GOLD LOAN NBFCs

Standing up to the test of fire

June 27, 2012

Edelweiss
Ideas create, values protect

Kunal Shah
+91 22 4040 7579
kunal.shah@edelcap.com

Nilesh Parikh
+91 22 4063 5470
nilesh.parikh@edelcap.com

Suruchi Chaudhary
+91 22 6623 3316
suruchi.chaudhary@edelcap.com

Edelweiss Securities Limited

Executive Summary

Kunal Shah
+91 22 4040 7579
kunal.shah@edelcap.com
Click on image to view video

Post the regulator cracking whip on the gold loan business, concerns have emerged about the survival of the business model given –

- The cap on LTVs – By targeting the main raison d'être for the booming business, the demand would be curbed to a great extent
- Deepening competition: Banks can swamp over the NBFCs
- Rickety lending yield: Ready to crack, taking a toll on margins

With these concerns clogging our mind, we decided to hit the road and visit branches and customers across multiple asset financiers across the nation to ascertain ourselves if it was the end of the game for gold loan NBFCs or if they could still survive the grueling times. The mission was undertaken mainly to gauge the competitive landscape, demand dynamics including the end-use of products, underwriting standards, risk management and security process besides the impact of recent regulatory changes on product profile, customer behavior, etc.

What we saw: Despite near term challenges, business model is here to stay
Our stopover at 150 plus branches across South, West and North of India attests the fact that the business model of gold loan NBFCs is here to stay for good notwithstanding the following lingering concerns:

- LTV: Limited impact due to a shift in collateral valuation to replacement cost (including making charges) vis-à-vis the gold content based valuation.
- Demand is genuine as gold loans being the fastest and the most convenient form of financing short term personal/business needs
- Lending yield: Pricing power is highly evident from the steadily sustained lending yield. In fact, we were surprised to find that some financers had even affected a hike. This reaffirms our belief that interest rate is less important a factor for decision making.
- Competition: Despite their twin advantages of higher LTV and lower interest rate offerings, banks will have to work hard to tackle the aggression of existing players and changing customer perception (high TAT, documentation, etc) to make a larger dent in the business.

How should investors view this space?

We accept that FY13 will be the year of consolidation for gold finance companies in term of growth and margins though stability at the ground level might surprise the consensus numbers and expectation. From FY14 onwards, the business model would deliver steady state of 15-20% growth, impressive return profile (ROA of 3.5-4.0% and ROE of 20-25%) and benign asset quality metrics, a key investor pull. **We prefer to play this space via quality players like Muthoot Finance (initiating with BUY/Sector Outperformer and TP of INR185, valuing it at 1.5x FY14E book) or major beneficiaries of regulatory changes like Federal Bank.** We also upgrade Manappuram Finance to BUY/Sector Outperformer with TP of INR41 (1x FY14E book).

Contents

At a Glance

	Rating	(INR)		%	Mcap	Gold loan	BV		P/BV		EPS (INR)		P/E (x)		EPS CAGR (%)	ROE (%)	
		CMP	TP	Upside	(INR bn)	AUM (INR bn)	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY12-14E	FY13E	FY14E
Muthoot Finance	BUY	140	185	31.4	52	244	99	123	1.4	1.1	24.4	29.3	5.7	4.8	10.5	27.5	26.4
Manappuram Finance	BUY	33	41	23.0	28	116	35	41	0.9	0.8	6.7	7.7	4.9	4.3	4.3	21.3	20.3
Federal Bank	BUY	445	535	20.2	76	37	374	425	1.2	1.0	50.5	63.7	8.8	7.0	18.5	14.3	16.0
South Indian Bank	HOLD	24	26	10.6	27	66	21	25	1.1	0.9	4.1	5.0	5.7	4.7	19.1	21.3	21.9

Source: Bloomberg, Edelweisss research

Key metrics

	Muthoot Finance				Manappuram Finance				Muthoot Fincorp
	FY12	CAGR /Average (FY09-12)	FY13E	FY14E	FY12	CAGR /Average (FY09-12)	FY13E	FY14E	FY12
Gold loan AUM (INR mn)	244,173	94.9	249,758	296,550	116,308	113.3	119,777	145,628	62,500
- of which assigned (%)	13.7	22.5	-	-	16.5	19.6	-	-	
AUM/branch (INR mn)	66.4	25.6	66.1	72.7	40.0	29.1	39.8	45.4	30.3
Margin metrics (%)									
YoA	22.6	20.9	20.7	20.1	27.4	24.8	24.6	23.2	
NIMs	10.1	10.1	9.1	9.5	14.1	14.2	12.1	12.4	
Branch metrics (Nos)									
Branches	3,678	55.1	3,778	4,078	2,908	65.3	3,008	3,208	2,060
Employees	25,351	61.9	24,935	26,099	21,924	65.2	21,658	21,814	
Employee/branch (x)	6.9	6.4	6.6	6.4	7.5	7.5	7.2	6.8	
Opex metrics (%)									
Opex/assets	3.8	4.0	3.8	3.8	6.0	6.4	5.6	5.5	
Employee/assets	1.9	1.9	1.9	1.9	2.8	2.6	2.8	2.8	
Receivable metrics									
Int. receivable/loan book (%)	3.5	3.0	3.5	3.5	7.3	8.1	7.3	7.3	
Leverage (x)									
Assets/equity	10.0	11.9	7.8	7.0	5.1	5.0	5.0	4.5	

Source: Company, Edelweiss research

Note: Muthoot Fincorp numbers are based on media sources

Our survey decisively answers following questions

- **Can benign gold prices explain all the exorbitant growth or is there something structurally driving the gold loan business model?**
  We believe genuine demand for the product lends it tremendous credibility.

- **Where do we stand in terms of penetration and potential of the product?**
  An in-depth study of the presence and concentration of gold loan players in South India reveals under-penetration in other geographies, signaling a great potential.

- **What can lead to customers becoming averse to pledging of gold?**
  Stable/declining gold prices for a long period can lead to selling of gold instead of pledging to meet requirement of funds.

- **Did rapid growth and burgeoning competition see dilution of lending standards?**
  Yes, given higher LTVs, lower allowances and relaxing of some system level checks.

- **Can specialized NBFCs hold the turf? How serious is the threat from banks?**
  The convenience offered by specialized NBFCs is insurmountable. Private bank pose a threat only if big ones like ICICI Bank, HDFC Bank etc. get aggressive.

- **RBI came cracking on gold loan NBFCs, how has the industry reacted?**
  Given the breakneck speed of growth, margins >10% and constant asset quality risk, RBI has gradually been turning heat with regulatory strictures on the liability front and LTV cap. While the business momentum has lost some traction and managements have curtailed their branch expansion plans, the impact of regulatory changes has been not as substantial as was envisaged earlier. Collateral valuation has shifted to the replacement cost basis as against the gold content based valuation earlier, leading to a lower than expected decline in disbursement/ gram. Even lending rates have remained steady at worst (if not increased) given strong pricing power.

- **Is this the end of regulatory rigmarole?**
  We can't call it an end till KUB Rao working group's report is tabled by July 2012. Further, limit on cash dealings though not anticipated, can have sizeable impact. Even under the worst case scenario, it will continue to deliver 2.5-3.0% RoA/10-15% RoE.

- **What do we gather from our branch visits on sustainable business prospects?**
  FY13 will be the year of consolidation for gold finance companies in term of growth and margins though stability at the ground level might surprise the consensus numbers and expectation. From FY14 onwards, the business model would deliver steady state of 15-20% growth, impressive return profile (ROA and ROE) and benign asset quality metrics, a key investor pull. We are confident of substantial merit in this business model as gold loan demand is genuine. Leading gold loan financiers will continue to hold the forte considering their USP – branding, convenience, trust, faster turnaround.

Genuine and structural demand; business model here to stay

Our branch visits of gold financiers made us more confident about genuineness of gold loan demand. Gold loans as a product is gaining significance as it is the fastest and most convenient form of financing, finding use in meeting urgent personal/business needs. Even though the current regulatory changes will impact growth, margins and hence profitability of business, the business model has merit and will continue to embark on a steady growth path post the consolidation period i.e., FY13. Despite heightened competition from banks like Federal Bank, HDFC Bank, ICICI Bank, etc., the USP that established gold loan NBFCs have developed, i.e., scale, first-mover advantage, brand equity, accessibility, relatively lower documentation and fast turnaround time, will ensure that customers keep flocking to their branches aiding gold lenders to continue to hold forte.

RBI came cracking; industry coping up better than expected

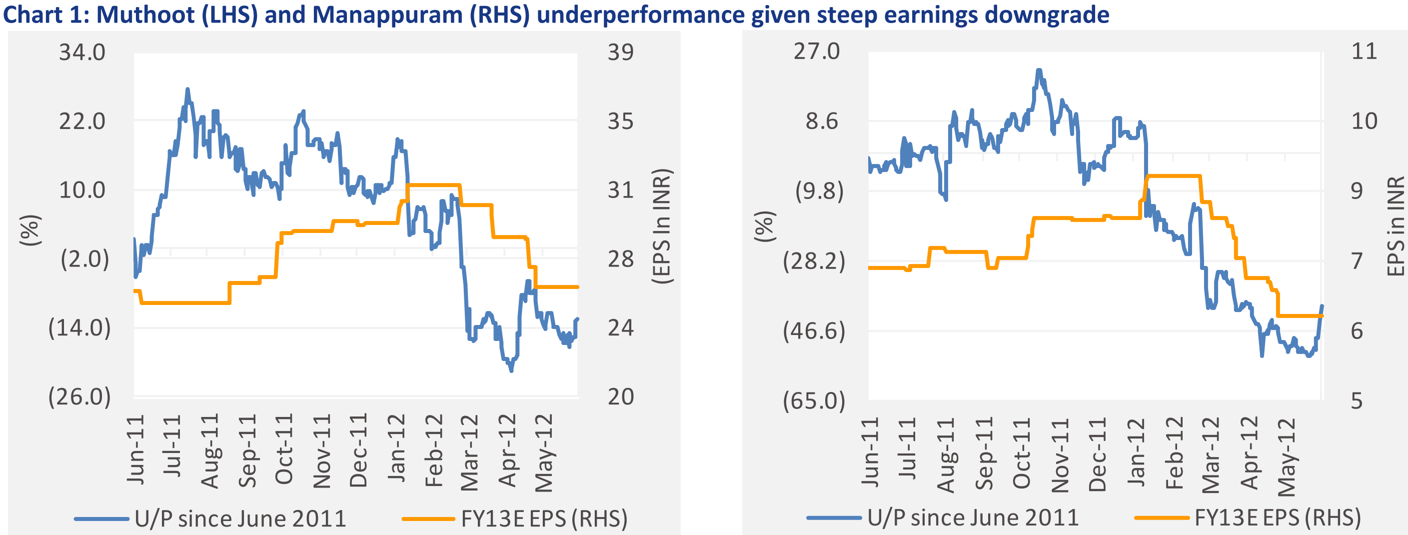
We believe investors are skeptical on monoline gold financiers considering recent regulatory upheavals and peak/volatile gold prices coupled with active competition from banks and NBFCs.

Collateral valuation has shifted to the replacement cost basis leading to a lower than expected decline in disbursement/ gram even while lending rates have held up

- **RBI came cracking on gold loan NBFCs…**

  Given the breakneck speed of growth, margins >10% and constant asset quality risk, RBI has gradually been turning heat with regulatory strictures on the liability front. It has 1) removed the benefit of PSL tag, 2) put a virtual end to assignment/securitization and 3) imposed an exposure ceiling on bank lending to these companies. Further, it recently capped the LTV at 60% among other measures. Uncertainty around the regulatory turmoil has led to an earnings downgrade of 18%-27% by the Street for Manappuram and Muthoot since March 2012, thereby leading to 15%-30% underperformance of these stocks.

Chart 1: Muthoot (LHS) and Manappuram (RHS) underperformance given steep earnings downgrade



Source: Bloomberg

…impact not as substantial as envisaged; high probability of earnings upgrade

The industry's reaction to regulatory actions was totally unlike our anticipation. While the business momentum has lost some traction and managements have curtailed their branch expansion plans, the impact of regulatory changes has been not as substantial as was envisaged earlier. Collateral valuation has shifted to the replacement cost basis as against the gold content based valuation earlier, leading to a lower than expected decline in disbursement/ gram. Even lending rates have at worst remained steady (if not increased) given strong pricing power. This makes us confident that there is a high probability of earnings upgrade in the coming quarters.

Table 1: We are ahead of consensus and expect earnings upgrade by the Street

	Edelweiss estimate		Consensus estimate		Difference (%)	
	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
Muthoot Finance	9,082	10,899	8,478	9,668	7.1	12.7
Manappuram Finance	5,646	6,436	5,263	5,550	7.3	16.0

Source: Bloomberg, Edelweiss research

What if…

Regulatory landscape becomes further assertive

Even under adverse scenario, RoA/Roe is likely to hold the 2.5-3%/10-15% mark

We cannot call it an end of regulatory rigmarole till the report of KUB Rao Working Group is tabled by July 2012. Even in a stress case, assuming further regulatory strictures either with respect to limit on cash disbursals or increase in risk-weights or definition of collateral value (though we assign low probability to this playing out), we expect 25%-30% decline in growth from our base case scenario. Even under these circumstances, it will continue to deliver 2.5%-3.0% RoA and 10%-15% RoE.

Table 2: Bear case scenario factoring further regulatory strictures and gold price crash

	Muthoot Finance						Manappuram Finance					
	Base case		Bear case		Change (%)		Base case		Bear case		Change (%)	
(INR mn)	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
AUM	249,758	296,550	182,723	191,703	(26.8)	(35.4)	119,777	145,628	87,116	98,160	(27.3)	(32.6)
Branches (Nos)	3,778	4,078	3,678	3,528	(2.6)	(13.5)	3,008	3,208	2,908	2,758	(3.3)	(14.0)
NIMs (%)	9.1	9.5	9.3	8.7			12.1	12.4	12.0	11.7		
Opex/assets (%)	3.8	3.8	4.0	4.6			5.6	5.5	6.0	6.7		
RoA (%)	3.5	3.8	3.6	2.7			4.3	4.5	4.0	3.0		
RoE (%)	27.5	26.4	24.6	14.0			21.3	20.3	17.5	10.4		
Gross NPA (%)	0.8	0.7	0.9	1.3			0.7	0.7	0.9	1.4		
Net revenues	23,763	27,508	21,027	17,375	(11.5)	(36.8)	16,403	18,271	14,093	12,303	(14.1)	(32.7)
Opex	9,848	10,902	8,853	8,951	(10.1)	(17.9)	7,435	7,949	6,893	6,784	(7.3)	(14.7)
Provisions	258	217	113	397	(56.1)	83.2	541	716	325	882	(39.8)	23.3
Profit after tax	9,082	10,899	8,021	5,338	(11.7)	(51.0)	5,646	6,436	4,606	3,107	(18.4)	(51.7)
EPS (INR)	24.4	29.3	21.6	14.4	(11.7)	(51.0)	6.7	7.7	5.5	3.7	(18.4)	(51.7)
Book value (INR)	98.9	123.0	96.5	108.3	(2.4)	(11.9)	34.8	40.6	34.1	37.2	(1.8)	(8.5)

Source: Edelweiss research

Table 3: Gold lenders to make 2.0-2.5%+ RoA even if worst case scenario plays out

	Base case			Worst case		
	Urban	Semi-Urban	Rural	Urban	Semi-Urban	Rural
Branch expenses (INR per month)						
Rent (A)	**75,000**	**40,000**	**10,000**	**75,000**	**40,000**	**10,000**
Total salary (B)	**98,500**	**69,500**	**29,000**	**64,000**	**45,500**	**26,000**
- Branch Head	*20,000*	*15,000*	*9,000*	*20,000*	*15,000*	*9,000*
- Asst. Branch Head	*18,000*	*12,500*	*7,000*	*18,000*	*12,500*	*7,000*
- Staff (3-4 ppl in base, 2 ppl in worst case)	*52,000*	*36,000*	*10,000*	*26,000*	*18,000*	*10,000*
- Support staff (1in base, NIL in worst case)	*8,500*	*6,000*	*3,000*			
Other cost (C)	**25,000**	**15,000**	**10,000**	**22,500**	**13,500**	**9,000**
Branch cost per month (A+B+C)	**198,500**	**124,500**	**49,000**	**161,500**	**99,000**	**45,000**
Average AUMs (INR mn)	100	70	30	70	49	21
Yield (%)	22.0	22.0	22.0	20.0	20.0	21.0
Interest cost (%)	13.5	13.5	13.5	13.5	13.5	13.5
Provision cost (%)	0.3	0.3	0.3	0.5	0.5	0.5
Leverage (Assets/Equity)	7	7	7	5.5	5.5	5.5
Head Office related cost (% of branch cost)	50	55	60	45	50	55
Sample Profit and loss (In INR mn)						
Investment in operations (AUM + 6m Branch running expenses)	**101**	**71**	**30**	**71**	**50**	**21**
- Of which debt	87	61	26	58	41	17
- Of which equity	14	10	4	13	9	4
Interest income	22.0	15.4	6.6	14.0	9.8	4.4
Interest expense	11.7	8.2	3.5	7.8	5.5	2.3
Net Interest income	10.3	7.2	3.1	6.2	4.3	2.1
Loan loss provisions	0.3	0.2	0.1	0.4	0.2	0.1
Operating expenses	4.8	3.3	1.5	3.5	2.4	1.2
PBT	5.2	3.7	1.5	2.3	1.7	0.8
Tax	1.7	1.2	0.5	0.8	0.6	0.2
PAT	3.5	2.5	1.0	1.5	1.1	0.5
Ratios (%)						
NIM	10.3	10.3	10.3	8.8	8.8	9.8
Opex	4.7	4.7	4.9	5.0	4.8	5.6
RoA	3.5	3.5	3.4	2.2	2.3	2.4
RoE	**24.2**	**24.4**	**23.8**	**11.9**	**12.6**	**13.1**

Source: Edelweiss research

A crash in gold prices to have a dual impact on business fundamentals

Trend analysis for the past five years shows that gold AUM/branch in volume terms i.e. in kg of gold/branch has remained more or less constant. Nonetheless, what has helped AUM (in value terms) clock a 75%+ CAGR is the 25% CAGR in gold prices and brisk pace of branch addition at a CAGR of 45%+ over the same period. If gold prices crash, we see its dual impact on business fundamentals. Firstly, it would moderate AUM growth and secondly, asset quality risks may crop up. Sensitivity of gold price correction to earnings suggests that every 25% decline in gold prices can impact the earnings by 15%-20%.

Table 4: Earnings can decline by 15-20% if gold prices correct by 25% as it has implications on both growth and asset quality

	EPS Impact	Gold price decline				
	FY13E	5%	10%	15%	20%	25%
GNPA Increase	10bps	(3.7)	(7.0)	(10.3)	(13.6)	(16.9)
	20bps	(4.0)	(7.3)	(10.6)	(13.9)	(17.1)
	30bps	(4.4)	(7.6)	(10.9)	(14.2)	(17.4)
	40bps	(4.7)	(8.0)	(11.2)	(14.5)	(17.7)
	50bps	(5.1)	(8.3)	(11.5)	(14.8)	(18.0)

	EPS Impact	Gold price decline				
	FY14E	5%	10%	15%	20%	25%
GNPA Increase	10bps	(7.3)	(14.4)	(21.6)	(28.8)	(36.0)
	20bps	(7.3)	(14.5)	(21.7)	(28.9)	(36.0)
	30bps	(7.4)	(14.6)	(21.7)	(28.9)	(36.1)
	40bps	(7.5)	(14.6)	(21.8)	(29.0)	(36.1)
	50bps	(7.5)	(14.7)	(21.9)	(29.0)	(36.2)

Source: Edelweiss research

How should investors view this space?

Regulatory risks remain only in interim, long term fundamentals stay firm

We accept that FY13 will be the year of consolidation for gold finance companies in term of growth and margins though stability at the ground level might surprise the consensus numbers and expectation. From FY14 onwards, the business model would deliver steady state of 15%-20% growth, impressive return profile (ROA and ROE) and benign asset quality metrics, a key investor pull. We are confident of substantial merit in this business model as gold loan demand is genuine being the fastest and the most convenient form of financing short term personal/business needs. Leading gold loan financiers will continue to hold the forte considering their USP – branding, convenience, trust, faster turnaround unless:

- Customers become averse to pledging of gold and instead prefer selling gold
- Banks get aggressive grabbing significant share due to rate, LTV and reach advantage

Play this space via Muthoot Finance and Federal Bank

We prefer to play this space via quality players like Muthoot Finance or major beneficiary of regulatory changes like Federal Bank. We also upgrade Manappuram Finance to **BUY**.

Muthoot Finance: We like Muthoot Finance for its franchise, brand value, employee quality and most importantly, customer centricity. Its leadership and ability to cope up with increasing competition from private banks is indisputable, in our view. We believe it will likely tread a steady 15%-20% growth path clocking 3.5%/25% RoA/RoE once it tides over the consolidation phase. We initiate coverage with 'BUY/Sector Performance' with TP of INR 185 (31% upside) valuing it is 1.5x FY14E book and is our chosen pick to play this space.

Federal Bank: Being in the hub of the gold loan industry, it is a major beneficiary of regulatory restrictions on NBFCs. While corporate level advertisements have increased, focused efforts at local branch level can lead to much better results. Gold loan is now being offered from all 950 branches. Moreover, it has floated NBFC subsidiary, Fedfina, which is making rapid progress since September 2011 - INR3.1bn loans across 130 branches. Maintain 'BUY'**.**

Manappuram Finance: It has been the fastest player with AUM CAGR of ~90% over past five years. Recent 3-4 months have been turbulent as along with regulatory upheavals, it bore RBI's brunt for having wrongly used its branches to raise deposits for Manappuram Agro (a promoter owned entity). This led to funding pressures, especially from the CP route, which is now sorted out after CRISIL put it back in the 'Stable' grade. A 0.8x FY14E P/B, factors in a fair bit of concerns and is attractive for RoA/RoE of 4%/20% with a steady growth. We upgrade it to 'BUY' with TP of INR41 (23% upside) valuing it at 1x FY14E book (35% discount to Muthoot).

Valuations

Chart 2: Muthoot Finance

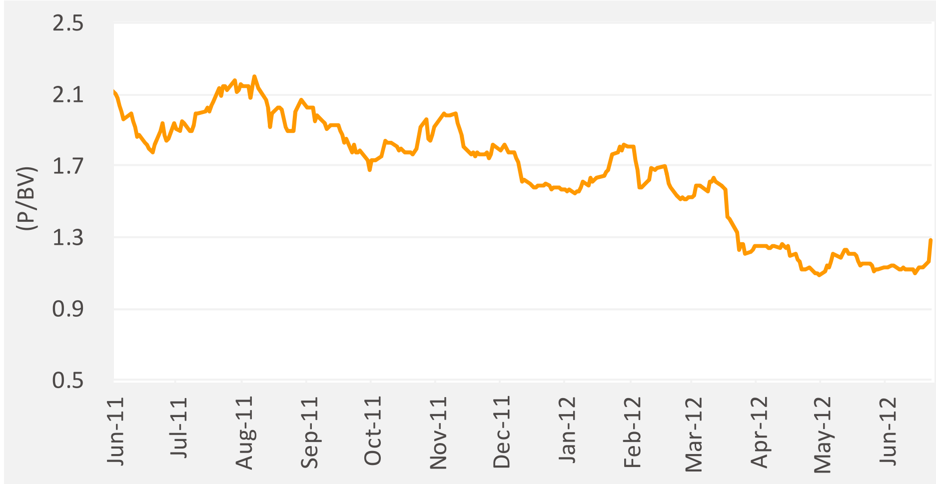


Chart 3: Manappuram Finance

Chart 4: Federal Bank

Source: Bloomberg, Edelweiss research

150+ branch visits in South, North and West India

We conducted 150+ branch visits across the country, this being the best way to understand the business dynamics and appreciate the customer's psyche. We covered a wide spectrum of players in the gold loan ecosystem, namely:

- **Established gold loan NBFCs** – Muthoot Finance, Manappuram Finance, Muthoot Fincorp
- **South India based banks with focus on gold loans** – Federal Bank, South Indian Bank
- **PSU banks engaging in gold loans on a selective basis** – State Bank of Travancore, State Bank of Hyderabad
- **Diversified NBFCs which have entered the space** – India Infoline, Future Capital
- **Regional co-operative banks** – Mangaldeep Co-operative Bank, Nagar Urban Co-operative Bank
- **Regional small scale NBFCs** – Mini Muthoottu, Kosamattam Finance

Fig. 1: Survey highlights – Gold loan NBFCs are the preferred financiers even while competition is heating up

Customer psyche	Competitive intensity	Risk management	Regulations impact
End use: A) personal/consumption needs (50%); B) working capital financing (50%)	South India – very competitive & hugely penetrated (established NBFCs, upcoming players, local NBFCs, Banks co-exist).	**Common standards** across country for collateral appraisal process, KYC, jewellery custody	**On demand**: Lower disb/gm is a dampener. While some customers are accepting lower LTV, other not willing to renew loans
Unawareness / reluctance for banks – unaware that banks offer gold loan and at much lower rates	Some Tier 2 & 3 cities – co-operative banks were active. In metros, private banks (ICICI, HDFC) getting aggressive	**Security standards varied** – armed guard in South needed for branches with AUM >INR 50mn, in West & North >INR 10mn	**On interest rates**: Given their pricing power, interest rates have stayed put or slightly increased
Choice of financiers depends on: **A) LTV,** B) TAT, C) Cash disbursals, D) location. Interest rate least important	Financiers typically **present in clusters** – most areas Muthoot and Manappuram branches located within ~500 mtrs	Strong rooms for jewellery storage; keys in joint custody of the Branch and Asst. Branch Manager	**On competition**: Gradually pvt banks getting aggressive; Pan-India increase in marketing by Federal Bank
Tendency to **stick to a particular financier** is high.	**Banks lacked local level advertising** about availability in 30 mins @ 14% interest rate	Branches connected to local police station, HO on real time basis; alarms activated in case of any burglary	Number of schemes on offer have reduced; lower rate products have been discontinued.

Source: Edelweiss research

Fig. 2: Federal bank seen getting aggressive with advertising..

Fig. 3: ..displaying high per gram loan and low interest rate

Fig. 4: Co-op. banks are strong players in semi-urban markets..

Fig. 5: ..and are offering lower interest rates as well

Fig. 6: Selective presence of PSU banks seen as well

Fig. 7: South India has many small NBFCs offering gold loans

Source: Edelweiss research

Fig. 8: Other asset NBFCs were also seen offering gold loans selectively to their existing customers

Fig. 9: Muthoot Fincorp's presence was hard to miss

Fig. 10: Diversified NBFCs aggressive even down in South India

Source: Edelweiss research

Fig. 11: Competition didn't seem to have much impact

Fig. 12: Muthoot branch setups mirror that of private banks

Fig. 13: Manappuram branches situated in busy commercial centers and few of them are open on Sundays as well..

Fig. 14: Advertisements involve roping in big celebrities..

Fig. 15: With branch level ads, regional media also being used

Source: Edelweiss research

Fig. 16: Few branches have exclusive counters in Federal bank

Fig. 17: Not much focus seen given their high gold loan book

Source: Edelweiss research

Is gold financing just reaping the benefits of a benign gold price cycle?

Gold financiers have created a niche by acting as a vehicle to treat gold as a quasi-currency instrument, by offering loans against jewellery. It has been a common notion that stupendous CAGR of 60% plus in the organized gold loan industry over FY09-12 (AUM of INR1.3tn) has primarily been on the back of a one-way gold price cycle and the industry may fall flat in case prices stagnate and more so in case of a decline. However, our branch visits of gold financiers made us more confident about genuineness of gold loan demand and we expect that customers to keep flocking to gold loan branches aiding gold lenders to continue to hold forte.

Table 5: Gold loans have grown at fast pace and have seen new entrants in the space

	Gold loan AUM (INR bn)			
	FY09	FY12	CAGR (%)	% of loan book
Speacialised NBFCs				
Muthoot Finance	33	244	94.9	100.0
Manappuram Finance	12	116	113.3	100.0
Muthoot Fincorp	11	63	76.2	100.0
South based private banks				
SIB	14	66	69.2	24.3
Federal bank	11	37	51.2	9.8
PSU Banks				
IOB	31	99	47.3	7.0
Indian Bank	33	80	34.3	8.9
Andhra bank	9	40	64.4	4.8
SBT	11	30	41.0	5.4
Private Banks				
ICICI Bank		25		1.0
HDFC Bank		31		1.6
Diversified NBFC				
Shriram City Union	23	48	28.0	36.0
India Infoline		28		40.7

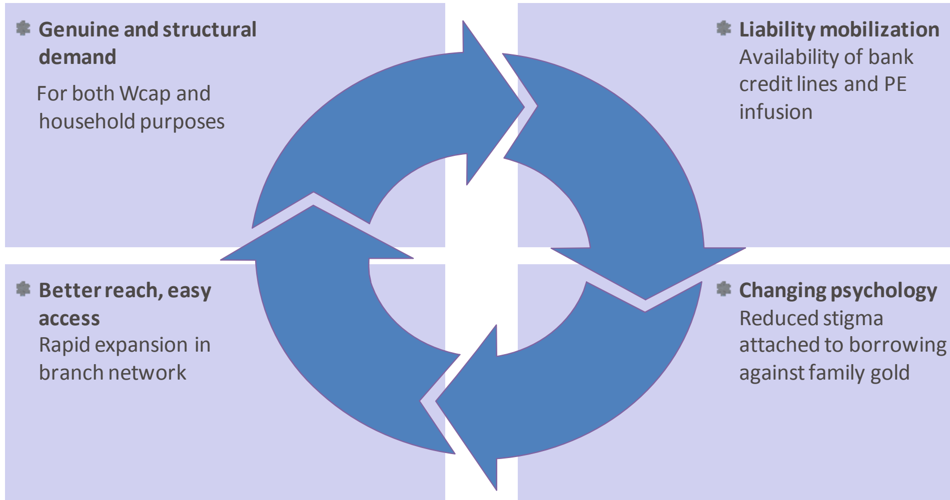
Source: Company

Chart 5: ..creating a skepticism that one way gold price move is the main driver

Source: Bloomberg

Most monoline gold financiers and regional banks (aggressive in gold) have been in the business for decades. However, the inflection point seems to be the past 4-5 years wherein gold loan AUMs grew almost 20x. While we believe consistent rise in gold prices has been a critical driver, there are other driving factors as well:

Fig. 18: Gold loans have multiple drivers – Easy fund availability being the main one



Source: Edelweiss research

- **Genuine and structural demand:** Gold loans, being the fastest and most convenient form of financing, are finding use in meeting urgent personal/consumption needs and working capital financing, particularly from micro and small enterprises. Also, our ground survey suggests that even banks are increasingly suggesting gold loans as an alternative to various one-time working capital facility (like cash credit, bank overdraft etc), since it saves both time and documentation work for the borrower and is a safe asset class for the lender.
- **Liability mobilization:** Initially, branch disbursement power was linked to its capacity to mobilize funds as well. However, with availability of bank credit lines and private equity infusion, branches are provided with more flexibility to disburse loans based on demand potential in the region.
- **Better reach, easy access:** Increasing presence of gold financiers has made accessibility easier. Gold financiers have aggressively ramped up their distribution networks to leverage an emerging opportunity and achieve significant scale and visibility.
- **Changing psychology:** Customer attitude towards gold pledging is becoming more positive due to changing psychographics (debt-averse psychology) in favour of asset creation through growth in financial liabilities. This was further aided by aggressive promotion by operators.

Our visit to 150+ branches of gold loan financiers across various regions (South, West & North) and interactions with customers and branch managers helped us gain insights into the application of this product. Our interactions ranged from a small scale rolling mill owner borrowing on a weekly basis to pay labour wages in Aurangabad to a small construction contractor borrowing to buy raw materials in Ghaziabad to that of a trader in need of short-term funds to buy an export reject garments lot in Tirupur to a real estate developer/buyer requiring fund to meet equity commitment. Significant utilization of gold loans was to:

- Provide quick liquidity to households to meet urgent but varied personal needs.
- Aid small/medium enterprises to manage cash flow mismatches or meet working capital needs.

Gold loans, with application in both personal and business purposes are being driven by their USP of lower loan disbursal time

The common thread has been urgency for funds and the end use of funds being more recurring in nature rather than typical consumer loans for various one-time usage. We, therefore, believe that demand is more genuine and structural, and even if gold prices were to remain flat or marginally decline going forward, it may not significantly affect the volume of pledges and hence the business.

Where do we stand in terms of penetration and product potential?

Despite posting 60% plus CAGR over FY09-12, we believe potential for growth in organized gold loan market is still humungous considering huge under-penetration. India has accumulated gold stock of ~20k tonnes, translating into 10% of the global gold stock, and value of gold in private hands is estimated at ~60% of total bank deposits. Organized gold loan market in India currently stands at INR1.3tn, equivalent to merely 2% of the value of total gold stock.

Penetration of organized gold loan market in terms of number of households is also miniscule at <5%, with penetration being relatively higher in the Southern region at ~25%. The likelihood of penetration rising is high due to ease of access to gold loans, trust, and customers' willingness to pledge gold to meet short-term funding needs that carries cost of 20% plus (relative to rates in excess of 36% p.a. for loans provided by local money lenders).

In India, there is no dearth of demand for funds for either personal or business purposes. Apart from demand-side pull, what actually buoyed demand for gold loans in India was easy accessibility to customers via shops in every nook and corner. Further, willingness to borrow against gold has surged, as when people borrow against gold they put it to productive use, while the metal is just a dead investment or drag on the economy when it is locked up in vaults and safes.

Penetration is lower than 5% for the country which will hold the demand in good stead

Further, a significant portion of gold loans has begun to shift from unorganised to organised lenders, fuelling growth in the organised market. In India, there is a large and long time operating unorganised gold loans market (no official estimates available, but believed to be 3-4x the size of the organised market) marked with presence of pawnbrokers and money lenders.

Table 6: Study of South India penetration levels indicate huge potential of growth elsewhere in the country

	# of loan accounts (mn)	# of customers (mn)	Gold loan portfolio (INR mn)	Avg ticket size (INR)
Muthoot Finance	6.0	3.2	244,170	40,695
Manappuram Finance	3.1	1.6	116,308	37,326
Total	**9.1**	**4.8**	**360,478**	**39,543**
Estimated Mkt share (%)	30	30	30	
Industrywide gold loan customer base	**30.4**	**16.0**	**1,201,593**	**39,543**
% of business in South	70	70	70	
Gold loan customers O/S in South	**21.3**	**11.2**	**841,115**	
Gold loan customers served in South		**16.0**		
(assuming 70% of business is repeat customers)				
Population of Southern States (mn)				
Andhra Pradesh		84.7		
Karnataka		61.1		
Kerala		33.4		
Tamil Nadu		72.1		
Total		**251.3**		
Penetration in terms of population (%)		**6.4**		
Penetration in terms of households (%)		**25.5**		

Source: Company, Edelweiss research

NOTE

1. *Manappuram - Number of customers - 1.64 mn (as of March 12) of which, as per its experience, the ratio of number of customers to loan accounts is 1.0:1.9. Muthoot discloses only number of loan accounts (6mn as of March, 2012) and hence we have assumed ration of customers to loan accounts similar to that of Manappuram.*
2. *Estimated combined market share of Muthoot and Manappuram at 30%.*
3. *Muthoot - Proportion of branches in Southern region (64%) and gold loan (69%). Manappuram – Customers based in South (~70%)*
4. *70%-80% of business is from repeat customers- On an outstanding base, would serve 1.2-1.3x customers higher*

What can lead to customers becoming averse to pledging of gold?

We have discussed in the previous section how customer attitude to gold pledging is becoming positive due to changing psychographics (debt-averse psychology) in favour of asset creation via growth in financial liabilities. However, we believe continuous rise in gold prices year–after-year and consequent optimism towards wealth creation by owning the gold has restrained customers from selling gold outright and preferring to pledge it to meet short-term requirements. If these sentiments change, either due to stability in gold prices or sudden crash, it can seriously hurt demand for gold loans and dynamics of the gold loan industry as well.

Year-after-year appreciation in gold prices have kept the customers from selling their gold ornaments to fund their cashflow mismatches

Churning of portfolio was also high as: (i) Gold prices were consistently rising; and (2) financiers were increasing LTV to be more competitive. Customers, therefore, had the tendency to release the pledge frequently and refinance it to get the benefit of higher loan value against same quantum of gold or lower interest rate for similar loan value. On an average, 70-80% disbursements were to repeat customers, of which, 50% was refinancing demand. Hence, average duration of gold loan was 3-4 months despite contracted loan tenor of a year.

In the transition phase, during which all loans shift to 60% LTV, we believe release of pledge by customers will be deferred as relatively lower LTV will be offered for new loans (INR 1900-1950/gram now vis-à-vis INR 2000-2100/gram disbursed earlier). The duration of the loan may also get extended from the current 3-4 months as customers will tend to continue with existing loan (previously releasing the pledge and refinancing it again to receive a higher loan amount).

Did rapid growth, burgeoning competition see some dilution in lending?

To grow aggressively and compete effectively, gold loan financiers did compromise on underwriting standards at some level. The regulator has significantly changed the business metrics by its policies. Our branch visits revealed dilution in lending practices on the following fronts:

We saw some dilution in terms of LTV, waiving off of allowances and dilution in system level mitigants

- LTVs: Increased from 60% to upwards of 80%, leaving low margin of safety
- Waiving off of allowances to offer higher loan value
- Dilution in system level mitigants framed earlier like prohibition in lending to jewelers or against bullion amongst others

LTVs increased from 60% to the highs of 80-85%

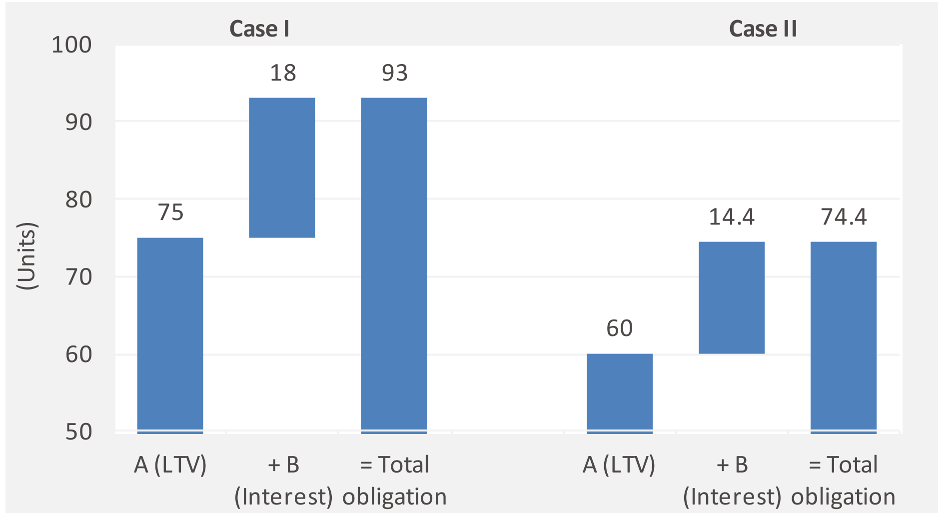
Loan amount is typically based on a fixed rate per gram of gold content in jewellery, which is internally decided based on centralised policies and guidelines. While jewellery can be appraised based on various factors such as total weight, weight of gold content, production cost, style, brand and value of any gemstones, gold loan financiers, before the regulatory upheaval appraised the collateral solely based on gold weight.

Financiers offered varied schemes with differing LTVs (in the range of 50-85%) on the benchmark price fixed internally per gram at varied lending rates (higher the LTV, higher the lending rate). With maximum loan value being a critical factor in choosing the financier, disbursements were more skewed in favour of maximum LTV products, which stood as high as 80-85% compared to 50% to begin with. With many players getting active in this space and no regulatory constraints in lending value, what followed was NBFCs, across the board, started to offer higher LTVs to compete effectively, thereby, signaling dilution in lending standards to some extent.

An LTV of 75-85% to be topped up by 20-25% interest rate for one year (typical contracted maturity of loan) meant that amount to be repaid came to 93% of gold value. This left a minuscule margin of safety against a correction in gold prices, which we believe cannot be ruled out.

Taking cognizance of this fact, RBI imposed a cap of 60% LTV for gold loan financiers, which combined with 24-25% interest rate ensures that the repayment value is at 75%, thereby providing adequate support to asset quality even if gold prices were to correct significantly. **However, with the 60% LTV cap, financiers have changed their valuation benchmark from pure gold content to market value of jewellery (i.e. inclusive of making charges of 20-25%) thereby limiting the downside in loan value offered per gram**.

Chart 6: With high LTVs, there is little margin of safety taking interest into account

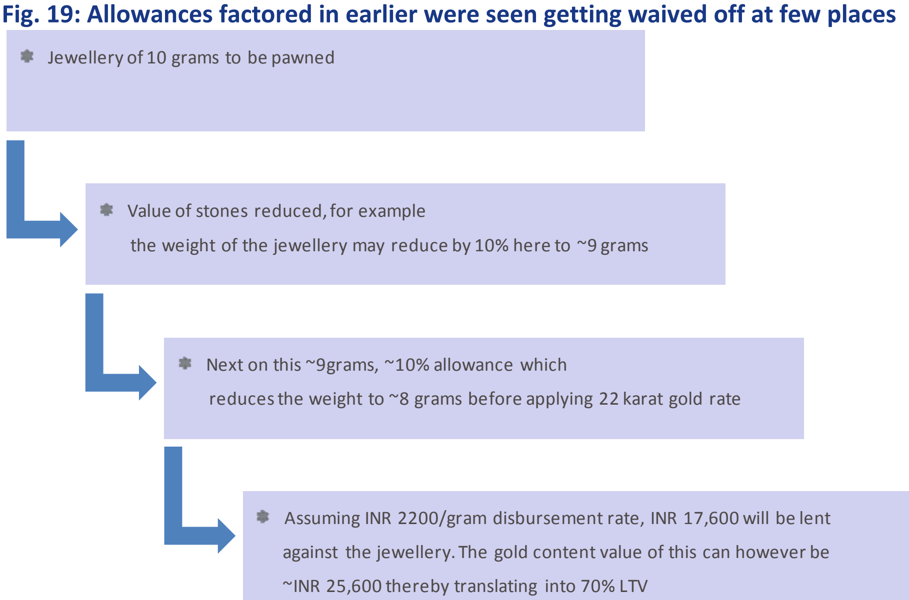


Source: Edelweiss research

Allowances charged earlier were waived off to provide higher loan amount

Gold loan financiers generally make an allowance (on gross weight) of at least 10-20% for purity of gold, gemstones attached, aging etc. There are no uniform guidelines and allowance is generally at the discretion of the appraiser based on his experience. However, with RBI regulating the LTV with cap at 60%, financiers sacrifice on this allowance quantum and offer 95-98% of gross weight to avoid any significant fall in loan value.

Fig. 19: Allowances factored in earlier were seen getting waived off at few places



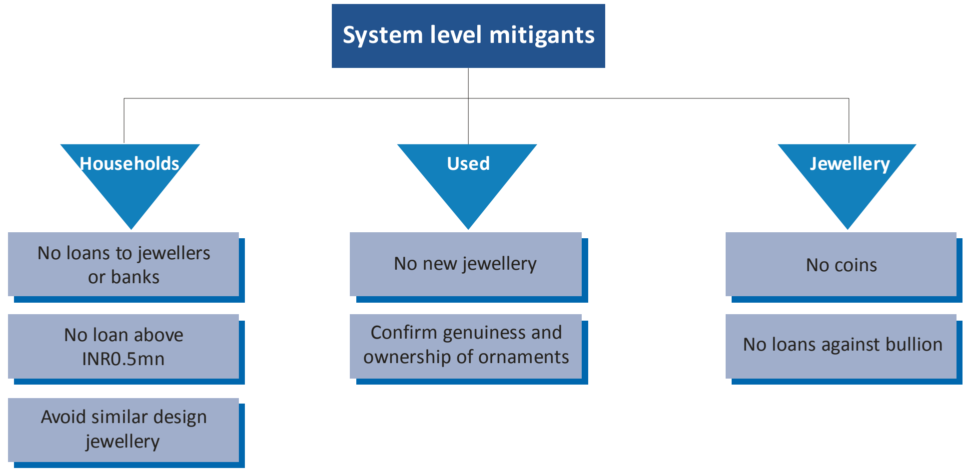
Source: Edelweiss research

Few system level mitigants framed initially were diluted

As a strategy to control defaults, gold loan NBFCs, had initially introduced a few system level mitigants, wherein it was decided that loans will not be provided: (a) to jewellers; (b) against gold, bullion and storable forms; (c) above INR0.5mn; and (d) for new jewellery. However, with competition heating up, financiers were seen to have compromised on these system-level mitigants in a bid to shore up AUMs and avoid losing customers.

While the current regulations restrict lending to local jewelers, earlier for some branches the proportion of such loans was in excess of 5-10%

Fig. 20: System level mitigants with respect to households and form of jewellery



Source: Company

Before regulations on fair practices code came, we gathered the following from our branch visits

- There were no restrictions on lending to local jewelers; in some branches we visited, this segment formed 5-15% of outstanding AUMs. Risks in refinancing jewellers for loans they provide to customers against gold, is high as: (a) there is absence of direct relationship with customers to understand their risk profile; (b) ownership of jewellery is not known; and (c) no sentimental value attached. Taking cognizance of these facts, the regulator has now made it compulsory for gold financiers to have internal systems to verify ownership.
- Also, there was no cap on ticket size of gold loans, though there are approval limits in place for branch manager, regional manager and loans where HO approval is mandatory. With gold loan as a product gaining significance amongst the business class, disbursement profile is skewing more towards business loans vis-à-vis personal loans, thereby leading to higher proportion of high ticket gold loans being offered. Currently, more than 15% of gold loans are of more than INR1mn ticket size.
- Further gold financiers had started offering loans against bullion. On an average, these constitute 2-5% of outstanding gold loans. RBI has now prohibited this activity as well.

NBFCs will hold the turf; but big private banks can change the game

Monoline gold loan financiers have, over the years, developed a strong and niche business model by catering to the urgent cash flow needs of borrowers. Quick hassle free processing of loans and minimal turnaround time for borrower are added advantages. Hence, it is no surprise that they charge interest rates way in excess of banks (7-10%) and still do brisk business (loan book CAGR of 80% plus over FY09-12).

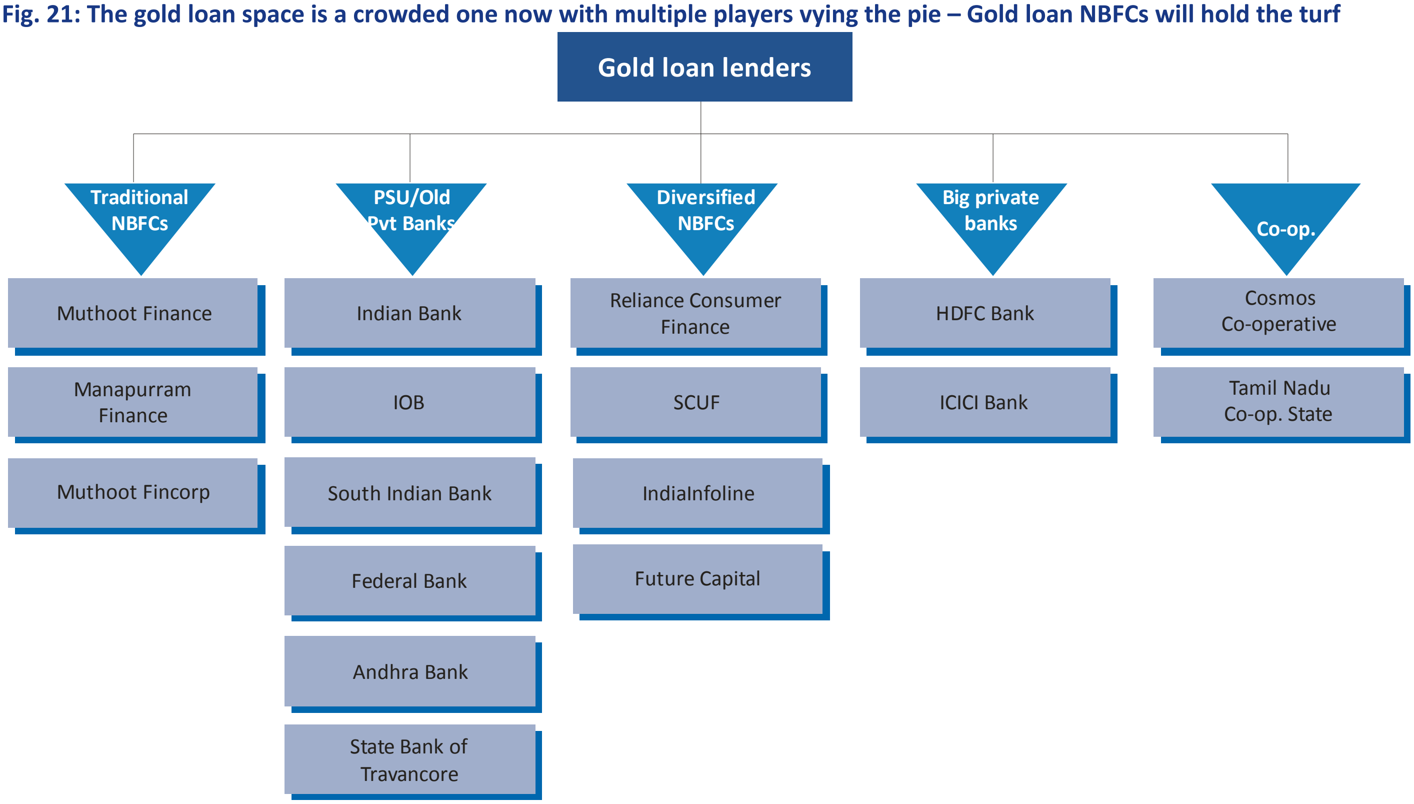
Stupendous growth and healthy return profile of existing niche gold loan companies led to crowding of the gold loan market and increased competition. There was: (i) Mushrooming of various new NBFCs which added gold loans to their product basket; (ii) increased aggression on gold loans by a few South India based banks; and (iii) launch of gold loans by private banks and local co-operative banks.

Gold loan NBFCs will continue to be preferred due to their focused approach to gold loans which ensures faster turnaround time

While we take cognizance of the fact that there are no strong entry barriers in terms of licences and registration, heavy capital expenditure or hard-to-acquire collateral appraisal skills, we like the brand and the franchise value that monoline gold loan companies have developed over several decades of existence.

Our branch visits to various gold financier outlets across the length and breadth of the country, both mature and upcoming geographies, indicate that even though the current regulatory changes will impact growth, margins and hence profitability of business, the business model has merit and will continue to embark on a steady growth path post the consolidation period i.e., FY13-14. Even though we expect heightened competition from banks with the likes of Federal Bank, HDFC Bank, ICICI Bank, etc. getting active in this space, it is the flow of business from new NBFC entrants and the unorganized sector that will work in favour of established gold loan companies (GLC). **Our interactions with customers suggest that LTV and turnaround time are the two most critical factors for choosing a gold financier. This, combined with extensive on–the-ground branding, convenient locations of branches in important business centres and trust amongst customers makes us confident that gold finance companies will continue to hold ground. So, even while competition from banks rises, the USP that established GLCs have developed, i.e., scale, first-mover advantage, brand equity, accessibility, relatively lower documentation and fast turnaround time, will ensure that customers keep flocking to their branches aiding gold lenders to continue to hold fort.**

Fig. 21: The gold loan space is a crowded one now with multiple players vying the pie – Gold loan NBFCs will hold the turf



Source: Edelweiss research

Table 7: Competitive landscape – New norms favors banks, but gold loan NBFCs will continue to be preferred

	NBFCs - Established			NBFCs - New	South India based banks		Private banks		PSU banks	Co-op. banks
	Muthoot Finance	Manappuram Finance	Muthoot Fincorp	IIFL, Future Capital	Federal Bank	South Indian Bank	ICICI Bank	HDFC Bank	All	All
Focus on gold loans	High	High	High	Medium	Medium	Medium	Low	Low	Low	Low
Product Features										
-No. of schemes	7-9	10 plus	2-3	5-6	2-3	2-3	2	3-4	2-3	2-3
-LTV range	40-85%	40-85%	40-75%	60-90%	50-85%	50-85%	60-85%	60-85%	60-85%	60-85%
-Interest rate range	12-24%	12-26%	12-24%	20-24%	10-14%	10-14%	13-16%	10-14%	7-14%	13-16%
-Processing fee	NIL	NIL	NIL	NIL	NIL	NIL	1% of sanctioned amount	0.5% + Valuation fee	0.25-0.5%	NIL
-Disbursement mode	Cash	Cash	Cash	Cash	Limited cash disbursals	Limited cash disbursals	Limited cash disbursals	Limited cash disbursals	Limited cash disbursals	Limited cash disbursals
Competition focus										
-Turnaround time	15-30 mins	15-30 mins	15-30 mins	15-30 mins	30-60 mins	30-60 mins	30-60 mins	30-60 mins	Fews hours to 2-3 days	30-60 mins
-Advertisements	High branch visibility	National and regional AV	Hoardings, print media	Print media	Regional AV and print	Low	Low	Print media, banners	Low	Low
-Branch network density	3678 branches with 64% in South	2900 branches with 74% in South	~2200 branches, with 85% in South	Urban based	Across all 935 branches	Across all the 693 branches	From ~1250 i.e at 45% of the branches	Facility available at ~25% of the branches	Active more from rural branches	Active more in agri and commercial centres
-Account opening	NA	NA	NA	NA	Not required upto INR 0.2mn	Not required upto INR 0.1mn	Not required upto certain limit	Not required upto INR 0.3mn	Required	Required
-Documentation	Identity and Address proof	Identity and Address proof	Identity and Address proof	Identity and Address proof	ID and Address proof, PAN card for A/C	ID and Address proof, PAN card for A/C	ID and Address proof, PAN card for A/C	ID and Address proof, PAN card for A/C	ID and Address proof, PAN card for A/C	ID and Address proof, PAN card for A/C
Customer perception										
-Product awareness	High	High	Moderate	Moderate	Moderate	Moderate	Low	Low	Low	Low
-Ease of transactions	HIgh	HIgh	HIgh	HIgh	Moderate	Moderate	Moderate	Moderate	Low	Low
-Brand recall	High	High	Moderate	Moderate	Moderate	Moderate	Low	Low	Low	Low

Source: Edelweiss research

How serious is the threat from banks?

Private banks are increasingly seen getting aggressive in this space – especially in the high ticket business loan category

Increased competition from large private sector banks will exacerbate the problem for gold loan NBFCs, in our view. During our branch visits to cities and metros, we noticed that NBFCs were facing tough competition, especially in the high-ticket business loan category (INR0.3mn-0.5mn) from banks viz., ICICI Bank, HDFC Bank, Federal Bank, among others. In the interiors, where loans were primarily used for agri purposes, PSU banks have a competitive edge over NBFCs, offering gold loans @ 7% (after timely repayment subvention rate could be as low as 4%). However, gold loan NBFCs will continue to have a clear advantage in semi-urban and rural areas due to their dense presence, brand recall and minimum documentation.

Further, even though banks may try to capitalize on the opportunity provided by regulatory changes disadvantaging NBFCs, there is a limit to which they can capture market share and grow their gold loan portfolios. First, banks generally have an in-built cap on product exposure e.g., gold loans cannot exceed a pre-decided proportion of the loan book; on nearing the limit, they tend to slow down aggression. Second and more importantly, gold loans will be just one of the products offered and unless there is a dedicated gold counter/staff at the bank, customers are averse to approach banks for gold loans due to their perception that the process will be time consuming, cumbersome in terms of documentation etc.

ICICI Bank and HDFC Bank currently have small proportions of their book in gold loans and hence given their size can be a serious threat

We present below the case of Federal Bank and South Indian Bank, two of South India based banks which are aggressive as far as gold based lending is concerned. For South Indian Bank, gold loans already comprise ~25% of the loan book, leaving little scope to scale the book meaningfully given its self imposed 30% cap on gold loans as a proportion of the total loan book. Federal Bank, with 9.8% of loan book in gold, has scope for growth via this medium till it reaches the 18-20% cap imposed by the management. However, the threat is not big given the current loan book size of the bank at INR378bn as on March 2012.

Severity of competition will increase if the larger private banks like ICICI Bank and HDFC bank get aggressive in this space and more so as they now mandatorily open branches in Tier 5 and Tier 6 towns/villages. Given that their loan book size is substantial and the current proportion of gold loans is miniscule, the scope to increase gold loans is immense.

Table 8: Incremental growth in INR terms not a big threat from smaller private sector banks **(INR bn)**

	Gold loans	% of loan book	FY14E advances	Loan book cap on gold (%)	Gold loans possible by FY14E	Incremental build up	FY12-14E CAGR (%)
SIB	66	24.3	413	30.0	124	57	36.6
Federal Bank	37	9.8	539	20.0	108	71	70.7
Sub-total	**103**		**952**		**232**	**128**	**49.7**
ICICI Bank*	25	1.0	3,419	5.0	171	146	161.5
HDFC Bank*	31	1.6	2,837	5.0	142	111	113.6
Sub-total	**56**		**6,256**		**313**	**257**	**136.2**

Source: Company, Edelweiss research

**For ICICI Bank and HDFC Bank, the limit on gold loans a proportion of loan book is assumed at 5%*

RBI came cracking; industry coping up better than expected

The breakneck speed of growth of gold loan financiers (both in terms of physical presence and loan book accretion) over the past 4-5 years, coupled with their superior return profile funded by increased amount of public money being channelized to these NBFCs, has led to RBI introducing some strict regulatory norms. Not only were existing players expanding rapidly, but new players were also entering the market with an even higher level of aggression. We believe the crowding of the gold loan market had led to some amount of dilution in credit standards by a few players, primarily by providing higher LTVs (thereby leaving little margin of safety if gold prices were to stay stable, not to mention a possible decline), quick turnaround, faster documentation etc.

Shift in collateral valuation approach has arrested the decline in disbursements/gram while the lending rates have held up

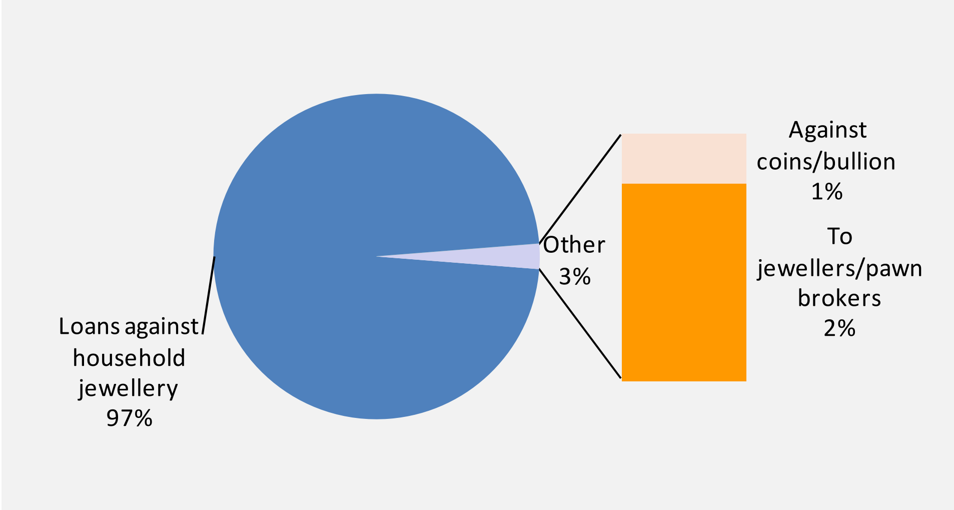
RBI has also been more vigilant on gold financiers considering the concentration risk (large exposure to single asset) that can adversely impact their business model in the event of sharp correction in gold prices. Besides, little control on end use of funds also made the central bank more skeptical. In light of the above, to begin with, it took away the benefit enjoyed by GLCs on liability side by withdrawing the priority sector lending tag available for banks' direct and indirect lending to gold loan NBFCs.

Then came the draft guideline on securitisation transactions, stipulating a minimum holding period (MHP) and minimum retention requirement, virtually putting an end to securitization/assignment transactions for short-term lenders. The final guidelines issued in May 2012 carry the same message, with minimum holding period of two installments being a hurdle since gold loans are generally repaid in bullet structures.

Along with all this, GLCs are bearing the brunt of RBI's regulations on the asset side (capping LTV at 60%) and strengthening credit appraisal standards by introducing fair practice code (which will increase their loan turnaround time). Within the fair practices code, guidelines pertain to collateral and borrower appraisal, as follows.

- Ensuring adequate KYC guidelines are complied with and adequate due diligence is carried out on the customer before extending any loan.
- Putting up systems to satisfy ownership of gold jewellery
- Setting adequate systems for storing jewellery in safe custody
- Insuring the jewellery accepted as collateral
- Following proper auction procedures that are appropriately communicated to borrowers.

Chart 7: RBI has banned loans against bullion, however they form a small proportion



Source: Edelweiss research

Our interactions with the management as well as our branch visits of gold loan financiers highlight that these entities follow most of the operating procedures. However, points 1 & 2 pertaining to adequate due diligence to be carried out and system to satisfy ownership of gold jewellery needs to be worked upon. Compliance to the above procedures may be time consuming and could dilute the competitive edge of gold financiers vis-à-vis banks.

The borrowing limit set by RBI at 7.5% of a bank's capital funds is unlikely to be breached by any gold loan NBFC

Further, in this annual monetary policy, RBI once again, directionally indicated that gold loan NBFCs are a relatively riskier segment and banks should differentiate while lending to gold NBFCs vis-à-vis other NBFCs by levying exposure ceiling on bank's finance to gold loan NBFCs. Banks should reduce their regulatory exposure ceiling in a single gold loan NBFC from the existing 10% to 7.5% of bank's capital funds. Banks should also have an internal sub-limit on their aggregate exposure to gold loan NBFCs, taken together. We believe that the exposure ceiling suggested for gold loan NBFC is unlikely to be breached or restrict their growth in the near term.

Our interaction with gold loan NBFCs management suggests that based on their initial estimate this limit of 7.5% of capital funds should not have any effect on their existing credit lines.

Table 9: Limit 7.5% of banks' networth is not likely to be a hindrance (INR bn)

FY12	Muthoot Finance	Manappuram Finance
Total borrowing	227	116
- From banks	92	72
% from banks	40.6	62.0
% of eligible borrowing limit from banks	20.5	16.0

Source: Company

Capital funds of banking system currently stands at ~INR6tn and 7.5% of capital funds would translate into INR450bn of permissible banking finance to a single gold loan NBFC, which we believe is sufficient, considering their individual asset base at less than INR300bn at present.

Fig. 22: Regulatory landscape has been turbulent since February of 2011

3 Feb 2011

- Bank lending to gold loan NBFCs for direct on-lending or against assigned/securitised pool removed from agri loan classification for PSL

21 March 2012

- LTV capped at 60% of the collateral value
- Lending prohibited against gold coins and bullion
- Tier I increased from 7.5% to 12% by April 2014 (However, this was already recommended under Usha Thorat Committee in August 2011)

26 March 2012

- Fair practices code including (applicable to all NBFCs):

  (A) Sending adequate prior notice before collateral auction

  (B) NBFCs not to participate in the auction themselves

  (C) NBFCs to be reasonably assured of the ownership of the asset

  (D) Tightened security measures for the safe custody of gold

17 April 2012

- Banks exposure to single gold loan NBFC reduced from 10% to 7.5% of its capital base
- Banks asked to set internal ceiling for overall exposure to gold loan NBFCs

17 April 2012

- Working group constituted under Mr. K.U.B. Rao to evaluate:

  (A) Trend in gold loan demand and its impact on gold imports

  (B) Impact of gold loans on the price of gold

  (C) Funding channels of gold loan NBFCs

  (D) Current lending practices of gold loan NBFCs amongst other topics

7 May 2012

- Final securitisation guidelines effectively kills securitisation/sell down of loans for gold loan NBFCs due to the minimum holding period of two installments whereas gold loans typically have bullet repayment structures.

Source: RBI, Edelweiss research

Post regulatory change, players have reacted differently from what was anticipated

From our visits to various branches of gold loan financiers post regulatory change, we garnered that:

While per gram disbursement and lending rates have surprised positively, the loss in momentum is a dampener

1. Most of the players have started offering lower LTV than before to meet RBI's requirement of 60% LTV cap. However, the divergence from expectations comes in the quantum of decline in the disbursement/gram. Had the earlier norm of collateral valuation been followed the decline would have been steeper from INR1900-2000/gram at 75%-80% LTV to INR1600 levels to comply with the 60% norm. However, shift to replacement cost based collateral valuation has allowed the AGLOC (Association of gold loan companies, to which all the 3 large NBFCs subscribe to) to prescribe disbursement/gram in the range of INR1900-2000/gram, taking making charges also into account.
2. Surprisingly, some of the players have increased the lending rates (by 0.10-0.25% per month) despite offering lower LTV, contrary to yield pressure that Street was expecting. Lending rates, at worst, have been maintained, if not increased; but, we have hardly witnessed any incident of lower lending rate with a relatively lower LTV.
3. Our interactions with branch managers suggest that business momentum has lost some traction post the regulatory changes.
4. When we interacted with customers, we sensed that customers were unaware about the regulatory change and were not taking lower LTV offer positively. However, since loan demand was genuine and on an urgent basis, some of the customers were willing to settle for the lower LTV.

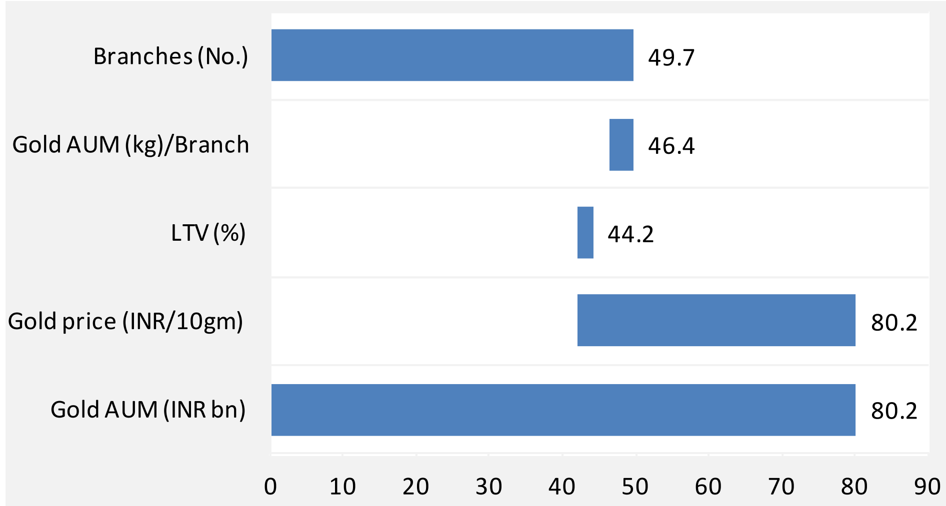
Consolidation in the interim; long-term fundamentals intact

I. Lower LTV and reduced branch additions will reflect in modest growth numbers

Post regulatory changes, business growth has lost some momentum as LTV was one of the most critical drivers in choosing a financier. Besides value, volume will also be volatile and uncertain as customer behavior will take some time to adjust to lower LTV.

Growth in AUMs for gold financiers has largely been a function of rapid expansion in distribution franchise and consistently rising gold prices. Manappuram and Muthoot have grown their AUMs at 90% and 76% CAGR, respectively, over the past five years. During the same period, gold price has risen by 25% CAGR.

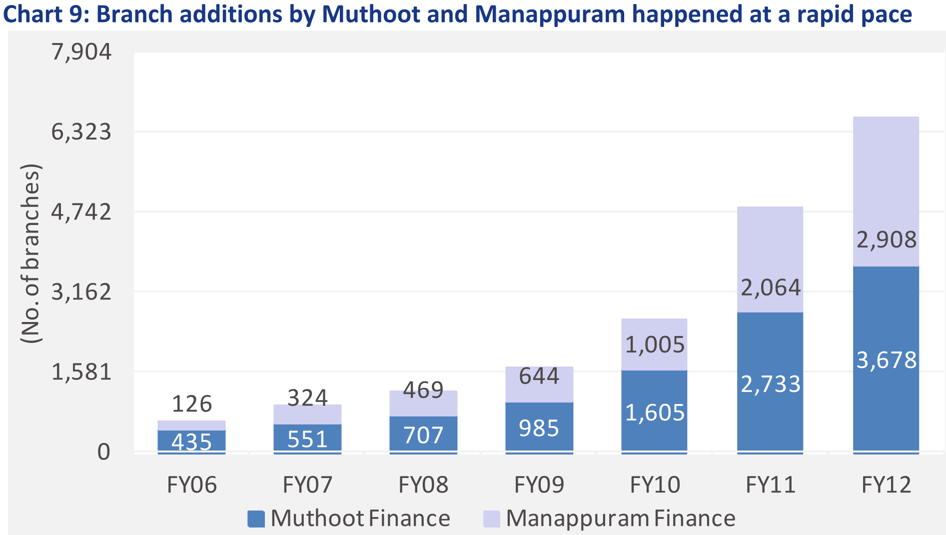
Chart 8: A large portion of growth was driven by branch expansion and gold prices



Source: Edelweiss research

Further, analyzing the metrics on per branch basis indicates that growth in gold loan AUM (in tonnes) is identical with growth in branch network and average AUM per branch (in Kgs) has almost remained steady over past 5-7 years (at ~40 tonnes per branch for Muthoot and ~25 tonnes for Manappuram).

Chart 9: Branch additions by Muthoot and Manappuram happened at a rapid pace



Source: Company

The rationale for steady AUM per branch seems to be:

- Aggressive rollout of branches has resulted in ~55-65% of branches being in existence only for less than 2 years (at any point in time over the past 3 years). This implies that the franchise has not reached optimal utilization all across and benefit of scale up in existing branches is offset by lower productivity at newly opened branches.

Aggressive rollout of branches and branches being opened to reduce the concentration risk of a mature branch has kept the AUM (in tonnes)/branch flattish

- Cannibalization of business: During our branch visits, we realized that in many locations the presence of financiers was massively concentrated (with 10-15 branches of one single financier in 2-3 kms stretch). After conducting survey to assess the demand for financing and customer behavioral trend, financiers tend to penetrate the presence in particular locations which are conducive for growth. Except for penetration in new geographies like North and West, most of branches in Southern region are offshoots of existing branches as customers are not willing to travel a longer distance to pledge their gold and scaling up a branch beyond a particular level of AUM gets riskier.

We believe pace of branch expansion would moderate during the transition phase. While 50% net addition in distribution franchise may not be sustainable, we believe on a normalized basis, gold loan NBFCs can expand network 5-10% every year considering the huge under penetration and genuine financing demand.

With moderation in branch expansion to 5-10%, coupled with an increase in average AUM per branch as branches mature and reach optimal level, we expect gold loan NBFCs AUM to grow on a steady state basis by 20% as there is substantial merit in this business model as gold loan demand is genuine being the fastest and the most convenient form of financing for short term personal/business needs.

II. Faster consumption of capital

Combined impact of absence of securitization/assignment and Tier 1 of 12% will lead to faster consumption of capital

RBI has already implemented Usha Thorat Committee's recommendation of 12% Tier I capital requirement for gold loan NBFCs wef April 14 (guidelines issued in March, '12). This will cap the leveraging ability of gold financiers – had leverage been extensively utilized without any capital buffer, it would have impacted RoEs by 5-6% points in the worst case. While Manappuram is adequately capitalized with Tier 1 in excess of 20%, Muthoot is operating at high leverage levels with Tier 1 close to regulatory requirement at 12.8%. Though current networth will be comfortable to support our growth estimate of 10% over FY12-14E, Tier 1 capital requirement of 12% by April, 14 will cap its growth to maximum at 25% (without any rounds of equity dilution).

Secondly, minimum holding period requirement of 2 installments and ban on revolving credit transactions, has effectively killed the securitization/assignment market for gold loan NBFCs. This will have dual impact on growth as well as interest income. As on FY12, 14% and 17% of the AUMs of Muthoot Finance and Manappuram respectively were assigned. These off balance sheet loans will run-down in FY13 and will have to be effectively replaced with on-balance sheet loans to report positive growth. This is the main reason for subdued AUM growth estimate for Manappuram and Muthoot in FY13.

III. NIM compression

Urgency of funds, LTVs of 75-80%, faster turnaround time and strong branch recall had enabled established gold lenders to charge interest rates of 20-26%. While currently the regulatory changes have not dented the margin profile, competition may get more intense from banks which are now capable of providing higher LTV loans at lower rates.

Though RBI is cautious of banks lending to NBFCs increasing at a much rapid pace than that of the overall industry, we do not foresee any further restriction on this front going forward. Removal of PSL status to banks lending to gold loan NBFCs and absence of securitization/assignment route will reflect in 100-150bps cost of funds impact.

Qualitative impact

1. **Business dynamics become tough with rising competition from banks**

   Post the regulatory changes, banks offering gold loans will surely be more attractive vis-à-vis NBFCs, given absence of LTV cap and lower interest rates (by ~7-10% points at 13-14%). Further, from the banks perspective, gold loan as a product offers various advantages:

   - **Attractive product to generate agri loans**: Gold loans extended for agriculture purposes help the bank meet PSL norms. Given the collateralized nature of the loan, asset quality concerns shall not materialize in any meaningful manner. Within banks also, PSU banks have leeway to provide agri gold loans at rates of 4-7% as they enjoy benefits of subvention from the government.

   - **Low risk product with relatively higher yields**: Our survey of branches suggests that private banks typically charge 13-15% for gold loans with LTVs of 75% and above. With the loans being fully collateralized with monthly interest deduction schemes, it surely fares well on risk return matrix.

   - **Risk weights advantage – very capital efficient product:** Risk weights for banks on gold loans is equal to 125% of the net exposure, whereby net exposure is defined as loan value reduced by 85% of collateral value. This basically implies that if banks keep LTVs below 85%, they don't need to provide any capital on gold loans, making it a very capital efficient product.

2. **Survival to come under question for new upcoming NBFCs**

   Our recent branch visits suggest that competition from new upcoming NBFCs will subside as the strategy followed by these players revolved mainly around offering higher LTV. With limited scope left for competing on LTV due to regulatory cap, within NBFCs, business should now shift more towards established players with strong brand, increased reach, lower rates and faster turnaround time. Diversified NBFCs, who have scaled up gold loan portfolio to leverage on robust growth, better margin and return profile, will have to re-strategize their business models, considering increased competition, lower growth and subdued margins.

Is this is the end of regulatory rigmarole?

Constituting of the Working Group (Convener: Shri K. U. B. Rao) for gold loans (expected to submit the report by end-July 2012) suggests that regulator is not yet over in introducing further strictures on gold loan companies. The parameters that this Committee would look into are more macro in nature, assessing whether gold loan demand is having any influence on gold imports or gold prices. To talk of specifics it will:

- Assess the trends in demand for gold loans and its influence on gold imports
- Analyse the implication of gold imports on external trade and financial stability
- Study the trends in gold price and examine whether NBFCs extending gold loans have any role in influencing gold prices
- Examine the sources of funds of gold loan NBFCs, especially their borrowings from the banking system
- Examine the current practices of NBFCs involved in lending against the collateral of gold

Any cap on cash disbursements or LTV standards reverting to the earlier gold content based valuation norms can be potential risk areas

Along with the impending committee report, there can be two further areas where some regulatory action can happen if things were to become even more hard-hitting for gold loan NBFCs which are:

1. **Any cap on cash disbursements:** Currently, ~50% of the AUM of gold loan companies is with ticket sizes in excess of INR0.1mn. While we don't foresee absolute ban on cash disbursements, some amount based caps can't be ruled out. While the gold loan NBFCs will eventually cope up with the restriction, in the interim it can depress AUMs by 10-15% (20-25% of the 50% AUM pie where ticket size is in excess of INR 0.1mn).
2. **LTV of 60% being implemented on the earlier practice of valuing only the gold content of the jewellery:** While disbursement/gram has moderated post the regulatory developments, the decline is obviously lower than anticipated as the collateral valuation methodology shifted from just gold value appraisal to that of entire jewellery inclusive of making charges. If the regulator were to shift the valuation methodology back to the earlier standard, disbursements can see another ~15% decline from our estimates of a base case scenario. However, we don't see this panning out as RBI's definition requires collateral valuation to be done on a replacement cost basis and the process being currently followed adheres to the norms.

COMPANY UPDATE

MUTHOOT FINANCE

The gold medalist

India Equity Research | BFSI

Edelweiss
Ideas create, values protect

We like Muthoot Finance, India's largest gold loan NBFC with INR244bn AUM spread across 3,700+ branches for its franchise, brand value, employee quality and most importantly customer centricity. Hence, its leadership and ability to cope up with increasing competition from private banks is indisputable, in our view. Although the previous 5 years when AUMs clocked 75%+ CAGR with ~4% plus RoA will be difficult to see again, the business model still has immense merit. It may tread a steady 15-20% growth path, clocking 3.5%/25% RoA/RoE and benign asset quality, once it tides over the consolidation phase (likely to stretch over FY13E). It is our chosen pick to play the Indian gold loan story. We initiate with 'BUY'.

- **Branch locations: Prominent and easily accessible, mainly in commercial centres**
  - Branches are prominent with presence on main roads in business areas. Despite competition, productivity is better (AUM/branch of INR66mn).
- **Branch setup and costs: Outlay similar to that of a private bank**
  - Rent on the higher side given prominent locations, the benefit of which is reflected well in the brand recall that it has in the vicinity.
  - Running cost at ~INR1,25,000/month with rural branches at INR50,000/month and urban ones at INR2,00,000/ month.
- **Number of schemes: Reduction seen post regulatory changes**
  - Post regulatory changes, number of schemes are reduced from 9 to 5, with more focus on higher yielding higher LTV products.
- **Customer feedback: High customer satisfaction**
  - Unawareness/reluctance towards banks due to fear of documentation and increased turnaround time. Customers tend to stick with Muthoot.
- **Employee quality: Quality and experience reflected in higher employee cost**
  - Relatively more experienced staff: Branch managers primarily retired bank employees. Muthoot does not follow a practice of frequent rotation.
  - Mandatory 2 weeks training at HO with 3 months on-the-job training. Per employee cost at INR0.2mn/year vis-à-vis INR0.16/year at Manappuram.
- **Security: Armed guard at few locations in South; no direct link to police station**
  - No direct alarm linkage to local police station, but patrolling happens once in a day. Though armed guards are stationed based on AUM strength, in South India they were seen only in few branches.
  - Regular appraisals by auditors besides online monitoring by in-house system.
- **Auction rates: Very low due to monthly repayment insistence**
  - This is due to constant reminders and insistence on monthly interest payment.
- **Other activities: Money transfer, gold coins, insurance, fund raising via NCDs**

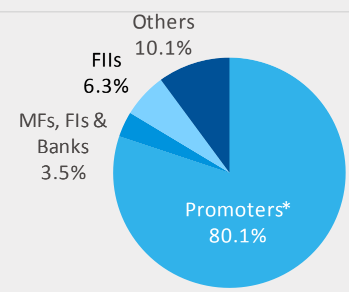
EDELWEISS 4D RATINGS

Absolute Rating	**BUY**
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Equalweight

MARKET DATA *(R: MUTT.BO, B: MUTH IN)*

CMP	: INR 140
Target Price	: INR 185
52-week range (INR)	: 198 / 105
Share in issue (mn)	: 371.7
M cap (INR bn/USD mn)	: 52 / 913
Avg. Daily Vol.BSE/NSE('000)	: 487.3

SHARE HOLDING PATTERN (%)



** Promoters pledged shares : NIL*
(% of share in issue)

RELATIVE PERFORMANCE (%)

	Sensex	Stock	Stock over Sensex
1 month	2.8	(11.0)	(13.8)
3 months	(1.0)	1.5	2.5
12 months	(8.3)	17.6	25.9

Kunal Shah
+91 22 4040 7579
kunal.shah@edelcap.com

Nilesh Parikh
+91 22 4063 5470
nilesh.parikh@edelcap.com

Suruchi Chaudhary
+91 22 6623 3316
suruchi.chaudhary@edelcap.com

June 27, 2012

Chart 1: Rapid AUM accretion seen..

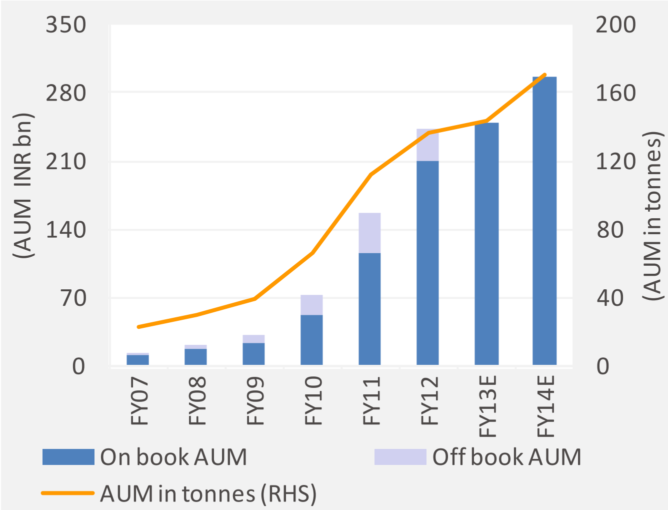


Chart 2: ..from continuous branch and headcount addition

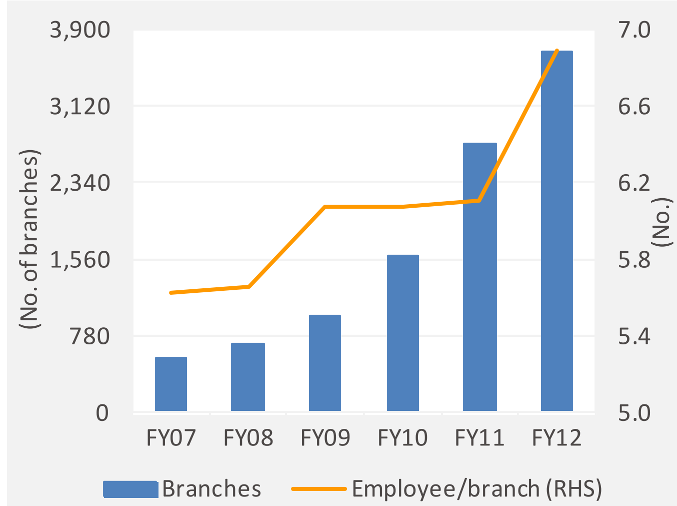


Chart 3: 56% of the branches are less than 2 yr old..

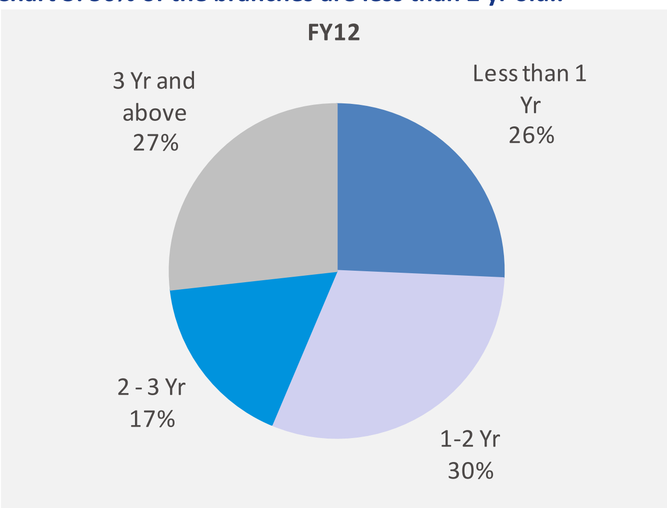


Chart 4: ..and so was the profile in FY10 as well..

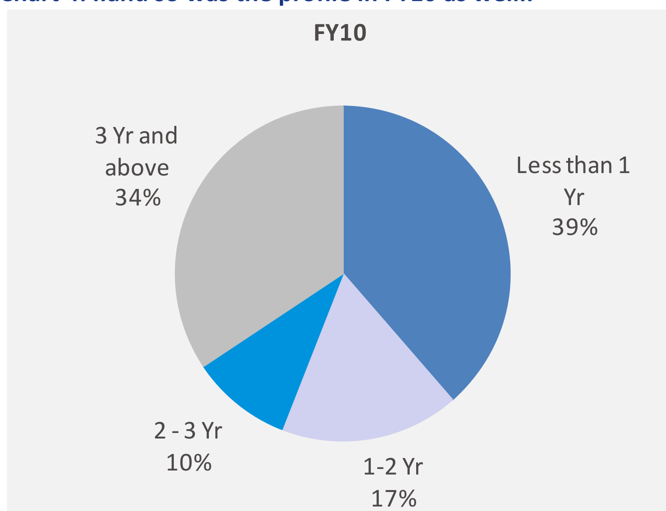
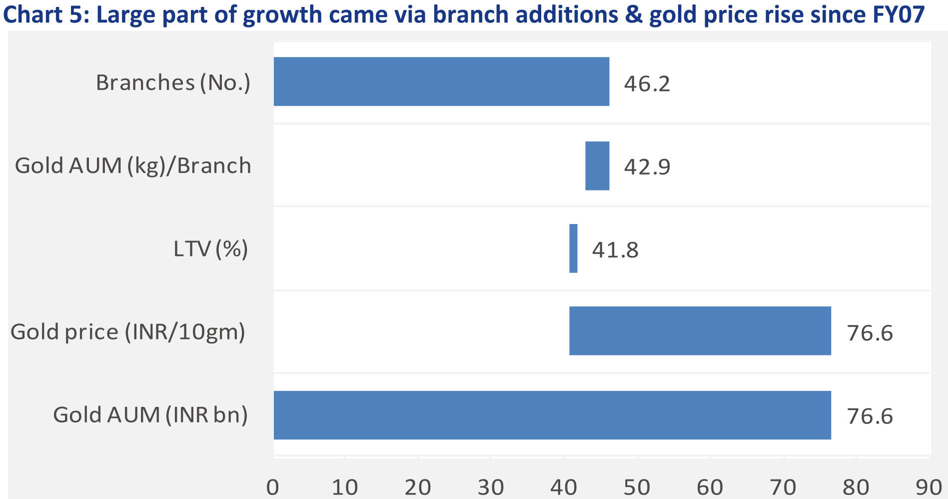


Chart 5: Large part of growth came via branch additions & gold price rise since FY07



Source: Company, Edelweiss research

Chart 6: While South India continues to be dominant..

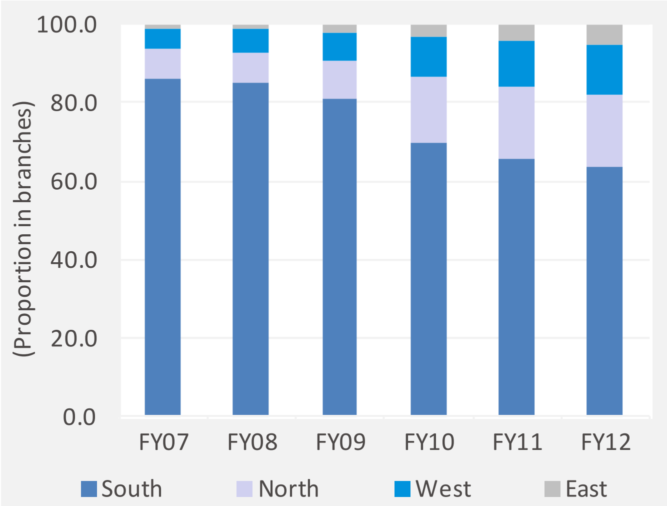


Chart 7:.. expansion seen in newer geographies as well..

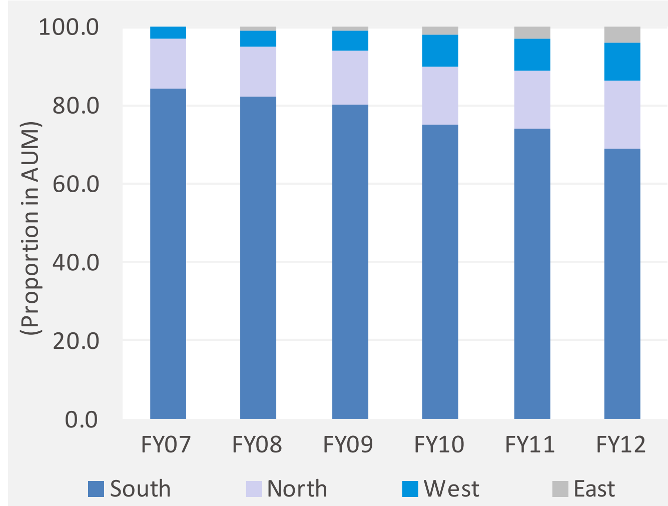


Chart 8: Productivity is the best for Muthoot amongst competitors

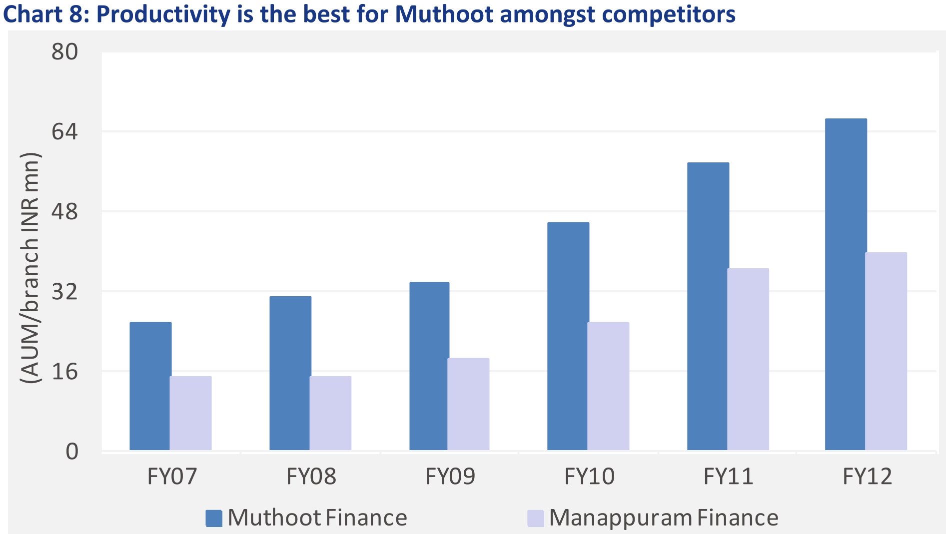


Chart 9: CoF decline will aid NIMs in FY14E..

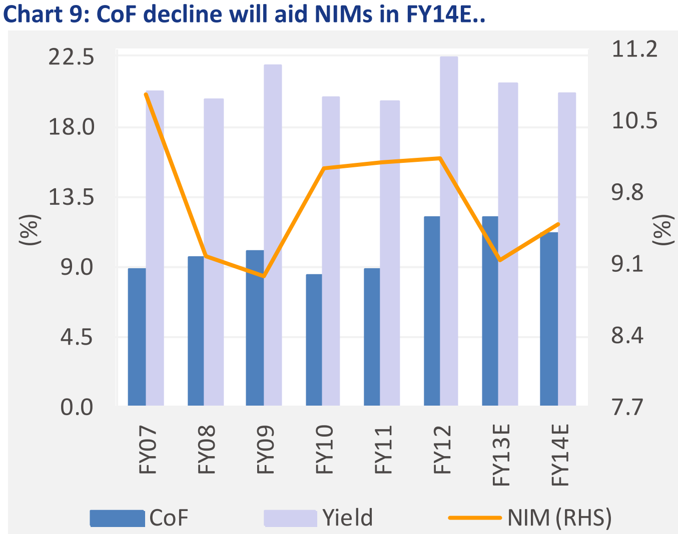
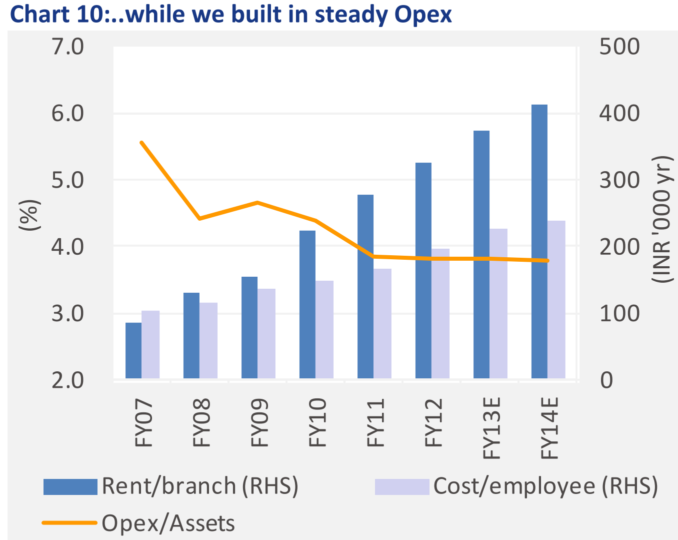


Chart 10:..while we built in steady Opex



Source: Company, Edelweiss research

Chart 11: Steady state RoA/RoE seen at 3.5%/25%

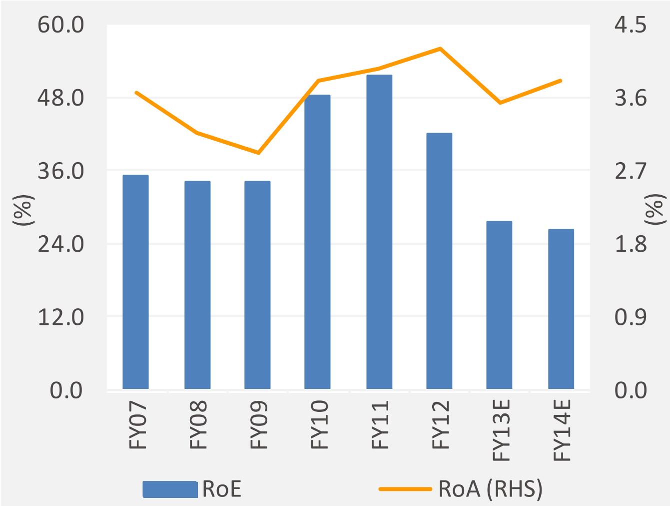


Chart 12: 12% Tier 1 will see reduction in leverage levels

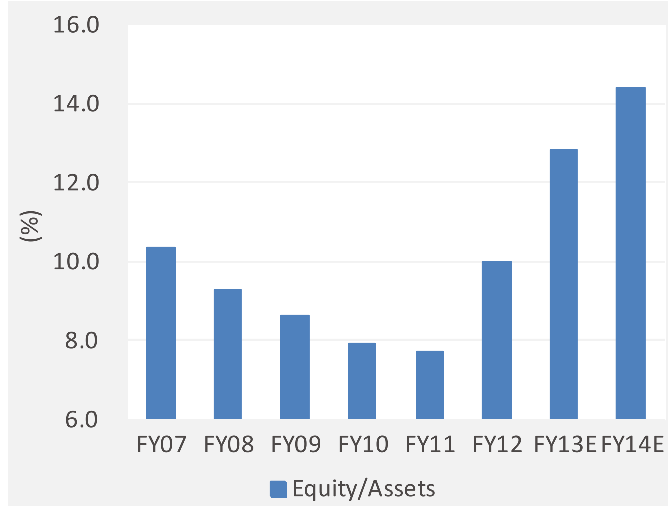


Chart 13: Tier 1 has always been closer to the regulatory norms

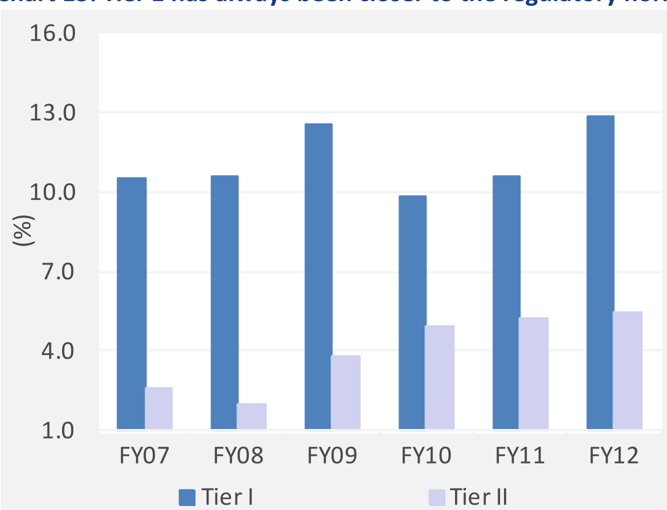


Chart 14: Borrowing profile has dominance of bank funding

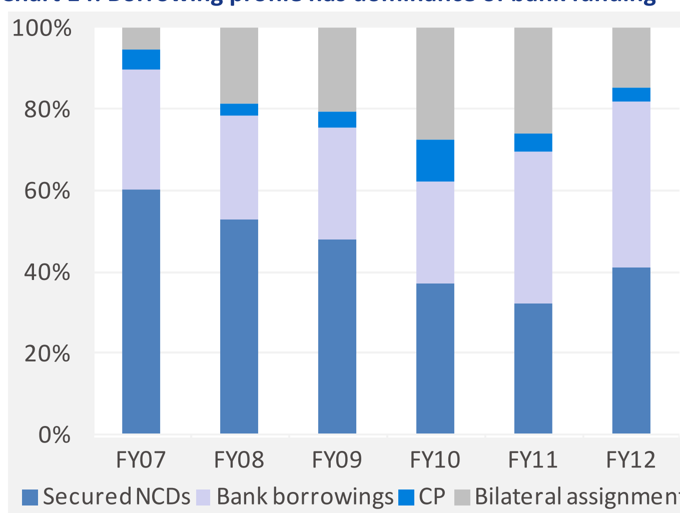
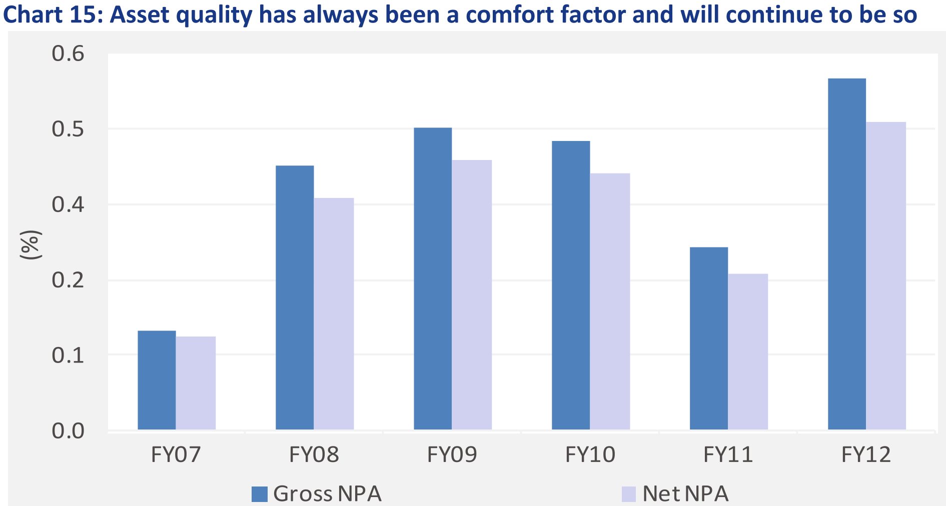


Chart 15: Asset quality has always been a comfort factor and will continue to be so



Source: Company, Edelweiss research

COMPANY UPDATE

MANAPPURAM FINANCE

Still the gold standard

India Equity Research | BFSI

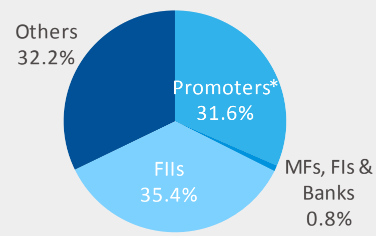
Manappuram Finance, with INR116bn AUM spread across 2900+ branches, has been the fastest player with AUM CAGR of ~90% over past 5 years. NIMs too have been at an enviable 13-14%, translating into RoA/RoE of 4.5%+/27%+. Recent 3-4 months have been turbulent, as along with regulatory upheavals, it bore RBI's brunt as its branches were being wrongly used to raise deposits for Manappuram Agro (promoter owned entity). This led to funding pressures, especially from the CP route (now sorted, as CRISIL has put it back to 'Stable' grade). A 0.8x FY13E P/B, factors in a fair bit of concerns and is attractive for RoA/RoE of 4%/20% with steady growth. Upgrade to 'BUY' with a target price of INR 41, valuing at 1x FY14E P/BV.

- **Branch locations: Strong presence in commercial centers, close to competitors**
  - Surrounded closely by competition, its focus is more on branch opening, as reflected in AUM/branch of INR40mn vis-à-vis INR66mn for Muthoot.
- **Branch setup and costs: Not so prominent locations; mainly on first floor**
  - Rent is lower, at INR19-20K/month vis-à-vis INR 25-27K/month for Muthoot.
  - Branch setup reflects expenses being skewed towards advertisements than on setups, advertisement to opex at 16% of FY12 vis-à-vis 10% for Muthoot.
- **Number of schemes: Only few schemes on offer post regulatory changes**
  - Regulatory changes coincided with ratings being put on 'Watch' by CRISIL which is now restored back to 'Stable'. However, funding constraint further ensured that loans are being given only under higher rate schemes.
- **High customer satisfaction**
  - Many customers are not aware of similar loans by banks at 7-10% lower rates.
  - Reluctance to shift to banks to avoid documentation, higher turnaround time.
- **Employee quality: Characterised by young staff, frequent rotation**
  - Young, less experienced staff relative to Muthoot. Practice of frequent transfers leading to loss of customer touch and attrition.
  - Training lasts for 2 days at time of joining. Per employee cost lower at INR0.16mn/year vis-à-vis INR0.2/year at Muthoot.
- **Risk management processes: Ensures processes and safety of collateral**
  - Alarm system linked to HO and police station. Security guards are stationed at all the branches. Armed guards are provided as per the AUM.
  - Appraisals by external auditors supplement the risk management along with live monitoring of loan approvals/disbursals via internal software, 'dot net'.
- **Auction rates: High compared to competition at 5-6%**
  - Historically higher LTV and shorter duration of loans led to higher auctions.
- **Other activities: Money transfer, foreign exchange**

EDELWEISS 4D RATINGS	
Absolute Rating	BUY
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Equalweight

MARKET DATA *(R: MGFL.BO, B: MGFL IN)*	
CMP	: INR 33
Target Price	: INR 41
52-week range (INR)	: 69 / 19
Share in issue (mn)	: 841.1
M cap (INR bn/USD mn)	: 28 / 485
Avg. Daily Vol.BSE/NSE('000)	: 3,606.8

SHARE HOLDING PATTERN (%)



** Promoters pledged shares (% of share in issue)* : *NIL*

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Banks and Financial Services Index
1 month	(0.3)	3.5	5.8
3 months	29.6	(4.8)	(4.8)
12 months	11.8	(5.6)	(4.0)

Kunal Shah
+91 22 4040 7579
kunal.shah@edelcap.com

Nilesh Parikh
+91 22 4063 5470
nilesh.parikh@edelcap.com

Suruchi Chaudhary
+91 22 6623 3316
suruchi.chaudhary@edelcap.com

June 27, 2012

Chart 1: Highest AUM CAGR within the industry..

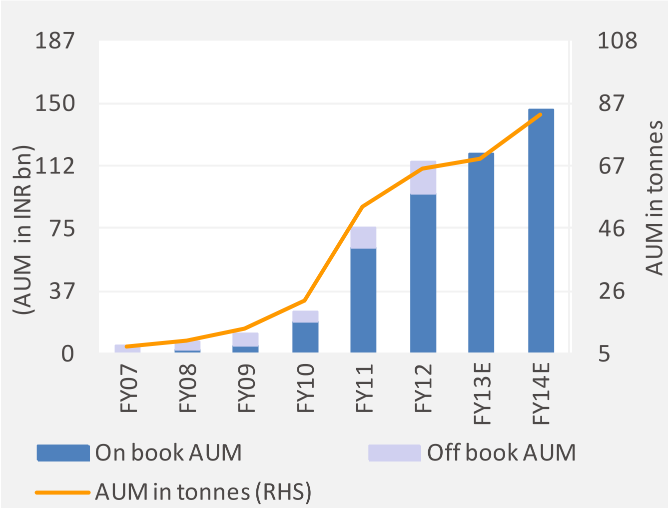


Chart 2:..buoyed by rapid branch expansion

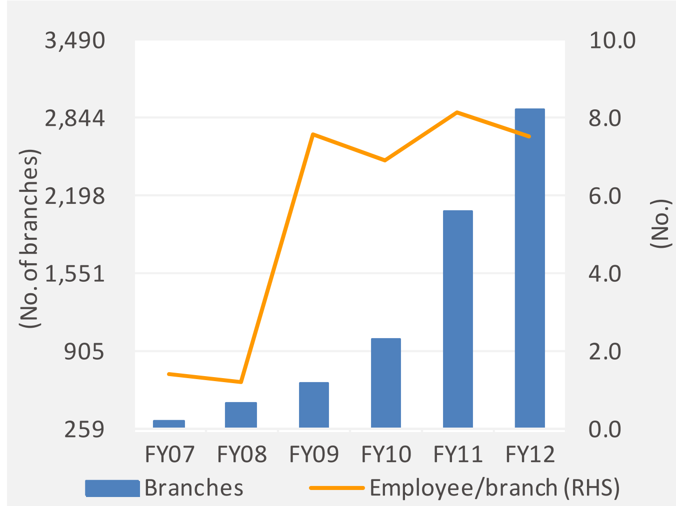


Chart 3: Two thirds of the branches are less than 2yr old..

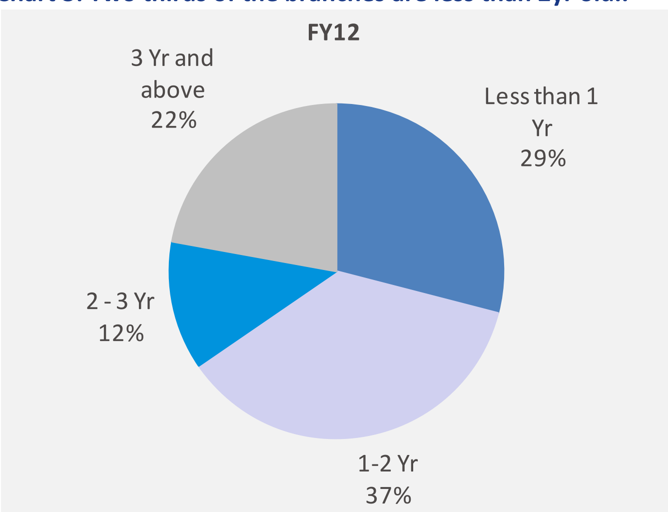


Chart 4:..up from 53% as on FY10

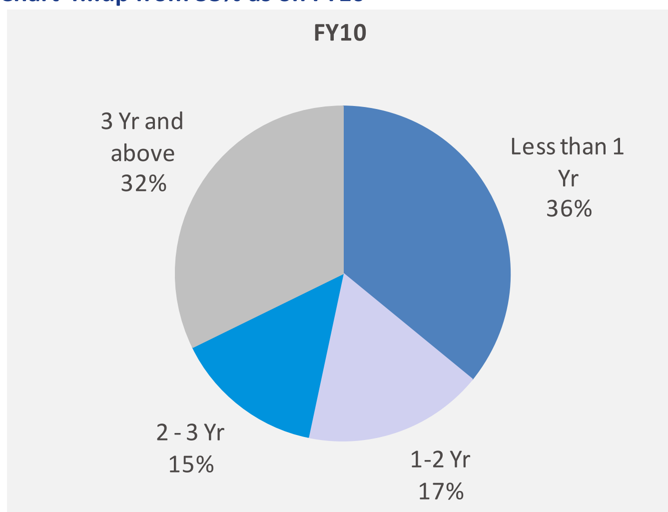
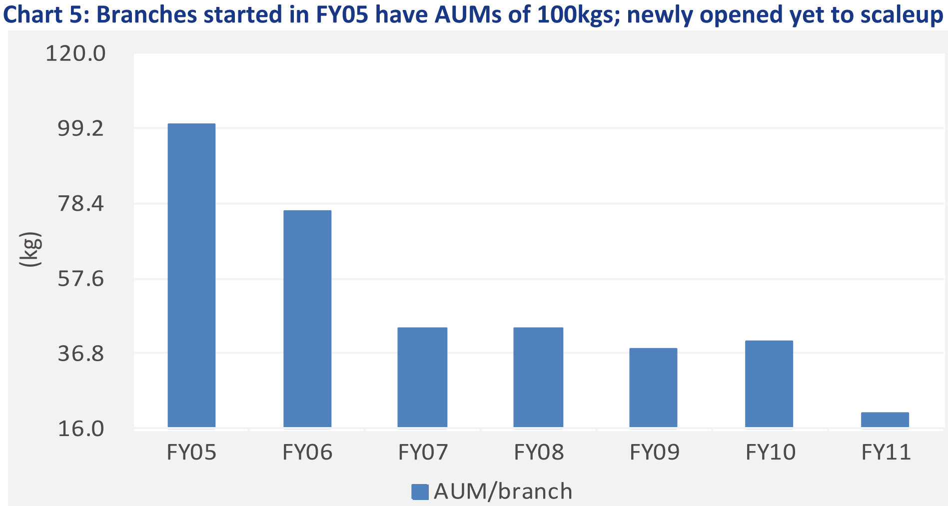


Chart 5: Branches started in FY05 have AUMs of 100kgs; newly opened yet to scaleup



Source: Company, Edelweiss research

Chart 6: Since FY07 branch additions have been major AUM growth contributor

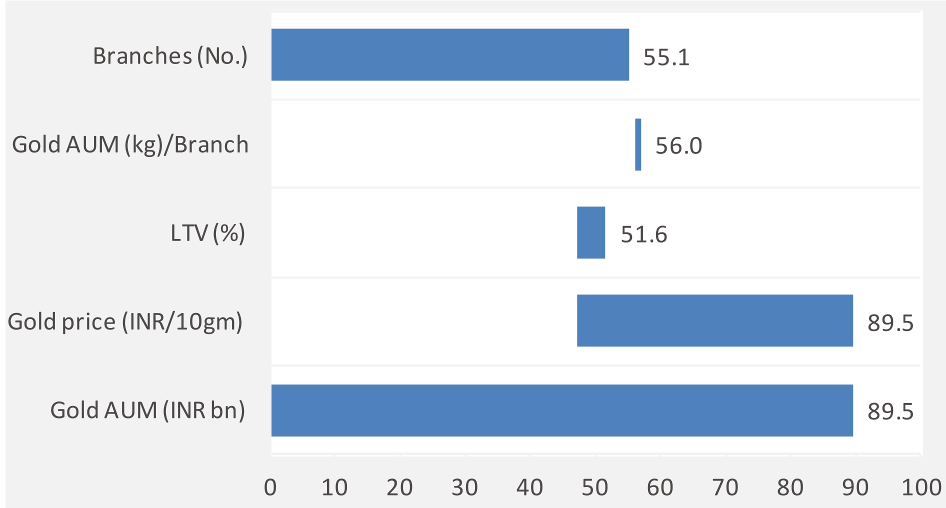


Chart 7: South India has the major chunk of branches

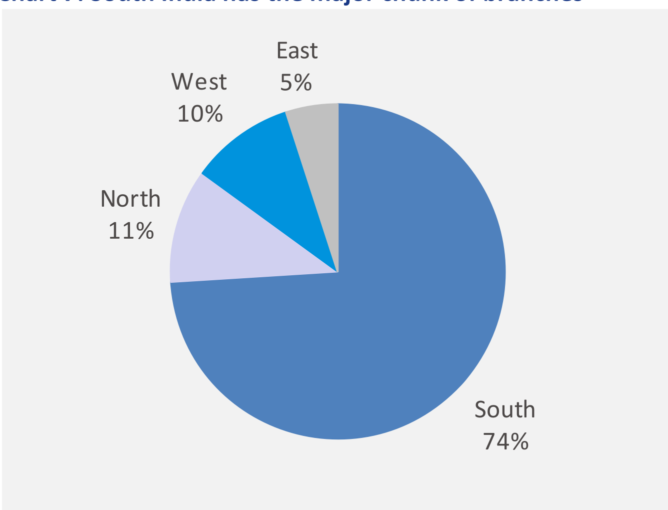


Chart 8: AUM/branch stands at INR40mn

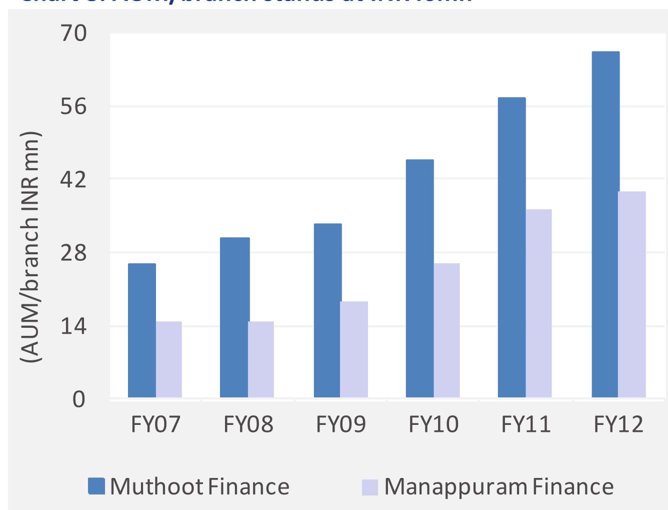


Chart 9: Steady NIMs seen at 12-13%

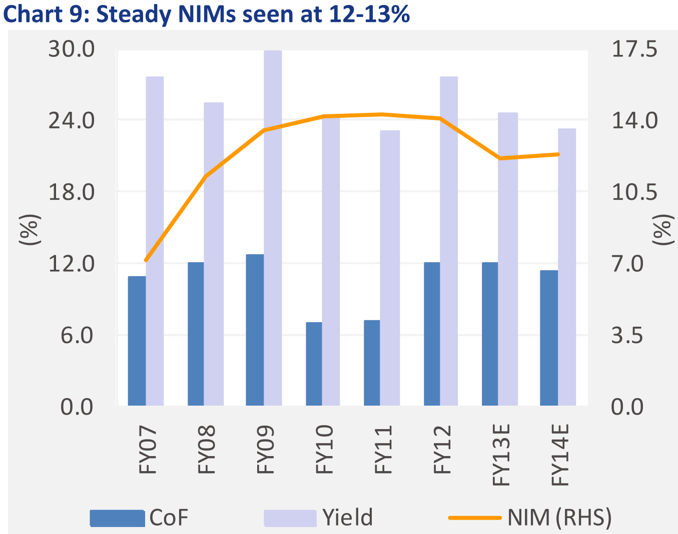
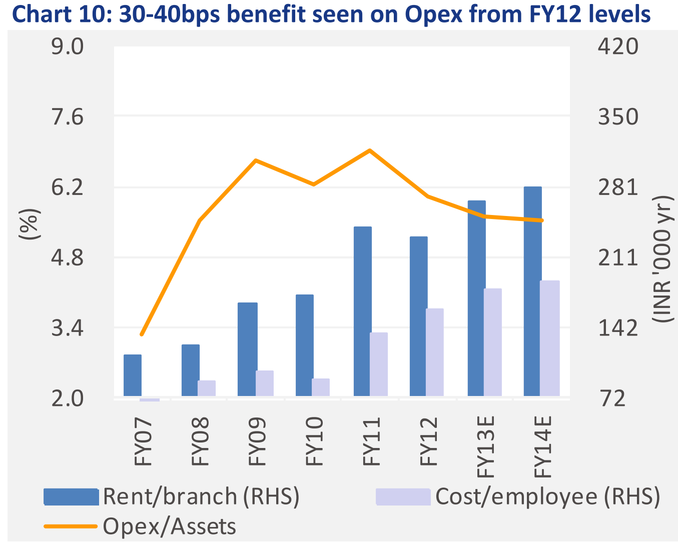


Chart 10: 30-40bps benefit seen on Opex from FY12 levels



Source: Company, Edelweiss research

Chart 11: Steady state RoA factored in at 4.5%

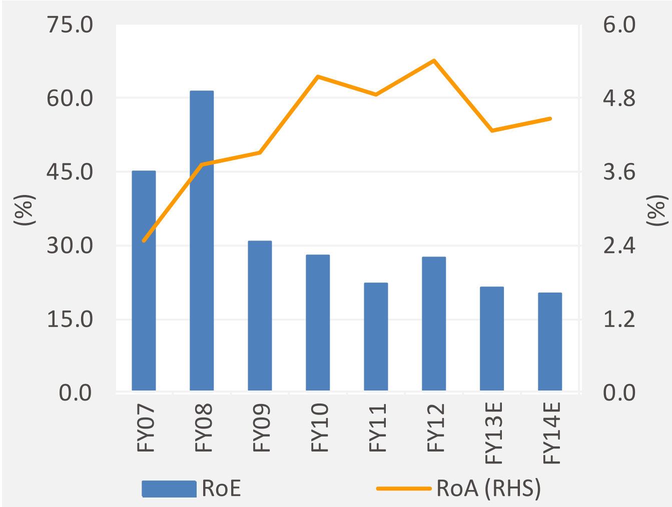


Chart 12: The company is adequately capitalized..

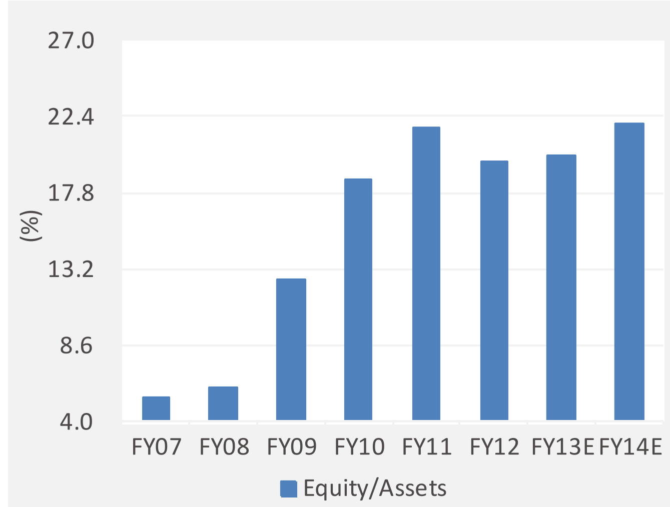


Chart 13:..as reflected in high Tier 1 against the 12% norm

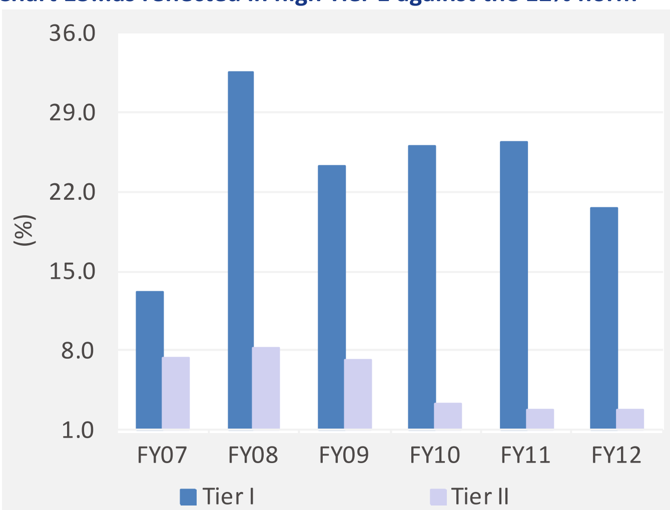


Chart 14: Bank borrowing is a major funding channel

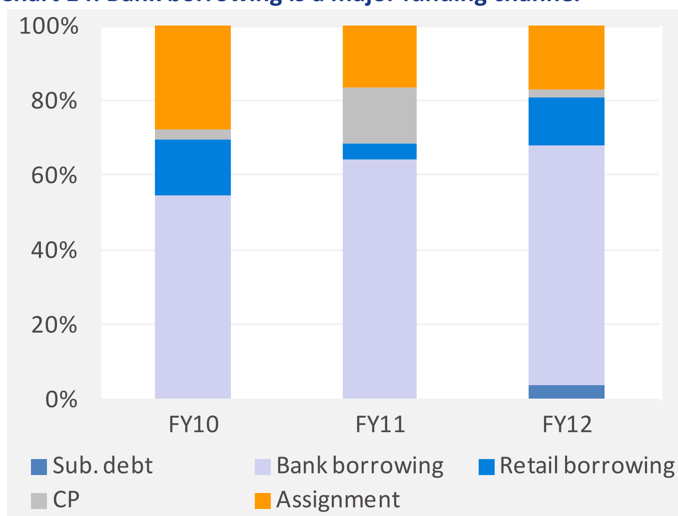
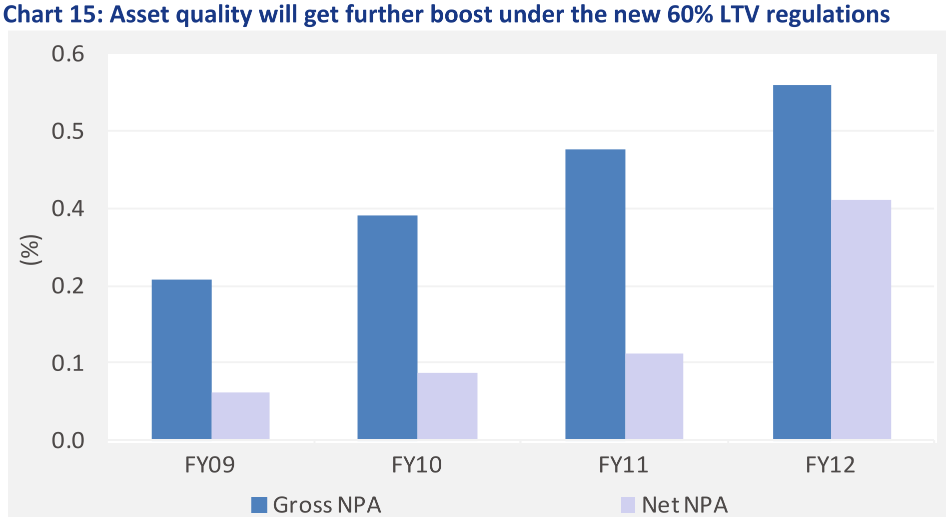


Chart 15: Asset quality will get further boost under the new 60% LTV regulations



Source: Company, Edelweiss research

Financial Statements

Income statement					(INR mn)
Year to March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Interest income	4,675	11,634	26,208	28,937	30,806
Interest charges	1,369	3,320	10,779	12,945	12,965
Net interest income	3,306	8,314	15,429	15,992	17,841
Fee & other income	107	181	351	411	431
Net revenues	3,413	8,496	15,780	16,403	18,271
Operating expense	1,453	4,032	6,597	7,435	7,949
- Employee exp	536	1,605	3,090	3,900	4,085
- Depreciation /amortisation	57	213	483	489	429
- Other opex	859	2,214	3,024	3,046	3,435
Preprovision profit	1,960	4,463	9,183	8,968	10,322
Provisions	142	224	309	541	716
PBT	1,818	4,239	8,874	8,428	9,607
Taxes	621	1,412	2,959	2,781	3,170
PAT	1,197	2,827	5,915	5,646	6,436
Reported PAT	1,197	2,827	5,915	5,646	6,436
Basic number of shares (mn)	585.3	833.8	841.1	841.1	841.1
Basic EPS (INR)	2.0	3.4	7.0	6.7	7.7
Diluted number of shares (mn)	589.0	833.8	841.1	841.1	841.1
Diluted EPS (INR)	2.0	3.4	7.0	6.7	7.7
DPS (INR)	0.5	0.5	1.5	1.3	1.5
Payout ratio (%)	16.1	20.6	21.3	20.0	20.0

Growth ratios (%)					
Year to March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Operating income growth	100.3	151.5	85.6	3.6	11.6
Net revenues growth	96.8	148.9	85.7	3.9	11.4
Opex growth	76.1	177.6	63.6	12.7	6.9
PPP growth	115.6	127.7	105.7	(2.3)	15.1
Provisions growth	(21.4)	57.9	37.8	74.9	32.4
PAT growth	150.5	136.1	109.2	(4.5)	14.0

Operating ratios (%)					
Year to March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Yield on advances	24.5	23.1	27.6	24.6	23.2
Cost of funds	7.1	7.1	12.0	12.0	11.3
Spread	17.4	16.0	15.6	12.6	11.9
Net interest margins	14.2	14.3	14.1	12.1	12.4
Cost-income	42.6	47.5	41.8	45.3	43.5
Tax rate	34.2	33.3	33.3	33.0	33.0

Balance sheet					(INR mn)
As on 31st March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Liabilities					
Equity capital	340	834	1,682	1,682	1,682
Reserves	5,765	18,406	22,128	27,559	32,463
Net worth	6,106	19,240	23,810	29,241	34,145
Subordinate debt	1,165	2,779	3,279	3,279	3,279
Secured loans	16,501	43,723	89,894	100,064	122,779
Unsecured loans	691	10,038	32	34	36
Deferred tax liability	(33)	(87)	0	(281)	(388)
Assignments	7,077	11,183	19,164	0	0
Total liabilities	**31,506**	**86,876**	**136,179**	**132,337**	**159,850**
Assets					
Loans	18,694	63,671	96,163	119,777	145,628
Investments	1,407	403	2,183	2,184	2,184
Current assets	*4,774*	*12,082*	*19,891*	*13,721*	*15,972*
Current liabilities	*1,015*	*1,911*	*3,605*	*5,364*	*5,775*
Net current assets	3,759	10,171	16,285	8,358	10,197
Fixed assets (net block)	569	1,448	2,384	2,019	1,840
Assignments	7,077	11,183	19,164	0	0
Total assets	**31,506**	**86,876**	**136,179**	**132,337**	**159,850**
Balance sheet ratios (%)					
Loan growth	107.3	190.5	54.1	3.9	21.6
Deposit growth	249.5	212.7	67.3	11.3	22.7
EA growth	98.6	176.1	56.6	(2.6)	21.2
Gross NPA ratio	0.4	0.5	0.6	0.7	0.7
Net NPA ratio	0.1	0.1	0.4	0.4	0.3
Provision coverage	70.0	70.0	42.0	50.0	55.0

RoE decomposition (%)

Year to March	FY10	FY11	FY12	FY13E	FY14E
Net interest income/Assets	14.2	14.3	14.1	12.1	12.4
Non-interest income/Assets	0.5	0.3	0.3	0.3	0.3
Net revenues/Assets	14.7	14.6	14.4	12.4	12.7
Operating expense/Assets	(6.2)	(6.9)	(6.0)	(5.6)	(5.5)
Provisions/Assets	(0.6)	(0.4)	(0.3)	(0.4)	(0.5)
Taxes/Assets	(2.7)	(2.4)	(2.7)	(2.1)	(2.2)
Total costs/Assets	(9.5)	(9.7)	(9.0)	(8.1)	(8.2)
ROA	5.1	4.9	5.4	4.3	4.5
Equity/Assets	18.5	21.8	19.6	20.1	22.0
ROAE	27.8	22.3	27.5	21.3	20.3

Valuation metrics

Year to March	FY10	FY11	FY12	FY13E	FY14E
Diluted EPS (INR)	2.0	3.4	7.0	6.7	7.7
EPS growth (%)	*306.1*	*66.8*	*107.4*	*(4.5)*	*14.0*
Book value per share (INR)	9.0	23.1	28.3	34.8	40.6
Adjusted book value per share (INR)	8.9	23.0	28.0	34.4	40.2
Diluted P/E (x)	16.2	9.7	4.7	4.9	4.3
Price/ BV (x)	3.7	1.4	1.2	0.9	0.8
Price/ Adj. BV (x)	3.7	1.4	1.2	1.0	0.8
Dividend yield (%)	1.5	1.4	4.5	4.1	4.6

COMPANY UPDATE

FEDERAL BANK

To shine under regulator's heat

India Equity Research | BFSI

Federal Bank, despite being in the hub of the gold loan industry, has become aggressive recently. Current gold loan book stands at INR36bn, 9.8% of its advances. While all the 950 branches offer gold loans, the proportion was higher in the urban centres during our branch visits. Being a bank, given regulatory approvals needed for branch expansion, it has relatively lower presence compared with other NBFCs. However, its subsidiary, Fedfina, an NBFC, is making rapid progress since September 2011 when it got the license and has INR3.1bn loans across 130 branches. While corporate level advertisements have increased to educate customers about the banks higher LTV and lower interest rate product, focused efforts at branch level can lead to better results. Maintain 'BUY'.

- **Branch locations: In main areas only in a particular city, town or village**
  - Locations selected keeping overall banking, i.e. lending and deposit mobilization in mind than just gold loans.
- **Branch setup: Very few branches were seen with an exclusive gold loan counter**
  - Quite a few branches have seen increased gold loan activity, leading to manpower being channelized for gold loan transactions.
  - At few places advertisements can be located, inside and outside the branch.
- **Number of schemes: Variety of schemes to suit various customer classes**
  - Schemes with different LTVs, duration, rates and maximum disbursements depending on the end use, i.e. business, agri or personal.
  - Against the perception, gold loans are disbursed within 15-20 minutes.
- **Lower rates a differentiator**
  - Of late, larger ticket size customers using gold loans for cash flow mismatches in business are seen shifting to banks to save on interest costs.
  - Few managers seen pushing gold loan as a onetime WCap financing product.
- **Employee quality: Stable employee base reduces risk of fraud**
  - Since employees at banks intend to stay with the bank for a long duration, there is minimal risk of fraudulent activities carried out by them.
- **Risk management processes: Regular branch setup ensures adequate security**
  - Monitoring by the bank managers and CBS ensures that disbursals are in line with stated policies. Jewelry appraisal is outsourced, if required.
  - While it insists on account opening, it is not binding for loans of certain limit.
- **Auction rates: At minimal levels given adequate time is provided to repay**
  - The customer having an account with the bank in most cases is an added advantage in ensuring superior asset quality.

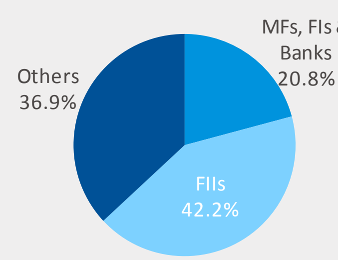
EDELWEISS 4D RATINGS

Absolute Rating	**BUY**
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Equalweight

MARKET DATA *(R: FED.BO, B: FB IN)*

CMP	: INR 445
Target Price	: INR 535
52-week range (INR)	: 480 / 322
Share in issue (mn)	: 171.0
M cap (INR bn/USD mn)	: 76 / 1,330
Avg. Daily Vol.BSE/NSE('000)	: 396.4

SHARE HOLDING PATTERN (%)



** Promoters pledged shares (% of share in issue) : NIL*

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Banks and Financial Services Index
1 month	5.2	3.5	5.8
3 months	(0.9)	(4.8)	(4.8)
12 months	(1.6)	(5.6)	(4.0)

Nilesh Parikh
+91 22 4063 5470
nilesh.parikh@edelcap.com

Kunal Shah
+91 22 4040 7579
kunal.shah@edelcap.com

Suruchi Chaudhary
+91 22 6623 3316
suruchi.chaudhary@edelcap.com

June 27, 2012

Fig. 1: Various schemes to suit demands of a varied set of customers – Business, consumption and emergency purposes

Express Gold loan – Personal/Business	Agri gold loan	Ashwas Gold loan – Distressed farmers/artisans	Business Gold loan	Easy Gold – Personal/Business
Loan amount from Rs 5000 to a maximum of Rs 75 lakhs	Loan amount up to a maximum of Rs 10 Lakhs	Loan amount up to a maximum of Rs 100000	Loan amount from Rs 50000 to a maximum of Rs 75 lakhs	Loans up to a maximum amount of Rs 5 Lakhs
Period of the loan is 66 days	Maximum period of the loan is 12 months	Maximum period of the loan is 12 months	Period of the loan is 12 months	Maximum period of the loan is 36 months
Rate per gram accounts to 80% of market value or maximum Rs 2000	Rate per gram accounts to 80% of market value subject to a maximum of Rs.1850 per gram for one year or Rs.1900 per gram for six months.	Rate per gram will be fixed by the bank with regard to market value	Rate per gram accounts to 75% / 80% / 90%, subject to market conditions and as fixed by the bank	Rate per gram accounts to 75% of the market value
Lump Sum Repayment with interest	Lump Sum Repayment with interest	Lump Sum Repayment with interest	Lump Sum Repayment with interest	Lump Sum Repayment of Principal and Interest shall be received on 31st of every March

Source: Company

Financial Statements

Income statement					(INR mn)
Year to March	FY10	FY11	FY12	FY13E	FY14E
Interest income	36,732	40,520	55,584	58,721	67,676
Interest expenses	22,624	23,055	36,050	36,161	40,972
Net interest income	14,108	17,466	19,534	22,559	26,704
Non interest income	6,287	5,168	5,323	6,338	7,010
- Fee & forex income	2,053	1,558	2,119	2,543	3,051
- Misc. income	3,153	3,153	2,385	2,796	2,959
- Investment profits	1,081	458	820	1,000	1,000
Net revenues	20,395	22,634	24,857	28,898	33,714
Operating expense	6,769	8,361	9,793	11,150	12,708
- Employee exp	3,661	4,804	5,439	6,196	7,066
- Other opex	3,109	3,557	4,354	4,954	5,642
Preprovision profit	13,626	14,273	15,065	17,748	21,006
Provisions	5,030	5,254	3,370	4,750	4,615
- Loan loss provisions	4,131	4,893	2,230	4,110	3,975
- Investment depreciation	0	28	353	90	90
- Other provisions	899	333	(131)	550	550
PBT	8,596	9,018	11,695	12,998	16,391
Taxes	3,950	3,147	3,927	4,354	5,491
PAT	4,646	5,871	7,768	8,644	10,900
Reported PAT	4,646	5,871	7,768	8,644	10,900
EPS (INR)	27.2	34.3	45.4	50.5	63.7
DPS (INR)	5.0	6.0	9.0	10.0	10.0
Payout ratio (%)	18.4	17.5	19.8	19.8	15.7

Growth ratios (%)					
Year to March	FY10	FY11	FY12	FY13E	FY14E
NII growth	7.3	23.8	11.8	15.5	18.4
Fees growth	0.6	(24.1)	36.0	20.0	20.0
Opex growth	18.5	23.5	17.1	13.9	14.0
PPOP growth	6.7	10.1	3.1	17.6	19.5
PPP growth	8.2	4.7	5.6	17.8	18.4
Provisions growth	7.8	4.5	(35.9)	41.0	(2.8)
PAT growth	(7.2)	26.4	32.3	11.3	26.1

Operating ratios (%)					
Year to March	FY10	FY11	FY12	FY13E	FY14E
Yield on advances	11.6	10.8	12.0	11.5	11.0
Yield on investments	6.3	5.9	5.9	5.9	6.0
Yield on assets	9.1	8.7	10.2	9.3	9.1
Net interest margins	3.5	3.8	3.6	3.6	3.6
Cost of funds	6.1	5.4	7.1	6.1	5.9
Cost of deposits	6.4	5.5	7.3	6.1	5.8
Cost of borrowings	6.8	6.6	7.7	7.6	7.2
Spread	3.0	3.3	3.1	3.1	3.2
Cost-income	33.2	36.9	39.4	38.6	37.7
Tax rate	46.0	34.9	33.6	33.5	33.5

Balance sheet					(INR mn)
As on 31st March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Liabilities					
Equity capital	1,710	1,711	1,711	1,711	1,711
Reserves	45,136	49,318	55,294	62,216	70,944
Net worth	46,846	51,028	57,005	63,926	72,654
Deposits	360,580	430,148	489,371	567,732	665,182
Borrowings	15,468	18,884	42,410	57,410	81,410
Other liabilities	15,272	14,446	17,423	6,771	10,899
Total	**438,165**	**514,506**	**606,209**	**695,839**	**830,146**
Assets					
Loans	269,501	319,532	377,560	449,296	539,155
Investments					
Gilts	*92,783*	*107,614*	*133,577*	*156,294*	*186,656*
Others	*37,763*	*37,763*	*40,448*	*43,349*	*46,493*
Cash & equi	27,234	37,483	35,326	32,233	37,885
Fixed assets	2,839	2,840	3,203	2,962	2,690
Other assets	8,044	9,273	16,096	11,705	17,267
Total	**438,165**	**514,506**	**606,209**	**695,839**	**830,146**
Balance sheet ratios (%)					
Credit growth	19.9	18.1	18.1	18.9	19.9
Deposit growth	12.0	19.3	13.8	16.0	17.2
EA growth	12.6	17.6	16.8	16.1	18.9
SLR ratio	24.7	24.3	24.0	25.0	25.0
C-D ratio	76.9	76.1	79.0	81.0	82.9
Low-cost deposits	26.2	38.1	27.5	27.5	27.5
Gross NPA ratio	3.0	3.5	3.4	3.2	2.9
Net NPA ratio	0.5	0.6	0.5	0.5	0.5
Provision coverage	84.3	85.4	84.7	83.2	82.9
Incremental slippage	3.3	4.3	3.6	3.0	2.8
Net NPA / Equity	2.7	3.7	3.5	3.8	3.8
Capital adequacy	18.3	16.4	14.8	13.4	12.1
- Tier 1	16.2	14.8	13.5	12.3	11.2
Book value	274	298	333	374	425

ROA decomposition (%)					
Year to March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Net interest income/Assets	3.5	3.8	3.59	3.56	3.58
Fees/Assets	1.3	1.0	0.8	0.8	0.8
Investment profits/Assets	0.3	0.1	0.2	0.2	0.1
Net revenues/Assets	5.1	4.9	4.6	4.6	4.5
Operating expense/Assets	(1.7)	(1.8)	(1.8)	(1.8)	(1.7)
Provisions/Assets	(1.2)	(1.1)	(0.6)	(0.7)	(0.6)
Taxes/Assets	(1.0)	(0.7)	(0.7)	(0.7)	(0.7)
Total costs/Assets	(3.9)	(3.6)	(3.1)	(3.2)	(3.1)
ROA	1.2	1.3	1.4	1.4	1.5
Equity/Assets	11.2	10.5	9.9	9.5	9.2
ROAE	10.3	12.0	14.4	14.3	16.0

Valuation metrics

Year to March	FY10	FY11	FY12	FY13E	FY14E
Diluted EPS (INR)	27.2	34.3	45.4	50.5	63.7
EPS growth (%)	*(7.2)*	*26.4*	*32.3*	*11.3*	*26.1*
Book value per share (INR)	273.9	298.3	333.3	373.7	424.8
Adjusted book value/share (INR)	268.6	290.5	325.1	363.7	413.6
Diluted P/E (x)	16.4	13.0	9.8	8.8	7.0
Price/ BV (x)	1.6	1.5	1.3	1.2	1.0
Price/ ABV (x)	1.7	1.5	1.4	1.2	1.1
Dividend yield (%)	*1.1*	*1.3*	*2.0*	*2.2*	*2.2*
Price to income (x)	9.2	9.2	8.6	7.4	6.5
Price to PPOP (x)	6.1	5.5	5.3	4.5	3.8

THIS PAGE IS INTENTIONALLY LEFT BLANK

COMPANY UPDATE

SOUTH INDIAN BANK

Near saturation point

India Equity Research | BFSI

South Indian Bank (SIB) has a substantial portion of its advances in the form of gold loans at 24% (internal cap set at 30%). However, our branch visits revealed that only the South India based branches have been generating gold loans. The loans are given out for PSL, personal needs and to meet working capital expenses. Given that gold loans already form a large portion of the book, we barely came across any advertisement of the product either at the corporate level or at branch level. While the recent regulatory changes surely make the bank's products attractive given lower interest rate, inability to sizably scale the book will be a constraint. We prefer Federal Bank over SIB to play gold loan story.

- **Branch locations: Gold loans carried out mostly from South India branches**
  - Even though the bank has presence elsewhere, gold loans outside of South India were negligible.
- **Branch setup: Handful of large commercial branches seen with exclusive counter**
  - In busy commercial centers of South India, managers were seen focused on gold loans with handful of branches having exclusive counters.
  - Very little done at local branch level to advertise the product.
- **Number of schemes: Two main schemes on offer**
  - The bank offers 'Gold Power' and 'Gold Rush', which essentially provide overdraft against pledge of gold and outright loans respectively.
- **Lower rates a differentiator but saturated book a concern**
  - Of late, larger ticket size customers using gold loans for business cash flow mismatch are seen shifting to banks to save on interest costs.
  - With gold loans forming ~25% of overall loans, few managers seen pushing it.
- **Employee quality: Stable employee base reduces risk of fraud by employees**
  - Since employees stay with the bank for a long duration there is minimal risk of fraud by them.
  - Various high ticket banking products are on offer; hence, priority, urgency and ownership to offer low ticket gold loan was lacking at some branches.
- **Risk management processes: Regular branch setup ensures adequate security**
  - Monitoring by bank managers and CBS ensures that disbursals are in line with stated policies. Jewelry appraisal is outsourced, if required.
  - Collateral safety is ensured as bank lockers are used for storing gold.
- **Auction rates: Very marginal given other banking relations**
  - Customer having an account with the bank in most cases is an added advantage in ensuring superior asset quality.

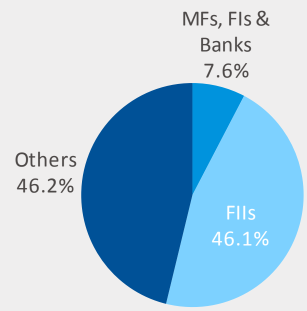
EDELWEISS 4D RATINGS

Absolute Rating	**HOLD**
Rating Relative to Sector	Performer
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Equalweight

MARKET DATA *(R: SIBK.BO, B: SIB IN)*

CMP	:	INR 24
Target Price	:	INR 26
52-week range (INR)	:	30 / 18
Share in issue (mn)	:	1,135.0
M cap (INR bn/USD mn)	:	27 / 466
Avg. Daily Vol.BSE/NSE('000)	:	3,056.6

SHARE HOLDING PATTERN (%)



** Promoters pledged shares (% of share in issue)* : *11.3*

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Banks and Financial Services Index
1 month	7.3	3.5	5.8
3 months	(4.0)	(4.8)	(4.8)
12 months	(4.4)	(5.6)	(4.0)

Nilesh Parikh
+91 22 4063 5470
nilesh.parikh@edelcap.com

Kunal Shah
+91 22 4040 7579
kunal.shah@edelcap.com

Suruchi Chaudhary
+91 22 6623 3316
suruchi.chaudhary@edelcap.com

June 27, 2012

Financial Statements

Income statement					(INR mn)
Year to March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Interest income	19,357	24,460	35,834	41,752	49,025
Interest expenses	13,681	16,549	25,617	29,310	33,693
Net interest income	5,676	7,911	10,217	12,443	15,333
Non interest income	2,085	1,967	2,473	2,910	3,309
- Fee & forex income	504	545	640	736	847
- Misc. income	800	1,038	1,423	1,724	2,012
- Investment profits	781	384	410	450	450
Net revenues	7,760	9,878	12,690	15,353	18,642
Operating expense	3,662	4,625	6,173	7,108	8,613
- Employee exp	2,263	2,898	3,741	4,222	5,234
- Other opex	1,399	1,727	2,432	2,886	3,378
Preprovision profit	4,099	5,253	6,517	8,245	10,029
Provisions	433	798	792	1,363	1,643
- Loan loss provisions	371	280	692	1,213	1,493
- Investment depreciation	(409)	0	0	50	50
- Other provisions	471	518	100	100	100
PBT	3,666	4,455	5,725	6,882	8,387
Taxes	1,335	1,529	1,707	2,202	2,684
PAT	2,331	2,926	4,018	4,680	5,703
Reported PAT	2,331	2,926	4,018	4,680	5,703
Diluted EPS	2.1	2.6	3.5	4.1	5.0
DPS	0.4	0.5	0.6	0.6	0.6
Payout ratio (%)	22.5	22.4	22.5	22.5	22.5

Growth ratios (%)					
Year to March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
NII growth	8.7	39.4	29.2	21.8	23.2
Fees growth	(9.7)	8.2	17.6	15.0	15.0
Opex growth	11.7	26.3	33.5	15.1	21.2
PPOP growth	1.9	46.7	25.4	27.6	22.9
PPP growth	13.2	28.2	24.1	26.5	21.6
Provisions growth	(28.6)	84.2	(0.7)	72.1	20.5
PAT growth	19.7	25.5	37.4	16.5	21.9

Operating ratios (%)					
Year to March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Yield on advances	11.0	10.6	12.0	11.3	10.9
Yield on investments	5.8	6.1	6.3	6.3	5.9
Yield on assets	8.6	8.6	10.1	9.6	9.3
Net interest margins	2.5	2.8	2.9	2.9	2.9
Cost of funds	6.3	6.0	7.4	7.0	6.6
Cost of deposits	6.5	6.1	7.6	7.1	6.7
Cost of borrowings	7.5	9.5	9.0	8.5	8.0
Spread	2.3	2.6	2.7	2.6	2.7
Cost-income	47.2	46.8	48.6	46.3	46.2
Tax rate	36.4	34.3	29.8	32.0	32.0

Balance sheet					(INR mn)
Year to March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Liabilities					
Equity capital	1,130	1,130	1,134	1,134	1,134
Reserves	13,542	15,827	19,054	22,680	27,098
Net worth	14,672	16,957	20,188	23,814	28,232
Sub bonds/pref cap	3,300	2,650	3,150	3,650	4,150
Deposits	230,115	297,211	365,005	442,220	541,644
Borrowings	10	254	2,732	2,732	2,732
Other liabilities	7,063	9,615	11,109	12,211	13,680
Total	**255,160**	**326,686**	**402,184**	**484,626**	**590,438**
Assets					
Loans	158,229	204,887	272,807	335,553	412,730
Investments					
Gilts	56,410	68,027	69,712	83,842	102,244
Others	15,146	21,211	24,286	26,614	29,174
Cash & equi	19,877	24,661	26,405	31,203	38,202
Fixed assets	1,345	2,052	2,259	2,383	2,479
Other assets	4,153	5,848	6,714	5,032	5,609
Total	**255,160**	**326,686**	**402,184**	**484,626**	**590,438**
Balance sheet ratios (%)					
Credit growth	31.7	28.9	33.1	23.0	23.0
Deposit growth	27.2	29.2	22.8	21.2	22.5
EA growth	25.1	27.7	23.3	21.4	22.0
SLR ratio	24.5	22.9	19.0	18.8	18.8
C-D ratio	69.3	69.2	75.0	76.1	76.4
Low-cost deposits	23.1	21.5	19.7	20.0	20.4
Gross NPA ratio	1.3	1.1	1.0	1.1	1.2
Net NPA ratio	0.4	0.3	0.3	0.4	0.4
Provision coverage	70.8	73.9	71.4	68.5	68.3
Incremental slippage	1.1	0.5	0.6	1.0	0.9
Capital adequacy	14.7	14.0	14.0	11.6	11.3
- Tier 1	11.9	11.3	11.5	11.4	11.1
Book value (INR)	13.0	15.0	17.8	21.0	24.9

ROA decomposition (%)

Year to March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Net interest Income/Assets	2.5	2.8	2.9	2.9	2.9
Fees/Assets	0.6	0.6	0.6	0.6	0.5
Investment profits/Assets	0.3	0.1	0.1	0.1	0.1
Net revenues/Assets	3.5	3.5	3.6	3.5	3.5
Operating expense/Assets	(1.6)	(1.6)	(1.7)	(1.6)	(1.6)
Provisions/Assets	(0.2)	(0.3)	(0.2)	(0.3)	(0.3)
Taxes/Assets	(0.6)	(0.5)	(0.5)	(0.5)	(0.5)
Total costs/Assets	(2.4)	(2.4)	(2.4)	(2.5)	(2.4)
ROA	1.0	1.0	1.1	1.1	1.1
Equity/Assets	6.1	5.6	5.2	5.1	4.9
ROAE	16.9	18.5	21.6	21.3	21.9

Valuation metrics

Year to March	FY10	FY11	FY12	FY13E	FY14E
Diluted EPS (INR)	2.1	2.6	3.5	4.1	5.0
EPS growth (%)	19.7	25.5	36.9	16.5	21.9
Book value per share (INR)	13.0	15.0	17.8	21.0	24.9
Adjusted book value/share (x)	12.6	14.6	17.3	20.3	24.0
Diluted P/E (x)	11.4	9.1	6.6	5.7	4.7
Price/ BV (x)	1.8	1.6	1.3	1.1	0.9
Price/ ABV (x)	1.9	1.6	1.4	1.2	1.0

INITIATING COVERAGE

MUTHOOT FINANCE

The gold medalist

India Equity Research | BFSI

Edelweiss
Ideas create, values protect

Recent RBI guidelines may have ensnared the gold rush for gold loan NBFCs, materially altering their business dynamics. But for Muthoot Finance (Muthoot), India's largest gold loan NBFC with INR244bn AUM, the business model is as good as gold given its leadership in this niche business, created meticulously through conservative practices. We visited Muthoot branches across the country and conclude that post the 60% LTV cap, even though the business momentum has slowed, growth and margin profile is much better than envisaged earlier. Expecting Muthoot to generate a steady RoA/RoE of 3.5%/25%+, we believe 1.1x FY14 P/B prices in many concerns. We initiate coverage with a 'BUY/Sector Outperformer' recommendation and a TP of INR 185 (31% upside). Risks are further adverse regulatory actions or decline in gold prices.

New regulations take sheen off industry, but Muthoot can cope better

Muthoot's average LTV before RBI norms stood at 70% while other players and new entrants had higher LTVs (up to 80-85%), employed to gain market share. Given the 60% cap, Muthoot's quality aspects like branch locations, brand value and employee quality will further polish its market leadership.

Seasoned player: Best in class productivity, risk management

With a fleet of experienced employees and easily accessible branches, productivity is high at INR 66mn AUM/branch, well ahead of the competition. With 56% of 3,678 branches being added over past two years, optimum operating leverage is yet to flow in. Auctions at mere ~0.5-1% of AUM for last 4-5 years reflect sound risk management.

Outlook and valuations: Valuation prices in risks; initiate with 'BUY'

The current fiscal will be a year of consolidation for the industry as well as Muthoot (flat AUM and earnings growth). However, post the consolidation phase (FY14 onwards), we expect it to retrace back to 20% growth profile with RoA/RoE in excess of 3.5%/25%. Branch visits makes us more confident on merit of Muthoot's business model and execution capabilities. Our earning estimates are 13% ahead of consensus. We initiate coverage with a **'BUY/Sector Outperformer'** with TP of INR 185.

Financials

Year to March	FY11	FY12	FY13E	FY14E
Net revenues (INR mn)	12,760	21,791	23,763	27,508
Net rev growth (%)	*109.1*	*70.8*	*9.0*	*15.8*
Net interest income (INR mn)	12,584	21,581	23,513	27,233
Net profit (INR mn)	4,942	8,920	9,082	10,899
Diluted EPS (INR)	15.4	24.0	24.4	29.3
EPS growth (%)	*104.1*	*55.5*	*1.8*	*20.0*
Diluted P/E (x)	9.1	5.9	5.7	4.8
Price to book (x)	3.4	1.8	1.4	1.1
ROAE (%)	51.5	41.9	27.5	26.4

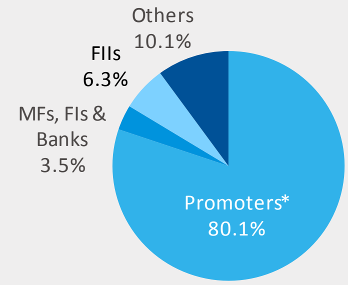
EDELWEISS 4D RATINGS

Absolute Rating	**BUY**
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Equalweight

MARKET DATA *(R: MUTT.BO, B: MUTH IN)*

CMP	: INR 140
Target Price	: INR 185
52-week range (INR)	: 198 / 105
Share in issue (mn)	: 371.7
M cap (INR bn/USD mn)	: 52 / 913
Avg. Daily Vol.BSE/NSE('000)	: 487.3

SHARE HOLDING PATTERN (%)



* *Promoters pledged shares (% of share in issue)* : *NIL*

RELATIVE PERFORMANCE (%)

	Sensex	Stock	Stock over Sensex
1 month	2.8	(11.0)	(13.8)
3 months	(1.0)	1.5	2.5
12 months	(8.3)	17.6	25.9

Kunal Shah
+91 22 4040 7579
kunal.shah@edelcap.com

Nilesh Parikh
+91 22 4063 5470
nilesh.parikh@edelcap.com

Suruchi Chaudhary
+91 22 6623 3316
suruchi.chaudhary@edelcap.com

June 27, 2012

Investment Rationale

Leadership to continue in niche business

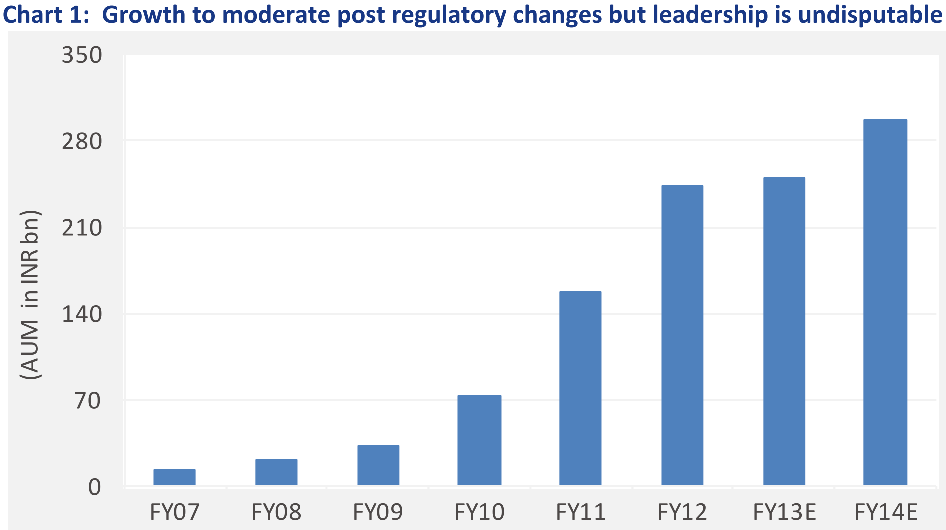
Muthoot Finance (Muthoot) is the market leader in the niche business of gold financing, holding a huge 20% plus of the organized gold loan market. The company's biggest advantage is its decade old presence in the gold loan market and as a corollary, strong understanding of the economics and drivers of the business. What further adds to its competitive edge is the convenient location of its branches and the ease with which it processes the loan, thereby ensuring minimal turnaround time for the borrower. It is then no surprise that it is able to charge interest rates in excess than that of banks (by 6-10% points) and still do brisk business (loan book CAGR of 95% over FY09-12).

While we take cognizance of the fact that there aren't strong entry barriers in terms of licenses and registration, heavy capital expenditure or hard to acquire collateral appraisal skills, we like the brand, the franchise and the trust that Muthoot has developed over time. Our branch visits to various Muthoot outlets across the length and breadth of India, comprising both mature and upcoming regions, reinforces our confidence on Muthoot. We believe, even though the current regulatory changes will significantly impact its growth, margins and profitability, its business model and execution capabilities have merit. We expect Muthoot to continue to embark on a steady growth path post the consolidation period i.e. FY14 onwards.

We are confident that Muthoot's market share of 20% will not get diluted significantly and it will very well grow in line with the industry, maintaining its leadership

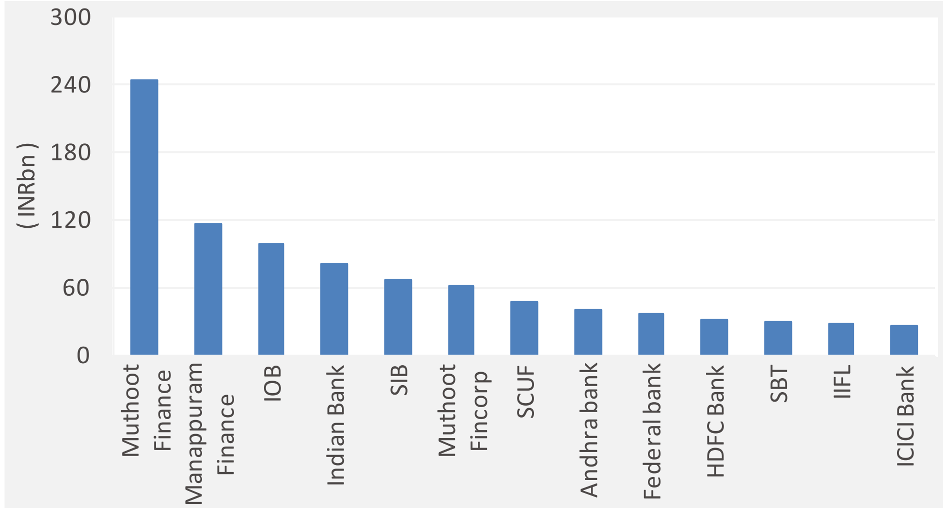
Even though we expect competition to increase from banks like Federal Bank, HDFC Bank, ICICI Bank, South Indian Bank etc. getting active in this space, it is the flow of business from new NBFC entrants, the unorganized sector and new customers using the gold loans that is going to fuel Muthoot's growth. Hence, we are confident that Muthoot's market share will not get diluted significantly and it will very well grow in line with the industry, maintaining its leadership.

Chart 1: Growth to moderate post regulatory changes but leadership is undisputable



Source: Company, Edelweiss research

Chart 2: Muthoot corners a major share of the organized gold loan market at 20%+



Source: Company

Regulatory changes: Muthoot better positioned to manage transition

Impact of recent regulations on return profile will be the lowest for Muthoot mainly due to its product stability, as reflected in its lower LTVs and lending rates

With the breakneck speed of growth, both in terms of physical presence and loan book accretion coupled with margins in excess of 10% and constant asset quality risk, gold loan NBFCs were in the regulator's purview since long. However, within the NBFC space, impact of recent regulations on return profile will be the lowest for Muthoot. This, we believe, is mainly due to the company's product stability, as reflected in its lower LTVs and lending rates. Before these regulatory changes, Muthoot's average LTV stood at 70%, significantly lower than those of established players as well as new entrants (with LTVs as high as 80-85%). Now that competition on the basis of LTV is over, Muthoot's strengths have come to the fore (namely branch locations, brand value, employee quality amongst others) to uphold it as the market leader. Second set of regulatory changes which pertain to stricter customer appraisal norms and ownership checks will have similar impact for all the industry participants.

On the flip side is the higher capital requirement of 12% Tier 1 by March 2014. Muthoot is operating at high leverage levels with Tier 1 close to regulatory requirement at 12.8%. Secondly, minimum holding period requirement of 2 installments and ban on revolving credit transactions, has effectively killed the assignment market for gold loan NBFCs. As on FY12, 14% of the AUMs of Muthoot Finance were assigned.

While the regulations undoubtedly have been a dampener, the clarity and robustness that they have injected into gold loan financing model is appreciated.

Broadly, we believe FY13 will be a year of consolidation for Muthoot where AUM and earnings growth will be flat (though higher than consensus). Post consolidation phase, it will retrace back to 20% growth profile and RoA/RoE in excess of 3.5/25%. Following is our assessment of the impact of recent regulatory changes on Muthoot's growth, profitability and capital consumption taking cues from the insights that we gathered from our branch visits.

LTV cap along with modest 100-200 branch additions (vis-à-vis an average of 1000 branches over the past two years) will keep the AUM growth modest

Modest loan growth as LTVs moderate and pace of branch additions slow

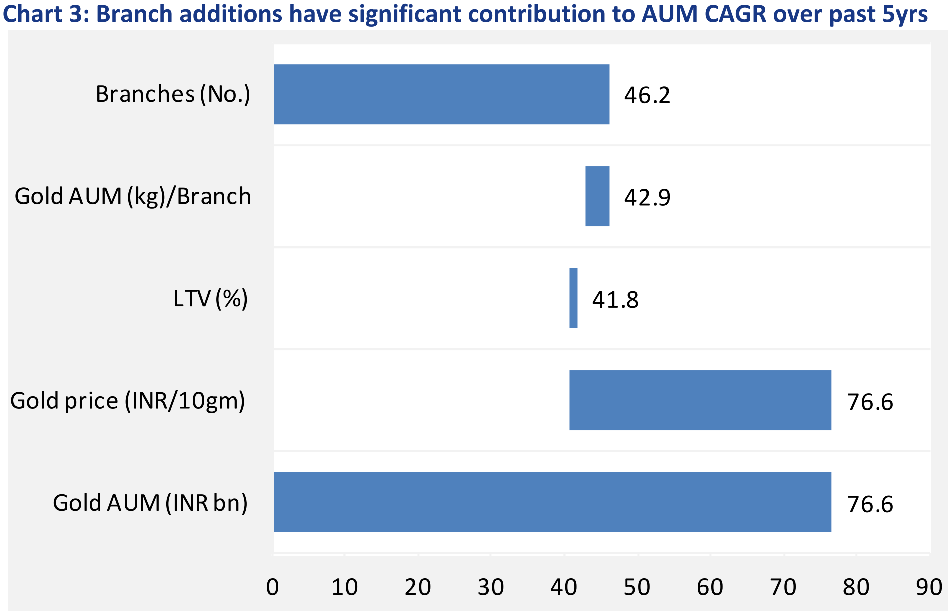
We had earlier anticipated that with the 60% LTV cap, disbursements will see a 15-20% decline to adjust to 60% levels from the earlier 70-75%. However, the shift in appraisal methodology from just gold based approach earlier to collateral valuation has restricted the damage. Factoring this into account along with modest 100-200 branch additions (vis-à-vis an average of 1000 branches over the past two years) will keep the AUM growth modest. We are building in AUM CAGR of 10% over FY12-14E. This will be aided by the newly opened branches reaching full scale, as 56% of the outstanding 3,678 branches were added over the past 2 years.

Table 1: No. of schemes have reduced post new regulations, but loan/gram has held up

	Before			After		
Scheme	Loan/gram (INR)	LTV (%)	Rate (%)	Loan/gram (INR)	LTV (%)	Rate (%)
TPL	990	38.5	12.0	1,000	28.4	15.0
FVL	1,430	55.5	17.0			
RPL	1,760	68.3	19.0	1,885	53.5	20.0
XPL	1,860	72.3	22.0	1,925	54.6	21.0
PPL	1,930	74.9	23.0			
SPL	1,950	76.4	24.0	2,100	59.6	24.0

Source:Company

Chart 3: Branch additions have significant contribution to AUM CAGR over past 5yrs

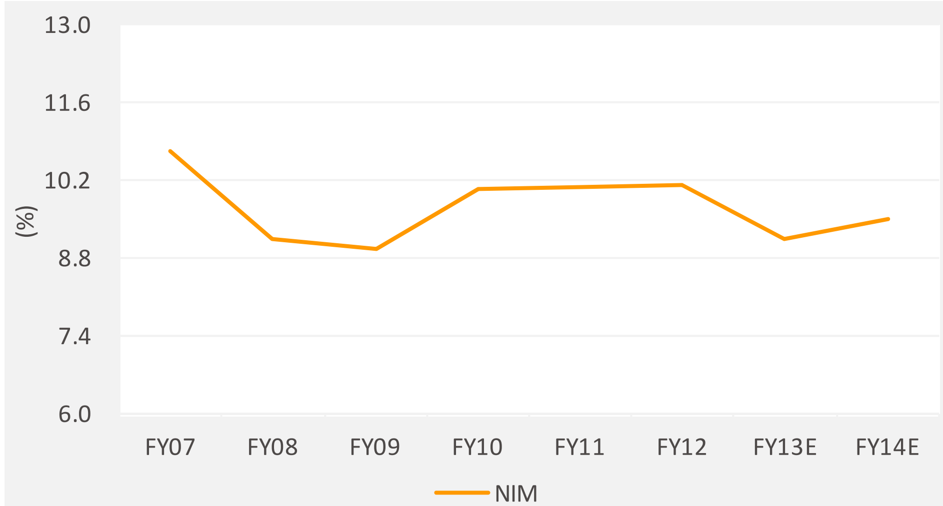


Source:Company, Edelweiss research

NIMs to decline, not due to LTV decline but due to competition and lack of assignment

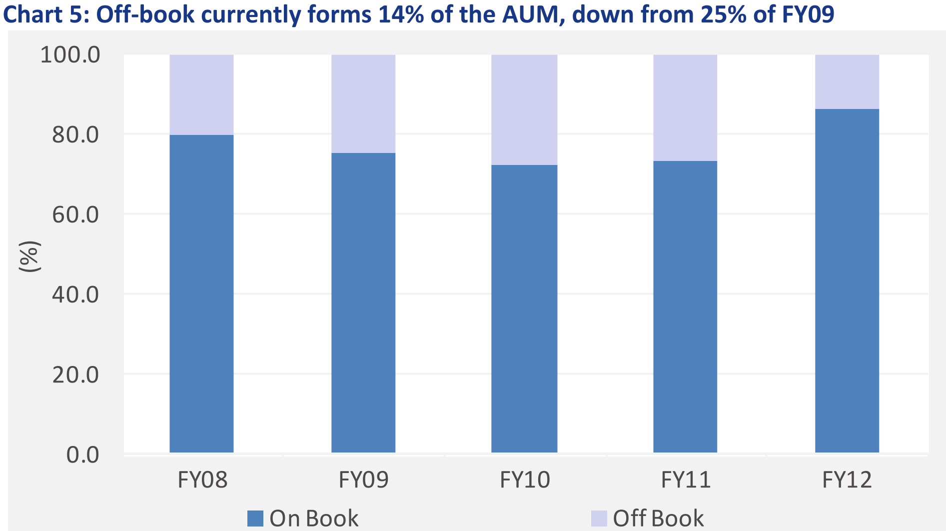
The NIM behavior post the regulatory action has also surprised positively. Steady disbursement/gram along with the robust demand has enaled the company to keep lending rates steady at 24% thereby ensuring no impact on the yields. Incrementally, though we believe NIMs will moderate by 50-100bps as we see competition increasing from private banks impacting the yields and lack of assignment transactions impacting the cost of funds. We believe margins for Muthoot will settle at 9-9.5% on a steady state basis.

Chart 4: Increased competition and lack of assignments to weigh on NIMs by ~50bps



Source: Company, Edelweiss research

Chart 5: Off-book currently forms 14% of the AUM, down from 25% of FY09



Source: Company

Faster consumption of capital; however comfortable to support the current growth

The full impact of absence of assignment route will reflect over FY13 as all the off balance sheet loans mature and get replaced with the on balance sheet ones. The combined effect of this and higher Tier I will lead to faster consumption of capital and have implication on growth rates unless equity is raised at frequent intervals.

Though current networth will be comfortable to support our growth estimate of 10% over FY12-14E, 12% Tier 1 capital requirement will cap its growth at 25% (without any rounds of equity dilution)

Though current networth will be comfortable to support our growth estimate of 10% over FY12-14E, Tier 1 capital requirement of 12% by April, 14 will cap its growth to maximum at 25% (without any rounds of equity dilution).

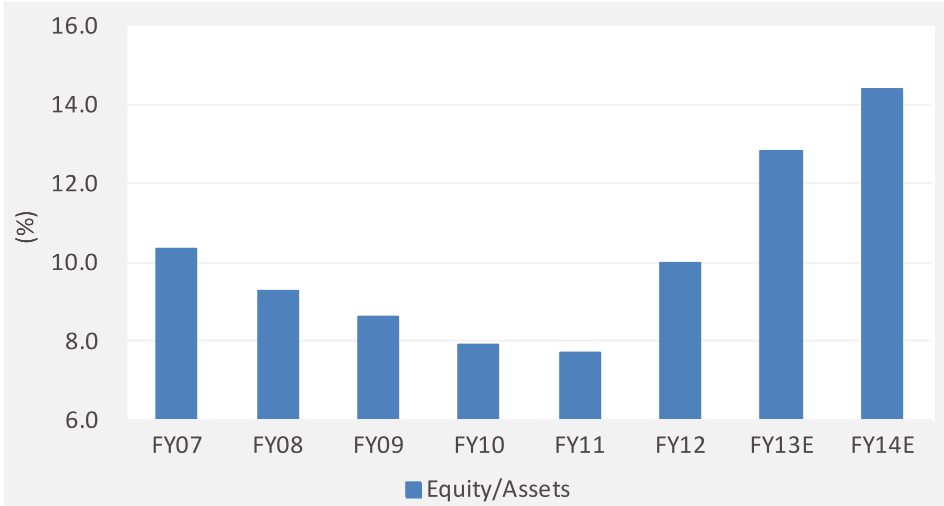
These off balance sheet loans will run-down in FY13 and this is the main reason for subdued AUM growth estimate for Muthoot in FY13.

Our base case AUM CAGR of 10% over FY12-14E is comfortable on the capital currently available with the company. Further we evaluate the maximum growth rate that Muthoot can clock with the current networth. We note that gold loans currently have 100% risk weights. Also all the components of the networth for Muthoot qualify for Tier 1 capital.

Case 1: We assume here that Muthoot will want to keep a buffer of 2% over the mandated 12% Tier 1 capital norm. In this case the AUM CAGR achievable over FY12-14E is 16%.

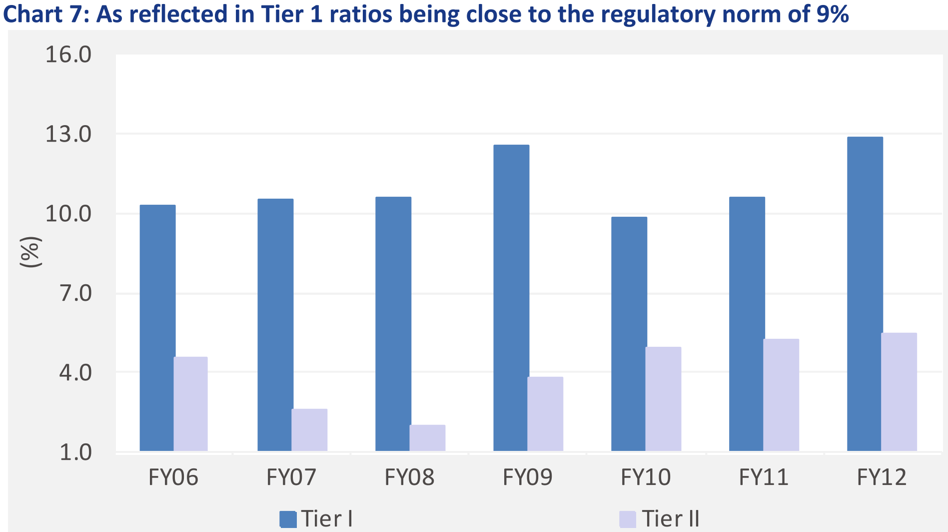
Case 2: Tier 1 will be maintained at 12% where AUM CAGR achievable over FY12-14E is 25%

Chart 6: Muthoot has always operated at higher leverage levels



Source: Company, Edelweiss research

Chart 7: As reflected in Tier 1 ratios being close to the regulatory norm of 9%



Source: Company

Table 2: The best possible AUM CAGR with the revised Tier 1 ratio stands at 25%

(INR bn)	FY10	FY11	FY12	FY13E	FY14E
Networth/Tier 1 capital (A)	6	13	29	37	46
Tier 1 ratio (%) (B)	9.9	10.6	12.8	14.7	15.4
Implied RWA	59	126	228	250	297
Base case					
AUM	75	159	245	250	297
FY12-14E AUM CAGR (%)					10.0
Case 1					
Tier 1 (%)				14	14
Maximum AUM possible (A/B)				262	327
Resultant FY12-14E AUM CAGR (%)					15.5
Case 2					
Tier 1 (%)				12	12
Maximum AUM possible (A/B)				306	381
Resultant FY12-14E AUM CAGR (%)					24.7

Source: Company

Seasoned player: Productivity and risk management best in industry

Muthoot scores better than banks in gold financing, mainly in terms of customer preference, given its speedy loan disbursal and the customer psyche that they have shaped over the years whereby Muthoot is the first choice for gold loans. We believe, Muthoot not only scores higher than banks but also NBFCs. Our liking for Muthoot stems from its operational efficiencies and stronger risk management practices.

Muthoot's AUM/branch is higher compared with other established players by upwards of 50% at INR66mn/branch and so is its operating efficiency (lower Opex/Assets vis-à-vis peers). This, we believe, is fallout of careful selection of branches (targeting proximity to customers) and highly trained staff (well-versed with the local aspects).

Employee quality and their understanding of the business is the most prominent differentiating factor of Muthoot

Superior employee quality: Employee quality and their understanding of the business is the most prominent differentiating factor of Muthoot. The branch managers are mostly retired employees from the banking industry and hence seasoned in the business of lending and collateral/customer appraisal. Also, the training imparted, spanning two weeks at the time of joining to three months on-the-job training for employees at matured branches has ensured that they are lot more adept at collateral appraisal. We also found another differentiating factor, whereby employees tend to stick to Muthoot (lower attrition) and hence are experienced in the processes followed. Further, recruitment from the local market has ensured that employees understand the customer psyche well and can connect with the customers better. Muthoot has two staff training colleges, one each in Cochin and in New Delhi, and four regional training centers located in Chennai, Hyderabad, Bangalore and in Cochin.

Muthoot has the highest monthly interest collection rate among NBFCs at 90% translating into minimal auction rates at a mere 0.5-1%

Branch visibility and set up: While it is understood that almost all the branches are in important business centres, the visibility and ease with which a Muthoot branch can be located sets it apart. The only other player which has invested heavily on the branch visibility is Muthoot Fincorp. Also, the branches are very well organized and mirror the setup of a private bank in most of the locations.

As mentioned above, another differentiating factor of Muthoot is its stronger risk management and better compliance with the policies and regulations:

Better market risk management: LTVs for Muthoot are in general lower than that of other gold loan NBFCs by ~5%, at 55-60%. This is also due to its steeper haircut to gross weight even while its LTV is on the lower side.

Stricter collateral appraisal: Well trained employees with mandatory training of two weeks to three months in case of mature branches have ensured that cases of spurious gold being pledged are minimal with the company.

Monthly interest collection keeps owners equity intact: Muthoot has the highest monthly interest collection rate among NBFCs at 90%. This implies that the borrower's equity in the jewellery remains intact at the LTV level, assuming gold prices remain constant. The company manages to achieve this by levying penal interest rates in case of delay in interest servicing and by sending constant reminders by way of phone calls and text messages to customers.

Lowest auction amount: All the above factors have translated into minimal auction rates at a mere 0.5-1%. This is way lower when compared with 5-7% clocked by some other players in the industry. Along with safeguarding the asset quality, it also goes a long way in maintaining the relationship with the customers as customer faith and trust gets spoiled if their possessions are auctioned.

Robust processes and compliance: Muthoot has demonstrated superior internal processes and controls in the business. In the recent past, we have seen its peers, Manappuram Finance and Muthoot Fincorp, bear regulatory action for taking deposits in promoter related entity (Manappuram Agro Farms) and in a group company (Muthoot Estate Investments), respectively.

Multiple growth drivers: Genuine demand captured by new branches + new geographies

It has been a common concern that growth of the gold loan industry, now with an AUM of INR1.3tn post a 60% plus CAGR over the past three years, has been on the back of a one way gold price cycle. Growth may fall flat in case prices stagnate and more so in case of a decline. Our interactions with customers and branch managers helped us learn that most of these loans are being driven by urgent business and personal needs. Hence, we are confident that this genuine need and application of the gold loan product will keep fueling Muthoot's loan book growth. The two main factors which will help the company grow are new branches/geographies and availability of credit lines.

More than half of the branches have been added over the past two years and ~10% as recent as the past six months

Newly opened branches yet to reach optimal level

Muthoot has a strong presence of 3,678 branches across the country, though 64% is concentrated in the South. Of this network, more than half has been added over the past two years and ~10% as recent as the past six months. While the average outstanding per branch is at INR66mn, our branch visits revealed that the mature branches (more than 3-5 years old) have AUMs way in excess of this mark. Going forward, we expect branch addition to slow down as the business metrics undergo change. However, it is the scaling up of these nascent branches which will ensure 10% loan CAGR over FY12-14E even while LTVs moderate.

Chart 8: Muthoot has seen rapid branch expansion over the past 3-4 years..

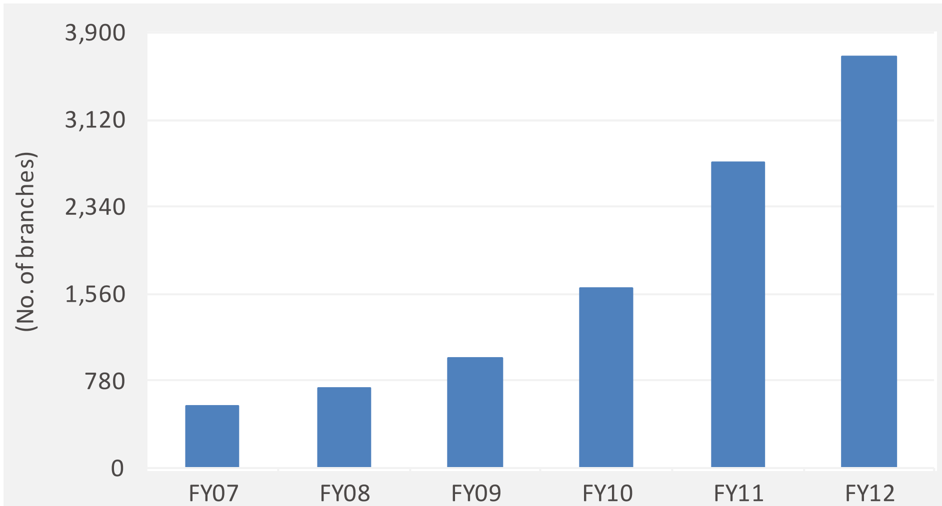
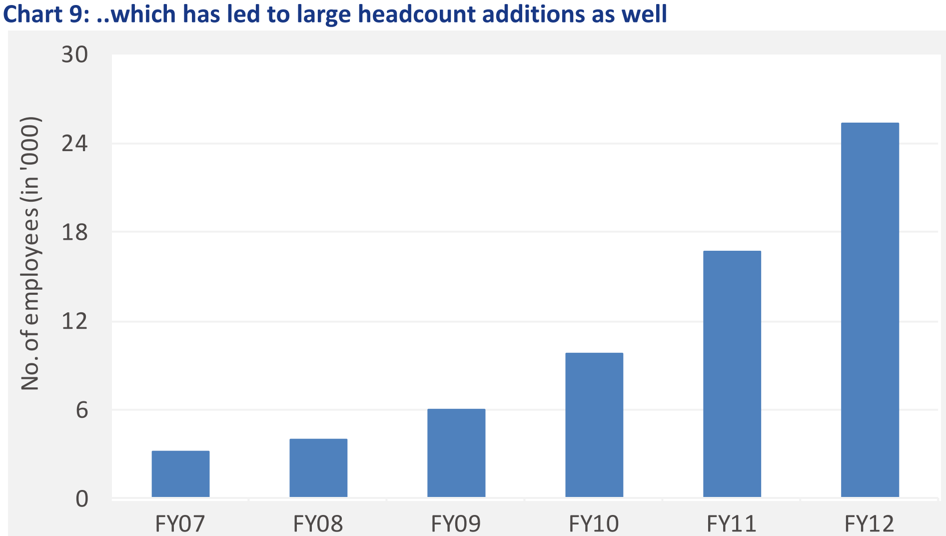
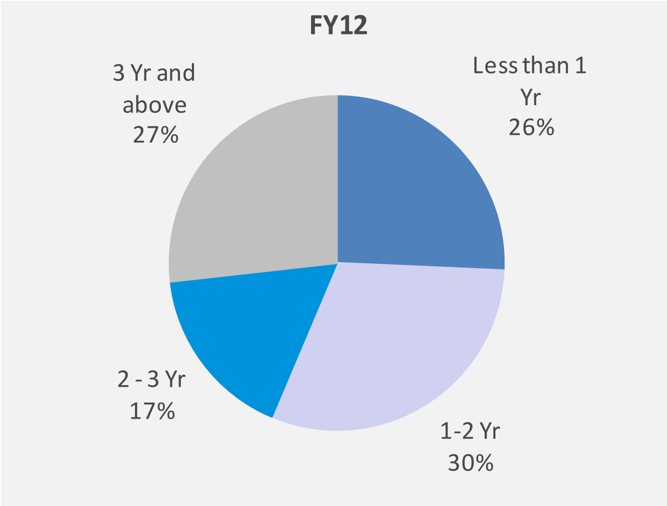


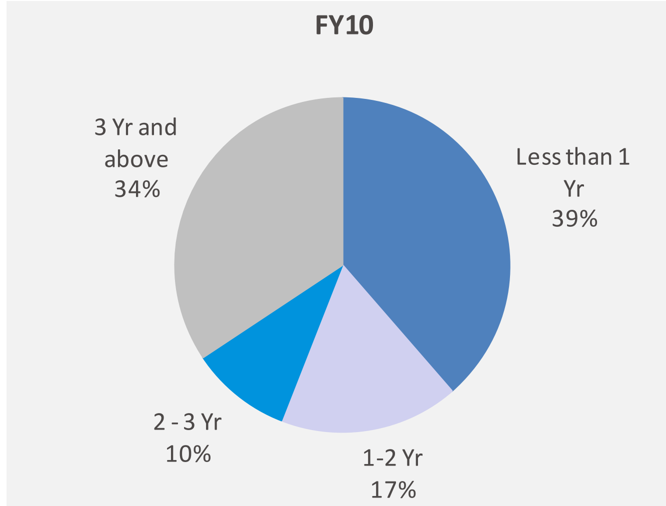
Chart 9: ..which has led to large headcount additions as well



Source: Company

Chart 10: Given that 56% of the existing branches have been added over the past 2 years, ramp up of these will support AUMs





Source: Company

Successfully implementing diversification; enjoys first mover advantage

In FY10-12, 40%+ of Muthoot's new branches have been outside South India. However, only 30%+ incremental loan book accretion can be attributed to these outlets given their recent setup and the fact that gold loans concept though present across India is far more prevalent in South. In fact, as a part of its aggressive marketing strategy to shed its South player image, the company was the main sponsor of IPL team "Delhi Daredevils". Its TV commercials too carry a very Pan India air. All this has ensured that it has been successful in extending the trust and the brand image that it enjoys in the South India to the newly chartered territories as well.

Diversifying outside of the four South Indian states ahead of its peers has also led to significant first mover advantage for the company. Our branch visits to the North and the West of the country revealed that the AUMs/branch of Muthoot is substantially higher than that of peers in any particular geography. This obviously comes on back of the presence of the branches being longer than that of others. In our view, the relationship that Muthoot has developed with its clients during the multiple transactions will be a strong entry barrier for others.

Chart 11: The proportion of South India branches is down to 64% from 86% in FY07

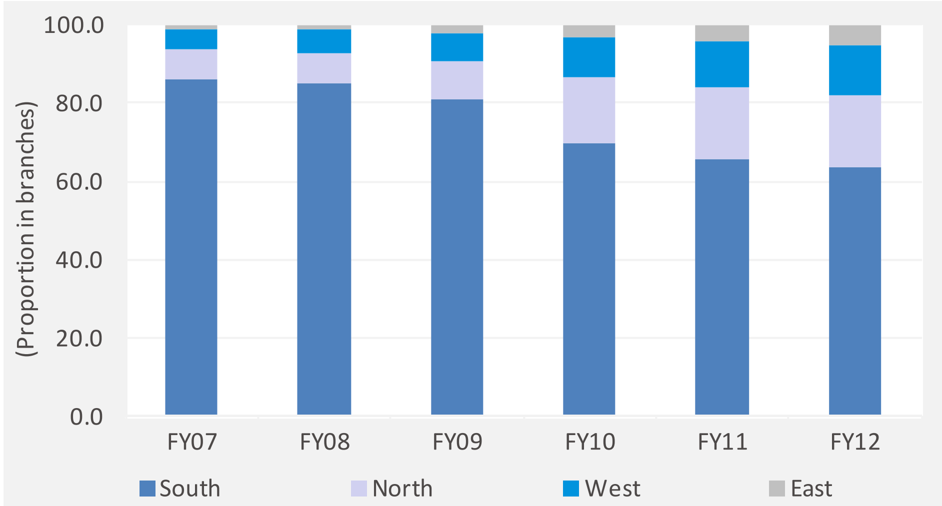
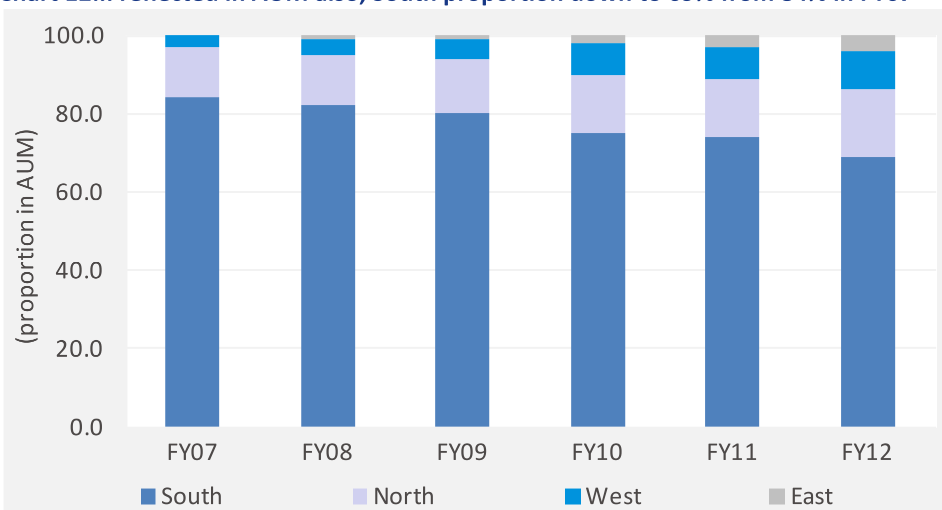


Chart 12:.. reflected in AUM also, South proportion down to 69% from 84% in FY07



Source: Company

Valuations

Business model has huge merit; valuations factor in regulatory risks

Despite regulatory headwinds surrounding the gold financing industry, we still see merit in monoline gold financiers' business model and we believe leaders like Muthoot will be able to hold on to their turf. With major regulatory hurdles on asset and liability side already in place, the underperformance of Muthoot to Bankex by 40% over the past 6 months and current valuations at 1.1x FY14E book for steady state RoA/RoEs of 3.5%/25% fairly prices in near term regulatory risks. Assigning 1.5 to FY14 BV, we arrive at a target price of INR 185/share and initiate coverage with "BUY/Sector Outperformer" rating/recommendation.

Regulatory changes – to alter business dynamics but may not kill the business model

While regulatory changes will alter the business dynamics in terms of future growth and expansion, it is not likely to kill the business model. Demand for gold financing is genuine for an urgent business and personal needs and will be here to stay. Moreover, players enjoy adequate pricing power to pass on the cost pressures.

Muthoot's dominant position to prevail in times to come

While competition is getting intense with banks and other NBFCs being active, Muthoot is still holding on to its dominant position with 20%+ market share. It has grown its AUM at 95% CAGR over FY09-12 – higher than the industry by rapidly expanding branches and penetrating into newer geographies and locations. We believe Muthoot can hold on to the leadership position in times to come as well considering: (1) conservative standards enabling it to navigate the regulatory turmoil in a better manner vis-à-vis peers and; (2) superior operations, as reflected in all aspects i.e. employees, branches and risk management processes. Highly experienced and quality management team further provides comfort.

Consolidation phase in the near term; steady state RoA/RoEs of 3.5/25%

We believe next 6-9 months will be a consolidation phase for Muthoot in light of the current regulatory developments, where branch expansion spree is expected to slow down to 100-200 branches per year and asset growth will moderate. However, given adequate pricing power, it may still generate high NIMs of ~9% plus. Keeping costs under control and managing asset quality well, we expect steady state RoA/RoE of 3.5%/25% towards the end of consolidation period of FY14 while it registers AUM CAGR of 10%.

Limited trading history but has been less volatile than peers

Muthoot made its debut on the stock exchanges in April 2011 whereby it raised INR9bn at INR175 per share valuing the financier at INR64bn. Since it has been listed for roughly a year and that too under constant regulatory overhang, we believe that there is limited to be read from its trading history other than the fact that it has been less volatile than its other listed peer Manappuram Finance as it faced wrath of the regulator for accepting public deposits in its promoter related entity Manappuram Agro.

Valuation premium to stay

Also, it has always traded at a premium to that of Manappuram given its lower vulnerability to NIMs/RoA. This implies that in case of adverse regulatory ruling the impact on Muthoot will be lower given its more stable return profile. We expect the premium to sustain in the future as well and believe that the current valuation of 1.1x FY14E BV is fairly attractive.

At a Glance

	Rating	(INR) CMP	(INR) TP	% Upside	Mcap (INR bn)	Gold loan AUM (INR bn)	BV FY13E	BV FY14E	P/BV FY13E	P/BV FY14E	EPS (INR) FY13E	EPS (INR) FY14E	P/E (x) FY13E	P/E (x) FY14E	EPS CAGR (%) FY12-14E	ROE (%) FY13E	ROE (%) FY14E
Muthoot Finance	BUY	140	185	31.4	52	244	99	123	1.4	1.1	24.4	29.3	5.7	4.8	10.5	27.5	26.4
Manappuram Finance	BUY	33	41	23.0	28	116	35	41	0.9	0.8	6.7	7.7	4.9	4.3	4.3	21.3	20.3
Federal Bank	BUY	445	535	20.2	76	37	374	425	1.2	1.0	50.5	63.7	8.8	7.0	18.5	14.3	16.0
South Indian Bank	HOLD	24	26	10.6	27	66	21	25	1.1	0.9	4.1	5.0	5.7	4.7	19.1	21.3	21.9

Source: Bloomberg, Edelweisss research

Key metrics

	Muthoot Finance FY12	Muthoot Finance CAGR /Average (FY09-12)	Muthoot Finance FY13E	Muthoot Finance FY14E	Manappuram Finance FY12	Manappuram Finance CAGR /Average (FY09-12)	Manappuram Finance FY13E	Manappuram Finance FY14E	Muthoot Fincorp FY12
Gold loan AUM (INR mn)	244,173	94.9	249,758	296,550	116,308	113.3	119,777	145,628	62,500
- of which assigned (%)	13.7	22.5	-	-	16.5	19.6	-	-	
AUM/branch (INR mn)	66.4	25.6	66.1	72.7	40.0	29.1	39.8	45.4	30.3
Margin metrics (%)									
YoA	22.6	20.9	20.7	20.1	27.4	24.8	24.6	23.2	
NIMs	10.1	10.1	9.1	9.5	14.1	14.2	12.1	12.4	
Branch metrics (Nos)									
Branches	3,678	55.1	3,778	4,078	2,908	65.3	3,008	3,208	2,060
Employees	25,351	61.9	24,935	26,099	21,924	65.2	21,658	21,814	
Employee/branch (x)	6.9	6.4	6.6	6.4	7.5	7.5	7.2	6.8	
Opex metrics (%)									
Opex/assets	3.8	4.0	3.8	3.8	6.0	6.4	5.6	5.5	
Employee/assets	1.9	1.9	1.9	1.9	2.8	2.6	2.8	2.8	
Receivable metrics									
Int. receivable/loan book (%)	3.5	3.0	3.5	3.5	7.3	8.1	7.3	7.3	
Leverage (x)									
Assets/equity	10.0	11.9	7.8	7.0	5.1	5.0	5.0	4.5	

Source: Company, Edelweiss research

Note: Muthoot Fincorp numbers are based on media sources

Company description

Muthoot is the largest gold financing NBFC with operating history of more than 70 years when M George Muthoot (the father of Promoters) founded a gold loan business in 1939. At present, it is closely held family owned business with promoters (sons of M. George Muthoot and their family) continuing to hold substantial stake of 80%. It is registered as a systematically important non-deposit accepting NBFC with RBI. Headquartered in Kerala, the gold loan NBFC has a network of 3,678 branches, 64% located in South India as of March 2012.

Muthoot has created leadership position in lending against gold jewellery with INR244bn AUMs (market share estimated at ~20% of the organised market, Source: IMaCS) comprising more than 60 mn loan accounts serviced through >3600 branches and 25,000 employees. It provides personal and business loans secured by gold jewellery, primarily to individuals who possess gold jewellery but could not access formal credit within a reasonable time, or to whom credit may not be available at all, to meet unanticipated or other short term liquidity requirements.

Although there is other gold loan financier Muthoot Fincorp that uses similar brand name ‘Muthoot’, both these companies have been maintaining distinct brand identities.

In addition to gold loan business, it also provides money transfer services through branches as sub-agents of various registered money transfer agencies, and recently has commenced providing collection agency services as well. Its other recent initiatives include sale of gold coins and insurance products amongst various other services.

The Muthoot group has interests in a diverse range of business in areas of hospitality, media, education, healthcare, information technology etc. However, gold loans continue to be the mainstay and hence Muthoot Finance continues to be the flagship company.

Key Risks

Risk of ownership split in future between four promoter brothers cannot be ruled out

The four Muthoot brothers namely M.G. George Muthoot, George Alexander Muthoot, George Jacob Muthoot and George Thomas Muthoot together run the operations of the 18 different businesses with the Muthoot Group, of which, Muthoot Finance is clearly the flagship company and the main contributor to revenues. Together, they own 80% of the company (As on March 2012).

We cannot rule out the split of ownership between the brothers in the future, hence, have listed the ownership pattern as a risk. ***A look at the history tells us that Mr. M. George Muthoot, father of the promoters, along with his brothers Muthoot M. Pappachan and Muthoot Mathew, started gold loan business in 1939. However, their businesses split in 1975 and are now run under Muthoot Fincorp and Muthoottu Mini.*** So, what we see here is that a set of cousins are carrying on similar business under three different companies.

Table 3: Four promoter brothers hold 20% each in Muthoot Finance

Shareholding pattern	(%)
M G George Muthoot	12.8
George Thomas Muthoot	12.0
George Jacob Muthoot	12.0
George Alexander Muthoot	12.0
Susan Thomas	8.1
George M Jacob	4.1
Elizabeth Jacob	4.0
Anna Alexander	4.0
Sara George	3.6
George M Alexander	2.0
Eapen Alexander	2.0
George M George	1.8
Alexander M George	1.8
Total promoter holding	**80.1**

Source: Company

Gold loan dynamics of regions beyond South India is bit different

Historically, the four southern states i.e. Kerala, Tamil Nadu, Karnataka and Andhra Pradesh have been the focus area for the company. Till today, the company is concentrated in these regions, with them contributing 70% to AUM. However, over the past two years, a third of the business has been sourced out of South India, primarily North and West India. The dynamics of these business areas, along with being different, are also new to the company.

Besides, differences in terms of competitive landscape, business practices, need for funds, and customer behavior across regions, other critical differences worth noting are operating cost structure and the risk of theft and frauds. The company, however, rolls out more or less standard products in terms of LTV and lending rates across the length and breadth of the company irrespective of the cost structure and RoAs seem to vary across regions and across urban, semi-urban and rural areas.

Considering the risk of theft and frauds being higher outside Southern region, security measures adopted are different – while branches in South India are given an armed guard when the AUM crosses INR50mn, in West India it was given one at an AUM level of INR 5mn. The absence of familiarity with local conditions, business practices and customer relationships makes us watchful of the expansion outside South India.

Chart 13: More than a third of branches are now outside of South India..

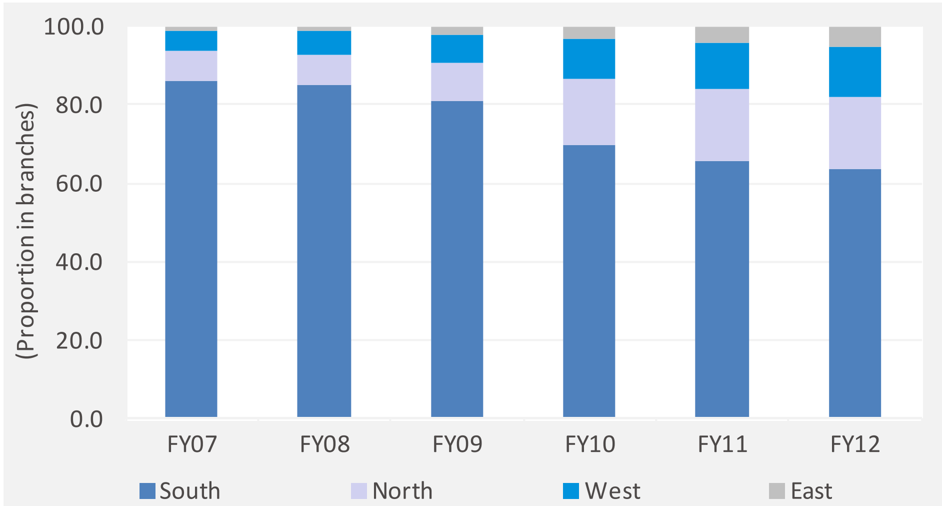
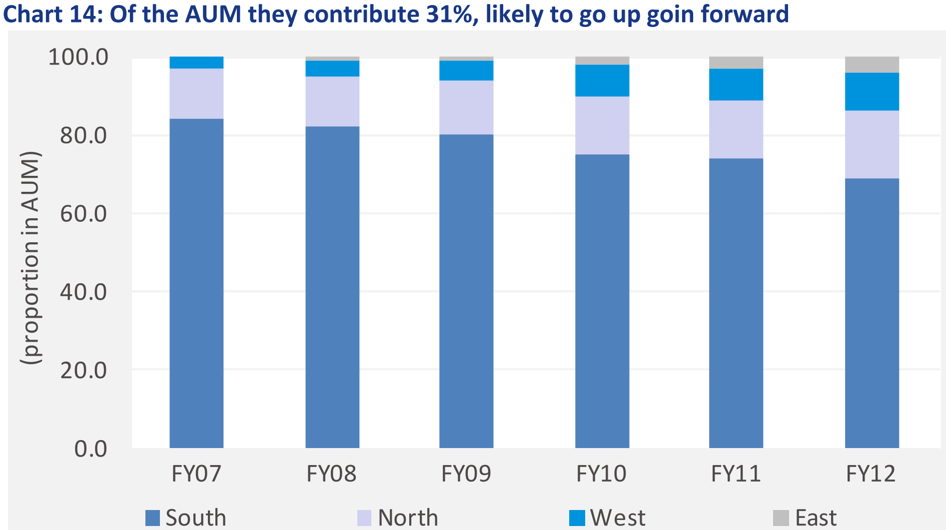


Chart 14: Of the AUM they contribute 31%, likely to go up goin forward



Source: Company

Pressure on growth in case of slower ramp up of new branches or decline in gold prices

Trend analysis for the past five years show that gold AUM/branch in volume terms i.e. in kg of gold/ branch has stayed more or less constant. Nonetheless, what has helped AUM in value terms clock a 75%+ CAGR is the 25% CAGR in gold prices and brisk pace of branch addition at a CAGR of 45%+ over the same period. In the unlikely event of branch expansion slowing down along with gold prices staying static, the growth prospects will likely be impacted. The problem becomes even more acute given the short duration of the loans which implies a faster run down of portfolio in case disbursements can't keep pace with repayments.

What provides relief to near term growth prospects is that 56% of branches have been in existence for less than 2 years suggesting that a significant proportion of branches are yet to reach optimal capacity. We factor in the new branches to ramp up and contribute to growth.

Chart 15: AUMs got major impetus from branch additions and gold price increase..

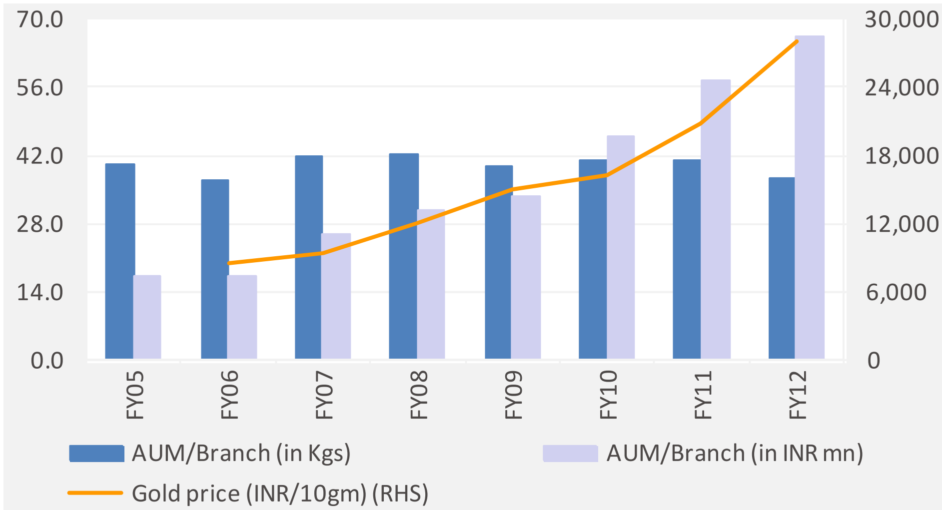
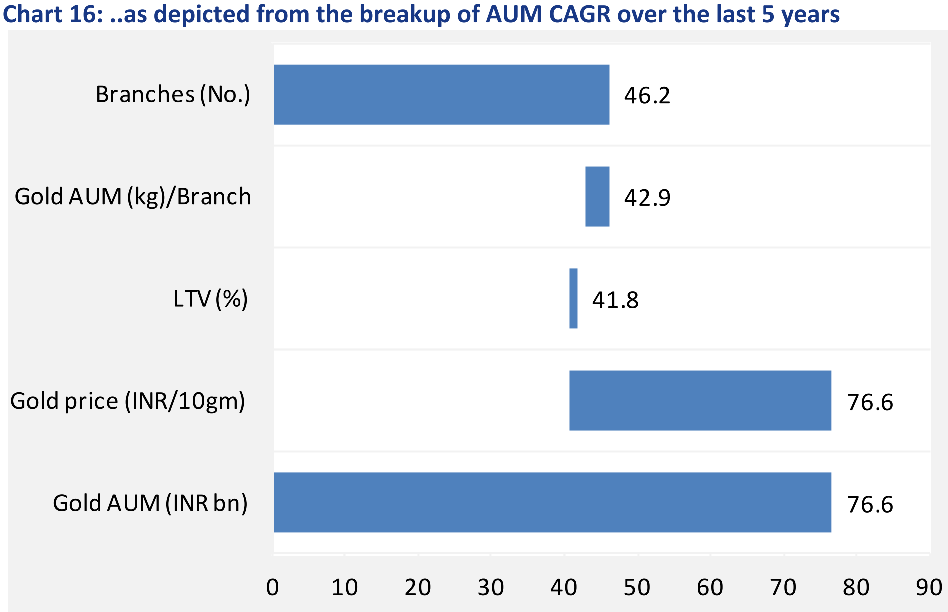


Chart 16: ..as depicted from the breakup of AUM CAGR over the last 5 years



Source: Company, Bloomberg

Difficult to call an end of regulatory actions

The recently constituted Shri K. U. B. Rao Working Group by RBI to assess whether gold loan demand is having any influence on gold imports or gold prices suggests that regulator is not yet over in introducing further strictures on gold loan companies. We have discussed in detail the foreseeable action in our industry section (Page 31). Other than that we don't expect any company specific regulatory action to impact Muthoot Finance.

Financial Outlook

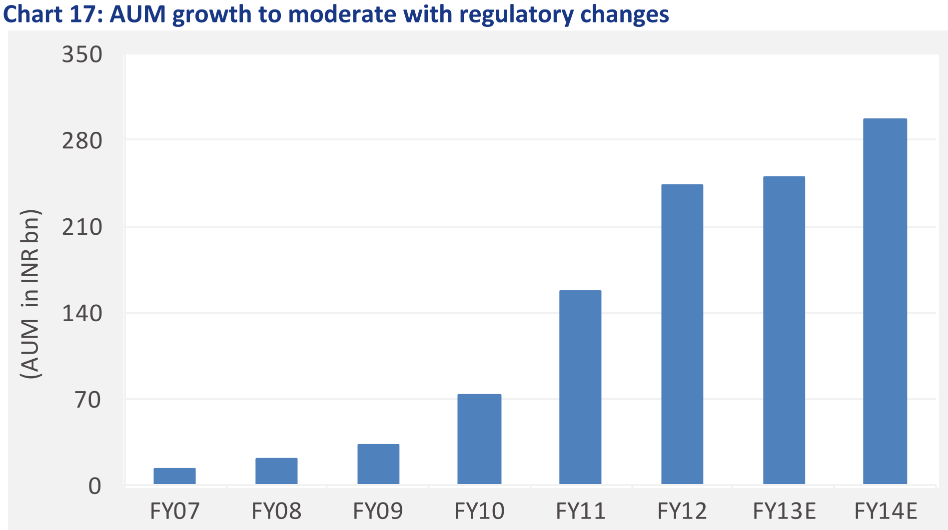
AUM: Modest growth ahead

Rapid expansion has been the key characteristic of Muthoot Finance over the past five years, whereby AUMs clocked 77% CAGR to reach INR 244bn as on March 2012. New branches, new geographies, ramp up of existing branches and needless to say one way gold price movement have been the catalysts behind the steady AUM pile up.

Going forward, as the company and customers settle to the new LTV norms we believe the growth rates will stabilize in 20% territory. This will be aided by the newly opened branches, particularly in new geographies reaching full scale even while we expect branch additions to slow down from the 1000 branches addition over the past 2-3 years to 100-200 branches in the next two years.

We are building in 10% AUM CAGR over FY12-14E. A substantial step up from this will be difficult even if demand picks up unless Muthoot raises capital to shore up its Tier I from the current 9%. Capital consumption will now be much faster with absence of assignment route and higher Tier I requirement of 12% by April 2014. The maximum possible growth can be 25% if Muthoot wants to maintain 12% Tier 1 capital and 15% dividend payout policy, in our view.

Chart 17: AUM growth to moderate with regulatory changes



Source: Company

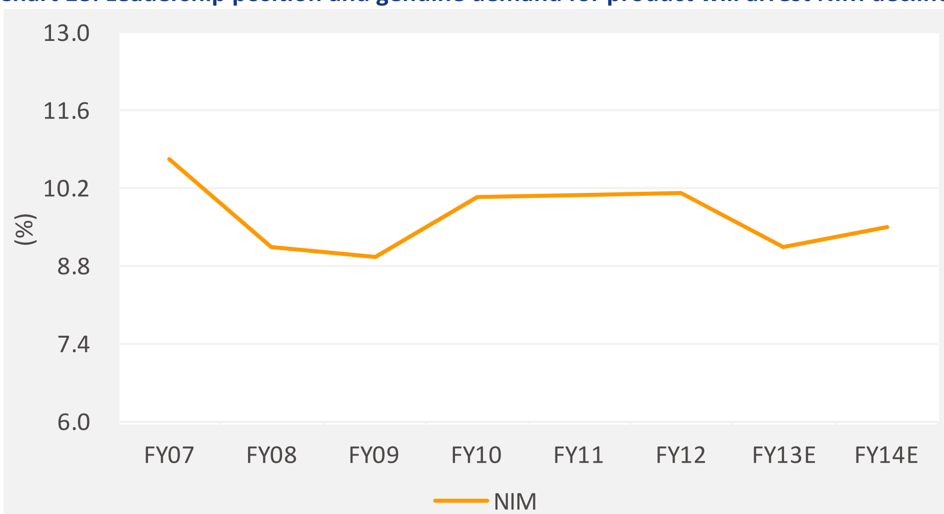
Margins: To witness some moderation structurally

With the niche product offering and superior customer convenience, Muthoot has been able to charge interest rates in the range of 12-30% with the average being ~20%. This has ensured that NIMs come in steady at 10% plus. Incrementally, RBI's recent guidelines have clearly altered the business metrics. With assignment/securitization virtually coming to an end and RBI clearly demarcating monoline gold loan companies as relatively riskier segment by imposing stricter cap on networth for bank funding, we believe on a steady state basis cost of funds will inch higher.

Even structurally yields are expected to compress due to: 1) increasing competition in the space; 2) with lower LTVs on offer now, the corresponding interest rates should also be lower. With this background, we are building in NIM compression of 50bps over FY13/FY14E to reach a steady state number of 9-9.5%.

However, our branch visits post the implementation of the guidelines revealed that even while LTVs have dropped to 60%, interest rates have actually increased to partially compensate for the loss in interest income. We read the current move by the companies more as a trial measure as it is too early to gauge customer sentiment. In case the customers keep flocking to Muthoot Finance irrespective of higher LTVs on offer by banks and moneylenders and the higher interest rate charged by it, NIMs can stay put at the current levels implying an upside to our profitability numbers. We are building in NIMs of 9.1/9.5% for FY13/14E which combined with 2%/19% AUM growth will lead to 9/16% NII growth.

Chart 18: Leadership position and genuine demand for product will arrest NIM decline



Source: Company, Edelweiss research

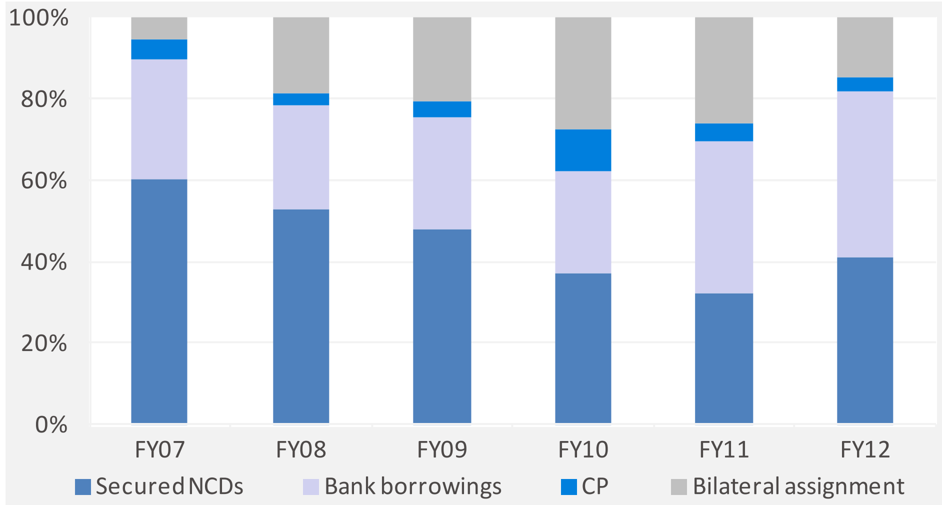
Borrowing profile: Diversifying the pool

Muthoot currently has a well-diversified borrowing profile with participation from banks, financial institutions and retail investors. Over the past 4-5 years, share of bank funding by way of both direct and indirect lending (assignment) has steadily grown, gaining share from NCD. While over the last one year, the company has started getting its NCDs listed so as to increase visibility and increase the retail investor base, it is currently at a smaller 2% of the total borrowings.

Incrementally, we believe the proportion of funding from banks (direct/Indirect at 41/15%) will come down primarily due to absence of assignment transactions. Further, if banks get cautious in lending to gold loan companies given the regulators constant vigil, Muthoot will have to tilt borrowings back in favour of NCDs.

In terms of ratings, Muthoot is well placed enjoying the highest short-term rating from both Crisil and ICRA at A1+ and long term at AA-, indicating high degree of safety and comfort.

Chart 19: Diversification of borrowing pool to aid fund raising immensely



Source: Company

ALM profile: Minimal interest rate risk

The asset side of the company carries 100% fixed interest rate with a contracted maturity of 1 year. However, the average duration of the loan is 3-4 months as repayments happen faster. On borrowing front, only 41% of funds from banks (direct lending) has floating interest rate while the others are fixed interest rate instruments with an average duration of 3-4 years.

Incrementally, we expect the average loan duration to increase from the current 3-4 months cycle as stable rates and lower LTVs on offer will incentivize borrowers to complete the full term rather than refinance to higher loan amount or lower interest rate. ALM profile, however, has no concerns given the short tenure of the product and the healthy rated short-term and long-term limits available with the company.

Operating expenses: Strong cost management key to restrict RoA slide

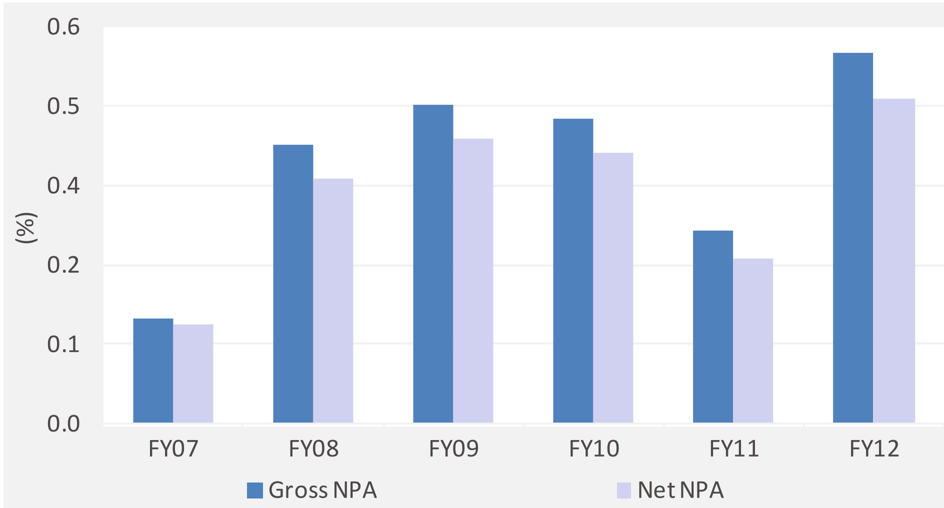
Opex/assets have been steadily coming down from 4.4% in FY10 to 3.8% as of March 2012. This clearly has drawn support from the rapid AUM increase. Hence, incrementally moderating growth will have an impact on this ratio. We believe reduced pace of branch additions, relatively lower cost of advertisements (as gold loans are now reasonably known and accepted as a product vis-à-vis 5 years back) and stricter control of costs will help maintain the downward trajectory of Opex/assets.

What needs to be watched is the imposition of royalty payment for the use of 'Muthoot' brand which can be enforced as per the terms of agreement with the Muthoot family. However, till date a decision on this regard is yet to be taken. If implemented, the royalty will be capped at minimum of 1% of income or 3% of PBT. We have not factored the same in our numbers.

Asset quality – Standard asset provisioning + 90dpd norm

Asset quality has never been a cause of concern in the history of the company as gold prices have shown one way movement upwards. Now, with 60% LTV cap, the margin of safety against gold price correction has gone up which makes us comfortable on the asset quality. In terms of credit costs, slight step up can be seen if standard asset provisioning for NBFCs is brought in line with that of banks, i.e. from 25bps to 40bps. This will increase LLP very marginally from the current 12bps level as the growth assumptions are very modest. Also, norms change from 180dpd NPA recognition norm to that of 90dpd as followed by banks will lead to an increase in GNPA from 0.56%. We view this more as a norm change as the ultimate credit cost is unlikely to be impacted due to this.

Chart 20: Steady gold price increase has led to pristine asset quality



Source: Company

Leverage – Increased Tier I and absence of securitization

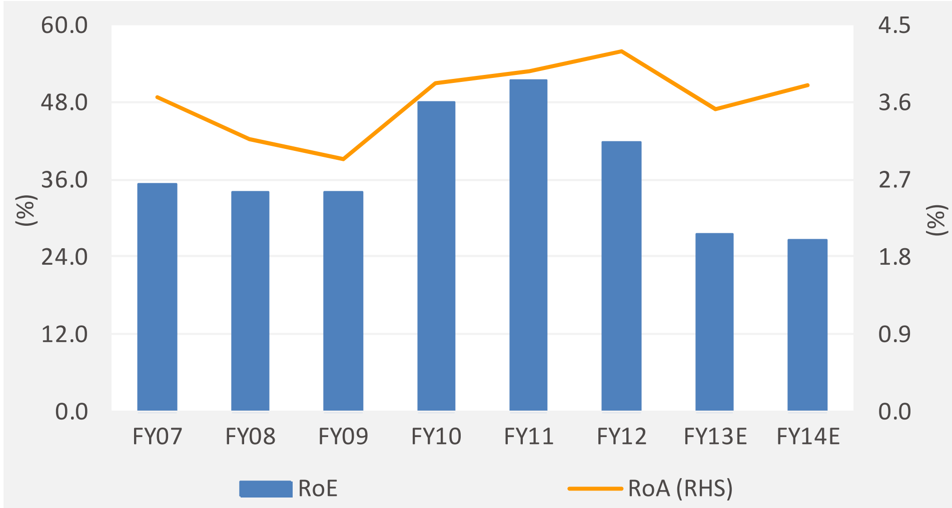
As with other NBFCs, the impact of recent RBI guidelines will be double, one by way of higher Tier I at 12% vis-à-vis 9% earlier and second due to absence of assignment route forcing it to warehouse all the loans in its own balance sheet thereby consuming more capital. As on FY12, 14% of the AUM was assigned. This has seen a decline from 25% of FY09 and may become negligible by the close of FY13E.

The full impact of absence of assignment route will reflect over FY13 as all the off balance sheet loans mature and get replaced with the on balance sheet ones. Other than the direct impact, indirectly higher capital will reflect in slower loan book growth unless equity is raised at frequent intervals.

Return profile – steady state RoA/RoE of 3.5/25%

With pressure on NIMs, we believe, RoAs will settle at 3.5% over a steady state basis. Positive triggers can obviously come from controlled Opex/Assets which we believe will not be very easy to achieve given the recent additions to branch network and the moderation in AUM growth. Increased Tier 1 and absence of securitization will further strain the RoE. We are building in RoA/RoE of 3.5%/25% over FY13-14E.

Chart 21: We are factoring in steady state RoA/RoE of 3.5%/25%



Source: Company, Edelweiss research

Financial Statements

Income statement					(INR mn)
Year to March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Interest income	10,775	22,984	45,280	51,265	54,926
Interest charges	4,790	10,399	23,699	27,753	27,693
Net interest income	5,984	12,584	21,581	23,513	27,233
Fee & other income	119	175	210	250	275
Net revenues	6,104	12,760	21,791	23,763	27,508
Operating expense	2,621	4,806	8,129	9,848	10,902
- Employee exp	1,169	2,210	4,145	5,655	6,215
- Depreciation /amortisation	149	180	329	274	269
- Other opex	1,303	2,416	3,655	3,920	4,419
Preprovision profit	3,483	7,954	13,663	13,914	16,606
Provisions	27	342	351	258	217
PBT	3,456	7,612	13,312	13,657	16,389
Taxes	1,180	2,670	4,392	4,575	5,490
PAT	2,276	4,942	8,920	9,082	10,899
Reported PAT	2,276	4,942	8,920	9,082	10,899
Basic number of shares (mn)	301.0	320.2	371.7	371.7	371.7
Basic EPS (INR)	7.6	15.4	24.0	24.4	29.3
Diluted number of shares (mn)	301.0	320.2	371.7	371.7	371.7
Diluted EPS (INR)	7.6	15.4	24.0	24.4	29.3
DPS (INR)	0.0	0.0	4.0	3.7	4.4
Payout ratio (%)	0.0	0.0	16.7	15.0	15.0

Growth ratios (%)					
Year to March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Operating income growth	100.0	110.3	71.5	9.0	15.8
Net revenues growth	101.0	109.1	70.8	9.0	15.8
Opex growth	69.3	83.4	69.1	21.2	10.7
PPP growth	134.0	128.4	71.8	1.8	19.3
Provisions growth	NA	NA	2.7	(26.6)	(15.8)
PAT growth	132.9	117.2	80.5	1.8	20.0

Operating ratios (%)					
Year to March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Yield on advances	19.8	19.6	22.4	20.7	20.1
Cost of funds	8.5	8.9	12.2	12.2	11.2
Spread	11.3	10.8	10.2	8.5	9.0
Net interest margins	10.0	10.1	10.1	9.1	9.5
Cost-income	42.9	37.7	37.3	41.4	39.6
Tax rate	34.1	35.1	33.0	33.5	33.5

Balance sheet					(INR mn)
Year to March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Liabilities					
Equity capital	3,010	3,202	3,717	3,717	3,717
Reserves	2,832	7,775	25,540	33,028	42,014
Net worth	5,842	13,342	29,257	36,745	45,731
Secured loans	45,471	102,112	163,832	189,059	224,790
Unsecured loans	7,334	17,274	30,000	37,812	44,958
Deferred tax liability	25	25	(4)	(4)	(4)
Assignments	20,083	41,863	33,352	0	0
Others					
Total liabilities	**78,755**	**174,616**	**256,437**	**263,612**	**315,475**
Assets					
Loans	54,617	117,518	211,718	249,758	296,550
Investments	75	75	75	75	75
Current assets	*8,202*	19,729	*19,243*	*23,058*	*28,077*
Current liabilities	*5,754*	6,910	*10,633*	*11,797*	*11,821*
Net current assets	2,447	12,819	8,610	11,261	16,256
Fixed assets (net block + WIP)	1,533	2,341	2,682	2,518	2,594
Assignments	20,083	41,863	33,352	0	0
Total assets	**78,755**	**174,616**	**256,437**	**263,612**	**315,475**
Balance sheet ratios (%)					
Loan growth	120.6	113.4	53.8	1.9	18.7
Deposit growth	66.8	126.1	62.4	17.0	18.9
EA growth	83.2	123.1	47.3	2.9	19.8

RoE decomposition (%)

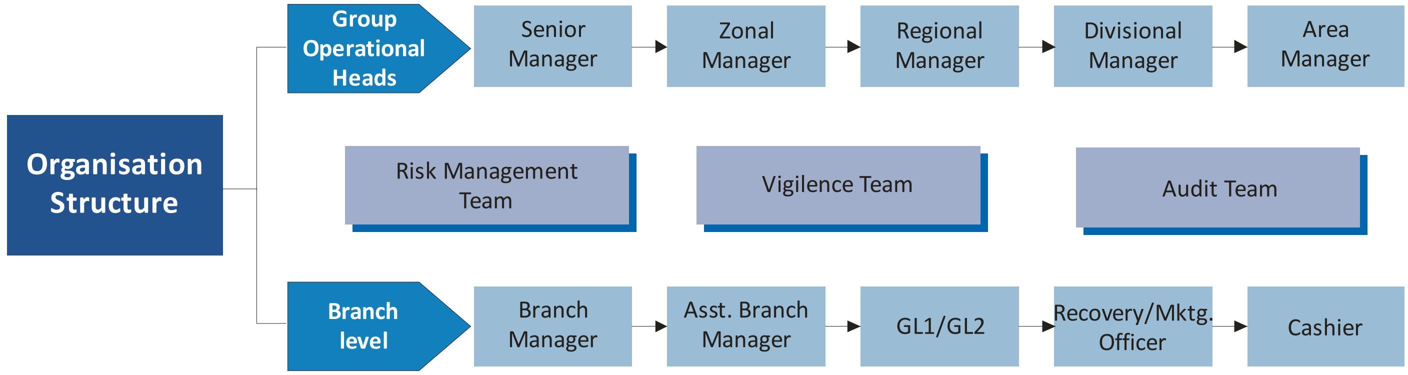
Year to March	FY10	FY11	FY12	FY13E	FY14E
Net interest income/Assets	10.0	10.1	10.1	9.1	9.5
Non-interest income/Assets	0.2	0.1	0.1	0.1	0.1
Net revenues/Assets	10.2	10.2	10.2	9.2	9.6
Operating expense/Assets	(4.4)	(3.9)	(3.8)	(3.8)	(3.8)
Provisions/Assets	(0.0)	(0.3)	(0.2)	(0.1)	(0.1)
Taxes/Assets	(2.0)	(2.1)	(2.1)	(1.8)	(1.9)
Total costs/Assets	(6.4)	(6.3)	(6.0)	(5.7)	(5.8)
ROA	3.8	4.0	4.2	3.5	3.8
Equity/Assets	7.9	7.7	10.0	12.8	14.4
ROAE	48.1	51.5	41.9	27.5	26.4

Valuation metrics

Year to March	FY10	FY11	FY12	FY13E	FY14E
Diluted EPS (INR)	7.6	15.4	24.0	24.4	29.3
EPS growth (%)	*116.7*	*104.1*	*55.5*	*1.8*	*20.0*
Book value per share (INR)	19.4	41.7	78.7	98.9	123.0
Diluted P/E (x)	18.6	9.1	5.9	5.7	4.8
Price/ BV (x)	7.2	3.4	1.8	1.4	1.1

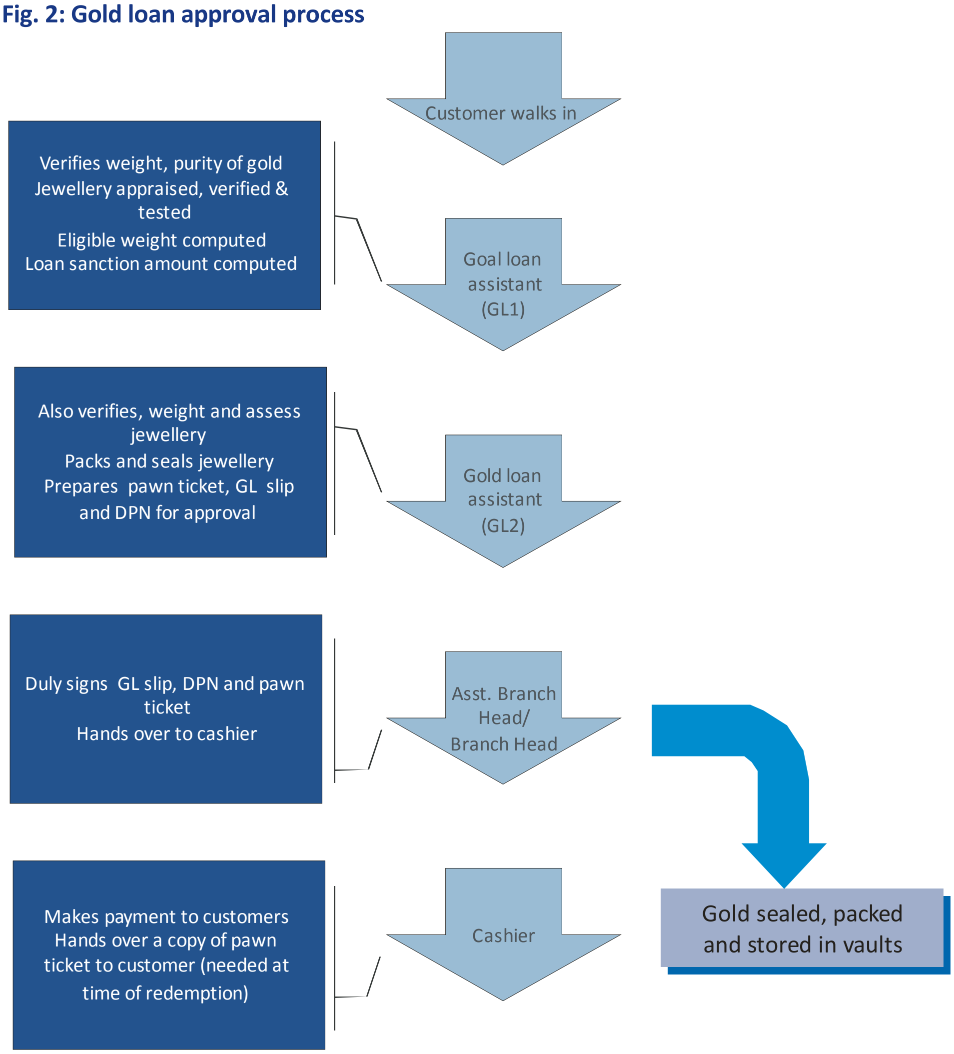
Annexure:

Fig. 1: Organizational hierarchy



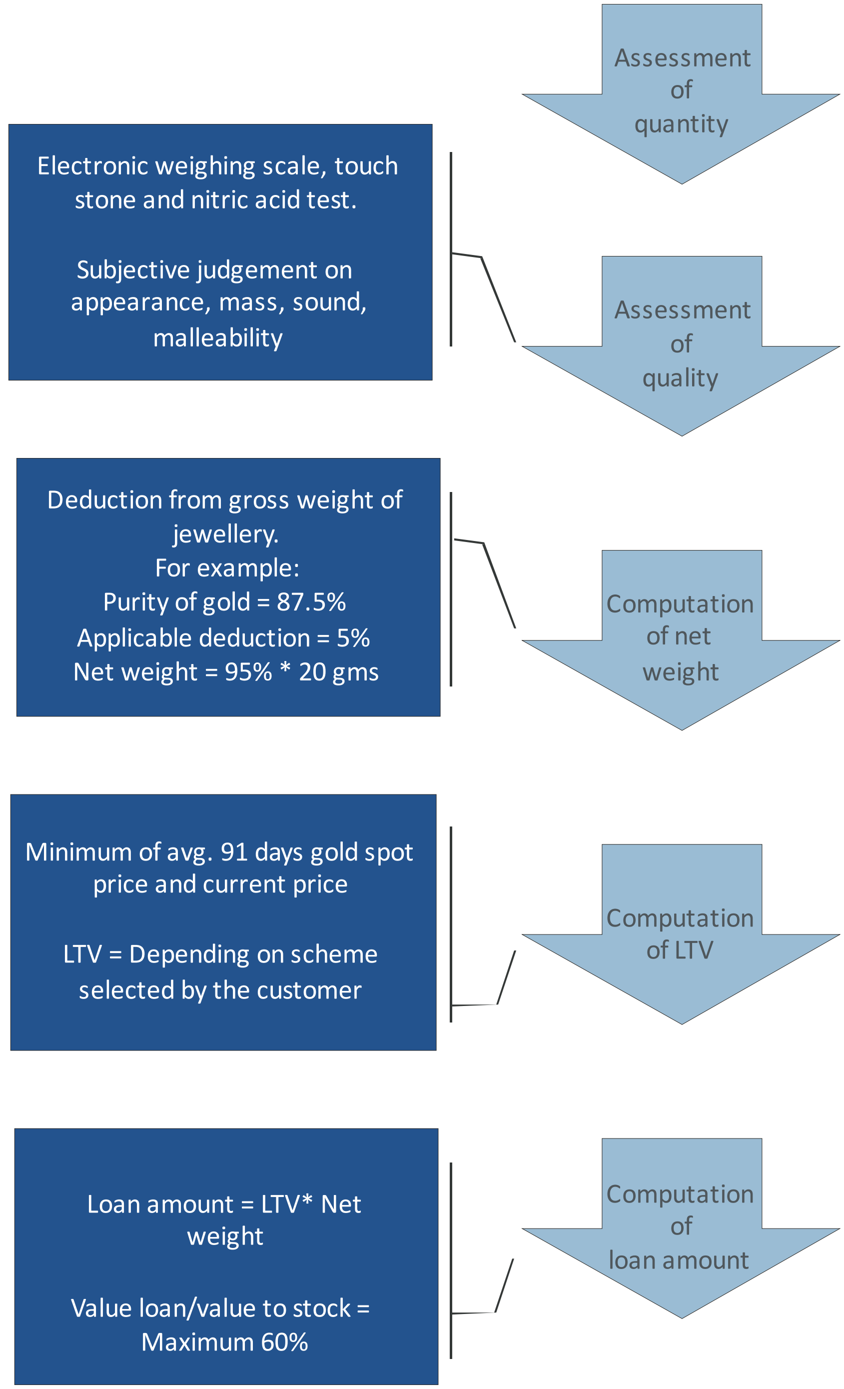
Source: Edelweiss research

Fig. 2: Gold loan approval process



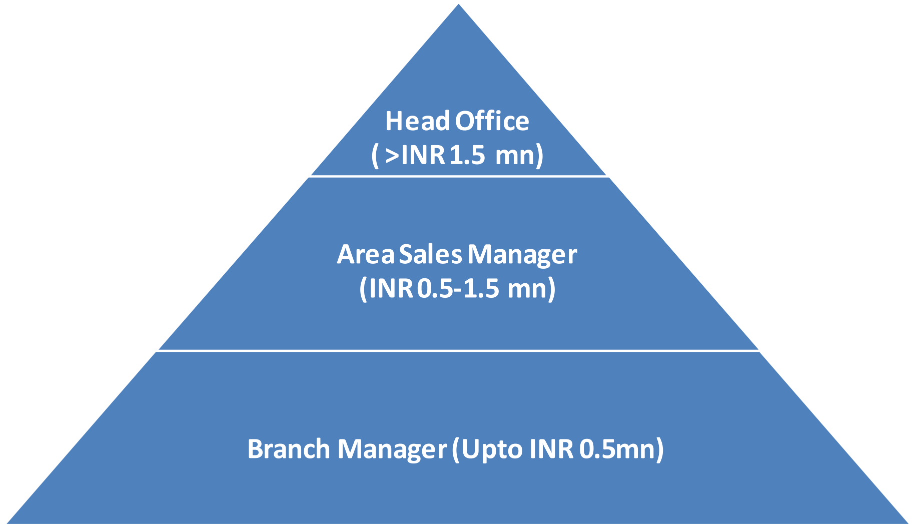
Source: Edelweiss research

Fig. 3: Loan/gram approval process



Source: Edelweiss research

Fig. 4: Loan sanctioning authority (Sample case as seen during branch vists)



Source: Edelweiss research

NOTES:

NOTES:

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
Allahabad Bank	REDUCE	SU	H	Axis Bank	BUY	SO	M
Bank of Baroda	HOLD	SP	L	Federal Bank	BUY	SO	M
HDFC	HOLD	SP	L	HDFC Bank	HOLD	SP	L
ICICI Bank	BUY	SO	L	Indian Overseas Bank	HOLD	SU	H
IndusInd Bank	BUY	SO	M	Infrastructure Development Finance Co Ltd	BUY	SO	M
ING Vysya	BUY	SO	M	Karnataka Bank	BUY	SO	M
Kotak Mahindra Bank	REDUCE	SU	L	LIC Housing Finance	HOLD	SP	M
Mahindra & Mahindra Financial Services	BUY	SO	M	Manappuram Finance	BUY	SO	M
Multi Commodity Exchange of India	BUY	SO	M	Oriental Bank Of Commerce	BUY	SO	H
Power Finance Corp	BUY	SO	L	Punjab National Bank	REDUCE	SU	M
Reliance Capital	BUY	SO	M	Rural Electrification Corporation	BUY	SO	L
Shriram City Union Finance	BUY	SO	H	South Indian Bank	HOLD	SP	M
State Bank of India	HOLD	SP	M	Union Bank Of India	HOLD	SP	H
Yes Bank	BUY	SO	M				

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

Edelweiss Securities Limited, Edelweiss House, off C.S.T. Road, Kalina, Mumbai – 400 098.
Board: (91-22) 4009 4400, Email: *research@edelcap.com*

Vikas Khemani	Head Institutional Equities	vikas.khemani@edelcap.com	+91 22 2286 4206
Nischal Maheshwari	Co-Head Institutional Equities & Head, Research	nischal.maheshwari@edelcap.com	+91 22 4063 5476
Nirav Sheth	Head Sales	nirav.sheth@edelcap.com	+91 22 4040 7499

Coverage group(s) of stocks by primary analyst(s): Banking and Financial Services

Allahabad Bank, Axis Bank, Bank of Baroda, Federal Bank, HDFC, HDFC Bank, ICICI Bank, Infrastructure Development Finance Co Ltd, IndusInd Bank, Indian Overseas Bank, Karnataka Bank, Kotak Mahindra Bank, LIC Housing Finance, Multi Commodity Exchange of India, Manappuram General Finance, Mahindra & Mahindra Financial Services, Oriental Bank Of Commerce, Punjab National Bank, Power Finance Corp, Reliance Capital, Rural Electrification Corporation, State Bank of India, Shriram City Union Finance, South Indian Bank, Union Bank Of India, ING Vysya, Yes Bank

Recent Research

Date	Company	Title	Price (INR)	Recos
21-Jun-12	**HDFC Bank**	Story intact; marginal change seen in retail asset quality; *Visit Note*	534	Hold
18-Jun-12	**HDFC**	Annual report: Non-retail NPLs rise, lower BV accretion; *Company Update*	644	Hold
11-Jun-12	**ICICI Bank**	Annual report: Read across PSL, retail profit, restructuring; *Company Update*	827	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution* * 1 stocks under review	104	60	18	183

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	114	58	11

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

DISCLAIMER

General Disclaimer:

This document has been prepared by Edelweiss Securities Limited (Edelweiss). Edelweiss, its holding company and associate companies are a full service, integrated investment banking, portfolio management and brokerage group. Our research analysts and sales persons provide important input into our investment banking activities. This document does not constitute an offer or solicitation for the purchase or sale of any financial instrument or as an official confirmation of any transaction. The information contained herein is from publicly available data or other sources believed to be reliable, but we do not represent that it is accurate or complete and it should not be relied on as such. Edelweiss or any of its affiliates/ group companies shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. This document is provided for assistance only and is not intended to be and must not alone be taken as the basis for an investment decision. The user assumes the entire risk of any use made of this information. Each recipient of this document should make such investigation as it deems necessary to arrive at an independent evaluation of an investment in the securities of companies referred to in this document (including the merits and risks involved), and should consult his own advisors to determine the merits and risks of such investment. The investment discussed or views expressed may not be suitable for all investors. We and our affiliates, group companies, officers, directors, and employees may: (a) from time to time, have long or short positions in, and buy or sell the securities thereof, of company (ies) mentioned herein or (b) be engaged in any other transaction involving such securities and earn brokerage or other compensation or act as advisor or lender/borrower to such company (ies) or have other potential conflict of interest with respect to any recommendation and related information and opinions. This information is strictly confidential and is being furnished to you solely for your information. This information should not be reproduced or redistributed or passed on directly or indirectly in any form to any other person or published, copied, in whole or in part, for any purpose. This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject Edelweiss and affiliates/ group companies to any registration or licensing requirements within such jurisdiction. The distribution of this document in certain jurisdictions may be restricted by law, and persons in whose possession this document comes, should inform themselves about and observe, any such restrictions. The information given in this document is as of the date of this report and there can be no assurance that future results or events will be consistent with this information. This information is subject to change without any prior notice. Edelweiss reserves the right to make modifications and alterations to this statement as may be required from time to time. However, Edelweiss is under no obligation to update or keep the information current. Nevertheless, Edelweiss is committed to providing independent and transparent recommendation to its client and would be happy to provide any information in response to specific client queries. Neither Edelweiss nor any of its affiliates, group companies, directors, employees, agents or representatives shall be liable for any damages whether direct, indirect, special or consequential including lost revenue or lost profits that may arise from or in connection with the use of the information. Past performance is not necessarily a guide to future performance. The disclosures of interest statements incorporated in this document are provided solely to enhance the transparency and should not be treated as endorsement of the views expressed in the report. Edelweiss Securities Limited generally prohibits its analysts, persons reporting to analysts and their dependents from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. The information provided in this document remains, unless otherwise stated, the copyright of Edelweiss. All layout, design, original artwork, concepts and other Intellectual Properties, remains the property and copyright Edelweiss and may not be used in any form or for any purpose whatsoever by any party without the express written permission of the copyright holders.

Analyst Certification:

The analyst for this report certifies that all of the views expressed in this report accurately reflect his or her personal views about the subject company or companies and its or their securities, and no part of his or her compensation was, is or will be, directly or indirectly related to specific recommendations or views expressed in this report.

Analyst holding in the stock: No.

Additional Disclaimer for U.S. Persons

This research report is a product of Edelweiss Securities Limited, which is the employer of the research analyst(s) who has prepared the research report. The research analyst(s) preparing the research report is/are resident outside the United States (U.S.) and are not associated persons of any U.S. regulated broker-dealer and therefore the analyst(s) is/are not subject to supervision by a U.S. broker-dealer, and is/are not required to satisfy the regulatory licensing requirements of FINRA or required to otherwise comply with U.S. rules or regulations regarding, among other things, communications with a subject company, public appearances and trading securities held by a research analyst account.

This report is intended for distribution by Edelweiss Securities Limited only to "Major Institutional Investors" as defined by Rule 15a-6(b)(4) of the U.S. Securities and Exchange Act, 1934 (the Exchange Act) and interpretations thereof by U.S. Securities and Exchange Commission (SEC) in reliance on Rule 15a 6(a)(2). If the recipient of this report is not a Major Institutional Investor as specified above, then it should not act upon this report and return the same to the sender. Further, this report may not be copied, duplicated and/or transmitted onward to any U.S. person, which is not the Major Institutional Investor.

In reliance on the exemption from registration provided by Rule 15a-6 of the Exchange Act and interpretations thereof by the SEC in order to conduct certain business with Major Institutional Investors, Edelweiss Securities Limited has entered into an agreement with a U.S. registered broker-dealer, Marco Polo Securities Inc. ("Marco Polo").

Transactions in securities discussed in this research report should be effected through Marco Polo or another U.S. registered broker dealer.

Edelweiss
Ideas create, values protect

Edelweiss Securities Limited, Edelweiss House, off C.S.T. Road, Kalina, Mumbai 400 098
Tel: +91 22 4009 4400. Email: research@edelcap.com