

18/6/2011

Sector  
NBFCCMP  
Rs 158Face Value  
Rs10/shareEquity Capital  
Rs 301Market cap  
Rs. 5859.85

## Muthoot Finance Ltd.

### Summary

Muthoot Finance Ltd. is the largest player in the gold loan business in India. 76% of its business is generated from the 5 southern states in the Country. The Company has a market share of 19.5% in the organized sector as on FY10. It is facing major legal hurdle related to Kerala State Money lender Act which, if implemented will substantially reduce the profitability of the Company as Kerala accounts to 24% of Company's business. Moreover, there is a good probability for gold price to get corrected after this prolonged bull run which may reduce the ticket size of the loans, leading to a drop in growth and associated profitability. We are quite bullish on the growth potential of this firm but we would like to avoid the scrip until the above mentioned factors are sorted out and the scrip is available at a deep discount.

### Introduction of the Company

Incorporated in 1997, Muthoot Finance Ltd. is India's largest gold loan Company. It is a subsidiary of Muthoot Group which is headquartered at Kochi, India. It provides personal and business loans secured by gold jewellery, or Gold Loans, primarily to individuals who possess gold jewellery but could not access formal credit within a reasonable time, or to whom credit may not be available at all, to meet unanticipated or other short-term liquidity requirements. It has the largest branch network among gold loan providers in India with 1921 branches and a strong presence in the under-served rural and semi-urban markets. In 2010, it received a fund infusion of Rs.250 cr. from private equity players like Baring India Private Equity, Matrix Partners India, Kotak India Private Equity Fund and Wellcome Trust for a 6% stake in the Company. In 2011, Wellcome Trust picked up an additional 1% stake from the promoters, taking the total stake of private equity investors to 7%.

### Share Holding

|              | Shares    | % holding |
|--------------|-----------|-----------|
| Promoter     | 297797872 | 80.12     |
| Institutions | 3831589   | 1.03      |
| FII.         | 18007005  | 4.84      |
| Pvt.bodies   | 4884140   | 1.31      |
| NRI's        | 22365875  | 6.02      |
| Public       | 20914881  | 5.63      |
| Total        | 371712768 | 100       |

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### Products

The various schemes for gold loan are categorized in a tabular form

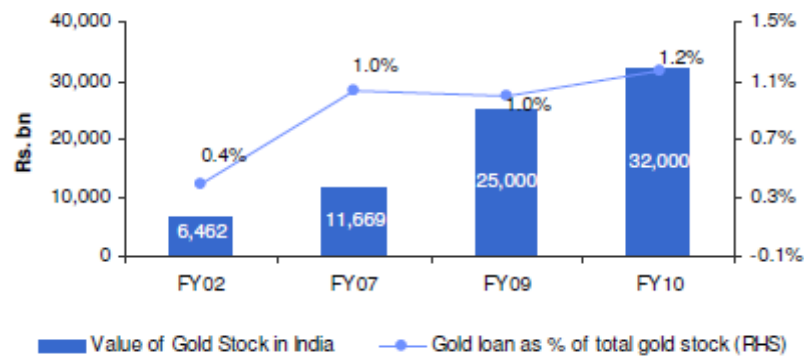
| Particular         | TPL     | RPL     | XPL     | EPL     | SPL     |
|--------------------|---------|---------|---------|---------|---------|
| Int. Schedule      | 1 Month | 3 Month | 9 Month | 3 Month | 1 Month |
| ROI/Annum          | 12%     | 16%     | 20%     | 24%     | 24%     |
| LTV(Loan to value) | 40%     | 62%     | 68%     | 70%     | 74%     |

**Process flow**

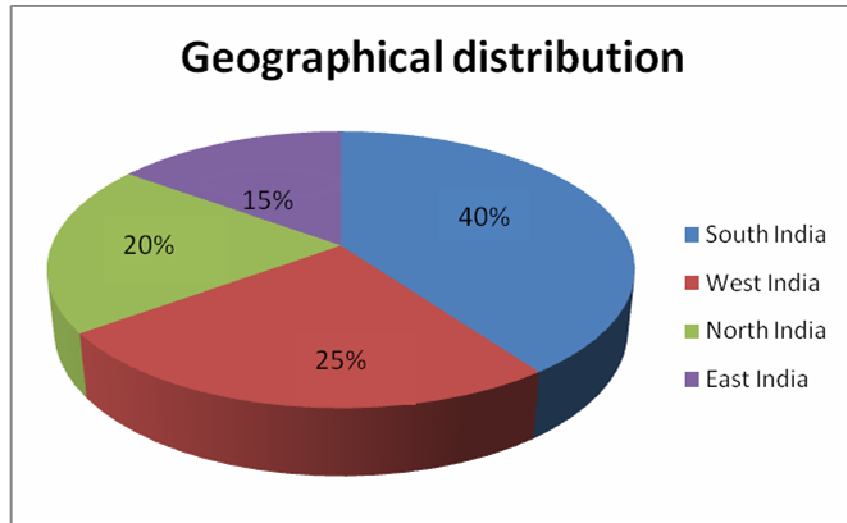


**Sector analysis**

India is the largest consumer of gold jewellery in the world. As of fiscal 2010, India accounted for approximately 10% of total world gold stock with an annual demand of approximately 980 tonnes. As on March 2010, the organized gold loan market in India was estimated at Rs.35000-45000 cr. with a CAGR of approximately 40% from 2002 to 2010.

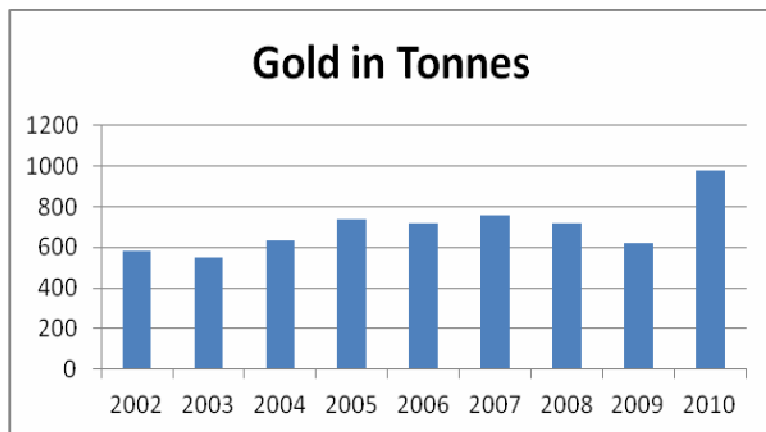


The gold loan market in India is not penetrated fully. As of FY2010, Gold loan portfolio accounted for just 1.2% of the value of total gold stock in India. The gold loan market is expected to grow at a CAGR of 35-40% in the future.



Southern India is the largest market for gold, accounting for approximately 40% of the gold demand, followed by western region at 25%, northern at 20% and eastern at 15%.



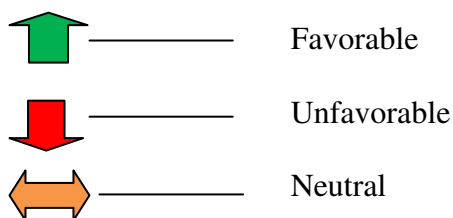


From the above graphs it can be seen that despite the increase in the value of gold from Rs.400 in 2002 to Rs.1800 in 2010 per gram, the demand for gold has risen from 580 tonnes in 2002 to 980 tonnes in 2010, showing relative price inelasticity.

Moreover, demand is further concentrated in rural section of India where people hold around 65% of the total gold stock.

**Gold Loan in comparison with other loans**

| Particulars                                | Home loans | Share pledging | Gold loans | Automobile loans | Unsecured loans |
|--|------------|----------------|------------|------------------|-----------------|
| Availability of security                   | ↑          | ↑              | ↑          | ↑                | ↓               |
| Possession of collateral                   | ↓          | ↑              | ↑          | ↓                | ↓               |
| Ease of Liquidation                        | ↔          | ↑              | ↑          | ↓                | ↓               |
| Sentimental value                          | ↑          | ↓              | ↑          | ↔                | ↓               |
| Ease of valuation                          | ↔          | ↑              | ↑          | ↔                | ↓               |
| Loan suitability for small ticket size     | ↓          | ↑              | ↑          | ↑                | ↑               |
| Knowledge for creditworthiness of customer | ↑          | ↑              | ↑          | ↓                | ↓               |

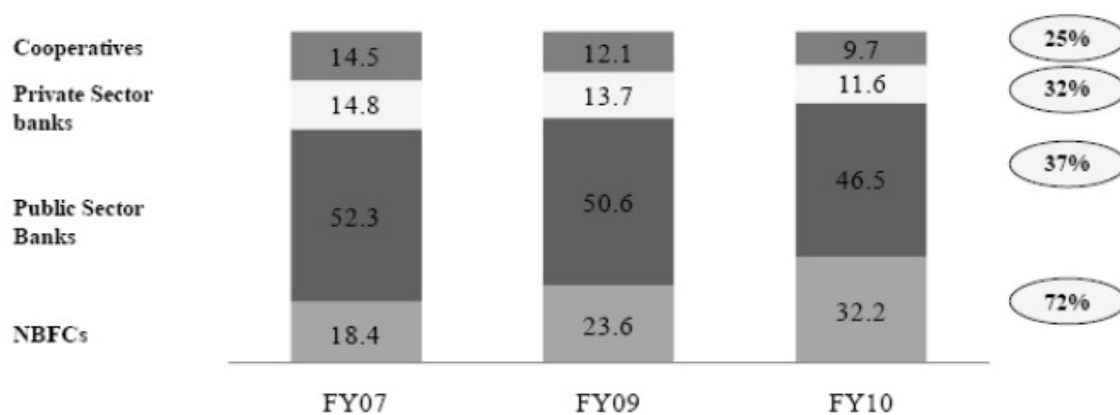


### Economics of gold loan business for NBFCs and Banks

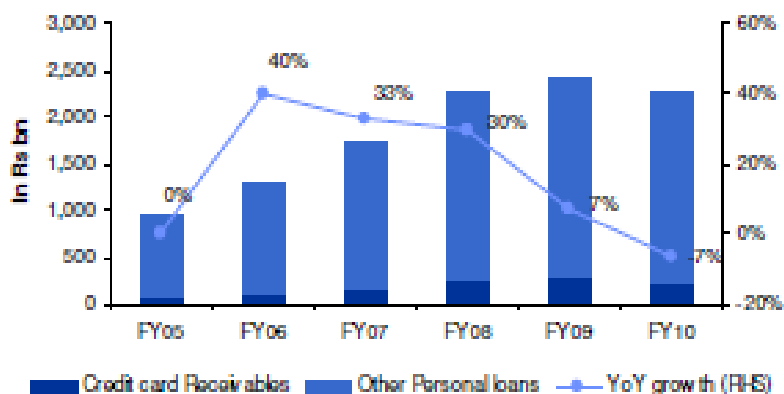
NBFCs view gold loan as one of their primary businesses and have significantly invested in building their service offerings and command premium yields and attractive profitability. On the other hand, banks view gold loan as an alternative to agriculture lending as a safer means to meet their priority lending targets which typically offer low returns with high defaults.

| Key Parameters                                 | NBFCs  | Banks  |
|--|--------|--------|
| ROI  | 24-26% | 14-15% |
| LTV (Loan to Value)                            | 75-80% | 55-60% |
| Interest Expense                               | 10-11% | 7-8%   |
| NIM (Net Interest Margin)                      | 12-14% | 7-8%   |
| NPA(Non Performing Assets) recognition(Months) | 18     | 3      |

### Market Share of Gold Loan Lenders and respective growth rate



### Personal Loan Scenario in banks



It can be analyzed from the above graphs that NBFCs are eventually eating away the pie from banks. Moreover banks are shying away from personal loans due to low ticket size.

### Company Analysis

The Company is run by Muthoot family which is one of the foremost business houses in South India. The incumbent chairman is Mr. M.G. George Muthoot. Muthoot Finance Ltd reported a gross asset under management (AUM) of over Rs.7400 cr. as on FY10.

### Yearly Performance (Rs. Mn.)

| Rs. In mn.        | 2006    | 2007     | 2008     | 2009     | 2010     |
|-------------------|---------|----------|----------|----------|----------|
| Interest Income   | 1428.3  | 2235.9   | 3579.4   | 6062.4   | 10774.5  |
| Other Income      | 52.4    | 103.8    | 107      | 141.6    | 119.3    |
| Total             | 1480.6  | 2339.7   | 3686.4   | 6204     | 10893.8  |
| Interest Expense  | 648.2   | 999      | 1798     | 3097.7   | 4737.3   |
| Administrative Ex | 372.3   | 551.2    | 795.6    | 1404.9   | 2359.9   |
| Depreciation      | 33.9    | 71       | 74.1     | 98.8     | 148.9    |
| Director Rmn.     | 12.9    | 48.9     | 48.9     | 120.9    | 192.2    |
| Total             | 1067.3  | 1670.1   | 2716.6   | 4722.3   | 7438.3   |
| EBT               | 413.4   | 669.6    | 969.8    | 1481.7   | 3455.5   |
| Tax               | 142.1   | 229.8    | 333.8    | 504.4    | 1179.8   |
| PAT               | 271.3   | 439.8    | 636      | 977.2    | 2275.7   |
| NIM               | -       | 10.51%   | 9.50%    | 11.78%   | 12.67%   |
| Loans & advances  | 7946.56 | 13893.02 | 18046.59 | 25735.53 | 54616.99 |
| AUM               | 7803.43 | 14512.55 | 22262.79 | 33690.09 | 74381.47 |
| CRAR*             | 14.83%  | 13.1%    | 12.56%   | 16.30%   | 14.79%   |

\* Capital to risk adjusted ratio

- Interest income increased by 77.73% to 10774.5 million in FY2010 compared to 2009. The retail loan portfolio under management grew by 120.78% to Rs.74381.5 million in FY2010. The interest income has grown at a CAGR of 65% in the last 5 years.
- Interest expense increased by 52.93% to Rs.4737.3 million in the FY2010.
- Administrative Expenditure increased 67.97% to Rs.2539.9 million in FY2010 mainly because of increased payments to employees, rent paid and advertisement expenses, as 620 additional branches have opened up during FY2010.
- Profit after tax increased by 133.49% to Rs.2275.2 million in FY2010.
- The NIM increased by 89 bps on account of 73 bps increase in yields on advances and a 16 bps decrease in cost of funds.

### Outlook and Valuation

| Rs. In mn.         | FY10     | FY11E    | FY12E    |
|--------------------|----------|----------|----------|
| Interest income    | 10774.52 | 19340.25 | 36851.25 |
| Other income       | 119.28   | 184.8    | 286.44   |
| Total income       | 10893.8  | 19525.05 | 37137.69 |
| Interest expense   | 4737.28  | 8738.4   | 17081.1  |
| Total Expenditure  | 7438.28  | 12908.25 | 23711.96 |
| Yields on advances | 22.70%   | 18.04%   | 18%      |
| Cost of fund       | 10.03%   | 9.24%    | 10.07%   |
| NIM                | 12.67%   | 8.79%    | 8.13%    |
| PAT                | 2285.2   | 4433.25  | 7269.49  |
| PAT margin         | 20.98%   | 22.71%   | 19.57%   |
| EPS                | 7.06     | 11.7     | 19.4     |

### Assumptions

- ◆ We have assumed the Gold under management to grow at 70%. The key driver for the growth will be the Company's foray to tap the northern markets as well as the huge demand from southern states as mentioned before.
- ◆ The recent announcement of RBI to curb interest rate of MFI to 26% has not affected the Gold Loan Lenders. Thus we have assumed the yields on advances to be in-line with FY2011E i.e. 18%.
- ◆ As per recent RBI notification, loans sanctioned by banks to NBFCs for lending against gold cannot be classified as priority loans. This may put upward pressure on cost of funds of MFL in future. Therefore we have assumed an 83 bps increase in the cost of funds.

Undergoing abovementioned assumptions our NIM comes out to 8.13% and EPS as Rs.19.4 for FY12E.

**Comparative Valuation (As on March 2010)**

| Particulars                            | Muthoot | Manappuram |
|--|---------|------------|
| Branches                               | 1605    | 1005       |
| AUM                                    | 74381   | 25987      |
| NIM                                    | 12.67%  | 19.3%      |
| ROA                                    | 4.81%   | 5.2%       |
| ROE                                    | 48.33%  | 44%        |
| GNPA                                   | 0.46%   | 0.39%      |
| AUM/Branch(Rs. Mn)                     | 46.34   | 25.86      |
| Concentration in 5 southern States (%) | 67.1%   | 76.4%      |

A comparative valuation suggests that Manappuram has better performance parameters compared to Muthoot. Manappuram's NIM is at 19.3% which is 600 bps above Muthoot. Its return on assets is 40 bps ahead of Muthoot and has a better GNPA than Muthoot. Manappuram trades at a PE of 8.44x TTM (Trailing Twelve Months) compared to Muthoot which is trading at 10.22x TTM. Therefore Manappuram is available at a much better valuation compared to Muthoot Finance.

**Risk factors**

- ◆ There are a number of civil, criminal, consumer, and tax cases by and against Muthoot and other Group Companies. One pending in the SC is related to the Kerala Money Lender's Act (KML). According to this act, the money lenders in Kerala cannot charge above 2% of the interest rate charged by banks. Therefore, if the case doesn't go in Company's favor, it will drastically affect the profitability of the Company.
- ◆ Concentration of the business to a single commodity makes the Company vulnerable to fluctuations in gold price. A global negative outlook like depreciation of dollar due to QE programs, sovereign debt concerns from Europe, inflation concerns from Emerging countries (BRIC), fear of asset bubble in China has played a major role in siphoning the funds to Gold ETF's thus making the commodity to trade at record levels. But slight positive news from any of these zones will make gold correction inevitable.
- ◆ As Banks and other NBFCs note the high growth in Gold loans, they will also become aggressive in this sector, and competition will intensify thus affecting the profitability of the Firm.
- ◆ Muthoot Finance's AUM is dominated by 75% participation by their South Indian branches. Any negatives from these regions may affect the Company's operating performance.

**RECOMMENDATION**

We are bullish on the "Unorganized lending market getting organized" theme as well as the huge untapped growth potential of this business. However, the Company is facing certain litigations which if goes against the Company can have an adverse impact on the scrip. Moreover, its concentrated business in gold makes it highly vulnerable to price fluctuations. So we would like to recommend this stock after the litigations are sorted out and a much awaited correction in Gold is done with, so that the scrip is available at a discount to current trading price of Rs.158 per share. Therefore, we recommend a **sell** on this stock.

**FINANCIAL PROJECTIONS**

| Rs. in mn.          | FY10     | FY11E    | FY12E    | Balance Sheet                     | FY10     | FY11E     | FY12E     |
|---------------------|----------|----------|----------|-----------------------------------|----------|-----------|-----------|
| Interest Income     | 10774.52 | 19340.25 | 36851.25 | Shareholder's Funds               | 5841.91  | 15180.94  | 27860.33  |
| Interest expense    | 4737.28  | 8738.4   | 17081.11 | Secured Loans                     | 45471.22 | 120495    | 197333.9  |
| Net Interest Income | 6037.24  | 10601.85 | 19770.14 | Unsecured Loans                   | 7334.03  | 15748.95  | 24360.42  |
| Profit before tax   | 3455.52  | 6616.82  | 10849.99 | Total Liabilities                 | 58647.16 | 151424.92 | 249554.62 |
| Tax expense         | 1179.78  | 2183.54  | 3580.49  | Net Block                         | 1242.05  | 2220.91   | 2731.70   |
| Profit after tax    | 2285.20  | 4433.25  | 7269.49  | Capital Work in Progress          | 290.65   | 765.62    | 1133.08   |
| EPS                 | 7.06     | 11.66    | 19.38    | Investments                       | 75.05    | 112.65    | 152.07    |
|                     |          |          |          | Deferred Tax Assets               | -24.84   | -24.44    | -24.00    |
| <b>Key ratios</b>   |          |          |          | Current assets Loans and Advances | 62818.5  | 156777    | 255252.6  |
| Yields on advances  | 22.70%   | 18.04%   | 18.00%   | Provisions                        | 5754.25  | 8426.85   | 9690.878  |
| Cost of liability   | 10.03%   | 9.24%    | 10.07%   | Total assets                      | 58647.16 | 151424.9  | 249554.6  |
| NIM                 | 12.67%   | 8.79%    | 8.13%    | AUM                               | 73417.3  | 193466.6  | 328893.1  |
| ROA                 | 4.81%    | 4.32%    | 3.59%    | Growth                            |          | 163.52%   | 70.00%    |
| ROE                 | 48.33%   | 29.20%   | 26.09%   |                                   |          |           |           |

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