

Initiating Coverage Cholamandalam Investment & Finance Company Ltd.

23-December-2020



Cholamandalam Investment & Finance Company Ltd.

Industry	LTP	Recommendation	Fair Value	Time Horizon
NBFC	Rs.361	Buy on dips to Rs.336-340 band and add more on dips to Rs.306-310 band	Rs.369	2 quarters

HDFC Scrip Code	CHOFIN
BSE Code	511243
NSE Code	CHOLAFIN
Bloomberg	CIFC
CMP Dec 22, 2020	361
Equity Capital (Rsmn)	1640
Face Value (Rs)	2
Equity Share O/S (mn)	820
Market Cap (Rs bn)	295.44
Book Value (Rs)	100
Avg. 52 Wk Volumes	8435538
52 Week High	394.3
52 Week Low	117.4

Share holding Pattern % (Sep, 2020)	
Promoters	51.64
Institutions	40.46
Non Institutions	7.90
Total	100.0

Fundamental Research Analyst

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Our Take:

Over the past 40 years, Cholamandalam Investment and Finance (Chola) has emerged as a comprehensive financial services provider. It has diversified product portfolio such as vehicle finance (73% of AUM), home loans, home equity loans (21% of AUM), SME loans (5% of AUM), investment advisory services, stock broking and other financial services. During the last five years, the company has established a credible operational and financial track record as manifested by superior AUM growth at 20% CAGR and a growth of 17% CAGR in EPS. As a part of the Murugappa Group, the company derives considerable management, operational and financial support from Group companies. A faster recovery of the rural sector and a good Rabi harvest is expected to drive rebound in rural demand and Chola with around 80% of branches in rural & semi urban areas is at clear advantage. An improvement in demand and better availability of funds could further improve the growth prospects. The Company has a comprehensive Risk Management Policy in place and has laid down a well-defined risk management framework to identify, assess and monitor risks and strengthen controls to mitigate risks. The best in class asset quality highlights prudent underwriting skills of the company.

Valuations & Recommendation:

Despite a difficult environment, the company delivered decent growth in H1FY21. There might be near term volatility in the performance of the company due to uncertainty in prevailing in the industry. Chola's ability to generate consistently superior return ratios backed by strong operating metrics and steady NIMs along with high promoter pedigree provides comfort. In our view, resilient rural economy, lower cost of funds resulting in higher NIMs along with improved traction in collection efficiency are key positives for Chola. We expect, FY22 onwards better capacity utilization across vehicles and gradual normalization of core economic activities will result in a sharp uptick in Chola's earnings.

Chola is well-diversified across product segments and there is no state-level concentration – the largest state accounts for only 11% of the total portfolio. It has superior asset quality track record, lower share of problem loans vs peers and expectation of faster recovery in ROEs to normalised levels.

We have estimated 12% CAGR for NII and 27% CAGR for Adjusted Net Profit over FY20-22E. We have estimated 7% CAGR for AUM over the same period. With incremental unlocking of the economy, demand for loans will improve from FY22E. We expect a sharp rise in GNPA's in FY21E to 4.8%. We have estimated lower provision given the significant improvement in collection efficiency and high coverage.

We feel that investors can buy Chola on dips to Rs.336-340 band (2.8x FY22E ABV) and add more in the Rs.306-310 band (2.55x FY22E ABV). We expect the fair value of Rs.369 (3.05x FY22E ABV) over the next 2 quarters.

Financial Summary

Particulars (Rsmn)	Q2FY21	Q2FY20	YoY-%	Q1FY21	QoQ-%	FY19	FY20	FY21E	FY22E
NII	11,728	8643	35.7	9403	24.7	29,868	35,319	41,964	44,472
PPOP	8996	6185	45.5	6371	41.2	21,344	24,831	29,958	31,488
PAT	4319	3070	40.7	4309	0.2	11,862	10,524	15,926	17,005
EPS (Rs)						15.2	12.1	19.4	20.7
ROAE (%)						21.1	13.8	17.9	16.3
ROAA (%)						2.34	1.63	2.41	2.37
ABVPS (Rs)						68.1	84.2	96.5	120.9
P/E (x)						23.8	29.8	18.6	17.4
P/ABV (x)						5.3	4.3	3.7	3.0

(Source: Company, HDFC sec)

Recent Developments

Q2FY21 highlights:

The company reported 35.7%/24.7% YoY/QoQ growth in NII and 40.7%/0.2% growth in Net profit. AUM growth was up by 13% YoY led by VF segment 12% YoY and LAP/SME grew 11.6% YoY. Cost to Income ratio improved further to 28.3% vs. 39.4/35.2% YoY/QoQ. Reported GS-II (Gross Stage II) dipped 12% QoQ (+6.3% YoY) to Rs 17.6bn (2.8%). Adjusted for the impact of the recent SC order, GS-III (Gross Stage III) would have been ~3%. Until July, ~50% of customers had paid at least one instalment (including part of an instalment). This number improved to ~95% in October. Collection efficiency stood at ~87% (vs. the usual run rate of 100-105%). The management forecasted a reversion to pre-COVID-19 levels in the near term. In the worst case scenario, the management expects ~5% of the portfolio to be restructured.

Change in portfolio mix towards high yielding segment aided NIM expansion. The company has been gaining market share across product segments, especially in Tractor

Funding and liquidity:

Chola remains one of the best-placed NBFCs on both these fronts. Borrowings grew 8.4/3.5% YoY/QoQ in Q2FY21, slightly behind AUMs. Overseas borrowings, which grew ~22/33%, accounted for a significant portion of the net QoQ increase, followed by debentures, which grew ~14% QoQ. Chola held cash and bank balances of ~Rs 68bn; together with undrawn lines, available liquidity was ~Rs 98bn (16.2% of borrowings). It is adequately capitalized, with total CAR at 19.5%. Chola's comfort on these fronts, together with its superior asset quality and execution capabilities, will allow the company to capture resurgent growth.

Rural recovery

The lockdown has immediately impact truck operators choking their cash flows, thereby creating asset quality challenges for the lenders. But once the economy re-opens post the lock down, the transportation of goods is expected to be one of the fastest recovering activities. Moreover, the demand for used commercial vehicles will emerge first (due to less cost) and Chola being one of the largest players in the segment will benefit. A faster recovery of the rural sector and a good Rabi harvest expected to support tractor demand immediately post easing of the lockdown. Chola has more than 80% of branches in rural & semi urban areas, which gives them a clear advantage to capitalize on the rebound in rural demand.

Used Vehicles

To combat the problem of slowdown in new vehicles sales, the company has started focusing on used vehicle segment. This will help them in the time of post corona recovery phase as the demand for used vehicles will emerge first (due to lower cost). Currently, used vehicles contribute ~26% of the Vehicle Finance AUM. Vehicle Manufacturers were giving heavy discount to for their BS-4 inventory so there was less demand for used vehicles. Now, as the time line for shift of BS-4 to BS-6 has expired we think that resale value of used vehicle will go up significantly and for company the asset coverage of their existing portfolio will also go up. Also, the government's proposed scrappage policy could help getting higher demand for pre-owned vehicle. It has been observed that post transitions to BS-6, CV prices have increased ~10-15%; which has translated into about 5-10% rise in used CV prices.

Home Equity

The COVID-19 pandemic and the resultant lockdown is likely to impact MSME credit growth majorly during first half of FY21. However, the initiatives taken by Government and RBI towards allowing for moratorium on payment of installments, priority sector lending, credit guarantee scheme and clearance of past payable dues to MSMEs are expected to help the sector recover. Despite these measures, the COVID related impact is expected to affect the business continuity of a significant share of MSMEs in the country.

As far as the lending institutions to the MSMEs are concerned, assets with lower ticket sizes and loans against Self-Occupied Residential Properties (SORP) are expected to have lesser stress on their portfolio. Cashflow impact is likely to remain in the short term even after the lockdown eases, due to supply chain disruptions and counter party debtor risk across the value chain. Asset quality concerns are expected to pose challenge over the next one year. Property prices may face downward revision in the short term, however lenders with optimal Loan-to-Value (LTV) ratio in their portfolio are expected to wear out this challenge sooner than others.

Long term Triggers

Strong Parent

Founded in 1900, the ~Rs. 381 Bn, Murugappa Group is one of India's leading business conglomerates. The Group has 28 businesses. These companies are market leaders in served segments including Abrasives, Auto Components, Transmission Systems, Cycles, Sugar, Farm Inputs, Fertilizers, Plantations, Bio-products and Nutraceuticals. The Group has a wide geographical presence all over India and spanning 6 continents. As a part of the Murugappa Group, Chola derives considerable management, operational and financial support from Group companies.

A well-diversified Business

Over the past 40 years, Chola has emerged as a comprehensive financial services provider. The core business segments include vehicle finance (73.3% of AUM) and home equity (HE) loans (21.3% of AUM). It has a housing loan and SME loan portfolio, which largely constitutes the rest of the portfolio. Its VF business is also well diversified. It lends in almost all the categories like commercial vehicle 2, 3 & 4 wheelers, tractors, Used Vehicles etc. Chola is one of the leaders in the commercial vehicle segment. The company has gained market share by growing vehicle book at a CAGR of 20% over FY15-20 compared to 15%/13%/9% for MMFS/Sundaram/SHTF.

Chola also has fairly diversified geographical presence. It has around 1000 branches with focus on rural and semi-urban markets. No single region (North/South/East/West) constitutes more than 30% of its overall branch network. As far as state-level concentration is concerned the largest state Maharashtra accounts for only 10% of total AUM. Chola has been deliberately opening new branches in rural and semi-urban markets to avoid competition from banks and new NBFCs having stronghold in metros.

On the liability side also the company is fairly diversified which has helped the company to maintain its liquidity position and borrowing cost even at times when there was stress across NBFC and HFC space. As on H1FY21, major chunk of its borrowing was from bank term loans which contributed ~2/3 of its total borrowings followed by NCD, CP, Sub-ordinated Debt, Working capital, Perpetual Debt and securitization.

Well established track record

During the last five years, the company has established a credible operational and financial track record as manifested by superior AUM growth at 20% CAGR and a growth of 17% CAGR in EPS. Despite the industry facing many challenges in past couple of years, Chola has been able to maintain stable asset quality. It has the lowest non-performing assets ratio in the industry. ROAA of the company stands at ~2.3%. It has been constantly giving dividend since more than last ten years. Recently the company undertook a QIP placement of 28.12mn shares at Rs.320 per share thereby raising Rs.9 bn. Hence, company has more than sufficient amount of capital to tackle collection efficiency issues and for any growth opportunities too.

Risk Management Policy

The best in class asset quality highlights prudent underwriting skills of the company; even during the recent weak economic scenarios the asset quality has remain stable. The Company has a comprehensive Risk Management Policy in place and has laid down a well-defined risk management framework to identify, assess and monitor risks and strengthen controls to mitigate risks. Established procedures are periodically placed before the Risk Management Committee. It is based on a meticulous assessment of risks through proper analysis and understanding of the underlying risks before undertaking any transactions and changing or implementing processes and systems. We believe that the company's long track record in the vehicle financing business, understanding of the target customer segment and robust underwriting practices should help company in this troubled time of asset quality deterioration.

Strengthening digital capabilities

The company has done significant investments to digitize all the activities throughout the lifecycle of the loan. Digital technology plays a key role not only as an efficiency enabler for on-going business operations but also empowers the business to transition towards being a nimble, customer-centric, and data-centric enterprise. Customer facing app with customer service module “i-Loads” and “GaadiBazaar” are few examples of company’s digital advancement strategy. This will help company in tackling current situation i.e. social distancing.

What could go wrong?

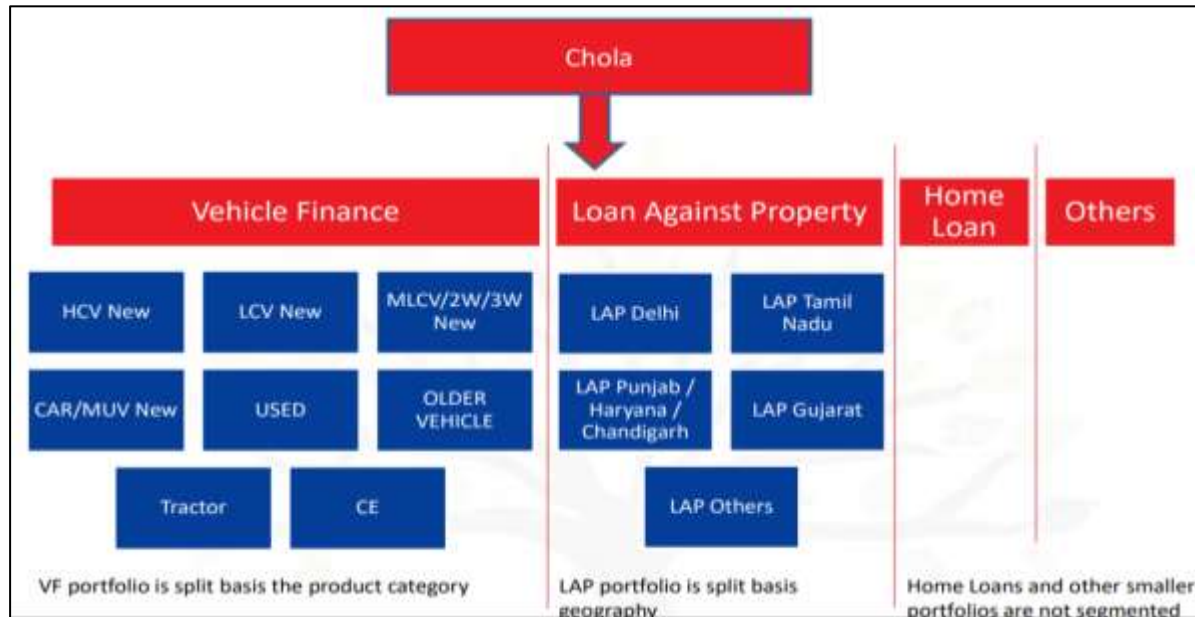
- The Indian vehicle industry was already under pressure due to the demand slow-down, axle load norms, GST etc. and now due to Corona virus outbreak, the whole new set of challenges have been emerged. But now the situation seems improving as the gradually economy is opening up.
- The prospects of Commercial Vehicle industry are largely linked to economic activity, so any prolonged slowdown in the economy will impact the sale of Commercial Vehicles and ultimately to the vehicle financing companies both in terms of loan growth and asset quality. Further, Chola has exposure to the SME segments which may be vulnerable if economic recovery is delayed.
- The company has large dependence on rural and semi-urban areas. Over 90% of the branches are located in semi-urban and rural areas. Poor rainfall could lead to slowdown in rural areas compounding problems for Chola. Further, the company has high-risk customer base as it offers loan to economically lower class, who have no credit ratings.
- Prolonged COVID-19 led slowdown might impact negatively to the company on multiple fronts i.e. liquidity, asset quality, loan growth etc.
- Lower than expected loan growth and greater than expected deterioration in asset quality remains key risk to our thesis.
- The Home Equity business witnessed a muted growth in disbursements in line with the overall industry trend. Delinquencies in this portfolio also remain high as reflected in high GNPA's numbers. The COVID-19 pandemic and the resultant cash flow issues of the customers might increase the stress on the collections in the coming quarters.
- Market share loss in large-tickets Construction equipment and Heavy Commercial Vehicles was due to the company avoiding disbursements in these segments. This could mean slower growth in disbursements.
- Overall ECL (expected credit loss) coverage increased 85 bps yoy/23 bps qoq to 2.6% which is lower than 5-6% coverage for most other vehicle financiers.
- Reduction in valuation premium vis-à-vis its peers; and greater-than-expected margin compression are two other risks faced by the company.

Cholamandalam Investment & Finance Company Ltd.

Company Profile:

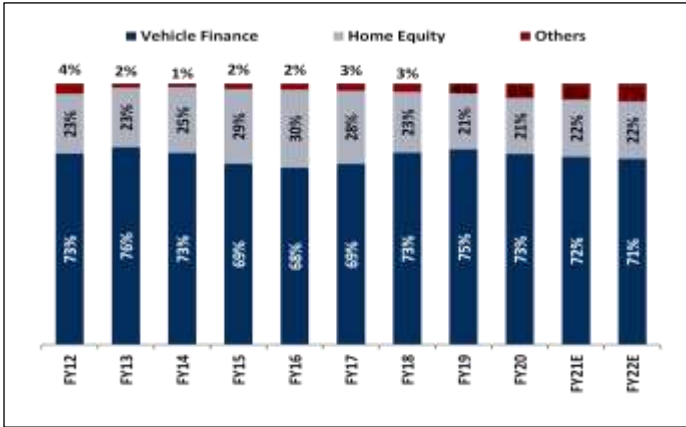
Incorporated in 1978 as the financial services arm of the Murugappa Group, Cholamandalam Investment and Finance (Chola) has grown into a comprehensive and full-fledged financial services provider. It had started business as an equipment financing company and forayed into vehicle finance, home loans, home equity loans, SME loans, investment advisory services, stock broking and other financial services. Chola is registered as an asset finance company with focus on rural and semi-urban markets, and it has ~1132 branches with assets under management of around Rs. 671.82 bn.

The company has two wholly-owned subsidiaries- Cholamandalam Home Finance Limited (erstwhile Cholamandalam Distribution Services Limited) and Cholamandalam Securities Limited, as well as an associate entity, White Data Systems India Private Limited (31% stake).

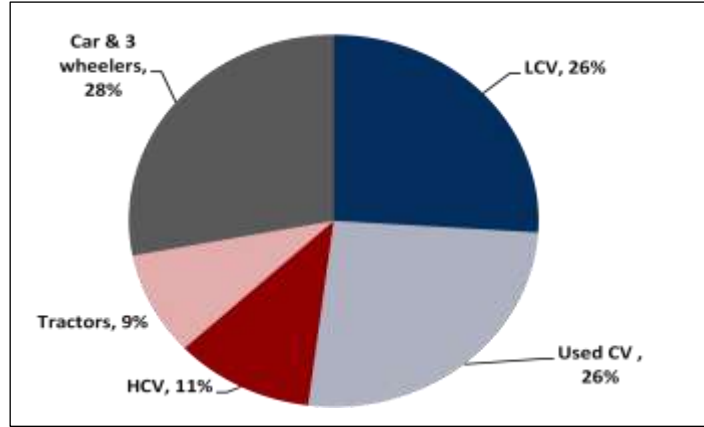


Cholamandalam Investment & Finance Company Ltd.

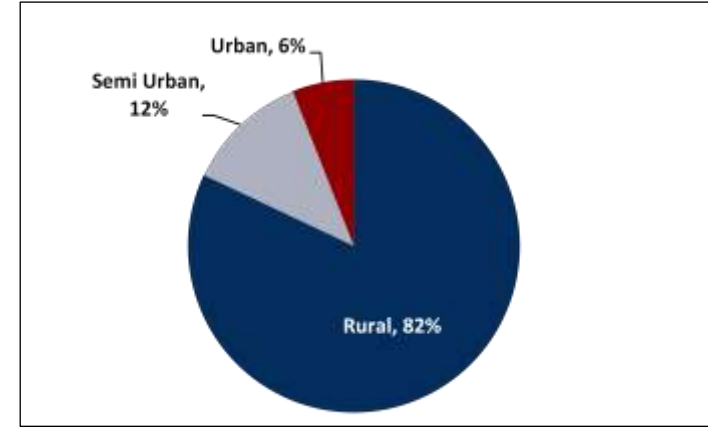
AUM Mix%



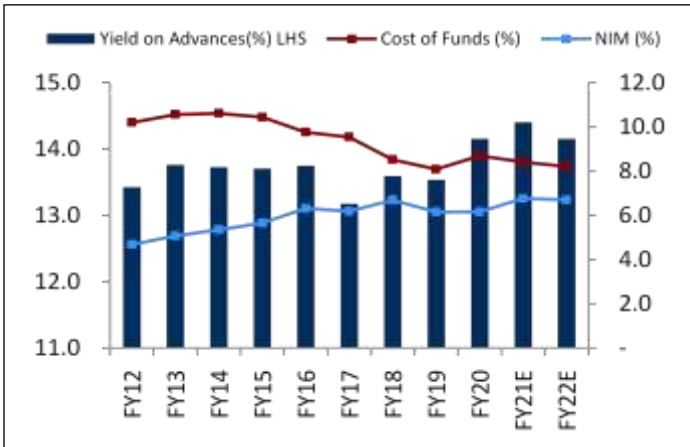
Vehicles Finance AUM mix – H1FY21



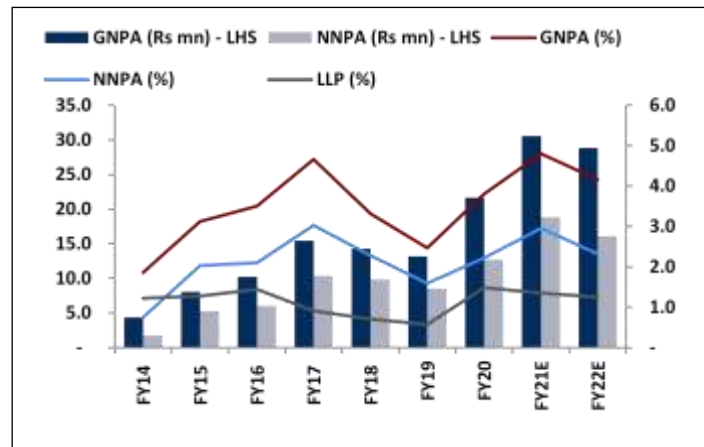
Strong Rural Presence



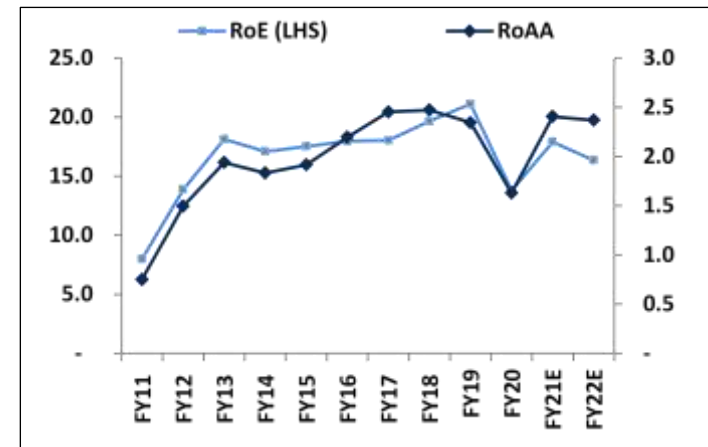
NIM Trend



NPA Trend



Return Ratios



Cholamandalam Investment & Finance Company Ltd.

Financials

INCOME STATEMENT

(Rs mn)	FY19	FY20	FY21E	FY22E
Interest Earned	65,755	81,242	89,360	94,000
Interest Expended	35,887	45,922	47,396	49,528
Net Interest Income	29,868	35,319	41,964	44,472
Other Income	4,171	5,287	3,708	4,615
Total Income	34,039	40,607	45,672	49,087
Total Operating Exp	12,696	15,776	15,714	17,598
PPOP	21,344	24,831	29,958	31,488
Provisions & Contingencies	3,112	8,973	8,581	8,663
PBT	18,232	15,857	21,377	22,826
Provision for Tax	6,370	5,334	5,451	5,821
PAT	11,862	10,524	15,926	17,005

BALANCE SHEET

(Rs mn)	FY19	FY20	FY21E	FY22E
SOURCES OF FUNDS				
Share capital	1,564	1,640	1,640	1,640
Reserves and surplus	60,193	80,079	94,651	1,10,211
Shareholders' funds	61,757	81,718	96,291	1,11,851
Total Borrowings	5,05,667	5,50,054	5,78,411	6,29,591
Other Liabilities, provisions	6,838	8,158	9,381	10,789
Total	5,74,263	6,39,930	6,84,083	7,52,230
APPLICATION OF FUNDS				
Advances	5,26,223	5,54,027	6,13,370	6,68,745
Investments	729	729	802	882
Fixed assets	1,759	2,839	3,122	3,435
Other Assets	45,553	82,335	66,789	79,168
Total assets	5,74,263	6,39,930	6,84,083	7,52,230

(Source: Company, HDFC sec Research)

Cholamandalam Investment & Finance Company Ltd.

Key Ratios:

	FY19	FY20	FY21E	FY22E
VALUATION RATIOS				
EPS	15.2	12.1	19.4	20.7
Earnings Growth (%)	29.1	- 11.3	51.3	6.8
BVPS (ex reval.)	79.0	99.7	117.4	136.4
Adj. BVPS (ex reval. & 100% cover)	68.1	84.2	96.5	120.9
RoAA (%)	2.34	1.63	2.41	2.37
ROAE (%)	21.1	13.8	17.9	16.3
P/E (x)	23.8	29.8	18.6	17.4
P/ABV (x)	5.3	4.3	3.7	3.0
Dividend Yield (%)	0.5	0.6	0.6	0.6
PROFITABILITY				
Yield on Advances (%)	13.54	14.15	14.40	14.15
Cost of Funds (%)	8.08	8.70	8.40	8.20
Core Spread (%)	5.46	5.45	6.00	5.95
NIM (%)	6.15	6.15	6.76	6.69
OPERATING EFFICIENCY				
Cost/Avg. AUM Ratio (%)	2.6	2.7	2.5	2.6
Cost-Income Ratio (%)	37.3	38.9	34.4	35.9

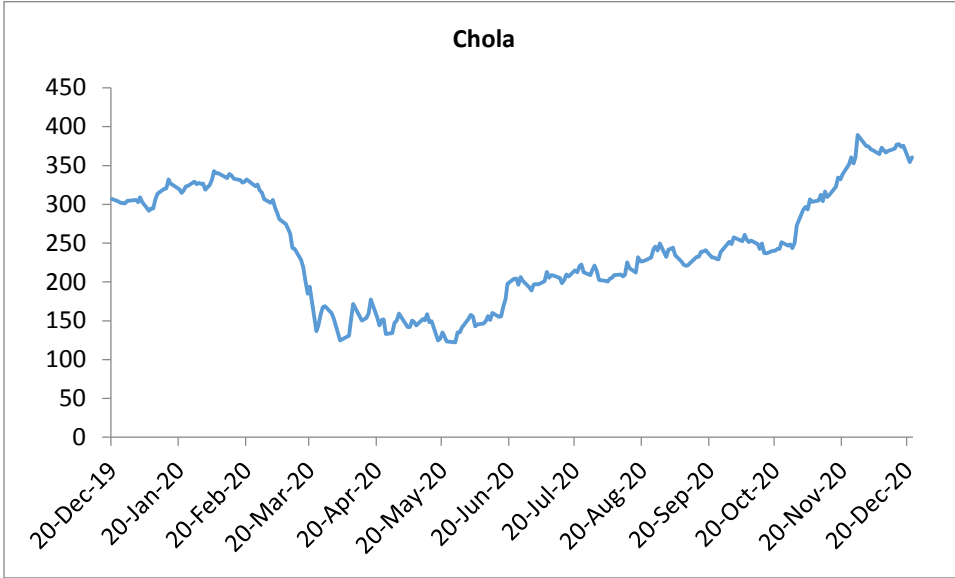
(Source: Company, HDFC sec Research)

Key Ratios:

	FY19	FY20	FY21E	FY22E
BALANCE SHEET STRUCTURE RATIOS				
Loan Growth (%)	26.6	11.6	5.0	9.0
Borrowing Growth (%)	31.3	8.8	5.2	8.8
Equity/Assets (%)	10.8	12.8	14.1	14.9
Equity/Loans (%)	11.4	13.5	15.1	16.1
CAR	17.6	20.7	21.1	20.8
Tier I CAR	12.6	15.3	16.6	16.5
ASSET QUALITY				
Gross NPLs (Rsm)	13,174	21,633	30,515	28,814
Net NPLs (Rsm)	8,502	12,650	18,790	16,047
Gross NPLs (%)	2.5	3.8	4.8	4.2
Net NPLs (%)	1.6	2.2	3.0	2.3
Coverage Ratio (%)	35.5	41.5	38.4	44.3
Provision/Avg. AUM (%)	0.57	1.48	1.35	1.25

Cholamandalam Investment & Finance Company Ltd.

One Year Price Chart



(Source: Company, HDFC sec Research)

Cholamandalam Investment & Finance Company Ltd.

Disclosure:

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