MUTHOOT FINANCE LTD. (MFL) – IPO NOTE

Issue Details	
Issue Date	April 18, 2011 – April 21, 2011
Issue Size	Rs. 8.24-9.01bn
Price Band	Rs. 160-175
FV	Rs.10
Fresh issue	51.5 mn equity shares
QIB	50%
Non Institutional/HNIs	15%
Retail	35%
Equity shares prior to issue	320.2mn equity shares
Equity shares post issue	371.7mn equity shares
Post issue market capitalization	Rs. 59.5-65.0bn
IPO Rating	Grade 4 by ICRA and CRISIL
Lot size	40 equity shares and multiples thereof
Issue Manager	ICICI Securities, Kotak
Co-Book Running Lead Manager	HDFC Bank Ltd.
Registrar to the issue	Link Intime

Shareholding pattern

Category	Pre Issue - % holding	Post Issue - % holding
Promoters	93	**80**
***Others (Private Equity players)**	7*	**6**
Public	-	14
Total		**100**

*Source: RHP, Ajcon Research, Note: * denotes shares held by Private Equity (PE) players which include Matrix Partners India Investments LLC, Barring India Pvt. Equity Fund Ltd., Kotak India Pvt. Equity Fund and the Wellcome Trust Ltd.*

About the company

MFL is Systemically Important Non-deposit taking NBFC based in the Kerala. It has an operating history of over 70 years. Gold Loan Business of MFL was founded by Late. M George Muthoot (father of the current promoter) under the heritage of trading business established by his father, Ninan Mathai Muthoot. As on December 31, 2010, the promoters of MFL held a 93% stake in the company. The promoters diluted their stake from 100%, following issue of fresh shares to the extent of 6% of their shareholding during H1, 2011 to private equity investors– Matrix Partners, Baring India Private Equity, Kotak India Private Equity, Kotak Investment Advisors Limited and the Wellcome Trust Limited. Subsequently the promoters sold 1% of their shareholding to the Wellcome Trust Limited.

Robust Business Model...

The company provides personal and business loans secured by gold jewellery, or Gold Loans, primarily to individuals who possess gold jewellery but could not access formal credit within a reasonable time, or to whom credit may not be available at all, to meet unanticipated or other short term liquidity requirements. It offers products with varying loan amounts, advance rates (per gram of gold) and interest rates. It typically charges interest rates of 12%-30% p.a on its gold loans. As on 30th November 2010, its gold loan portfolio comprised 4.1mn loan accounts in India that it services through its 2,611 branches (as on February 28, 2011) across 20 states, the national capital territory of Delhi and four union territories in India.

On an average, the company services 67,953 customers per day through its various branches. Its customers are typically small businessmen, vendors, traders, farmers and salaried individuals, who avail credit facilities by pledging their gold jewellery with the company. The gold loans have a maximum term of 12 months with a small ticket size. Its average disbursed gold loan amount outstanding was Rs. 31,553 per loan account as on November, 2010. In FY10, its retail loan portfolio earned, on average, 1.67% per month, or 19.94% per annum, and in the eight months ended November 30, 2010, its retail loan portfolio earned, on average, 1.57% per month, or 18.92% per annum. As on November 30, 2010, its gross NPAs stood at 0.35%.

The company depends on the following sources of funds for its financing business:

a) Bonds: The company has issued secured non-convertible debentures called “Muthoot Gold Bonds” on a private placement basis. The issuance of Muthoot Gold Bonds forms a significant source of funds for its Gold loan business.
b) Bank loans and surbordinated instruments.
c) The company also raised capital by selling a portion of its loan receivables under bilateral assignment agreements with various banks.

As on November, 2010, MFL had Rs.33.6 bn in outstanding Muthoot Gold Bonds and Rs. 57.2 bn in other borrowings. The company has witnessed a good financial performance over the period 2006-10. It witnessed a CAGR of 65% in total income, 68% in operating income and 71% in net profit. Today, MFL enjoys the status of the largest gold financing company in terms of loan portfolio.

In addition to gold financing business, the company also provides money transfer services, collection services and is also engaged in wind mills business.

Objects of the issue

Augment capital base to meet the capital adequacy norms for future capital requirements and growth in assets.

Key positives

Underpenetrated gold loans market, rural India to drive growth

India is one of the largest markets for gold and as of fiscal 2010, accounts for ~10% of the total world gold stock with an annual demand for ~700 tonnes. (Source: IMaCS Industry Report -2010). Lending against gold has been one of the most popular instruments based on gold, and it works well with the Indian rural population, which typically views gold as an important savings instrument that is liquid and can be converted into cash instantly to meet their urgent cash requirements. Rural India is estimated to hold ~65% of the total gold stock. The organized gold loans portfolio accounted for merely 1.2% of the value of total gold stock in India.

Gold loans market in India was estimated at ~Rs.350-400bn which has witnessed a CAGR of 40% over the period 2002-2010. The gold loans market is significantly under penetrated and is expected to grow at rate of 35-40% in the future. (Source: IMaCS Industry Report – 2010 update).

Moreover, traditionally gold owners in southern India are more open than elsewhere in the country to accept and exercuise the option of pledging gold to borrow money (Source: IMaCS Industry Report – 2009).

The company has a dominant presence in Southern India which augurs well for the company as it is the largest market accounting for ~40% of the gold demand.

Market leading position in Gold Loan business, early mover advantage and strong brand

MFL has been the leader in gold financing business with 20% share as on FY10. The other players in this segment with major market share are Indian Overseas Bank (20%) and Indian Bank (10%).

The company due to its early entry has built a recognizable brand in the rural and semi –urban markets of India, particularly in the southern Indian states of Tamil Nadu, Kerala, Andhra Pradesh and Karnataka. This has led to strong distribution network. As on March 31, 2010 and November 30, 2010, the southern Indian states of Tamil Nadu, Kerala, Andhra Pradesh, Karnataka and Union Territory of Pondicherry constituted 75.4% and 75.3%, respectively of its gold loan portfolio.

Diversifying presence

The company has predominantly been a south based player. The company is now diversifying its presence in Northern and Western India. Its efforts of diversifying presence have been evident through its reducing branch concentration in South to 70% in FY10 from 85%.

Strong capital raising ability

MFL raises funds at relatively competitive rates from banks and institutional investors. It enjoys high credit ratings of LAA- and A1+ from ICRA, which support its ability to raise funds at competitive rates. In addition, the strong franchise and the group's long track record in Kerala enable MFL to tap retail funding sources (accounting for about 33% of total funding in

September 2010). As on December 2010, the capital adequacy of MFL was at 15.19% (Tier 1 of 10.69%). The company raises subordinate debt (which classifies as Tier 2 capital, subject to a maximum of 50% of Tier I capital) placed primarily to its retail investors. MFL currently has limited headroom to raise additional Tier 2 capital in the form of subordinate debt but has headroom (of Rs. 5.9bn) to raise Tier 2 capital in the form of preference shares to meet its regulatory capital adequacy requirements of 15% (with effect from March 2011). Proposed IPO would create additional headroom for MFL to raise Tier 2 capital, thereby expanding its capacity to lend.

High margin of safety enjoyed by MFL in gold financing business

It provides loan which is ~70-80% of the asset value, average maturity of loan is~4-5 months and smaller ticket size loans (average ticket size Rs.31,553/-) leading to higher response time. On account of this, there are no calls for margin payments to clients, in the event of decline in gold prices. Over the last three years, the company has not more than 3% of gold against loans outstanding has been auctioned. This is primarily on account of gold ornaments being pledged by families where huge sentiments are involved leading to higher recovery of loans.

Key risks

MFL loan portfolio not classified as priority sector advances by the RBI

A recent notification issued by the RBI in February 2011, has stipulated that loans sanctioned to NBFCs for on lending to individuals or other entities against gold jewellery would not be eligible for classification as priority sector advances in the context of priority sector lending guidelines issued by RBI. Accordingly, its ability to raise capital by selling down its gold loan portfolio under bilateral assignments will be hampered in the future and impact its ability to raise funds through loans from banks, which may adversely affect its financial condition.

Major concentration in southern India

As on February 28, 2011, 1753 out of its 2,611 branches are located in the southern states of Tamil Nadu (593 branches), Kerala (607 branches), Andhra Pradesh (316 branches), Karnataka (230 branches) and Union Territory of Pondicherry (7 branches). Moreover, southern states as on November, 2010 accounted for 75.28% of its total gold loan portfolio. Any slowdown in the southern Indian economy could affect business and profitability.

Exposed to an event risk – Kerala Money Lender's Act

MFL is exposed to an event risk- 'Kerala Money Lender's Act' (KML), which empowers the state government to regulate lending rates of money lenders operating in the state and requires money lenders to register branches with the state authorities apart from other things. The matter is subjudice at the Supreme Court. Any adverse ruling in this case could impact the growth prospects of the company in the state of Kerala, which accounted for around 16% of its portfolio as on September 30, 2010. However, the impact on asset quality may not be significant as the company can auctions the pledged gold ornaments.

Financial performance (Rs. in mn.)

Particulars	FY08	FY09	FY10	8MFY11 (November 30, 2010)
Total Income	3,686	6,204	10,894	13,017
Profit before Tax	970	1,482	3,456	4,411
Net Profit	631	979	2,285	2,915
Basic EPS (Rs.)	2.57	3.49	7.59	9.30#
Share Capital	**50**	**490**	**3,010**	**3,202**
Reserves and Surplus	2,174	3,212	2,835	8,115
Net worth	**2,131**	**3,614**	**5,842**	**11,315**
Book value (Rs.)	**426**	**74**	**19**	**35**
Gross Gold Loans	**21,790**	**33,001**	**73,417**	**1,28,978**
Gross NPAs as a % of Gross Retail Loans	0.42%	0.48%	0.46%	***0.35%***
RONW (%)	**29.6**	**27.1**	**39.1**	**25.8**
CAR (%)	**12.6**	**16.3**	**14.8**	**15.1**
Net Interest Margin (%)	**8.2**	**8.2**	**9.3**	**9.2**
Cost of deposit (%)	**9.4**	**9.8**	**8.4**	**9**
Yield on average loans (%)	**19**	**21.1**	**19.4**	**18.5**
Cost income ratio (%)	**48.3**	**52.3**	**43.4**	**38.7**

Source: RHP, Ajcon Research, # not on annualized basis

Peer analysis

Company	Branches	Gold loan portfolio	CMP/Issue price (Rs.)	Book Value(BV)	P/BV(x)
Muthoot Finance Ltd.	2,611	Rs.128.9bn	160-175	Rs. 54.69*	2.93-3.20
Manappuram General Finance Ltd.	1,800	Rs.65bn	129.85#	Rs. 45.13	2.88

Note: * denotes Book Value calculated on post IPO Networth, #price as on 15th April, 2011

Outlook and recommendation

We believe the stock valuation of P/BV – 3.2x at the upper end of the price band of Rs. 175 is justified, because of the following reasons:

a) MFL being the market leader in gold financing business,
b) Early mover advantage in gold financing business and strong brand in southern India,
c) Strong fund raising capabilities at competitive rates,
d) Diversifying presence in northern and western parts of the country,
e) CRISIL and ICRA rating of 4, indicating above average fundamentals,
f) Larger presence (2,611 branches) with a higher scale in terms of gold loan portfolio of Rs.128.9bn as compared to its peer Manappuram General Finance Ltd. (MGFL) with 1,800 branches and gold loan portfolio of Rs.65bn,
g) No offer for sale by PE players and Preferential allotment to private equity players(Matrix Partners India Investments, LLC and The Wellcome Trust) on September 23, 2010 at Rs.173.5 instills confidence and provides a comfort on the valuation front

We recommend **'SUBSCRIBE'** to the issue for short term listing gains.

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