

12 December 2011

## Non-Banking Finance Companies

*Mission possible: The rural protocol*

**Overweight**

Sensex: 16488

Nifty: 4944

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The operating environment of retail NBFCs is likely to improve over the next 12 months, led by an expected dip in inflation, easing monetary policy stance and falling wholesale borrowing rates. Regulatory issues, barring priority-sector status, are near finalization and are unlikely to have a material impact on earnings. In addition, our NBFC coverage universe is strategically poised to cash in on rising rural demand. At current valuations, the risk-reward appears favourable for these stocks. We initiate coverage on the sector with a positive stance. Top picks: M&M Financial Services (MMFS) and Shriram City Union Finance (SCUF).

- Macro headwinds to ease.** We expect the economic environment to improve, led by falling inflation (estimated to soften to 7% by Mar '12), easing monetary policy stance (estimated ~100bps CRR cut by Mar '12) and falling wholesale borrowing rates. This is likely to drive growth in NBFCs.
- Regulatory issues unlikely to impact earnings.** Regulatory changes regarding capital adequacy, NPA recognition norms and securitization are unlikely to materially impact the earnings of our NBFC universe. We see little possibility of a complete curb on priority sector status on securitization, given: 1) the importance of lending to under-banked regions/credit-starved sections of society and 2) the necessity of meeting priority-sector lending criteria for foreign/small private-sector banks.
- Strategically poised to cater to rising rural demand.** Our coverage universe of retail NBFCs has strong parentage and several decades of expertise. The NBFCs have built large-scale franchises and have improved loan origination and risk management processes. They are now strategically placed to reap the benefit of greater rural demand due to rising food prices, high minimum support prices and rising government expenditure on rural projects and employment-generating schemes.
- Top picks: MMFS (Buy; TP: ₹845) & SCUF (Buy; TP: ₹680).** Our preference is for wholesale funded retail NBFCs (backed by secured assets) over banks and infrastructure NBFCs. At current valuations, the risk-reward favours NBFCs. We initiate coverage on Magma (Buy; TP: ₹80), SCUF (Buy; TP: ₹680), Chola Finance (Buy; TP: ₹181) and Bajaj Finance (Sell; TP: ₹712).

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Key data	Rating	Price (₹)**	Target price (₹)	M cap (US\$bn)	PE (x)*	PBV (x)*	RoE*
MMFS	Buy	686	845	1.4	9.8	2.0	22.3
STFC	Buy	554	700	2.5	8.4	1.7	22.6
Magma	Buy	56	80	0.2	5.4	0.8	16.5
SCUF	Buy	512	680	0.5	5.9	1.3	25.4
Bajaj Finance	Sell	660	712	0.5	5.1	1.1	24.4
Chola Finance	Buy	133	181	0.4	8.7	1.1	15.1

Source: Company, Anand Rathi Research Note: \*FY13e; \*\*Prices as of 8<sup>th</sup> December 2011

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# Non-Banking Finance Companies

## *Mission possible: The rural protocol*

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## Investment argument and valuation

The operating environment of retail NBFCs is likely to improve over the next 12 months, led by an expected dip in inflation, easing monetary policy stance and falling wholesale borrowing rates.

Regulatory issues, barring priority-sector status, are near finalization and are unlikely to have a material impact on earnings. In addition, our NBFC coverage universe is strategically poised to cash in on rising rural demand. At current valuations, the risk-reward appears favourable for these stocks. We initiate coverage on the sector with a positive stance. Top picks: M&M Financial Services (MMFS) and Shriram City Union Finance (SCUF).

### Macro-economic environment to ease

*With easing inflation and policy action (CRR, repo cut), the wholesale cost of funds is likely to drop*

The economic environment is likely to improve, led by falling inflation, easing monetary policy stance and falling wholesale borrowing rates. This is expected to drive growth for retail NBFCs.

We expect inflation to soften to 7.5% by Mar '12 due to lower prices and the high base of the past year. With lower inflation, we expect policy action by RBI over the next six months – such as a cut in repo rate and liquidity measures. Lower policy rates and liquidity measures are likely to bring down the wholesale cost of funds. With the lower cost of funds, margins are expected to increase in FY13.

### Regulatory issues near finalization

#### RBI recommendations unlikely to impact earnings

*Higher capital requirement and provisioning norms are not likely to have a major earnings impact*

The RBI's working group recommendations – on higher provisioning norms, high tier-1 capital, and guidelines for securitization and assignment transaction – are unlikely to materially affect the earnings of our retail NBFC universe.

1. **Stringent provisioning norms:** The RBI working group has suggested that NPA provisioning guidelines for NBFCs should be in line with those of banks. The recommendations, if implemented, would require NBFCs to recognize NPAs on a 90-day basis (from 180/360 days currently). NBFCs would also have to make high standard-asset provisioning. (Banks make 0.4% standard assets provisioning; NBFCs make 0.25%.)

However, we believe the increase in gross NPAs would be mainly technical. A large part of gross NPAs would be concentrated in the first bracket of sub-standard assets (which attracts 15% provisioning requirement). The existing higher NPA coverage for most NBFCs (2QFY12) is likely to limit credit costs for increased gross NPAs. We expect delinquencies to increase due to the slowing economy and higher interest rates. We estimate ~5% impact on earnings for FY12/13 due to the increased provisioning requirement as a result of the slowing economy and the RBI's proposed changes.

2. **High tier-1 capital:** The committee has also recommended that the minimum tier-1 requirement for all NBFCs be increased to 12% (from 10% currently). Most NBFCs in our coverage universe have maintained higher tier-1 capital in order to obtain a higher credit rating. Thus, the short-term impact would be limited. The RBI has

stated that the higher requirement of capital adequacy should be met over three years, giving the NBFCs sufficient time frame.

- 3. Securitization and assignment:** We view the draft guidelines as less stringent than earlier guidelines and market expectations, in terms of minimum holding period and minimum retention requirement. The crux of securitization/assignment transactions in India is to meet priority-sector targets. Credit enhancements may become difficult under assignment transactions and result in lower credit rating. We do not see a sharp drop in securitization yield, even if a portfolio is rated lower than AAA, as the demand for such transactions is vast.

**Complete curb on regulatory arbitrage unlikely**

We see little possibility of a complete curb on priority-sector status regarding securitization, given (1) the importance of lending to under-banked regions/credit-starved sections of society and (2) the necessity of meeting priority-sector lending criteria for foreign/small private-sector banks.

**Strategically placed to cater to rising rural demand**

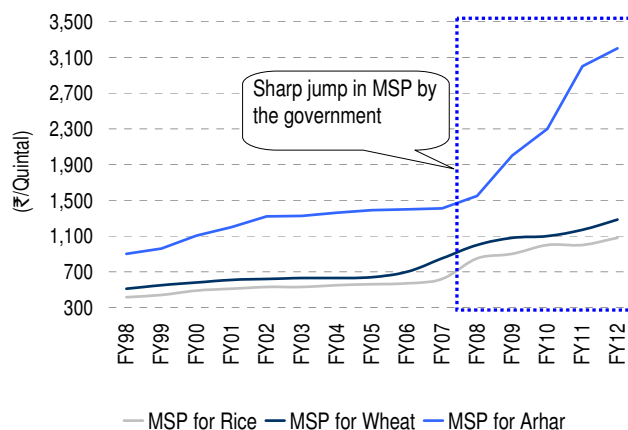
Rural India’s share in overall GDP is around 50%. Within this, nearly 40% of rural income arises from agriculture. As a result, high food prices imply a considerable rise in rural income.

*Rural income growth to be robust given increased government thrust and high food prices*

In addition, the greater thrust of the government towards rural India has been a boon to the rural economy. The Central government’s flagship Mahatma Gandhi National Rural Employment Guarantee Scheme has resulted in significant higher disposable incomes for the rural population. The scheme has also set a floor for wages of rural unskilled workers and, thereby, substantially enhanced income and food demand, even among the lowest income stratum of the rural economy.

The government has consistently raised the minimum support price (MSP) of food grains. MSP for various food grains such as *arhar*, wheat and rice has risen substantially since FY07.

**Fig 1 – Steep increase in minimum support prices**



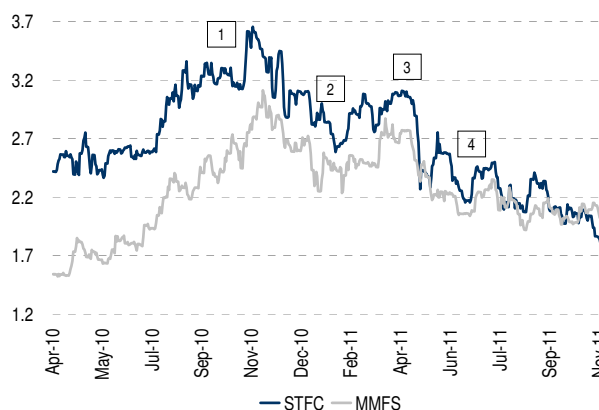
Source: The Government of India

Our coverage universe of retail NBFCs has strong parentage and 2-3 decades of expertise in the business. With large-scale franchises built over several years and improved loan-origination and risk-management processes, retail NBFCs are strategically poised to reap the benefits of mounting rural demand.

## Valuation

Retail NBFCs have undershot Oct '10 peaks given concerns over regulatory changes, fears of a slowing economy and higher interest rates.

**Fig 2 – PBV of NBFC coverage universe following various RBI announcements**



1. RBI starts tightening policy rates aggressively;
2. RBI sets up a panel to examine regulation of NBFCs;
3. Removal of priority-sector status on bank loans to NBFCs;
4. A 50-bp increase in policy rates; GDP downgrades.

Source: Companies, The RBI, Anand Rathi Research

However, we are of the view that, with easing concerns regarding regulations and macro economic conditions, retail NBFCs are likely to perform better over infrastructure NBFCs and banks.

We have used the two-stage dividend-discount model (DDM) to arrive at our price target, as we expect our NBFC universe to witness higher asset growth than RoE (post-dividend).

Our assumptions for normalized RoE are based on the RoE that NBFCs can sustainably generate, long term. Our assumptions of a risk-free rate (Rf) and a market-risk premium (Rm) are 8% and 7%, respectively.

**Fig 3 – NBFCs: Dividend-discount model (DDM) assumptions**

	MMFS	STFC	Magma	SCUF	BAF	CIF
Terminal growth (%)	5.0	5.0	5.0	5.0	5.0	5.0
Risk-free rate (Rf) (%)	8.0	8.0	8.0	8.0	8.0	8.0
Risk premium (Rm) (%)	7.0	7.0	7.0	7.0	7.0	7.0
Beta (x)	1.1	1.1	1.3	1.2	1.2	1.0
CoE (%)	15.7	15.7	16.8	16.1	16.4	15.3
EPS CAGR FY11-FY16 (%)	27.2	19.1	19.1	26.9	24.4	40.6
EPS CAGR FY16-FY20 (%)	17.4	15.1	11.6	12.9	8.7	9.5
Price target (₹)	845	700	80	680	712	181
BV FY13 (₹)	343	318	68	381	585	121
Implied target P/BV (x)	2.5	2.2	1.2	1.8	1.2	1.5
Recommendation	Buy	Buy	Buy	Buy	Sell	Buy

Source: Anand Rathi Research

## Risks

- A slowing economy could curtail business-growth prospects for NBFCs.
- Retail asset financing NBFCs lend to riskier asset classes. The economic slowdown could raise the delinquency rate and, subsequently, increase credit costs.
- Unlike banks, NBFCs depend on non-retail borrowing. A tighter liquidity scenario would not only increase the cost of funds, but also curb growth prospects (due to shortage of funds).
- An adverse recommendation by the RBI-appointed committee to review priority-sector status for various types of loans (including loans sold by NBFCs to banks) could hit the return ratios of NBFCs and, therefore, their valuations.

## Recommendations

### M&M Financial Services (Buy; Target Price: ₹845)

The robust loan growth of M&M Financial Services (MMFS) is likely to continue, backed by strong rural demand due to rising disposable incomes in rural/semi-urban regions. Asset quality is robust and we estimate credit costs at 2.1-2.4% over FY11-14. Despite a ~70-bp NIM contraction due to higher borrowing cost, we estimate net profit at 24% CAGR and healthy profitability, with an RoE of ~22% over FY11-14.

We estimate strong RoA and RoE at 3.5%+ and 22%+, respectively, in FY13/14. At current valuations, the risk-reward equation favours MMFS. Greater profitability and easing macro-economic concerns would drive valuation up. Our price target of ₹845 is based on the two-stage DDM (CoE: 15.7%; beta: 1.1; Rf: 8%). At our target price, the stock would trade at a PBV of 3x FY12e and 2.5x FY13e.

### Shriram Transport Finance (Buy; Target Price: ₹700)

We expect Shriram Transport Finance's (STFC) loan growth to slow down in the next 12 months, due to higher interest rates and a slowing economy. Credit costs are likely to be high in FY12/13 due to the RBI-proposed prudential norms and issues in the southern mining belt. However, we believe that concerns regarding loss of priority-sector status on securitizations are overdone. We lower our FY12/13 EPS estimates by ~8% and our target price from ₹845 to ₹700. The risk-reward equation is favourable for STFC's strong retail franchise.

Our price target of ₹700 is based on the two-stage DDM (CoE: 15.7%; beta: 1.2; Rf: 8%). At our target price, the stock would trade at a PBV of 2.7x FY12e and 2.2x FY13e.

### Magma Fincorp (Buy; Target Price: ₹80)

Magma Fincorp's all-India operations in under-banked areas and its multiple products offer vast growth potential. We expect its balance sheet to expand two-and-a-half times by FY14. Consistent improvement in profitability from FY13 is expected to drive valuations up.

Our price target of ₹80 is based on the two-stage DDM (CoE: 16.8%; beta: 1.25; Rf: 8%). At our target price, the stock would trade at a PBV of 1.3x FY12e and 1.2x FY13e.

**Shriram City Union Finance (Buy; Target Price: ₹680)**

With over 650 branches (its own and those of the Group), Shriram City Union Finance (SCUF) is poised to benefit from rural prosperity. Strong loan growth, cost efficiencies and stable asset quality should support superior profitability over FY11-14. We estimate the RoA at a superior ~3% and RoE at 25% (up from 22%) over FY11-14 on increased leverage. SCUF, being a strong consumer retail franchise, is attractively priced at a PBV of 1.7x FY12e and 1.3x FY13e.

Our price target of ₹680 is based on the two-stage DDM (CoE: 16.1%; beta: 1.15; Rf: 8%). At our target price, the stock would trade at a PBV of 2.2x FY12e and 1.8x FY13e.

**Bajaj Finance (Sell; Target Price: ₹712)**

We expect Bajaj Finance's loan growth to slow down and margins to decline from FY13, given the high interest rates, a slowing economy and the change in loan mix. Higher slippages and credit cost are likely to result in lower profitability in FY13e/14e than in FY12. Bajaj Finance has focused on a variety of products with no niche expertise. This is in contrast to most NBFCs that have an edge over banks due to their niche expertise that, in turn, justifies the premiums. Within the NBFC sector, we prefer stocks of companies that have penetrated under-banked regions in India and have built up a superior model in the last 2-3 decades.

Our price target of ₹712 is based on the two-stage DDM (CoE: 16.4%; beta: 1.2; Rf: 8%). At our target price, the stock would trade at a PBV of 1.5x FY12e and 1.2x FY13e.

**Cholamandalam Investment and Finance (Buy; Target Price: ₹181)**

After having consolidated its personal loan portfolio over FY08-10, Cholamandalam Investment and Finance (CIF) has embarked on significant branch addition and has focused on the middle and lower income segment in rural India. This, coupled with the introduction of high-yielding new products, is expected to drive robust loan CAGR of 34% over FY11-14. NIM improvement led by greater exposure to high-yield assets, coupled with strong loan growth and lower provisioning, is likely to drive RoA to 1.6% by FY14 (from 0.7% in FY11).

Our price target of ₹181 is based on the two-stage DDM (CoE: 15.3%; beta: 1.04; Rf: 8%). At our target price, the stock would trade at a PBV of 1.8x FY12e and 1.5x FY13e.

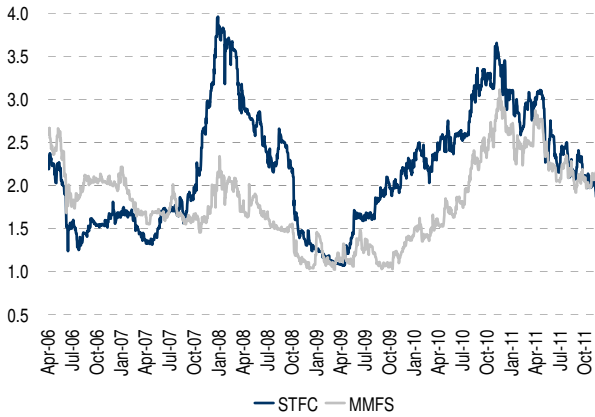
**Fig 4 – Valuations: Non-banking finance companies**

		MMFS	STFC	Magma	SCUF	BAF	CIF
Current price	₹	686	554	56	512	660	133
Market cap	₹bn	70	125	10	25	24	22
	US\$bn	1.4	2.5	0.2	0.5	0.5	0.4
Target price	₹	845	700	80	680	712	181
Upside	%	23.2	26.4	42.1	32.8	7.9	36.1
Recommendation		Buy	Buy	Buy	Buy	Sell	Buy
FY11-14 EPS CAGR	%	23.8	13.9	18.7	29.9	32.5	58.1
P/BV (x)	FY11	2.8	2.6	1.3	2.1	1.8	8.8
	FY12	2.4	2.1	0.9	1.7	1.4	1.3
	FY13	2.0	1.7	0.8	1.3	1.1	1.1
P/E (x)	FY11	15.2	10.2	6.4	10.5	9.8	25.5
	FY12	12.2	9.9	8.5	7.6	6.0	10.4
	FY13	9.8	8.4	5.4	5.9	5.1	8.7
RoA (%)	FY11	4.1	4.2	2.2	3.1	3.8	0.7
	FY12	3.7	3.6	1.7	3.0	4.0	1.4
	FY13	3.7	3.6	2.0	3.0	3.7	1.5
RoE (%)	FY11	22.0	28.2	24.8	21.9	19.7	6.7
	FY12	21.3	23.3	14.1	24.5	26.4	13.5
	FY13	22.3	22.6	16.5	25.4	24.4	15.1
BV (₹)	FY11	243	217	44	245	371	90
	FY12	286	263	61	304	470	100
	FY13	343	318	68	381	585	121
EPS (₹)	FY11	45	54	9	49	67	5
	FY12	56	56	7	67	111	13
	FY13	70	66	10	87	128	15
Dividend yield (%)	FY12	1.6	1.4	1.8	1.4	1.8	1.5
	FY11	4.6	2.6	0.0	1.9	4.3	2.6
Gross NPAs (%)	FY12	5.0	3.0	0.0	2.0	4.7	2.7
	FY13	5.5	3.8	0.0	2.4	6.5	2.1
	FY11	0.6	0.4	0.0	0.4	1.1	0.3
Net NPAs (%)	FY12	1.2	0.3	0.0	0.4	1.2	0.3
	FY13	1.3	0.2	0.0	0.4	1.2	0.3

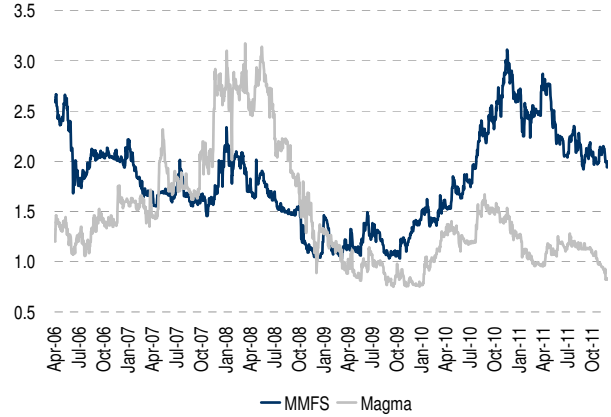
Source: Bloomberg, Company, Anand Rathi Research

**Fig 5 – Intra-company PBV band**

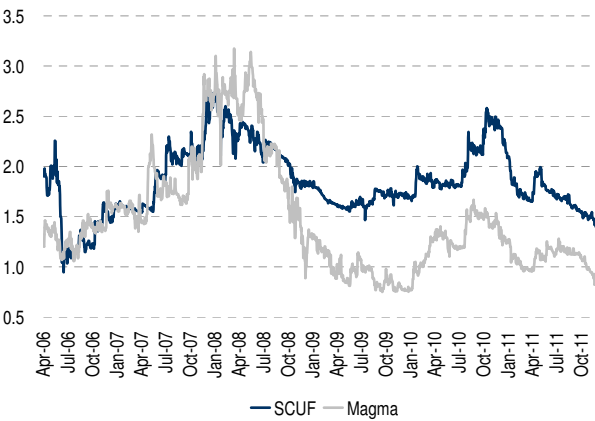
**MMFS vs STFC**



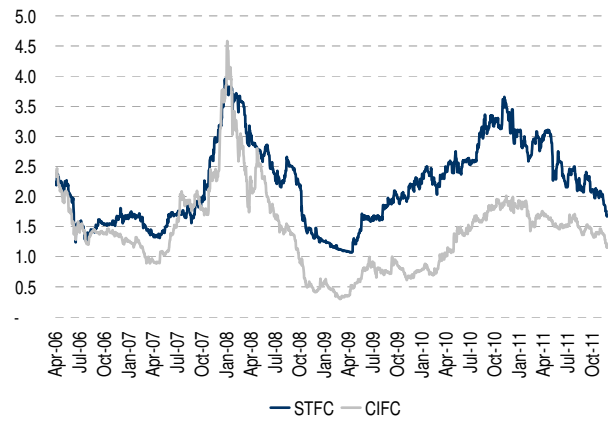
**MMFS vs Magma**



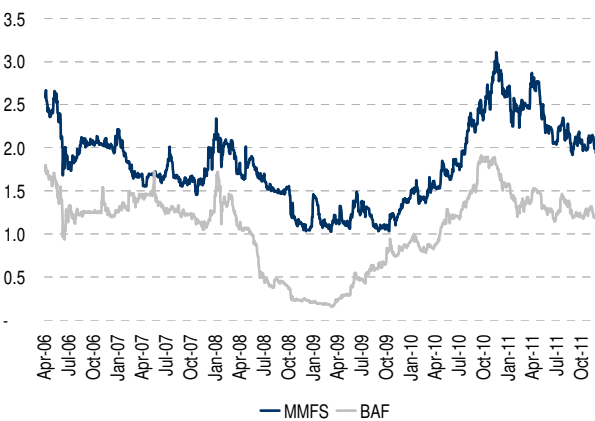
**SCUF vs Magma**



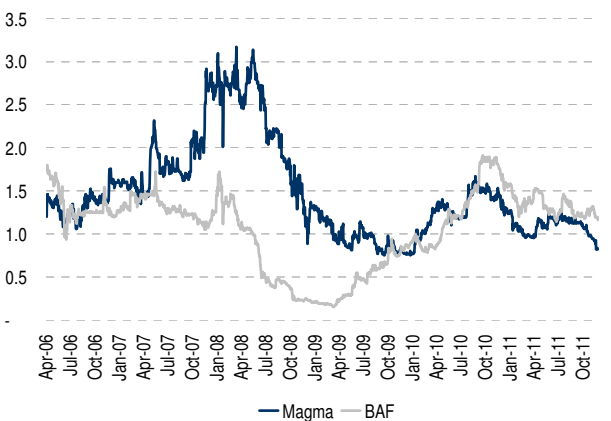
**STFC vs CIF**



**MMFS vs BAF**



**Magma vs BAF**



Source: Bloomberg, Anand Rathi Research

## Macro headwinds to ease

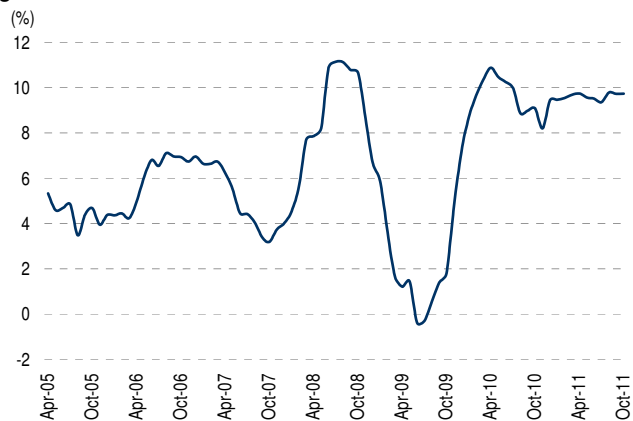
We expect the economic environment to improve, led by falling inflation, easing monetary policy stance and falling wholesale borrowing rates. This is likely to drive growth for retail NBFCs.

### Inflation to soften

Wholesale price index (WPI) and consumer price index (CPI) based-inflation have accelerated and turned volatile since '08, following a stable and low inflationary environment during '00-07. In recent years, the spike in food prices has been a major reason for the rise in average inflation in India as also in many other emerging market economies.

Cost-push pressures due to high commodity prices globally and demand-pull pressures due to strong growth in private consumption and exports in FY11 had increased the price pressure on manufactured products. Along with these, the lack of pick-up in industrial capex resulted in high prices of manufactured goods.

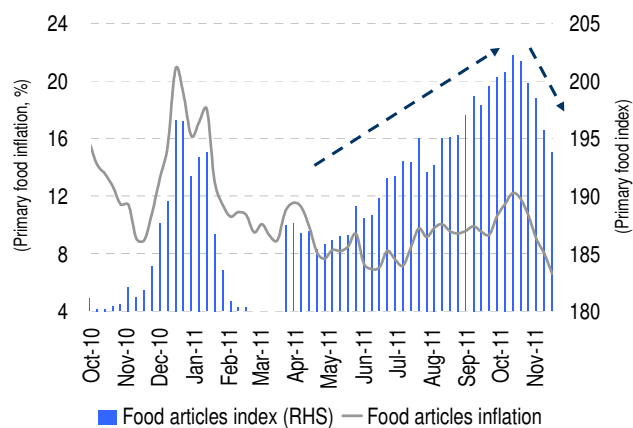
**Fig 6 – High inflation since Dec '09**



Source: Gol, RBI, Anand Rathi Research

A bumper *kbharif* crop, which hit the market in Nov '11, has led to softening of food prices in the last five weeks. Primary food article index inflation has corrected from 12.2% in Oct '11 to 6.6% in Nov '11.

**Fig 7 – Food inflation has softened in the last one month**

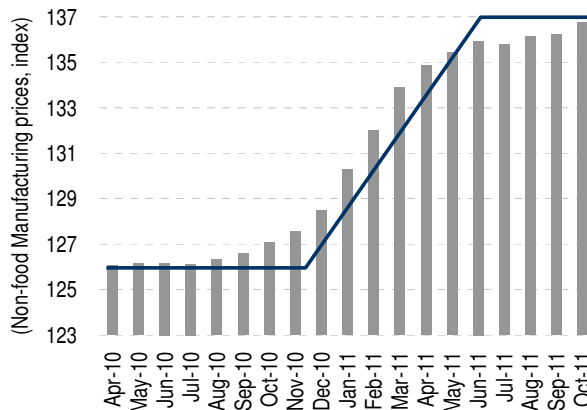


Source: Gol, RBI, Anand Rathi Research

Following a sharp rise between Nov '10 and Jun '11, manufactured product prices have started stabilizing in the last five months. A slowdown in domestic activities would keep the manufactured products prices contained, going forward. Our economist expects that WPI inflation would soften below 8% by Jan '12 and to ~7% by the end of FY12.

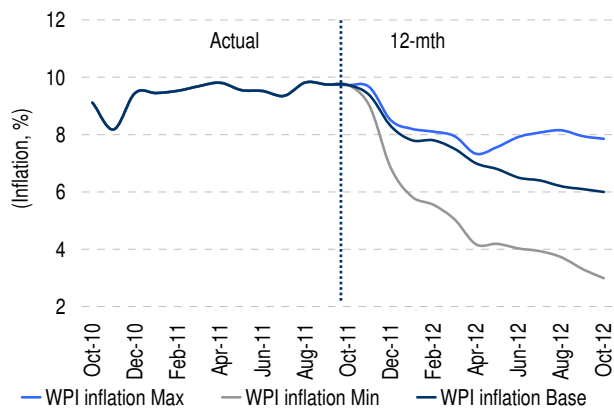
This, coupled with a strong favorable base effect, would lead to a sharp softening of the overall WPI inflation in next three months.

**Fig 8 – Manufactured product prices have been contained in the last 5 months**



Source: Gol, RBI, Anand Rathi Research

**Fig 9 – Inflation to soften (%)**



Source: Gol, RBI, Anand Rathi Research

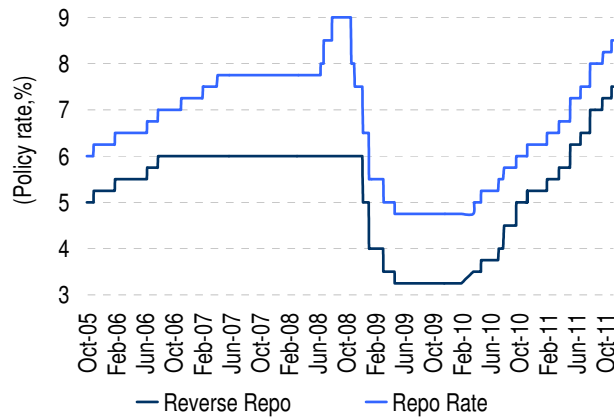
## Easing monetary stance

### Strong monetary tightening since Feb '10

*Effective policy rate has risen by 525bps since Feb '10*

In a bid to normalize policy rates from the global-economic-crisis-induced lows and to anchor rising inflationary expectations, the RBI has raised policy rates 12 times since Feb '10. The repo rate (at which banks borrow from the RBI) has been raised by 375bps, from 4.75% in Feb '10 to 8.5% in Oct '11. The reverse repo rate (at which banks park funds with the RBI) has been increased by 425bps, from 3.25% in Feb '10 to 7.5% in Oct '11. Moreover, between Dec '08 and May '10, due to the liquidity-surplus situation, reverse-repo was the operating policy rate. The liquidity situation has remained persistently in deficit mode since Jun '10, which has made repo the operating policy rate. Therefore, the effective increase in policy rate was 525bps – from 3.25% in Feb '10 to 8.5% in Jan '11. Along with rate tightening, the RBI has also raised the cash reserve ratio (CRR), the statutory cash balance of banks with the RBI, by 100bps.

**Fig 10 – Key policy rates on the rise since Feb '10**



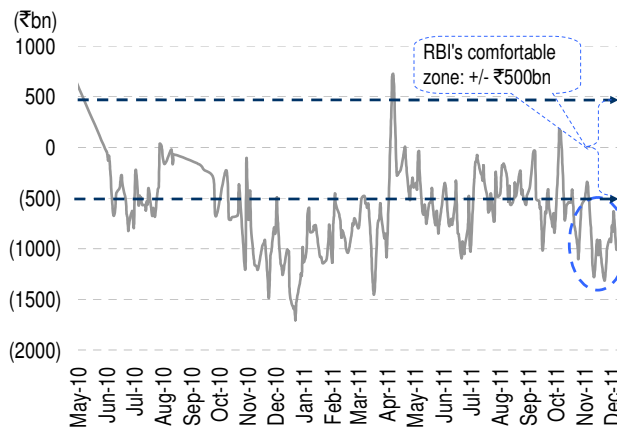
Source: RBI, Anand Rathi Research

**Banking liquidity in deficit**

*Banking liquidity shortfall of ~₹1trn, higher than RBI comfort zone*

Banking sector liquidity (net liquidity under the liquidity adjustment facility) has turned negative since Jun '10, after staying positive for 18 months, between Dec '08 and May '10. Between Dec '08 and May '10, the level of average daily excess liquidity was ₹630bn, with a peak of ₹1,700bn. Since Jun '10, banks maintained an average liquidity deficit of ₹650bn; at the bottom, the shortage was over ₹1,700bn. Currently, liquidity shortfall in the market is ~₹1trn.

**Fig 11 – Sharp turnaround in liquidity**



Source: Gol, RBI, Anand Rathi Research

**We expect 100bps cut in Cash Reserve Ratio (CRR) by Mar '12**

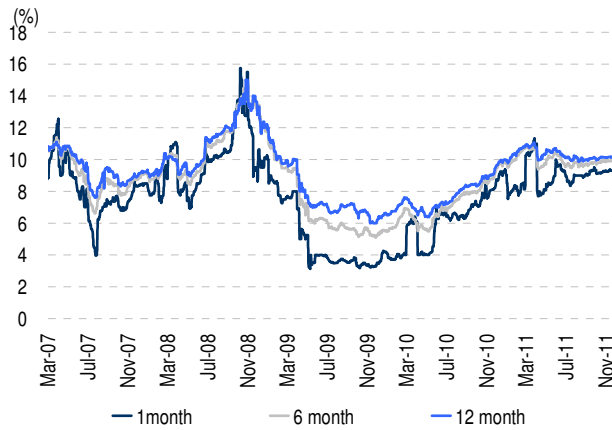
The RBI seems comfortable with a liquidity deficit of ~1% of net demand and time liabilities (NDTL) in the banking system. This translates into a liquidity deficit of ₹500bn. Therefore, we expect the RBI to intervene and take measures against the liquidity situation turning into a considerable deficit. The RBI has various tools including lowering the CRR, statutory liquidity ratio (SLR) and issuance of MSS bonds to ease liquidity for the banking system.

Given the current liquidity situation in the market, our economy team is of the view that RBI has left with no other option but to cut the CRR by at least 100 bps by Mar '12. A 100bps CRR cut would inject ~₹600bn into the market, bringing the liquidity shortage to ₹400bn, which is in the range of the RBI comfort zone of +/-1% of NDTL.

## Wholesale cost of funds to slide

*Wholesale cost of funds is currently at an elevated level; we expect this to ease, going forward, driving NIM expansion*

**Fig 12 – Wholesale cost of funds (%)**



Source: RBI, Bloomberg

We believe FY12 margins would be lower for NBFCs due to the rise in the cost of funds and the loss of priority-sector status on borrowings from banks. However, with wholesale cost of funds sliding from 2QFY13, margins are expected to expand in FY13. Lower securitization in FY12 and loss of priority-sector borrowings would restrict margin expansion for some companies.

## Regulations unlikely to hit earnings

Regulatory changes regarding capital adequacy, NPA recognition norms and securitization are unlikely to materially impact the earnings of our NBFC universe. We see little possibility of a complete curb on priority sector status on securitization, given: 1) the importance of lending to under-banked regions/credit-starved sections of society and, 2) the necessity of meeting priority sector lending criteria for foreign/small private-sector banks.

### Regulatory issues near finalization

The rapid balance-sheet growth of non-banking finance companies has raised their significance, according to the RBI. Hence, the RBI has suggested the need for tighter regulations on NBFCs in order to better control system-wide financial risk.

The RBI has come out with two draft guidelines: 1) Recommendations of a working group (the Usha Thorat Committee) on NBFC regulation; and 2) Guidelines on securitization and direct assignment. In addition, guidelines on priority-sector status on various categories of loans are pending with the M.V. Nair Committee.

### Recommendations of the Usha Throat Committee

This independent committee was constituted by the RBI in Mar '11 to review the regulatory and supervisory framework for NBFCs with special focus on risks in the sector. In our view, the key recommendations material to our NBFC coverage relates to NPA provisioning and capital adequacy.

The RBI's working group recommendations regarding higher provisioning norms and high tier-1 capital are unlikely to materially affect our retail NBFC coverage.

### Stringent provision norms

The RBI working group has suggested that NPA provisioning guidelines should be in line with those of banks. The recommendations, if implemented, would require NBFCs to recognize NPAs on a 90-day basis (from 180/360 days currently). NBFCs would also have to make high standard-asset provisions. (Banks make 0.4% standard-asset provisioning vs. 0.25% for NBFCs now.)

*Higher provisioning norms boost investor confidence without altering end-loss for the company*

**Fig 13 – Higher provisioning requirements for banks than for NBFCs (%)**

	Banks	NBFCs
Standard-asset provisioning	0.40	0.25
Sub-standard asset provisioning	15	10
Doubtful assets		
- one year	25	20
- one to three years	40	30
- more than three years	100	50
Loss assets	100	100
Sub-standard assets	90-days overdue	180-days overdue

Source: Companies

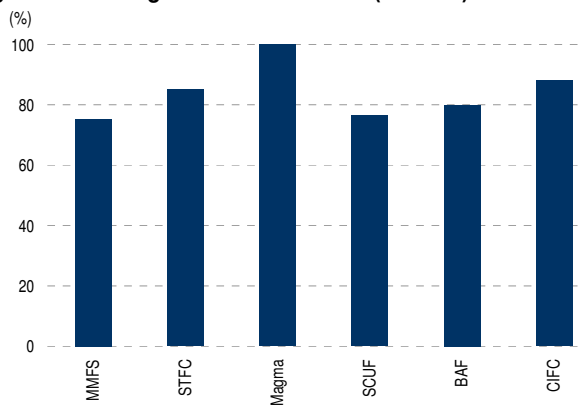
**The history of tightening in provisioning norms for banks suggests that:**

- Most companies quickly adapt to tightened norms, in less than 2-3 quarters;
- Loss-given default does not alter with early recognition of NPA; it only enhances chances of recovery for the company;
- Stringent norms boost investor confidence in the company.

The cash flow for retail NBFCs is largely linked to rural/semi-urban income. The income of the rural population is volatile, dependent on the monsoon/harvesting season. Due to this, 90-day defaults are usual but are mostly technical. NBFCs have presented a strong case to the RBI for not lowering the NPA recognition timeline (from 180/360 days to 90 days).

However, if the RBI sticks to the 90-day provisioning norms, we expect ~40% increase in gross NPAs for most retail NBFCs in our coverage universe. Higher NPA coverage is likely to limit credit cost for increased gross NPAs.

**Fig 14 – High NPA coverage to limit credit cost (2QFY12)**

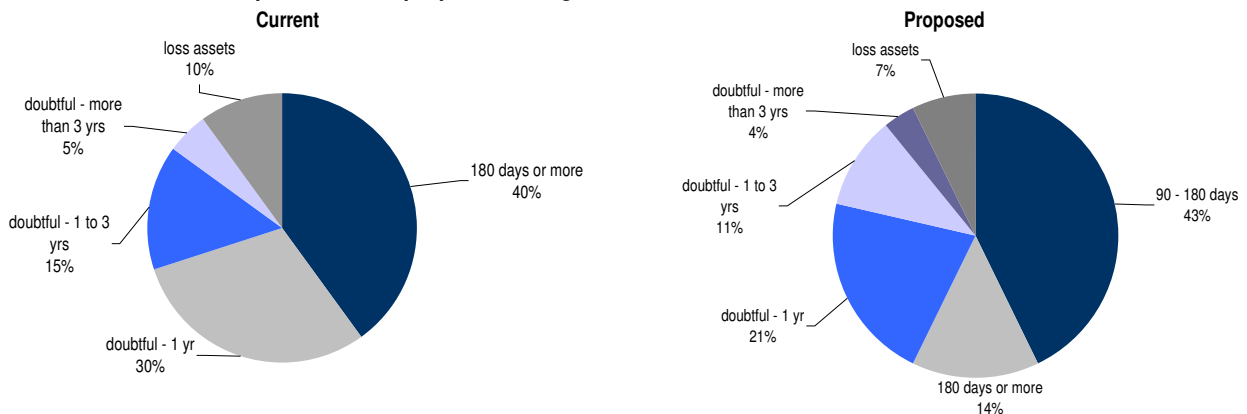


Source: Companies

*Gross NPA additions would be largely in the sub-standard category; attracting only 15% provisioning*

However, we believe that most delinquencies would be merely technical and a large part of gross NPAs would be concentrated in the first bracket of sub-standard assets (which attract 15% provisioning). This makes a strong case for NBFCs to lower NPA coverage from the current high +70%. This in turn would limit credit costs for NBFCs. The timing of recognition of NPAs is not expected to alter the end loss, given defaults. In all probability, it is likely to enhance the chances of recovery by early remedial measures.

**Fig 15 – Gross NPA break-up: Current vs. proposed change**

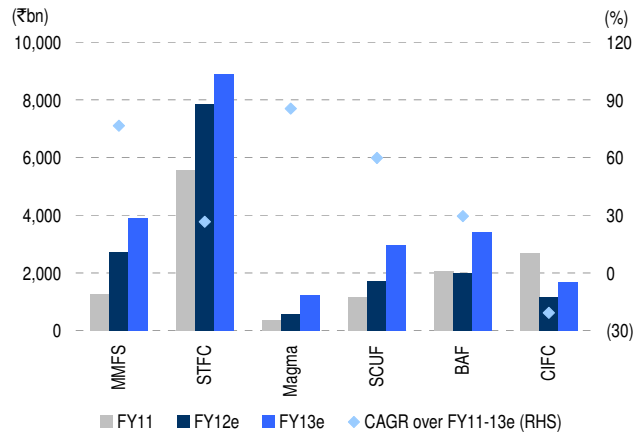


Source: Anand Rathi Research

We estimate an ~5% downward impact on earnings for our retail NBFC coverage due to the higher provisioning requirement. We assume increased provisioning costs in our estimate for FY12/13 due to the slowing economy and the RBI-proposed changes. However, the RBI has suggested that the guidelines would eventually be implemented in a phased manner. In this case, the earnings impact could be further limited.

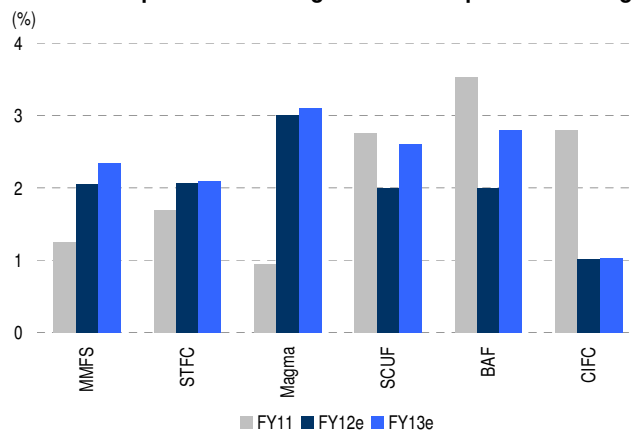
*We factor in higher provision cost given the regulatory changes and uncertain macro conditions*

**Fig 16 – Higher credit cost in FY12/13 than in FY11**



Source: Companies, Anand Rathi Research

**Fig 17 – Credit cost as percent of average assets is expected to be high**



Source: Companies, Anand Rathi Research

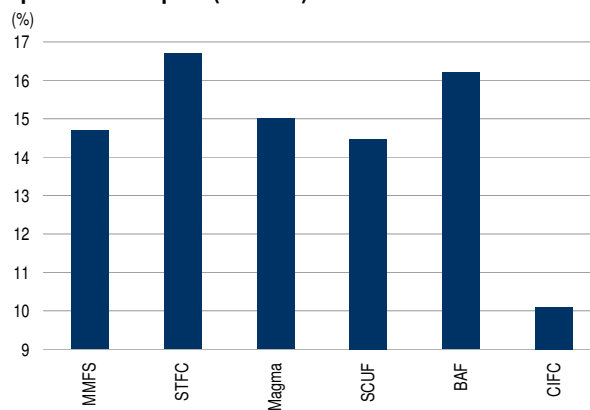
**Benefit under the SARFASI Act**

The committee has recommended that NBFCs be allowed to benefit under the SARFASI Act (Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002). With the introduction of this Act, banks have benefited from a speedy and effective recovery mechanism. This is likely to improve the recovery process for NBFCs as well.

**Higher tier-1 capital requirement**

The committee has also recommended the minimum tier-1 capital required for all NBFCs be raised from 10% currently to 12%. Most NBFCs in our coverage universe have maintained higher tier-1 capital to obtain higher credit ratings. Thus, the impact would be limited in the short term. The RBI has said that the increased requirement (of capital adequacy) needs to be met over three years. This should provide NBFCs with time to make the requisite provisioning.

Fig 18 – Adequate tier-1 capital (2QFY12)



Source: Companies, Anand Rathi Research

We believe the higher capital requirement would be negative for localized small, unlisted NBFCs, as they find it difficult to raise capital. This in turn would give medium-sized and large NBFCs an edge.

### Other recommendations

#### Branch licensing

*Branch licensing unlikely for semi-urban and rural regions*

At present, there is no limit on the number of branches that an NBFC can open. (Banks, however, have specific guidelines.) The committee has drawn the RBI's attention to this regulatory gap but has not recommended anything in this regard.

Specific guidelines in place for banks do not stop them from opening branches in semi-urban and rural areas. More than 70% of retail NBFCs branches are in semi-urban and rural areas. We are of the view that even if similar guidelines are made applicable to NBFCs, it would not alter their branch expansion plans in a major way.

#### More disclosures

NBFCs with assets of over ₹1bn would be required to report: i) NPA-coverage ratio, ii) asset-liability profile (ALM), iii) liquidity ratios, iv) extent of financing of parent-company products, v) movement of non-performing assets (NPAs), vi) off-balance-sheet exposures, and vii) structured products and securitizations/assignments.

Most large NBFCs do disclose the above information quarterly/yearly. Increased disclosures would boost investor confidence.

#### Draft guidelines on securitization/assignment

*Securitization guidelines less stringent than market expectations*

In Sep '11, the RBI came out with revised draft guidelines on securitization/assignment transactions by NBFCs. We view the draft guidelines as less stringent than earlier guidelines. This is also the market view.

- **Lower minimum holding period:** The minimum holding period (MHP) for loans with less than a quarterly-repayment schedule has been kept at six months (compared to the one year proposed in the annual policy statement of Apr '09). A six-month holding period is manageable for the portfolios of MMFS and STFC.
- **Minimum retention requirement manageable:** The minimum retention requirement (MRR) for loans with maturity of over 24 months would be 10% of the cash flows of the loans (5% for less than

24 months). However, the RBI has allowed first loss to be counted in MRR. Shriram Transport Finance Corp. and M&M Financial Services typically provide, in the form of fixed deposits, 6-8% as first loss. This means that additionally only 2-4% of the portfolio is required to be retained.

- **Amortization of securitization income:** The RBI has recommended that securitized/assignment income generated by NBFCs/banks be amortized over the remaining life of the assets on the straight-line method. This contrasts with the practice currently followed by MMFS (upfront booking of securitization income at the time of transaction). We expect MMFS securitization income to be ~65% lower in the year the guidelines are changed. STFC has recognized assignment income on the reducing balance over the life of the assets; thus the impact for it is likely to be negligible.
- **Due diligence of only 5% of the portfolio:** The due diligence of 40-100% of bought-out loans is too cumbersome for banks. According to the draft guidelines, a bank should do due diligence on the loans it purchases from NBFCs. However, due diligence is limited to only 5% of the portfolio.

### **No credit enhancement for loan assignments**

The new draft guideline has disallowed credit enhancement in loan-assignment transactions. Currently, almost all priority-sector portfolio sales by NBFCs to banks are through the assignment route. The RBI has said that as the originating entities (NBFCs) would not be allowed to provide any credit enhancements, MRR would have to be met fully (10% in case of loan tenure of more than 24 months; 5% otherwise). The implications of this are:

- In the past 2-3 years, credit enhancements in most of the assigned portfolios were ~3x peak delinquencies. Due to the high credit enhancements, the portfolios would be rated AAA by rating agencies. This would result in almost zero credit costs for the purchaser of the portfolio (banks). Because of such credit enhancements, banks bought portfolios from NBFCs at lower yields. Banks will now ask for higher pricing in loans assigned, as the credit ratings of these portfolios are lowered due to lack of credit enhancements, and banks would need to share the losses arising from such transactions.
- Banks may prefer securitization over assignments due to the lack of credit enhancement. Credit enhancement for securitization transactions would be deducted from tier-1 capital. This would be negative for NBFCs.
- **Our view:** The essence of securitization /assignment transactions in India is to meet priority-sector targets. We do not see a sharp drop in securitization yield even if portfolios are rated lower than AAA, as demand for such transactions is immense.

*We do not see a sharp drop in securitization yield even if portfolios are rated lower than AAA, as demand for such transactions is immense*

Overall, in their current form, the draft guidelines would result in slightly lower NIM and capital adequacy for NBFCs.

**Complete curb on priority sector status on securitization unlikely**

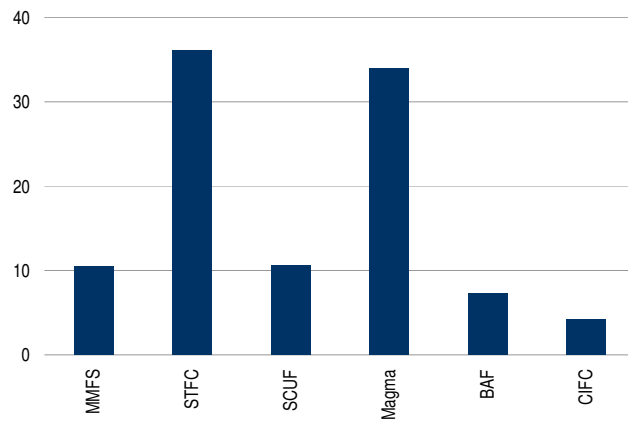
NBFCs such as STFC and MMFS enjoy regulatory arbitrage by selling their portfolios to banks to meet their priority-sector requirements. The RBI has set up a committee to look into the priority-sector status of various loans.

*Priority sector benefit on securitization is likely to stay, given the importance of lending to under-banked rural areas*

STFC and MMFS are specialized NBFCs that cater to the need for loans of the under-banked and credit-starved rural/semi-urban population. We expect that, given the importance of lending in the case of used-CVs, micro, small and medium enterprises (MSME) and tractors in rural/semi-urban areas and the necessity of meeting priority-sector requirements by foreign/small private-sector banks, a complete curb on the priority-sector status of securitization/assignment of loans is unlikely.

Companies such as STFC, MMFS and SCUF, which have strong business models, are likely to withstand any stringent set-up required by the RBI in this regard.

**Fig 19 – Off-book loans as proportion of AUM (2QFY12)**



Source: Companies

## Poised to cater to rising rural demand

Our retail NBFC coverage universe has a strong parentage and 2-3 decades of expertise in the business. They have built up large franchises over several years and have improved loan-origination and risk-management processes. Retail NBFCs are strategically poised to reap the benefit of greater rural demand due to rising food prices, higher minimum support prices and the increasing government expenditure on rural projects/employment-generating schemes.

### Robust rural demand

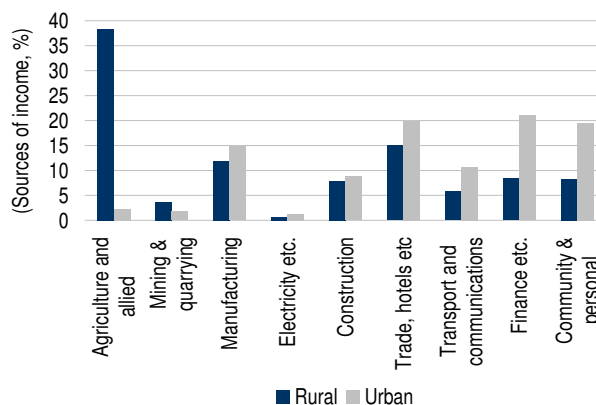
The rural demand outlook is robust for the next couple of years due to rising food prices, higher minimum support prices and the increasing government expenditure on rural projects/employment-generating schemes. All this implies higher rural income and transfer of wealth to rural India.

### High food prices imply transfer of wealth from urban to rural India

Rural India's share in GDP is around 50%. Within this, nearly 40% of rural income arises from agriculture. As a result, high food prices imply a considerable rise in rural incomes. The immediate result of rising food prices is the transfer of wealth from urban to rural India.

*India's rural population derives ~40% of income from agriculture*

Fig 20 – Sources of rural-urban income



Source: The Government of India

Food prices in India have been high since Mar '10. Average food inflation in the past one year was 10.9%. There are several structural factors that contributed to high food prices. These include:

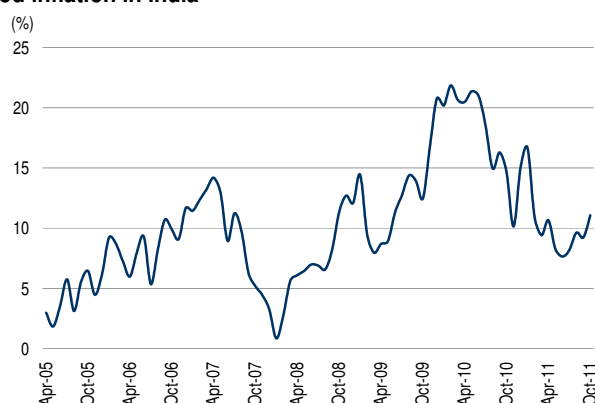
*Transfer of wealth to the rural population is largely structural; unlikely to reverse in the near term*

- 1. A sharp jump in food demand in emerging market (EM) economies:** Average per-capita income in EM has risen from 1.5% in the 1990s to 3.4% in the past decade (compared to 1.5% for the global economy). With the high proportion of poor in the overall population and the low per-capita income, higher income is likely to be utilized to finance basic needs (including food) that were earlier unmet. Therefore, rising income has been a key reason for the strong jump in food demand in EM economies.
- 2. Deceleration in food production:** Annual average global food production growth decelerated from 2.9% in the 1990s to 2% in the past decade. Together with the increase in food demand growth,

deceleration in food supply growth explains the considerable acceleration in food prices in the past decade.

- 3. Shrinking agricultural land:** The past decade has seen shrinking of global agricultural land, by 60m hectares (1.2% of the total). This is in sharp contrast to the addition of 500m hectares (10% of global agricultural land) to agricultural use between 1961 and 2001. In addition, various food products are being diverted to non-food use such as alternative fuels.

**Fig 21 – Food inflation in India**



Source: The Government of India

Many structural issues can only be addressed in the medium to long term – tackling high food prices requires more investment, innovation and technological progress in the agricultural sector. All these factors would reduce food prices but also increase volumes, which would in turn raise rural income in the long run.

*Government expenditure on rural projects has doubled over the last three years*

### Increased government spend on rural India

The increased thrust of the government on rural India has been a boon to the rural economy. The Central government's flagship "Mahatma Gandhi National Rural Employment Guarantee" scheme has resulted in significantly higher disposable incomes of the rural population. The scheme has also set a floor for wages of rural unskilled workers, thereby, substantially enhancing income and food demand even among the lowest income stratum of the rural economy.

**Fig 22 – Allocation under various rural schemes (₹bn)**

Union budget/schemes	'07-08	'08-09	'09-10	'10-11
Swaranjayanti Gram Swarozgar Yojana (SGSY)	16	19	21	21
National Employment Guarantee Schemes	142	221	391	400
Rural Housing Schemes	36	49	79	100
Pradhan Mantri Gram Sadak Yojana (PMGSY)	106	141	174	212
National Rural Health Mission	101	121	141	188

Source: Planning Commission

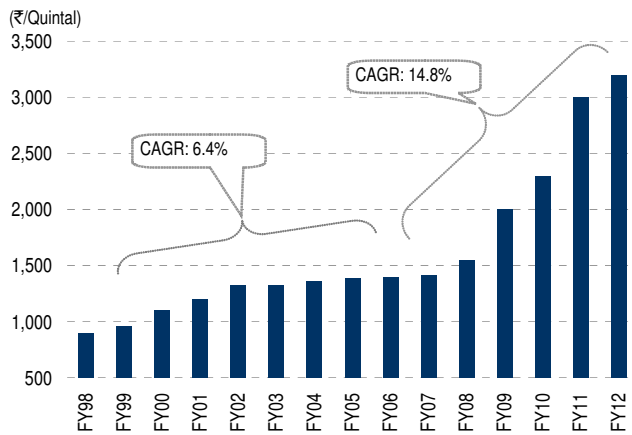
### Sharp increase in minimum support prices

*Minimum support prices have increased three-fold over FY06-12*

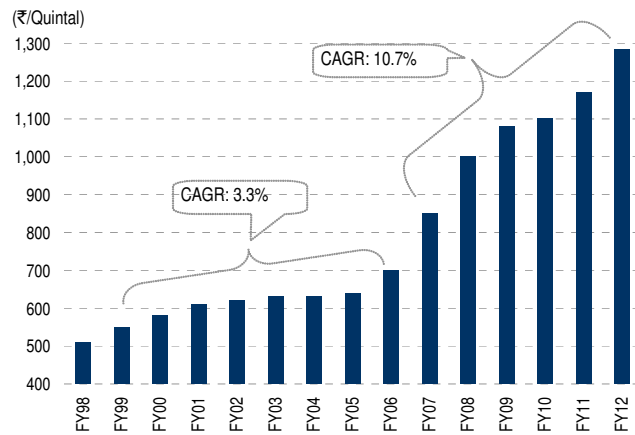
The government has consistently raised the minimum support price of food grain. The MSP for various food grain items such as *arhar*, wheat and rice has seen a substantial rise at CAGRs of 14.8%, 10.7% and 11.2%, respectively, over FY06-12. This has led to a significant transfer of wealth to the agricultural sector. In comparison, the increase in MSP from FY98 to FY06 was 6.3%, 3.3% and 4.4%, respectively.

**Fig 23 – Increase in minimum support prices of food grains**

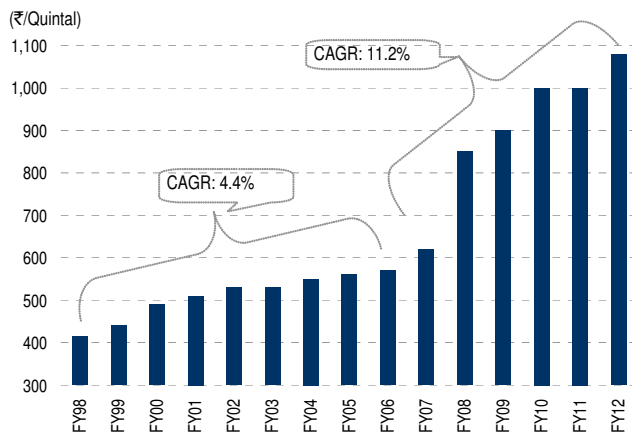
**MSP for arhar**



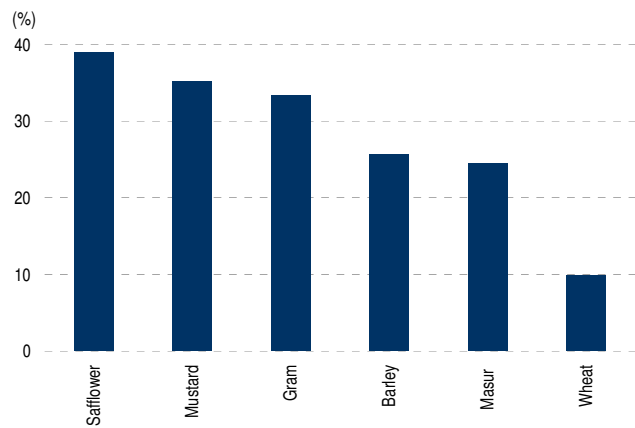
**MSP for wheat**



**MSP for rice**



**increase in MSP in FY12**



Source: GoI, Anand Rathi Research

**Retail NBFCs: key beneficiaries of rising rural income**

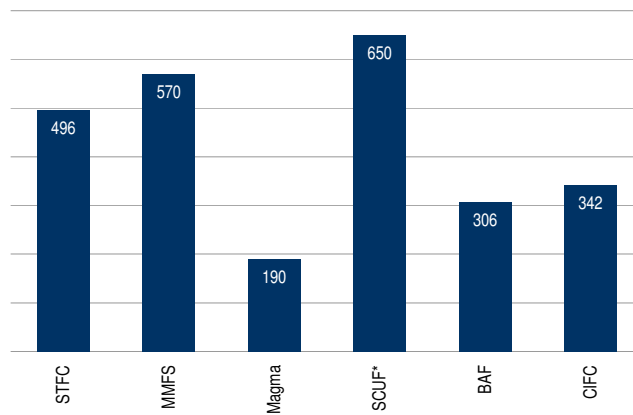
Due to their extensive distribution networks in semi-urban and rural areas, we expect our retail NBFC universe to be the key beneficiary of the rise in rural incomes, as a result of higher food prices and efforts to improve agricultural productivity.

The NBFCs are strategically poised, with 2-3 decades of experience in the rural asset-financing market, and have developed a sound business model for this niche. This model is difficult for other financiers (banks in particular) to replicate.

They have also built up robust branch networks over the years and are especially strong in under-banked credit-starved rural/semi-urban areas. Some of the large NBFCs have become household names among borrowers: Shriram Transport Finance among truck owners, and MMFS among tractor and passenger-vehicle buyers in rural India.

*Extensive branch network, expertise built over the years and strong parentage are likely to give NBFCs strong bargaining power in rural markets*

**Fig 24 – Extensive branch network**



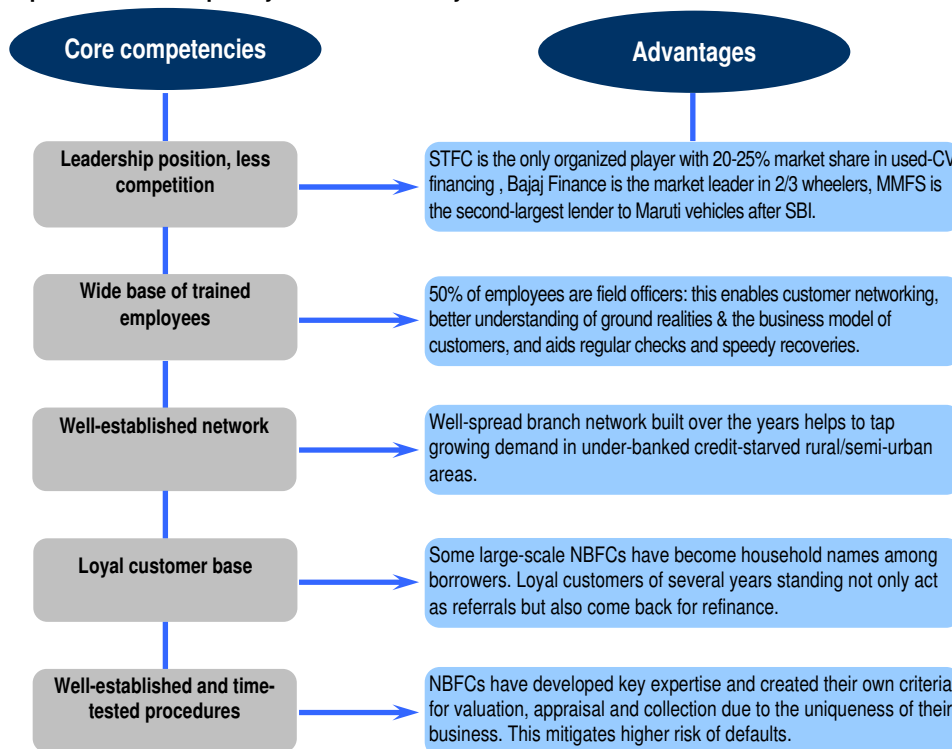
Source: Companies

Note: \* includes branches of Shriram Chit Fund

These NBFCs have strong bargaining power in niche rural markets. They mainly compete with small NBFCs/money lenders. Our retail NBFC universe has an advantage over such players owing to their large and diversified operations across India, strong parentage (hence, a trusted name among borrowers), expertise gained over the years and lower cost of funds.

They also suit rural customers, as alternative sources of funds are unattractive (exorbitant interest charged by money-lenders, and lack of trust for small NBFCs due to their poor track record). In addition, NBFCs have an edge over banks due to less stringent lending norms and less paper work.

**Fig 25 – Core competencies developed by NBFCs over the years**



Source: Companies, Anand Rathi Research



# Company Section

12 December 2011

## M&M Financial Services

*Strong growth momentum to continue; we reiterate a Buy*

Rating: **Buy**

Target Price: ₹845

Share Price: ₹686

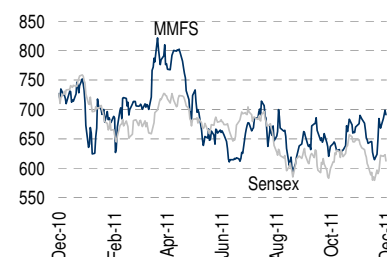
M&M Financial Services (MMFS) is likely to see robust loan growth, backed by strong rural demand due to rising disposable incomes in rural/semi-urban areas. The asset quality is encouraging and we estimate credit costs at 2.1-2.4% over FY11-14. Despite ~70-bp contraction in NIM due to higher borrowing costs, we estimate 24% CAGR in net profit, and healthy profitability with RoE of ~22% over FY11-14. We reiterate a Buy rating on the stock.

- **Robust loan growth to continue due to rural demand.** We expect 24% CAGR over FY11-14 and a rise in the rural-housing subsidiary's loan book to ₹15bn by FY15. This is based on good monsoons, high food prices and the larger outlay on government schemes. In the past year, MMFS saw robust loan growth (2QFY12 AUM growth of 40.7% yoy) despite interest rates rising ~200bps. This was backed by strong rural demand due to rising disposable incomes in rural/semi-urban regions.
- **Asset quality assurance encouraging; superior NIM at 11%+.** MMFS assets are robust, with net NPA of 1% and NPA coverage of 75% as of 30 Sep '11. We expect credit costs at 2.1-2.4% over FY11-14 (1.3% in FY11) due to strong rural cash flow. Despite a ~70-bp NIM contraction in FY12 due to higher borrowing costs and loss of priority-sector loan (10% of total on 30 Sep '11), we estimate NIM at 11%+ over FY11-14.
- **Strong profitability to drive valuations.** We estimate strong RoA and RoE, at 3.5%+ and 22%+, respectively, in FY13/14. At current valuations, the risk-reward equation favours MMFS. Higher profitability and easing macro-economic concerns are likely to drive valuations.
- **Valuation.** At our price target, the stock would trade at a PBV of 3x FY12e and 2.5x FY13e. **Risks:** Slower-than-expected rural economic growth could impact loan growth; increase in NPAs.

Key data	MMFS IN / MMFS.BO
52-week high / low	₹835 / ₹590
Sensex / Nifty	16488 / 4944
3-m average volume	US\$1.4m
Market cap	₹71bn / US\$1.4bn
Shares outstanding	101.4m

Shareholding pattern (%)	Sep '11	Jun '11	Mar '11
Promoters	57.4	57.4	57.5
- of which, pledged	NA	NA	NA
Free float	42.6	42.6	42.5
- Foreign institutions	34.3	34.5	34.1
- Domestic institutions	4.5	3.5	4.4
- Public	3.8	4.6	4.0

### Relative price performance



Source: Bloomberg

Key financials (YE Mar)	FY10	FY11	FY12e	FY13e	FY14e
Net interest income (₹m)	10,290	13,137	16,250	20,381	24,754
Net profit (₹m)	3,444	4,631	5,773	7,195	8,796
EPS (₹)	35.9	45.2	56.4	70.2	85.9
Growth (%)	60.1	26.0	24.7	24.6	22.3
PE (x)	19.6	15.6	12.5	10.0	8.2
PABV (x)	4.0	2.9	2.5	2.1	1.7
RoE (%)	21.5	22.0	21.3	22.3	22.7
RoA (%)	4.2	4.1	3.7	3.7	3.8
Dividend yield (%)	1.1	1.4	1.6	1.7	1.8
Net NPA (%)	1.0	0.6	1.2	1.3	1.5

Source: Company, Anand Rathi Research

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## Quick Glance – Financials and Valuations

**Fig 1 – Income statement (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Net interest income	10,290	13,137	16,250	20,381	24,754
NII growth (%)	20.4	27.7	23.7	25.4	21.5
Non-interest inc	380	386	690	781	882
Total income	10,671	13,524	16,940	21,162	25,636
Total inc growth (%)	22.0	26.7	25.3	24.9	21.1
Op. expenses	3,250	4,932	5,465	6,355	7,359
Operating profit	7,421	8,592	11,475	14,807	18,277
Op profit growth (%)	22.1	15.8	33.6	29.0	23.4
Provisions	2,215	1,253	2,728	3,906	4,949
PBT	5,206	7,339	8,748	10,902	13,327
Tax	1,762	2,393	2,974	3,707	4,531
PAT	3,444	4,945	5,773	7,195	8,796
PAT growth (%)	60.5	34.5	24.7	24.6	22.3
FDEPS (₹/share)	35.9	45.2	56.4	70.2	85.9
DPS (₹/share)	7.5	10.0	11.0	12.0	13.0

Source: Company, Anand Rathi Research

**Fig 2 – Balance sheet (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Share capital	960	1,025	1,025	1,025	1,025
Reserves & surplus	16,326	23,876	28,323	34,080	41,318
Borrowings	64,578	96,750	124,840	150,146	182,069
Current liab & prov	9,087	15,890	19,862	24,828	31,035
Deferred tax liabilities	-	-	-	-	-
Total liabilities	90,950	137,541	174,050	210,079	255,446
Advances	83,788	115,700	150,410	181,996	222,035
Investments	2,159	6,746	7,757	9,154	10,801
Cash & bank bal	2,420	3,064	3,416	5,949	9,111
Fixed & other assets	2,583	12,031	12,467	12,980	13,499
Total assets	90,950	137,541	174,050	210,079	255,446
No. of shares (m)	96	102	102	102	102
Borrowing growth (%)	23.9	49.8	29.0	20.3	21.3
Loans growth (%)	23.2	38.1	30.0	21.0	22.0

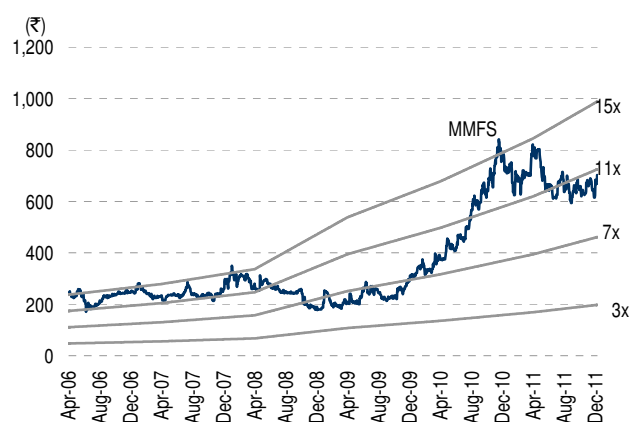
Source: Company, Anand Rathi Research

**Fig 3 – Key ratios**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
NIM (%)	11.5	11.9	11.2	11.3	11.3
Other inc / total inc (%)	3.6	2.9	4.1	3.7	3.4
Cost-income (%)	30.5	36.5	32.3	30.0	28.7
Provision coverage (%)	86.4	86.4	77.0	76.4	75.4
Dividend payout (%)	21.0	22.5	19.5	17.1	15.1
Borrowings-loans (%)	77.1	83.6	83.0	82.5	82.0
Investment-deposit (%)					
Gross NPA (%)	6.9	4.6	5.0	5.5	5.9
Net NPA (%)	1.0	0.6	1.2	1.3	1.5
BV (₹)	180.1	243.0	286.5	342.6	413.3
Adj BV (₹)	177.1	240.5	280.3	334.3	401.7
CAR (%)	18.5	17.5	16.0	15.5	15.0
RoE (%)	16.1	15.1	13.8	13.1	12.8
RoA (%)	21.5	22.0	21.3	22.3	22.7
Dividend yield (%)	4.2	4.1	3.7	3.7	3.8

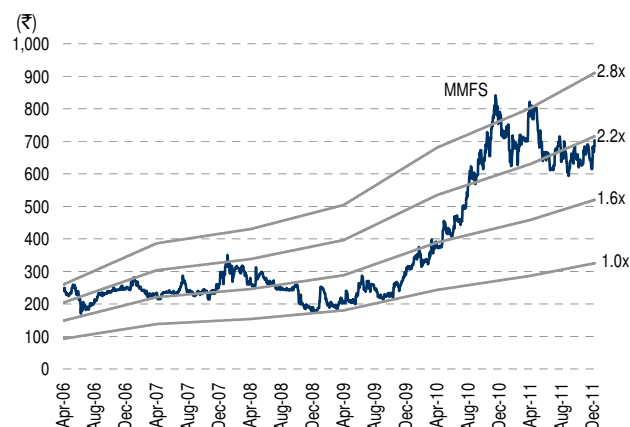
Source: Company, Anand Rathi Research

**Fig 4 – PE band**



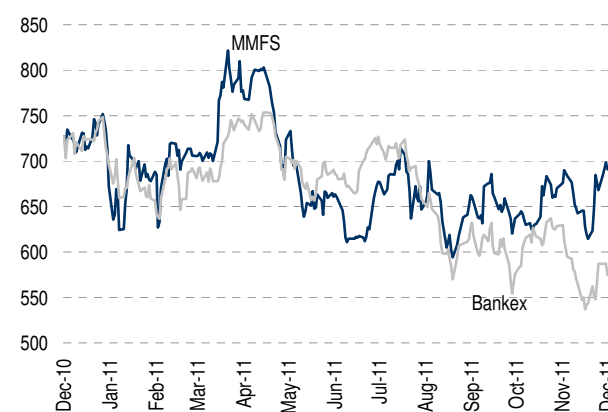
Source: Bloomberg, Anand Rathi Research

**Fig 5 – Price-to-book band**



Source: Bloomberg, Anand Rathi Research

**Fig 6 – MMFS vs. Bankex**



Source: Bloomberg

12 December 2011

## Shriram Transport Finance

Macro issues to hit loan growth; we lower estimates but retain a Buy

Rating: **Buy**

Target Price: ₹700

Share Price: ₹554

We expect higher interest rates and a slowing economy to slow down Shriram Transport Finance's loan growth over the next 12 months. Credit cost is likely to be high in FY12/13 due to problems in the southern mining belt and RBI-proposed prudential norms. We believe, however, that concerns over loss of priority-sector status on securitizations are overblown. We lower FY12/13 EPS estimates by ~8% and our price target from ₹845 to ₹700. The risk-reward ratio is favourable for a strong retail franchise. We retain a Buy.

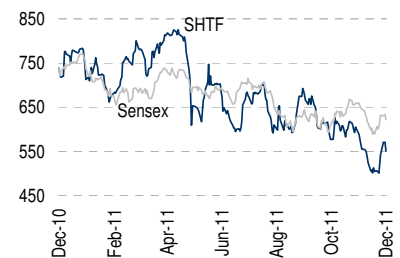
- **Volume growth to slow down.** Slower CV growth and high interest rates are expected to impact loan growth in the next 12 months. Given the higher borrowing cost, low securitization and high credit costs, margin compression is likely to result in weak net profit growth in FY12. We expect macro headwinds to ease and margins to rebound in FY13.
- **Higher credit cost in FY12/13.** We expect high credit cost in FY12/13, due to the effect of problems in the mining industry in Karnataka, Goa and AP (exposure of ~₹2bn) on truckers and the RBI-proposed changes in prudential norms. We estimate credit cost (on average AUM) of ~1.9% for FY12/13, compared to an average 1.6% over FY08-11.
- **Complete curb on regulatory arbitrage unlikely.** Given the importance of lending for used CVs in rural/semi-urban areas and the need to meet priority-sector requirements by foreign/small private-sector banks, a complete curb on regulatory arbitrage is unlikely.
- **Valuation.** We expect RoA of ~3.6% and RoE of ~23% over FY12/13 despite slow net profit growth in FY12. The present 1.7x FY13e PBV is a good entry point for a strong retail franchise. At our revised price target, the stock trades at a PBV of 2.7x FY12e and 2.2x FY13e. **Risks:** Slower-than-expected economic growth could impact loan growth; increase in NPAs.

Key data	SHTF IN / SRTR .BO
52-week high / low	₹869 / ₹442
Sensex / Nifty	16488 / 4944
3-m average volume	US\$5.6m
Market cap	₹131bn / US\$2.7bn
Shares outstanding	226.2m

Shareholding pattern (%)	Sep-11	Jun-11	Mar-11
Promoters	41.4	41.3	41.3
- of which, pledged	-	-	-
Free float	58.6	58.7	58.7
- Foreign institutions	43.2	42.4	40.7
- Domestic institutions	2.0	2.2	2.9
- Public	13.4	14.1	15.1

Estimates revision (%)	FY12e	FY13e	FY14e
Net interest income	-3.7	-7.0	NA
PAT	-8.3	-8.0	NA
RoE	-110bps	-300bps	NA
Target multiple (x)	-0.2	-0.2	NA

### Relative price performance



Source: Bloomberg

Key financials (YE Mar)	FY10	FY11	FY12e	FY13e	FY14e
Net interest income (₹m)	21,560	29,582	33,446	38,806	45,264
Net profit (₹m)	8,731	12,299	12,627	14,892	18,183
EPS (₹)	38.7	54.4	55.8	65.8	80.4
Growth (%)	28.7	40.5	2.7	17.9	22.1
PE (x)	14.7	10.4	10.2	8.6	7.1
PABV (x)	3.4	2.6	2.2	1.8	1.5
RoE (%)	28.6	28.2	23.3	22.6	22.8
RoA (%)	3.4	4.2	3.6	3.6	3.8
Dividend yield (%)	1.1	1.1	1.4	1.6	1.9
Net NPA (%)	0.7	0.4	0.3	0.2	0.3

Source: Company, Anand Rathi Research

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## Quick Glance – Financials and Valuations

**Fig 1 – Income statement (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Net interest income	21,560	29,582	33,446	38,806	45,264
NII growth (%)	28.2	37.2	13.1	16.0	16.6
Non-interest inc	968	1,995	1,375	1,550	1,720
Total income	22,528	31,577	34,821	40,356	46,984
Total income growth (%)	28.5	40.2	10.3	15.9	16.4
Op. expenses	5,176	7,540	8,113	9,229	10,658
Operating profit	17,352	24,037	26,708	31,127	36,326
Operating profit growth (%)	41.5	38.5	11.1	16.5	16.7
Provisions	4,106	5,548	7,862	8,900	9,187
PBT	13,246	18,489	18,846	22,227	27,139
Tax	4,515	6,190	6,219	7,335	8,956
PAT	8,731	12,299	12,627	14,892	18,183
PAT growth (%)	42.6	40.9	2.7	17.9	22.1
FDEPS (₹/share)	38.7	54.4	55.8	65.8	80.4
DPS (₹/share)	6.0	6.5	8.0	9.0	11.0

Source: Company, Anand Rathi Research

**Fig 2 – Balance sheet (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Share capital	2,255	2,262	2,262	2,262	2,262
Reserves & surplus	36,168	46,782	57,292	69,802	85,074
Borrowings	184,599	198,817	255,128	290,207	335,073
Current liab. & prov.	46,741	68,223	75,046	79,486	84,216
Minority interests	-	-	-	-	-
Total liabilities	269,764	316,084	389,728	441,757	506,626
Advances	179,650	198,656	253,145	280,095	321,725
Investments	18,560	36,507	40,158	43,170	46,407
Cash & bank	45,373	36,251	46,662	63,080	76,692
Fixed & other assets	26,181	44,670	49,762	55,413	61,801
Total assets	269,764	316,084	389,728	441,757	506,626
No. of shares (m)	226	226	226	226	226
Borrowings growth (%)	(8.3)	7.7	28.3	13.7	15.5
Advances growth (%)	0.1	10.6	27.4	10.6	14.9

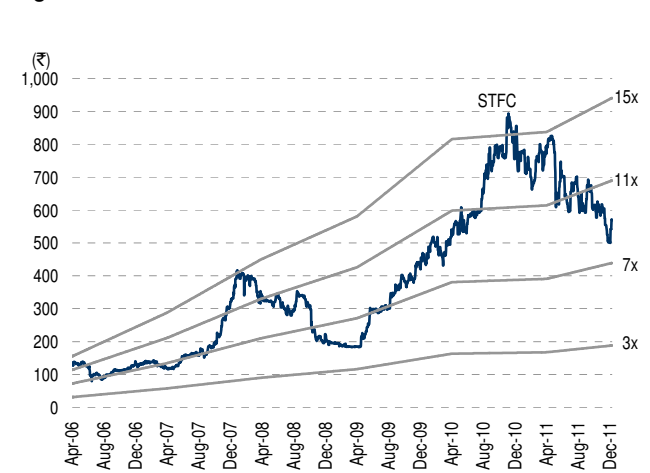
Source: Company, Anand Rathi Research

**Fig 3 – Key ratios**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
NIM (%)	6.9	8.1	7.9	8.1	8.2
Other inc. / total inc. (%)	4.3	6.3	3.9	3.8	3.7
Cost-Income (%)	23.0	23.9	23.3	22.9	22.7
Provision coverage (%)	75.6	85.9	91.6	94.3	93.1
Dividend payout (%)	17.8	13.9	16.8	16.0	16.0
Borrowings-loans (%)	102.8	100.1	100.8	103.6	104.1
Investment-deposit (%)					
Gross NPA (%)	2.8	2.6	3.0	3.8	4.3
Net NPA (%)	0.7	0.4	0.3	0.2	0.3
BV (₹)	170.0	216.7	263.1	318.5	386.0
Adj. BV (₹)	168.1	215.5	262.1	317.5	384.5
CAR (%)	21.4	21.5	21.9	23.4	20.0
RoE (%)	28.6	28.2	23.3	22.6	22.8
RoA (%)	3.4	4.2	3.6	3.6	3.8
Dividend yield (%)	1.1	1.1	1.4	1.6	1.9

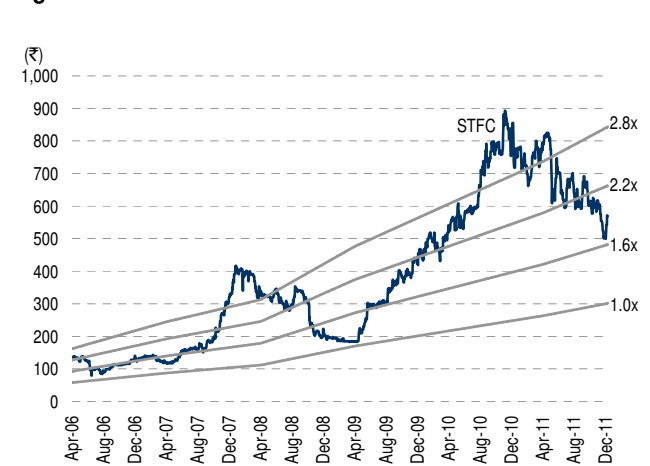
Source: Company, Anand Rathi Research

**Fig 4 – PE band**



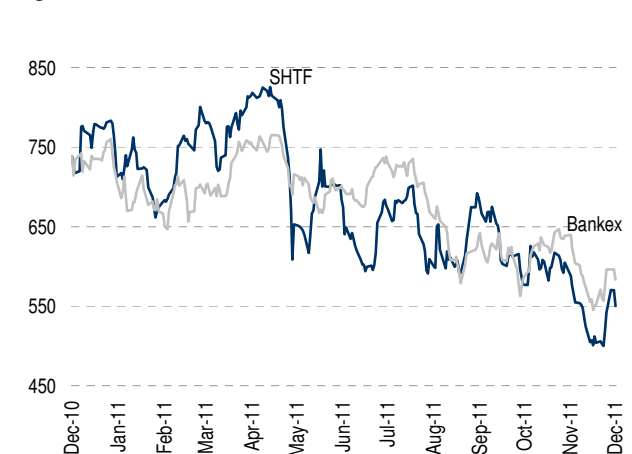
Source: Bloomberg, Anand Rathi Research

**Fig 5 – Price-to-book band**



Source: Bloomberg, Anand Rathi Research

**Fig 6 – STF vs BANKEX**



Source: Bloomberg

## Investment argument and valuation

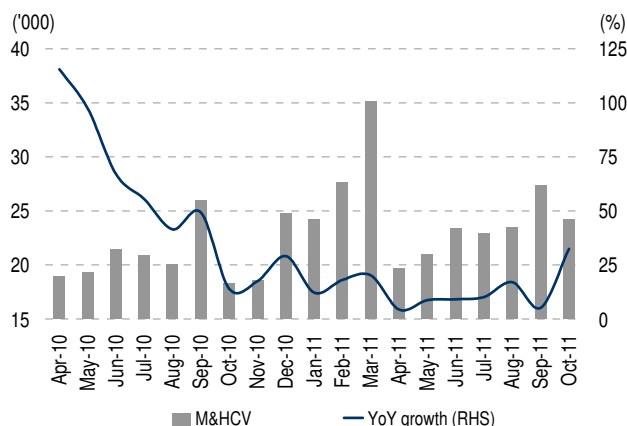
Higher interest rates and a slowing economy are likely to slow down STFC’s loan growth in the next 12 months. Credit cost would be high in FY12/13 due to issues in the southern mining belt and RBI-proposed prudential norms. A complete curb on regulatory arbitrage is unlikely. We lower FY12/13 EPS estimates by ~8% and the price target from ₹845 to ₹700. The risk-reward ratio is favourable for this strong retail franchise with RoE of ~23% over FY11-14. We retain a Buy rating.

### Volume growth to slow

*Slower GDP; sluggish MHCV growth to result in lower disbursement growth*

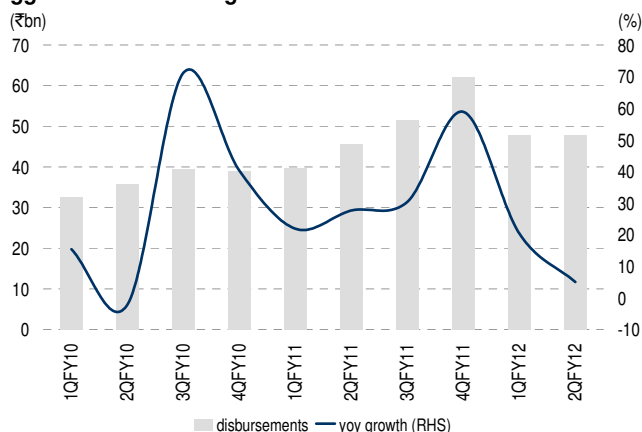
In 2QFY12, STFC’s disbursement growth was weak at 5% yoy, and largely flat qoq. New-vehicle disbursement fell 8.2% yoy and 5.9% qoq, indicating softening demand due to higher interest rates and a slowing economy. STFC greatly depends on medium and heavy commercial vehicle (MHCV) loans, which have been slowing down over the past one year.

Fig 7 – Slower MHCV growth (domestic – goods carriers)



Source: SIAM, Anand Rathi Research

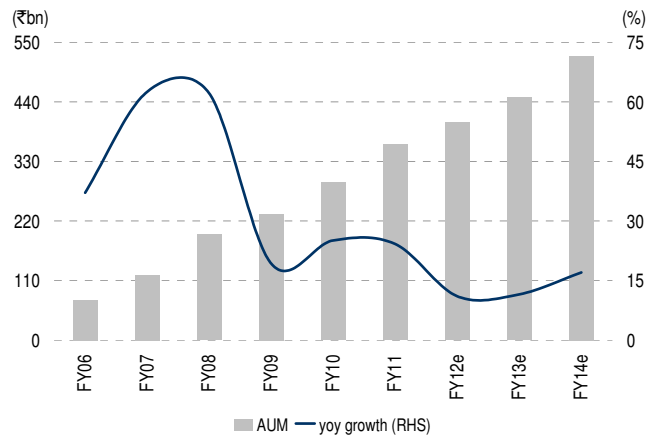
Fig 8 – Sluggish disbursement growth



Source: Company

We expect disbursements to be largely flat in FY12, translating into subdued AUM growth at 11% in FY12. However, the slowing economy is expected to continue to impact volumes and we expect AUM growth of 11.5% for FY13.

**Fig 9 – AUM to slow down**

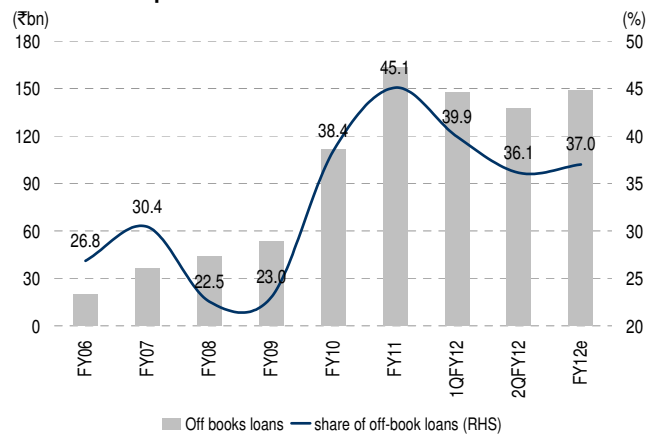


Source: Company, Anand Rathi Research

**Lower NIM for FY12; likely to bounce back in FY13**

STFC is likely to slow down securitization in order to manage the risk on the balance sheet. We expect off-book loans to be largely flat (-2% yoy) at end-FY12 and its share in AUM to fall to ~37%, from 45% in FY11. We expect lower securitization to impact the spread/NIM over FY13/14.

**Fig 10 – Loan-book composition**

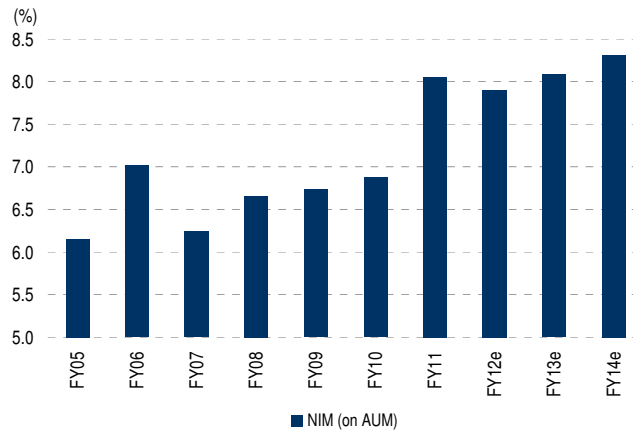


Source: Company, Anand Rathi Research

We expect FY12 NIM to contract by 20-30bps due to higher borrowing costs. Margin contraction is likely to be lower than other NBFCs on account of superior borrowing mix (no ALM mismatch, over 60% retail borrowing), high securitization income despite lower asset growth due to the high unamortized securitization income of earlier years, and better utilization of cash. In 2QFY12, outstanding cash plus liquid investments as percent of borrowings dropped to ~25%, compared to +30% in earlier quarters.

We expect margins to rebound from FY13, once wholesale borrowing costs start easing, due to lower inflation. However, lower securitization in FY12 (therefore lower securitization income in FY13) is likely to restrict margin expansion.

**Fig 11 – NIM to contract by ~20bps in FY12**



Source: Company, Anand Rathi Research

*Mining problems in southern regions and higher delinquencies due to slower economy to increase credit cost*

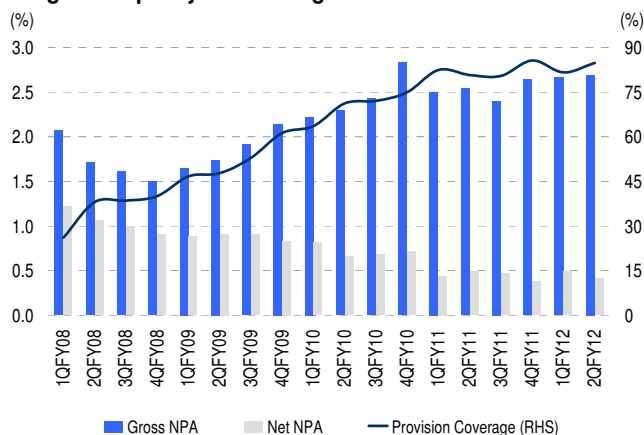
**Higher credit cost in FY12/13**

Credit cost is likely to be high in FY12 and FY13, due to mining issues in Karnataka, Goa and AP, and the RBI-proposed changes in prudential norms.

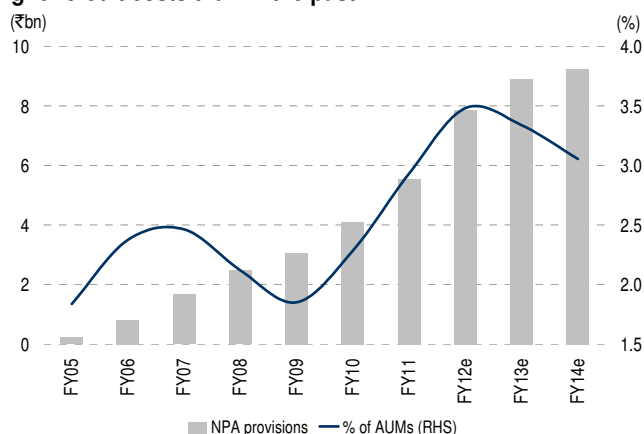
STFC has ₹2bn of exposure to truckers operating in southern mining areas. Environmental issues in the region have led to the complete halt of transportation, seriously affecting truck owners. The company has written off ₹600m on such stressed assets and expects further write-downs in the coming quarters. The proposed change (90-day recognition from 180 days currently) in RBI norms regarding NPAs is likely to raise STFC’s NPA levels. We expect NPAs to at least double once the proposed RBI norms become applicable.

In Sep ’11, asset quality was robust, with net NPA ratio at a manageable 0.41% and NPA coverage of 85%. We expect higher credit costs in FY12 and FY13 (than in FY11) on account of write-offs from mining-related areas, stringent NPA classification norms and high delinquencies due to a slowing economy.

**Fig 12 – Strong asset quality with manageable net NPAs**



Source: Company

**Fig 13 – Higher credit costs than in the past**

Source: Company, Anand Rathi Research

### Complete curb on regulatory arbitrage unlikely

NBFCs such as STFC and MMFS enjoy regulatory arbitrage by selling their portfolios to banks for the latter's priority-sector requirements. The RBI has set up a committee to look into the priority-sector status of various loans.

We expect that, given the importance of lending for used CVs in rural/semi-urban areas and the need to meet priority sector requirements by foreign/small private-sector banks, a complete curb on the priority-sector status of securitization/assignment of loans is unlikely. STFC, with its superb business model, should be able to withstand any stringent requirement set up by the RBI in this regard.

**Fig 14 – Estimate revisions**

(₹m)	From		To		% change	
	FY12e	FY13e	FY12e	FY13e	FY12e	FY13e
NII (₹m)	34,723	41,710	33,446	38,806	-3.7	-7.0
PAT (₹m)	13,771	16,196	12,627	14,892	-8.3	-8.0
RoA (%)	3.7	3.8	3.6	3.6	(10)bps	(20)bps
RoE (%)	24.4	25.7	23.3	22.6	(110)bps	(300)bps
EPS (₹)	61.0	72.0	55.8	65.8	-8.4	-8.6
BV (₹)	267.8	326.8	263.1	318.5	-1.7	-2.6

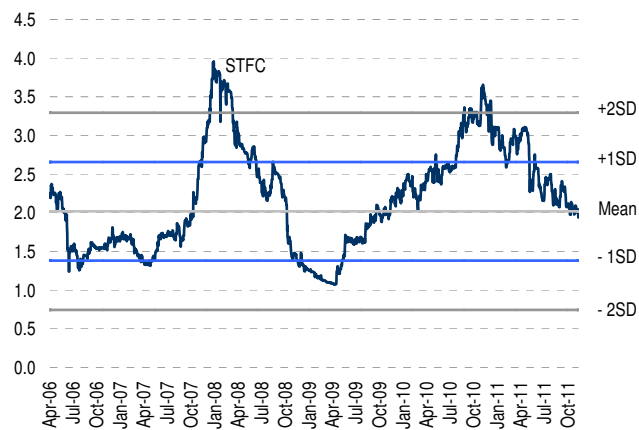
Source: Anand Rathi Research

## Valuation

We trim our FY12e and FY13e EPS by ~8% each owing to: i) lower loan growth due to macro-economic headwinds, ii) lower margins due to a rise in wholesale borrowing costs, and iii) higher costs of provisioning. We expect a regulatory uncertainty overhang on the stock price performance. We lower our price target from ₹845 to ₹700.

We expect RoA of ~3.6% and RoE of ~23% over FY12/13 despite slow net profit growth in FY12. We believe the present 1.7x FY13e PBV is a good entry point for a strong retail franchise.

**Fig 15 – Past one-year-forward PBV**



Source: Bloomberg, Anand Rathi Research

### Risks

- A slowdown would hit the rural economy and lead to slower loan growth and more delinquencies.
- Any regulatory changes regarding SLR/CRR requirements and sector caps could impact the company.

## Financials

We expect 17.4% CAGR in STFC's loan book over FY11-FY14, with 14% CAGR in net profit.

**Fig 16 – Income statement (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Interest income	44,028	52,302	64,853	74,340	87,515
Interest expended	22,468	22,720	31,407	35,534	42,251
<b>Net interest income</b>	<b>21,560</b>	<b>29,582</b>	<b>33,446</b>	<b>38,806</b>	<b>45,264</b>
Growth (%)	9.9	(9.5)	11.9	23.5	15.1
Non-interest income	968	1,995	1,375	1,550	1,720
<b>Total income</b>	<b>22,528</b>	<b>31,577</b>	<b>34,821</b>	<b>40,356</b>	<b>46,984</b>
Non-interest income / total income (%)	4.3	6.3	3.9	3.8	3.7
<b>Operating expenses</b>	<b>5,176</b>	<b>7,540</b>	<b>8,113</b>	<b>9,229</b>	<b>10,658</b>
Employee expenses	2,251	3,582	4,119	4,737	5,448
Other expenses	2,925	3,958	3,994	4,492	5,210
<b>Pre-provisioning profit</b>	<b>17,352</b>	<b>24,037</b>	<b>26,708</b>	<b>31,127</b>	<b>36,326</b>
Growth (%)	41.5	38.5	11.1	16.5	16.7
Provisions	4,106	5,548	7,862	8,900	9,187
<b>Profit before tax</b>	<b>13,246</b>	<b>18,489</b>	<b>18,846</b>	<b>22,227</b>	<b>27,139</b>
Taxes	4,515	6,190	6,219	7,335	8,956
Tax rate (%)	34.1	33.5	33.0	33.0	33.0
<b>Profit after tax</b>	<b>8,731</b>	<b>12,299</b>	<b>12,627</b>	<b>14,892</b>	<b>18,183</b>
Growth (%)	42.6	40.9	2.7	17.9	22.1
Number of shares	226	226	226	226	226
Earnings per share	38.7	54.4	55.8	65.8	80.4

Source: Company, Anand Rathi Research

**Fig 17 – Balance sheet (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Share capital	2,255	2,262	2,262	2,262	2,262
Reserves and surpluses	36,168	46,782	57,292	69,802	85,074
<b>Net worth</b>	<b>38,424</b>	<b>49,044</b>	<b>59,554</b>	<b>72,064</b>	<b>87,336</b>
Borrowings	184,599	198,817	255,128	290,207	335,073
Deposits	46,741	68,223	75,046	79,486	84,216
<b>Total loans</b>					
<b>Total liabilities</b>	<b>269,764</b>	<b>316,084</b>	<b>389,728</b>	<b>441,757</b>	<b>506,626</b>
Advances	179,650	198,656	253,145	280,095	321,725
Investments	18,560	36,507	40,158	43,170	46,407
Cash & bank balances	45,373	36,251	46,662	63,080	76,692
Fixed & other assets	26,181	44,670	49,762	55,413	61,801
<b>Total assets</b>	<b>269,764</b>	<b>316,084</b>	<b>389,728</b>	<b>441,757</b>	<b>506,626</b>

Source: Company, Anand Rathi Research

12 December 2011

## Magma Fincorp

*Improvement in profitability underway; we initiate with a Buy*

Rating: **Buy**

Target Price: ₹80

Share Price: ₹56

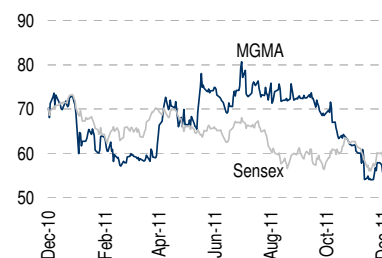
Magma Fincorp's operations in under-banked areas across India and its multiple products indicate strong growth potential. We expect the NBFC's balance sheet to expand two-and-a-half times over FY11-14e and expect consistent improvement in profitability from FY13 to drive valuations up. We initiate coverage on the stock with a Buy rating and a price target of ₹80.

- Poised to benefit from strong rural demand.** We expect strong rural demand to continue, backed by high food prices and increased government expenditure on rural projects. Magma has a well-diversified branch network (194) in 21 states. Most branches (~80%) are in under-banked rural/semi-urban areas that offer huge growth potential.
- Balance sheet estimated to expand two-and-a-half times over FY11-14.** We expect 40% CAGR in loans over FY11-14, backed by: 1) strong disbursement growth across product segments by leveraging its branches and, 2) a drop in securitized loan book, from 46% of AUM in FY11 to 28% by FY14, supported by capital infusion of ₹4.9bn in 2011-12. We expect the lower share of off-book loans and strong disbursements to result in robust balance sheet growth over FY11-14.
- Sharp rise in profitability to raise valuations.** We expect subdued RoE of ~14% (flat PAT growth) in FY12 due to +200bps NIM contraction, given: 1) lower securitization income and high borrowing cost, 2) change in accounting policies and, 3) capital infusion. However, consistent rise in profitability is likely over FY12-14 on better margins and greater leverage. We expect RoE of 20% by FY14, which should drive valuations up.
- Valuation.** At our target price, the stock would trade at a PBV of 1.3x FY12e and 1.2x FY13e. **Risks:** Slower-than-expected rural economic growth that could impact loan growth; increase in NPAs.

Key data	MGMA IN / MAGM.BO
52-week high / low	₹87 / ₹48
Sensex / Nifty	16488 / 4944
3-m average volume	US\$0.1m
Market cap	₹10.6bn / US\$0.2bn
Shares outstanding	189.6m

Shareholding pattern (%)	Sep '11	Jun '11	Mar '11
Promoters	30.0	29.3	41.6
- of which, pledged	NA	NA	NA
Free float	70.0	70.7	58.4
- Foreign institutions	30.8	29.3	40.4
- Domestic institutions	29.4	29.3	1.9
- Public	9.8	12.1	16.1

### Relative price performance



Source: Bloomberg

Key financials (YE Mar)	FY10	FY11	FY12e	FY13e	FY14e
Net interest income (₹m)	3,203	4,519	4,965	7,387	9,895
Net profit (₹m)	665	1,144	1,181	1,975	2,796
EPS (₹)	6.1	8.8	6.2	10.4	14.7
Growth (%)	70.2	44.5	(29.4)	67.2	41.6
PE (x)	9.2	6.4	9.0	5.4	3.8
PABV (x)	1.7	1.3	0.9	0.8	0.7
RoE (%)	20.6	24.8	13.8	16.3	19.8
RoA (%)	1.7	2.2	1.7	2.0	2.3
Dividend yield (%)	1.1	1.8	1.8	2.1	2.5
Net NPA (%)	-	-	-	-	-

Source: Company, Anand Rathi Research

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## Quick Glance – Financials and Valuations

**Fig 1 – Income statement (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Net interest income	3,203	4,519	4,965	7,387	9,895
NII growth (%)	12.8	41.1	9.9	48.8	34.0
Non-interest inc	665	573	691	851	1,048
Total income	3,868	5,092	5,656	8,237	10,943
Total Inc growth (%)	13.7	31.7	11.1	45.6	32.8
Op. expenses	2,437	3,032	3,335	4,068	5,020
Operating profit	1,431	2,060	2,322	4,169	5,923
Op profit growth (%)	40.8	44.0	12.7	79.6	42.1
Provisions	400	355	559	1,222	1,750
PBT	1,030	1,705	1,762	2,947	4,174
Tax	366	561	582	973	1,377
PAT	665	1,144	1,181	1,975	2,796
PAT growth (%)	70.2	72.2	3.2	67.2	41.6
FDEPS (₹/share)	6.1	8.8	6.2	10.4	14.7
DPS (₹/share)	0.6	1.0	1.0	1.2	1.4

Source: Company, Anand Rathi Research

**Fig 2 – Balance sheet (₹m)**

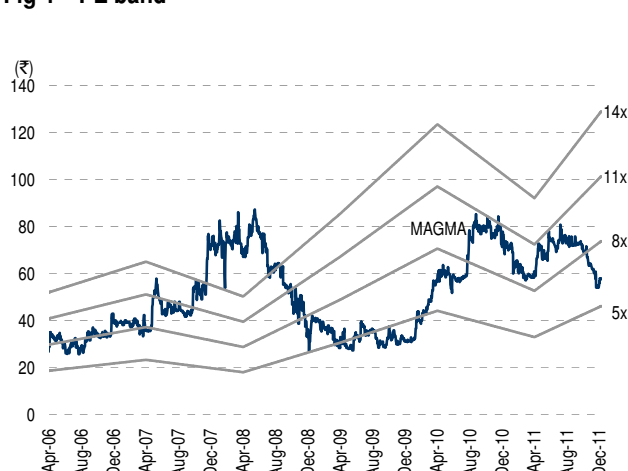
Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Share capital	1,379	1,728	1,848	1,848	1,848
Reserves & surplus	3,267	5,493	10,977	12,569	14,938
Borrowings	35,671	44,084	67,313	87,198	107,453
Current liab & prov	5,266	5,451	6,011	6,657	7,395
Deferred tax liabilities	-	-	-	-	-
Total liabilities	45,583	56,757	86,150	108,272	131,634
Advances	31,816	42,837	71,610	93,260	116,797
Investments	302	299	329	362	398
Cash & bank bal	9,685	10,043	10,599	11,002	11,198
Fixed & other assets	3,780	3,578	3,613	3,649	3,242
Total assets	45,583	56,757	86,150	108,272	131,634
No. of shares (m)	109	130	190	190	190
Borrowing growth (%)	44.3	23.6	52.7	29.5	23.2
Loans growth (%)	60.7	34.6	67.2	30.2	25.2

Source: Company, Anand Rathi Research

**Fig 3 – Key ratios**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
NIM (%)	8.9	9.4	7.2	7.8	8.4
Other inc / total inc (%)	17.2	11.3	12.2	10.3	9.6
Cost-Income (%)	63.0	59.5	59.0	49.4	45.9
Provision coverage (%)	-	-	-	-	-
Dividend payout (%)	7.8	1.3	1.8	2.0	1.4
Borrowings-loans (%)	112.1	102.9	94.0	93.5	92.0
Investment-deposit (%)	-	-	-	-	-
Gross NPA (%)	-	-	-	-	-
Net NPA (%)	-	-	-	-	-
BV (₹)	32.0	44.3	59.9	68.3	80.8
Adj BV (₹)	32.0	44.3	59.9	68.3	80.8
CAR (%)	14.9	18.2	16.0	15.5	14.9
RoE (%)	20.6	24.8	13.8	16.3	19.8
RoA (%)	1.7	2.2	1.7	2.0	2.3
Dividend yield (%)	1.1	1.8	1.8	2.1	2.5

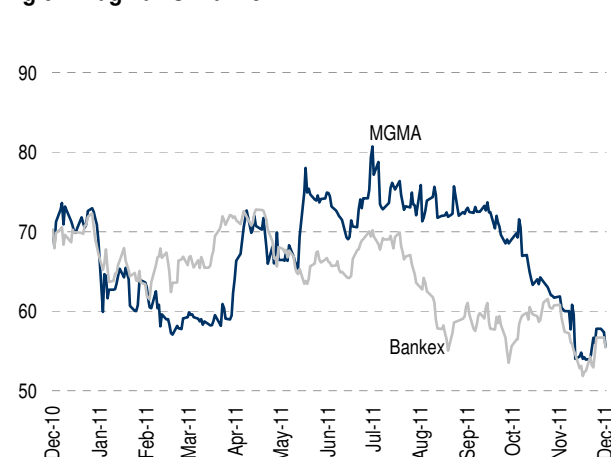
Source: Company, Anand Rathi Research

**Fig 4 – PE band**


Source: Bloomberg, Anand Rathi Research

**Fig 5 – Price-to-book band**


Source: Bloomberg, Anand Rathi Research

**Fig 6 – Magma vs. Bankex**


Source: Bloomberg

## Investment argument and valuation

Magma Fincorp's operations in under-banked areas across India and its multiple products indicate strong growth potential. We expect its balance sheet to expand two-and-a-half times over FY11-14 and expect consistent improvement in profitability from FY13 to drive valuations up. We initiate coverage on the stock with a Buy rating and a price target of ₹80.

### Poised to reap the benefit of strong rural demand

*Magma's strong branch network across the country in under-banked areas offers huge potential for growth*

We expect the trend of strong rural demand to continue, backed by a good monsoon this year, high food prices and increased government expenditure on rural projects.

Magma has a well-diversified branch network (194 branches covering over 2,500 business clusters) in 21 states. Disbursements/loan book are well diversified. Barring Andhra Pradesh (~12% of disbursements) none of the states accounted for over 10% of disbursement in 2QFY12. Most branches (~80%) are situated in under-banked rural/semi-urban areas that offer huge potential for growth.

### Balance sheet to expand 2.5 times over FY11-14

*Change in business model to build on-book assets, supported by capital infusion*

Magma is altering its business model of high off-balance-sheet book, to building on-book assets. We believe the change in its model is good for the long term in the light of likely changes in priority sector and securitization norms by the RBI. The small proportion of off-book loans is expected to reduce uncertainty and balance-sheet risks.

Magma raised ₹4.4bn in May '11 through placements to private equity investors and ₹0.5bn in Oct '11 by way of warrant conversion subscribed by the existing promoters. It has carefully chosen its equity partner for long-term value addition. Kohlberg Kravis Roberts & Co (KKR) and International Finance Corp., Washington (IFC), a member of the World Bank group, have invested ₹2.4bn for 15% stake and ₹2bn for 12.8% stake, respectively. Capital infusion is likely to support strong on-book asset growth over FY11-14.

We expect 40% CAGR in loans over FY11-14, backed by: 1) strong disbursement growth in products by leveraging existing branches and, 2) a drop in the securitized book, from 46% of AUM in FY11 to 28% by FY14. We expect the lower share of off-book loans and robust disbursements to result in strong balance-sheet growth over FY11-14.

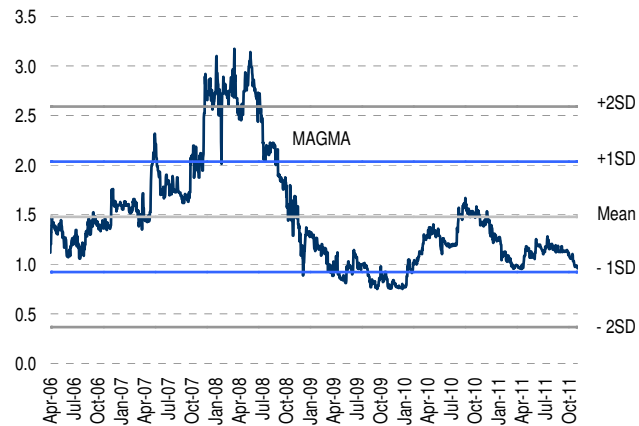
### Sharply improved profitability to drive valuations up

We expect subdued RoE of ~14% (flat net profit growth) in FY12 due to: 1) contraction in NIM by +200bps, given lower securitization income and high borrowing cost, 2) change in accounting policies and, 3) capital infusion. However, we expect consistent improvement in profitability over FY12-14 on better margins and greater leverage. We expect RoE to touch 20% by FY14, driving up valuations.

## Valuation

We initiate coverage on Magma Fincorp, with a Buy rating and a price target of ₹80. At our target price, the stock would trade at a PBV of 1.3x FY12e and 1.2x FY13e. Our target price is based on the two-stage DDM (CoE: 16.8%; Beta: 1.25; Rf: 8%).

Fig 7 – Magma: PBV band



Source: Anand Rathi Research

## Risks

- An economic slowdown would impact the rural economy, and may lead to slower loan growth and higher delinquencies.
- Any regulatory changes regarding SLR/CRR requirements and sector caps may impact the company.
- Business model transformation is key to valuation re-rating. Any change/delay could impact the on-book assets-growth outlook.

## Benefits from strong rural demand

We expect strong rural demand to continue, backed by high food prices and increased government expenditure on rural projects. Magma has a well-diversified branch network in 21 states. Most branches (~80%) are in under-banked rural/semi-urban areas, offering huge growth potential.

### Rural demand expected to be robust

The government has, over the years, increased allocations for various rural development schemes that would drive farm and non-farm demand.

Farmers' disposable incomes have increased due to the rise in minimum support prices, agricultural debt-waiving/debt-relief schemes and interest subsidies on farm loans. Further, the government thrust on better rural infrastructure (roads/ electricity) is expected to enhance employment opportunities in rural India.

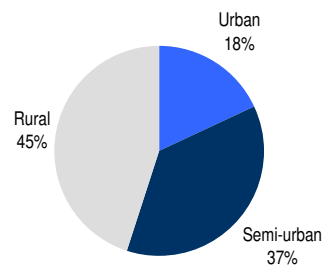
### Diversified distribution reach

Magma has built a strong branch network over the years and has broadened operations in under-banked and credit-starved rural/semi-urban India.

It has a well-diversified branch network (194 branches covering over 2,500 business clusters) in 21 states. Most branches (~80%) are situated in under-banked rural/semi-urban areas that offer vast potential for growth.

*Barring Andhra Pradesh, none of the states accounts for more than 10% of disbursements*

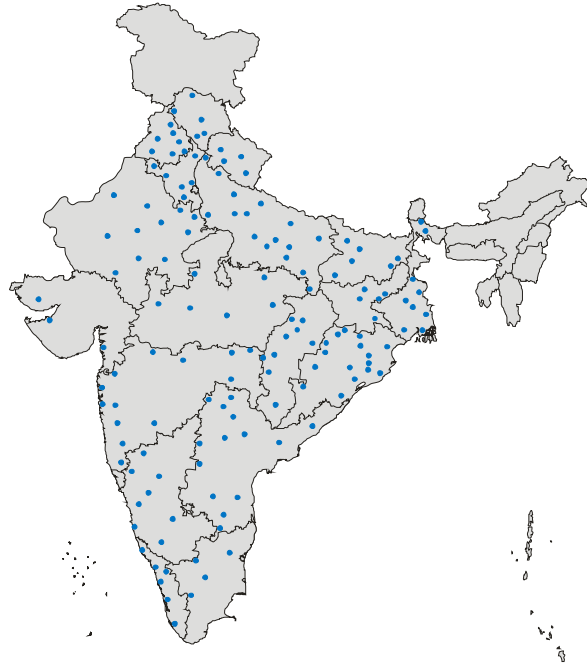
**Fig 8 – Strong presence in semi-urban and rural regions (194 branches)**



Source: Company; Note: data as of 30 Sep '11

Magma has well-diversified disbursements/loan book. Barring Andhra Pradesh (~12% of disbursements), none of the states accounts for more than 10% of disbursement in 2QFY12.

**Fig 9 – Well-diversified branch network across the states**



Source: Company

## Balance sheet to expand 2.5 times

We expect 40% CAGR in loans over FY11-14, backed by: (1) strong disbursement growth across product segments by leveraging existing branches and (2) a drop in securitized loan book, from 46% of AUM in FY11 to 28% by FY14, supported by capital infusion of ₹4.9bn in FY12. We expect the lower share of off-book loans and strong disbursements to result in robust balance sheet growth over FY11-14.

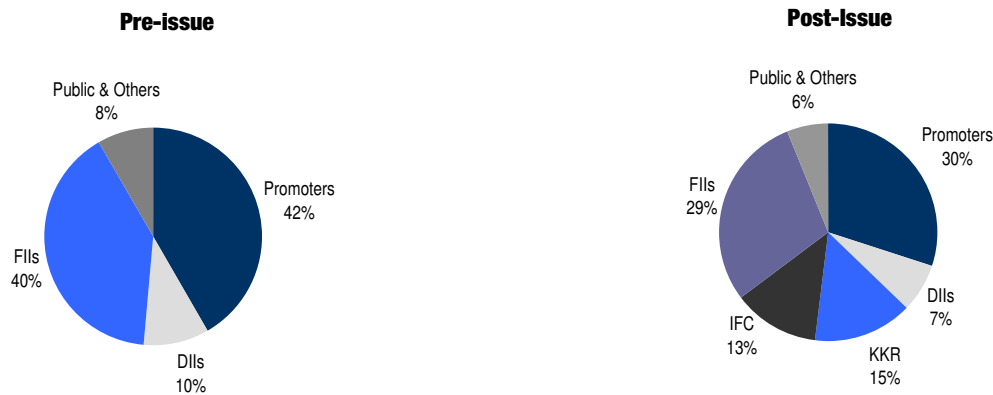
### Change in business model backed by capital infusion

Magma is altering its business model of high off-balance-sheet book, to build on-book assets. We believe the change in the model is good for the long term in the light of likely changes in the priority sector and securitization norms by the RBI. The small proportion of off-book loans should reduce uncertainty and balance-sheet risks.

*Capital infusion by PE investors to support strong balance sheet growth*

Magma raised ₹4.4bn in May '11 in private equity. It chose its equity partners for long-term value addition. KKR (Kohlberg Kravis Roberts & Co) and IFC (International Finance Corporation, a member of the World Bank) have respectively invested ₹2.4bn for 15% stake and ₹2bn for 12.8% stake. We expect the capital infusion to support strong on-book asset growth over FY11-14.

Fig 10 – Capital infusion of ₹4.4bn: changes in capital structure



Source: Company

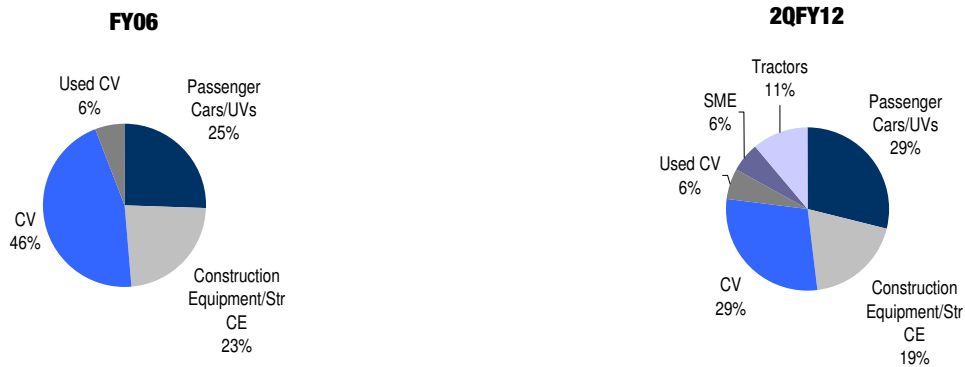
### Strong disbursement growth over FY11-14

*Diversified product offering to drive disbursement growth*

Magma has diversified products and all-India operations in various states. It has increased its product offering over the years. In FY06, disbursements were limited to four categories: i) passenger cars/utility vehicles, ii) construction and strategic equipment, iii) commercial vehicles and iv) used-vehicles.

Magma now offers loans for six products: i) passenger cars/utility vehicles, ii) construction & strategic equipment, iii) tractors, iv) commercial vehicles, v) SME and vi) used-vehicles. In FY06, commercial vehicles and passenger cars accounted for ~70% of disbursements (vs ~60% in 2QFY12). Unlike other financiers, its loan book is not geared towards one product offering. This is likely to provide balanced loan growth if growth in one product slows down.

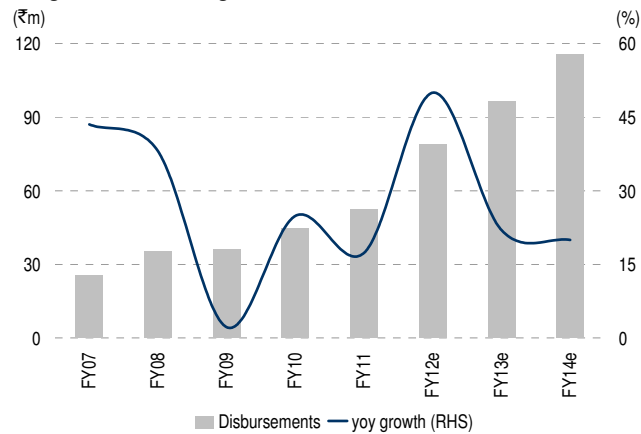
Fig 11 – Diversified disbursement mix (FY06 vs 2QFY12)



Source: Company

Magma plans to expand its branch network while leveraging its present infrastructure (branches, current customers and employees), by offering more products across branches to capitalize on a buoyant rural economy. We expect this to keep disbursements strong over FY11-14. We expect an increase in the share of tractor loans (~11% in 2QFY12), used CV loans (~6% in 2QFY12) and SME loans (6%) in overall disbursements. We estimate disbursement CAGR of 30% over FY11-14.

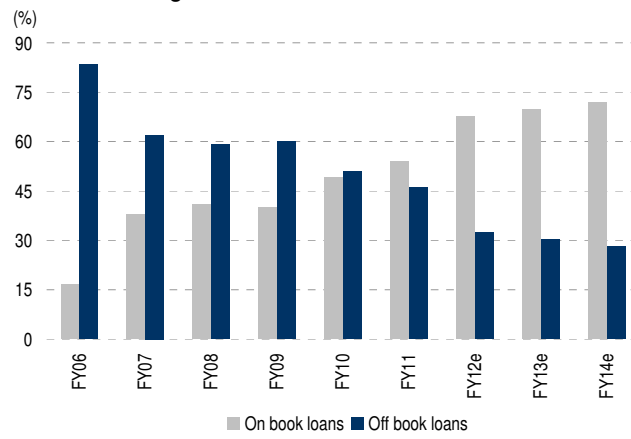
Fig 12 – Strong disbursement growth over FY11-14e



Source: Company, Anand Rathi Research

We expect 27.1% CAGR in AUM over FY11-14. However, on-book loans are expected to grow much faster. We estimate 40% CAGR in loans over FY11-14, due to a drop in the securitized book, from 46% of AUM in FY11 to 28% by FY14. We expect the small share of off-book loans and robust disbursements to result in strong balance-sheet growth over FY11-14.

**Fig 13 – AUM mix to change in favour of on-book assets**



Source: Company, Anand Rathi Research

## Sharp improvement in profitability

We expect consistent rise in profitability over FY12-14 on better margins and greater leverage. We estimate RoE of 20% by FY14, which should drive valuations up. In the near term, however, subdued RoE of ~14% (flat PAT growth) is likely in FY12, due to +200bps NIM contraction, given: 1) lower securitization income and high borrowing cost, 2) change in accounting policies and 3) capital infusion.

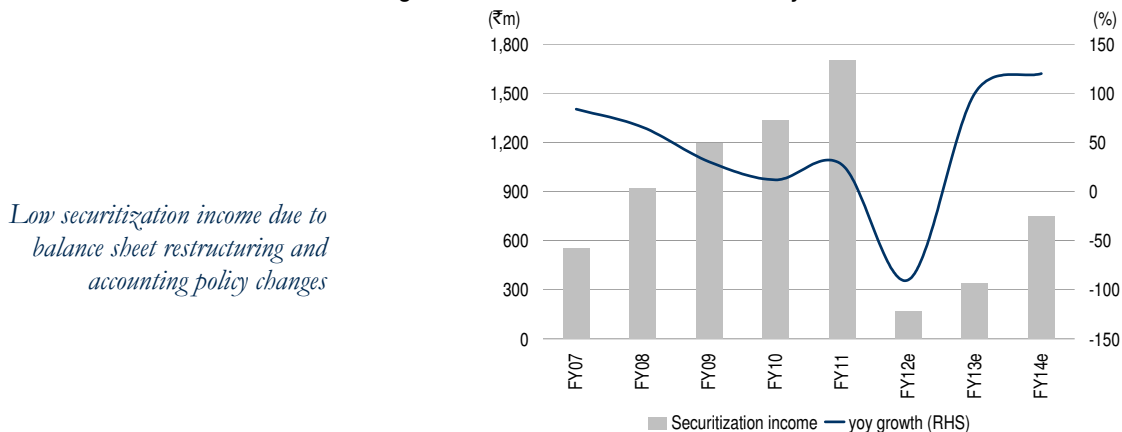
### Securitization income expected to improve from FY13

In FY12, Magma altered its accounting policy with respect to accounting of securitization income. It now defers the securitization income over the life of the underlying assets rather than accounting for it upfront.

Securitized loans as a proportion of total loans were very high till FY11. This raised earnings volatility and balance-sheet risk. Magma plans a faster increase in on-book assets through lower securitization of loans in FY12.

We expect negligible securitization income in FY12 compared with FY11 due to: 1) change in accounting policy and 2) lower securitization of loans. However, from FY13 we expect securitization income to improve on the lower base and high deferred securitization income.

Fig 14 – Securitization income over the years



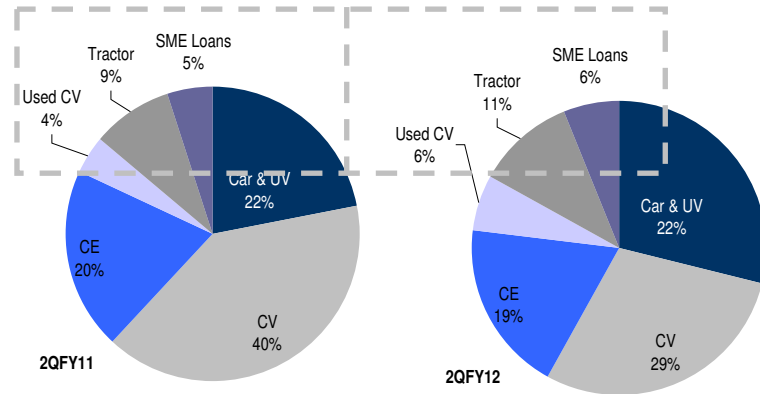
Source: Company, Anand Rathi Research

Negligible securitization income and high borrowing cost are likely to result in lower NIM for FY12. We expect a ~200bps decline in NIM even after capital infusion.

### Rising share of high-yield assets; easing interest rates to drive NIM in FY13/14

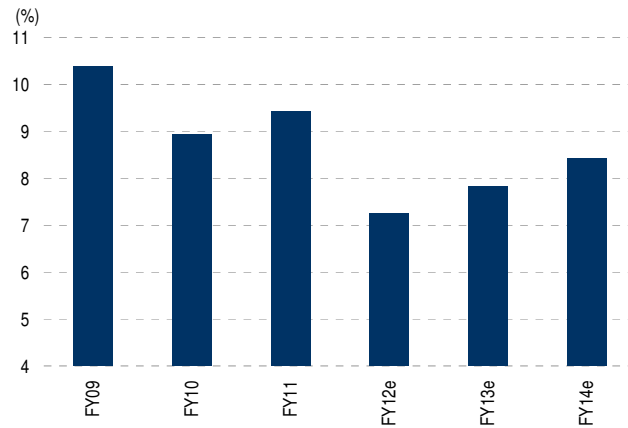
The share of used CV, tractor and SME loans in disbursements has risen over the years and was 23% in 2QFY12 vs. 18% in 2QFY11 (still lower in FY10 and negligible in FY09). This is expected to drive margins up as their share in overall AUMs increases meaningfully in FY13/14. With easing interest rates from 1HFY13 and higher securitization income, we expect NIM to expand in FY13 and FY14.

**Fig 15 – Greater share of high-yielding loans**



Source: company, Anand Rathi Research

**Fig 16 – NIM to expand in FY13/14**

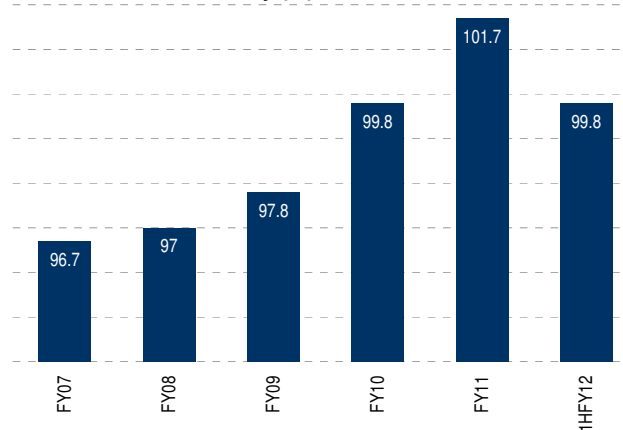


Source: Company, Anand Rathi Research

**Robust asset quality**

Superior collection efficiency, stringent credit-appraisal standards and regular (monthly/bi-monthly) interaction with customers has helped Magma maintain robust asset quality. All internal checks are conducted by an experienced in-house team. For local operations, Magma hires locals who possess a good understanding of the market and the credit-worthiness of individual borrowers.

**Fig 17 – Robust collection efficiency (%)**



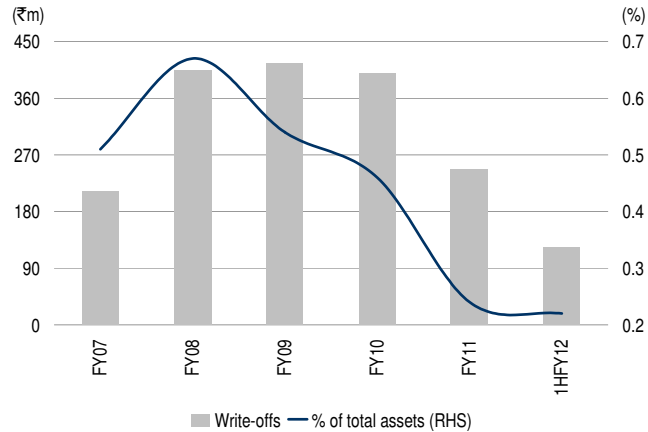
Source: Company

*Credit cost has declined over the years due to robust collection efficiencies*

This strategy has helped hold delinquencies in check, even in relatively high-risk market segments, evidenced by the decline in NPA expenses (as percent of assets) since FY07. Magma also has zero NPAs, as any non-paying account is completely written off on a 180-day basis.

However, we expect Magma’s credit costs to rise with the slowing economy and rising interest rates. We are conservative on asset quality and model 3% credit cost for FY11-14 vs. 1% in FY11.

**Fig 18 – NPA provisions on declining trend**



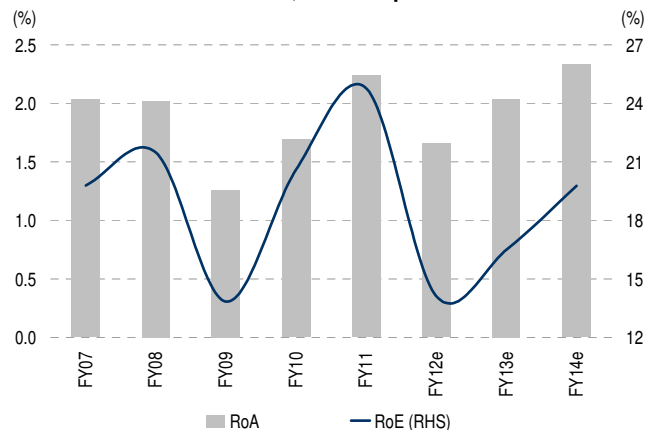
Source: Company

**Return ratio to improve**

We expect subdued RoE in FY12, of ~14% (flat net profit growth) due to: 1) contraction in NIM by +200bps given: 1) lower securitization income and high borrowing cost, 2) change in accounting policies and, 3) capital infusion. However, we expect consistent improvement in profitability over FY12-14 on wider margins and greater leverage. We expect RoE to touch 20% by FY14, driving up valuations.

*We expect RoE to touch ~20% by FY14*

**Fig 19 – Subdued return ratio in FY12; set to expand from FY13**



Source: Company, Anand Rathi Research

Magma has been de-rated due to mounting macro-economic concerns and lower return ratios, given its balance-sheet restructuring. We expect the return ratios to improve and, with easing macro-economic concerns, the stock to be re-rated.

## Financials

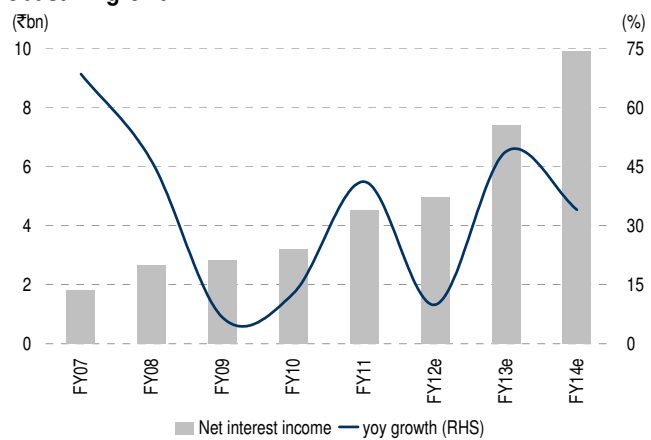
We estimate 30% CAGR in net interest income over FY11-14 on account of strong expected balance-sheet growth and margin improvement from FY13. Growth in non-interest income is estimated at 22.3%, slower than balance-sheet growth over the same period. We expect significant improvement in profitability over FY13/14.

### Strong NII growth

We estimate 30% CAGR in net interest income over FY11-14 on account of the strong expected balance-sheet loan growth (40% CAGR over FY11-14) and margin improvement from FY13 (110bps in FY13/14 over FY12).

*Robust NII growth in FY13/14 following balance sheet restructuring in FY12*

Fig 20 – Robust NII growth

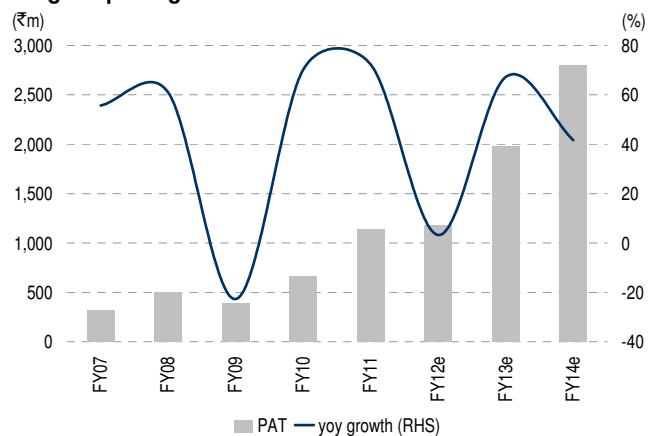


Source: Company, Anand Rathi Research

### Flat net profit growth in FY12e; revival in FY13/14e

We expect non-interest income growth at 22.3% to be slower than balance-sheet growth over FY13/14. We expect flat net profit growth in FY12 due to over 200bps NIM contraction, given lower securitization income, high borrowing cost and the change in accounting policies. We expect consistent improvement in profit over FY13/14, driven by higher securitization income; lower borrowing cost and, thus, higher margins.

Fig 21 – Strong net profit growth in FY13/14e



Source: Company, Anand Rathi Research

**Fig 22 – Income statement (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Interest income	6,365	7,900	9,922	14,571	19,141
Interest expended	3,162	3,381	4,957	7,185	9,246
<b>Net interest income</b>	<b>3,203</b>	<b>4,519</b>	<b>4,965</b>	<b>7,387</b>	<b>9,895</b>
Growth (%)	12.8	41.1	9.9	48.8	34.0
Non-interest income	665	573	691	851	1,048
<b>Total income</b>	<b>3,868</b>	<b>5,092</b>	<b>5,656</b>	<b>8,237</b>	<b>10,943</b>
Non-interest income / total Income (%)	17.2	11.3	12.2	10.3	9.6
<b>Operating expenses</b>	<b>2,437</b>	<b>3,032</b>	<b>3,335</b>	<b>4,068</b>	<b>5,020</b>
Employee expenses	1,053	1,346	1,481	1,807	2,205
Other expenses	1,384	1,685	1,854	2,261	2,816
<b>Pre-provisioning profit</b>	<b>1,431</b>	<b>2,060</b>	<b>2,322</b>	<b>4,169</b>	<b>5,923</b>
Growth (%)	40.8	44.0	12.7	79.6	42.1
Provisions	400	355	559	1,222	1,750
<b>Profit before tax</b>	<b>1,030</b>	<b>1,705</b>	<b>1,762</b>	<b>2,947</b>	<b>4,174</b>
Taxes	366	561	582	973	1,377
Tax rate (%)	35.5	32.9	33.0	33.0	33.0
<b>Profit after tax</b>	<b>665</b>	<b>1,144</b>	<b>1,181</b>	<b>1,975</b>	<b>2,796</b>
Share of profit from associates	-	-	-	-	-
Minority interest	-	-	-	-	-
<b>Consolidated profit after tax</b>	<b>665</b>	<b>1,144</b>	<b>1,181</b>	<b>1,975</b>	<b>2,796</b>
Growth (%)	70.2	72.2	3.2	67.2	41.6
Number of shares	109	130	190	190	190
Earnings per share	6.1	8.8	6.2	10.4	14.7

Source : Company, Anand Rathi Research

**Fig 23 – Balance Sheet (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Share capital	1,379	1,728	1,848	1,848	1,848
Reserves and surplus	3,267	5,493	10,977	12,569	14,938
<b>Net worth</b>	<b>4,646</b>	<b>7,221</b>	<b>12,826</b>	<b>14,417</b>	<b>16,786</b>
Borrowings	35,671	44,084	67,313	87,198	107,453
Other liabilities & provisions	5,266	5,451	6,011	6,657	7,395
<b>Total loans</b>					
<b>Total liabilities</b>	<b>45,583</b>	<b>56,757</b>	<b>86,150</b>	<b>108,272</b>	<b>131,634</b>
Loans	31,816	42,837	71,610	93,260	116,797
Investments	302	299	329	362	398
Cash & bank balances	9,685	10,043	10,599	11,002	11,198
Fixed & other assets	3,780	3,578	3,613	3,649	3,242
<b>Total assets</b>	<b>45,583</b>	<b>56,757</b>	<b>86,150</b>	<b>108,272</b>	<b>131,634</b>

Source : Company, Anand Rathi Research

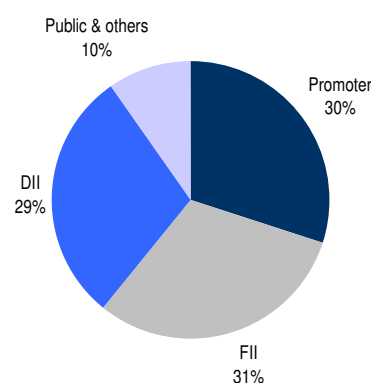
## Company Background & Management

Incorporated in 1988 in Kolkata, in early 2007, Magma Fincorp acquired the non-banking retail financing Shrachi Infrastructure Finance, along with its network in west and south India. Magma today has all-India operations – over 194 offices in 21 states, represented by a qualified, 5,000-member team. It secured capital infusion of ₹4.4bn from PE investors for growth and balance-sheet re-structuring.

### Background

Incorporated in 1988 in Kolkata, Magma Fincorp strengthened its business, by amalgamating with ARM Group Enterprises in 1992 and by acquiring Consortium Finance, a northern NBFC, in 2000. In early 2007, it acquired the non-banking retail financing Shrachi Infrastructure Finance, with a network in west and south India. Magma today has all-India operations, with over 190 offices in 21 states, represented by a qualified team of over 5,000 members. It received capital infusion of ₹4.4bn from PE investors for growth and balance-sheet re-structuring.

Fig 24 – Shareholding pattern



Source: Company; Note: data as of 30 Sep '11

### Management

Fig 25 – Key management

Name	Designation	Background
Mr Mayank Poddar	Chairman	More than 30 years' experience in finance; contributes to policy formulation and provides overall support and guidance to the Board and management.
Mr Sanjay Chamria	Vice-Chairman & Managing Director	Anchors strategic policy formulation and execution; drives new business initiatives and leads the management team in the achievement of goals.
Mr Narayan Seshadri	Independent Non-Executive Director	Has over 30 years' experience in corporate finance and consulting; formerly associated with KPMG and Arthur Anderson.
Mr Sanjay Nayar	Non-Independent Non-Executive Director	Currently CEO and country head for KKR in India; Has spent 24 years at Citigroup, most recently as CEO of CITI's Indian and South Asian operations. Was deputy chairman of the IBA and chairman of the Foreign Banks' Committee of the IBA, member of the Board of USIBC.

Source: Company

12 December 2011

## Shriram City Union Finance

*Strong rural network to drive growth in tough times; Buy*

Rating: **Buy**

Target Price: ₹680

Share Price: ₹512

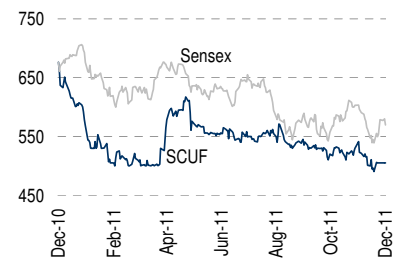
With 75% of its 650 branches (own + group) in semi-urban and rural areas, Shriram City Union Finance (SCUF) is geared to benefit from the rise in rural income levels. Strong loan growth, cost efficiencies and stable asset quality are expected to drive profitability over FY11-14. We initiate coverage on SCUF with a Buy rating and a price target of ₹680.

- Leveraging a strong network to profit from rising rural income.** SCUF is leveraging its wide distribution network in semi-urban and rural areas (over 75% of its branches) and the strong branch network of group companies, Shriram Chit Fund and Shriram Transport, in order to benefit from the rising prosperity of under-banked semi-urban and rural areas.
- Robust earnings outlook despite challenging environment.** We expect strong disbursement growth, backed by robust demand for gold and SME loans in rural areas, and project 30% CAGR in AUM over FY11-14. We factor in a 70-bp margin decline due to a rise in wholesale funding costs in FY12. Operating efficiency is likely to increase as SCUF leverages the branch networks of group companies over the next 2-3 years. We expect net slippages to be contained below 1% due to the high proportion of secured assets, and estimate 30% CAGR in net profit over FY11-14.
- Attractively priced.** We estimate RoA at a superior ~3% and expect RoE to improve from 22% to 25% over FY11-14 on greater leverage. SCUF, which has a strong consumer retail franchise network, is attractively priced at a PBV of 1.7x FY12e and 1.3x FY13e.
- Valuation.** At our target price, the stock would trade at a PBV of 2.2x FY12e and 1.8x FY13e. **Risks:** Slower-than-expected rural economic growth that could impact loan growth; increase in NPAs.

Key data	SCUF IN / SHCU.BO
52-week high / low	₹688 / ₹490
Sensex / Nifty	16488 / 4944
3-m average volume	US\$0m
Market cap	₹25.3bn / US\$0.5bn
Shares outstanding	49.5m

Shareholding pattern (%)	Sep '11	Jun '11	Mar '11
Promoters	53.2	53.2	53.5
- of which, pledged	NA	NA	NA
Free float	46.8	46.8	46.5
- Foreign institutions	15.3	15.1	15.0
- Domestic institutions	0.2	0.3	0.2
- Public	31.3	31.4	31.3

### Relative price performance



Source: Bloomberg

Key financials (YE Mar)	FY10	FY11	FY12e	FY13e	FY14e
Net interest income (₹m)	5,709	7,313	9,766	13,153	16,367
Net profit (₹m)	2,106	2,424	3,325	4,305	5,317
EPS (₹)	42.9	48.9	67.1	86.9	107.3
Growth (%)	65.2	14.2	37.1	29.5	23.5
PE (x)	11.9	10.4	7.6	5.9	4.8
PABV (x)	2.6	2.1	1.7	1.4	1.1
RoE (%)	24.6	21.9	24.5	25.4	25.1
RoA (%)	3.6	3.1	3.0	3.0	2.9
Dividend yield (%)	1.0	1.2	1.4	1.7	2.0
Net NPA (%)	0.7	0.4	0.4	0.4	0.4

Source: Company, Anand Rathi Research

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## Quick Glance – Financials and Valuations

**Fig 1 – Income statement (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Net interest income	5,709	7,313	9,766	13,153	16,367
NII growth (%)	31.2	28.1	33.5	34.7	24.4
Non-interest inc	308	29	41	51	64
Total income	6,016	7,343	9,807	13,204	16,431
Total inc growth (%)	35.1	22.0	33.6	34.6	24.4
Op. expenses	1,824	2,558	3,135	3,816	4,645
Operating profit	4,192	4,784	6,672	9,387	11,785
Op profit growth (%)	62.1	14.1	39.5	40.7	25.5
Provisions	1,166	1,160	1,710	2,962	3,850
PBT	3,026	3,624	4,962	6,425	7,936
Tax	920	1,200	1,637	2,120	2,619
PAT	2,106	2,424	3,325	4,305	5,317
PAT growth (%)	77.1	15.1	37.1	29.5	23.5
FDEPS (₹/share)	42.9	48.9	67.1	86.9	107.3
DPS (₹/share)	5.0	6.0	7.0	8.5	10.0

Source: Company, Anand Rathi Research

**Fig 2 – Balance sheet (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Share capital	492	495	495	495	495
Reserves & surplus	9,508	11,625	14,544	18,357	23,094
Borrowings	46,671	73,278	103,101	126,747	160,018
Current liab & prov	5,810	8,721	12,210	15,262	19,078
Deferred tax liabilities	-	-	-	-	-
Total liabilities	62,481	94,120	130,350	160,861	202,685
Advances	47,314	69,892	101,079	126,747	158,433
Investments	10	55	61	67	73
Cash & bank bal	14,021	21,654	26,614	31,191	41,036
Fixed & other assets	1,136	2,519	2,596	2,856	3,142
Total assets	62,481	94,120	130,350	160,861	202,685
No. of shares (m)	49	50	50	50	50
Borrowing growth (%)	8.0	57.0	40.7	22.9	26.3
Loans growth (%)	27.5	47.7	44.6	25.4	25.0

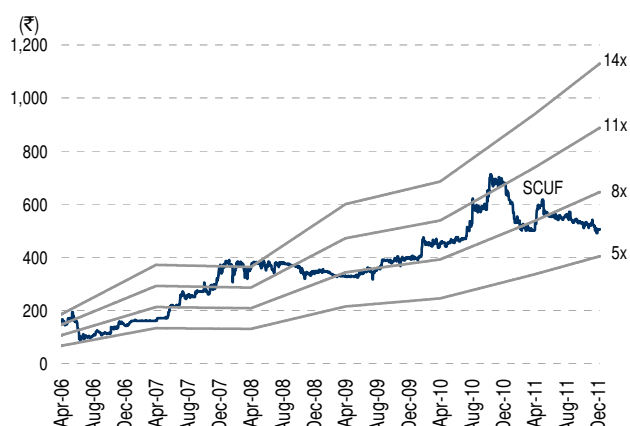
Source: Company, Anand Rathi Research

**Fig 3 – Key ratios**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
NIM (%)	10.0	9.6	8.9	9.2	9.2
Other inc / total inc (%)	5.1	0.4	0.4	0.4	0.4
Cost-income (%)	9.9	44.5	23.0	22.0	22.0
Provision coverage (%)	69.1	77.0	80.6	83.4	85.6
Dividend payout (%)	11.7	12.3	10.4	9.8	9.3
Borrowings-loans (%)	98.6	104.8	102.0	100.0	101.0
Investment-deposit (%)					
Gross NPA (%)	2.3	1.9	2.0	2.4	2.8
Net NPA (%)	0.7	0.4	0.4	0.4	0.4
BV (₹)	203.4	244.7	303.6	380.6	476.2
Adj BV (₹)	198.9	240.6	298.4	373.8	467.5
CAR (%)	26.3	20.5	19.0	17.5	16.0
RoE (%)	24.6	21.9	24.5	25.4	25.1
RoA (%)	3.6	3.1	3.0	3.0	2.9
Dividend yield (%)	1.0	1.2	1.4	1.7	2.0

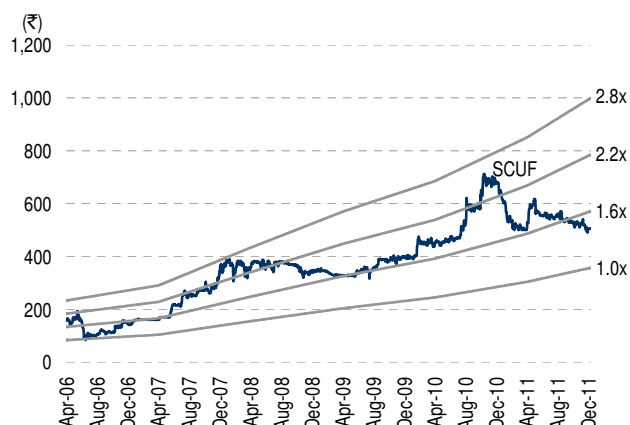
Source: Company, Anand Rathi Research

**Fig 4 – PE band**



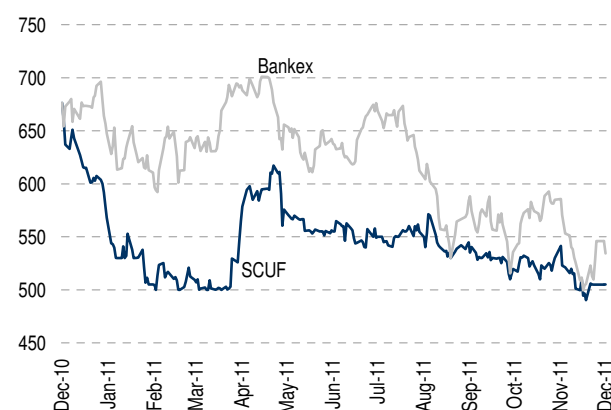
Source: Bloomberg, Anand Rathi Research

**Fig 5 – Price-to-book band**



Source: Bloomberg, Anand Rathi Research

**Fig 6 – SCUF vs. Bankex**



Source: Bloomberg

## Investment argument and valuation

Shriram City Union Finance (SCUF) is geared to benefit from the rise in rural income levels, with 75% of its 650 branches (own + group) in semi-urban and rural areas. Strong loan growth, cost efficiencies and stable asset quality are expected to drive profitability over FY11-14. We initiate coverage on SCUF with a Buy rating and a price target of ₹680.

### Tapping into rural prosperity with a strong network

*SCUF is poised, with ~650 branches, to tap the rising disposable income in rural areas*

Increased government spend on rural projects has resulted in robust growth in rural income. (Budget estimates of outlay on rural projects doubled in two years, from ₹400bn in FY09 to ₹800bn in FY11.) This, combined with a high minimum support price set by the government for various crops and growing opportunities in non-agricultural areas (from rising industrialization), is leading to more disposable income in rural areas.

SCUF, a south-based Shriram Group company, has a wide distribution network in semi-urban and rural areas (over 75% of its branches). In addition, it utilizes the branch networks of other group companies (Shriram Chit and Shriram Transport have +400 branches each) to deepen its rural penetration. With this extensive branch network, SCUF is well-placed to profit from the growing prosperity of the under-banked rural/semi-urban areas.

### Robust earning outlook despite challenging scenario

*We estimate 27% CAGR in PAT over FY11-14 despite lower NIM in FY12 and higher credit cost*

Higher interest rates and fears of slower economic growth have caused most finance companies to worry about margins and asset quality. This has led to slower loan growth and asset-quality issues across the board. However, we see little problems for SCUF in this regard, as it enjoys strong pricing power and over 90% of its loan book is secured.

We expect strong disbursement growth, backed by robust demand for gold and SME loans in under-banked rural areas, and project 30% CAGR in AUM over FY11-14. We factor in a 70-bp margin decline due to higher wholesale funding costs in FY12. We also expect some operating efficiency to kick in as the company leverages existing/group companies' branch networks over the next 2-3 years. Net slippages are likely to be contained below 1% due to the high proportion of secured assets, and estimate 30% CAGR in net profit over FY11-14.

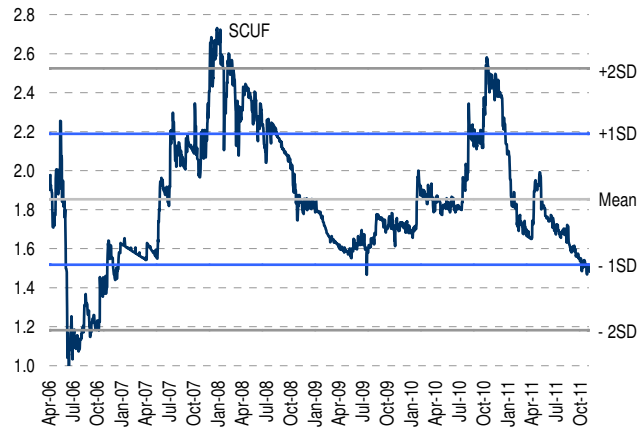
### Attractively priced for strong profitability

We expect RoA at a superior ~3% and RoE to improve from 22% to 25% over FY11-14 on greater leverage, after factoring in a ~70-bp drop in margins. A strong consumer retail franchise, SCUF is attractively priced at a PBV of 1.7x FY12e and 1.3x FY13e. Given its strong growth and superior return ratios, we believe the stock has re-rating potential.

## Valuation

We initiate coverage on SCUF, with a Buy rating and a price target of ₹680. At our target price, the stock would trade at a PBV of 2.2x FY12e and 1.8x FY13e. Our target price is based on the two-stage DDM (CoE: 16.1%; Beta: 1.15; Rf: 8%).

Fig 7 – SCUF: PBV band



Source: Bloomberg, Anand Rathi Research

## Risks

- Further economic slowdown would impact the rural economy, leading to slower loan growth and more delinquencies.
- Any regulatory changes regarding SLR/CRR requirements and sectoral caps may impact the company.
- Over 40% of incremental disbursements are for gold loans. Any steep downtrend in gold prices could impact growth and asset quality.

## Wide network to tap rural prosperity

SCUF's extensive distribution network in semi-urban and rural areas (over 75% of its branches) helps it benefit from rising rural income. In addition, it utilizes the branch networks of its group companies (Shriram Chit and Shriram Transport) to deepen penetration in rural areas.

### Strong rural demand expected

The government has, over the years, increased allocations for various rural development schemes that would drive farm and non-farm demand.

**Fig 8 – Allocation under various rural schemes (₹bn)**

Union Budget/schemes	'07-08	'08-09	'09-10	'10-11
Swaranjayanti Gram Swarozgar Yojana (SGSY)	16	19	21	21
National Employment Guarantee Schemes	142	221	391	400
Rural Housing Schemes	36	49	79	100
Pradhan Mantri Gram Sadak Yojana (PMGSY)	106	141	174	212
National Rural Health Mission	101	121	141	188

Source: Planning Commission

*Budget allocation for rural projects has doubled over last three years to ₹900bn*

Higher minimum support prices, agricultural debt-waiver/debt-relief schemes and interest subsidies on farm loans have increased farmers' disposable incomes. Government thrust on better rural infrastructure (roads/electricity supply) should enhance employment opportunities in rural India.

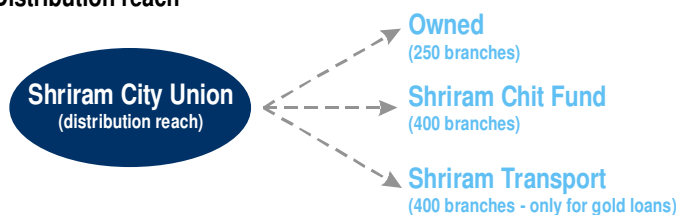
*Improved auto demand is expected after the harvest and festive seasons, due to better crops as a result of the good monsoon this year*

According to the Meteorological Department of India, the monsoons in the country were largely normal to above-normal this year. This is expected to lead to better crops this year, thereby resulting in more rural cash flow. This would drive auto demand following the harvest in 2QFY12 and the festival season in 3QFY12.

### Wide distribution reach

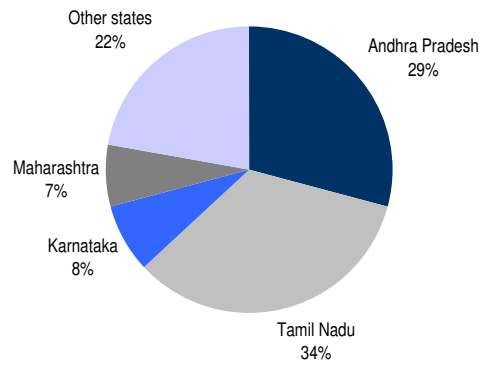
A south-based Shriram Group company, SCUF has a wide distribution network in semi-urban and rural areas (over 75% of its branches). In addition, it utilizes the branch networks of its group companies (Shriram Chit and Shriram Transport have 400 branches each) to deepen penetration in rural areas. With its extensive branch network in rural and semi-urban areas, SCUF is poised to reap the benefit of the growing prosperity of under-banked rural/semi-urban areas.

**Fig 9 – Distribution reach**



Source: Company

**Fig 10 – Strong southern presence: branches (state-wise ) as of Sep '11**



Source: Company

## Robust earnings outlook

We expect strong disbursement growth for SCUF, backed by robust demand for gold, auto and SME loans in rural areas, and project 30% CAGR in AUM over FY11-14. We factor in a 70-bp decline in margin due to a rise in wholesale funding costs in FY12. Increased operating efficiency is likely, as SCUF leverages the branch networks of group companies over the next 2-3 years. We expect net slippages to be contained below 1% due to the high proportion of secured assets, and estimate 30% CAGR in net profit over FY11-14.

### 30% CAGR in AUM over FY11-14e

#### Well-positioned due to strong pricing power

Higher interest rates and the fear of a further slowdown in economic growth have led to concerns about margins and asset quality in the case of most finance companies. This has led to slower loan growth and asset quality issues across the board. However, SCUF is likely to face few problems in this regard, as the company enjoys strong pricing power and over 90% of its loan book is secured.

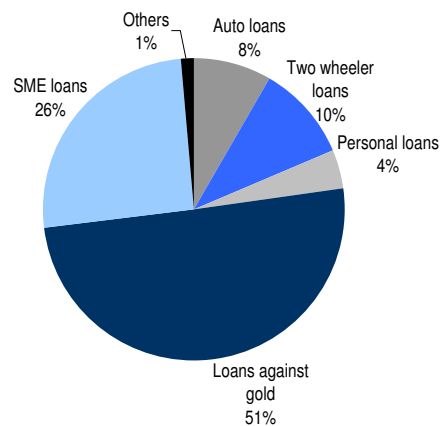
#### Gold and SME loans to drive disbursement growth

*A large customer database of 4.5m and SCUF's established brand name are expected to drive the company's new gold loan business*

We expect strong disbursement growth for SCUF, backed by robust demand for gold and SME loans in under-banked rural/semi-urban areas. Along with Shriram Chit Fund, SCUF has a huge customer database of over 4.5m; of this, 1.6m are customers of either SCUF or Shriram Chit Fund. The huge customer base and strong brand name are expected to drive the NBFC's gold-loan business.

Targeted customers for SME loans are local businessmen in under-banked, credit-starved regions. This typically includes small traders, retailers and stockists, who take loans of ₹0.5m-1m.

**Fig 11 – Disbursement mix: highly skewed towards gold/SME loans (2QFY12)**

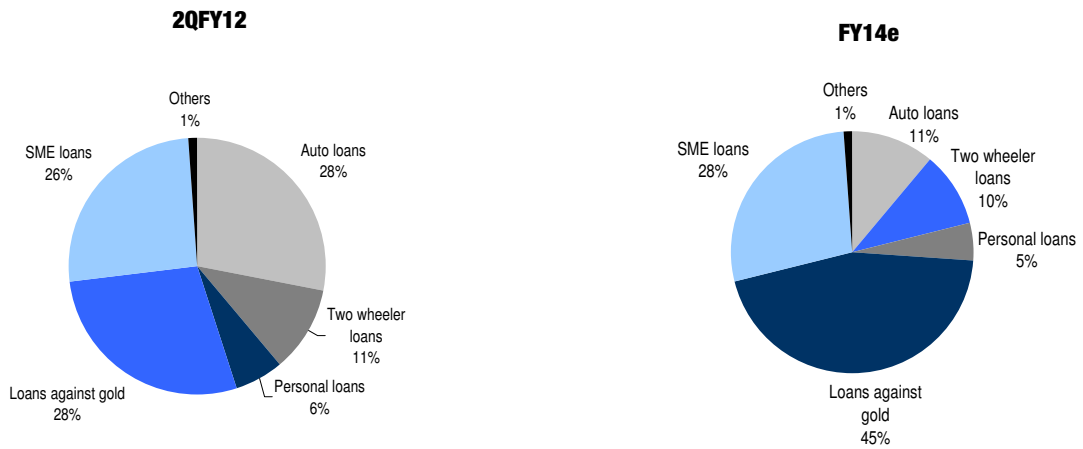


Source: Company

At end-Sep '11, gold loans (28% of AUM) and SME loans (26%) accounted for ~54% of AUM. However, ~70% of further disbursement is towards gold loans (~45%) and SME loans (~25%). Incremental disbursement to the passenger-car segment is expected to slow down going ahead. (Its share in disbursement is 11% vs. 28% share in AUM).

This trend is likely to continue for the next 1-1.5 years and, in turn, is expected to alter the AUM mix by FY14. We expect 70-75% of AUM to be dominated by gold and SME loans.

**Fig 12 – Business mix to change by FY14**

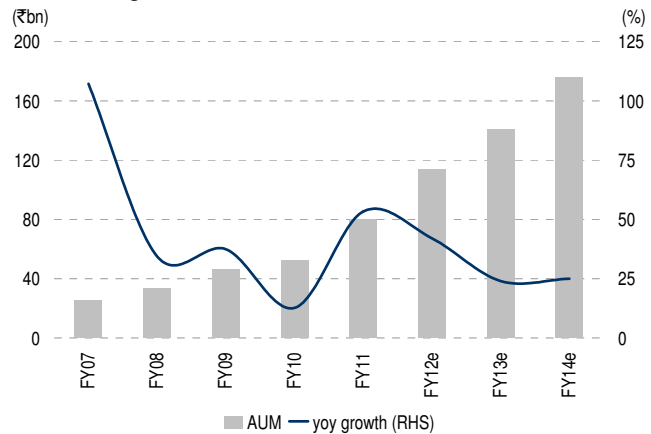


Source: Company, Anand Rathi Research

**30% CAGR in AUM estimated over FY11-14**

The changing business-mix, coupled with rural penetration, should ensure strong disbursement growth for the company. SCUF has increased its disbursement by over 50% yoy in 2QFY12. We expect this trend to continue for the rest of FY12 and estimate 42% AUM growth for the year. A slowdown in disbursement growth is expected from FY13, due to the sluggish macro-economic environment and the higher base of FY12. We estimate 30% CAGR in AUM over FY11-14.

**Fig 13 – Robust AUM growth over FY11-14e**



Source: Company, Anand Rathi Research

## Marginal contraction (70bps) in NIM for FY12

### Strong pricing power and borrowing mix to limit NIM compression

*Strong pricing power, superior borrowing mix and low duration of assets to limit NIM compression*

SCUF has sufficient pricing power to pass on any increased borrowing cost to final customers. Most loans have relatively small EMIs, so even a ~200-bp rise in loan rates would result in only a marginal increase in EMI.

SCUF has a good mix of retail and wholesale borrowing. At end-Sep '11, 42% of the borrowings were from retail, 50% from banks/FIs (wholesale borrowing) and 8% through CPs.

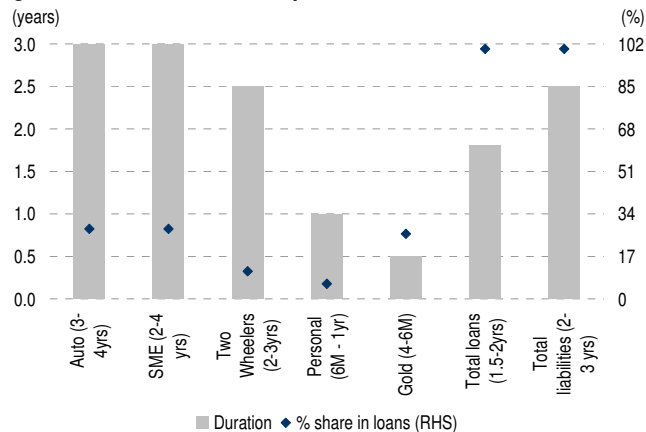
Twenty-eight percent of SCUF's borrowings are "floating" (carry an adjustable rate of interest). In a rising interest-rate environment, this could eat into margins, as loans given by the company are "fixed" (carry a fixed rate of interest). However, the impact of an increase in borrowing costs is limited, due to a difference in tenure (duration) of assets and liabilities. SCUF's average duration of assets (18-24 months) is lower than that of its liabilities (24-36 months). This leads to faster re-pricing of assets than of liabilities. Therefore, the impact on NIM is likely to be restricted to 2-3 quarters.

Fig 14 – Superior borrowing mix



Source: Company

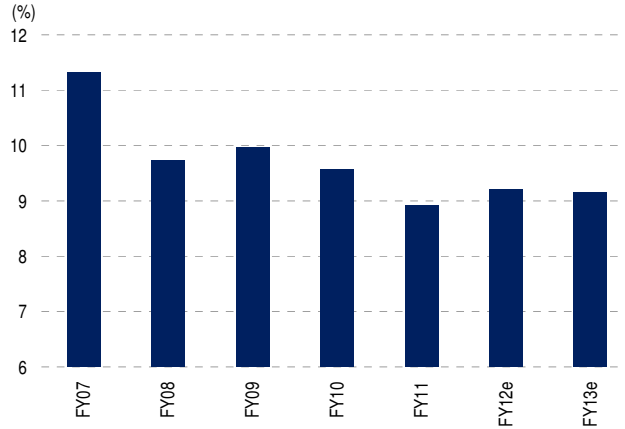
Fig 15 – High duration of liabilities to protect NIM



Source: Company

We factor in a 70-bp drop in margin due to an increase in wholesale funding cost for FY12. However, the reverse is true in the case of easing interest rates. We expect interest rates to ease from FY13 and, therefore, estimate a 60-70bps increase in margins in FY13/14.

**Fig 16 – High duration of liabilities to protect NIM**



Source: Company, Anand Rathi Research

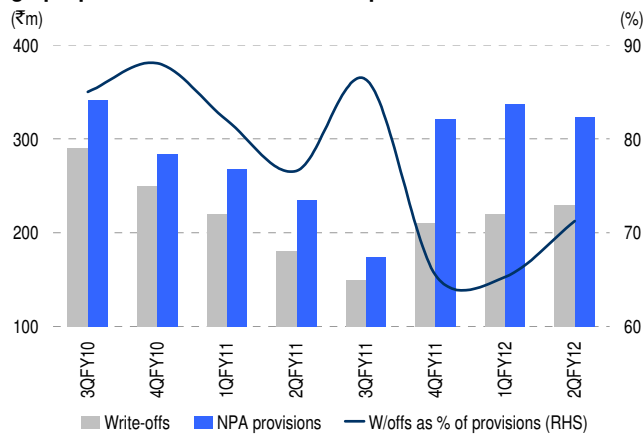
### Robust asset quality; manageable credit cost

#### High write-offs, net NPAs below 0.5%; NPA coverage at +75%

We expect SCUF to have fewer problems with regard to asset quality as compared to its peers, since over 80% of its loan book is secured. With regard to the unsecured (personal and part of SME) loans, cash flow is guaranteed through the contributions of customers in Shriram Chit Fund.

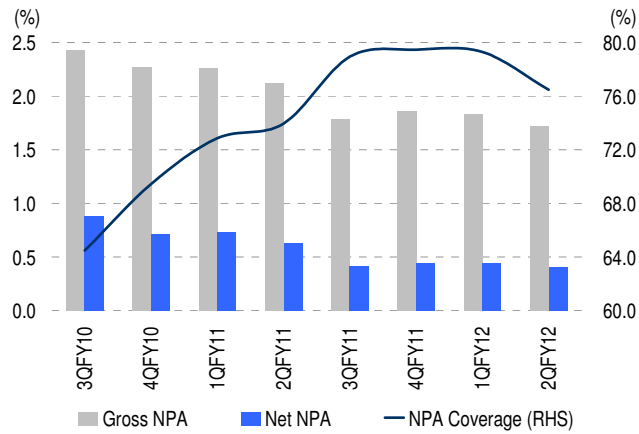
Moreover, SCUF follows a more prudent write-off policy than its peers. Write-offs comprise 65-80% of the quarterly provisioning for asset quality. Gross and net NPA on 30 Sep '11 were a robust 1.7% and 0.4%, respectively. NPA coverage was a healthy 76.5%.

**Fig 17 – High proportion of write-offs in NPA provisions**



Source: Company

**Fig 18 – Robust asset quality**

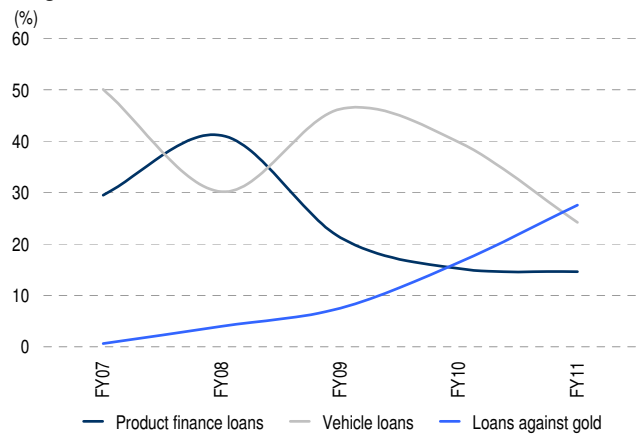


Source: Company

*High proportion of secured assets to limit delinquencies in uncertain macro conditions*

In the past few years, SCUF has prudently raised the share of gold loans in its AUM at the cost of product/vehicle loans. The share of gold loans has risen from 0.6% in Mar '07 to 28% by Sep '11, and the share of product-finance loans and vehicle loans has slipped from, respectively, 30% and 50% to 15% and 24%. An outstanding gold loan with LTV of ~55% (for incremental disbursement LTV is ~70%) is the most secured asset in the company's books.

**Fig 19 – Change in business mix towards safer assets**



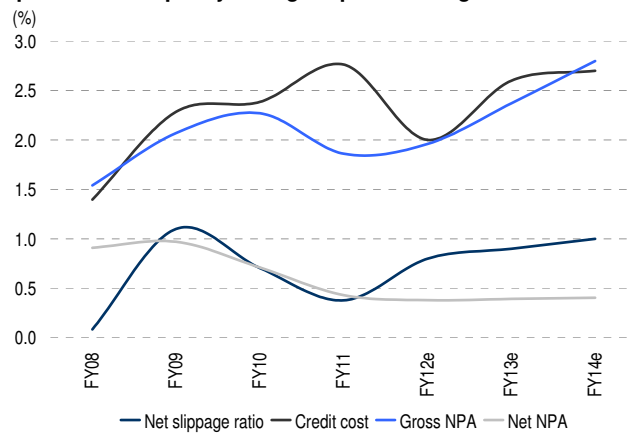
Source: Company

*We conservatively build in high credit cost over FY11-14e*

SCUF has kept credit costs high, despite low slippages in the past four years. This has resulted in the lowest net NPA, of 0.5% on 30 Sep '11.

We expect FY12 credit cost to decline sharply to 2%, compared with 2.8% in FY11. However, we believe that credit costs and slippages will increase, going forward, due to the economic slowdown and higher interest rates. We expect slippages to increase in auto and two-wheeler loans and in personal and SME loans. We remain conservative and build in higher credit cost for FY12-14e.

**Fig 20 – Improved asset quality on higher provisioning**



Source: Company, Anand Rathi Research

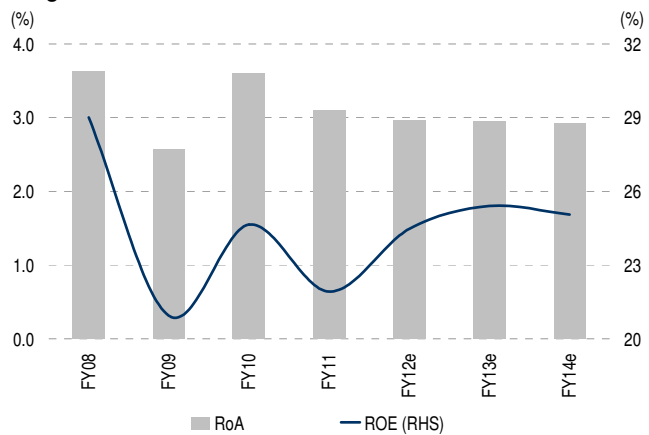
## Attractively priced

We estimate RoA at a superior ~3% and expect RoE to improve from 22% to 25% over FY11-14 on greater leverage. SCUF, being a strong consumer retail franchise, is attractively priced at a PBV of 1.7x FY12e and 1.3x FY13e.

### Strong profitability

We expect a CAGR of 30% in net profit over FY11-14 despite increased credit cost, due to strong business growth and improved margins. We expect RoA at a superior +2.6% and expect RoE to improve from 22% to 24% over FY11-14 due to greater leverage.

Fig 21 – Strong return ratios



Source: Company, Anand Rathi Research

*Balance sheet risk is lower for SCUF as over 80% of its loan book is secured*

Balance-sheet risk is lower for SCUF as over 80% of its loan book is secured and as unsecured customers’ loans (personal loans and part of SME loans) are backed by their investment in Shriram Chit Fund.

SCUF widely operates in under-banked areas and is supported by the strong brand name of the parent. Being a strong consumer retail franchise with lower balance-sheet risk, it is attractively priced at a PBV of 1.5x FY12e and 1.2x FY13e.

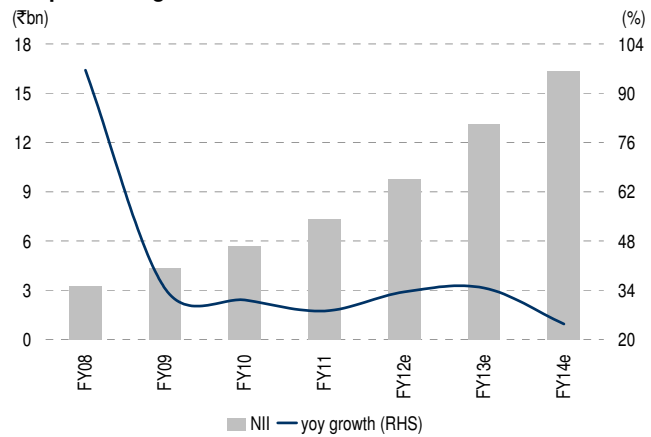
## Financials

We expect 31% CAGR in net interest income, backed by strong disbursement growth and NIM improvement from FY13. We are conservative regarding asset quality and have built in credit cost of ~2.5% over FY11-14. We expect ‘other income’ to grow in tandem with the balance sheet.

### Robust NII growth

We expect 31% CAGR in net interest income, backed by strong disbursement growth and NIM improvement from FY13. We are building in an NIM contraction of ~70bps for FY12. However, with easing interest rates and superior assets and liabilities mix of SCUF, we expect margins to rebound by ~60bps in FY13.

Fig 22 – NII expected to grow ~30% over FY11-14



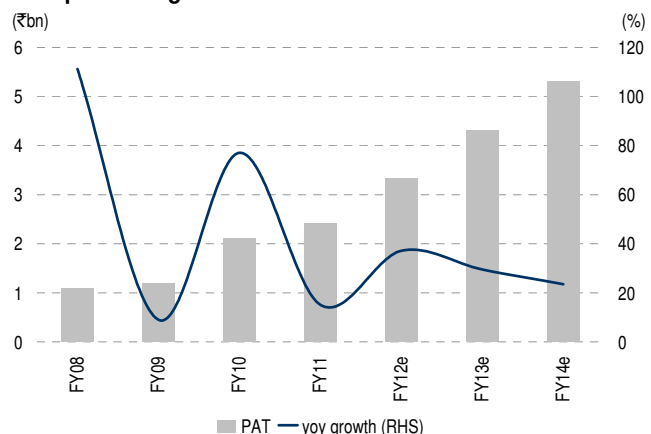
Source: Company, Anand Rathi Research

*We expect ~30% CAGR in PAT over FY11-14*

### Strong profit growth over FY11-14

We expect ‘other income’ to grow in line with balance-sheet growth. We expect strong net profit CAGR of 30% over FY11-14. We expect operating efficiency to kick in as the company leverages existing/group companies’ branch networks over the next 2-3 years. We are conservative regarding the asset quality and have built in credit cost of ~2.5% over FY11-14.

Fig 23 – PAT expected to grow ~30% over FY11-14



Source: Company, Anand Rathi Research

**Fig 24 – Income statement (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Interest income	10,884	13,198	19,213	25,693	32,587
Interest expended	5,176	5,885	9,447	12,541	16,220
<b>Net interest income</b>	<b>5,709</b>	<b>7,313</b>	<b>9,766</b>	<b>13,153</b>	<b>16,367</b>
Growth (%)	31.2	28.1	33.5	34.7	24.4
Non-interest income	308	29	41	51	64
<b>Total Income</b>	<b>6,016</b>	<b>7,343</b>	<b>9,807</b>	<b>13,204</b>	<b>16,431</b>
Non-interest income / total income (%)	5.1	0.4	0.4	0.4	0.4
<b>Operating expenses</b>	<b>1,824</b>	<b>2,558</b>	<b>3,135</b>	<b>3,816</b>	<b>4,645</b>
Employee expenses	361	437	533	650	793
Other expenses	1,463	2,122	2,603	3,166	3,852
<b>Pre-provisioning profit</b>	<b>4,192</b>	<b>4,784</b>	<b>6,672</b>	<b>9,387</b>	<b>11,785</b>
Growth (%)	62.1	14.1	39.5	40.7	25.5
Provisions	1,166	1,160	1,710	2,962	3,850
<b>Profit before tax</b>	<b>3,026</b>	<b>3,624</b>	<b>4,962</b>	<b>6,425</b>	<b>7,936</b>
Taxes	920	1,200	1,637	2,120	2,619
Tax rate (%)	30.4	33.1	33.0	33.0	33.0
<b>Profit after tax</b>	<b>2,106</b>	<b>2,424</b>	<b>3,325</b>	<b>4,305</b>	<b>5,317</b>
Share of profit from associates	-	-	-	-	-
Minority interest	-	-	-	-	-
<b>Consolidated profit after tax</b>	<b>2,106</b>	<b>2,424</b>	<b>3,325</b>	<b>4,305</b>	<b>5,317</b>
Growth (%)	77.1	15.1	37.1	29.5	23.5
Number of shares	49	50	50	50	50
Earnings per share	42.9	48.9	67.1	86.9	107.3

Source : Company, Anand Rathi Research

**Fig 25 – Balance Sheet (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Share capital	492	495	495	495	495
Reserves and surplus	9,508	11,625	14,544	18,357	23,094
<b>Net worth</b>	<b>10,000</b>	<b>12,121</b>	<b>15,040</b>	<b>18,852</b>	<b>23,589</b>
Borrowings	46,671	73,278	103,101	126,747	160,018
Other liabilities & provisions	5,810	8,721	12,210	15,262	19,078
<b>Total loans</b>	<b>62,481</b>	<b>94,120</b>	<b>130,350</b>	<b>160,861</b>	<b>202,685</b>
Loans	47,314	69,892	101,079	126,747	158,433
Investments	10	55	61	67	73
Cash & bank balances	14,021	21,654	26,614	31,191	41,036
Fixed & other assets	1,136	2,519	2,596	2,856	3,142
<b>Total assets</b>	<b>62,481</b>	<b>94,120</b>	<b>130,350</b>	<b>160,861</b>	<b>202,685</b>

Source : Company, Anand Rathi Research

## Company Background & Management

The flagship company of the Chennai-based Shriram Group and involved in small-ticket loans, Shriram City Union Finance is strategically poised in the under-banked regions of south India. It operates through over 650 branches (200 owned and 400 of Shriram Chit Fund). Its business is likely to be driven by its ties with over 1.6m customers and over two decades of experience.

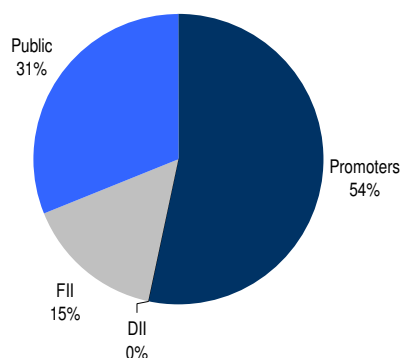
### Background

The flagship company of the Chennai-based Shriram Group, focused on small-ticket loans, Shriram City Union Finance is strategically poised in the under-banked regions of south India and is slowly strengthening its position in northern India. It operates through more than 650 branches (200 owned and 400 of Shriram Chit Fund), concentrated largely in rural/semi-urban areas.

*SCUF is strategically poised in the under-banked regions of south India and is slowly strengthening its position in northern India*

In July 2010, it set up a wholly-owned subsidiary for housing finance, mortgage finance, and other related finance activities. We believe that over two decades of experience and its ties with over 1.6m customers should drive its business.

Fig 26 – Shareholding pattern



Source: Company

### Management

Fig 27 – Key management

Name	Designation	Background
Mr R. Kannan	Managing Director	Part of the Shriram Chits business, he has built up a huge network for the Shriram Group. Strong and deep knowledge of the lending business / customers.
Ms Subhasri Sriram	Executive Director	Two decades of experience with the Group; earlier was in the truck-financing business.
Mr R. Chandrasekar	Chief Technology & Accounts Officer	More than 20 years of experience with the Shriram Group and involved in the Shriram Chits business.
Mr Y.S. Chakravarti	Chief Operating Officer	With the Group for nearly two decades, he is also executive director of Shriram Chits.

Source: Company

12 December 2011

## Bajaj Finance

*No niche expertise, lower profitability indicated; Sell*

Rating: **Sell**

Target Price: ₹712

Share Price: ₹660

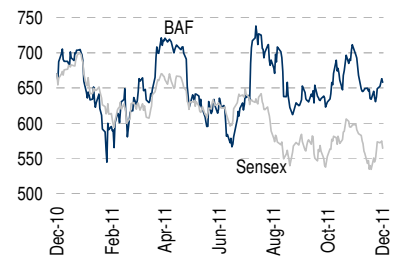
Given the high interest rates, slowing economy and changed loan mix, we expect Bajaj Finance's loan growth to slow and margins to decline from FY13. Higher slippage and credit costs are likely to result in lower profitability in FY13/14 than in FY12. We prefer stocks with niche expertise that justifies their premium valuations over banks. We initiate coverage on Bajaj Finance, with a Sell rating and a price target of ₹712.

- Loan growth to moderate; margins to fall.** Bajaj Finance grew its loan book 4x from Mar '09 to Sept' 11. However, we expect loan growth to decelerate from FY13, due to the slowing economy and high interest rates. In addition, we expect margins to fall due to higher borrowing costs in FY12 and to remain flat in FY13/14 due to the NBFC's altered loan-mix favouring lower-yield infra loans and loans against property. We estimate 26% CAGR in NII in FY13/14, against 56% CAGR over FY08-12.
- Slippages to rise; high credit cost to drag down profitability.** Bajaj Finance has huge exposure to high-risk segments: two-/three-wheeler loans (~23% of loans) and consumer-durable and personal loans (17%). In case of default, recovery chances are low for +40% of loans. We estimate 3% rise in slippages in FY13/14 against -1.5% over Mar '09-Sep '11. We also expect a ~250-bp drop in RoE over FY13/14 from FY12.
- No niche expertise; better value elsewhere.** With no niche expertise, Bajaj Finance focuses on a variety of products. In general, niche expertise gives NBFCs an edge over banks, which justifies their premiums. In non-banking finance, we prefer companies that have penetrated under-banked regions in India and built a superior model in the last 2-3 decades.
- Valuation.** At our target price, the stock trades at a PBV of 1.5x FY12e and 1.2x FY13e. **Risk:** Higher-than-expected economic growth could increase loan growth and reduce NPA.

Key data	BAF IN / BJFN.BO
52-week high / low	₹780 / ₹524
Sensex / Nifty	16488 / 4944
3-m average volume	US\$0.3m
Market cap	₹24bn / US\$0.5bn
Shares outstanding	36.6m

Shareholding pattern (%)	Sep '11	Jun '11	Mar '11
Promoters	56.1	56.1	56.1
- of which, pledged	NA	NA	NA
Free float	43.9	43.9	43.9
- Foreign institutions	5.1	5.0	5.5
- Domestic institutions	12.9	13.1	12.6
- Public	25.9	25.8	25.8

### Relative price performance



Source: Bloomberg

Key financials (YE Mar)	FY10	FY11	FY12e	FY13e	FY14e
Net interest income (₹m)	7,084	10,144	14,040	17,954	22,024
Net profit (₹m)	894	2,470	4,055	4,704	5,743
EPS (₹)	24.4	67.4	110.7	128.4	156.8
Growth (%)	163.6	176.0	64.2	16.0	22.1
PE (x)	26.8	9.7	5.9	5.1	4.2
PABV (x)	2.4	1.9	1.5	1.2	1.0
RoE (%)	8.0	19.7	26.4	24.4	23.9
RoA (%)	2.4	3.8	4.0	3.7	3.7
Dividend yield (%)	0.9	1.5	1.8	2.0	2.1
Net NPA (%)	3.6	1.1	1.2	1.2	1.2

Source: Company, Anand Rathi Research

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## Quick Glance – Financials and Valuations

**Fig 1 – Income statement (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Net interest income	7,084	10,144	14,040	17,954	22,024
NII growth (%)	64.6	43.2	38.4	27.9	22.7
Non-interest inc	61	138	145	171	205
Total income	7,145	10,282	14,184	18,125	22,229
Total Inc growth (%)	64.2	43.9	38.0	27.8	22.6
Op. expenses	3,196	4,537	6,101	7,618	9,514
Operating profit	3,949	5,745	8,084	10,506	12,715
Op profit growth (%)	84.0	45.5	40.7	30.0	21.0
Provisions	2,606	2,046	1,986	3,433	4,080
PBT	1,343	3,699	6,098	7,073	8,635
Tax	449	1,233	2,043	2,370	2,893
PAT	894	2,466	4,055	4,704	5,743
PAT growth (%)	163.6	176.2	64.2	16.0	22.1
FDEPS (₹/share)	24.4	67.4	110.7	128.4	156.8
DPS (₹/share)	6.0	10.0	12.0	13.0	14.0

Source: Company, Anand Rathi Research

**Fig 2 – Balance sheet (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Share capital	366	366	366	366	366
Reserves & surplus	11,159	13,215	16,831	21,058	26,288
Borrowings	32,268	67,086	93,130	109,924	136,306
Current liab & prov	2,135	4,514	5,643	7,053	8,817
Deferred tax liabilities	-	-	-	-	-
Total liabilities	45,928	85,181	115,969	138,402	171,777
Advances	40,318	72,701	101,781	122,138	151,451
Investments	3,018	4,453	5,255	6,200	6,820
Cash & bank bal	224	4,320	4,329	4,800	7,328
Fixed & other assets	2,368	3,707	4,605	5,264	6,178
Total assets	45,928	85,181	115,969	138,402	171,777
No. of shares (m)	37	37	37	37	37
Borrowing growth (%)	100.2	107.9	38.8	18.0	24.0
Loans growth (%)	70.1	80.3	40.0	20.0	24.0

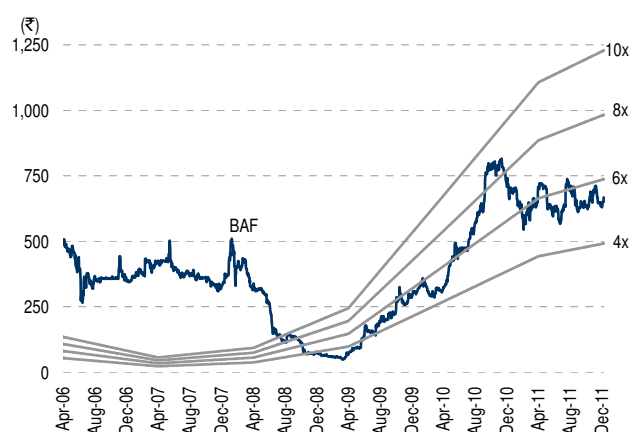
Source: Company, Anand Rathi Research

**Fig 3 – Key ratios**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
NIM (%)	21.9	17.3	15.3	15.4	15.4
Other inc / total inc (%)	0.9	1.3	1.0	0.9	0.9
Cost-income (%)	44.7	44.1	43.0	42.0	42.8
Provision coverage (%)	55.0	67.7	76.7	83.4	85.6
Dividend payout (%)	15.9	11.0	10.8	10.1	8.9
Borrowings-loans (%)	80.0	92.3	91.5	90.0	90.0
Investment-deposit (%)					
Gross NPA (%)	7.6	4.3	4.7	6.5	7.7
Net NPA (%)	3.6	1.1	1.2	1.2	1.2
BV (₹)	314.9	370.8	469.5	584.9	727.7
Adj BV (₹)	275.8	343.5	437.3	546.5	677.8
CAR (%)	26.0	19.1	17.2	16.1	15.0
RoE (%)	8.0	19.7	26.4	24.4	23.9
RoA (%)	2.4	3.8	4.0	3.7	3.7
Dividend yield (%)	0.9	1.5	1.8	2.0	2.1

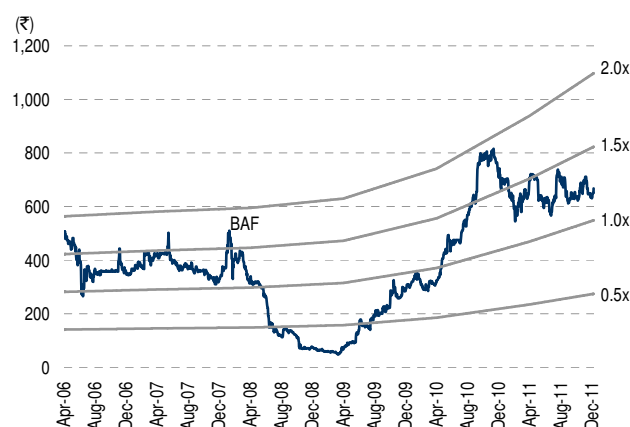
Source: Company, Anand Rathi Research

**Fig 4 – PE band**



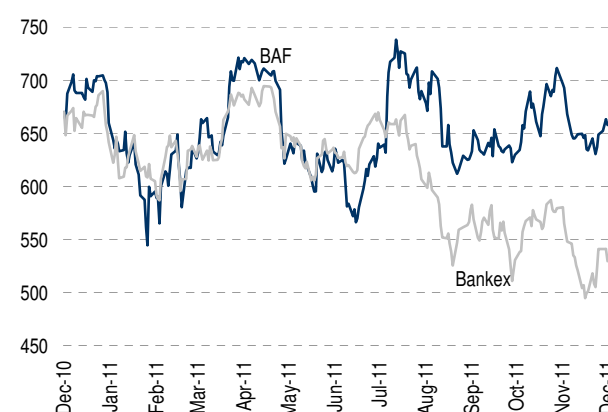
Source: Bloomberg, Anand Rathi Research

**Fig 5 – Price-to-book band**



Source: Bloomberg, Anand Rathi Research

**Fig 6 – BAF vs. Bankex**



Source: Bloomberg

## Investment argument and valuation

Given the high interest rates, slowing economy and changed loan mix, we expect Bajaj Finance's loan growth to slow and margins to decline from FY13. Higher slippage and credit costs are likely to result in lower profitability in FY13/14 as compared to FY12. We prefer stocks with niche expertise, justifying their premium valuations over banks. We initiate coverage on Bajaj Finance, with a Sell rating and a price target of ₹712.

### Loan growth to moderate; margins to decline

*Slower economy, change in business mix and higher interest rates are expected to lower loan growth and margins*

Bajaj Finance has successfully turned around in the past three years, under the new management headed by Rajiv Jain. It has transformed from a captive lender for parent Bajaj Auto, to a full-fledged finance company. As a result, its loan book has grown 4x from Mar '09 to Sept' 11. Margins have also risen from ~7.5% in FY08 to ~17% in FY11.

However, we expect loan growth to decelerate from FY13 due to the slowing economy and high interest rates. We expect also margins to decline due to the rise in borrowing costs and the altered loan-mix favouring infrastructure loans and loans against property. The yield on these loans is lower than that on consumer durable and two-/three-wheeler loans. We estimate 26% CAGR in NII in FY13/14 against 56% over FY08-12.

### Slippages to rise; high credit cost to drag profitability

*We expect slippages to rise to 3% in FY13/14 from -1.5% over the last two-and-half years*

The company has large exposure to high-risk segments such as two-/three-wheeler loans (~23% of loans) and consumer-durable & personal loans (17%). The credit profile of buyers of two-/three-wheelers is weaker than that of car/UV purchasers. Consumer-durable and personal loans are not backed by adequate collateral, as the value of consumer durables in the secondary market is less than 50% after three months of use. In case of default, recovery chances are low for over 40% of loans.

We estimate slippages to rise to 3% in FY13/14 against the -1.5% (up-gradation and recovery) averaged in the last two-and-a-half years (Mar '09 to Sep '11), and credit costs to be high. We expect a ~250-bp drop in RoE over FY13/14, from an expected high of ~26.4% in FY12.

### No niche expertise; better value elsewhere

*We prefer NBFCs with niche expertise and a strong presence in rural India, justifying the premium to banks*

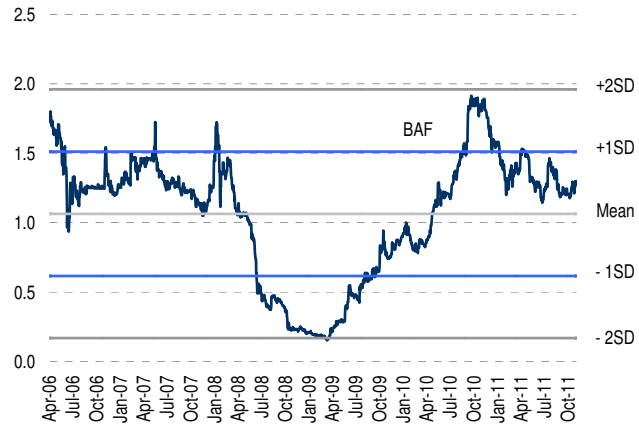
Among NBFCs, we prefer companies that have penetrated under-banked regions across India and built up a sound model in the past 2-3 decades. Niche expertise provides NBFCs with an edge over banks, in turn justifying their premiums. With no niche expertise, Bajaj Finance has focused on a variety of products. In the last three years, it has introduced six products, which resulted in its rapid growth between FY10-12.

However, the loan mix has now altered dramatically in favour of non-retail loans – up from 18% share in disbursements in FY07 to 54.5% in FY11. We believe the non-retail loan business is keenly competitive and does not offer NBFCs any edge over banks. The risk-reward is not favourable to NBFCs over banks for retail loans to rich and affluent customers.

## Valuation

We initiate coverage on Bajaj Finance, with a Sell rating and a price target of ₹712. At our target price, the stock would trade at a PBV of 1.5x FY12e and 1.2x FY13e. Our target is based on the two-stage DDM (CoE: 16.4%; beta: 1.2; Rf: 8%).

Fig 7 – Bajaj Finance: PBV band



Source: Company, Anand Rathi Research

## Risks

- Higher-than-expected economic growth could boost the demand for retail loans. In such case, loan growth could be higher than our estimates for FY13/14.
- Lower-than-expected interest rates could lead to margin expansion in FY13/14.
- Lower delinquencies rates would lower credit costs and in turn improve profitability.

## Loan growth/margins to moderate

In the past three years, under the new management headed by Rajiv Jain, Bajaj Finance has successfully turned around. From Mar '09 to Sept' 11, its loan book has grown 4x. Margins too have rebounded from ~7.5% in FY08 to ~17% in FY11. However, we expect loan growth to decelerate from FY13, due to a slowing economy and high interest rates. We expect margins to decline due to higher borrowing costs and the altered loan-mix favouring infrastructure loans and loans against property. We estimate NII CAGR of 26% in FY13/14 against 56% over FY08-12.

### Successful transformation by new management

In the past three years, under the new management headed by Rajiv Jain, Bajaj Finance has successfully turned around. It has transformed from a captive lender for parent Bajaj Auto to a full-fledged finance company.

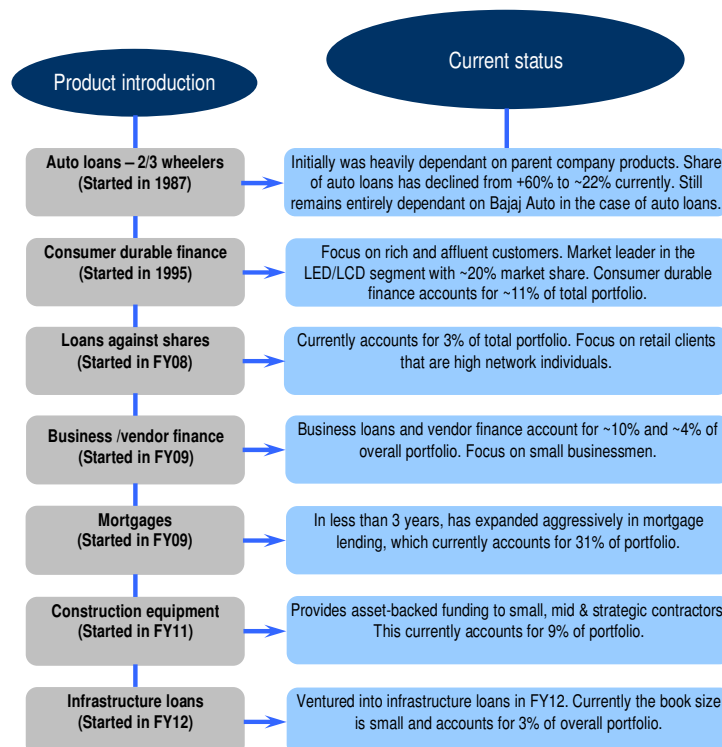
Investment in processes and innovation over FY08-10 has led to better loan-origination and risk-management processes, as well as credit quality. As a result, its loan book has grown 4x from Mar '09 to Sep '11. Margins have also risen from ~7.5% in FY08 to ~17% in FY11.

### Loan growth to moderate

*Bajaj Finance has diversified its product offering to non-retail loans over the last three years*

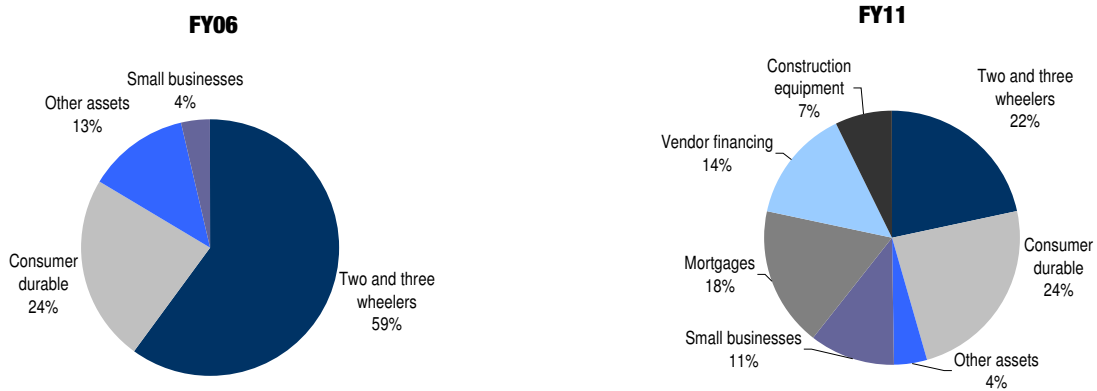
In the '80s and '90s, the company was a finance subsidiary of the Bajaj Group and dealt with loans for its parent company, Bajaj Auto, and for the Bajaj Group's consumer appliances. On restructuring, it ventured into a number of other products, including: (1) loans against shares/securities, (2) business loans/vendor finance, (3) mortgages, (4) personal loans, (5) construction-equipment finance and (6) infrastructure loans.

Fig 8 – Gradual scaling-up of non-retail business



Source: Company

**Fig 9 – Diversification of loan offerings**

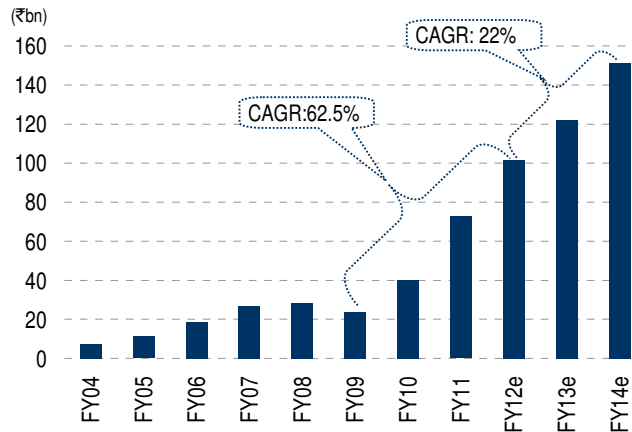


Source: Company

Between FY09 and FY11, Bajaj Finance recorded 75% CAGR in loans due to the introduction of new products and the robust demand environment. Mortgages (tenure: 60-180 months), vendor financing (tenure: 24-48 months) and infrastructure loans (60-180 months) have longer tenures than two-/three-wheeler loans (tenure: 12-18 months) and consumer finance (tenure: 6-12 months). This was the prime reason for the company's higher-than-industry growth rate.

However, we expect loan growth to decelerate from FY13, due to a slowing economy and high interest rates. Mortgage finance, vendor finance and infrastructure loans, which were prime growth drivers between FY08 and 1HFY12, may face headwinds due to the slowing economy. Higher interest rates, at least for the next 6-12 months, would also put pressure on consumer-durable and auto loans.

**Fig 10 – Loan growth to moderate**



Source: Company, Anand Rathi Research

**Margins to slide in FY12/13**

*We expect margins to slide due to higher interest rates and change in loan mix*

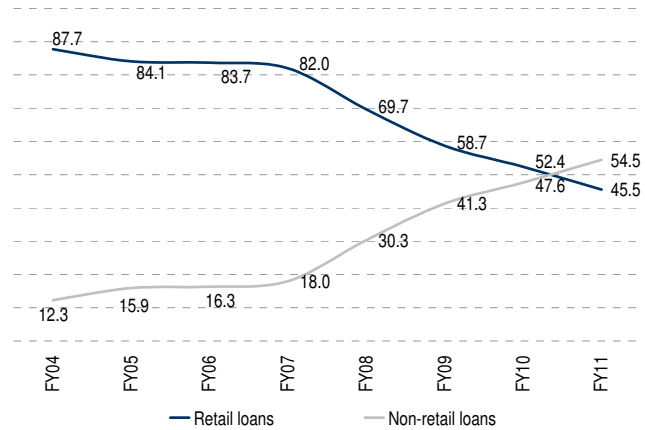
Bajaj Finance's net interest margin (calculated) has risen from 7.2% in FY07 to 17.6% in FY11, following the robust growth and sharp fall in NPA (interest income on NPA cannot be recognised on an accrual basis). Leverage has also gone up substantially, from 3.2x in FY09 to 5.2x in FY11.

Retail NBFCs are likely to see increased margins in FY13 and 1HFY14 on the correction in wholesale interest rates from 1HFY13. However, in the

case of Bajaj Finance, we expect margins to decline by ~200bps in FY12 from FY11 and to remain flat in FY13/14, since the altered loan-mix favouring lower-yielding infrastructure and loans against property should offset gains from lower borrowing costs. We estimate NII CAGR of 26% in FY13/14 against 56% over FY08-12.

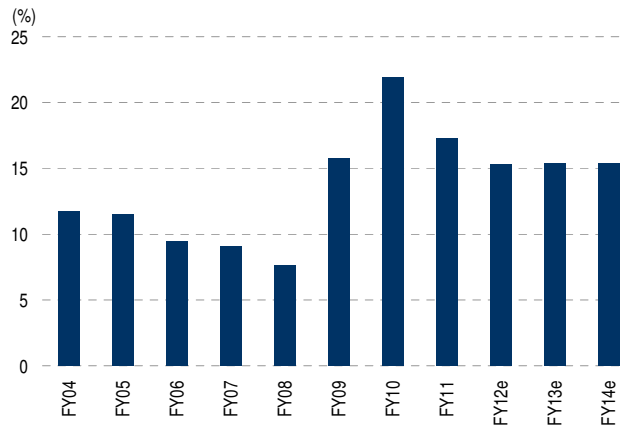
With a shift in the company’s business strategy, the disbursement mix has changed over the years in favour of mortgages, construction equipment and infrastructure loans. The share of non-retail business in disbursements has shot up from 18% in FY07 to 54.5% in FY11. We expect the share of non-retail business to climb further with: (1) the increasing share of longer-tenure loans as disbursements slow down, and (2) the introduction of infrastructure loans in FY12.

**Fig 11 – Loan-book mix has changed in favour of non-retail loans (%)**



Source: Company

**Fig 12 – Unlike in the case of other NBFCs, margins to be flat in FY13/14e**



Source: Company, Anand Rathi Research

## High credit costs to weigh on profit

Bajaj Finance has large exposure to high-risk segments such as two-/three-wheeler loans (~23% of loans) and consumer-durable and personal loans (17%). In case of default, chances of recovery are low for over 40% of loans. We estimate a 3% rise in slippages in FY13/14 against -1.5% in the last two-and-a-half years (Mar '09 to Sep '11), and an increase in credit costs. We also estimate a ~250-bp drop in RoE over FY13/14 from the expected high of ~28% in FY12.

### Asset quality currently at record best

*Sharp improvement in asset quality due to improved economy and faster balance sheet expansion*

*Recovery chances are low for ~40% of Bajaj Finance's loan portfolio in the event of default*

The company's asset quality is at a record high, in our view, with gross and net NPAs of 1.7% and 0.33%, respectively, and NPA coverage of 80% at end-Sep '11.

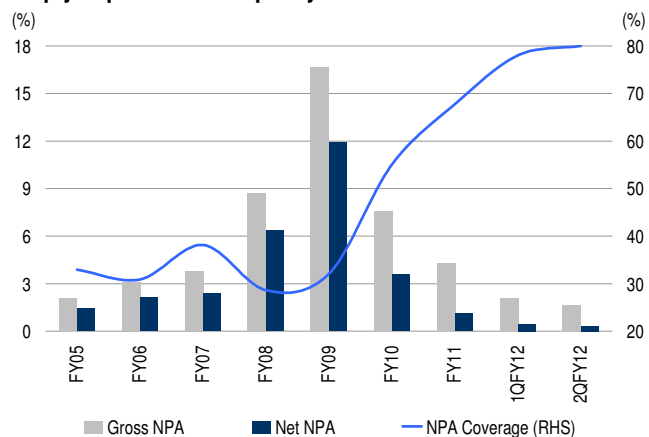
In the past two-and-a-half years, Bajaj Finance has consolidated operations and brought delinquencies under control. It brought down the number of dealers sourcing vehicle loans. It has also closed down the personal-computer finance business, which accounted for ~20% of overall NPAs in FY08-10. In FY10, the company's credit cost touched 7%.

Net slippage ratio has been negative (strong recovery and upgradation) since Apr '10. This has resulted in a sharp drop in NPAs. Gross and net NPAs declined from Mar '09 highs and were 1.3% and 0.33%, respectively, in Sep '11. NPA coverage was also a healthy 80%.

This is a strong improvement in the last two years. Poor risk-management practices and excessive reliance on parent products had led to massive slippages in FY08 and FY09. The net slippage ratio in FY08 and FY09 was, respectively, 4.8% and 5.6%. Gross and net NPA at end-FY09 touched record highs of 16.6% and 11.9%, respectively.

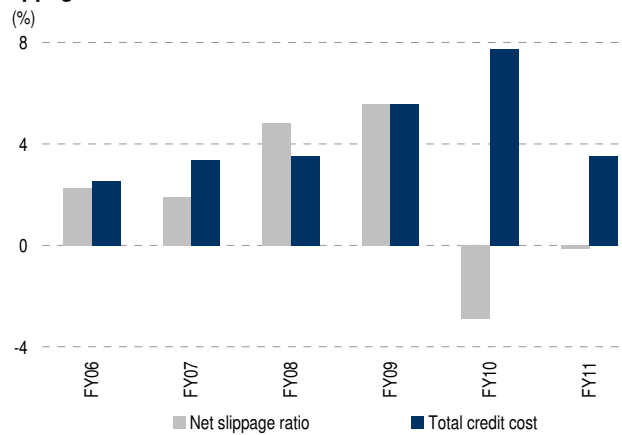
*Negative slippage ratio (net recovery) and higher credit cost has resulted in robust asset quality*

**Fig 13 – Sharply improved asset quality since FY09**



Source: Company

**Fig 14 – Slippages and credit costs at record lows**



Source: Company

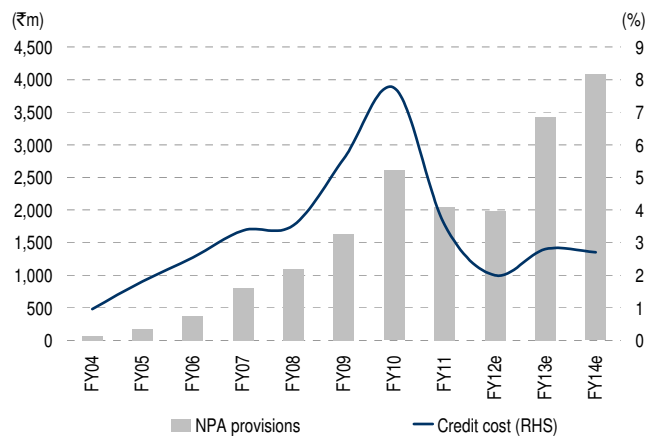
### Slippages to rise

We expect slippages to rise to 3% in FY13/14 against the -1.5% average (upgradation and recovery) in the last two-and-a-half years (Mar '09 to Sep '11), and also expect high credit costs.

Credit profiles of two- and three-wheeler buyers are weaker than those of car/UV purchasers. Consumer-durable and personal loans do not have adequate collateral, as the value of consumer durables in the secondary market is less than 50% after three months of use. Bajaj Finance’s personal computer finance portfolio had bled in the past – accounted for ~20% of overall NPAs in FY08-09. We do not see much difference between loans on consumer durables and personal computers, as chances of recovery in both cases are negligible.

In the past (FY09/10), parent Bajaj Auto had agreed to share losses of over 3%. This was withdrawn due to the improved NPA level since FY09. In the absence of this scheme, Bajaj Finance is vulnerable to greater delinquencies in the Bajaj Auto portfolio. It has large exposure to high-risk segments such as two-/three-wheeler loans (~23% of loans), consumer-durables and personal loans (17%). In case of default, chances of recovery are low for over 40% of the loans.

**Fig 15 – Credit costs to rise**



Source: Company, Anand Rathi Research

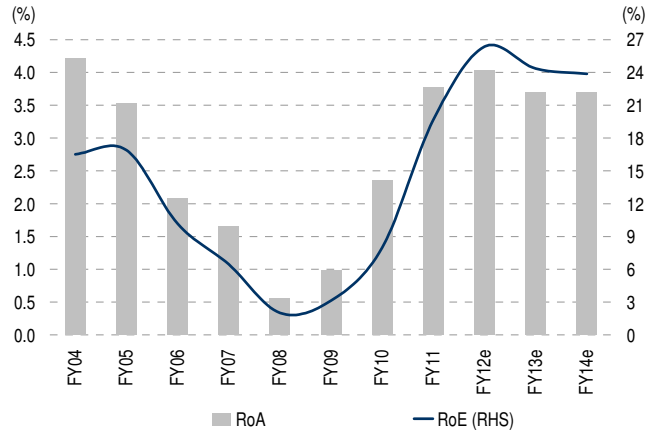
### RoE likely to contract by ~250bps

Robust loan growth (and improving leverage), margin expansion and lower credit costs have resulted in significant expansion in return ratios over the years. We expect RoE to touch 26.4% in FY12, from a low of 8% in FY10.

However, significantly lower loan growth than in the past, flat margins and higher credit costs are likely to dent profitability in the next two years. We expect a ~250-bp drop in RoE over FY13/14, from an expected high of ~26.4% in FY12.

*We expect lower profitability in FY13/14 than in FY12*

**Fig 16 – Profitability to decline in FY13/14e**



Source: Company Anand Rathi Research

## No niche expertise

With no niche expertise, Bajaj Finance has focused on a variety of products. In general, niche expertise provides NBFCs with an edge over banks, in turn justifying their premiums. Among NBFCs, we prefer companies that have penetrated under-banked regions across India and have built up a sound model in the past 2-3 decades.

### No competitive edge over banks

Bajaj Finance has a well-known customer base for two- and three-wheeler loans (it finances only Bajaj Auto vehicles), though in other segments it is a new entrant. In recent years, Bajaj Finance has focused on a variety of products. In the past three years, it has introduced six products, which resulted in rapid growth in FY10-12.

Its loan mix has altered dramatically in favour of non-retail loans – share in total disbursements has shot up from 18% in FY07 to 54.5% in FY11. However, we believe the non-retail loan business is keenly competitive and does not offer NBFCs any edge over banks. The risk-reward ratio is not favourable to NBFCs over banks for retail loans to rich and affluent customers.

### Better value elsewhere

Niche expertise provides NBFCs with an edge over banks, in turn justifying their premiums. However, in the case of Bajaj Finance this niche expertise is missing. Among NBFCs, we prefer companies that have penetrated under-banked regions across India and built up a sound model in the past 2-3 decades. Such NBFCs have become trusted names to their customers, who often return for repeat loans.

*We believe that core niche competencies constitute the primary condition for justifying the premium valuation of NBFCs over banks*

**Fig 17 – Core competencies of other NBFCs**

Company	Core competencies
Shriram Transport Finance	<ul style="list-style-type: none"> <li>■ Only organized player in used CV finance, with a 25% market share</li> <li>■ Large and loyal customer base built over the years</li> <li>■ Investment in procedures and people over the years translates into sound asset quality</li> </ul>
M&M Financial Services	<ul style="list-style-type: none"> <li>■ Strong rural presence built over the years; strong parentage</li> <li>■ Second-largest lender for Maruti vehicles</li> <li>■ Strong understanding of rural market, developed over the years</li> </ul>
Shriram City Union Finance	<ul style="list-style-type: none"> <li>■ Strong parentage and network of the Shriram Group</li> <li>■ Specialized in small-ticket loans over the years</li> </ul>

Source: Companies, Anand Rathi Research

## Financials

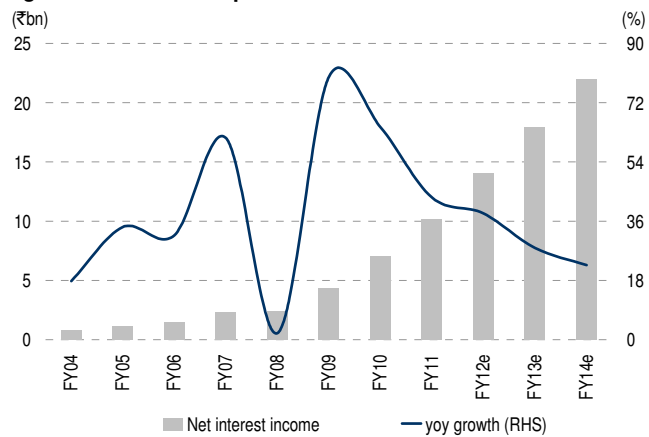
We expect Bajaj Finance to register subdued net profit CAGR of ~20% over FY12-14, due to lower disbursements, flat margins on the changed business mix and higher credit costs. However, we expect robust net profit growth in FY12 (65% yoy), due to strong loan growth and lower credit costs.

### NII growth to taper off in FY13e and FY14e

We expect loan growth to slow post FY12, following weak demand for consumer durable and vehicle loans. The non-retail business is also expected to moderate due to higher interest rates and a slowing economy. We estimate NIM to remain flat despite a fall in borrowing costs in FY13/14e, due to the change in loan mix in favour of low-yielding assets.

*NII growth to slow down due to lower loan growth and contraction in margins*

Fig 18 – NII growth to moderate post FY12

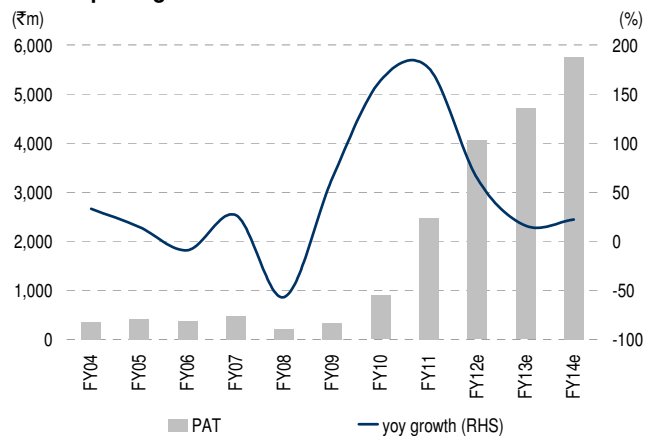


Source: Company, Anand Rathi Research

### Weak net profit growth in FY13/14e

We expect Bajaj Finance to register 111% CAGR in net profit over FY08-12 due to robust loan growth (expanding leverage), NIM expansion, and falling credit costs. We estimate ~20% CAGR in net profit in FY13/14, the lowest of our NBFC coverage. Slower NII growth and high credit costs are likely to eat into profitability.

Fig 19 – Weak net profit growth in FY13e and FY14e



Source: Company, Anand Rathi Research

**Fig 20 – Income statement (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Interest income	9,101	13,923	21,650	27,497	33,597
Interest expended	2,017	3,780	7,610	9,544	11,573
<b>Net interest income</b>	<b>7,084</b>	<b>10,144</b>	<b>14,040</b>	<b>17,954</b>	<b>22,024</b>
Growth (%)	64.6	43.2	38.4	27.9	22.7
Non-interest income	61	138	145	171	205
<b>Total income</b>	<b>7,145</b>	<b>10,282</b>	<b>14,184</b>	<b>18,125</b>	<b>22,229</b>
Non-interest income / total Income (%)	0.9	1.3	1.0	0.9	0.9
<b>Operating expenses</b>	<b>3,196</b>	<b>4,537</b>	<b>6,101</b>	<b>7,618</b>	<b>9,514</b>
Employee expenses	994	1,447	2,171	2,714	3,392
Other expenses	2,202	3,089	3,930	4,905	6,122
<b>Pre-provisioning profit</b>	<b>3,949</b>	<b>5,745</b>	<b>8,084</b>	<b>10,506</b>	<b>12,715</b>
Growth (%)	84.0	45.5	40.7	30.0	21.0
Provisions	2,606	2,046	1,986	3,433	4,080
<b>Profit before tax</b>	<b>1,343</b>	<b>3,699</b>	<b>6,098</b>	<b>7,073</b>	<b>8,635</b>
Taxes	449	1,233	2,043	2,370	2,893
Tax rate (%)	33.4	33.3	33.5	33.5	33.5
<b>Profit after tax</b>	<b>894</b>	<b>2,466</b>	<b>4,055</b>	<b>4,704</b>	<b>5,743</b>
Share of profit from associates	-	-	-	-	-
Minority interest	-	-	-	-	-
<b>Consolidated profit after tax</b>	<b>894</b>	<b>2,466</b>	<b>4,055</b>	<b>4,704</b>	<b>5,743</b>
Growth (%)	163.6	176.2	64.2	16.0	22.1
Number of shares	37	37	37	37	37
Earnings per share	24.4	67.3	110.7	128.4	156.8

Source: Company, Anand Rathi Research

**Fig 21 – Balance Sheet (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Share capital	366	366	366	366	366
Reserves and surplus	11,159	13,215	16,831	21,058	26,288
<b>Net worth</b>	<b>11,525</b>	<b>13,581</b>	<b>17,197</b>	<b>21,424</b>	<b>26,654</b>
Borrowings	32,268	67,086	93,130	109,924	136,306
Other liabilities & provisions	2,135	4,514	5,643	7,053	8,817
<b>Total liabilities</b>	<b>45,928</b>	<b>85,181</b>	<b>115,969</b>	<b>138,402</b>	<b>171,777</b>
Loans	40,318	72,701	101,781	122,138	151,451
Investments	3,018	4,453	5,255	6,200	6,820
Cash & bank balances	224	4,320	4,329	4,800	7,328
Fixed & other assets	2,368	3,707	4,605	5,264	6,178
<b>Total assets</b>	<b>45,928</b>	<b>85,181</b>	<b>115,969</b>	<b>138,402</b>	<b>171,777</b>

Source: Company, Anand Rathi Research

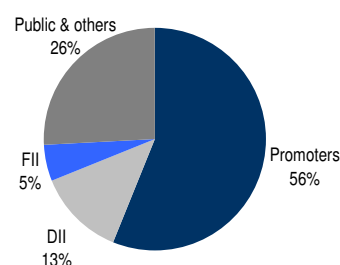
## Company background & management

The flagship finance company of the Bajaj Group, Bajaj Auto Finance was incorporated in 1987 to finance parent group products. In the 1990s, it ventured into consumer-durables financing (chiefly personal computers). In FY08-10, the company reported high NPAs due to poor risk-management procedures and high exposure to the retail business. Bajaj Finance was restructured following the introduction of a new management team headed by Rajiv Jain. It had ₹101bn in AUM as on 30 Sep '11.

### Background

Incorporated as Bajaj Auto Finance in 1987 to finance its parent's group products in the 1990s, the flagship finance company of the Bajaj Group, was then renamed Bajaj Finance and ventured into consumer-durables financing (mainly personal computers). In FY08-10, it reported a high level of NPAs due to poor risk-management procedures and high exposure to the retail business. In the last three years, it has introduced various non-retail verticals such as small-business loans, construction-equipment finance, loans against securities, infrastructure loans and vendor financing. On the introduction of a new management team headed by Rajiv Jain, the company was restructured. By end-Sep'11, Bajaj Finance had ₹101bn in AUM.

Fig 22 – Shareholding pattern



Source: Company, as on 30 Sep '11

### Management

Fig 23 – Key management

Name	Designation	Background
Mr Rajeev Jain	Chief Executive Officer	Over 18 years experience in consumer lending; was with GE for over four years and with American Express for eight years.
Mr Pankaj Thadani	Chief Financial Officer	Joined Bajaj Finserv Lending in 2006, bringing rich experience of 28 years in financing, financial accounting, cost-accounting, tax and systems.
Mr Rajesh K	Chief Risk Officer	Over 13 years' experience in financial services; Was earlier with HSBC, GE Money and First Leasing.

Source: Company

12 December 2011

## Cholamandalam Investment and Finance

*Strong growth prospects post consolidation; Buy*

Rating: **Buy**

Target Price: ₹181

Share Price: ₹133

Cholamandalam Investment and Finance (CIF) has embarked on significant branch addition after having consolidated its personal loan portfolio over FY08-10. About 90% of its branches are in tier-2 & tier-3 cities, where rising rural disposable income acts as a hedge against the tough macro-economic environment. This, coupled with the introduction of high-yielding new products, is likely to result in robust loan growth. We expect strong loan growth, better NIM and lower provisioning to drive RoA to 1.6% by FY14 (from 0.7% in FY11). We initiate coverage on CIF with a Buy rating and a price target of ₹181.

- Focus on bottom of pyramid to drive robust loan growth.** With ~90% of branches in tier-2 and tier-3 cities, CIF's focus is on the middle- and lower-income segment in rural India. Post consolidation of its personal loan portfolio over FY09-10, CIF has widened its branch network by 45% to 342 branches in the last six months. It also plans to diversify its product mix – commercial vehicle financing constitutes 67% of its credit portfolio – by introducing gold loan and tractor finance. We expect branch expansion and new products to drive 34% CAGR in loan book over FY11-14.
- High-yield products to improve NIM.** CIF plans to raise exposure to high-yield secured retail products such as used-vehicle and gold-loan financing. Together with the expected easing of interest rates, this is likely to aid NIM improvement to 6.5% by FY14, from 6% in 1HFY12.
- Improving asset quality.** Provisions rose to over 3.7% of advances over FY08-11 on significant write-offs in personal loans. With limited exposure to personal loans and stable levels of gross NPAs in the vehicle & mortgage businesses (0.6% & 1.3%, respectively), credit cost is estimated to improve to 0.9% of loans, and drive 70.3% CAGR in earnings over FY11-14.
- Valuation.** At our target price, CIF is estimated to trade at a PBV of 1.8x FY12e and 1.5x FY13e. **Risk:** Slower-than-expected rural economic growth could impact loan growth.

Key data	CIFC IN / CHLA.BO
52-week high / low	₹196 / ₹122
Sensex / Nifty	16488 / 4944
3-m average volume	US\$0.03m
Market cap	₹16bn / US\$309m
Shares outstanding	119.3m

Shareholding pattern (%)	Sep '11	Jun '11	Mar '11
Promoters	69.2	69.1	69.1
- of which, pledged	NA	NA	NA
Free float	30.8	30.9	30.9
- Foreign institutions	6.7	6.2	5.9
- Domestic institutions	13.9	13.8	13.2
- Public	10.2	11.0	11.9

### Relative price performance



Source: Bloomberg

Key financials (YE Mar)	FY10	FY11	FY12e	FY13e	FY14e
Net interest income (₹m)	4,056	5,882	6,675	9,282	12,225
Net profit (₹m)	154	622	1,531	2,270	3,069
EPS (₹)	2.3	5.2	12.8	15.2	20.6
Growth (%)	(63.9)	124.7	146.2	18.6	35.2
PE (x)	58.2	25.9	10.5	8.9	6.6
PABV (x)	2.5	1.6	1.4	1.1	1.0
RoE (%)	2.0	6.7	13.5	15.1	15.8
RoA (%)	0.2	0.7	1.4	1.5	1.6
Dividend yield (%)	0.7	1.1	1.5	1.9	2.2
Net NPA (%)	1.5	0.3	0.3	0.3	0.2

Source: Company, Anand Rathi Research

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## Quick Glance – Financials and Valuations

**Fig 1 – Income statement (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Net interest income	4,056	5,882	6,675	9,282	12,225
NII growth (%)	(19.6)	45.0	13.5	39.1	31.7
Non-interest inc	172	279	323	426	474
Total income	4,228	6,161	6,997	9,708	12,699
Total Inc growth (%)	(18.5)	45.7	13.6	38.7	30.8
Op. expenses	2,001	2,466	3,366	4,611	5,981
Operating profit	2,227	3,696	3,632	5,097	6,718
Op profit growth (%)	(12.7)	66.0	(1.7)	40.3	31.8
Provisions	1,914	2,694	1,162	1,693	2,116
PBT	313	1,001	2,470	3,404	4,602
Tax	159	379	938	1,133	1,532
PAT	154	622	1,531	2,270	3,069
PAT growth (%)	(63.9)	303.4	146.2	48.3	35.2
FDEPS (₹/share)	2.3	5.2	12.8	15.2	20.6
DPS (₹/share)	1.0	1.5	2.0	2.5	3.0

Source: Company, Anand Rathi Research

**Fig 2 – Balance sheet (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Share capital	665	1,194	1,194	1,492	1,492
Reserves & surplus	7,185	9,526	10,783	16,593	19,147
Borrowings	53,936	79,453	109,222	140,309	191,263
Current liab & prov	7,626	6,649	8,644	11,237	13,484
Deferred tax liabilities	-	-	-	-	-
Total Liabilities	69,412	96,822	129,842	169,631	225,387
Advances	54,896	86,092	118,807	155,638	206,998
Investments	2,193	683	939	1,206	1,644
Cash & bank bal	10,636	8,391	7,815	10,043	13,407
Fixed & other assets	1,687	1,656	2,281	2,745	3,339
Total assets	69,412	96,822	129,842	169,631	225,387
No. of shares (m)	66	119	119	149	149
Borrowing growth (%)	0.0	47.3	37.5	28.5	36.3
Loans growth (%)	20.5	56.8	38.0	31.0	33.0

Source: Company, Anand Rathi Research

**Fig 3 – Key ratios**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
NIM (%)	6.3	7.6	6.2	6.5	6.5
Other inc / total inc (%)	4.1	4.5	4.6	4.4	3.7
Cost-income (%)	47.3	40.0	48.1	47.5	47.1
Provision coverage (%)	73.3	87.6	88.2	87.4	82.4
Dividend payout (%)	43.1	28.8	15.6	16.4	14.6
Borrowings-loans (%)	98.3	92.3	91.9	90.2	92.4
Investment-deposit (%)	n.a	n.a	n.a	n.a	n.a
Gross NPA (%)	5.2	2.6	2.7	2.1	1.3
Net NPA (%)	1.5	0.3	0.3	0.3	0.2
BV (₹)	73.0	89.8	100.3	121.2	138.3
Adj BV (₹)	54.9	87.0	97.0	118.3	135.1
CAR (%)	14.8	16.7	15.5	16.8	15.5
RoE (%)	2.0	6.7	13.5	15.1	15.9
RoA (%)	0.2	0.7	1.4	1.5	1.6
Dividend yield (%)	0.7	1.1	1.4	1.8	2.2

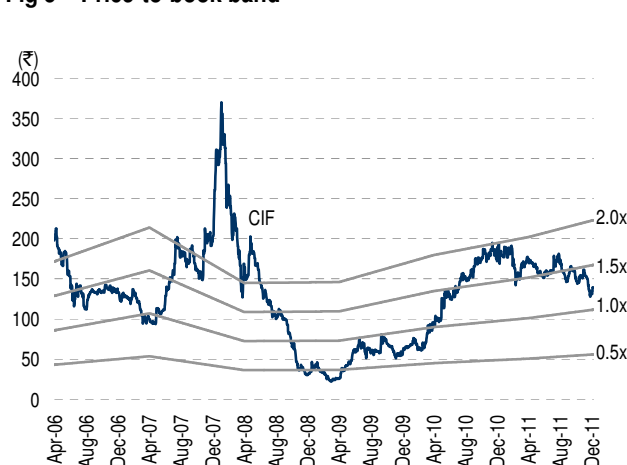
Source: Company, Anand Rathi Research

**Fig 4 – PE band**



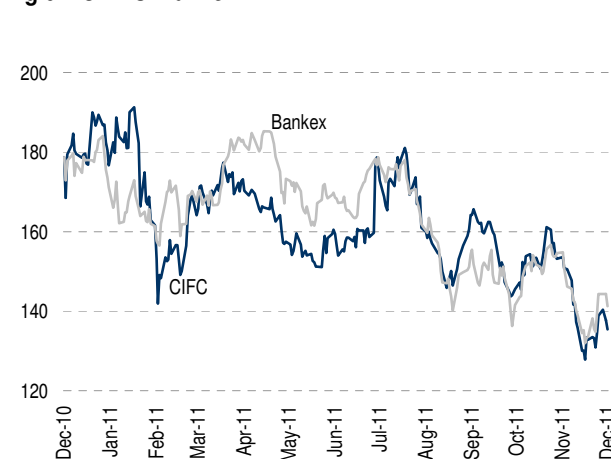
Source: Bloomberg, Anand Rathi Research

**Fig 5 – Price-to-book band**



Source: Bloomberg, Anand Rathi Research

**Fig 6 – CIF vs. Bankex**



Source: Bloomberg

## Investment Argument and Valuation

We initiate coverage on Cholamandalam Investment and Finance (CIF) with a Buy and a price target of ₹181. On consolidating its personal loan portfolio over FY08-10, the NBFC has embarked on significant branch expansion. This, coupled with the introduction of high-yield products, should drive robust loan growth. We expect strong loan growth, better NIM and lower provisioning to drive an improved RoA of 1.6% by FY14, from 0.7% in FY11.

### Focus on bottom of pyramid to drive loan growth

We expect strong branch expansion and launch of products to drive 34% CAGR in loan book over FY11-14. Following consolidation in FY08-10, CIF is growing its loan book with a focus on clients in the middle and bottom sections of the income pyramid. The NBFC has increased its branch network by 45% to 342 branches in the last six months and is likely to add another 70 branches in FY12. It also plans to leverage group companies such as Coromandel Fertiliser and EID Parry for their strong agricultural links.

Further, CIF has halted lending in the loss-suffering personal-loan portfolio and plans to diversify its product mix by introducing gold loan and construction equipment financing.

### High-yield products to improve NIM

CIF intends to raise exposure to higher-yielding secured retail products such as used-vehicle and tractor financing and gold-loan financing, which are of lower duration than home-equity loans.

We assume an easing of interest rates as a result of lower expected inflation. Greater exposure to higher-yielding products, coupled with higher interest rates, is likely to aid NIM improvement to 6.5% by FY14, from 6% in 1HFY12.

At present, CIF disburses loans for vehicles, home equity and businesses. Vehicle finance forms nearly 70% of its portfolio, with a bias towards light commercial vehicles (LCVs). Home equity forms 22% of the portfolio, while business finance comprises the rest.

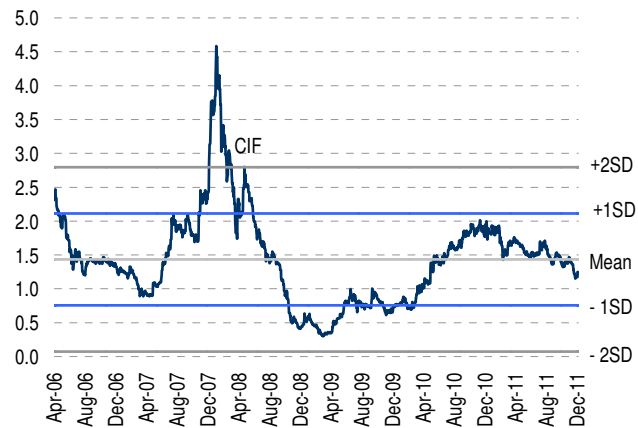
### Improving asset quality

Provisioning over FY08-11 was elevated to over 3.7% of advances, on significant write-offs in its loss-suffering personal-loan portfolio. Exposure to personal loans dropped to less than 1% (from 31% in FY09). Gross NPAs in the vehicular and mortgage businesses are 0.6% and 1.3%, respectively, with zero delinquencies in the promoter-funding portfolio. With no further provisioning for the personal-loan portfolio, stable asset-quality outlook on vehicle finance and home-equity businesses, we expect credit cost to improve to an average of 0.9% of loans over FY12-14.

## Valuation

We initiate coverage on Cholamandalam Investment and Finance, with a Buy rating and a price target of ₹181. At our target price, the stock would trade at a PBV of 1.8x FY12e and 1.5x FY13e. Our price target is based on the two-stage DDM (CoE: 14.3%; Beta: 1.04; Rf: 7.5%).

Fig 7 – CIFCL: PBV band



Source: Bloomberg, Anand Rathi Research.

## Risks

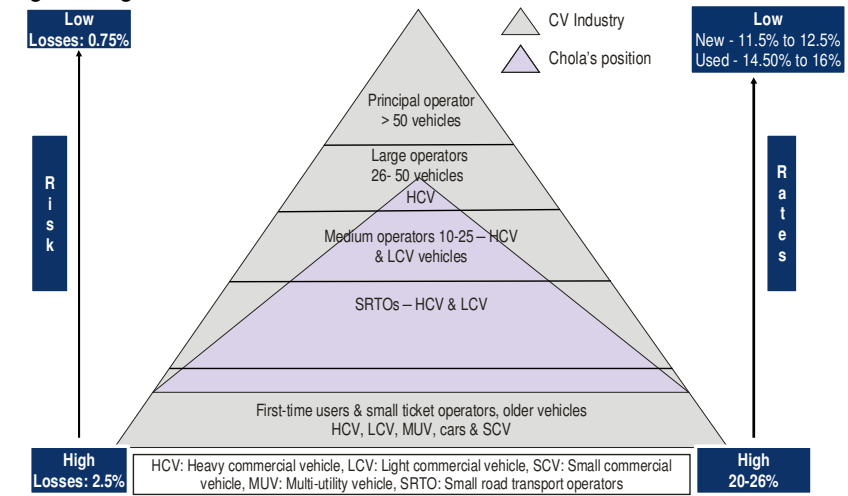
- Economic slowdown and high interest rates could impact the rural economy, which may lead to slower loan growth and more delinquencies.
- Any regulatory changes regarding SLR/CRR requirements and sector caps may impact the company.
- Capital constraints in a tough macro-economic environment may hamper CIF's growth prospects.

## Focus on bottom of pyramid for growth

65% of advances are to SME and agri-based customer segments

We estimate 34% CAGR in CIF's loan book over FY11-14 as a result of strong branch expansion and new product offerings. CIF has increased its branch network by 45%, to 342 branches, in the last six months and plans another 70 branches in FY12. The NBFC targets middle-of-the-pyramid truck operators (10-25 vehicles), as also first-time entrepreneurs and small-ticket operators. It will finance both new and used CVs. At present, vehicle financing constitutes 70% of its credit portfolio. CIF introduced tractor financing and is likely to introduce gold-loan products in the near future.

Fig 8 – Target area of CIF



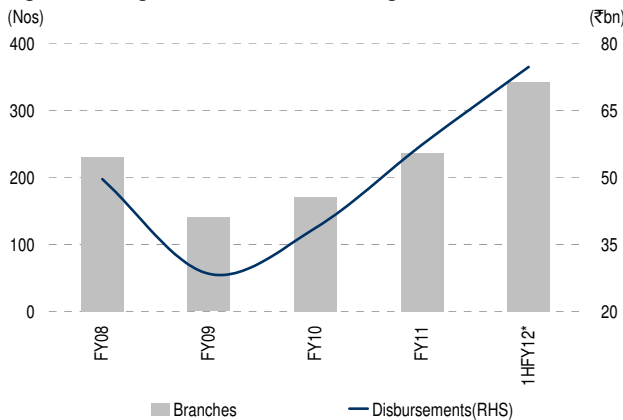
Source: Company

## Strong branch addition in the offing

106 branches (45% of FY11 branch network) have been added in the past six months

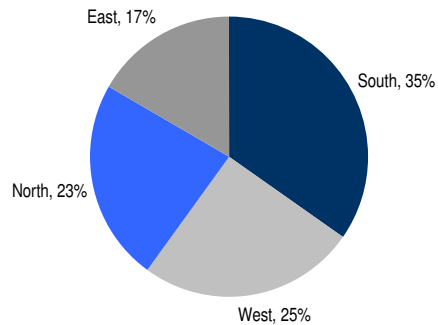
CIF intends to recoup lost time with a focus on branch addition and increased leverage through its branches. During consolidation in FY09 and FY10, the NBFC's branch network declined from 230 in FY08 to 171 in FY10. In the last 18 months, it added 171 branches, taking the total to 342. Of these, 106 were opened in the last six months, successfully driving robust disbursement growth.

Fig 9 – Strong branch addition driving disbursements



Source: Company

Fig 10 – Geographical break-up of branches (Sept '11)



Source: Company

### Rural branch network diversified geographically

*90% of branches are in tier-2 and tier-3 cities where rising rural disposable income acts as a hedge against the tough macro-economic environment*

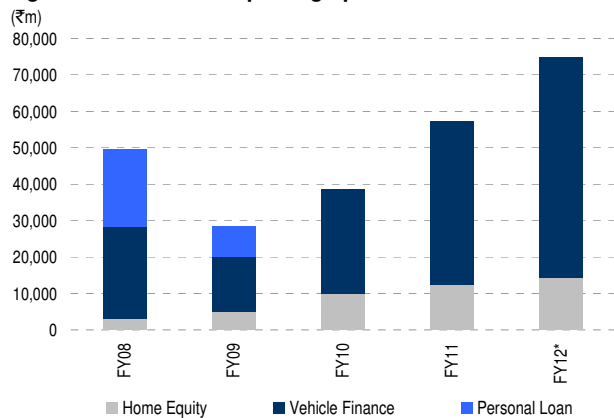
According to management, 90% of CIF’s branch network is located in tier-2 and tier-3 cities, where rising rural disposable income acts as a hedge against the tough macro-economic environment. CIF has a pan-India branch network: 33% in the south, 27% in the west and 21% in the north. The remaining branches form part of CIF’s growing presence in the east. With an extensive branch network in rural and semi-urban areas, CIF is poised to benefit from the growing prosperity of the under-banked rural/semi-urban areas.

### Robust disbursements

Disbursement growth picked up in FY11 following the strong branch expansion and renewed focus on healthy growth. At 55%, disbursement growth continues to be robust in this fiscal as well. This is despite CIF’s exit from personal loans, which is now less than 1% of the entire portfolio. Vehicle finance dominates disbursements and forms nearly 70% of the portfolio.

The AFC has introduced tractor and farm loans in this fiscal and intends to launch gold-loan and construction-equipment financing in the near future. Management aims at nearly ₹5bn of disbursals in this fiscal from such new products.

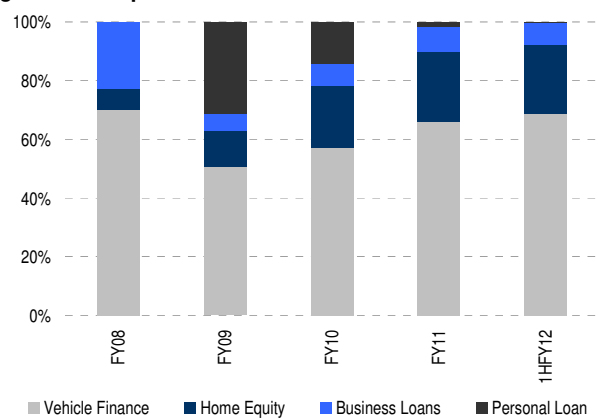
**Fig 11 – Disbursement picking up**



Source: Company

\*Annualized

**Fig 12 – AUM: personal loans written off**

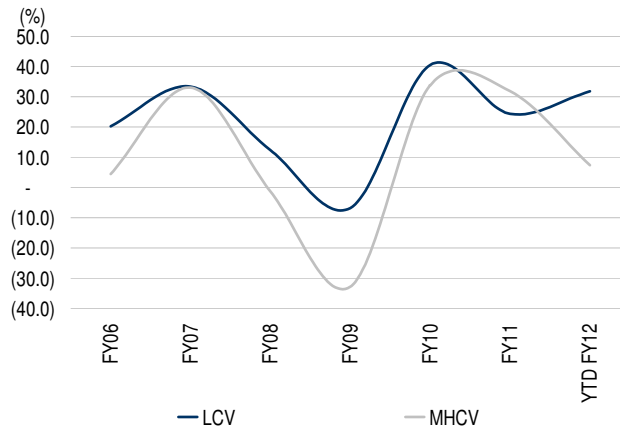


Source: Company

### LCV growth better than M&H CVs

At 46%, the bulk of the vehicle finance book comprises finance for light commercial vehicles (LCV). This is more resilient in a downturn in the economy than car or heavy commercial vehicle financing, as LCVs are primarily used for last-mile delivery of basic items.

Fig 13 – India: LCV growth vs M&H CV growth

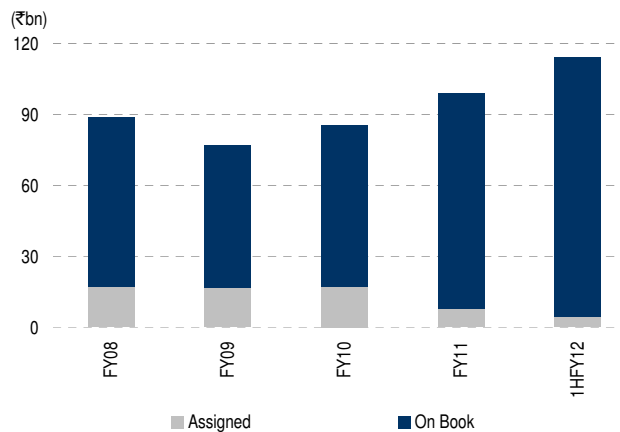


Source: SIAM, Anand Rathi Research

### Modest dependence on securitization

CIF has reduced dependence on securitization income. Off-balance-sheet assets have slid from 19.3% of AUM in FY08 to 4% in 1HFY12. The NBFC has not done any securitization in the current fiscal. Recognition of income has also been conservative, with income to be amortized over the tenure of the securitized asset. Minimal dependence on securitization mitigates any regulatory risk to earnings.

Fig 14 – Declining securitized portfolio



Source: Company

## High-yield products to improve NIM

CIF intends to raise exposure to high-yield secured retail products such as used-vehicle and gold loan finance. We estimate high-yield products, along with the expected easing of interest rates, to aid improvement in NIM to 6.5% by FY14, from 6% in 1HFY12.

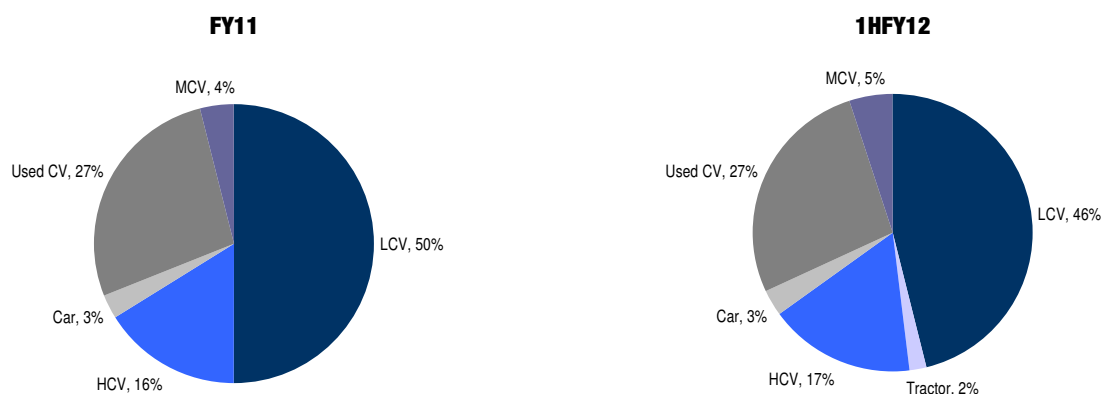
### Change in product mix

#### Vehicle finance dominates portfolio

At present, CIF's portfolio comprises vehicle finance (70.2%), home equity (21.6%) and business finance (8.0%). Used-vehicle financing, commanding higher yields, comprised 27% of vehicle finance at end-Sep '11. Management intends to raise exposure to higher-yield used-CV loans. This augurs well for its NIM.

*Management plans to raise exposure to higher-yield used-CV loans. Used-vehicle financing, commanding higher yields, comprised 27% of vehicle finance at end-Sep '11.*

Fig 15 – Break-up of vehicle-finance portfolio



Source: Company

Source: Company

### Introduction of tractor financing and gold loans

The NBFC launched financing of tractor and farm equipment in the current fiscal and intends to fully leverage the relations that its group companies – Coromandel Fertilizers, EID Parry, Tube Investments, etc. – have with farmers. The share of tractor loans – which offer higher yields than new CV loans and do not require an additional branch and employee setup – in the overall portfolio has risen to 1.4%. CIF has also set up nearly 45 branches, primarily in Andhra Pradesh, Karnataka and Tamil Nadu, dedicated to gold-loan financing. Disbursements are to start this fiscal.

### Inflation to ease

We expect inflation to soften and fall to 7.5% by Mar '12, due to lower prices and the high base of last year. In the event of lower inflation and RBI policy action in 2QFY13 (a cut in the repo rate/liquidity measure), we expect the wholesale cost of funds to slip.

With the expected ease in interest rate and greater exposure to higher-yielding used-CV loans, tractor and gold-loan financing, we expect NIM to improve to 6.5% by FY14, from 6% in 1HFY12.

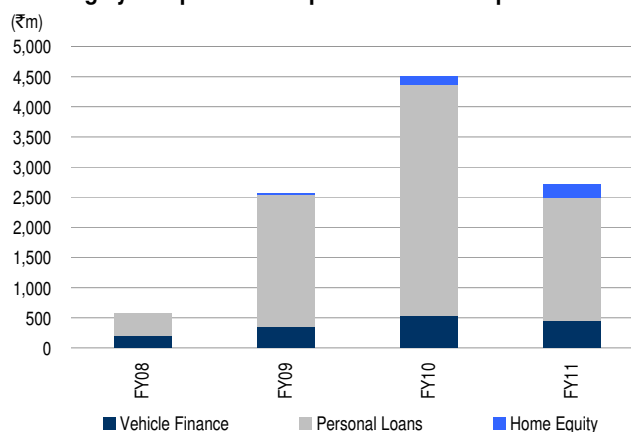
## Stable asset quality

With limited exposure to personal loans and stable levels of gross NPAs in the vehicle and mortgage businesses (0.6% and 1.3%, respectively), we expect credit cost to improve to an average of 0.9% of loans, and drive 70.3% CAGR in earnings over FY11-14. This follows elevated positioning at over 3.7% of advances over FY08-11 on considerable write-offs in the personal-loan portfolio.

### Personal loan portfolio written off

In FY06, in conjunction with DBS Singapore, CIF started disbursements under its unsecured personal-loan portfolio, which went on to suffer huge book losses. In 2008, it stopped disbursements under this scheme, ended its JV with DBS and made provision for the losses. Over FY08-11, the NBFC completely wrote off losses in its personal-loan portfolio, significantly subduing its earnings growth. With no additional provisions expected from this portfolio, we expect credit cost to improve over FY12-14.

Fig 16 – GNPA largely comprises delinquencies from the personal loan portfolio

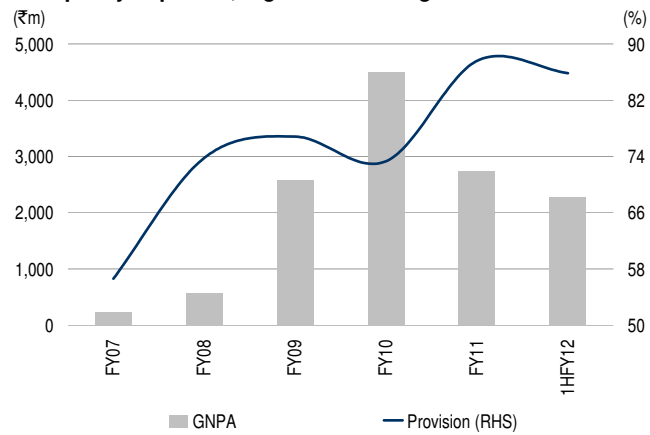


Source: Company

### Low delinquencies in vehicle finance and home equity

Gross NPAs in vehicle financing and home equity have been stable, at 0.6% and 1.3%, respectively, while business finance has zero NPAs. We do not foresee significant delinquencies as such loans are fully secured, with less than 80% loan-to-value (LTV). Additionally, a significant portion of these loans are to rural India, which is expected to be a more buoyant geography on account of the various socio-economic rural schemes undertaken by the Government of India.

Fig 17 – Asset quality improves, high NPA coverage



Source: Company, Anand Rathi Research

### High NPA coverage

*100% NPA coverage in the personal loan portfolio*

We expect credit cost to improve to 0.9% of loans over FY12-14 and to drive 70.3% CAGR in earnings improvement over FY11-14, due to high NPA coverage, a stable outlook on slippages in vehicle-financing and home-equity portfolios, and a fully provisioned for personal-loan portfolio.

NPA coverage has improved from a low of 57% in FY07 to 85.8% at present, on account of better underwriting practices and improvement in risk-management systems. Provisions in the personal-loan portfolio are 100% and CIF's provisioning policies are more conservative than those mandated by the RBI.

### Capital-raising plans

CIF's capital adequacy was 16.3% at end-Sep '11, with tier-1 of 10.1%, which is more than the RBI-prescribed prudential norms. CIF raised close to ₹2.8bn in the form of perpetual and subordinated bonds to augment its tier-2 capital in the first half of FY12. There is further headroom available in tier-2 capital. Given its robust growth plans, we have built in 25% equity dilution in FY13 at the current market price of ₹133, or 1.2 FY13 ABV. This would help CIF's achieve its faster-than-industry growth targets.

## Financials

We expect 27.6% CAGR in net interest income over FY11-14, backed by strong disbursement growth and NIM improvement from FY13. We expect credit cost to improve to an average of 0.9% of loans over FY12-14, from 2.8% in FY11 and to drive earnings CAGR of 70.3% over FY11-14.

### Robust NII growth

We expect 27.6% CAGR in net interest income over FY11-14, backed by strong disbursement growth and NIM improvement from FY13. We build in NIM improvement of ~50bps for FY13, driven by the change in portfolio mix and an expected easing in wholesale borrowing rates.

### Productivity improvement

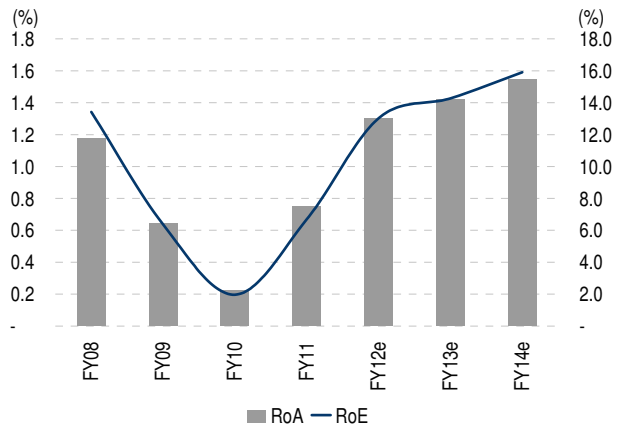
We expect productivity to improve in FY13, once branch expansion normalizes and the benefits of operating leverage pan out. We expect cost-income to improve to 47.5% by FY14, from 48.3% in Sept '12.

### Strong improvement in return ratios

With personal loan losses written off completely, credit cost is likely to ease to an average of 0.9% of loans over FY12-14, from averaging 3.7% over FY08-11, and to drive improved RoA and RoE by FY14, to 1.6% and 16%, respectively, from 0.7% and 6.7% in FY11.

*With personal loan losses written off, credit cost is likely to ease to 0.9% of loans over FY12-14 and to drive improved RoA and RoE by FY14, to 1.6% and 16%, respectively*

Fig 18 – Improving RoA and RoE



Source: Company, Anand Rathi Research

**Fig 19 – Income statement (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Interest income	9,092	11,739	16,391	21,759	29,002
Interest expended	5,036	5,857	9,717	12,477	16,778
<b>Net interest income</b>	<b>4,056</b>	<b>5,882</b>	<b>6,675</b>	<b>9,282</b>	<b>12,225</b>
Growth (%)	(19.6)	45.0	13.5	39.1	31.7
Non-interest income	172	279	323	426	474
<b>Total income</b>	<b>4,228</b>	<b>6,161</b>	<b>6,997</b>	<b>9,708</b>	<b>12,699</b>
Non-interest income / total income (%)	4.1	4.5	4.6	4.4	3.7
<b>Operating expenses</b>	<b>2,001</b>	<b>2,466</b>	<b>3,366</b>	<b>4,611</b>	<b>5,981</b>
Employee expenses	765	897	1,212	1,706	2,273
Other expenses	1,236	1,569	2,154	2,905	3,708
<b>Pre-provisioning profit</b>	<b>2,227</b>	<b>3,696</b>	<b>3,632</b>	<b>5,097</b>	<b>6,718</b>
Growth (%)	(12.7)	66.0	(1.7)	40.3	31.8
Provisions	1,914	2,694	1,162	1,693	2,116
<b>Profit before tax</b>	<b>313</b>	<b>1,001</b>	<b>2,470</b>	<b>3,404</b>	<b>4,602</b>
Taxes	159	379	938	1,133	1,532
Tax rate (%)	50.8	37.9	38.0	33.3	33.3
<b>Profit after tax</b>	<b>154</b>	<b>622</b>	<b>1,531</b>	<b>2,270</b>	<b>3,069</b>
Growth (%)	(63.9)	303.4	146.2	48.3	35.2
Number of shares	66	119	119	149	149
Earnings per share	2.3	5.2	12.8	15.2	20.6

Source: Company, Anand Rathi Research

**Fig 20 – Balance sheet (₹m)**

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Share capital	665	1,194	1,194	1,492	1,492
Reserves and surpluses	7,185	9,526	10,783	16,593	19,147
<b>Net worth</b>	<b>7,850</b>	<b>10,720</b>	<b>11,977</b>	<b>18,085</b>	<b>20,639</b>
Borrowings	53,936	79,453	109,222	140,309	191,263
Deposits	-	-	-	-	-
<b>Total loans</b>	<b>53,936</b>	<b>79,453</b>	<b>109,222</b>	<b>140,309</b>	<b>191,263</b>
<b>Total liabilities</b>	<b>69,412</b>	<b>96,822</b>	<b>129,842</b>	<b>169,631</b>	<b>225,387</b>
Advances	54,896	86,092	118,807	155,638	206,998
Investments	2,193	683	939	1,206	1,644
Cash & bank balances	7,451	4,462	3,297	4,847	7,432
Fixed & other assets	4,872	5,585	6,799	7,941	9,314
<b>Total assets</b>	<b>69,412</b>	<b>96,822</b>	<b>129,842</b>	<b>169,631</b>	<b>225,387</b>

Source: Company, Anand Rathi Research

## Company Background & Management

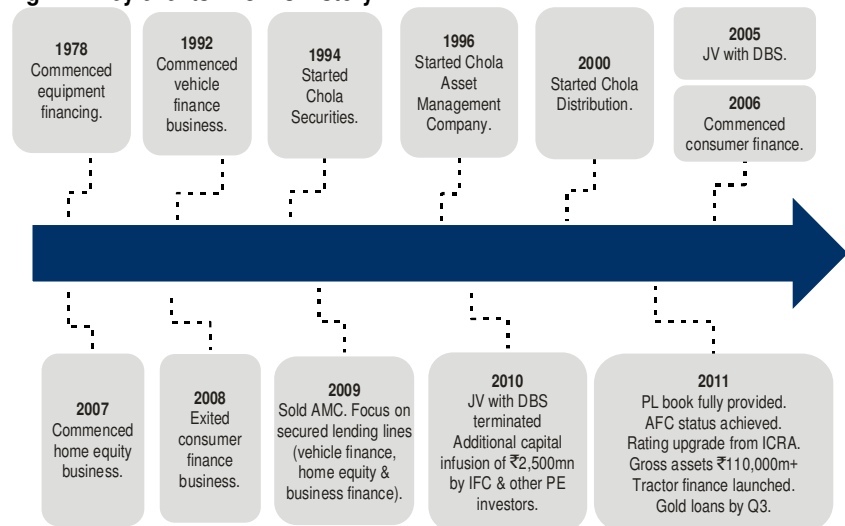
Established in 1978, the asset-financing Cholamandalam Investment and Finance is part of the Chennai-based Murugappa Group. Other listed group entities are Coromandel International, EID Parry, Carborundum Universal, and Tube Investments of India. With 342 branches, CIF has a well-spread network across 21 states.

### Top management

Chairman MBN Rao currently heads CIF with over 38 years’ experience in finance. He was earlier CMD of Canara Bank and Indian Bank. He has also served as member of various committees constituted by the RBI, the Ministry of Finance (The Government of India), SEBI and The National Institute of Bank Management.

Managing Director Vellayan Subbiah, a B. Tech from IIT, Madras and an MBA from the University of Michigan, was earlier MD of Laserwords, a provider of pre-press services. He has previously worked with McKinsey and The Carlyle Group, San Francisco.

Fig 21 – Key events in CIF’s history



Source: Company

## Appendix 1

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The views expressed in this research report accurately reflect the personal views of the analyst(s) about the subject securities or issuers and no part of the compensation of the research analyst(s) was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst(s) in this report.

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Large Caps (>US\$1bn)	>20%	5-20%	<5%
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