Gold Loan Companies

Q1. Let's begin with what attracted me to Gold Loan Companies?

CANSLIM Model (A screener I use to filter stocks) spits out Gold Finance Co's

a. Excellent Price Momentum backed by Sales & Profit Growth
b. Asset backed loan business – hence lower probability of default
c. Valuation Arbitrage - Asset backed businesses available at lower P/B & PE multiples than the Micro Finance NBFC's having unsecured loans on book

	Manappuram Finance			Muthoot Finance		
	Mar-17	Mar-16	% Chg	Mar-17	Mar-16	% Chg
Mkt Cap (Rs Cr)	8,263	2,944 ⇧	181%	14,739	7,132 ⇧	107%
Total Income (Rs Cr)	3,409	2,371 ⇧	44%	5,911	4,920 ⇧	20%
PBT (Rs Cr)	1,166	551 ⇧	112%	1,959	1,327 ⇧	48%
PAT (Rs Cr)	756	353 ⇧	114%	1,200	815 ⇧	47%
EPS	8.98	4.20 ⇧	114%	29.95	20.22 ⇧	48%
NPM (%)	22%	15%		20%	17%	

Valuation Arbitrage

	Bharat Finance	Ujjivan	Equitas	Manapp Finance	Muthoot Finance
CMP (31st Mar 2017)	808.40	423.35	169.55	98.15	368.95
Book Value (TTM)	177	147	66	40	164
P/BV x	4.6	2.9	2.6	2.5	2.3
TTM EPS	21.8	17.8	4.8	9.0	30.1
TTM Pe x	37.0	23.8	35.4	10.9	12.3

Source: Bloomberg, Company

Q2. Before we move on to understanding the Gold Finance Business – let's first understand some macro stats with reference to Gold in India?

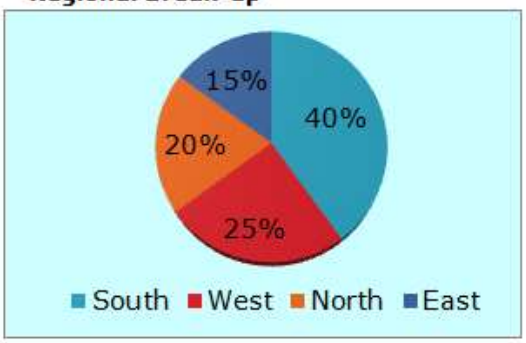
- According to the World Gold Council - India possess ~ 22,000 tons of gold, in the form of gold jewelry, gold coins and bars. It is also one of the largest importers of gold in the world.
- Primary reasons for India's huge demand for gold is it's cultural significance (marriages, offerings to god, long term investment to be passed on to future generations to cite a few)
- Limited access to other financial assets / low penetration of banking system and alternate investment products, especially in rural areas, further boosts the demand for gold.
- About 65% of the total gold stock lies in rural India and ~40% of gold demand comes from South India
- Gold Loan penetration by the organized sector is very minuscule at close to 3%
- Gold remains the second choice (after bank deposits) as an asset to liquidate at the time of major financial crisis
- Initially gold loans were considered a taboo but this attitude is changing fast as more people are now open to gold loans – not only to fund medical emergencies and important occasions but also to meet their short term working capital needs

Gold Loan Penetration - Organised sector

Total Gold Holding in India (tons)	22,000
Gold Price (Rs/gm)	2,700
Value of Gold holding (Rs bn)	59,400
Gold Loan Potential Size (75% of LTV) (Rs bn)	44,550
Outstanding gold loans	1,350
Market penetration of organised business (%)	**3.0%**

Company, Nirmal Bang Research Nov'16

Regional Break-up



Q3. Who are the major players in the Gold Loan Market?

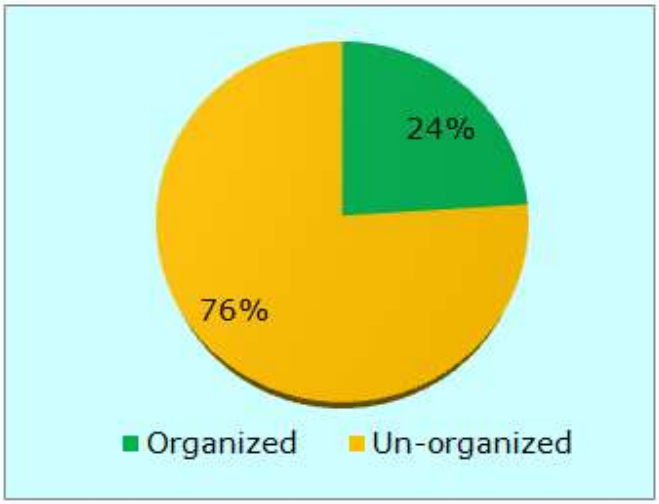
Gold loan market constitutes of Unorganized & Organized players.

Unorganized Players

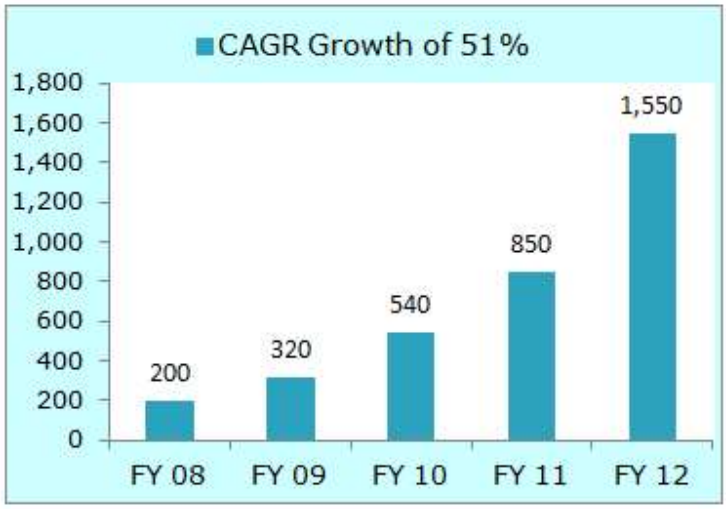
- These consist of pawn-brokers, money-lenders and landlords who operate at the local level
- They have a strong understanding of local customer base and offer immediate credit
- Being unregulated they are highly exploitative in nature charging interest rates in excess of 30% p.a.
- It is still a dominant segment accounting for over 76% of the total Gold Loan Market

Organized Players

- These consist of Specialized Gold Loan NBFC's (Muthoot & Manappuram), Other NBFC's (Shriram City Union Finance, IIFL etc.) and Banks (HDFC Bank, State Bank of India etc)
- They primarily differ from each other in their operating procedures, terms of loan, Loan to Value Ratio (LTV), documentation etc.
- They constitute about 24% of the total Gold Loan Market (1/3rd of Unorganized Size). This segment has grown at a CAGR of 51% from FY 08 to FY 12



DCMS, Nirmal Bang Report Nov '16



RBI, Nirmal Bang Report Nov '16

Q4. Do the Gold loan companies possess any distinct advantage over their competition?

Specialized Gold loan companies (Muthoot & Manappuram) have gained significant market share from both their unorganized as well as organized peers, for reasons cited below

Competitive Advantage of Gold Loan NBFC's

Parameters	Banks	Money Lenders	Gold NBFC's
Loan to Value Ratio (LTV)	Upto 75%	Higher than 75%	Upto 75%
Processing Fees	Higher than NBFC's	NIL	Minimal to NIL
Interest Chg.	12% to 15%	30% to 60%	18% to 24%
Penetration	Lower	Higher	Higher
Mode of disbursal	Cheque	Cash	Cash / Cheque
Working Hours	Banking hours	Anytime	Open beyond banking hours
Regulated	Regulated by RBI	Unregulated	Regulated by RBI
Fixed office place	Proper Branch	No fixed place to conduct business	Proper branch with dedicated staff for gold loans
Documentation	Entire KYC compliance	Minimal / No documents	Minimal documentation
Repayment structure	EMI based with prepayment penalties. Less flexible	Flexible	Flexible - bullet payments with no prepayment penalty
Turnaround time	1 to 2 hours	10 min	10 min to 30 min

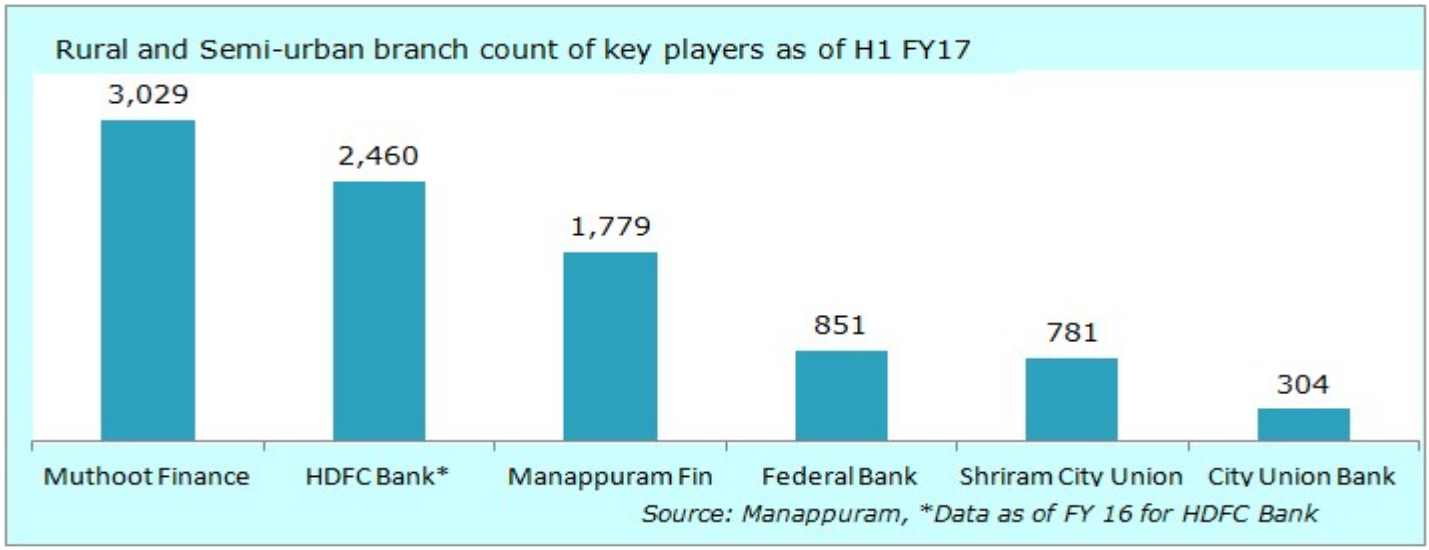
To Summarize – NBFC's have the following advantages over Banks

- Flexible Repayment Terms
- Less documentation, lower processing charges
- More working hours, faster disbursement, better penetration

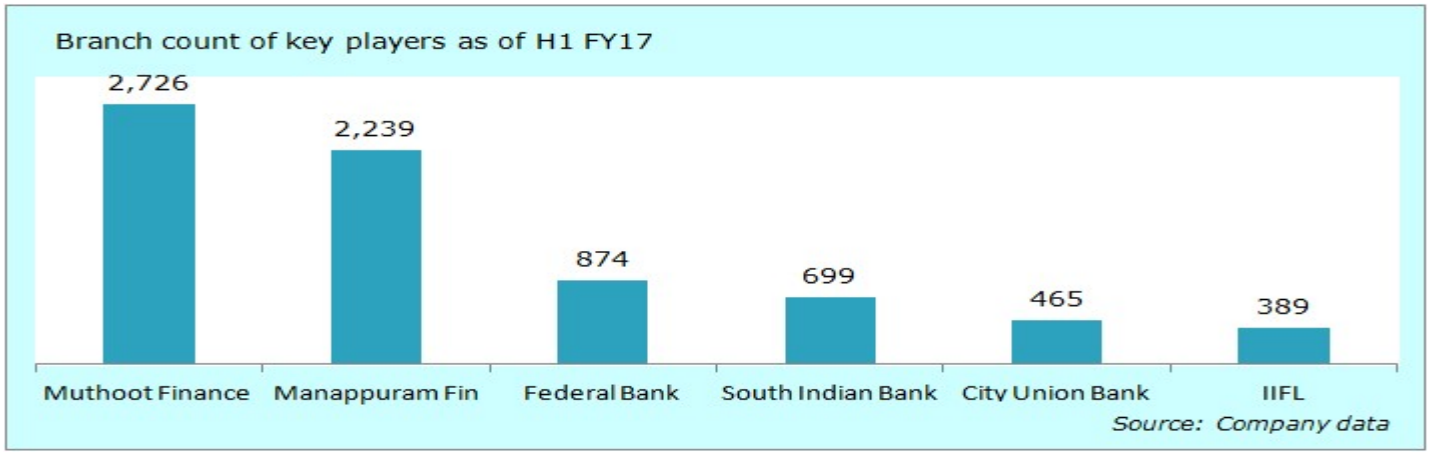
As against money lenders, who possess all the advantages of the NBFC's – differentiation is on account of Lower rate of Int charged and larger scale of operations due to organized capital structure

Q5. While the point on competitive advantage is well established, do they have the necessary reach to capitalize on these advantages to register the growth?

- Since a typical gold loan borrower is looking to avail loan in shortest possible time (often to meet emergency needs), distance from borrower to lender becomes a key differentiating factor. Also, interest rate being high – he would prefer easy accessibility to repay the loan quickly. Hence, penetration and proximity assume vital significance.
- The primary reason for the excellent growth of Gold NBFC's has been their branch accessibility. With 65% of the gold lying in rural India, branch penetration in rural and semi-urban areas would be quintessential. The graph below clearly shows that both Muthoot and Manappuram have significant penetration, apart from HDFC bank.



- Branch penetration in South India is another key parameter to track as ~40% of Gold demand stems from this region. Gold NBFC's again score high on this parameter. Most importantly, difference in penetration of Gold NBFC's Vs Banks is much higher than the figures indicated, as branches of the former are solely for disbursing gold loans, whereas for others not all branches are capable of doing so - as not all branches conduct the Gold loan business.



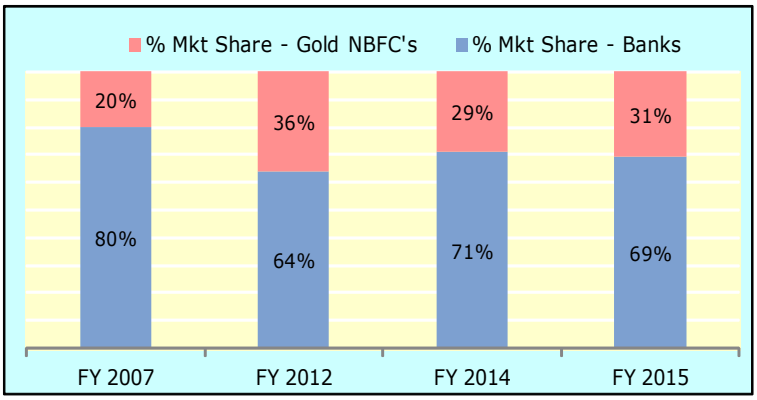
Q6. If penetration is of significance, what stops the Banks & other NBFC's to open more branches? Is there evidence of Gold NBFC's capturing market share?

While expanding new branches in rural India is easy, dynamics of the Gold loan business requires some expertise, without which it is difficult to sustain profitability, especially during tough times.

- Avg. ticket size of a gold loan is between Rs 30,000/- to 40,000/-. Hence, scale of operations have to be high to sustain profitability
- The business demands quick turnaround times and a host of operational expertise like valuation of gold, safeguarding the pledged gold and ability to recover adequate value on gold auctioned to contain credit losses. Hence, it is a low ticket size – high operational expense business
- Stringent regulations by RBI (LTV Cap @ 75%, recognition of NPA on 120 days overdue, Tier I Capital @ 12% etc) and volatility in gold prices impacting asset quality makes it difficult for smaller players to sustain during tough times
- Single minded focus of gold NBFC's have enabled them to develop systems and processes – tailored specifically to deal with these issues, thereby enabling them to garner market share from peers

Gold Loan Industry - Organized Players Mkt Share Trends

	FY 2007	FY 2012	FY 2014	FY 2015
Co-operative Banks	18%	6%	5%	5%
Private Sector Banks	16%	15%	16%	15%
Public Sector Banks	46%	36%	45%	44%
Other NBFC's	0%	7%	5%	5%
Total - Banks	***80%***	***64%***	***71%***	***69%***
Specialised NBFC's	***20%***	***36%***	***29%***	***31%***
	181%	**164%**	**171%**	**170%**



- As can be seen from the above stats – that Gold NBFC's Mkt share has increased from 20% in FY 2007 to 31% in FY 2015.
- Analysis of key players, comprising of 43% of Gold AUM in FY 2015, suggest that apart from HDFC Bank, all south based banks have reduced their Gold Loan exposures

- PSU's who have a significant rural branch network are unlikely to increase exposure to Gold loans as they are still toiling with the NPA mess
- Unorganized players offer the same advantages as NBFC's – but being unregulated – they charge exorbitant rates (>30% p.a.) and lower scale of operations, which is the prime reason of shift from unorganized to organized.

Movement of Gold Loan AUM from FY 15 to FY 16

	FY 2015	FY 2016	% Growth
Muthoot Finance	233	243 ⇧	4%
Manappuram Finance	92	101 ⇧	10%
Muthoot Fincorp	65	68 ⇧	5%
Shriram City Union Fin	30	33 ⇧	10%
IIFL	38	29 ⇩	-24%
HDFC Bank	41	45 ⇧	10%
South Indian Bank	25	14 ⇩	-44%
Federal Bank	34	23 ⇩	-32%
City Union Bank	25	20 ⇩	-20%

Source: Manappuram

Q7. How has Gold Loan Industry developed over the past decade?

Phase 1: (FY06- FY12) – High Growth

- Branch Network grew 7x
- Higher LTV upto 85%
- Gold Prices rose 150% in 5 years
- Low cost of funds as agri loans backed by gold was eligible under priority sector lending
- Support from buoyant economic growth

Phase 2: (FY12- FY14) – Decline

- RBI removed the priority sector lending status – which resulted in borrowing costs increasing by 150 to 200 bps
- RBI capped LTV Ratio to 60% in Mar '12 – which further weakened the competitive positioning. Higher LTV focused customers migrated to moneylenders and interest sensitive ones moved to Banks
- Gold prices fell 23% in 2 yrs
- RBI prohibited grant of loans against bullion and gold coins and excluded the making charges in the valuation of jewellery
- RBI restricted the exposure to single gold NBFC to 7.5% from initial 10% - making the bank funding more difficult
- Increased the Tier 1 Capital requirement to 12% in 2014

Phase 3: (FY14- FY16) – Growth Rebounds

- RBI increased the LTV cap from 60% to 75% in Sep 2013 – Growth caught up in 2014 onwards
- RBI capped the Bank's LTV also to 75% - creating a level playing field
- Gold prices stabilized
- Gold NBFC's introduced non-gold products (Mirco finance, affordable housing, etc)
- Operating leverage kicked in

Q7. What are key risks associated with Gold Finance Business? How are the Gold Finance NBFC's geared to deal with them?

1. Extreme volatility in Gold prices – especially downside

- Volatility in Gold prices – especially a sharp downfall – is primary risk as it increases a risk of default and increase the credit costs (Provisioning + Auctions)

- Since loan value is a % of the value of gold article pledged, a drop in gold prices will reduce the quantum of loan disbursed and in turn the revenue growth
- Return Ratios deteriorate along with profitability

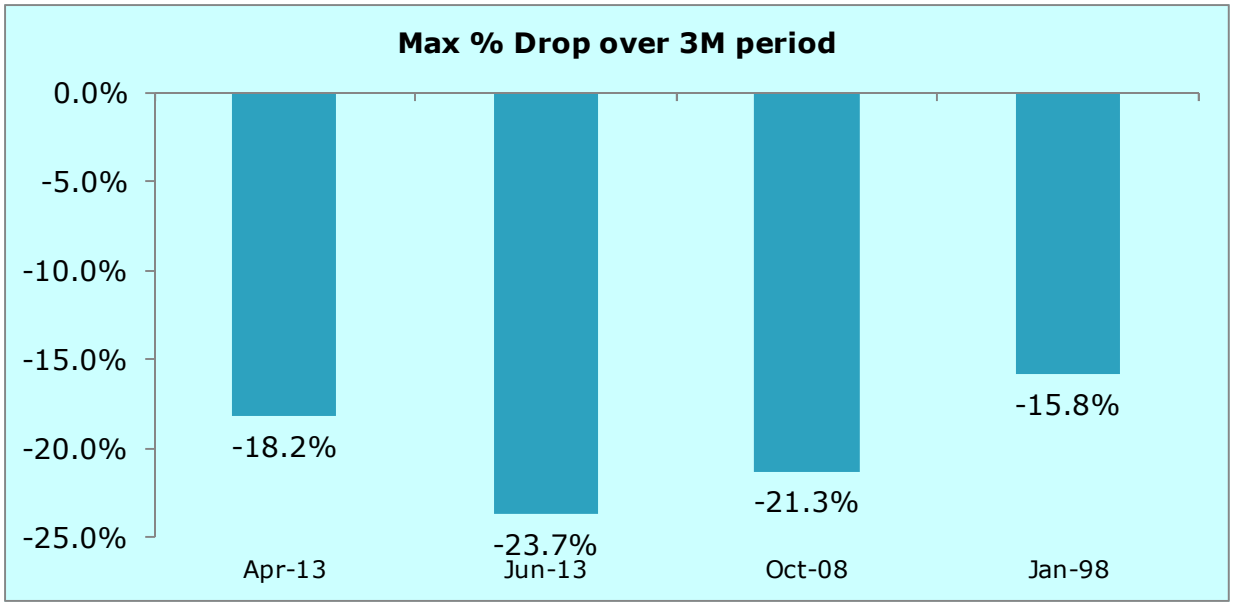
Risk mitigation

- Reduction in tenure of gold loan & reduction on LTV Ratio, reduces the amount recoverable from the borrower and provides sufficient cushion in spite of the drop in collateral value (see the table below)
- Diversification to other synergistic loan segments, like Micro finance, Housing Loan & Vehicle Finance thereby reducing dependence on Gold Loan business

Illustration of Product modification and it's impact

Tenure	12 Months	3 Months	6 Months	9 Months	12 Months
Value of pledged gold (Rs)	100	100	100	100	100
LTV Ratio (%)	75%	75%	70%	65%	60%
Loan disbursed (Rs)	75	75	70	65	60
Annualised Int. Rate	24%	24%	24%	24%	24%
Tenure in Months	12	3	6	9	12
Simple Int (Rs)	18	4.5	8.4	11.7	14.4
Total repayment due (Rs)	93.0	79.5	78.4	76.7	74.4
Cushion (%)	7.0%	20.5%	21.6%	23.3%	25.6%
Time taken to auction (months)	2	2	2	2	2
Simple Int for auction period	3.0	3.0	2.8	2.6	2.4
Target Recoverable	96.0	82.5	81.2	79.3	76.8
Auction loss (% of Pledged Gold)	10%	10%	10%	10%	10%
Realisation post auction	90	90	90	90	90
Excess / Shortfall post auction	-6.0	7.5	8.8	10.7	13.2
% Excess / Shortfall	-6.7%	8.3%	9.8%	11.9%	14.7%

- From the above illustration, it is amply clear that a 12M loan offers a cushion of just 7%, post which probability of borrower default increases. Further, if the borrower defaults, resulting in auction – the lender is bound to lose 6.7%.
- Analysis of MCX gold data from 2005 (by Edelweiss) shows that historically, a drop of more than 7% in gold prices over a 12M rolling period occurred 42% of the times. Even for a 3M rolling period, a drop of 7% occurred 24% of the times. Hence, one can conclude that offering a 12M loan @ 75% LTV will entail huge risks of default.
- Now, a 3M loan with 75% LTV – offers significant cushion of 20.5%. Historically, drop of 20.5% over 3 M rolling periods occurred only 0.03% of times. This increases the margin of safety significantly. In case of default, after accounting for a 10% drop in realization, the lender is still left with a cushion of 8.3%
- Study of past 30 years of gold prices suggests that a fall in excess of 15% over a 3 month rolling period occurred only 4 times.



2. Regulatory Risk

- RBI has tightened regulations in the past which impacted the competitive positioning of gold NBFC's

Risk mitigation

- While it is difficult to mitigate a risk like this, responsible lending, adequate provisioning and prudent growth would go a long way in managing such risks

3. Competitive Intensity

- While Gold NBFC's possess competitive advantages over Banks & Moneylenders – high ROE and asset backed nature of the business will most likely to invite competition

Risk mitigation

- India being a capital hungry & under penetrated nation, the runway is huge for multiple players to coexist, without impacting too much profitability

4. Employee Management

- Gold finance business is manpower intensive – Muthoot employs ~23,200 people while Manappuram employs ~18,700 people.

Risk mitigation

- Strong and experienced management team would be ideal to deal with such challenges. Both Manappuram and Muthoot have been carrying on this business since generations and possess the necessary DNA to deal with such huge employee base

5. Easy access to stolen jewelry & collusion between borrower & loan approver

- Less stringent documentation and quick disbursement implies that approver spends very little time trying to establish the valid title to the jewelry, thereby providing easy credit to stolen jewelry.
- Collusion between borrower and loan approver could also result into losses

Risk mitigation

- Both these risks are serious business risks and cannot be completely mitigated
- Low ticket size per loan, regulation of granting loans in excess of Rs 1 lakh via cheque and adequate internal controls – would reduce the quantum to an extent

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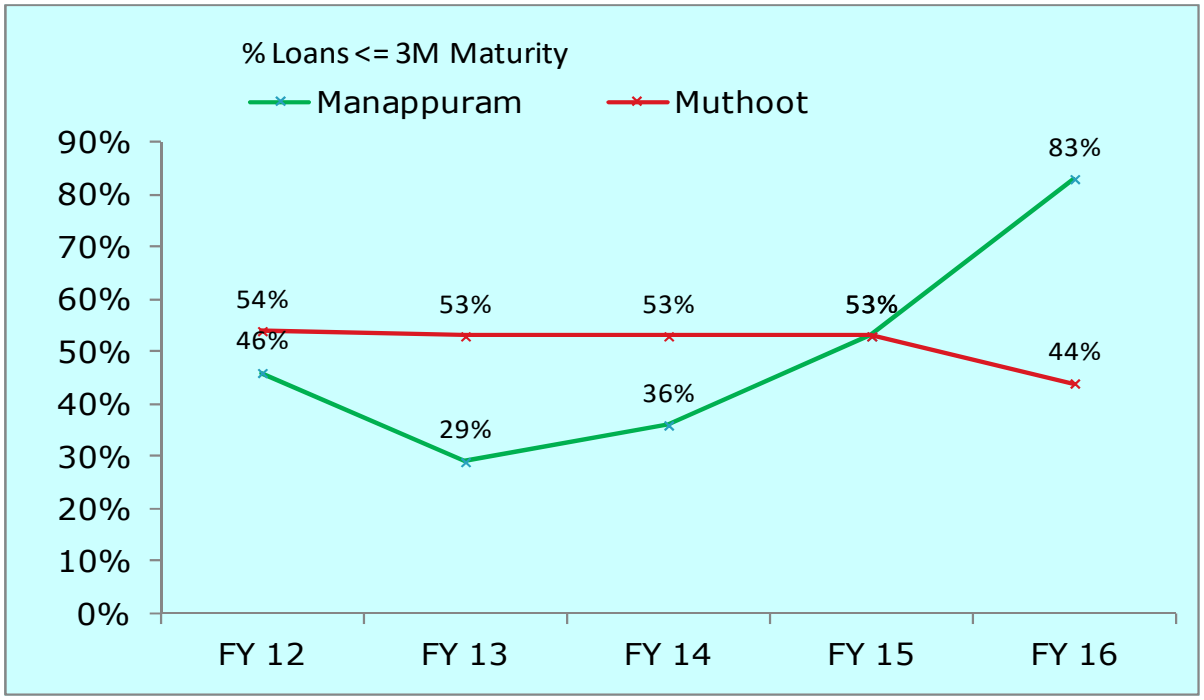
Gold Loan Companies: Manappuram Finance

Edelweiss had done an excellent comparison of the 2 Gold Loan companies Muthoot & Manappuram, while initiating coverage on the Manappuram Finance – on 6th Feb 2017. I have summarized the comparison below

1. Shorter Tenure Loans by Manappuram reduces risk – Not the case with Muthoot

- Chart below shows maturity profile of the loan <=3M maturity as of FY 12 & FY 16.



- For Manappuram - 46% of the total loan book was < 3M, which in FY 16 stands at 83%
- For Muthoot - 54% of Loan book is <3M in FY 12 which in FY 16 stands at 44%
- All incremental loans by Manappuram are offered for <=3M
- Hence, Muthoot is keeping a higher gold price risk on its balancesheet Vs Manappuram as is reflected in the asset quality. Gross NPA of Manappuram @ 0.9% Vs 2.2% for Muthoot as on 1HFY17
- Importantly – this has not impacted Manappuram's growth as it's AUM grew @ 11% CAGR from FY14 - 16 Vs 6% for Muthoot.

2. Manappuram managed to outpace Muthoot without resorting to yield dilutive measures

Key differences between Manappuram & Muthoot's gold loan products

	Manapp	Muthoot
- Min Int Rate	15%	14%
- Rebate on final install		
in case of regular int payment	0.75%	2.00%
- Max Loan Amt	50,000	100,000
- Tenure	3M	12M
- Dedicated Relationship Manager	No	Yes
- Customer Loyalty Programme	No	Yes

- The above chart shows that terms of Muthoot are more customer friendly but yield dilutive
- Manappuram has stayed away from such measures but has still outpaced Muthoot on AUM growth (This could be due to base effect as well)

3. Underlying Gold holdings for Manappuram less dependent on gold prices

- The co-relation of gold prices and gold loans is 2 fold – 1st higher the gold price, higher the loan, as gold loan is given as % of gold value pledged. 2nd customers are more likely to avail gold loans at times of rising gold prices vs otherwise. Hence, logically, gold holdings of gold companies would rise with the rise in gold prices – as customers avail more loans and vice versa
- Correlation analysis of Manapppuram Gold holdings with gold price over FY 12-H1FY17, suggest a weak correlation of just 0.06 Vs 0.61 for Muthoot. This suggests that Manappuram is not too dependent on the gold prices to build it's AUM
- Importantly, gold prices fell from FY 14-16 @ CAGR of 4.7%, but both Manappuram & Muthoot increased gold holding by 15% & 10%. Hence, Gold Loan companies can increase their AUM's when the price fall is not rapid and happens in an orderly manner

4. Manappuram is half the size of Muthoot (Loan Book) – but can be can catch up on the operating leverage

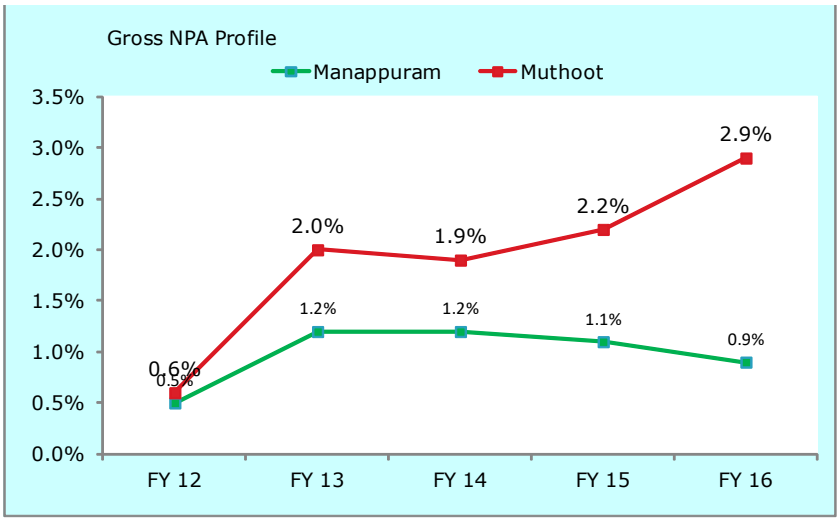
Comparison of Manappuram with Muthoot– Q2FY17

	Manappuram Finance	Muthoot Finance
Loan book:		
Loans book size (Rs cr)	14,486	28,308
Gold Loans as a % Total Loans	85.5%	96.8%
Funding mix:		
Bank Finance	62%	42%
DCM	37%	44%
Other	1.4%	14%
Other key metrics:		
AUM / branch (INR cr)	3.9	6.3
Opex to AUM	6.9%	4.8%
GNPA Ratio	0.9%	2.2%
NNPA Ratio	0.7%	1.8%
Gold Holding (T)	66	150
RoA	5.1%	4.5%
RoE	24%	20%
CAR	22%	24%

- AUM per branch for Manappuram @ 3.9 Cr Vs 6.3 Cr for Muthoot – suggests potential upside to increase AUM without significant branch addition
- Manappuram has significant branch network of 3,293 branches as of FY 13 and can augment it's business without additional branch expansion
- Manappuram's Gross NPA profile is better than Muthoot inspite of it moving to 90 days past due (90 dpd). Muthoot recognizes Gross NA on 120 dpd basis
- ROA & ROE of Manappuram @ is superior to Muthoot

ROA / ROE Calculation of Manappuram Vs Muthoot – FY 17

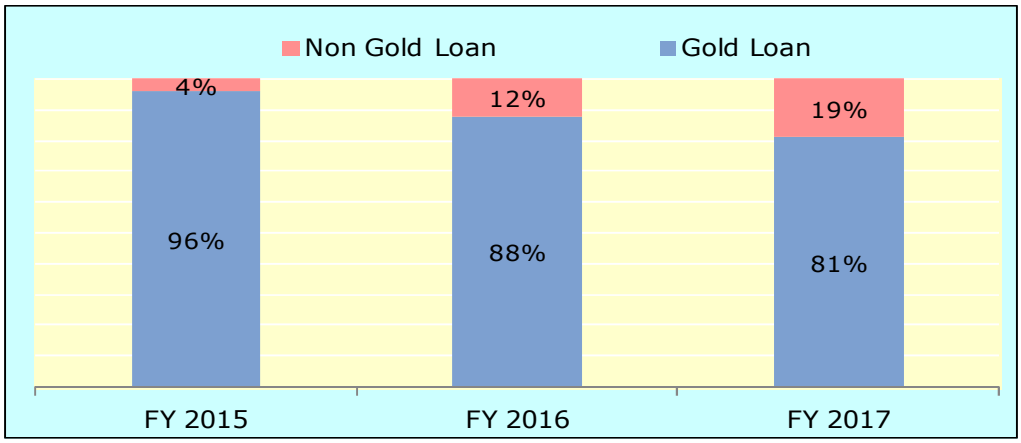
Calculation	Manappuram	Muthoot
Int Income	24.1%	19.6%
Int Exp	8.4%	7.9%
NIM	15.8%	11.6%
Non Int Income	0.2%	0.3%
Operting Exp	6.9%	4.3%
- Employee	3.6%	2.5%
- Other Exp	3.3%	1.8%
Operating Profit	9.1%	7.6%
Provision	0.8%	1.0%
PBT	8.3%	6.7%
Tax	2.9%	2.6%
PAT (ROA)	5.4%	4.1%
Leverage	4.6	4.8
ROE	25%	19%



Pointers hereon are not comparison to Muthoot but specific to Manappuram

5. Manappuram's strategy to diversify to synergistic loan products – well thought out

- Manappuram forayed into non gold loan products like Microfinance, Housing loan & Vehicle financing.
- This is highly synergistic as the company can disburse these loans from the same branches and the target customers also are of the same profile as Gold loan customers
- As of FY 17 – 81% of the AUM comprises of Gold Loans Vs 96% in FY 15. Company aims at increasing the Non-gold loan portfolio to 25% by FY 18 & 50% by FY 20



6. Reduced credit costs – accrued int as % of AUM drops and auction losses reduce

- Introduction of short term products and encouragement to pay repay interest on regular basis has reduced the accrued int as % of AUM from 5.9% in FY 15 to 3% in FY 16. About 35% of the total customer pay interest on periodic basis instead of maturity

- Auction to disbursement ratio dropped to its lowest level to 1.7% in 4QFY 16 – again due to lower maturity products and hence lower delinquencies

Valuations

- Edelweiss values the company as per Residual Income method @ Rs 120. On Price to Book basis it works out to 1.9x FY 19E Book value of 47.4. key growth assumptions are give below

Edelweiss Estimates - Manappuram *Rs in Cr*

Income Statement	FY 17	FY 18E	FY 19E	2 Yr CAGR
Net Int. Income	2,004	2,186	2,491	11%
% Growth	*51%*	*9%*	*14%*	
Other Income	1	70	82	
Total Income	2,005	2,256	2,573	13%
Operating Exp	835	932	1,047	
Provisions	56	65	79	18%
% Growth	*75%*	*16%*	*21%*	
PBT	1,114	1,260	1,447	14%
Tax	389	422	485	
PAT	725	838	962	15%
% Growth	*115%*	*16%*	*15%*	

Edelweiss Estimates - Manappuram

Valuations	FY 16	FY 17	FY 18E	FY 19E
CMP	91.0	91.0	91.0	91.0
Adj. EPS	4.0	8.6	10.0	11.4
% Growth		*115%*	*16%*	*14%*
Adj. BV Per Sh	31.9	35.5	41.1	47.4
PE x	22.8	10.6	9.1	8.0
P/B x	2.9	2.6	2.2	1.9

- Nirmal Bang also uses residual income method to value the company which comes to 120. On Price to Book basis it works out to 1.8x FY 19E Book Value of 48.5. Key growth assumptions are given below

Nirmal Bang Estimates - Manappuram *Rs in Cr*

Income Statement	FY 17	FY 18E	FY 19E	2 Yr CAGR
Net Int. Income	2,208	2,414	2,764	12%
% Growth		*9%*	*14%*	
Other Income	34	42	51	
Total Income	2,242	2,456	2,815	12%
Operating Exp	967	1,215	1,486	
Provisions	109	78	70	-20%
% Growth		*-29%*	*-10%*	
PBT	1,166	1,164	1,259	4%
Tax	407	407	441	
PAT	759	757	818	4%
% Growth	*125%*	*0%*	*8%*	

Nirmal Bang Estimates - Manappuram

Valuations	FY 16	FY 17	FY 18E	FY 19E
CMP	89.0	89.0	89.0	89.0
Adj. EPS	4.2	9.0	9.0	9.7
% Growth		*114%*	*0%*	*8%*
Adj. BV Per Sh	31.9	37.3	42.6	48.5
PE x	21.2	9.9	9.9	9.2
P/B x	2.8	2.4	2.1	1.8

Current Valuations

	Edelweiss	Nirmal Bang
CMP	99	99
Estimated BV - FY 19	47.4	48.5
Estimated EPS - FY 19	11.4	9.7
PE x	8.7	10.2
P/B x	2.1	2.0
Target Price	120	120
% Appreciation	21%	21%