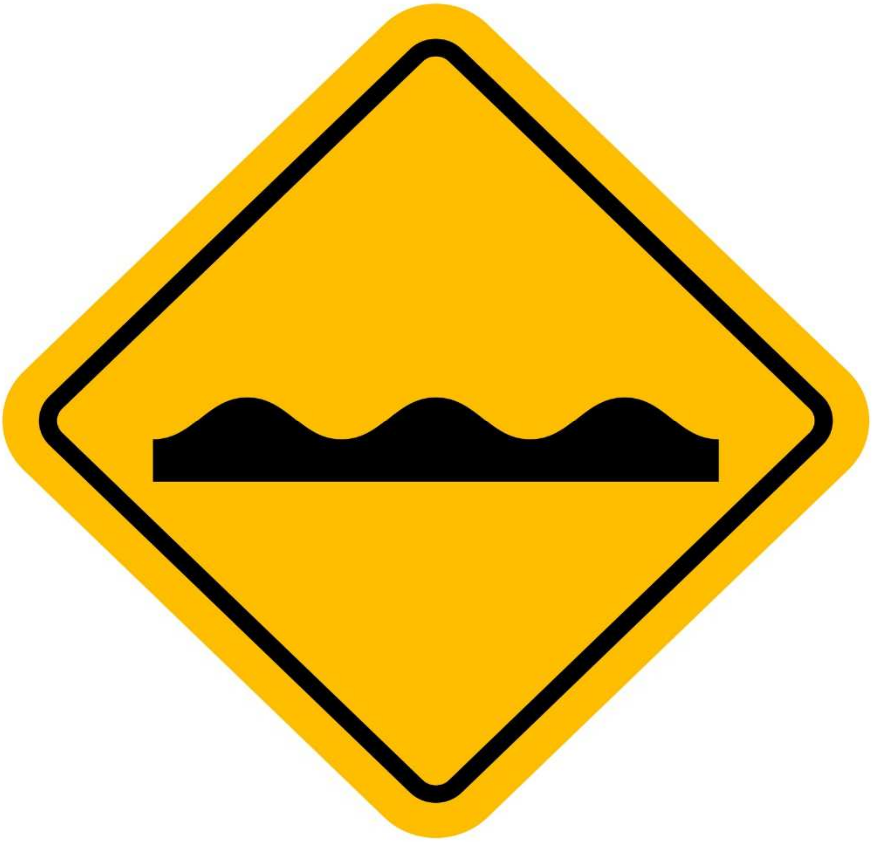

Vehicle Finance NBFCs

Recovery in H2FY22E

June 2020

Shubhranshu Mishra

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NBFC

10 June 2020

Vehicle Finance NBFCs: Recovery in H2FY22E

Automotive production and sales are expected to plummet to multi-year lows in FY21 as pressures arising from the Covid-19 crisis engulf both demand and supply channels. Tractors and two-wheelers should witness faster recovery (by H2FY21) than PVs and CVs as rural India benefits from a good rabi harvest and likely normal monsoons. We expect vehicle financiers to focus on collections and cost control in FY21, with disbursal growth staying muted in the range of 0-6% CAGR over FY21-FY24. Initiate with BUY on CIFC; ADD on MMFS.

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Slowdown in PVs and CVs; tractors and 2Ws bright spots: As per CRISIL, India's automobile sector is likely to hit a decadal low in car and truck sales in FY21. Sales of PVs and CVs are expected to sink to FY10 levels, with declines of ~25% and ~27% respectively given the extended lockdown to contain the pandemic. Demand revival in both these segments is expected only in H2FY22. 2Ws and tractors should recover faster in H2FY21 driven by a bumper rabi crop and a normal monsoon forecast. We expect disbursements in auto finance to remain within a tepid CAGR range of 0-6% during FY21-FY24.

Comfort on liquidity, focus on cost control and collections: We believe vehicle finance NBFCs will manage liquidity well in FY21 given regulatory support from RBI and cash levels at 8-10% of the balance sheet (maintained since the FY19 IL&FS crisis). Most players should benefit from a lower repo rate as liabilities come up for repricing. A focus on curbing discretionary and employee expenses will also curb opex, while planned diversion of manpower from sales to collection teams will strengthen the collections architecture.

Recommendations: We initiate coverage on Cholamandalam Investment and Finance (CIFC) with BUY (Mar'21 TP of Rs 200) and Mahindra & Mahindra Financial Services (MMFS) with ADD (Mar'21 TP of Rs 170). CIFC has built a diversified vehicle finance and granular home equity business, wherein we expect stable spreads of 6.2% through FY22 backed by strong pricing power.

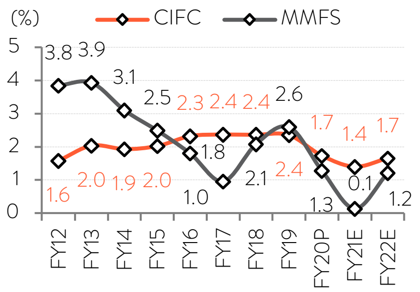
MMFS' pricing power is also likely to remain intact due to its wide distribution reach and multi-OEM client base. With surplus systemic liquidity and strong parentage in M&M, funding costs should decline. We expect covid-19 will weigh more on MMFS on credit costs and profitability than CIFC; normalisation in H2FY22.

KEY RECOMMENDATIONS

Ticker	Price	Target	Rating
CIFC IN	156	200	BUY
MMFS IN	154	170	ADD

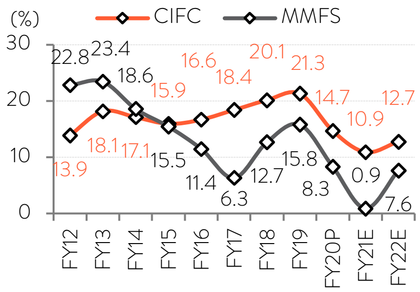
Price & Target in Rupees

CIFC HAS MORE PREDICTABLE ROA THAN MMFS...



Source: Company, BOBCAPS Research

...AND ALSO ROE



Source: Company, BOBCAPS Research

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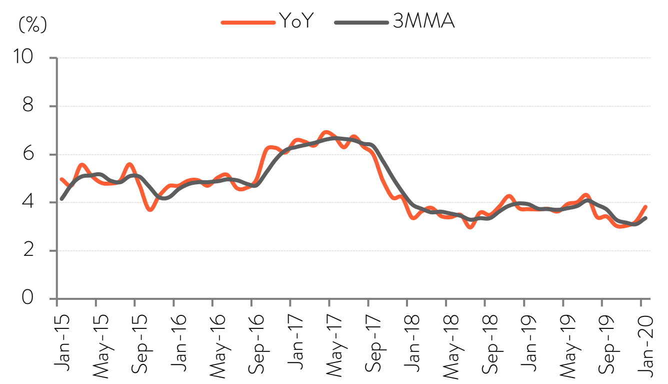

Source: MOSPI, GST Data, BOBCAPS Research

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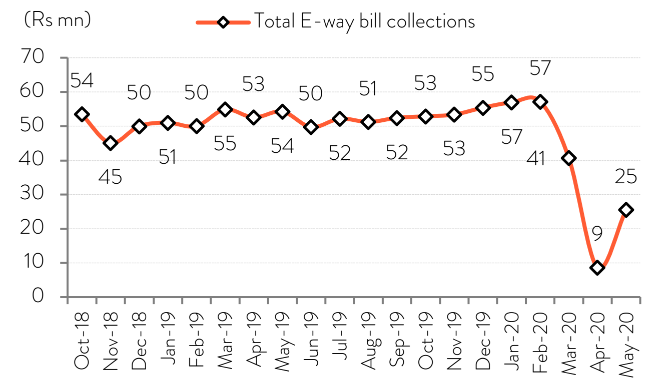
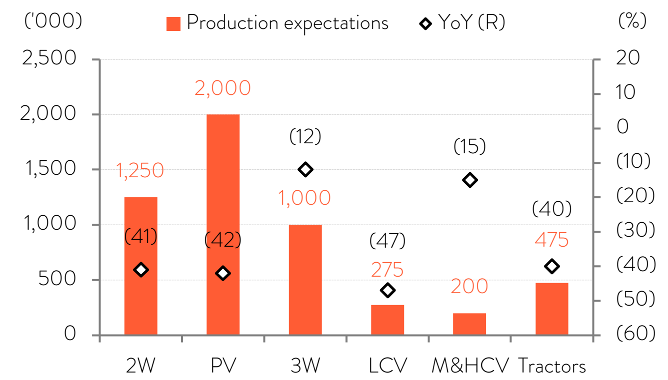


Source: MOSPI, GST Data, BOBCAPS Research

FIG 3 – VEHICLE PRODUCTION WILL TAKE 4 YEARS TO HIT FY18 PEAK, PER BOSCH INDIA



Source: Bosch India, BOBCAPS Research

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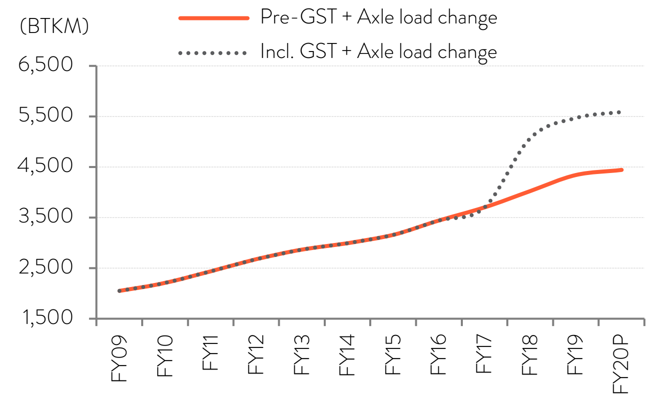

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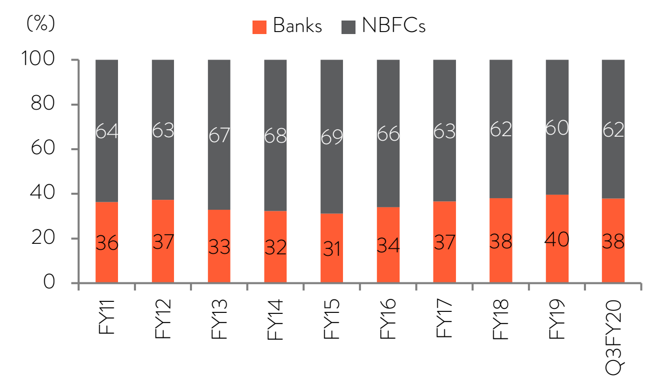

Source: Company, BOBCAPS Research

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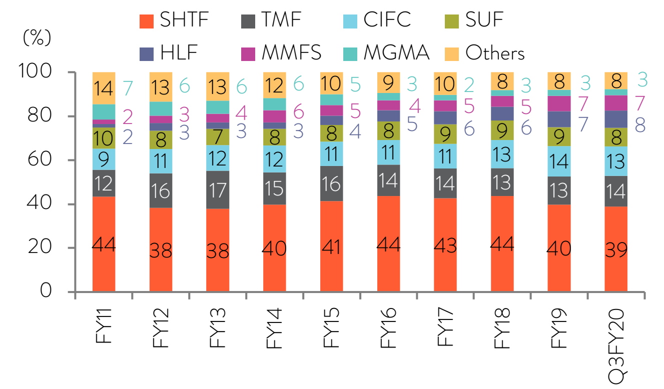
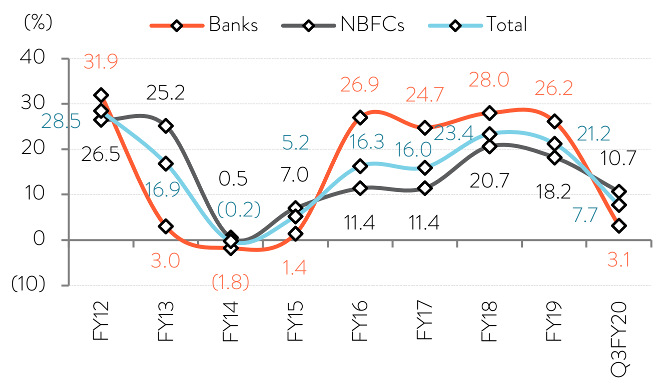


Source: Company, BOBCAPS Research

FIG 7 – CV FINANCE CYCLE (AUM GROWTH) ACROSS FY12-Q3FY20



Source: Company, BOBCAPS Research

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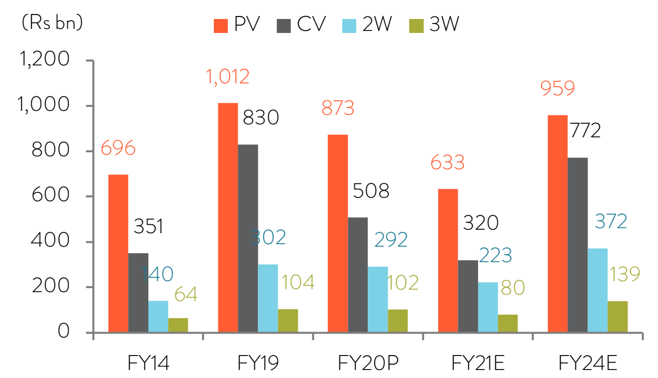


Source: Company, CRISIL, BOBCAPS Research Note: Data for bank and NBFCs

Initiate on CIFC and MMFS

CIFC: Prudent vehicle financier

Two aspects of CIFC's vehicle finance business stand out compared to most peers: (i) diversification across product segments, and (ii) low state-level concentration – the largest state accounts for only 11% of the total portfolio. An early entry into LAP and focus on affordable housing are also likely to yield results in the medium term.

AUM has grown at 20%+ over FY19-FY20 though disbursals have slowed amid a tough economic environment. The near-to-medium-term outlook appears challenging due to Covid-19 disruptions – we expect back-ended recovery in H2FY22 given both supply and demand constraints. Hence, we model for slower AUM growth at ~4% CAGR during FY20-FY22. Strong asset quality has been a hallmark of CIFC. Credit costs could remain elevated in FY21, but are likely to normalise in H2FY22. Thus, we expect mild ROA/ROE recovery in FY22.

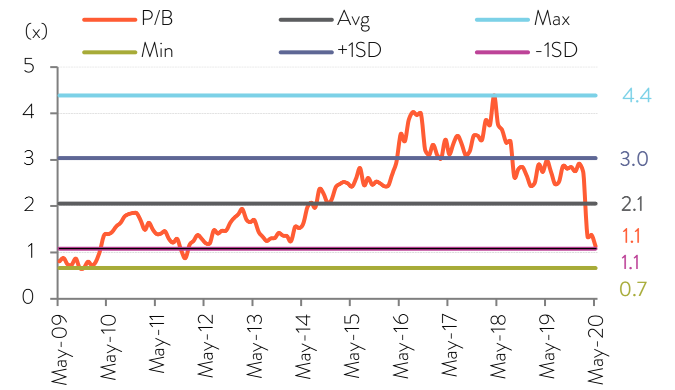
VALUATION ASSUMPTIONS

Parameter	(%)
Cost of equity	14.0
Risk-free rate	7.75
Risk premium	5.0
Terminal growth rate	5.0

Source: BOBCAPS Research

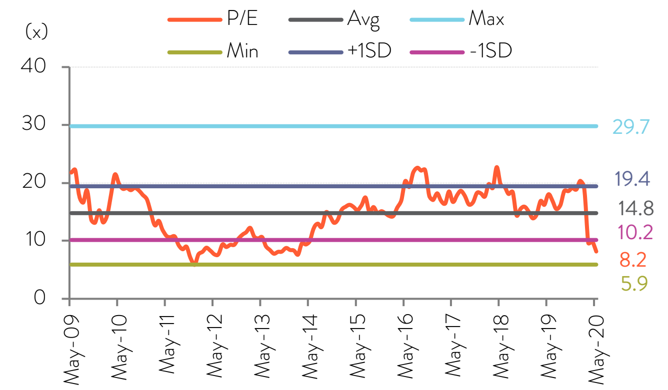
The stock currently trades at 1.2x FY22E BVPS, reflecting the successful scaling up of key businesses and robust profitability (21% AUM CAGR, FY11-FY20). We use a residual income model to arrive at our Mar'21 target price of Rs 200 (1.6x FY22E BV), which values the company at a risk-free rate of 7.75%, cost of equity of 14.0%, and terminal growth of 5%. We incorporate the recent Rs 9bn QIP and Rs 3bn of preferential issue in our numbers. We believe the business will remain well capitalised and flush with liquidity through FY22. Initiate with BUY.

FIG 9 – ONE-YEAR FORWARD P/B



Source: Bloomberg, BOBCAPS Research

FIG 10 – ONE-YEAR FORWARD P/E



Source: Bloomberg, BOBCAPS Research

MMFS: Challenging year ahead

MMFS faces multiple challenges as asset health likely deteriorates sharply in the wake of Covid-19. We believe the demand environment will take two years to normalise, thereby affecting volume and value growth though to FY22. Tepid AUM growth and intensified collection efforts are expected to drive up the expense ratio to ~300bps. Higher opex and elevated credit costs are estimated to mute earnings growth.

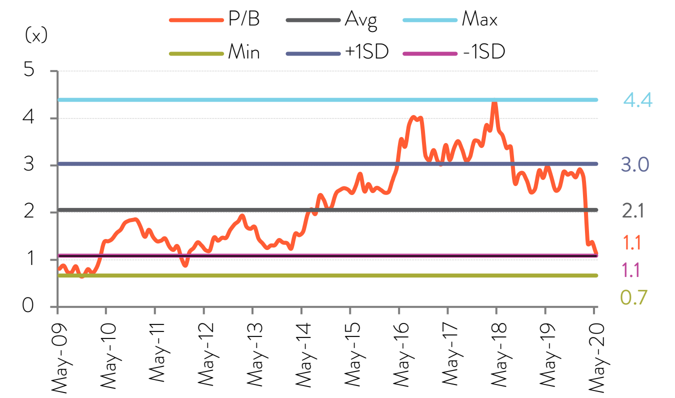
We value the stock based on a residual income model, which yields a Mar'21 target price of Rs 170. Initiate with ADD on FY22E recovery potential. Our assumptions include cost of equity of 14.8%, risk-free rate of 7.75%, risk premium of 5%, and a long-term growth rate of 5%.

VALUATION ASSUMPTIONS

Parameter	(%)
Cost of equity	14.8
Risk-free rate	7.75
Risk premium	5.0
Terminal growth rate	5.0

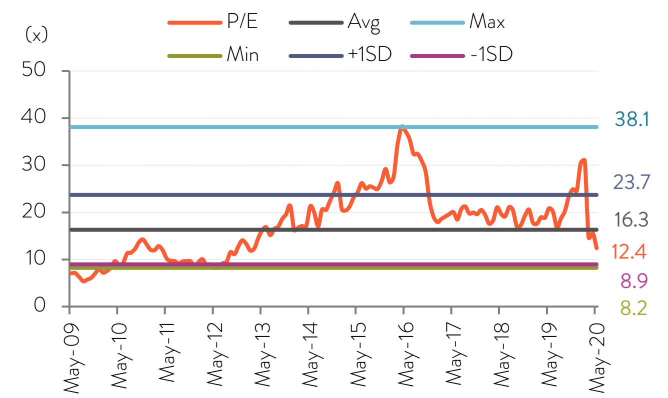
Source: BOBCAPS Research

FIG 11 – ONE-YEAR FORWARD P/B



Source: Bloomberg, BOBCAPS Research

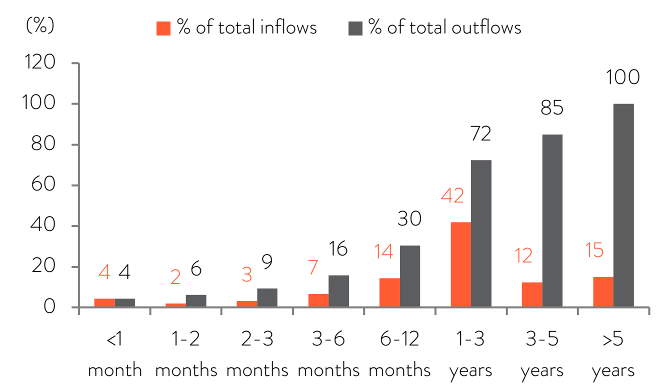
FIG 12 – ONE-YEAR FORWARD P/E



Source: Bloomberg, BOBCAPS Research

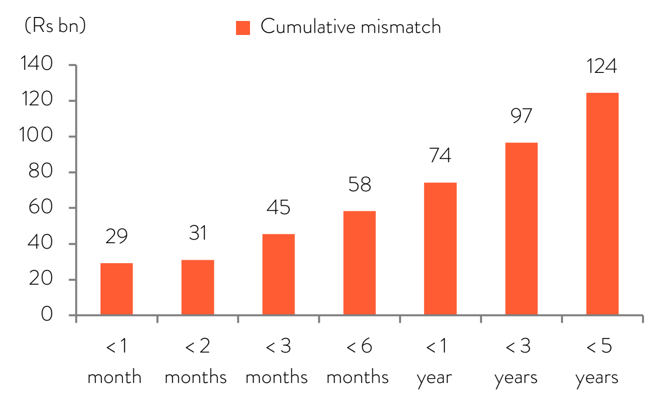
MMFS vs. CIFC

FIG 13 – WELL MATCHED ALM IN LESS THAN ONE YEAR BUCKET FOR CIFC...



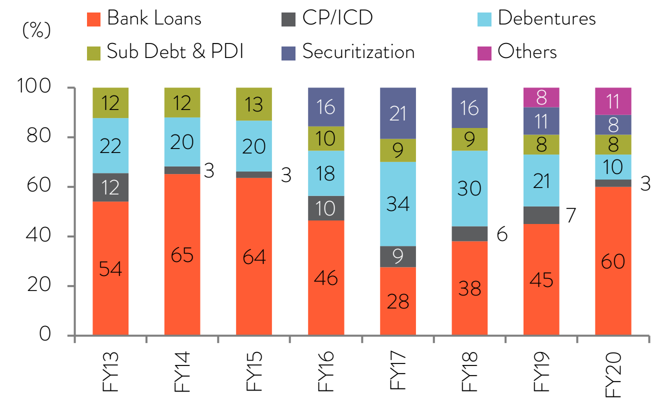
Source: Company, BOBCAPS Research

FIG 14 – ...AND ALSO FOR MMFS AS OF FY20



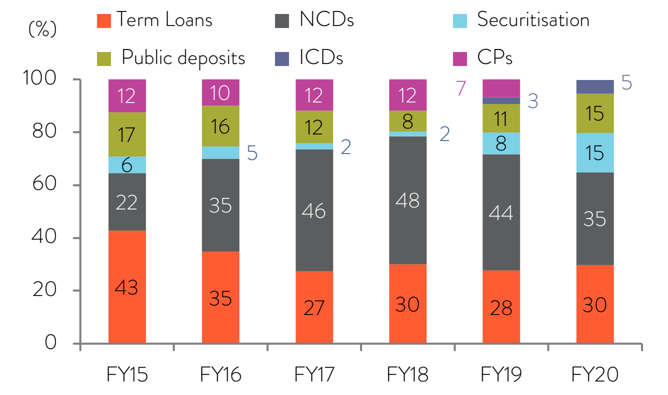
Source: Company, BOBCAPS Research

FIG 15 – CIFC HAS REDUCED EXPOSURE TO CPS TO 3% AS OF FY20



Source: Company, BOBCAPS Research

FIG 16 – MMFS HAS SLASHED CP EXPOSURE TO ZERO AS OF FY20



Source: Company, BOBCAPS Research

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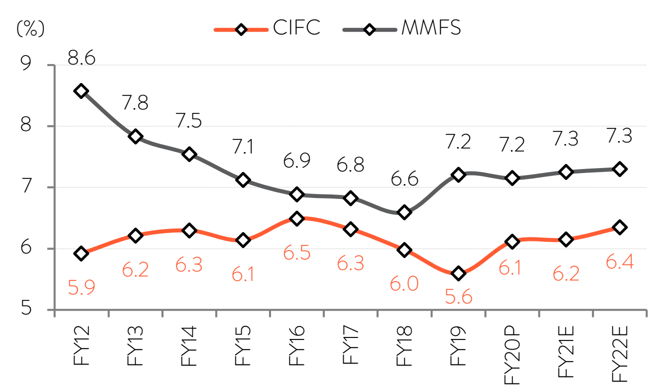
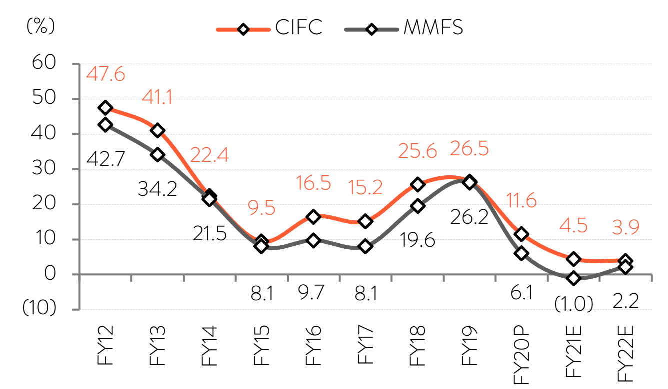


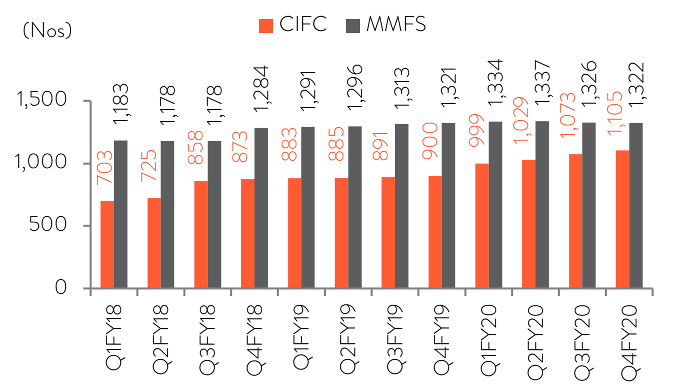
Source: Company, BOBCAPS Research

FIG 18 – AUM GROWTH EXPECTED TO TAPER FOR BOTH COMPANIES BUT STEEPER FALL FOR MMFS



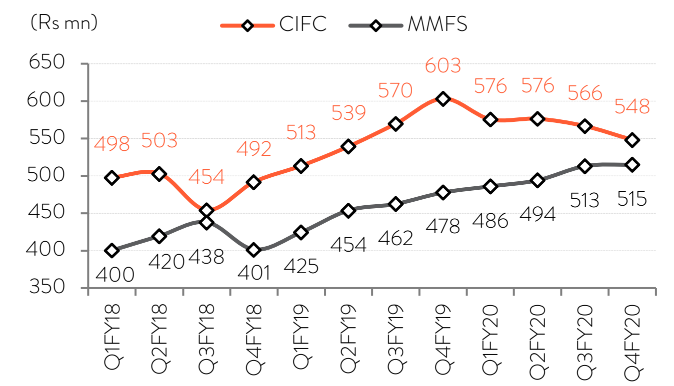
Source: Company, BOBCAPS Research

FIG 19 – BOTH PLAYERS HAVE EXPANDED BRANCHES OVER LAST 3 YEARS…



Source: Company, BOBCAPS Research

FIG 20 – …LEADING TO MMFS NARROWING THE GAP WITH CIFC ON PRODUCTIVITY PER BRANCH



Source: Company, BOBCAPS Research

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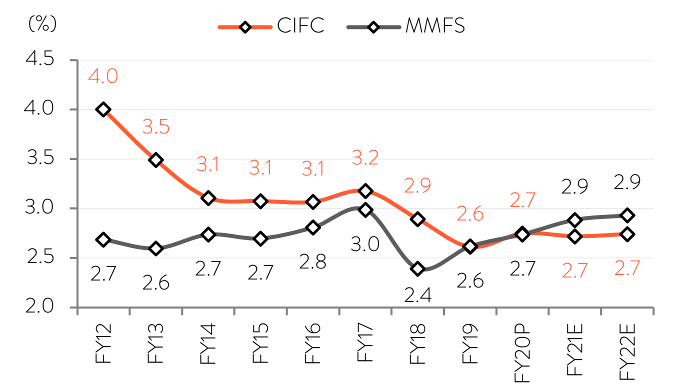

Source: Company, BOBCAPS Research

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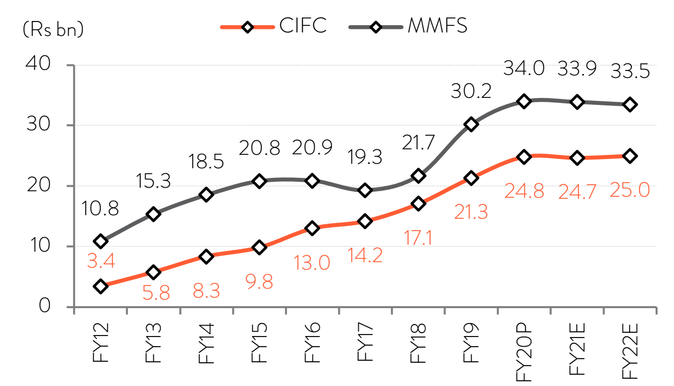

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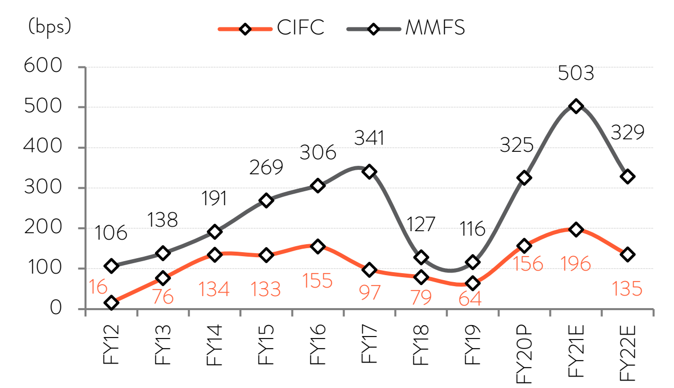
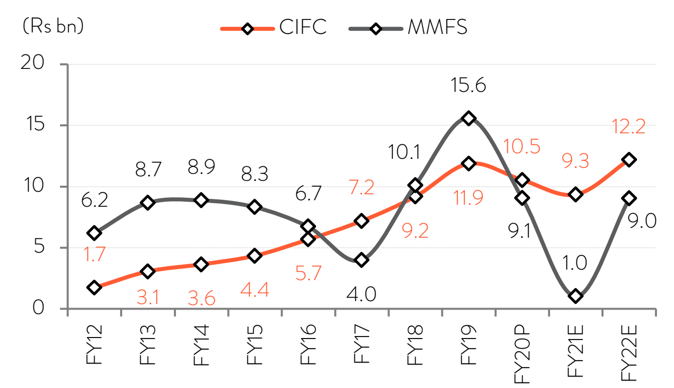


Source: Company, BOBCAPS Research

FIG 24 – …LEADING TO SMOOTHER PAT GROWTH TRAJECTORY FOR CIFC OVER THE SAME PERIOD



Source: Company, BOBCAPS Research

Covid-19 impact – Auto slump to hit financiers

As per CRISIL, India's automobile sector is likely to hit a decadal low in car and truck sales in FY21. Industry capacity utilisation could plunge below 50% from ~58%. Sales of PVs and CVs are expected to sink to FY10 levels, with estimated declines of ~25% and ~27% respectively in FY21 given the extended lockdown to contain the Covid-19 pandemic – this could take the auto industry into another year of double-digit volume decline at 15-40%. Demand revival for PVs and CVs is expected only in H2FY22, although 2Ws and tractors should recover faster. Disbursal growth trends for auto financiers are expected to follow suit.

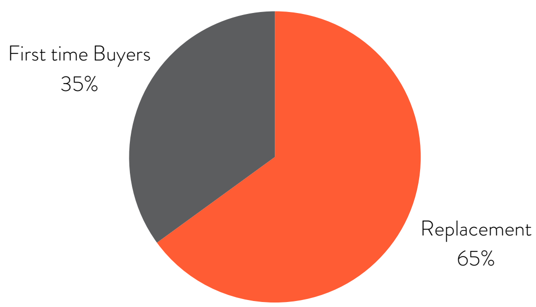
Risk of job losses to weigh on PV demand

After the nationwide lockdown was put in place to contain the pandemic in late Mar'20, what started as supply-side pain has quickly engulfed the demand side as well, with job-loss and pay-cut fears dampening consumer sentiment. Automobile sales are running out of steam as urban income sentiment wilts under the pandemic.

As per CRISIL's assessment, ~26,000 companies have a total employee cost of Rs 7tn. About 60% of this cost resides in companies that are expected to see a sharp reduction in revenue growth, and where employees are a meaningful cost head. This implies a higher risk of job losses or pay cuts.

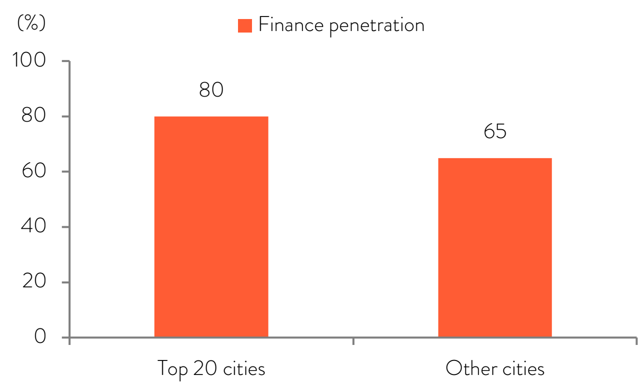
Given this overhang, passenger vehicles (PV) – a big-ticket purchase with a replacement share of 60-70% in segmental sale volumes – are expected to see buying decisions postponed. That's also because the segment has high finance penetration of ~80%, and given the income uncertainty, fewer consumers would now be willing to take a loan.

FIG 25 – PV DEMAND HAS A HIGH REPLACEMENT SHARE



Source: CRISIL, BOBCAPS Research

FIG 26 – HIGH PV FINANCE PENETRATION IMPLIES FEWER PURCHASES WHEN RISK TO INCOME IS HIGH



Source: CRISIL, BOBCAPS Research

CV outlook bleak

Commercial vehicle (CV) sales have been languishing under the impact of new axle-load norms and are unlikely to show much recovery as freight demand remains low. Our auto analyst Mayur Milak expects flattish (0%) to single-digit (–5%) decline in MHCV segment volumes in FY21 on account of the transition to new emission (BS-VI) norms, slow pick-up in industrial activity, and the adverse economic fallout of the pandemic.

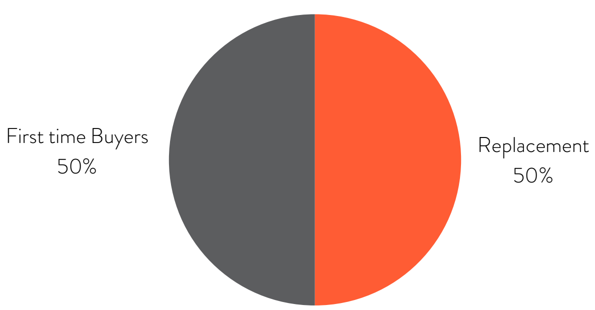
LCV volumes have contracted all through FY20 (by ~20%) owing to the slowdown in consumption-driven sectors and the rural economy, a strict financing environment and a high base effect. With consumer sentiment remaining weak and challenges on the financing front, the LCV segment is projected to show flattish growth of 0-2% in FY21 a well.

Tractors and 2Ws bright spots

We believe tractors and two-wheelers (2W) are likely to see relatively faster recovery in H2FY21. Both segments benefit from the recent bumper rabi harvest and the forecast of a normal monsoon, which augurs well for rural incomes. Within 2Ws, which have a lower replacement share of ~50% and lower finance penetration of 35-40%, motorcycles are expected to fare better, riding on rural demand.

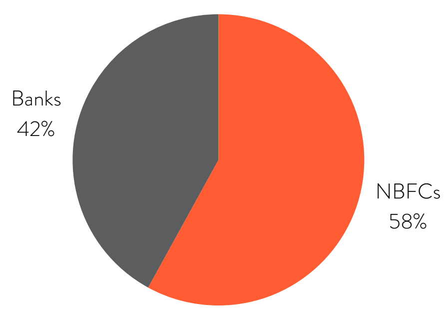
As for tractors, sentiment is only moderately negative as agricultural activity is exempt from the lockdown and prospects for the crop season are better. Already, in the tractor segment, the major states of Uttar Pradesh, Punjab, Madhya Pradesh, parts of Maharashtra, parts of Rajasthan and Karnataka are showing a strong demand uptick. We expect the farm community to shore up demand for tractor financing, rather than the haulage or contracting segments.

FIG 27 – 2W DEMAND HAS LOWER REPLACEMENT SHARE THAN PVs



Source: CRISIL, BOBCAPS Research

FIG 28 – 2W FINANCING DISBURSEMENT TO GROW TO RS 372BN BY FY24E



Source: CRISIL, BOBCAPS Research | Note: Data as of FY19

Replacement demand could prop up bus segment

Bus sales are typically supported by a steady demand from the school bus segment. However, volumes contracted 9-10% through FY20, with both light and heavy passenger carriers displaying a similar trend. Strained liquidity conditions, an increasing focus on electric buses by government bodies and state road transport undertakings (SRTU), expectations of a GST rate reduction, and a high base effect led to the volume contraction.

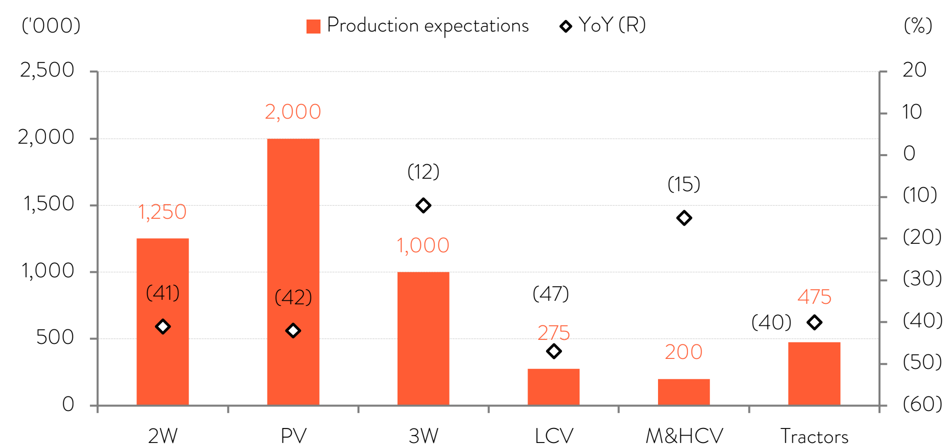
Accordingly, the outlook for the bus segment in FY21 depends on the expected revival in SRTU orders (replacement-driven demand) and stable demand from the school, college and staff carrier segment.

OEM capacity utilisation to plummet in FY21

As per CRISIL, a sharp contraction in automotive sales would push average utilisation at the industry level down from ~58% to below 50% in FY21. In the PV segment, utilisation would roll down from 58% to 44%, in 2Ws from 65% to 50%, in tractors from 59% to 51%, and in CVs from 51% to 39%.

A recovery in demand is expected only from the festival season in Q3FY21 – and largely for 2Ws and tractors which have a higher rural share. PVs and CVs, which have a higher share of replacement demand, are forecast to revive only in H2FY22. For FY21, CRISIL expects sales of PVs to decline 24-26%, compared with a 21-23% contraction for 2Ws. CV sales are expected to drop 26-28% while tractor sales are likely to fall only 7-9%.

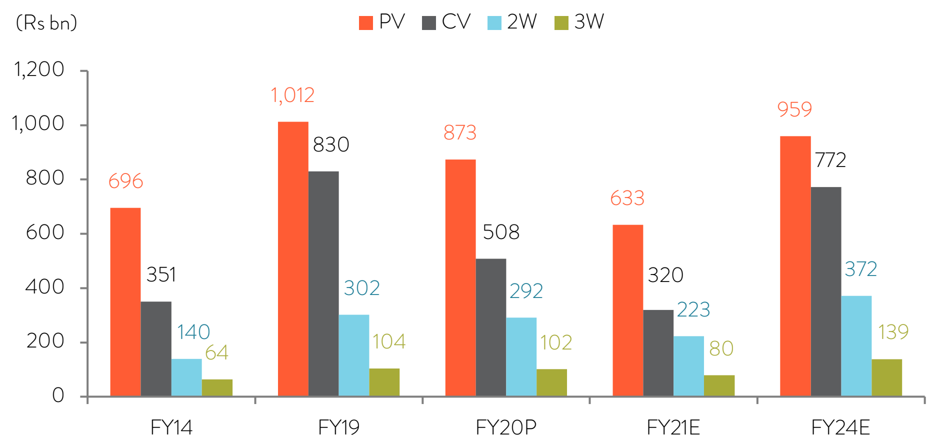
FIG 29 – VEHICLE PRODUCTION TO TAKE 4 YEARS TO HIT FY18 PEAK, PER BOSCH INDIA



Source: Bosch India, BOBCAPS Research

Expect tepid disbursements in FY21

FIG 30 – DISBURSALS TO SLOW ACROSS SEGMENTS OVER FY21E-FY24E

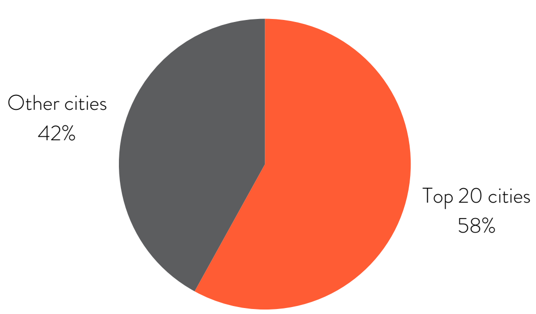


Source: Company, CRISIL, BOBCAPS Research

PV financing to slow dramatically

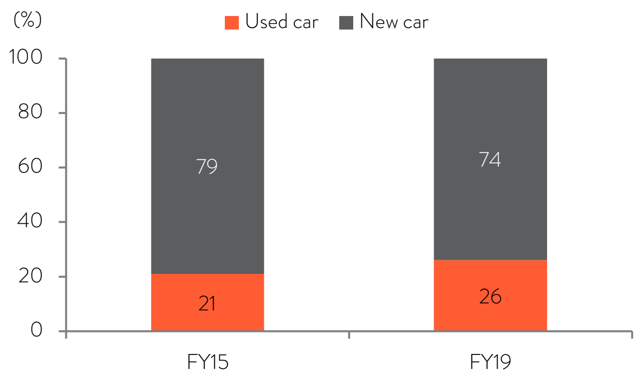
NBFC credit to the PV segment grew 6-10% over FY17-FY20P, supported by a focus on semi-urban and rural borrowers and the used car segment; banks typically prefer the salaried and new car segments. The used car market is estimated to be larger in terms of volumes than the new car market.

FIG 31 – PV LOAN COMPOSITION



Source: Company, BOBCAPS Research Note: Data as of FY20

FIG 32 – INCREASE IN USED CARS IN NBFC PV PORTFOLIO



Source: Company, BOBCAPS Research

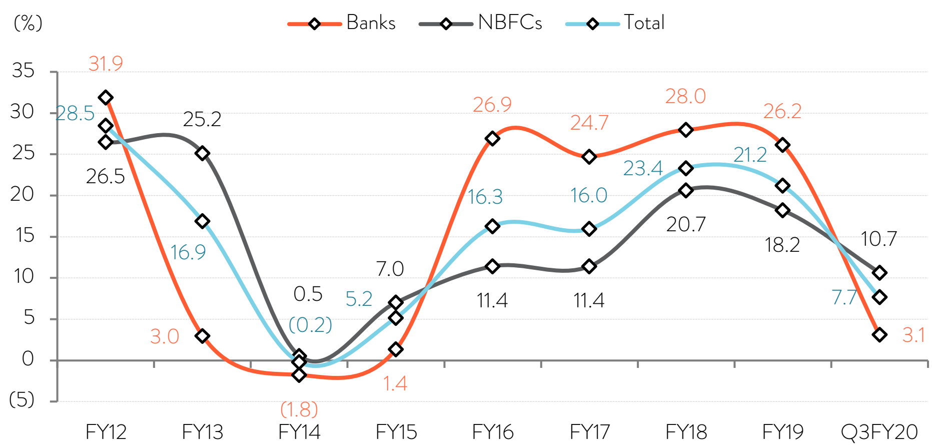
Finance penetration currently stands at 15-20% in used PVs (14-18% yield) vs. 75-80% in the new car segment (9.5-12.0% yield depending on borrower profile). Salaried borrowers enjoy better rates compared to the self-employed. Growth in NBFC credit to the PV segment is expected to slow drastically in FY21 on account of salary cuts, job losses and income loss post Covid-19.

Contours of CV finance industry

CV finance cycles

In this section, we examine domestic demand trends for commercial vehicles over close to a decade to offer a perspective on growth trends in the CV finance industry.

FIG 33 – CV FINANCE CYCLE ACROSS FY12-Q3FY20 (AUM GROWTH)



Source: Company, BOBCAPS Research

- **FY12:** Despite subdued IIP, domestic CV sales witnessed healthy growth of 18% during FY12, primarily in the LCV and SCV segments. Growth was lower than the 31% registered in FY11 largely due to a sharp drop in HCV volumes and a higher base. MHCVs/LCVs grew 8%/27% in FY12.

- **FY13:** The economic slowdown hurt sales in FY13, particularly for HCVs. The CV industry declined 2%, led by a sharp 23% drop in HCVs, which are essentially production-driven assets. Demand for LCVs and SCVs held up at >14% YoY as these are consumption-driven assets, primarily engaged in last-mile transportation.

- **FY14:** CV sales plunged 20% in FY14, posing stiff headwinds for the vehicle financing industry. Demand corrected across tonnage segments, with HCV volumes declining for the second year in a row and LCVs/SCVs also reporting lower sales.

- **FY15:** The downturn continued in FY15, with CV sales down 3%. LCVs fell ~12%. However, the sector showed signs of revival in H2FY15 backed by improvement in industrial activity, enhanced agricultural output, faster execution of infrastructure projects and improvement in consumption spend.

- **FY16:** During FY16, domestic CV industry sales growth recovered to ~12%, driven by continuing healthy replacement demand in MHCVs, renewal as well as fleet expansion by various SRTUs and increasing demand pick-up from the mining and construction sectors. In addition, the industry benefitted from implementation of BS-IV emission norms, which became mandatory across North India and some nearby regions from Oct'15. Accordingly, the MHCV segment grew 32%. LCV demand also started picking up from H2FY16 after a two-year decline.

- **FY17:** Dwindling replacement demand by large fleet operators and slow growth in industrial output caused domestic CV industry sales to grow at just 3% in FY17. Green shoots of recovery were, however, seen towards the end of the year when all major CV manufacturers registered buoyant sales in the last two months of FY17. Some segments like tippers and buses posted rapid growth.

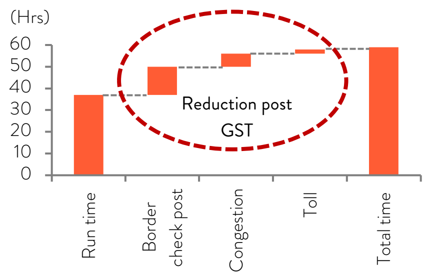
- **FY18:** The CV recovery trend started in early 2017, when the government intensified its crackdown on overloaded vehicles and advanced the timelines for migration to BS-VI norms. Demonetisation in Nov'16 had a major adverse impact on small fleet operators and first-time buyers. Post-demonetisation, an improved liquidity situation and good monsoons helped revive the rural economy. Crop output was stable while consumption demand picked up. Changes in warehousing pattern post GST implementation, through increasing adoption of the hub-and-spoke model, drove the need for faster and more efficient trucks.

  The domestic CV industry was in recovery mode from Q2FY18, after contracting in Q1 due to limited availability of BS-IV compliant vehicles and deferral of new vehicle purchases by fleet operators due to impending GST implementation. The factors that led to recovery were pent-up demand post GST, healthy replacement-led demand, and pick up in construction and mining activities, further aided by the government's increased thrust in the infrastructure and rural sectors.

- **FY19-FY20:** The slowdown in the domestic CV industry that began in H2FY19 continued into FY20, with volumes contracting 29% YoY in FY20. CV OEMs reduced their wholesale dispatches to curtail inventory levels at dealerships on account of reduced footfalls and lower retail sales.

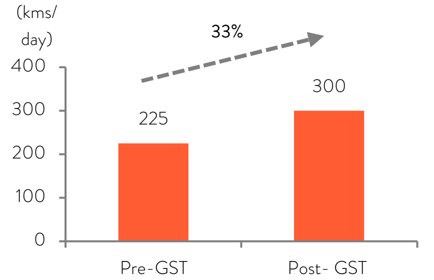
  MHCVs posted a sharp drop during this period as excess capacity and low freight availability suppressed freight rates and impacted profitability of fleet operators. In addition, tight liquidity in the NBFC industry and expectations of a GST rate cut led fleet operators to defer vehicle purchases.

FIG 34 – PRE-GST AVG. TRAVEL TIME



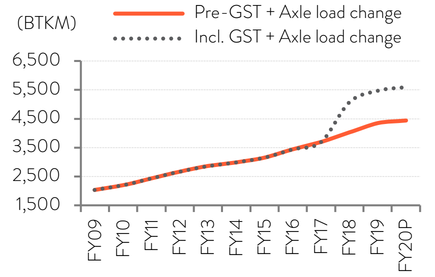
Source: MORTH, BOBCAPS Research
Note: For Chennai-Kolkata route

FIG 35 – IMPACT ON AVG. RUNNING DISTANCE



Source: MORTH, BOBCAPS Research

FIG 36 – BTKM FOR MHCV TRUCKS POST GST & AXLE NORMS



Source: SIAM, ET Autolytics, BOBCAPS Research, MORTH

Key industry participants

India's Rs 3tn CV finance market is highly fragmented and has historically been serviced by a range of financial entities, including the captive finance affiliates of OEMs (~14%), banks (~38%) and NBFCs (~48%). Besides longstanding relationships with automobile dealerships, many of these players have strong financial resources and large business volumes, leading to a low cost of funds.

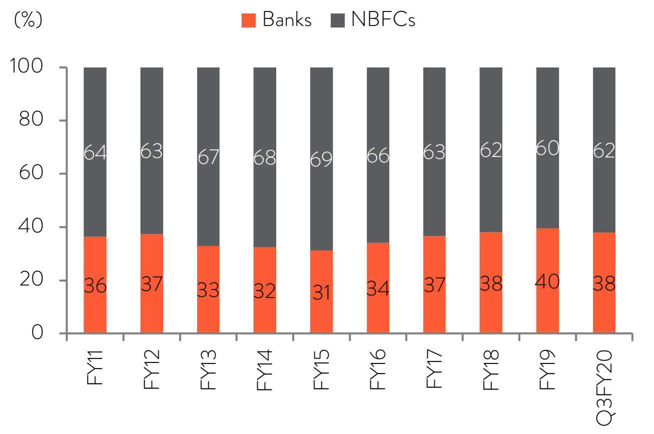
Competition in many states also comes from small finance banks (SFB) who are focussed on the regional mass market and have access to cheaper funds by way of CASA deposits. Loan pricing is a key factor in customers' choice of a financier and some captive finance affiliates of OEMs offer loans at competitive rates to retain market share.

FIG 37 – KEY VEHICLE FINANCIERS IN INDIA

NBFCs	Banks
Shriram Transport Finance Company (SHTF)	DCB Bank (DCBB)
Sundaram Finance (SUF)	HDFC Bank (HDFCB)
Mahindra and Mahindra Financial Services (MMFS)	ICICI Bank (ICICIBC)
Cholamandalam Investment and Finance (CIFC)	IndusInd Bank (IIB)
Tata Motors Finance (TMF)	Kotak Mahindra Bank (KMBB)
Hinduja Leyland Finance (HLF)	
Magma Fincorp (MGMA)	

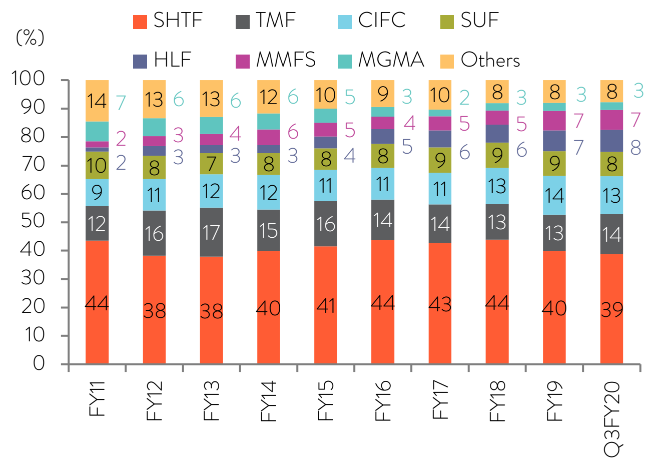
Source: BOBCAPS Research

FIG 38 – CV FINANCING MARKET WORTH RS 3TN AS OF Q3FY20



Source: Company, BOBCAPS Research

FIG 39 – MARKET SHARE TRENDS OF NBFCs IN CV LOANS



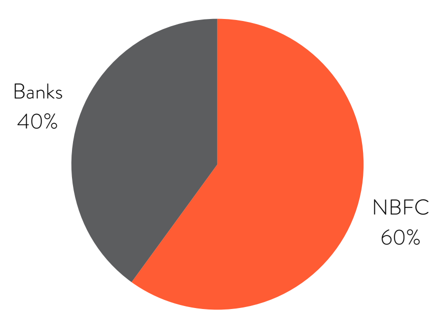
Source: Company, BOBCAPS Research

NBFCs better placed than banks…

We believe NBFCs have an edge over banks in the vehicle financing space for a variety of reasons:

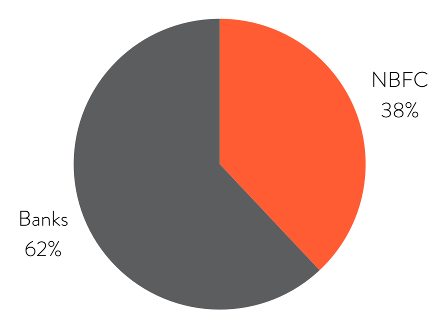
- stronger ability to cater to riskier segments, especially used vehicle financing, based on better customer connect;
- superior follow-up, account monitoring and maintenance, along with rigorous focus on collections;
- doorstep collections, flexibility in repayment schedule (weekly, monthly) and in the amount to be repaid offer convenience to customers; and
- recruiting of local employees enables better understanding of ground operations, aiding stronger efficiency and collections.

FIG 40 – MARKET SHARE IN CV LOANS, FY19



Source: Company, BOBCAPS Research

FIG 41 – MARKET SHARE IN NEW CV LOANS, FY19

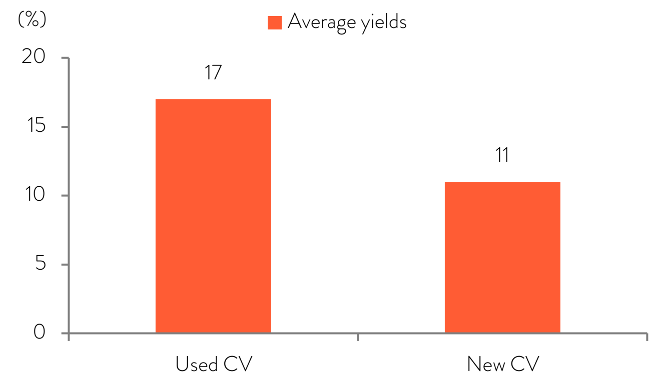


Source: Company, BOBCAPS Research

...but market share to drift towards banks in near term

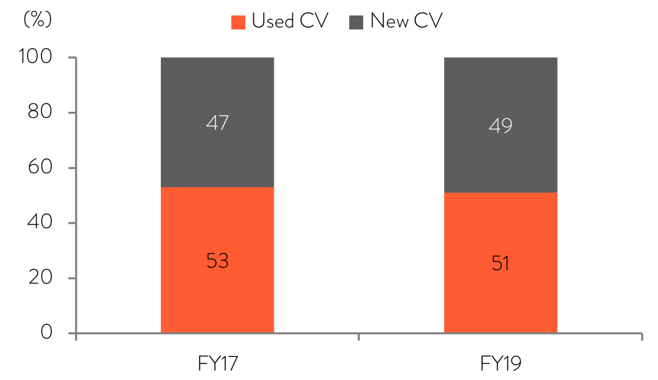
Disbursements of the top 5 CV financiers – have remained stable over the last five quarters despite a slowdown in CV sales, as larger players have taken market share from smaller rivals. Going forward, loan disbursements for new CVs are expected to trend down due to weak demand while disbursals in the used CV segment should hold at current levels for two reasons: (1) new BS-IV vehicles are priced higher and hence buyers may prefer cheaper second-hand options, and (2) used vehicles offer better economic viability under the current reduced demand/freight rate conditions.

FIG 42 – YIELDS IN USED CVs BETTER THAN NEW CVs



Source: Company, BOBCAPS Research

FIG 43 – NBFC SECTOR CV AUM BREAKUP



Source: Company, BOBCAPS Research

The market share of NBFCs in new CV financing has been reducing from 38% in FY19 as liquidity became scarce due to mutual funds retracting from funding NBFCs, thereby making them less competitive in the large fleet and medium/heavy CV segments. Banks, on the other hand, are reducing their benchmark lending rates.

However, banks do not have a significant presence in used CVs, putting NBFCs at the forefront. In addition, used CV financing experienced some increase as prices of existing vehicles eligible for refinance would increase as new CV prices post BS-VI implementation increased by 10-12%. Due to the overhang of margin contraction and decline in new CV sales, NBFCs are likely to increase the share of used CVs in their overall exposure in order to balance the impact of a rising cost of funds.

Companies

BUY
TP: Rs 200 | ⮝ 28%

CHOLAMANDALAM INVESTMENT | NBFC | 10 June 2020

Prudent vehicle financier – initiate with BUY

Cholamandalam Investment and Finance (CIFC) has built a diversified vehicle finance and granular home equity business since FY12. We expect the company to post stable spreads of 6.2% over FY20-FY22 backed by strong pricing power. CIFC will keep opex under check. While Covid-19 disruptions would weigh on credit cost and net profit, we expect normalisation of these metrics in H2FY22, aiding a recovery in ROE/ROA to 12.7%/1.7% in FY22E. Initiate with BUY and a Mar'21 TP of Rs 200.

Shubhranshu Mishra
research@bobcaps.in

Expect recovery in H2FY22, stable spreads: AUM has grown at 20%+ over FY19-FY20 though disbursals have slowed amid a tough economy. Given the Covid-19 turmoil, we expect back-ended recovery in H2FY22 and hence model for a slower ~4% AUM CAGR during FY20-FY22. Spreads are likely to remain stable at 6.2% led by strong pricing power and a lower cost of funds.

Cost control to buoy operating profit: Though recovery costs would rise, we expect strong control over discretionary expenditure. We thus model for 2.7% opex-to-average assets (expense ratio) during FY20-FY22, leading to flattish operating profit of Rs 25bn.

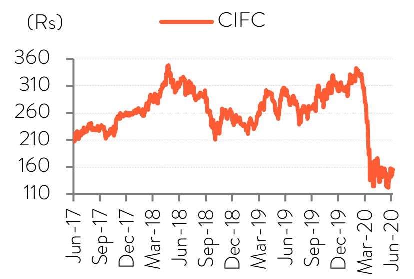
Covid-led disruptions to weigh on credit cost: Cash flow troubles for customers due to Covid-19 are expected to take credit cost higher to ~200bps in FY21 – levels last seen in FY16, the peak of the previous CV cycle. We thus model for a feeble 8% CAGR in PAT to Rs 12bn through to FY22. The business remains well capitalised and return ratios are projected to recover in FY22.

Initiate with BUY, Mar'21 TP Rs 200: We use a residual income model to value the company, assuming a risk-free rate of 7.75%, cost of equity of 14.0% and terminal growth of 5%. This yields a Mar'21 TP of Rs 200 (1.6x FY22E BV).

Ticker/Price	CIFC IN/Rs 156
Market cap	US$ 1.7bn
Shares o/s	820mn
3M ADV	US$ 22.7mn
52wk high/low	Rs 264/Rs 117
Promoter/FPI/DII	52%/12%/27%

Source: NSE

STOCK PERFORMANCE



Source: NSE

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20P	FY21E	FY22E
Net interest income	25,268	28,972	34,101	34,146	34,213
NII growth (%)	18.0	14.7	17.7	0.1	0.2
Adj. net profit (Rs mn)	9,183	11,862	10,524	9,350	12,192
EPS (Rs)	11.7	15.2	12.8	11.4	14.9
P/E (x)	13.3	10.3	12.1	13.7	10.5
P/BV (x)	2.4	2.0	1.6	1.4	1.3
ROA (%)	2.4	2.4	1.7	1.4	1.7
ROE (%)	20.1	21.3	14.7	10.9	12.7

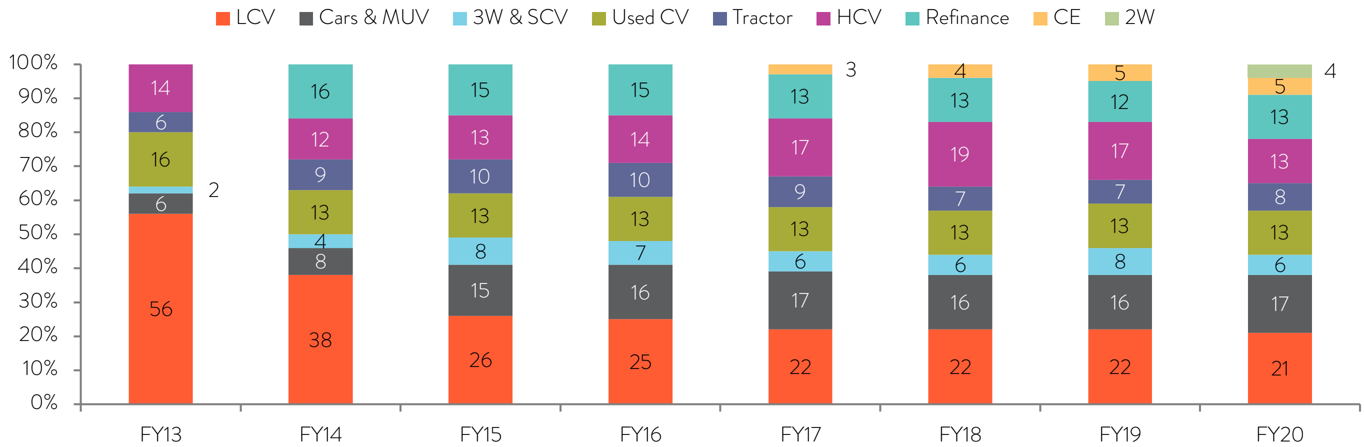
Source: Company, BOBCAPS Research

Investment rationale

Strong foothold in vehicle finance

CIFC is among the largest commercial vehicle financiers in India and has two key differentiating features vis-à-vis peers, viz. a diversified product suite and a wide footprint across 25 states. The company is a dominant player in the LCV segment with ~20% market share, while M&HCV share has doubled from 3% to 6% over the past five years. Vehicle finance contributes close to 75% of revenue and achieved 22% AUM CAGR over FY11-FY20. Given Covid-19 challenges, we model for a 6% AUM CAGR in vehicle finance over FY20-FY22 which bakes in recovery from H2FY22, aiding an overall 4% AUM CAGR for the company.

FIG 1 – DIVERSIFIED AUM PROTECTS CIFC FROM CYCLICALITY



Source: Company, BOBCAPS Research

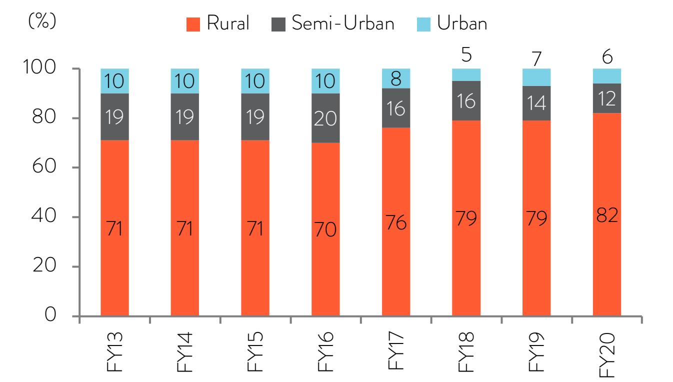
Strong positioning in rural/semi-urban VF play

CIFC's loan products are spread across medium (MCV), heavy (HCV) and light commercial vehicles (LCV), tractors, used CVs, passenger vehicles (PV), three-wheelers (3W), multi-utility (MUV) and used cars. Further, the company has aggressively expanded its branch network across 25 states, and no single state accounts for more than 12% of the loan book. We believe these aspects are among CIFC's biggest strengths vis-à-vis peers that are more concentrated in terms of products and regions. Diversification provides flexibility to reorient the portfolio based on market opportunity and optimises the risk-return profile.

Over 90% of the branches are located in semi-urban and rural areas. In CVs, CIFC has strategically positioned itself in the mid-to-low end of the opportunity pyramid by targeting small road transport operators (SRTO) for new vehicles, first-time users, and intra-city operators for used vehicles. About 65% of disbursements for CV financing are to micro/small enterprises and agriculture-based customers.

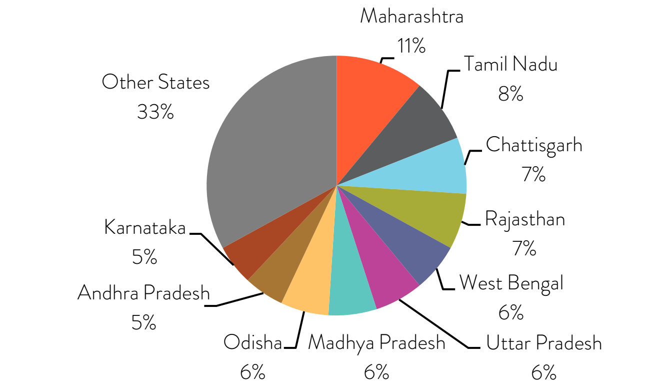
In PV financing, CIFC positions itself in the middle of the pyramid through agriculture, asset and commercial usage vehicle loans. About 66% of PV disbursements are to existing customers and agriculture/commercial usage customers, with the balance 34% disbursed to the self-employed.

FIG 2 – RURAL FOCUS HAS STEADILY INCREASED OVER THE YEARS



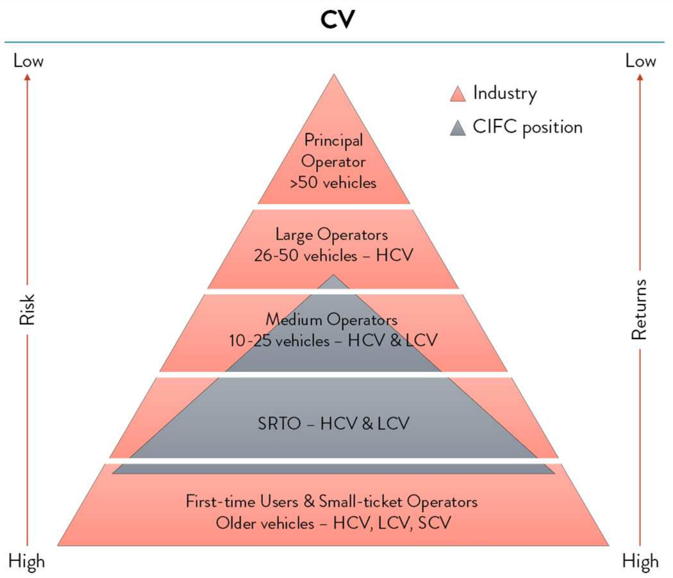
Source: Company, BOBCAPS Research

FIG 3 – VEHICLE FINANCE BOOK DIVERSIFIED ACROSS STATES



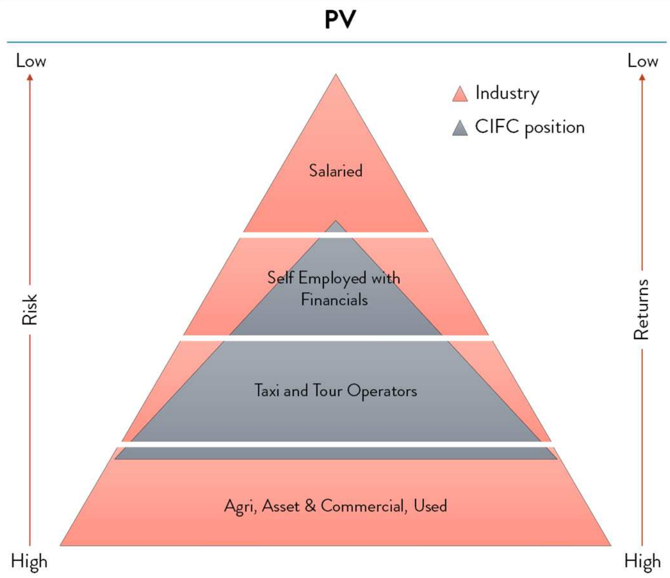
Source: Company, BOBCAPS Research

FIG 4 – COMPETITIVE POSITIONING IN MID-TO-LOW END CV FINANCE SEGMENT



Source: Company, BOBCAPS Research

FIG 5 – CIFC POSITIONS ITSELF IN AGRI AND COMMERCIAL USE PVs

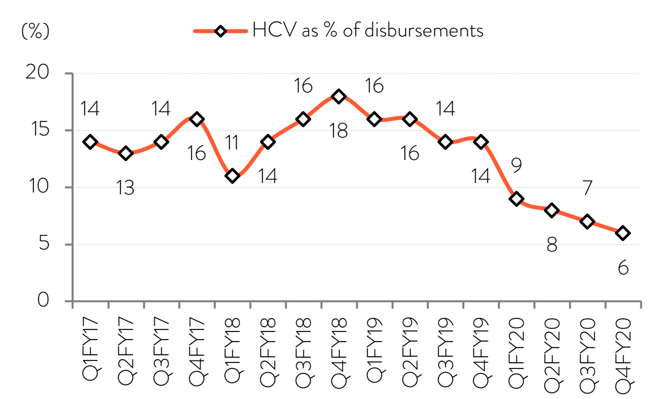


Source: Company, BOBCAPS Research

Expect 6% AUM CAGR

Vehicle finance disbursements reduced 6% in FY20 primarily due to an industry-wide slowdown in CV sales. To compensate for this drop, CIFC consciously increased its product mix in other segments such as PVs, 2Ws, 3Ws and used vehicles. The CV segment which comprised 34% of the company's disbursal mix for FY19 has thus come down to 25% in FY20.

FIG 6 – REDUCED FOCUS ON HCV DISBURSAL IN FY20



Source: Company, BOBCAPS Research

FIG 7 – VEHICLE FINANCING SNAPSHOT, FY20

Category	% of Portfolio	% of Disbursement	Avg. ticket size (Rs mn)
LCV	21	19	0.45
Cars & MUV	17	16	0.4
3W & SCV	6	8	0.4
Used CV	13	17	0.18
Tractor	8	7	0.38
HCV	13	6	1.2
Refinance	13	16	NA
CE	5	5	NA
2W	4	6	NA

Source: Company, BOBCAPS Research

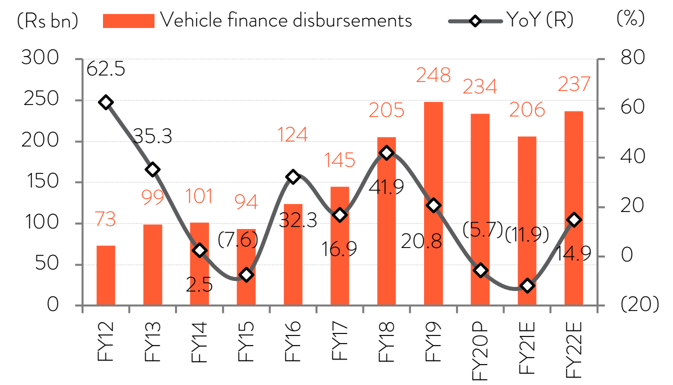
With the nationwide Covid-19 lockdown easing from Q1FY21 onwards, we are likely to see better utilisation of CVs in rural and semi-urban areas as transportation of farm produce and non-essential goods recommences. Also, as we move from BS-IV to BS-VI auto emission norms in Apr'20, OEMs and dealers will clear old inventory and start rebuilding a stock of compliant vehicles, serving as a demand tailwind.

On the other hand, ~81% of CIFC's branches are in rural areas where customers are typically first-time buyers of vehicles, have informal income, and limited banking and credit history. Given the hardships faced by rural India during the lockdown, we expect demand to remain tepid in FY21 and FY22. Also, CIFC being a conservative financier may likely increase equity contribution from its customers and have stricter underwriting standards.

According to management, SCVs, 3Ws and ICVs, which are used for last-mile transportation, should continue to witness strong traction. CIFC will focus on increasing the share of financing these vehicles in rural areas, where the impact of Covid-19 is relatively lower. On the back of a strong Rabi crop, high water reservoir levels and expectations of a normal monsoon, tractor demand is likely to be robust (flat YoY in May'20). Entry-level 2W demand should be buoyant in FY21 though 2Ws above Rs 0.1mn ticket size could see low offtake.

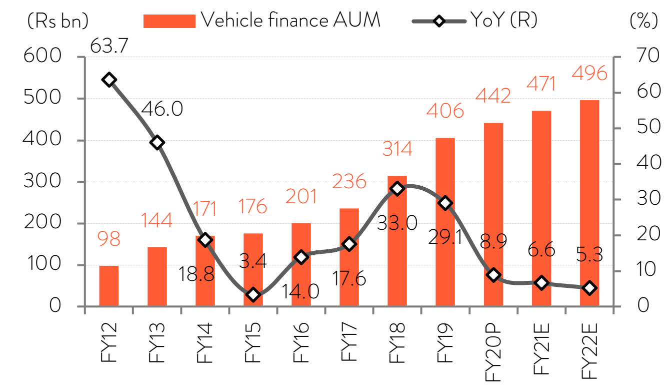
Used CV prices have increased 20% post transition to BS-VI (proportionate to hikes for new CVs). Additionally, large fleet operators will focus on rationalisation of available fleet based on driver availability and freight demand. Under such circumstances, used vehicle sales would remain strong. CIFC is one of the largest players in used vehicle finance and hence well placed to capitalise on the opportunity. We thus expect vehicle finance AUM to log a 6% CAGR for FY20-FY22, though disbursements are modelled to be largely flat over the same period.

FIG 8 – WE EXPECT FLAT VEHICLE FINANCE DISBURSEMENTS…



Source: Company, BOBCAPS Research

FIG 9 – …AND 6% CAGR IN VEHICLE FINANCE AUM OVER FY20P-FY22E



Source: Company, BOBCAPS Research

Well entrenched in home equity (LAP) segment

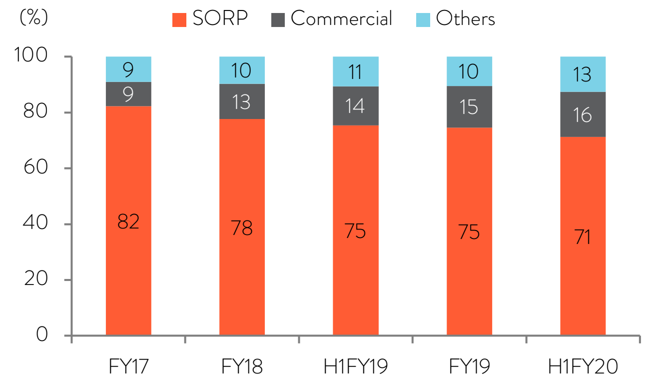
CIFC entered the home equity (loans against property) business in 2007 in order to provide stability to its loan growth and earnings. Over the past few years, the company has built capabilities in assessing underlying assets and cash flows of borrowers, aiding steady growth (20% AUM CAGR over FY11-FY20) and healthy asset quality (~6.2% gross stage-3 assets in FY20). The business currently contributes ~20% revenue share. With lockdown restrictions being gradually lifted, we expect demand recovery in H2FY22.

Strong retail focus to spur growth

About two years ago, the company focused on making the home equity book more granular, maintaining self-employed residential properties at 80%+ of disbursals in the segment. We expect this strategy to yield healthy rewards in the near term as CIFC's expansion in tier-3/4 cities would allow for better product pricing even as delinquencies should be lower due a non-migratory population. Though disbursals for commercial property (self-occupied) increased in H1FY20, management reiterated that the strategy remains unchanged in that the residential segment will hold at >80% of the mix.

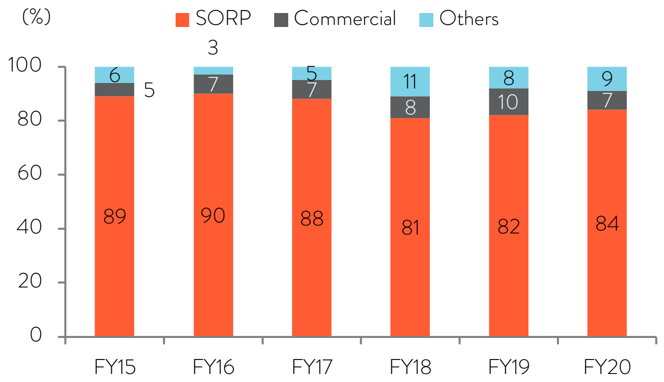
In the commercial space, SMEs form a chunk of the client base. Despite a series of challenges assailing SMEs in FY20 due to GST compliance and lower turnover post slowdown in economic activity, CIFC was able to tide over the crisis via prudent funding and focused collections.

FIG 10 – SELF-OCCUPIED RESIDENTIAL PROPERTIES (SORP) DOMINATE THE DISBURSEMENT MIX….



Source: Company, BOBCAPS Research

FIG 11 – …AND AUM MIX IN HOME EQUITY LOAN SEGMENT

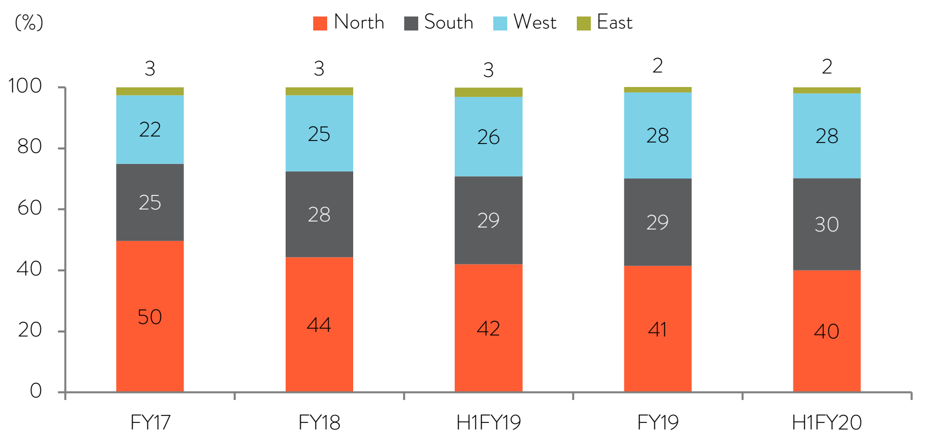


Source: Company, BOBCAPS Research

Moving into tier-2/3 cities

CIFC offers home equity finance through 234 branches across India as of FY20. Realising that the LAP market is moving towards tier-2 and tier-3 cities, management has begun beefing up branches there. This recalibration could augment volumes and has reduced average ticket size from Rs 5.5mn to Rs 4.5mn over last two years.

FIG 12 – WESTERN AND SOUTHERN REGIONS HAVE BEEN GAINING IN CIFC'S HOME EQUITY AUM SHARE

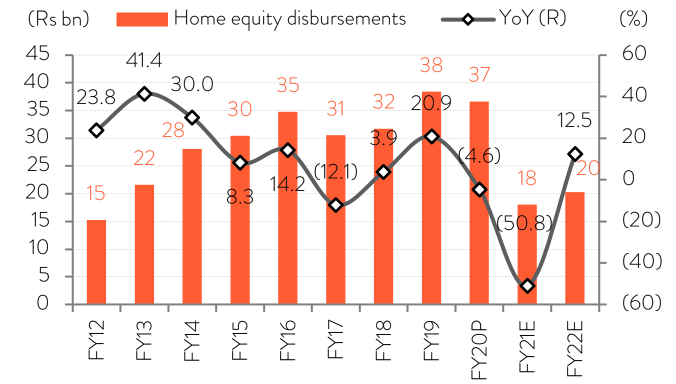


Source: Company, BOBCAPS Research

Expect 5% AUM decline through to FY22

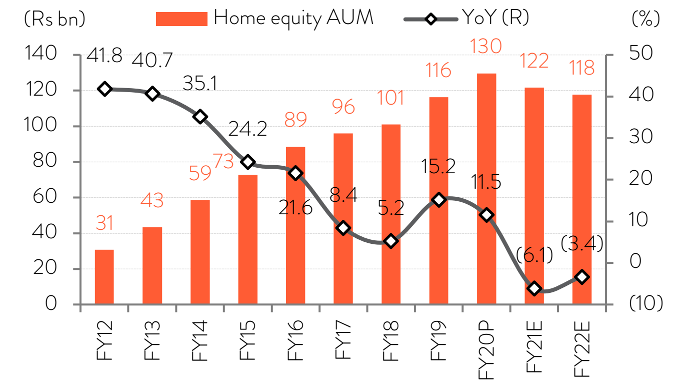
Credit growth in LAP will be negatively affected by poor sentiment in the property market amid the pandemic. Market pressures will also cause a shift in composition of LAP originations towards more self-occupied properties. With lockdown restrictions being gradually lifted, we expect growth in disbursements only from H2FY22 and accordingly model for a 5% decline in home equity loan AUM for FY20-FY22.

FIG 13 – WE EXPECT HOME EQUITY DISBURSEMENTS TO TURN AROUND IN H2FY22E



Source: Company, BOBCAPS Research

FIG 14 – HOME EQUITY AUM TO DECLINE 5% DURING FY20E-FY22E



Source: Company, BOBCAPS Research

Hive off to augment focus on housing finance

The home loans business (affordable housing) was started in 2013. CIFC currently has a managed AUM of ~Rs 29bn with average ticket size of ~Rs 1.4mn and LTV of ~60%. In order to augment focus on the business, it will be hived off into a separate housing finance subsidiary once HFC license is received. We expect a 14% CAGR in AUM for the 'others' business through FY22 (led by home loans), with revenue share largely stable at 6-7%.

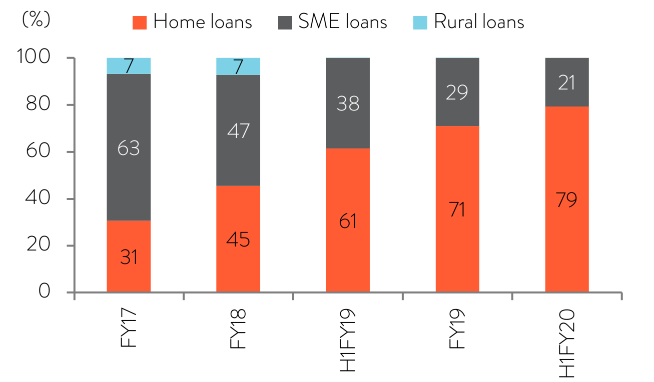
Growth strategy in place

The government's initiative of providing 'housing for all' has lent a fillip to the housing sector. Since the asset base is low and opportunities are aplenty, CIFC plans to expand into newer markets next year, targeting loan ticket size above Rs 1mn. Apart from its presence across 1,000+ locations, the company has a keen understanding of risk management in the lower and middle income (LMI) group, which will be crucial to growing the business.

Management aims to build a home finance company that leverages digital, data and analytics, and agile tech platforms. To that effect a year-long project was initiated in FY18 wherein technical consultants scrutinised multiple strategies.

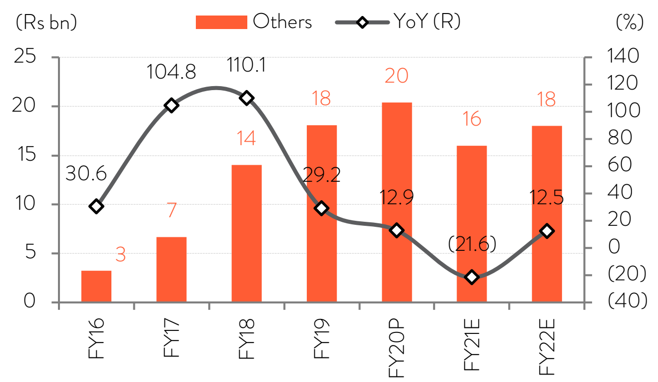
Thereafter, the product design team has built five new products, enabling the company to cater to current and future demand for affordable housing finance.

FIG 15 – HOME LOANS DOMINATE DISBURSEMENTS IN 'OTHERS' CATEGORY



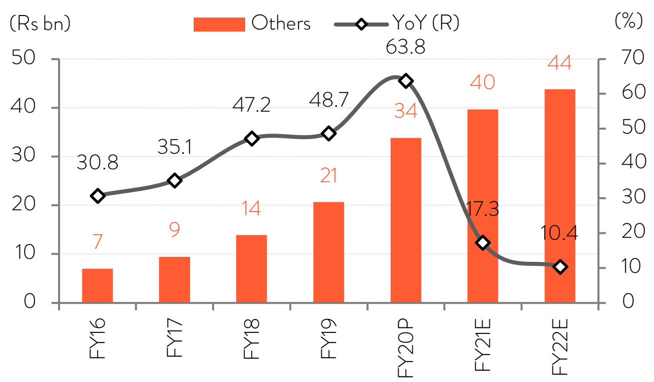
Source: Company, BOBCAPS Research

FIG 16 – EXPECT 6% DECLINE IN 'OTHERS' DISBURSALS LED BY HOME LOANS IN FY20P-FY22E



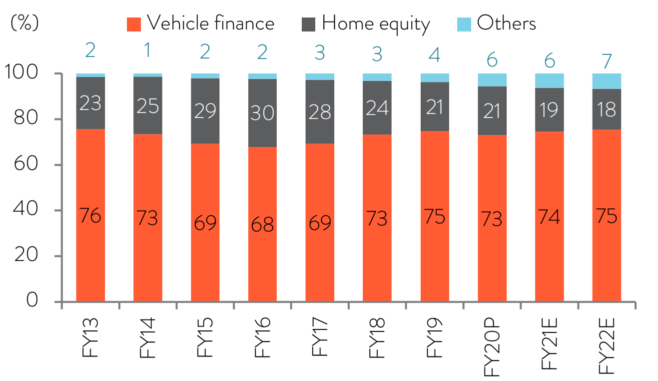
Source: Company, BOBCAPS Research

FIG 17 – OTHERS SEGMENT DOMINATED BY HOME LOANS TO REGISTER 14% AUM CAGR IN FY20P-FY22E



Source: Company, BOBCAPS Research

FIG 18 – AUM MIX SET TO BECOME FURTHER DIVERSIFIED BY FY22E



Source: Company, BOBCAPS Research

Spreads expected to increase over FY21-FY22

Pricing (yield) has come off by 100-150bps over the last three years due to competition, though cost of funds has remained largely steady at ~8.5%. We expect the company to post stable spreads of 6.2% over FY20-FY22 backed by expertise in vetting borrower cash flows, strong pricing power and a lower cost of funds.

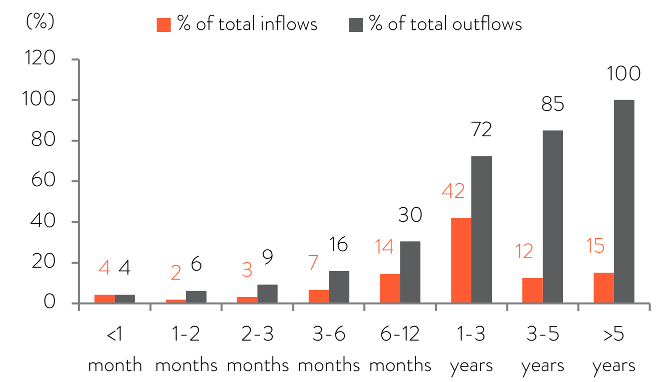
Prudent ALM and borrowing mix

FY19 and FY20 have been difficult years for NBFCs and HFCs due to tight systemic liquidity. CIFC's conservative policy of ensuring no negative mismatches in any of the time buckets in its structural liquidity statement fully insulated the company from the industry-wide liquidity crunch, keeping cost of funds under control at ~8.7% in FY20.

Post the IL&FS crisis in Sep'18, CIFC had maintained a high level of liquid assets to ensure meeting a minimum two months of maturities. The company altered its long-term borrowing profile, moving from market borrowings such as non-convertible debentures (NCD) that were seeing a liquidity crunch to bank borrowings. It was successful in garnering higher volumes of bank term loans at competitive rates and thus maintained a healthy asset-liability management (ALM) position throughout the crisis period.

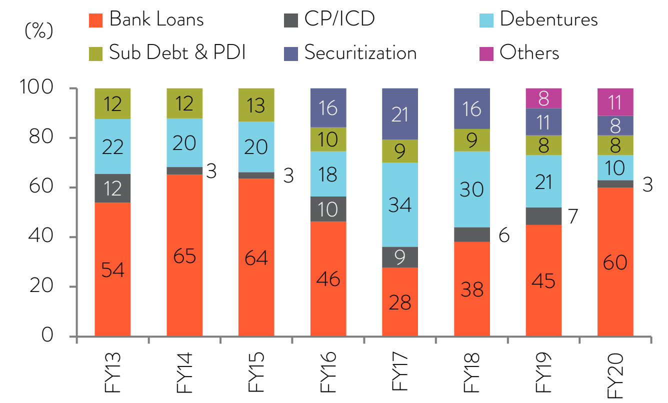
The company has not availed of the moratorium on its borrowings so far and does not intend to do so. Cash balance totalled Rs 64.5bn and sanctioned lines stood at Rs 44.6bn as of FY20 (cumulatively ~Rs 100bn as of 31 May). We believe this adequately covers the needs of the ALM process with no negative cumulative mismatches across all time buckets. Even after extending the moratorium to its customers for the second phase, the cash position is adequate to meet all maturities and fixed obligations till H1FY21. The ALM chart below is adjusted for six months of moratorium.

FIG 19 – WELL MATCHED ALM IN LESS THAN ONE-YEAR BUCKETS (FY20)…



Source: Company, BOBCAPS Research

FIG 20 – …AND PRUDENT TREASURY OPERATIONS HAVE KEPT BORROWING MIX OPTIMUM



Source: Company, BOBCAPS Research

Expertise in assessing cash flows of borrowers

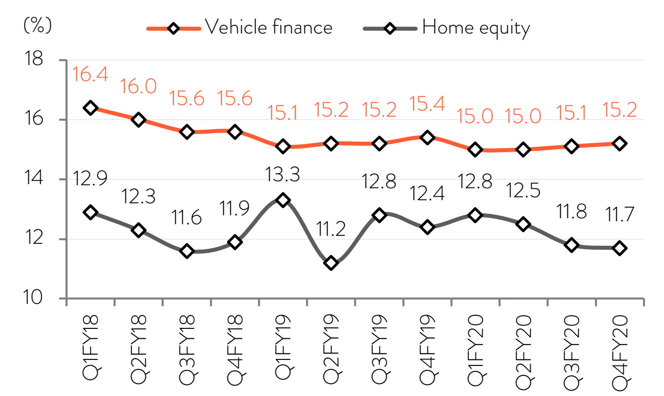
CIFC does not rely solely on assessment of the collateralised asset for credit sanction. Instead, appraisal of the business and its cash flows are key factors. Most SMEs do not disclose their entire income in financial statements and hence assessing cash flows becomes challenging. The appraisal team at CIFC forecasts cash flows of businesses through analysis via site visits, local intelligence and reference checks.

Moreover, rather than restricting itself to any particular segment, the company has developed expertise in understanding business dynamics across surrogates for cash flows, seasonality of cash flows and strong technology and data analytics, among others. Around 65-70% of credit decisions are taken at the branch level. Credit decisions for cases with large ticket sizes, high LTVs or specific industries where branch-level credit managers lack expertise are taken at the head office level.

In vehicle finance, the company has a dedicated team for business origination which sources and identifies prospective borrowers. All activities, including field investigation, personal discussion, verification of 'know your customer' documents, collection of documents, and due diligence to evaluate credit worthiness are undertaken by sales executives. Document verification is conducted by the credit and operations department. In addition to its own sales force, CIFC had 24,150 sourcing intermediaries in vehicle financing as of Q2FY20.

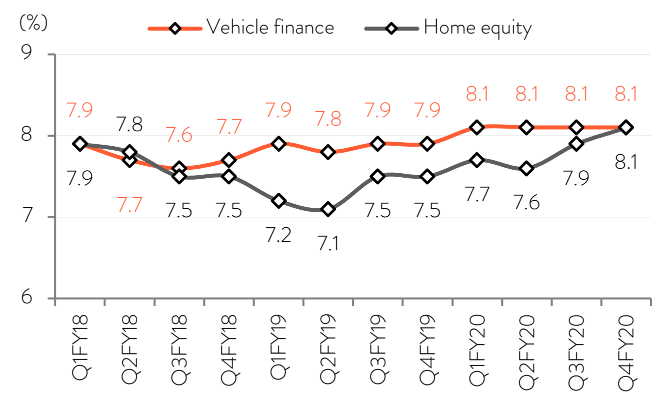
For the home equity business, customers are sourced through a combination of in-house sales teams and direct sales agents (DSA). In addition, digital channel lead sourcing has been created to generate organic online leads, which are then assigned to the in-house sales team for processing. As of Q2FY20, CIFC engaged 550 DSAs and 12,170 referral agents in this segment. A focus on tier-3 and tier-4 towns should aid better pricing and fees due to lower competition in these markets and better understanding of risk-reward in the target customer segment, translating to higher segmental NIMs over the long term.

FIG 21 – PRICING (YIELD) HAS COME OFF BY 100-150BPS OVER LAST 3 YEARS DUE TO COMPETITION…



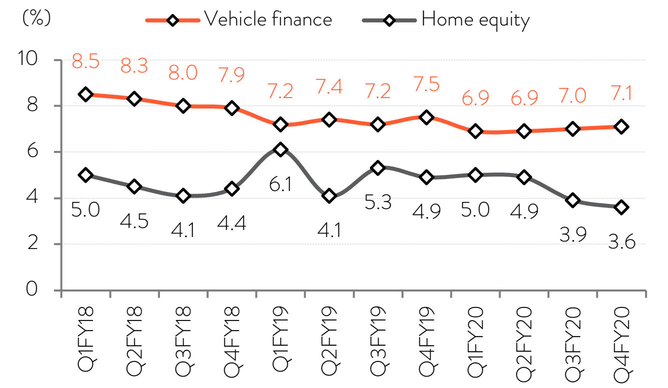
Source: Company, BOBCAPS Research

FIG 22 – …THOUGH COST OF FUNDS HAS REMAINED LARGELY STEADY



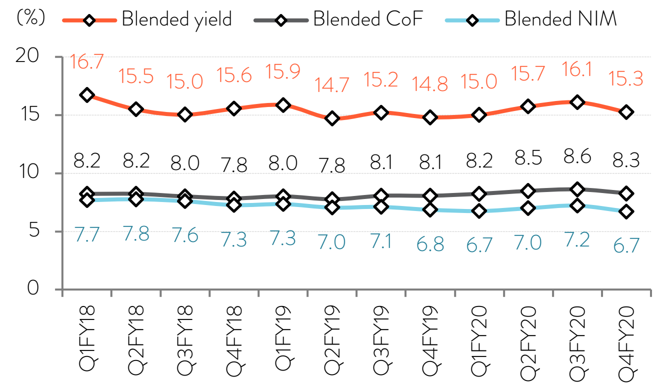
Source: Company, BOBCAPS Research

FIG 23 – NIMs HAVE COME OFF BY 100-150BPS OVER LAST 3 YEARS DUE TO PRICING PRESSURE



Source: Company, BOBCAPS Research

FIG 24 – HIGHER VEHICLE FINANCE SHARE LIMITED BLENDED YIELD AND NIM DECLINE TO 50-70BPS

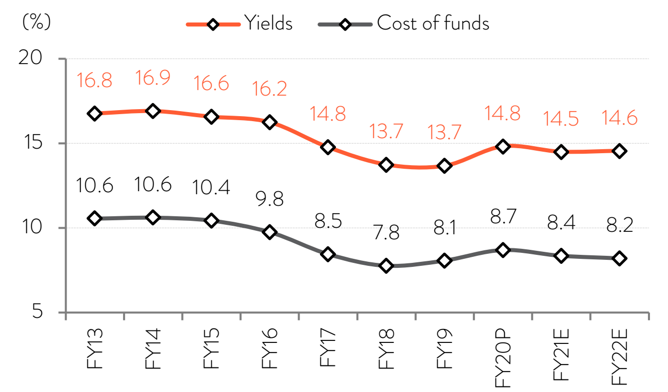


Source: Company, BOBCAPS Research

Expect strong pricing power and lower cost of funds

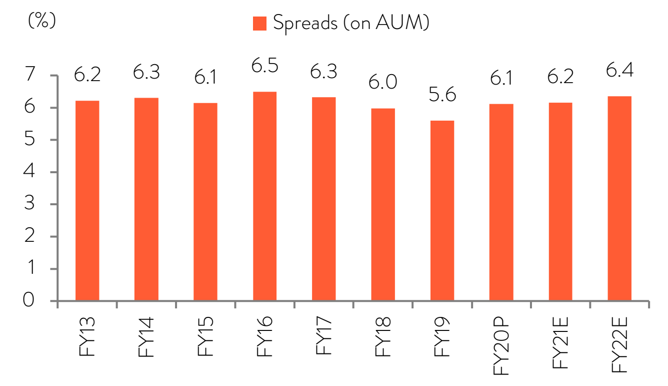
We expect CIFC to maintain its pricing (yields) as it caters to largely self-employed customers in the pay-and-earn segment who are located in rural and semi-urban areas where access to formal credit is limited. Given the company's diversified borrowing mix and successful replacement of market borrowings with bank borrowings over FY19-FY20, we expect cost of funds to decline by 20-40bps over FY21-FY22. Also, a likely reset of term loans to lower rates by banks should aid a 10-30bps rise in spreads over our forecast period.

FIG 25 – WE EXPECT STRONG PRICING AND COST OF FUNDS DURING FY20P-FY22E…



Source: Company, BOBCAPS Research

FIG 26 – …LEADING TO STABLE SPREADS (ON AUM) DURING THE SAME PERIOD



Source: Company, BOBCAPS Research

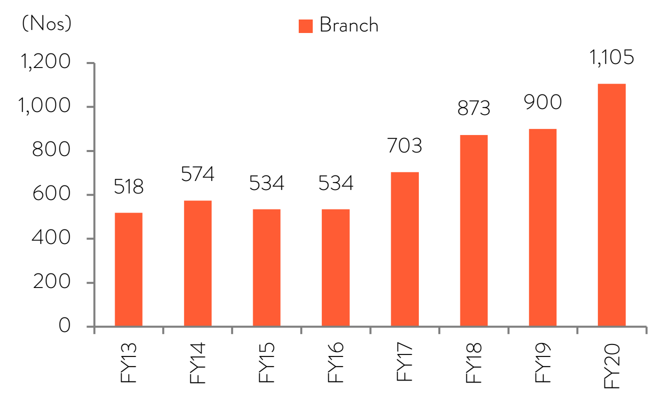
Strong cost control and improved productivity

Though recovery costs would be higher in FY21-FY22, management's stated intent of focusing on cost reduction over the next two years implies cutbacks on discretionary spends. Branch expansion is also limited to smaller, low-cost touchpoints. We model for stable 2.7% opex-to-average assets (expense ratio) during FY20-FY22, leading to a 6% CAGR in operating profit.

Calibrated network expansion

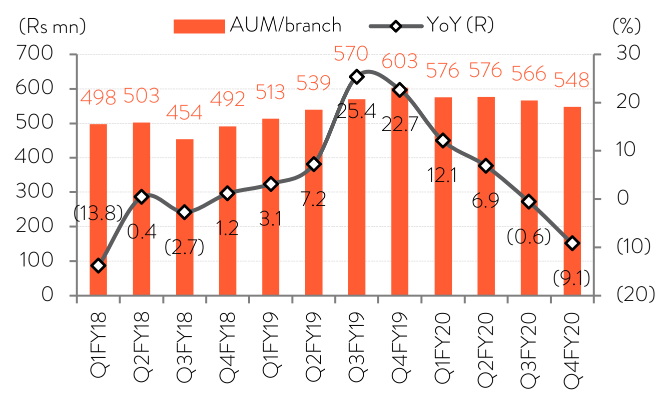
After rapid capacity addition up to FY14, CIFC went into consolidation mode over the next two years, with branch count largely stable over FY14-FY16. The company resumed branch opening in FY17, taking the count from 534 in FY16 to 1,105 in FY20. Most of the new locations are Class 'E' branches, i.e. small-scale outlets with only 2-4 employees, mostly in rural areas. Additionally, the share of branches opened in eastern states is higher than that in other geographies, leading to better pricing power and improved productivity.

FIG 27 – SIGNIFICANT BRANCH NETWORK EXPANSION SINCE FY17



Source: Company, BOBCAPS Research

FIG 28 – PRODUCTIVITY TO INCREASE AS BRANCHES ARE BREAKING EVEN



Source: Company, BOBCAPS Research

Focus on cost reduction

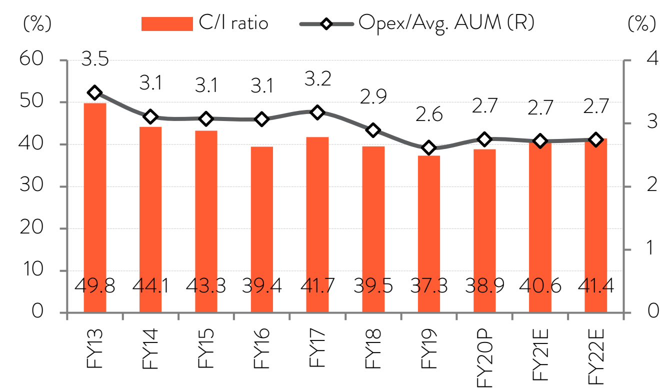
Management intends to focus on cost reduction over the next two years. Loan origination has been automated by equipping the sales force with tablets. Around 35-40% of credit decisions can be taken by the sales manager on the spot, depending on a host of parameters fed into the tablet.

Besides lower costs through automation, the employee base will grow at a slower pace going forward as CIFC limits new hiring post-Covid. As part of the cost-cutting measures, management plans to lower variable payouts, slow business expansion, renegotiate rent contracts and reduce discretionary expenses.

Expect stable cost ratios but no growth in operating profit

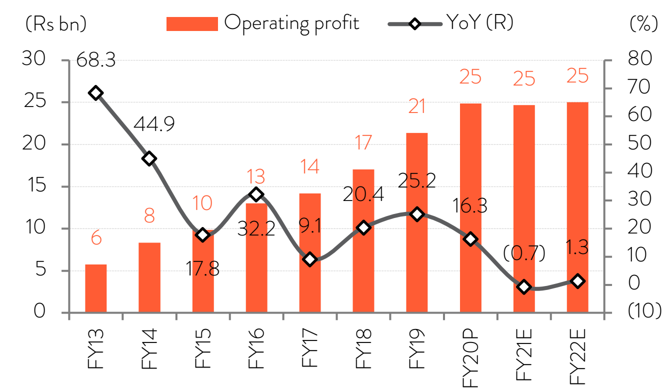
Driven by better efficiencies, CIFC's cost ratios have improved over the past few years — C/I ratio declined to 37% in FY19 from 50% in FY13 and expense ratio shed 90bps to 2.6%. We expect continued focus on opex control post-lockdown driven by the absence of new hiring and lower discretionary expenditure. Hence, we model for stable opex-to-average assets of 2.7% during FY20-FY22 and flat growth in operating profit to Rs 25bn.

FIG 29 – OPEX-TO-AVERAGE AUM TO BE MAINTAINED OVER FY20E-FY22E…



Source: Company, BOBCAPS Research

FIG 30 – …LEADING TO FLAT OPERATING PROFIT



Source: Company, BOBCAPS Research

Financial review

HCV/MCV and home equity to face credit stress

HCV operators have been facing cash flow constraints for the last one year and hence the company has reduced focus on this product. Management expects HCV asset stress to remain elevated for at least 12-15 months. MCVs (>12.5t-16t) have also seen deteriorating portfolio quality. Muted demand due to delay in pick-up of construction and infrastructure activities, as well as a lack of migrant drivers, will curtail fleet utilisation and put pressure on cash flows of fleet operators, curbing their repayment capability. The driver-owner segment may benefit on this account.

Home equity (LAP) is a proxy for SME loans. Though the company has been successful in making the portfolio granular and resolving assets by invoking the SARFAESI Act 2002, we expect asset quality to deteriorate for this segment post-lockdown. Resolutions could be elongated as customer cash flows will be stressed. We believe the company will be forced to restructure these loans over FY21 and also offer some top-up loan facility to keep customer attrition at bay.

Credit cost to peak in FY21

Collections in the vehicle finance segment typically tend to pick up in March, leading to sequential improvement in asset quality in the fourth quarter. But weak freight volumes and lower collections due to the lockdown led to lower recoveries during Q4FY20.

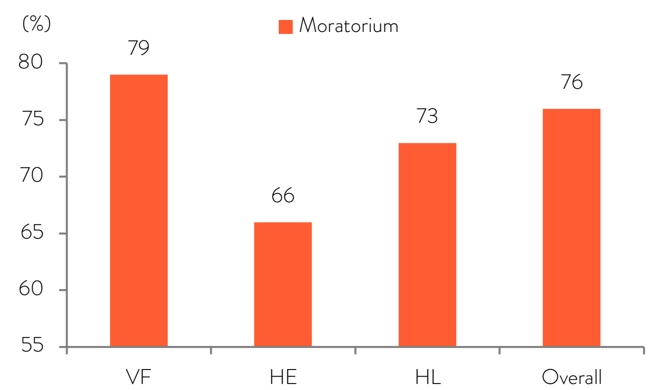
CIFC offered moratorium to its customers as per its board approved policy and 76% (by value) of its customers have taken moratorium. The company reached out to all 1m+ VF customers to understand cash flows and vehicle status. Some customers who were overdue at the end of February and had taken moratorium have cleared dues for 1-2 months. Also, among non-moratorium customers, the slippage rate into higher buckets has been lower. However, not many moratorium customers are paying dues.

In a bid to tide over the pandemic-led slowdown, CIFC is revisiting product-wise and geography-wise disbursements, revamping credit policies and strengthening its collection teams. In the digital space, the company is working on end-to-end digital integration with auto OEMs and channel partners, setting up alternative digital collection modes and remote investigation of field assets.

Customers who honor one of the overdue EMIs are rolled back, and the ones who honor all overdue EMIs are normalized. Higher the ratio, better is the asset quality. Currently no billing is happening for these customers as they have opted for the moratorium, hence the ratio is improving as they are clearing past dues. Since the current month billing is not happening, there are no roll forwards, and hence, the normalizing and roll-forward (NRRB) ratio is reducing. This shows that the delinquent bucket customers are counter intuitively paying up; this may likely be due to the fact that these vehicles are deployed in transportation of essentials.

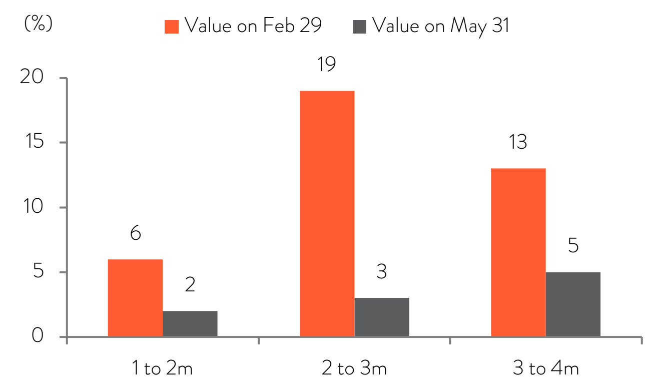
CIFC has made Rs 5bn of incremental provisions for Covid-19 in FY20, thereby taking the credit cost (on AUM) to ~170bps in FY20, close to the previous peak of ~180bps in FY16. Cash flow troubles for customers due to the pandemic are expected to take credit cost higher to ~200bps in FY21.

FIG 31 – 76% OF CUSTOMERS (BY VALUE) HAVE TAKEN MORATORIUM



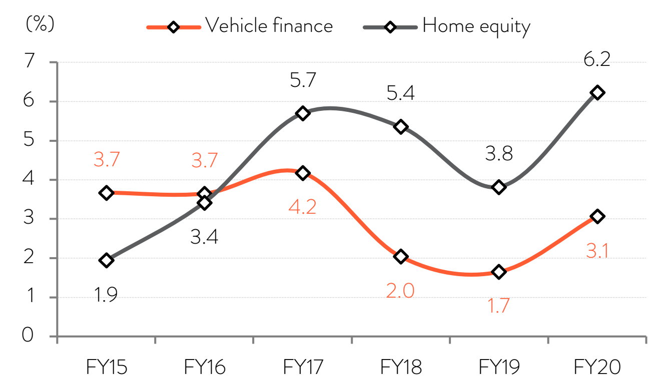
Source: Company, BOBCAPS Research

FIG 32 – ROLL FORWARD DATA (% OF AUM MOVING INTO HIGHER BUCKET IN THE MONTH) DECLINING



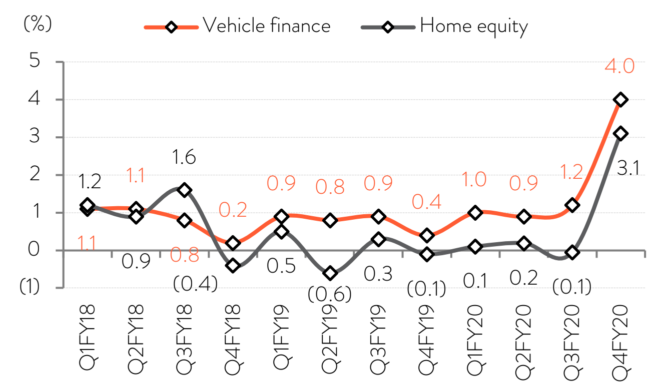
Source: Company, BOBCAPS Research | Note: Includes non-moratorium customers only

FIG 33 – GNPA RATIOS/GROSS STAGE 3 ASSETS HAVE INCREASED DUE TO TEPID BUSINESS ENVIRONMENT



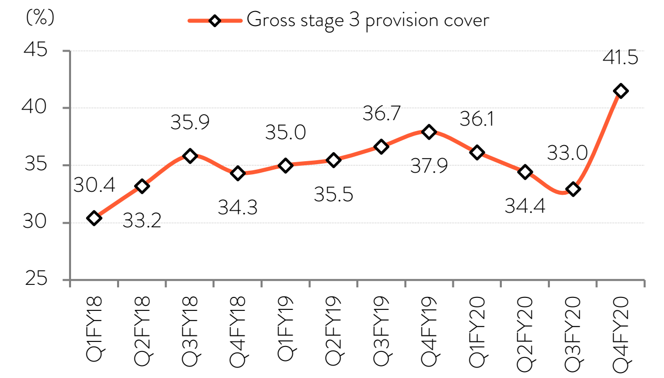
Source: Company, BOBCAPS Research Note: from FY15-FY19 it's GNPA ratio, for FY20 its gross stage 3 assets

FIG 34 – CREDIT COSTS SPIKED DUE INCREMENTAL PROVISION FOR COVID-19



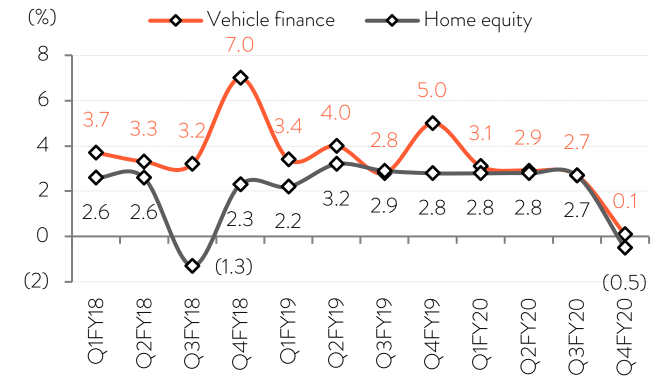
Source: Company, BOBCAPS Research

FIG 35 – CIFC CONTINUES TO MAINTAIN PRUDENT PROVISION COVER…



Source: Company, BOBCAPS Research

FIG 36 – …PBT-ROTA DECLINED DUE TO INCREMENTAL PROVISION FOR COVID-19



Source: Company, BOBCAPS Research

FIG 37 – STAGE-WISE PROVISIONS AS OF FY20

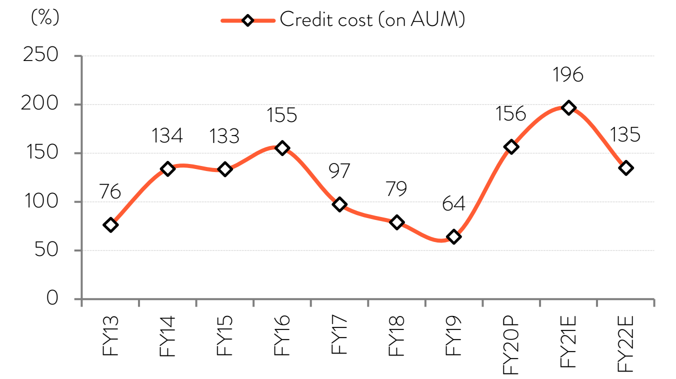
Asset classification (Rs bn) DPD Freeze	Moratorium Status	Asset	Normal	Additional provision		Total additional provision	Total provision	PCR (%)
				Covid-19 provision	Macro provision			
Stage 1	Non-Moratorium	113	0.3	0.0	0.0	0.0	0.3	0.26
Stage 1 (0 overdues)	Moratorium	378	1.1	0.0	0.0	0.0	1.1	0.29
Stage 1 (No past history of flows)	Moratorium	24	0.1	1.2	0.0	1.2	1.2	5.07
Stage 1 (Past history of flow to Stage 2)	Moratorium	12	0.1	1.1	0.0	1.2	1.2	10.12
Stage 1 (Past history of flow to Stage 3)	Moratorium	0	0.0	0.1	0.0	0.1	0.1	34.48
Total Stage 1		**527**	**1.5**	**2.4**	**0.1**	**2.4**	**3.9**	**0.75**
Stage 2	Non-Moratorium	1	0.1	0.0	0.0	0.0	0.1	8.57
Stage 2 (No past history of flows)	Moratorium	17	1.4	0.2	0.1	0.3	1.8	10.09
Stage 2 (Past history of flow to Stage 3)	Moratorium	1	0.1	0.3	0.1	0.3	0.5	31.51
Total Stage 2		**20**	**1.7**	**0.5**	**0.2**	**0.7**	**2.3**	**11.53**
Stage 3	Non-Moratorium	16	3.8	0.0	1.9	1.9	5.7	34.92
Stage 3	Moratorium	3	0.6	0.0	0.4	0.4	0.9	35.07
Stage 3 - Legal	Non-Moratorium	3	2.4	0.0	0.0	0.0	2.4	87.23
Total Stage 3		**22**	**6.7**	**0.0**	**2.3**	**2.3**	**9.0**	**41.56**
Total		**569**	**9.9**	**2.9**	**2.5**	**5.3**	**15.3**	**2.68**

Source: Company, BOBCAPS Research

In an effort to contain delinquencies, the company will increase focus on collections over the next few quarters via its workforce of 7,000 collection executives and 7,000 sales representatives. While collection efficiency was at ~17% as of Apr'20, management highlighted green shoots in recoveries from overdue customers.

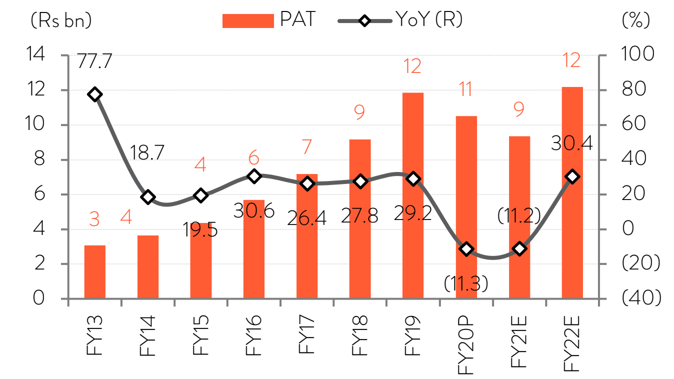
Given the rising credit cost, we model for a feeble 8% CAGR in PAT to Rs 12bn through to FY22. CIFC maintains ~10% of its balance sheet in cash & cash equivalents and liquid investments. The business remains well capitalised and ROA/ROE are projected to see recovery to 1.7%/12.7% in FY22 as credit cost normalises.

FIG 38 – WE EXPECT CREDIT COST TO PEAK IN FY21E…



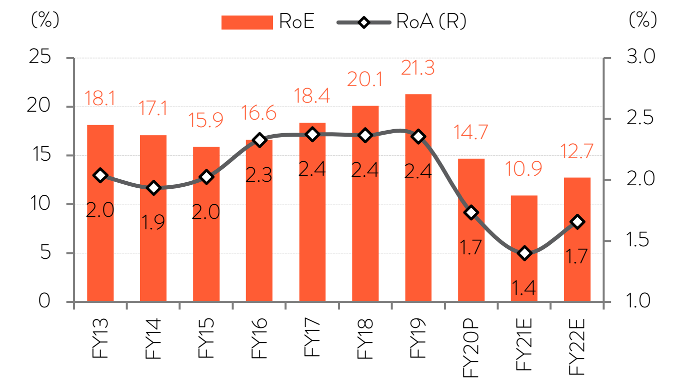
Source: Company, BOBCAPS Research

FIG 39 – …LEADING TO 8% CAGR IN PAT DURING FY20P-FY22E



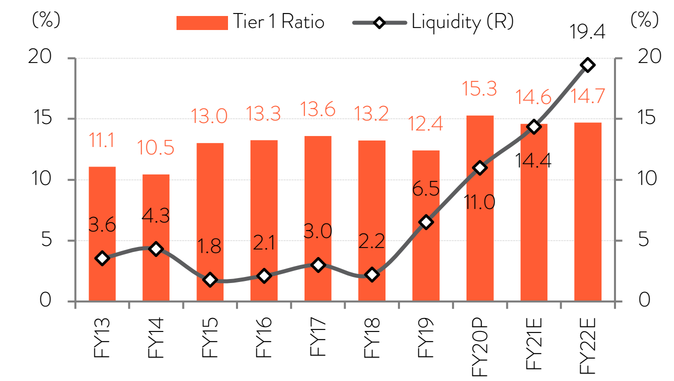
Source: Company, BOBCAPS Research

FIG 40 – RETURN RATIOS TO SEE RECOVERY IN FY22E



Source: Company, BOBCAPS Research

FIG 41 – CIFC REMAINS WELL CAPITALISED AND FLUSH WITH LIQUIDITY



Source: Company, BOBCAPS Research | Note: Liquidity = (Cash + Investments)/Total Assets

Technology backbone curbs asset risk

CIFC's use of technology and analytics helps the company maintain quality growth of assets. Existing underwriting models are being augmented by artificial intelligence and machine learning tools across credit, sales, collection and risk functions. These capabilities help the company predict and strategise for credit risk, field collection efficiency, sales and productivity, cross-sell efficiency, audit and fraud monitoring.

Valuation methodology

Two aspects of CIFC's vehicle finance business stand out compared to most peers: (i) diversification across product segments, and (ii) low state-level concentration – the largest state accounts for only 11% of the total portfolio. An early entry into LAP and focus on affordable housing are also likely to yield results in the medium term.

AUM has grown at 20%+ over FY19-FY20 though disbursals have slowed amid a tough economic environment. The near-to-medium-term outlook appears challenging due to Covid-19 disruptions – we expect back-ended recovery in H2FY22 given both supply and demand constraints. Hence, we model for slower AUM growth at ~4% CAGR during FY20-FY22. Strong asset quality has been a hallmark of CIFC. Credit costs could remain elevated in FY21, but are likely to normalise in H2FY22. Thus, we expect ROA/ROE recovery in FY22.

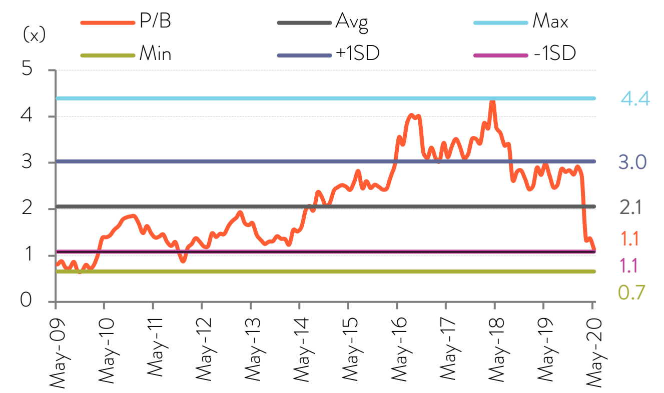
The stock currently trades at 1.2x FY22E BVPS, reflecting the successful scaling up of key businesses and robust profitability (21% AUM CAGR, FY11-FY20). We use a residual income model to arrive at our Mar'21 target price of Rs 200 (1.6x FY22E BV), which values the company at a risk-free rate of 7.75%, cost of equity of 14.0%, and terminal growth of 5%. We incorporate the recent Rs 9bn QIP and Rs 3bn of preferential issue in our numbers. We believe the business will remain well capitalised and flush with liquidity through FY22. Initiate with BUY.

FIG 42 – VALUATION ASSUMPTIONS

Parameter	(%)
Cost of Equity	14.0
Risk-free rate	7.75
Risk Premium	5.0
Terminal growth rate	5.0

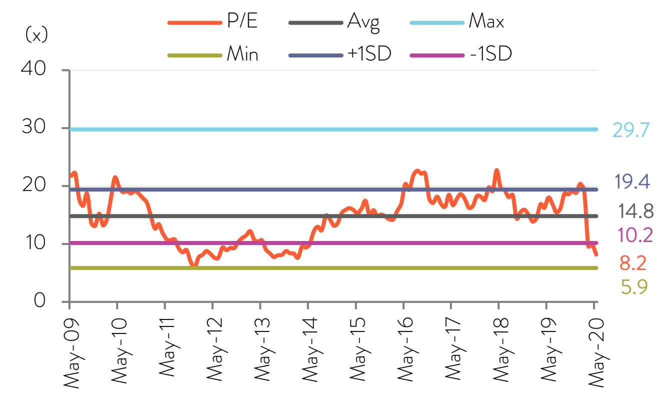
Source: BOBCAPS Research

FIG 43 – ONE-YEAR FORWARD P/B



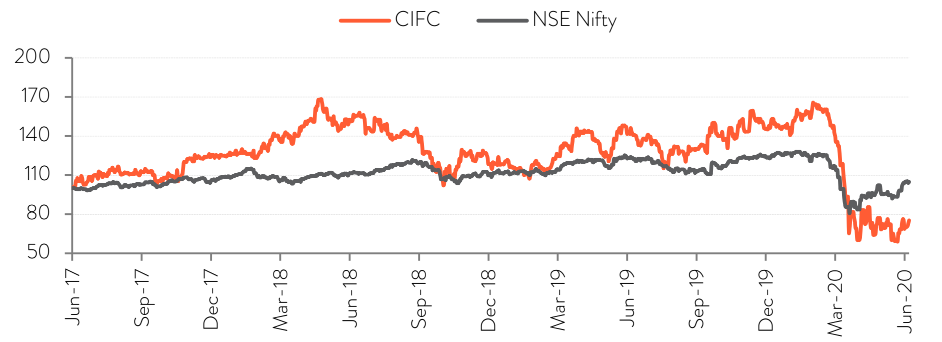
Source: Bloomberg, BOBCAPS Research

FIG 44 – ONE-YEAR FORWARD P/E



Source: Bloomberg, BOBCAPS Research

FIG 45 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

Downside risks to our estimates are:

- reduced repayment discipline among customers seeking moratorium;
- longer-than-expected recovery in supply chains, affecting cash flows; and
- long drawn recoveries in the home equity business.

Management team

Name	Designation
Arun Alagappan	Managing Director
Arul Selvan	Executive Vice President & Chief Financial Officer
Ravindra Kundu	Executive Director
Shaji Varghese	President, Housing Finance
Rupinder Singh	Senior Vice President & Business Head, Home Equity And SME

Source: Company, BOBCAPS Research

FINANCIALS

Income Statement

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20P	FY21E	FY22E
Net interest income	**25,268**	**28,972**	**34,101**	**34,146**	**34,213**
NII growth (%)	18.0	14.7	17.7	0.1	0.2
Non-interest income	2,935	5,067	6,506	7,339	8,456
Total income	28,203	34,039	40,607	41,486	42,669
Operating expenses	11,153	12,695	15,776	16,830	17,681
Operating profit	17,051	21,344	24,831	24,655	24,988
Operating profit growth (%)	20.4	25.2	16.3	(0.7)	1.3
Provisions	3,037	3,112	8,973	12,156	8,688
PBT	14,014	18,232	15,857	12,500	16,299
Tax	4,831	6,370	5,334	3,150	4,107
Reported net profit	**9,183**	**11,862**	**10,524**	**9,350**	**12,192**
Adjustments	0	0	0	0	0
Adjusted net profit	**9,183**	**11,862**	**10,524**	**9,350**	**12,192**

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20P	FY21E	FY22E
Equity capital	1,564	1,564	1,640	1,640	1,640
Reserves & surplus	48,194	60,193	80,079	88,445	99,653
Net worth	49,758	61,757	81,718	90,084	101,292
Deposits	0	0	0	0	0
Borrowings	383,303	505,667	550,054	596,809	665,442
Other liabilities & provisions	0	0	0	0	0
Total liabilities and equities	**433,061**	**567,425**	**631,773**	**686,893**	**766,734**
Cash & bank balance	8,880	36,749	69,591	97,085	147,606
Investments	729	729	729	2,984	3,327
Advances	422,532	526,223	554,027	577,393	604,258
Fixed & Other assets	1,646	1,754	2,837	3,405	4,086
Total assets	**433,061**	**567,425**	**631,773**	**686,893**	**766,734**
Deposit growth (%)	NA	NA	NA	NA	NA
Advances growth (%)	27.2	24.5	5.3	4.2	4.7

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20P	FY21E	FY22E
EPS	11.7	15.2	12.8	11.4	14.9
Dividend per share	1.3	1.3	1.7	1.0	1.0
Book value per share	63.6	79.0	99.7	109.9	123.5

Source: Company, BOBCAPS Research

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20P	FY21E	FY22E
P/E	13.3	10.3	12.1	13.7	10.5
P/BV	2.4	2.0	1.6	1.4	1.3
Dividend yield (%)	0.8	0.8	1.1	0.6	0.6

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20P	FY21E	FY22E
Net interest income	6.5	5.8	5.6	5.1	4.6
Non-interest income	0.8	1.0	1.1	1.1	1.1
Operating expenses	2.9	2.5	2.6	2.5	2.4
Pre-provisioning profit	4.4	4.2	4.1	3.7	3.4
Provisions	0.8	0.6	1.5	1.8	1.2
PBT	3.6	3.6	2.6	1.9	2.2
Tax	1.2	1.3	0.9	0.5	0.6
ROA	2.4	2.4	1.7	1.4	1.7
Leverage (x)	8.5	9.0	8.5	7.8	7.7
ROE	20.1	21.3	14.7	10.9	12.7

Ratio Analysis

Y/E 31 Mar	FY18A	FY19A	FY20P	FY21E	FY22E
YoY growth (%)					
Net interest income	18.0	14.7	17.7	0.1	0.2
Pre-provisioning profit	20.4	25.2	16.3	(0.7)	1.3
EPS	1174.3	1516.5	1283.5	1140.4	1487.0
Profitability & Return ratios (%)					
Net interest margin	7.3	6.1	6.4	6.0	5.8
Fees / Avg. assets	0.4	0.4	0.3	0.3	0.3
Cost-Income	39.5	37.3	38.9	40.6	41.4
ROE	20.1	21.3	14.7	10.9	12.7
ROA	2.4	2.4	1.7	1.4	1.7
Asset quality (%)					
GNPA	3.4	2.7	3.4	3.8	4.6
NNPA	1.8	1.2	1.7	2.3	2.1
Provision coverage	46.6	53.1	30.3	41.5	41.1
Ratios (%)					
Credit-Deposit	0.0	0.0	0.0	0.0	0.0
Investment-Deposit	0.0	0.0	0.0	0.0	0.0
CAR	18.4	17.4	20.7	20.7	19.5
Tier-1	13.2	12.4	15.3	15.3	14.7

Source: Company, BOBCAPS Research

ADD
TP: Rs 170 | ⮝ 10%

MAHINDRA & MAHINDRA FIN SVCS | NBFC | 10 June 2020

Challenging year ahead – initiate with ADD

Mahindra & Mahindra Financial Services (MMFS) is likely to post flat AUM growth over FY20-FY22 in the wake of Covid-19. We believe pricing power will remain intact due to its wide distribution reach and multi-OEM client base. Also, with surplus systemic liquidity and strong parentage in M&M, funding costs should decline, keeping spreads stable at ~7.3%. We model for a rise in expense ratio to ~300bps and in average credit cost to 420bps for FY21-FY22 as a fallout of the pandemic. Initiate with ADD and a Mar'21 TP of Rs 170.

Shubhranshu Mishra
research@bobcaps.in

Tepid volume/value growth: We believe the demand environment for MMFS's loan products will take two years to recover from Covid-19, thereby affecting volume and value growth through to FY22. Assuming adoption of stricter credit screens by the company and deferred vehicle purchase decisions by consumers, we model for flat AUM growth over FY20-FY22.

Spreads stable: Apart from anchor customer and parent Mahindra & Mahindra (M&M), MMFS has relationships with multiple OEMs for vehicle financing and enjoys strong pricing power backed by a wide distribution network. Diverse funding and strong parentage are likely to aid steady spreads of ~7.3% over FY21-FY22.

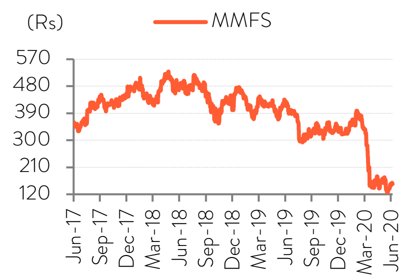
High opex and credit cost: Though we believe MMFS will work to contain fixed costs, we model for a spike in expense ratio to ~300bps during FY21-FY22 due to lower AUM growth and higher collection efforts post the coronavirus crisis. Credit cost is estimated to swell to 500bps in FY21 (driving an 89% earnings drop) due to the lockdown and moratorium, before normalising to 330bps in FY22.

FY22 recovery potential; initiate with ADD: Using a residual income model, we arrive at a Mar'21 TP of Rs 170. Our assumptions include 14.8% cost of equity, 7.75% risk-free rate, 5% risk premium and 5% long-term growth.

Ticker/Price	MMFS IN/Rs 154
Market cap	US$ 1.3bn
Shares o/s	618mn
3M ADV	US$ 22.4mn
52wk high/low	Rs 313/Rs 125
Promoter/FPI/DII	51%/24%/16%

Source: NSE

STOCK PERFORMANCE



Source: NSE

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20P	FY21E	FY22E
Net interest income	35,025	46,700	51,130	51,829	53,113
NII growth (%)	11.0	33.3	9.5	1.4	2.5
Adj. net profit (Rs mn)	10,111	15,571	9,064	1,032	9,038
EPS (Rs)	16.5	25.3	14.7	1.7	14.7
P/E (x)	9.4	6.1	10.5	92.1	10.5
P/BV (x)	1.0	0.9	0.8	0.8	0.8
ROA (%)	2.1	2.6	1.3	0.1	1.2
ROE (%)	12.7	15.8	8.3	0.9	7.6

Source: Company, BOBCAPS Research

Multiple challenges ahead

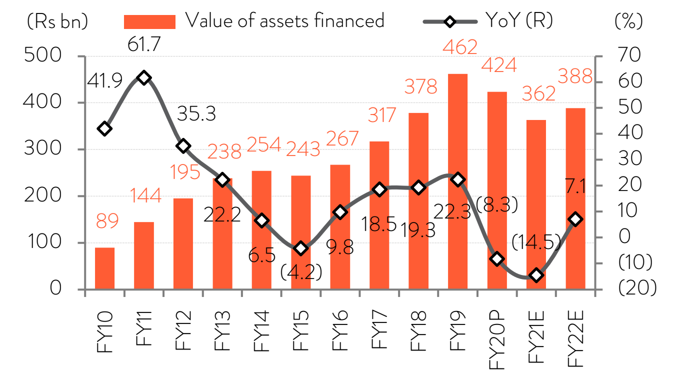
Muted AUM growth prospects amid Covid-19

MMFS is a rural and semi-urban NBFC focused on auto and tractor financing, with a dominant 16% market share in tractors. Given the impending slowdown in utility (UV) and commercial vehicles (CV) amid the Covid-19 crisis, MMFS faces severe headwinds to growth. Despite healthy monsoons last year and a good harvest season, we believe AUM expansion over FY20-FY22 will be undermined by (a) stricter credit screens put in place by the company to weather the crisis, and (b) deferred purchase decisions by consumers reeling from cash flow mismatches.

Once the crisis abates, we do expect a pick-up in tractor and UV sales during the festive season in H2FY21, but car sales could lag as customers either downtrade or postpone purchase decisions. Pre-owned vehicle sales could do well, especially post-festive season, as financiers likely reduce equity participation by customers.

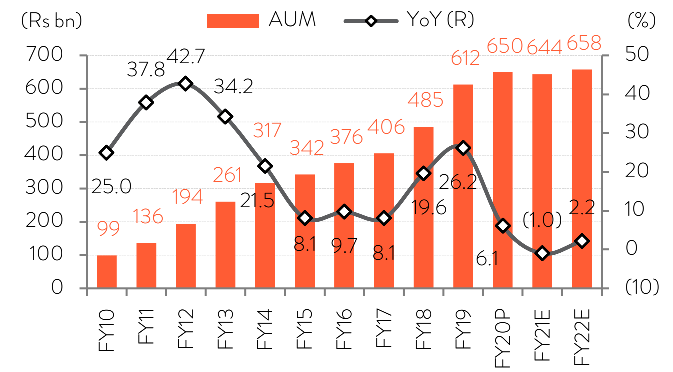
Overall, we forecast flat AUM growth for MMFS over FY20-FY22, with FY22 being a year of gradual recovery. Growth through the crisis will be aided by branch expansion, recent reorganisation into a product-based business structure, an increasing share of non-M&M OEMs, and expected better cash flows in rural areas (via crop support price hikes, direct benefit transfers and farm loan waivers). Despite tepid growth, portfolio yields are expected to hold firm at ~15.5% as concentration risk reduces and new branches turn productive.

FIG 1 – VALUE OF ASSETS FINANCED (VAF) EXPECTED TO DECLINE ~4% OVER FY20E-FY22E…



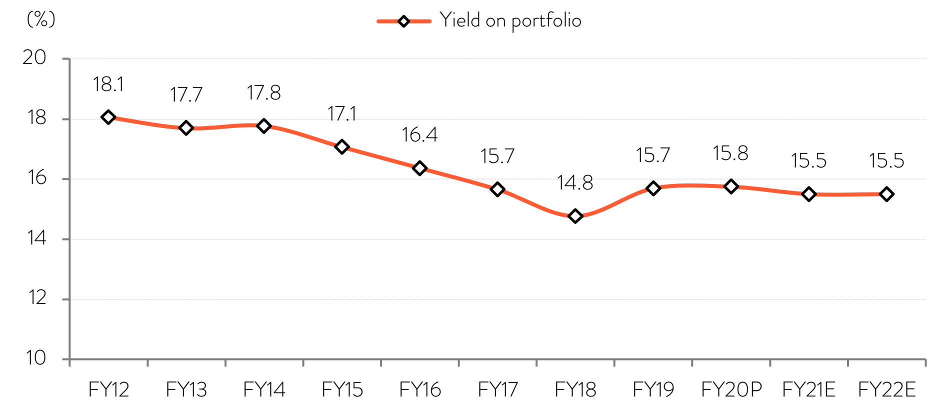
Source: Company, BOBCAPS Research

FIG 2 – …TRANSLATING TO FLAT AUM GROWTH OVER THIS PERIOD



Source: Company, BOBCAPS Research

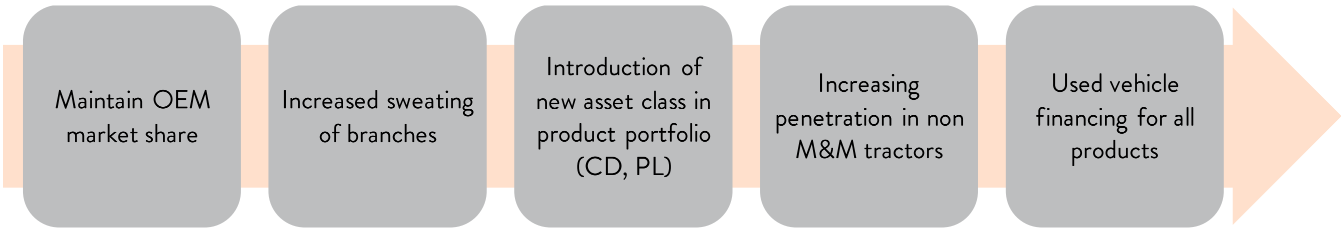
FIG 3 – EXPECT STEADY YIELDS DURING FY19-FY22E



Source: Company, BOBCAPS Research

Key growth drivers

FIG 4 – ANATOMY OF GROWTH



Source: Company, BOBCAPS Research

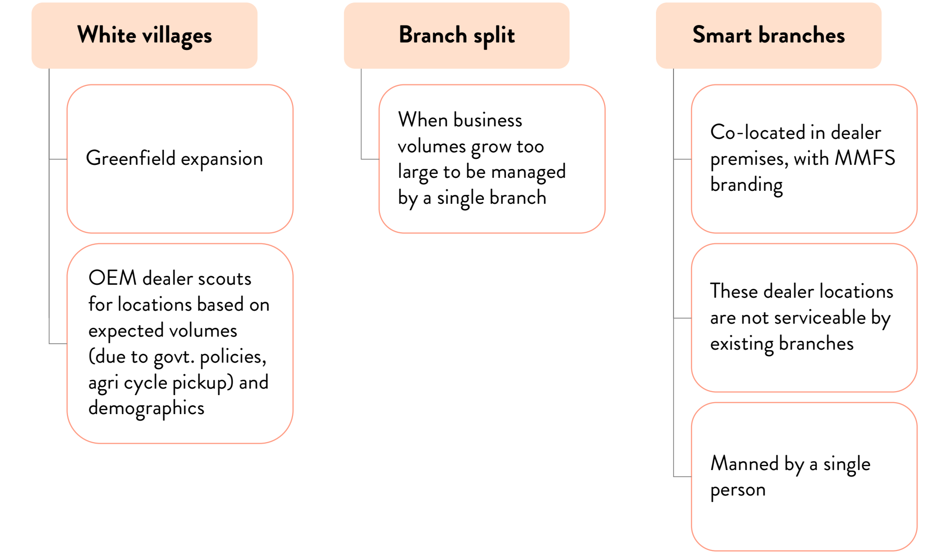
#1 Branch expansion to raise productivity

MMFS has access to ~350,000 villages through its 1,322-strong branch network and ~17,000+ dealer relationships. The top-10 states account for 67% of the company's branch presence as of FY20 and ~67% of additions over FY12-FY20.

By widening its footprint in key states such as Uttar Pradesh, Maharashtra and Madhya Pradesh which are major tractor and UV markets, MMFS has largely managed to offset lumpiness in demand arising from uneven spatial distribution of the monsoons. Collection centres opened over FY13-FY16 (~500 in all) have now started breaking even and should contribute significantly to growth. With a lagged increase in headcount, productivity is set to increase.

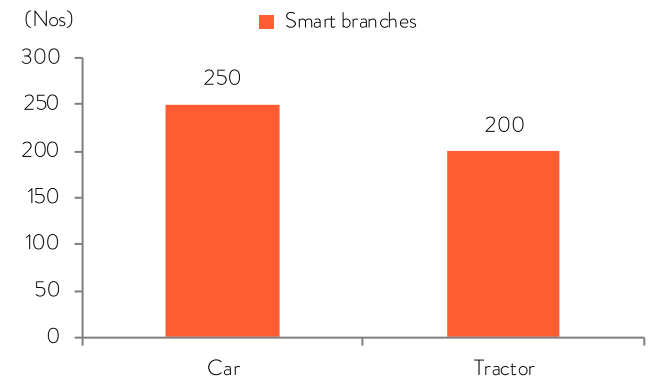
The company also rolled out 450 smart branches a little over two years ago. These are dealer locations that are not serviceable by present infrastructure and are manned by a single salesperson, co-located in dealer premises with MMFS branding. As per management, competitor branches are generally co-located with MMFS branches. But differentiated customer segments and sourcing through field agents as opposed to walk-ins negates the co-location risk.

FIG 5 – BRANCH EXPANSION STRATEGY



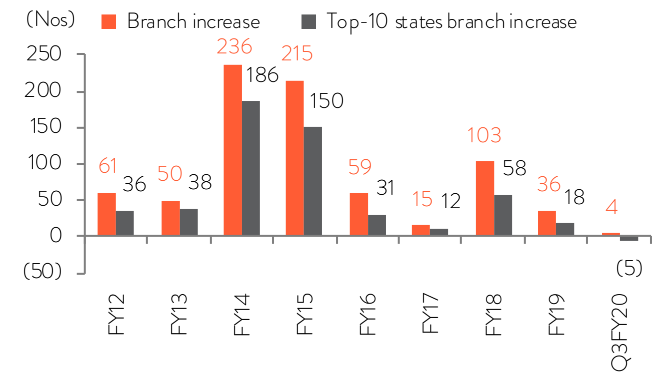
Source: Company, BOBCAPS Research

FIG 6 – SMART BRANCHES ARE CO-LOCATED IN DEALER PREMISES



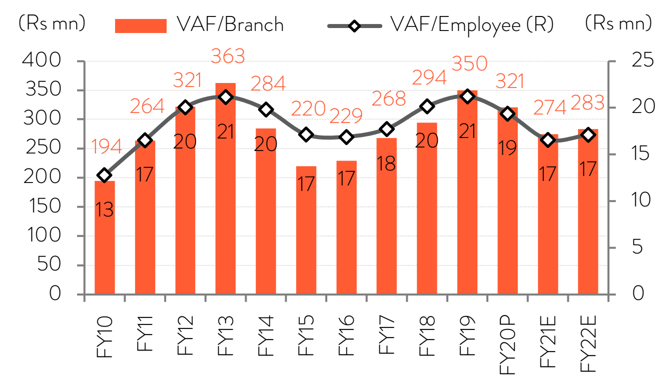
Source: Company, BOBCAPS Research

FIG 7 – BRANCH ADDITION DURING THE DOWN-CYCLE TOOK PLACE IN KEY STATES



Source: Company, BOBCAPS Research

FIG 8 – BRANCH PRODUCTIVITY TO REMAIN STAGNANT IN FY22E



Source: Company, BOBCAPS Research | Note: VAF = Value of asset financed

FIG 9 – INCREASE IN TOP-10 STATE BRANCH COUNT COUNTERS MONSOON SPATIAL VARIANCE

Branches	FY16	FY17	FY18	FY19	Q3FY20
Uttar Pradesh	105	106	124	127	128
Andhra Pradesh	116	120	125	126	123
Maharashtra	102	103	118	121	121
Madhya Pradesh	95	97	106	111	113
Kerala	94	94	87	87	85
Tamil Nadu	78	78	82	82	73
Gujarat	69	72	77	77	78
Rajasthan	71	73	76	76	76
Karnataka	63	63	67	72	72
West Bengal	64	63	65	66	67

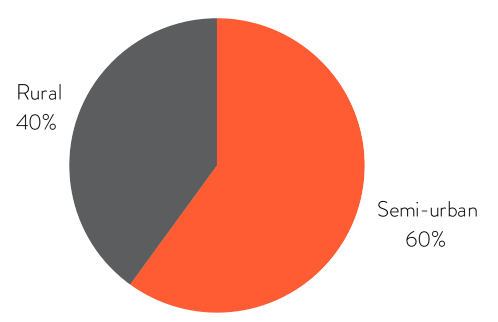
Source: Company, BOBCAPS Research | Note: Andhra Pradesh includes Telangana branches

#2 Focus on used vehicle financing

MMFS has a leading 16% market share in tractor financing supported by a large branch presence (40% of total) in rural India. The company is ramping up focus on used vehicle financing. At present, an estimated 5mn+ tractors are operated in India. Of these, 1.5mn are under loans and another 1.5mn are over 10 years old. Thus, the remaining 1.5-2.0mn are available for refinance. MMFS also plans to tap customers for their next purchase.

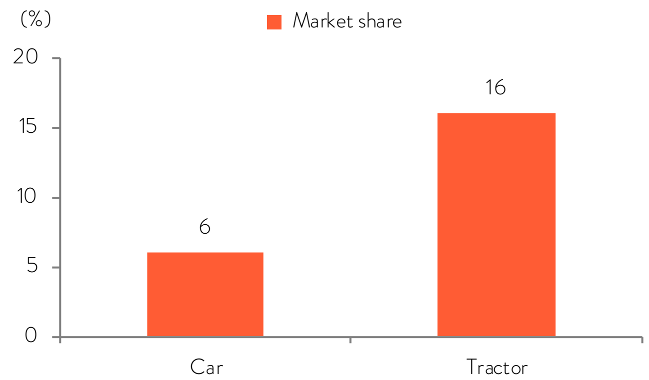
Direct marketing initiatives started four years ago are yielding results, with 12-15% of volumes sourced from direct channels. This helps lower the cost of customer acquisition and raise customer retention.

FIG 10 – BRANCH SPLIT SHOWS SIGNIFICANT RURAL COVERAGE



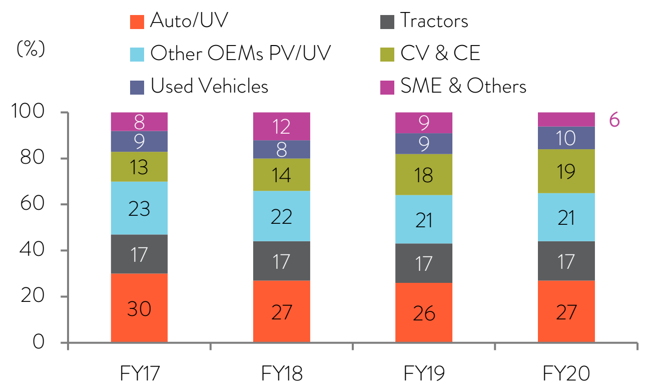
Source: Company, BOBCAPS Research

FIG 11 – DOMINANT MARKET SHARE IN TRACTOR FINANCING



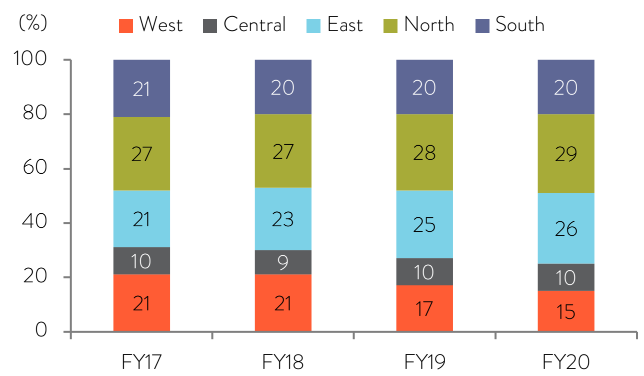
Source: Company, BOBCAPS Research

FIG 12 – AUM MIX OVER LAST 4 YEARS



Source: Company, BOBCAPS Research

FIG 13 – EMPHASIS ON W. BENGAL, ASSAM AND ODISHA FOR SOURCING INCREMENTAL AUM

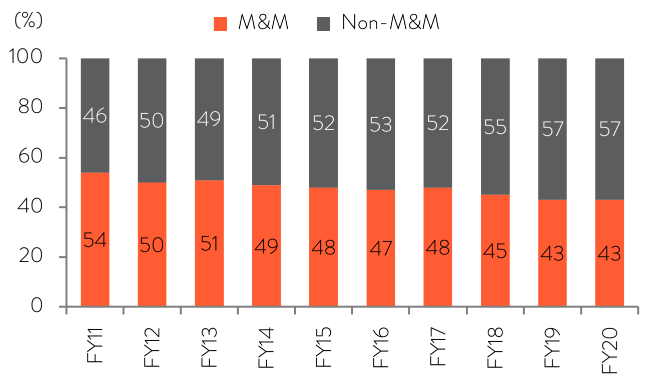


Source: Company, BOBCAPS Research

#3 Rising share of non-M&M OEMs

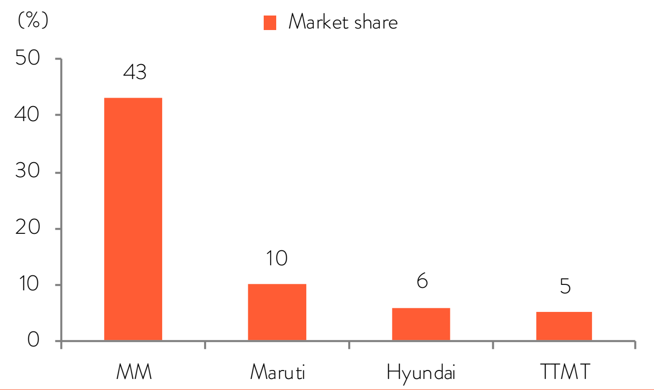
MMFS has been deepening its relationships with non-M&M OEMs such as Maruti, Hyundai, Nissan, Renault, TAFE and Sonalika. The company finances 10,000-11,000 Maruti cars per month, competing closely with large banks such as SBI (~13,000 cars) and HDFC Bank (~15,000 cars) despite a smaller branch footprint. Over FY11-FY20, the share of anchor client M&M has reduced from 54% to 43%, lowering business concentrating risk.

FIG 14 – INCREASING AUM SHARE OF NON-M&M OEMs TO COUNTER CONCENTRATION RISK



Source: Company, BOBCAPS Research

FIG 15 – MARKET SHARE IN KEY OEMs



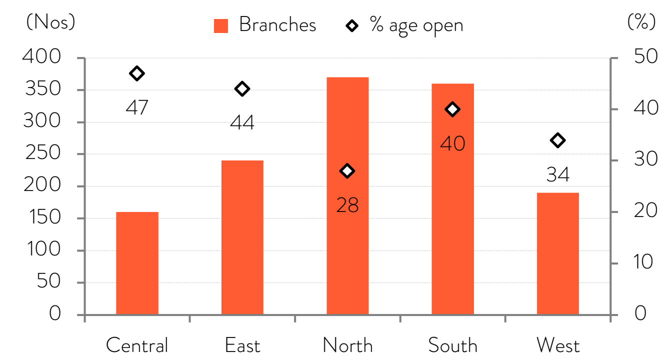
Source: Company, BOBCAPS Research

Spreads to remain stable

MMFS has a healthy borrowing mix comprising NCDs (35%), bank loans (30%), securitisation (15%), public deposits (15%) and inter-corporate deposits (ICD: 5%). The company has mitigated short-term pricing risk to liabilities by completely running down commercial papers (CP). Management expects to maintain a similar mix in FY21. MMFS undertakes most of its securitisation with HDFC Bank, ICICI Bank, Standard Chartered and HSBC – this allows it to access funding ~200bps cheaper than term loans.

The company has adequate arrangements for liquidity and expects to meet all liabilities, including interest payments as also fixed costs, on time. Management does not anticipate cash flow constraints even if the pandemic-led crisis were to run for a protracted period. The company had ~Rs 45bn of liquid investment as of May'20 and has raised over Rs 30bn in the last couple of months through term loans, NCDs and securitisation. It has maturities of close to Rs 10bn every month in FY21.

FIG 16 – MMFS HAD ~500 BRANCHES OPEN AS OF MAY'20 AS LOCKDOWN WAS GRADUALLY LIFTED



Source: Company, BOBCAPS Research

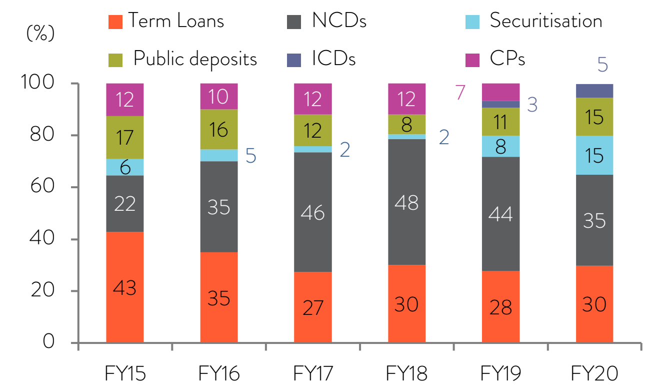
FIG 17 – LIABILITY MATURITY MONTH-WISE

Liability maturity (Rs bn)	May-20	Jun-20	Jul-20	Aug-20	Sep-20	H1FY21
Bank Loans	1.0	6.6	2.5	7.3	4.4	21.9
Market Instruments	0.5	11.2	8.9	1.8	4.6	27.0
Others	0.6	1.3	1.3	1.6	1.3	6.0
Total	**2.1**	**19.1**	**12.7**	**10.7**	**10.3**	**54.9**

Source: Company, BOBCAPS Research Note: Data as of May 14, 2020 and excl. WCDL and securitisaton

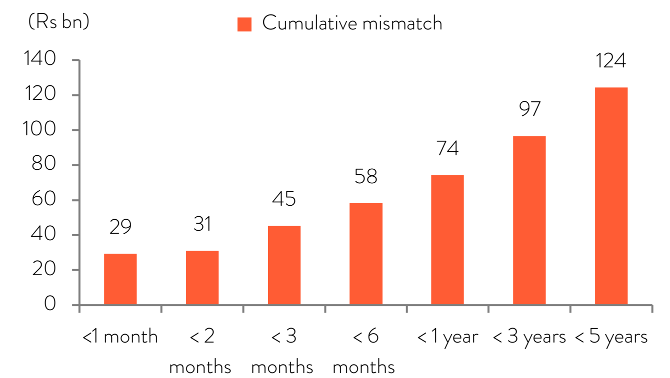
The company is running a positive cumulative surplus liquidity in all buckets, lending comfort on its ability to sustain spreads. With surplus systemic liquidity and the availability of funds from diversified sources, we model for a 25-30bps decrease in cost of funds (CoF) through FY21-FY22. In turn, we expect spreads to hold at ~7.3% levels during this period.

FIG 18 – HEALTHY BORROWING MIX…



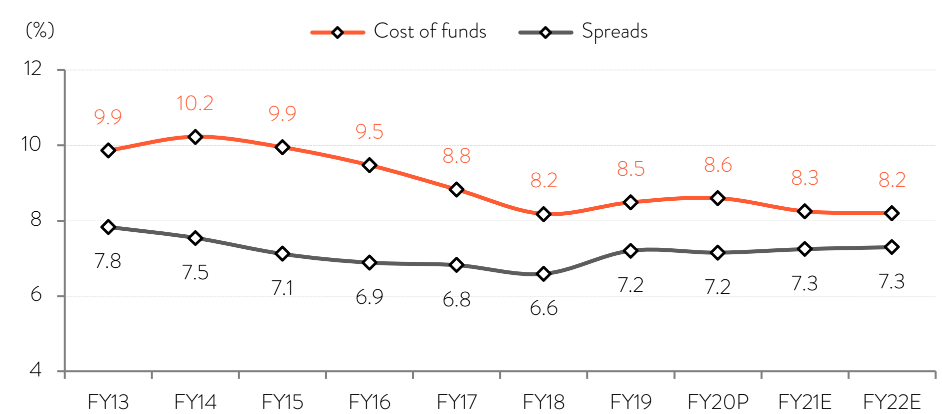
Source: Company, BOBCAPS Research

FIG 19 – …AND POSITIVE ALM GAP IN <1-YEAR BUCKET



Source: Company, BOBCAPS Research

FIG 20 – SPREADS OF 7.3% IN FY21E-FY22E



Source: Company, BOBCAPS Research

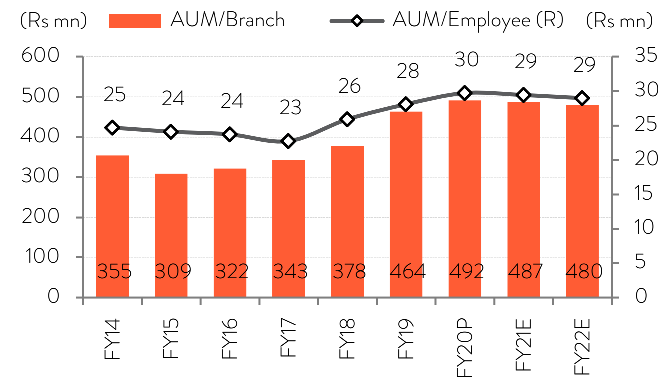
Opex elevated amid IL&FS, Covid crises

Business restructuring undertaken by MMFS in FY17 introduced a product vertical-based structure (versus the branch-based architecture earlier), spurring a sharper focus on product sourcing and stronger collections. Around 200 collection centres were converted to full-fledged branches during this rejig and have now started generating business volumes. But following the Sep'18 IL&FS crisis and resultant squeeze on systemic liquidity, CV and UV sale volumes have slowed considerably over FY19-FY20. We expect post-Covid-19 lockdown volumes to be even lower.

In the wake of the IL&FS crisis, MMFS stepped up collection efforts in order to maintain asset quality. We expect a redoubling of these efforts once the ongoing lockdown is lifted. As the company's clientele is largely self-employed and dependent on agriculture income, collections are mostly in cash. Digital collections accounted for only 30-35% share as of FY20.

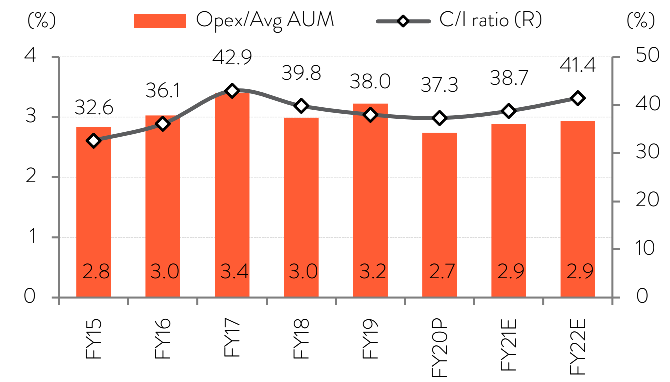
Given the cash flow mismatches that occur seasonally for rural clients during H1FY21 and the RBI loan moratorium, we expect significant pressure on asset quality. Opex towards collections will likely be stepped up to rein in delinquencies – we conservatively model for a ~300bps expense ratio in FY21 and FY22.

FIG 21 – PRODUCTIVITY EXPECTED TO REMAIN STABLE DURING FY21E-FY22E



Source: Company, BOBCAPS Research

FIG 22 – EXPENSE RATIO ESTIMATED AT ~300BPS THROUGH TO FY22E



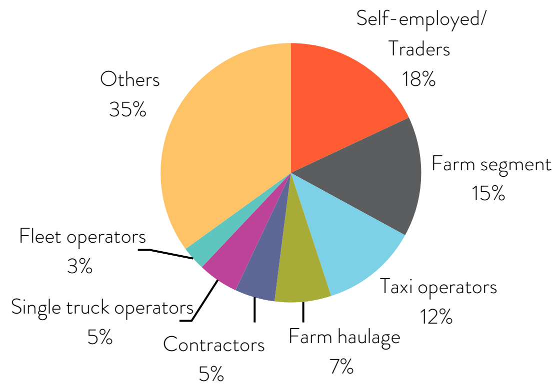
Source: Company, BOBCAPS Research

Asset quality to deteriorate

Write-offs as a percentage of AUM (two-year lag) declined ~150bps for MMFS in the last CV upcycle of FY10-FY14 as nominal rural wages increased by an average of ~17%, boosting cash flows of the client segment. Thereafter, write-offs peaked at 4.3% in FY19 due to the better cash flows of customers, before coming off to 2.5% in FY20. We expect this metric to deteriorate to 2.7-2.9% levels during FY21-FY22 due the Covid-19 effect.

Given the good harvest this season in most states, we believe that farm cash flow will hold up, aiding improved collections. Over 75% of customers by value took the moratorium. The farming community, professionals such as local teachers, doctors and customers with fixed incomes have not opted for this concession. The company took a voluntary provision of Rs 5.6bn for Covid-19 exposures in FY20.

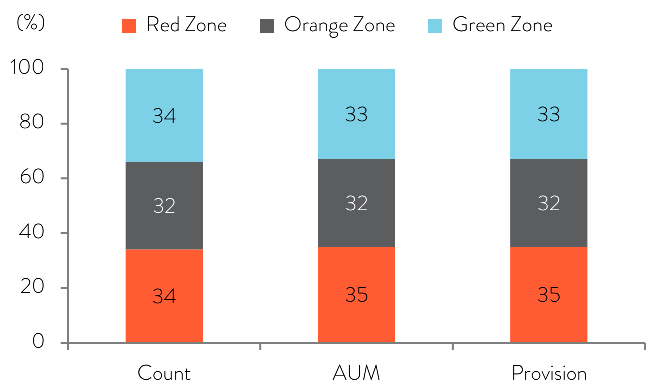
FIG 23 – CUSTOMER BREAKUP AS OF FY20



Source: Company, BOBCAPS Research

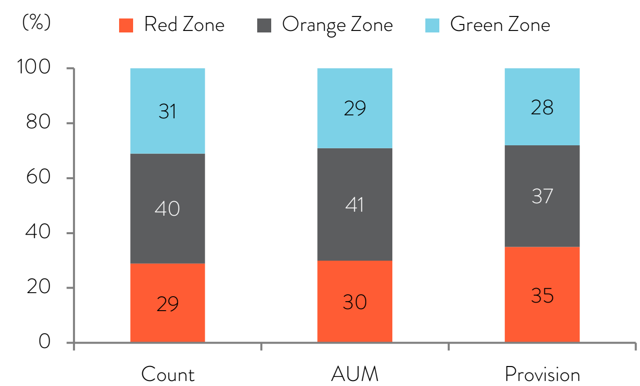
April registered a collection efficiency of ~15% and collections till 15 May were better than that in April, suggesting a gradual return to normalcy. Some delinquency could arise out of the moratorium as customers in red zones (areas with a heavy Covid caseload) or in the commercial transport segment or working as taxi aggregators or tour operators could see slower recovery. The company has been lobbying for one-time loan restructuring, which can take the pressure off credit cost.

FIG 24 – MMFS PROVIDED 35% FOR ITS RED ZONE EXPOSURE IN STAGE 2 ASSETS...



Source: Company, BOBCAPS Research

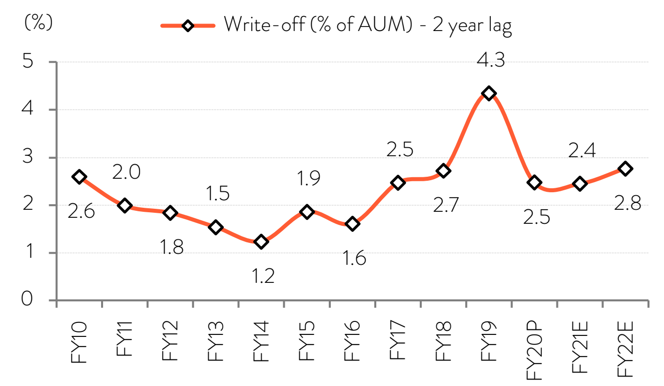
FIG 25 – ...AND THE SAME FOR STAGE 3 ASSETS



Source: Company, BOBCAPS Research

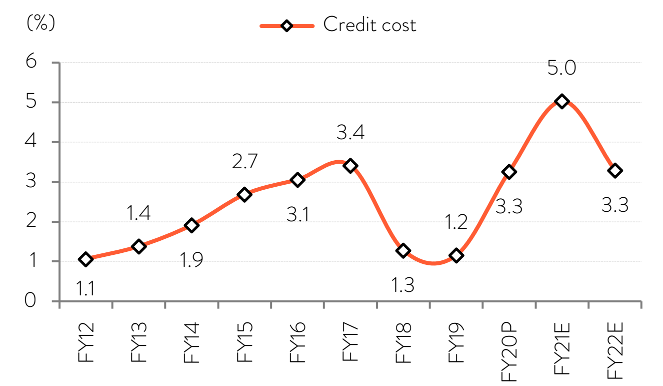
Credit cost is projected to rise sharply in FY21 due to the lockdown and moratorium, before normalising in FY22. We model for credit cost of 500bps/ 330bps in FY21/FY22.

FIG 26 – WRITE-OFFS AS % OF AUM TO REMAIN RANGE-BOUND DURING FY21E-FY22E



Source: Company, BOBCAPS Research

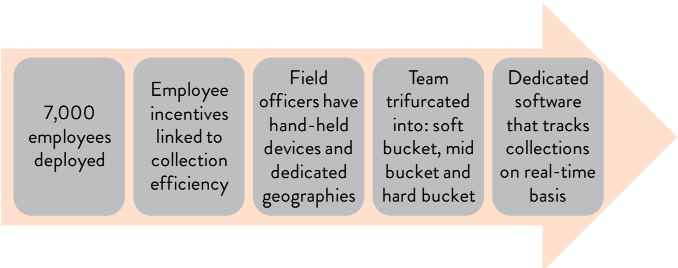
FIG 27 – CREDIT COST TO SPIKE IN FY21E, BEFORE NORMALISING IN FY22E



Source: Company, BOBCAPS Research

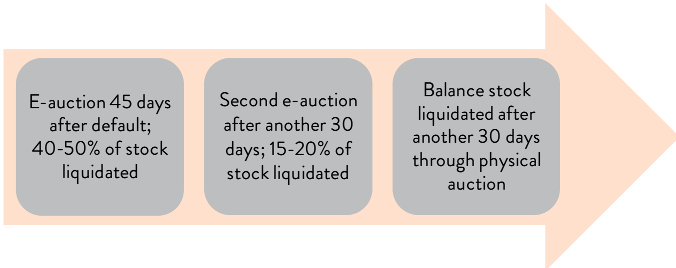
The company's robust collection infrastructure is likely to be stretched post-lockdown as delinquencies surge. Though the business looks at delinquencies in the less-than-12-month bucket and collections are largely done by on-roll employees, we expect collection cost to go up as customers will need hand-holding during this period of stress.

FIG 28 – COLLECTION INFRASTRUCTURE



Source: Company, BOBCAPS Research

FIG 29 – REPOSSESSED STOCK LIQUIDATION PROCESS

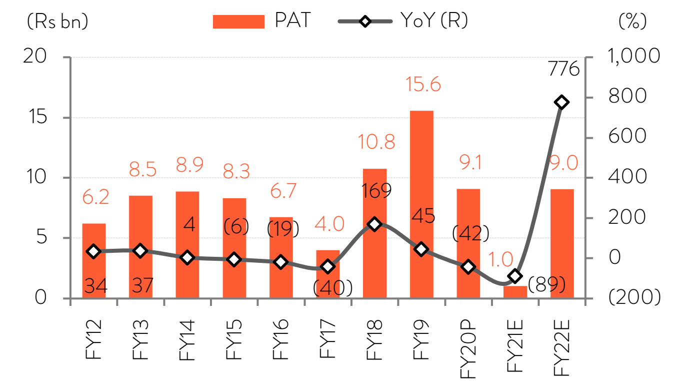


Source: Company, BOBCAPS Research

Profit to weaken in FY21 but recover thereafter

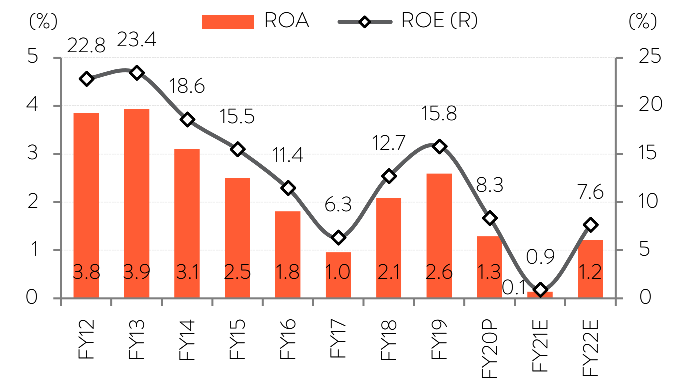
MMFS has a strong capital adequacy ratio of ~20% and asset-to-equity leverage of ~6.5x as of FY20. In our view, this will suffice to cover for 3-4 quarters of asset quality deterioration. Capital is unlikely to be a constraint for the company due to its strong parentage in M&M. Factoring in flat AUM growth and rising credit cost, we forecast an 89% decline in PAT to Rs 1bn in FY21. We anticipate a recovery to ~9x growth in FY22 at Rs 9bn as business likely normalises post-Covid-19, with ROE coming in at 7.6%.

FIG 30 – PROFIT TO DIP IN FY21E, RECOVER IN FY22E



Source: Company, BOBCAPS Research

FIG 31 – ROE TO REVIVE FROM FY22E ONWARDS



Source: Company, BOBCAPS Research

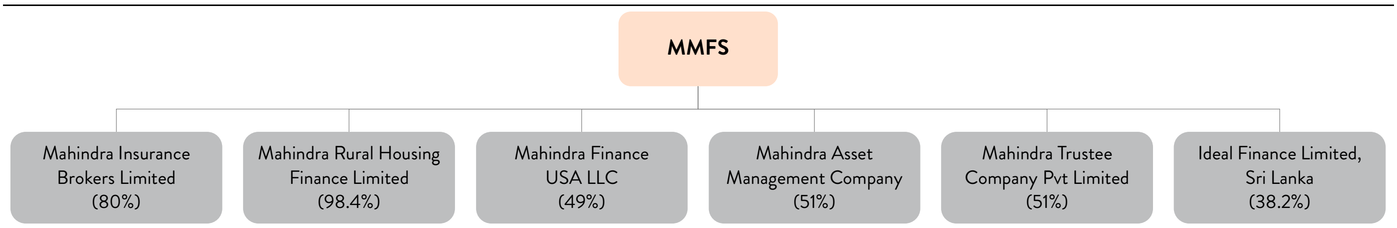
Management team & Corporate structure

FIG 32 – MANAGEMENT TEAM

Name	Function	Description
Ramesh Iyer	Vice-Chairman & MD	Ramesh Iyer has been the MD of MMFS since 30 Apr 2001 and has been associated with the company since inception.
V Ravi	ED & CFO	V Ravi has been associated with the company since its inception and has been associated with the Mahindra Group for the past 26 years.
Dr Jaideep Devare	MD, Mahindra Insurance Brokers Limited (MIBL)	Dr Jaideep Devare is the MD of MIBL and has been responsible for setting up, operationalising and managing the organisation since inception in 2004.
Anuj Mehra	MD, Mahindra Rural Housing Finance Limited (MRHFL)	Anuj Mehra is currently the MD of MRHFL, a subsidiary of MMFS. He has obtained a Bachelor's Degree in Economics from Delhi University and has pursued post-graduation in Management from Indian Institute of Management, Ahmedabad.
Vinay Deshpande	Chief People Officer	Vinay Deshpande is the Chief People Officer for the financial services sector of the Mahindra group. In this capacity, he is responsible for the HR function in all companies of this sector.
Mr. Rajnish Agarwal	EVP - Operations	Rajnish Agarwal is currently working as EVP – Operations. He is a graduate in Science from Lucknow University and has a Master's degree in Management Studies from Mumbai University.
Gururaj Rao	Chief Information Officer	Gururaj Rao is the Chief Information Officer and is responsible for the information technology function of the company along with its subsidiaries.
R Balaji	SVP – Marketing and Strategy	R Balaji has ~16 years of experience across marketing and strategy. He is at present the SVP – Marketing & Strategy of MMFS. Before moving to MMFS, he was the General Manager – Corporate Strategy of M&M. Prior to joining the Mahindra group, he has spent nearly nine years in marketing assignments at ITC Agrotech and Nestle India.
Rajesh Vasudevan	SVP – Accounts	Rajesh Vasudevan is SVP – Accounts of MMFS and has more than 20 years of experience in accounts and taxation with companies such as Tata Finance and Asian Paints (India). In his current capacity, he is responsible for the accounts and taxation functions.
Dinesh Prajapati	SVP – Treasury and Corporate Affairs	Dinesh Prajapati, SVP – Treasury & Corporate Affairs, is a Chartered and Cost Accountant by profession. Prior to joining MMFS, he worked as an auditor in a steel company. He joined MMFS in 1995 and is amongst the first few employees who helped set up operations. He has >20 years of experience in Accounting, Treasury, MIS and Budgeting, System Implementation and Functional Specification, Risk Management and Project Implementation. He currently heads the Treasury Function, Investor Relationship Cell and Risk Management Team.

Source: Company, BOBCAPS Research

FIG 33 – MMFS CORPORATE STRUCTURE



Source: Company, BOBCAPS Research

Valuation methodology

MMFS faces multiple challenges as asset health likely deteriorates sharply in the wake of Covid-19. We believe the demand environment will take two years to normalise, thereby affecting volume and value growth though to FY22. Tepid AUM growth and intensified collection efforts are expected to drive up the expense ratio to ~300bps. Higher opex and elevated credit costs are estimated to mute earnings growth.

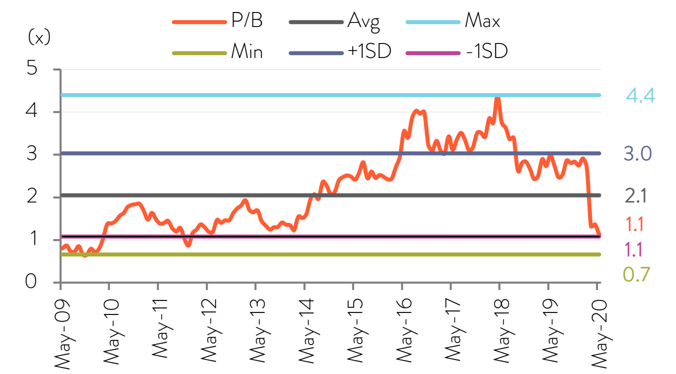
We value the stock based on a residual income model, which yields a Mar'21 target price of Rs 170. Initiate with ADD on FY22E recovery potential. Our assumptions include cost of equity of 14.8%, risk-free rate of 7.75%, risk premium of 5%, and a long-term growth rate of 5%.

FIG 34 – VALUATION ASSUMPTIONS

Parameter	(%)
Cost of Equity	14.8
Risk-free rate	7.75
Risk Premium	5.0
Terminal growth rate	5.0

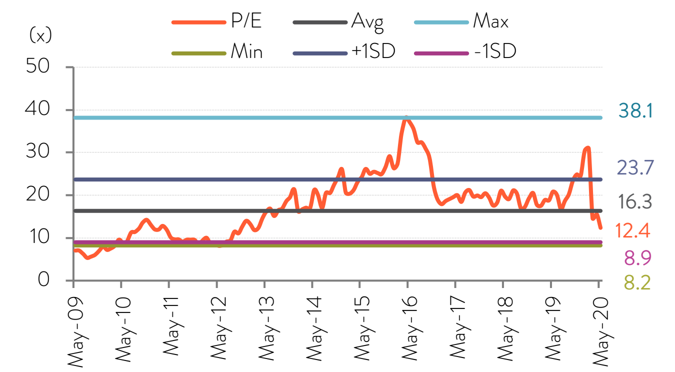
Source: BOBCAPS Research

FIG 35 – ONE-YEAR FORWARD P/B



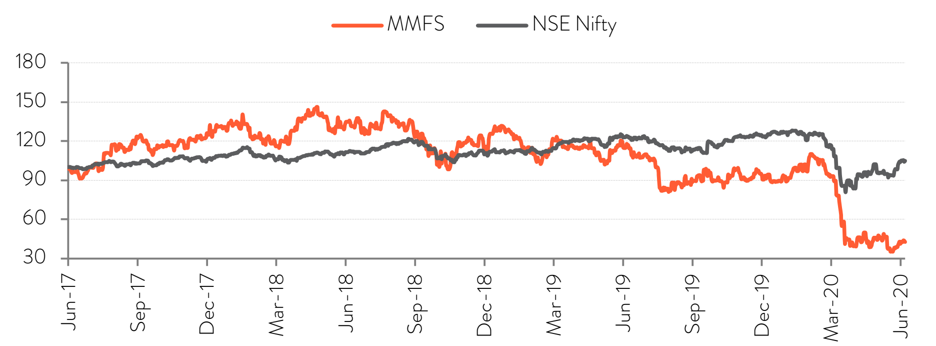
Source: Bloomberg, BOBCAPS Research

FIG 36 – ONE-YEAR FORWARD P/E



Source: Bloomberg, BOBCAPS Research

FIG 37 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

- Below-expected harvest yield in FY21
- Poor monsoon in FY21
- Lower water reservoir levels during FY21-FY22

FINANCIALS

Income Statement

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20P	FY21E	FY22E
Net interest income	**35,025**	**46,700**	**51,130**	**51,829**	**53,113**
NII growth (%)	11.0	33.3	9.5	1.4	2.5
Non-interest income	1,010	1,953	3,034	3,489	4,013
Total income	36,036	48,653	54,164	55,319	57,126
Operating expenses	14,336	18,476	20,182	21,421	23,663
Operating profit	21,700	30,177	33,982	33,898	33,462
Operating profit growth (%)	12.5	39.1	12.6	(0.2)	(1.3)
Provisions	5,681	6,352	20,545	32,522	21,411
PBT	16,019	23,824	13,438	1,376	12,051
Tax	5,907	8,254	4,374	344	3,013
Reported net profit	**10,111**	**15,571**	**9,064**	**1,032**	**9,038**
Adjustments	0	0	0	0	0
Adjusted net profit	**10,111**	**15,571**	**9,064**	**1,032**	**9,038**

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20P	FY21E	FY22E
Equity capital	1,229	1,230	1,231	1,231	1,231
Reserves & surplus	92,052	103,072	112,408	113,440	120,583
Net worth	93,281	104,302	113,639	114,671	121,814
Deposits	0	0	0	0	0
Borrowings	400,932	528,469	594,623	579,289	585,529
Other liabilities & provisions	33,715	38,009	32,451	38,941	44,782
Total liabilities and equities	**527,927**	**670,780**	**740,712**	**732,900**	**752,125**
Cash & bank balance	4,111	9,585	14,258	10,722	13,645
Investments	27,341	37,917	59,110	60,587	62,102
Advances	485,470	612,496	649,935	643,654	657,898
Fixed & Other assets	11,005	10,782	17,410	17,936	18,480
Total assets	**527,927**	**670,780**	**740,712**	**732,900**	**752,125**
Deposit growth (%)	NA	NA	NA	NA	NA
Advances growth (%)	19.6	26.2	6.1	(1.0)	2.2

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20P	FY21E	FY22E
EPS	16.5	25.3	14.7	1.7	14.7
Dividend per share	4.0	6.5	0.0	0.0	2.6
Book value per share	151.8	169.5	184.7	186.4	198.0

Source: Company, BOBCAPS Research

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20P	FY21E	FY22E
P/E	9.4	6.1	10.5	92.1	10.5
P/BV	1.0	0.9	0.8	0.8	0.8
Dividend yield (%)	2.6	4.2	0.0	0.0	1.7

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20P	FY21E	FY22E
Net interest income	7.2	7.8	7.2	7.0	7.2
Non-interest income	0.2	0.3	0.4	0.5	0.5
Operating expenses	3.0	3.1	2.9	2.9	3.2
Pre-provisioning profit	4.5	5.0	4.8	4.6	4.5
Provisions	1.2	1.1	2.9	4.4	2.9
PBT	3.3	4.0	1.9	0.2	1.6
Tax	1.2	1.4	0.6	0.0	0.4
ROA	2.1	2.6	1.3	0.1	1.2
Leverage (x)	6.1	6.1	6.5	6.5	6.3
ROE	12.7	15.8	8.3	0.9	7.6

Ratio Analysis

Y/E 31 Mar	FY18A	FY19A	FY20P	FY21E	FY22E
YoY growth (%)					
Net interest income	11.0	33.3	9.5	1.4	2.5
Pre-provisioning profit	12.5	39.1	12.6	(0.2)	(1.3)
EPS	1645.5	2532.3	1473.0	167.7	1468.8
Profitability & Return ratios (%)					
Net interest margin	8.0	8.7	8.3	8.3	8.5
Fees / Avg. assets	0.2	0.3	0.4	0.5	0.5
Cost-Income	39.8	38.0	37.3	38.7	41.4
ROE	12.7	15.8	8.3	0.9	7.6
ROA	2.1	2.6	1.3	0.1	1.2
Asset quality (%)					
GNPA	9.8	5.9	8.4	10.7	9.6
NNPA	6.8	4.8	6.0	7.3	6.0
Provision coverage	34.1	19.2	31.0	35.0	40.0
Ratios (%)					
Credit-Deposit	0.0	0.0	0.0	0.0	0.0
Investment-Deposit	0.0	0.0	0.0	0.0	0.0
CAR	22.7	20.3	19.6	19.5	19.8
Tier-1	17.0	15.5	15.4	15.7	16.4

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

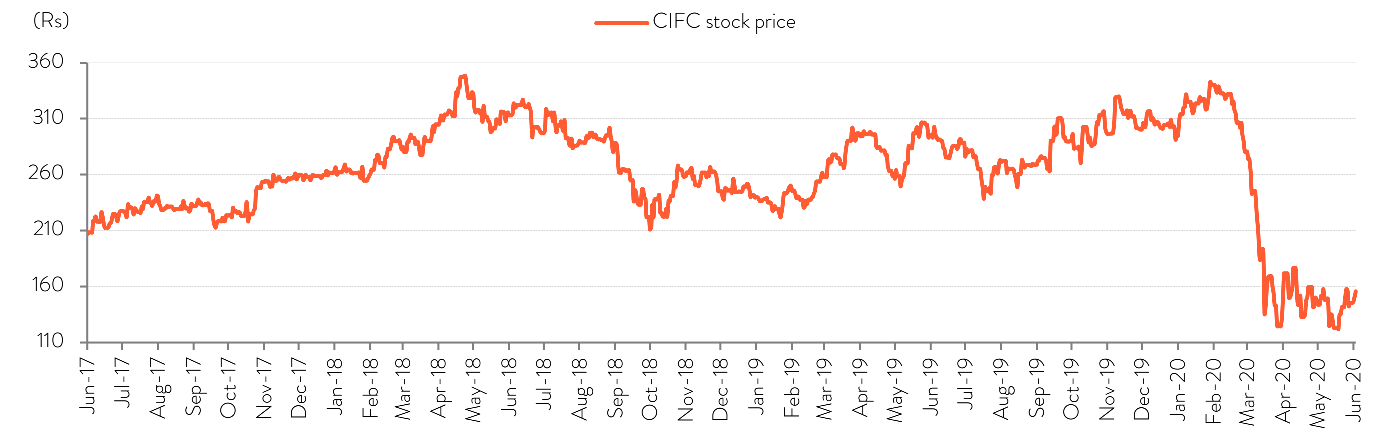
ADD – Expected return from >+5% to +15%

REDUCE – Expected return from -5% to +5%

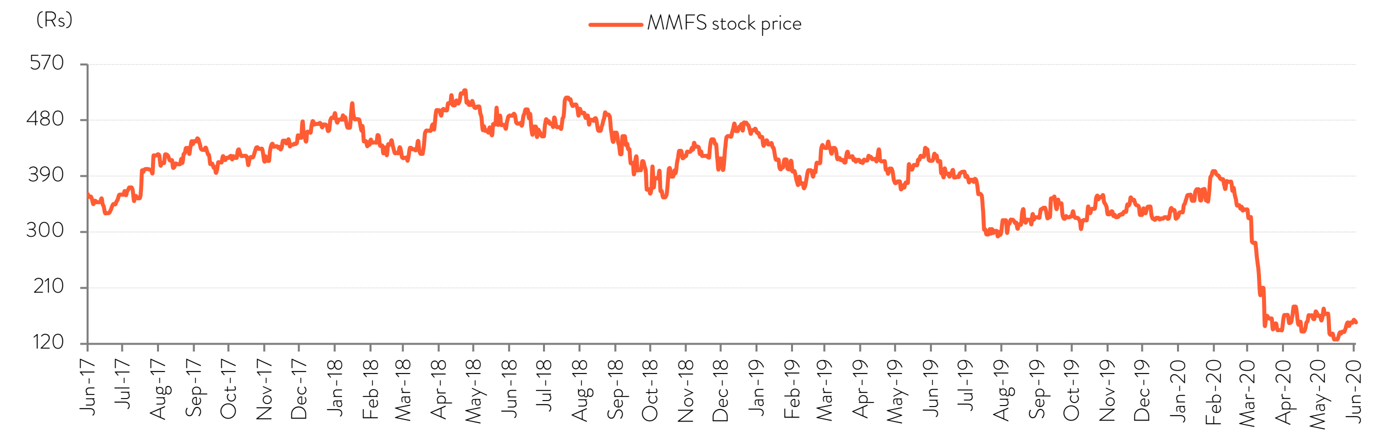
SELL – Expected return <-5%

Note: Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

HISTORICAL RATINGS AND TARGET PRICE: CHOLAMANDALAM INVESTMENT (CIFC IN)



HISTORICAL RATINGS AND TARGET PRICE: MAHINDRA & MAHINDRA FIN SVCS (MMFS IN)



B – Buy, A – Add, R – Reduce, S – Sell

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