Non-Banking Finance Companies

Emerging from the shadows

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Financial Exclusion

- Almost half of India is non-banked
- Only 55% of the population have deposit accounts and 9% have credit accounts with banks
- India has the highest number of households (145 million) out of the banking system
- Only one bank branch per 14,000 people
- Only a little less than 20% of the population has any kind of life insurance and 9.6% has non-life insurance coverage
- Only 18% had debit cards and less than 2% had credit cards

Role and Background

The NBFC sector has played an important role in

- Enabling / facilitating
- Product innovation
- Improving service levels
- Flexible timings

Low barriers to entry

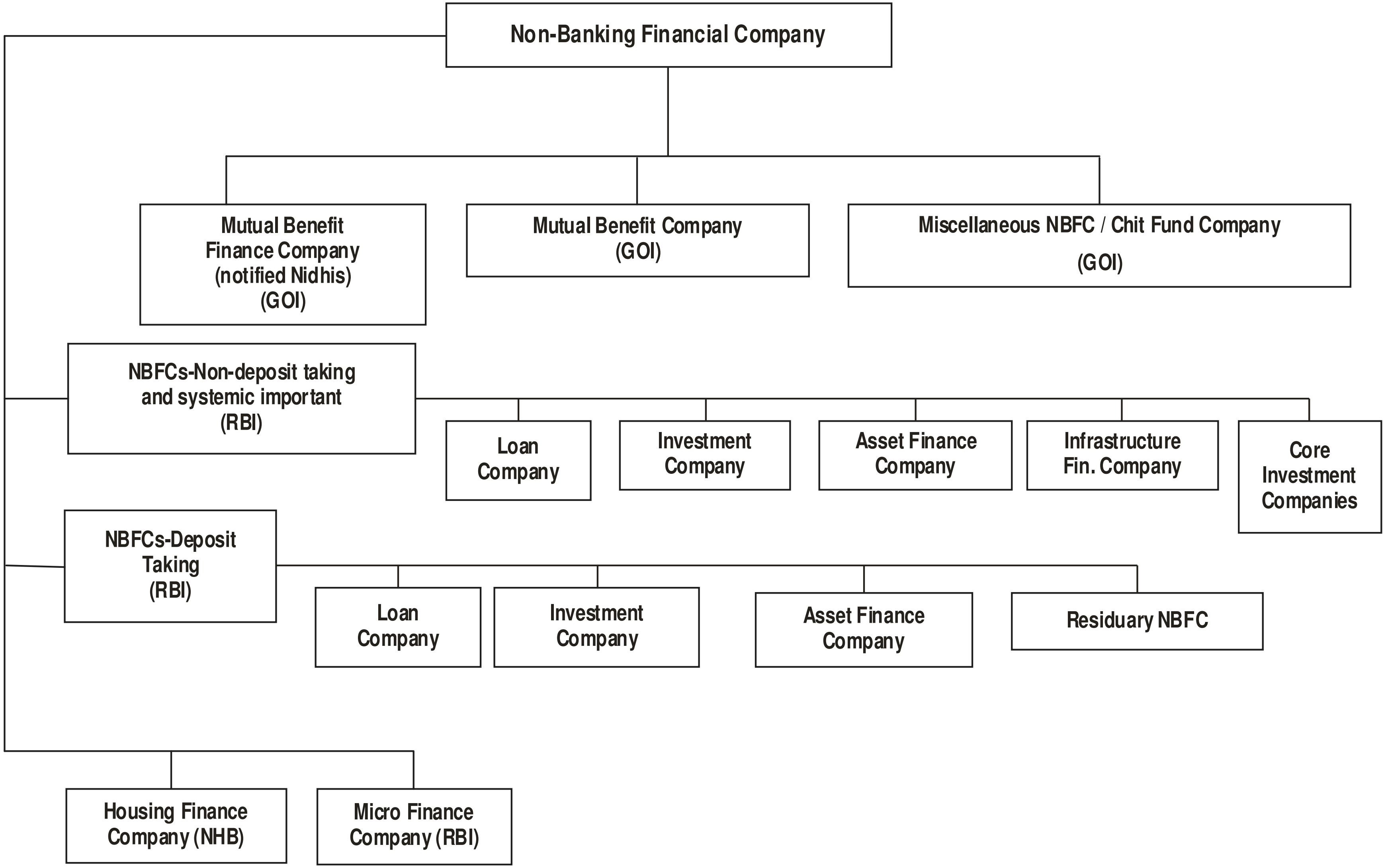
- Number of NBFCs registered with the RBI: ~12,500 at end-Mar'12

Growing size and stature of the sector

- Equivalent to 15.4% of banking credit (11.2% in FY06)
- Asset size has increased at a robust 24.2% CAGR over FY06-12

Wide disparity in NBFC sector in terms of business models, nature of operations, funding patterns and asset sizes, making regulations asymmetrical

Sectoral Structure



Note: Name in brackets indicates regulatory body

Key Types of NBFCs - RBI

- Infra Financing companies
- Asset Financing companies
- Investment companies
- Loan, Gold finance, MFI, IDF, Factoring

What makes NBFCs successful?

Niche expertise developed by NBFCs

Core competencies	Advantages
Nimble and Flexible	NBFCs have developed key expertise and created own criteria for valuation, appraisal and collection due to the uniqueness of their business and products. Improves service quality and efficiency.
Skilled employees	In-depth knowledge of customers, better understanding of ground realities & the business model of customers, and aids regular checks and speedy recoveries.
Well-established network	Well-spread branch network built over the years helps to tap growing demand in under-banked credit-starved rural / semi-urban areas.
Loyal customer base	Several large NBFCs have become household names among borrowers. Loyal customers of several years standing not only act as referrals but also come back for refinance.
Identify a niche and create leadership position	STFC i s an organized player with a large 20-25% market share in used-CV financing. Bajaj Finance is the market leader in 2/3 wheelers. MMFS is the second-largest lender to Maruti vehicles, after SBI.

Source: Company ,Anand Rathi Research

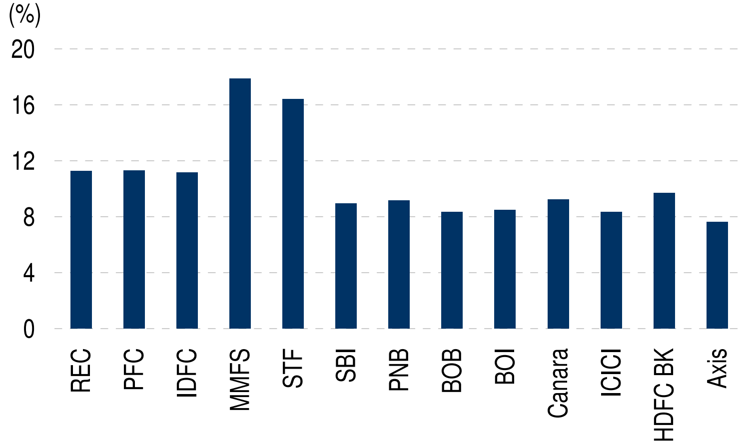
Niche expertise developed by NBFCs

Name	Year of Incorporation	Experience (Years)	Positioning
REC	1969	+40	- Operating under the Ministry of Power; Navratna PSU - Enjoys strong relationship with state and Central government - One of the few lenders to SEBs, thus strong pricing power - Nodal agency for RGGVY
PFC	1986	+25	- Operating under the Ministry of Power; Navratna PSU - Enjoys strong relationship with state and Central government utilities (~90% of loan book) - Nodal agency for UMPPs (huge lending potential) and R–APDRP
IDFC	1997	+15	- One of the few private players in infrastructure lending - Presence across the value chain - Diversified lending (unlike REC, PFC) to mitigate segmental risk - Well capitalised to tap huge lending potential
Shriram Transport	1979	+30	- Specialised in used-CV financing, with 20-25% market share - Expertise developed over the years for loan generation, asset valuation and collection - more than 500 branches and 1 million loyal customers
Mahindra Finance	1991	+20	- Rich experience in and better understanding of rural auto financing - Strong brand name of the parent helps in gaining customer confidence - more than 600 branches and 1 million loyal customers

Source: Company,Anand Rathi Research

Where are NBFCs placed compared to banks?

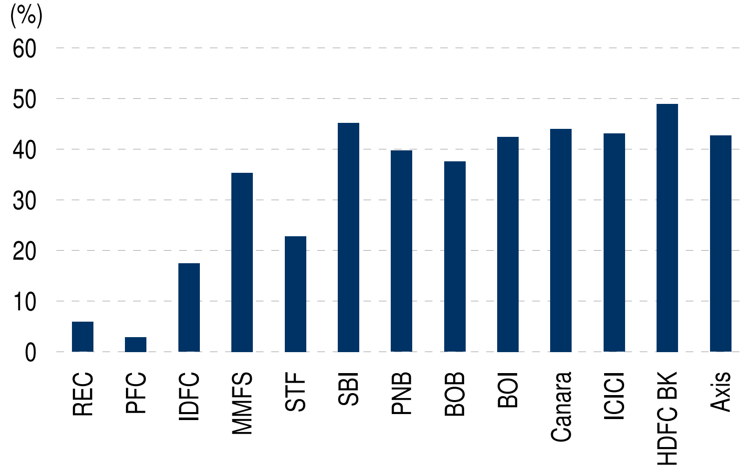
Superior pricing power



Yield on Earning Assets (FY12)

Source: Company and Anand Rathi Research

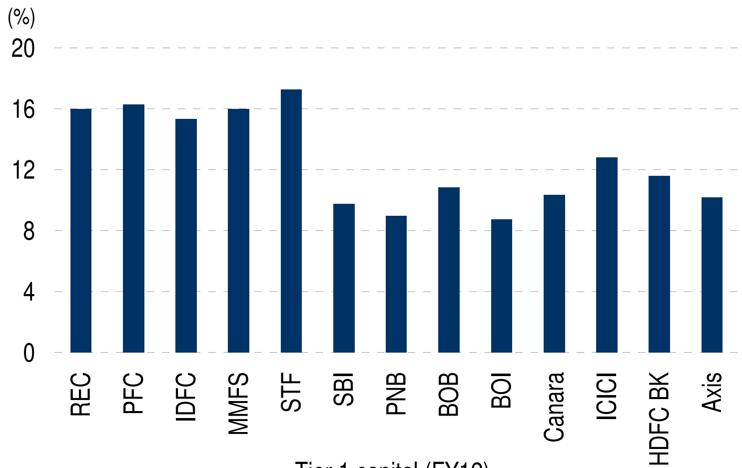
Better productivity



Cost-Income (FY12)

Source: Company and Anand Rathi Research

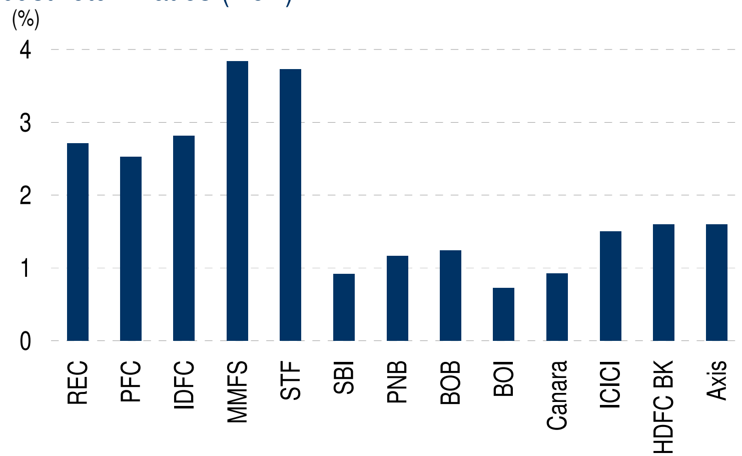
Higher capital



Tier 1 capital (FY12)

Source: Company and Anand Rathi Research

Robust return ratios (RoA)



Return on Asset (FY12)

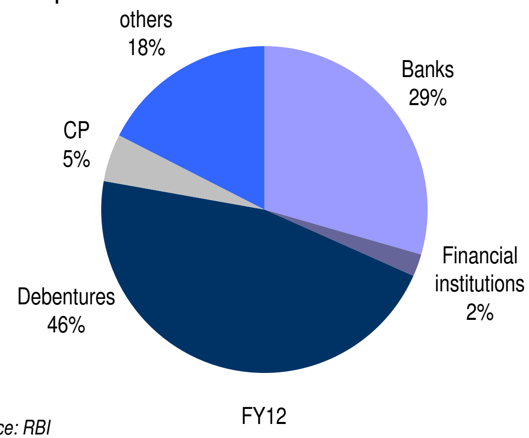
Source: Company and Anand Rathi Research

Key Shortcomings

Lower diversification in liability mix

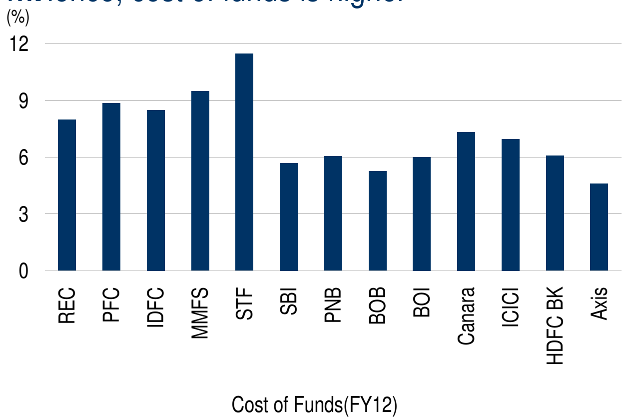
- Highly dependent on banks for funding
- Relatively lower leverage allowed due to higher product concentration
- As a result despite higher RoAs, RoEs are comparable to banks

High dependence on banks



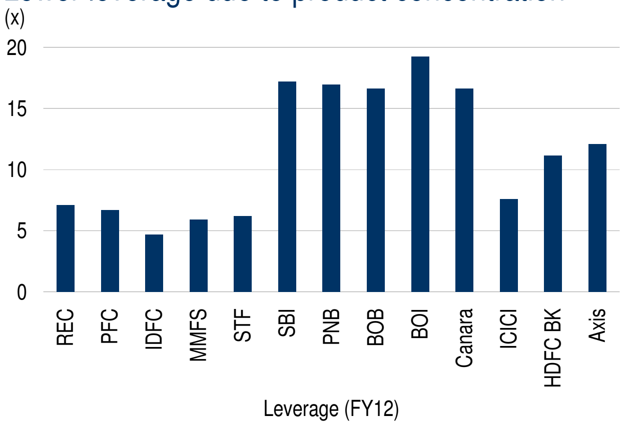
Source: RBI

...Hence, cost of funds is higher



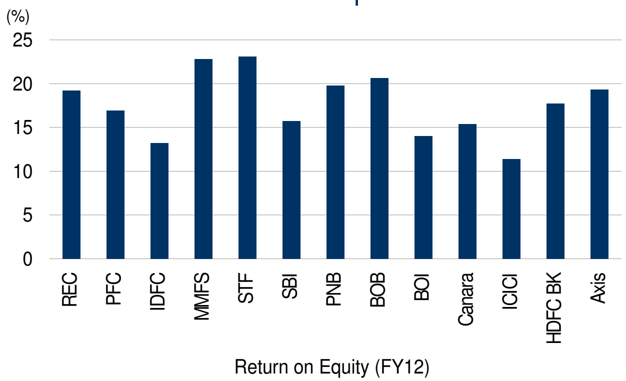
Source: Company, Anand Rathi Research

Lower leverage due to product concentration



Source: Company, Anand Rathi Research

As a result .. RoEs are comparable to banks



Source: Company, Anand Rathi Research

IFC, AFC status positive for growth and margins

Positives

- Higher exposure limits for single/group borrowers (5% for lending, 10% for lending and investing)
- Banks can lend more (5% extra) to infrastructure NBFCs and asset-financing NBFCs
- Higher ECB borrowings – (50% of net worth under automatic route) for IFCs
- Tax-free infrastructure bonds for IFCs
- 20% risk-weight for government-guaranteed loans given by IFCs, against 100% risk-weight for other NBFCs

Negatives

- Higher CAR requirement; 10% Tier 1 for IFCs, against 7.5% for asset-financing NBFCs at present

Opportunities unlimited for NBFCs

Opportunity unlimited – Infrastructure financing

- Huge investment in infrastructure – US$1trn in FYP XII (~10% of GDP)
- Share of NBFCs expected to increase
- Private share + PPP in infra to increase (36% in FYP XI to 50% in FYP XII)
- Private sector has high dependence on debt - ~70% of project cost

XII Plan: Investment outlay

(₹bn)	2012-13	2013-14	2014-15	2015 -16	2016-17
Domestic Bank Credit	1,191	1,627	2,160	2,855	3,814
NBFCs	570	810	1,120	1,541	2,143
Pension/Insurance funds	217	257	296	339	393
ECBs	468	560	652	755	883
Likely Total Debt Resources	2,445	3,252	4,226	5,490	7,238
Estimated Requirement of Debt	3,364	4,174	5,183	6,562	8,473
Gap	919	922	957	1,072	1,234

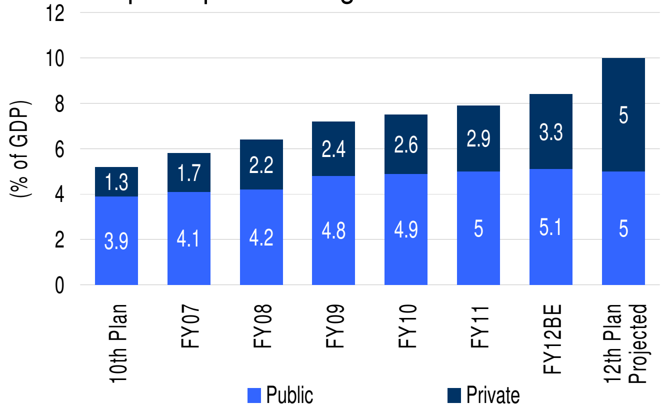
Source: GoI

XII Plan: Sources of Funding

(₹bn)	2012-13	2013-14	2014-15	2015-16	2016-17
Centre	2,508	2,807	3,152	3,543	4,001
States	2,069	2,300	2,556	2,832	3,139
Private	2,933	3,767	4,905	6,481	8,753
Total projected investment	**7,510**	**8,875**	**10,613**	**12,856**	**15,893**
Non-debt	4,146	4,700	5,430	6,293	7,421
Debt	3,364	4,174	5,183	6,562	8,473

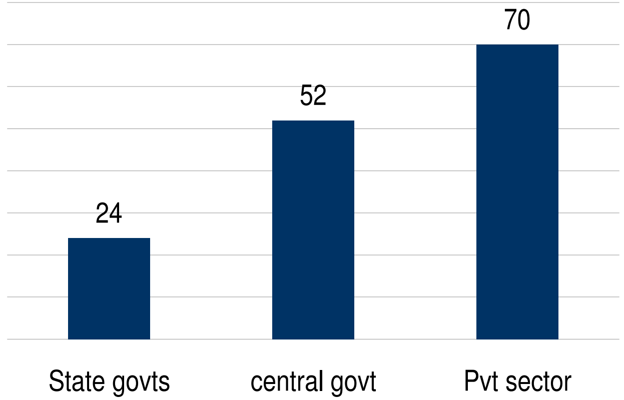
Source: GoI

Private participation rising



Source: RBI

Reliance on debt for infrastructure projects (%)

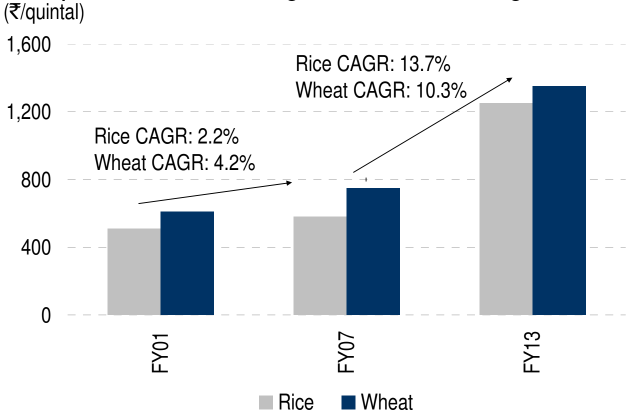


Source: RBI

Opportunity unlimited – Structural change in rural consumption

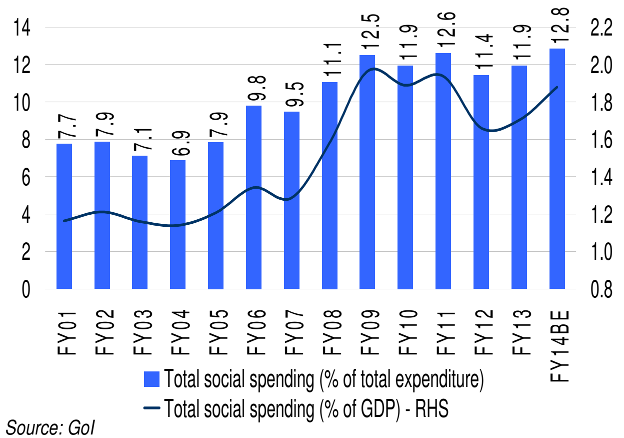
- Increase in MSP driving structural change
- Social spending by government increasing rural cashflows
- Rural road connectivity improving
- Rural household consumer expenditure increases faster
- Dependence on rainfall decreases

Sharp rise in MSP brings structural change



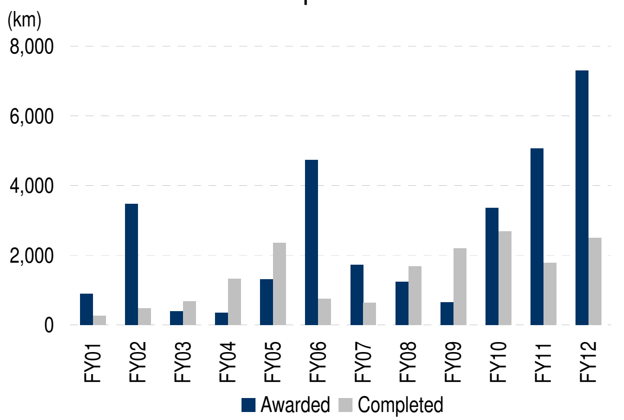
Source: CMIE

Sharp rise in social spending



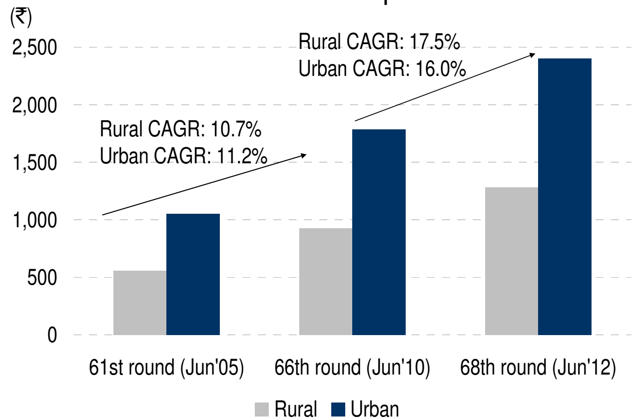
Source: GoI

Roads awarded on an uptrend



Source: IMD

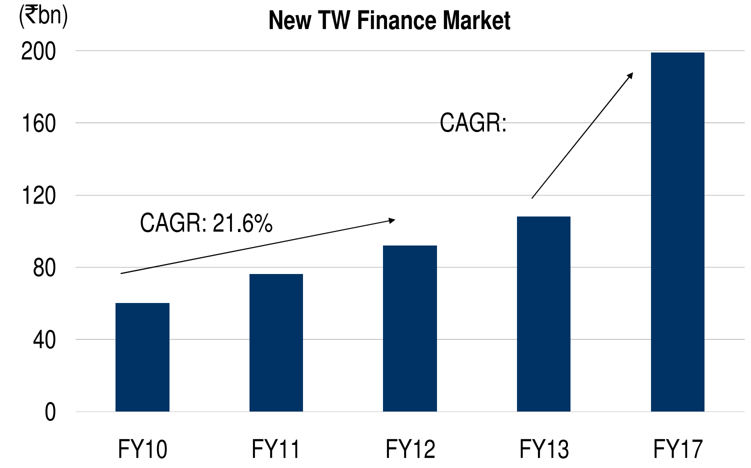
Rural Household consumer expenditure faster



Source: NSSO

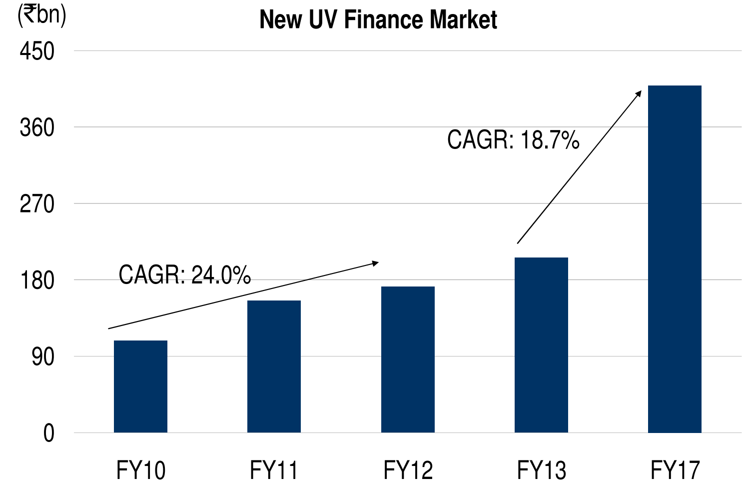
Opportunity unlimited –Estimation of vehicle finance market

Two-wheeler-market finance



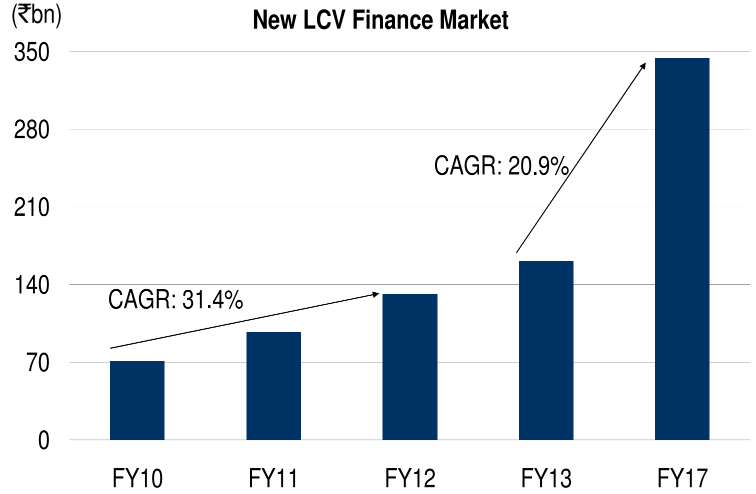
Source: Shriram City Union Finance, Crisil

Utility-vehicle finance



Source: Shriram City Union Finance, Crisil

Light-commercial-vehicle Finance



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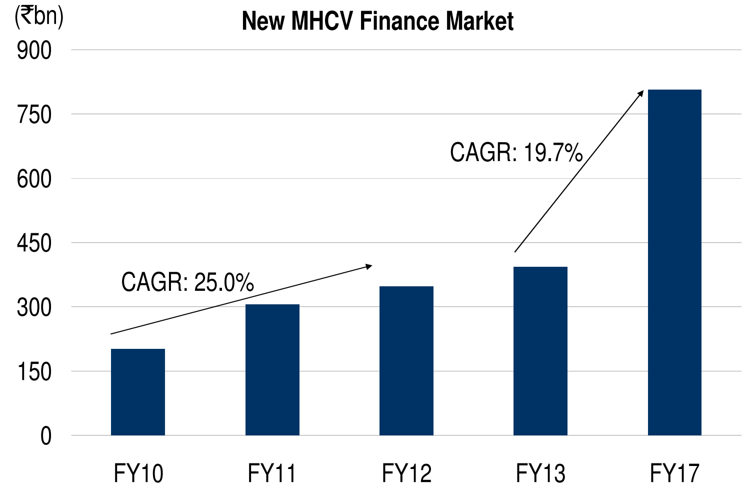
Medium-and-heavy-commercial-vehicle finance



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Keys challenges to growth and earnings

- **Regulatory arbitrage:** RBI tightening its grip on the sector
  - Securitization norms
  - Accelerated NPA recognition expected
  - Higher capital adequacy expected
- Political risk
  - Microfinance industry
  - Discom restructuring / FSA
- Emerging competition from banks
  - Will lead to lower LTV and reduction in pricing power

Niche expertise

- Niche expertise, higher capital and lower operating costs place them ahead of banks
- IFC, AFC status positive for business growth and margins
- Robust loan growth and higher RoA than banks

Dependence on banks

- Funding mix less diversified than banks
- Given the higher concentration of products, rating companies allow lower leverage than banks

Opportunities galore

- IFCs like PFC, REC, IDFC to benefit from massive investment in infrastructure (estimated at $1trn in XII Five-year Plan)
- Asset financing companies like Mahindra Finance and Bajaj Finance are a play on a resilient consumption economy

Regulatory, Political threat

- RBI sharpening its focus on NBFCs may lead to lower earnings .
- Political risk from state and Central governments impacts business model
- Increasing competition from banks may impact pricing power negatively

Current Issue: Should an NBFC convert into a Bank

Positives

- Access to capital
- Access to low-cost funds
- Access to Repo market
- Allow provisions as a taxable expense
- SARFAESI Act
- Highly experienced in understanding the rural market

Negatives

- Negative carry of SLR and CRR
- Operationally seamless transition difficult
- Adherence to tighter KYC norms
- Loss in flexibility

How to value an NBFC…

- **There are several commonly used and accepted methods for valuation**
  - Market multiples (P/E, P/B, P/S, P/CF)
  - DCF
  - DDM
  - Residual value
- **Valuation for Banks and NBFCs are different**
  - Higher leverage
  - Predictable dividend payouts.
- ***We use a multi-stage DDM, in which we assume the company grows at a high rate for a short time (high-growth stage); then gradually reverts to a long-run perpetual growth rate (stable stage). We use the Gordon growth model to estimate terminal value***

CASE STUDIES

Mahindra Finance

Bajaj Finance

M&M Financial Services

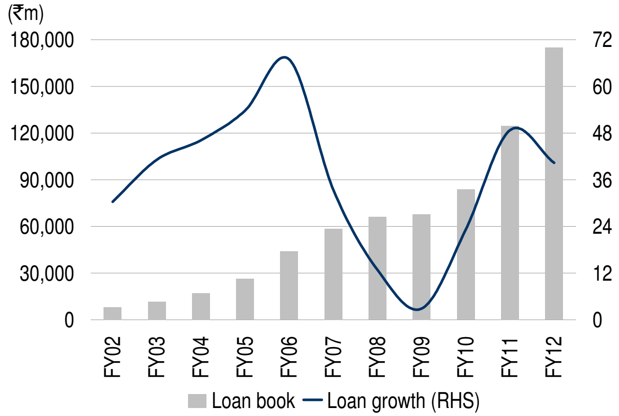
- Well placed (600 branches, +1000 M&M dealers) to tap increasing rural demand
- Strong brand name of the parent supports business growth and keeps cost of funds low
- Premium pricing power helps sustain high NIM
- A diversified product mix helps offset slowdown in an individual sector
- Rural prosperity and better underwriting standards to keep credit cost under check

Key Financials

Year end: March	FY10	FY11	FY12
Net interest income (₹m)	10,290	13,137	16,474
Net profit (₹m)	3,444	4,631	6,201
EPS (₹)	7.2	9.0	12.1
Growth (%)	60.1	26.0	33.6
PE (x)	26.0	20.6	15.4
PABV (x)	5.4	4.0	3.4
RoE (%)	21.5	22.0	22.8
RoA (%)	4.2	4.1	3.8
Dividend yield (%)	0.8	1.1	1.2
NetNPA (%)	1.0	0.6	0.7

Source: Company, Anand Rathi Research

Robust loan growth



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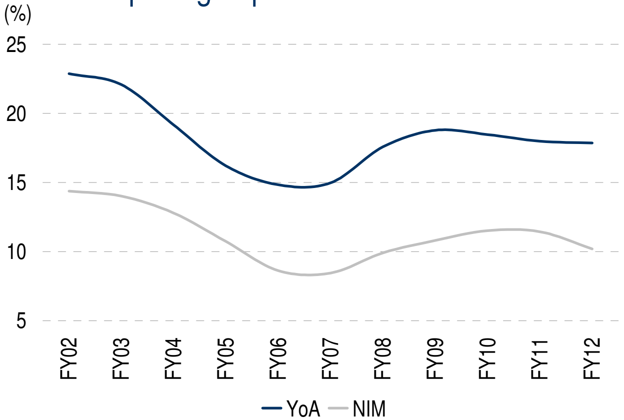
Premium pricing of products



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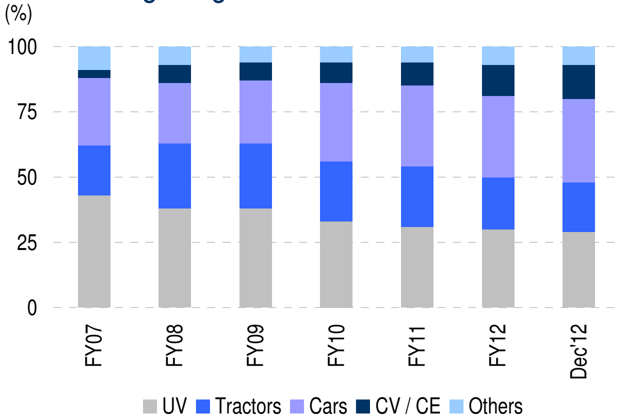
Different legs of growth



Source: Company, Anand Rathi Research

Bajaj Finance

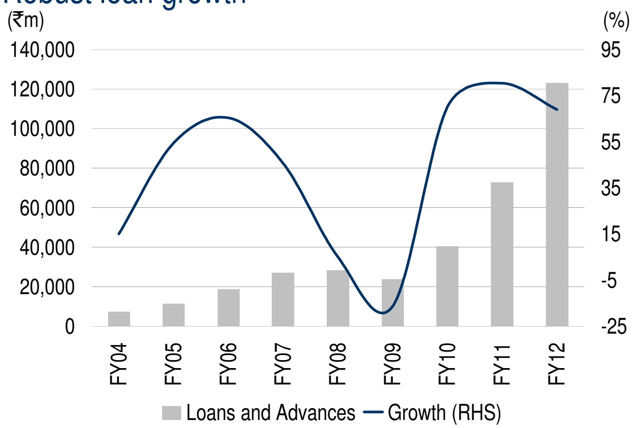
- Niche in consumer durables and 2w finance
- From a captive financier of two-wheelers, the company has successfully diversified its product mix to encompass consumer durables and LAP
- Rising consumption of aspirational products in tier 1 and tier 2 cities has so far driven growth. Penetration in tier 2 and tier 3 cities are the next growth triggers
- Premium pricing power helps sustain best in class NIMs
- Rise of CIBIL and a benign retail credit cycle have kept credit costs in check

Key Financials

Year end 31 Mar	FY10	FY11	FY12
Net interest income (₹m)	7,084	9,537	12,983
Net profit (₹m)	894	2,470	4,064
EPS (₹)	24.4	67.4	98.4
Growth (%)	163.6	176.0	45.9
PE (x)	52.2	18.9	13.0
PABV (x)	4.6	3.7	2.6
RoE (%)	8.0	19.7	24.0
RoA (%)	2.4	3.8	3.8
Dividend yield (%)	0.5	0.8	0.9
Net NPA (%)	3.6	1.1	0.1

Source: Company, Anand Rathi Research

Robust loan growth



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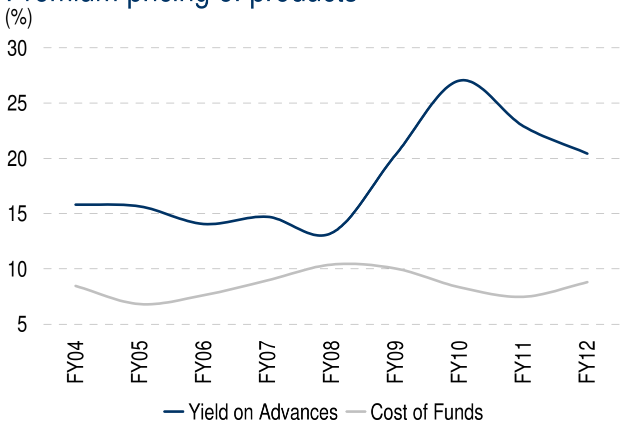

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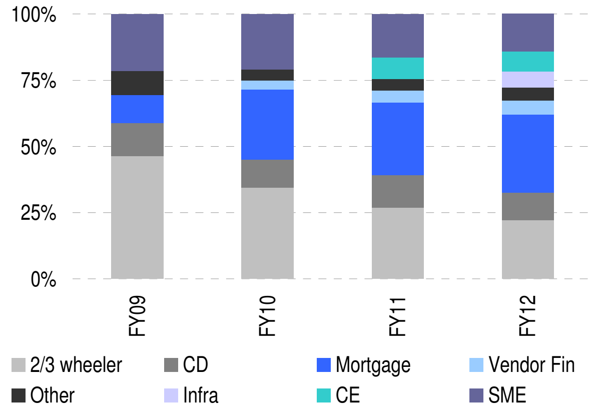

Source: Company, Anand Rathi Research

THANK YOU

Appendix

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