L&T Finance Holdings Ltd.

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L&T Finance Holdings Ltd.

BSE Code: 533519 **NSE Code: L&TFH** **Reuters Code: LTFH.NS** **Bloomberg Code: LTFH:IN**

Transformation in motion…

L&T Finance Holdings Ltd. (LTFH) is a financial holding company offering a diverse range of financial products and services across retail, corporate, housing and infrastructure finance sectors. It also has presence in asset management and investment management services.

Investment Rationale

- **Strong parentage – a key moat:** LTFH derives significant competitive advantage over peers because of its parentage. It not only enjoys strong backing from the parent but also derives synergy from L&T's industry knowledge in the infrastructure sector. Hence, L&T's extensive domain experience (for its loan underwriting business) and strong brand equity (that helps it to raise funds) provides an edge over peers. L&T holds a controlling stake of 66.7% (as on Q3FY17) in LTFH.

- **Robust and well diversified business model:** Owing to difficult macro-environment and the challenges in large numbers of infrastructure projects and CV/CE segment, the company has been on a course correction path over the past two years. Thus, LTFH has decided to sell/run down less profitable/loss businesses and identified select focus segments which it believes offer strong long-term growth opportunities. It includes three key lending businesses (Rural, Housing and Wholesale), asset management and wealth management.

- **Robust improvement in earnings on the card:** LTFH's RoE is expected to touch 20% mark by FY20E from current level of 10.6% (FY16) mainly led by 1) sell/rundown of the defocused (less profitable) portfolio which includes cars, CE/CV, SME term loans and leases, 2) reducing the risk in wholesale/infra business by focusing more on operational projects which is likely to reduce provisioning 3) delivering industry leading growth in focus segments like micro-finance and housing finance, 4) improving cost to income ratio with increasing productivity, 5) reallocating capital towards more profitable businesses and 6) creating value in the asset management business and increasing fee income from wealth management.

Valuation: After undergoing significant business restructuring in FY16, LTFH has made substantial progress in achieving scale in its focus business verticals. As a result, we expect return ratios (1.9% RoA and 17.2% RoE by FY19E) to show a marked improvement over the next two years. We expect LTFH to deliver a loan growth CAGR of ~15% over FY16-19E which coupled with higher operating efficiency and improvement in credit cost will help in delivering ~24% earnings CAGR for the consolidated entity. We initiate coverage on LTFH with a BUY rating and assign TP of Rs135 (P/ABV of 3.0x for FY19E) valuing it at a premium to its four-year mean (P/ABV of 2.2x for 1 year forward ABV).

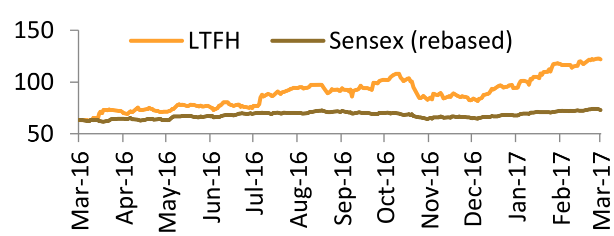
Market Data

Rating	**BUY**
CMP (Rs.)	121
Target (Rs.)	135
Potential Upside	12%
Duration	Long Term
Face Value (Rs.)	10.0
52 week H/L (Rs.)	124/61
Adj. all time High (Rs.)	124
Decline from 52WH (%)	2.6
Rise from 52WL (%)	96.8
Beta	1.8
Mkt. Cap (Rs.Cr)	21,218

Fiscal Year Ended

Y/E	FY16	FY17E	FY18E	FY19E
Net Interest Income (Rs. Cr)	6,605	7,843	8,994	10,448
Pre-Pro Profit (Rs. Cr)	2,034	2,611	3,072	3,580
Net Profit (Rs. Cr)	857	1,013	1,305	1,614
EPS	4.9	5.8	7.4	9.2
P/E (x)	24.7	20.9	16.2	13.1
P/BV (x)	2.9	2.5	2.3	2.2
P/ABV (x)	4.2	3.1	2.9	2.6
ROE (%)	10.6	11.9	14.8	17.2
ROA (%)	1.5	1.5	1.7	1.9

One-year Price Chart



Shareholding Pattern	Dec-16	Sep-16	Chg.
Promoters (%)	66.7	66.7	-
Public (%)	33.3	33.3	-

LTFH is a financial holding company offering a diverse range of financial products and services across retail, corporate, housing and infrastructure finance sectors.

L&T Finance Holdings Ltd. - Company Overview

L&T Finance Holdings Ltd. (LTFH) was incorporated in 2008 and is promoted by the construction major Larsen & Toubro (L&T). LTFH is a financial holding company offering a diverse range of financial products and services across retail, corporate, housing and infrastructure finance sectors. It also has presence in asset management and investment management services through its wholly owned subsidiaries. Further, the company has a strong parentage and a highly-qualified management team which has significant experience in evaluating long-gestation infrastructure projects.

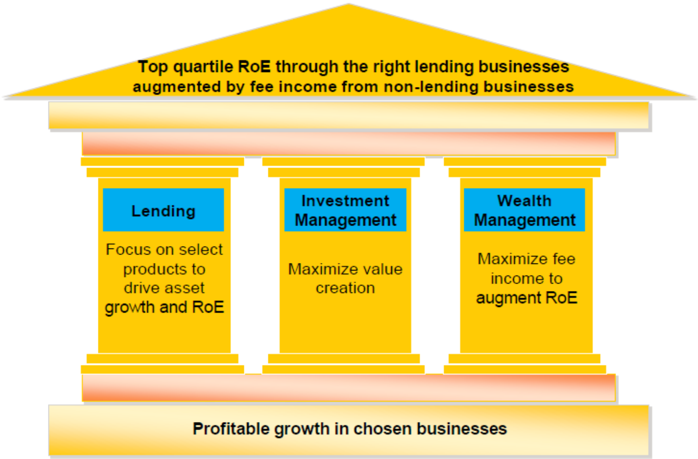
The company has gradually built-up several businesses/product lines through both organic and inorganic route over the past few years. LTFH has identified select segments to grow its loan book— Housing finance, Tractor, Two-wheeler and Microfinance in the retail business and roads, renewable energy projects in the wholesale segment.

Sell down of unprofitable businesses to improve profitability

LTFH has articulated its new business strategy in FY17 wherein it will exit the segments which are earning sub-optimal returns. Hence, in 9MFY17, the company reported 39% YoY decline in de-focused portfolio which includes CV (commercial vehicle), Cars, CE (commercial equipment), Leases and SME (small and medium enterprise) Term Loans. De-focused segments currently account for 5.1% (Q3FY17) of the advances. The defocused segment reported negative RoE of 25.3% in 9MFY17 thus dragging the overall RoE of the consolidated business. However, the management is looking to run down or sell the defocus businesses and will churn some of the wholesale assets to Infrastructure Debt Funds (IDF). We believe this strategy of moving away from long term SME and CV/CE financing is a step in the right direction as it will reduce business cyclicality and improve RoE.

Focus on select products to help achieve top quartile RoE

LTFH has gradually built-up several businesses/product lines through both organic and inorganic route over the past few years. However, the company has now identified lending, investment management and wealth management as the three main pillars of business growth.



Source: Company, In-house research

Further, the company has redefined its lending business strategy to focus on nine distinct lending products across three business verticals viz. wholesale, housing and rural. This will drive asset growth and help company in achieving top quartile RoE of 20% by FY20.

Reclassification of focused businesses and products

Rural Business	Housing Business	Wholesale Business
• Microfinance	• Home Loans	• Infra Finance
• Two Wheeler Finance	• LAP	• Structured Corporate Finance
• Farm Equipment	• Real Estate Finance	• Supply Chain Finance

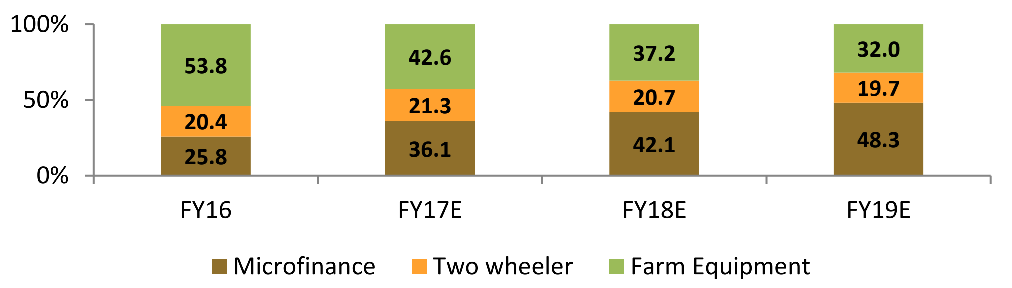
Source: Company, In-house research

Realignment of rural business to drive higher profitability

In a strategic move, the company has trimmed the number of lending products under rural business based on its analysis of competitive positioning, scalability and profitability. As a result, LTFH has identified microfinance, two-wheeler and tractors (farm equipment) as the key product segments. Further, the company has decided to de-emphasize its small and light commercial vehicles (SCV/LCV) and car loans businesses. Hence, the company has primarily shifted its focus in lending to income generating assets across rural areas.

Further, to mitigate the risk in the rural segment, loan origination and collection in the consumer, auto finance and microfinance businesses have been migrated completely to mobility solutions. Under mobility solutions, loan origination is carried out through tablets/mobile handsets that aim to drive sales effectiveness by reducing the turnaround time (TAT). Collections are also carried out through mobile phones, coupled with thermal bluetooth printers to issue receipts. Further, mobile based rule engine has also been developed to improve TAT and approval rate with minimal the chance of errors.

Rural Finance - Loan Composition / Product Mix



Source: Company, In-house research

Growth momentum to continue in microfinance business

It is the most profitable business with ~30%+ of RoE for the company. Further, the loan book also grew at a robust pace of 141% YoY (albeit on a low base) in FY16. Under microfinance business, the company offers micro loans through a joint liability group model. This business is currently operational in eight states of India - Tamil Nadu, Karnataka, Maharashtra, Gujarat, Orissa, West Bengal, Madhya Pradesh and Kerala and likely to enter in the state of Uttar Pradesh in FY17. Moreover, the company is ahead of the curve as it had fully implemented cashless disbursement for its customers even before demonetisation. Hence, the company had minimal impact on its business and the loan book increased 86% YoY in 9MFY17. Further, the company is planning to migrate to Aadhaar linked biometric technology for cashless disbursements. Going forward, we expect growth momentum to continue and project loan book to grow at a robust CAGR of 50% over FY17-19E.

Increasing market share in two-wheeler business

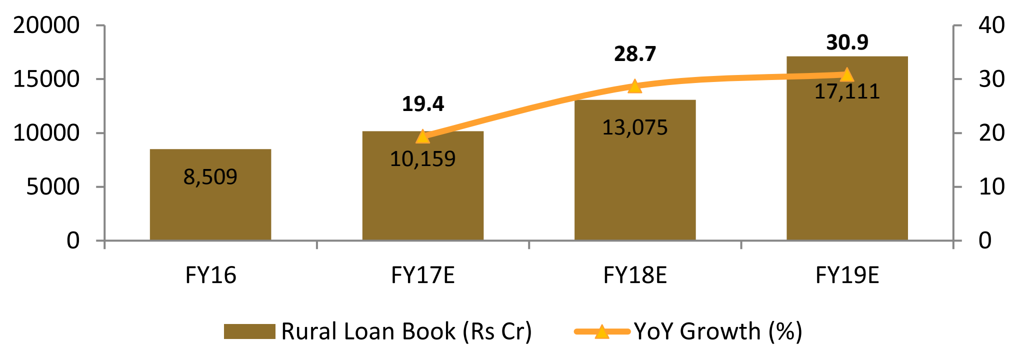
LTFH entered the two-wheeler financing space after acquisition of Family Credit in FY13. The company has since reported strong growth in the segment. While the industry volume increased at a moderate pace of 3% YoY during FY16, the book size of LTFH grew strongly by 24% YoY (↑18% YoY in 9MFY17), resulting in an increase in market share. This superior performance was driven by better penetration in existing locations as well as active efforts to reach new markets. The company currently ranks amongst top 5 two-wheeler financiers with 10% market share which it aims to increase to ~15% over next 1-2 years. Hence, we expect loan book to grow at a strong CAGR of 25% over FY17-19E.

Better monsoon to back gradual improvement in farm equipment business

This business continuous to reel under stress due to weakness in rural economy post two consecutive draughts in FY15 and FY16. Consequently, the farm equipment business (tractor) reported 9% YoY decline in 9MFY17 and 12% YoY in FY16. As a result, the company's market share of tractor financing declined from the peak level of 10-11% to 7% in Q3FY17. However, to counteract this, the company started focusing on financing pre-owned tractors and refinancing opportunities. Going forward, we expect gradual improvement in this business on the back of good monsoon this year and project 13% CAGR in loan book over FY17-19E.

Overall, we believe that strong growth momentum to continue in rural business and project 26% CAGR in loan book over FY16-19E.

Trend in loan growth of rural finance



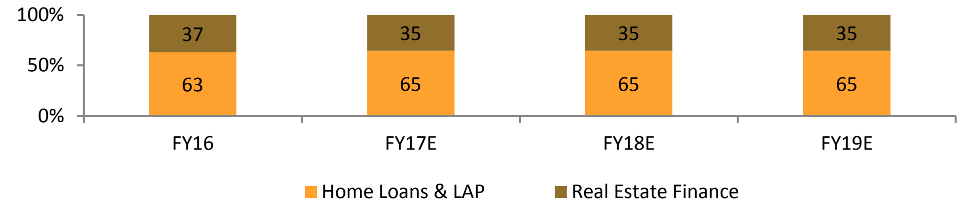
Source: Company, In-house research

Housing business - another growth engine

LTFH entered the housing finance space with the acquisition of Indo-Pacific Housing Finance in 2012. Its business got a boost when it acquired the housing portfolio of CitiFinancial in 2014. Further, the company has been scaling up the business by increasing its geographical spread (44 locations) as well as by increasing market share in the existing markets. Hence, loan book for retail and construction business grew at a stellar 78% and 108% YoY, respectively in FY16. Likewise, loan disbursements in the retail business grew by 62% YoY while that of construction business grew by 149% YoY.

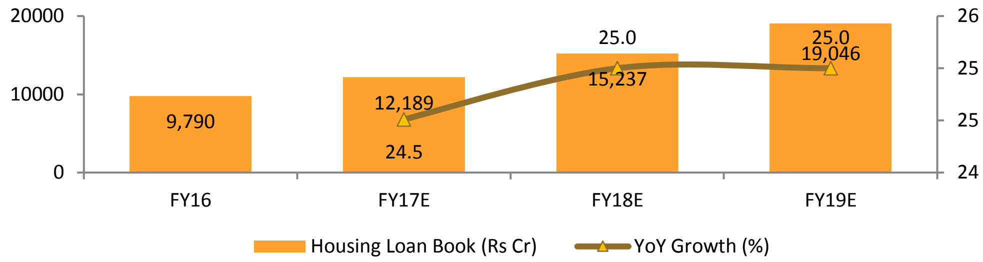
Overall, the company reported 34% YoY growth in loan book in 9MFY17 largely led by home loans & LAP (↑36% YoY) segment. Although the company witnessed short term negative impact of demonetization on the business, the management expects to regain growth momentum gradually over the next 1-2 quarters. We expect housing finance business to be one of the key growth driver for the company going forward. Hence, we estimate loan book to grow at a CAGR of 25% over FY16-19E.

Housing Finance - Loan Composition / Product Mix



Source: Company, In-house research

Trend in loan growth of housing finance



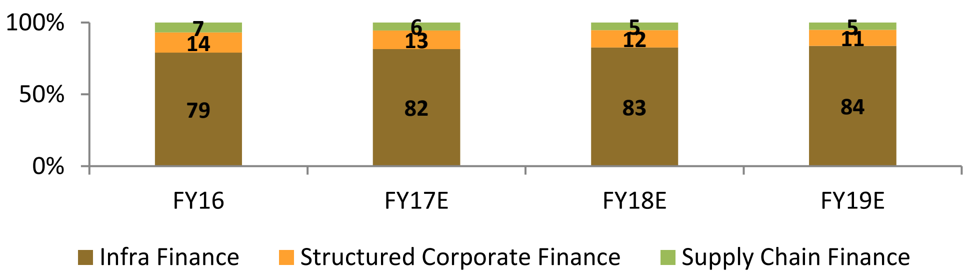
Source: Company, In-house research

Strategic shift in product mix to strengthen wholesale finance business

LTFH entered the wholesale finance segment in 2006 with the objective of lending to key infrastructure development projects with a focus in power, telecom, roads, water and oil & gas sectors. The company was awarded the PFI (Public Financial Institution) status and an IFC (Infrastructure Finance Company) status by RBI which enables it to access low cost long-term funds and also at the same time allows it to take higher exposure while lending.

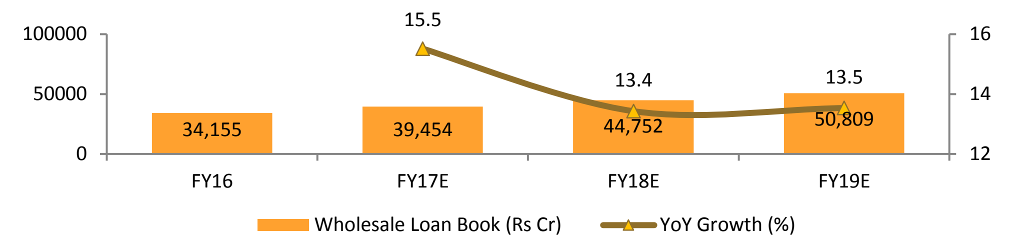
The wholesale finance business comprises of infrastructure and non-infra wholesale financing. The company's wholesale business witnessed pressure over the last three years due to slowdown in infrastructure sector. Hence, the company has tweaked its business strategy to de-risk its wholesale business by focusing more on relatively low-risk renewable energy and road projects. Further, the company intends to increase proportion of operational projects in the total loan assets to contain portfolio risk. As a result, the share of operating projects in its portfolio has increased to 61% in FY16 as compared to 21% in FY11. Moreover, LTFH is looking to aggressively grow its Infrastructure Debt Fund (IDF) to benefit from lower funding cost (as IDF is an AAA-rated entity), tax exemptions and lower risk weight (reduction available on the operational projects), thus freeing up its capital. Thus, we expect wholesale finance to deliver loan CAGR of 14% over FY16-19E (impacted by rundown of defocused products) driven by transmission, renewable energy and roads sectors.

Wholesale Finance - Loan Composition / Product Mix



Source: Company, In-house research

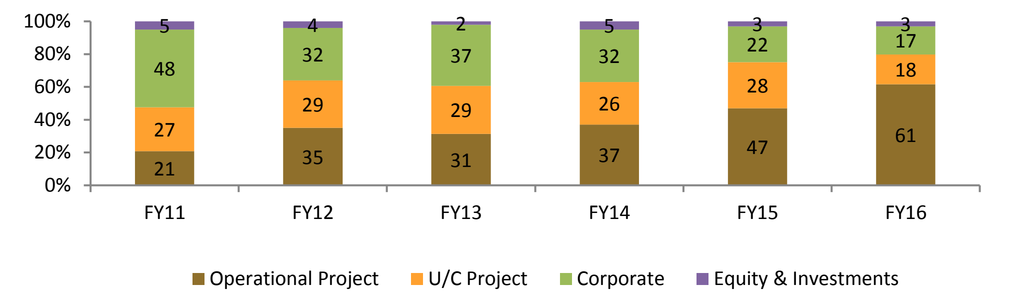
Trend in loan growth of wholesale finance



Source: Company, In-house research

The wholesale finance business has evolved from being a corporate lender to a specialised project financier and has shifted focus to operating projects to balance the overall risk of the portfolio.

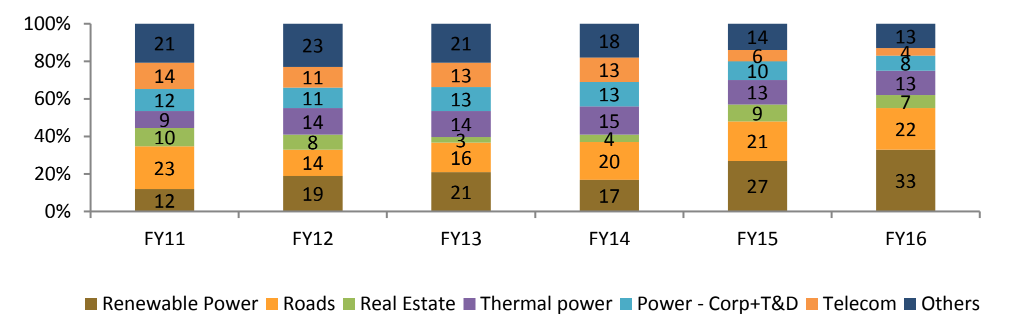
Shifting focus to operating projects from corporate lender



Source: Company, In-house research

The business has also emerged as a leading financier in the renewable energy and road sector as is visible in the chart below.

Sector-wise composition - Increasing composition of renewable energy



Source: Company, In-house research

Investment management & wealth management business gaining strong traction

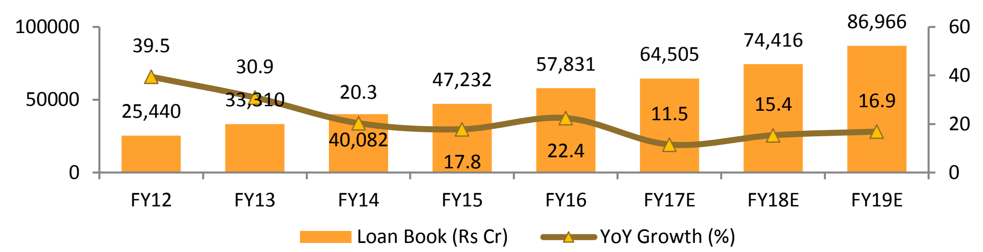
The Company's Investment Management business is carried out by L&T Investment Management Ltd. (LTIM), its wholly owned subsidiary. The average assets under management grew by 15% YoY to Rs25,945cr in FY16 mainly led by equity assets (↑21% YoY). This was achieved through a combination of consistent fund performance, building scale in existing product offerings and improving acceptance in various distribution channels. Hence, we expect contribution of fee income to increase from investment management and thus aid in RoE expansion.

The Company's Wealth Management business is carried out through L&T Capital Markets Ltd. (LTCM), its wholly owned subsidiary, offering services to Ultra High Net Worth (UHNI) and High Net Worth (HNI) individuals. It is present in 9 locations, including Dubai. The business has been progressing well, led by a robust model built on the fundamental tenets of client centricity, intellectual property and execution efficiency. The average assets under service grew by 33% YoY to Rs9,315cr in FY16. We expect wealth management to contribute positively going forward to profitability as it has achieved breakeven in Q2FY17.

Consolidated loan book to grow at 15% CAGR over FY16-19E

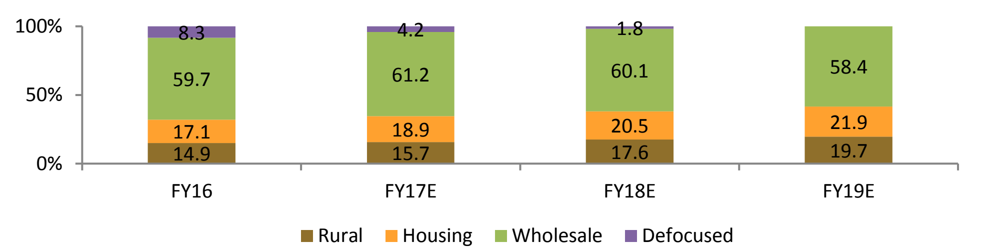
LTFH has reported a strong 26% CAGR in consolidated loan book over FY11-16 driven by diversified product portfolio as well as acquisition of number of companies. In CY12, the company acquired Indo Pacific Housing Finance to foray into housing finance and Family Credit to enter into two-wheeler financing. Further, LTFH acquired CitiFinancial's housing finance portfolio worth Rs700cr in FY14 to achieve scale in housing finance. Going forward, we expect LTFH to deliver industry leading growth in microfinance and housing verticals while wholesale vertical is expected to report steady growth (impacted by rundown of defocused portfolio) leading to 15% CAGR in consolidated loan book over FY16-19E.

AUM to grow at 14.6% CAGR over FY16-19E



Source: Company, In-house research

Changing business mix in favour of retail

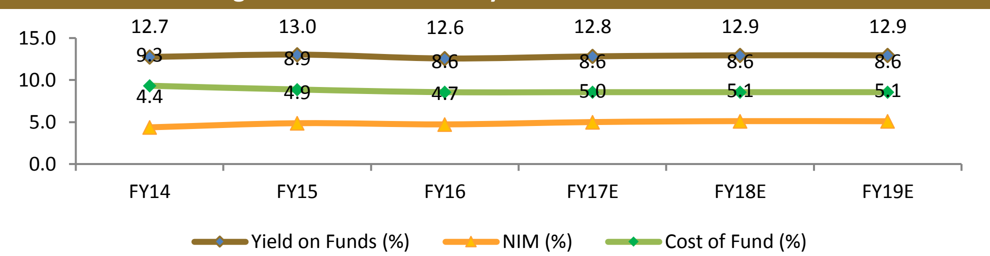


Source: Company, In-house research

Margins to broadly remain stable

While margin in the rural business is likely to remain high, wholesale business margin is expected to remain under pressure given the increasing share of low yielding operational projects. Hence, we expect LTFH's margin to remain largely stable at current level of 5.0% over FY16-19E.

Margins to remain relatively stable at 5% over FY16-19E



Source: Company, In-house research

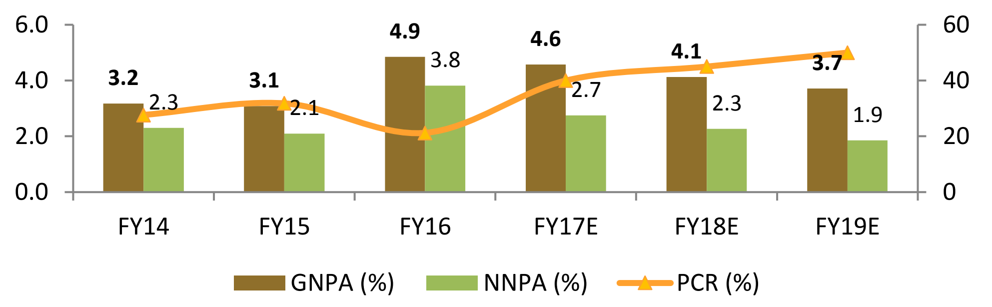
Cost to Income (C/I) ratio to improve significantly with improving productivity

Under the management's new strategy, we expect C/I ratio to decline significantly from 39% in FY16 to 33% in FY19E. To achieve this, the company has taken various steps: (1) automation and digitalisation of various processes under mobility solutions, (2) reduction in workforce in both the branches and head-office, (3) optimization of office space and (4) increased focus on mobile branches (low cost).

Asset quality restoration on track

LTFH's asset quality has been on a restoration path after suffering deterioration during FY11-FY16. Thus, gross NPA ratio has remained broadly stable at 4.9% as of Q3FY17 which is similar to FY16 level. However, the provision coverage ratio (PCR) improved significantly from 21% in FY16 to 36% as of Q3FY17 which helped Net NPA ratio to improve to 3.1% as of Q3FY17 as compared to 3.8% in FY16. LTFH has moved to 120 days past due (dpd) recognition of assets except for housing finance business which is already at 90 dpd. However, we believe transition to 90 dpd for rest of the portfolio will not have any significant impact on asset quality of the company due to lower delinquencies in the focus segments. Further, as per the management, income reversals based on 90 days will be done in FY17 itself however reporting of Gross/Net NPA is likely to happen only in FY18. We expect gross NPA ratio to improve to 3.7% by FY19E as we expect NPA formation to subside while the PCR is also likely to improve to 50% during the similar period.

Asset quality ratios to improve over FY16-19E

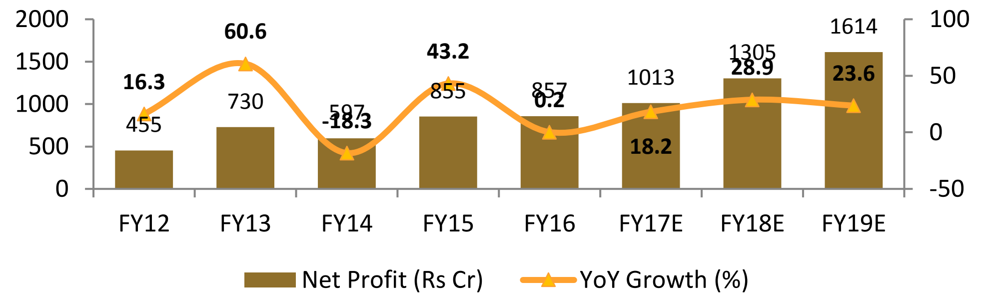


Source: Company, In-house research

Consolidated earnings to grow at 24% CAGR over FY16-19E

Profitability remained under pressure in FY16 due to change in business strategy, lower NIM and higher credit cost. However, we expect consolidated PAT to grow at a 24% CAGR over FY16-19E driven by strong business growth coupled with reduction in operational as well as credit cost.

Earnings to grow at a CAGR of 24% over FY16-19E



Source: Company, In-house research

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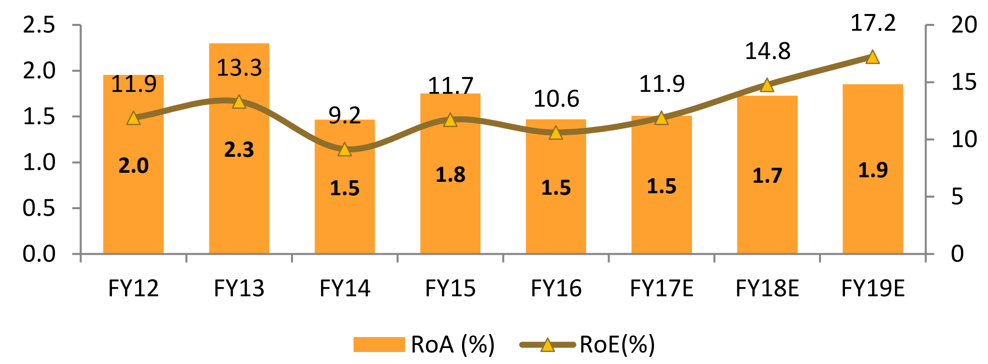
Focus on execution to drive RoE

LTFH's RoE remained subdued (10-12%) over FY14-16 mainly due to 1) losses in defocussed portfolio driven by higher delinquencies 2) high operating cost especially in housing finance and family credit business and 3) zero contribution to profitability from investment management subsidiary. However, we believe return ratios should improve meaningfully hereon as LTFH has put forth a very clear execution plan including quarter to quarter milestones for achieving top quartile RoE. Further, the company is on its track to achieve top quartile ROE driven by a sharp focus on cost optimisation, reallocation of capital towards focused businesses and creating Centres of Excellence (CoE) in the chosen areas. Moreover, the company aims to augment its lending income with higher share of fee income from both lending and non-lending businesses. Hence, we expect ROEs to improve by 530 bps to 17.2% by FY19E.

RoE to expand by 530 bps to 17.2% by FY19E



Source: Company, In-house research

Key Risks:

- **Asset quality risks in rural portfolio:** Higher-than-expected delinquencies in LTHF business, particularly the farm equipment portfolio which has so far shown strong resilience despite headwinds which the industry is facing, could impact earnings and our valuations.
- **Regulatory changes could impact profitability:** LTHF was impacted by regulatory changes in the microfinance segment and had to make significant provisions on its Andhra Pradesh portfolio. Any significant change in regulations (related to exposure, LTV, lending rates or capital requirements) could significantly impact the company's profitability.
- **Delays in scaling up business segment:** Inability to scale-up its microfinance and two wheelers portfolios, which are the key growth drivers in rural finance would cap the expected expansion in RoE.

Profit & Loss Account (Consolidated)

Y/E (Rs. Cr)	FY16	FY17E	FY18E	FY19E
Interest Income	6,605	7,843	8,994	10,448
Interest Expense	4,124	4,786	5,444	6,334
Net Interest Income	**2,481**	**3,057**	**3,550**	**4,113**
Non Interest Income	866	936	1,081	1,264
Net Income	**3,347**	**3,994**	**4,631**	**5,377**
Operating Expenses	1,313	1,382	1,558	1,797
Total Income	**7,471**	**8,780**	**10,074**	**11,712**
Total Expenditure	**5,437**	**6,168**	**7,002**	**8,131**
Pre Provisioning Profit	**2,034**	**2,611**	**3,072**	**3,580**
Provisions	781	1,236	1,299	1,388
Profit Before Tax	**1,253**	**1,376**	**1,773**	**2,193**
Tax	399	367	473	585
Net Profit	**857**	**1,013**	**1,305**	**1,614**

Balance Sheet (Consolidated)

Y/E (Rs. Cr)	FY16	FY17E	FY18E	FY19E
Liabilities				
Capital	2,967	2,968	2,968	2,968
Reserves and Surplus	5,442	5,638	6,092	6,693
Minority Interest	100	100	100	100
Borrowings	51,616	57,583	66,441	77,661
Provisions	592	661	762	891
Other Liabilities and Provisions	3,030	3,521	4,226	5,131
Total Liabilities	**63,746**	**70,471**	**80,590**	**93,444**
Assets				
Fixed Assets	1,335	1,295	1,295	1,295
Investments	3,563	3,768	4,108	4,522
Advances	56,468	62,718	72,045	83,835
Other Assets	1,979	2,181	2,486	2,870
Cash & Bank Balances	402	510	657	922
Total Assets	**63,746**	**70,471**	**80,590**	**93,444**

Key Ratios (Consolidated)

Y/E	FY16	FY17E	FY18E	FY19E
Per share data (Rs.)				
EPS	4.9	5.8	7.4	9.2
DPS	0.8	1.7	2.2	2.8
BV	41.0	49.1	51.6	55.1
ABV	28.8	39.0	42.0	45.9
Valuation (%)				
P/E	24.7	20.9	16.2	13.1
P/BV	2.9	2.5	2.3	2.2
P/ABV	4.2	3.1	2.9	2.6
Div. Yield	0.7	1.4	1.8	2.3
Spreads (%)				
Yield on Funds	12.6	12.8	12.9	12.9
Cost of Funds	8.6	8.6	8.6	8.6
Asset (%)				
GNPA	4.9	4.6	4.1	3.7
NNPA	3.8	2.7	2.3	1.9
PCR	21.2	40.0	45.0	50.0
Management (%)				
Debt/ Equity	6.1	6.7	7.3	8.0
Cost/ Income	39.2	34.6	33.7	33.4
Earnings (%)				
NIM	4.7	5.0	5.1	5.1
ROE	10.6	11.9	14.8	17.2
ROA	1.5	1.5	1.7	1.9

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Rating Criteria

Large Cap.	Return	Mid/Small Cap.	Return
Buy	More than equal to 10%	**Buy**	More than equal to 15%
Hold	Upside or downside is less than 10%	**Accumulate***	Upside between 10% & 15%
Reduce	Less than equal to -10%	**Hold**	Between 0% & 10%
		Reduce/sell	Less than 0%

* To satisfy regulatory requirements, we attribute 'Accumulate' as Buy and 'Reduce' as Sell.

* L&TFH is a large-cap NBFC.

Disclaimer:

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