

# SREI Infrastructure Finance (SREI IN)

## Focused on ROE Improvement

### Profitability over balance sheet growth

We recently met with the MD and senior members of SREI's management. The meetings reinforced our view that SREI is focused on scaling up its return ratios, rather than chasing balance sheet growth. Commercial equipment (CE) lending business will be core to business. Project financing will be done opportunistically. Asset quality pains have peaked. We forecast 900bps ROE improvement over FY16-19F to 11%. Value-unlocking potential in subsidiaries remains. Maintain BUY and raise TP 16% to INR110 as we roll forward to FY18. TP based on 1.1x FY18F P/BV.

### Equipment lending business picking up

CE industry volumes in 1QFY17 registered 58% YoY growth. Higher road projects awarded by the government resulted in the pickup. SREI being the market leader in the segment (c.35% market share in CE loans) registered 57% YoY growth in loan disbursements. As per management, the sector is witnessing early signs of pickup. We expect healthy disbursements to continue leading to 15-20% p.a. loan growth.

### Asset quality has peaked; NIMs to improve

Asset quality issues have peaked with fresh accretion to NPLs dropping. Management expects trends to be better as cash flows of borrowers improve, leading to higher recoveries. Gross NPLs in the last one year have dropped from 4.6% to 2.7% due higher recoveries and write-offs. We expect NPLs to fall to 1.8% by FY18. With change in loan mix towards higher yielding loans, NIMs will improve 40bps to 4.3% by FY19F.

### Stock still cheap; Value unlocking potential

With improvement in ROEs, valuations have room for re-rating. Potential value unlocking in strategic investments, such as road projects, social rural network business (Sahaj), and industrial parks can provide an additional kicker to earnings. Maintain BUY, and raise TP to INR110 (from INR95) as we roll valuation forward to FY18F. TP based on 1.1x FY18F P/BV (0.8x current valuation), in line with peers reporting 8-10% ROE.

FYE Mar (INR m)	FY15A	FY16A	FY17E	FY18E	FY19E
Operating income	10,862	9,512	17,039	16,863	20,060
Pre-provision profit	4,938	3,784	9,454	8,357	10,763
Core net profit	1,294	733	2,798	4,029	5,472
Core EPS (INR)	2	1	5	8	11
Core EPS growth (%)	(11.7)	(49.1)	342.4	46.9	37.2
Net DPS (INR)	1	1	1	1	1
Core P/E (x)	31.8	62.4	14.1	9.6	7.0
P/BV (x)	1.2	1.2	0.9	0.8	0.7
Net dividend yield (%)	0.7	0.7	1.3	1.6	1.6
Book value (INR)	65	66	89	96	105
ROAE (%)	4.1	2.2	7.2	8.7	10.8
ROAA (%)	0.5	0.3	0.9	1.0	1.2
Consensus net profit	-	-	339	na	na
MKE vs. Consensus (%)	-	-	725.3	na	na

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# BUY

Share Price	INR 74
12m Price Target	INR 110 (+50%)
Previous Price Target	INR 95

### Company Description

SREI Infrastructure Finance is a non-banking finance company, which is engaged in equipment financing and project financing.

### Statistics

52w high/low (INR)	82/41
3m avg turnover (USDm)	2.2
Free float (%)	26.2
Issued shares (m)	503
Market capitalisation	INR38.5B USD577M

### Major shareholders:

Adisri Investment Ltd.	60.4%
Fidelity Investment	8.5%
BNP Paribas Lease Group	5.0%

### Price Performance



	-1M	-3M	-12M
Absolute (%)	(2)	29	67
Relative to index (%)	(4)	20	49

Source: FactSet

## Commercial equipment volumes showing uptrend

SREI being market leader in CE industry closely tracks industry volume growth. CE industry had strong recovery in 1QFY17 with volumes picking up 58% YoY. SREI has benefitted from this pickup and witnessed 57% YoY growth in disbursements. As road construction gains momentum, SREI stands to benefit. We expect disbursements to grow at 50-70% YoY over the next three years. This will result in healthy loan growth of 15-20% p.a. for SREI. The project finance business for SREI will grow at a slower pace. Management intends to participate in selective projects where the opportunity of making high fee income is present. In the project finance business, SREI may look at originating loans and selling them down while retaining a spread. This would lower capital consumption and improve profitability.

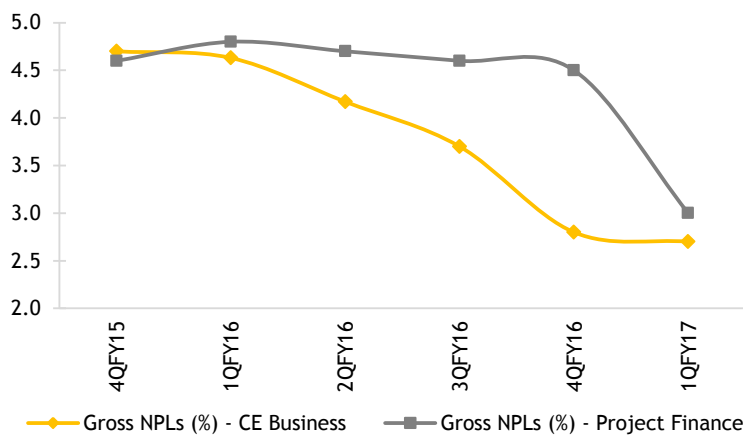
Commercial equipment - Industry volumes	1QFY15	1QFY16	1QFY17	YoY Growth (%)
Backhoe Loaders	4,728	4,519	7,535	66.7
Crawler Excavator	2,420	2,561	4,097	60.0
Wheel Loaders	360	422	507	20.1
Motor Graders	42	124	175	41.1
Skid Steer Loaders	70	102	134	31.4
Off highway Trucks	42	126	91	-27.8
Track Type Tractors	131	57	48	-15.8
Wheel Dozer	1	2	6	200.0
Telescopic Handlers	0	33	35	6.1
<b>Earthmoving Equipment (a)</b>	<b>7,794</b>	<b>7,946</b>	<b>12,628</b>	<b>58.9</b>
Pick and Carry Cranes	866	611	984	61.0
<b>Material Handling Equipment (b)</b>	<b>866</b>	<b>611</b>	<b>984</b>	<b>61.0</b>
Compactors	542	500	712	42.4
Pavers	7	18	132	633.3
Milling	4	6	9	50.0
<b>Road Construction Equipment (c)</b>	<b>553</b>	<b>524</b>	<b>853</b>	<b>62.8</b>
Concrete Pumps	119	125	286	128.8
Batching Plants	122	96	120	25.0
<b>Concreting Equipment (d)</b>	<b>241</b>	<b>221</b>	<b>406</b>	<b>83.7</b>
Compressors	285	402	462	14.9
Wheeled Crushers	106	88	154	75.0
Screens	90	92	100	8.7
Static Crushers	46	47	93	97.9
Tracked Crushers	20	5	9	80.0
<b>Quarry Equipment (e)</b>	<b>547</b>	<b>634</b>	<b>818</b>	<b>29.0</b>
<b>Total for Commercial Equipment (a+b+c+d+e)</b>	<b>10,001</b>	<b>9,936</b>	<b>15,689</b>	<b>57.9</b>

Source: Industry data

## Asset quality stress has peaked

Gross NPLs in the CE business have fallen to 2.7% as of 1Q17 from a peak of 5%. Higher recoveries and write-offs led to a drop in NPLs. SREI used a one-time gain of INR3.3b in 1Q to write-off bad loans and reduce the level of gross NPLs. NPLs for the sector have peaked with addition of fresh accounts witnessing a drop. With road sector activity picking up, borrowers have witnessed improvement in cash flows. Gross NPLs in the project finance business have also improved from 4.8% last year to 3% as of 1QFY17. We believe incrementally, fresh accretion will be at a slower pace and recoveries stronger. Our gross NPL forecast for the consolidated entity stands at 2.8% for FY18 and 2.5% for FY19. We believe credit cost will peak in FY17 at 2% and drop sharply after to 0.7% in FY18 and FY19.

Gross NPLs falling due to high recoveries and write-offs

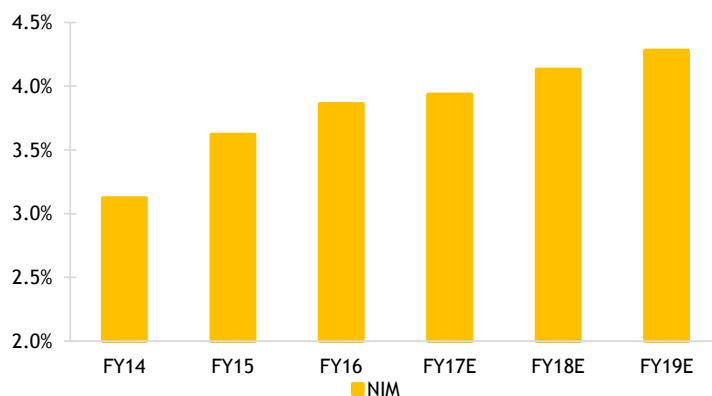


Source: Company

## NIMs to improve on change in product mix

We expect NIMs to improve 40bps over next two years to 4.3%. Diversification to high yielding loans will be the key driver for NIM improvement. Currently, non-CE loans such as tractors, medical equipment finance and information technology infrastructure finance form under 10% of loans. Management intends to increase the proportion of such loans to 25-30% over the next three years. Yields in these segments are 400-500bps higher than in CE lending. SREI plans to increase low ticket loans to SME customers to fetch higher yields. On the cost of funds side, diversification of funds and retirement of high cost debt would aid drop.

Forecast 40bps NIM improvement to 4.3% by FY19



Source: Company, Maybank KE

## Value unlocking potential in subsidiaries

SREI has the potential to unlock value through divestments of strategic investments in subsidiaries. For the road projects company, it plans to have its IPO in 4QFY17. The road company has seven projects out of which five are operational and two under construction. SREI's equity investment in it is INR5.5b and debt from these companies attributable to SREI stands at INR5.5b. Listing at a premium to book value can result in potential investment gains. We have not considered any gains from potential divestments in our forecast. We await further clarity on the size and valuations of divestments.

### Strategic investments (INRm)

Road assets	5,480
Rural centres - Sahaj	130

### Road assets

No. of projects	7
Operation projects	5
Under construction	2
Total lanes in KMs	2,450
Cumulative toll revenue INRm in 1QFY17	1,050

Source: Company

SREI owns a 48% stake in Sahaj, a social rural centre business, through an investment of INR130m. The number of rural centres is approximately 60,000 which the management intends to double over the next three years. The centres offer government services to customers (G2C), basic banking and financial services, e-commerce services and education services, among others. The business broke even at the EBITDA level last year. Potential valuation of the business is INR17-20b, based on peer valuations.

SREI owns three industrial parks in which it plans to dilute its stake over time. The three industrial parks are in Mumbai (345 acres), West Bengal (128 acres) and Tamil Nadu (2518 acres).

### Industrial parks (in acres)

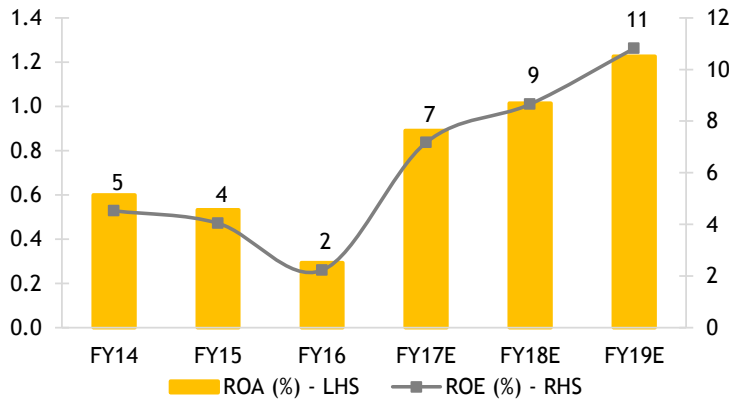
Mumbai	345
West Bengal	128
Tamil Nadu	2,518

Source: Company

### Multiple drivers for ROE improvement

We forecast consistent improvement in ROEs to 11% by FY19F from 2% in FY16. EPS growth for FY17 would be 342 YoY (not comparable YoY due to impact from merger of erstwhile SREI BNP), 47% YoY in FY18F and 37% YoY in FY19F. Drivers for ROE improvement will be: (a) NIM improvement of 40bps to 4.3%; (b) lower credit cost of 0.7% in FY18-19 vs. 2% in FY16-17; and (c) lower operating expense growth of 10-12% YoY.

ROEs to scale up over FY17-19F

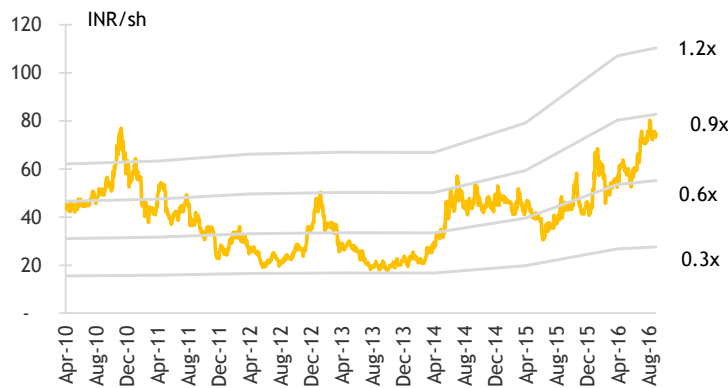


Source: Company, Maybank KE

### Stock cheap relative to peers

SREI currently trades at 0.8x FY18F P/BV, which is cheap compared with peers. With improvement in return ratios and stable asset quality, we expect multiples to re-rate. Potential value unlocking through divestment of its strategic investments, such as road, social rural network (Sahaj) and industrial parks over time will aid earnings. Peer NBFCs’ average multiple is over 2x forward P/BV for ROEs of 10-18%. A revival in infrastructure lending and economic growth will aid loan growth, enable asset monetization and reduce asset quality stress. Maintain BUY with revised TP of INR110 from INR95 based on 1.1x FY18F adjusted P/BV, in line with peers reporting 8-10% ROE.

Valuation still cheap at 0.8x FY18F P/BV



Source: Company, Bloomberg, Maybank KE

## Comparative valuations

BB Ticker	Mkt Cap (INRm)	AUM (INRb)	ROE (%)			ROA (%)			P/B (x)			P/E (x)		
			FY16	FY17F	FY18F	FY16	FY17F	FY18F	FY16	FY17F	FY18F	FY16	FY17F	FY18F
POWF IN	3,12,057	2,250	18.0	15.9	15.2	2.6	2.4	2.3	0.9	0.8	0.7	5.1	5.2	4.9
RECL IN	2,24,153	1,876	21.0	18.0	16.3	2.9	2.6	2.4	0.8	0.7	0.6	4.0	4.1	4.0
IDFCBN IN	2,14,384	1,017	3.4	6.3	7.4	0.6	1.0	1.0	1.6	1.5	1.4	27.0	23.1	18.3
LTFH IN	1,56,116	284	9.7	12.9	14.6	1.5	1.4	1.5	2.2	2.0	1.8	23.5	16.0	12.8
SREI IN	36,398	355	2.2	7.2	8.7	0.3	0.9	1.0	1.2	0.9	0.8	62.4	14.1	9.6
PTCIF IN	20,937	86	24.6	15.5	16.7	5.0	2.9	2.8	1.2	1.1	0.9	5.3	7.1	5.7

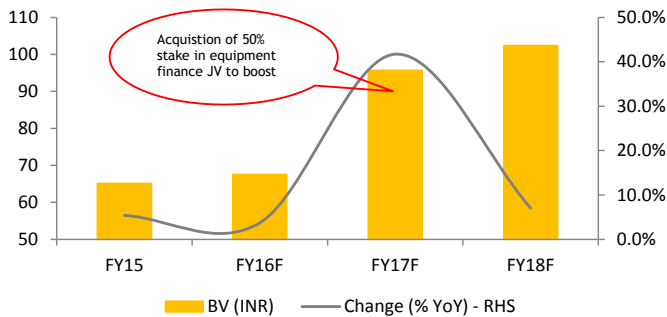
Source: Company, Bloomberg, Maybank KE

Note: Bloomberg consensus estimates for stocks not under coverage

## Company Proposition

- India's leading financier to the infrastructure sector. Beneficiary of a pickup in government awarding new projects in the infrastructure space.
- Asset quality stress peaked out; incremental NPLs lower as CE demand witnessing uptick.
- Value unlocking potential in road projects (7 projects worth INR5.5b), social rural infrastructure (Sahaj), and industrial parks.
- Focus on diversification of lending book to new areas, such as health care equipment, technology infrastructure, and used vehicles to de-risk the business.

### Acquisition of stake in JV to lift BV by 35%

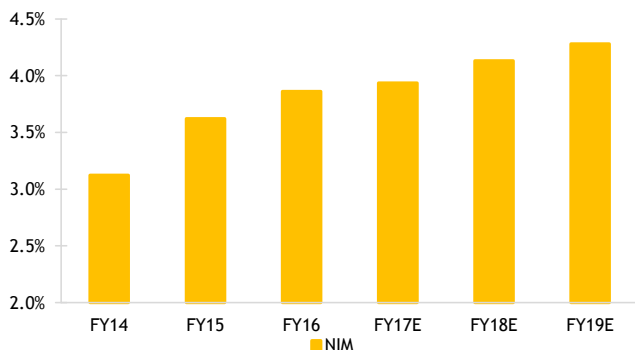


Source: Company, Maybank Kim Eng

## Financial Metrics

- NIM to improve by 40bps to 4.3% in FY19F, because the change in loan mix to high yielding loans and repayment of high cost debt.
- Credit cost to drop from 2.0% in FY17 to 0.7% in FY18 on lower NPL accretion. Improvement in economic growth to aid asset quality recovery.
- We forecast ROE improvement from 2% in FY16 to 7% in FY17F on NIM improvement and lower credit cost.

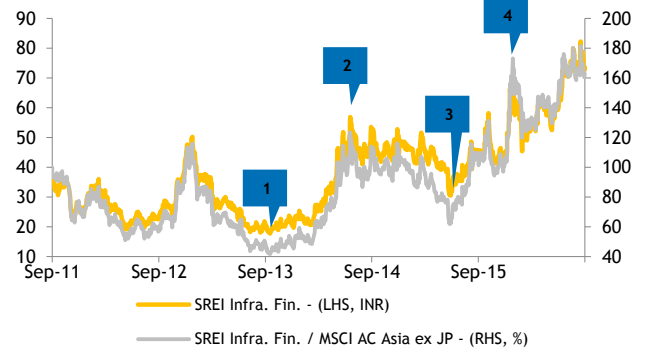
### NIM to inch up on repayment of debt and change in mix



Source: Company

## Price Drivers

### Historical share price movement



Source: Company, Maybank Kim Eng

- Slowdown in infrastructure lending and increase in NPLs weighed on the stock price.
- New government's plan to increase infrastructure spending led to optimising of infrastructure financiers.
- Delay in monetisation of telecom tower business (VIOM) pushed the stock price down.
- Announcement of transaction to acquire 50% of JV with BNP Paribas. BV and EPS accretive deal led to rally in the stock price.

## Swing Factors

### Upside

- Strong recovery in infrastructure lending can push the loan growth higher than expected.
- Stake sale in road projects investments at higher than expected valuations.
- Better than expected NPLs in FY17-18F.

### Downside

- Delay in pick up infrastructure lending could hamper the loan growth revival.
- Delay in monetisation on investments in road and rural network projects.

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FYE 31 Mar	FY15A	FY16A	FY17E	FY18E	FY19E
<b>Key Metrics</b>					
Core P/E (x)	31.8	62.4	14.1	9.6	7.0
Core FD P/E (x)	31.8	62.4	14.1	9.6	7.0
P/BV (x)	1.2	1.2	0.9	0.8	0.7
P/NTA (x)	1.2	1.2	0.9	0.8	0.7
Net dividend yield (%)	0.7	0.7	1.3	1.6	1.6
<b>INCOME STATEMENT (INR m)</b>					
Interest income	30,195.7	31,475.7	39,737.6	50,341.2	56,769.7
Interest expense	(22,741.5)	(23,107.5)	(29,037.2)	(36,256.2)	(40,168.6)
<b>Net interest income</b>	<b>7,454.2</b>	<b>8,368.2</b>	<b>10,700.4</b>	<b>14,085.0</b>	<b>16,601.0</b>
Net insurance income	0.0	0.0	0.0	0.0	0.0
Net fees and commission	1,613.4	502.5	630.1	756.2	907.4
Other income	1,794.1	641.2	5,708.6	2,022.0	2,551.3
<b>Total non-interest income</b>	<b>3,407.5</b>	<b>1,143.7</b>	<b>6,338.8</b>	<b>2,778.2</b>	<b>3,458.7</b>
<b>Operating income</b>	<b>10,861.7</b>	<b>9,511.9</b>	<b>17,039.2</b>	<b>16,863.2</b>	<b>20,059.7</b>
Staff costs	(1,442.9)	(1,448.6)	(2,135.2)	(2,348.8)	(2,583.6)
Other operating expenses	(4,481.2)	(4,279.1)	(5,450.4)	(6,157.5)	(6,712.9)
<b>Operating expenses</b>	<b>(5,924.1)</b>	<b>(5,727.7)</b>	<b>(7,585.7)</b>	<b>(8,506.2)</b>	<b>(9,296.5)</b>
<b>Pre-provision profit</b>	<b>4,937.6</b>	<b>3,784.2</b>	<b>9,453.5</b>	<b>8,357.0</b>	<b>10,763.2</b>
Loan impairment allowances	(2,962.8)	(2,712.5)	(5,181.5)	(2,308.7)	(2,469.9)
Other allowances	(92.8)	(12.3)	(162.3)	(12.3)	(12.3)
Associates & JV income	2.5	2.5	2.5	2.5	2.5
<b>Pretax profit</b>	<b>1,886.9</b>	<b>1,064.3</b>	<b>4,112.2</b>	<b>6,038.5</b>	<b>8,283.5</b>
Income tax	(670.4)	(444.1)	(1,376.8)	(2,022.1)	(2,774.1)
Minorities	77.1	112.4	62.4	12.4	(37.6)
Discontinued operations	0.0	0.0	0.0	0.0	0.0
<b>Reported net profit</b>	<b>1,293.6</b>	<b>732.6</b>	<b>2,797.9</b>	<b>4,028.8</b>	<b>5,471.7</b>
<b>Core net profit</b>	<b>1,293.6</b>	<b>732.6</b>	<b>2,797.9</b>	<b>4,028.8</b>	<b>5,471.7</b>
<b>BALANCE SHEET (INR m)</b>					
Cash & deposits with banks	5,747.6	6,641.5	10,286.4	11,520.8	13,248.9
Sec. under resale agreements	0.0	0.0	0.0	0.0	0.0
Derivatives financial assets	0.0	0.0	0.0	0.0	0.0
Dealing securities	0.0	0.0	0.0	0.0	0.0
Available-for-sale securities	0.0	0.0	0.0	0.0	0.0
Investment securities	0.0	0.0	0.0	0.0	0.0
Loans & advances	192,054.4	203,244.8	314,788.2	352,562.7	405,447.2
Central bank deposits	0.0	0.0	0.0	0.0	0.0
Investment in associates/JVs	22,499.4	21,698.2	10,230.6	10,576.9	13,177.0
Insurance assets	0.0	0.0	0.0	0.0	0.0
Fixed assets	15,513.4	14,319.7	20,595.4	22,067.6	24,051.3
Intangible assets	0.0	0.0	0.0	0.0	0.0
Other assets	10,047.0	6,394.8	20,224.4	21,559.9	17,928.8
<b>Total assets</b>	<b>245,861.8</b>	<b>252,299.0</b>	<b>376,125.1</b>	<b>418,287.9</b>	<b>473,853.2</b>
Deposits from customers	0.0	0.0	0.0	0.0	0.0
Deposits from banks & FIs	0.0	0.0	0.0	0.0	0.0
Derivatives financial instruments	0.0	0.0	0.0	0.0	0.0
Subordinated debt	15,691.4	16,466.6	26,094.5	28,685.2	32,104.9
Other securities in issue	0.0	0.0	0.0	0.0	0.0
Other borrowings	187,566.2	190,260.2	291,675.8	326,676.9	372,411.7
Insurance liabilities	0.0	0.0	0.0	0.0	0.0
Other liabilities	9,709.7	12,387.5	13,461.0	14,709.7	16,355.4
<b>Total liabilities</b>	<b>212,967.3</b>	<b>219,114.3</b>	<b>331,231.3</b>	<b>370,071.8</b>	<b>420,872.0</b>
Share capital	5,032.4	5,032.4	5,032.4	5,032.4	5,032.4
Reserves	27,736.5	28,140.3	39,849.4	43,171.7	47,936.9
Shareholders' funds	32,768.9	33,172.7	44,881.8	48,204.1	52,969.3
Preference shares	0.0	0.0	0.0	0.0	0.0
Minority interest	125.6	12.0	12.0	12.0	12.0
Total equity	32,894.5	33,184.7	44,893.8	48,216.1	52,981.3
<b>Total liabilities &amp; equity</b>	<b>245,861.8</b>	<b>252,299.0</b>	<b>376,125.1</b>	<b>418,287.9</b>	<b>473,853.2</b>



FYE 31 Mar	FY15A	FY16A	FY17E	FY18E	FY19E
<b>Key Ratios</b>					
<b>Growth (%)</b>					
Net interest income	22.3	12.3	27.9	31.6	17.9
Non-interest income	13.3	(66.4)	454.2	(56.2)	24.5
Operating expenses	14.6	(3.3)	32.4	12.1	9.3
Pre-provision profit	25.6	(23.4)	149.8	(11.6)	28.8
Core net profit	(6.8)	(43.4)	281.9	44.0	35.8
Gross loans	8.3	5.1	53.5	11.7	14.7
Customer deposits	na	na	na	na	na
Total assets	2.8	2.6	49.1	11.2	13.3
<b>Profitability (%)</b>					
Non-int. income/Total income	31.4	12.0	37.2	16.5	17.2
Average lending yields	14.67	14.53	14.61	14.76	14.64
Average financing yields	14.67	14.53	14.61	14.76	14.64
Average cost of funds	11.34	11.27	11.07	10.77	10.57
Net interest margin	3.62	3.86	3.94	4.13	4.28
Net income margin	3.33	3.25	3.54	3.99	4.07
Cost/income	54.5	60.2	44.5	50.4	46.3
<b>Liquidity (%)</b>					
Loans/customer deposits	nm	nm	nm	nm	nm
<b>Asset quality (%)</b>					
Net NPL	3.8	3.1	2.2	1.8	1.5
Gross NPL	4.7	4.0	3.1	2.8	2.5
Gross NPF	4.7	4.0	3.1	2.8	2.5
(SP+GP)/average gross loans	1.6	1.4	2.0	0.7	0.7
(SP+GP)/average gross financing	1.6	1.4	2.0	0.7	0.7
Loan loss coverage	18.5	23.1	29.0	36.0	43.0
<b>Capital adequacy (%)</b>					
CET1	11.2	12.5	10.4	10.0	9.7
Tier 1 capital	11.2	12.5	10.4	10.0	9.7
Risk-weighted capital	17.0	17.5	16.4	16.0	15.6
<b>Returns (%)</b>					
ROAE	4.1	2.2	7.2	8.7	10.8
ROAA	0.5	0.3	0.9	1.0	1.2
Shareholders equity/assets	13.3	13.1	11.9	11.5	11.2

Source: Company; Maybank

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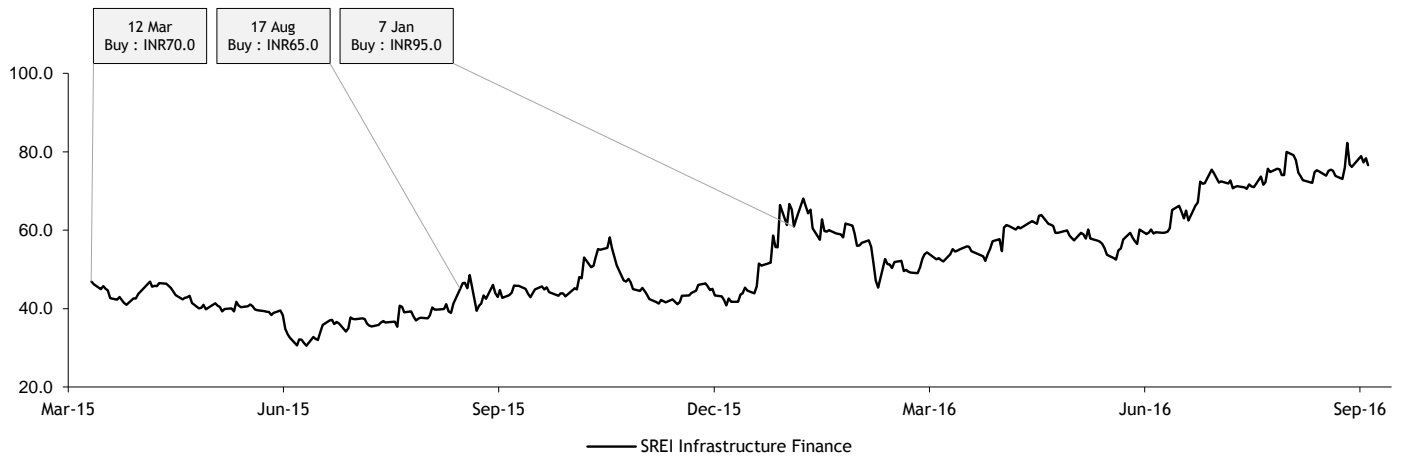
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