,161	1,469	1,469	1,469
Minority interest	42	52	98	134	238
Loan funds	**74,724**	**84,727**	**96,072**	**112,673**	**140,432**
On book loans	25,066	36,543	45,924	83,362	122,516
Loans through securitisation	49,658	48,183	50,148	29,311	17,916
Total sources of funds	**78,910**	**89,462**	**103,487**	**125,560**	**155,584**
Application of funds					
Fixed assets	2,382	2,080	1,871	1,845	1,865
Cash and equivalents	9,315	9,901	10,189	10,632	13,211
Loan book	**70,842**	**81,723**	**95,672**	**118,345**	**147,046**
On book loans	21,184	33,540	45,524	89,033	129,131
Securitised loans	49,658	48,183	50,148	29,311	17,916
Net current assets	(3,629)	(4,241)	(4,245)	(5,262)	(6,539)
Total application of funds	**78,910**	**89,462**	**103,487**	**125,560**	**155,584**
Outstanding number of shares (mn)	109	109	130	190	190
Book value per share (Rs)	27	32	45	60	71

Source: Company, Ambit Capital research

Income statement

Year to March (Rs mn)	FY09	FY10	FY11	FY12E	FY13E
Income from operations	5,747	6,566	8,190	10,930	17,520
Interest expense	2,880	3,250	3,523	6,415	9,933
Net income from operations	**2,867**	**3,316**	**4,667**	**4,515**	**7,587**
Other income	564	665	550	651	808
Total net income	**3,431**	**3,980**	**5,217**	**5,166**	**8,394**
Expenditure	**2,405**	**2,467**	**3,040**	**3,262**	**3,977**
Employee cost	999	1,053	1,346	1,594	1,862
Other operating expenses	1,406	1,414	1,693	1,668	2,115
Operating profit	**1,026**	**1,513**	**2,177**	**1,904**	**4,417**
Bad debts and provisions	415	408	356	691	895
Profit before tax	**611**	**1,105**	**1,822**	**1,214**	**3,522**
Taxes	212	392	601	395	1,145
Profit after tax	**398**	**713**	**1,221**	**819**	**2,377**
Minority Interest	2	13	20	36	104
Dividend for preference equity	70	70	112	112	112
Net profit	**328**	**631**	**1,089**	**707**	**2,265**
Basic EPS	3.0	5.8	8.6	4.1	11.9
Diluted EPS	3.0	5.8	8.4	4.0	11.7
Weighted average number of shares-Basic	109	109	127	174	190
Weighted average number of shares-Diluted	109	109	130	177	193

Source: Company, Ambit Capital research

Ratio analysis

Year to March (%)	FYO9	FY10	FY11	FY12E	FY13E
Disbursal growth (YoY)	5%	24%	19%	29%	24%
Loan growth (YoY)	16%	15%	17%	24%	24%
Gross yield*	14.7%	18.0%	14.9%	16.2%	16.1%
Cost of funds*	10.2%	12.3%	9.1%	10.5%	10.0%
Spread*	4.5%	5.7%	5.9%	5.7%	6.1%
NIM*	4.0%	3.9%	6.0%	6.7%	7.0%
Cost to income ratio	70.1%	62.0%	58.3%	59.1%	46.1%
Opex as a % loan assets	3.36%	2.93%	3.15%	2.85%	2.83%
Credit costs as a % of loan assets	0.63%	0.53%	0.27%	0.57%	0.62%
CAR	17.3%	14.9%	18.2%	16.1%	15.3%
Tier I	9.2%	8.6%	11.3%	12.2%	10.2%
Tier II	8.1%	6.3%	6.9%	3.9%	5.1%

*Source: Company, Ambit Capital research. *Gross yield, cost of funds, spread and NIM are on calculated basis*

Valuation

Year to March (%)	FYO9	FY10	FY11	FY12E	FY13E
P/E	24.0	12.5	8.6	18.1	6.1
P/BV	2.6	2.2	1.6	1.2	1.0
ROA (%)	0.5%	0.7%	1.1%	0.6%	1.6%
ROE (%)	11.5%	19.4%	23.3%	8.2%	18.3%

Source: Company, Ambit Capital research

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