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HEAD–PMS, EQUIRUS SECURITIES

With steady cash flow, robust business model and prudent risk management, Manappuram Finance's future looks golden

*The stock is part of Equirus Long Horizon Fund

STOCK PRICE	₹97
M-CAP	₹82 BILLION
FY20* RETURN	23%
TTM PBV	2.3X
ROE	30.4%
ROA	6.3%
NET SALES	₹38.6 BILLION
PAT	₹10.8 BILLION

*Market data as on March 20, 2020. Financials for 9MFY20; Return ratios as of Q3FY20

Data: Ace Equity

"When lending people money, be sure their character exceeds their collateral"

– Jackson Brown Jr

This lesson was one of the thousands in the American author's book of life instructions, which, if our bankers had read, would have done great service to this country. While growth is important, risk assessment is vital. While asset quality is important, determining loss in case of a default is vital. While NIM is important, risk adjusted yield is vital.

It may be a cliché, nonetheless true, that anyone can lend but not everyone recovers. This is where risk management plays an important role in any lending business. For instance, in the gold-loan business, a company would have to closely assess the quality of gold and price fluctuations, both are major risk parameters. While the first is objective, insulating against the latter requires a nuanced strategy. That's why we like Manappuram Finance, a company that has smartly introduced an additional protection measure by shortening the tenure of loans to three months compared to industry practice of one year. Thus, it protects the lender from sharp vagaries of price fluctuations. It's no wonder then that its gross NPA rose above 1% only in one out of the past five years, which was the year of demonetisation.

From FY08 to FY12, its gold loans grew at a scorching pace with AUM increasing ~15x on the back of rising gold prices. Over the consequent five years, the industry underwent a consolidation, primarily due to stagnant gold prices and regulatory interventions. But now that the players have adjusted to the new norms, the industry is expected to grow at 8-10% rate for the foreseeable future.

Manappuram has introduced an additional protection measure with a loan tenure of three months compared to industry practice of one year

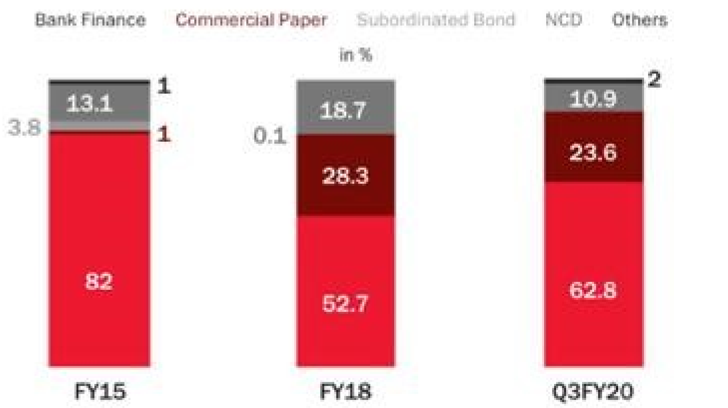
SAFE HAVEN

Billionaire investor George Soros once wrote, "The act of lending can change the value of the collateral." While this may be true in most forms of lending, it does not hold water in case of gold loans. Gold is a highly liquid asset and can be easily monetised in case of a default without having much effect on its value. Another common financial market wisdom falls on its face in case of Manappuram's gold loans business — high risk, high return. The company has one of the highest spreads in the lending business and, despite being one of the safest forms of lending, it earns a very high yield.

What further strengthens our case for the stock is the current economic turmoil. Considered safe and valuable when things get tough, gold holds a special appeal in Indian households. Collectively, Indians own more than ~20,000 tonne of gold, approximately valued at ₹80 trillion at current prices. At 70% loan-to-value ratio, this translates to an opportunity size of ₹56

Well-funded

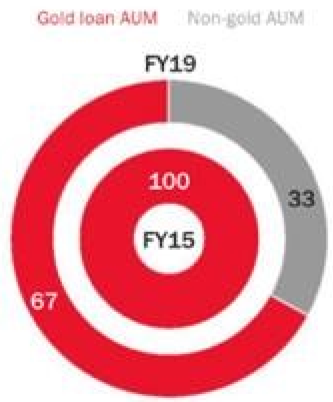
A well-diversified liability mix ensures cost of capital is in check



Source: Company, PL

All that glitters is not gold

Manappuram has derisked its business



Source: Company, PL

trillion. Of this, organised gold loans have barely scratched the surface with 3% penetration. That means a long growth runway for players such as Manappuram Finance. Furthermore, lending is a commodity business and anyone including banks, NBFCs, local money lenders can lend against gold. However, specialised NBFCs have a distinct advantage against other lenders. Gold loan NBFCs enjoy speed and flexibility of local moneylenders while benefiting from much lower cost of funds.

The company has already proved its mettle as it emerged out of the IL&FS fallout mostly unscathed. While the cost of borrowing for troubled NBFCs increased substantially over two years, Manappuram was not one of them. In fact, recent commercial paper issuance at 6.12% yield was at a much lower rate compared to peers *(See: Well-funded)*. This is because of its high quality loan book backed by highly liquid collateral.

Due to its healthy gold loans business, the company has maintained substantial cash flow, which has been prudently utilised by the management. From being a 100% gold loan company in FY14, Manappuram's 33% of the loan book now comes from sectors such as micro finance, vehicle loans and housing finance. Ashirvad Micro Finance, which it acquired in February 2015, is now among the top five MFI lenders in the country. The subsidiary's AUM has grown from ₹3 billion to more than ₹50 billion over the past five years. It enjoys RoA/RoE of ~5.3%/~26.8% and gross NPA of <0.5% as of Q3FY20. While Manappuram's gold business continues to be a core one, we believe non-gold business will also be a substantial growth driver, contributing nearly 50% of the AUM in the next five years *(See: All that glitters is not gold)*. With a customer base of 4.93 million customers, it has large cross-sell opportunities, which Manappuram should be able to capitalise.

Due to its healthy gold loans business, Manappuram has steady cash flow, which has been prudently utilised by the management

SHINING BRIGHT

Despite high growth over the past decade, Manappuram raised equity only once, in FY11. It has reported strong earnings growth with EPS rising from ₹1.8 in FY10 to ₹15.9 in FY19 on a trailing twelve months basis. The financier's efforts to lower security cost over the years has also reaped rich dividends in the form of healthy return ratios — RoA of 6.3% and RoE of 30.4% on consolidated basis as of Q3FY20. Despite being in a capital-intensive business, Manappuram has not missed dividend payouts for more than 15 years, which demonstrates the robustness of its business model as well as cash flows.

All these factors prove the company has significant room to grow, and it would not even require much capex. It already has more than 4,600 branches across the country and as business grows, operating leverage should kick in, which would mean extremely attractive return ratios. At ₹82 billion market cap, Manappuram trades at ~5x estimated FY21 earnings. That, without a doubt, is a great steal.