Dimensional Securities Pvt Ltd.

Date: 5th June, 2017
Recommendation: Buy
CMP: 709
Target Price: 1000

Capital First Limited
Initiating Coverage

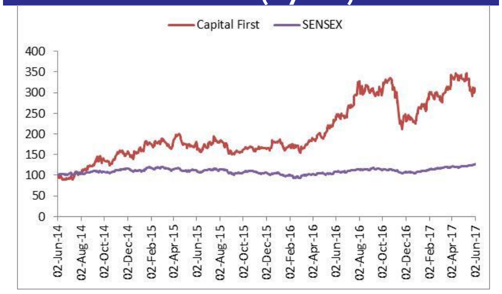
MARKET DATA – JM Financial	
Net worth (₹Cr)	2298
P/BV Ratio (FY17) (x)	3.0x
EPS (FY17) (₹)	24.5
Market Price (₹)	709
P/E Ratio (FY17) (x)	28.9
52 Week High	814
52 Week Low	465
Market Capitalisation (₹Cr)	6908

AVERAGE VOLUME PAST 30 DAYS ('000)	
BSE	1303
NSE	688

SHARE HOLDING PATTERN (Mar-17) (%)

Promoters	FII, DII	Others	KMP
61.06	19.57	15.73	3.64

INDEXED PRICE CHART (3 years)



Return (%)	3M	6M	12M
Capital First	9.2	33.2	25.7
Sensex	8.6	19.4	16.8

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About the Company

Capital First Limited is a leading Indian financial institution, specializing in providing debt financing to MSMEs and Consumers in India.

- **Phase 1, 2008 to 2010:-** Company was largely in the business of wholesale Financing, asset management, and had JVs in Foreign Exchange and retail equity Broking
- **Phase 2, 2010 to 2012:-** Mr. Vaidyanathan acquired a stake in the company, changed the business model to retail, and executed a Management Buyout of the company by securing backing from Warburg Pincus for ₹810 Crores
- **Phase 3, 2012 to 2017:-** Focussed on building back-bone for a strong consumer finance business using a differentiated model, based on new technologies and deep analytics.
- **Phase 4, 2017 Onward:-** To emerge as a dominant player in consumer finance and reap benefits of business networks & technology investments

Key Drivers of Alpha

- **Commendable shift in Loan Book Mix**
  - The company has reduced corporate loans to 7% of AUM from ~90% of AUM in FY10
  - Shift within Retail book commendable with high ROE consumer loans increasing to ~31% of retail book, up from ~18% in FY15
- **Consumer Finance The under-appreciated Jewell**
  - Fast growing, high spread business with extremely high operating leverage would change the return profile of the company as it grows larger thereby driving a re-rating
- **Highly Conservative Provisioning**
  - The Company Provisions for NPA's well ahead of RBI requirements and industry peers thereby artificially suppressing profitability
- **Rigorous Credit Underwriting Process to Maintain High Asset Quality**
  - In the SME Mortgages business company disburses ~38% of overall loan applications thereby providing comfort on asset quality

Reason for Recent Price Correction:-

Reputed private equity firm Warburg recently sold 25% of the company via block deals due to LP requirements. This has created a technical over-supply in the stock thereby creating an opportunity for long term investors.

Financial Outlook, Valuation & Risks

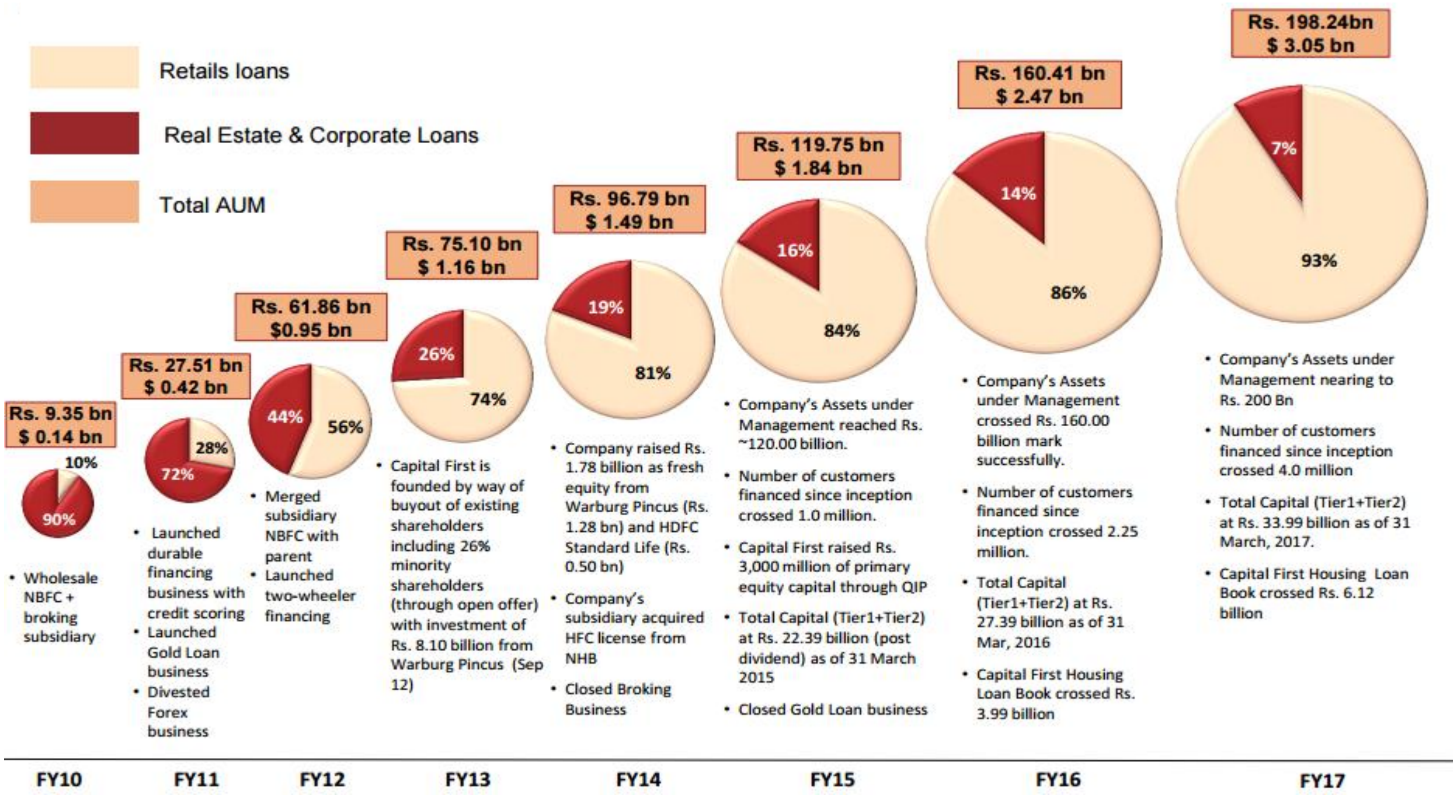
We expect Capital First's return ratio's to improve significantly as the company's consumer finance book scales up. We value the Consumer Finance business at 7.0x LTM Book Value (~15% discount to market leader Bajaj Finance), and value the rest of the book at ~3.0x LTM Book Value on par with high quality NBFCs.

We thereby arrive at our target price of ₹1,000/- per share which represents a 41% upside from CMP and initiate coverage on the stock with a Buy rating.

Financial summary:

Particulars ₹Cr	Net Sales	AUM	(%) Retail	BV/Share	PAT	EPS	ROE (%)	ROA (%)
FY14	1,061	7,883	81%	142	53	6.4	4.1	0.7
FY15	1,442	10,113	84%	173	114	12.1	7.7	1.3
FY16	1,889	13,756	86%	187	166	17.7	9.9	1.4
FY17	2,790	18,353	93%	236	239	24.5	11.6	1.5

Brief History



Source: - Investor Presentation

Post the management buy-out, management has divested non-core For-ex and discontinued the broking, gold loan businesses to focus on its retail lending franchise and has emerged as a leading retail NBFC. The pivot from being a Wholesale lending NBFC to a primarily retail NBFC while maintaining growth and carrying out heavy investments in technology is highly commendable.

Commendable shift in loan Mix

Year	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Retail	10%	28%	56%	74%	81%	84%	86%	93%
Corporate	90%	72%	44%	26%	19%	16%	14%	7%

Granular Loan Mix within the Retail Category:-

Loan Category	FY15	FY16	FY17	Segment Yield (%)*	Key Features
Secured MSME Loans	72.7%	60.5%	49.9%	12%	Collaterised- cash flow based
Unsecured MSME Loans	9.5%	14.9%	19.1%	16%-20%	WC loans, cash flow based
Two Wheeler Loans	8.4%	10.2%	11.0%	22%-24%	Credit score based lending
Consumer Durable Loans	7.3%	11.5%	14.0%	30+%	Credit score based lending
Others (Personal Loans)etc.	2.1%	2.9%	6.0%	15%-18%	Credit score based lending

** Based on Market Information*

Today the Companies Retail loan book can be primarily divided into three parts:-

- SME Loans: - Collateralised loans, largely mortgages cash flow cover yielding ~12%
    - Is growing at a CAGR of ~11%, currently accounts for ~46% of the overall loan book, will continue to shrink as a % of overall loan book as other segments grow faster
- Unsecured MSME Loans:- Working Capital Loans based on cash-flow projections, have a higher yield of ~16%-20%
    - Growing at a CAGR of ~104%, accounts for ~17% of overall book, will grow to ~25% of loan book in near term
- Credit Score Based Consumer Loans:- High yielding, low ticket size loans to consumers based on credit scores
    - Growing at a CAGR of ~92%, accounts for ~28% of overall book, will grow to ~40% of loan book in near term

Consumer Finance the Crown Jewell

Loan Segment	FY15 (AUM) ₹Cr	FY17 (AUM) ₹Cr	CAGR %
Consumer Durable Finance	620	2389	96%
Overall Credit Score Based Lending*	1510	5290	87.2%

**Includes two wheeler loans, consumer durable finance and personal loans*

As credit score based lending grows at a faster pace on a larger base it would pick up the overall growth rate of the company. Below I would delve deeper into why consumer durable finance is a business with a sustainable moat driven by strong network effects.

Key Entry Barriers:-

Consumer financing has significant entry barriers. High initial set-up costs with a long payback period. It requires relationships with manufacturers across product categories, presence across multiple touch-points i.e. dealership network for loan origination, and a sizable customer base. One can't be acquired without the other thereby making the business a tough one to replicate "Chicken & Egg Story". The product is underwritten through automated credit scorecards following an IT-enabled process requiring contemporary analytics, access to different credit bureaus and risk databases. An additional entry barrier to keep credit costs under control is that too reach optimal efficiency on scorecards, a high number of data points on customer experiences are required.

Average ticket size of such loans is small at ₹30,000 with tenure of 8-12 months. The arrangement is such that the consumer is not charged any interest on his purchase apart from a nominal processing fee. CAFL earns subvention income from the manufacturers of products which is typically 6-10% of the retail price of the product. This is based on the product and the schemes available. This is highly favourable for manufacturers as it induces further consumption allowing them to convert sales and up-sell products to customers who were otherwise out of their target segment. Manufacturers view this as marketing spend which greatly expands their target addressable market.

Illustration of A Consumer Finance Loan:-

Particulars	Description	Amount (₹)
MRP of Product		30,000
Upfront recovery from consumer (4 instalments)/33.3% of MRP	4 x 2,500	10,000
Processing fee paid by customer (2% of MRP)	2% x 30,000	600
Financing provided (8 instalments less processing fee)		19,400
Subvention Income from Manufacturer @6% of MRP	6% x 30,000	1,800
Monthly Subvention		225
Monthly EMI Paid by Customer		2,500
Monthly Cash-flows		
Origination of Loan		-19,400
Month 1:- EMI 2,500 + Subvention 225		2,725
Month 2:- EMI 2,500 + Subvention 225		2,725
Month 3:- EMI 2,500 + Subvention 225		2,725
Month 4:- EMI 2,500 + Subvention 225		2,725
Month 5:- EMI 2,500 + Subvention 225		2,725
Month 6:- EMI 2,500 + Subvention 225		2,725
Month 7:- EMI 2,500 + Subvention 225		2,725
Month 8:- EMI 2,500 + Subvention 225		2,725
IRR on Loan		**37%**

Extremely high IRR/ Yield on loans with a fixed up-front op-ex would allow for exceptionally high ROE's in the business once mature

Why is competition limited, Why have banks not entered such a lucrative segment?

Quick turnaround time is key to CD loans. CAFL has set up a database of consumers based on their credit history. Lending is done in the span of a few minutes based on the credit score. CAFL has a customer base of more than 4 million and their past track records and patterns play a significant role in arriving at lending decisions. Consumers may not prefer to use their credit card for purchases as it blocks the credit limit for the entire amount for the entire period.

Easy buy card (EBC):

CAFL has issued EBCs to its existing customer base for consumer durable financing products. The card is essentially a pre-approved loan card. It has the verification record of the customer along with his credit rating. The customer has to present the card at the showroom while making a purchase. Once the card is swiped, his KYC documents are retrieved and credit limit defined. The loan is disbursed instantly, if he meets all criteria. It makes for a hassle-free purchase for the customer. CAFL charges a fee of ₹299 per card. The card is despatched only after the satisfactory credit performance of the existing loan with CAFL.

Banks have stayed away from this segment as operating costs are high, ticket size is small, and multiple tie-ups with manufacturers and dealers are required. It's very difficult to build a large book in this product segment as the tenure is very short and hence it would be only a very tiny portion of the bank's overall AUM. Yield on these loans are highly remunerative at 21-25%. Cross sell and manufacturer subvention make this business viable. However, initial investments as well as the operating costs are high. Setting up analytical scorecards and models requires significant investments.

Competitive Intensity in the Segment

The niche segment remains a duopoly in the country with Bajaj Finance being the clear leader with ~75% market share with Capital first having the other 25% however growing faster due to launch of more incremental products and a smaller base.

Heads-up Comparison Consumer Finance Distribution & Reach

Company	Bajaj Finance	Capital First
Number of Customers (Total)	19 Mn	4 Mn
Consumer Durable Points of Sale	9,400	3,500
TW Dealers	3,000	1,500
Furniture Life Care	3,200	0
Digital (Mobile/Laptop	5,200	To be launched in FY18
Rural Consumer Durable	3,200	0
Total Points of Sale	20,600	5,000
Market Share	75%	25%
Credit Score Based Consumer Finance Loan Book (₹Cr)	22,600	5,688
% book credit score based lending	39.2%	31%

The business has huge up-front Op-ex costs which are incurred while issuing cards and finalizing merchant tie-ups. Incremental Op-ex on business generated from existing merchants is negligible thereby driving a very profitable business with scale.

One can however observe a similar intensity of business per distribution point between Capital First and Bajaj Finance, despite Bajaj Finance having a much larger customer base. This is most likely because Capital First has already targeted the high velocity outlets of Bajaj Finance.

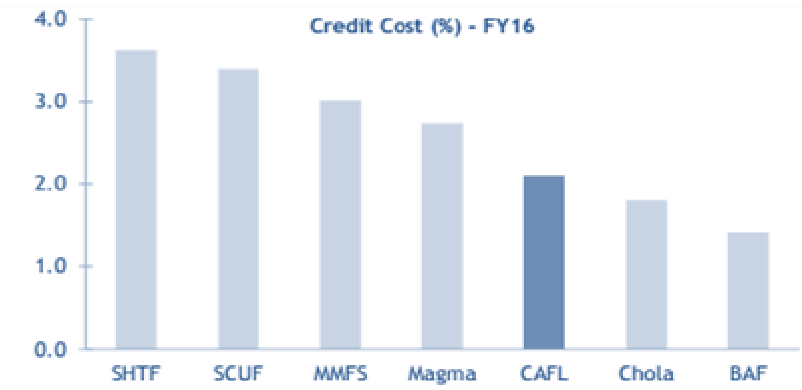
Highly Conservative Provisioning:-

Days Past Due	Regulatory Norm	Capital First Policy (Write-offs)			Bajaj Finance Policy (Write-offs)		
		Mortgage/ SME	Consumer Durable	TW	SME Loans	Consumer Durable	TW
90 DPD	0.4%	10%	50%	25%	0.4%	75%	30%
120 DPD	0.4%	10%	**100%**	50%	15%	75%	30%
150 DPD	15%	10%	100%	**100%**	15%	75%	30%
180 DPD	15%	33%	100%	100%	25%	**100%**	60%
360 DPD	15%	**100%**	100%	100%	40%	100%	**100%**
540 DPD	30%	100%	100%	100%	60%	100%	100%
720 DPD	50%	100%	100%	100%	**100%**	100%	100%
1440 DPD	**100%**	100%	100%	100%	100%	100%	100%

Credit provisioning norms are highly conservative as compared to both regulatory norms and leading industry peers such as Bajaj Finance.

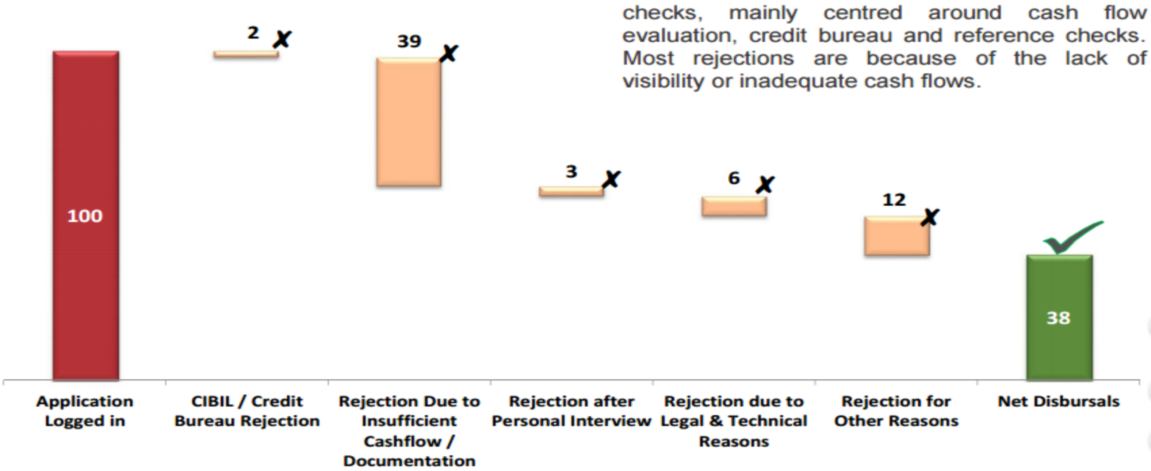
These ultra-conservative write-offs suppress near term RoA's by ~1% - 1.5% thereby suppressing profitability and return ratios as compared to peers. The same would start to reflect in the form of strong write-backs as the book matures, and growth rate normalizes.

Lower Credit Costs as Compared to Peers Despite Ultra-Conservative Provisioning:-



Rigorous credit underwriting process in SME business to maintain High Asset Quality

In the Mortgages business at Capital First, about 38% of the total applications are disbursed after passing through several levels of scrutiny and checks, mainly centred around cash flow evaluation, credit bureau and reference checks. Most rejections are because of the lack of visibility or inadequate cash flows.



Source Investor Presentation

The company only disburses ~38% of the total applications, thereby demonstrating a highly rigorous disbursement process which is key to maintaining low credit costs.

Financial Outlook, Valuation & Risks

Re-rating to be driven by an increase in return ratios (20% ROE by 2020) driven by faster growth in segments with higher NIM's.

We value the consumer finance business at ~7.0x LTM Book Value, a ~15% discount to Bajaj Finance, while we value the SME book at ~3.0x LTM Book Value. We thereby arrive at our target price of ₹~1,000/- per share which represents a ~41% upside from CMP.

We initiate coverage with a Buy rating and believe the recent technical oversupply due to Warburg's exit provides a good opportunity for long term investors to accumulate this structural compounder.

Key Risk to our Thesis

Private Equity Fund Warburg Pincus still owns ~35% of the company and might trigger further exits in the near to medium term which could cause further oversupply, resulting in an elongated time correction in the stock. We however believe the business is fundamentally strong and structural growth should over-ride near term over-supply.

Profit & Loss

Particulars (₹Cr)	FY13	FY14	FY15	FY16	FY17
Net sales	800.3	1,053.0	1,424.4	1,882.2	2,790.0
YoY (%)	8.1%	31.6%	35.3%	32.1%	48.2%
Total expenses					
Employee costs	130.8	126.8	135.8	176.8	239.4
Other Cost	130.1	199.6	313.6	486.3	1,026.8
EBITDA	**539.4**	**726.6**	**975.0**	**1,219.1**	**1,523.7**
Depreciation	6.1	5.9	10.0	10.0	16.6
EBIT	**533.3**	**720.8**	**965.1**	**1,209.2**	**1,507.1**
Interest	483.3	665.5	820.9	963.9	1,160.6
Other income	8.3	9.5	22.2	6.8	11.0
PBT	**79.7**	**64.8**	**166.3**	**252.2**	**357.4**
Less: Taxation	9.9	5.8	52.0	86.0	118.5
Effective tax rate (%)	12.4%	9.0%	31.3%	34.1%	33.2%
PAT	**69.8**	**59.0**	**114.3**	**166.2**	**238.9**
Minority Interest & Share of Associates	-6.7	-6.3			-
Consolidated Net Profit	**66.4**	**52.6**	**114.3**	**166.2**	**238.9**

Key Ratios

	FY13	FY14	FY15	FY16	FY17
EPS (₹)	10.4	7.2	12.6	18.2	25.6
Book value (₹)	136.4	142.9	173.0	186.7	236.5
Dividend per share (₹)	1.8	2	2.2	2.4	2.6
ROE (%)	7.3	5.0	7.3	9.8	10.4
ROA (%)	0.9	0.5	1.1	1.1	1.4
Div Yield (%)	1.1	1.1	0.5	0.6	0.3
Valuation Ratios					
PE (x)	15.675	24.534	31.855	23.693	30.647
Price/book value (x)	1.2	1.2	2.3	2.3	3.3
Earnings growth					
EPS (%)	-36.8%	-30.7%	74.8%	45.0%	40.4%
PAT (%)	-37.3%	-20.7%	117.1%	45.4%	43.8%

Balance Sheet

(₹Cr)	FY13	FY14	FY15	FY16	FY17
Equity capital	70	82	91	91	97
Share Warrants & Outstanding	-	1	-	0	-
Reserves	890	1,089	1,483	1,612	2,206
Net worth	961	1,172	1,574	1,704	2,304
Total borrowings	5,492	7,037	6,110	8,945	11,544
Minority Interest	-	-	-	-	-
Non-Current Liabilities	106	117	91	123	199
Current Liabilities	968	1,790	2,865	3,699	3,609
Total liabilities	**7,527**	**10,115**	**10,640**	**14,470**	**17,655**
Net block	39	34	19	29	65
Investments	1	1	99	142	215
Long Term Loans & Advances	4,184	5,201	6,709	8,582	9,619
Current assets					
Inventories		346	95	42	44
Debtors	39	9	10	27	62
Cash	1,191	2,013	1,057	1,113	1,594
Loans and Advances	1,692	2,314	2,394	4,134	5,727
Other Current assets	381	195	257	402	330
Total assets	**7,527**	**10,115**	**10,640**	**14,470**	**17,655**

Source: Company, DSPL

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