

Initiating Coverage Care Ratings Ltd.

January 13, 2023





Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
Credit Rating	Rs 640	Buy in Rs 635-650 band & add more on dips in Rs 560-575 band	Rs 708	Rs 748	2 quarters

HDFC Scrip Code	CARRATEQNR
BSE Code	534804
NSE Code	CARERATING
Bloomberg	CARE IN
CMP Jan 12, 2023	639.5
Equity Capital (Rs cr)	29.6
Face Value (Rs)	10
Equity Share O/S (cr)	3.0
Market Cap (Rs cr)	1897
Book Value (Rs)	223.8
Avg. 52 Wk Volumes	162,500
52 Week High (Rs)	677.2
52 Week Low (Rs)	402.8

Share holding Pattern % (Dec, 2022)	
Promoters	0.0
Institutions	43.0
Non Institutions	57.0
Total	100.0



**HDFCsec Retail research
stock rating meter**

for details about the ratings, refer at the end of the report

* Refer at the end for explanation on Risk Ratings

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Our Take:

CARE ratings is the second largest credit rating agency in India after Crisil. Regulatory bodies like RBI, SEBI and other bodies like NCLT have mandated ratings for new products/borrowers, bringing in new sources of income for credit rating agencies (CRA). The COVID-19 pandemic had disrupted businesses and the rated volumes plummeted. However now the economy is back on the revival path. Businesses have announced significant capex plans and the Government has also announced ~25% increase in its capex for 2022-23. The requirement for credit rating is likely to grow along with the economy. Measures such as the PLI scheme and increased ease of doing business are expected to boost capital expenditure in the next five years. Given that bank credit is expected to double in the next five years, the long-term value proposition of CRAs seems intact.

The current valuation of the stock is not demanding given that the business and relationships takes time to scale up, revenue growth is assured (though its pace may change) and margins are high in a low capex intensity business.

Valuation & Recommendation:

CARE seems to back on track after the turmoil in the top management seen in 2021. It is fast catching up with its two large competitors. The gap in valuation with the two competitors is large even granting the shareholding by foreign promoters in the other two. CARE also has cash and cash equivalents as on Sept 30, 2022 of Rs 187 per share (which is ~30% of its current market price).

We expect CARE's revenue/EBITDA/PAT to grow at 12/21/19% CAGR over FY22-FY25E, led by increase in volume of debt rated and operating efficiencies. We believe investors can buy the stock in the band of Rs 635-650 and add on dips in Rs 560-575 band (14x Sep'24E EPS) for a base case fair value of Rs 708 (17.5x Sep'24E EPS) and bull case fair value of Rs 748 (18.5x Sep'24E EPS) over the next 2 quarters.

Financial Summary

Particulars (Rs cr)	Q2FY23	Q2FY22	YoY (%)	Q1FY23	QoQ (%)	FY22	FY23E	FY24E	FY25E
Revenues	84.8	76.4	11.0	54.6	55.3	247.6	284.3	315.0	346.5
EBITDA	42.0	33.5	25.3	16.1	160.4	79.6	110.9	126.0	142.1
APAT	34.3	26.6	28.9	13.7	151.1	75.1	98.3	112.3	127.3
Diluted EPS (Rs)	11.6	9.0	28.1	4.6	151.0	25.3	33.2	37.9	43.0



RoE (%)						12.2	14.5	15.2	15.7
P/E (x)						25.2	19.3	16.9	14.9
EV/EBITDA (x)						17.2	11.8	9.8	8.1

(Source: Company, HDFC sec)

Q2FY23 Result Update

Revenue of the company grew by 11% YoY in Q2FY23 to Rs 85cr as rating and related services segment revenue increased 12.2% to Rs 81cr. Non rating revenues declined from Rs 4.5cr in Q2FY22 to Rs 4cr in the current quarter. During this quarter, volume of bond issuances declined 5% YoY to Rs 2 lakh crore and CP issuances fell ~39% to Rs 3.8 lakh crore. Employee expenses grew by 6.8% YoY and other expenses fell 20.4% resulting in 25.3% YoY growth in EBITDA to Rs 42cr and 566bps YoY expansion in EBITDA margin to 49.5%. PAT increased by 28.9% YoY to Rs 34.3cr and PAT margin expanded 563bps to 40.8% as other income jumped 43.4% YoY to Rs 8.5cr.

Issuances of commercial paper (CPs) and corporate bonds remained muted in Q2 FY23 compared to last year. However, there has been improvement in Corporate Bond issuances in Q2 FY23 when compared to Q1 FY23 (increase by 107% QoQ). Growth in bank credit has been driven by the services (20% growth), followed by retail segment (19.6% growth). Credit to industrial sector has grown by 12.6%. However, credit growth for large enterprises relatively lower at 7.9% (YoY).

Key triggers

Oligopolistic market structure in the rating business prevalent in India, favourable regulatory regime

CARE performs under an oligopolistic market structure that acts as a boon for the company. With only three large players (CRISIL, ICRA, CARE), and four other players into the business, the company enjoys a good market share. All these rating agencies have tie-ups with international agencies, CRISIL has with the S&P's and ICRA has it with the Moody's, but CARE does not have any.

Rating business performance is directly linked with amount of borrowing, companies does with the banks. More the amount of borrowings more the need for ratings would be, thus, raising the quantum, and demand for the company's services and products. As per management, there had been many structural changes that has contributed to the volume growth. CARE normally charges 10 bps for bond issuance, 3 bps for surveillance, and 4 bps for bank ratings.

Government capex could drive higher bond issuance

As India emerged from the shadow of the COVID-19 pandemic, the finance minister in FY23 budget made a steep increase in government expenditure which in time will spur private investments that have so far remained stalled. The Government in its budget for 2022-23 increased capex by 24.47% over previous year's budget to Rs 7.5 lakh crore (compared with the revised estimate for 2021-22 at Rs 6.02 lakh crore).



crore), which is almost 2.9% of the GDP. The higher capex would aid in boosting economic activity by increasing connectivity that solves supply-chain and logistical problems. Together with grants in aid for creation of capital assets (including MNREGA works), the effective capital expenditure for FY23 is budgeted at Rs 10.67 lakh crore, 27% more than the RE of 2021-22 at Rs 8.40 lakh crore. This is likely to drive higher bond issuance. Even in the FY24 Union Budget, the Govt could continue its focus on capex, also given that it is the last Budget of the current Govt.

Recent RBI norms could lead to increase in NPA

Reserve Bank of India's (RBI) clarification on non-performing advances (NPA) accounting is likely to increase NPAs by around one third for non-banking finance companies (NBFCs). NBFCs generally classify an account as stage 3 when there is a payment overdue for more than 90 days. However, when the borrower makes part payment such that the total overdue is less than three instalments, the account is removed from NPA classification and classified as a standard asset, although it remains in the overdue category. However, as per RBI clarification, a stage 3 asset would become standard only when all the overdues / arrears (including interest) are cleared.

The RBI circular also calls for daily stamping of accounts to count the number of days they are overdue instead of a monthly or quarterly stamping. This again would result in an accelerated pace of NPA recognition for accounts. This could lead to increased volume of restructured loans which would be beneficial for CRAs.

Higher scrutiny by banks while lending

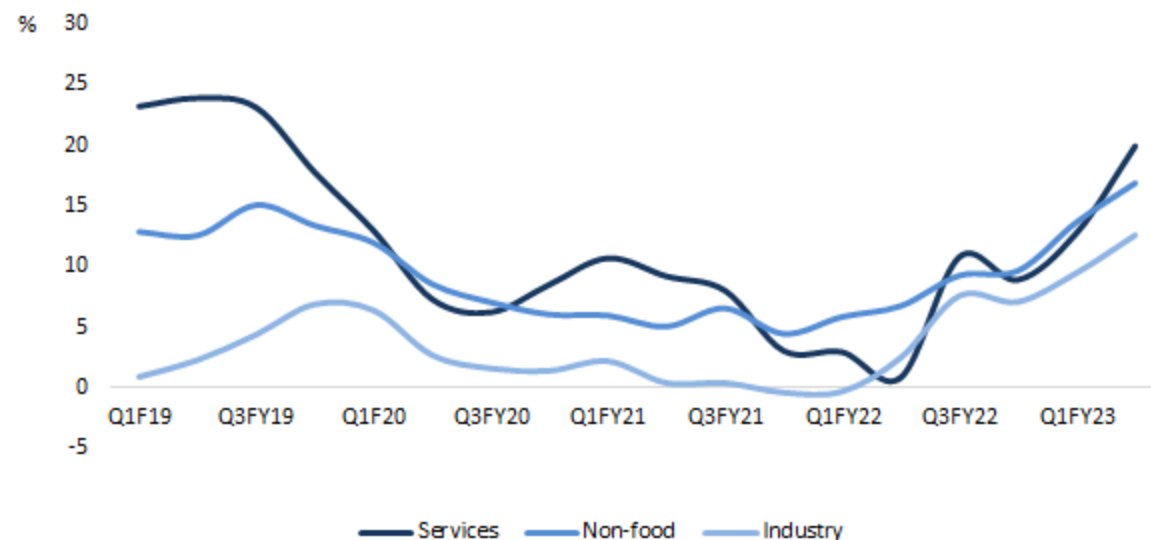
After sharp increase in corporate led NPAs and subsequent write-offs, overall NPA levels were on an improving trajectory. Banks have also become stricter in lending without a rating report. Recently, the Reserve Bank of India (RBI) said that a bank loan rating by rating agencies not having lenders' names won't be considered for capital computation by banks. For rating companies this is positive in the long-run, and is likely to increase the volume of business in the coming years.

Bank credit growth improving

Credit growth, which had been languishing through 2021 due to Covid-19 and also deleveraging of balance sheets by large corporates, has been recovering as indicated by the RBI data. Increasing credit would drive higher demand for ratings, benefitting rating agencies like CARE. Amid a spike in credit offtake by the industry, non-food bank credit saw 17.6% YoY growth in Nov'22, much above the 7.1% level a year ago, as per latest RBI data. The RBI said credit growth to industry rose 13.1% in Nov'22 from 3.4% in the same month last year. The improved capital position, coupled with an increasing growth appetite, should help banks continue on their recent performance trajectory.



Credit growth has started to pick up across sectors



(Source: RBI, HDFC sec)

Boost for private participation in bond market

In the private sector as well, there has been a development wherein the SEBI announced several initiatives, which were implemented in this year, to help widen and deepen the bond market. While all this while, around 90% of bonds that came in from the corporate world through private placement had a face value of Rs 10 lakh, effective January 2023 corporates will be able to issue bonds at a face value of Rs 1 lakh. This will indeed help bring the bond market closer to retail investors. While the growth of the bond market is something that has to be looked at, SEBI is working with an aim to reduce the initial price of each bond and thus lower the value of bonds for private placements, allowing greater retail investors to participate in these bond issuances.

The increase in participation of corporates in the bond market will lead to a simultaneous growth of the bond market and further promote the opening up of more avenues for institutions to participate. This could lead to higher bond issuance by corporates.



Restructuring complete; focus now on gaining market share

Post the resignation of Mr Ajay Mahajan in Apr'22, Mr. Mehul Pandya has been appointed as an Additional Director designated as Managing Director and CEO of the Company for a term of five years. A new CEO has also been appointed for subsidiary CRSPL. At the senior management level, CARE has hired professionals from the industry with a long and established track record in their respective fields. With these new appointments, the management team is all set to usher the Group into a new era of high growth.

The level of integration and information sharing with the subsidiaries has gone up and are placed under the 'CARE Edge' brand. Efforts are also being made to improve the communication to all stakeholders so that CARE's capabilities are marketed better. The company is now focusing on gaining market share which could result in significant margin expansion.

Geographical diversification and new ventures to de-risk its revenues to some extent

Care ratings has three subsidiaries, and one Joint Venture. Two subsidiaries are located outside of India, one in Africa (Mauritius) and the other in Nepal. Its geographical diversification will help in gaining market share that would help add to its top-line. Its advisory research, and training group is engaged in the class-room type training, where they recruit people, and educate them about the capital market. The Nepal one is a Joint Venture with Vishal group, and is a life insurance company. The table below shows a brief summary of the subsidiaries.

Subsidiary & J.V. Information FY22				
Name of the Subsidiary	CARE Risk Solutions Private Ltd.	CARE Ratings (Africa) Private Ltd.	Care Advisory Research and Training Ltd	CARE Ratings Nepal Ltd.
Share Capital	15.8	2.6	4.1	3.1
Reserves and Surplus	-13.2	5.1	-0.3	4.4
Total Assets	24.6	8.5	5.9	10.0
Total Liabilities	22.0	1.2	2.2	2.4
Investments	-	-	-	-
Turnover	13.5	6.0	7.4	4.4
PBT	-11.8	3.4	-1.7	2.9
Provision for taxation	-2.1	-0.6	-0.1	0.7
Profit/(Loss) after taxation	-9.7	2.8	-1.8	2.2
Proposed Dividend	-	0.7	-	0.7
Extent of shareholding (%)	100	78	100	51



Risk & Concern

Rate hikes by RBI could result on slow-down in borrowings which would be unfavourable for CARE

Interest rates have moved up and could rise further if RBI does not stop hiking repo rates. A rate hike always remains a concern, as investor's sentiments to borrow diminishes.

Competition from new players could hurt growth in revenues

There are already three established players in this industry. Thus, as it is a boon it is also a threat, as in this form of market structure, companies normally tend to be price takers, and have to take the bite of severe competition. CRISIL is the market leader. Although, very small, but, to aggravate the situation there are four other companies (India Ratings, Brickworks, Acuite & Infomerics).

Economic slowdown could reduce business volumes

Credit rating volumes are directly linked with the economic growth of a country. In times of slowdown the overall volumes could take a hit reducing the scope of earnings for the company.

Increased shift of borrowers from banks to MFs

The dramatic growth in resources flowing to mutual funds (MFs) suggests that there is a discernible shift in the pattern of deployment of financial savings in India. This gives plenty of scope for potential movement of borrowers away from banks to mutual funds.

Proportion of non rating business to total income is still low in CARE compared to the other two large players.

Company Background:

Credit Analysis & Research Ltd (CARE) is full service rating company that offers a wide range of rating and grading services across sectors. CARE has commenced operations in April 1993 (promoted by several banks and financial institutions) and in nearly three decades time, it has established itself as the second-largest credit rating agency in India in terms of rating income. CARE Ratings has also emerged as the leading agency for covering many rating segments like that for banks, sub-sovereigns and IPO grading. The company's main source of revenue include Bank Loan ratings, Bond ratings & SME ratings.

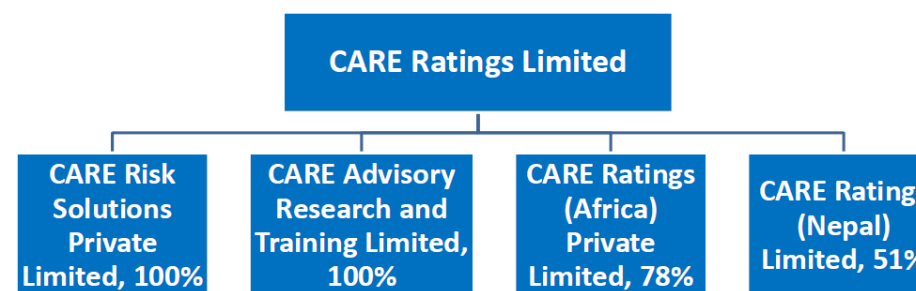
The company's rating services include corporate rating services, such as corporate debt, bank loan, issuer, corporate governance, and recovery rating services; financial sector rating services, which cover banks, mutual funds, capital protection oriented schemes, insurance, NBFCs, securitization, and housing finance companies; and public finance rating services that cover ratings of state government entities and



urban local bodies, as well as project finance, infrastructure sector, and small and medium enterprises rating services. It also offers grading services for educational institutes, IPOs, industrial training institutes, construction companies, shipyard companies, maritime training institutes, renewable energy service companies and system integrators, micro finance institutions, and energy service companies, as well as provides equity research and grading services, and real estate project star and REIT rating services.

Besides its registered office at Mumbai CARE has regional offices at Ahmedabad, Bangalore, Chennai, Hyderabad, Jaipur, Kolkata, New Delhi, Pune, Coimbatore and international operation in Male in the Republic of Maldives. To enhance its scope of business CARE Ratings has been nurturing global opportunities and made forays in different forms.

Corporate Structure



(Source: Company, HDFC sec)

Peer comparison

(FY22)	CMP (Rs)	Mcap (Rs cr)	EPS (Rs)	OPM (%)	PATM (%)	RoE (%)	D/E (x)	P/E (x)	P/BV (x)
CRISIL (CY21)	3052	22286	63.8	26.3	20.2	29.5	0.0	47.8	14.1
ICRA	4696	4532	116.3	35.2	32.8	13.3	0.0	40.4	5.4
CARE Ratings	640	1897	25.3	32.1	30.3	11.6	0.0	25.3	2.9



Financials

Income Statement

(Rs cr)	FY21	FY22	FY23E	FY24E	FY25E
Net Revenues	248.5	247.6	284.3	315.0	346.5
Growth (%)	2.0	-0.3	14.8	10.8	10.0
Operating Expenses	152.7	168.0	173.5	189.0	204.5
EBITDA	95.8	79.6	110.9	126.0	142.1
Growth (%)	17.8	-16.9	39.3	13.6	12.8
EBITDA Margin (%)	38.6	32.1	39.0	40.0	41.0
Depreciation	7.8	7.7	10.0	11.1	12.2
Other Income	31.3	27.2	34.1	39.4	45.0
EBIT	119.3	99.1	135.0	154.3	175.0
Interest expenses	0.6	0.5	1.1	1.3	1.7
PBT	118.7	98.6	134.0	153.0	173.3
Tax	27.7	21.8	33.8	38.6	43.7
PAT	91.0	76.8	100.2	114.4	129.6
Share of Asso./Minority Int.	-1.4	-1.7	-1.9	-2.1	-2.3
Adj. PAT	89.5	75.1	98.3	112.3	127.3
Growth (%)	8.7	-16.1	30.9	14.3	13.4
EPS	30.4	25.3	33.2	37.9	43.0

Balance Sheet

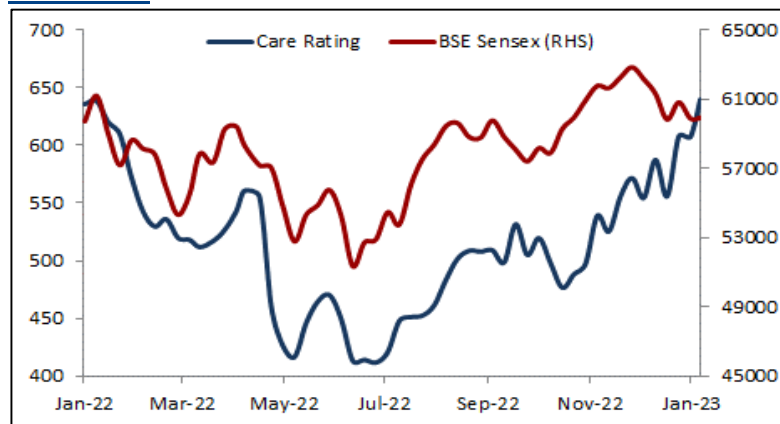
As at March (Rs cr)	FY21	FY22	FY23E	FY24E	FY25E
SOURCE OF FUNDS					
Share Capital	29.5	29.6	29.6	29.6	29.6
Reserves & Surplus	559.4	617.8	677.4	745.3	822.3
Shareholders' Funds	588.8	647.5	707.1	774.9	851.9
Minority Interest	4.2	5.3	7.2	9.3	11.6
Total Debt	0.0	0.0	0.0	0.0	0.0
Net Deferred Taxes	9.3	3.7	3.7	3.7	3.7
Total Source of Funds	602.3	656.5	718.0	788.0	867.2
APPLICATION OF FUNDS					
Net Block & Goodwill	85.1	95.6	91.6	87.0	82.4
CWIP	3.2	8.2	8.2	8.2	8.2
Investments	238.9	44.0	119.0	194.0	269.0
Other Non-Current Assets	1.4	13.3	6.4	8.6	11.9
Total Non Current Assets	328.4	161.1	225.2	297.8	371.5
Trade Receivables	21.4	16.6	23.4	25.9	28.5
Cash & Equivalents	283.1	523.6	513.3	515.5	528.3
Other Current Assets	37.7	23.7	25.7	24.2	21.8
Total Current Assets	342.1	564.0	562.3	565.5	578.6
Trade Payables	2.8	5.1	3.1	3.5	3.8
Other Current Liab & Provisions	72.6	70.3	70.9	74.6	80.1
Total Current Liabilities	75.3	75.4	74.0	78.1	83.9
Net Current Assets	266.8	488.5	488.3	487.4	494.7
Total Application of Funds	602.3	656.5	718.0	788.0	867.2



Cash Flow Statement

(Rs cr)	FY21	FY22	FY23E	FY24E	FY25E
Reported PBT	118.7	98.6	134.0	153.0	173.3
Non-operating & EO items	-31.0	-13.2	6.9	-1.6	-2.7
Interest Expenses	0.6	0.5	1.1	1.3	1.7
Depreciation	8.0	7.7	10.0	11.1	12.2
Working Capital Change	12.9	3.7	-7.7	4.2	6.6
Tax Paid	-23.0	-29.3	-33.8	-38.6	-43.7
OPERATING CASH FLOW (a)	86.2	68.0	110.5	129.5	147.4
Capex	-4.2	-18.8	-6.0	-6.5	-7.5
Free Cash Flow	82.0	49.2	104.5	123.0	139.9
Investments	113.1	205.6	-75.0	-75.0	-75.0
Non-operating income	-146.9	-214.2	0.0	0.0	0.0
INVESTING CASH FLOW (b)	-38.0	-27.3	-81.0	-81.5	-82.5
Debt Issuance / (Repaid)	0.0	0.0	0.0	0.0	0.0
Interest Expenses	-0.6	-0.5	-1.1	-1.3	-1.7
FCFE	47.5	40.2	28.4	46.7	63.2
Share Capital Issuance	0.0	0.0	-0.2	0.0	0.0
Dividend	-39.8	-38.3	-38.5	-44.5	-50.4
FINANCING CASH FLOW (c)	-40.4	-38.8	-39.8	-45.7	-52.1
NET CASH FLOW (a+b+c)	7.8	1.9	-10.3	2.2	12.8

Price chart



Key Ratios

	FY21	FY22	FY23E	FY24E	FY25E
Profitability Ratios (%)					
EBITDA Margin	38.6	32.1	39.0	40.0	41.0
EBIT Margin	48.0	40.0	47.5	49.0	50.5
APAT Margin	36.0	30.3	34.6	35.7	36.7
RoE	16.0	12.2	14.5	15.2	15.7
RoCE	21.3	16.0	19.9	20.8	21.5
Solvency Ratio (x)					
Net Debt/EBITDA	-3.0	-6.6	-4.6	-4.1	-3.7
Net D/E	-0.5	-0.8	-0.7	-0.7	-0.6
PER SHARE DATA (Rs)					
EPS	30.4	25.3	33.2	37.9	43.0
CEPS	33.0	27.9	36.5	41.7	47.1
BV	199.9	218.4	238.5	261.4	287.4
Dividend	17.0	10.0	13.0	15.0	17.0
Turnover Ratios (days)					
Debtor	45.7	28.0	25.7	28.5	28.6
Creditor	3.2	5.8	5.3	3.8	3.8
VALUATION (x)					
P/E	21.0	25.2	19.3	16.9	14.9
P/BV	3.2	2.9	2.7	2.4	2.2
EV/EBITDA	14.7	17.2	11.8	9.8	8.0
EV / Revenues	5.7	5.5	4.6	3.9	3.3
Dividend Yield (%)	2.7	1.6	2.0	2.3	2.7
Dividend Payout (%)	55.9	39.5	39.2	39.6	39.6



HDFC Sec Retail Research Rating description

Green Rating stocks

This rating is given to stocks that represent large and established business having track record of decades and good reputation in the industry. They are industry leaders or have significant market share. They have multiple streams of cash flows and/or strong balance sheet to withstand downturn in economic cycle. These stocks offer moderate returns and at the same time are unlikely to suffer severe drawdown in their stock prices. These stocks can be kept as a part of long term portfolio holding, if so desired. This stocks offer low risk and lower reward and are suitable for beginners. They offer stability to the portfolio.

Yellow Rating stocks

This rating is given to stocks that have strong balance sheet and are from relatively stable industries which are likely to remain relevant for long time and unlikely to be affected much by economic or technological disruptions. These stocks have emerged stronger over time but are yet to reach the level of green rating stocks. They offer medium risk, medium return opportunities. Some of these have the potential to attain green rating over time.

Red Rating stocks

This rating is given to emerging companies which are riskier than their established peers. Their share price tends to be volatile though they offer high growth potential. They are susceptible to severe downturn in their industry or in overall economy. Management of these companies need to prove their mettle in handling cyclicity of their business. If they are successful in navigating challenges, the market rewards their shareholders with handsome gains; otherwise their stock prices can take a severe beating. Overall these stocks offer high risk high return opportunities.

Disclosure:

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