Finance Sector

29 December 2020

Sector Report

Well capitalized for asset quality stress; valuation to rise when clarity on growth emerges

View: Positive

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We are positive on auto finance NBFCs due to following factors: (1) the asset quality stress or restructuring requirement is lower than initially anticipated; large provision buffers have already been built up in case of downside scenario (2) liquidity buoyancy providing access to lower cost of funds for NBFCs with strong parentage (3) Positive data points indicating that the CV cycle is on the cusp of a recovery. The additional provisioning towards Covid and macro factors (avg 1.82% of AUM for NBFCs we cover in this report) can be tapped to cover any NPA stress that may emerge. Additionally, the recent capital raises and conservative ALM provide enough balance sheet strength to grow when the cycle turns positive. Auto finance NBFCs have underperformed the Nifty by 13% YTD. They are currently trading at a P/ABV multiple of 2.3x vs historical 5-year average of 2.8x. Even on FY23E, auto NBFSs are trading at 40% discount to Nifty on P/B and P/E basis. We initiate coverage on Cholamandalam (CIFC), Mahindra Finance (MMFS) and Shriram Transport (SHTF) with a Buy rating. Our top pick is CIFC followed by SHTF and MMFS. In our view, CIFC is best placed among peers in terms of product diversification, asset quality, cost of funding and client & geographical positioning.

Asset quality stress lower than anticipated: The collection efficiencies for auto-finance NBFCs ranged ~82-95% in Sept'20 and have been gradually improving thereafter. The management commentary around restructuring between 1% to 8% is lower than initially anticipated. Auto NBFCs have built in additional provision buffers in the range of 1.2% to 2.2% (avg 1.8%) of AUM, providing headroom in case of there is a downside in the economy. We estimate Gross NPAs for auto NBFCs to increase by 240bps vs FY20 level but fall by 40bps vs. demonetization. In our view, better clarity on NPAs and restructuring will emerge only post 3QFY21 results. CIFC's historical track of managing asset quality will help it to emerge better compared to peers.

Stimulus packages helped improve liquidity position for NBFCs: Risk perception towards NBFCs has improved, resulting in a better funding environment. "AA" 1-Year NBFC bond yields have fallen to 5.2% from 7.8% in May'20 while the spread to the government bonds dropped to 180bps - below the peak of 370bps observed over the same period. The Special Liquidity scheme (SLS) and Partial Credit Guarantee Scheme 2 (PCGS2) aided in liquidity support for NBFCs. While the SLS was mainly aimed at providing short-term liquidity support, PCGS2 provided 20% Govt. guarantee in case of default from BBB+ rated NBFCs. NCDs raised by NBFCs have increased by 92% YoY from April'20 till date.

CV cycle on the cusp of a recovery: CV sales in LTM have been at a decadal low, but have witnessed some recovery July'20 onwards. This is visible in monthly auto sales data and is further reflected in pick-up in e-way bill generation, capital goods production and IIP data. Resilience in the rural economy is likely to support disbursements for auto NBFCs, who have ~90% of their branches in rural and semi-urban India. As per industry estimates, the CV sales are likely to grow in the range of 13-18% over FY21-24E.

		Market cap		CMP	Target	Up /	P/B (Rs)			P/ABVP(x)			RoE (%)		
Company	Rating	Rsbn	US$bn	(Rs)	Price	Down (%)	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E
Cholamandalam	Buy	317	4.3	386	480	24	3.4	2.9	2.4	4.2	3.5	2.8	*16.0*	*19.4*	*19.2*
Mahindra Fin	Buy	217	2.9	176	210	19	1.5	1.4	1.2	2.0	1.8	1.6	*7.0*	*9.4*	*12.0*
Shriram Tran	Buy	257	3.5	1,016	1,265	25	1.2	1.1	1.0	2.0	1.7	1.4	*9.6*	*12.0*	*12.8*

Source: Company, Nirmal Bang Institutional Equities Research

Summary financial models

Rs mn	Chola				MMFS				SHTF			
	FY20	FY21E	FY22E	FY23E	FY20	FY21E	FY22E	FY23E	FY20	FY21E	FY22E	FY23E
Income statement												
Financing Income	81,242	89,603	1,00,329	1,14,883	99,417	1,05,118	1,06,935	1,19,478	1,62,675	1,71,847	1,84,991	2,06,783
Finanancing charges	45,922	48,092	52,950	60,033	48,287	49,267	47,358	51,581	82,703	88,715	96,137	1,08,641
Net Financing income	**35,319**	**41,511**	**47,378**	**54,850**	**51,130**	**55,851**	**59,578**	**67,896**	**79,972**	**83,131**	**88,853**	**98,141**
Change (%)	18	18	14	16	9	9	7	14	2	4	7	10
Other Income	5,287	5,578	5,944	6,491	3,034	2,969	3,266	3,593	3,152	1,500	1,575	1,654
Net Income	**40,607**	**47,090**	**53,323**	**61,341**	**54,164**	**58,820**	**62,844**	**71,489**	**83,124**	**84,631**	**90,428**	**99,795**
Change (%)	19	16	13	15	11	9	7	14	3	2	7	10
Other Operating Exp.	15,776	17,239	19,256	22,063	20,182	17,634	19,912	22,137	10,680	11,184	12,328	14,028
Operating Profit	**24,831**	**29,851**	**34,067**	**39,277**	**33,982**	**41,186**	**42,932**	**49,352**	**62,336**	**64,021**	**67,420**	**73,405**
Change (%)	16	20	14	15	13	21	4	15	1	3	5	9
Total Provisions	8,973	11,013	7,500	8,251	**20,545**	**28,824**	**23,213**	**22,051**	**27,949**	**38,185**	**30,716**	**30,173**
% to operating income	0	0	0	0	60	70	54	45	45	60	46	41
PBT	**15,857**	**18,838**	**26,567**	**31,027**	**13,438**	**12,362**	**19,719**	**27,301**	**34,387**	**25,836**	**36,704**	**43,231**
Tax	5,334	4,841	6,828	7,974	4,374	3,214	5,127	7,098	9,368	7,027	9,984	11,759
Tax Rate (%)	34	26	26	26	33	26	26	26	27	27	27	27
PAT	**10,524**	**13,996**	**19,740**	**23,053**	**9,064**	**9,148**	**14,592**	**20,203**	**25,018**	**18,809**	**26,721**	**31,473**
Change (%)	(11)	33	41	17	-42	1	60	38	-2	-25	42	18
Dividend	1,680	2,099	2,961	3,458	0	4,933	2,918	4,041	1,134	2,531	5,061	5,568
Balance Sheet												
Equity share Capital	1,640	1,639	1,639	1,639	1,231	2,466	2,466	2,466	2,269	2,531	2,531	2,531
Reserves & Surplus	80,078	91,975	1,08,753	1,28,348	1,12,408	1,46,358	1,58,032	1,74,194	1,77,783	2,08,721	2,30,381	2,56,286
Net Worth	**81,717**	**93,614**	**1,10,392**	**1,29,987**	**1,13,639**	**1,48,825**	**1,60,498**	**1,76,661**	**1,80,052**	**2,11,252**	**2,32,911**	**2,58,816**
Borrowings	5,50,054	5,94,993	6,65,727	7,63,636	**5,94,623**	**5,78,411**	**5,90,914**	**6,82,698**	**9,43,718**	**9,64,138**	**11,03,329**	**12,33,047**
Change (%)	**9**	8	12	15	13	-3	2	16	7	2	14	12
Other Liabilities	8,158	497	(2,453)	(6,270)	32,451	37,318	42,916	49,353	17,517	18,443	19,133	19,842
Total Liabilities	**6,39,930**	**6,89,104**	**7,73,666**	**8,87,353**	**7,40,712**	**7,64,473**	**7,94,247**	**9,08,631**	**11,41,286**	**11,93,833**	**13,55,373**	**15,11,705**
Investments	729	872	903	949	59,110	65,021	68,272	71,685	27,985	30,783	33,862	37,248
Change (%)	0	20	3	5	56	10	5	5	-30	10	10	10
Loans	5,54,027	6,10,959	6,87,425	7,92,926	6,49,935	6,47,821	6,97,278	8,05,583	10,22,316	10,60,552	12,35,728	13,93,343
Change (%)	5	10	13	15	6	0	8	16	6	4	17	13
Other Assets	85,173	77,272	85,338	93,477	31,668	51,632	28,697	31,362	90,985	1,02,497	85,783	81,114
Total Assets	**6,39,930**	**6,89,104**	**7,73,666**	**8,87,353**	**7,40,712**	**7,64,473**	**7,94,247**	**9,08,631**	**11,41,286**	**11,93,833**	**13,55,373**	**15,11,705**
Assumptions												
Borrowings Growth	8.8	8.2	11.9	14.7	12.5	(2.7)	2.2	15.5	7.3	2.2	14.4	11.8
Advances Growth	5.3	10.3	12.5	15.3	6.1	(0.3)	7.6	15.5	5.7	3.7	16.5	12.8
AUM Growth	11.6	10.9	12.4	16.5	7.2	0.2	7.7	15.4	5.0	3.4	11.8	11.8
Spreads Analysis on AUM (%)												
Avg. Yield - on Financing portfolio	14.2	14.0	14.1	14.1	15.8	16.2	15.9	15.9	15.2	15.4	15.4	15.4
Avg Cost of funds	8.0	7.5	7.4	7.3	8.6	8.4	8.1	8.1	7.7	8.0	8.0	8.1
Int. Spread on Financing portfolio	6.2	6.5	6.6	6.7	7.2	7.8	7.8	7.8	7.5	7.4	7.4	7.3
RoE	14.7	16.0	19.4	19.2	8.3	7.0	9.4	12.0	14.8	9.6	12.0	12.8
RoA	1.7	2.1	2.7	2.8	1.3	1.2	1.9	2.4	2.3	1.6	2.1	2.2
GNPL ratio (%)	3.8	4.9	4.2	3.5	8.4	11.9	11.4	10.4	8.4	11.0	9.5	8.4
NNPL ratio (%)	2.3	2.9	2.7	2.2	6.1	8.1	7.7	7.0	5.6	7.1	6.2	5.5
Average leverage (on BS)	8.5	7.6	7.2	6.9	6.5	5.7	5.0	5.1	6.5	6.0	5.7	5.8
CAR	20.7	21.0	20.9	21.0	19.6	22.8	22.5	21.1	22.0	22.0	20.9	20.6
Valuations												
P/BV	3.9	3.4	2.9	2.4	1.0	1.5	1.4	1.2	1.3	1.2	1.1	1.0
P/ABV	4.6	4.2	3.5	2.8	1.3	2.0	1.8	1.6	1.9	2.0	1.7	1.4
P/E	30.1	22.6	16.0	13.7	11.9	23.7	14.9	10.7	9.2	13.2	9.6	8.2
Dividend yield	0.5	0.7	0.9	1.1	-	2.3	1.3	1.9	0.6	1.0	2.0	2.2

Source: Company, Nirmal Bang Institutional Equities Research

Summary background

FY20	CIFC	SHTF	MMFS
Size			
AUM (Rs mn)	6,05,490	10,97,492	6,49,930
Disbursement (Rs mn)	2,90,900	4,76,912	4,23,882
Core product segment	LCV	Used CV	Tractors & UV
Operations			
Branches	1,091	1,758	1,322
Employess	26,558	28,045	21,862
AUM/branch (Rs mn)	555	624	492
AUM/Employee (Rs mn)	23	39	30
Employee/Branch	24	16	17
Underwriting model	Centralised	Branch driven	Branch driven
Growth			
5Y Disbursement CAGR (FY15-20)	18%	7%	12%
10Y Disbursement CAGR (FY10-20)	22%	13%	17%
5Y AUM CAGR (FY15-20)	19%	13%	15%
10Y AUM CAGR (FY10-20)	24%	14%	22%

Source: Company, Nirmal Bang Institutional Equities Research

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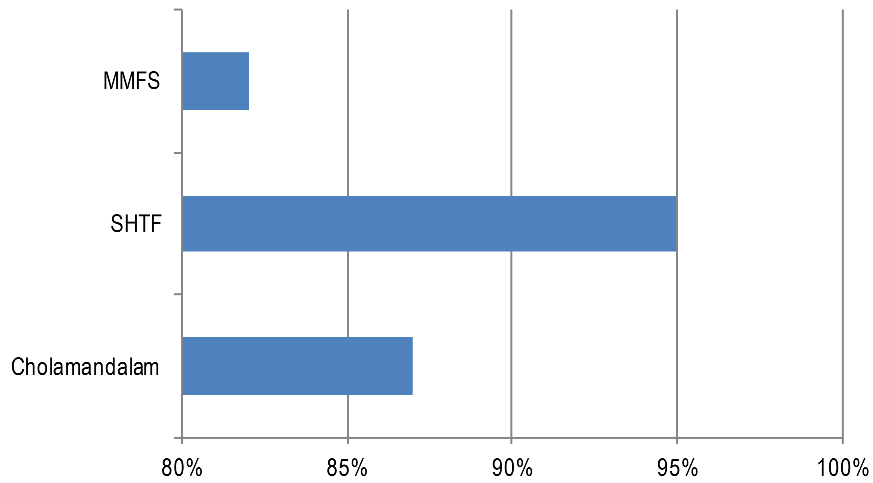
Asset quality stress lower than anticipated; clarity to emerge post December quarter

Auto finance NBFC stock prices had corrected in March'20 with the expectation of pressure on asset quality metrics due to the impact of the nation-wide lockdown and challenging economic environment. The impact of lockdown was witnessed in the early phases with their collection efficiencies dropping in April to August'20 period. However, auto finance NBFCs' stock prices have rallied by 60% in the last three months, hinting that restructuring and NPAs could be lower than expected. This was supported by increase in collection efficiency, which ranged ~82-95%. Our recent interactions with the managements suggest that the collection efficiency has increased further since October'20.

Exhibit 1: Collection efficiency in Sept'20

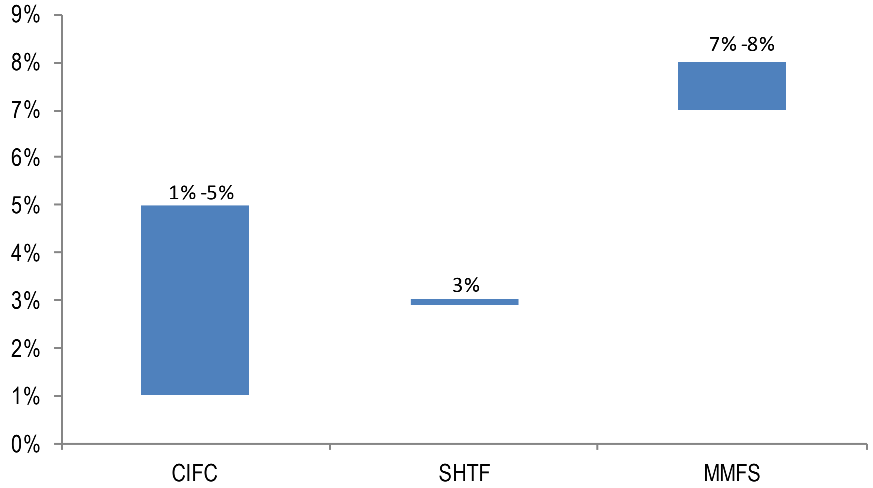


Source: Company, Nirmal Bang Institutional Equities Research

The management commentary around restructuring is better than initially anticipated. Given the trend in collection efficiency, the auto finance NBFCs expect restructuring to remain in the range of 1% to 8%.

The impact of Covid on Gross NPAs and restructured assets is likely to crystallize only post 3QFY21 and will remain a key element to watch for further increase in valuations.

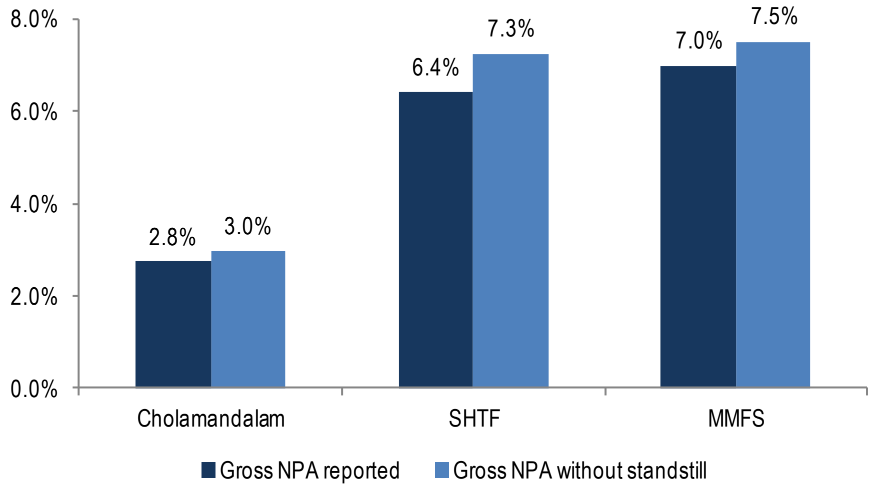
Exhibit 2: Restructuring estimated to be in the range of 1% to 8%



Source: Company, Nirmal Bang Institutional Equities Research

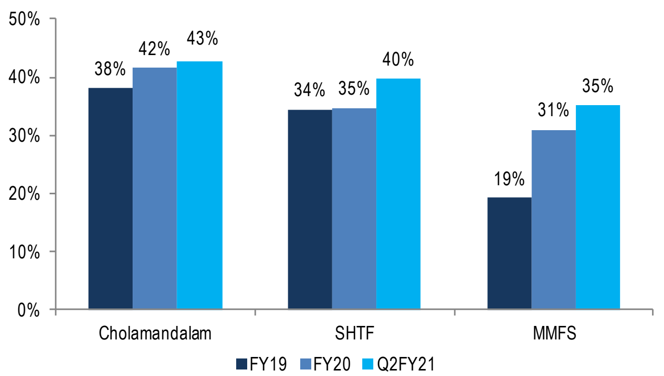
The increase in gross stage 3/NPA without considering the SC standstill clause is higher by 52bps on avg. in comparison to the reported gross NPA numbers. However, the additional provision buffers built by the NBFCs are in the range of 1.2% to 2.2% (avg 1.8%) of AUM, providing headroom in case of downside scenario.

Exhibit 3: Gross NPA (Sept'20) higher by 20-80bps bps without standstill clause



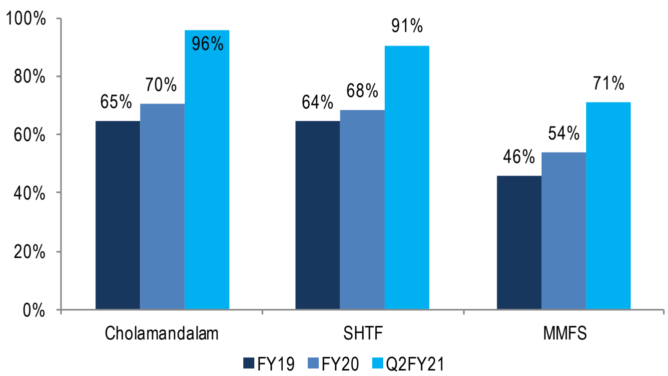
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 4: Stage III provisions increased meaningfully for vehicle financiers



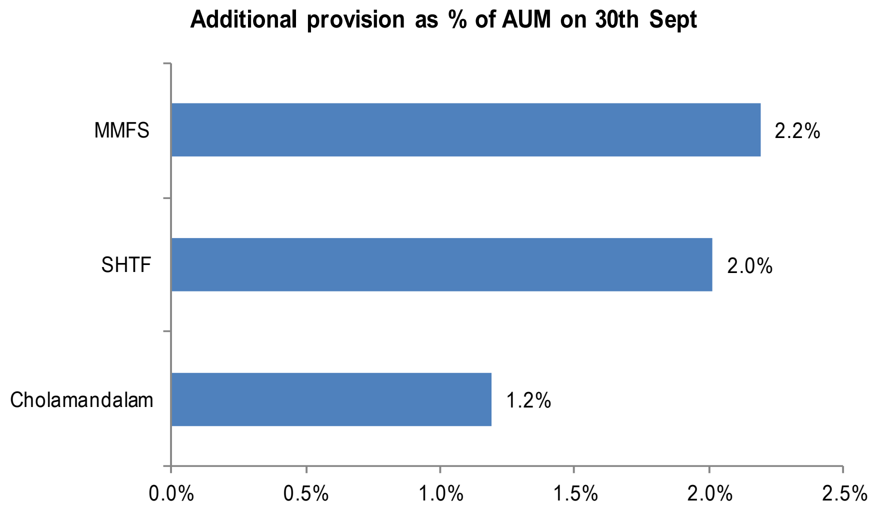
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 5: Total provisions as a % of Gross NPA increased significantly in Q2



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 6: Additional provisions buffer as a % of AUM



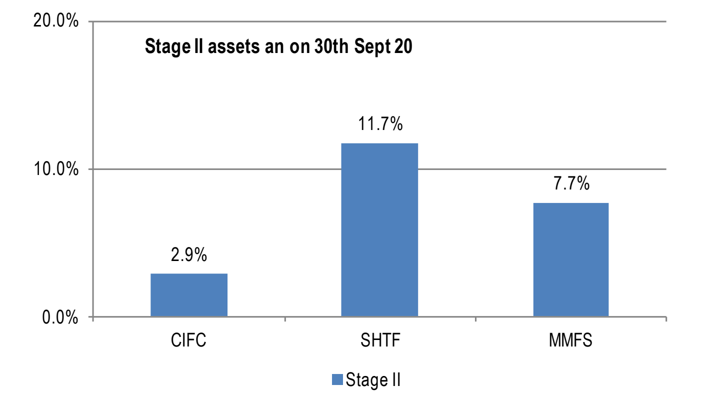
Source: Company, Nirmal Bang Institutional Equities Research

As per a RBI circular on asset classification and provisioning, moratorium benefit was extended to SMAs (special mention accounts), which were standard as on 29th Feb'20. However, NBFCs were allowed to be governed by their board policies and ICAI directives. Accordingly, MMFS and SHTF granted moratorium benefit up to 90dpd whereas CIFC granted it up to 180dpd.

All NBFCs created additional provision buffers in order to control slippages arising due to the Covid-related lockdown. We compared the SMA overdue accounts, which are likely to slip into NPA category along with the additional provisional buffers. While some of the SMA accounts may slip into NPA category, a few may repay while others may be restructured. NBFCs are mandated to provide 10% provisions on restructured accounts. Given the management commentary on restructuring, in our view, SHTF has adequate provisions compared to peers in order to absorb additional stress in its book.

Historically, CIFC has been prudent in asset quality management, which is reflected in low stage 3 assets. Also, stage 2 assets are the lowest for CIFC, indicating strong credit appraisals, underwriting standards and collection efforts compared to peers.

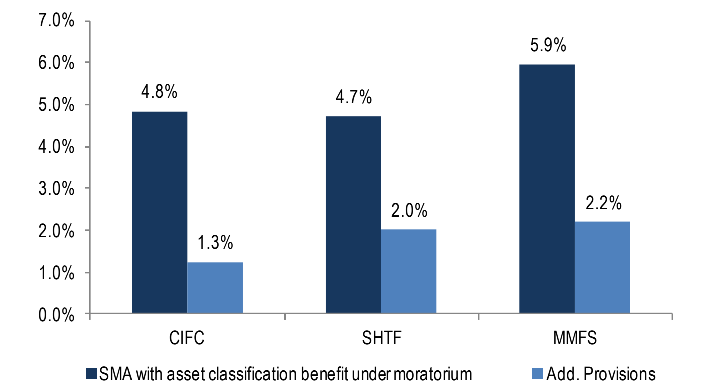
Exhibit 7: Stage 2 assets lowest for CIFC



Note: Denominator for Stage II, SMA & additional provisions is gross loans

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 8: Additional provisioning seems adequate



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 9: Key parameters for vehicle financiers

Particulars (as of September 30,2020)	Cholamandalam	SHTF	MMFS
AUM (Rsmn)	671,820	1,133,459	677,687
Loans o/s as on 30th Sept (Rsmn)	622,570	1,043,395	643,890
Customers under moratorium	76%	94%	75%
Collection efficiency in September	87%	95%	82%
Collection guidance (Oct 20 onwards)	>105%	>95%	NA
Stressed sub-segments	NA	7-8%	4%
Potential restructuring	1-5%	3%	7-8%
Gross Stage III reported	**2.75%**	**6.42%**	**7.0%**
Gross Stage III without standstill clause	2.98%	7.26%	7.53%
Net Stage III reported	**1.91%**	**3.64%**	**4.7%**
Net Stage III without standstill clause	1.70%	4.51%	4.97%
Stage III provision coverage (%)	42.7%	39.7%	35.1%
Gross Stage II %	2.90%	11.70%	7.70%
Stage I + II provision coverage	1.51%	4.0%	2.50%
Additional Covid provisioning made by NBFC's (Rsmn)	8,000	22,824	14,842
Additional provisions as % of AUM	1.19%	2.0%	2.2%

Source: Company, Nirmal Bang Institutional Equities Research

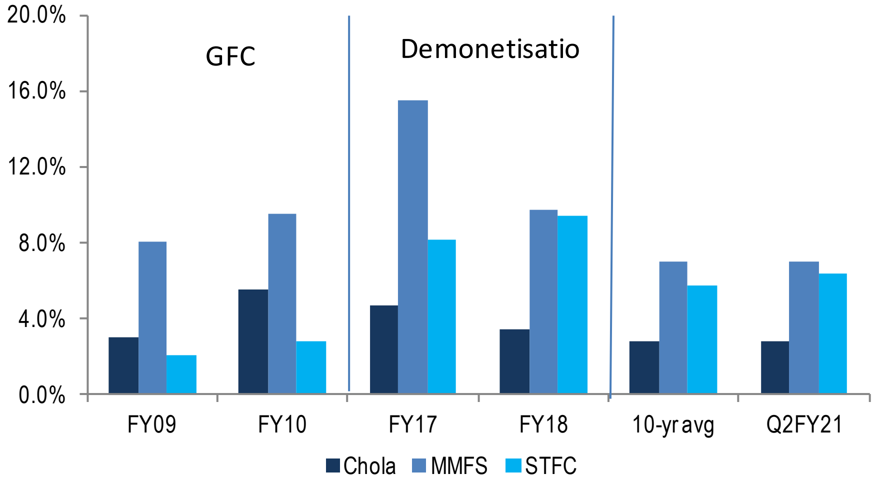
Gross NPA (Stage 3) to increase by 240bps on an avg. in FY21

CIFC: We estimate Stage 3 assets at 4.9% in FY21, broadly in line with GNPA of 4.7% in FY17 (demonetization).

MMFS: We estimate Stage 3 assets at 11.9% in FY21 vs 8.4% in FY20. Our FY21 estimates are lower than 15.5% of GNPAs reported in FY17 because of strong farm cash flows, driven by good monsoon and resilience observed in the rural economy.

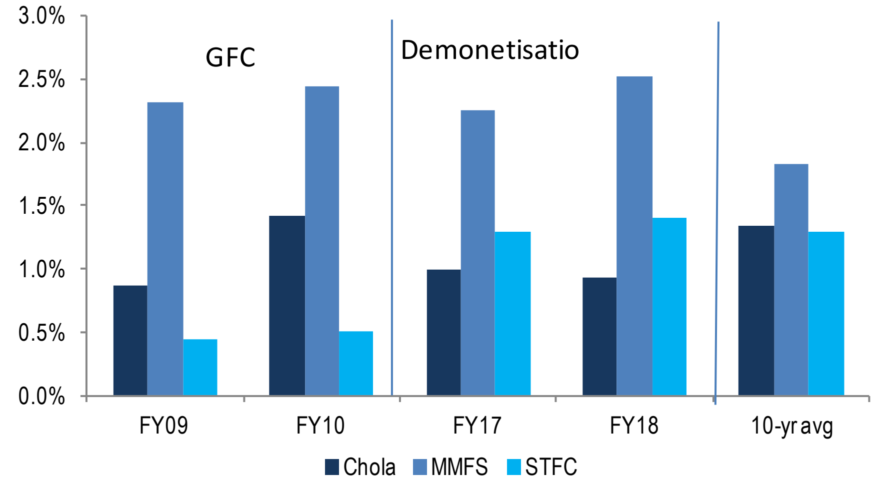
SHTF: We expect Stage 3 assets to increase to 11% in FY21 from 8.4% reported in FY20. This is higher than avg. GNPAs of 8.8% reported in FY17 & FY18. SHTF's stage 2 assets at 11.7% are significantly higher than its peers. Also, SMA accounts under moratorium stand tall at 34% vs 20% & 13% for CIFC & MMFS.

Exhibit 10: GNPAs increased drastically during demonetization due to cash flow issues…



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 11: …however, write-offs were below 10-yr avg ex- MMFS in FY17 and FY18



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 12: Asset quality assumptions

	CIFC			MMFS			SHTF		
	FY20	FY21E	FY22E	FY20	FY21E	FY22E	FY20	FY21E	FY22E
Slippages (as % of op. AUM)	2.54%	4.50%	3.70%	5.2%	10.0%	6.0%	13.2%	14.5%	13.0%
Recoveries as % of op Gross NPA + slippage	11.8%	20.0%	30.0%	10.2%	19.0%	15.0%	49.3%	40.0%	44.0%
Write-offs as % of op Gross NPA + slippage	10.9%	15.0%	15.0%	11.4%	15.9%	16.3%	9.2%	10.0%	10.0%
Gross Stage III	3.80%	4.87%	4.21%	8.4%	11.9%	11.4%	8.3%	11.0%	9.5%
Net Stage III	2.26%	2.92%	2.65%	6.1%	8.1%	7.7%	5.6%	7.1%	6.2%
Gross Stage III coverage	41.5%	40.0%	37.0%	31.0%	35.0%	35.0%	34.7%	35.0%	35.0%
Stage I + II coverage	1.1%	1.1%	1.1%	2.1%	1.8%	2.0%	2.8%	2.8%	2.7%
Provisions as % of Business AUM	2.6%	3.0%	2.6%	4.5%	5.8%	5.8%	5.8%	6.7%	6.0%
Credit cost	1.7%	1.9%	1.2%	3.3%	4.4%	3.5%	2.8%	3.7%	2.7%

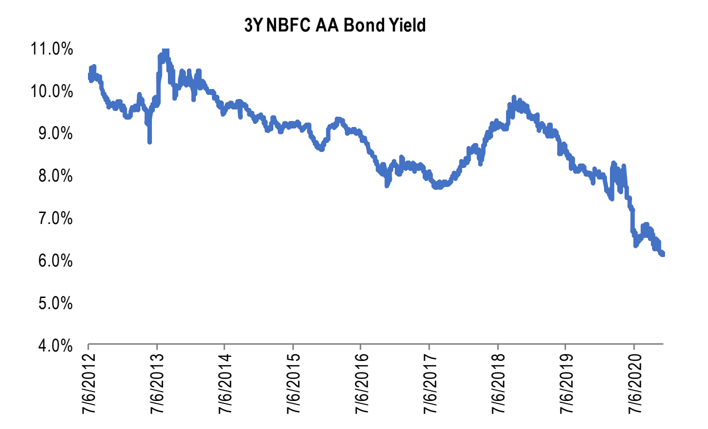
Source: Company, Nirmal Bang Institutional Equities Research

Liquidity position improved for NBFCs

Risk perception towards NBFCs has improved, resulting in a better funding environment. CIFC, SHTF and MMFS have raised Rs94bn through bonds over the last 9 months vs Rs49bn raised over the same period a year ago. The AA bond yields have fallen by ~160-170bps since January'20. "AA" NBFC spreads to corporates (3Y) has also eased to 60bps vs 90bps noted in June' 20. However, this spread remains volatile. The regulatory measures to improve system liquidity, coupled with improvement in asset quality outlook and recent capital raises would have aided in reducing the decline.

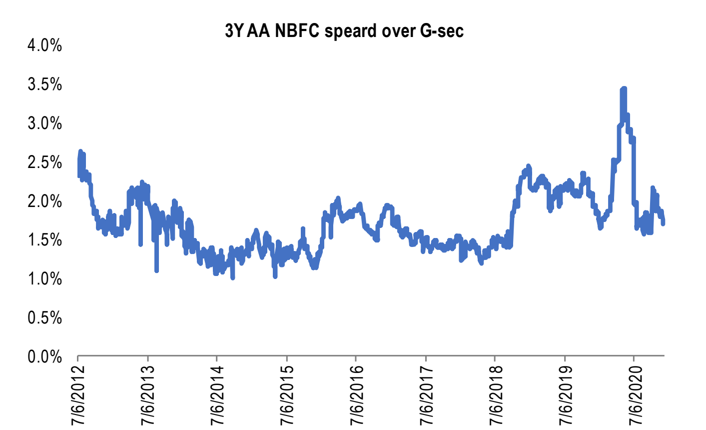
The auto finance NBFCs we have covered in this report are AA-rated and therefore we have used data on AA rated bonds in our analysis.

Exhibit 13: 3Y NBFC bond yield have come down to 6.2% from recent peak of 8.2%



Source: Bloomberg, Nirmal Bang Institutional Equities Research

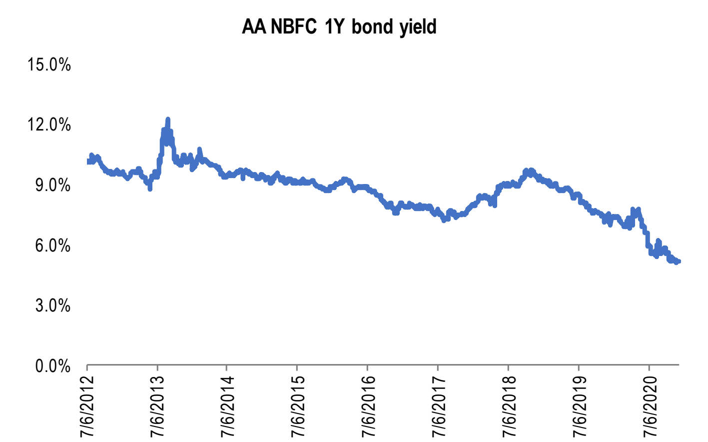
Exhibit 14: 3Y AA NBFC bond yields spread over 3Y G-Sec have softened after 2Q results



Source: Bloomberg, Nirmal Bang Institutional Equities Research

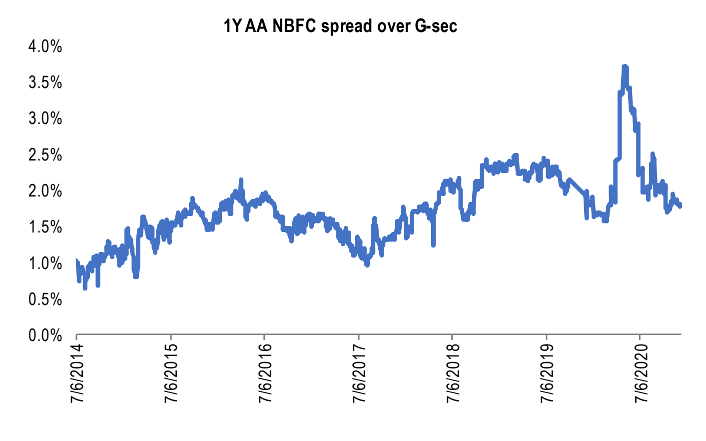
1-Year AA-rated NBFC bond yields have fallen to 5.2% and spread to government bonds at 30bps is below 3-year average of 210bps.

Exhibit 15: 1Y NBFC bond yield have come down to 5.2% from peak of 7.2% in March



Source: Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 16: 1Y AA NBFC bond yields spread over 1Y G-Sec is down in recent months



Source: Bloomberg, Nirmal Bang Institutional Equities Research

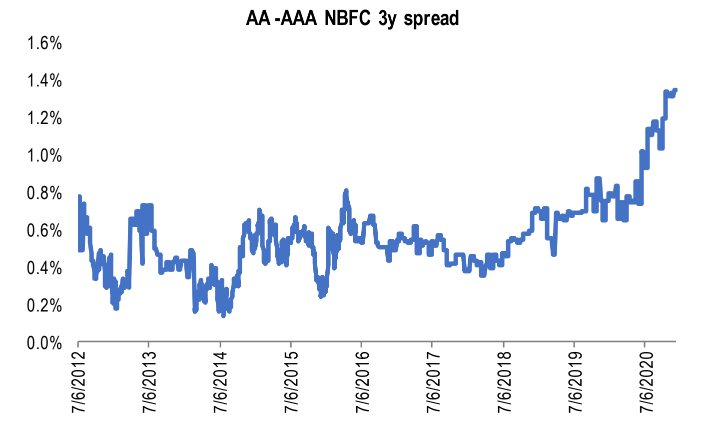
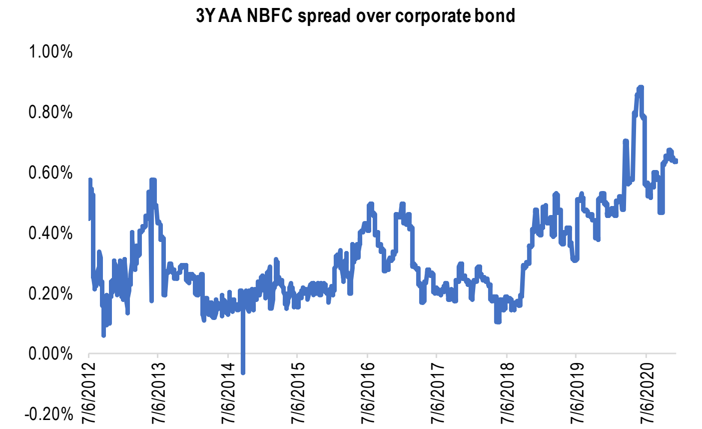
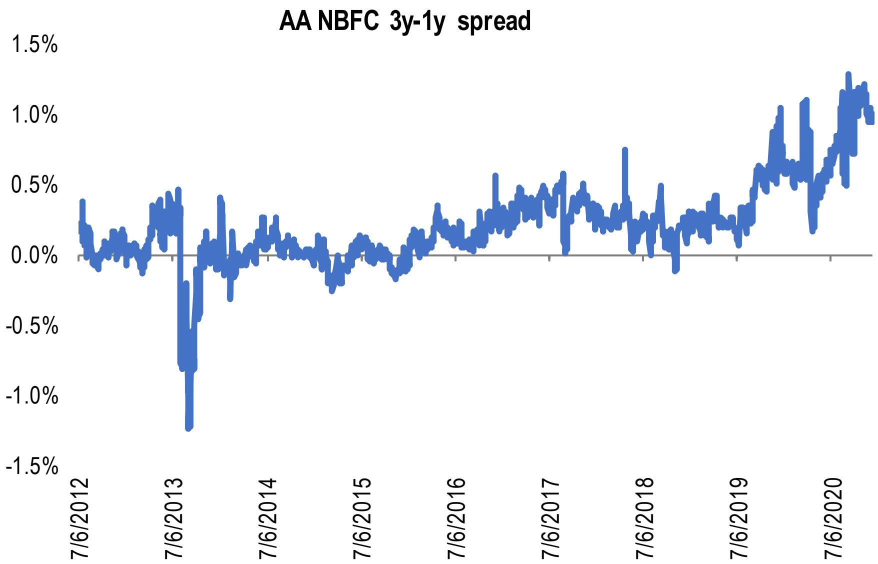
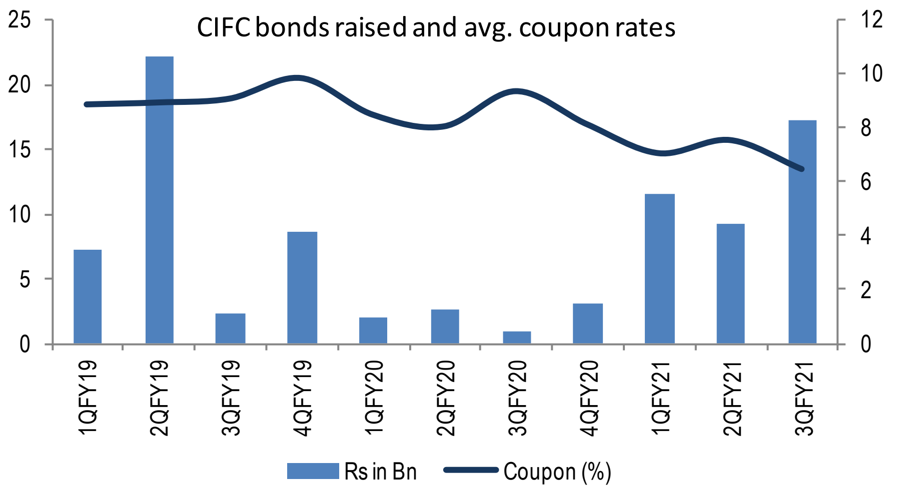
Exhibit 17: Spread between AA and AAA rated bonds have increased in recent months….	Exhibit 18:..however spread as compared to AA rated corporate bonds have declined
	
Source: Bloomberg, Nirmal Bang Institutional Equities Research	*Source: Bloomberg, Nirmal Bang Institutional Equities Research*

Exhibit 19: Increase in spreads between 3Y & 1Y bonds implies that the long tenure bonds are perceived more risky than it was historically



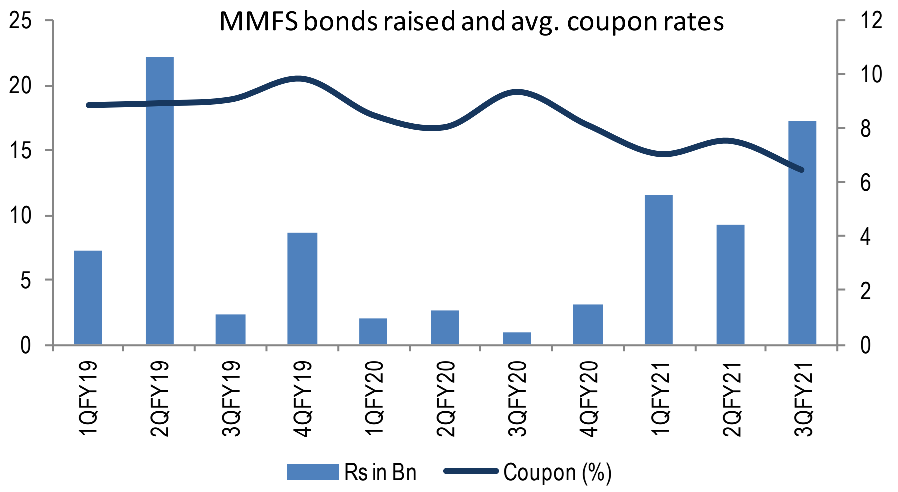
Source: Bloomberg, company

Exhibit 20: Coupon rates for CIFC have come down in recent months



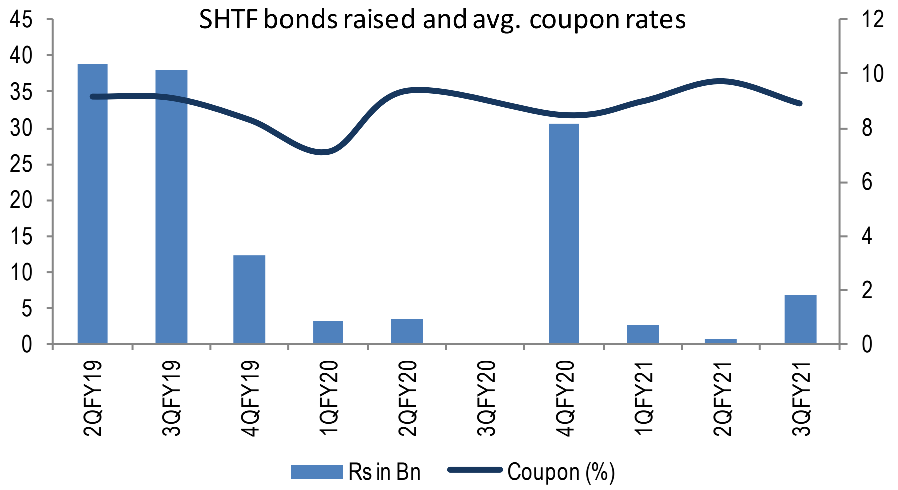
Source: BSE filings, Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 21: Coupon rates for Mahindra Finance remain best amongst auto NBFCs due to its parentage



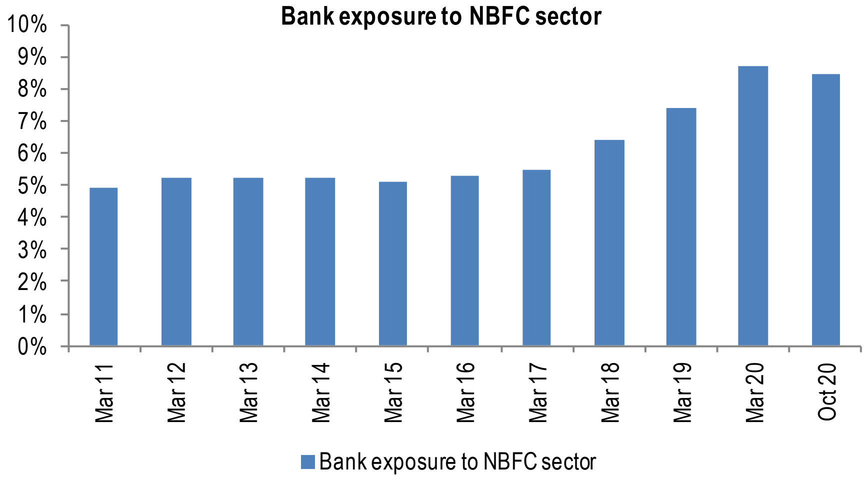
Source: BSE filings, Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 22: Coupon rates for SHTF remain high due to its modest customer profile and asset quality



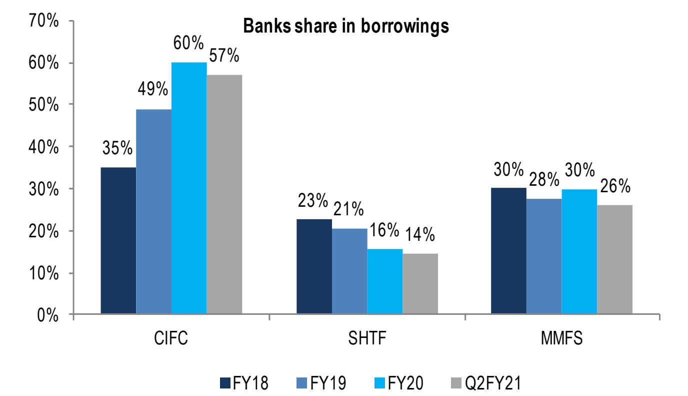
Source: BSE filings, Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 23: NBFCs share of bank funding has increased especially after governments regulatory measures on improving system liquidity.



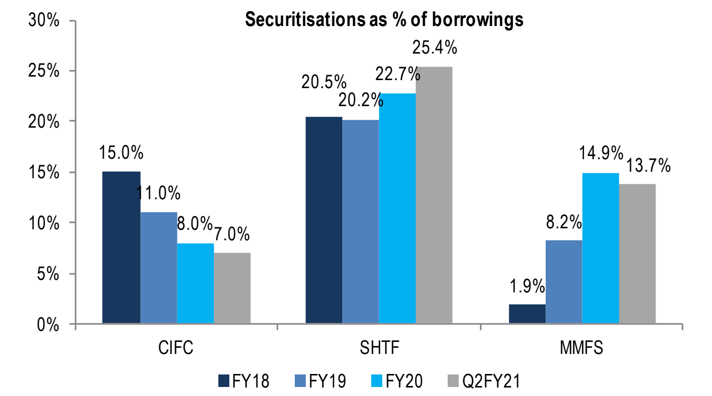
Source: RBI, Nirmal Bang Institutional Equities Research

Exhibit 24: This is reflected in increase in share of bank borrowings for CIFC…



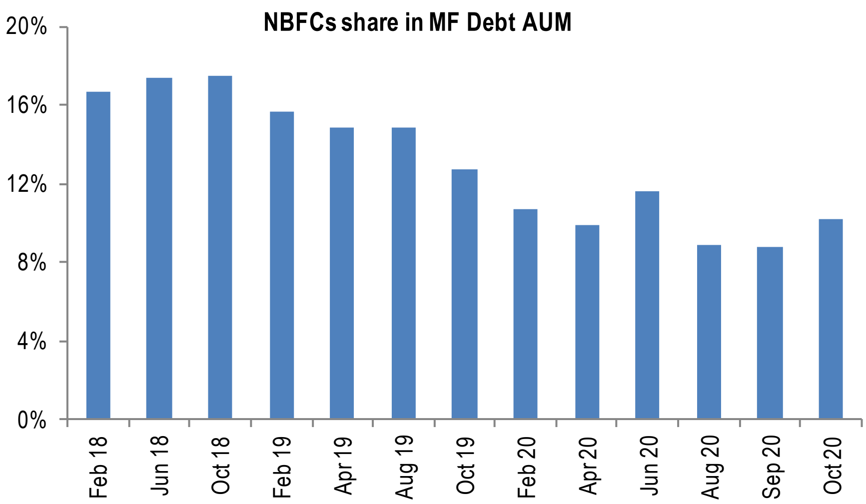
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 25: …and increase in securitisations for SHTF and MMFS



Source: Company, Nirmal Bang Institutional Equities Research

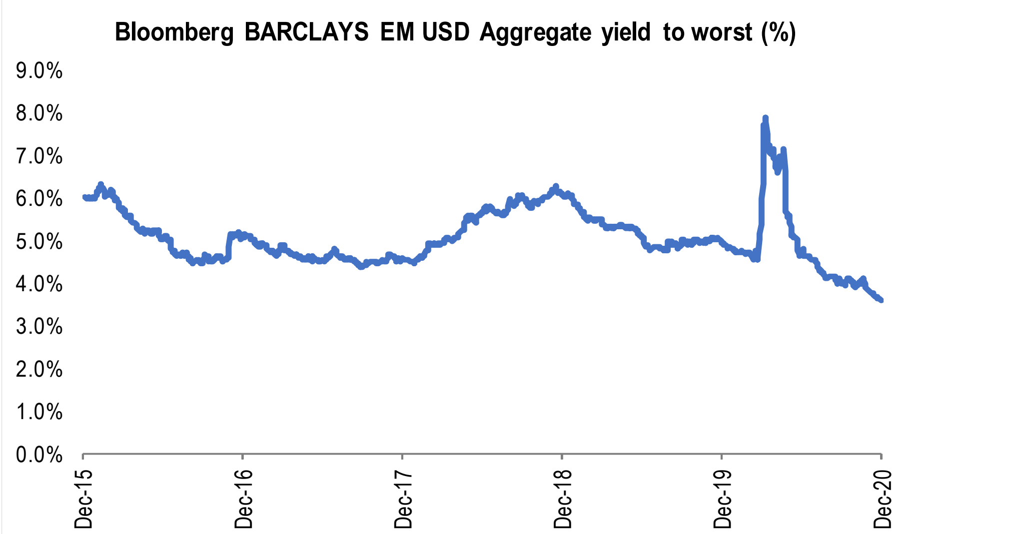
Exhibit 26: Share of NBFC's in MF debt AUM is recovering from all time low



Source: Company, Nirmal Bang Institutional Equities Research

Yield on USD denominated emerging market bond is at 5 year low.

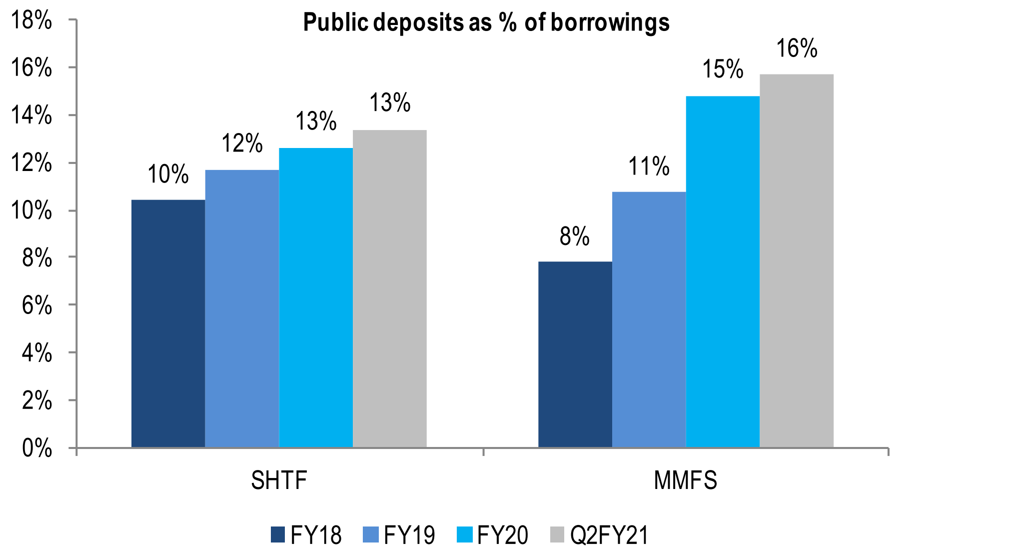
Exhibit 27: Global emerging market bond yields at 5 year low



Source: Bloomberg, Nirmal Bang Institutional Equities Research

Deposit taking NBFCs focused on increasing share of deposits in borrowings mix

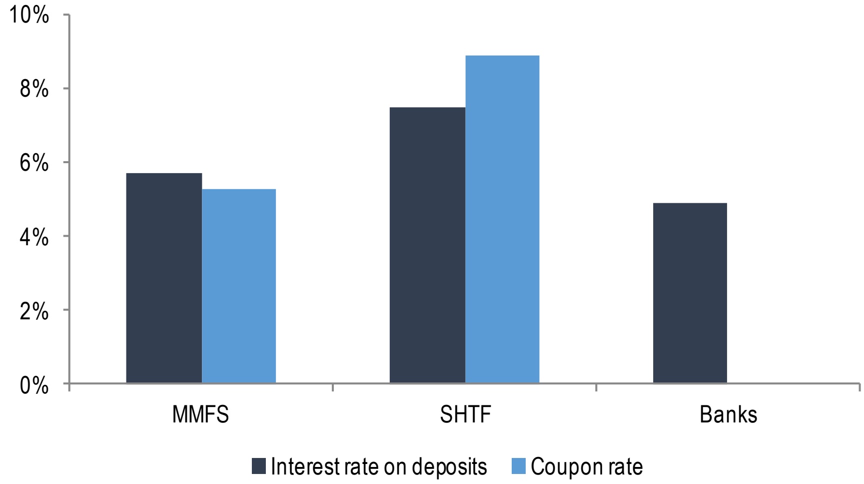
Exhibit 28: Share of public and corporate deposits on rise



Source: Company, Nirmal Bang Institutional Equities Research

SHTF's interest rates on deposits are well below bond coupon rates compared to MMFS. Any increase in funding from this source will help it to reduce the cost of borrowings. For MMFS, coupon rates on bonds remain marginally lower than interest rates on deposits due to the backing from a strong parent group.

Exhibit 29: Interest rate on deposits vs coupon rates on recent bond issue



Source: Company, Nirmal Bang Institutional Equities Research

Liquidity indicators adequate

Liquidity position for NBFCs has been positive across buckets up to 5 years in 2QFY21. The recent capital raises and system liquidity have aided NBFCs to maintain a comfortable inflow/outflow position. MMFS had superior ALM even prior to liquidity crisis.

Exhibit 30: Liquidity indicators adequate

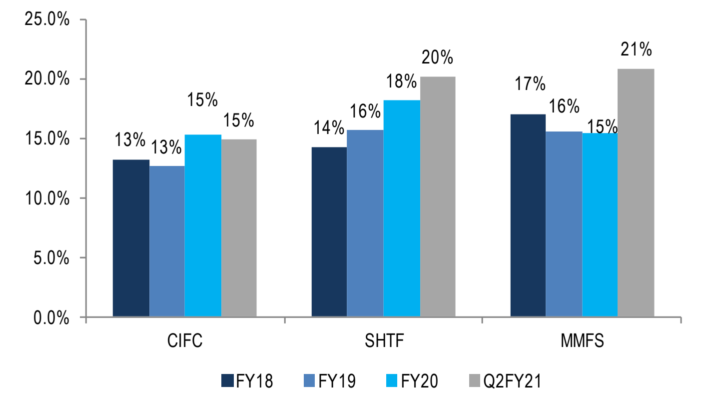
ALM Gap	SHTF	MMFS	Chola
Upto 1 month	47%	265%	61%
>1 month to 2 months	25%	189%	36%
>2 months to 3 months	41%	63%	24%
>3 months to 6 months	24%	33%	18%
>6 months to 1 year	3%	19%	4%
>1 year to 3 years	13%	2%	8%
>3 years to 5 years	50%	25%	9%
>5 years	-81%		0%

Cumulative ALM gap	SHTF	MMFS	Chola
Upto 1 month	47%	265%	61%
>1 month to 2 months	41%	244%	45%
>2 months to 3 months	41%	166%	34%
>3 months to 6 months	33%	106%	26%
>6 months to 1 year	19%	66%	16%
>1 year to 3 years	16%	29%	12%
>3 years to 5 years	20%	28%	11%
>5 years	-2%		8%

Source: Company, Nirmal Bang Institutional Equities Research

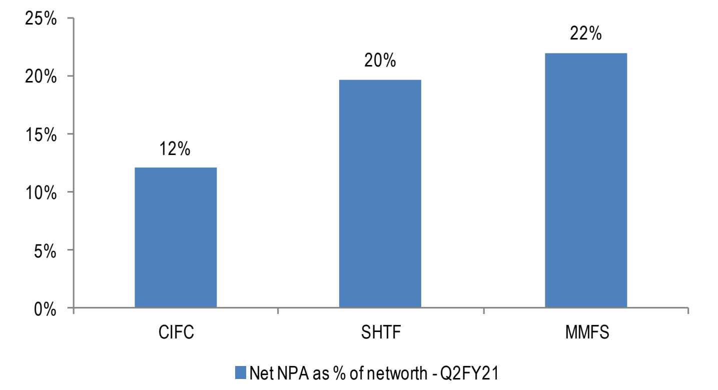
NBFCs' Tier 1 ratios have looked comfortable after the recent capital raises. It provides a cushion in case of a downside scenario of increase in credit losses ahead of provisions. CIFC has the lowest Tier 1 ratio of 14.9% in comparison to minimum requirement of 10%. However, we believe that CIFC has the best asset quality and the provisions might be adequate to cover further slippages.

Exhibit 31: Tier 1 ratio better than a year ago



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 32: Net NPA as % of Networth



Source: Company, Nirmal Bang Institutional Equities Research

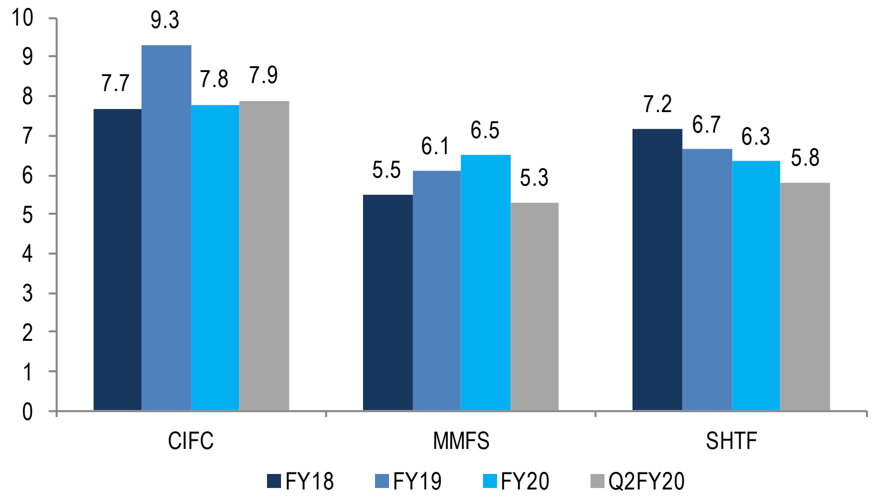
Note: For calculation of Net NPA as % of Networth we have used net NPAs without asset classification benefit

Exhibit 33: Recent capital raises have improved Tier 1 ratio and leverage position for all the NBFCs

Capital raise	Issue price	Amount raised in Mn	Mode of issue	Date of issue
CIFC	320	9,000	QIP	31-Jan-20
CIFC	321	3,000	Preferential allotment	7-Mar-20
MMFS	50	30,890	Rights issue	27-Aug-20
SHTF	570	14,922	Rights issue	6-Aug-20

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 34: NBFC's leverage positions (assets/ equity) as on 30th Sept 20 vs FY19 improved after capital raises



Source: Company, Nirmal Bang Institutional Equities Research

Stimulus packages aided liquidity for NBFCs

To aid NBFCs to cope with the Covid-19 challenges, the MoF and the RBI have extended moratorium and stimulus packages. The Special Liquidity Scheme (SLS) and the Partial Credit Guarantee Scheme 2 (PCGS2) have lent liquidity support to NBFCs. While the SLS was mainly aimed at providing short-term liquidity support PCGS2 has provided 20% Govt. guarantee in case of default from BBB+ rated NBFCs.

Exhibit 35: Stimulus packages to aid liquidity after onset of Covid

Announced on	Package	Coverage
March 27	Loan Moratorium	The RBI announces all lending institutions to offer a 3-moonth moratorium to borrowers on all term loans. This was further extended by another 3 months until August 31,2020
March 27	TLTRO 1	The RBI announced Rs 1000bn liquidity to banks to utilize at least 50% of the funds towards non-bank lending sector by investing in their corporate bonds, commercial paper.
April 17	TLTRO 2	The RBI announced Rs 500bn window ensuring a specific allocation of at least 50% dedicated at small and medium sized non-bank lenders (AA and below)
April 17	Refinancing facility through NABARD, SIDBI and NHB	Liquidity support worth Rs 500bn to NABARD, NHB and SIDBI to refinance loan assets of NBFCs (including RRBs and co-operative banks to meet sectoral credit requirement
April 17	Relaxation of asset classification norms	The period of moratorium is to be excluded from the 90-day NPA classification norms of the RBI for accounts that have availed the moratorium facility
April 17	Relief for NBFC on commercial real estate (CRE) exposure	The RBI allowed restructuring of loans to CRE projects by extending date of commencement ofoperations by 1 year
April 27	Special liquidity facility (SLF) for Mutual Funds	The RBI announced Rs 500bn window for Mutual funds facing liquidity pressure on account of increased redemptions. The same was subsequently extended to banks for providing loans or for purchase of investment grade corporate bonds, commercial paper or certificates of deposit held by Mutual Funds.
April 27	Atmanirbhar Bharat package - MSME package	The MoF provided a fully guaranteed scheme worth Rs 3 lakh crore for banks and NBFCs to extend collateral free loans to business, including MSMEs
May 13 - May 17	Atmanirbhar Bharat package - Special Liquidity scheme	Announced Rs 300bn liquidity for a PSB operated SPV to utilize funds towards non-banking lending sector by investing in their investment grade bonds, commercial paper. These securities, from primary and secondary transactions, would be fully guaranteed by the government.
May 13 - May 17	Atmanirbhar Bharat package - Partial Credit Guarantee Scheme	Announced Rs 450bn liquidity measure to cover initial 20% loss on primary issuances of bonds and commercial paper of low rating NBFC (AA or below, unrated)

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 36: Borrowings mix of NBFCs

	CIFC	SHTF	MMFS
Bond	18%	43%	36%
Bank/Other term	62%	14%	26%
Securitisation	7%	25%	14%
Deposits	0	13%	22%
Commercial paper	6%	0%	2%
FCNR	6%	0%	0%
Others	0%	3.59%	0%

Source: Company, Nirmal Bang Institutional Equities Research

- CIFC is a non-deposit taking NBFC and most of its funding requirements are met through bank borrowings.
- SHTF has been trying to scale up its deposit franchise over the past few quarters. A large part of the SHTF's book is eligible for PSL lending. In FY21, SHTF has raised ~Rs116bn till Sept'20. About 51% of incremental funds raised by SHTF are through securitisations. Access to capital markets remains subdued as yields for bonds in the secondary market have been higher than in the past. SHTF has tapped the ECB route and currently 17% of its funding is from ECB bonds.
- MMFS has a strong deposit franchise compared to peers. Securitisation constitutes 14% of MMFS' funding and the company may further resort to it as majority part of the book is eligible for PSL funding.

NBFCs long term Crisil credit ratings and global ratings

CIFC and MMFS have maintained their long-term credit rating of AA+ with a stable outlook. SHTF' credit rating has remained at AA+ but the outlook is negative due to its modest asset profile and average resource profile (Crisil). However, assignment of 'Provisional IND AAA(CE)/Stable' rating for structured NCDs to be issued by SHTF for Rs 5.0 bn is a positive.

Exhibit 37: Ratings assigned to long term debt

Crisil Rating	
AA+ Stable	CIFC & MMFS
AA+ Negative	SHTF
S&P rating	
BB-/ Stable	SHTF

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 38: S&P rating action on SHTF

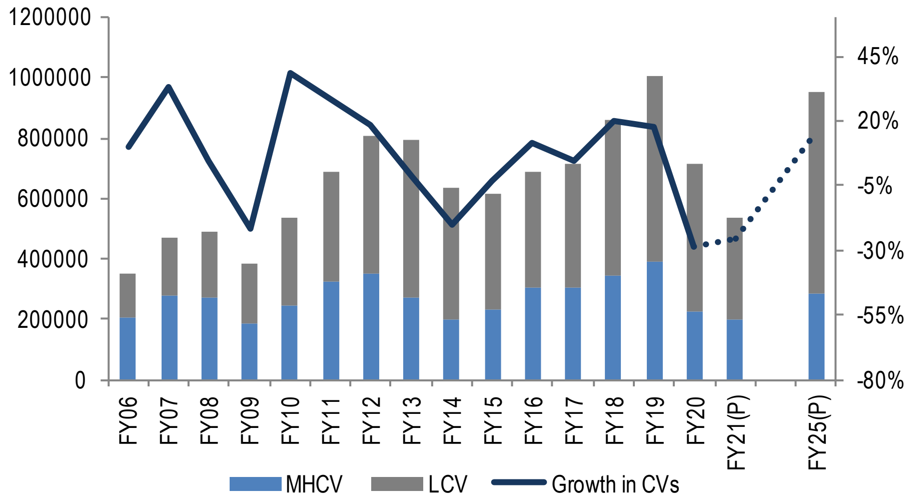
Month	Rating	Outlook
Feb 20	BB+	Stable
Apr 20	BB	Negative
Aug 20	BB-	Negative
Dec 16	BB-	Stable

Source: Company, Nirmal Bang Institutional Equities Research

CV cycle on the cusp of a recovery:

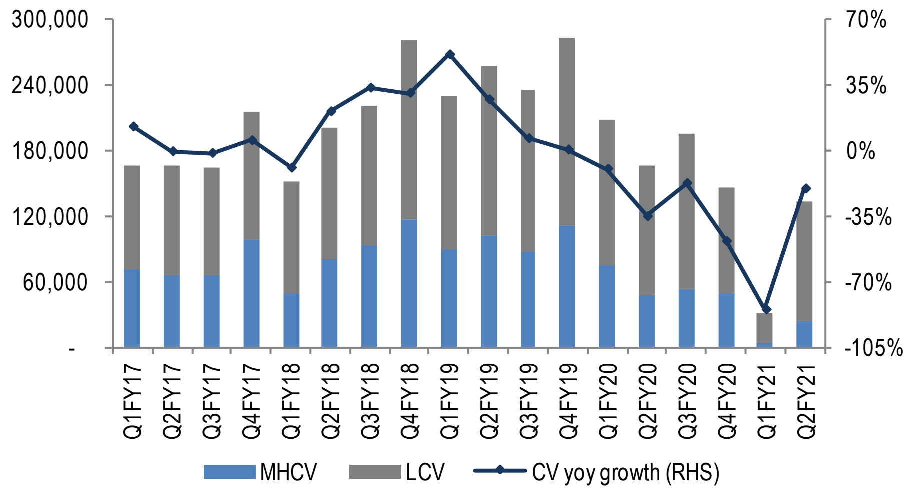
CV sales in LTM have been at a decadal low, but it has witnessed some recovery July'20 onwards. The early green shoots in recovery are visible from e-way bill generation, GST collections and pick-up in construction and mining activities. As per industry estimates, the CV sales are projected to decline in the range of 23-28% in FY21 and grow thereon in the range of 13-18% over FY21-24P. CV volume was down 56% YoY in H1FY21. Assuming a 25% decline in FY21, the implied H2FY21 estimates show a growth of 9% YoY.

Exhibit 39: CV sales are projected to grow at a CAGR of 13-18% over FY21-25



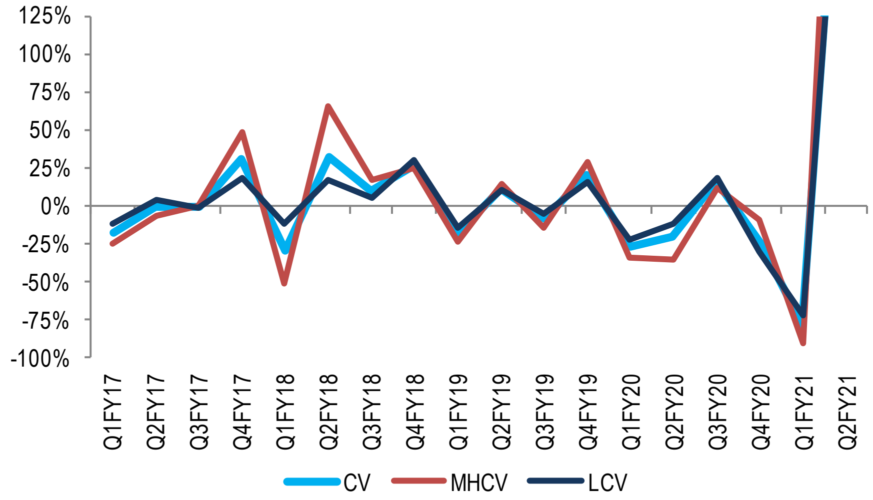
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 40: CV sales are in a negative territory over last six quarters ….



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 41: ….but showing signs of recovery on a sequential basis

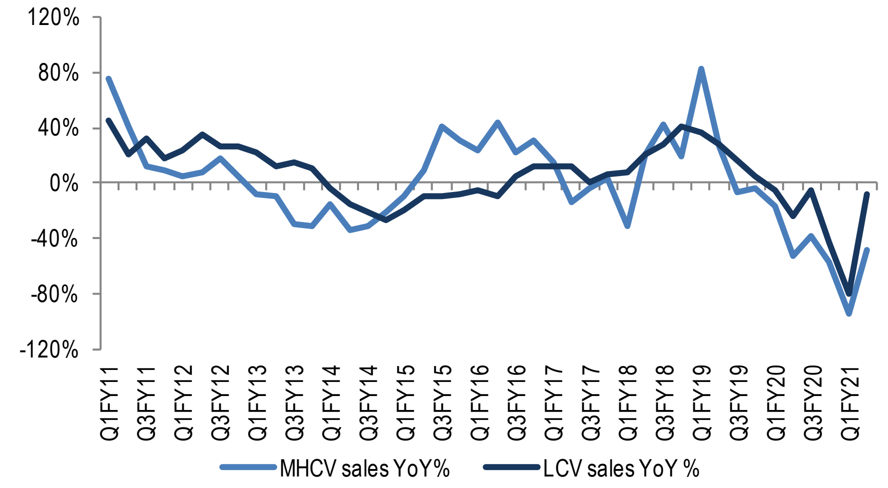


Source: Company, Nirmal Bang Institutional Equities Research

LCV sales have recovered faster

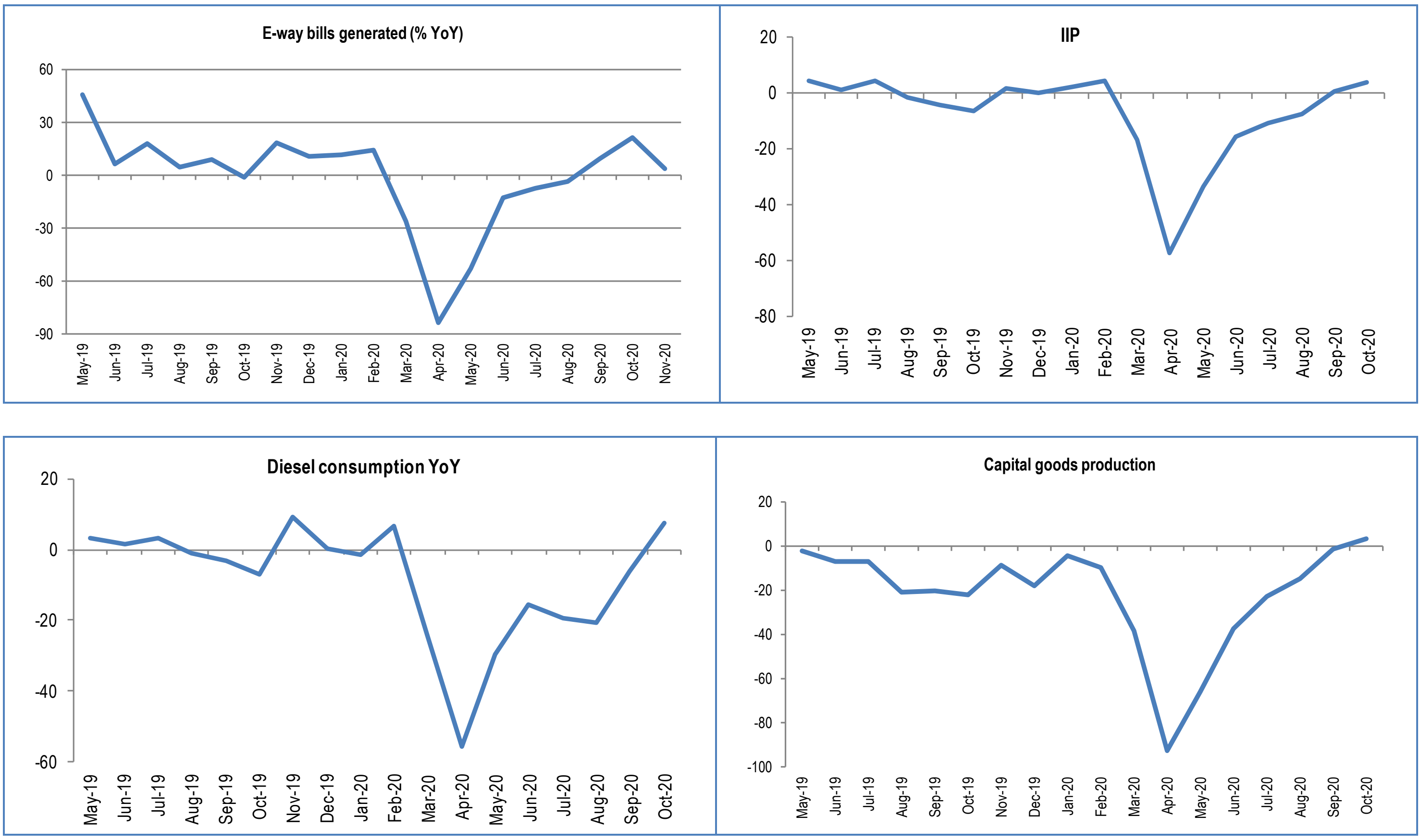
LCV sales have recovered faster than the CV segment. The MHCV segment has witnessed lower volume of 76% compared to 46% decline in LCV volume. Among LCVs, the truck segment has grown faster in order to meet last mile connectivity amid the surge in e-commerce, FMCG and agricultural activities.

Exhibit 42: LCV sales have recovered faster



Source: Company, Nirmal Bang Institutional Equities Research

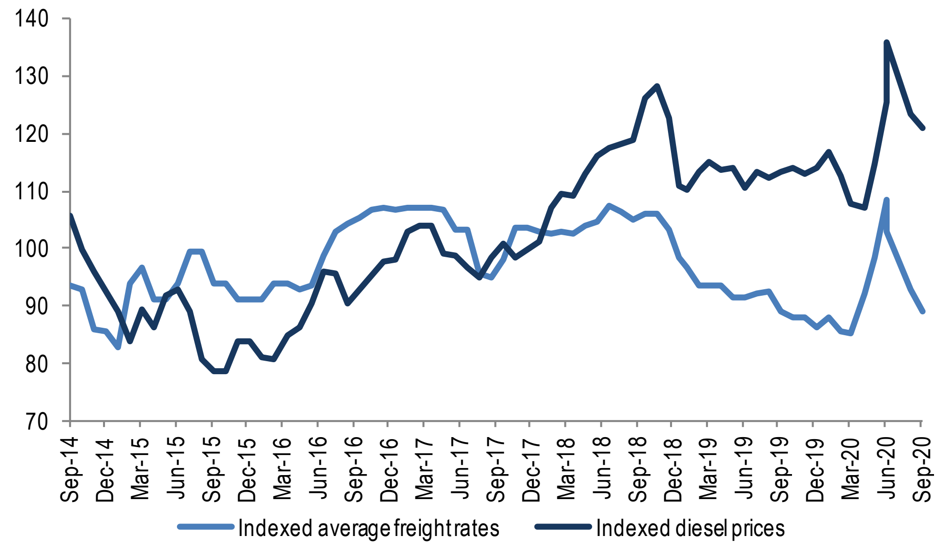
The MHCV segment remains a laggard. This shall continue until the economic activities pick up. We see some greenshoots with improvement in IIP data (improvement in manufacturing and mining output), e-way bill generation, diesel consumption etc. But we remain watchful about sustainability in these trends.



Source: Company, Nirmal Bang Institutional Equities Research

The increase in diesel prices and low freight availability have brought the fleet economics under stress. The change in axle norms in July'18 led to increase in 15-20% of fleet capacity. As per industry estimates, this sector will grow at a stronger pace though the growth entirely depends on the acceleration of economic activities.

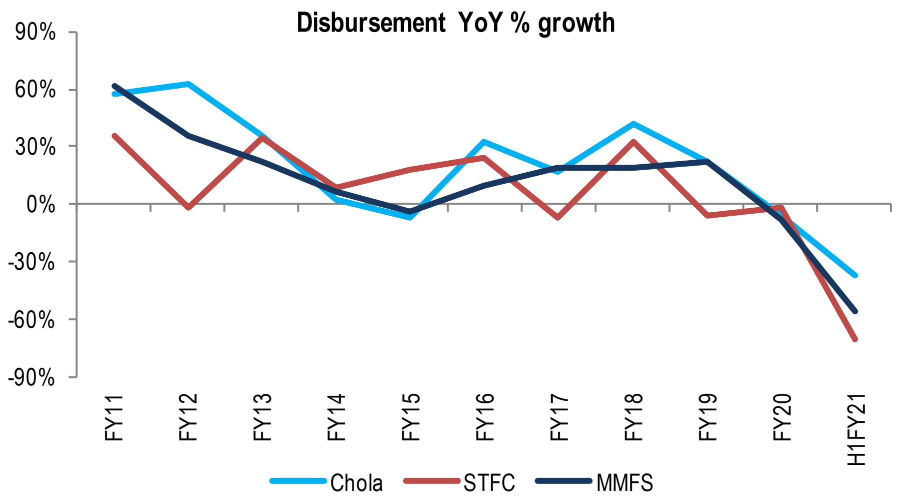
Exhibit 43: Freight rates under pressure while diesel prices have increased



Source: Bloomberg, Nirmal Bang Institutional Equities Research

Given the cyclical nature of the CV business, out of last 10 years, only in three years CV sales went beyond 0.8m units. They generally hovered in a range of 0.6m to 0.7m units. Despite this, the vehicle financiers have been able to grow their disbursements on average barring FY20 & H1FY21, which were marred by the Covid outbreak.

Exhibit 44: Disbursements for Vehicle financiers have grown on average despite cyclicality in CV sales

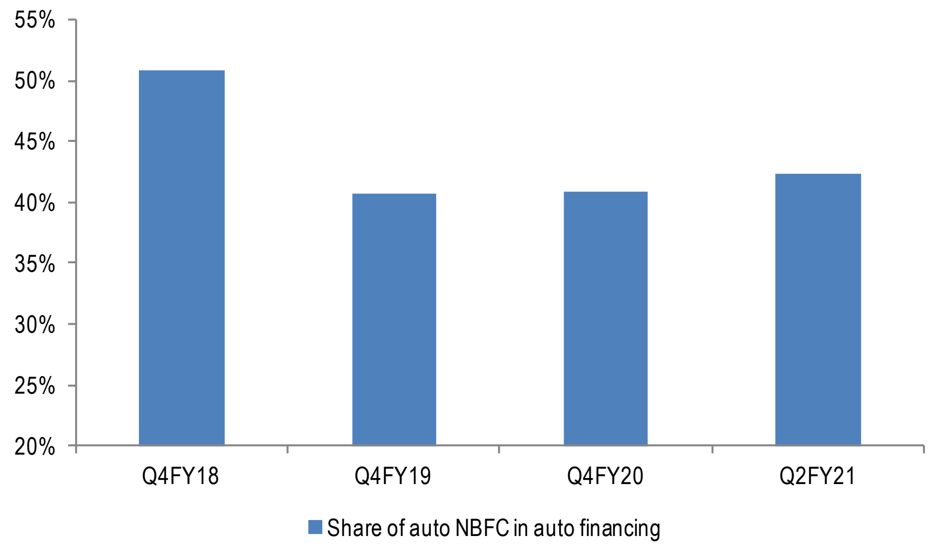


Source: Company, Nirmal Bang Institutional Equities Research

After transition to BS-VI norms, the CV prices have gone up by 15-20% on average. The pick-up in the replacement cycle and increase in prices should aid vehicle financiers to grow disbursements meaningfully. We estimate an average growth of 48%/23% in disbursements for FY22/FY23.

Vehicle financiers lost market share to banks in auto financing after the liquidity crisis, which started post the default of IL&FS. However, they have started gaining market share.

Exhibit 45: Share of NBFC in auto financing declined after liquidity crisis



Source: Company reports, Nirmal Bang Institutional Equities Research

Note: Share of CIFC, SHTF, MMFS and Sundaram as % of top 10 auto financiers (banks+NBFCs) considered

Exhibit 46: Management commentary across auto makers turned positive as compared to Q4FY20

Entity Name	Segment	Market share	Commentary in 4QFY20	Commentary in 1QFY21	Commentary in 2QFY21	November sales data
Ashok Leyland	MHCV & LCV	16.20%	1) Slowdown due to weak ecnomomy and BS-VI transition. Covid-19 added to the the industry woes 2) Within MHCV tippers are showing good improvement in demand 3) Expected 3QFY21 to be better due to pent up demand 4) Passenger bus will take longer to revive	1) April, May complete washout leading to 94% decline in volumes. Gradual recovery in July & August. 2) ICV & Tippers showing good demand from cement sector 3) Fleet utilization estimated at 50-55% 4) Expects H2 to be better	1) ICV& Tippers witnessing good recovery in demand with rise in infra spends 2) Fleet utilization consistently increasing & replacement demand is expected to revice 3) As per various industry estimates, the MHCV segment is expected to decline by 25-30% in FY21, which implies significant growth in 2HFY21. 4) LCV demand back to pre-covid levels	Total domestoc CV volumes were up 3.7% YoY (+9.5% MoM), reflecting a gradual revival in demand and a very weak base. The 23% YoY growth in domestic MHCV trucks and 31% growth in domestic LCVs drove overall growth. Domestic MHCV buses declined 90% and recovery is still sometime away
Tata Motors	MHCV & LCV	42.30%	1) Management witnessed good growth coming in from few segments like tipper in MHCV compared to the cargo range of vehicles. 2) It also witnessed demand from e-commerce and transportation of agricultural and daily produce.	1) E-way bills and freights have reached ~65% of pre-covid levels 2) Company sees green shoots in steel, petroleum, especially FMCG and eCommerce, pharma, dairy, fresh produce. 3) Demand seen for SCVs to meet last mile transportation. Revival seen in LCV while MHCV largely impacted 4) Reduced LTV ratios and increase in vehicle prices may impact demand	1) Demand gradually recovering. As compared to 31% decline in MHCV in Q2FY21, decline in Sept 20 has been in low single digits. ILCV declined 30% in Q2. SCV and pickup witnessed a growth in Sept'20 vs Sept'19 2) Fleet utilization is improving and consumer sentiment is positive. 3) Mining and infrastructure (highways) is picking up. Rural demand remains strong. 4) E-way bill generation, diesel consumption, GST collection going up	Domestic CV volumes declined 5% YoY (+1% MoM). Domestic ILCV volumes improved 11.5% YoY (-6% QoQ)
VECV	MHCV & LCV	6.2%	1) Industry facing slowdown due to weak economy, axle load norm changes, driver availability issues etc. Expectation of pre-buying demand before BS-VI transition did not materialize. 2) Management expects slower industry recovery	1) VECV operating at 25% capacity and will ramp-up on revival of demand 2) Recovery expected from festive months, led by infrastructure investments, pent up demand and replacement demand	1) The company is seeing initial signs of revival with good demand witnessed in niche segments such as construction, mining, agriculture and e-commerce. Bus segment remains a laggard 2) expects revival in replacement demand	-
Mahindra & Mahindra	SCV	27.70%	Expects rural focused products (i.e Bolero, Scorpio, Pickups etc) to perform better in the medium term given the strong pick-up in rural demand.	M&M expects higher demand for movement of goods, last mile connectivity and e-commerce to drive demand for Pick-ups and SCVs.	Pick-ups are currently operating at full production capacity on account of surge in demand and no pipeline inventory	Total CV volumes were up 9.5% YoY though it declined 7.6% on a QoQ basis. SCV (LCV<2T) grew strongest at 19.2% YoY.
M&M	Tractors	41.20%	1) M&M is witnessing strong tractor demand on the back of bumper rabi, higher cashflow, normal monsoon expectation and adequate reservior levels. 2) Plants are operating at over 80% level and more than 90% of dealers are operational.	1) Strong tractor demand continues 2) Even with plants operating at ~90%-92% level, demand is not being met.	1) Strong tractor demand continues 2) The management expects the tractor industry to grow in low double-digits in FY21. According to the management, the tractor cycle is difficult to predict but the industry grows at CAGR 8% over the long term	Domestic tractor volumes improved 55% YoY, however declined 31% on a QoQ basis
Escorts	Tractors	11.60%	1) All the rural sentiments are positive because of a record output of Rabi crop and a favorable initial prediction of this year's monsoon 2) Going forward, expect tractor industry to regroup faster as compared to lot of other sectors;	Demand was strong due to pent-up demand and better crop prices, expectation of a good and widespread monsoon, record rabbi crop harvest, timely opening of retail finance and government focus on agri and rural development.	The rural demand remained positive and expect industry to be growing on a full year basis in lower double digits.	Domestic tractor volumes improved 31% YoY

Source: Company, Nirmal Bang Institutional Equities Research

Financials for Vehicle Financiers

Exhibit 47: Vehicle type wise AUM as on 30th Sept 2021

AUM Mix	CIFC	SHTF*	MMFS
Overall AUM size (RsBn)	**672**	**1133**	**678**
VF AUM size	**493**	**1073**	**637**
HCV	11%	47%	
LCV	26%	24%	18%
Construction Equipment	6%	-	
Car & MUV	17%	22%	21%
- UV	-	-	28%
Tractors	9%	3%	17%
3W & SCV	1%	-	-
Older vehicles	26%	86.5%*	9%
2W	4%	-	-
VF AUM/total AUM	73%	95%	-
Other segments	27%	5%	6%

Note: Older vehicles and other vehicle types overlap; older vehicle is 87% of AUM

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 48: Vehicle type wise disbursement growth in recent quarters

	CIFC				SHTF*#				MMFS			
Disbursement growth	**Q3FY20**	**Q4FY20**	**Q1FY21**	**Q2FY21**	**Q3FY20**	**Q4FY20**	**Q1FY21**	**Q2FY21**	**Q3FY20**	**Q4FY20**	**Q1FY21**	**Q2FY21**
Overall Disbursements	-5%	-36%	-53%	-18%	22%	-9%	-92%	-51%	-4%	-21%	-67%	-45%
HCV	-80%	-76%	-94%	-76%	-	-	-	-				
LCV	-19%	-35%	-74%	-24%	-	-	-	-	-23%	-59%	-89%	-85%
Construction Equipment	-14%	-39%	-6%	61%	-	-	-	-				
Car & MUV	15%	-30%	-59%	-18%	-	-	-	-	-9%	-25%	-75%	-23%
- UV	-	-	-	-	-	-	-	-	1%	-11%	-72%	-22%
Tractors	15%	-24%	64%	86%	-	-	-	-	-13%	-11%	-34%	-23%
3W & SCV	-52%	-21%	-67%	-31%	-	-	-	-	-	-	-	-
Older vehicles	12%	-31%	-60%	-30%	22%	-6%	-92%	-49%	24%	2%	-94%	-74%
2W	-	-3%	-31%	3%	-	-	-	-	-	-	-	-
Other segments	-	-	-	-	-	-	-	-	59%	124%	213%	-66%

Overall disbursements for CIFC pertains to VF segment; Mini LCV clubbed with 3W

#SHTF – Older vehicles and other vehicle types overlap; older vehicle is 87% of AUM portfolio; Other segments for SHTF includes new vehicle and other segments

Source: Company, Nirmal Bang Institutional Equities Research

Company Pages

Cholamandalam Investment and Finance (CIFC IN Equity)

Company Description
CIFC is engaged in vehicle finance and loan against property (LAP). It is backed by the Murugappa Group and has over 3 decades of operational experience, built through expertise in underwriting for less-banked segments. This reflects in 10-Year track record of 24% CAGR in assets under management (AUM) and a 15% average ROE in a period that has seen multiple product cycles. It has two subsidiaries (i) Cholamandalam Securities and (ii) Cholamandalam Home Finance.

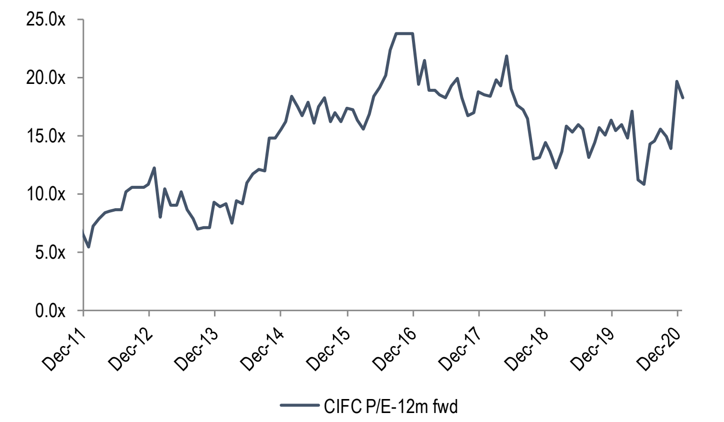
Investment Strategy
We rate Cholamandalam as a Buy. A diversified product mix provides multiple growth levers and a strong underwriting framework has enabled low credit costs. Lending to small-to-mid CV operators (21% of AUM) in rural/semi-urban locations drives pricing power. A diversified portfolio has helped mitigate volatility of product cycles and drive 19% CAGR in AUM over FY15-20. While Covid-19 would affect performance in FY21, the Murugappa Group's backing and high underwriting standards should help it to manage asset quality concerns.

Valuation
We value the stock at 3.5x P/ABV, a 10% premium to its 5-year average multiple on FY23E ABV of Rs137 to arrive at our TP of Rs480. We believe that this premium is justified given the sharp improvement in expected ROE of 19.2% and RoA of 2.8% in FY23E.

Risks
Poor macros, heightened competition from banks in low-mid tier of the market, uncertainty due to new Covid strain and increase in borrowing costs.

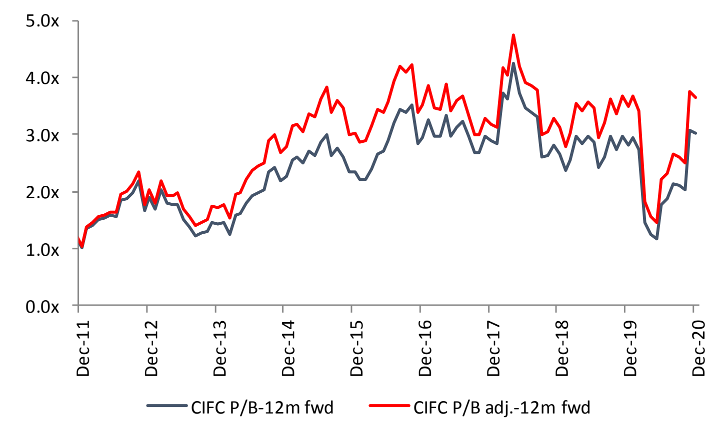
Valuation charts

Exhibit 49: CIFC P/E – 12m fwd



Source: Bloomberg

Exhibit 50: CIFC P/B – 12m fwd



Source: Bloomberg

Mahindra And Mahindra Financial Services (MMFS IN Equity)

Company description

Mahindra Finance is one of India's leading NBFCs, with a strong presence in vehicle financing, especially in rural areas. It is primarily engaged in lending for cars, tractors and commercial vehicles. It also has a housing finance subsidiary, Mahindra Rural Housing Finance Ltd (MRHFL) and an insurance broking subsidiary, Mahindra Insurance Brokers Ltd (MIBL), for distribution of insurance products. MMFS has a high penetration in rural areas and mainly provides finance to customers with weak credit profiles. Therefore, the company is crucial to M&M's sales of rural and semi-urban products (tractors, pick-up vans and others).

Investment Strategy

Robust rural economy and improvement in collection efficiency augur well for MMFS. Disbursements growth for MMFS (captive financier for M&M) has remained resilient compared to peers, but profitability has remained volatile due to asset quality issues. Above normal monsoon bodes well for asset quality and disbursements while deviation below normal leads to spike in NPAs. MMFS has several tailwinds for growth going ahead – (1) Pick-up in disbursements due to strong farm cash flows and expected replacement demand in CVs (2) Improvement in NIMs due to reduction in cost of funds (3) Moderation in opex expenses leading to high profitability (4) improvement in asset quality, supported by strong rural income. We expect ROE to expand by ~600bps during FY21E-FY23E, supported by low credit costs and better utilization of capital towards disbursements.

Valuation

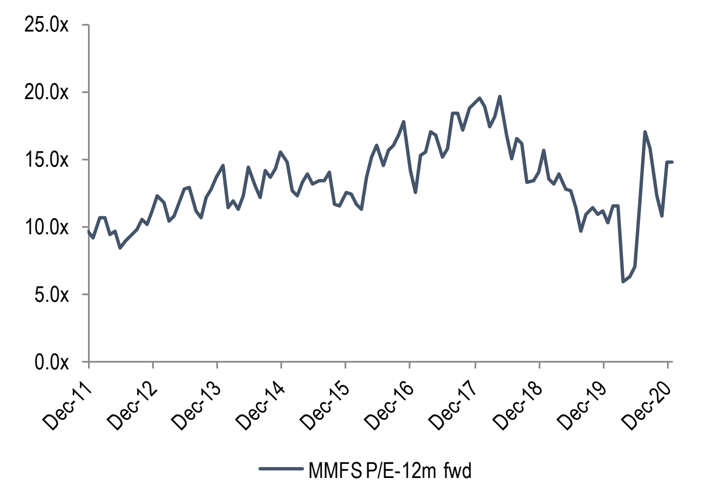
We use SOTP method to value MMFS with core business valued at 2.2x P/ABV (~20% discount to 5-year avg.) on FY23E due to uncertainty around asset quality given SC's standstill clause. We expect discounts to historical valuation to erode with pick-up in disbursements.

Risks

Downside risks that could cause MMFS shares to trade below our target price include: (a) weak monsoon impacting rural consumption (b) prolonged slowdown in economy, leading to surfacing of stress in commercial vehicles loans and (c) more aggressive competition halting market share gains.

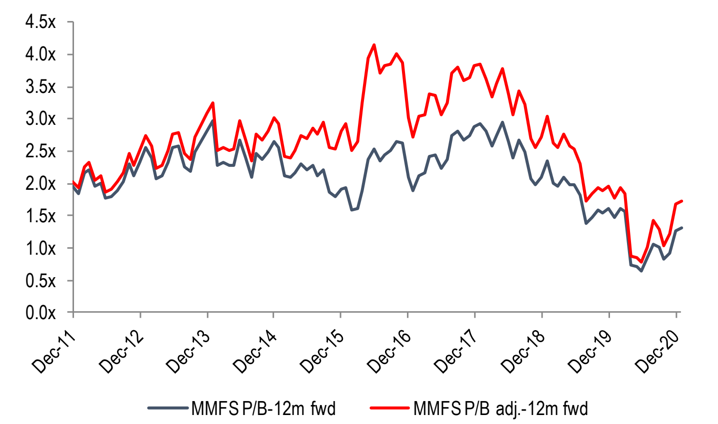
Valuation charts

Exhibit 51: MMFS P/E - 12m fwd



Source: Bloomberg

Exhibit 52: MMFS P/B -12m fwd



Source: Bloomberg

Shriram Transport Finance Corporation (SHTF IN Equity)

Company description

Shriram Transport is the largest organized participant in the pre-owned commercial vehicle (CV) financing segment in India. It was started in 1979 by three entrepreneurs and focuses on financing CVs. Subsequently, it diversified into financing of 3-wheelers and tractors, besides providing working capital, engine replacement and tire loans to truck operators.

Investment Strategy

We rate Shriram Transport as a Buy. With its focus on used-CV lending, Shriram's disbursements are more resilient to a slowdown in the CV cycle. Its focus on less-banked customers gives it pricing power, which supports margins. Shriram is trading at low valuations relative to its history as well as NBFC peers and could in our view re-rate as it delivers steady asset quality performance along with a gradual pick-up in disbursements.

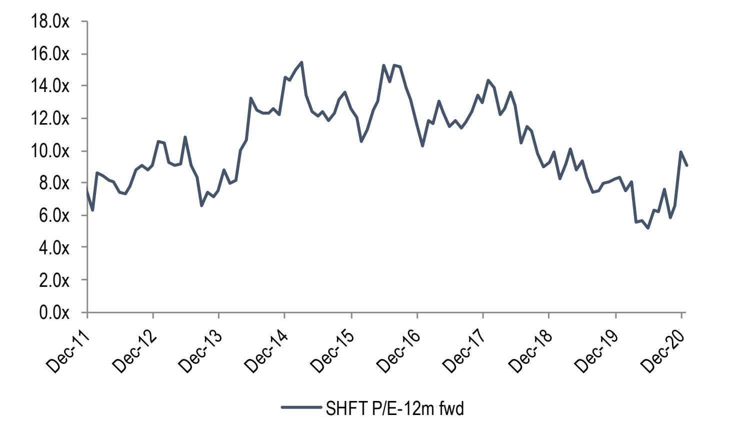
Valuation

SHTF is currently trading at 1.7x P/ABV (on 12-month fwd basis), ~30% discount to its 5-year average and >25% to its 3-year avg multiple of 2.4x/2.3x, respectively. During the CV upcycle, SHTF has traded in the range of 2.0x-3.5x P/ABV while during a slowdown it has traded in a range of 1.0x-2.0x. We value SHTF at P/ABV of 1.8x, a ~20% discount to its 3-year average due to slowdown in disbursements compared to peers.

Risks

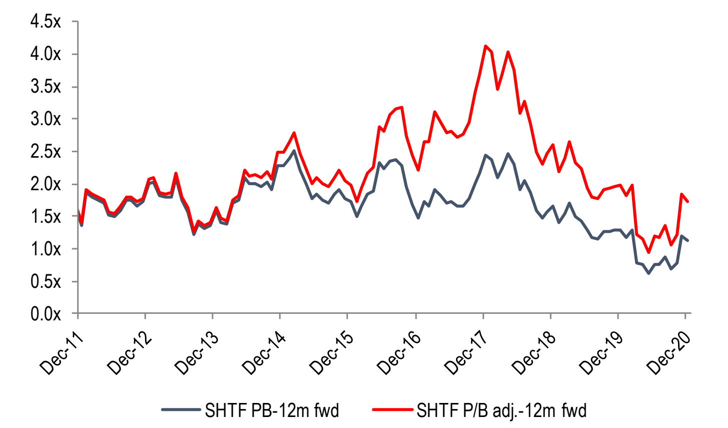
We believe the key downside risks that could impede Shriram Transport shares from reaching our target price include (a) Asset quality - slower economic activity and weak rural demand could lead to high credit costs (b) Wholesale funding – can hurt in a tight-liquidity scenario and (c) unfavorable regulatory changes in the NBFC and transportation sectors.

Exhibit 53: SHTF P/E – 12m fwd.



Source: Bloomberg

Exhibit 54: SHTF P/B 12m fwd



Source: Bloomberg

Company Section

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Cholamandalam

29 December 2020

Reuters: CHLA.BO; Bloomberg: CIFC IN

Initiating Coverage

Diversified financier with strong execution capabilities; initiating with a Buy

Cholamandalam Investment and Finance Company (CIFC) is a well-diversified NBFC, with an excellent track record of AUM growth (CAGR of 19% over FY15-20), asset quality and profitability (average RoE of 18% over the last 5 years). CIFC is the 10th largest NBFC in India and provides vehicle finance, loan against property (LAP) and home loans. It has a balanced geographical portfolio in India. ~80% of its branches are located in rural/semi-urban India, giving it access to small-to-mid-sized vehicle operators, farmers and self-employed individuals. We initiate with a **BUY** rating and a target price (TP) of Rs480. We expect CIFC to grow ahead of its peers due to diversified book dampening effect of product cycle (we estimate disbursements growth at 14% CAGR over FY20-23E), low credit cost and balanced geographical presence. We value the stock at 3.5x P/ABV on FY23 basis, a 10% premium to its last 5 years' average P/ABV, with RoA of 2.8% and RoE of 19.2%. CIFCs stock price has run-up by 60% over the last 3 months as Covid-related asset quality fears were allayed by improvement in collection efficiency and guidance around asset restructuring. We expect replacement demand for CVs to pick up in FY22E-23E and as we move closer to the event, it should start reflecting in the share price.

ROE set to improve; multiple levers at play: CIFC borrows ~60% of its funding requirements from banks. Since Jan'20, SBI's MCLR rate has declined by 90bps. This should aid in overall reduction in cost of funds for incremental borrowings. Also, the recent NCD placements have been at 230bps lower than bonds placed a year ago. The reduction in cost of borrowings should drive ~6.4% NIMs. Opex is likely to reduce due to one-time negotiations done for rental, BPO and other expenses. Strong underwriting is likely to limit credit cost at ~1.1% in FY22E/23E, driving overall ROE to 19.2%.

Multi-product portfolio to reduce product cycle effect: Vehicle Finance (VF) contributes ~73% to CIFC's AUM while LAP and SME add up another ~22% of the company's book. Even in the VF segment, 21%/23% of the portfolio is concentrated in LCV and Used Vehicles while the contribution of other segments is at ~11% or less. Multiple product financing options reduced the impact of product cycle turns, thereby leading to stable growth. This is visible in the 19% AUM CAGR registered over FY15-20.

Covid impact on asset quality seems manageable: Collection efficiency improved to 87% in October and is likely to reach pre-covid levels (~105%) in the following months. Management has guided restructuring to be limited at 1-5% - mostly in the PV category. The company has already provided Rs8bn of additional provisions (1.2% of AUM) to cover for credit losses arising from Covid and macro factors. We believe that the Covid event is different from previous shocks due to regulatory support, ample liquidity and additional provisioning to safeguard future slippages. Even in the past shocks, the company had successfully navigated through asset quality stress compared to peers.

Valuations: We value the stock at 3.5x P/ABV, a 10% premium to 5 year average multiple on FY23E ABV of Rs 137 to arrive at our PT of Rs480. We believe that this premium is justified given the sharp improvement in expected ROE at 19.2% and RoA at 2.8% in FY23E.

Y/E March (Rsmn)	FY19	FY20	FY21E	FY22E	FY23E
NII	3,404	4,061	4,709	5,332	6,134
PPOP	2,134	2,483	2,985	3,407	3,928
PAT	1,186	1,052	1,400	1,974	2,305
Loans	52,622	55,403	61,096	68,743	79,293
RoA (%)	*2.4*	*1.7*	*2.1*	*2.7*	*2.8*
RoE (%)	*20.9*	*14.7*	*16.0*	*19.4*	*19.2*
P/ABV	5.7	4.6	4.2	3.5	2.8

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: BFSI

CMP: Rs387

Target Price: Rs480

Upside: 24%

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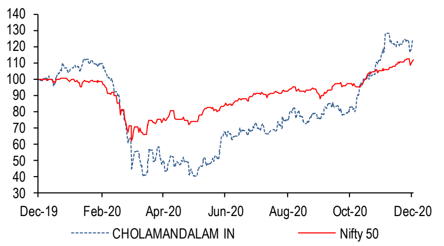
Key Data

Current Shares O/S (mn)	819.7
Mkt Cap (Rsbn/US$bn)	308.5/4.2
52 Wk H / L (Rs)	395/117
Daily Vol. (3M NSE Avg.)	5,945,394

Share holding (%)	2QFY21	1QFY21	4QFY20
Promoter	51.6	51.7	51.7
Public	48.4	48.4	48.4
Others	-	-	-

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
Cholamandalam	4.5	91.2	24.7
Nifty Index	5.3	33.4	12.6

Source: Bloomberg

Executive summary

CIFC is a well-diversified NBFC, with an excellent track record of AUM growth, underwriting and collection. The company has a strong parentage with the Murugappa Group holding ~52% stake. CIFC provides vehicle finance, LAP, with small contribution coming in from SME lending and home loans. The company has a balanced geographical portfolio across India. It is considered as one of the best quality auto NBFCs because of its high asset quality, strong execution and relatively less cyclical business model compared to other vehicle financiers. This is reflected in its strong ROE and ROA. The company has achieved >24% CAGR in AUM in 10 years with ROE ranging from 14% to 21% during FY12-FY20 with an average ROE of ~18%.

We initiate CIFC with a Buy rating, TP of Rs480 due to following:-

- Diversified portfolio allowing relative stability and hedging against unfavorable cycles in vehicle financing
- Impressive control over asset quality
- Better cost of funding and access to borrowings
- Impressive profitability with stable earnings growth
- Superior underwriting model for less banked segments in rural/semi-urban India and strong collection efficiency
- AUM growth and financial ahead of peers

Valuation: We value the stock at 3.5x P/ABV (10% premium to last 5 years' average) to arrive at our TP of Rs480.

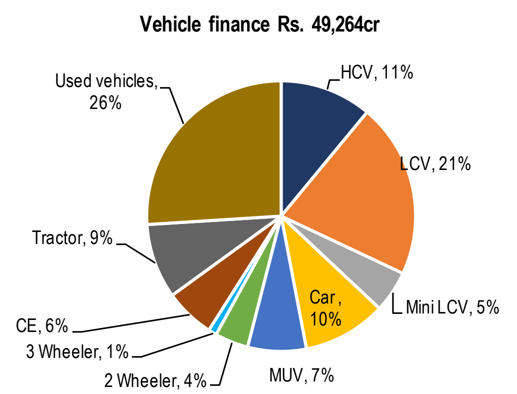
Risks: Poor macros, increased competition from banks in low-to-mid tier of the market, uncertainty due to new COVID strain and increase in borrowing costs.

Investment thesis

Diversified portfolio allowing relative stability and hedging against unfavorable cycles in vehicle financing

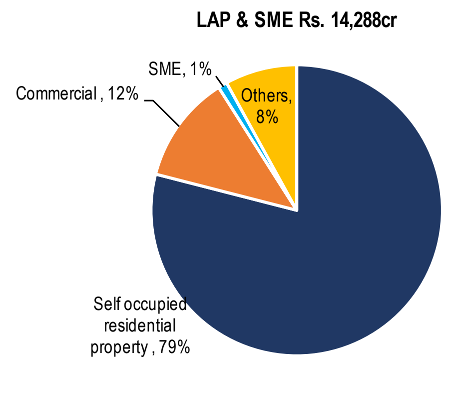
While vehicle financing at ~73% is the largest segment, CIFC has ~22% of its AUM in LAP and SME, which we think allows the company relative stability compared to other vehicle financiers.

Exhibit 1: Vehicle finance forms ~73% of the AUM…



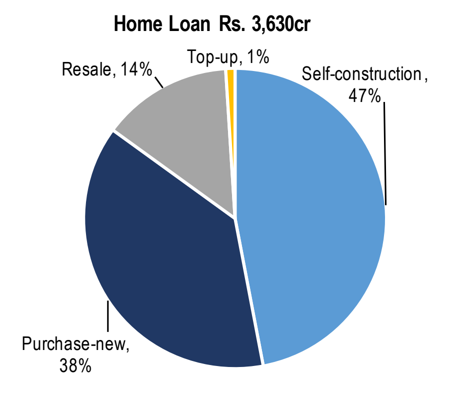
*Source: Company data *as of Sept 2020*

Exhibit 2: … while LAP & SME is ~22%…



*Source: Company data, *as of Sept 202*

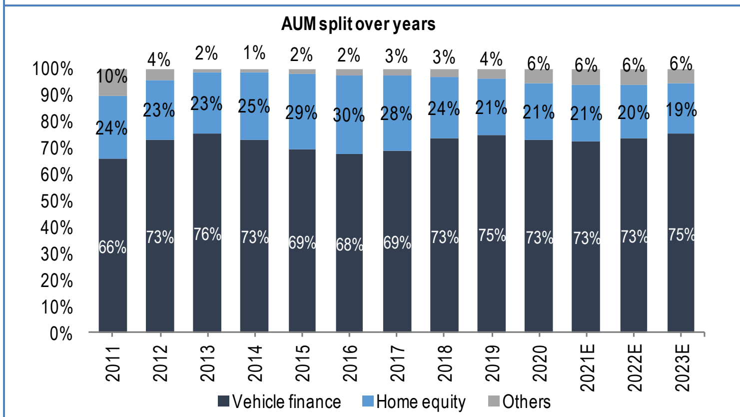
Exhibit 3: … and Home loan is ~5%



*Source: Company data, *as of Sept 202*

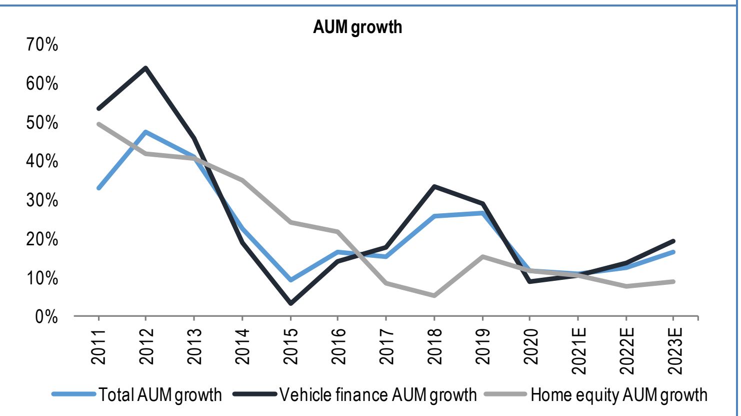
Since the days of visible concentration, CIFC has come a long way in terms of diversifying its VF book – from being concentrated mostly on LCVs, the company today offers financing of 2 wheelers, tractors, construction equipment, cars etc. Apart from this, the company has diversified in terms of used vehicles and new vehicles, which besides helping guard against concentration, has also helped in pricing (used vehicles command higher yields). While individual segments move directionally in line with the industry, the same is offset by other segments, helping CIFC to deliver stable growth. E.g., in FY20, refinance/LCVs gave buffer against an extremely weak HCV cycle. Along with product diversification, CIFC also hires specialized personnel for each sub-segment. The company has 3 product teams under the VF vertical with each focusing on (1) used vehicles (2) new vehicles and (3) tractors, which helps the company to deliver focused effort in terms of pursuing sub-segmental growth.

Exhibit 4: AUM mix over the years



Source: Company data, Nirmal Bang Institutional Equities Research Estimates

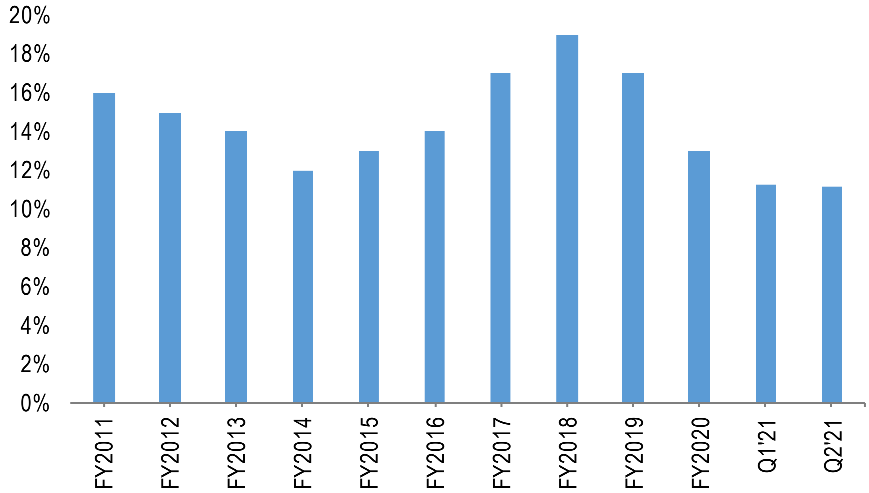
Exhibit 5: AUM growth within categories



Source: Company data, Nirmal Bang Institutional Equities Research Estimates

CIFC's diversification also provides cushion to the highly cyclical vehicle finance segment and makes the total business less volatile compared to its peers. Even within vehicle financing, the share of more volatile HCV has reduced to ~11% now.

Exhibit 6: CIFC's HCV share in vehicle financing has fallen to ~11%, making it less cyclical



Source: Company data, Nirmal Bang Institutional Equities Research

Our recent channel checks suggest that the enquiry for used commercial vehicles has sharply risen in the last few months. The used CV segment is the least affected category due to increase in affordability vs new vehicles after the transition to BS-VI norms. CIFC's exposure to heavy commercial vehicles has fallen in the last two years and now stands at ~11% while its exposure to the light commercial vehicles is at ~21%. HCV is expected to bounce back sharply in FY22 due to pick-up in replacement demand while LCV is expected to be softer due to strong sales until FY19 (cyclicality).

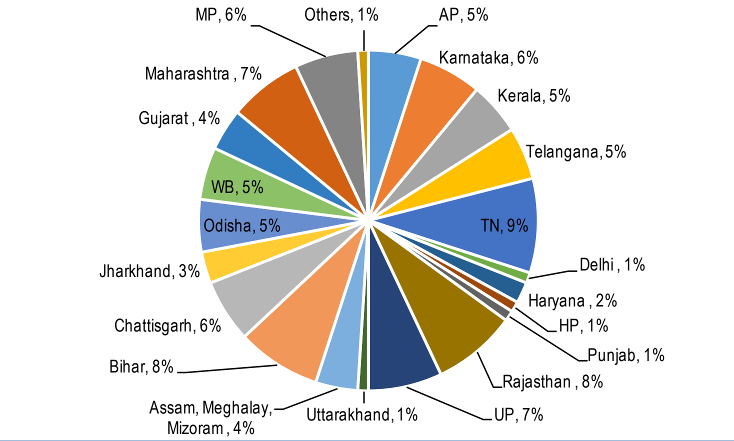
A faster recovery in the rural sector and a good Rabi harvest are key positives for tractor demand. The industry is expected to be backed by government support apart from a good monsoon and higher sowing. Supply chain bottlenecks in the tractor industry have also been resolved to a larger extent.

In LAP, CIFC continues to focus on retail ticket size loans and avoids MSMEs, which have been significantly affected by Covid. Portfolio LTV at origination is low at 52%, providing adequate security cover.

Well diversified geographical and client exposure

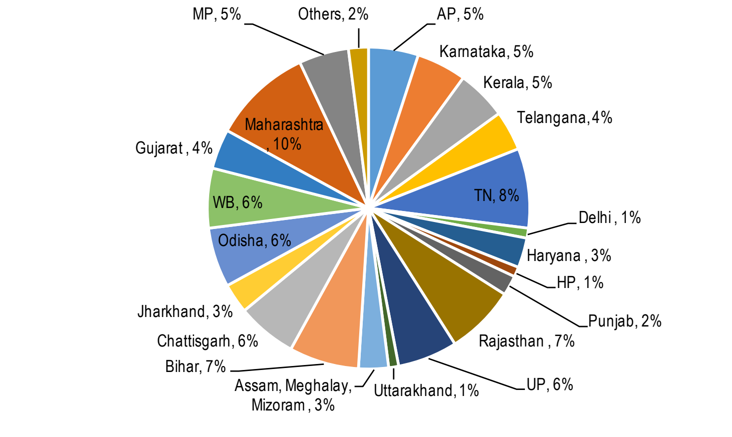
Geographical diversification has strengthened the company's portfolio. The company has been aggressive in branch addition; 51% of total branches have been added in the last 4 years (51% of portfolio). As against a share of 33% as of FY14, South India makes up 27% of total AUM as of 2QFY21. The share of north and west branches has remained steady while exposure to the east has increased considerably - from 15% in FY14 to 26% in 2QFY21. CIFC expanded in the east due to rising competition in the south and lack of credit services in the east despite healthy demand.

Exhibit 7: CIFC's state-wise disbursements in vehicle financing



Source: Company data

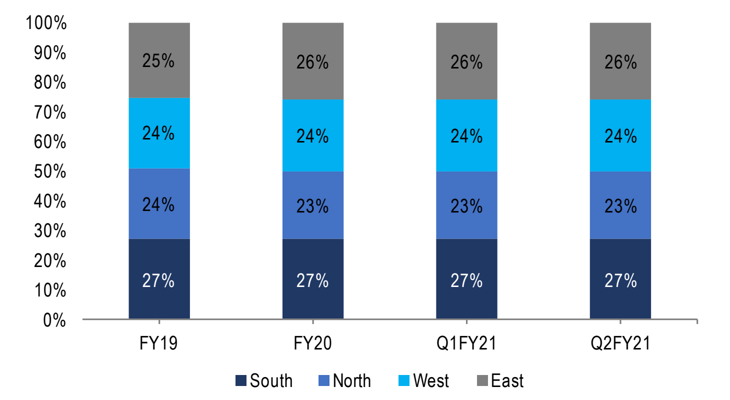
Exhibit 8: CIFC's state-wise portfolio in vehicle financing



Source: Company data

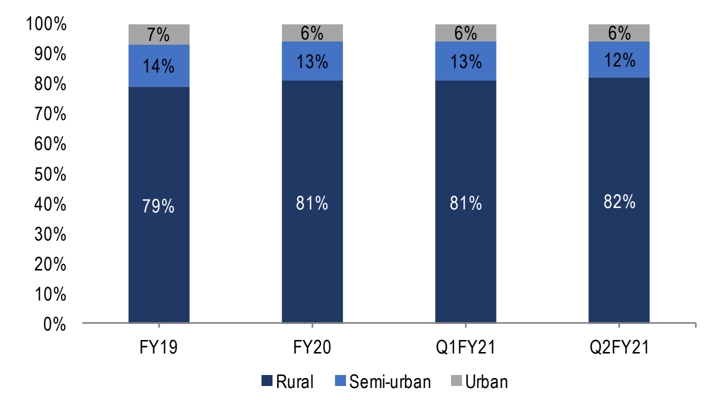
CIFC has balanced exposure across India, with >80% from rural areas. Recently, NABRD introduced Partial Credit Guarantee Scheme for NBFCs to ensure credit flow to rural areas to counter the Covid impact. Also, the rural economy has been supported by a good monsoon, excellent rabi sowing and relatively lower spread of Covid.

Exhibit 9: CIFC has balanced exposure across India…



Source: Company data

Exhibit 10: … with more focus on rural economy

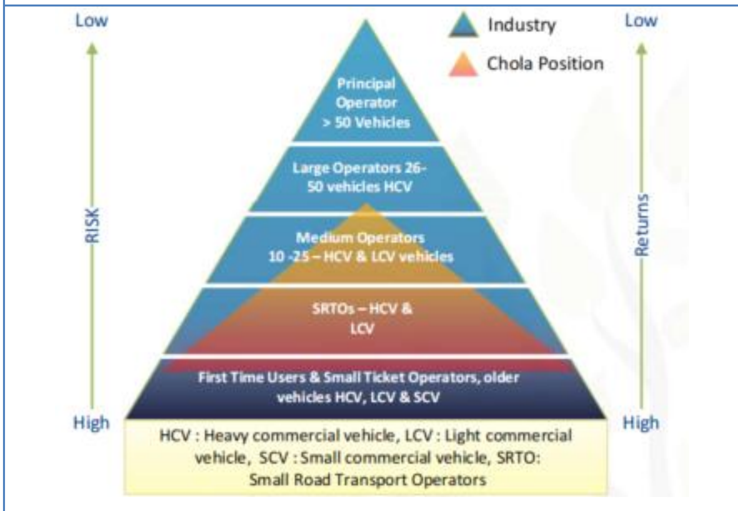


Source: Company data

CIFC lies in the medium risk-return business model when compared to the industry. Low risk customers generally prefer banks as their preferred lenders due to availability of credit at a lower cost. In the CV segment, CIFC does ~65% disbursements to micro and small enterprises and agri-based customers, and ~35% disbursements to medium operators. Compared to the industry, CIFC lies at the middle of the pyramid through new CVs and used CVs, and at the top of the bottom of the pyramid for small commercial vehicles (SCVs).

In the PV segment, ~66% of the disbursements are to CIFC's existing, agri & commercial usage customers while ~34% disbursements are to the self-employed customers. Compared to the industry, CIFC is at the middle of the pyramid.

Exhibit 11: CIFC's vehicle finance- business model and positioning in CV



Source: Company data

Exhibit 12: CIFC's vehicle finance- business model and positioning in PV

Source: Company data

In the Tractor segment, ~65% of the disbursements are to agri-based customers while the rest are for commercial use. Most of the disbursements are to medium, small and marginal farmers, as large farmers prefer banks rather than NBFCs.

In the construction equipment (CE) segment, ~69% of the disbursements are to retail customers.

Exhibit 13: CIFC's vehicle finance- business model and positioning in Tractors

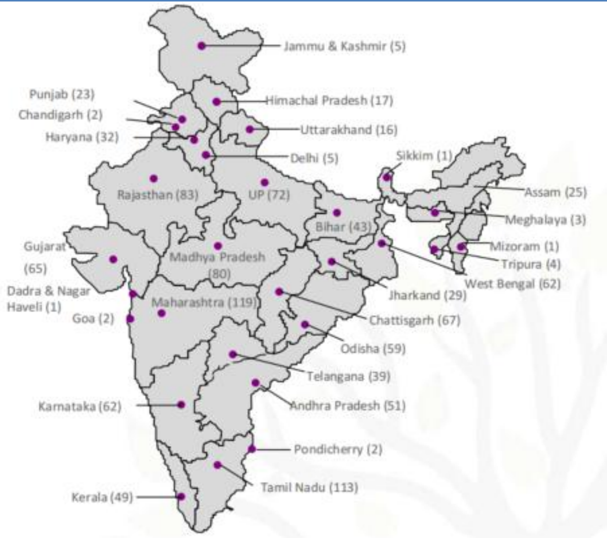
Source: Company data

Exhibit 14: CIFC's vehicle finance- business model and positioning in CE

Source: Company data

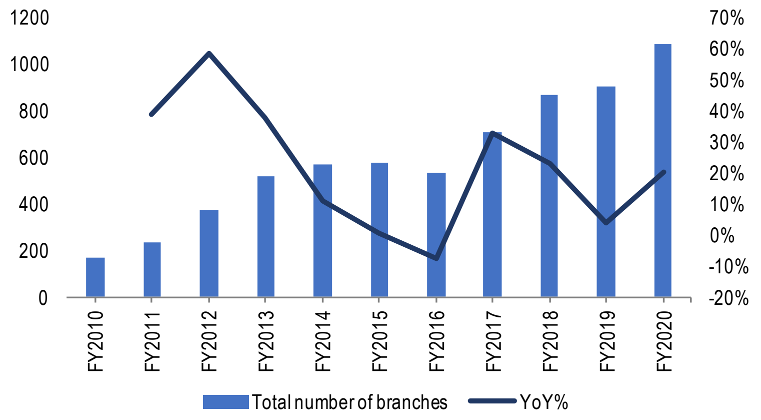
CIFC has ~1,100 branches, of which majority are in the rural areas (tier 2 to tier 4 cities). Vehicle Finance is provided in all its branches whereas LAP is provided in ~250 branches and home loans in ~200 branches. So, there is more potential for penetration in these two segments through existing branches..

Exhibit 15: CIFC has India-wide presence



Source: Company data

Exhibit 16: The number of branches are on the rise



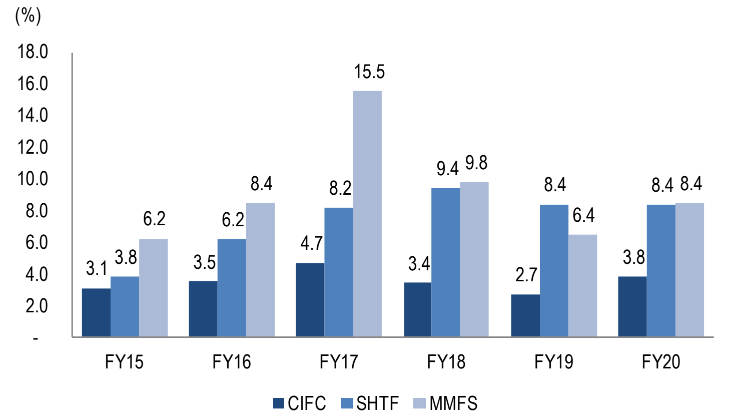
Source: Company data

Impressive control over asset quality

CIFC's asset quality has been consistently better than its peers. Between 2013 and 2016, when the economy was struggling with slowdown, mining ban in Odisha and political instability in Karnataka and AP, CIFC increased its collection intensity, resulting in low credit cost. In the last two years, CIFC has also reduced its disbursements in the HCV segment due to decline in freight volume availability causing freight rates to come under stress.

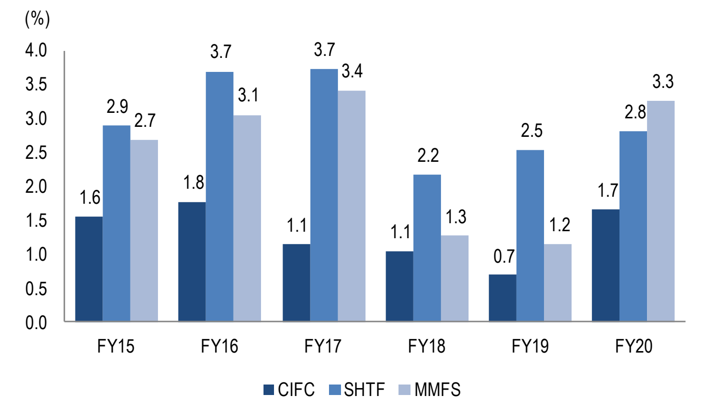
In FY15, the company restrained disbursements in the Home Equity segment due to heightened competition. Disbursements declined from 30% in FY14 to 8% in FY15. Home Equity NPA had been low till FY14 but rose gradually to 6% in FY17 (partly affected due to change in regulations on asset recognition). Disbursements stayed low over four years of FY15-18 (-12% to +14%) before resuming growth in FY19 (21%). Also, this segment has shown an improvement in asset quality over the years. The SARFAESI Act as a recovery tool under the Home Equity segment has been effective in reducing NPAs.

Exhibit 17: CIFC's gross NPA is better than peers…



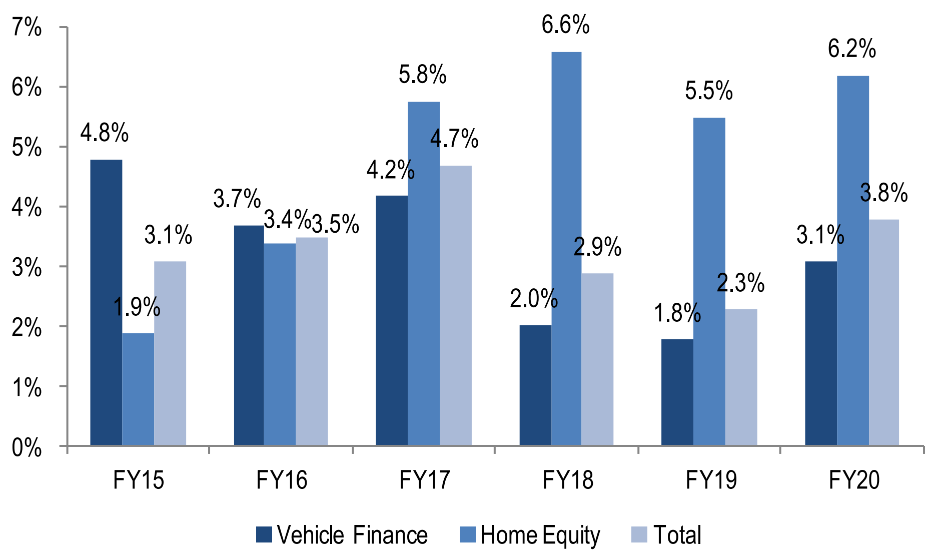
Source: Company data, Nirmal Bang Institutional Equities Research

Exhibit 18: … with lower credit cost (P&L provisions as % of loans)



Source: Company data, Nirmal Bang Institutional Equities Research

Exhibit 19: Gross NPA have been higher in Home equity business, however SARFAESI aided in recovery from FY18



Source: Company data, Nirmal Bang Institutional Equities Research

Superior underwriting model and collection efficiency

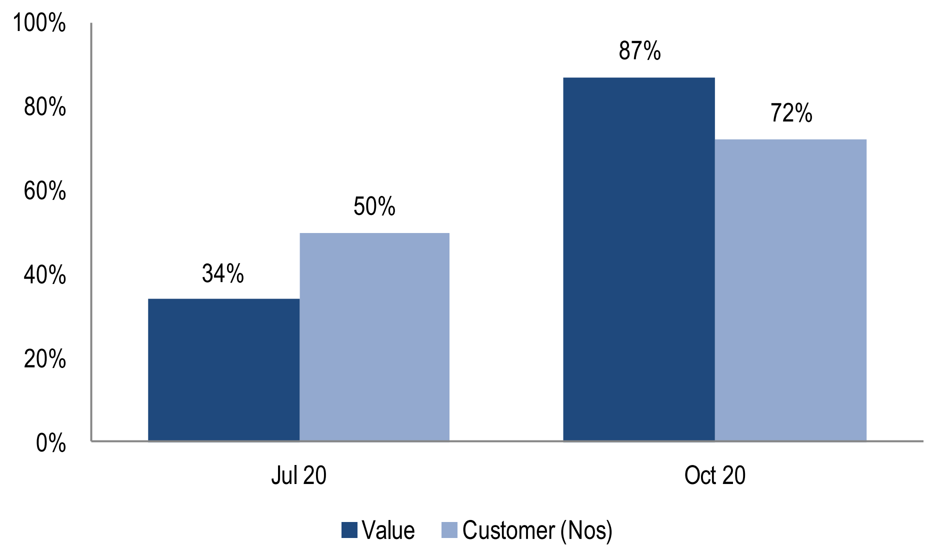
CIFC has data and analytics driven underwriting and collections. The company uses machine learning tools and platforms to continuously refine the predictive models for credit, sales, collections and risk functions. These capabilities enable CIFC to be the best in class among its peers in terms of credit risk, field collection efficiency, sales productivity, cross-sell efficiency, audit and fraud monitoring. CIFC also uses process automation to increase efficiency. The upcoming digital data center will further boost the company's ability to manage data.

At CIFC, the collection vertical is entirely different from other functions. Branches do not have the authority to make credit decisions. The credit manager uses algorithmic tools to make the credit decision wherein the loan is granted immediately or the decision is taken by the credit manager above the branch level. CIFC's elevated cost structure is the function of its focus on collections, ensuring high asset quality.

To mitigate the Covid impact to some extent, the company has developed a targeted collection strategy to identify low/medium/high risk customer segments and manage repayments after moratorium.

The company has already witnessed better-than-expected collections in 2QFY21 and expects the trend to continue in 3QFY21. CIFC expects 3QFY21 to reach pre-Covid field collection numbers (100-105% of demand raised. In the latest earnings call, the company mentioned that 95% of the moratorium customers (volume) have started repaying their installments. The company achieved the lowest stage 2 and stage 3 in 2QFY21 and is expected to continue its trajectory with solid underwriting business model and robust collection mechanism.

Exhibit 20: Collection efficiency improved in 'Oct 20



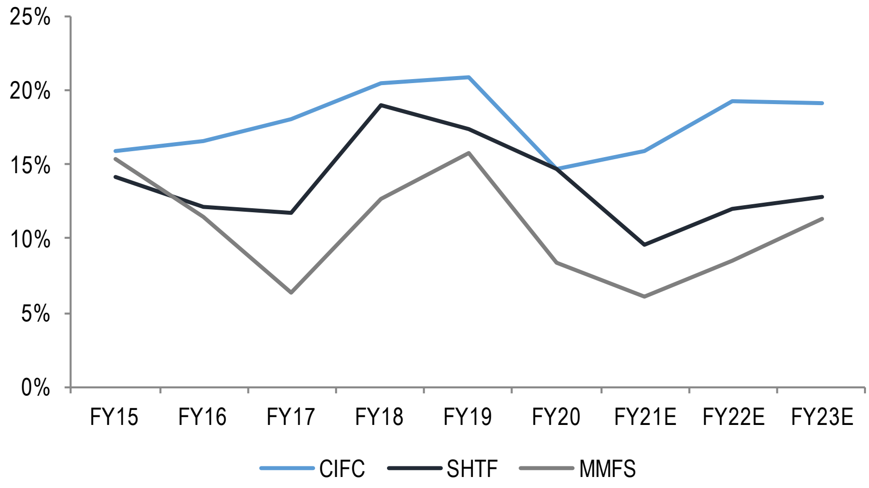
Source: Company, Nirmal Bang Institutional Equities Research

Note: July 20 - 34% of customers paid at least one installment in July'20; 17% customers made partial payments; Oct'20 – 95% of moratorium customers (moratorium availed by 76% customers) started repaying

Superior return profile

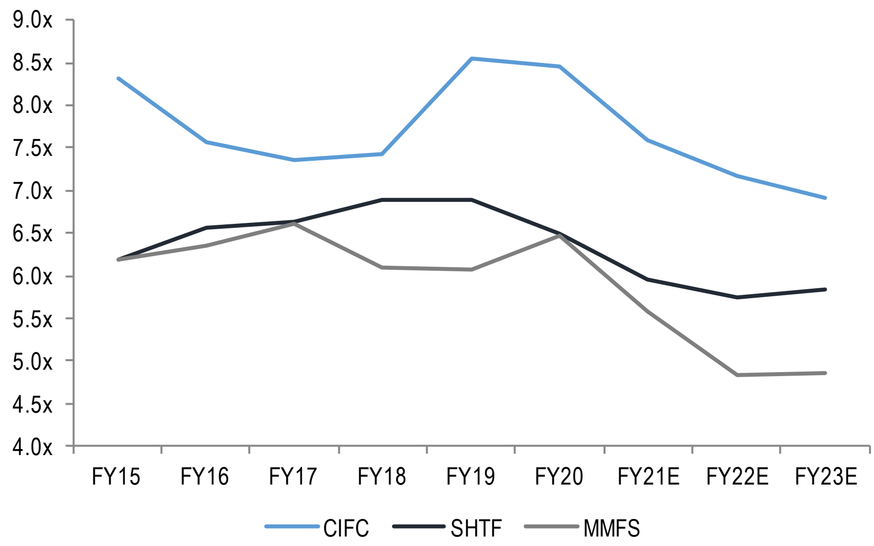
CIFC has superior ROE compared to its peers due to lower provisioning (low GNPA) despite higher operating expenses. We expect ROE to be better than peers over FY21E-23E due to lower provisioning and better NIMs – impact of low cost of borrowings.

Exhibit 21: CIFC's ROE has broadly remained stable and better compared to its peers



Source: Company data, Nirmal Bang Institutional Equities Research

Exhibit 22: CIFC's ROE is also supported by higher leverage compared to peers

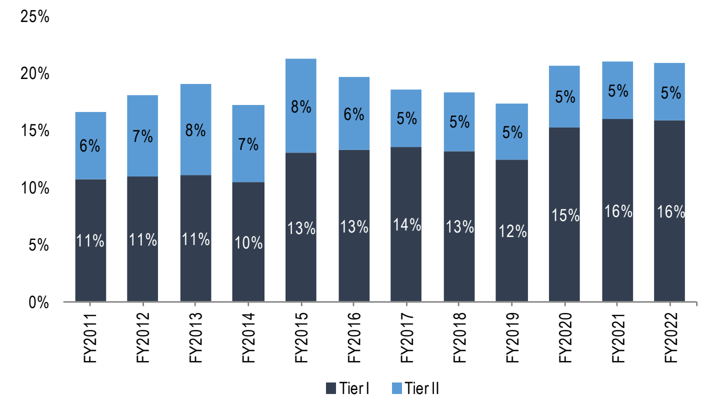


Source: Company, Nirmal Bang Institutional Equities Research

Balance sheet strong; parent support gives resilience

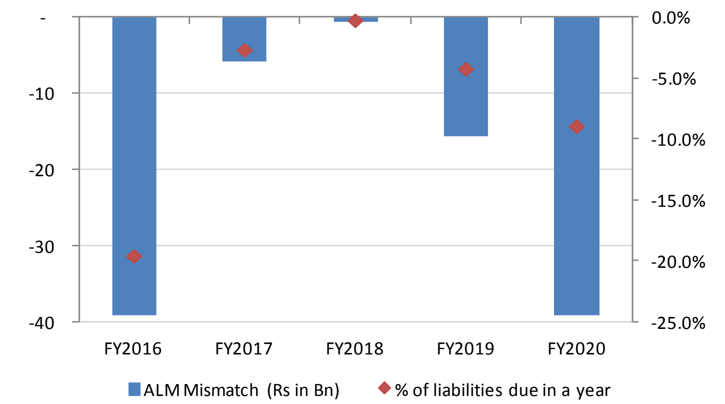
CIFC's strong parentage, Murugappa Group, gives it a better standing when it comes to its risk perception in the market. Also, the better asset quality results in better rates for funding. CIFC's Tier 1 capital now stands at ~15% (as on 2QFY21), well above the regulatory requirement of 10% while the CAR is at ~19%, above the regulatory requirement of 15%. The increase in capital was helped by a capital raise in 4QFY20. ALM mismatch across buckets has remained comfortable over the years.

Exhibit 23: Tier 1 capital is comfortably above the minimum requirement of 10%



Source: Company data, Nirmal Bang Institutional Equities Research

Exhibit 24: Asset liability match (1 year tenure)



Source: Company data, Nirmal Bang Institutional Equities Research

Credit ratings from agencies reflect CIFC's strong credit profile. The ratings are also supported by parentage - Murugappa Group, which holds ~52% stake in the company and CIFC's healthy market position in vehicle finance.

Exhibit 25: Latest credit ratings show CIFC's good credit worthiness

Loan type	India ratings	Care	ICRA	Crisil
ST CP/ WCDL	-	CARE A1+^	[ICRA] A1+	[CRISIL] A1+
LT NCD/ CC	IND AA+ (ind) stable*	-	[ICRA] AA+	-
Tier II SD	IND AA+ (ind) stable	CARE AA+	[ICRA] AA+/ Stable	[CRISIL] AA+/ Stable
Tier I PDI	IND AA (ind)	CARE AA	[ICRA] AA/ Stable	-

*Source: Company data. Nirmal Bang Institutional Equities Research, *rating for NCD, ^CP rating*

In June 2018, CRISIL upgraded its rating on Lower Tier II bonds to AA+/stable from AA/stable. This reflects the continuous improvement in CIFC's asset quality.

Exhibit 26: Latest credit ratings

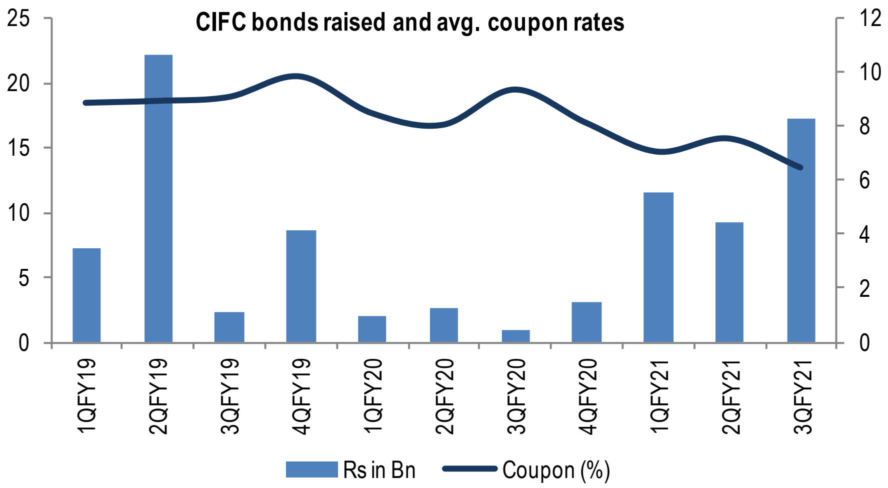
Date	Rating/ outlook- prev.	Rating/ outlook revised
20/8/2014	AA-/ Stable	AA-/Positive
19/6/2015	AA-/ Positive	AA/ Stable
22/6/2018	AA/ Stable	AA+/ Stable

*Source: Company data. Nirmal Bang Institutional Equities Research, *rating for NCD, ^CP rating*

Better cost of funding and access to borrowings

In the recent quarters, CIFC's cost of funding has improved steadily due to improvement in the liquidity situation and parent's backing. Cost of borrowing for CIFC has improved vs. Shriram Transport Finance (SHTF) but has remained higher than Mahindra & Mahindra Financial Services (MMFS) (Mahindra group backing). This suggests the bond market's comfort in lending to CIFC. The recent coupon rates for bonds raised at FV have been lower by 230bps vs bonds issued a year ago.

Exhibit 27: CIFC's bond coupon rates have declined steadily



Source: Bloomberg, BSE filings, Company, Nirmal Bang Institutional Equities Research

CIFC's coupon rates are lower than SHTF's over the last 6 quarters but higher than MMFS'.

Exhibit 28: Coupon rates

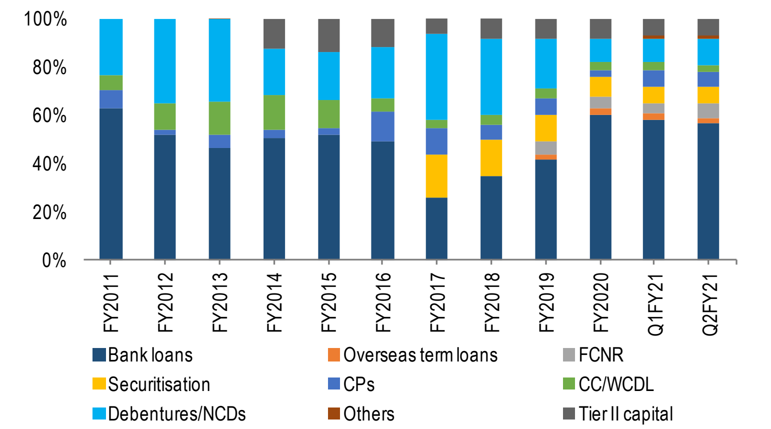
	CIFC		MMFS		SHTF	
	Rs in Bn	Coupon (%)	Rs in Bn	Coupon (%)	Rs in Bn	Coupon (%)
1QFY19	7.3	8.9	18.4	8.2	0.0	0.0
2QFY19	22.2	8.9	18.3	8.6	38.7	9.2
3QFY19	2.4	9.1	28.0	9.0	37.9	9.1
4QFY19	8.6	9.9	27.8	9.1	12.3	8.3
1QFY20	2.0	8.5	10.0	8.5	3.1	7.1
2QFY20	2.6	8.1	20.0	8.5	3.4	9.4
3QFY20	1.0	9.4	7.3	7.6	-	-
4QFY20	3.1	8.1	12.3	7.6	30.4	8.5
1QFY21	11.6	7.1	26.7	7.1	2.5	9.0
2QFY21	9.3	7.5	7.8	5.3	0.5	9.8
3QFY21	17.2	6.5	11.8	5.3	6.8	8.9

Source: Bloomberg, BSE filings, Company, Nirmal Bang Institutional Equities Research

Note: For Q3FY21, data updated until 14th Dec, 20; Coupon rate is simple average of coupon rates for bond issued in the qtr

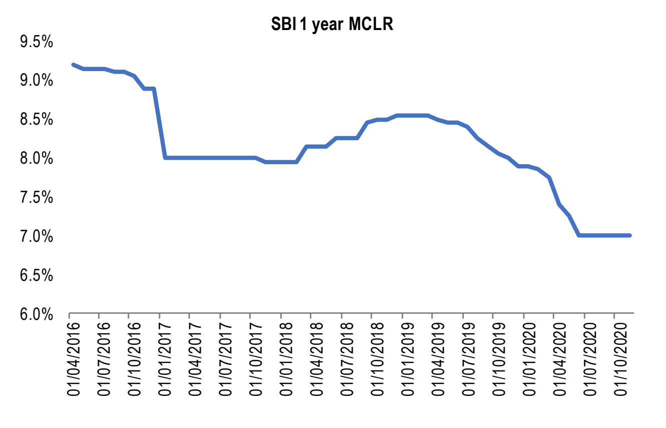
CIFC has maximum funding (60%) from banks, which have reduced their MCLR. This should result in lower cost of borrowings as the old debt is replaced with the new one. As per the FY20 balance sheet, ~30% of total debt was due to retire in 12 months (includes NCDs, bank borrowings, CPs etc).

Exhibit 29: Funding profile: Bank contributes 60% to CIFC's borrowings



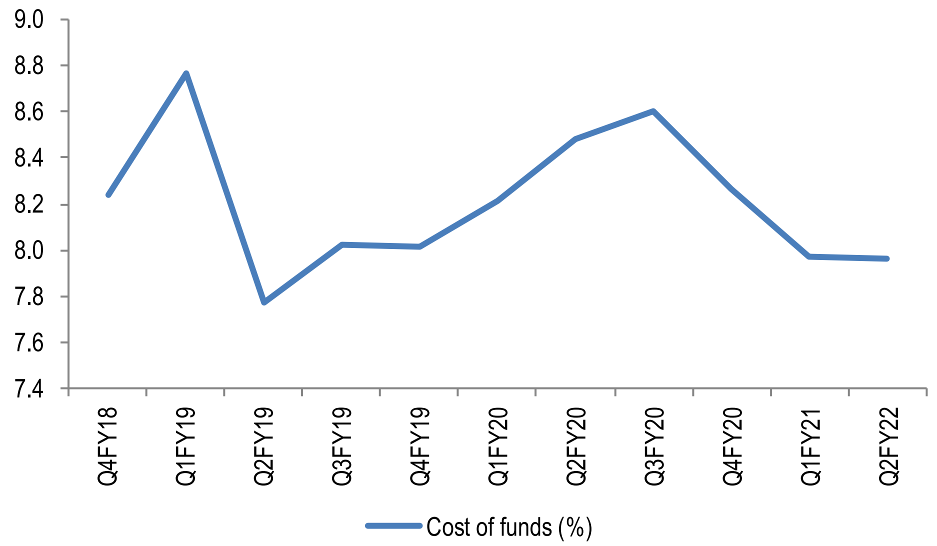
Source: BSE, Bloomberg, Company data. Nirmal Bang Institutional Equities Research

Exhibit 30: SBI 1 year MCLR down ~90bps since Jan'20



Source: Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 31: CIFC cost of funding reduced over last one year as reflected in quarterly numbers

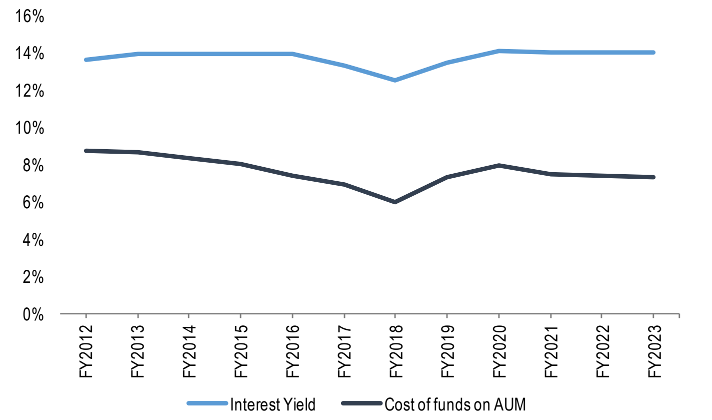


Source: Company, Nirmal Bang Institutional Equities Research

Impressive profitability with stable earnings growth

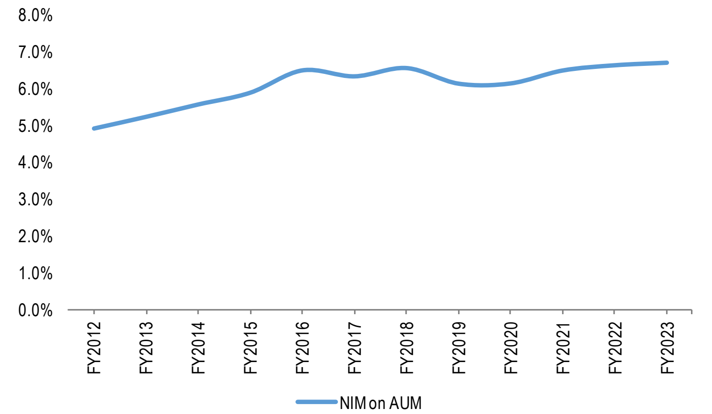
CIFC's average yield on AUM has remained in the range of 14-15% over the last 3 years and we expect this to pick up marginally going ahead with increasing focus on used vehicles. Cost of borrowings is likely to reduce due to overall reduction in the cost of debt. This should aid CIFC to increase its NIM going ahead to ~6.5% over the next two years.

Exhibit 32: Reduction in cost of funds and slight increase in yields…..



Source: Company data, Nirmal Bang Institutional Equities Research

Exhibit 33: …will drive NIMs over next 3-years

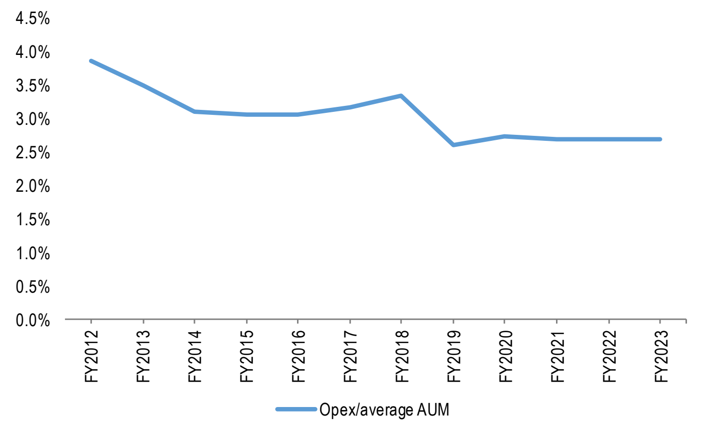


Source: Company data, Nirmal Bang Institutional Equities Research

CIFC's pre-provisioning operating profit and PAT increased at a CAGR of 20.4% and 19.3% over FY15-20. Lower provisioning and tight control over costs (16% CAGR over FY15-20) were key to impressive RoE of 18% (average) in the last 5 years.

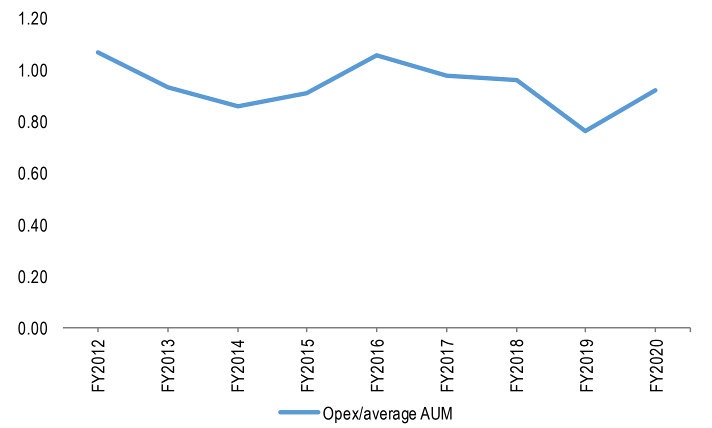
CIFC's focus on reducing opex has yielded good results and the company has been able to structurally reduce expenses. Opex as a percentage of AUM hit the bottom of 2.1% in the recent quarter. We expect it to increase going ahead with increase in disbursements, collection costs and infra costs. Also, higher focus on small ticket size loans (two wheelers and three wheelers) should increase opex. However, re-negotiation of rentals, BPO expenses etc are more sustainable in nature. This should comfortably aid CIFC to maintain opex at 2.7% of AUM.

Exhibit 34: CIFC's opex as % of AUM has reduced significantly and should hover around 2.7% going forward



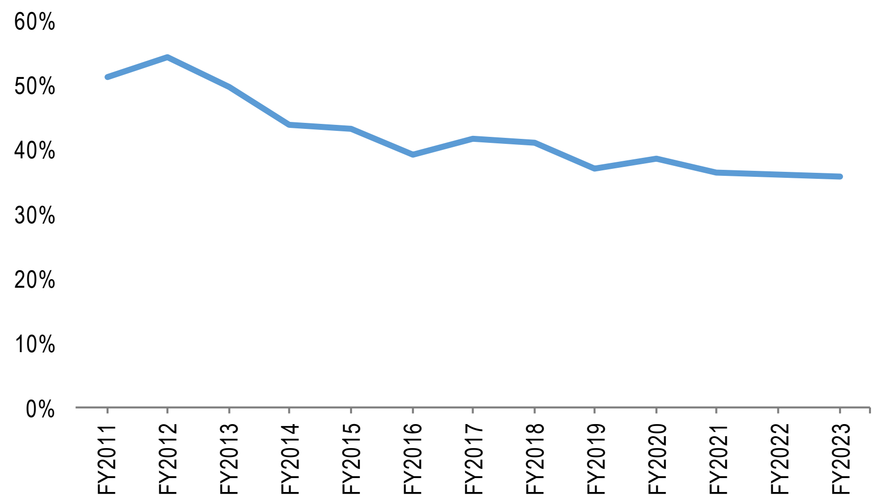
Source: Company data, Nirmal Bang Institutional Equities Research

Exhibit 35: Opex / branch has come down as well



Source: Company data, Nirmal Bang Institutional Equities Research

Exhibit 36: Opex as a % of the net income on the decline



Source: Company data, Nirmal Bang Institutional Equities Research

Valuation

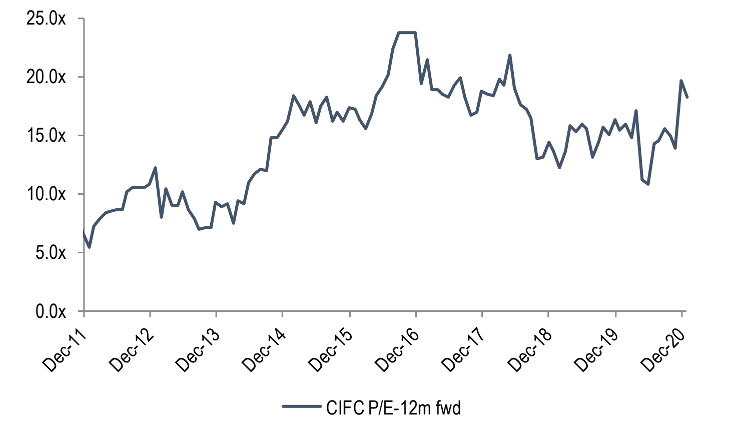
Premium valuation for better asset quality and strong execution

CIFC has historically traded at a premium (~55% 5 year avg.) to its peers and now stands at P/B of 2.9x and P/E of 18.3x on 12 months forward basis. We believe that this premium is justified given its carefully built diversified portfolio, superior execution, better asset quality and stable returns.
We value the stock at 3.5x P/ABV (10% premium to last 5 year average multiple) on FY23E ABV to arrive at our PT of Rs 480. We believe that this premium is justified given the sharp improvement in expected ROE of 19.2% and RoA of 2.8% in FY23E.

The stock has run up 60% over the last three months as the asset quality fears were allayed due to increase in collection efficiency. However, in our view, the current stock price still does not build in any upside in the CV cycle, arising out of strong replacement demand, which is likely to kick in from FY22E.

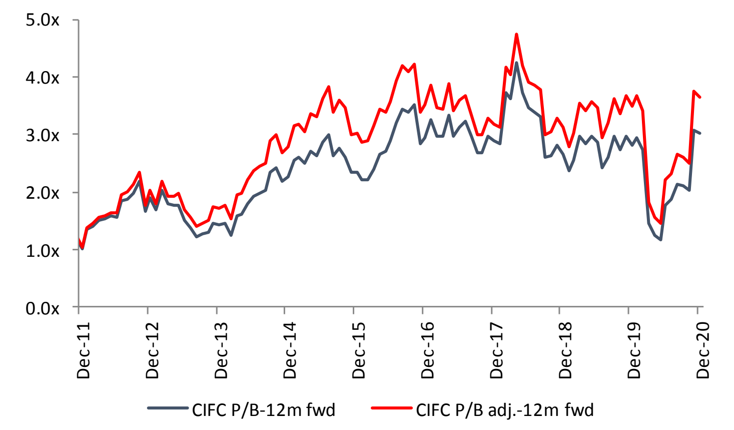
The stock has outperformed the Nifty 50 by 12% since the beginning of the year and 115% in the last 5 years.

Exhibit 37: CIFC P/E - 12m fwd



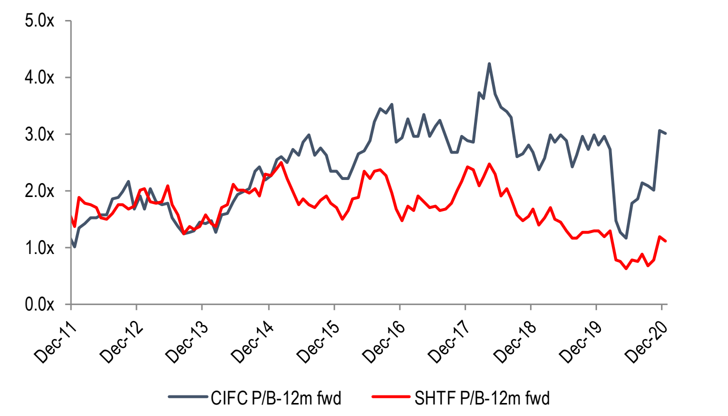
Source: Bloomberg

Exhibit 38: CIFC P/B -12m fwd



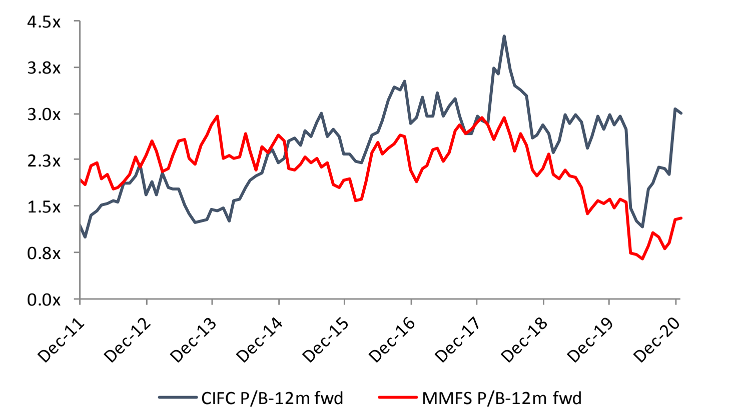
Source: Bloomberg

Exhibit 39: CIFC vs. Shriram Transport P/B-12 m fwd



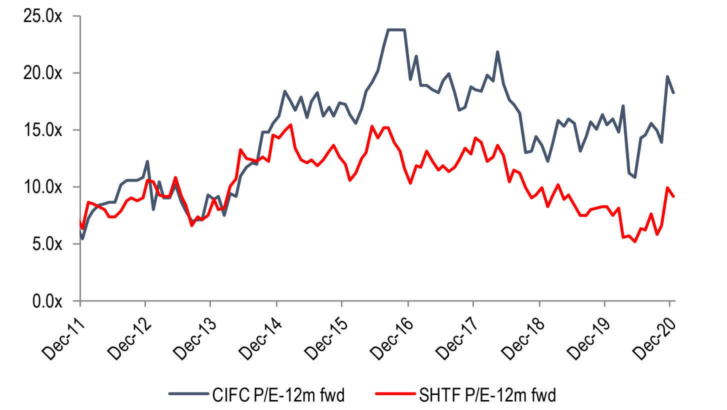
Source: Bloomberg

Exhibit 40: CIFC vs. Mahindra Finance P/B -12m fwd



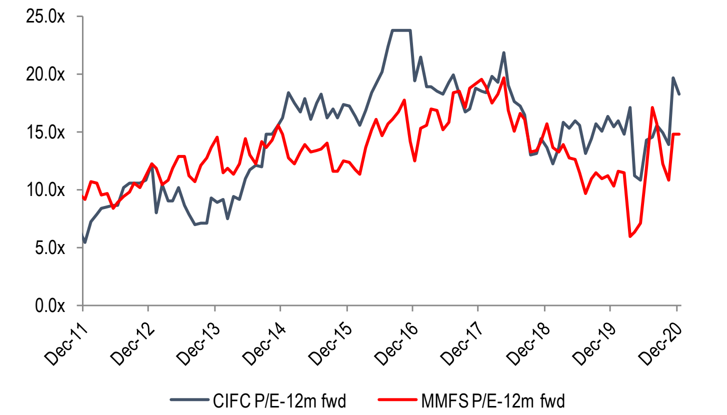
Source: Bloomberg

Exhibit 41: CIFC vs. Shriram Transport P/E - 12 m fwd



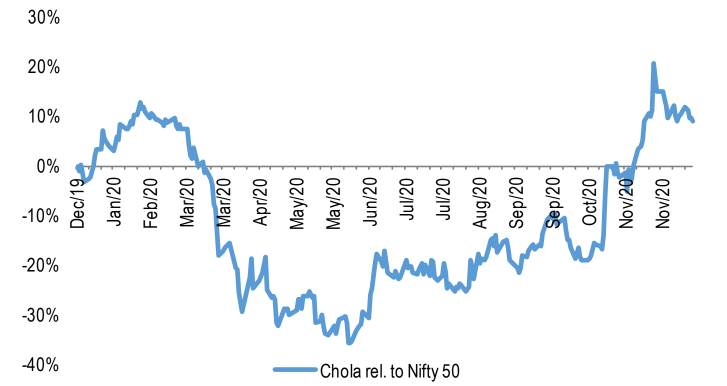
Source: Bloomberg

Exhibit 42: CIFC vs. Mahindra Finance P/E -12m fwd



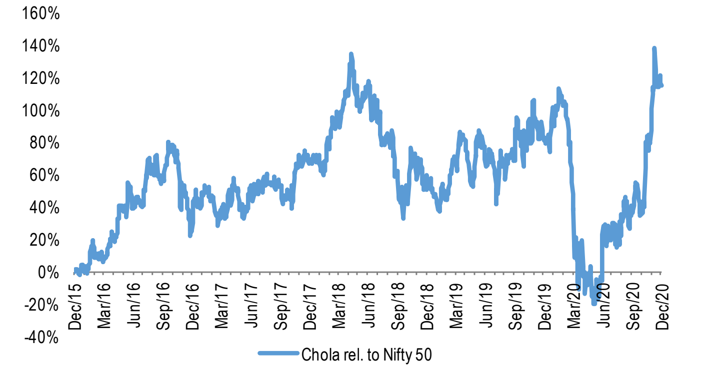
Source: Bloomberg

Exhibit 43: CIFC performance YTD rel. to Nifty 50



Source: Bloomberg

Exhibit 44: CIFC performance last 5 years re. to Nifty 50



Source: Bloomberg

Exhibit 45: Peer valuation

	Price	M cap	P/B			P/B- adj.			P/E			ROE			ROA		
Name	(Rs)	Rs. (bn)	FY21	FY22	FY23	FY21	FY22	FY23	FY21	FY22	FY23	FY21	FY22	FY23	FY21	FY22	FY23
CIFC	386.4	317	3.4x	2.9x	2.4x	4.2x	3.5x	2.8x	22.6x	16.0x	13.7x	16.0%	19.4%	19.2%	2.1%	2.7%	2.8%
SHTF	1016.1	257	1.2x	1.1x	1.0x	2.0x	1.7x	1.4x	13.2x	9.6x	8.2x	9.6%	12.0%	12.8%	1.6%	2.1%	2.2%
MMFS	175.8	217	1.5x	1.4x	1.2x	2.0x	1.8x	1.6x	23.7x	14.9x	10.7x	7.0%	9.4%	12.0%	1.2%	1.9%	2.4%

Source: Nirmal Bang Institutional Equities Research

Risks

- The vehicle financing business is well correlated with the macro environment. Cash flows from the borrowers and collateral values, both are impacted by the general macro environment. Delay in GDP recovery may result in less transportation of goods & services, which would affect the HCV and LCV segments directly. This would affect borrowers' debt servicing capability and may result in increase in NPAs. On the flip side, if the recovery is more than anticipated, transportation may improve drastically with a multiplier effect and increase collateral values as well. As of now, the economy seems to be on track for a good recovery.

- The recent more dangerous coronavirus strain found in the UK may pose risk to gradual opening of the global and Indian economy.

- Rural incomes are correlated with farming, which in turn depends on rains and water levels. Change in weather conditions and untimely/insufficient rains may hamper rural incomes and in turn demand for transportation and tractors. This would negatively impact CIFC’s growth as well as collections.

- Currently, banks do not generally prefer to lend to mid-tier vehicle owners due to credit risk/ relatively low ticket size. If banks start to target this area, there is risk for CIFC to lose market share. Furthermore, as banks have lower cost of funds than NBFCs, it may pressure CIFC’s NIMs. However, due to relatively high risk and lack of expertise in the rural mid-tier level, banks have generally kept themselves on the sideline.

- We think that the current interest rates are at bottom and though interest rates in future are expected to increase, if the increase is faster and more than anticipated, it would affect NIMs.

Financials

Exhibit 46: Income statement

Y/E March (Rsmn)	FY19	FY20	FY21E	FY22E	FY23E
Financing Income	6,576	8,124	8,960	10,033	11,488
Fining charges	3,589	4,592	4,809	5,295	6,003
Net Financing income	2,987	3,532	4,151	4,738	5,485
Change (%)	18	18	18	14	16
Other Income	417	529	558	594	649
Net Income	3,404	4,061	4,709	5,332	6,134
Change (%)	9	19	16	13	15
Employee cost	591	655	690	789	905
Other Operating Exp.	679	923	1,034	1,136	1,302
Operating Profit	2,134	2,483	2,985	3,407	3,928
Change (%)	17	16	20	14	15
Total Provisions	311	897	1,101	750	825
% to operating income	15	36	37	22	21
Excpetional items	0	0	0	0	0
PBT	1,823	1,586	1,884	2,657	3,103
Tax	637	533	484	683	797
Tax Rate (%)	35	34	26	26	26
PAT	1,186	1,052	1,400	1,974	2,305
Change (%)	22	-11	33	41	17
Dividend	122.7	168.0	209.9	296.1	345.8

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 47: Balance sheet

Y/E March (Rsmn)	FY19	FY20	FY21E	FY22E	FY23E
Capital	156	164	164	164	164
Reserves & Surplus	6,019	8,008	9,197	10,875	12,835
Net Worth	**6,176**	**8,172**	**9,361**	**11,039**	**12,999**
Borrowings	**50,567**	**55,005**	**59,499**	**66,573**	**76,364**
Change (%)	58.5	8.8	8.2	11.9	14.7
Other Liabilities	684	816	50	-245	-627
Total Liabilities	**57,426**	**63,993**	**68,910**	**77,367**	**88,735**
Investments	73	73	87	90	95
Change (%)	-77.1	0.0	19.7	3.5	5.1
Loans	**52,622**	**55,403**	**61,096**	**68,743**	**79,293**
Change (%)	41.5	5.3	10.3	12.5	15.3
Net Fixed Assets	176	284	326	375	432
Net Current Assets	4,555	8,233	7,401	8,158	8,916
Total Assets	**57,426**	**63,993**	**68,910**	**77,367**	**88,735**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 48: Key ratios

Y/E March	FY19	FY20	FY21E	FY22E	FY23E
Spreads Analysis on AUM (%)					
Avg. Yield	13.5	14.2	14.0	14.1	14.1
Avg Cost of funds	7.4	8.0	7.5	7.4	7.3
Int Spread	6.1	6.2	6.5	6.6	6.7
Profitability Ratios (%)					
RoE	20.9	14.7	16.0	19.4	19.2
RoA	2.4	1.7	2.1	2.7	2.8
Int. Expended/Int.Earned	54.6	56.5	53.7	52.8	52.3
Other Inc./Net Income	12.3	13.0	11.8	11.1	10.6
Efficiency Ratios (%)					
Op. Exps./Net Income	37.3	38.9	36.6	36.1	36.0
Empl. Cost/Op. Exps.	46.5	41.5	40.0	41.0	41.0
Asset-Liability Profile (%)					
Loans/Borrowings Ratio	104.1	100.7	102.7	103.3	103.8
GNPA	1,438.5	2,163.3	3,071.2	2,971.4	2,877
NNPA	892.1	1,265.0	1,842.7	1,872.0	1,812
GNPL ratio (%)	2.7	3.8	4.9	4.2	3.5
NNPL ratio (%)	1.7	2.3	2.9	2.7	2.2
Leverage	9.3	7.8	7.4	7.0	6.8
Average leverage (on BS)	8.6	8.5	7.6	7.2	6.9
CAR	17.4	20.7	21.0	20.9	21.0

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 49: Valuations

Y/E March (Rsmn)	FY19	FY20	FY21E	FY22E	FY23E
BVPS (INR)	79	100	114	135	159
BV Growth (%)	19.8	26.3	14.6	17.9	17.8
Price-BV (x)	4.9	3.9	3.4	2.9	2.4
Adjusted book value (Rs)	67.6	84.2	91.7	111.9	136.5
Price-ABV(x)	5.7	4.6	4.2	3.5	2.8
EPS (INR)	15.2	12.8	17.1	24.1	28.1
Growth (%)	21.6	-15.3	33.0	41.0	16.8
Price-Earnings (x)	25.5	30.1	22.6	16.0	13.7
Dividend	1.6	2.0	2.6	3.6	4.2
Dividend Yield (%)	0.41	0.53	0.66	0.94	1.09

Source: Company, Nirmal Bang Institutional Equities Research

Management

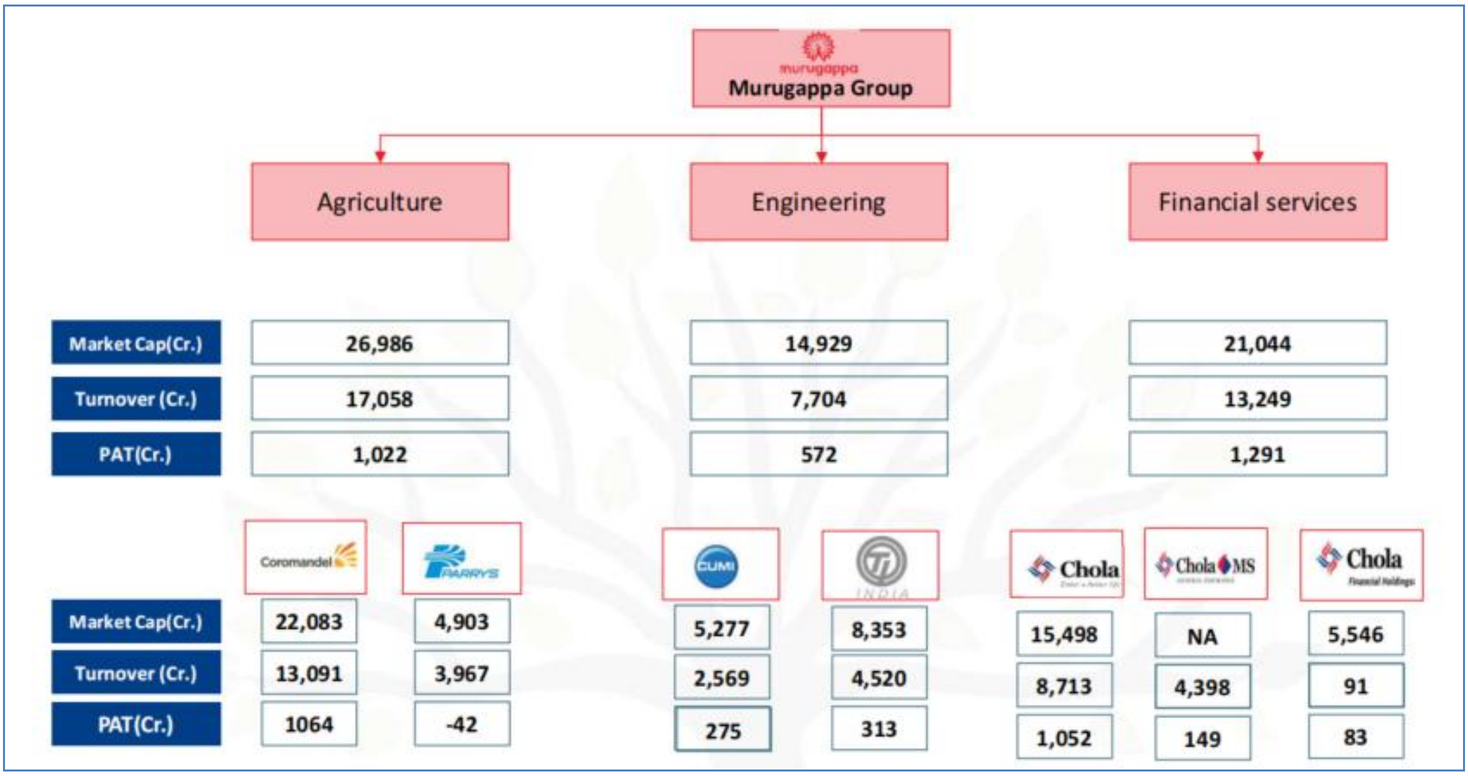
Mr. Vellayan Subbiah, Chairman	• 23 years in consulting, technology and financial services in different positions across various industries • Was MD of CIFC from 19th Aug 2010 to 18th Aug 2017. Currently he is MD of Tube Investments of India Limited (TII) since Aug'18
Mr. Ashok Kumar Barat, Independent Director	• Was MD and CEO of Forbes & Company Limited
Mr. N. Ramesh Rajan, Independent Director	• Over 38 years of experience in the fields of finance, strategy and operations. • Was the Chairman and Senior Partner, PwC India
Mr. Rohan Verma, Independent Director	• A recipient of the President's Award for Academic excellence in Stanford University and Dean's List and Distinction Award from London Business School • A member of the FICCI Young Leaders Forum
Ms. Bhama Krishnamurthy, Independent Director	• Over over 35 years in IDBI (now IDBI Bank) and SIDBI • Is on the boards of various companies including Reliance Industrial Infrastructure Limited, Network18 Media and Investments Limited etc.
Mr. Arun Alagappan, Managing Director	• Over 20 years of experience and has held senior management positions in various units of the group viz., Parryware, Tube products of India and lastly as the President of TI Cycles. • Is on the Boards of Lakshmi Machine Works Limited, CIFCmandalam Home Finance Limited etc.
Mr. Ravindra Kumar Kundu, Executive Director	• 32 years of professional experience in automobile and financial services industry including 20 years in CIFC. • Is on the Boards of CIFCmandalam Securities Limited and White Data Systems India Private Limited.

About Murugappa Group

The Rs381bn (Rs38,105 crores) Murugappa Group is one of India's leading business conglomerates, which was founded in 1900 and is headquartered in Chennai. The group has 28 businesses, including nine listed companies on NSE and BSE. Major companies of the group include Carborundum Universal Ltd., Cholamandalam Financial Holdings Ltd., Cholamandalam Investment and Finance Company Ltd., Cholamandalam MS General Insurance Company Ltd., Coromandel International Ltd., Coromandel Engineering Company Ltd., E.I.D. Parry (India) Ltd., Parry Agro Industries Ltd., Shanthi Gears Ltd., Tube Investments of India Ltd. and Wendt (India) Ltd.

Renowned brands like BSA, Hercules, Montra, Mach City, Ballmaster, Ajax, Parry's, Chola, Gromor, Shanthi Gears and Paramfos are from the Murugappa Group.

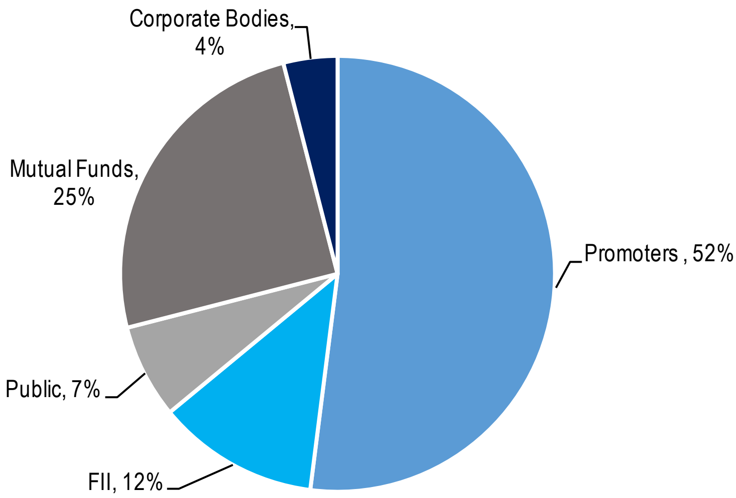
Exhibit 50: Murugappa Group Overview



Source: Company data

Shareholding Structure

Exhibit 51: Murugappa Group holds 52% in CIFC - providing a strong parentage



Source: Company data, Promoters shareholding of 51..65% includes Cholamandalam Financial Holdings Limited – 45.49%, Ambadi Investments Limited – 4.11%, Others - 2.04%

Institutional shareholders (>1%) as on September 30, 2020

Top domestic institutional holdings-
- HDFC Mutual Fund
- SBI Mutual Fund
- Axis Mutual Fund
- Birla Sun Life Mutual Fund
- DSP Mutual Fund

Top foreign institutional holdings-
- Cartica Capital
- Vanguard
- Government of Singapore (GIC)
- VanEck
- Janchor Partners

Mahindra and Mahindra Financial Services

29 December 2020

Reuters: MMFS.BO; Bloomberg: MMFS IN

Initiating Coverage

Robust rural and reasonable valuation; Buy

We initiate coverage on Mahindra and Mahindra Financial Services (MMFS) with a BUY rating and a target price (TP) of Rs210. Robust rural economy and improvement in collection efficiency augur well for MMFS. Disbursements growth for MMFS (captive financier for M&M) has remained resilient compared to peers, but profitability has remained volatile due to asset quality issues. Above normal monsoon bodes well for asset quality and disbursements while deviation below normal leads to spike in NPAs. MMFS has strong disbursement linkages with volume of M&M tractors, M&M UVs and Maruti cars. The company has historically traded at a discount to CIFC due to earnings volatility but at a premium to SHTF given its strong balance sheet and low cost of funds. The stock has run up by >50% in the last 3 months due to receding fears on asset quality and strong rural income. However, in our view, the current stock price still does not discount in full upside from the strong rural economy lifting disbursements across segments. We value vehicle financing business at 2.2x P/ABV and subsidiaries - housing finance at 1.0x P/B and insurance on the basis of last stake sale to arrive at our TP of Rs210.

Tailwinds for growth visible: MMFS has several tailwinds for growth going ahead – (1) Pick-up in disbursements due to strong farm cash flows and expected replacement demand in CVs (2) Improvement in NIM due to reduction in cost of funds (3) Moderation in opex expenses, leading to high profitability (4) improvement in asset quality, supported by strong rural income. We expect ROE to expand by ~500bps during FY21E-FY23E, supported by low credit cost and better utilization of capital towards disbursements.

Increased farm income augurs well for MMFS: We see some positive indicators - Khariff production is up 1% (despite strong base of FY20), Rabi sowing is up 4.9% YoY, improvement in rural wages and reduction in rural unemployment level. These indicate that the rural income may remain strong and should aid in lifting asset quality in the next few quarters. Despite 75% customers opting for moratorium until August'20, collection efficiency improved to 82% in Sept'20. vs normal 87%, indicating that stress will be lower than initially anticipated.

Robust balance sheet: MMFS' Tier 1/Total CAR stand at ~21% /25% (as of 2QFY21), well above the regulatory requirement of 10%/15% due to capital raise (Rs30.9bn) in 2QFY21. Even if we assume that 10% of the borrowers opt for restructuring (mgmt. guidance of 7-8%), additional provision requirement will only be 1%. MMFS has already provisioned 2.2% of AUM towards Covid-related stress and additional provisioning, if any may be very limited. However, the stock may experience some overhang due to restructuring. MMFS' ALM profile across buckets is strong (has remained so for year) and may not see any mismatch even in case of a downside scenario.

Valuation: We use the SOTP method to value MMFS, with the core business valued at 2.2x P/ABV (~20% discount to 5-year avg.) on FY23E due to uncertainty around asset quality given the SC's standstill clause. We expect discounts to historical valuation to erode with pick-up in disbursements. Risks: below normal monsoon causing rise in NPAs, slowdown in parent's business and Covid-related uncertainty.

Y/E March (Rsmn)	FY19	FY20	FY21	FY22	FY23
NII	46,700	51,130	55,851	59,578	67,896
PPOP	30,177	33,982	41,186	42,932	49,352
PAT	15,571	9,064	9,148	14,592	20,203
Loans	6,12,496	6,49,935	6,47,821	6,97,278	8,05,583
RoA (%)	*2.6*	*1.3*	*1.2*	*1.9*	*2.4*
RoE (%)	*15.8*	*8.3*	*7.0*	*9.4*	*12.0*
P/ABV	1.3	1.3	2.0	1.8	1.6

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: BFSI

CMP: Rs176

Target Price: Rs210

Upside: 19%

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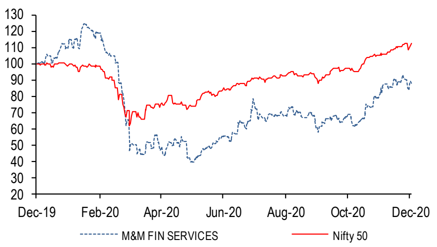
Key Data

Current Shares O/S (mn)	1,235.5
Mkt Cap (Rsbn/US$bn)	211.9/2.9
52 Wk H / L (Rs)	246/76
Daily Vol. (3M NSE Avg.)	11,457,180

Share holding (%)	2QFY21	1QFY21	4QFY20
Promoter	52.2	52.2	51.2
Public	47.5	48.5	48.4
Others	0.3	0.3	0.4

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
Mahindra & Mahindra Financial Services	3.1	57.4	(12.7)
Nifty Index	5.3	33.4	12.6

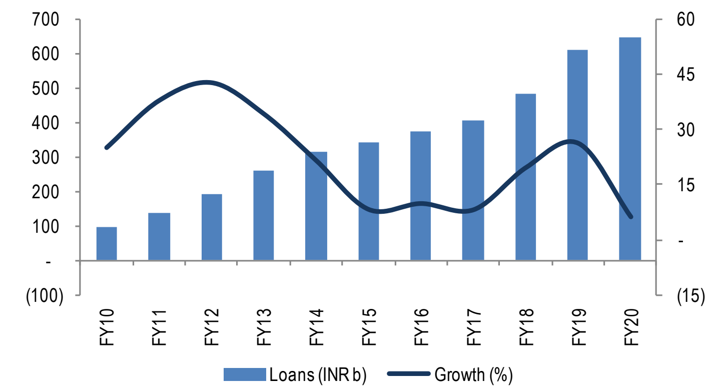
Source: Bloomberg

Executive Summary

MMFS is the largest financier for M&M's vehicles; in terms of units, the company financed about 39% of M&M's auto sales and 30% of the tractor sales in FY20. The proportion of M&M assets in MMFS's AUM stood at 43% as of Sept.20. As part of its growth strategy, MMFS has been increasingly financing vehicles of other manufacturers. The company has tie-ups with original equipment manufacturers (OEM) in the car segment while it also finances non-M&M tractors and heavy commercial vehicles. MMFS has high penetration in rural areas and mainly provides financing to customers with weak credit profiles. Therefore, the company is crucial to M&M's sales of rural and semi-urban products (tractors, pick-up vans and others).

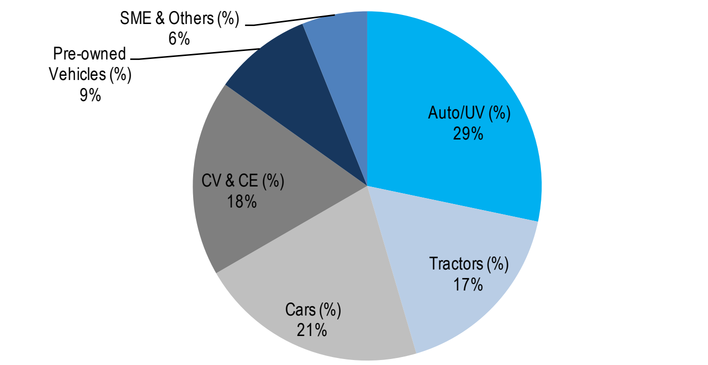
MMFS's AUM and loan outstanding stood at Rs817bn and Rs644bn as of 2QFY21. It's AUM and loan book have grown at a CAGR of 22% and 21% over FY10-20, respectively. High dependence on tractor sales and penetration in rural areas have led to high cyclicality in its disbursements.

Exhibit 1: Loan book growth at 21% CAGR over FY10-20



Source: Company, Nirmal Bang Institutional Equities Research

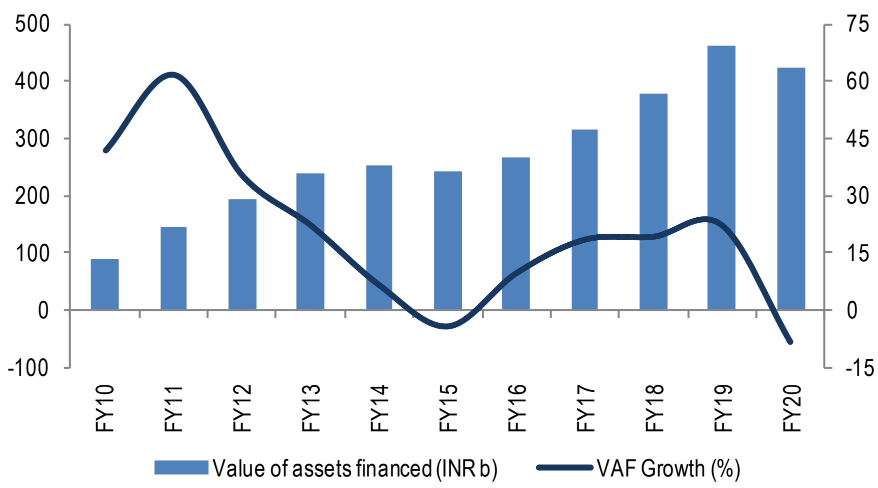
Exhibit 2: AUM Mix as of H1FY21



Source: Company, Nirmal Bang Institutional Equities Research

Value of asset financed (disbursements) has grown at a CAGR of 17% over FY10-20. Pre-owned vehicles and CVs have grown at a higher rate (10 year CAGR) while SME loans have declined (4-year CAGR). UV and tractors have grown at 14% 10-year CAGR. MMFS' disbursements growth has a strong linkage with monsoon variation due to its high penetration in the rural economy. Timely and well distributed monsoon bodes well for auto demand, especially that of tractors.

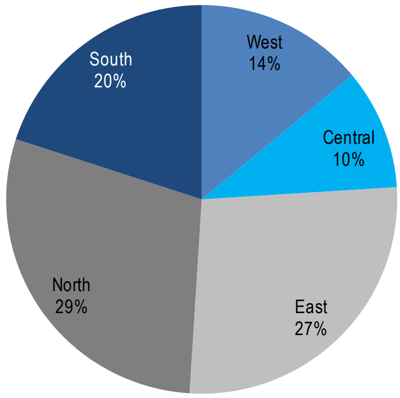
Exhibit 3: Value of assets financed grew at 17% CAGR over FY10-20



Source: Company, Nirmal Bang Institutional Equities Research

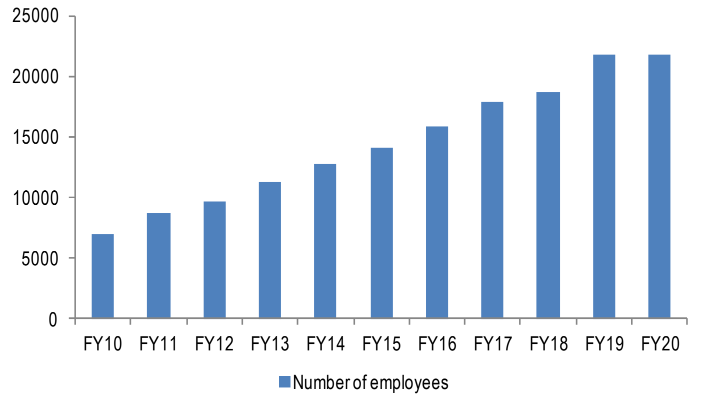
MMFS has considerably strengthened its distribution network: it had 1332 branches with a large number of branches in semi-urban and rural areas, where it enjoys a strong market share. The company has more than 21000 employees, including office staff and field officers. This network helps it to understand local conditions and customers quality. As a captive financier, MMFS has access to M&M's dealers, providing it direct access to customers and loan growth.

Exhibit 4: Geographical reach



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 5: Employee count on rise

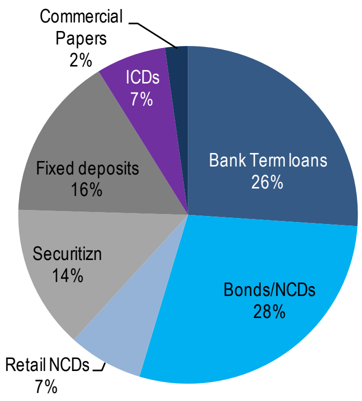


Source: Company, Nirmal Bang Institutional Equities Research

MMFS has diversified sources of funding, with access to banks and capital markets. It also has access to public, corporate and inter-corporate deposits. The company can mobilize funds from banks under the PSL category or through securitizations. The company has an option to raise funds through External Commercial Borrowings (ECB). MMFS enjoys low cost of funding due to its strong parentage. M&M infused Rs16bn into MMFS as part of the rights issue in Aug'20, indicating the former's commitment towards the financing vertical.

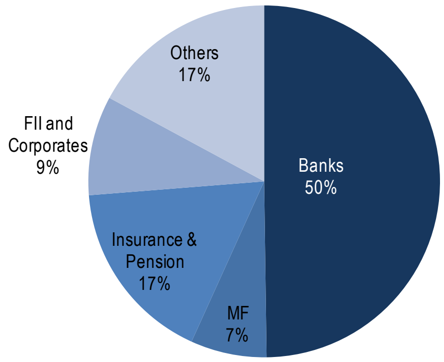
MMFS's ability to raise funds at a low cost compared to peers is the biggest differentiating factor. One of the recent bond raise of Rs2.5bn (2 year tenure) was done at the coupon rate of 4.8%. Improvement in the liquidity situation has further strengthened MMFS' position to raise funds at low costs.

Exhibit 6: Diversified sources of borrowings (Q2FY21)



Source: Company, NBIE

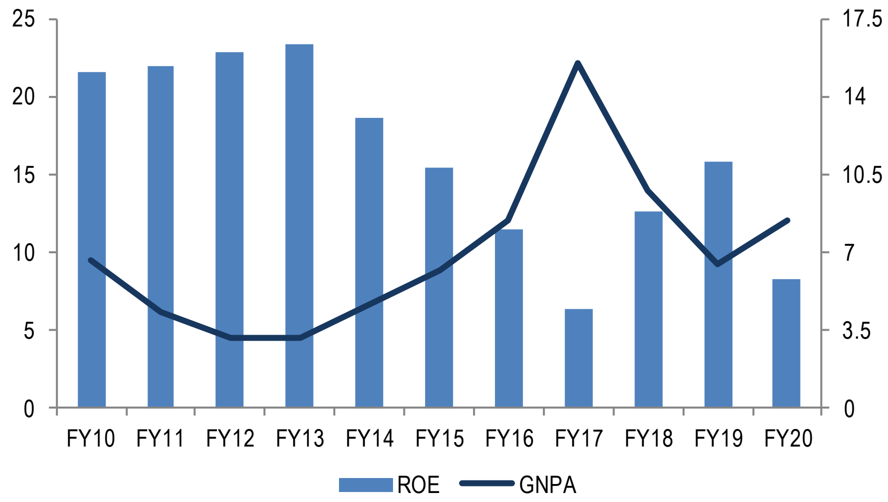
Exhibit 7: Diversified investor profile (Q2FY21)



Source: Company, NBIE

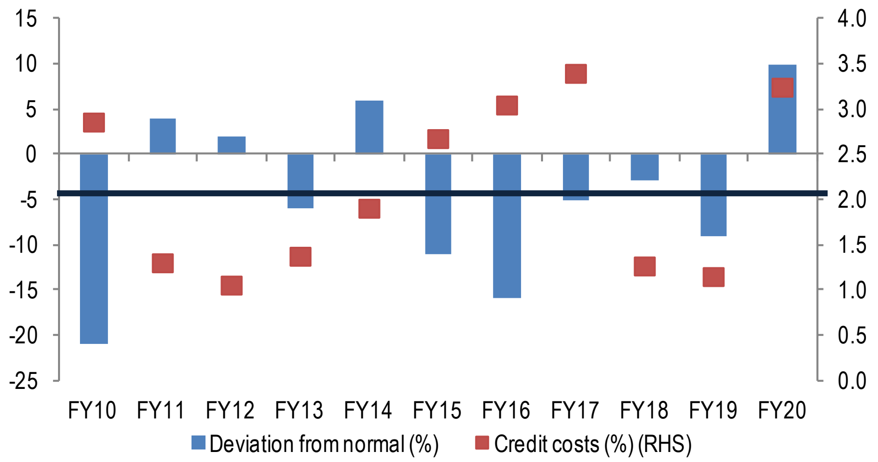
MMFS' earnings profile has been volatile due to increase in GNPA, consequent increase in interest reversals (pre-IndAS) and provisions. This has led to volatility in ROE. MMFS' customers are strongly dependent on farm cash flows and below normal monsoon rains lead to increase in credit costs. This has led to volatility in the company's ROE.

Exhibit 8: ROE has been volatile over last 7 years due to increase in GNPA



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 9: Impact of monsoons on credit costs



Source: Company, Nirmal Bang Institutional Equities Research

=Note: Lower credit costs in FY19 were due to drop in PCR from 34% to 19%; Increase in credit costs in FY20 was on account of covid related additional provisions

Risks

- Cyclical business, below normal monsoon may lead to pile up in GNPAs, impacting profitability
- Any slowdown in M&M will directly impact disbursements for MMFS
- Economic slowdown leading to stress in CVs
- Aggressive competition from banks and other NBFCs
- Covid reaching hinterlands

Increased farm income augurs well for MMFS:

MMFS has strong linkages with the rural economy, with disbursements and asset quality being strong during years with above normal monsoon. The case in point being periods of FY12-16 and FY19 when farm cash flows declined, resulting in low disbursements for MMFS. Low farm incomes led to loan defaults, thereby increasing GNPAs and credit cost.

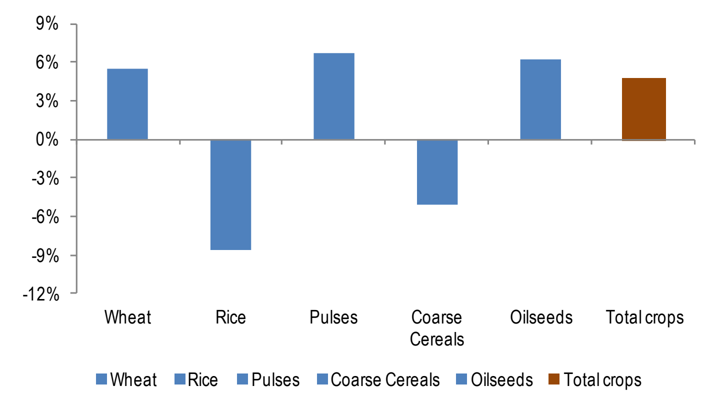
We see some positive indicators which make us believe that rural incomes will remain strong over the next one year. The Khariff production has been up 1% (despite strong base of FY20) and Rabi sowing is already up 4.9% YoY. MoM growth in rural wages has been in the range of 5-7% vs 3-5% a year ago. Rural unemployment has shown an improving trend but has remained volatile.

Exhibit 10: Rural consumption indicators – YoY growth shows some green shoots

Rural consumption indicators	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20
Currency in circulatiom (% YoY)	11.9	11.5	14.5	15.7	18.4	20.6	22.2	23.2	22.7	20.3	22.2
Rural wage (% YoY)	4.5	4.5	4.0	0.0	5.7	5.7	7.5	6.6	5.4	N.A	N.A
Rural unemployment (% YoY)	6.1	7.3	8.4	22.9	22.5	10.5	6.5	7.7	5.9	6.9	6.3
Tractor Sales (% YoY)	4.8	21.3	(49.9)	(79.4)	4.0	22.4	38.5	74.7	28.3	7.7	51.3
2W sales (% YoY)	(16.1)	(19.8)	(39.8)	(96.2)	(83.8)	(38.6)	(15.2)	3.0	11.6	16.9	13.4
Diesel consumption (% YoY)	(1.6)	6.6	(24.0)	(55.6)	(29.5)	(15.4)	(19.5)	(20.7)	(6.0)	7.4	(6.9)
Consumer non-durables (% YoY)	(0.3)	0.0	(20.2)	(48.1)	(9.7)	14.3	1.8	(2.3)	2.4	7.5	N.A

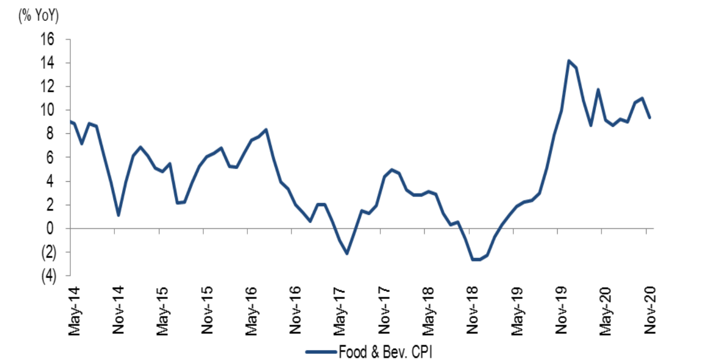
Source: Nirmal Bang Institutional Equities Research

Exhibit 11: Rabi sowing up 4.9%



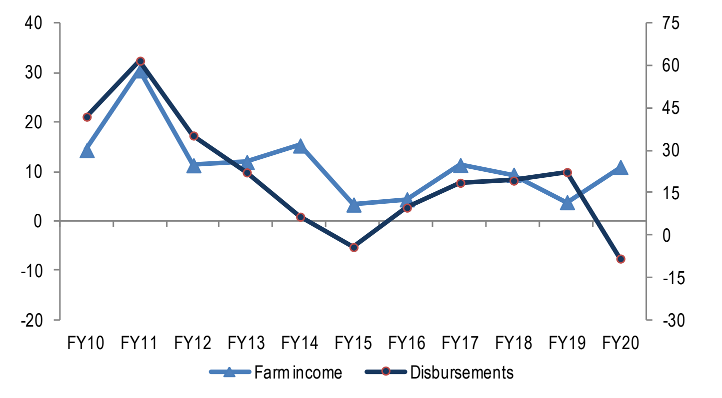
Source: Govt websites, Nirmal Bang Institutional Equities Research

Exhibit 12: CPI inflation in food basket remains high



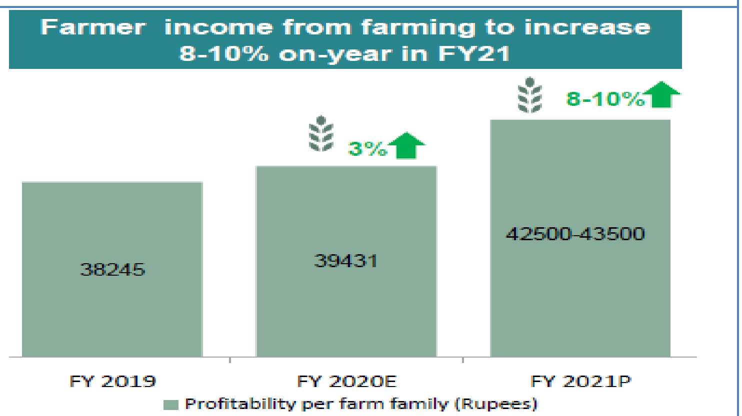
Source: Govt websites, Nirmal Bang Institutional Equities Research

Exhibit 13: Farm income and MMFS disbursements



Source: Govt websites, Nirmal Bang Institutional Equities Research

Exhibit 14: Farm income projected to increase by 8-10% in FY21



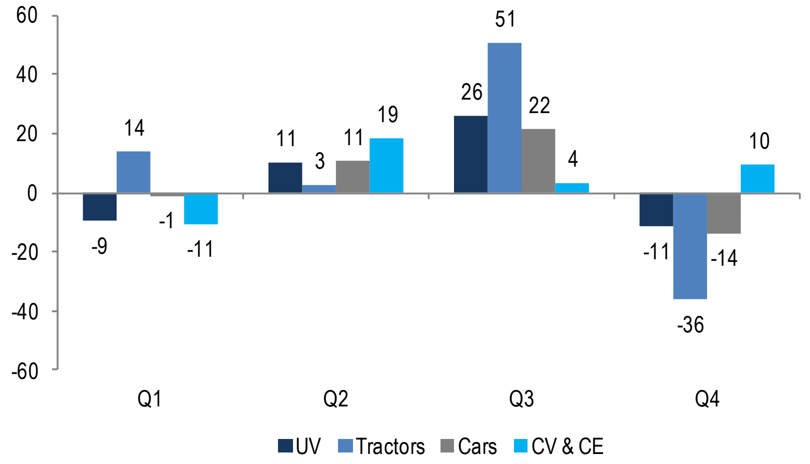
Source: Crisil estimates, Nirmal Bang Institutional Equities Research

Note: Disbursements declined due to onset of Covid in FY20

Business cyclicality

MMFS' disbursements are highly cyclical. 3Q accounts for the highest disbursements sequentially as farm incomes start trickling in and as farmers enter Rabi sowing season. High dependence on 3Q for disbursements makes the business more vulnerable compared to its peers. Demand for tractors is the highest in 3Q followed by UVs & Cars. Generally, UVs are also used for transportation of agricultural produce.

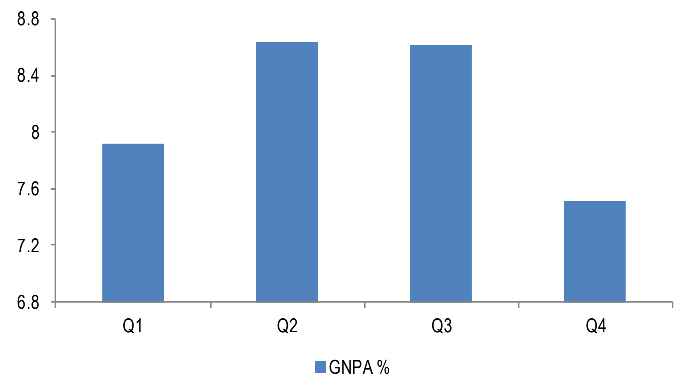
Exhibit 15: Average sequential growth in disbursements from Q1-Q4 over FY14-20



Source: Company, Nirmal Bang Institutional Equities Research

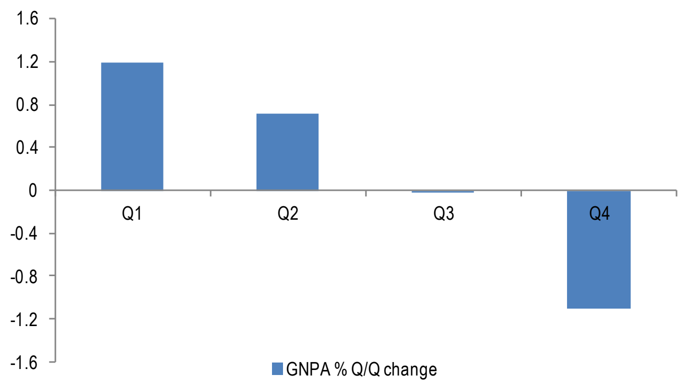
Along with disbursements, cyclicality is also observed in asset quality improvement in 4Q. GNPAs generally peak in 3Q and reduce in 4Q as Rabi season cash flows start coming in.

Exhibit 16: Average GNPA % over quarters



Source: Company, Nirmal Bang Institutional Equities Research

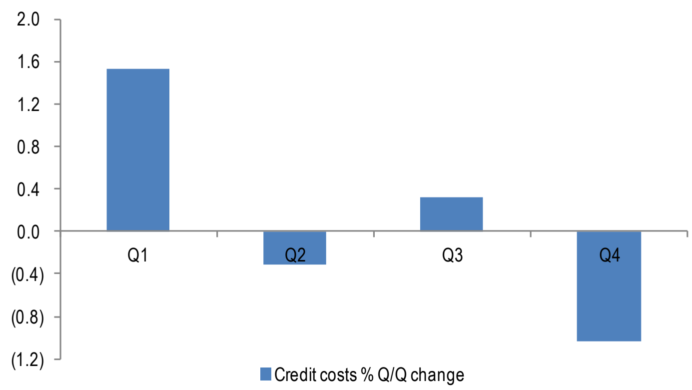
Exhibit 17: GNPA % sequentially registers a decline in Q4



Source: Company, Nirmal Bang Institutional Equities Research

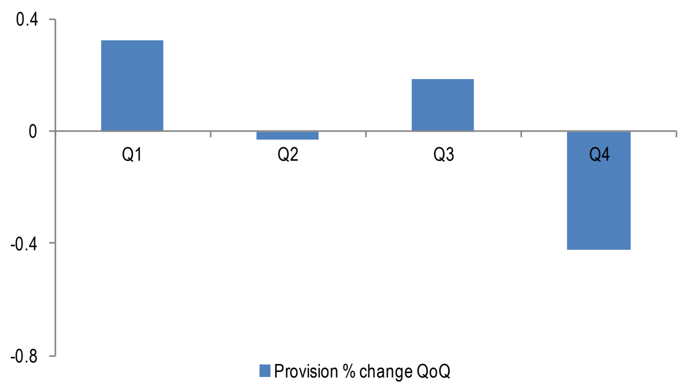
Provisions as a percentage of AUM decline in 4Q along with reduction in GNPAs, thereby reducing credits cost.

Exhibit 18: Average Credit cost % QoQ decline in Q4



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 19: Average Provision % change QoQ



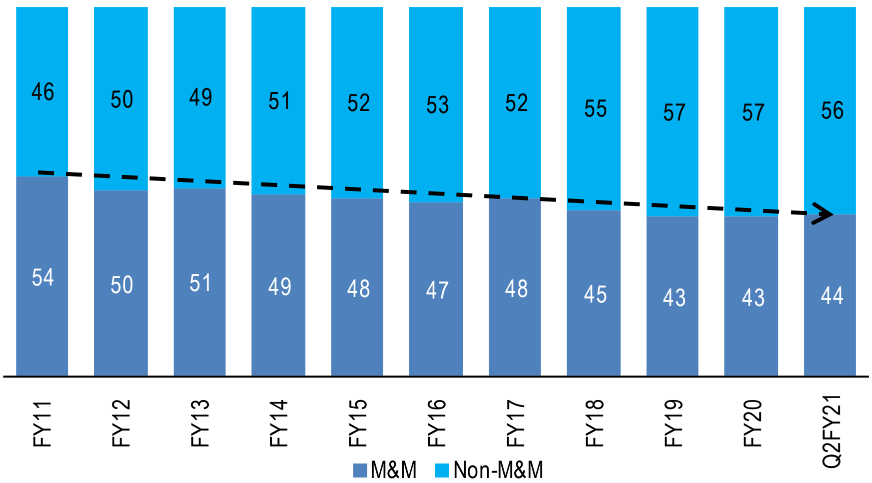
Source: Company, Nirmal Bang Institutional Equities Research

Company has diversified in terms of financing for non-M&M OEMs over last few years

MMFS is an important entity for launching M&M's new products in the rural geographies and securing a foothold in the target market. MMFS shares its parent's brand name and has strong operational linkages with it. MMFS targets minimum 40% share in Mahindra auto products, and in overall tractor sales, its share is at 40%. Strong volume growth for M&M results in AUM mix tilting towards the parent's auto financing. M&M infused Rs16bn into MMFS as part of the rights issue, which closed in August'20, indicating the former's commitment towards the financing vertical.

MMFS has established strong relationships with other auto OEMs. Financing of M&M vehicles as a proportion of MMFS' total loan disbursements has declined from 54% in FY11 to 43% as of 2QFY21. MMFS financed ~39% of M&M's auto sales and 30% of M&M's tractor sales in FY20.

Exhibit 20: Share of other OEM's increased in disbursements

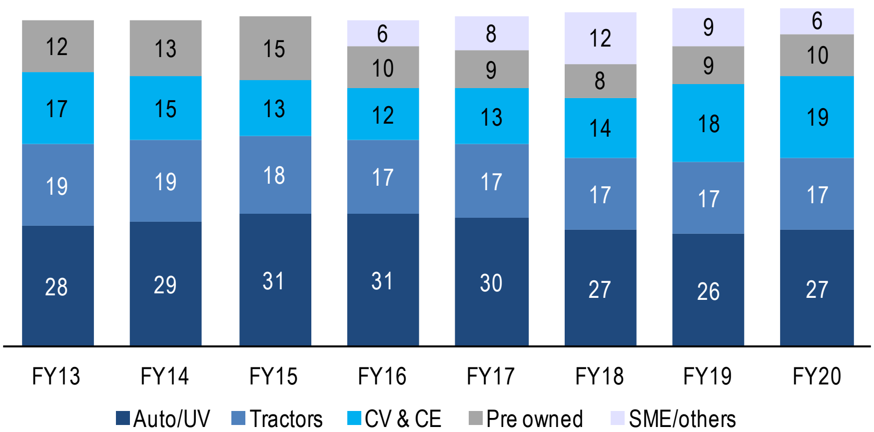


Source: Company, Nirmal Bang Institutional Equities Research

AUM mix largely constant

MMFS' AUM mix has largely remained constant for UVs and tractor financing. The share of pre-owned vehicles and cars has declined while the share of CVs has increased. MMFS strategically reduced MSME funding in FY19-20 due to stress in that sector.

Exhibit 21: AUM Mix

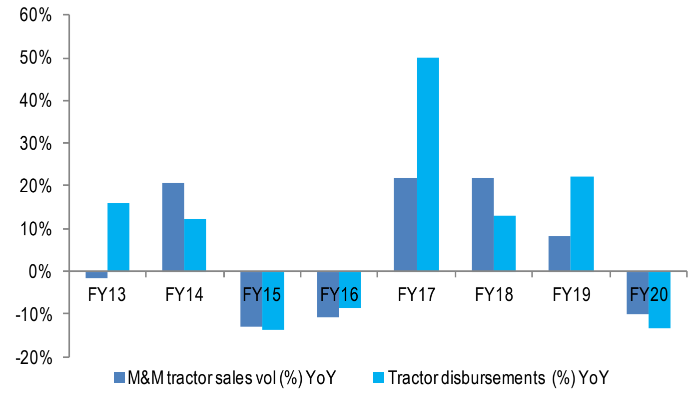


Source: Company, Nirmal Bang Institutional Equities Research

OEM linkages

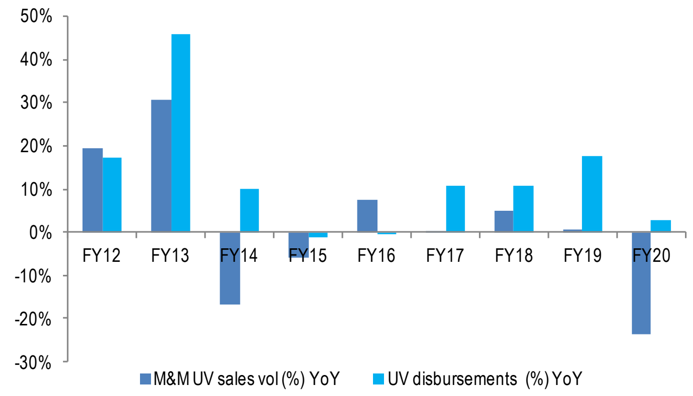
MMFS is a captive financier for M&M and therefore its growth is strongly linked to volume growth of the parent company. Such high dependence on parent adds an advantage in up-cycle but acts as a drag in a down cycle. Maruti accounts for ~51% market share of the PV industry (63% in cars) and has a strong dealership network even in rural India. In fact, rural penetration of other OEMs is also positive and may lead to higher growth for MMFS.

Exhibit 22: Tractor disbursement linked to M&M tractor's volume growth



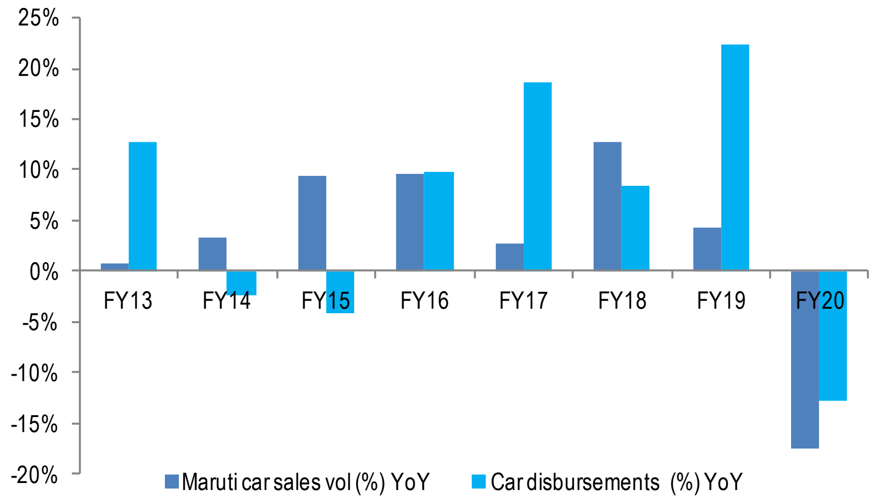
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 23: UV disbursement linked to M&M UV's volume growth



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 24: Disbursements in car linked to Maruti's PV volume growth



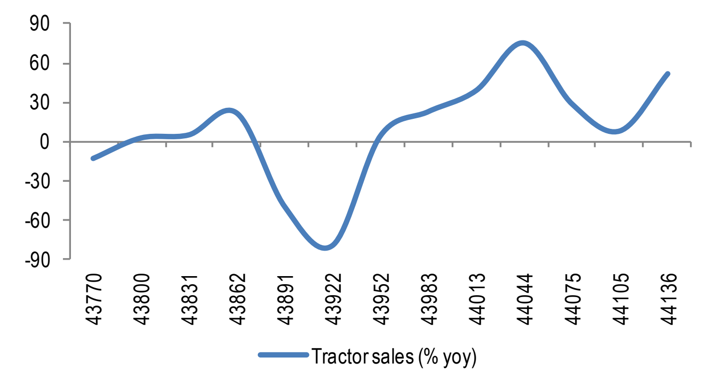
Source: Company, Nirmal Bang Institutional Equities Research

Tailwinds for growth visible

MMFS has several tailwinds for growth going ahead – (1) Pick-up in disbursements due to strong farm cash flows and expected replacement demand in CVs (2) Improvement in NIM due to reduction in cost of funds (3) Moderation in opex expenses, leading to high profitability (4) improvement in asset quality, supported by strong rural incomes.

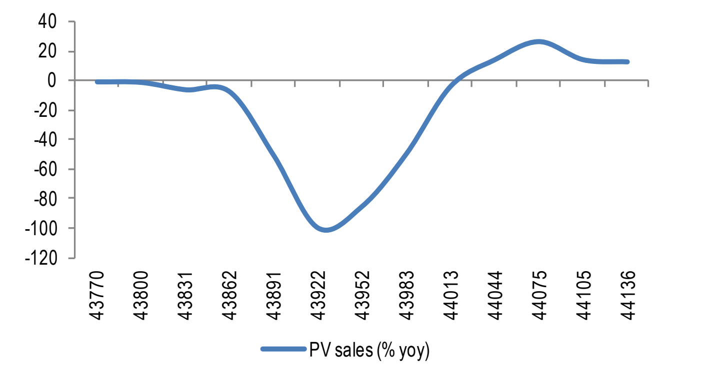
Growth in tractors has remained resilient while demand for cars & UVs is growing due to preference for personal mobility. PV data is showing positive growth in the last four months after being in the negative territory for 19 months. Our channel checks suggest that demand for used vehicles is picking up strongly. However, supply remains an issue.

Exhibit 25: Tractor sales remain strong over last 7 months



Source: Industry, Nirmal Bang Institutional Equities Research

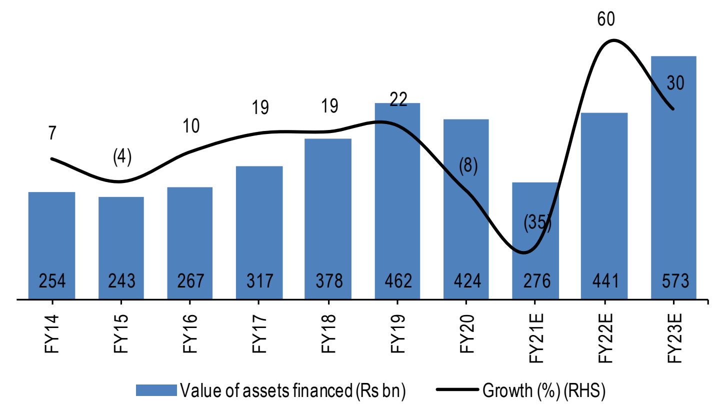
Exhibit 26: Car sales pick up from Aug 20



Source: Industry, Nirmal Bang Institutional Equities Research

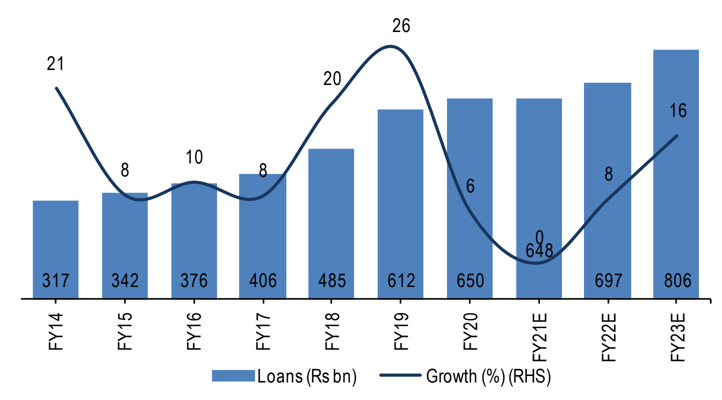
This should translate into disbursement growth for MMFS. CV cycle has been in a negative territory for the last 6 quarters and in our view, strong replacement demand is expected to kick in FY22 onwards. Increase in farm incomes should translate into higher demand for PVs. We estimate MMFS' disbursements to grow at a CAGR of 10.6% over FY20-FY23E.

Exhibit 27: Disbursements to grow at 11% over FY20-23E….



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 28: …resulting into 7% increase in loans (AUM)

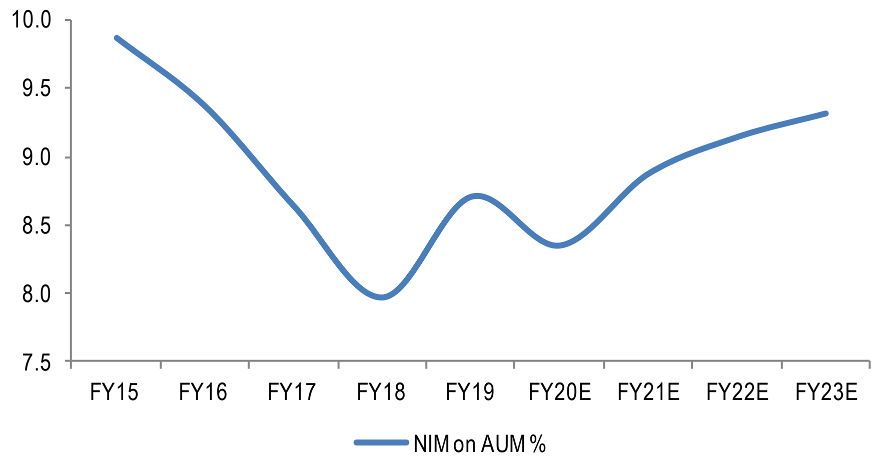


Source: Company, Nirmal Bang Institutional Equities Research

NIMs set to improve

Interest yields have been volatile for MMFS due to interest reversals on GNPAs (pre-IND AS). However, post IndAS, there is no impact of interest reversals, and interest yields stabilised at ~15.7% in FY19-20. The cost of funds has been relatively stable ~8.5% over the last three years despite liquidity crisis in FY18. Management has guided towards increasing share of pre-owned vehicles from 9% in FY20 to 15% over the next 2-3 years. Change in mix towards high yield products and reduction in borrowing cost should augur well for margin expansion. We build in ~100bps NIM expansion over FY20-23E.

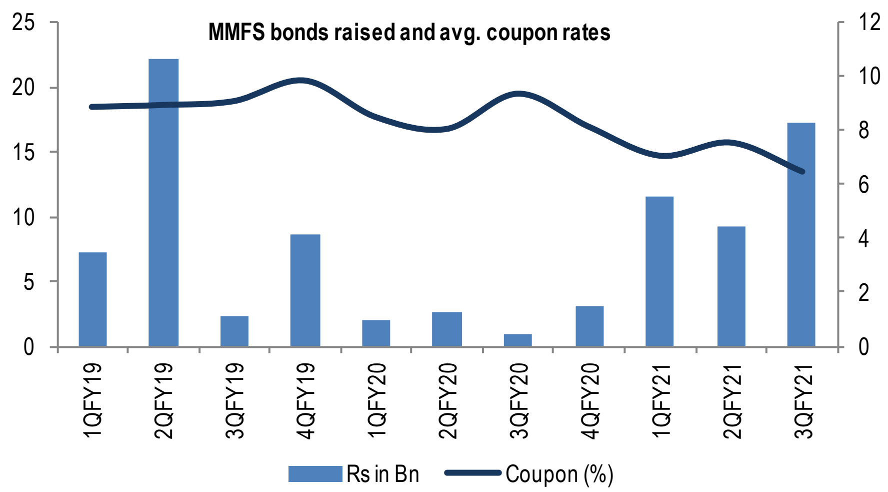
Exhibit 29: NIMs to improve



Source: Company, Nirmal Bang Institutional Equities Research

Coupon rates for recent bonds issued by MMFS have been at all-time low. Company has been able to raise 3 year bonds (Rs4.25bn) at rate as low as 5.2% in Dec'20. Overall cost of funding for MMFS is the lowest among auto NBFC peers.

Exhibit 30: Bond coupon rates on decline for MMFS



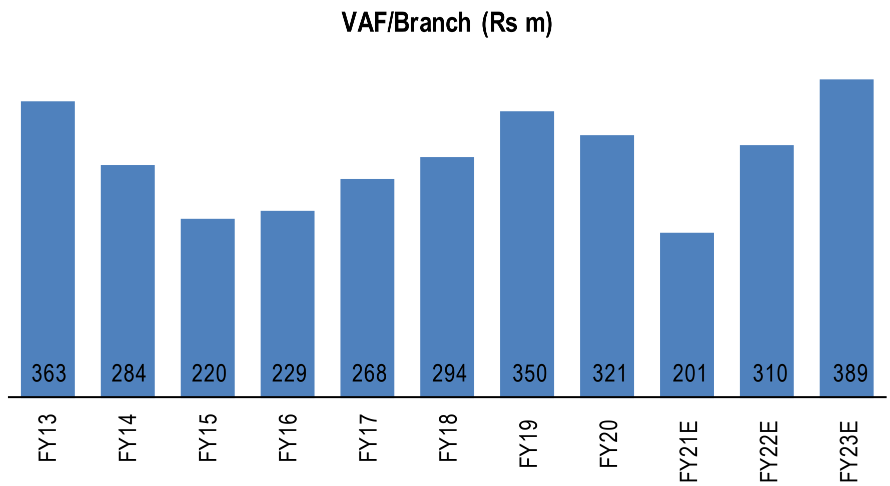
Source: Bloomberg, BSE filings, NBFC

Operating expenses likely to moderate, operating leverage to kick in

Value of assets financed (VAF, invoice value of disbursements done) declined from Rs363mn in FY13 to Rs321mn in FY20 after rampant branch additions over FY14-16. With expectations of growth coming back, in our view, productivity ratios will get a boost.

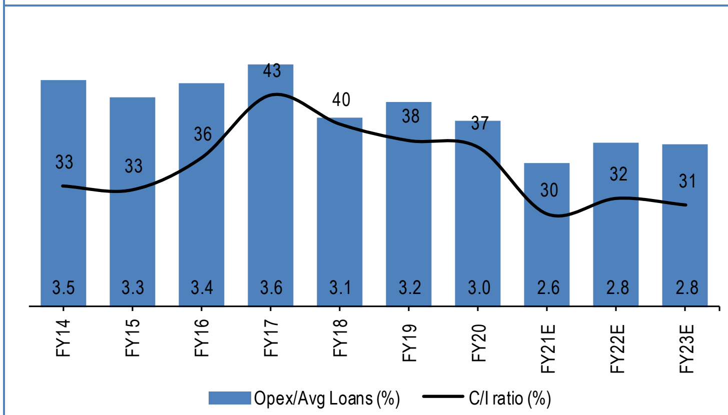
Opex/average branch increased drastically in FY19 due to increase in employee costs on the back of 16% increase in employee count. We expect this cost to moderate going ahead as employee productivity increases and less number of employees is added per branch. Management alluded to opex/AUM at 2.4% for the next few years.

Exhibit 31: VAF/branch likely to improve with increase in employee productivity



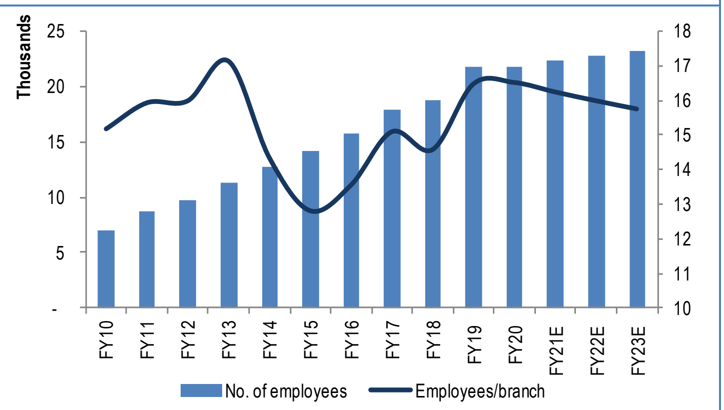
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 32: We expect opex/AUM % to improve..



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 33: …with rationalization of Employee/branch

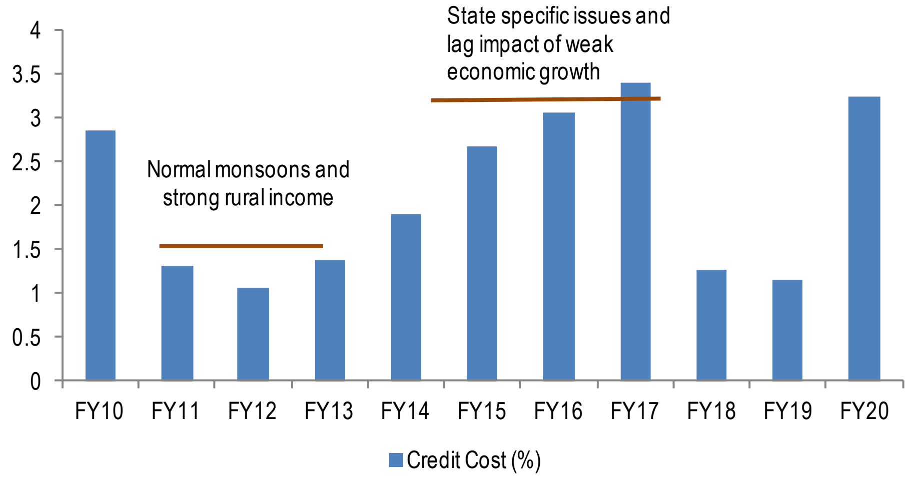


Source: Company, Nirmal Bang Institutional Equities Research

Credit cost high in years of rural income stress; increase in farm income bodes well

A key feature of MMFS' business model is that growth and asset quality are highly related. The borrower profile for MMFS is largely dependent on farm cash flows and infra spends in rural areas in order to pay their debts. The periods of FY11-13 and FY18 witnessed normal monsoons, resulting in low credit costs. FY15-16 was affected due to weak economic environment and change in provisioning norms, resulting in high credit costs. FY17 was affected due to demonetization whereas provisions increased in FY20 due to increase in covid-related provisions.

Exhibit 34: Credit costs strongly related to rural buoyancy



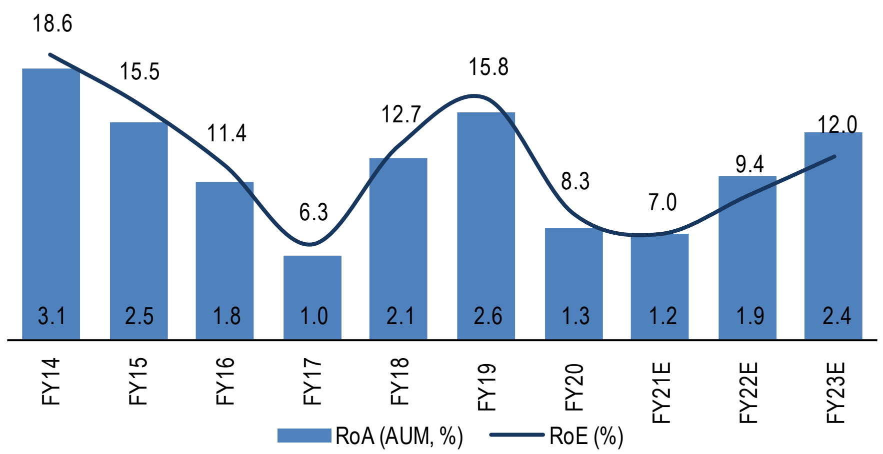
Source: Company, Nirmal Bang Institutional Equities Research

Note: Credit costs lower in FY19 due to reduction in PCR from 34% to 19%

ROE and ROA to improve with improvement in profitability

We build in RoE expansion of 500bps over FY21E-FY23E to 12%, supported by 49% CAGR in profitability (low base). MMFS's profitability has remained very volatile and generally improves only in the years of strong farm cash flows (due to good monsoons, high MSPs, improvement in rural infra etc).

Exhibit 35: ROE and ROA set to expand

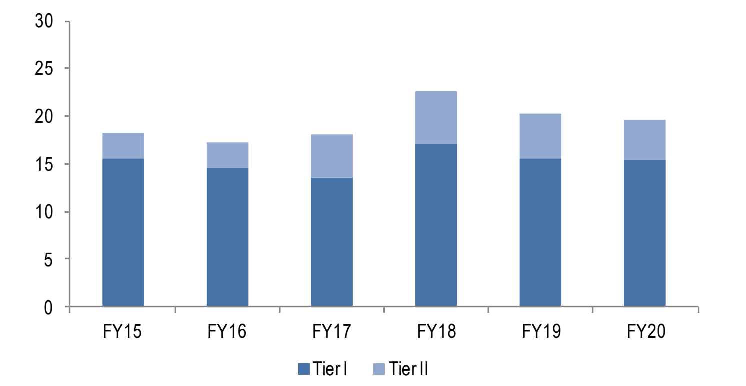


Source: Company, Nirmal Bang Institutional Equities Research

Balance sheet strong; parent support lends resilience

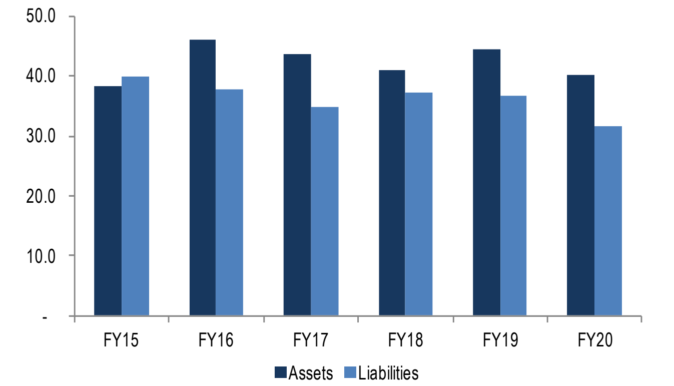
MMFS' strong parentage, M&M, gives it relatively more strength when it comes to its risk perception in the market and thereby low rate of interest compared to peers. MMFS' Tier 1 capital now stands at ~21% (as on 2QFY21), well above the regulatory requirement of 10% while the CAR stands at ~25%, way above the regulatory requirement of 15%. The increase in the capital adequacy was helped by a capital raise (Rs30.9bn) in 2QFY21. ALM mismatch across buckets has remained robust over the years.

Exhibit 36: Tier 1 capital is comfortably above the minimum requirement of 10%



Source: Company data, Nirmal Bang Institutional Equities Research

Exhibit 37: Asset liability match (1 year tenure)



Source: Company data, Nirmal Bang Institutional Equities Research

The credit ratings from agencies reflect MMFS' strong credit profile and ability to raise funds. The ratings are also supported by its parentage (M&M Group, which holds ~52% stake in the company) and MMFS' healthy market position in tractors and auto finance in rural areas.

Exhibit 38: Credit rating

Loan type	India Ratings	CARE Ratings	Brickwork	Crisil
LT & SD	IND AAA	CARE AAA	BWR AAA	Crisil AA+
STD	IND A1+	-	-	Crisil A1+
Bank Facilities	IND AAA	-	-	-
Fixed deposit Programme	-	-	-	FAAA

Source: Company data, Nirmal Bang Institutional Equities Research

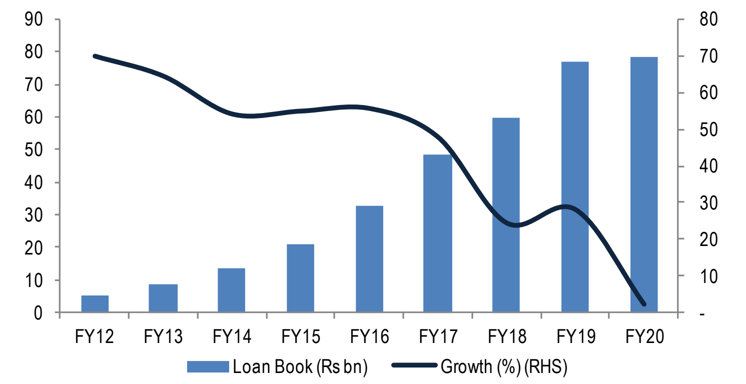
In FY15, India Rating and Brickwork upgraded MMFS' long term debt rating to AAA.

Key Subsidiaries:

Mahindra Rural housing Finance Ltd

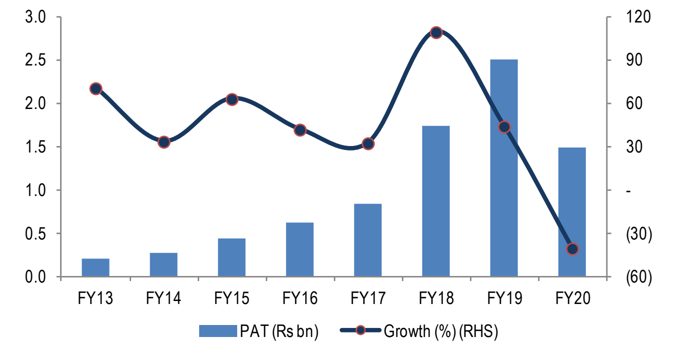
MMFS provides housing finance to individuals through its subsidiary, Mahindra Rural Housing Finance Limited (MRHFL), a registered housing finance company. MMFS holds 98.4% stake in MRHFL and the balance is held by MRHFL Employee Welfare Trust. MRHFL grants housing loans for purchase, construction, extension and renovation of property. Majority of the loans are to the customers in villages with an average annual household income of less than ~Rs0.2m. Asset quality is low due to stress largely from Maharashtra. In FY20, disbursements were affected due to MRHFL management's focus on collections.

Exhibit 39: Loan book growth strong @ 40% CAGR



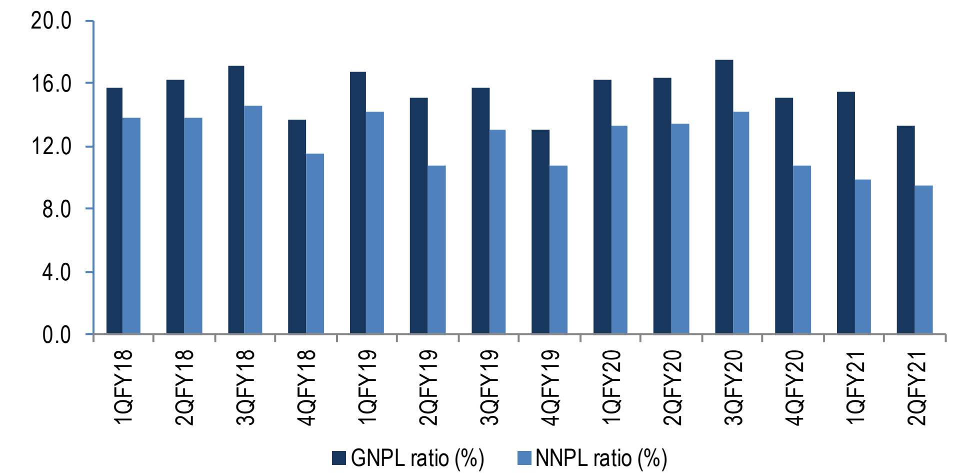
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 40: PAT growth on a YoY basis remain strong



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 41: Asset quality slightly better in FY 20 due to mgmt. focus on collections

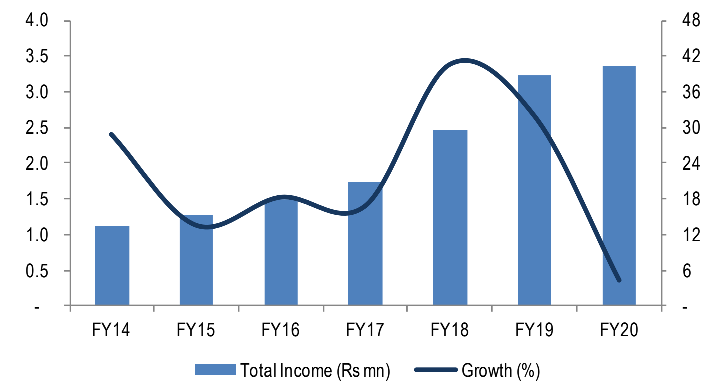


Source: Company, Nirmal Bang Institutional Equities Research

Mahindra Insurance Brokers Ltd

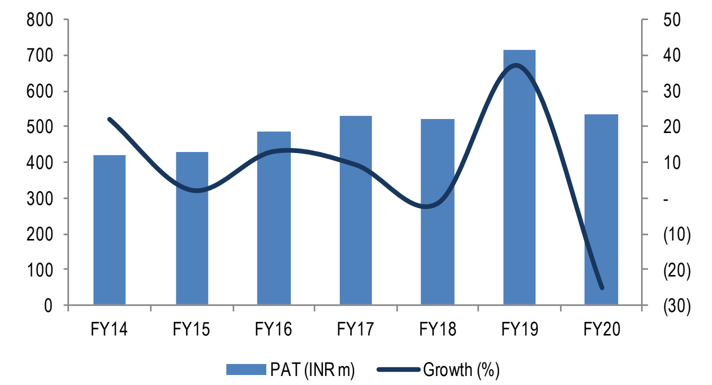
MMFS offers insurance broking through its subsidiary - Mahindra Insurance Brokers Ltd (MIBL). Started in 2004 as a wholly-owned subsidiary, currently MMFS holds ~80% stake in the company. The balance 20% stake is held by Inclusion Resourced Pvt. Ltd, Sri Lanka. This company is engaged in insurance broking for life, non-life products and re-insurance business, especially targeting rural customers. Currently, it has 1145 employees, covering ~2 lakh villages. No. of policies in H1FY21 was down 51% at 0.53m, impacting net premium (down 24% YoY) and profitability (down 67% YoY).

Exhibit 42: Total income improved steadily



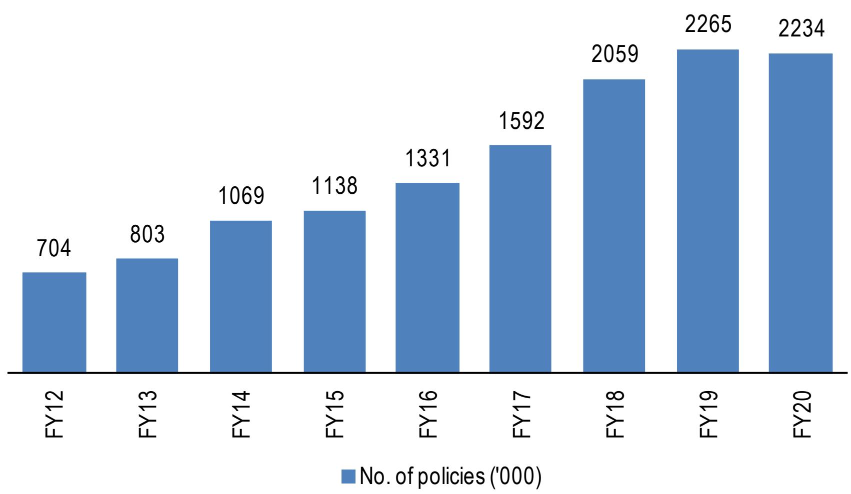
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 43: PAT growth has remained tepid over last 4 yrs ex-FY19



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 44: No. of policies



Source: Company, Nirmal Bang Institutional Equities Research

Valuation & Risks

Valuation

Premium valuation for best-in-class business

MMFS historically has traded at a discount to CIFC (>15% in the last 5 years), but at a premium to SHTF (>10% in the last 5 years) when compared on 12-month forward adjusted P/B. It stands now at adj. P/B of 1.8x and P/E of 14.5x. We believe that the premium to SHTF is justified given its strong parentage and the discount to CIFC is justified due to its high volatility in earnings. On P/ABV, MMFS has traded at 2.7x (5 year average multiple).

We have used SOTP methodology to arrive at the total valuation after valuing MMFS standalone at 2.2x (~20% discount to 5 years' average) on 2023 adjusted book value. Then, we added subsidiaries' valuation. We use 20% discount to its 5-year average given its highly volatile earnings.

Exhibit 45: SOTP March 2023 Based (Rs)

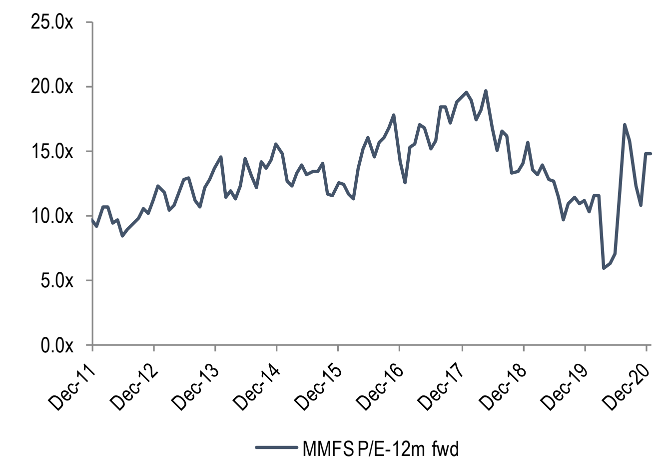
SOTP March 2023 Based (Rs)	Networth	PAT	Multiple	Value (Rs bn)	Value/Sh. (Rs)	% of total	Rationale
Core business	**1,08,992**	**NA**	**2.2**	**240**	**194**	**92.5**	**2.2x ABV**
Key Ventures							
Mahindra Rural Housing Finance	16,392		**1.0**	16	13	6.3	1.0x BV
Mahindra Insurance Brokers				11	9	4.3	1.5x Based on last stake sale value
Total Value of Ventures				**28**	**22**	**10.7**	
Less: 30% holding discount				8	7	3.2	
Value of Key Ventures				**19**	**16**	**7.5**	
Target Value Post 30% Holding Co Disc				**259**	**210**	**100.0**	
CMP				217	176		
Upside - %				***19.5***	***19.5***		

Source: Company, Nirmal Bang Institutional Equities Research

The stock has run up by >50% in the last three months as the asset quality fears have subsided due to increase in collection efficiency. However, in our view, the current stock price still does not completely price in full upside from the strong rural economy lifting disbursements across segments.

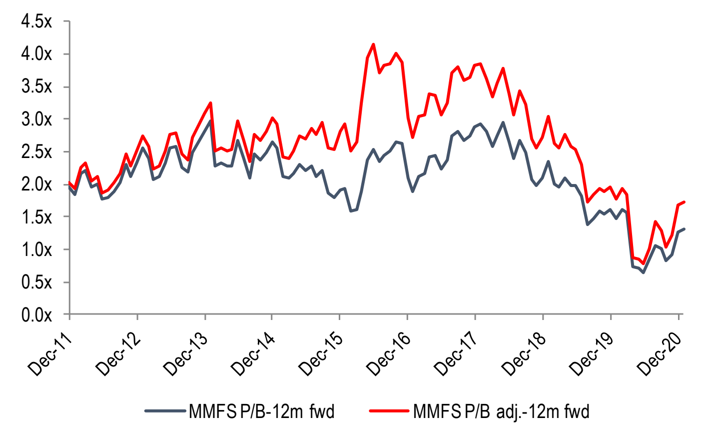
The stock has under-performed the Nifty 50 by 28% and the Bank Nifty by 10% since the beginning of the year. In the last 5 years, the stock has under-performed the Nifty 50 by 58% and the Bank Nifty by 64%.

Exhibit 46: MMFS P/E - 12m fwd



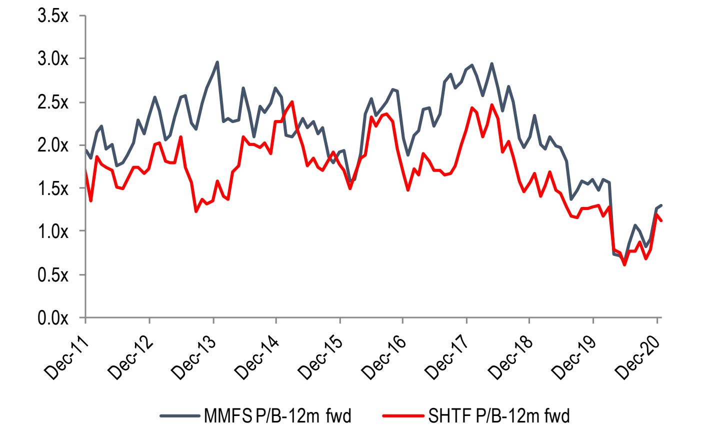
Source: Bloomberg

Exhibit 47: MMFS P/B -12m fwd



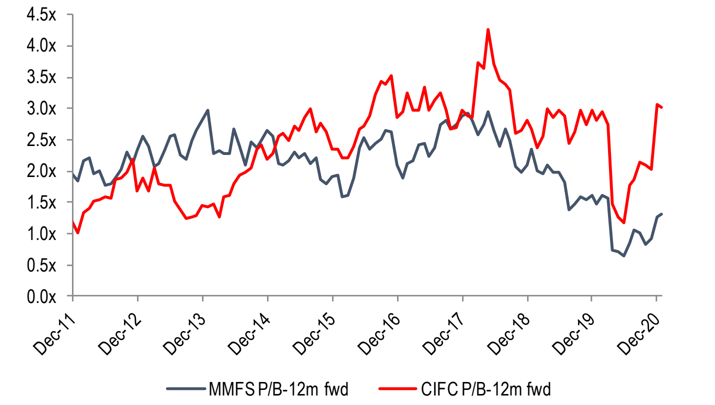
Source: Bloomberg

Exhibit 48: MMFS vs. SHTF P/B-12 m fwd



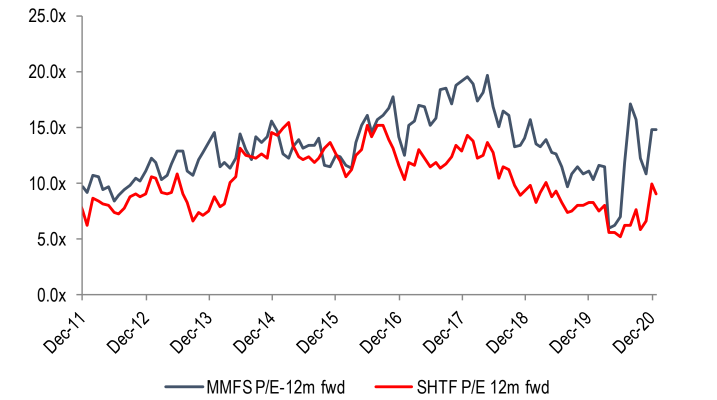
Source: Bloomberg

Exhibit 49: MMFS vs. CIFC P/B -12m fwd



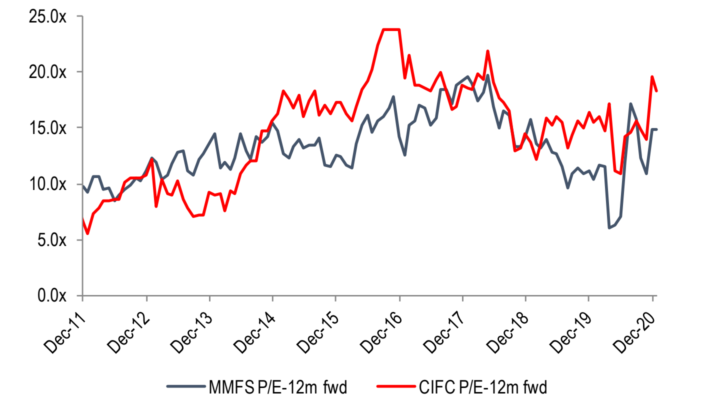
Source: Bloomberg

Exhibit 50: CIFC vs. SHTF P/E - 12 m fwd



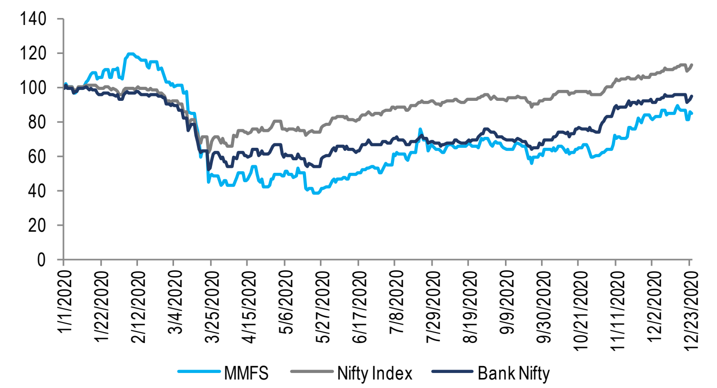
Source: Bloomberg

Exhibit 51: CIFC vs. MMFS P/E -12m fwd



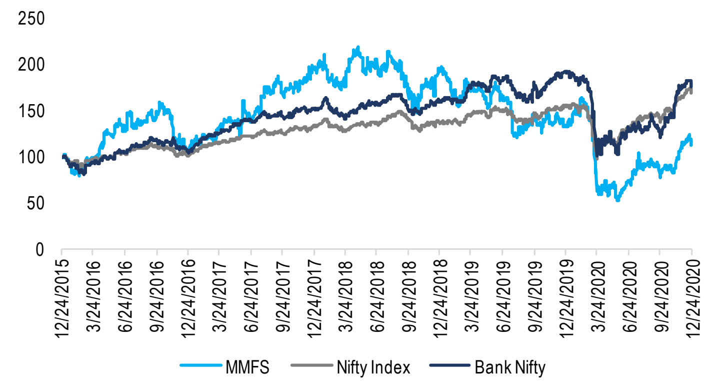
Source: Bloomberg

Exhibit 52: MMFS performance YTD rel. to Nifty 50



Source: Bloomberg

Exhibit 53: MMFS performance last 5 years re. to Nifty 50



Source: Bloomberg

Exhibit 54: Peer valuation

	Price	M cap	P/B			P/B- adj.			P/E			ROE			ROA		
Name	(Rs)	Rs. (bn)	FY21	FY22	FY23	FY21	FY22	FY23	FY21	FY22	FY23	FY21	FY22	FY23	FY21	FY22	FY23
CIFC	386.4	317	3.4x	2.9x	2.4x	4.2x	3.5x	2.8x	22.6x	16.0x	13.7x	16.0%	19.4%	19.2%	2.1%	2.7%	2.8%
SHTF	1016.1	257	1.2x	1.1x	1.0x	2.0x	1.7x	1.4x	13.2x	9.6x	8.2x	9.6%	12.0%	12.8%	1.6%	2.1%	2.2%
MMFS	175.8	217	1.5x	1.4x	1.2x	2.0x	1.8x	1.6x	23.7x	14.9x	10.7x	7.0%	9.4%	12.0%	1.2%	1.9%	2.4%

Source: Nirmal Bang Institutional Equities Research

Risks:

High dependence on monsoons: MMFS has substantial proportion of loans advanced to borrowers wherein dependency on agriculture is high. Below normal monsoon or drought situation leads to deceleration in disbursements and pile-up in bad debts.

Slowdown in parent's business: M&M makes up ~43% of MMFS' disbursements. Any decline in M&M's sales due to unforeseen circumstances or downturn in an economy may affect disbursements for MMFS. In addition, it limits the ability of MMFS to alter its AUM mix to suit business cycles.

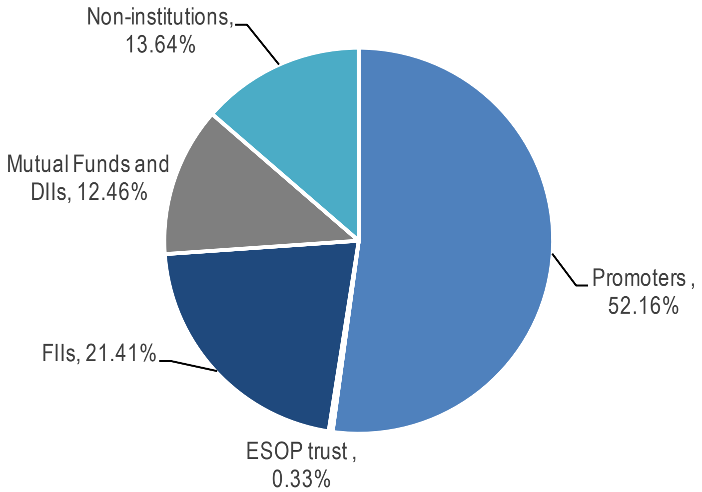
Cyclical nature of business: MMFS is mainly present in rural and semi-urban areas, making its business susceptible to vagaries of the rural economy. While the AUM growth has been impressive, the earning profile has been very volatile. Company has diversified into other businesses like rural housing and insurance. But, the target segment remains the same.

	Management & Board of Directors
Mr. Dhananjay Mungale, Chairman and Independent Director	He is a member of the Institute of Chartered Accountants of India and has a Bachelor's Degree in Commerce and Law from Mumbai University. He has spent a major part of his career in corporate and investment banking in India and Europe. He was Vice President – Private Banking, Bank of America and was a Member – Executive Committee, DSP Merrill Lynch Limited. Presently, he is an advisor to various corporations in both, India and Europe.
Mr. Ramesh Iyer Vice Chairman & MD - MMFSL, President - Financial Services Sector & Member of the GEB – M&M Limited	He has been instrumental in building Mahindra Finance since 1994 into one of India's leading rural finance companies. Mr. Iyer manages the Financial Services Sector of the Mahindra Group which includes Mahindra & Mahindra Financial Services Limited, Mahindra Insurance Brokers Limited, Mahindra Rural Housing Finance Limited, Mahindra Manulife Investment Management Private Limited and Mahindra Manulife Trustee Private Limited.
Mr. C. B. Bhave, Independent Director	He started his career in the IAS in 1975 and worked in different positions in the Central and State Governments. He then worked in SEBI as a Senior Executive Director from 1992–1996, helping create the regulatory infrastructure for Indian capital markets. He set up the National Securities Depository Limited (NSDL) in 1996 and was its Chairman and Managing Director from 1996 to 2008. Mr. Bhave was the Chairman of SEBI, India's capital markets regulator, from 2008 to 2011.
Mrs. Rama Bijapurkar, Independent Director	She has an independent market strategy consulting practice and almost four decades of experience in market research and market strategy consulting. She has served on the boards of several blue chip corporates and social organisations and is a professor of management practice at IIM Ahmedabad, and author of acclaimed books on India's consumer market and consumer based business strategy.
Mr. Milind Sarwate Independent Director	He is a Chartered Accountant, Cost Accountant, Company Secretary, Commerce Graduate and CII-Fulbright Fellow (Carnegie Mellon University, Pittsburgh, USA). He brings over 35 years of experience in Finance, HR, Strategy and Corporate Communication in groups such as Marico and Godrej. He is the Founder & CEO of Increate Value Advisors LLP.
Mr. Arvind V. Sonde Independent Director	He is an Advocate, a member of the Institute of Chartered Accountants of India. He specialises in Direct Tax law and as an Advocate for over three decades he has counselled major corporations, organizations, and individuals. He has often been named by the International Tax Review as one of India's Top 10 Tax Controversy Leaders and Top 10 Tax Dispute Advisers.
Dr. Anish Shah Non-Executive Non-Independent Director	He is currently the Non-Executive Non-Independent Director for the Mahindra Group, with responsibility for the Group Corporate Office and full oversight of all businesses other than the Auto and Farm sectors. The Board has appointed him as the Managing Director and CEO designate for the Mahindra Group, effective Apr 2, 2021. was President and CEO of GE Capital India from 2009-14, where he led the transformation of the business, including a turnaround of its SBI Card joint venture.
Mr. Amit Raje Additional Non- Executive Non-Independent Director	He is currently Additional Non- Executive Non-Independent Director – Partnerships & Alliances of Mahindra & Mahindra Limited, the Parent company and is responsible for leading M&A and Investor Relations at the Mahindra Group. Prior to joining the Mahindra Group, he was the Managing Director in the Principal Investing Area of Goldman Sachs. He was a Nominee Director of Goldman Sachs on the Boards of Noveltech Feeds Private Limited, Good Host Spaces Private Limited and Global Consumer Products Private Limited.
Mr. Vivek Karve Chief Financial Officer of the Company and Group Financial Services Sector	He is a Chartered Accountant and a Cost Accountant. He has over 25 years of rich experience across different sectors viz. Consumer goods, IT consulting and Project Finance during his stints at P&G, Siemens Information Systems and ICICI. Before joining Mahindra Finance, for nearly 20 years, he has been with Marico Limited, a listed FMCG Company. In his last role as the Group CFO of Marico.
Mr. Anuj Mehra MD - MRHFL	He is the MD of Mahindra Rural Housing Finance Limited (MRHFL), which is in the business of housing finance loans. He has a well-rounded experience across functional areas and over 16 years of experience in the Financial Services Sector.
Mr. Ashutosh Bishnoi MD & CEO – MMIMPL	He has over 36 years experience in the Consumer Marketing and Financial Service businesses in India. He held senior roles in the Mutual Fund business including Chief Marketing Officer of DSP Merrill Lynch Asset Management Ltd., President & CEO of JM Mutual Fund, Executive Director of UTI Mutual Fund and Acting-CEO of L&T Mutual Fund.
Dr. Jaideep Devare MD - MIBL	He has been responsible for setting up, operationalising and managing the company. Dr. Devare is also a Director on the Board of Mahindra Business & Consulting Services Pvt. Ltd., a wholly-owned subsidiary of Mahindra & Mahindra Financial Services Ltd.

Shareholders structure

Mahindra Group holds ~52% in MMFS. Top public shareholders include HDFC Life Insurance, Valiant Mauritious Partners Offshore Limited, LIC India, Government Pension Fund Global, Wishbone Fund Ltd., Buena Vista Asian Opportunities Master Fund Ltd., Kotak Funds- India Midcap Fund, Valiant Mauritius Partners Limited, SBI Blue Chip Fund and Bank Muscat India Fund.

Exhibit 55: MMFS shareholders structure



*Source: Company data, *as on 30th Sept 2020*

About Mahindra Finance

Parentage	Mahindra & Mahindra Financial Services Limited ("MMFSL") is a subsidiary of Mahindra and Mahindra Limited (Mcap: Rs 848 billion)
About MMFS	MMFS has market cap of ~ Rs 211 billion, and is one of India's leading non-banking finance companies focused in the rural and semi-urban sector
Key business area	It is primarily in the business of financing purchase of new and pre-owned auto and utility vehicles, tractors, cars, commercial vehicles, construction equipment and SME Financing
Reach	It has 1,256 offices covering 27 states and 7 union territories in India, with over 6.99 million vehicle finance customer contracts since inception
Credit ratings	India Ratings has assigned AAA/Stable, CARE Ratings has assigned AAA/Stable, Brickwork has assigned AAA/Stable and CRISIL has assigned AA+/Stable rating to the Company's long term and subordinated debt

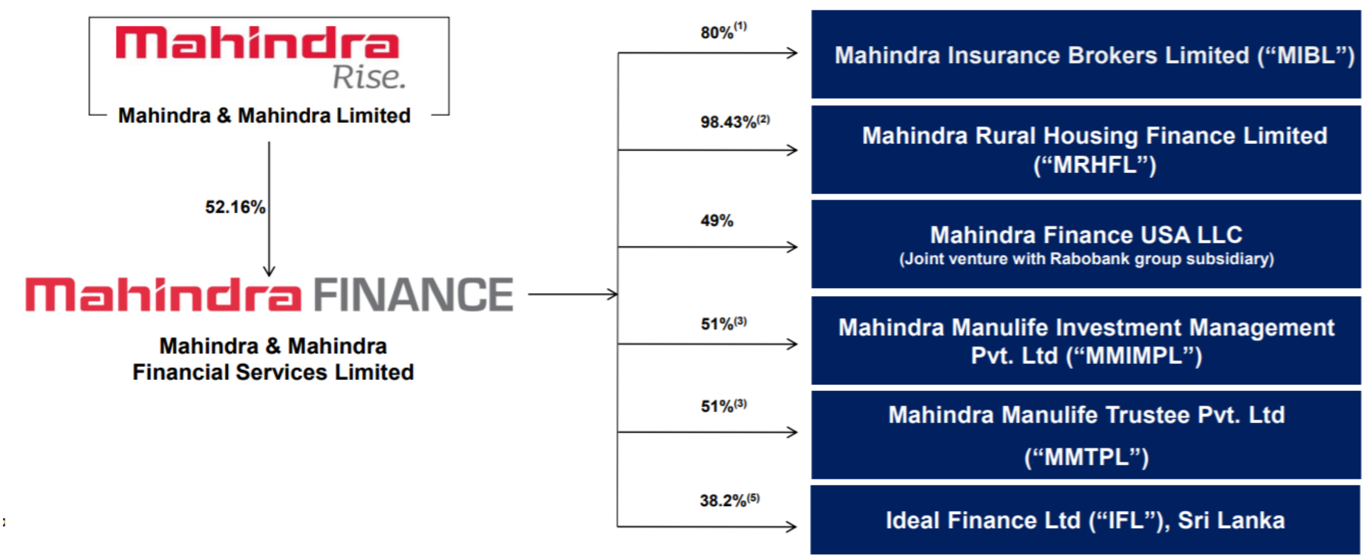
Mahindra Finance product portfolio

Vehicle financing	Loans for auto and utility vehicles, tractors, cars, commercial vehicles and construction equipment
Pre-owned vehicles	Loans for pre-owned cars, multi-utility vehicles, tractors and commercial vehicles
SME financing	Loans for varied purposes like project finance, equipment finance and working capital finance
Personal loans	Offers personal loans typically for weddings, children's education, medical treatment and working capital
Mutual fund distribution	Advises clients on investing money through AMFI certified professionals under the brand "MAHINDRA FINANCE FINSMART"
Insurance Broking	Insurance solutions to retail customers as well as corporations through its subsidiary MIBL
Housing Finance	Loans for buying, renovating, extending and improving homes in rural and semi-urban India through its subsidiary MRHFL
Mutual Fund & AMC	Asset Management Company/ Investment Manager to 'Mahindra Mutual Fund', which received certificate of registration from SEBI

Corporate history

Year	Events
FY06	Completed IPO
FY08	Commenced housing finance business through MRHFL Raised Rs. 4.14 Bn through Private Equity
FY09	Equity participation of 12.5%by NHB in MRHFL Recommenced Fixed Deposit Program
FY10	Crossed 1 million cumulative customer contracts
FY11	Maiden QIP Issue of Rs. 4.26 bn JV with Rabobank subsidiary for tractor financing in USA
FY13	Stake sale in MIBL to Inclusion Resources Pvt. Ltd. QIP Issue of Rs. 8.67 bn
FY15	Long term debt rating upgraded to AAA by India Ratings and Brickwork CARE Ratings assigned AAA rating to long term debt
FY16	Certificate of Registration received from SEBI by Mahindra Mutual Fund
FY17	Maiden Retail NCD Issue of Rs. 1000 crores
FY18	Sale of 5% of MIBL at a valuation of Rs. 1300 crores QIP Issuance : Rs. 10.56 bn and Preferential Issue to M&M : Rs. 10.55 bn
FY19	Maiden issue of ECB undertaken. Raised over $200 mn Crossed 6 million cumulative customer contracts
FY20	Partnered with Manulife for Mutual Fund business Invested in Ideal Finance for providing financial services in Sri Lanka
FY21	Completed Rights Issue of Rs. 3,089 crores Tier I Capital Adequacy enhanced to 20.8%

MMFS Group Structure



Source: Company data

1. Balance 20% with Inclusion Resources Pvt. Ltd. (IRPL), subsidiary of AXA XL Group 2. Balance 1.57% held by MRHFL Employee Welfare Trust and employees 3. Manulife Investment Management (Singapore) Pte. Ltd. holds 49% of the shareholding of MMIMPL and MMTPL. 4. Mahindra Finance CSR Foundation is a wholly owned subsidiary to undertake all CSR initiatives under one umbrella 5. The Company has entered into a subscription agreement to acquire 58.26% of IFL and has remitted an amount of Rs.440 million towards acquiring 38.2% of its equity share capital

Shareholding pattern

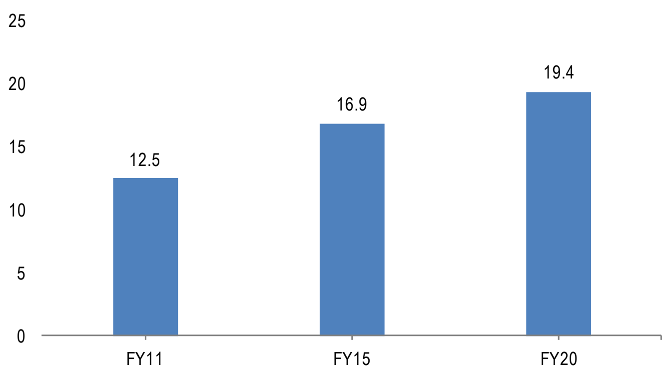
About Mahindra Group

Mahindra Group is one of the largest Indian multinational conglomerates and has more than 150 companies in 100+ countries. The group employs >250k people around the globe and has a history of more than 7 decades. It generates sales of US$19-20bn and has presence in 22 industries like automotive, commercial vehicles, two wheelers, farm equipment, IT, rural housing finance, vehicle & equipment finance, retail, agri industry, hospitality, construction equipment, clean energy, defence, aerospace, boats, consulting, insurance broking, logistics, power backup, real estate & infrastructure and steel .

M&M is the largest tractor company in the world by volume and one of the largest utility vehicle manufacturers in India. Tech Mahindra is among India's top 5 IT service providers. Mahindra Holidays is no.1 hospitality company outside the US. Mahindra First Choice is India's no.1 multi-brand certified used-car company.

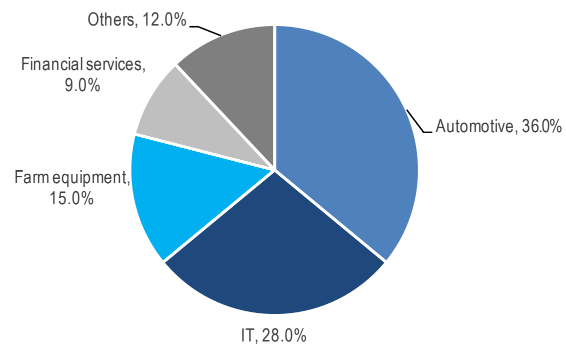
The company was incorporated in 1945 to trade steel. In 1947, the company started contract manufacturing of Willys jeeps. In 1956, the company was listed on the BSE. By 1969, the company entered the world markets as an exporter of utility vehicles and spare parts. M&M created a tractor division in 1982 and a technology division (Tech Mahindra) in 1986. In 2009, Forbes ranked Mahindra among the top 200 most reputable companies around the globe.

Exhibit 56: Mahindra Group sales (in US$bn)



Source: Company data

Exhibit 57: Mahindra Group sales split by Industry



Source: Company data

Financials

Exhibit 58:Income statement

Y/E March (Rsmn)	FY19	FY20	FY21E	FY22E	FY23E
Interest Income	86,146	99,417	1,05,118	1,06,935	1,19,478
Interest Expended	39,446	48,287	49,267	47,358	51,581
Net Interest Income	**46,700**	**51,130**	**55,851**	**59,578**	**67,896**
Change (%)	33.3	9.5	9.2	6.7	14.0
Other Operating Income	1,084	1,561	1,718	1,889	2,078
Other Income	869	1,473	1,252	1,377	1,515
Net Income	**48,653**	**54,164**	**58,820**	**62,844**	**71,489**
Change (%)	35.0	11.3	8.6	6.8	13.8
Operating Expenses	18,476	20,182	17,634	19,912	22,137
Operating Profits	**30,177**	**33,982**	**41,186**	**42,932**	**49,352**
Change (%)	39.1	12.6	21.2	4.2	15.0
Provisions	6,352	20,545	28,824	23,213	22,051
PBT	**23,824**	**13,438**	**12,362**	**19,719**	**27,301**
Tax	8,254	4,374	3,214	5,127	7,098
Tax Rate (%)	34.6	32.5	26.0	26.0	26.0
PAT	**15,571**	**9,064**	**9,148**	**14,592**	**20,203**
Change (%)	54.0	-41.8	0.9	59.5	38.5
Proposed Dividend (Incl Tax)	4,779	0	4,933	2,918	4,041

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 59: Balance sheet

Y/E March (Rsmn)	FY19	FY20	FY21E	FY22E	FY23E
Equity Share Capital	1,230	1,231	2,466	2,466	2,466
Reserves & Surplus (Ex OCI)	1,03,072	1,12,408	1,46,278	1,57,951	1,74,113
Net Worth	**1,04,221**	**1,13,558**	**1,48,663**	**1,60,336**	**1,76,580**
Other Comprehensive Income	81	81	81	81	81
Net Worth	**1,04,302**	**1,13,639**	**1,48,744**	**1,60,417**	**1,76,661**
Change (%)	11.8	9.0	30.9	7.8	10.1
Borrowings	**5,28,469**	**5,94,623**	**5,78,411**	**5,90,914**	**6,82,698**
Change (%)	31.8	12.5	-2.7	2.2	15.5
Other liabilities	38,009	32,451	37,318	42,916	49,353
Total Liabilities	**6,70,780**	**7,40,712**	**7,64,473**	**7,94,247**	**9,08,631**
Investments	37,917	59,110	65,021	68,272	71,685
Change (%)	38.7	55.9	10.0	5.0	5.0
Loans and Advances	**6,12,496**	**6,49,935**	**6,47,821**	**6,97,278**	**8,05,583**
Change (%)	26.2	6.1	-0.3	7.6	15.5
Other assets	20,367	31,668	51,632	28,697	31,362
Total Assets	**6,70,780**	**7,40,712**	**7,64,473**	**7,94,247**	**9,08,631**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 60:Key ratios

Y/E March	FY19	FY20	FY21E	FY22E	FY23E
Spreads Analysis (%)					
Yield on Portfolio	15.7	15.8	16.2	15.9	15.9
Cost of Borrowings	8.5	8.6	8.4	8.1	8.1
Interest Spread	7.2	7.2	7.8	7.8	7.8
Net Interest Margin	8.7	8.3	8.9	9.1	9.3
Profitability Ratios (%)					
Cost/Income	38.0	37.3	30.0	31.7	31.0
Empl. Cost/Op. Exps.	59.0	56.9	59.3	58.8	59.2
RoE	15.8	8.3	7.0	9.4	12.0
RoA	2.6	1.3	1.2	1.9	2.4
Asset Quality (%)					
GNPA	40,706	57,467	81,698	84,509	88,438
NNPA	32,907	39,665	53,103	54,931	57,485
GNPA %	6.4	8.4	11.9	11.4	10.4
NNPA %	5.4	6.1	8.1	7.7	7.0
PCR %	19.2	31.0	35.0	35.0	35.0
Total Provisions/loans %	3.4	4.9	6.1	6.4	6.3
Capitalisation (%)					
CAR	20.3	19.6	22.8	22.5	21.1
Tier I	15.5	15.4	19.3	19.5	18.8
Tier II	4.8	4.2	3.5	2.9	2.3
Average Leverage on Assets (x)	6.1	6.5	5.7	5.0	5.1

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 61: Valuation

Y/E March (Rsmn)	FY19	FY20	FY21E	FY22E	FY23E
Book Value (INR)	169.5	184.5	120.6	130.0	143.2
BV Growth (%)	11.7	8.9	-34.7	7.9	10.1
Price-BV (x)	**1.0**	**1.0**	**1.5**	**1.4**	**1.2**
Adjusted BV (INR)	132.0	136.2	88.3	96.6	108.2
Price-ABV (x)	**1.3**	**1.3**	**2.0**	**1.8**	**1.6**
OPS (INR)	49.1	55.2	33.4	34.8	40.0
OPS Growth (%)	39.0	12.5	-39.5	4.2	15.0
Price-OP (x)	**3.6**	**3.2**	**5.3**	**5.0**	**4.4**
EPS (INR)	25.3	14.7	7.4	11.8	16.4
EPS Growth (%)	53.9	-41.8	-49.6	59.5	38.5
Price-Earnings (x)	**6.9**	**11.9**	**23.7**	**14.9**	**10.7**
Dividend	6.5	0.0	4.0	2.4	3.3
Dividend Yield (%)	**3.7**	**0.0**	**2.3**	**1.3**	**1.9**

Source: Company, Nirmal Bang Institutional Equities Research

Shriram Transport Finance

29 December 2020

Reuters: SRTR.BO; Bloomberg: SHTF IN

Initiating Coverage

Recovery in sight; initiating with a Buy

We initiate coverage on Shriram Transport Finance (SHTF) with a Buy rating and a target price (TP) of Rs1,265. In our view, SHTF's business model is difficult to replicate. Its multi-cycle experience in underwriting used vehicles and collection processes established over the years are impeccable. We have listed three key investment rationales for our Buy rating: (1) market leadership (~25%) in used CV space to benefit when cycle turns positive (2) fairly positive guidance on collection efficiency and potential restructuring, allaying fears on asset quality (c) inexpensive valuation vs 3-year historical average of 2.3x (P/ABV). A 60% increase in the stock price over the last 3 months indicates that the positive momentum in asset quality and disbursements have been priced in, though not fully. We expect a 25% upside in the stock price as we believe that demand for used CVs is likely to rise with 15-20% increase in prices of new vehicles. We value the stock at 1.8x P/ABV on FY23 basis with RoA of 2.2% and RoE of 12.8%

Market leader in used CV space: SHTF is the largest CV financier in the country with assets under management (AUM) of Rs1133.50bn as on Sept 31, 2020. SHTF has created a strong and sustainable competitive advantage through deep understanding of the borrower profile and their credit behavior. Proximity to customers, referral-based lending, door-step collection, strong valuation capabilities of used CVs and the ability to dispose re-possessed vehicles are the strong pillars of SHTF's business model. We expect limited competition from banks due to high risk customer profile.

Improved collection efficiency and low restructuring guidance allay fears on asset quality deterioration: Collection efficiency has gradually improved and reached ~95% in Oct'20. Management is confident of capping asset restructuring at 3%. SHTF has provided additional provisions of Rs22.8mn, 2% of AUM to cover Covid related credit losses. Our sensitivity analysis suggests that a 100bps increase in slippage ratio will lead to 50bps increase in Stage 3 assets and 30bps increase in credit cost. We think a better picture on asset quality will emerge post Dec'20.

Valuation: SHTF is currently trading at 1.7x P/ABV (on 12-month fwd basis) - a ~30% discount to its 5-year average multiple of 2.4x and >25% discount to its 3-year average multiple of 2.3x. During the CV upcycle, SHTF has traded in the range of 2.0x-3.5x P/ABV while during a slowdown it has traded in a range of 1.0x-2.0x. We value SHTF at P/ABV of 1.8x - a ~20% discount to its 3-year average multiple due to slowdown in disbursements compared to peers.

Y/E March (Rsmn)	FY19	FY20	FY21	FY22	FY23
NII	78,730	79,972	83,131	88,853	98,141
PPOP	61,605	62,336	64,021	67,420	73,405
PAT	25,640	25,018	18,809	26,721	31,473
Loans	9,67,515	10,22,316	10,60,552	12,35,728	13,93,343
RoA (%)	*2.5*	*2.3*	*1.6*	*2.1*	*2.2*
RoE (%)	*17.4*	*14.8*	*9.6*	*12.0*	*12.8*
P/ABV	2.3	1.9	2.0	1.7	1.4

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: BFSI

CMP: Rs1,016

Target Price: Rs1,265

Upside: 24.5%

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Research Analyst
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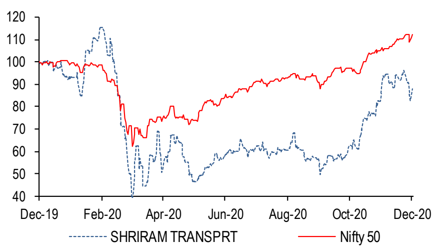
Key Data

Current Shares O/S (mn)	253.1
Mkt Cap (Rsbn/US$bn)	252.2/3.4
52 Wk H / L (Rs)	1,332/429
Daily Vol. (3M NSE Avg.)	5,017,191

Share holding (%)	2QFY21	1QFY21	4QFY20
Promoter	26.5	26.5	26.3
Public	73.5	73.5	73.8
Others	-	-	-

One Year Indexed Stock Performance



Price Performance (%)

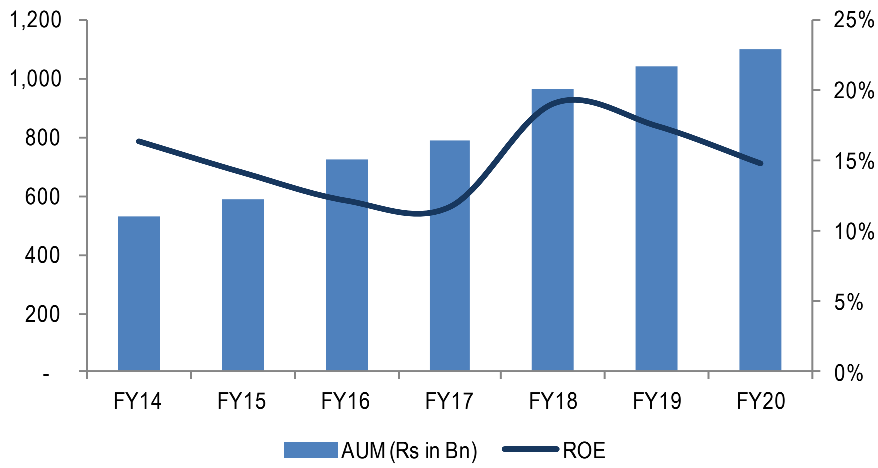
	1 M	6 M	1 Yr
Shriram Transport Fin.	(3.2)	49.9	(11.4)
Nifty Index	5.3	33.4	12.6

Source: Bloomberg

Executive summary

Market leadership in the pre-owned commercial vehicle (CV) financing segment
SHTF is the largest CV financier in the country with AUM of Rs1133.50bn as on Sept 31, 2020. With presence of four decades in the pre-owned CV financing business, SHTF has created a strong and sustainable competitive advantage through deep understanding of the borrower profile and their credit behavior. Proximity to customers, referral-based lending, door-step collection, strong valuation capabilities of pre-owned vehicles and the ability to dispose re-possessed vehicles are the strong pillars of SHTF's business model. Apart from CV financing, SHTF is present in financing of passenger vehicles (21% of AUM), tractor financing and construction equipment financing. The company has also introduced top-up products like finance for tyres, working capital and engine replacement. SHTF has registered 12% CAGR in AUM over FY13-20 and an average ROE of 15.1% during the same period.

Exhibit 1: Long term AUM growth and ROE

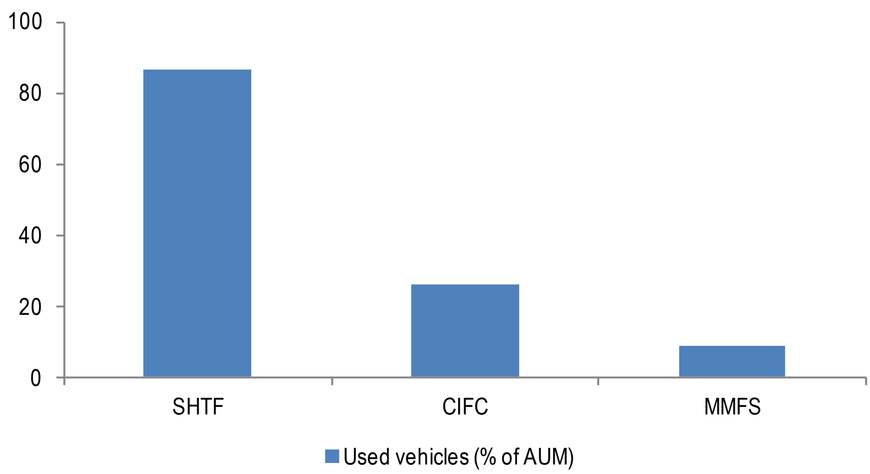


Source: Company, Nirmal Bang Institutional Equities Research

First time buyers (FTB) and small road transport operators (SRTO) of pre-owned CVs form a large borrower base for SHTF. These borrowers represent high risk due to (a) lack of banking habit (b) low credit history and documents (c) bulk cash transactions (d) highly fragmented market (e) mobile nature of customers and assets financed. The company faces limited competition from other organized financiers, including banks in this segment due to the inherent risk of the target product and the customer profile. SHTF holds 25-27% market share in pre-owned CV financing while 60-65% of the market share is controlled by private financiers charging high interest rates.

Other players have made their entry into the used vehicle space given the high yields and moderate risk-adjusted returns. However, they might not be significant competition to SHTF given the scale and expertise it has established over the years.

Exhibit 2: Used vehicles - share of AUM for vehicle financiers

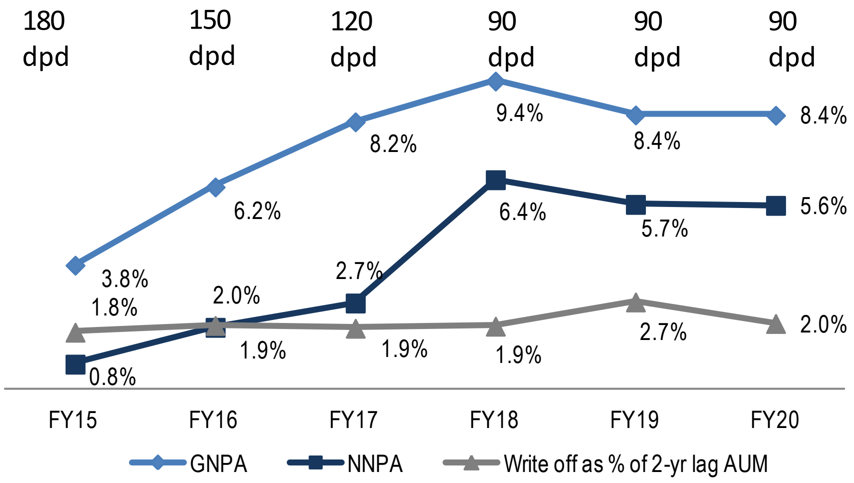


Source: Company, Nirmal Bang Institutional Equities Research; Note: For CIFC, Used vehicles AUM is as a % of Vehicle finance AUM

In our view, the business prospects for the pre-owned CV financing segment remain strong given the large unorganized market and significant entry barriers. Owing to increased demand for pre-owned vehicles in deep rural areas, the company has been increasing its presence in rural and semi urban areas to maintain its niche presence. In the last one year, the company has been adding new branches, majority of which are satellite branches outside the semi-urban centers. SHTF has 976 branches in rural areas (55% of total branches) apart from 801 rural centers. Consequently, the share of rural AUM has also risen to 48% of total AUM as on Sept. 30,2020 as against 26% in FY17.

Change in asset classification norms for NBFCs coupled with demonetization and slowdown led to a huge spike in GNPAs for the company. However, SHTF has been able to maintain its credit write-offs at ~2% (average) over the last 10 years. In our view, the credit write-offs are the close indicator of asset quality of any NBFC.

Exhibit 3: Credit write-offs remain low



Source: Company, Nirmal Bang Institutional Equities Research

CV sales are highly cyclical and near-term macro headwinds are likely to keep growth low before recovering sharply in FY22. Ticket sizes are likely to rise by 10-15% with transition to BS-VI norms. High replacement demand and increase in ticket sizes should aid disbursement growth for SHTF in FY22.

Risks

- Asset quality risks are higher, especially in the pre-owned vehicle segment, due to vehicle operators' vulnerability to freight rates and asset utilization levels
- Net interest margins are relatively more sensitive to interest rates/liquidity environment
- Strong linkage to overall economics and industrial cycles makes it vulnerable to growth and quality
- Increase in competitive intensity, thereby leading to lower margins and profitability

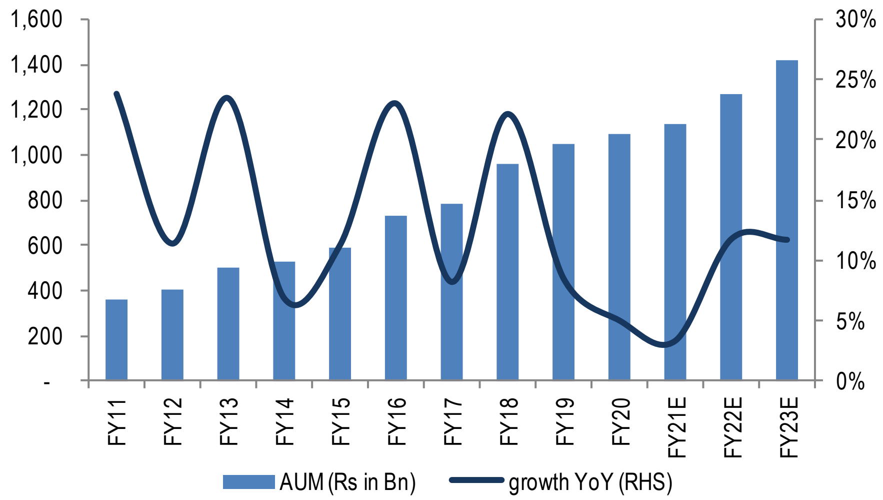
To summarize, the key reasons to invest in SHTF are:

- Market leadership in the used CV business established through deep understanding of customer borrowing profile and their credit behavior. Limited competition from banks due to high risk perception of borrowers.
- SHTF's customers generally transport end-consumption related goods & services, demand for which is expected to remain moderately strong.
- Expertise in underwriting for less banked segments in rural and semi-urban areas, which supports profitability. Robust collection infrastructure, which limits credit write-offs to ~2%.
- Moderately better net interest margins due to high yields on financing of used vehicles. Cost to income ratios better than peers due to the vast scale of operations and established business model.
- Improved RoE and RoA profile over the last three years. We expect RoE to decline to 9.6% in FY21 due to higher provisioning before improving to 12.4% in FY23E. We have built in higher slippages at 12.8% (average over FY21-23) vs last 5-year average of 8.2%. Our sensitivity suggests that a 100bps decline in FY21 slippage ratio of 14.5% will lead to RoE expansion of ~200bps.
- Improvement in funding conditions with the company being able to raise funds from banks and capital markets over the past 3-4 months.

AUM to grow at a moderate pace until demand picks up

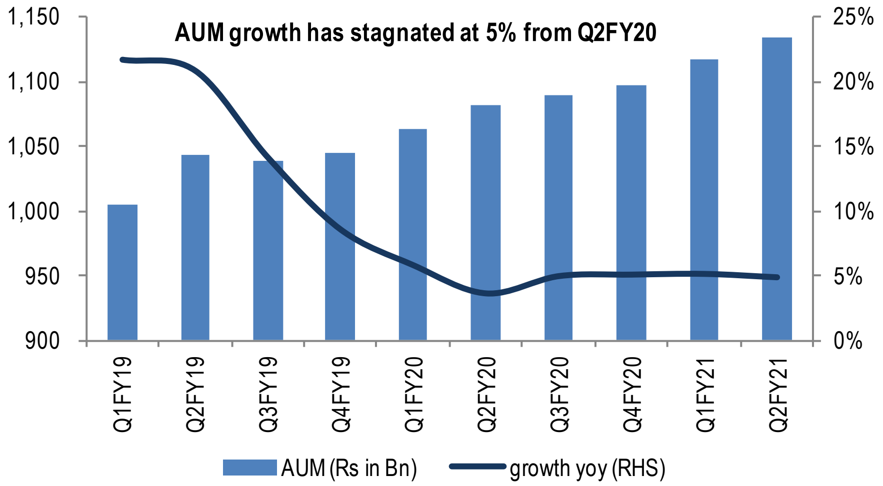
SHTF's AUM grew at 14.2% over FY10-20 and at 16.7% over FY15-20. The AUM growth slowed starting from 3QFY19 after the change in axle norms and reduction in LTV (loan to value) ratio around 5%, impacting disbursements. Also, the funding situation worsened in FY19 following liquidity crisis. The industry expectations about demand before the transition to BS-VI vehicles did not materialize due to weak macros and the onset of Covid 19 in FY20. We expect AUM to grow by 3.4% in FY21 due to extension in tenure of loans under moratorium and likely growth in disbursements starting from 4QFY21. We build in 12% growth in AUM in FY22, supported by 66% growth in disbursements (flat at FY20 levels) and 31% growth in repayments.

Exhibit 4: AUM grew at 14% CAGR over FY10-20; expect 9% CAGR over FY20-23E



Source: Company, Nirmal Bang Institutional Equities Research

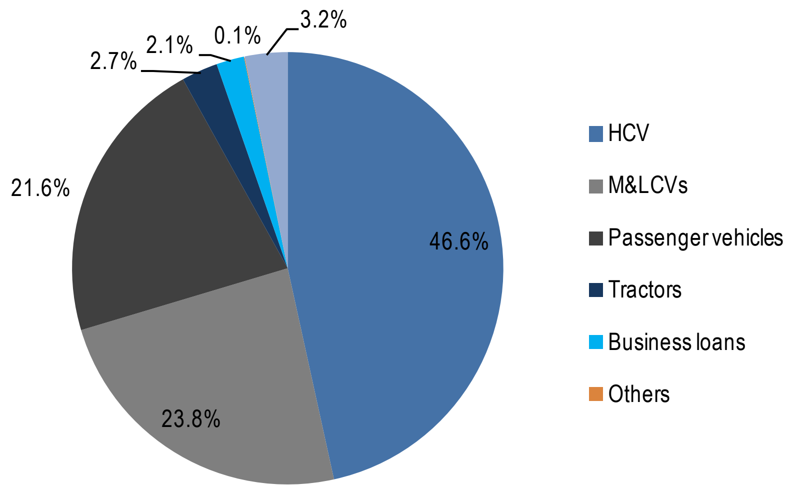
Exhibit 5: AUM growth has remained below 5% levels over the last 5 quarters; we expect it to bottom out in FY21



Source: Company, Nirmal Bang Institutional Equities Research

SHTF's AUM is concentrated with 70.4% of its portfolio under the HCV (Heavy Commercial Vehicles) and M&LCV (Medium and Light Commercial Vehicles) segments. The concentration in the CV portfolio makes it more susceptible to economic cycles. Passenger Vehicles constitute another 21.6% and are likely to remain under stress over the next one year. Other segments of business loans and working capital loans account for small chunk of AUM and we expect their share in total AUM to remain at similar levels.

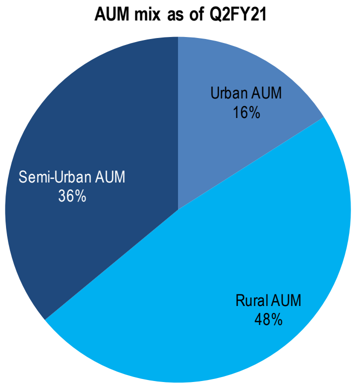
Exhibit 6: AUM mix as on 2QFY21



Source: Company, Nirmal Bang Institutional Equities Research

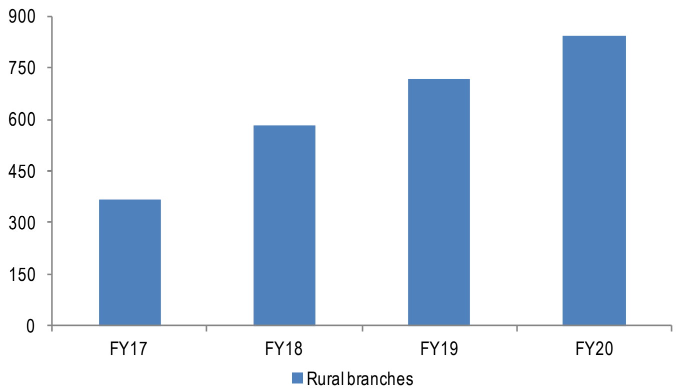
SHTF is strengthening its presence in rural and semi-urban areas by expanding its reach. Consequently, the share of rural branches has increased from 366 branches in FY17 to 976 branches in 2QFY21.

Exhibit 7: AUM mix based on the location of the branches



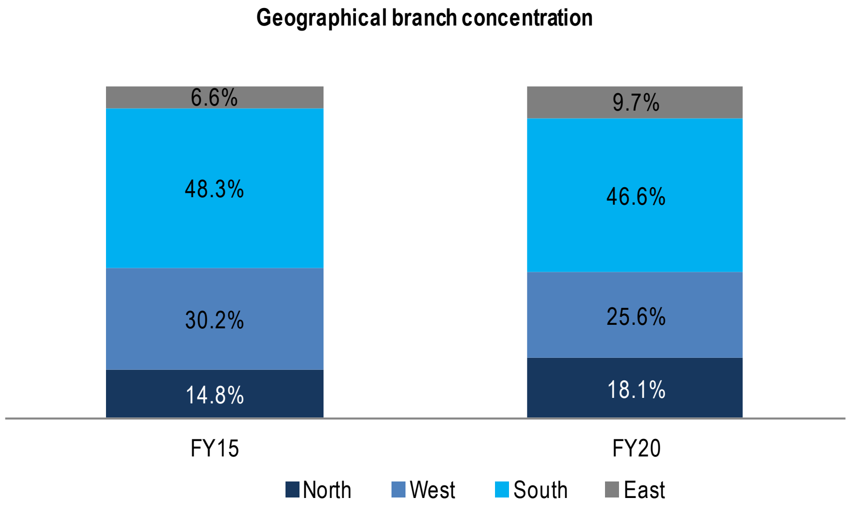
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 8: Number of rural branches increased as company builds breadth in the interiors



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 9: SHTF is a strong player in South and West

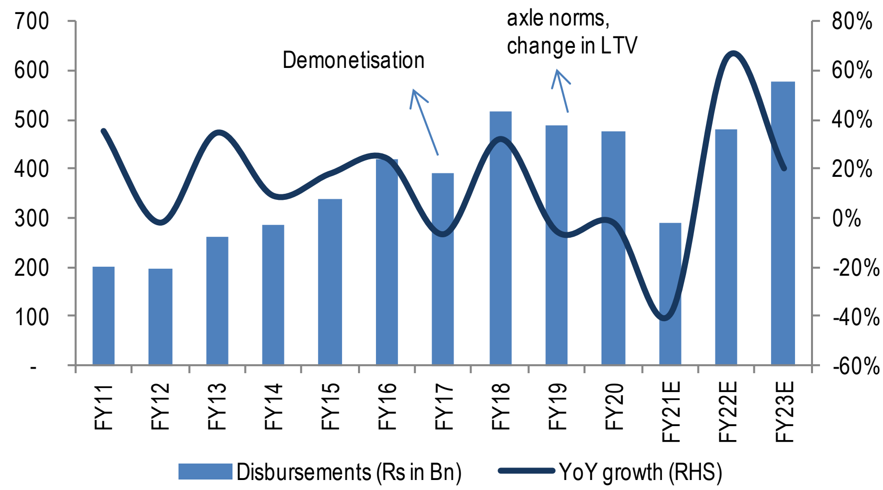


Source: Company, Nirmal Bang Institutional Equities Research

Disbursements in negative territory over last two years, expect to pick up from FY22 onwards

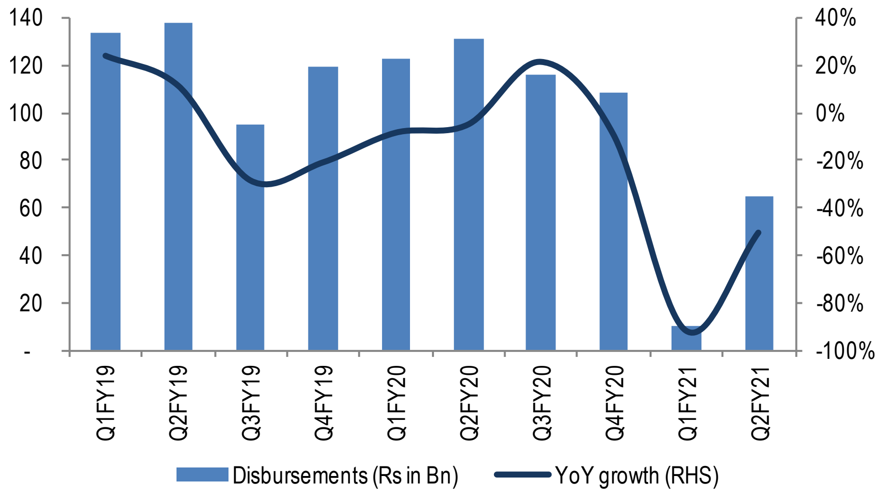
Disbursements have grown at a CAGR of 13% over FY10-20 but declined in FY19 & FY20. Disbursements were affected in FY19 due to change in axle norms, liquidity crisis and change in LTV ratios. Decline in FY20 disbursements was in line with the industry due to poor macros. FY21E is likely to be a complete washout year with disbursements declining by 71% in H1FY21 due to Covid related lockdowns. We build in 39% decline in disbursements in FY21E with complete recovery only starting from 4QFY21. There is an upside potential to our numbers as we build in FY22E disbursements at FY20 levels.

Exhibit 10: Disbursements expected to pick up from FY22 onwards



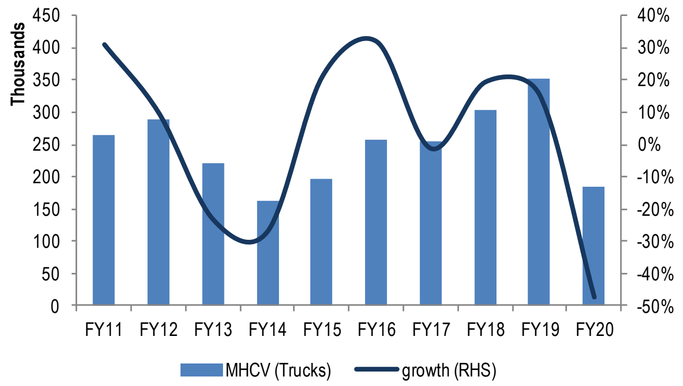
Source: Company. Nirmal Bang Institutional Equities Research

Exhibit 11: Disbursements growth tepid over the last few quarters



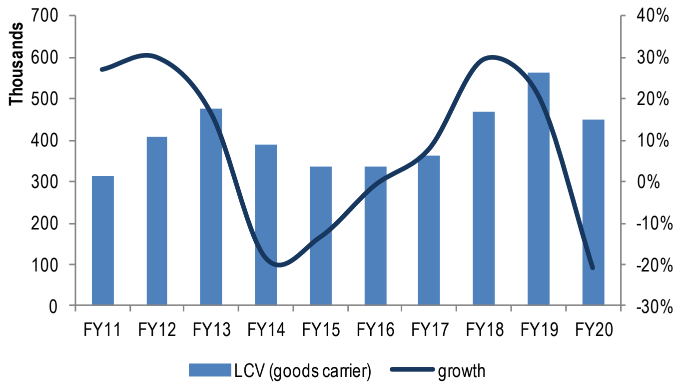
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 12: MHCV (trucks) sales volume declined 50% yoy in FY20



Source: Company, Nirmal Bang Institutional Equities Research

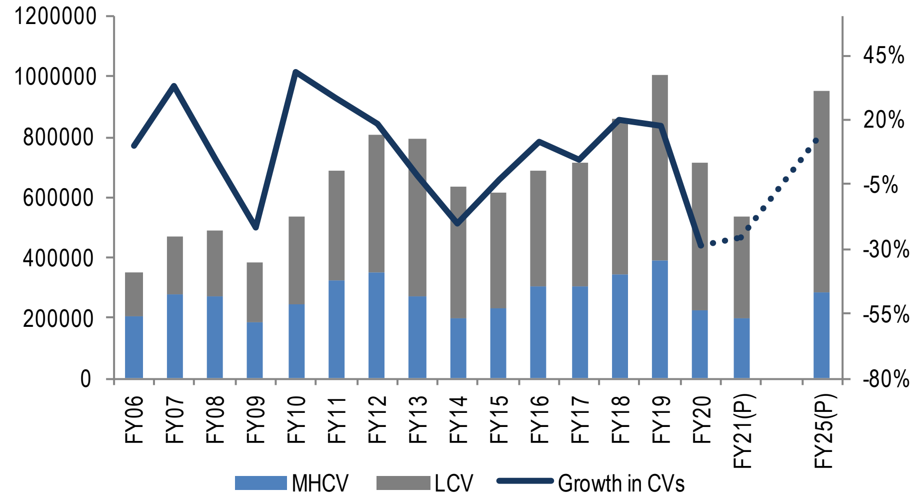
Exhibit 13: LCV (trucks) sales volumes declined 21%YoY in FY20



Source: Company, Nirmal Bang Institutional Equities Research

As per industry estimates, the CV cycle is set for recovery from FY22E with a huge replacement demand expected for CV sales done between FY17-19. Currently, the transactions for used vehicles remain tepid due to increase in prices for new vehicles and cash flow uncertainty for the truck operators. Once the replacement cycle picks up, we believe that the transactions in the used vehicle space will gain momentum.

Exhibit 14: CV sales projected to grow at a CAGR of 13-18% over FY21-25



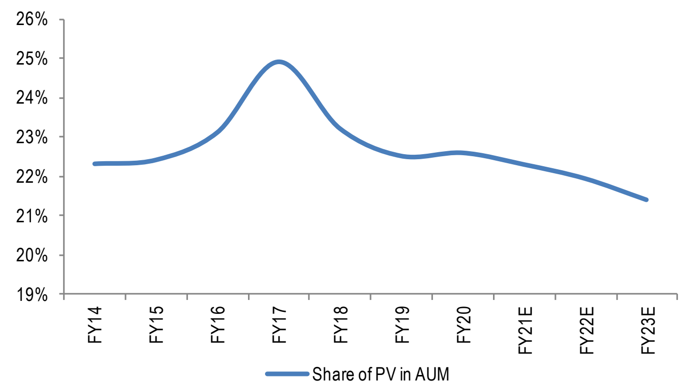
Source: Company, Nirmal Bang Institutional Equities Research

Growth in passenger vehicles is likely to remain subdued until FY22

Covid had the most impact on the PV segment, which constituted ~22% to SHTF's AUM. We expect disbursements to remain negligible under this category until the schools and public travel resume fully. SHTF only lends to income generating assets (yellow plates) and not for self-consumption. Even though there is a pick-up in cars and MUV segments, this seems more for private use as demand from travel - tourist segment remains lackluster.

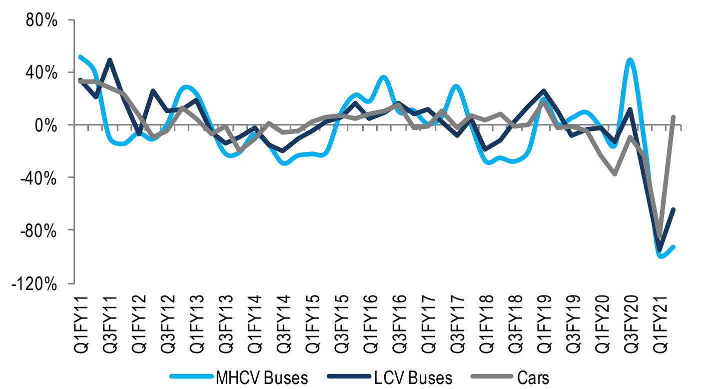
Passenger Vehicles contribute ~22% to the company's AUM; most impacted by Covid

Exhibit 15: Share of PV in AUM



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 16: Passenger Vehicles most impacted due to Covid



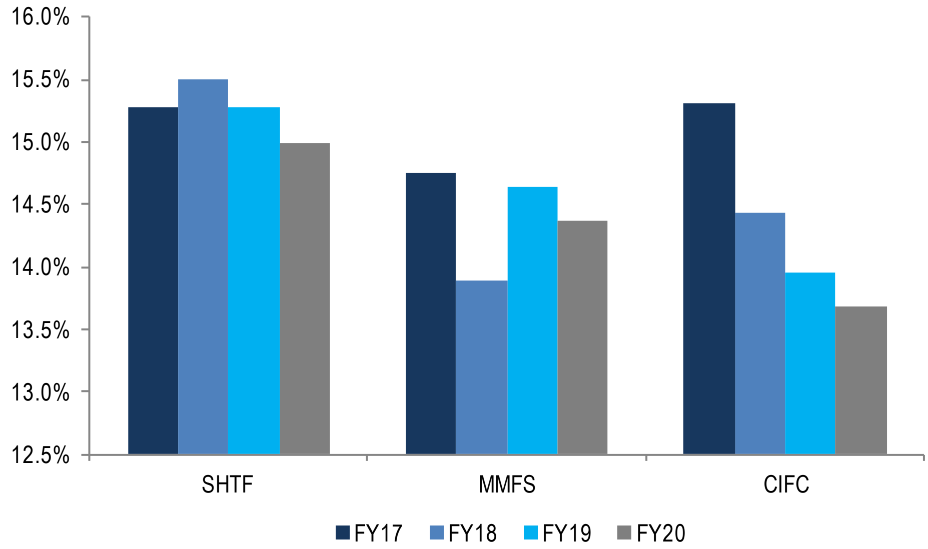
Source: Industry, Nirmal Bang Institutional Equities Research

Used vehicle financing is the primary driver of growth for SHTF. The share of new vehicle disbursement remains on average at 10% of total disbursements over the last five years. Generally, we have seen a trend in pick-up in new vehicle disbursements during up-cycle as some of the vintage customers may upgrade to new vehicles. This can be an additional avenue to grow disbursements when the CV cycle picks up.

Interest yields strong due to presence in high yield used CV segment

Loan yields in the used CV segment are significantly higher at 14-16% for 2 to 5 year old CVs and 16-24% for 5 to 10 year old CVs. Interest cost for new vehicles ranges between 12% and 16%. The company's strong presence in the used CV segment reflects in high interest yields.

Exhibit 17: Interest yields higher than peers



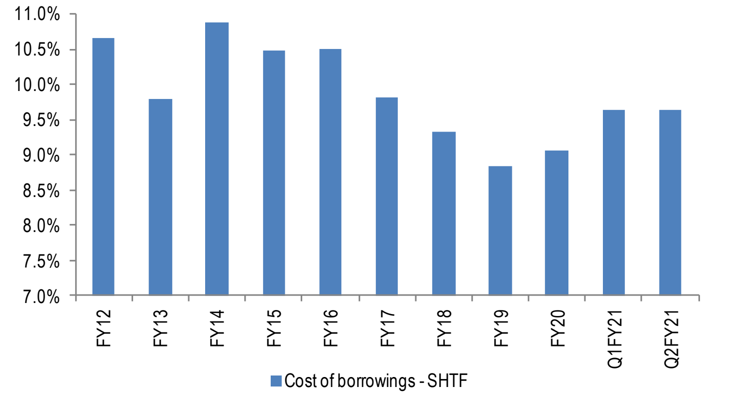
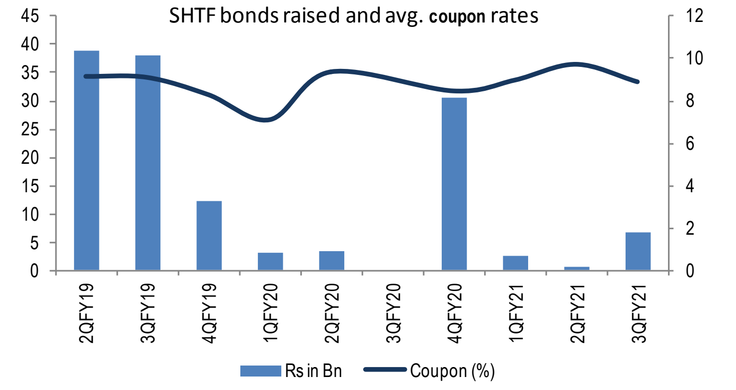
Source: Company, Nirmal Bang Institutional Equities Research

Note: interest yields are calculated as % of interest earning assets (cash+investments+loan)

Cost of borrowings is high than AA rated NBFC bonds due to high risk associated with target borrower segment

Cost of borrowings declined by 87bps from FY16 to 2QFY21 with change in the interest rate environment. However, government yields for 3Y/1Y AAA rated bonds declined by 229/380bps over the same period. Also, AA rated bond yield declined by 263/326bps over FY16-2QFY21. In our view, the bond yields for SHTF are higher than its peers due to high risk associated with the target borrower segment and their vulnerability to economic cycles. Also, the recent change in outlook by CRISIL from stable to negative might affect coupon rates in the near to medium term. S&P has recently removed the company from negative credit watch, which is a positive but not enough to move the needle.

Our data analysis of recent bonds raised by SHTF suggests that the average cost of borrowing is down by ~75bps sequentially on an average. Weighted interest cost calculations suggest a 10bps decline in cost compared to 4QFY20.

Exhibit 18: Average cost of borrowings	Exhibit 19: Average coupon rates indicate softening of interest rates
	
Note: average coupon rates is simple avg of coupons for bonds issued in the qtr	

39% of debt outstanding on 31st March'20 is due to mature before FY22

Our analysis of FY20 balance sheet suggests that ~44% of NCDs and subordinate debt are likely to mature by FY22 (18.6% of total debts). Of the total debt, 38.8% is due to mature by FY22-end. We build in 30bps reduction in the cost of borrowings starting from FY21 onwards. The cost of borrowings in H1FY21 was at 9.6%. The recent provisional AAA rating assigned by India Rating on provisional NCD issue of Rs 5bn is a positive. Our thesis on cost reduction is essentially on replacement of existing debt with lower cost of funds.

Exhibit 20: NCD Maturity Profile

Maturity	<10%	>=10%<12%	>=12%<14%
Upto 12 months	10.9%	3.7%	-
12-24 months	17.4%	11.9%	0.1%
24-36 months	19.2%	1.5%	0.4%
36-48 months	15.6%	1.3%	-
48-60 months	0.7%	5.9%	4.0%
Over 60 months	6.9%	0.4%	-

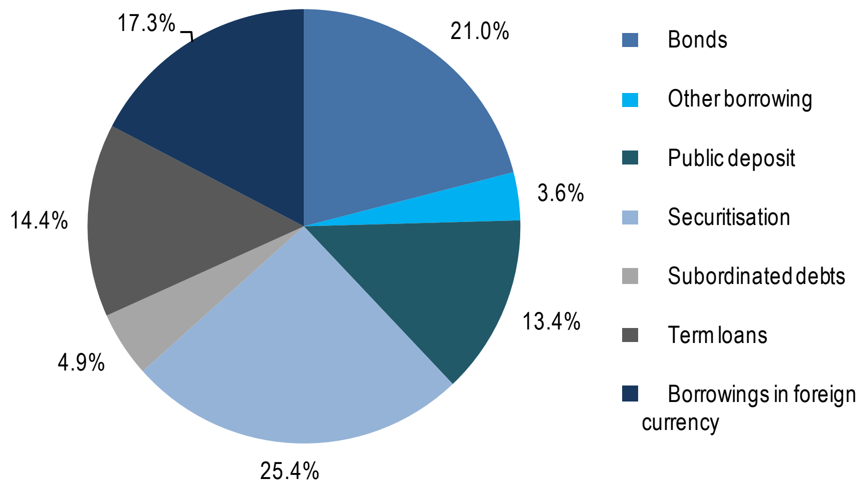
Overall maturity profile	
Upto 12 months	18.6%
12-24 months	20.2%
24-36 months	18.2%
36-48 months	18.6%
48-60 months	18.7%
Over 60 months	5.6%

Source: Company, Nirmal Bang Institutional Equities Research

Diversified cost of borrowings

After the liquidity crisis in 2018, SHTF has diversified its funding base by tapping the ECB route. Under this route, any NBFC can raise upto US$750mn each year and needs the RBI's approval if they wish to exceed this limit. As on 30th Sept'21, securitization was the largest source of funding at 25% and may continue to remain around this level as majority of the book is eligible under PSL (priority sector lending) category. The share of domestic bonds declined from 35% to 21% over FY19-2QFY21. However, the decline in the share of bonds has been raised by tapping foreign borrowings.

Exhibit 21: Diversified sources of borrowings

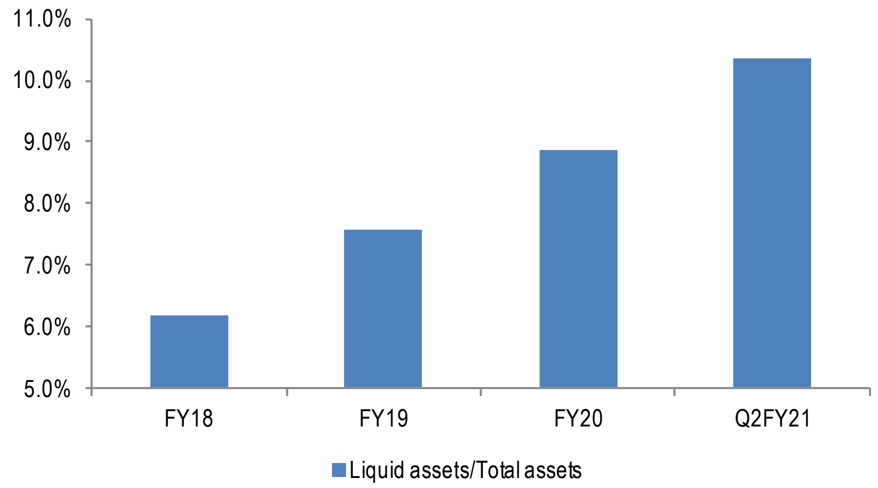


Source: Company, Nirmal Bang Institutional Equities Research

High interest spreads, but managing costs and asset quality are key to profitability

SHTF extends used vehicle loan for tenure of ~3 years with fixed rate of interest. The interest rates on CV loans are fixed and any change in the cost of borrowings is not passed on to the existing borrowers. This should aid SHTF to improve its NIMs going ahead. Also, the company is carrying 10.3% of cash and investments in order to tide over the liquidity concerns arising out of moratorium. Our calculation suggests that NIMs would have been higher by 30bps if liquidity was maintained at FY19 level of 7.6%.

Exhibit 22: Liquid assets as a percentage of total assets on rise

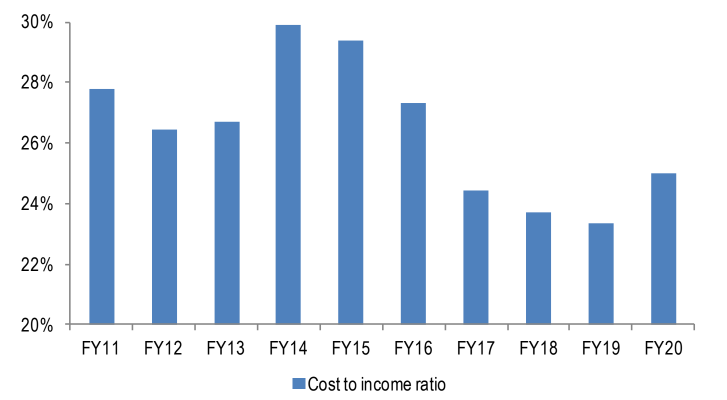


Source: Company, Nirmal Bang Institutional Equities Research

Operating expenses remain best in class despite significant increase in branches

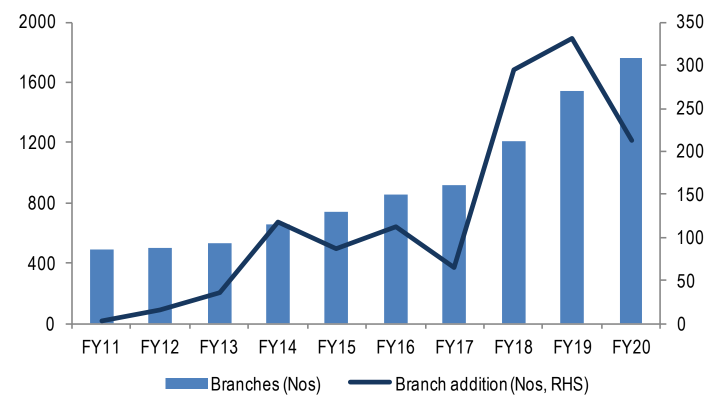
Cost to income ratio for the company remains low despite significant increase in branch additions. The company has been focused on opening satellite branches (big branch split into 3-4 branches) to better cater to its borrower segments. This has in–turn led to increase in overall AUM with less employees per branch and low rental costs (as these branches are in the interiors).

Exhibit 23: Cost to income ratio remains low…



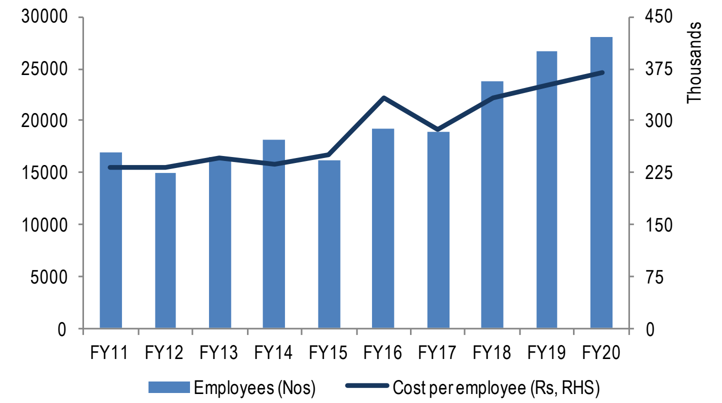
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 24: …despite significant increase in branch addition



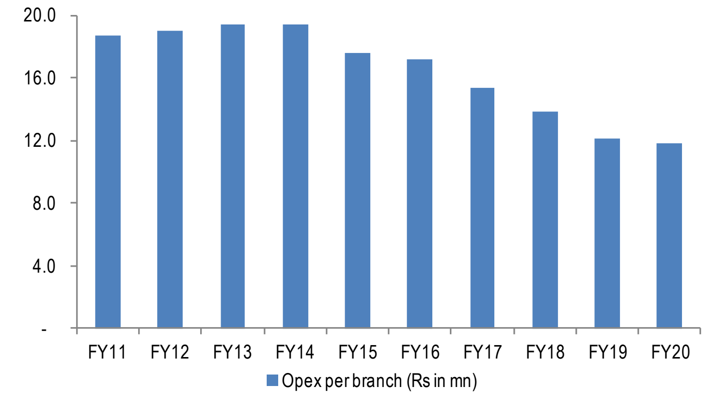
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 25: Employee cost grew at a CAGR of 7.4% over FY10-20



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 26: Opex per branch continues to come down

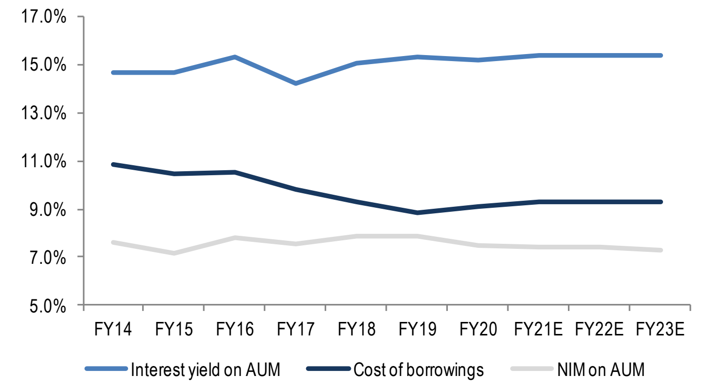


Source: Company, Nirmal Bang Institutional Equities Research

Net Interest Margins

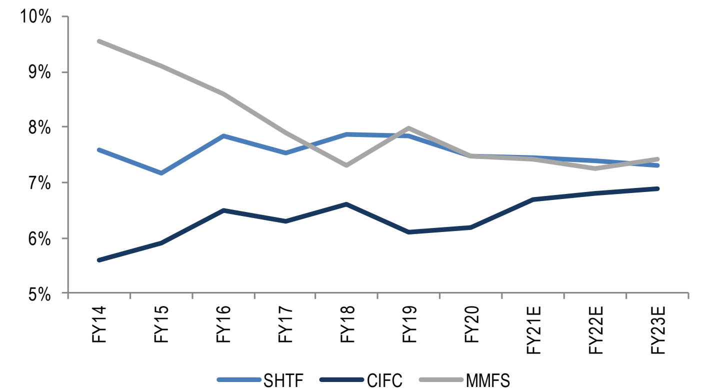
Net interest margins have been stable between 7% and 8% over the last 7 years. The funding cost for the company remained elevated in H1FY21, likely due to the perception of higher slippages once the moratorium is over.

Exhibit 27: SHTF NIMs remained stable between 7-8%



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 28: NIMs are higher than CIFC due to higher yield; lower than MMFS due to high borrowing cost

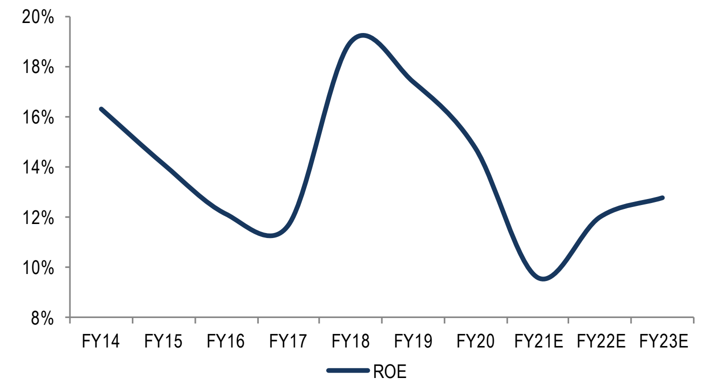


Source: Company, Nirmal Bang Institutional Equities Research

ROE to remain subdued at 12.8% in FY23; leverage position comfortable

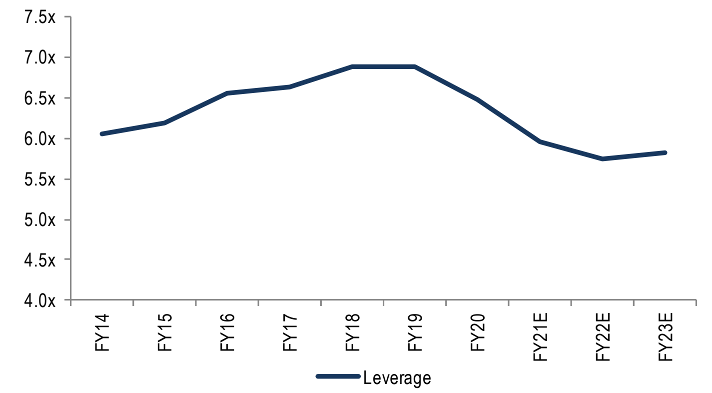
We expect net profit to grow at a CAGR of 8%, in line with 9% growth in AUM. Over FY14-20, the company maintained average ROE of 15% despite change in asset classification norm, demonetization and downturn of CV cycle. We believe that our and consensus numbers are a little depressed given the uncertainty around asset classification and general economic slowdown. There remains an upside to our numbers if asset quality is better than expected (GNPA of 11%), which is highly probable and if the CV cycle picks up (uncertain).

Exhibit 29: ROE to remain subdued



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 30: Leverage remains comfortable



Source: Company, Nirmal Bang Institutional Equities Research

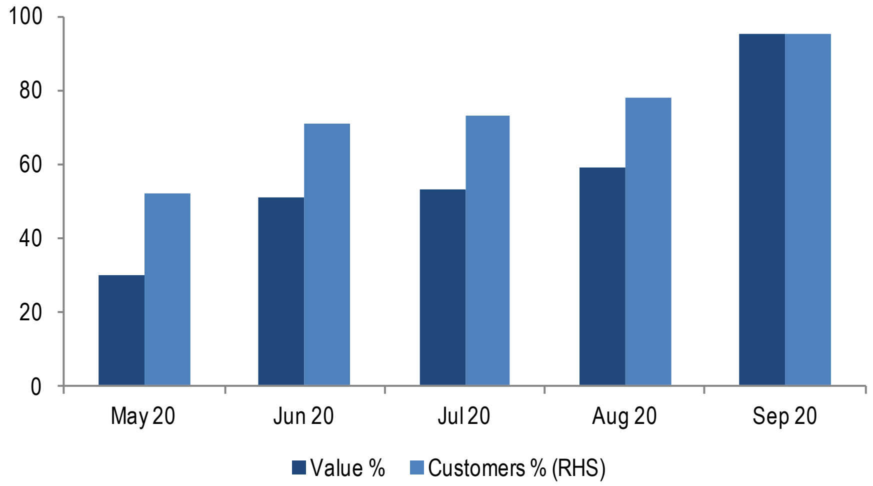
Asset quality deterioration fears allayed with improvement in collection efficiency and low restructuring guidance

Collection efficiency has gradually improved and reached ~95% in Sep'20. Management is confident of capping asset restructuring at 3%. Given the moratorium and partial write-offs, stage 3 assets declined by 154bps to 7.3% as on 2QFY21. SHTF has provided additional provisions of Rs22.8mn, 2.2% of AUM to cover Covid related losses. Our sensitivity analysis suggests that a 100bps increase in the slippage ratio will lead to 50bps increase in Stage 3 assets and 30bps increase in credit cost.

Collection efficiency

Collection efficiency improved gradually on a monthly basis and is near pre-covid levels. The trend in improvement should alleviate investors' concerns over asset quality issues. Our interaction with the management suggests that the collection efficiency has remained closer to September levels and the management expects restructuring to be lower than 3%.

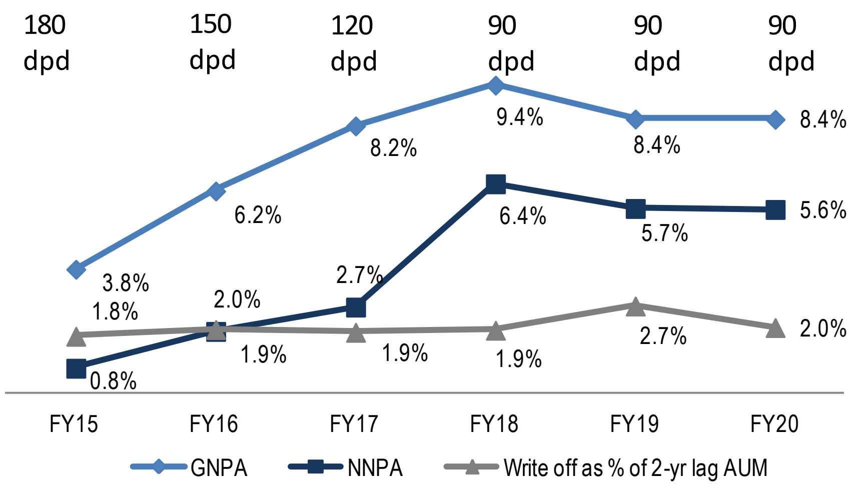
Exhibit 31: Collection efficiency improves in value and volume terms



Source: Company, Nirmal Bang Institutional Equities Research

Historically, SHTF has witnessed a huge spike in its GNPA with change in asset classification norms, demonetization and general slowdown thereafter. However, the company has been able to maintain its credit write-offs at ~2% (avg) over the last 10 years. In our view, the credit write-offs are the closest indicator of asset quality of any NBFC as the target borrower segment generally fall under earn and pay category.

Exhibit 32: GNPA increased with change in asset classification norms however actual write offs have remained stable



Source: Company, Nirmal Bang Institutional Equities Research

The company has established a robust credit appraisal and collection model honed over the years. The key here is the field officers who are in touch with the customers throughout the loan tenure, from the origination of the loan until the collection is done. The field officer has a good knowledge of the catchment area and the customer base. The object of assessment of customer is not only to forecast the earning capacity of asset, but also the borrower, his income, net worth and repayment capability. The company has aligned employee compensation in line with loan recovery in order to restrain poor underwriting. Generally, repossession is the last resort in loan recovery process.

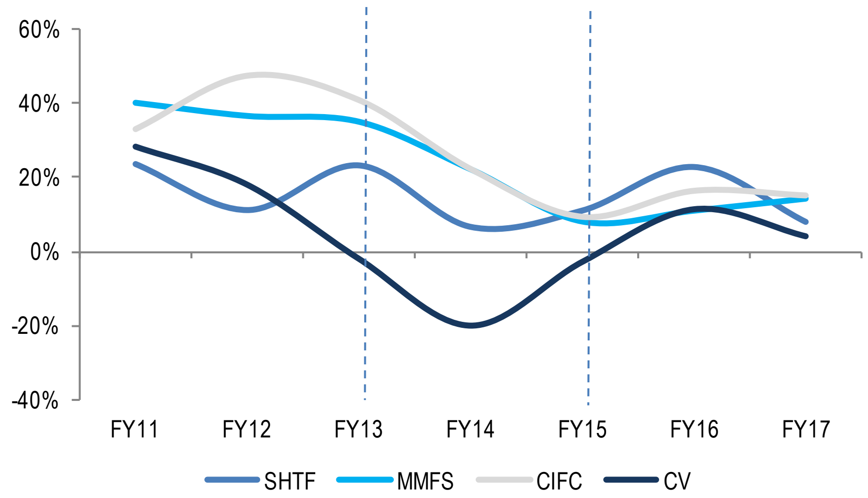
Previous shocks and cycles and how did SHTF emerge?

Our analysis of SHTF's historical data suggests that it is more susceptible to shocks with disbursements falling into negative territory. Demonetisation led to decline in disbursements of 23% and 17% in 3QFY17 and 4QFY17 and recovered thereafter. Credit cost in FY17 remained broadly at FY16 level and write-offs were maintained below 2% of AUM, suggesting strong underwriting process and strong collection efforts.

Liquidity crisis was more of a supply-side shock whereby disbursements declined and remained in negative territory for succeeding four quarters. NCD borrowings for SHTF for the next 12 months remained tepid due to overall liquidity constraint impacting NBFCs.

CV downcycle of FY13-15: FY13-15/16 was a particularly dull period for the CV industry, especially for MHCVs on the back of mining ban in Odisha, disturbances in Karnataka, political instability in AP besides the general slowdown in the economy. During this period, freight volume availability declined, causing freight rates to come under pressure due to excess supply of transportation services. Rise in input cost was an additional factor causing operator margins to come under pressure. During this period, SHTF's AUM grew slower than peers. AUM growth was however higher than the decline in CV volume.

Exhibit 33: AUM growth slower than peers during CV downcycle during FY13-15



Source: Company, Nirmal Bang Institutional Equities Research

SHTF has seen various shocks and cycles over 40 years of its operating history. We believe that the asset quality will deteriorate, but the impact will be lower than initially anticipated. In the next section, we have tried to analyse the sensitivity of increase/decrease in slippages and provision coverage ratio (PCR) over various financial metrics.

Sensitivity analysis – Impact of slippages and PCR on various metrics

In our estimates, we build in slippages at 14.5% (5-yr avg at 8.2%) and recovery at 40% (5-yr avg of 26.8%) for FY21. We estimate provision coverage of 35% (FY21) - in line with 3-yr avg. This leads us to gross and net NPA of 11% and 7.1% (5-yr avg at 8.09% and 4.45%), respectively and credit cost of 3.7%.

We build in 24-25% higher credit cost and slippages in our estimates vis-à-vis demonetization when the businesses were affected due to cash flow crunch. It is difficult to estimate the impact of Covid 19 on asset quality of STO's due to moratorium and SC's standstill clause on asset recognition. Any clarity on this is only likely to emerge after the Oct-Dec'20 quarter. We have built in an interactive model, which will help us to understand the impact on NPAs and credit costs to change in assumptions in slippages and PCR.

Exhibit 34: Provisions vis-à-vis demonetisation

	FY17	FY18	Demonetisation Average	Covid-19 FY21E	Increase in provisions
GNPA	8.2%	9.4%	8.8%	11.0%	24.8
Credit costs	3.7%	2.2%	3.0%	3.7%	24.2
Slippages	5.4%	9.4%	7.4%	14.5%	95.9

Source: Company; Nirmal Bang Institutional Equities Research

Exhibit 35: Sensitivity of GNPA to slippages and PCR estimates

		Slippage						
		10.5%	11.5%	12.5%	13.5%	14.5%	15.5%	16.5%
PCR	31.0%	9.0%	9.5%	10.0%	10.5%	11.0%	11.4%	11.9%
	33.0%	9.0%	9.5%	10.0%	10.5%	11.0%	11.4%	11.9%
	35.0%	9.0%	9.5%	10.0%	10.5%	11.0%	11.4%	11.9%
	37.0%	9.0%	9.5%	10.0%	10.5%	11.0%	11.4%	11.9%
	39.0%	9.0%	9.5%	10.0%	10.5%	11.0%	11.4%	11.9%

Exhibit 36: Sensitivity of Credit costs to slippages and PCR estimates

		Slippage						
		10.5%	11.5%	12.5%	13.5%	14.5%	15.5%	16.5%
PCR	31.0%	2.1%	2.4%	2.7%	2.9%	3.2%	3.5%	3.7%
	33.0%	2.3%	2.6%	2.9%	3.2%	3.4%	3.7%	4.0%
	35.0%	2.5%	2.8%	3.1%	3.4%	3.7%	4.0%	4.2%
	37.0%	2.7%	3.0%	3.3%	3.6%	3.9%	4.2%	4.5%
	39.0%	2.9%	3.2%	3.5%	3.8%	4.1%	4.5%	4.8%

Exhibit 37: Sensitivity of RoE to slippages and PCR estimates

		Slippage						
		10.5%	11.5%	12.5%	13.5%	14.5%	15.5%	16.5%
PCR	31.0%	15.1%	14.2%	13.3%	12.3%	11.4%	10.4%	9.4%
	33.0%	14.4%	13.5%	12.5%	11.5%	10.5%	9.5%	8.5%
	35.0%	13.7%	12.7%	11.7%	10.7%	9.6%	8.6%	7.5%
	37.0%	13.0%	12.0%	10.9%	9.8%	8.7%	7.6%	6.5%
	39.0%	12.3%	11.2%	10.1%	9.0%	7.8%	6.7%	5.5%

Exhibit 38: Sensitivity of RoA to slippages and PCR estimates

		Slippage						
		10.5%	11.5%	12.5%	13.5%	14.5%	15.5%	16.5%
PCR	31.0%	2.6%	2.4%	2.3%	2.1%	1.9%	1.7%	1.6%
	33.0%	2.5%	2.3%	2.1%	1.9%	1.8%	1.6%	1.4%
	35.0%	2.3%	2.2%	2.0%	1.8%	1.6%	1.4%	1.2%
	37.0%	2.2%	2.0%	1.8%	1.6%	1.5%	1.3%	1.1%
	39.0%	2.1%	1.9%	1.7%	1.5%	1.3%	1.1%	0.9%

Exhibit 39: Sensitivity of Tier 1 to slippages and PCR estimates

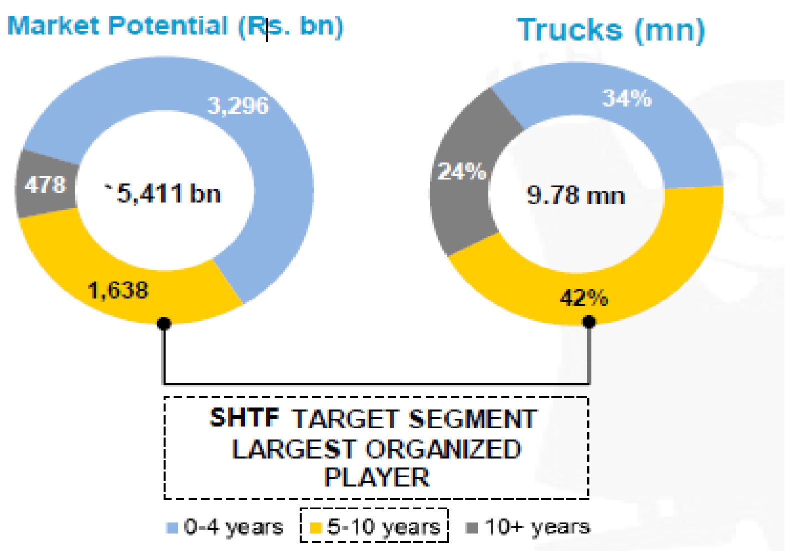
		Slippage						
		10.5%	11.5%	12.5%	13.5%	14.5%	15.5%	16.5%
PCR	31.0%	19.5%	19.3%	19.2%	19.0%	18.9%	18.7%	18.6%
	33.0%	19.4%	19.2%	19.1%	18.9%	18.8%	18.6%	18.5%
	35.0%	19.3%	19.1%	18.9%	18.8%	18.6%	18.5%	18.3%
	37.0%	19.1%	19.0%	18.8%	18.7%	18.5%	18.3%	18.2%
	39.0%	19.0%	18.9%	18.7%	18.5%	18.4%	18.2%	18.0%

Source: Nirmal Bang Institutional Equities Research estimates

Industry overview

Pre-owned CV market is estimated at Rs5.4bn. Market for second hand trucks is under penetrated with 55-60% of the market with private financiers/money lenders who charge a high rate of interest. According to industry estimates, financing amount of Rs1,350bn is likely to be triggered through replacement demand for 1.35mn new as well as pre-owned trucks. Stricter emission norms and legislative pressure on banning trucks older than 15 years will also boost replacement demand. With rural buoyancy, growth of LCVs in rural areas is expected to be good over the next 2-3 years.

Exhibit 40: Strong industry potential



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 41: CV Industry dynamics

	New	**Used**
Age	**1-5 years**	**more than 5 years**
Dominated by	Manufacturers backed NBFC & Banks	Unorganised players
Financing focus	Manufacturer driven	Customer driven
Yields %	12-14%	16-20%
LTV	85-90%	65-70%
Operator	LTO (Large truck operator)	STO (Small truck operator)
Loan tenure	3-5 years	2-4 years
Primary usage	Metro & big cities - Long hauls	Interstate & small-towns
Efficiencies	Low	High
Primary growth drivers	High GDP/IIP growth	Increased freight rates, increasing aspirations for drivers

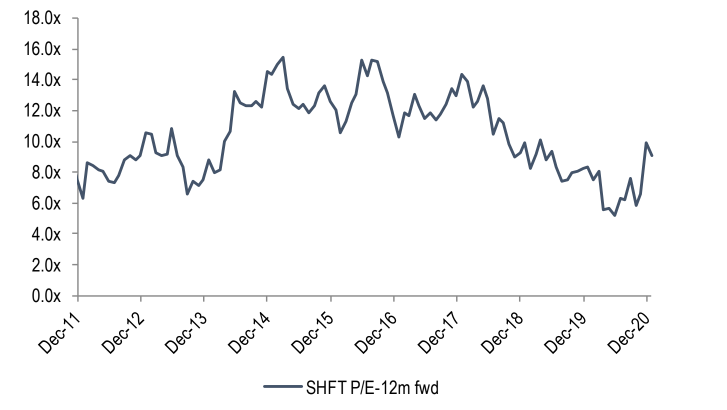
Source: Company, Nirmal Bang Institutional Equities Research

Valuation

Attractive valuation

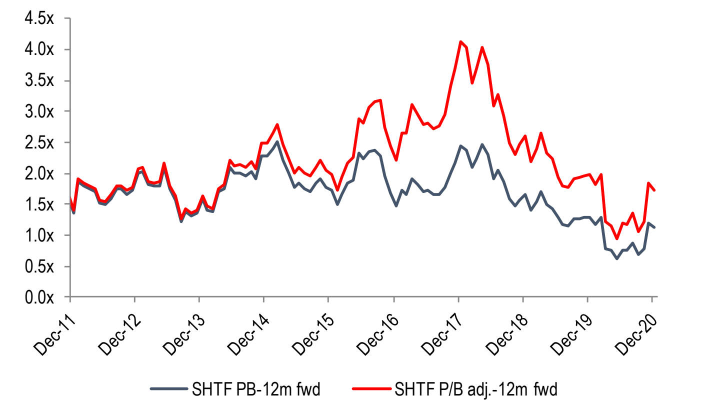
SHTF trades at a discount (50%) to its peers at P/E of 9.6x and P/B of 1.1x on 12-month forward basis. The implied discount to the sector is due to its high exposure to cyclical HCV finance business and market perception of execution risk. At P/ABV, it is currently trading at ~1.7x (on 12-month fwd basis).

Exhibit 42: SHTF P/E - 12m fwd



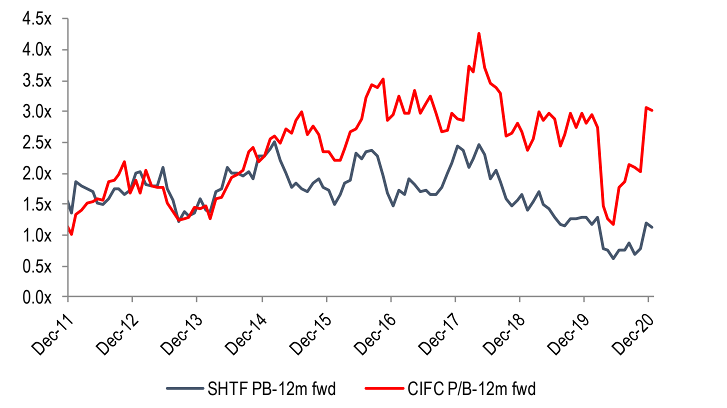
Source: Bloomberg

Exhibit 43: SHTF P/B -12m fwd



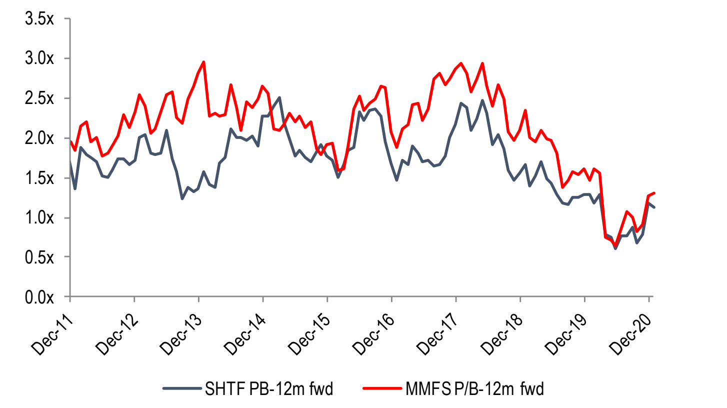
Source: Bloomberg

Exhibit 44: SHTF vs. CIFC P/B-12 m fwd



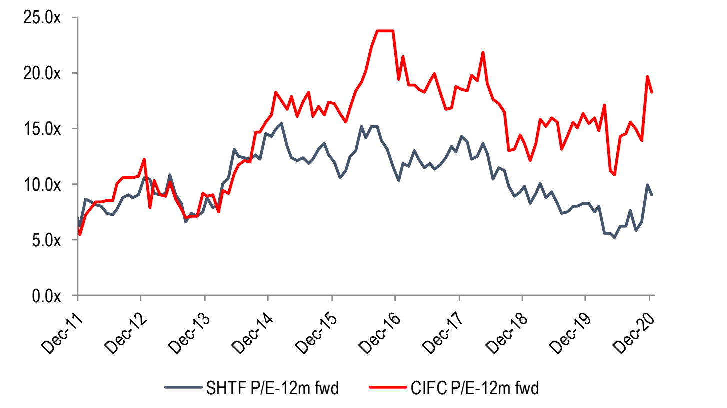
Source: Bloomberg

Exhibit 45: SHTF vs. Mahindra Finance P/B -12m fwd



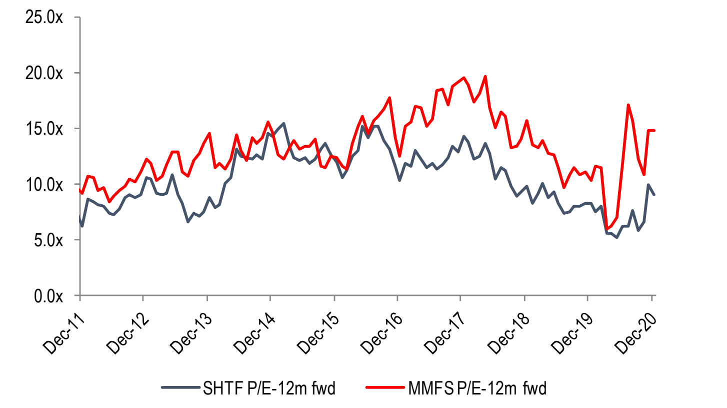
Source: Bloomberg

Exhibit 46: SHTF vs. CIFC P/E - 12 m fwd



Source: Bloomberg

Exhibit 47: SHTF vs. Mahindra Finance P/E -12m fwd

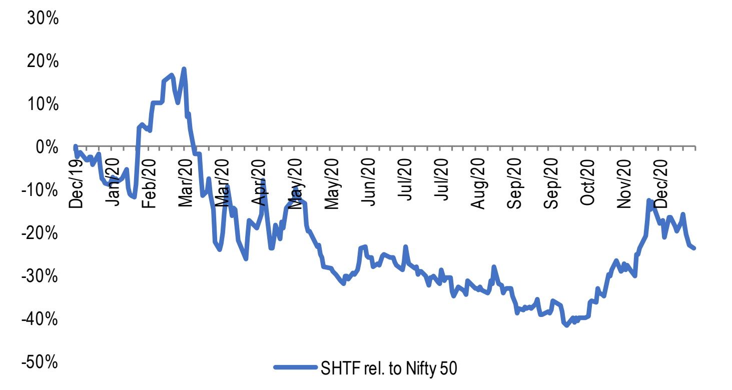


Source: Bloomberg

We value the stock at 1.8x P/ABV on FY23E, a ~20% discount to its 3 year average multiple given its highly cyclical nature and uncertainty in the current scenario.

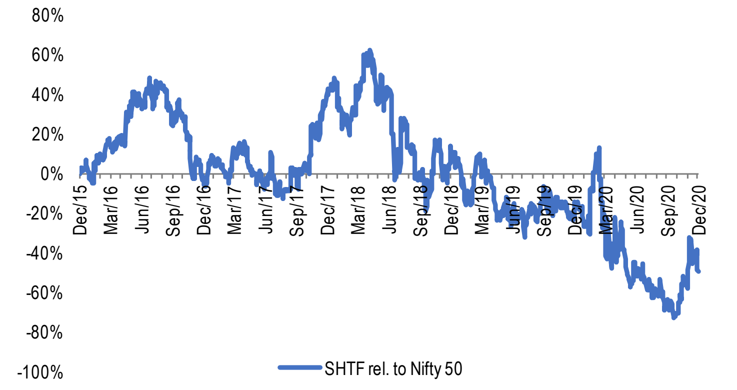
The stock has under-performed the Nifty 50 by 24% since the beginning of the year and by ~50% over the last five years.

Exhibit 48: SHTF performance YTD rel. to Nifty 50



Source: Bloomberg

Exhibit 49: SHTF performance last 5 years re. to Nifty 50



Source: Bloomberg

Exhibit 50: Peer valuation

	Price	M cap	P/B			P/B- adj.			P/E			ROE			ROA		
Name	(Rs)	Rs. (bn)	FY21	FY22	FY23	FY21	FY22	FY23	FY21	FY22	FY23	FY21	FY22	FY23	FY21	FY22	FY23
CIFC	386.4	317	3.4x	2.9x	2.4x	4.2x	3.5x	2.8x	22.6x	16.0x	13.7x	16.0%	19.4%	19.2%	2.1%	2.7%	2.8%
SHTF	1016.1	257	1.2x	1.1x	1.0x	2.0x	1.7x	1.4x	13.2x	9.6x	8.2x	9.6%	12.0%	12.8%	1.6%	2.1%	2.2%
MMFS	175.8	217	1.5x	1.4x	1.2x	2.0x	1.8x	1.6x	23.7x	14.9x	10.7x	7.0%	9.4%	12.0%	1.2%	1.9%	2.4%

Source: Nirmal Bang Institutional Equities Research

Risks

- Asset quality risks are perceived to be higher, especially in the pre-owned vehicle segment, due to vehicle operators' vulnerability to freight rates and asset utilization levels
- Net interest margins are relatively more sensitive to interest rates/liquidity environment
- Strong linkage to overall economics and industrial cycles making it vulnerable to growth and quality
- Increase in competitive intensity, thereby leading to lower margins and profitability
- Risks of regulatory changes

Asset quality environment can deteriorate

SHTF's typical customer is a small fleet operator or first time user who is more vulnerable to declining income levels. Any dip in asset utilization rates due to economic slowdown can materially affect its cash flows. Also, decline in freight rates or increase in diesel prices can have a significant impact on its operations, in turn affecting its profitability and repayment ability.

Increase in interest rates

SHTF is largely dependent on wholesale funding sources. The company is now focused on increasing share of more stable and relatively lower cost retail deposits. However, wholesale funding will contribute to majority of borrowings going ahead. Wholesale funds re-price faster than retail funding during tight liquidity conditions and rising interest rate environment. In our view, liquidity is likely to remain easy in the near term. But, any increase in interest rates is likely to affect SHTF's funding cost. This can affect our net interest margin estimates.

Merger which is not in favor of minority shareholders

Earlier, the Shriram group had considered a merger but it did not materialise. In January'20, the Shriram group planned a three-way merger between Shriram Capital (unlisted), Shriram City Union and SHTF. However, the plan was halted due to observations from the RBI on divestment of stake in the insurance business. Management's focus over the last 9 months has been essentially on managing asset quality. However, once the Covid impact is neutralized in our view, management may consider merging existing companies into a large NBFC. Any merger announcement, which is not in favor of shareholders, may have a negative impact on the share price, even if it does not materialize.

Increase in competitive intensity

SHTF enjoyed a dominant position in the used vehicles segment due to its wide and low cost distribution network, which has been difficult to replicate. The cyclical nature of the CV business and the perceived riskiness of target customer segment kept banks away from lending to used vehicles. Any improvement in risk perception of business or reduction in cash flow intensity may lead to entry of banks or NBFCs into this segment, which may impact net interest spreads or profitability of the company.

Regulatory changes

SHTF is supervised and regulated by the RBI, which is also the regulator for the banking system. The company operates as a NBFC and any change in regulation for NBFCs to bring it in line with banks may have an impact on its growth and profitability, in turn impacting its earnings.

Exhibit 51: Corporate history

1979	SHTF was established
1984	Initial Public Offering
1990	Investment from Telco and Ashok Leyland
1999	-Tier-up with Citicorp for CV financing under PMS -The first securitisation transaction by SHTF
2002-04	-Preferential allotment to Citicorp Finance (India) in 2002 - Preferential allotment to Axis bank and Reliance Capital in 2004
2005-06	- Merger of Shriram Investment Ltd and Shriram Overseas Finance Ltd with SHTF - Investment from ChrysCapital (2005) and TPG (2006)
2009	-Place Rs 10bn of NCD with domestic investors - Purchased hypothecation loan outstanding of CV and construction equipment of GE Capital Financial Services (GE) aggregating to approx. Rs 11bn
2010	-Successfully raised Rs 5.84bn through QIP with domestic and international investors - Initiated financing of construction equipment
2011	Introduced Shriram Automalls - a dedicated platform for trading of pre-owned trucks at a fair value
2013	AUM crosses Rs 500 bn
2015-16	-Ratings upgrade from FITCH and CRISIL -Merger of Shriram Equipment Finance Co. Ltd with SHTF
2016-17	Raised Rs13.5Bn through Masala bonds listed on Singapore Stock Exchange
2017-18	-Raised Rs11.6Bn through Masala bonds listed on Singapore Stock Exchange -Sold 55.4% stake in Shriram Automall India Ltd to MXC Solutions India Pvt. Ltd
2018-20	-Raised US$750mn through ECB route in FY19 and Rs4.9bn in Jan 20 AUM crosses 1 tn Raised Rs 14.9bn through rights issue in Aug 20

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 52: Professional management team

Umesh Revankar MD & CEO	Holds a degree in MBA finance. Associated with Shriram group for over 30 years and has been in-charge of various responsibilities and worked in several key roles of business operations
Parag Sharma Executive Director & CFO	Qualified cost accountant with 28 years of experience in finance industry Joined SHTF in 1995
S. Sunder Executive Director Accounts & Admin	Qualified cost accountant with 28 years of experience in finance industry Joined SHTF in 1995.
Sanjay Mundra President - Investment & Media Relations	Qualifies Company Secretary with 25 year of experience in finance industry Joined in 2007

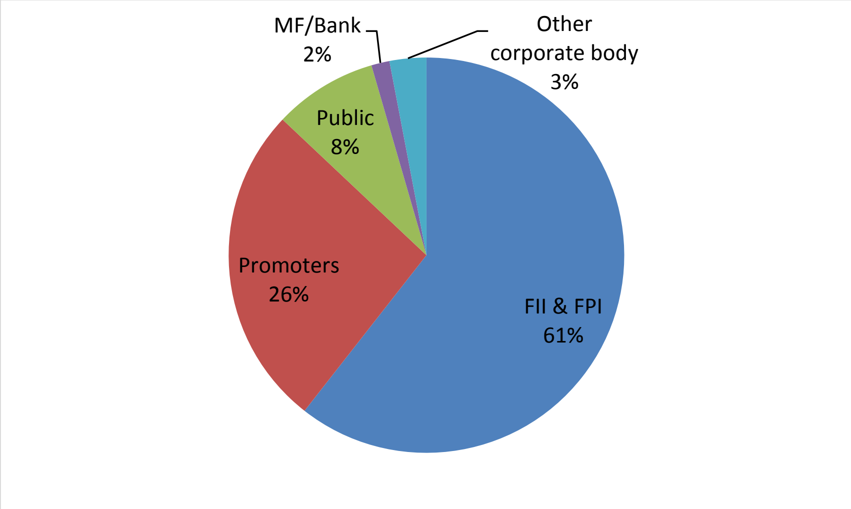
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 53: Board of Directors

Subramanian Lakhsminarayanan Chairman	Retired IAS officer. Served at senior positions in the Ministry of Home Affairs, Ministry of Communication & IT etc
Umesh Revankar MD & CEO	Holds a degree in MBA finance. Associated with Shriram group for over 30 years and has been in-charge of various responsibilities and worked in several key roles of business operations
S Sridhar Director	Former Chairman & Managing Director of Central Bank of India, with nearly four decades of experience in commercial and development banking out of which 13 years were at the CEO/Board level. Currently, serves as an independent Director on the Boards of various companies
D V Ravi Director	Commerce graduate from University of Bangalore and holds PG Diploma in Management from the Institute of Rural Management, Anand (IRMA). Joined CV Finance business of Shriram Group in 1992 as Head of Investment Servicing. Currently serves as Managing Director of Shriram Capital Ltd.
Mrs Kishori Udeshi Director	Holds degree in MA in Economics. First woman Deputy Governor of RBI and also on the Board of SEBI, NABARD & EXIM Bank. Holds directorship in many other listed companies
Ignatius Michael Viljoen Director	Associated with Sanlam group since 2003 and is a nominee Director of Sanlam. Head of Credit - Sanlam Pan Africa Portfolio Management, South Africa and is responsible for range of credit risk and credit portfolio management aspects across the various entities owned by the Sanlam Group outside of the Republic of South Africa .
Pradeep Kumar Panja Director	Holds Masters degree in Science (Statistics) from the University of Madras. He is a Certified Associate of the Indian Institute of Bankers. Retired as a Managing Director (Corporate Banking) of State Bank of India in October 2015

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 54: Ownership structure as on Q2FY21



Source: BSE filings, Company, Nirmal Bang Institutional Equities Research

Exhibit 55: Top shareholders

Key shareholders	%
Fidelity Investment Trust Fidelity Series Emerging Markets	5.1
Sanlam Life Insurance Ltd	3.0
Govt. Pension Fund Global	1.9
Wishbone Fund, Ltd	1.7
T. Rowe Price International Growth and Income Fund	1.7
Life Insurance Corporation of India	1.7
T. Rowe Price New Asia Fund LP	1.3
Composite Capital Master Fund LP	1.3
Vanguard Total International Stock Index Fund	1.2

Financials

Exhibit 56:Income statement

Y/E March (Rsmn)	FY19	FY20	FY21E	FY22E	FY23E
Financing Income	1,53,843	1,62,675	1,71,847	1,84,991	2,06,783
Finanancing charges	75,113	82,703	88,715	96,137	1,08,641
Net Financing income	**78,730**	**79,972**	**83,131**	**88,853**	**98,141**
Change (%)	14.3	1.6	4.0	6.9	10.5
Other Income	1,614	3,152	1,500	1,575	1,654
Net Income	**80,344**	**83,124**	**84,631**	**90,428**	**99,795**
Change (%)	13.8	3.5	1.8	6.8	10.4
Employee Cost	8,831	10,108	9,426	10,680	12,362
Other Operating Exp.	9,909	10,680	11,184	12,328	14,028
Operating Profit	**61,605**	**62,336**	**64,021**	**67,420**	**73,405**
Change (%)	14.4	1.2	2.7	5.3	8.9
Total Provisions	**23,823**	**27,949**	**38,185**	**30,716**	**30,173**
% to operating income	38.7	44.8	59.6	45.6	41.1
PBT	**37,783**	**34,387**	**25,836**	**36,704**	**43,231**
Tax	12,143	9,368	7,027	9,984	11,759
Tax Rate (%)	32.1	27.2	27.2	27.2	27.2
PAT	**25,640**	**25,018**	**18,809**	**26,721**	**31,473**
Change (%)	8.3	-2.4	-24.8	42.1	17.8
Dividend	2,723	1,134	2,531	5,061	5,568

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 57: Balance sheet

Y/E March (Rsmn)	FY19	FY20	FY21E	FY22E	FY23E
Capital	2,269	2,269	2,531	2,531	2,531
Reserves & Surplus	1,56,094	1,77,783	2,08,721	2,30,381	2,56,286
Net Worth	**1,58,363**	**1,80,052**	**2,11,252**	**2,32,911**	**2,58,816**
Borrowings	**8,79,144**	**9,43,718**	**9,64,138**	**11,03,329**	**12,33,047**
Change (%)	7.0	7.3	2.2	14.4	11.8
Other Liabilities	15,418	17,517	18,443	19,133	19,842
Total Liabilities	**10,52,925**	**11,41,286**	**11,93,833**	**13,55,373**	**15,11,705**
Investments	39,991	27,985	30,783	33,862	37,248
Change (%)	70.8	-30.0	10.0	10.0	10.0
Loans	**9,67,515**	**10,22,316**	**10,60,552**	**12,35,728**	**13,93,343**
Change (%)	6.6	5.7	3.7	16.5	12.8
Net Fixed Assets	1,454	4,804	5,016	5,087	5,167
Net Current Assets	43,965	86,181	97,481	80,696	75,947
Total Assets	**10,52,925**	**11,41,286**	**11,93,833**	**13,55,373**	**15,11,705**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 58:Key ratios

Y/E March	FY19	FY20	FY21E	FY22E	FY23E
Spreads Analysis on AUM (%)					
Avg. Yield - on Financing portfolio	15.3	15.2	15.4	15.4	15.4
Avg Cost of funds	7.5	7.7	8.0	8.0	8.1
Int Spread on Financing portfolio	7.8	7.5	7.4	7.4	7.3
Profitability Ratios (%)					
RoE	17.4	14.8	9.6	12.0	12.8
RoA	2.5	2.3	1.6	2.1	2.2
Int. Expended/Int.Earned	48.8	50.8	51.6	52.0	52.5
Other Inc./Net Income	2.0	3.8	1.8	1.7	1.7
	2.6	2.3	1.7	2.2	2.3
Efficiency Ratios (%)					
Op. Exps./Net Income	23.3	25.0	24.4	25.4	26.4
Empl. Cost/Op. Exps.	47.1	48.6	45.7	46.4	46.8
Asset-Liability Profile (%)					
Loans/Borrowings Ratio	110.1	108.3	110.0	112.0	113.0
GNPA	86,163	91,771	1,24,549	1,25,257	1,24,167
NNPA	56,465	59,911	80,957	81,417	80,708
GNPL ratio (%)	8.4	8.4	11.0	9.5	8.4
NNPL ratio (%)	5.7	5.6	7.1	6.2	5.5
Leverage	6.6	6.3	5.7	5.8	5.8
Average leverage (on BS)	6.9	6.5	6.0	5.7	5.8
CAR	20.3	22.0	22.0	20.9	20.6

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 59: Valuation

Y/E March (Rsmn)	FY19	FY20	FY21E	FY22E	FY23E
BVPS (INR)	698	794	866	920	1,023
BV Growth (%)	26.0	13.7	9.1	6.3	11.1
Price-BV (x)	1.5	1.3	1.2	1.1	1.0
Adjusted BV per share	449.1	529.5	514.9	598.6	703.8
P/ABV	2.3	1.9	2.0	1.7	1.4
EPS (INR)	113.0	110.3	77.1	105.6	124.4
Growth (%)	8.3	-2.4	-30.1	36.9	17.8
Price-Earnings (x)	9.0	9.2	13.2	9.6	8.2
Dividend	14.5	6.0	10.0	20.0	22.0
Dividend Yield (%)	1.4	0.6	1.0	2.0	2.2

Source: Company, Nirmal Bang Institutional Equities Research

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