Buy

# Cholamandalam Investment and Finance Ltd.

Strong tailwinds | CMP INR: 290 | Target Price INR: 378

**Cholamandalam Investment and Finance Ltd. (CFL), promoted by the Murugappa group, is a retail finance company with primary focus on vehicle finance and loan against property. The company is one of the leading vehicle finance companies with market share of 9.8% and 11.8% in Commercial Vehicles (CV) and Light Commercial Vehicle (LCV), respectively. The company is mainly focused on rural areas with 90% of its branches located in Tier II and Tier III cities.. We expect the company to grow bottom line at a CAGR of 28% over FY14-16E. We recommend 'BUY' on the stock.**

### Focus on niche segments

CFL is one of the leading financiers in the vehicle segment with market share of 9.8% and 11.8% in CV and LCV financing business, respectively. Of the total AUM of INR 20,178 crores, vehicle finance constitutes 76%. LCV constitutes 33% of total vehicle finance book. The loan-to-value (LTV) ratio is in comfortable range at ~79%. In addition, the company is adding new lines of businesses like tractor financing and SME financing, both working capital and term loans. One of the key strengths of the company is the relationship built over the years with the Original Equipment Manufacturers (OEM) and the vehicle dealers. Around 27% of overall disbursements come from existing customers.

### Past issues behind: Focus back on secured lending

In 2006, the company started consumer finance business in JV with DBS Bank, Singapore. This unsecured lending business led to pressure on the overall book, with gross NPAs jumping to 5.53% in FY10. The company exited the personal loan business in 2009 and post that terminated the JV with DBS pursuant to the purchase of their stake by the promoters. Post the exit from consumer finance, the company started focusing solely on the core business of secured lending. This is visible in the Gross NPA, which came back to nominal levels of 0.80% in FY12. The outstanding personal loan book is currently at INR 60 crores. The company also sold the asset management business. The scale down of unsecured lending business will lead to RoE moving from 6.7% in FY11 to 17.7% in FY15E.

### Improvement in efficiency

Over the last few years, the company was under rapid branch expansion phase. The branch network has increased from 236 branches in FY11 to 529 branches as on Dec. 2013. A branch normally takes 12 months to break even. The operating cost as a percentage of assets has come down from 5.1% in FY09 to 3.8% in FY13. As the scale-up of branches happen, the operating cost will keep coming down. The company is targeting to reduce it to 3% over the next three years.

### Asset quality intact

CFL was going through a tough phase due to its personal loan portfolio. Currently, the portfolio has been reduced to INR 60 crores, which is fully provided for. The company is at present focusing on quality and not on gaining market share. In case of Small CVs, the company has lost market share by 50 bps during the last one year. In addition, the company gives loan only on chassis of vehicle and not on the full body. The company also does not provide tyre loans.

### Outlook and valuations: Positive; 'BUY'

We believe that CFL will be able to sustain growth in excess of 20% and RoAE of ~18% in coming years on the back of strong growth (5 year PAT CAGR of 40%), strong business model and efficient operation. At the current market price of INR 290, the stock is trading at 1.4x FY16E PB ratio. We recommend a 'BUY' with a price target of INR 378 at 1.8x FY16E PB ratio.

| Year to March | FY12 | FY13 | FY14E | FY15E | FY16E |
|---|---|---|---|---|---|
| Net Interest Income (INR cr) | 754 | 1,107 | 1,357 | 1,650 | 2,029 |
| Net Profit after tax | 171 | 307 | 344 | 445 | 567 |
| Adjusted BV per share | 107 | 137 | 155 | 182 | 210 |
| Dilute EPS (Rs.) | 12.9 | 21.4 | 24.0 | 29.6 | 37.7 |
| Gross NPA ratio (%) | 0.9 | 1.0 | 1.7 | 1.6 | 1.6 |
| Net NPA ratio (%) | 0.3 | 0.2 | 0.7 | 0.7 | 0.6 |
| Price/Adj. Book Value(x) | 2.7 | 2.1 | 1.9 | 1.6 | 1.4 |
| Price/Earnings (x) | 22.5 | 13.6 | 12.1 | 9.8 | 7.7 |

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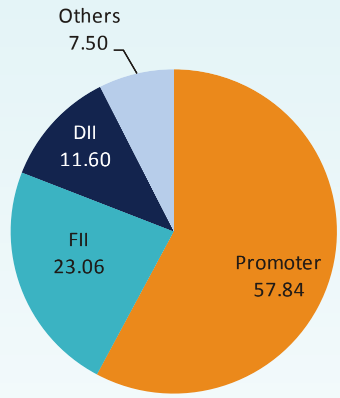
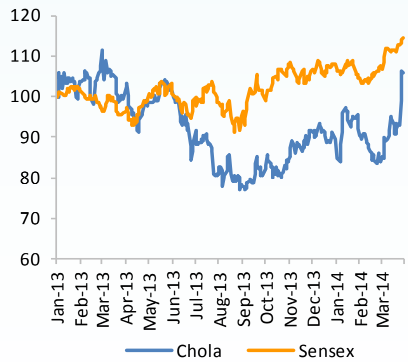
| Bloomberg: | CIFC:IN |
|---|---|
| 52-week range (INR): | 296 / 202 |
| Share in issue (Crs): | 14.3 |
| M cap (INR crs): | 4,150 |
| Avg. Daily Vol. BSE/NSE :('000): | 20/1 |

**SHARE HOLDING PATTERN (%)**




Date: 22nd April, 2014

Investment Rationale

**Opportunity size**

India is the fourth largest commercial vehicle (CV) market in the world with 8.70 lakh CV's sold in FY13. In India, 95% of CVs are sold on financing. This implies that financing penetration is high in CV segment of financing.

The Medium and Heavy CV industry is highly correlated with the GDP growth and IIP. On the revenue side, the slowdown in GDP growth and IIP lead to a decrease in vehicle utilization, which leads to pressure on freight rates. In addition, on the cost front, the diesel price hikes, rising spare parts & tyre costs, increase in toll rates and higher driver costs due to general inflation impacted the margins.

**Chart 1: MHCV sales and LCV sales**

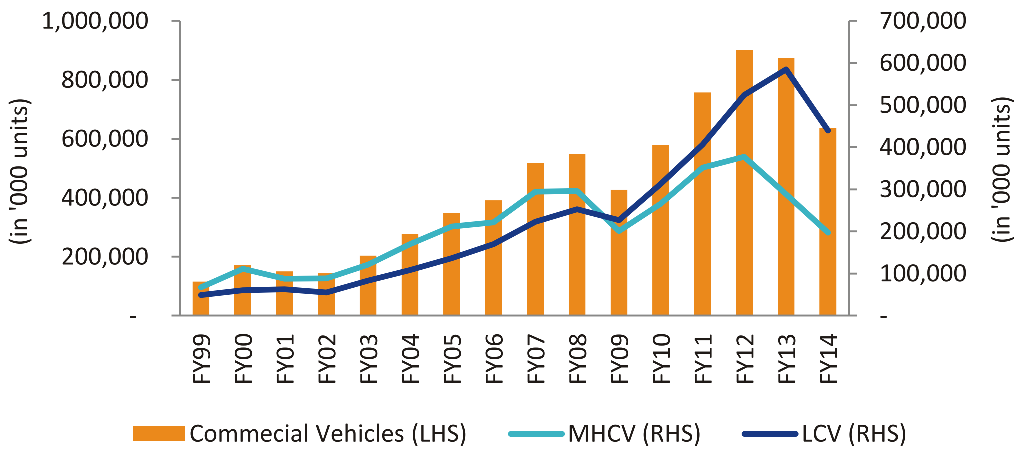
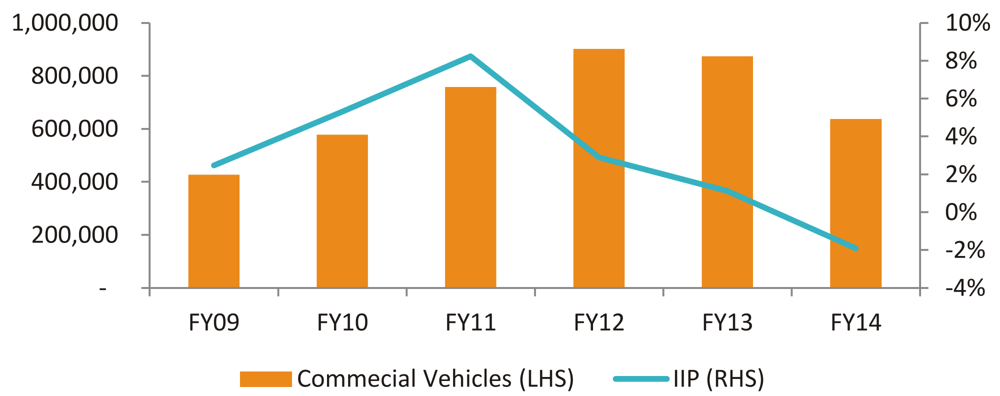



**Chart 2: IIP and CV sales**




Source: Company, Edel Invest Research

### Medium term triggers

- Growth uptick due to pent-up demand in the CV segment – CV sales growth worst in last 10 years
- Improvement in the product mix - tractors, used vehicles
- Reduction in cost of funding - pick up in securitisation, rating improvement
- Streamlining of operating cost - operating cost one of the highest in the industry

### Positioning in vehicle finance value chain

CFL is one of the leading financiers in the vehicle finance segment. Within vehicle finance, the company is focused on small and medium truck operators. In case of large truck operators, the players like Sundaram Finance are dominant and they compete directly with banks like HDFC Bank and Indusind Bank. Due to the dominant size of the borrower and mainly new vehicle, the yields are low but at the same time the asset quality is relatively better.

CFL mainly caters to small and medium truck operators. This segment is in middle of the CV value chain. The yields are better than large truck operators but ability of the borrower to repay is less due to concentrated exposure.

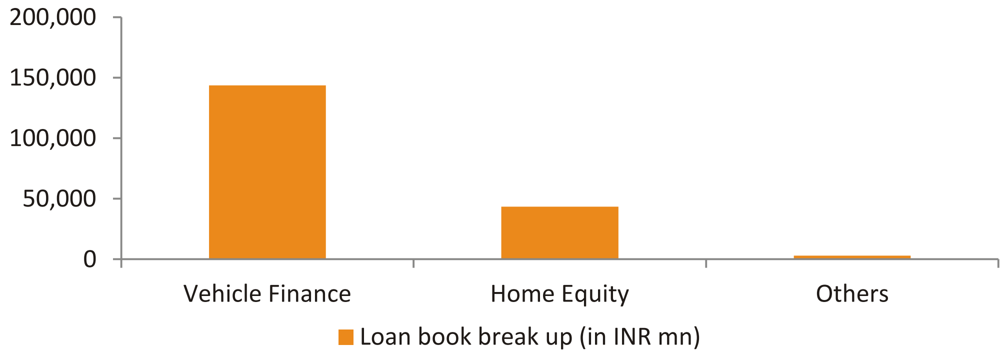
In addition, slowly the company is increasing focus on the used vehicle segment. In this segment, the yields are higher but at the same time risk of default also increases. The higher yield compensates for the dip in asset quality.

| Key Segment | Company | Characteristics |
|---|---|---|
| Large Truck Operator | Sundaram Finance | Low yield, low NPA |
| Small Truck Operator | Cholamandalam Finance | Medium yield, medium NPA |
| Used Truck Operator | Shriram Transport | high yield, high NPA |

### Focus on diversifying loan book

CFL is one of the leading financiers in the vehicle segment with market share of 9.8% and 11.8% in CV and LCV financing business, respectively. One of the key strengths of the company is the relationship built over the years with the OEMs and auto dealers. Of the total AUM of INR 22,007 crores, vehicle finance constitutes 74%. Within vehicle finance, LCV constitute 31% of total book. The loan-to-value (LTV) ratio is in comfortable range at ~79%. In addition, the company is adding new lines of businesses like tractor financing and SME financing, both working capital and term loans. Around 27% of overall disbursements come from existing customers.

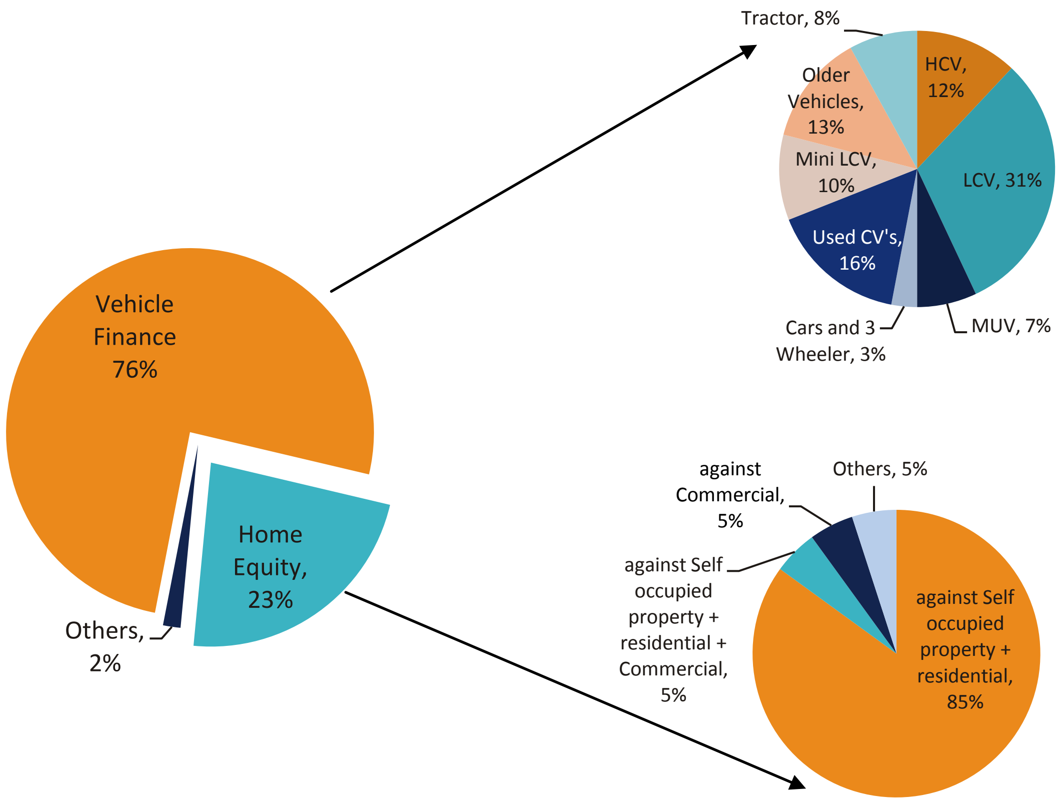
**Chart 3: Loan book break up**




Source: Company, Edel Invest Research

Currently, CV segment constitutes major chunk of the company's vehicle loan book. As part of a strategy, the company is adding new product lines like tractors. The share of tractors as % of overall vehicle finance book has grown from 4% in FY12 to current level of 8%.

**Chart 4: Segment wise loan book break up**

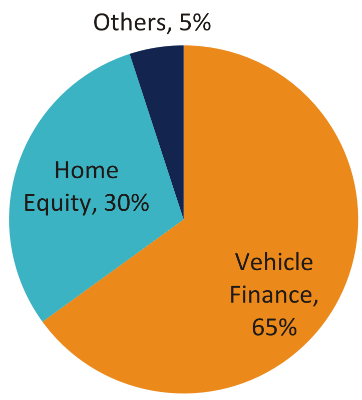



Source: Company, Edel Invest Research

In addition to vehicle finance and home equity, the company provides loan against securities, SME funding for working capital, bill discounting and new home loans on its own books besides gold loans and rural financing on outsourcing model.

The company targets to increase the share of non-vehicle finance book. From the current level of 76%, the vehicle finance book share is expected to go down to 65%. The share of Home Equity (Loan against property) book is expected to go up to 30%. In addition, new business lines like rural finance are expected to gain traction. In case of rural finance, the Murugappa group experience in rural and SME segment will help the company in better execution.

**Chart 5: Target loan book mix:**

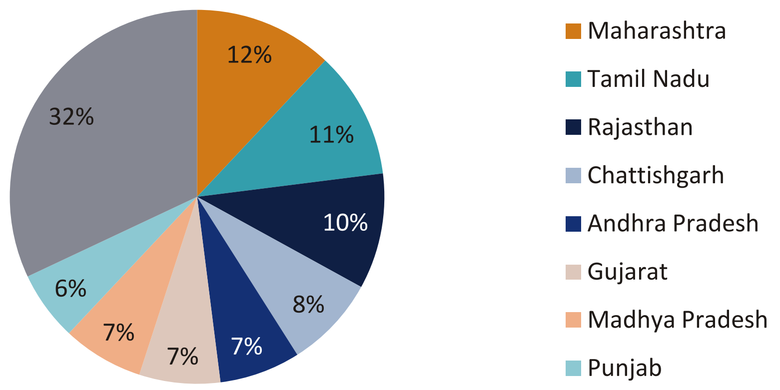



Source:, Edel Invest Research

### Well diversified across geography

The company is no more a regional player. The loan book is well diversified across geographies.

**Chart 6: Geographical diversification**

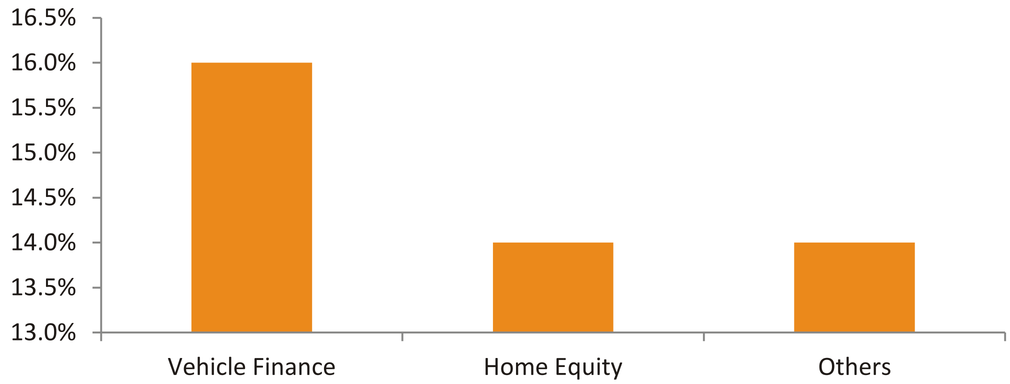



Source: Company, Edel Invest Research

The company current earns yield of around 16% on vehicle finance book. In addition, the processing fee is around 1% on disbursement. The processing fee is upfront and sourcing cost is also charged off on incurrence. On the other hand, the yield on Home equity portfolio is around 14% and processing fee around 1%.

Going forward, the increase in the share of high yield products like tractor and used financing will aid the improvement in yield of the vehicle finance book.

**Chart 7: IRR**




Source: Company, Edel Invest Research

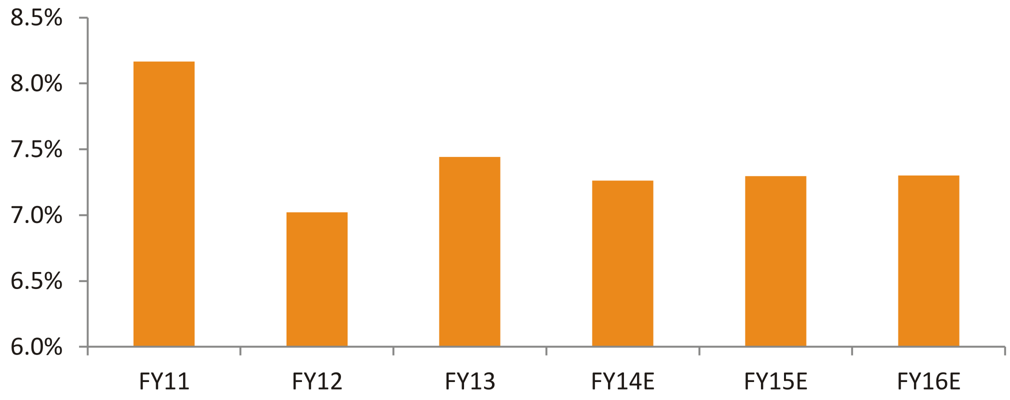
### Past issues behind: focus back on secured lending

During 2006, the company started consumer finance business in JV with DBS Bank, Singapore. This unsecured lending business led to pressure on the overall book with gross NPA jumping to 5.53% in FY10. The company exited the personal loan business in 2009 and post that terminated the JV with DBS pursuant to the purchase of their stake by the promoters. Post the exit, the company started focusing on the core business of secured lending.

**Profitability sustainable**

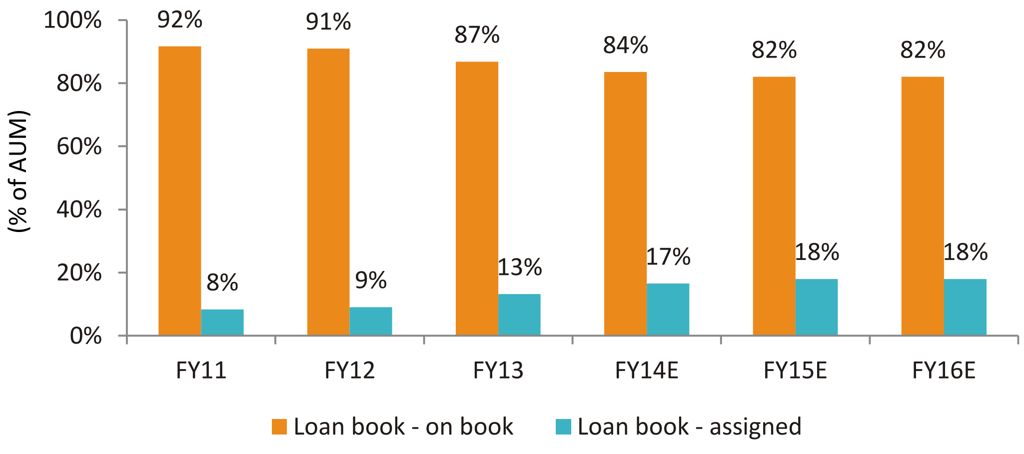
We expect the company to make net interest margins of 7.3% in FY14. As the share of non vehicle finance book increases there will be dip in the blended yield. Within vehicle finance book, change in mix towards high yielding segments like tractors and used vehicles will lead to increase in margins. In addition, the increase in share of securitisation book will add to the net interest margins.

**Chart 8: Sustainable NIM's**




Source: Company, Edel Invest Research

**Chart 9: Increase in securitisation**

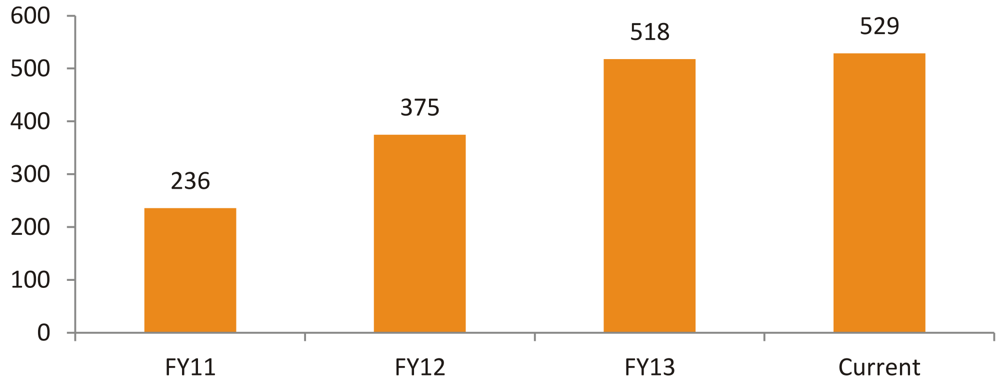



Source: Company, Edel Invest Research

### Improvement in efficiency

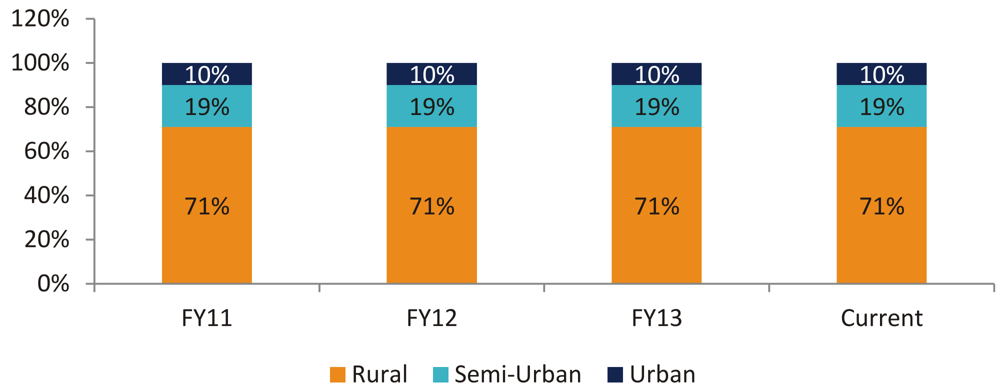
Over the last few years, the company was under rapid branch expansion phase. The branch network has increased from 236 branches in FY11 to 529 branches as on Dec. 2013. A branch normally takes 12 months to break even.

**Chart 10: Branch Network**




Source: Company, Edel Invest Research

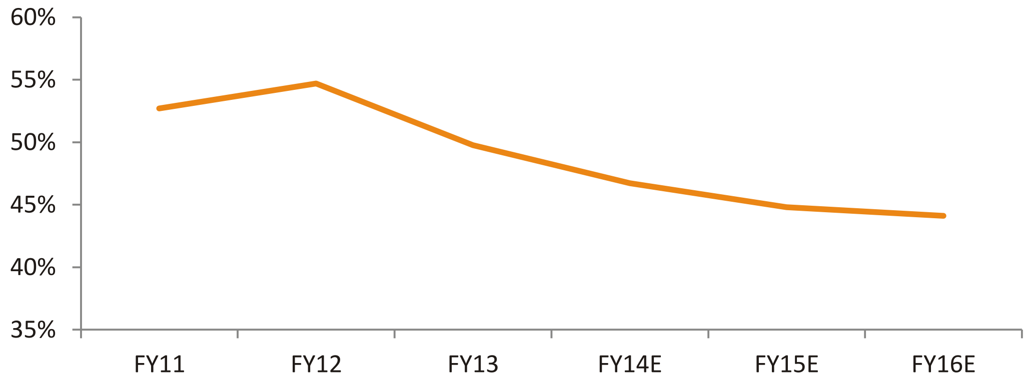
**Chart 11: Strong distrution in rural area**




Source: Company, Edel Invest Research

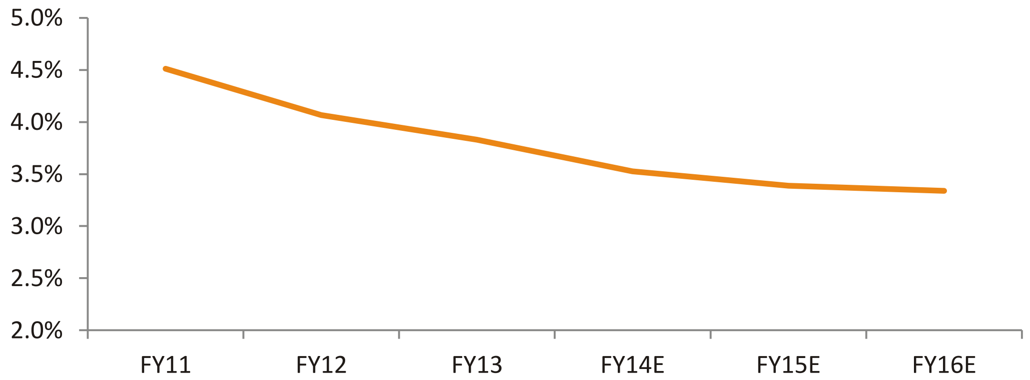
The operating cost as a percentage of asset has come down from 4.5% in FY11 to 3.8% in FY13. As the scale-up of branches happen, the operating cost will keep coming down. The company is targeting to reduce it to 3% over next three years.

**Chart 12: Cost to income**




Source: Company, Edel Invest Research

**Chart 13: Opex/Asset**



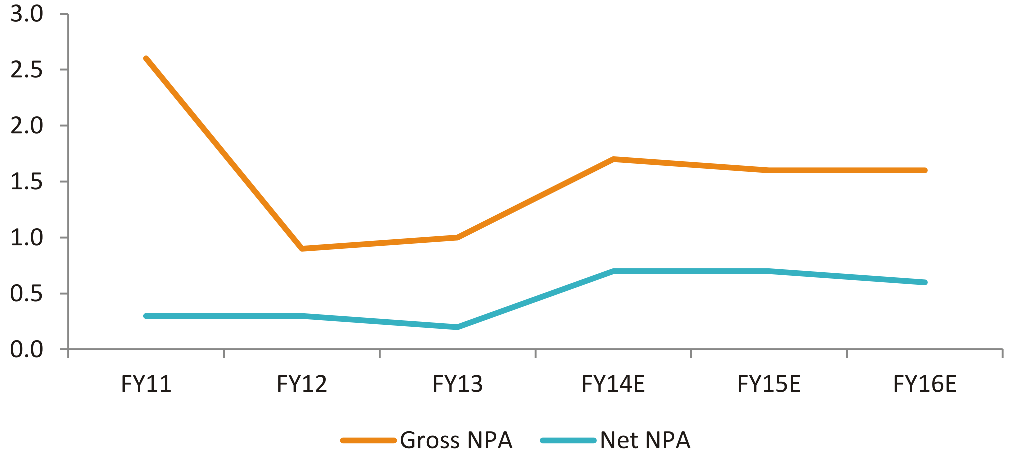

Source: Company, Edel Invest Research

### Asset quality intact

The company was going through tough phase due to its personal loan portfolio. Currently, the portfolio has been reduced to INR 60 crores which is fully provided for. The company is at present focusing on quality and not on gaining market share. In case of Small CVs, the company has lost market share by 50 bps during the last one year. In addition, the company gives loan only on chassis not on the full body. The company also does not provide tyre loans.

On the organisation structure front, there are three independent teams for Sales, Credit and Collection. The sales person gets penalised for early default. This structure to make sales person responsible for early default helps in keeping low quality loan from entering the system.

Chart 14: Asset quality under control

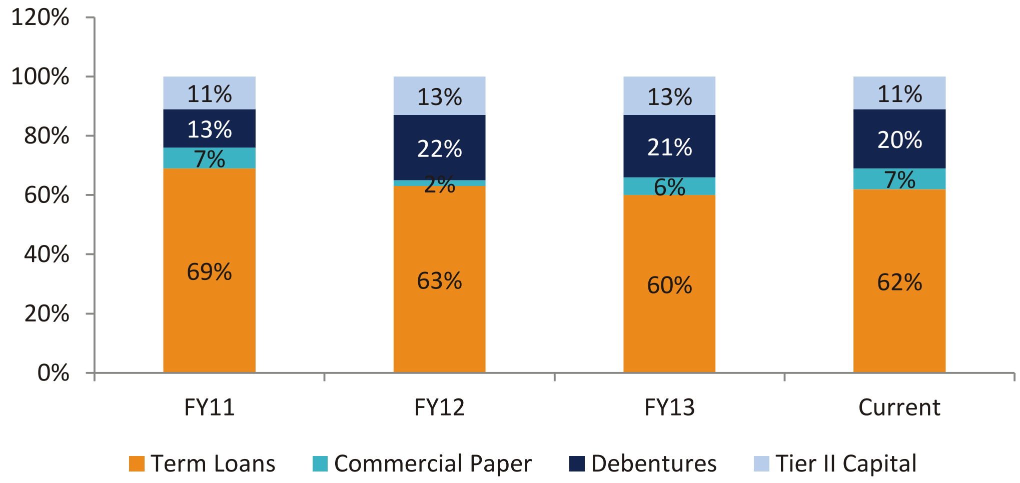



Source: Company, Edel Invest Research

### Liability Profile

Currently, major chunk of the borrowings come from banks. Over the last four years, the ratio of bank borrowing has reduced from 69% to 62%. The company is not heavily focused on the money market. Past issues related to the unsecured personal loan book led to delay in rating improvement. But with all the issues behind, we expect improvement in rating. We expect the share of money market instruments to increase and the funding cost to come down going forward.

Chart 15: Borrowings break up



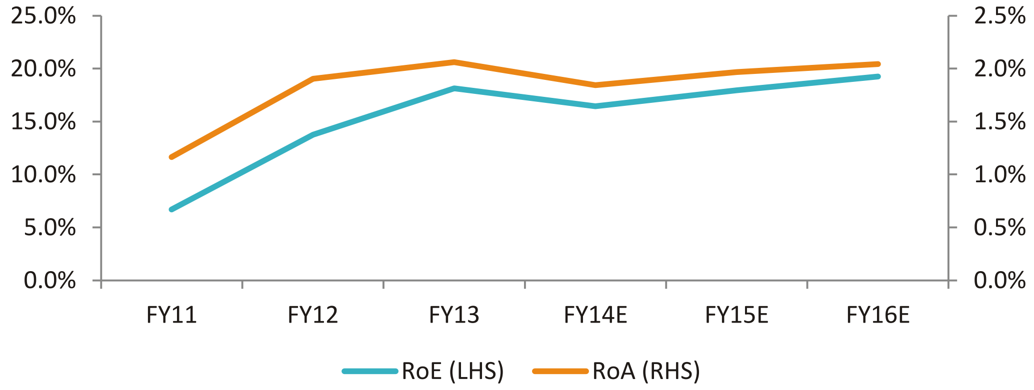

Source: Company, Edel Invest Research

Around 60% of the loan book is eligible for the priority sector lending. Currently, around 17% of the book is securitised. We expect the securitisation book to increase going forward. This will lead to reduction in effective cost of funding.

### Profitability sustainable

Due to historical issue of unsecured lending, the profitability took a sharp hit. Over the last few years, the business has come back on track and past issues are behind. We expect the company to go back to ~2% RoE level.

**Chart 16: Return ratios**

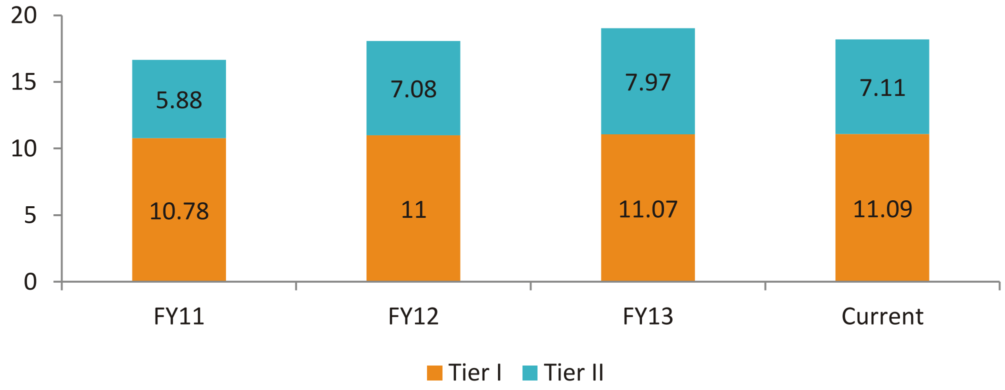



Source: Company, Edel Invest Research

### Fund raising sometime away

Currently, the company has capital adequacy ratio of 18.2%. Tier I capital constitutes 11.09% and Tier II capital constitutes 7.11%. As per current draft guidelines, the company requires 10% and 3% Tier I and Tier II capital, respectively. We believe that the company will be required to raise funds next year.

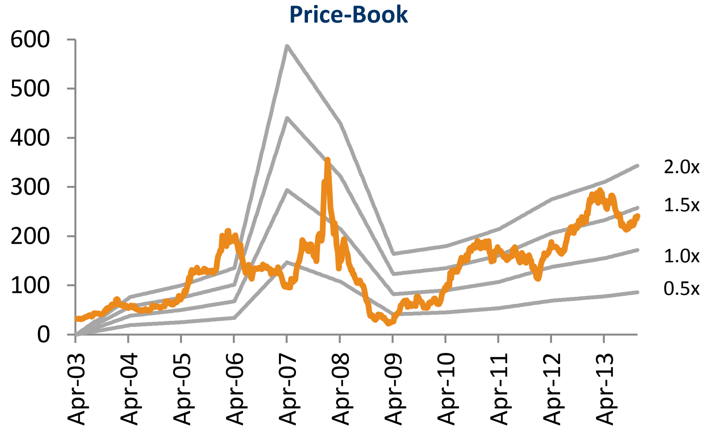
**Chart 17: Capital Adequacy ratio**

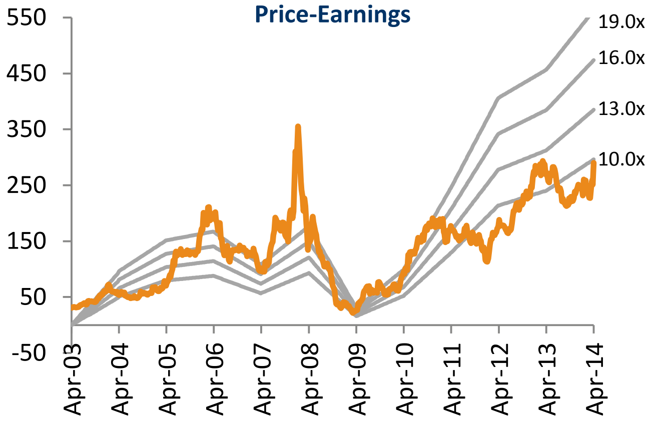



Source: Company, Edel Invest Research

**Outlook and valuations: Positive; 'BUY'**

We believe that CFL will be able to sustain growth in excess of 20%, RoA of ~2% and RoAE of ~18% in coming years on the back of strong growth (5 year PAT CAGR of 40%), robust business model and efficient operations. At the current market price of INR 290, the stock is trading at 1.4 FY16E PB ratio. We recommend a 'BUY' with a price target of INR 378 at 1.8x FY16E PB ratio.




| Comparative Valuations (FY15E) | Mkt Cap | P/ABV (x) | ROA (%) | NIM's (%) |
|---|---|---|---|---|
| Sundaram Finance | 7888 | 1.4 | 3.0 | 6.8 |
| Cholamandalam | 4150 | 1.6 | 2.0 | 7.3 |
| M&M Finance | 13121 | 2.4 | 3.3 | 9.6 |

## Key Risks

***Asset quality deterioration***

Currently, the CV industry is under severe pressure due to the economic slowdown. On the cost front, the diesel price hikes, rising spare parts & tyre costs, increae in toll rates and higher driver costs are adding pressure on the ability of borrowers to repay loans. We are already seeing marginal uptick in NPA's. Further pressure on the borrowers ability to repay will lead to asset quality deterioration.

***Portfolio concentration risk***

Of the total loan book, vehicle loans constitute 73.6%. The dependence on a single segment is high. The CV industry is seeing lot of stress. Any further deterioration in the vehicle financing industry will have big impact on the profitability of the company.

## About the Company

Cholamandalam Investment and Finance Ltd. (CFL), promoted by the Murugappa group, is a retail finance company with primary focus on vehicle finance and home equity loans. The company is one of the leading vehicle finance companies with market share of 9.8% and 11.8% in CV and LCV, respectively. The company is mainly focused on rural areas with 90% of branches in Tier II and Tier III cities.

- Started equipment financing in 1979
- Started Chola securities in 1995
- Started JV with DBS Bank Singapore. Entered into consumer financing business in 2006
- Exited Cosnumer finance business in 2009
- TerminatedJV with DBS Bank Singapore in 2011

## Management Team

| | |
|---|---|
| **M B N Rao**<br>*(Chairman)* | **Mr. Rao has over 40 years of experience in the field of** banking, finance, economics, technology treasury etc and has over nine years of international banking experience in South East Asia. He is a member of various committees constituted by RBI, SEBI, MOF and NIBM.<br>He has a graduate degree in agriculture, an Associate of the Chartered Institute of Bankers, London, a Certified Associate of the Indian Institute of Bankers and a Fellow of the Indian Institute of Banking & Finance. |
| **Mr. N Srinivasan**<br>*(Vice Chairman)* | **Mr. Srinivasan**, has over 29 years of experience in areas of legal, corporate finance, projects and general management. |
| **Mr. Nalin Mansukhlal Shah**<br>*(Director)* | **Mr. Shah** is a Chartered Accountant from Institute of Chartered Accountants in England & Wales.<br>**Mr. Shah** has held various key positions through his professional career. He was on the Governing Board of Delloitte India and was the Chairman of the firm's Audit Technical Committee for over five years. |
| **Mr. Vellayan Subbiah**<br>*(Managing Director)* | **Mr.Subbiah** holds a degree in Civil Engineering from IITMadras and a MBA from University of Michigan.<br>He has worked with reputed organizations prior to Cholamandalam i.e. Mckinsey and Company, Chicago, 24/7 Customer Inc. and Sundram Fasteners.<br>Mr. Subbiah joined the board of Cholamandalam in August 2010. |
| **Non-Executive Directors** | Indresh Narain, V Srinivasa Rangan, L Ramkumar |

## Financials

**Income statement** (INR cr)

| Year to March | FY12 | FY13 | FY14E | FY15E | FY16E |
|---|---|---|---|---|---|
| Interest income | 1,743 | 2,518 | 3,173 | 3,824 | 4,661 |
| Income from Financing activity | 1,685 | 2,432 | 3,062 | 3,670 | 4,466 |
| Other Operating Income | 58 | 86 | 111 | 154 | 195 |
| Interest charges | 988 | 1,411 | 1,816 | 2,174 | 2,632 |
| Net interest income | 754 | 1,107 | 1,357 | 1,650 | 2,029 |
| Fee & other income | 44 | 38 | 53 | 61 | 75 |
| Net revenues | 798 | 1,145 | 1,410 | 1,711 | 2,104 |
| Operating expense | 437 | 570 | 659 | 767 | 928 |
| *- Employee exp* | 110 | 153 | 177 | 206 | 249 |
| *- Depreciation /amortisation* | 9 | 20 | 23 | 27 | 33 |
| *- Other opex* | 318 | 396 | 458 | 533 | 645 |
| Preprovision profit | 362 | 575 | 751 | 944 | 1,176 |
| Provisions | 40 | 124 | 239 | 280 | 329 |
| PBT | 322 | 451 | 512 | 665 | 847 |
| Taxes | 118 | 144 | 168 | 219 | 279 |
| PAT | 205 | 307 | 344 | 445 | 567 |
| Extraordinaries | (33) | 0 | 0 | 0 | 0 |
| Reported PAT | 171 | 307 | 344 | 445 | 567 |
| Basic number of shares (cr.) | 13.3 | 14.3 | 14.3 | 15.0 | 15.0 |
| Basic EPS (INR) | 12.9 | 21.4 | 24.0 | 29.6 | 37.7 |
| Diluted number of shares (cr.) | 13.3 | 14.3 | 14.3 | 15.0 | 15.0 |
| Diluted EPS (INR) | 12.9 | 21.4 | 24.0 | 29.6 | 37.7 |

**Growth ratios (%)**

| Year to March | FY12 | FY13 | FY14E | FY15E | FY16E |
|---|---|---|---|---|---|
| NII growth | 24.8 | 46.7 | 22.6 | 21.6 | 23.0 |
| Net revenues growth | 26.0 | 43.4 | 23.2 | 21.3 | 23.0 |
| Opex growth | 30.8 | 30.4 | 15.7 | 16.4 | 21.0 |
| PPP growth | 20.7 | 59.0 | 30.6 | 25.7 | 24.5 |
| Provisions growth | (77.4) | 213.9 | 92.6 | 16.9 | 17.7 |
| PAT growth | 137.1 | 49.9 | 12.3 | 29.4 | 27.4 |

**Operating ratios (%)**

| Year to March | FY12 | FY13 | FY14E | FY15E | FY16E |
|---|---|---|---|---|---|
| Yield on advances | 16.7 | 17.4 | 17.4 | 17.3 | 17.2 |
| Cost of funds | 10.2 | 10.6 | 10.8 | 10.7 | 10.5 |
| Spread | 6.5 | 6.8 | 6.6 | 6.6 | 6.7 |
| Net interest margins | 7.0 | 7.4 | 7.3 | 7.3 | 7.3 |
| Cost-income | 54.7 | 49.8 | 46.7 | 44.8 | 44.1 |
| Tax rate | 36.5 | 32.0 | 32.8 | 33.0 | 33.0 |

## Financials

| Balance sheet | | | | | (INR cr) |
|---|---|---|---|---|---|
| **As on 31st March** | **FY12** | **FY13** | **FY14E** | **FY15E** | **FY16E** |
| **Liabilities** | | | | | |
| Equity capital | 133 | 143 | 143 | 150 | 150 |
| Reserves | 1,285 | 1,822 | 2,080 | 2,585 | 3,011 |
| **Net worth** | 1,417 | 1,965 | 2,223 | 2,736 | 3,161 |
| Secured loans | 10,701 | 13,593 | 16,242 | 19,907 | 24,665 |
| Unsecured loans | 743 | 1,696 | 2,027 | 2,484 | 3,078 |
| Total borrowings | 11,444 | 15,289 | 18,268 | 22,392 | 27,743 |
| **Total liabilities** | **12,861** | **17,254** | **20,491** | **25,127** | **30,904** |
| **Assets** | | | | | |
| Loans | 12,330 | 16,626 | 19,785 | 24,335 | 29,932 |
| Investments | 62 | 225 | 198 | 243 | 299 |
| *Current assets* | *934* | *1,195* | *1,523* | *1,543* | *1,898* |
| *Current liabilities* | *569* | *931* | *1,187* | *1,202* | *1,479* |
| Net current assets | 366 | 264 | 336 | 341 | 419 |
| Fixed assets (net block) | 53 | 71 | 91 | 111 | 131 |
| Deferred tax asset | 51 | 69 | 82 | 97 | 123 |
| **Total assets** | **12,861** | **17,254** | **20,491** | **25,127** | **30,904** |
| **Balance sheet ratios (%)** | | | | | |
| Loan growth | 43.4 | 34.8 | 19.0 | 23.0 | 23.0 |
| EA growth | 44.4 | 34.2 | 19.2 | 22.6 | 23.0 |
| Disbursement growth | 55.1 | 36.3 | 11.9 | 25.5 | 20.9 |
| Gross NPA ratio | 0.9 | 1.0 | 1.7 | 1.6 | 1.6 |
| Net NPA ratio | 0.3 | 0.2 | 0.7 | 0.7 | 0.6 |
| Provision coverage | 66.7 | 80.0 | 58.8 | 56.3 | 62.5 |
| CAR | 18.1 | 19.0 | 18.0 | 18.7 | 17.7 |

**RoE decomposition (%)**

| Year to March | FY12 | FY13 | FY14E | FY15E | FY16E |
|---|---|---|---|---|---|
| Net interest income/Assets | 7.0 | 7.4 | 7.3 | 7.3 | 7.3 |
| Other Income/Assets | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 |
| Net revenues/Assets | 7.4 | 7.7 | 7.5 | 7.6 | 7.6 |
| Operating expense/Assets | 4.1 | 3.8 | 3.5 | 3.4 | 3.3 |
| Provisions/Assets | 0.4 | 0.8 | 1.3 | 1.2 | 1.2 |
| Taxes/Assets | 1.1 | 1.0 | 0.9 | 1.0 | 1.0 |
| Total costs/Assets | 5.5 | 5.6 | 5.7 | 5.6 | 5.5 |
| ROA | 1.9 | 2.1 | 1.8 | 2.0 | 2.0 |
| Equity/Assets | 11.6 | 11.4 | 11.2 | 11.0 | 10.6 |
| ROAE | 13.7 | 18.1 | 16.4 | 18.0 | 19.2 |

**Valuation metrics**

| Year to March | FY12 | FY13 | FY14E | FY15E | FY16E |
|---|---|---|---|---|---|
| Diluted EPS (INR) | 12.9 | 21.4 | 24.0 | 29.6 | 37.7 |
| *EPS growth (%)* | *147.2* | *65.6* | *12.5* | *23.2* | *27.4* |
| Book value per share (INR) | 106.9 | 137.3 | 155.3 | 182.0 | 210.3 |
| Diluted P/E (x) | 22.5 | 13.6 | 12.1 | 9.8 | 7.7 |
| Price/ BV (x) | 2.7 | 2.1 | 1.9 | 1.6 | 1.4 |
| Price/ Earning (x) | 22.5 | 13.6 | 12.1 | 9.8 | 7.7 |

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