Muthoot Finance Ltd

Industry	CMP	Recommendation	Add on Dips to band	Sequential Targets	Time Horizon
BFSI	Rs. 447	Buy at CMP and add on declines	Rs. 412-418	Rs. 506 & Rs. 546	2-3 quarters

HDFC Scrip Code	MUTFINEQNR
BSE Code	533398
NSE Code	MUTHOOTFIN
Bloomberg	MUTH IN
CMP as on 09 Jun 17	447.10
Eq. Capital (Rs cr)	399.54
Face Value (Rs)	10
Equity Sh. Outs (Cr)	4.00
Market Cap (Rs cr)	17863
Book Value (Rs)	140.83
Avg. 52 Week Vol	875000
52 Week High	452.90
52 Week Low	250.00

Shareholding Pattern-% (Mar-2017)	
Promoters	73.71
Institutions	21.66
Non Institutions	4.63
Total	100.0

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We had issued Stock Note dated 19th May 2016 at the then CMP of Rs. 218 and had recommended to buy at CMP and add on dips to Rs. 196-204 with price targets of Rs. 243 and Rs. 258. Both the targets were met in the month of June 2016 and the stock recently made a high of Rs. 439.30 on 5th June 2017. Refer: http://old.hdfcsec.com/Research/ResearchDetails.aspx?report_id=3017761. We now review the developments in the company and provide our updated view on the stock.

Company Description

Muthoot Finance Ltd is India's largest, niche gold finance company with an AUM of ~Rs273 bn in March 2017. Headquartered in Kochi (Kerala), the company is majority owned by the Muthoot family (73.7% stake as of March 2017). It currently has 4,307 branches and presence across 29 states/union territory in the country. However, its footprint is concentrated mostly in the South with ~62% of the branches. While loans are typically disbursed with tenure of 6-12 months, most of the loans are repaid within six months – implying average duration of close to six months for the loans.

Investment Rationale:

- Demonetization blues waning away, growth to resume
- Rating upgrade and softer interest rates to bring down cost of borrowing
- Strong performance at subsidiaries – derisking dependence on gold loans
- Improving asset quality to keep provisioning requirement at lower levels

Concerns:

- Increase in NPA
- Gold price fluctuations
- Interest rate risk
- Overdependence on Gold loans – derisking to reduce dependence slowly.

Financial Summary

(Rs Cr)	Q4FY17	Q4FY16	YoY (%)	Q3FY17	QoQ (%)	FY16	FY17	FY18E	FY19E
NII	1150	865	*32.9*	725	*58.5*	2542	3346	3369	3851
PPP	885	585	*51.2*	503	*76.0*	1479	2184	2177	2558
PAT	385	265	*45.0*	348	*10.4*	810	1162	1296	1541
EPS (Rs)	9.6	6.6	*44.8*	8.7	*10.4*	20.3	29.1	32.5	38.6
P/E (x)						22.0	15.4	13.8	11.6
P/ABV (x)						3.6	2.9	2.6	2.2
RoAA (%)						3.0	4.0	4.0	4.2

(Source: Company, HDFC sec)

Recent updates/triggers

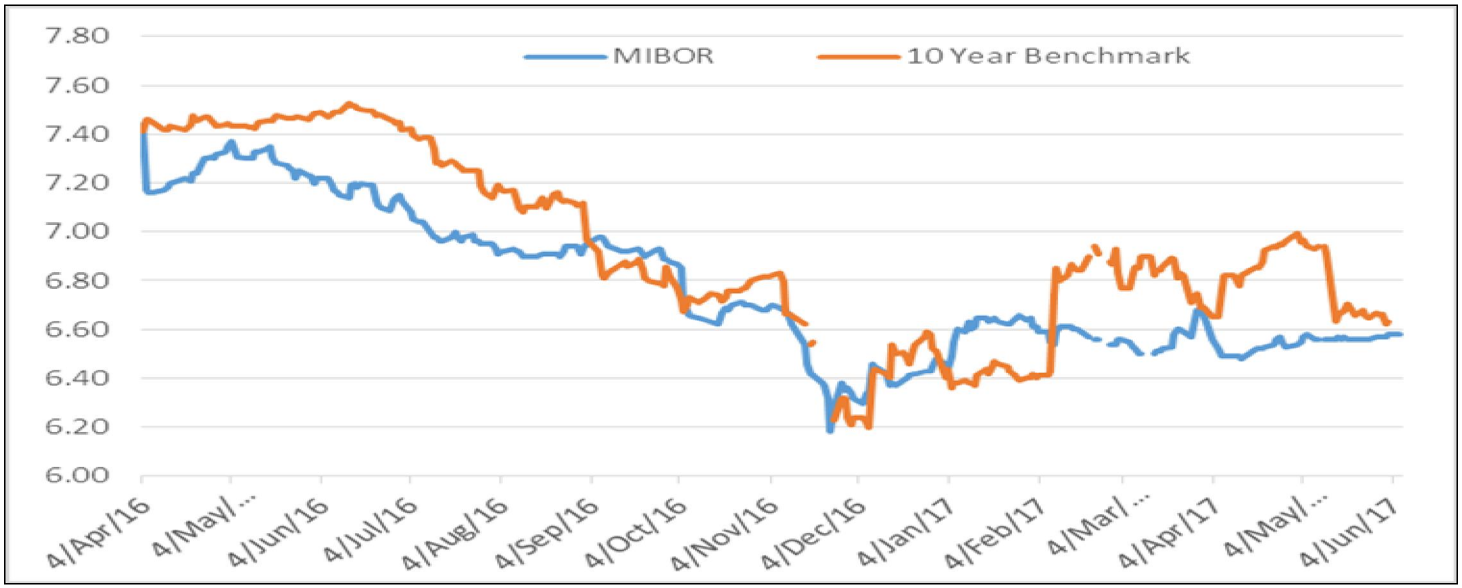
Demonetization blues waning away, growth to resume

The demonetization of currency announced by the Government in Nov-16 impacted the business of the company as a significant portion of loans and repayments were done in cash. AUM declined sequentially by ~2% in Q3FY17 but picked up by 1.2% in Q4FY17. For the year, AUM increased 12% yoy to Rs 27279 cr. Management has guided for a minimum growth of 10% in gold loans on a steady state basis and a consolidated growth of 15% in loans.

Rating upgrade to bring down cost of borrowing

In Aug 2016, ICRA upgraded long term debt rating of Muthoot Finance from AA-/Stable to AA/ Stable. The upgrade reflects the resilient business risk profile of Muthoot Finance as demonstrated during the past few years during which the gold loan sector went through challenging times, and the company's strong earnings profile. The rating upgrade also factors in a stable operating environment with an established regulatory regime. Further Muthoot is replacing its higher cost debentures issued in earlier years at interest rates of ~11% with new debentures at a cost of ~9.5%.

Interest rates in the system have also come down post demonetisation. Although interest rates have inched up post Dec 2016, they are still lower on a YoY basis. Muthoot Finance will get benefit of these going forward.



Ratings upgrade combined with lower borrowing costs would bring down the overall cost of borrowings and lead to margin expansion. The full impact of lower cost borrowings will come in H1FY18.

Strong performance at subsidiaries – Derisking dependence on gold loans

Muthoot is looking to scale up its non-gold business from ~5% of consolidated business in FY17 to 9-10% by FY18 driven mainly by the home loan business.

- Muthoot Homefin's loan portfolio stood at Rs 441 cr at the end of FY17 as compared to Rs 32 cr in FY16), with operations in Kerala, Maharashtra, Gujarat, Rajasthan and Madhya Pradesh. Home loan business posted total revenues of Rs 24 cr and PAT of Rs 0.3 cr. The company is targeting home loan portfolio of Rs 1500 cr and Rs 3000 cr in FY18 and FY19. Average home loan size stood at Rs 11 lakhs, entirely in the affordable housing sector. Muthoot owns 88.27% in the subsidiary.
- Belstar Investment & Finance, microfinance subsidiary of Muthoot (64.6% stake) posted a 114% yoy growth in its loan portfolio to Rs 567 cr. It has doubled its presence from 76 branches in FY16 to 155 in FY17 across 5 states (Tamil Nadu, Karnataka, Madhya Pradesh, Maharashtra and Kerala) and 1 Union Territory (Pondicherry). PAT for the year stood at Rs 1 cr as compared to Rs 0.6 cr in FY16 with GNPAs and NNPAs of 0.09% and 0.02%, respectively.
- Muthoot Insurance Brokers became a wholly owned subsidiary of Muthoot Finance in June 2016 and is actively distributing both life and non-life insurance products of various insurance companies. During FY17 it collected first year premium of Rs 70 cr as compared to Rs 48 cr in FY16 and 35 cr in FY15. It reported a PAT of Rs 0.6 cr.
- Muthoot holds 60% stake in Sri Lanka based Asia Asset Finance which is involved in Retail Finance, Hire Purchase & Business Loans and has 15 branches across Sri Lanka. AAF's loan portfolio grew by 26% yoy to Lankan Rs 866 cr. It reported PAT of Lankan Rs 28 cr against Lankan Rs 18 cr in FY16.

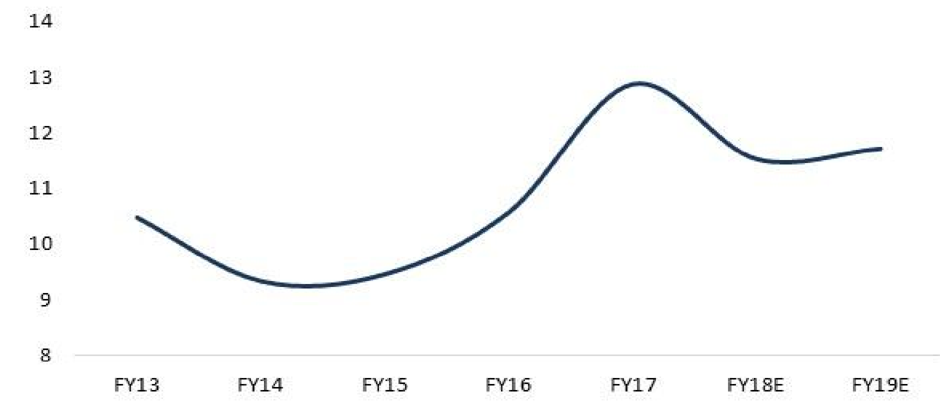
Rs Cr	Muthoot Finance		Muthoot Homefin		Belstar Inv. & Finance		Muthoot Insurance Brokers		Asia Asset Finance*	
Year	**FY17**	**FY16**	**FY17**	**FY16**	**FY17**	**FY16**	**FY17**	**FY16**	**FY17**	**FY16**
Loan AUM/Premium	27279	24379	441	32	567	264	70	48	363	288
Total Revenues	5747	4875	24	2	103	58	12	10	89	58
PAT	1180	810	3	0	10	6	6	5	12	7

** Converted at 1 LKR=0.42 INR* *(Source: Company, HDFC Sec)*

NIMs likely to stabilize at current levels

Muthoot reported elevated NIMs for FY17 at 12.7% against 10.5% in FY16. Higher NIMs were on account of change in income recognition policy wherein the company recognized accrued interest of Rs 374 cr in Q4FY17 which were earlier being recognized on receipt basis. Excluding the additional recognition, calculated NIMs were in the range of ~11.5%, an expansion of 100 bps yoy. We expect NIMs to stabilize ~11.5% levels going forward.

Reported NIMs likely to stabilize ~11.5% levels

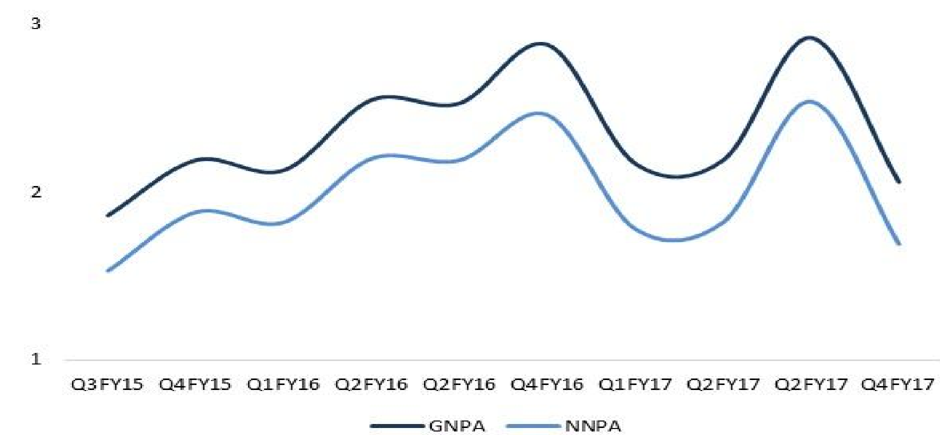


(Source: Company, HDFC Sec)

Improving asset quality to keep provisioning requirement at lower levels

Muthoot's GNPA declined from 2.9% at the end of Q3FY17 to 2.1% at the end of Q4FY17 as it was able to auction the overdue accounts without any losses. NNPA also fell from 2.5% to 1.7%. Asset quality has been the best in the last 9 quarters. The company has utilized the one-off increase in interest income on account of change in income recognition on the recommendation of Income Tax authorities, to create a gold price fluctuation provision of Rs.233 cr which should help the company in case of extreme volatility in gold prices. Management is not very concerned about NPAs since they have more than 100% collateral in the form of gold which can be auctioned without any loss to the company.

Asset quality has been the best in the last 9 quarters



(Source: Company, HDFC Sec)

Increasing use of technologies to bring down costs

From being a mere "gold evaluation centre", Muthoot's branches have transformed into a vibrant business centres. Responsibility of employee has been expanded from mere valuation of gold ornaments to sourcing of business, local marketing and collection of overdue interest. Also, Muthoot has been at the forefront of adapting to new age technologies by launching online gold loan product through web and app. 84% of new KYCs are done through e-KYC. Loan proceeds are directly credited to bank account. It has introduced Gold Cash Card wherein the loan amount is loaded in card which can be used at ATMs and shopping. This also eliminates the need to have a bank account. More than 10% of its active gold loan customers are transacting online. All these measure would reduce cash handling at its branches and improve efficiency thereby bringing down operating expenses.

Q4FY17 Result Review

Net interest income increased by 32.9% yoy to Rs 1150 cr in Q4FY17 aided by volume growth and one off impact of interest income recognition of Rs 374 cr. Borrowing cost also declined by ~70 bps sequentially resulting in higher net interest margins. Non-interest income declined 23.3% yoy to Rs 17 cr. Assets under management increased by 12% yoy to Rs 272 bn. Asset quality improved as collection efficiency returned to normal post the impact of demonetization in Q3FY17. GNPA declined by 86 bps qoq to 2.1% while NNPA were lower by 77 bps at 1.7%. The company utilized the one-off interest gains towards creating a gold price fluctuation reserve of Rs 233 cr. PAT increased by 45% yoy to Rs 385 cr. Management has guided for consolidate loan growth of 15% for FY18 with share of non-gold loans increasing to 9-10% from 5% currently.

Particulars	Q4FY17	Q4FY16	YoY (%)	Q3FY17	QoQ (%)	FY17	FY16	YoY (%)
Interest Income	1696	1429	*18.7*	1322	*28.3*	5640	4801	*17.5*
Interest Expenses	546	564	*-3.2*	597	*-8.5*	2294	2258	*1.6*
Net Interest Income	**1150**	**865**	***32.9***	**725**	***58.5***	**3346**	**2543**	***31.6***
Non interest income	17	22	*-23.3*	24	*-28.8*	107	74	*44.1*
Total Income	**1167**	**887**	***31.5***	**749**	***55.7***	**3453**	**2617**	***31.9***
Operating Expenses	282	302	*-6.6*	246	*14.5*	1030	1158	*-11.0*
PPP	885	585	*51.2*	503	*76.0*	2423	1459	*66.0*
Prov & Cont	233	110	*111.6*	0	*NA*	268	143	*87.7*
Profit Before Tax	652	475	*37.3*	503	*29.6*	2155	1317	*63.7*
Tax	268	210	*27.5*	155	*73.1*	741	507	*46.1*
PAT	**385**	**265**	***45.0***	**348**	***10.4***	**1414**	**810**	***74.6***
EPS	**9.6**	**6.6**	***44.8***	**8.7**	***10.4***	**35.4**	**20.3**	***74.4***
GNPA (%)	2.1	2.9	*-82 bps*	2.9	*-86 bps*	2.1	2.9	*-82 bps*
NNPA (%)	1.7	2.5	*-77 bps*	2.5	*-85 bps*	1.7	2.5	*-77 bps*

(Source: Company, HDFC sec)

Concerns

Increase in NPA

This risk denotes the possibility of loss due to the failure of any counterparty to abide by the terms and conditions of any financial contract. This risk is mitigated by a rigorous loan approval and collateral appraisal process, strong NPA monitoring and collection strategy. This risk is further diminished because the gold jewellery used as collateral for loans can be readily liquidated.

Gold price fluctuations

This risk arises from the decline in the value of the gold collateral due to fluctuation in gold prices. However, this risk is in part mitigated by at least 25% margin retained on the value of jewellery for the purpose of calculation of the loan amount, i.e. the company lends maximum of only 75% of the value of jewellery (current Loan to value ratio is 67%). Further, risk is reduced because the price of gold jewellery is higher given that the production costs, design cost and the gemstones associated with making the item is not considered for arriving at the value of jewellery for the calculation of the loan amount. Having said that, gold prices do have an impact on the Gross NPA ratios of Muthoot Finance.

When gold prices are on up move, GNPA is low and vice versa as shown in the chart above. But the management is of the view that the gold prices would going forward remain steady and would not be very volatile.

Global and Domestic gold prices have been on an uptrend in the last 6 months

(Source: Kitco, MCX, HDFC Sec)

Interest Rate Risk

This risk reflects potential losses arising from the movement in interest rates. To avoid excessive exposure of Muthoot's earnings and equity to loss and to reduce its exposure to the volatility inherent in financial instruments, majority of the company's borrowings, and all the loans and advances it makes, are at fixed rates of interest. This minimises the company's interest rate risk.

Overdependence on Gold loans – diversification to take time to make a difference

Even in FY18, MFL is targeting just 9-10% of its AUM coming from non gold loan segments. Given the large AUM of Gold loans, the non gold loan portfolio will take time to reach a decent proportion of the overall AUM.

Liquidity Risk

Liquidity management is to ensure sufficient cash flow to meet all financial commitments and to capitalise on opportunities for business expansion. The nature of business is such that source of funds, primarily proceeds from issue of debentures and bank loans has longer maturities than the loans and advances given resulting in low liquidity risk.

View and Valuation:

Over 2012-2016 the gold loan industry has been dragged down by various regulatory pressures. With a more stable regulatory environment, healthy RoE, expected improvement in RoA, low asset quality risk and a gradual pick-up in loan growth in the medium term, we believe Muthoot's valuations are quite attractive. While recent growth rates were impacted by demonetization, current valuations leave room for improvement if the rural economy and SME/trade community see better times and its growth rate breaks into higher trajectory.

MFL has utilized one-off recognition of higher income to create a gold price fluctuation provision, excluding which its ABV would have been higher by ~Rs 6. The company has the highest rating among gold loan companies for short term paper. Its capital adequacy of 24.9% (March 2017) is well above the regulatory minimum of 15%. The subsidiaries are profitable and are witnessing strong growth. While we do not assign any value to these businesses yet, they could contribute meaningfully in years to come.

Gold loan companies even after the recent run up quote at a discount in terms of P/ABV compared to other categories of NBFCs like Housing finance, Personal/durable finance, micro finance. This is despite the fact that the possibility of NPAs in this segment is the lowest. While growth in AUM is lesser than those in the other segments, the diversification by these companies into other segments via subsidiaries could overcome this constraint. Expectation of good monsoon this year could trigger larger demand for gold loans across the country (especially in the south). We think the gap in the valuations of gold loan companies could narrow going forward.

We feel investors could buy the stock at the CMP of Rs 447 (2.2x FY19E ABV) and add on declines to Rs. 412-418 band (2.05x FY19E ABV) for sequential targets of Rs. 506 (2.5x FY19E ABV) and Rs. 546 (2.7x FY19E ABV) in 2-3 quarters.

Peer comparison (Standalone-FY17)

	CMP (Rs)	Mcap (Rs Cr)	Gold Loan AUM (Rs Cr)	NII (Rs Cr)	PAT (Rs Cr)	EPS (Rs)	ABV (Rs)	P/E (x)	P/ABV (x)	RoNW (%)
Muthoot	447.1	17863	27220	3346.0	1179.8	29.5	151.8	15.1	2.9	18.1
Manappuram	94.8	7982	11125	2004.5	726.0	8.6	36.5	11.0	2.6	21.9

Financial Statements

Income Statement

(Rs Cr)	FY15	FY16	FY17P	FY18E	FY19E
Interest Income	4261	4800	5640	5900	6603
Interest Expenses	2106	2258	2294	2531	2752
Net Interest Income	**2155**	**2542**	**3346**	**3369**	**3851**
Non interest income	64	75	89	108	131
Operating Income	**2218**	**2617**	**3435**	**3477**	**3982**
Operating Expenses	1153	1138	1250	1300	1424
PPP	1065	1479	2184	2177	2558
Prov & Cont	37	162	282	199	223
Profit Before Tax	1028	1317	1903	1978	2335
Tax	357	507	741	682	794
PAT	**671**	**810**	**1162**	**1296**	**1541**

Balance Sheet

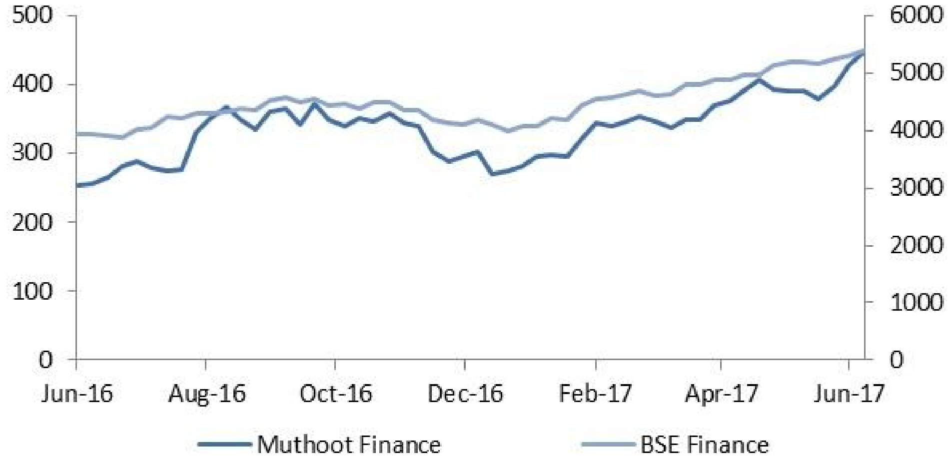
(Rs Cr)	FY15	FY16	FY17P	FY18E	FY19E
Share Capital	398	399	399	399	399
Reserves & Surplus	4686	5220	6117	7101	8307
Shareholder funds	**5084**	**5619**	**6516**	**7501**	**8707**
Borrowings	19436	18567	21096	23695	26339
Other Liab & Prov.	2250	2862	3101	3428	3808
SOURCES OF FUNDS	**26769**	**27049**	**30713**	**34623**	**38853**
Cash & Bank Balance	264	227	218	225	223
Investment	38	98	209	310	416
Advances	1737	679	1534	1549	1735
Fixed Assets	23539	24524	27424	30989	34708
Other Assets	1191	1520	1327	1549	1770
TOTAL ASSETS	**26769**	**27049**	**30713**	**34623**	**38853**

Ratio Analysis

Particulars	FY15	FY16	FY17P	FY18E	FY19E
Return Ratios					
Calc. Yield on adv	18.7%	20.0%	21.7%	20.2%	20.1%
Calc. Cost of borr	10.8%	11.9%	11.6%	11.3%	11.0%
NIM	9.5%	10.6%	12.9%	11.5%	11.7%
RoAE	14.3%	15.1%	19.1%	18.5%	19.0%
RoAA	2.6%	3.0%	4.0%	4.0%	4.2%
Asset Quality Ratios					
GNPA	2.2%	2.9%	2.1%	2.1%	2.3%
NNPA	1.9%	2.5%	1.7%	1.7%	1.9%
Growth Ratios					
Advances	7.0%	4.2%	11.8%	13.0%	12.0%
Borrowings	-0.2%	-4.5%	13.6%	12.3%	11.2%
NII	-4.9%	18.0%	31.6%	0.7%	14.3%
PPP	-13.9%	38.9%	47.7%	-0.3%	17.5%
PAT	-14.0%	20.7%	43.5%	11.5%	18.9%
Valuation Ratios					
EPS	16.8	20.3	29.1	32.5	38.6
P/E	26.5	22.0	15.4	13.8	11.6
Adj. BVPS	116.7	125.8	151.8	174.4	202.1
P/ABV	3.5	3.2	2.7	2.4	2.0
Dividend per share	6.0	6.0	6.0	6.5	7.0
Dividend Yield (%)	1.3	1.3	1.3	1.5	1.6
Other Ratios					
Cost-Income	52.0	43.5	36.4	37.4	35.8

One year Forward PABV

One year Price chart



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