Arman Financial Services Ltd - BUY

Small, but blooming

A fast growing franchise; AUM to grow by 42% pa over FY16-19

Arman Financial Services Ltd (AFSL) has witnessed an impressive growth of 38% p.a. in AUM over FY14-16 driven by robust traction in its MFI portfolio which resides in the subsidiary Namra Finance Ltd. (NFL). MFI loans now comprise 70% of the consolidated AUM (Rs1.9bn) with the residual largely being 2w loans. Thanks to the turnaround in MFI industry fortunes besides modest growth and intensifying competition in 2w financing, AFSL has been channelizing investments towards growing its MFI book over the past few years. This trend is unlikely to change as the management is now in pursuit of regional diversification by adding more branches in high-potential states. Ensuing growth in the number of active borrowers, cycle migration, scope for increasing ticket size across loan cycles and lengthening of portfolio duration will collectively drive sustained brisk growth in MFI AUM going forward. Growth in 2w portfolio should improve with the expected acceleration in industry volume growth. Overall AUM growth would also receive a marginal boost from the scale-up of the recently piloted MSME loan product.

Strong profitability and attractive valuation; initiate with BUY

AFSL has earned RoA of 4.5%+ in the preceding three years. We estimate an unchanged RoA delivery in the coming three years even after assuming an increase in credit cost on account of early NPL identification and some normalization in MFI industry credit trends. The funding cost is on the decline courtesy an increasing asset base and upgrade in credit rating. This should underpin stable spreads over the medium term. While investment in network and resources would continue, improving throughput from matured branches and quick break-even of new branches would eke out productivity gains each year. Even if the company chooses to operate with a conservative financial leverage of 5x, it would imply a robust RoE of 20%+. Given high likelihood of a superior profitability delivery over FY16-19, we believe that AFSL's valuation is attractive at 1.4x FY19 P/ABV. We have assumed a capital raise of Rs450mn through 25% equity dilution in FY18. Initiate coverage with 12-month price target of Rs350.

Analyst: Franklin Moraes, Rajiv Mehta

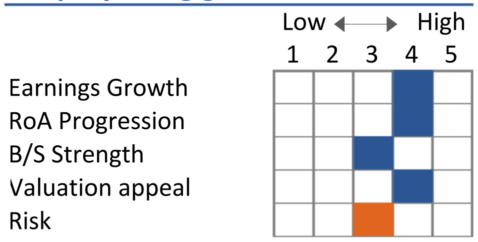
CMP (Rs) 264	12-mts Target (Rs) 350	Upside 32.6%

Stock data — **Sector: Financials**

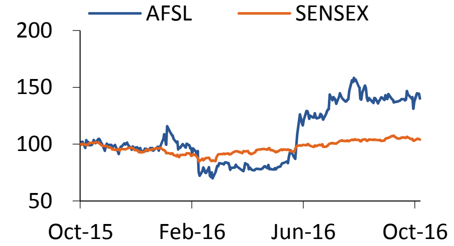
Sensex:	28,061	Bloomberg code:	ARLF IN
52 Week h/l (Rs):	325/121	BSE code:	531179
Market cap (Rs mn) :	1,510	NSE code:	ARMANFIN
Enterprise value (Rs mn):	-	FV (Rs):	10
6m Avg t/o (Rs mn):	12.7	Div yield (%):	0.5

Prices as on Oct 07, 2016

Company rating grid



Stock performance



	1M	3M	1Y
Absolute return (%)	1.0	4.4	41.4

Shareholding pattern (%)

Promoter	28.1
FII+DII	25.0
Others	46.9

Financial summary

Y/e 31 Mar (Rs mn)	FY15	FY16	FY17E	FY18E	FY19E
Total operating income	189	253	367	530	733
yoy growth (%)	22.9	34.1	45.2	44.2	38.2
Operating profit (pre-provisions)	103	135	194	287	402
Net profit	61	80	112	163	225
yoy growth (%)	36.7	30.5	39.7	45.1	38.5
EPS (Rs)	10.7	14.0	19.6	22.7	31.5
Adj.BVPS (Rs)	66.5	84.9	100.7	160.4	184.4
P/E (x)	24.6	18.8	13.5	11.6	8.4
P/BV (x)	4.0	3.1	2.6	1.6	1.4
ROE (%)	17.0	18.0	20.3	18.3	17.6
ROA (%)	4.9	4.8	4.7	4.7	4.7

Source: Company, IIFL Research

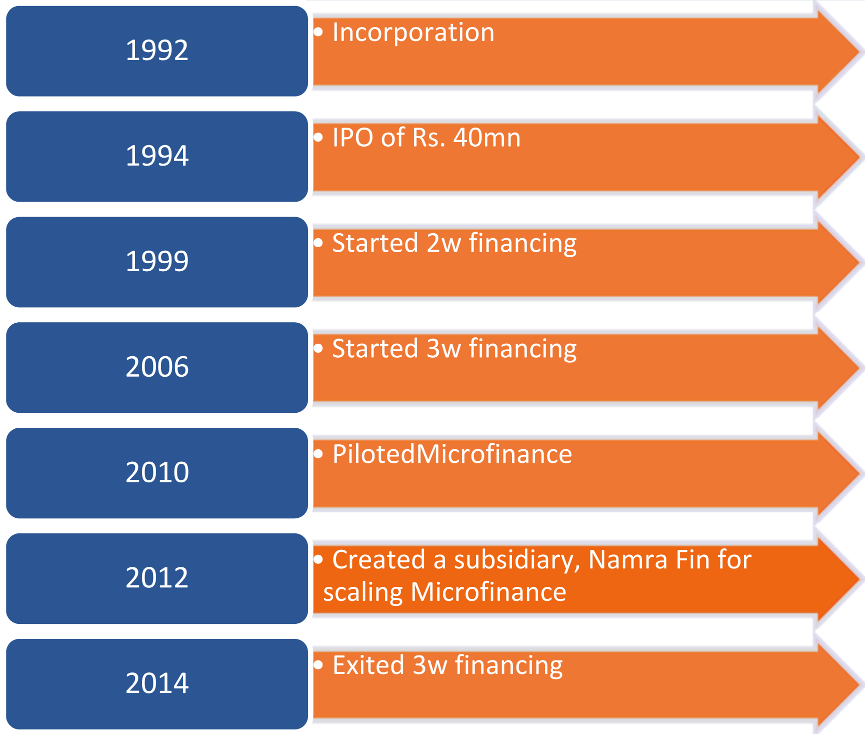
A small NBFC with good experience

Arman Financial Services Ltd. (AFSL) is an NBFC primarily engaged in the business of Microfinance and 2-wheeler financing. It has a deep-rooted presence in Gujarat and Madhya Pradesh and is now fast expanding into Maharashtra and Uttar Pradesh. Incepted way back in 1992, the company floated an IPO of Rs. 40mn in 1995 in the name of Arman Lease and Finance Ltd. AFSL shifted focus and forayed into 2-wheeler financing in 1999. Over the years, it has developed a strong positioning for itself in the state of Gujarat and continues to grow this business at a decent pace of 10-15% p.a.

AFSL was also quick to spot an opportunity in 3-wheeler financing in 2006 after the enactment of a law in Gujarat that required all petrol rickshaws to convert to CNG. The company was quick to realize that given the livelihood of rickshaw driver integrally attached to the asset, the likelihood of a loan default was low. The success of AFSL in Gujarat caught the attention of other financiers. The company chose to move out of this business in 2014 as competition from Banks and NBFCs had intensified by then and tightening of regulations made it difficult for rickshaw drivers to get new licenses.

2010 proved to be another crucial year for AFSL which marked its entry into the Microfinance business. With RBI coming out with a detailed set of guidelines and creating a new category 'NBFC-MFI' in response to the AP crisis, AFSL created a wholly owned subsidiary 'Namra Finance Limited' (NFL) in 2012 to drive focused growth of the microfinance business. NFL was the first MFI to receive the NBFC-MFI licence in India by RBI. Over the past few years, the MFI business has been a major contributor to the company's growth and presently comprises 70% of total AUM.

Chart 1: Journey of AFSL since inception



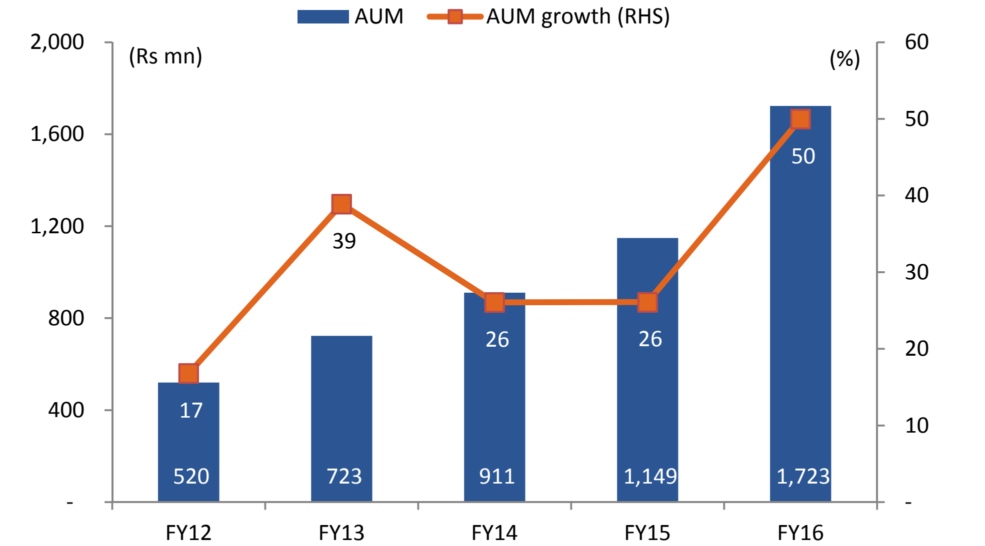
Source: Company, IIFL Research

Strong growth in AUM over FY12-16

AFSL's consol AUM growth has been pretty impressive over FY12-16, representing a CAGR of 35%. The key growth impetus has come from rapid scale-up of the MFI business which witnessed an AUM CAGR of 54% during the past three years. This in turn was driven by more-than-doubling of the branches which led to wider borrower outreach and significant jump in loan tickets (especially in the recent past). The increase in portfolio duration since the start of FY16 has also supported growth. Compared to the sole 12-month loan product till FY15, AFSL's portfolio now comprises 14-month and 24-month loans. The share of MFI assets in the consolidated AUM has consistently risen from 49% as of Q1 FY15 to 70% at the end of Q1 FY17. The proportion of income from MFI business in the consolidated income has also commensurately increased.

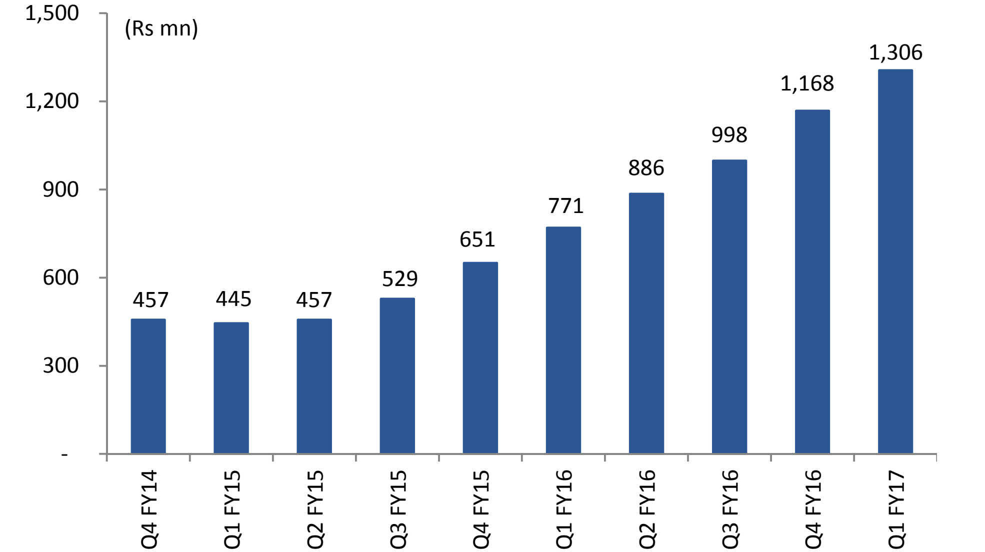
A deeper analysis of the MFI AUM growth in the past couple of years reveals that growth has been contributed by both increase in client base and rise in average ticket size (ATS). Since FY14, the book has grown by nearly 3x on the back of 1.7x growth in the live customer base and 1.6x increase in the loan ATS. AFSL has increased the range of loan amounts offered across cycles, taking into account the swelled up loan requirement on account of inflation and the regulatory liberalisation of income threshold for qualifying borrowers and loan amounts for first and subsequent cycles. In recent times, the company seems to have caught up to many of its larger peers to some extent, as the ticket sizes offered by AFSL were much smaller till FY14. The portfolio shift to longer duration products over the past few quarters has also increased the average loan amount per borrower. Presently, AFSL offers loan amount in the range of Rs. 15,000-30,000 under its 14-month product and above Rs. 30,000 in the 24-month product. In terms of loan cycle, the first cycle tickets are in the band of Rs 14,000-18,000 and the second cycle ticket range is Rs 18,000-25,000.

Chart 2: Consol. AUM clocks an impressive 35% CAGR over FY12-16



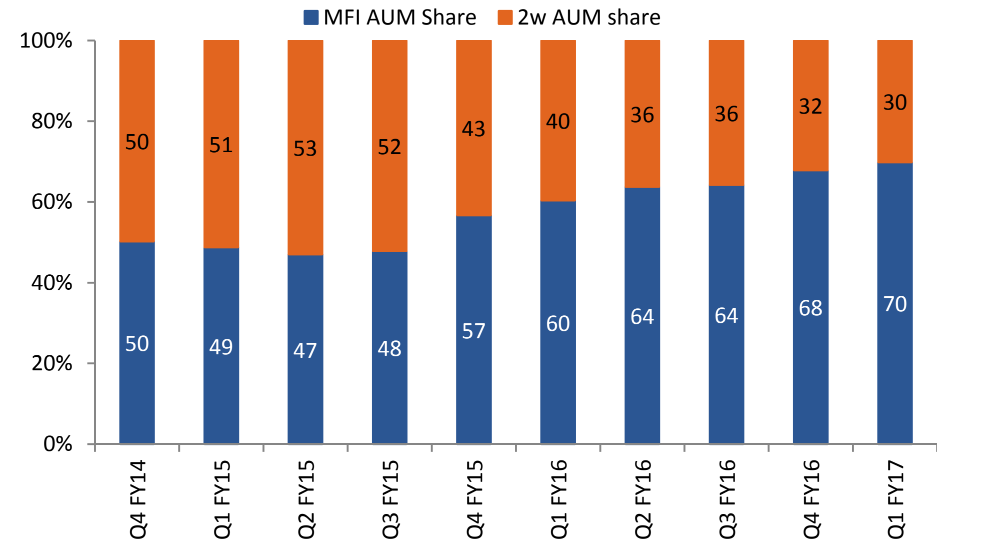
Source: Company, IIFL Research

Chart 3: MFI AUM has picked up materially post FY14



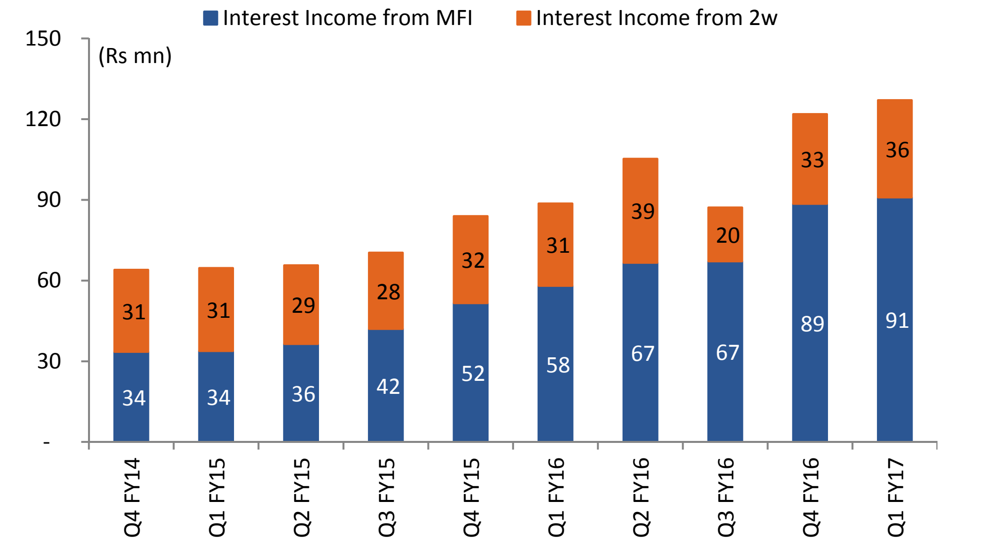
Source: Company, IIFL Research

Chart 4: Business shifts materially towards Microfinance



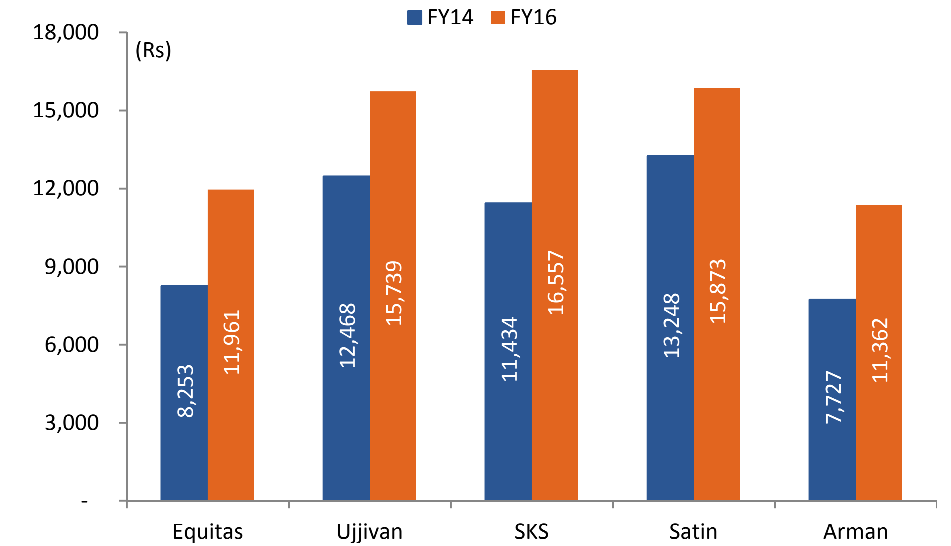
Source: Company, IIFL Research

Chart 5: MFI share in income has increased commensurately



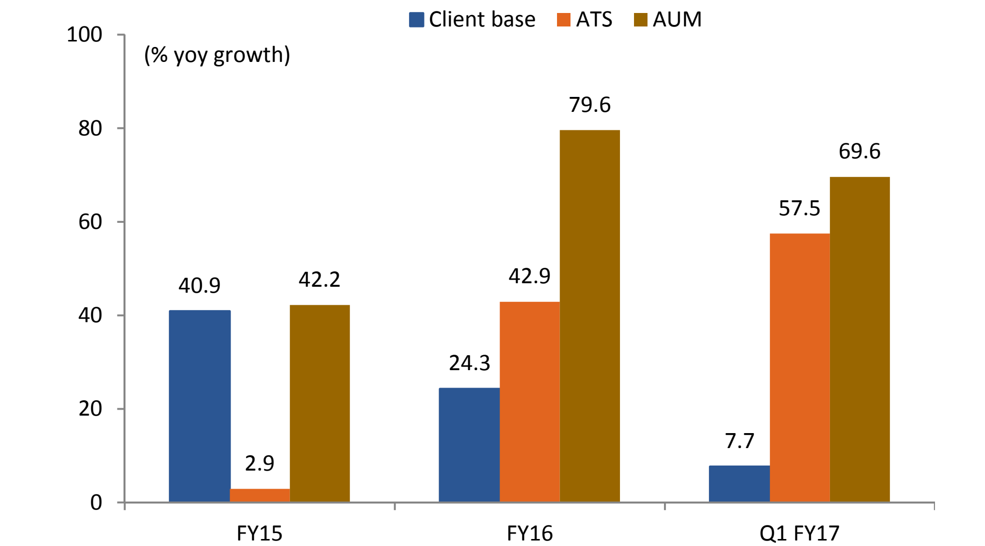
Source: Company, IIFL Research

Chart 7: Reducing the gap with peers on average loan tickets



Source: MFIN, Company, IIFL Research

Chart 6: MFI AUM growth has been driven by increase in loan tickets in the recent past

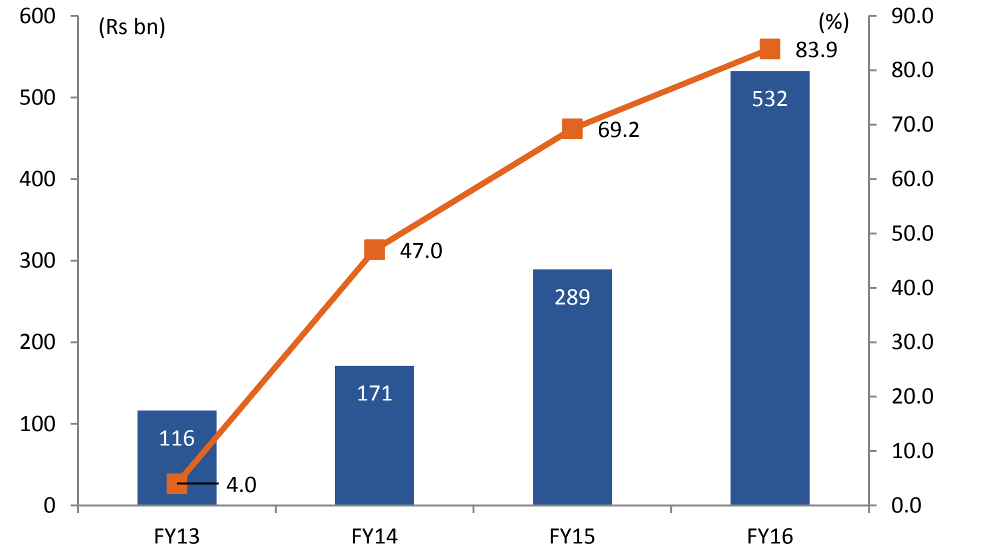


Source: Company, IIFL Research

Microfinance industry has seen a major turnaround post AP crisis

The Microfinance industry has come a long way from bearing the brunt of the 2010-11 turmoil in the wake of the AP crisis to becoming a well-regulated and rapidly growing sector. RBI was quick to address the causes triggering the industry crisis and implemented appropriate measures to prevent the recurrence of similar shocks in future. On the back of well enforced regulations, the MFI industry came about a full circle and funding returned to the sector. With demand being abundant considering the under-penetration of microfinance in India and inadequate access to the formal financial system in many parts of the country, the sector started delivering robust loan growth post FY12. Given RBI's continued support towards facilitating sector development and growth, conversion of eight MFIs into SFBs and a grossly under-penetrated market, we expect this sector to continue to show robust growth in the coming year also.

Chart 8: MFI industry has seen rapid growth in Gross Loan Portfolio



Source: MFIN, IIFL Research

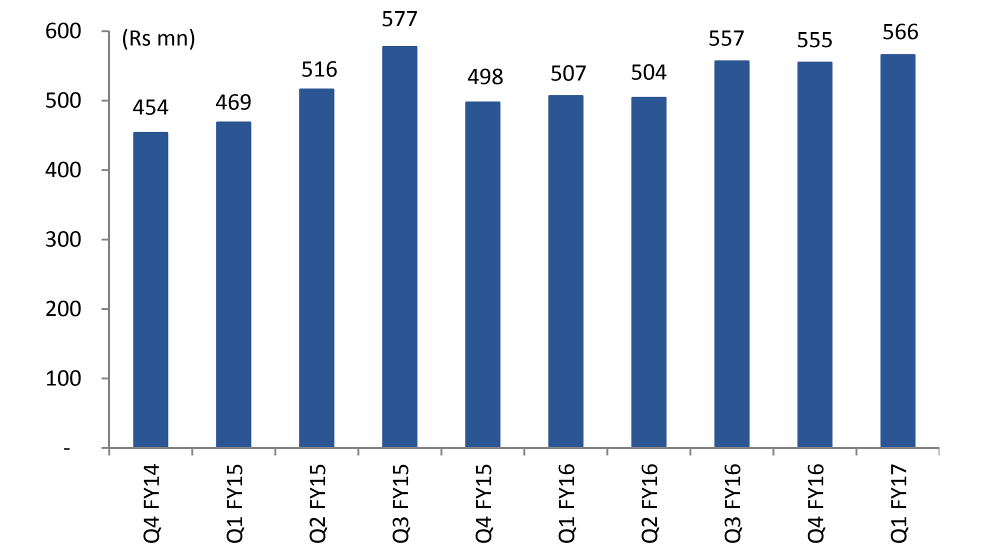
A strong credit evaluation process

AFSL follows a strong risk management process with multiple checks enforced before sanctioning of a MFI loan. The credit sanctioning is carried out at the Head Office as against at the branch level in case of most others MFIs. The group is first formed and the credit information pertaining to all the members of the group is extracted from Highmark, a Credit Information Company (CIC). It is mandatory for all MFIs to share borrower's credit data with CICs like Highmark and Equifax, a move aimed at protecting the MFI industry. The borrowers that pass the credit screening then go through a Group Training, a Group Assessment Test and a Lifestyle Assessment house visit executed at the branch level. Cash flow analysis is done by the field officer. Once the entire process is done, the results are forwarded to the Head Office. The credit department evaluates the reports and calls customers for information verification before loan sanction. Though the centralized credit underwriting process increases TAT by one day compared to competitors, it ensures good quality of the loan book. Also at AFSL, the Branch Manager's incentive is linked to the asset quality and the Field Officer's incentive is based on the numbers of clients acquired and not AUM.

2-wheeler business will continue to grow at steady pace

The 2-wheeler loan portfolio has been growing at a steady pace of 8-10% pa and constitutes ~30% of the overall AUM currently. The business is being originated from five branches (four in Gujarat and one recently opened in Indore) and more than 50 dealer locations. AFSL has developed strong bonds with most dealers that enable it to secure a good share of the business at each location. Quick turnaround time and flexibility offered in repayment terms are key factors that attract customers. The verification and disbursal process is completed on the very same day of loan request, provided all documents are in place. The interest rate charged by AFSL is not among the cheapest in the industry given its higher funding cost. The yields in this business have been under pressure with intensified competition from captive financiers. Management expects this portfolio to grow at 12-15% pa in the coming years aided by cyclical acceleration in industry volume growth and increasing addition in business from the newly opened Indore branch.

Chart 9: 2w AUM has started to grow



Source: Company, IIFL Research

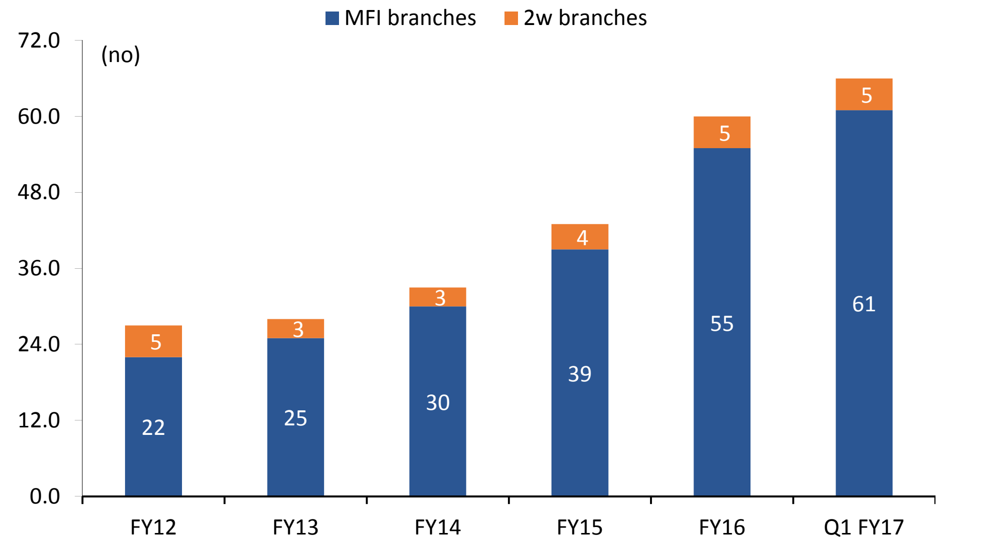
MSME finance in on the verge of a commercial launch

AFSL soon plans to launch its MSME financing product having already initiated pilots at its Godhra (Gujarat) and Indore branches. The above locations were purposely chosen as they have been strong markets for other products of the company. Also, the management wanted to test the product in both rural and urban markets. The MSME financing product has been designed to tap the huge market of loans ranging Rs 50,000-150,000 for customers having an established small business and a good credit track record. The same doorstep collection model has been retained so that field officers are in constant touch with the client. It is an unsecured loan; however the cash flow would be thoroughly evaluated at the household level, credit bureau check of even the spouse would be done and a reasonably margin of safety for instalment servicing would be reserved. Assuming a 3% loan loss, the pilot is being run at an interest rate of 28-30%. Given much higher tickets in this business when compared to 2w financing and MFI loans, the management intends to build a portfolio gradually. This will diversify AFSL's AUM base in the longer term which is very crucial.

Rapid branch expansion in MFI business

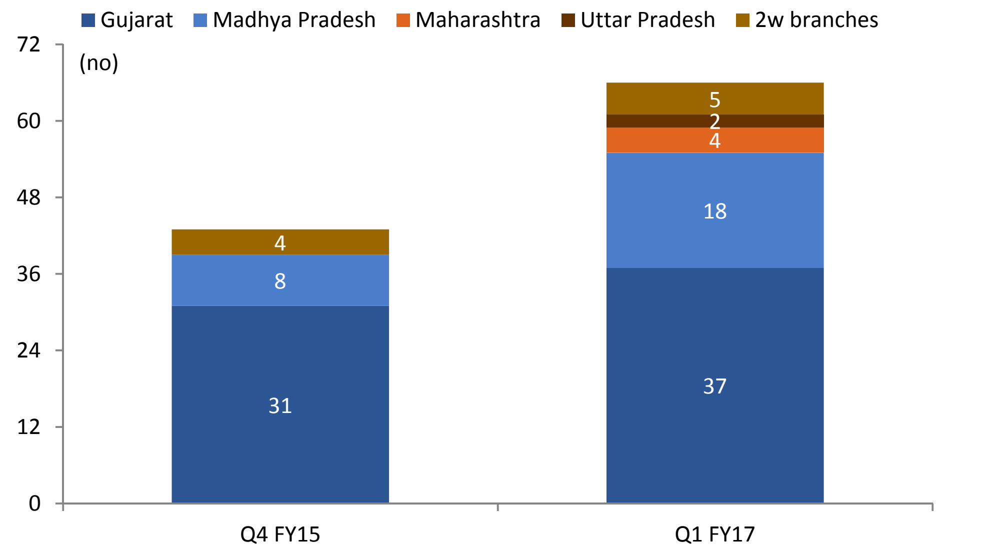
With a quest for growth and regional diversification, AFSL has been on a branch addition spree in the MFI business since FY13. The branch count has grown 2.4x, standing at 61 at the end of Q1 FY17. While initially the company penetrated Gujarat, over the past couple of years the focus has been on entering large under-penetrated markets. In FY16, bulk of the branch addition was towards establishing a strong foothold in Madhya Pradesh. During Q1 FY17, the company has entered Maharashtra and UP by opening 4 and 2 branches respectively. AFSL intends to have a branch count of more than 10 in each of these states by end of the current fiscal. Within Maharashtra, the company is targeting the north-west belt and in UP, the focus is on central UP (around Lucknow) and North UP (around Saharanpur). Microfinance penetration in both these states is much lower than the industry average at 15.3% and 7.3% respectively. The company is focussing on expansion in rural and semi-rural areas, with over 80% of the AUMs in those areas. In 2w financing, only one branch has been added in the past 15 months as the business is largely driven from dealer locations.

Chart 10: Significant addition in MFI branches post FY13



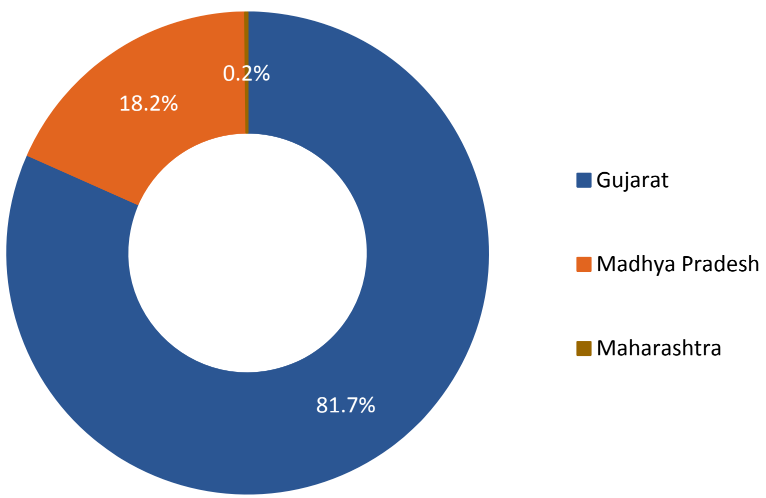
Source: Company, IIFL Research

Chart 11: Branch expansion into newer territories



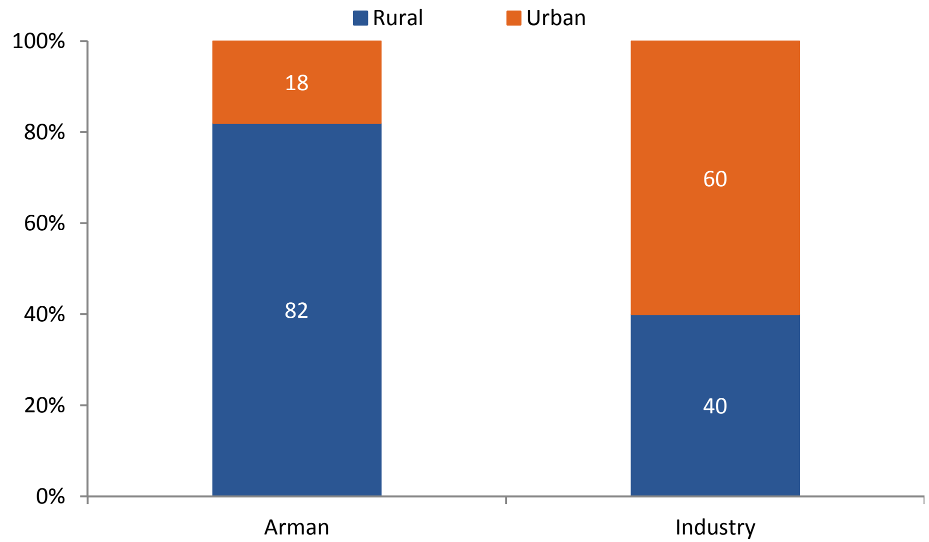
Source: Company, IIFL Research

Chart 12: AUM concentrated in Gujarat and MP currently



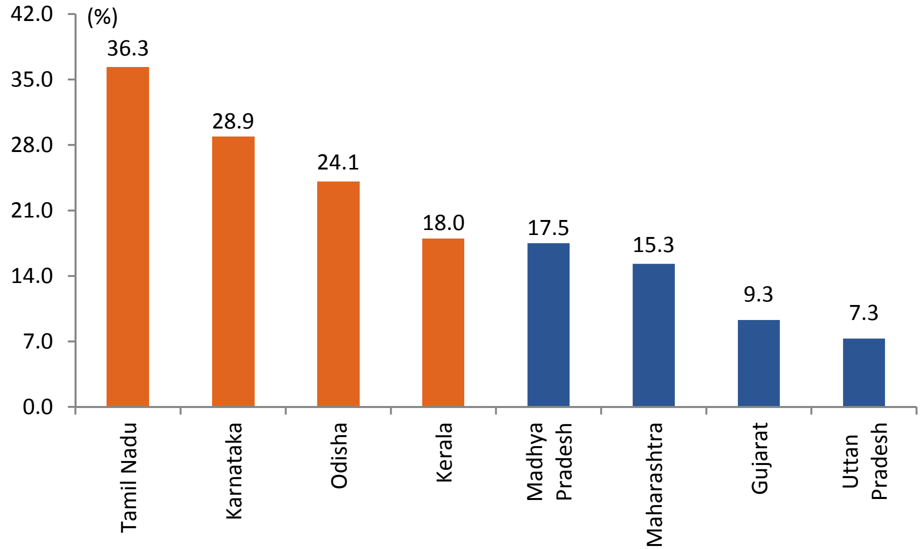
Source: Company, IIFL Research

Chart 14: AFSL remains a rural focussed MFI



Source: Company, IIFL Research

Chart 13: Arman operates in relatively under penetrated MFI markets

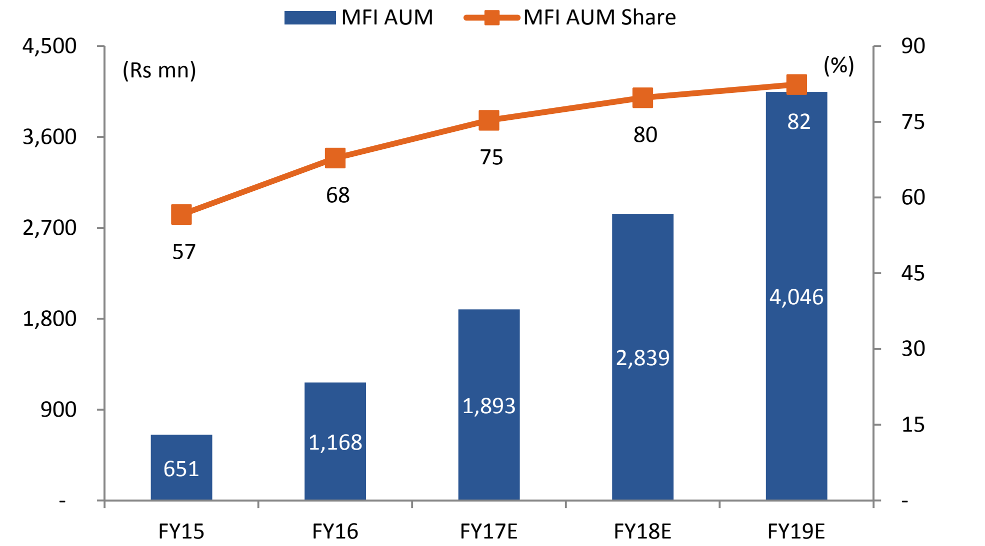


Source: MFIN, Population –http://www.indiaonlinepages.com, IIFL Research

Robust AUM growth should continue

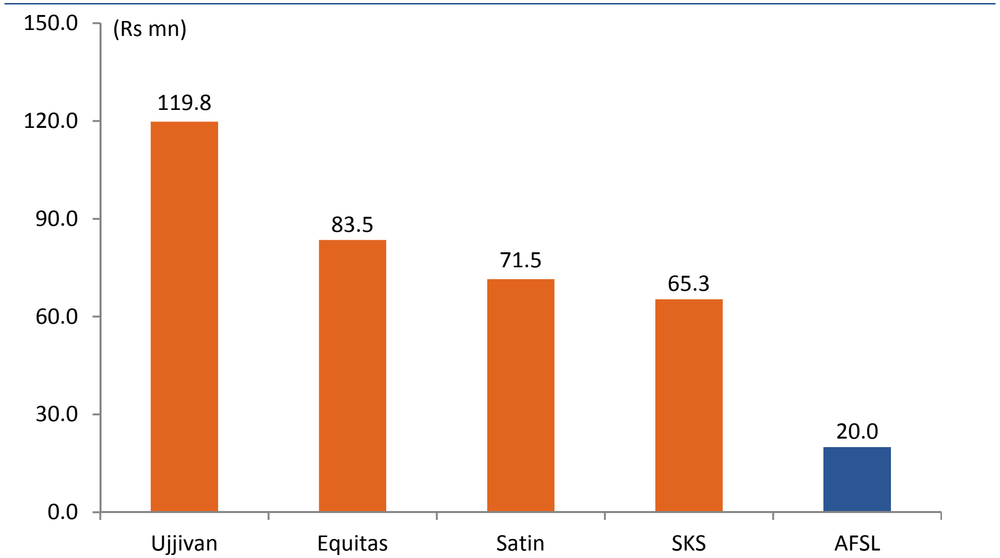
We expect AFSL's consol. AUM to grow by a brisk 42% pa over FY16-19. This would be underpinned by robust 51% CAGR in MFI AUM and an improved 16% CAGR in the asset base of the parent. The latter would be driven by cyclical growth acceleration in 2w financing and a gradual construction of the MSME portfolio. In the MFI business, substantial branch addition, improving maturity of newly added and young branches, further increase in ticket sizes and incremental lengthening of portfolio duration would be the growth drivers. The average AUM/branch in the MFI segment currently stands at just above Rs20mn, which implies a low capacity utilization given that a branch can reach Rs50-60mn of business, as is the case with company's matured branches in Gujarat. The share of MFI AUM in the consol AUM is estimated to increase further and reach 82% by FY19. By the end of FY17, the management expects consol AUM at Rs2.6-2.7bn and aspires to reach Rs8bn by 2020.

Chart 15: MFI AUM to lead overall AUM growth



Source: Company, IIFL Research

Chart 16: Low Avg. AUM/Branch for Arman offers scope for better utilization

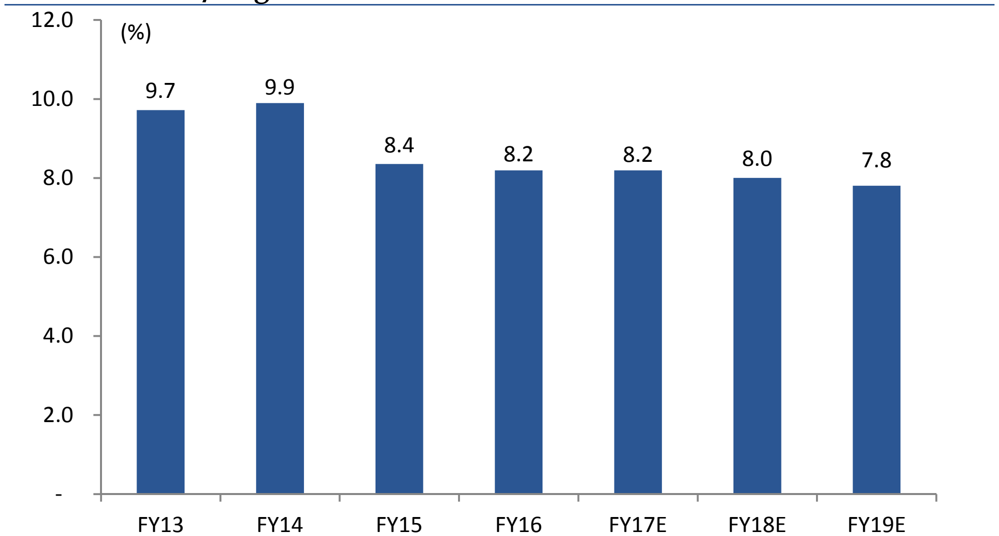


Source: MFIN, Company, IIFL Research

Opex/Avg. AUM has improved despite branch expansion

Opex/Avg. AUM has improved significantly since FY14 in spite of the significant investments made in augmenting branch network. The ratio has come off from 9.9% in FY14 to 8.2% in FY16. This trend is particularly encouraging and represents shortening cycles for operational breakeven and profitability turnaround of the new branches. Material increase in the average loan tickets has aided here, as the number of clients required to reach the break-even point is lesser. For instance, based on the current disbursement tickets, a branch can achieve operational break-even with around 600 clients as against the need of ~800 customers more than a year ago. As per the management, a new branch can reach a base of 600 customers in 6-9 months depending on its location. Currently, most branches in Gujarat and more than 60% of the branches in Madhya Pradesh are profitable. It is likely that incremental gains on cost productivity would be gradual in the next couple of years as AFSL continues to aggressively invest in developing newer markets. Efficiency gains will accrue when the company moves from cash disbursements to a cashless model by transferring loan amounts directly into the bank account of the borrowers. This might allow field officers to conduct more centre meetings in a day.

Chart 17: Cost/Avg. AUM will continue to trend lower



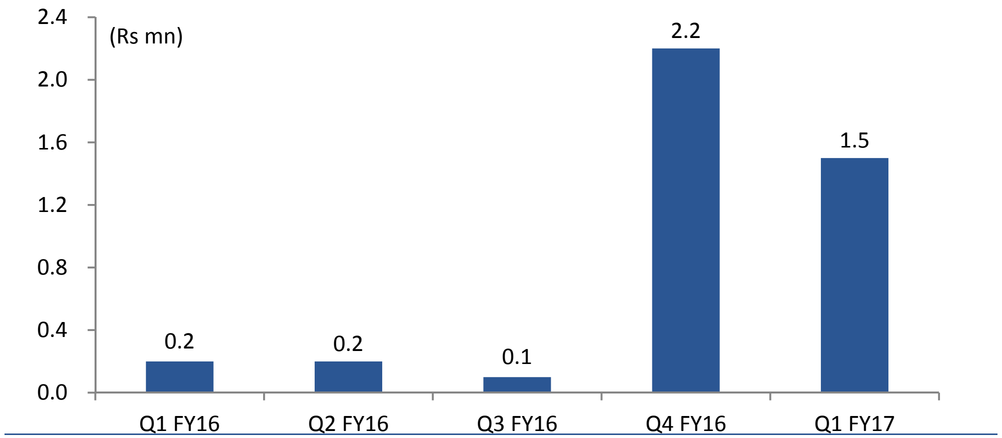
Source: Company, IIFL Research

Credit cost will increase over FY16-19

In 2w financing business, asset quality has deteriorated in the past couple of years on account of a stressed rural economy. Also, the regulatory shift from 180 dpd to 150 dpd NPL recognition increased NPL levels during FY16. While migration to 90 dpd NPL recognition by FY18 would further raise NPL levels, inherent credit trends of the portfolio may improve on account of an anticipated recovery in rural economy driven by satisfactory monsoon and government initiatives.

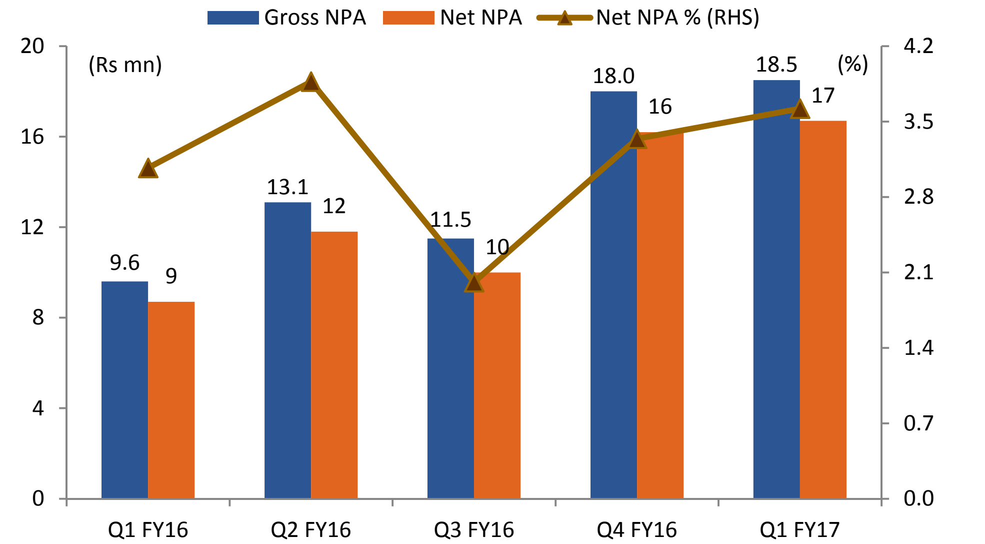
Asset quality trends in AFSL's MFI business has been quite benign so far, as is also seen across the industry. While the development of credit bureaus and credible discipline maintained by MFI players has structurally helped, the aggression shown by some private banks recently is a cause of concern. Also adherence of the 2 MFI loans per borrower regulation by the converting SFBs remains uncertain. All this may lead to some increase in delinquencies for the industry in future. High portfolio concentration is an additional risk for AFSL as the impact of any local or a district level event will be high. Even the management expects credit cost to gradually move towards 1% in the MFI business. Taking this into account and the impact of migration to early NPL recognition in the 2w business, we have assumed a material increase in consol. credit cost over FY16-19.

Chart 18: Low Gross NPLs in MFI segment



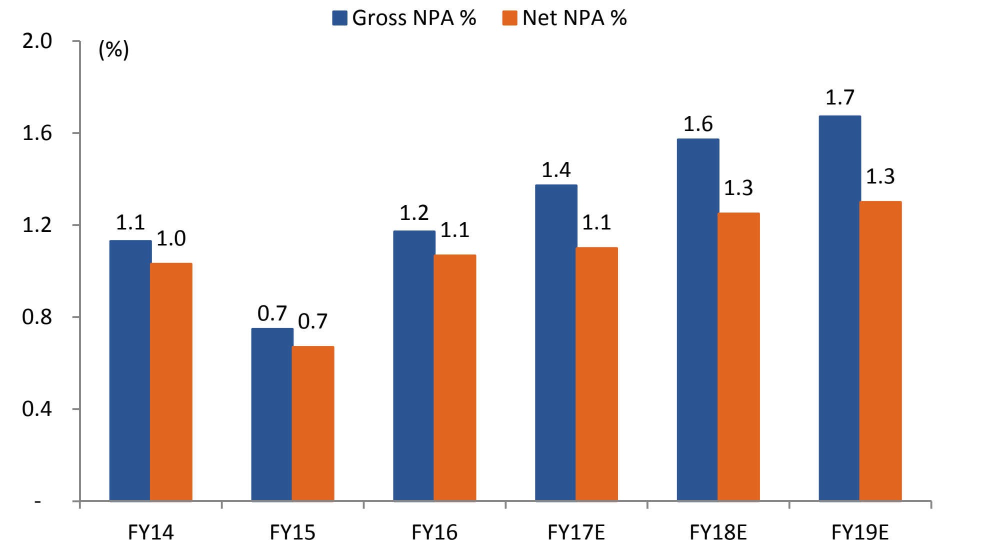
Source: Company, IIFL Research

Chart 19: Gross NPA levels rise in the 2-w segment



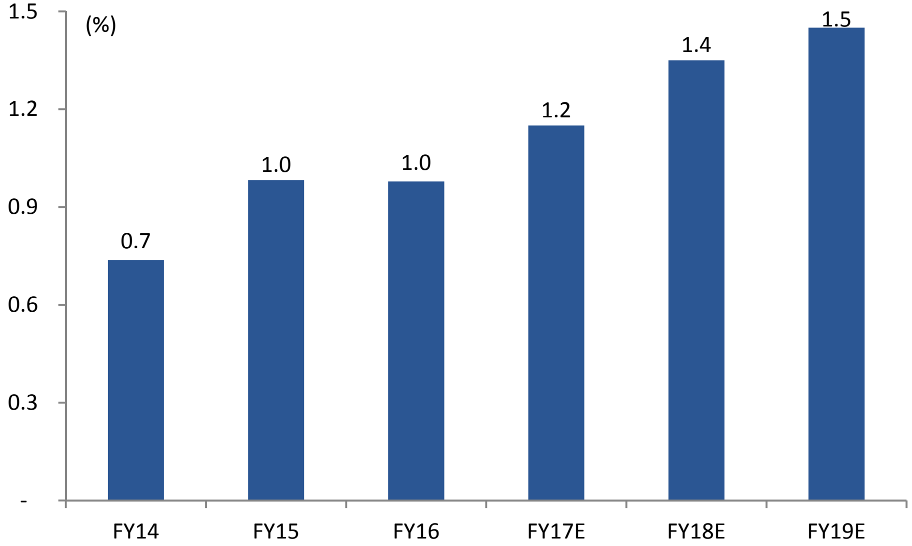
Source: Company, IIFL Research

Chart 20: Consol. Gross NPA levels (MFI+2w) will inch up



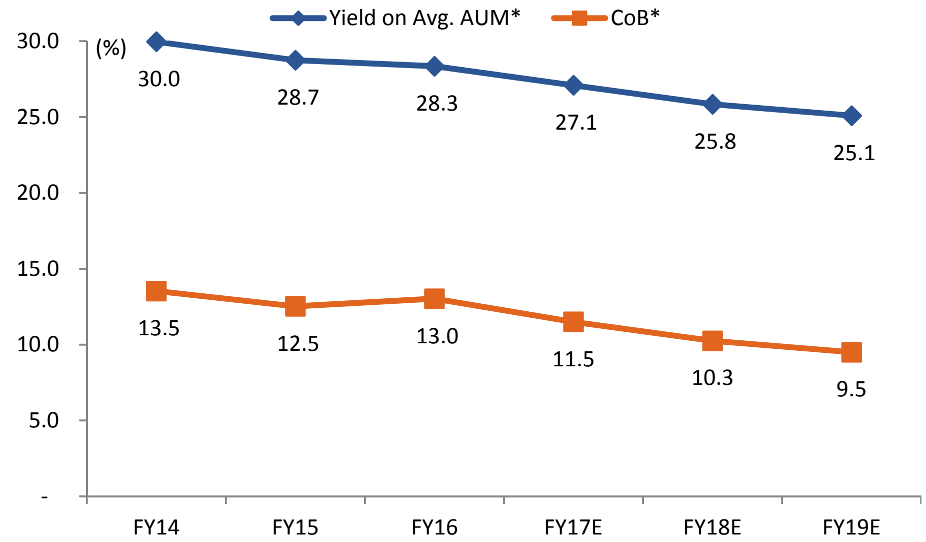
Source: Company, IIFL Research

Chart 21: Credit cost to rise, but remain within manageable levels



Source: Company, IIFL Research

Chart 22: Yields to mimic the drop in cost of borrowings

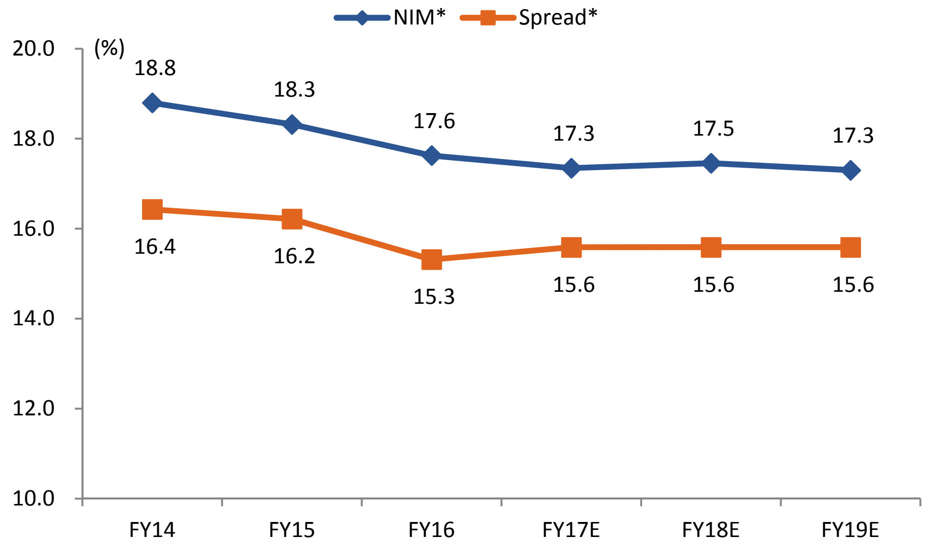


*Source: Company, IIFL Research, *calculated*

Spread and NIM to remain stable; capital raise likely in early FY18

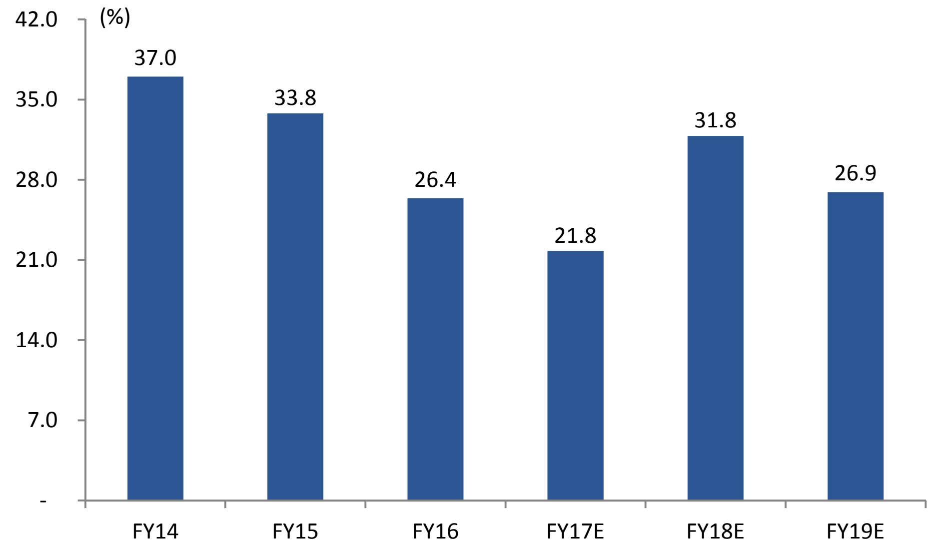
Cost of funding for AFSL has been on the decline. It has fallen by 100bps since March 2016 and is likely to moderate further over the medium term on account of a) improvement in credit rating to BBB in August 2016 and b) improved availability of bank funding. Earlier, the company was heavily reliant on Financial Institutions from whom the funds were coming at a higher cost. The recent upgrade in the credit rating has come on the back of strong growth in the consolidated loan portfolio, sustained high profitability and gradual diversification of operations. With growth momentum and progress on portfolio diversification to continue and a likely augmentation of equity in early FY18, the credit rating of AFSL could get enhanced in the next year also. This should enable the company to maintain a healthy spread notwithstanding shift to lower rates for MFI loans and persistence of yield pressure in the 2w segment. With CAR at ~23% on consol basis, AFSL seems adequately capitalized to drive a brisk portfolio growth in the near term. To continue the growth momentum in FY18/19, the company intends to raise capital in the coming 6-12 months. We believe that AFSL could raise Rs.400-500mn by diluting 20-25% equity.

Chart 23: Consequently, spreads to remain stable over FY16-19



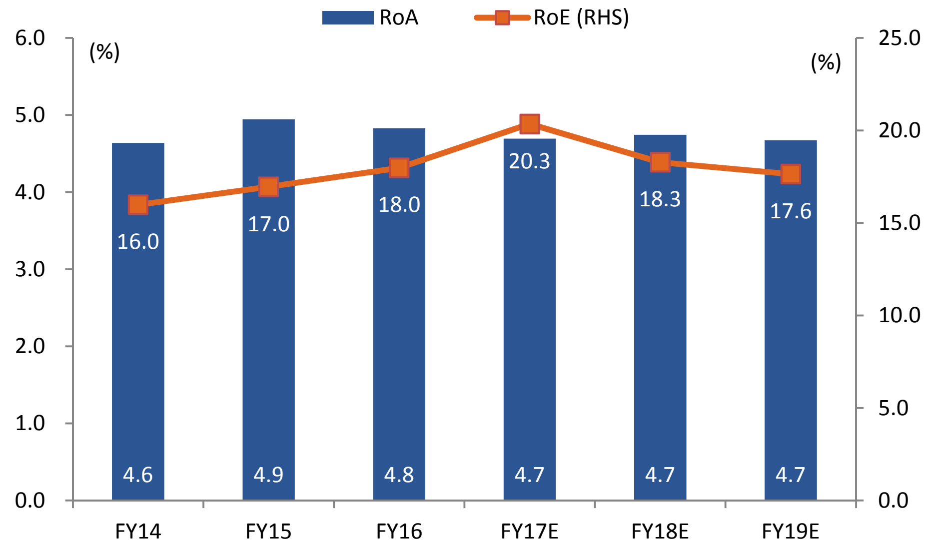
*Source: Company, IIFL Research, *calculated*

Chart 24: Consolidated Tier I Ratio will rise post capital raising in FY18



Source: Company, IIFL Research

Chart 25: Return ratios to remain strong



Source: Company, IIFL Research

Strong profitability and attractive valuation; initiate with BUY

AFSL has been able to deliver strong RoAs and RoEs driven by high core operating profitability and low credit costs. We believe that ROA delivery is unlikely to change in the coming years notwithstanding a likely increase in the credit cost. The impact of the latter would be largely negated by gradual gains on the cost productivity front as strong asset growth continues. RoEs should touch 20% even on conservative leverage levels of 5x. In this context, we believe that AFSL's valuation is quite attractive at 1.4x FY19 P/ABV. Initiate coverage with a BUY rating and 12-month price target of Rs350.

Financials

Balance sheet

Y/e 31 Mar (Rs mn)	FY16	FY17E	FY18E	FY19E
Equity Capital	69	69	84	84
Preference Capital	50	50	50	50
Reserves	385	478	1,049	1,238
Shareholder's funds	**455**	**548**	**1,133**	**1,322**
Long-term borrowings	458	707	905	1,349
Other Long-term liabilities	0	0	0	0
Long term provisions	3	4	5	6
Total Non-current liabilities	**461**	**711**	**910**	**1,355**
Short Term Borrowings	334	516	660	984
Trade payables	0	0	0	0
Other current liabilities	619	956	1,223	1,823
Short term provisions	35	45	59	76
Total Current liabilities	**987**	**1,517**	**1,942**	**2,883**
Total Equities and Liabilities	**1,953**	**2,825**	**4,036**	**5,610**
Assets				
Fixed Assets	19	23	28	34
Non-current investments	14	17	20	24
Deferred tax assets (Net)	4	5	8	12
Long-term loans and advances	263	383	542	748
Other non-current assets	68	88	114	148
Total Non-current assets	**367**	**516**	**713**	**967**
Trade Rec. under loan contracts	20	26	33	43
Cash and cash equivalents	107	155	276	443
Short-term loans and advances	1,459	2,128	3,014	4,157
Other current assets	0	0	0	0
Total Current assets	**1,585**	**2,309**	**3,323**	**4,643**
Total Assets	**1,953**	**2,825**	**4,036**	**5,610**

Income statement

Y/e 31 Mar (Rs mn)	FY16	FY17E	FY18E	FY19E
Income from Operations	407	574	785	1,063
Interest expense	(154)	(206)	(255)	(330)
Net interest income	**253**	**367**	**530**	**733**
Non-interest income	0	0	0	0
Total op income	**253**	**367**	**530**	**733**
Total op expenses	(118)	(174)	(243)	(330)
Op profit (pre-prov)	**135**	**194**	**287**	**402**
Provisions	(14)	(24)	(41)	(61)
Profit before tax	**121**	**170**	**246**	**341**
Taxes	(41)	(57)	(83)	(115)
Net profit	**80**	**112**	**163**	**225**

Key Ratios

Y/e 31 Mar (Rs mn)	FY16	FY17E	FY18E	FY19E
Growth matrix (%)				
Net interest income	34.1	45.2	44.2	38.2
Total op income	34.1	45.2	44.2	38.2
Op profit (pre-prov)	31.9	43.2	48.0	40.1
Net profit	30.5	39.7	45.1	38.5
Advances	49.7	45.9	41.6	37.9
Borrowings	48.1	54.5	28.0	49.0
Total assets	42.4	44.7	42.8	39.0
Profitability Ratios (%)				
NIM	17.6	17.3	17.5	17.3
Return on Avg Equity	18.0	20.3	18.3	17.6
Return on Avg Assets	4.8	4.7	4.7	4.7
Per share ratios (Rs)				
EPS	14.0	19.6	22.7	31.5
Adj.BVPS	84.9	100.7	160.4	184.4
DPS	1.4	2.5	3.0	4.0
Other key ratios (%)				
Cost/Income	46.5	47.2	45.8	45.1
CAR	29.3	25.8	36.0	31.0
Tier-I capital	26.4	21.8	31.8	26.9
Gross NPLs/Loans	1.2	1.4	1.6	1.7
Credit Cost	1.0	1.2	1.4	1.5
Net NPLs/Net loans	1.1	1.1	1.3	1.3
Tax rate	33.9	33.9	33.9	33.9
Dividend yield	0.5	1.0	1.2	1.6

IIFL Wealth Research bags 2 Best Analyst Awards

IIFL Wealth Research has bagged two prestigious awards at the ***Zee Business Market Excellence Awards 2016***.

Prayesh Jain was conferred the Best Analyst Award for Auto sector and **Bhavesh Gandhi** bagged the Best Analyst Award for Pharma sector.

Besides the twin awards, IIFL Wealth Research was also nominated in the categories of Oil/Gas, Banking and Industrials.

IIFL Research, as you know, has always prided itself on its unique value proposition in a swarming market space of cut-throat competition, among other things, on our wealth of actionable ideas, tailored portfolio approach and thorough research in line with client needs and priorities, distinctive practice of following up with Call Success post recommendations and a vast coverage universe of as many as 300 companies (comprising 70% of India's equity mcap).

In the past, the research team has won Zee Biz Awards under different categories; Bloomberg has rated our research as the most accurate, while we have twice been winners of Business Standard Smart Portfolios, having received awards at the hands of luminaries including President Pranab Mukherjee, Prime Minister Narendra Modi and Minister of State Piyush Goyal.

Recommendation parameters for fundamental reports:

Buy = >15%+

Accumulate = 5% to 15%

Reduce = -10% to 5%

Sell = >-10%

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