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BUY
TP: Rs 1,000 | ⮝ 52%

SHRIRAM TRANSPORT FINANCE | NBFC | 16 September 2020

Limited pandemic headwinds – initiate with BUY

Over the last four decades, Shriram Transport Finance (SHTF) has built a pan-India network in a fragmented used-CV market (~16% CV market share). After a phase of weak growth since FY19, we expect business to rebound in H2FY22 led by firming up of used CV prices – we bake in a 7% AUM CAGR for FY20-FY23, with stable spreads (~6%). We expect restructuring post-pandemic to be limited to <10% of AUM, with average credit cost of ~300bps through to FY23. ROA/ROE are forecast to recover in FY22 to 2.4%/12.9%. Initiate with BUY; Sep'21 TP Rs 1,000.

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Business to rebound in H2FY22; expect stable spreads: We expect SHTF to post a 7% CAGR in AUM and 8% in disbursements during FY20-FY23, aided by a greater rural thrust and progressive unlocking of the economy in the wake of Covid-19. With bond markets thawing in recent months and banks offering repo rate cut translation, borrowing costs should hold at 8.8-9% over FY21-FY23. We draw comfort from a well-matched ALM in the under one-year bucket and high liquidity buffers, which should keep spreads stable at ~6.3% over our forecast period.

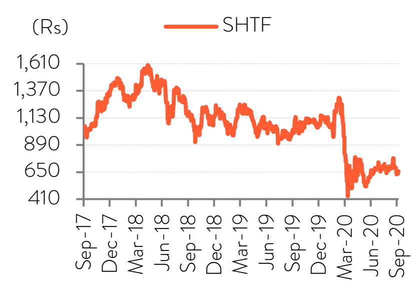
Opex control, limited restructuring to aid profitability: Given management's prudent, volume-based branch expansion strategy and strong focus on cost control, we bake in flat opex and a 7% CAGR in operating profit through to FY23. Given that loans are for income-generating assets, AUM restructuring due to the pandemic is likely to be limited to <10% by value. We thus expect average credit cost of ~300bps for FY21-FY23. PAT is projected to clock a 12% CAGR during FY20-FY23, aiding a bounce back in return ratios next year.

Initiate with BUY: We use a residual income model to value the company, assuming a risk-free rate of 7.75%, cost of equity of 14.0% and terminal growth of 5%. This yields a Sep'21 TP of Rs 1,000, which implies 1x Sep'22E BV.

Ticker/Price	SHTF IN/Rs 658
Market cap	US$ 2.3bn
Shares o/s	253mn
3M ADV	US$ 42.7mn
52wk high/low	Rs 1,340/Rs 431
Promoter/FPI/DII	26%/64%/2%

Source: NSE

STOCK PERFORMANCE



Source: NSE

KEY FINANCIALS

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
Net interest income	78,244	79,972	81,077	86,208	93,803
NII growth (%)	14.6	2.2	1.4	6.3	8.8
Adj. net profit (Rs mn)	25,640	25,018	19,151	29,164	35,312
EPS (Rs)	113.0	110.3	75.7	115.2	139.5
P/E (x)	5.8	6.0	8.7	5.7	4.7
P/BV (x)	1.0	0.8	0.8	0.7	0.6
ROA (%)	2.5	2.3	1.6	2.4	2.6
ROE (%)	17.6	14.9	9.8	12.9	13.9

Source: Company, BOBCAPS Research

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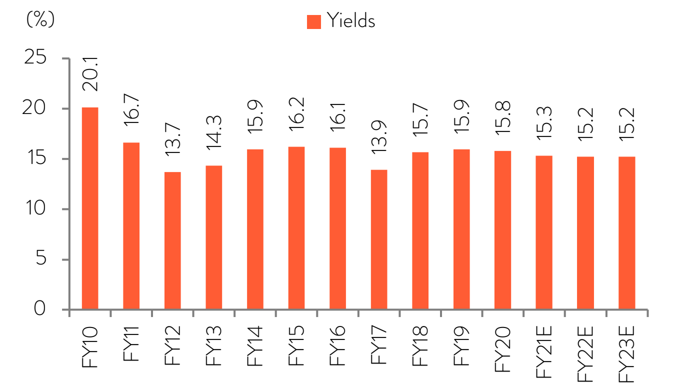
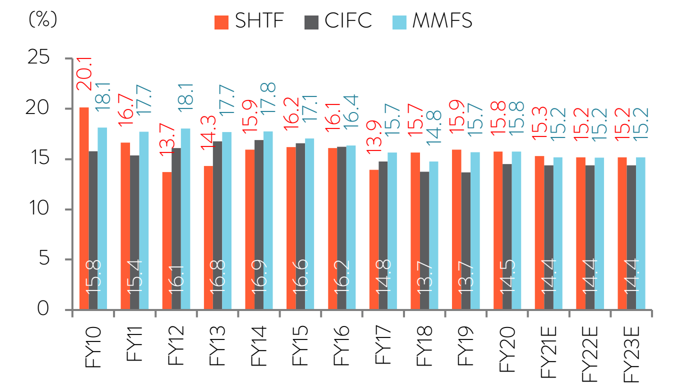


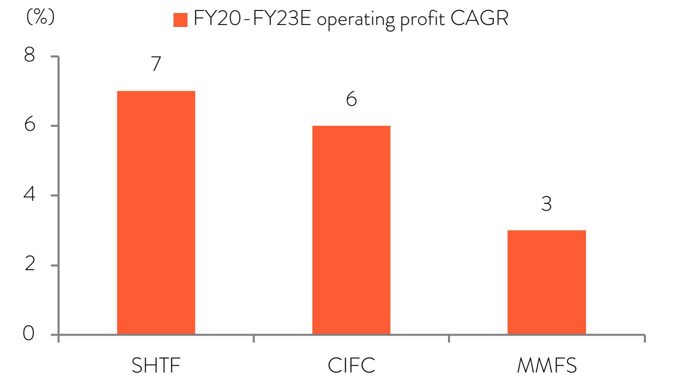
Source: Company, BOBCAPS Research

FIG 2 – LIKE PEERS, SHTF HAS COME DOWN THE YIELD RISK CURVE OVER THE LAST DECADE



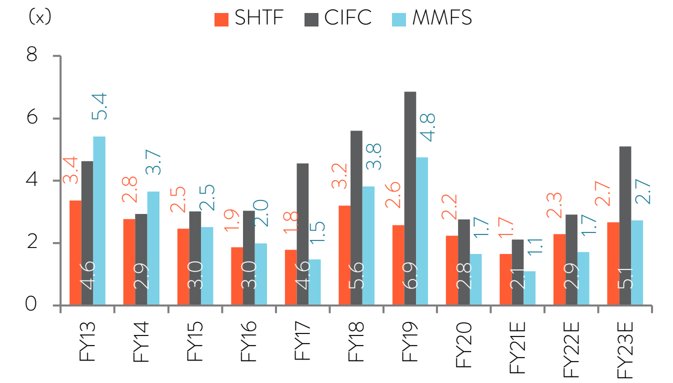
Source: Company, BOBCAPS Research | Note: CIFC yields incl. LAP yield

FIG 3 – SHTF TO HAVE HIGHEST OPERATING PROFIT GROWTH IN OUR CV FINANCIER COVERAGE…



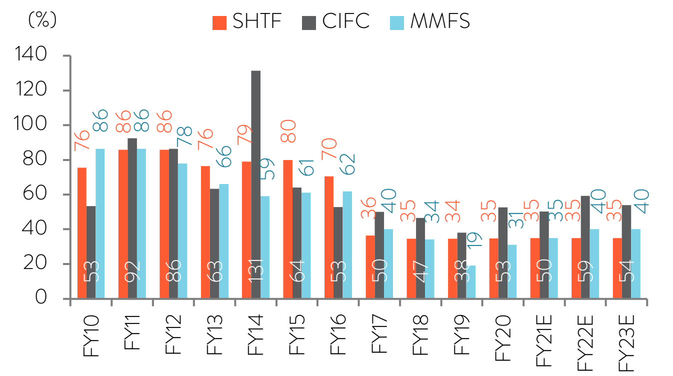
Source: Company, BOBCAPS Research

FIG 4 – …AND PPOP BUFFER NEXT ONLY TO CIFC THROUGH TO FY23E



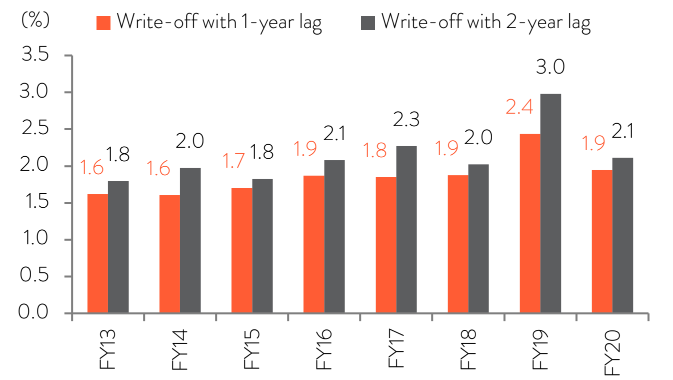
Source: Company, BOBCAPS Research

FIG 5 – PCR EXPECTED TO REMAIN STABLE AT 35%



Source: Company, BOBCAPS Research

FIG 6 – WRITE-OFFS WITH 2Y LAG LOW AT 2.1% IN FY20



Source: Company, BOBCAPS Research

Investment summary

FIG 7 – BOBCAPS VS. CONSENSUS – CONCERNS RAISED BY THE STREET LOOK OVERSTATED

Parameter	Market View	BOBCAPS View
Spreads	Spreads will be compressed due to competition from banks and other NBFCs	SHTF specialises in used CV financing and has a well-oiled machinery for sourcing and servicing of loans. With abundant liquidity, diversification of liabilities and securitisation, we expect spreads to remain stable through to FY23.
Asset quality	Asset quality will deteriorate as the moratorium ends, leading to restructuring of a sizeable portion of the loan book	Customers are driver-owners of CVs (income-generating assets) and their cash flows are improving MoM as the economy rapidly reopens. Goods supply is yet to reach pre-Covid levels, but we expect business recovery from FY22 to enable borrowers to make part/full loan repayments. This will lead to lower credit cost than estimated by the street.

Source: BOBCAPS Research

FIG 8 – WHY SHTF IS A GOOD INVESTMENT AT THIS JUNCTURE

Investment thesis	Why Shriram Transport fits the bill
Deep understanding of the business across economic cycles	SHTF is a pioneer in vehicle financing and has been in the business for close to four decades. The company caters to driver-owner used-CV customers as compared to LCV/UV customers for peers, making it difficult for competitors to replicate the business model.
Healthy bottomline growth	Though we expect SHTF to post a decline in FY21 PAT due to the Covid-19 effect, we build in a sharp recovery in FY22 driven by a strong demand outlook for used CVs, opening up of the economy to normal levels over the next 12 months, and tapering of credit costs in FY22-FY23. In our view, this will aid a 12% earnings CAGR over FY20-FY23.
Strong return ratios	Before the CV downcycle in FY20, ROA/ROE were at 2.5%/18%. We expect these return ratios to retrace to 2.6%/14% in FY23.
Healthy, stable asset quality	While the current GNPA ratio of 8%+ seems high, this is reflective of uneven cash flows of the customer segment that SHTF caters to. Also, it is important to note that the actual write-off (without lag) at the peak of the last CV cycle was at 1.5% of AUM in FY15 and 1.9% as of FY20. The average write-off (without lag) for the last 10 years was 1.6%.
Reasonable valuations	The stock is trading at 0.7x one-year forward P/B, which is even lower than its –1 standard deviation of 1.4x one-year forward book. We believe risk-reward is favourable as most negative news flow is priced in and valuations undemanding.
Key risk	Over 85% of the loan book is concentrated in vehicles over five years old.

Source: BOBCAPS Research

Investment rationale

Business expected to rebound in H2FY22

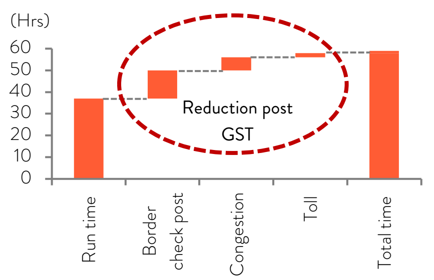
SHTF commands 16% share in India's commercial vehicle (CV) financing market and ~40% share in the NBFC CV financier space. Though the demand outlook for new CVs remains bleak, we believe SHTF is poised to benefit from rising used vehicle demand, albeit with a lag effect, starting H2FY22. This will be fuelled by the company's increased rural focus, branch expansion drive and benefits from progressive unlocking of the economy in the wake of Covid-19. We thus build a 7% and 8% CAGR in AUM and disbursements respectively for SHTF during FY20-FY23.

Demand outlook bleak for new CVs but sanguine for used vehicles

As discussed in our **Jun'20 initiation report on CV financiers**, even before the Covid-19 pandemic, commercial vehicle sales in India were languishing under the impact of new axle-load norms. MHCV volumes have contracted by 32% YoY in FY20 as overcapacity in the system and tighter financing owing to a liquidity crunch in the economy played spoilsport in the goods carrier market, with pressure largely visible in the HCV segment (>12T).

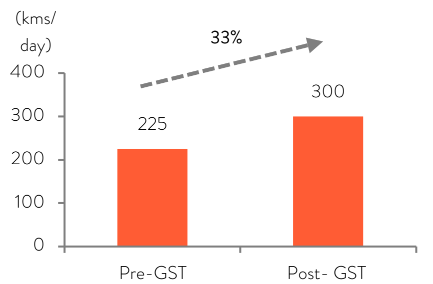
Market sentiment remains weak as slowing economic growth and Covid-led disruptions are impacting freight availability. Coupled with tepid freight rates and high fuel costs, the viability pressure on road transporters has increased in recent months. Our auto analyst Mayur Milak expects a flattish (0%) to single-digit (–5%) decline in MHCV volumes in FY21 on account of the transition to new emission (BS-VI) norms, slow pick-up in industrial activity, and pandemic fallout.

FIG 9 – PRE-GST AVG. TRAVEL TIME



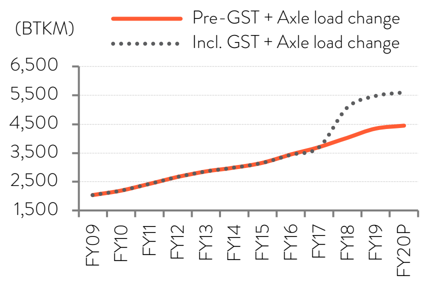
Source: MORTH, BOBCAPS Research
Note: For Chennai-Kolkata route

FIG 10 – IMPACT ON AVG. RUNNING DISTANCE



Source: MORTH, BOBCAPS Research

FIG 11 – BTKM FOR MHCV TRUCKS POST GST & AXLE NORMS



Source: SIAM, ET Autolytics, BOBCAPS Research, MORTH

Although the LCV (truck) segment was relatively less impacted by the revision in axle load norms, volumes came under pressure in FY20 (down ~20%) owing to the slowdown in consumption-driven sectors and the rural economy, a strict financing environment and high base effect. With consumer sentiment remaining weak and challenges on the financing front, our auto analyst expects the LCV segment to show flattish growth of 0-2% in FY21 a well.

Upon transition to BSVI emission norms in Apr'20, CV prices have increased by 10-15%; this has translated into a 5-6% rise in used CV prices, which we expect will pick up further in H2FY22 as demand revives. In our view, used vehicles prices are likely to firm up as customers who have strong cash flow visibility add or replace their vehicles with ones of lower vintage in order to conserve cash and mitigate the steep cost of BSVI vehicles.

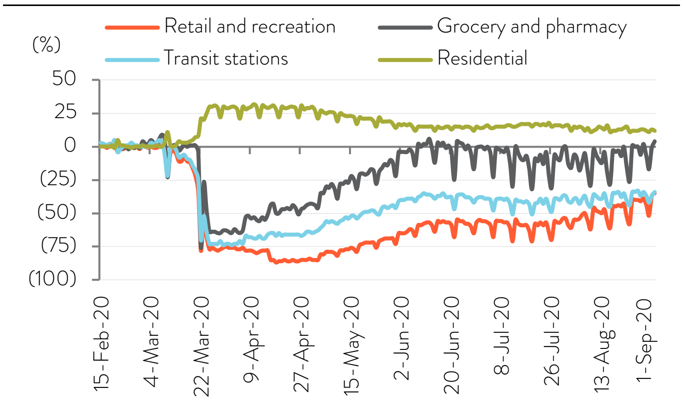
Also, the government's proposed scrappage policy should lend further impetus to pre-owned vehicle demand over FY22-FY23. Given that SHTF has built a granular pan-India network for used CV financing, we believe it is poised to benefit from these tailwinds.

Transport activity resuming as economy unlocks

With the nationwide Covid-19 lockdown being announced in Mar'20, supply chains across industries were disrupted, thereby impeding the cash flows of road transporters. Thereafter, with each incremental unlock announcement since Apr'20, the economy is coming back to life and cash flows of transporters are gradually returning to normalcy.

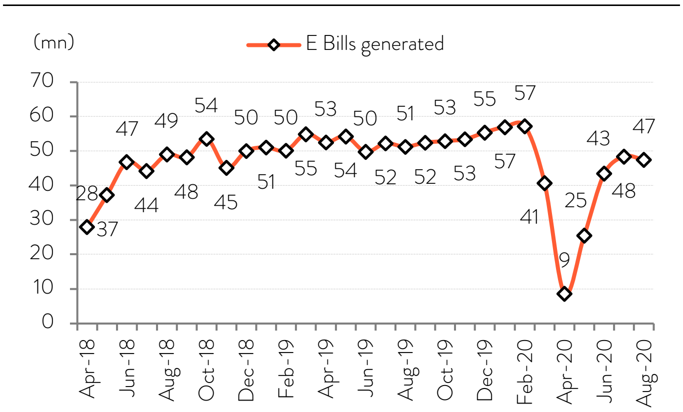
A recent publication from the Indian Foundation of Transport Research and Training (IFTRT) suggests that fleet utilisation has increased from 15-20% till Jun'20 to 30-35% in Aug'20. Truck rentals have risen 15-20% in June led by a Rs 11/litre increase in diesel prices, firming up of tyre prices due to import restrictions, and driver shortage. Rentals have largely normalised in August given improvement in industrial activity, peaking of arrivals of fruits and vegetables, and loosening of lockdown restrictions across the country.

FIG 12 – GOOGLE MOBILITY REPORTS SUGGEST PICK-UP IN ECONOMIC ACTIVITY AT BROAD LEVEL…



Source: Google, BOBCAPS Research | Note: Data as of 1 Sep 2020

FIG 13 – …LEADING TO IMPROVEMENT IN GOODS TRANSPORT VOLUMES (REFLECTED IN E-WAY BILLS)



Source: GST, BOBCAPS Research | Note: Data as of 31 Aug 2020

FIG 14 – FULL TRUCK LOAD (28T GVW): RENTAL SNAPSHOT

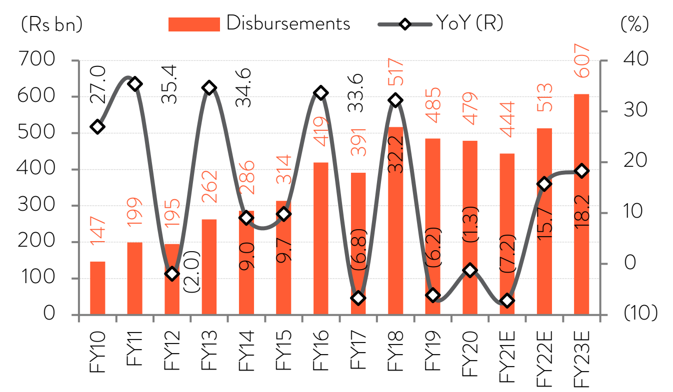
Trunk Route	Rental movement per round trip (Rs '000)				
Round trip per 18-tonne payload	FY18	FY19	As on 1-Mar-20	As on 1-Jul-20	As on 1-Sep-20
Delhi-Mumbai-Delhi	83.0	90.9	84.0	100.8	90.7
Delhi-Nagpur-Delhi	80.7	86.7	82.3	98.7	84.0
Delhi-Kolkata-Delhi	80.4	85.5	80.0	96.0	86.5
Delhi-Guwahati-Delhi	140.6	150.4	126.5	145.5	131.0
Delhi-Hyderabad-Delhi	113.0	121.0	108.4	130.0	117.0
Delhi-Chennai-Delhi	119.2	126.0	111.8	134.0	120.0
Delhi-Bangalore-Delhi	126.8	135.0	122.5	147.0	132.0
Delhi-Ranchi-Delhi	93.4	109.8	90.7	104.3	94.0
Delhi-Raipur-Delhi	77.2	83.3	78.8	94.5	85.0
Delhi-Kandla-Delhi	82.2	88.3	80.0	96.0	82.0
Delhi-Bilaspur-Delhi	81.0	87.4	81.3	97.5	88.0

Source: IFTRT, BOBCAPS Research

Expect AUM to grow at 7% CAGR over FY20-FY23

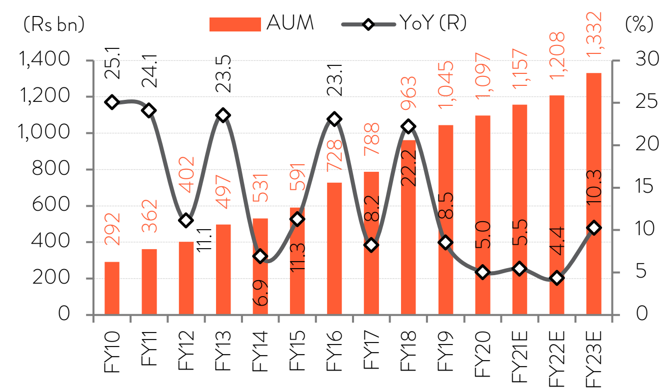
With incremental unlocking of the economy and a cautious stance by lenders towards road transport operators, we expect used CV sales and financing to gather pace, albeit restricted to customers with a strong repayment record and good cash flow visibility. This gives us reasonable confidence in AUM growth for SHTF from H2FY22, further aided by the company's rural focus and sustained branch expansion drive, as detailed below. We model for a 7%/8% CAGR in AUM/disbursements during FY20-FY23.

FIG 15 – WE EXPECT 8% CAGR IN DISBURSEMENTS…



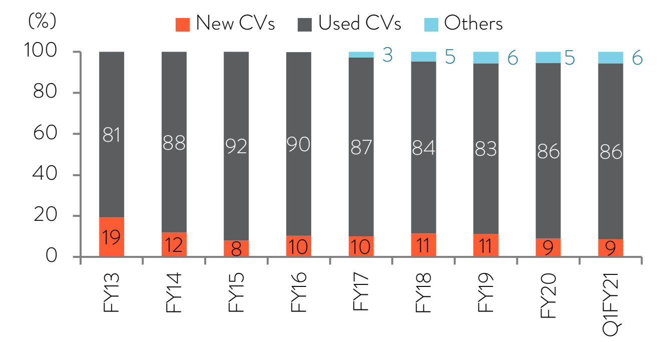
Source: Company, BOBCAPS Research

FIG 16 – …AND 7% CAGR IN AUM DURING FY20-FY23E



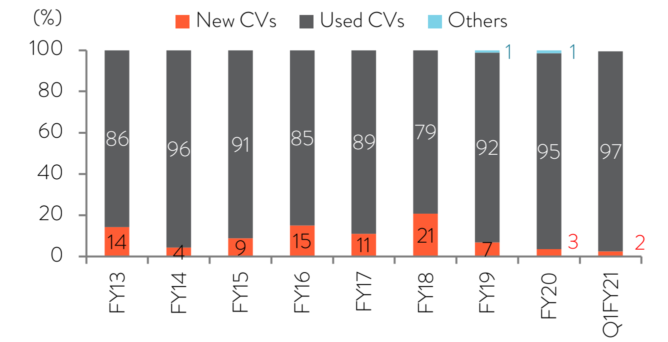
Source: Company, BOBCAPS Research

FIG 17 – USED CVs DOMINATE AUM MIX…



Source: Company, BOBCAPS Research

FIG 18 – …AND DISBURSEMENT MIX

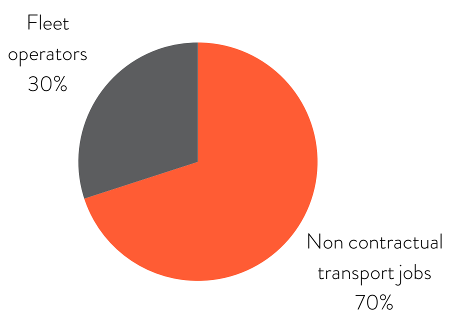


Source: Company, BOBCAPS Research

Unique model, branch expansion to underpin growth

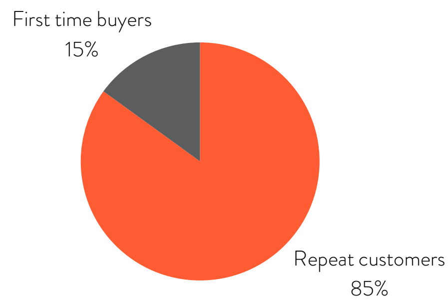
SHTF has ~40% market share in India's NBFC CV financing industry as of FY20. The company specialises in extending credit to first-time buyers (FTB) and small road transport operators (SRTO) who lack substantial credit histories and other financial documentation on which banks rely to identify and target new customers. As the market for CV financing is fragmented, especially for pre-owned vehicles, we believe SHTF's pan-India branch network, customer knowledge and relationships cultivated over the past four decades will help it maintain market share.

FIG 19 – ~70% OF SHTF CUSTOMERS ARE IN NON-CONTRACTUAL TRANSPORT JOBS



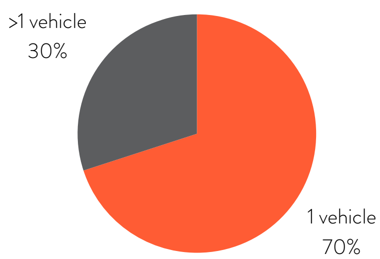
Source: Company, BOBCAPS Research

FIG 20 – ~85% SHARE OF REPEAT CUSTOMERS ENSURES STRONG CREDIT CONTROL



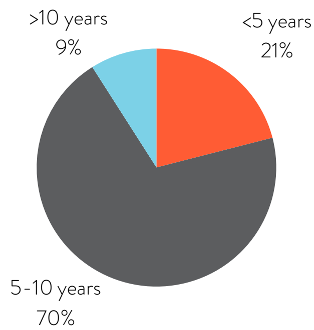
Source: Company, BOBCAPS Research

FIG 21 – ~70% OF SHTF CUSTOMERS HAVE ONE VEHICLE…



Source: Company, BOBCAPS Research

FIG 22 – …AND A SIMILAR PROPORTION HAVE VEHICLES THAT ARE 5-10 YEARS OLD



Source: Company, BOBCAPS Research

Niche expertise in CV financing

SHTF has developed a unique business model that addresses the financing needs of a targeted, high-growth market segment (FTBs, SRTOs) while ensuring minimal asset risk.

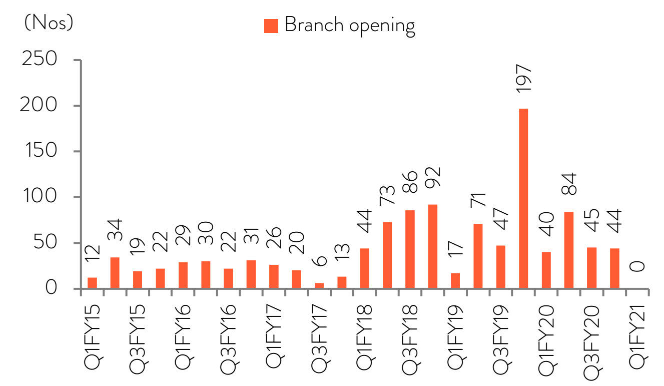
- FTBs and SRTOs comprise ~70% of the company's AUM.
- Over the years, SHTF has developed **expertise in valuing** pre-owned vehicles, which enables it to accurately determine a recoverable loan amount for CV purchases. We believe a tested valuation technique for these assets is a crucial entry barrier for others seeking to enter the company's market segment.
- In addition to **stringent credit evaluation** of the borrower and limits on customer exposure, the company relies on guarantor arrangements, the availability of security, referrals from existing customers and close client relationships in order to manage asset quality. Loan-to-value (LTV) ratio for old CVs is fixed at 60-70% and for new CVs at 75-80%.
- SHTF focuses on closely monitoring its assets and borrowers through inhouse relationship executives who build long-term client engagements – this enables it to **capitalise on local knowledge** and address specific issues and local business requirements of potential customers.
- All customer origination and evaluation, loan disbursement, administration and monitoring as well as loan recovery processes are carried out by its relationship executives – fostering a **culture of accountability**.

Investments in branch network

While SHTF did not launch any branches in Q1FY21 due to macro uncertainty, the number of branches it opened in the past 10 quarters is four times that opened in the preceding 12 quarters. This has taken the total branch count to 1,758 and given the company a vast pan-India network to support anticipated growth in used CV demand.

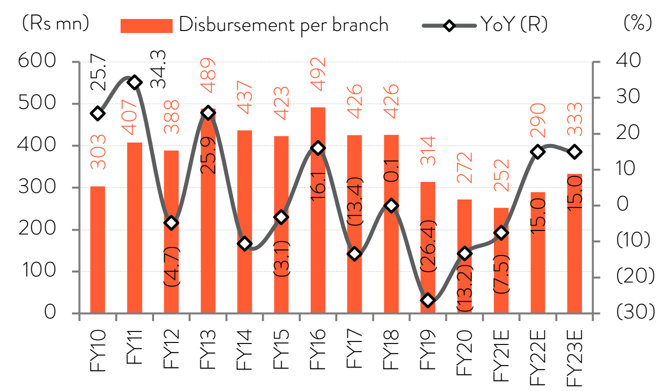
Management intends to continue strategically expanding operations in target markets comprising large CV hubs and rural centres by establishing additional branches. It is also looking to widen its footprint in the eastern and northern parts of India where it has a limited presence and to further consolidate operations in the western and southern parts of the country.

FIG 23 – BRANCH OPENING PEAKED DURING LAST CV CYCLE (FY18-FY19)



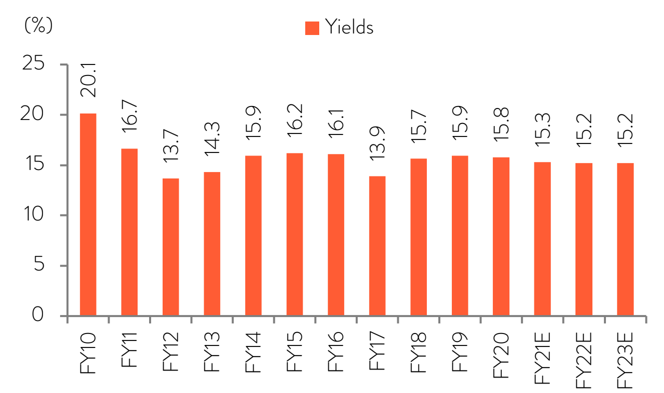
Source: Company, BOBCAPS Research

FIG 24 – WE EXPECT DISBURSEMENT PER BRANCH TO PICK UP IN H2FY22E



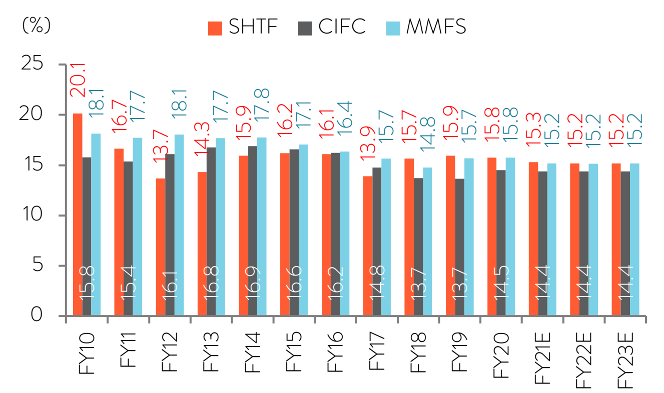
Source: Company, BOBCAPS Research

FIG 25 – YIELDS EXPECTED TO REMAIN STABLE THROUGH FY23E



Source: Company, BOBCAPS Research

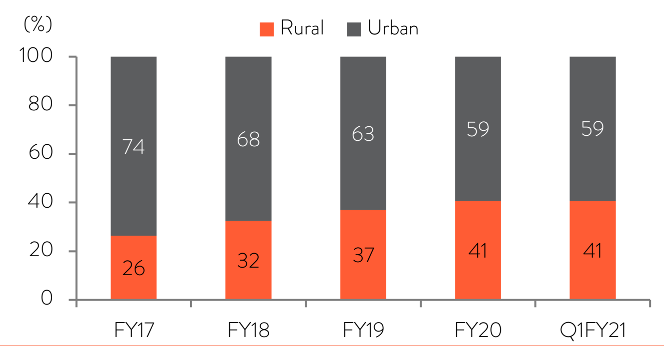
FIG 26 – LIKE PEERS, SHTF HAS COME DOWN THE YIELD RISK CURVE OVER THE LAST DECADE



Source: Company, BOBCAPS Research | Note: CIFC yields incl. LAP yield

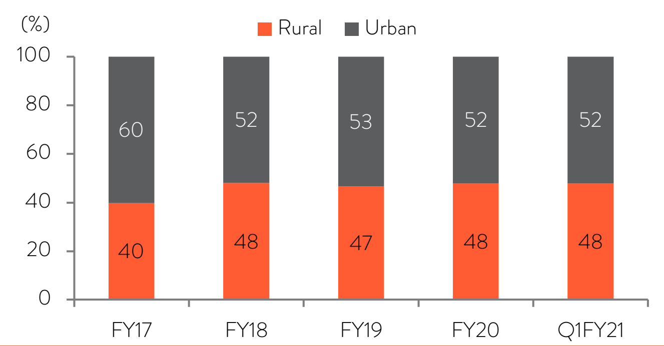
Over the past three years, SHTF has adopted a strategy of establishing its presence in rural centres with a view towards increasing its presence in the pre-owned CV market and reaching out to a relatively newer customer segment in these areas. The rural mix in AUM has risen from 26% in FY17 to 41% in FY20, with branches now split almost equally between rural and urban locations. We expect this shift in market focus to catalyse AUM growth for the company.

FIG 27 – INCREASING RURAL MIX IN AUM…



Source: Company, BOBCAPS Research

FIG 28 – …AND ALSO IN BRANCHES



Source: Company, BOBCAPS Research

Diversifying borrowing mix – a prudent strategy

Following the IL&FS crisis in Q3FY19, SHTF has diversified its borrowings mix by raising the share of retail deposits and foreign borrowings, mitigating liquidity risk. We believe ECB and securitisation will remain bulwarks for fund sourcing in the near term. With bond markets thawing in recent months and banks offering repo rate cut translation, we bake in flattish borrowing costs of 8.8-9.0% over FY21-FY23. The company has a well-matched ALM in the under one-year bucket and high liquidity buffers, though the latter could be a near-term drag on margins.

ECB and securitisation to provide stable funding

SHTF has longstanding relationships with financial institutions and accesses funds from a number of credit providers, including 56 banks (public, private, foreign) and institutions. As a deposit-taking NBFC, the company also mobilises fixed deposits. It began accepting deposits at all branches from Jun'20, mitigating its earlier dependence on the IFA channel. Management expects to reach Rs 150bn in deposits by FY21-end and is targeting Rs 300bn by FY22-end.

With abundant liquidity in the bond market, SHTF has been benefitting from lower rates through LTRO route. Also, the repricing of bank term loans due to repo rate cut translation is reducing borrowing cost.

On the securitisation front, the RBI mandates that commercial banks maintain an aggregate 40% of adjusted net bank credit or credit equivalent of off-balance sheet exposure, whichever is higher, as 'priority sector advances'. These include advances to agriculture, micro and small enterprises (including SRTOs, which constitute the largest proportion of SHTF's loan portfolio), export credit, and advances to weaker sections. Banks that are unable to meet priority sector targets rely on specialised institutions like SHTF, which are better positioned to originate the requisite loans through purchase of assets or securitised and assigned pools.

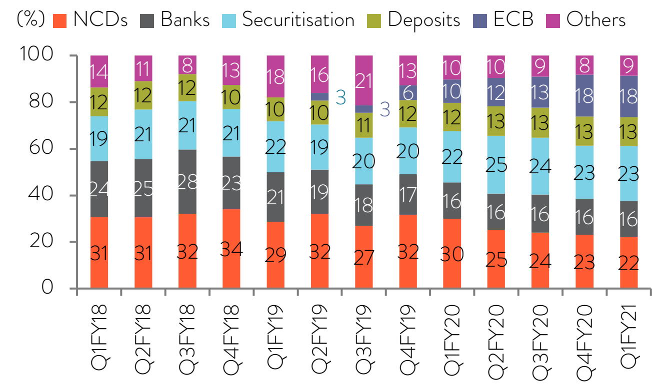
The company negotiates competitive interest rates with banks, NBFCs and other lenders since the majority of its loan portfolio is classified as priority sector lending. Its securitised and assigned asset pools are particularly attractive to banks as such transactions give them an avenue to increase their asset base through low-cost investments at limited risk.

FIG 29 – SECURITISATION AND ASSIGNMENT PRUDENT WAY TO DIVERSIFY FUNDING SOURCES

(Rs mn)	FY16	FY17	FY18	FY19	FY20
Total number of loan assets securitised and assigned	441,180	404,650	456,036	511,787	519,087
Total book value of loan assets securitised and assigned	89,918	112,143	124,672	151,231	165,811
Sale consideration received for securitised and assigned assets	89,918	112,143	124,672	148,505	164,702
Gain on account of securitisation and assignment	9,899	14,862	20,740	16,937	21,245

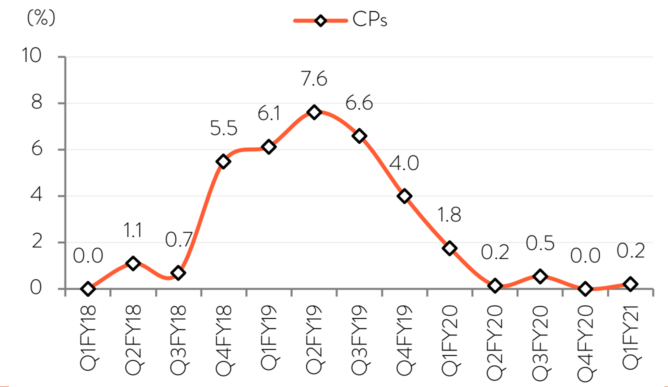
Source: Company, BOBCAPS Research

FIG 30 – SHTF HAS INCREMENTALLY RELIED ON ECB SINCE IL&FS CRISIS...



Source: Company, BOBCAPS Research

FIG 31 – ...SIMULTANEOUSLY RUNNING DOWN CPs TO MINIMISE NEAR-TERM PRICING RISK

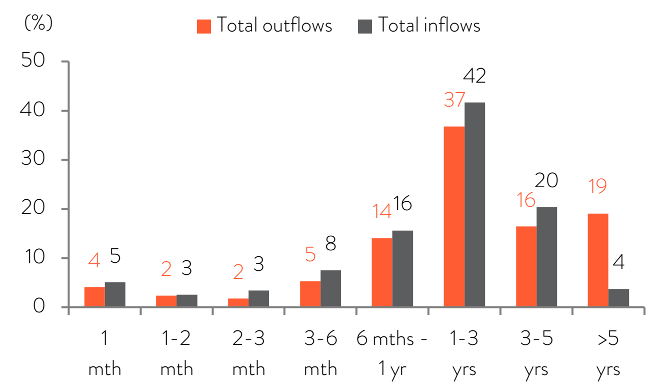


Source: Company, BOBCAPS Research

High liquidity offers comfort but a near-term drag on margins

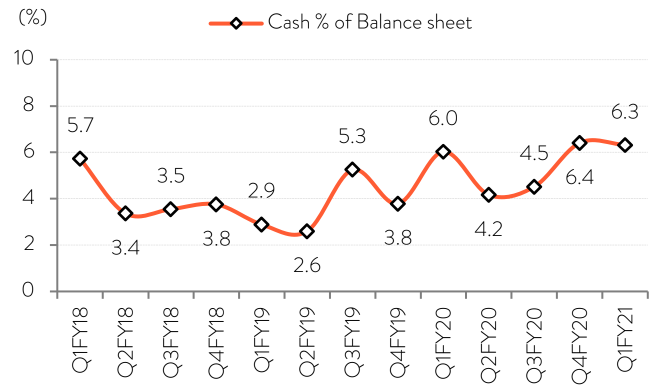
As of Q1FY21, SHTF has well-matched ALM in the less-than-one-year bucket, thereby mitigating any repricing risk in liabilities or liquidity risk. Cash of Rs 73bn on its balance sheet would weigh on margins in the near term but is a comfort factor for debt and equity investors alike. A further ~Rs 20bn of unused bank lines as of Q1 also strengthens the liquidity buffer.

FIG 32 – WELL-MATCHED ALM IN <1YR BUCKET...



Source: Company, BOBCAPS Research | Note: Data as of 30 Jun 2020

FIG 33 – ...AND STRONG CASH BUFFERS

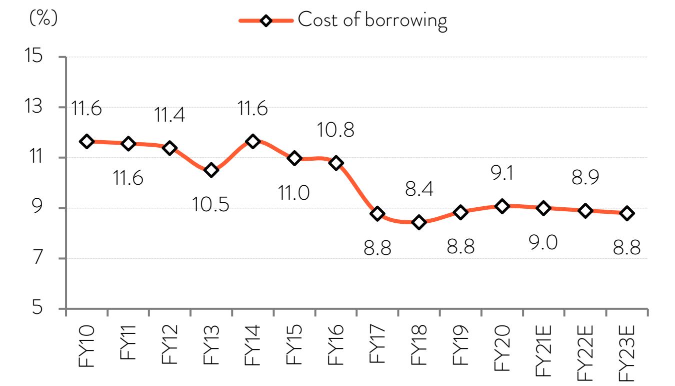


Source: Company, BOBCAPS Research

Expect stable borrowing cost, margin recovery

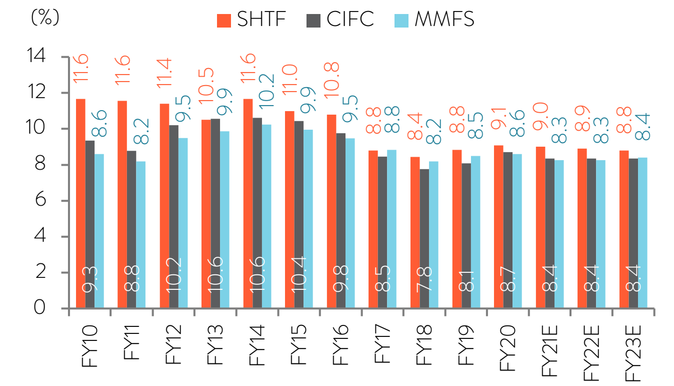
SHTF's borrowing cost remains higher than peers but is likely to be range-bound between 8.8-9.0% through FY23E backed by higher ECB and securitisation funds. NIM is forecast to recover to 7.8% in FY22 given lowering of cash buffers with probability of an event risk being lower.

FIG 34 – WE EXPECT STABLE BORROWING COST FOR SHTF THROUGH FY23E…



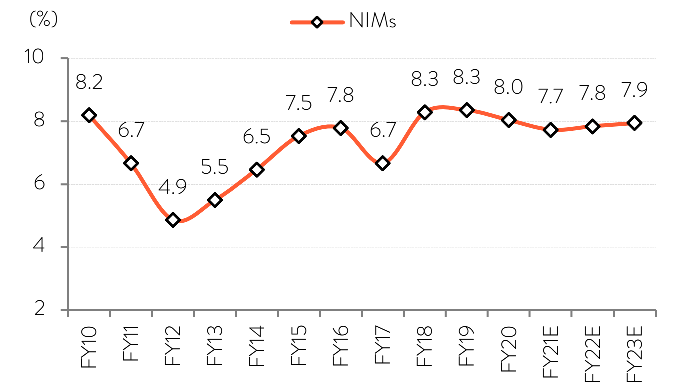
Source: Company, BOBCAPS Research

FIG 35 – …ALBEIT 40-70BPS HIGHER THAN CIFC AND MMFS



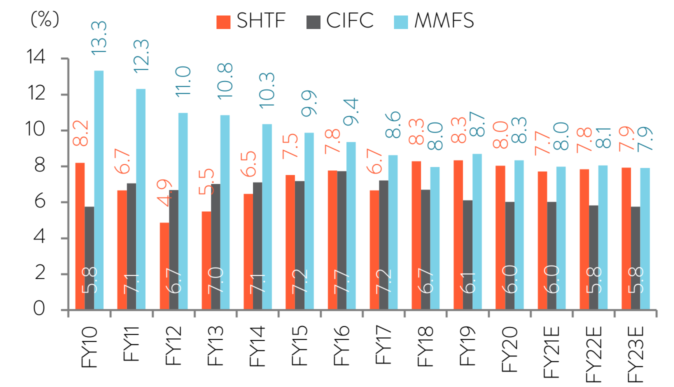
Source: Company, BOBCAPS Research

FIG 36 – MARGINS LIKELY TO BOUNCE BACK FROM FY22E…



Source: Company, BOBCAPS Research

FIG 37 – …IN LINE WITH MARGIN REVIVAL FOR BOTH CIFC AND MMFS



Source: Company, BOBCAPS Research

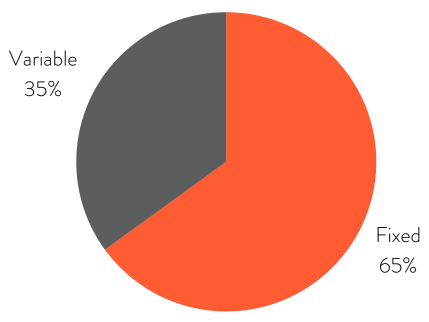
Opex control to lend tailwinds to operating profit

SHTF keeps credit sourcing limited to own employees which reins in both product pricing and opex. A prudent branch expansion strategy and recent cost control initiatives should further aid flat opex, translating to an estimated 7% CAGR in operating profit over FY20-FY23. SHTF remains the lowest cost CV financier in our coverage (expense ratio of ~1.6% for FY21E-FY23E) and its pre-provision operating profit (PPoP) buffer ranks next only to Cholamandalam Investment (CIFC).

In-house credit sourcing

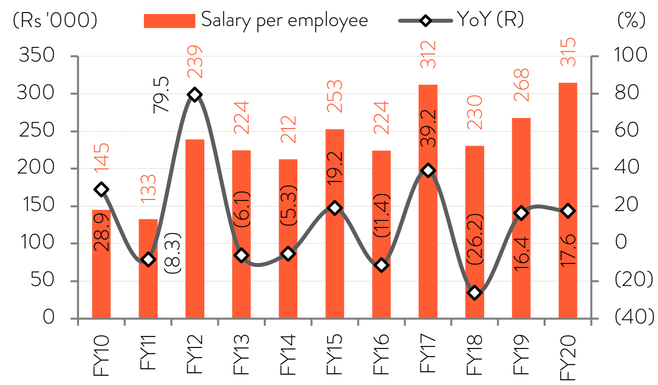
SHTF relies on its employees for credit sourcing, thereby keeping a check on pricing of the credit product and the resultant outreach opex. A typical branch consists of 10-12 executives who conduct both sourcing and collections, thereby aligning employee and business incentives. Loan underwriting is done by the branch manager or zonal head. Each field executive manages 100-150 customers, implying close client relationships.

FIG 38 – SALARY SPLIT OF A TYPICAL BRANCH EXECUTIVE HAS HIGHER VARIABLE FACTOR…



Source: Company, BOBCAPS Research

FIG 39 – …THEREBY KEEPING EMPLOYEE COSTS UNDER CONTROL IN A DOWNTURN (E.G. FY13-FY14)



Source: Company, BOBCAPS Research

Judicious branch opening

Branch cost is contained by streamlining the opening of new locations – this typically occurs in two ways: (1) When customers at a particular location exceed 3,500, the branch is split. This ensures that the new branch achieves breakeven from day one and also allows for its rapid scale-up and closer proximity to customers. (2) In the case of rural centres which are generally a one-man setup, conversion into a full-fledged branch occurs when cases reach 250-300 a month.

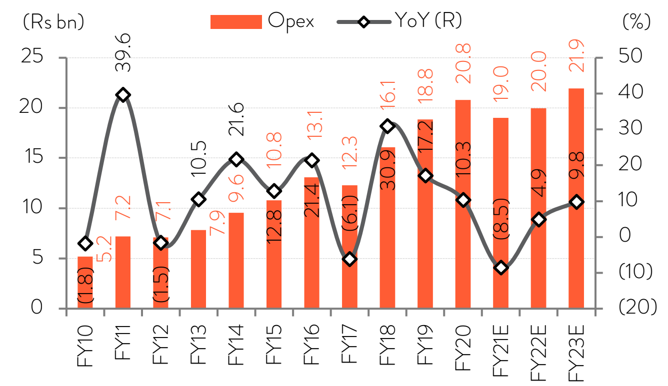
Tighter cost control amid Covid-19

The company has ~2,000 employees averaging >20 years of experience, which reflects the low attrition rate. After Covid-19, it was decided that senior management executives would take a voluntary pay cut of 10-20% and other employees will receive no increments in FY21. Hiring has been frozen till further notice, except for critical positions. The company has deferred branch expansion plans and renegotiated a 15-20% cut in rental cost for the next couple of years. Management has also restricted all travel and most meetings are held virtually.

Opex to remain range-bound

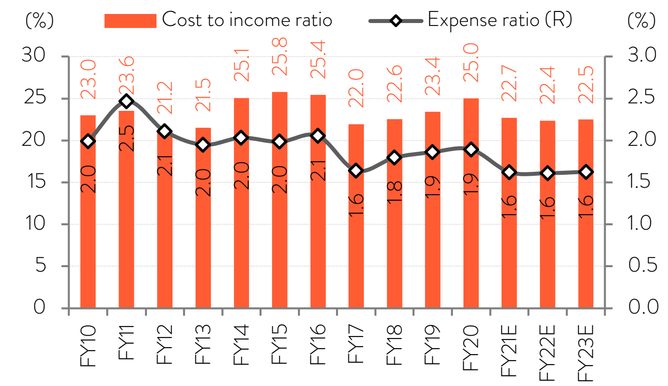
Considering the tight leash on costs, we bake in range-bound opex during FY21-FY23, leading to a cost-to-income ratio of 22-23% – lower than our estimates for both CIFC and Mahindra & Mahindra Finance (MMFS). This will manifest in an expense ratio (opex/average assets) of ~1.6% and operating profit CAGR of 7% over our forecast period.

FIG 40 – OPEX TO REMAIN RANGE BOUND AT ~RS 19BN-22BN DURING FY21E-FY23E…



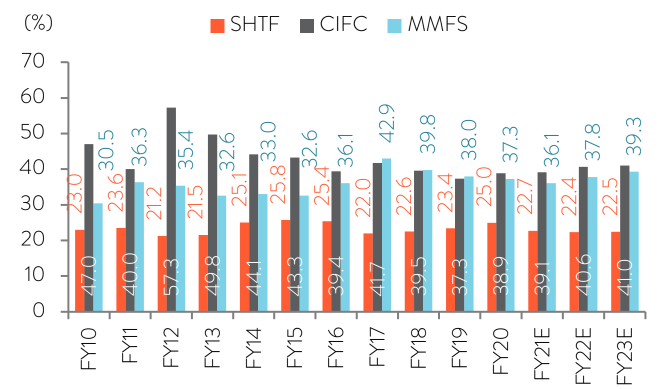
Source: Company, BOBCAPS Research

FIG 41 – …LEADING TO EXPENSE RATIO OF ~1.6% FOR THE SAME PERIOD



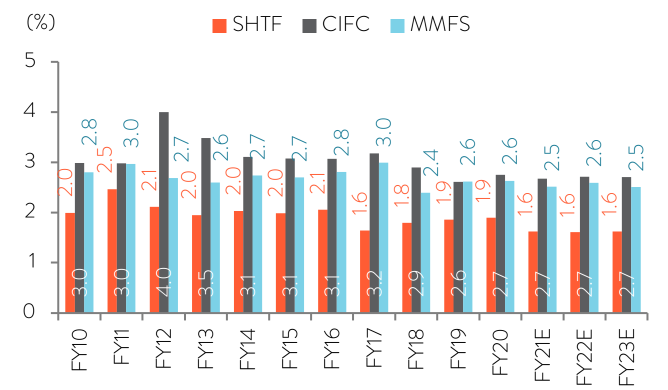
Source: Company, BOBCAPS Research

FIG 42 – SHTF IS THE LOWEST COST CV FINANCIER IN TERMS OF BOTH C/I RATIO…



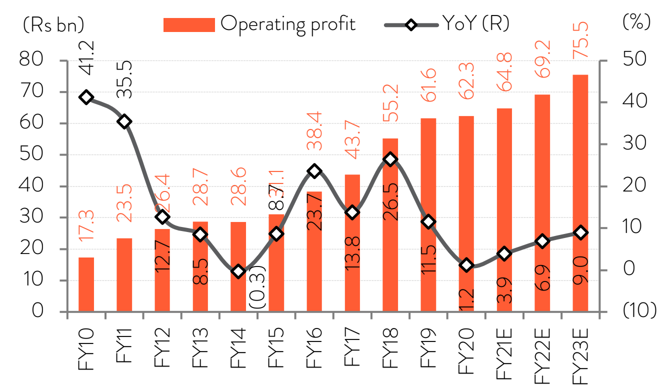
Source: Company, BOBCAPS Research

FIG 43 – …AND EXPENSE RATIO



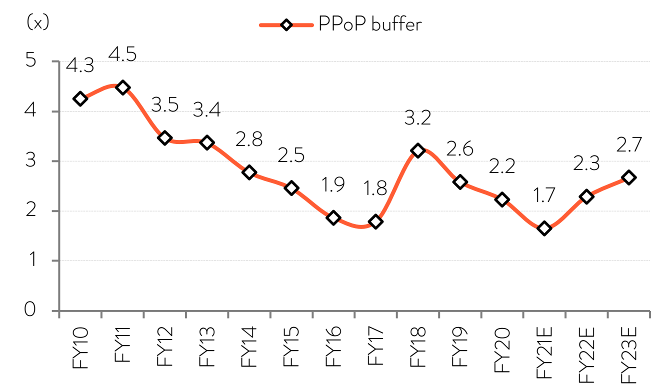
Source: Company, BOBCAPS Research

FIG 44 – WE EXPECT AN OPERATING PROFIT CAGR OF 7% OVER FY20-FY23E…



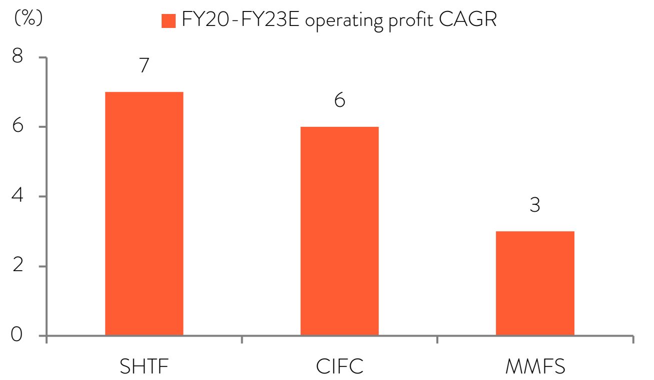
Source: Company, BOBCAPS Research

FIG 45 – …SHORING UP THE PPOP BUFFER (OPERATING PROFIT/PROVISIONS) FY22E ONWARDS



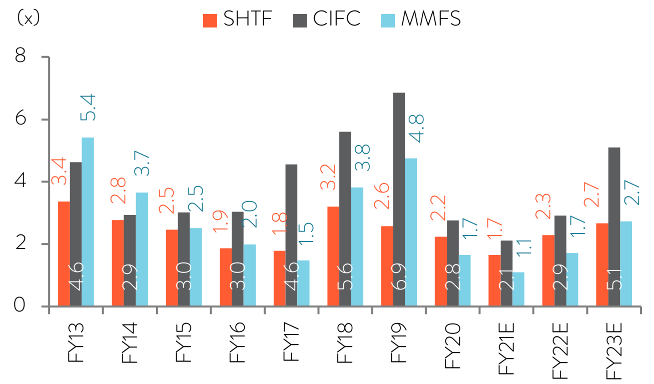
Source: Company, BOBCAPS Research

FIG 46 – SHTF TO HAVE HIGHEST OPERATING PROFIT GROWTH IN OUR CV FINANCIER COVERAGE…



Source: Company, BOBCAPS Research

FIG 47 – …AND PPOP BUFFER NEXT ONLY TO CIFC THROUGH TO FY23E



Source: Company, BOBCAPS Research

Return ratios set to recover in FY22

Prudent risk management and risk monitoring policies are difficult to replicate for competitors. SHTF has historically maintained higher coverage than most peers as it lends to a high-risk customer cohort. Though we expect GNPA to rise ~300bps to ~12% in FY21, the risk has been well provided for. Borrowers including those under moratorium have started repayments, with ~73% making part/full payments (by volume) in Jul'20. We thus expect limited loan restructuring post-moratorium, at <10% of AUM, implying average credit cost of ~300bps during FY21-FY23. PAT is projected to log a 12% CAGR over FY20-FY23, aiding recovery in return ratios.

Stringent risk management practices

In order to safeguard asset quality, the company not only conducts a stringent credit evaluation of the borrower, but also ensures guarantor arrangements, the availability of security, and referrals from existing relationships.

FIG 48 – CREDIT POLICIES

Parameter	SHTF credit evaluation policy
Vehicle type	SHTF only finances vehicles that are used for commercial purposes. These are income-generating assets and hence reduce the company's credit risk.
Hypothecation	All loans include hypothecations are in the company's favour.
Guarantor requirement	Loans must be secured by a personal guarantee of the borrower as well as at least one third-party guarantor. The guarantor must be a CV owner, preferably the company's existing or former customer, and preferably operating in the same locality as the borrower.
Insurance	Comprehensive insurance is required.
Loan approval guidelines	From time to time, management lays down loan approval parameters which are typically linked to the value of the vehicle and loan amount.
Age limit	SHTF extends loans for pre-owned vehicles that are < 12 years old but the age limit may vary as per usability in specific geographies.

Parameter	SHTF credit evaluation policy
Period	The maximum period for loan repayment does not exceed 84 months.
Release of documents	Security received from the borrower is released on repayment of all dues or on collection of the entire outstanding loan amount, provided no other existing claim exists against the borrower.
RTO records	In the case of pre-owned vehicle financing, Regional Transport Office (RTO) records are inspected for non-payment of road tax, pending court cases, and other issues, and the records retained as part of loan documentation.
Physical inspection and trade reference	For pre-owned vehicle financing, the branch manager must physically inspect the vehicle, assess its value and record the same in the evaluation report. He must also conduct contact point verification and a trade reference check of the borrower before an actual disbursement is made.

Source: Company, BOBCAPS Research

Robust collection and recovery mechanism

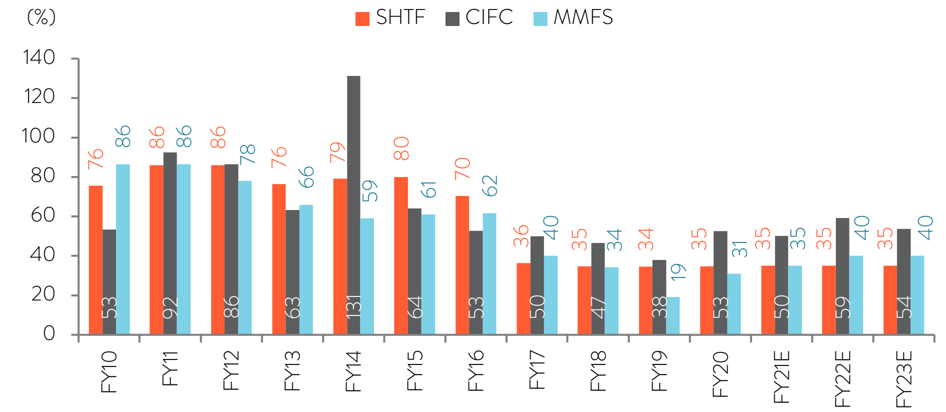
SHTF undertakes centralised tracking of customer loan repayment schedules on a monthly basis based on the outstanding tenure, number of instalments due and defaults committed, if any. Further, all borrower accounts are reviewed at least once a year, with a higher frequency for larger exposures and delinquent borrowers. The lending team reviews collections regularly, personally contacts borrowers that have defaulted and handles collection of instalments from 150-200 borrowers each, depending on territorial dispersal.

Recovery and collection operations are administered entirely in-house, ensuring better oversight and lower delinquencies. In our view, this loan recovery procedure is particularly well suited to the company's target market in the CV financing industry. Further, SHTF's localised knowledge and relationship-based recovery process would be difficult for competitors to replicate.

NPAs may spike due to pandemic but well provided for

The company has demonstrated better asset quality in FY20 compared to our CV financier coverage (gross stage 3-loans at 8.4%; no change YoY vs. 140bps for CIFC and >200bps for MMFS). SHTF has historically maintained higher provision coverage, owing to its high-risk customer base. The company has provided 83bps of AUM as incremental provisions for Covid-19 in Q4FY20 (similar to peers) and closed the year with a PCR of 35%, vs. 53% for CIFC and 31% for MMFS. Healthy coverage provides comfort in case of a sharp rise in delinquencies.

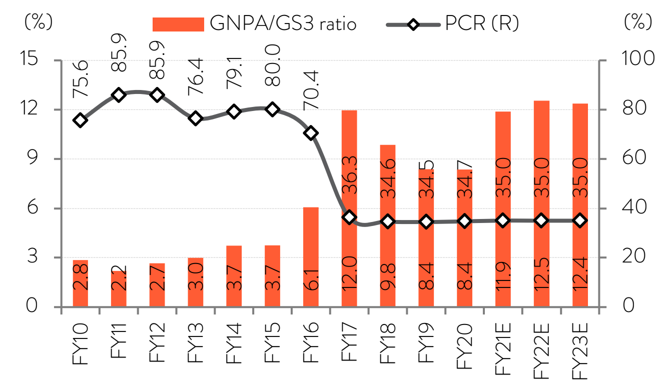
FIG 49 – PCR COMPARISON



Source: Company, BOBCAPS Research

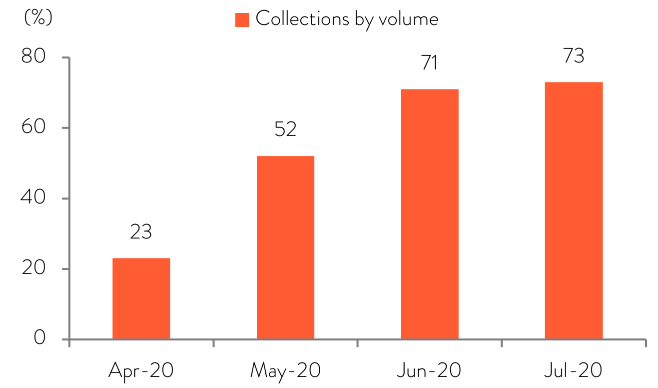
SHTF's LTV is currently set at 60-70% for old CVs and 75-80% for new CVs. The company had reduced loss given default (LGD) on incremental disbursements from Oct'18 to 65% for used CVs vs. 70% earlier (and to 75% for new CVs). Rising prices and lower LTV on loans disbursed post Sep'18 will provide a cushion to LGD.

FIG 50 – LIKELY TO MAINTAIN PCR AT ~35%



Source: Company, BOBCAPS Research

FIG 51 – STEADY RISE IN PART/FULL COLLECTIONS



Source: Company, BOBCAPS Research

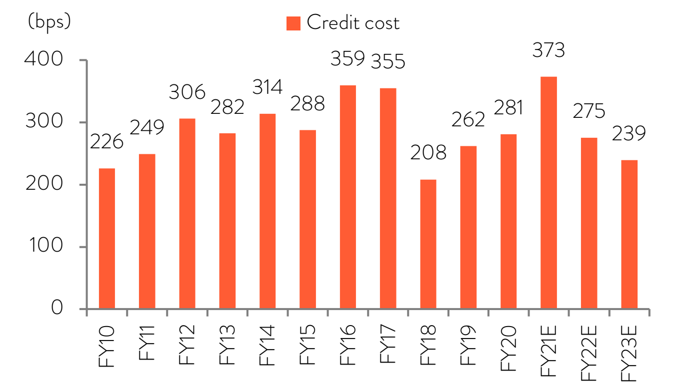
Covid-led restructuring estimated at only ~10% of AUM

A majority of borrowers who have availed of the RBI's Covid-linked moratorium scheme have started making payments – this has increased EMI collections in July, with 73% of SHTF's customer base (including those not under moratorium) repaying dues in full or part. Given the high collection figure, management expects restructuring to be only 5-10% of AUM in FY21.

In our view, defaults could arise largely from borrowers who have not been able to operate businesses over the past six months, such as cab aggregator services Ola and Uber. SHTF's exposure to such businesses is limited to 3-4% of AUM. Similarly, its exposure to travel, aviation and hotels – industries most affected by the pandemic – is low.

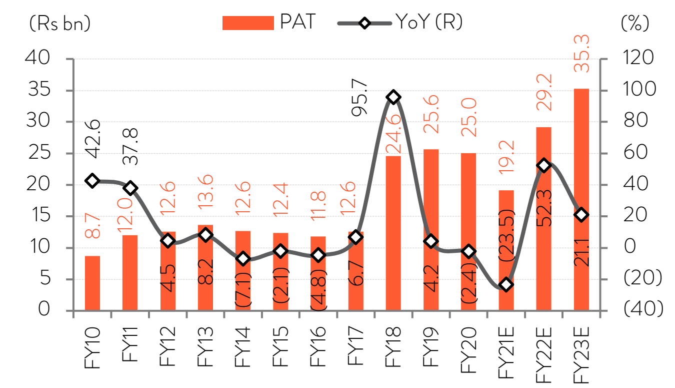
Factoring in the deterioration in macroeconomic environment and stretched financials of fleet operators/driver-cum-operators, we model for a rise in credit cost from 2.8% in FY20 to 3.7% in FY21, before a return to normal in FY22. SHTF's return ratios have moderated compared to historical trends, but we expect ROA of 2.4%+ and ROE of 13%+ over FY22-FY23 as PAT recovers.

FIG 52 – AVERAGE CREDIT COST FORECAST AT 300BPS DURING FY21E-FY23E…



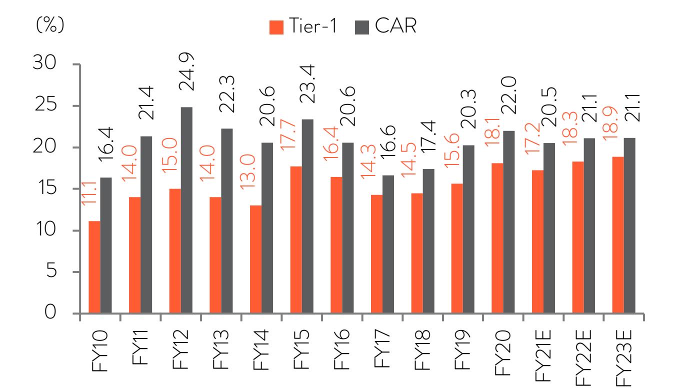
Source: Company, BOBCAPS Research

FIG 53 – …LEADING TO 12% CAGR IN PAT OVER FY20-FY23E



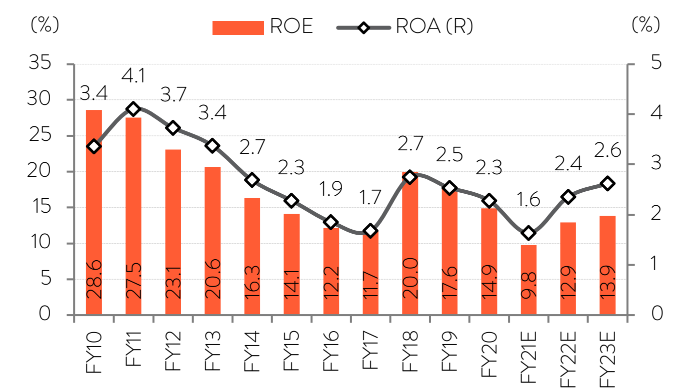
Source: Company, BOBCAPS Research

FIG 54 – WELL CAPITALISED AFTER RECENT CAPITAL RAISE



Source: Company, BOBCAPS Research

FIG 55 – WE EXPECT BOUNCE BACK IN RETURN RATIOS IN FY22E



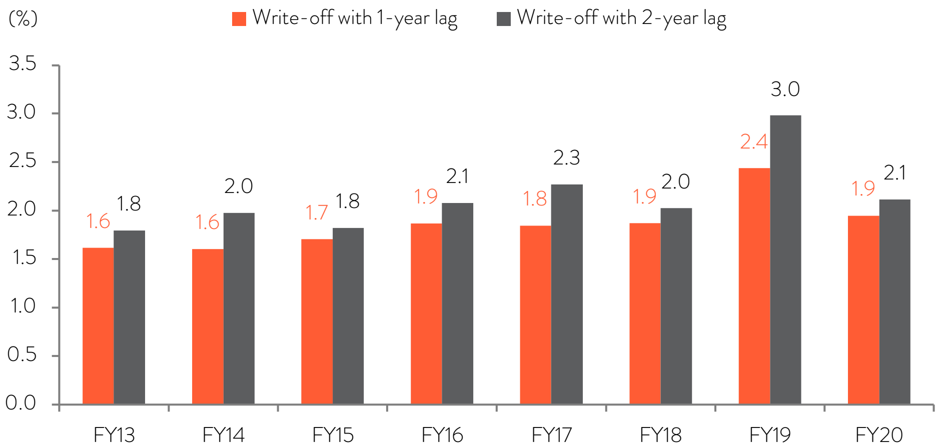
Source: Company, BOBCAPS Research

Analysing write-offs to gauge actual losses

Credit cost for SHTF has risen 70bps over FY18-FY20 – our analysis shows this increase was merely statutory in nature, stemming from RBI's NPA migration mandate and not underlying asset quality issues. In our view, write-offs represent a more accurate picture of asset health as these are the only actual losses for any financing business.

We have analysed write-offs as a percentage of AUM on a one-year lag and two-year lag basis. This assumes a two-year time difference between a loan being disbursed, it becoming an NPA and then being written-off. Our analysis reveals that SHTF's write-offs as a percentage of AUM have remained stable (excl. FY19) and in line with the long-term averages over the past eight years (at 2.1% on a two-year lag basis).

FIG 56 – TREND IN WRITE-OFFS



Source: Company, BOBCAPS Research

Valuation methodology

Since the IL&FS crisis, SHTF has diversified into new borrowing sources such as retail NCDs and ECBs. The share of ECBs in total borrowings has increased meaningfully to 18% in FY20 from 6% in FY19. Liquidity has also been bolstered to 11–12% of the balance sheet. AUM growth, however, has been weak for the past several quarters but is likely to recover from H2FY22.

On the asset quality front, the company has been able to reduce its GNPA ratio over the past year. While the collection efficiency number is encouraging, a clearer picture will emerge after the moratorium ends in Sep'20. We model for a rise in credit cost from 2.8% in FY20 to 3.7% in FY21. Return ratios are forecast to recover by FY22 (to ROA of 2.4% and ROE of 13%).

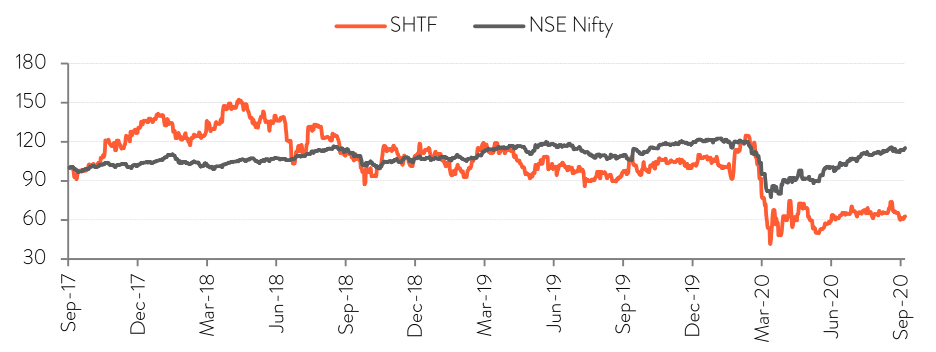
The stock currently trades at 0.7x FY22E BVPS, reflecting the concerns on cash flow disruption and impending asset quality stress. We use a residual income model to arrive at our Sep'21 target price of Rs 1,000 (1x Sep'22E BV), which values the company at a risk-free rate of 7.75%, cost of equity of 14.0%, and terminal growth of 5%. The recent Rs 15bn rights issue is incorporated in our numbers. We believe the business will remain well capitalised with healthy liquidity through to FY23. Initiate with BUY.

FIG 57 – VALUATION ASSUMPTIONS

Parameter	(%)
Cost of equity	14.0
Risk-free rate	7.75
Risk premium	5.0
Terminal growth rate	5.0

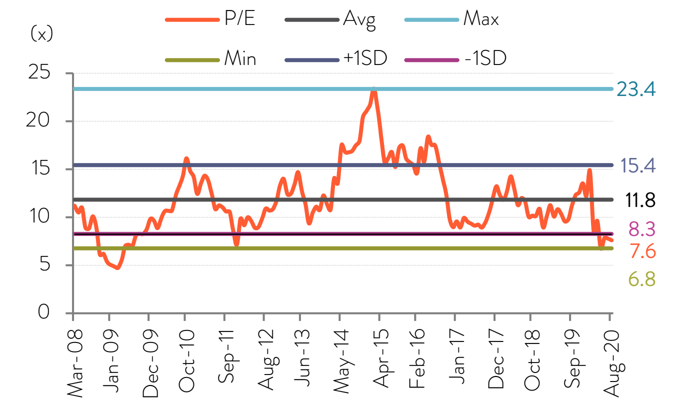
Source: BOBCAPS Research

FIG 58 – RELATIVE STOCK PERFORMANCE



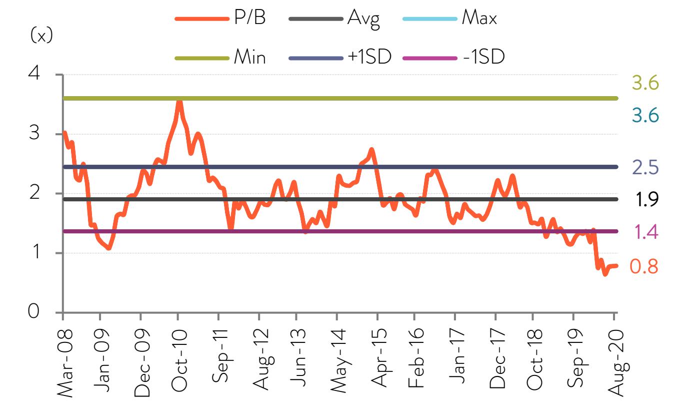
Source: NSE

FIG 59 – ONE-YEAR FORWARD P/E



Source: Bloomberg, BOBCAPS Research

FIG 60 – ONE-YEAR FORWARD P/B



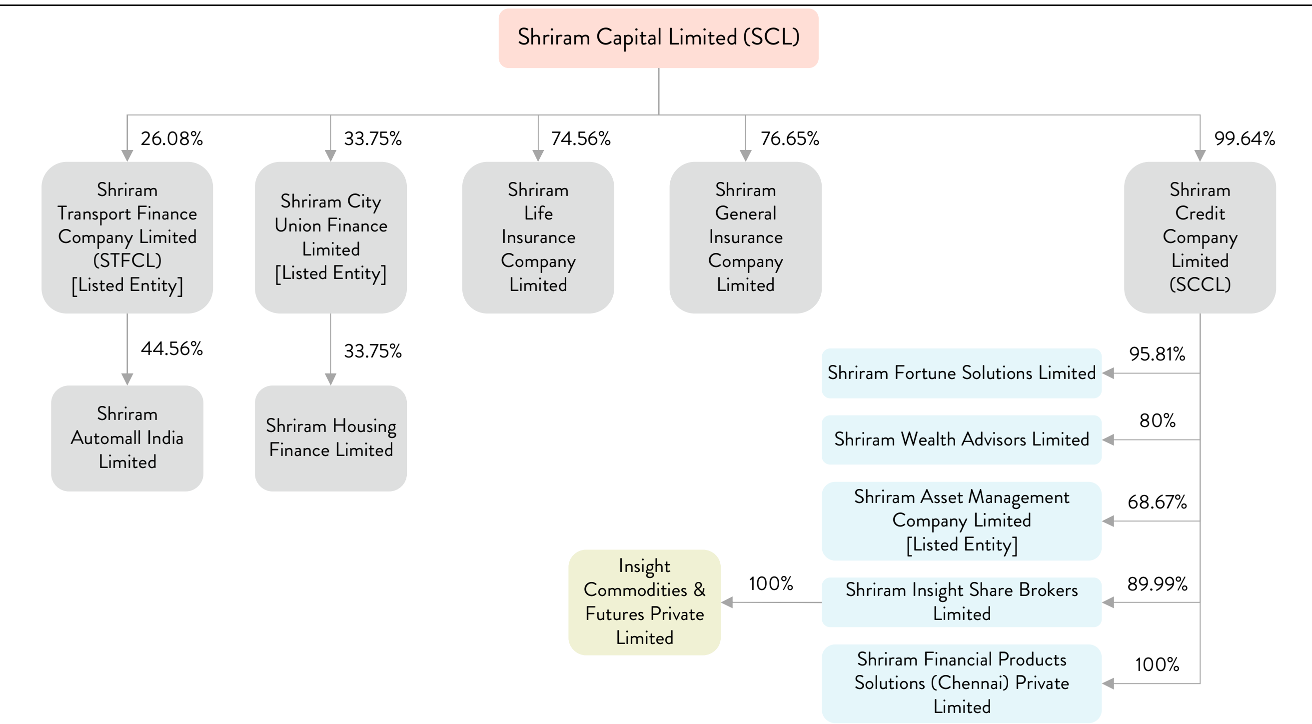
Source: Bloomberg, BOBCAPS Research

Key risks

- Another full lockdown could disrupt the fragile recovery.
- Above-expected AUM restructuring could lead to delayed recognition of bad assets.
- Domestic bond markets could remain aloof to SHTF's papers.

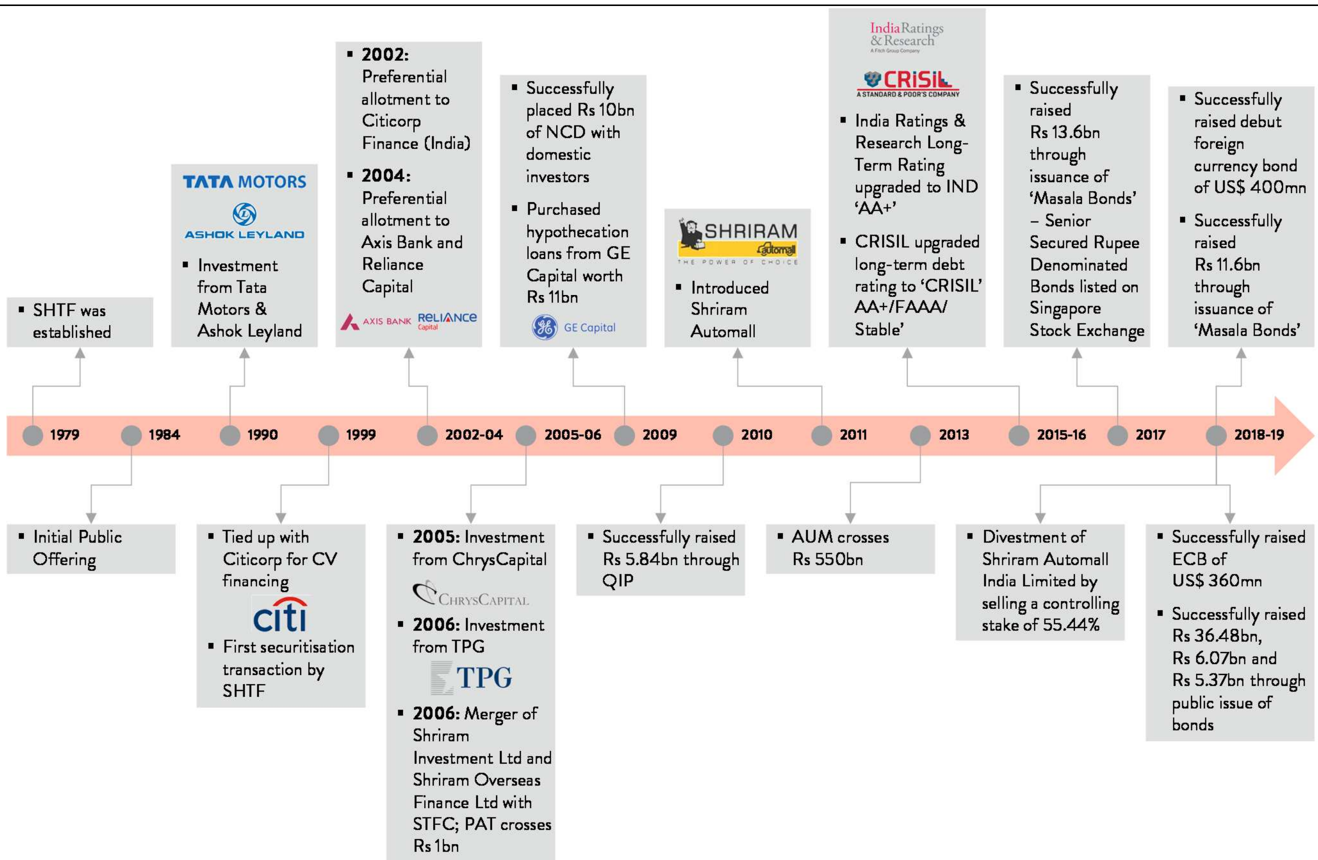
Annexure A

FIG 1 – ORGANISATION STRUCTURE



Source: Company, BOBCAPS Research

FIG 2 – MILESTONES SINCE INCEPTION



Source: Company, BOBCAPS Research

FINANCIALS

Income Statement

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Net interest income	**78,244**	**79,972**	**81,077**	**86,208**	**93,803**
NII growth (%)	14.6	2.2	1.4	6.3	8.8
Non-interest income	2,210	3,152	2,709	2,990	3,577
Total income	80,454	83,124	83,786	89,199	97,380
Operating expenses	18,849	20,788	19,017	19,953	21,913
Operating profit	61,605	62,336	64,769	69,246	75,468
Operating profit growth (%)	11.5	1.2	3.9	6.9	9.0
Provisions	23,823	27,949	39,166	30,257	28,259
PBT	37,783	34,387	25,604	38,989	47,209
Tax	12,143	9,368	6,452	9,825	11,897
Reported net profit	**25,640**	**25,018**	**19,151**	**29,164**	**35,312**
Adjustments	0	0	0	0	0
Adjusted net profit	**25,640**	**25,018**	**19,151**	**29,164**	**35,312**

Balance Sheet

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Equity capital	2,269	2,269	2,531	2,531	2,531
Reserves & surplus	154,179	177,783	209,941	236,189	267,969
Net worth	156,448	180,052	212,472	238,719	270,500
Deposits	0	0	0	0	0
Borrowings	879,144	943,718	969,676	1,021,218	1,126,052
Other liabilities & provisions	17,333	17,517	17,867	18,225	18,589
Total liabilities and equities	**1,052,925**	**1,141,286**	**1,200,015**	**1,278,162**	**1,415,141**
Cash & bank balance	39,815	73,149	74,194	97,739	110,359
Investments	39,991	27,985	30,783	33,862	37,248
Advances	967,515	1,022,316	1,076,340	1,123,340	1,238,657
Fixed & Other assets	45,419	90,985	92,891	120,961	139,236
Total assets	**1,052,925**	**1,141,286**	**1,200,015**	**1,278,162**	**1,415,141**
Deposit growth (%)	NA	NA	NA	NA	NA
Advances growth (%)	6.6	5.7	5.3	4.4	10.3

Per Share

Y/E 31 Mar (Rs)	FY19A	FY20A	FY21E	FY22E	FY23E
EPS	113.0	110.3	75.7	115.2	139.5
Dividend per share	12.0	5.0	7.6	11.5	14.0
Book value per share	689.7	793.8	847.3	951.0	1,076.6

Source: Company, BOBCAPS Research

Valuations Ratios

Y/E 31 Mar (x)	FY19A	FY20A	FY21E	FY22E	FY23E
P/E	5.8	6.0	8.7	5.7	4.7
P/BV	1.0	0.8	0.8	0.7	0.6
Dividend yield (%)	1.8	0.8	1.1	1.8	2.1

DuPont Analysis

Y/E 31 Mar (%)	FY19A	FY20A	FY21E	FY22E	FY23E
Net interest income	7.7	7.3	6.9	7.0	7.0
Non-interest income	0.2	0.3	0.2	0.2	0.3
Operating expenses	1.9	1.9	1.6	1.6	1.6
Pre-provisioning profit	6.1	5.7	5.5	5.6	5.6
Provisions	2.4	2.5	3.3	2.4	2.1
PBT	3.7	3.1	2.2	3.1	3.5
Tax	1.2	0.9	0.6	0.8	0.9
ROA	2.5	2.3	1.6	2.4	2.6
Leverage (x)	7.0	6.5	6.0	5.5	5.3
ROE	17.6	14.9	9.8	12.9	13.9

Ratio Analysis

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
YoY growth (%)					
Net interest income	14.6	2.2	1.4	6.3	8.8
Pre-provisioning profit	11.5	1.2	3.9	6.9	9.0
EPS	4.2	(2.4)	(31.4)	52.3	21.1
Profitability & Return ratios (%)					
Net interest margin	8.3	8.0	7.7	7.8	7.9
Fees / Avg. assets	0.2	0.3	0.2	0.2	0.3
Cost-Income	23.4	25.0	22.7	22.4	22.5
ROE	17.6	14.9	9.8	12.9	13.9
ROA	2.5	2.3	1.6	2.4	2.6
Asset quality (%)					
GNPA	8.4	8.4	11.9	12.5	12.4
NNPA	5.7	5.6	8.0	8.5	8.4
Provision coverage	34.5	34.7	35.0	35.0	35.0
Ratios (%)					
Credit-Deposit	0.0	0.0	0.0	0.0	0.0
Investment-Deposit	0.0	0.0	0.0	0.0	0.0
CAR	20.3	22.0	20.5	21.1	21.1
Tier-1	15.6	18.1	17.2	18.3	18.9

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

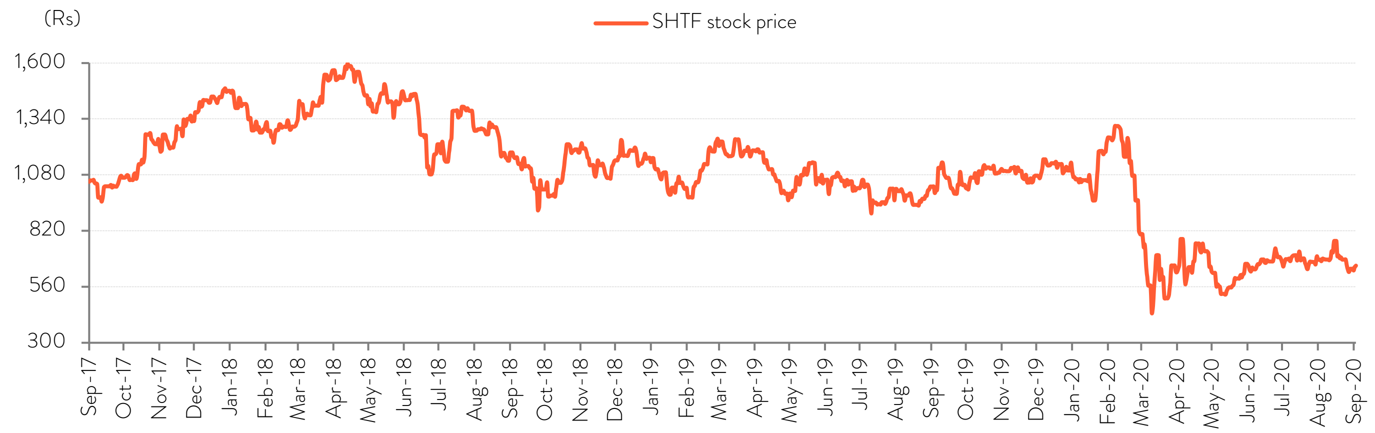
ADD – Expected return from >+5% to +15%

REDUCE – Expected return from -5% to +5%

SELL – Expected return <-5%

Note: Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

RATINGS AND TARGET PRICE (3-YEAR HISTORY): SHRIRAM TRANSPORT FINANCE (SHTF IN)



B – Buy, A – Add, R – Reduce, S – Sell

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