- Muthoot has very high capital levels and an established record in the gold loan business. However, the company accounts for a small part of the overall financial sector in India.
- Muthoot's funding is predominantly short-term wholesale and the India-based finance company relies on strong short-term cash flows to meet these commitments.
- We are assigning our 'BB' long-term and 'B' short-term issuer credit ratings to Muthoot.
- The stable outlook reflects our view that Muthoot will largely maintain its financial profile despite challenging conditions over the next 12-18 months.

SINGAPORE (S&P Global Ratings) Oct. 10, 2019--S&P Global Ratings said today that it had assigned its 'BB' long-term and 'B' short-term issuer credit ratings to Muthoot Finance Ltd., an India-based finance company. The outlook on the long-term rating is stable.

The ratings on Muthoot are driven by the company's very strong capital and earnings, with the risk-adjusted capital ratio at above 45%. Muthoot also has a strong market position in loans against gold, although it is relatively small in the overall financial sector in India. The company's assets and liabilities are well matched. However, given the short-term nature of its borrowings, Muthoot needs to continuously refinance its funding to meet its lending needs.

Muthoot is exposed to economic risk in India, the company's predominant market. We believe that Indian finance companies (fincos) face greater operating risk than banks because they usually have no access to central bank funding, and have less onerous regulations--notwithstanding some regulations on capital adequacy, asset quality, and asset-liability management. Gold financing companies are subjected to additional regulations such as loan-to-value (LTV) restrictions and higher capital requirements for lending against gold. Several fincos in India have created strong niches, domain expertise, and economies of scale to support revenue stability and mitigate competitive pressure. Our starting point for rating fincos in India is 'bb'.

The gold financing industry is susceptible to regulatory risks such as imposition of interest-rate caps. We have seen LTV restrictions imposed on the business in the past. Growth could also be impacted if gold prices decline sharply. In our base case, we do not factor these risks in the rating. However, we see these as event risks.

Muthoot is a market leader in the niche area of loans with gold jewelry as collateral. It competes against money lenders and banks, and has been able to garner a large market share of about 18% in the organized segment. The business is profitable, and the company has one of the highest returns on average assets (ROAAs) among Indian finco peers.

Muthoot has strong brand recognition and an established record in gold-backed financing. It has a large distribution network comprising 4,480 branches, one of the highest among the Indian fincos. As Muthoot is a retail-focused company, its loan book is quite granular, with an average ticket size for gold loans of about Indian rupee (INR) 42,000.

However, Muthoot is a relatively small finance company with a market share of just 1.4% in the fragmented Indian nonbanking financial institution (NBFI) sector. The company has some geographic concentration, with southern India contributing about 49% of the company's assets under management. While the concentration has reduced from 75% in fiscal 2010 (year ended March 31, 2010), it remains high, making the company sensitive to the economic, social, and political situation in the region.

Muthoot was fined INR26.9 million (0.13% of fiscal 2019 earnings) under the Prevention of Money Laundering Act, 2002 (PMLA). The company was granting loans against gold in cash but had not reported cash transaction reports (for amounts above INR1 million) between April 1, 2006, and Nov. 30, 2010, as required under the Act. The company has filed an appeal and requested for condonation of the mistake, stating it was unintentional and inadvertent, and had occurred because PMLA was a new legislation and there was lack of proper understanding regarding the type of transactions required to be reported. The matter is pending with the Appellate Tribunal under PMLA.

We view Muthoot's capital and earnings as very strong, given the company's low leverage and very good profitability. We expect Muthoot's pre-diversification risk-adjusted capital (RAC) ratio to remain very strong in the next couple of years, at 45%-50%, compared with 46% as of March 31, 2019. Our RAC model incorporates the benefits of gold as collateral (after applying a "haircut" of 30%). However, the central bank does not give any such benefit. Our RAC ratio is much higher than the regulatory tier-1 capital ratio for Muthoot of 25.61% as of March 31, 2019. If we were to remove the benefit of gold collateral, the RAC ratio would be 15.9%.

We expect Muthoot's revenue growth to pick up and normalize at 15%-22% annually in the next few years. We expect the company's good profitability and high earnings retention to support growth, leading to further improvement in RAC. We anticipate Muthoot will continue to pay dividends in line with the payouts in the past.

Muthoot's profitability is among the highest of domestic peers, and is strong compared with international peers'. The company's superior margins and low credit costs underpin its high earnings. Its ROAA has improved sharply in the last couple of years to 5.5% in fiscal 2019, from the low of 2.6% in fiscal 2015, mainly due to improvement in margins. Muthoot has low earnings diversity, with a negligible proportion of fee income. We expect its ROAA to decline during the next 12-18 months to around 4.5% due to a change in asset mix and a resultant increase in credit costs, and our expectation of lower margins.

Muthoot's gold loans is collateral based (rather than cash flow based) lending to relatively low to middle income sections of the society that need money quickly or for a short period and are prepared to pay high rates of interest. Gold loan forms the major portion of is loans, at about 89% of total loans; housing finance and micro finance loans are another about 5% each. The majority of banks and other fincos assess customer cash flow in addition to the collateral; but in this kind of business (i.e. gold loan), underwriting is primarily based on collateral value alone. Muthoot like other lenders in the segment also does mainly collateral-based lending, based on the appraisal of jewelry.

While the business has lower credit risks than other finance businesses, it has higher operational and market risk, in our view. The collateral is subject to high price volatility. The company also faces heightened operational risk, which arises from risk of theft/burglary of cash or pledged gold, staff frauds, spurious/low quality gold, civil cases etc.

Mitigating these risks is the company's operation at a loan-to-value ratio of about 70%, which is lower than the central bank's 75% cap. Muthoot therefore has some buffer to absorb price fluctuations. In addition, the company haircuts the value of jewels and discounts the value of stones to ensure the value is primarily of the gold. Muthoot also has vast experience in operating in this segment, and has been able to manage its operations risk well, as seen in its very low loan loss experience. Only few other domestic finance companies such as HDFC Ltd. have lower credit costs; HDFC operates in the low-risk housing finance business.

Given the highly liquid nature of gold, Muthoot has been able to auction the commodity and typically recover the principal amount for its nonperforming book, although only a small percentage of loans need auctioning.

The company is diversifying into other business segments, namely microfinance, housing finance, and vehicle loans. All these business are relatively new and yet to season. We do expect credit costs to increase as the company diversifies its asset mix. However, the consolidated credit cost should remain low when compared to peers', given that the gold loan business will remain the major proportion of the company's business. We note that housing finance and vehicle loans are generally lower yielding and may be a headwind to overall ROAA.

Muthoot's funding profile is reliant on short-term wholesale funding. Loans from banks (largely working capital loans, which are repayable on demand) form about 49% of the company's funding mix as of March 31, 2019. This is supplemented by nonconvertible debentures (listed and unlisted) at 30%, and commercial paper (CP) at 18%. Given the company's asset base is largely of shorter tenor, its short-term funding leads to generally matched assets and liabilities.

However, Muthoot's reliance on short-term debt (i.e., working capital lines, which are repayable on demand and CP) is high. This debt forms about 64.4% of the total borrowing, which is high compared with peers' and exposes the company to refinancing risk. Moreover, as of March 2019, Muthoot has cash and bank balance and unutilized lines of INR29.8 billion, which would meet only two months' maturity. The company also has some reliance on mutual funds, which account for five of its top 10 lenders; these funds tend to have volatile finances at times of stress.

Muthoot's asset base is very liquid and is generally self-liquidating in less than 12 months, reducing risks. That said, given the short-term nature of its borrowings, the company needs to continuously refinance its funding to meet the needs of its incremental loans. Muthoot plans to increase the proportion of long-term borrowing by relying more on retail bonds and foreign-currency bonds, which could elongate the tenor of its liabilities and reduce refinancing risk.

The stable outlook on Muthoot reflects our view that the company will largely maintain its financial profile despite the challenging environment over the next 12-18 months.

We could raise the ratings on Muthoot if the company is able to diversify its funding profile into more long-term and stable sources. We view this as unlikely in the next one year.

We could lower the ratings if Muthoot's credit costs increase substantially, either due to a sharp deterioration in the company's asset quality or if operational risks materialize. We view this as unlikely in our base case.

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019

- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Financial Institutions | General: Nonbank Financial Institutions Rating Methodology, Dec. 9, 2014
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

Primary Credit Analyst:	Michael D Puli, Singapore (65) 6239-6324; michael.puli@spglobal.com
Secondary Contact:	Deepali V Seth Chhabria, Mumbai (91) 22-3342-4186; deepali.seth@spglobal.com

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor’s Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an “as is” basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT’S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P’s opinions, analyses and rating acknowledgment decisions (described below) are not

recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw or suspend such acknowledgment at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

Any Passwords/user IDs issued by S&P to users are single user-dedicated and may ONLY be used by the individual to whom they have been assigned. No sharing of passwords/user IDs and no simultaneous access via the same password/user ID is permitted. To reprint, translate, or use the data or information other than as provided herein, contact S&P Global Ratings, Client Services, 55 Water Street, New York, NY 10041; (1) 212-438-7280 or by e-mail to: research_request@spglobal.com.