3 NBFC stocks at reasonable valuations

Capital First, Cholamandalam Investment and L&T Finance also stand out for unique business models

Illustration: AJAY MOHANTY

HAMSINI KARTHIK
Mumbai, 14 August

While banking channel credit growth remains anaemic, the performance of non-banking finance companies (NBFCs) is noteworthy. They remain notches ahead of banks in demonstrating strong growth.

For an investor, while the 'me-too' model of pure-play housing finance companies (HFCs) might limit the scope for incremental growth, NBFCs outside this basket could offer higher return and diversified growth. From this standpoint, stocks such as Capital First, Cholamandalam Investment & Finance and L&T Finance offer uniqueness.

Importantly, trading at 2.5-2.8 times the FY19 book, these stocks are still affordable as compared to larger peers such as Bajaj Finance and HDFC.

Capital First

Despite being a relatively new addition in the crowded NBFC space, it stands for transformation over the years. From largely a wholesale lender, Capital First now represents what Bajaj Finance is but in the micro, small and medium enterprises (MSMEs) lending side. With over half its loan book focused on secured MSME loans, Capital First has almost trebled the loan book from ₹5,500 crore in FY13 to ₹15,000 crore in FY17.

Analysts at Edelweiss believe the assets under management (AUM) might annually compound by 25–27 per cent in FY17-FY19, helped by an expanding footprint. Capital First has diversified its loan book to cater to two-wheeler, consumer durables and even housing loans over the past four years. Strong management competency has helped it establish robust underwriting standards.

However, as against the one per cent gross non-performing assets (NPA) ratio maintained in the past two years, FY18 could see an increase due to tighter (shift to 90-day) NPA recognition norms, as seen in the first quarter. Net interest margin (NIM) at about eight per cent implies superior profitability and with plans to reduce the dependence on bank loans for funding (58 per cent in FY17), profitability should further improve.

UPSIDES AHEAD

Data compiled by BS Research Bureau

GROWTH MOMENTUM TO CONTINUE

FY18 estimates (₹ crore)	Capital First	Chola Investment	L&T Finance
Net interest income	1,651	2,502	3,566
% change year-on-year	34.4	20.1	13.4
Net profit	312	886	1,421
% change year-on-year	34.0	23.3	36.4
Return on equity (%)	13.2	19.0	15.3
Price-to-book (x)	2.8	2.8	2.6
Price as on August 14 (₹)	731	1,150	172
Year-to-date gains (%)	30.9	23.0	96.6
Upside (%) *	20.9	12.5	8.1

* Based on target price of analysts polled by Bloomberg
Source: Brokerage reports

Cholamandalam

One of the oldest NBFCs, Chola's strategy of growing its loan book is its biggest strength. A little over 70 per cent comprises vehicle loans, with light commercial (LCV) and medium utility vehicles accounting for the bulk. With equal presence across the country, 19 per cent market share in the LCV loan segment (consistent for five years) and strong underwriting skills, it has been able to maintain superior return ratios and NIMs of about eight per cent.

About 30 per cent of its loan book is in housing loans, a segment it entered to beat the slowdown in commercial vehicles and rapidly expanded in FY11-15. And, over 80 per cent exposure to self-employed borrowers. The financier has recently expanded to MSME and agricultural loans, which analysts at IIFL feel should help grow its loan book by 17 per cent by FY17-20. While adoption of tighter loan provisioning standards has kept the gross NPA ratios on the higher side in recent years, higher provisioning haven't eaten into its profitability.

L&T Finance

L&T Finance is a classic turnaround story. From being a jack of all trades, which ate into its profitability, the financier has identified eight products, structured under three verticals, to propel growth. These are housing, rural and wholesale finance, 19 per cent, 15 per cent and 62 per cent, respectively, of the loan book. As achieving an 18-20 per cent return on equity (RoE) by FY20 is the key objective, pruning of its focus areas is clearly helping. RoE improved from about nine per cent in FY14 to a little over 12 per cent in FY17.

Among the three, rural finance (micro finance, two-wheeler and tractor loans) is the most profitable, with RoE of 22 per cent. As the housing finance loan book is also getting seasoned (good quality loans), it should support the financier's goal. Going ahead, analysts will monitor the performance of the lumpy wholesale book. With L&T Finance concentrating on generating and sell-down of wholesale loans (renewables, structured finance and thermal power) to investors, analysts at Motilal Oswal Financial Services feel it should help generate strong fee income and result in 15-16 per cent RoE by FY19.