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25 March 2015

SREI Infrastructure Finance

CE lending industry still not out of the woods

We interacted with the top management as well as several regional/state heads at SREI to discuss the company's construction equipment (CE) lending business. Given lacklustre manufacturing and infrastructure activities in India, SREI's slippages/credit costs are likely to stay elevated while growth would remain sluggish in the near term. SREI is not facing pricing pressure and is incrementally focusing on retail customers to improve profitability. We do not have a rating on the stock.

- **Market leader in CE financing:** SREI started operations in 1989 and currently has a 50:50 JV with BNP Paribas for infrastructure equipment finance. The SREI-BNP JV is a market leader in equipment financing with 30% market share and a presence across the value chain of infrastructure equipment. The company has interests in QUIPPO (India's largest equipment rental company) and an 18% stake in VIOM networks (independent tower company with +40K towers). It also lends to infrastructure projects and has equity interest in eight road assets.

- **Credit costs likely to remain elevated in FY15/Q1FY16:** Management stated that it has seen no improvement on the ground over the last one year, as industrial production (IIP), infrastructure spending (especially on roads) and mining activity remain lacklustre. Slippages are expected to remain elevated and credit cost high in the next 2-3 quarters. SREI is looking to improve its provision coverage ratio in coming quarters. Gross/net NPA on 90-DPD stood at 4.8%/3.6% as at end-Q3FY15.

- **Disbursement growth to remain sluggish:** SREI's experience over the last two decades suggests that recovery in the CE cycle always precedes growth. However, there are no clear signs of recovery and utilisation levels for equipment are still poor. Many of the company's regional branches are achieving only a third of their peak capacity (FY08-FY10) disbursements. Therefore, a meaningful recovery in loan growth is still some time away. If there is a broad-based recovery in FY16, management expects 10-15% growth.

- **Strategically focusing on retail customers to improve profitability:** SREI currently has ~60% of its portfolio concentrated with corporate clients. Yields are lower and risk of NPA is high as the equipment cannot be used for alternate purposes. The company plans to increase the share of retail loans in coming years, which will help improve profitability. Management is targeting an improvement in ROE band from 12-18% currently to 14-20% over the next 2-3 years.

- **No pricing pressure; cost of funds to ease going forward:** Despite weak disbursement trends, management is not seeing any pressure on lending rates (yields). This is mainly because business is concentrated among a few large players (small/inexperienced players have exited in the last two years). Currently, the major source of funding is bank borrowings (working capital at 52% and term loan from banks at 20%), while debentures constitute 7% of total loans (up from 3% in Q2FY15). The company is exploring new avenues to reduce the cost of funds, including higher NCD issuances.

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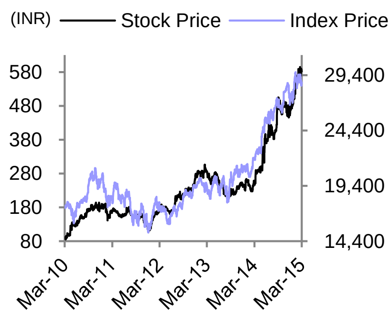
PRICE CLOSE (24 Mar 15)	INR 43.00
MARKET CAP	INR 21.6 bln USD 348.9 mln
SHARES O/S	503.0 mln
FREE FLOAT	50.7%
3M AVG DAILY VOLUME/VALUE	0.1 mln / USD 1.1 mln
52 WK HIGH	INR 57.55
52 WK LOW	INR 24.9



Region and state-wise trends

We met SREI's CFO (Sanjeev Sancheti) and Investor Relations head (Amit Agarwal). In addition, we interacted with several regional and state heads at SREI to discuss the company's construction equipment (CE) lending business. Our findings suggest that given weak manufacturing and infrastructure activity in India, SREI's slippages and credit costs are likely to stay elevated while growth remains sluggish in the near term.

Slippages still high, disbursements sluggish

Western region – Rajasthan and Gujarat better off; mixed trends in Maharashtra

Trends are better in Gujarat and Rajasthan due to higher spending by the state on infrastructure projects

- Infrastructure activities in Rajasthan and Gujarat are driven mainly by their respective state governments and the EPC model is used for most projects. Therefore, asset quality disturbances have been lower in these states in the last 1-1.5 years.
- In terms of loan/disbursement growth as well, these two states have posted a better performance than the rest of India.
- In Maharashtra, the corporate business has been sluggish for the last 2-3 years as fewer new projects have come up. Companies are hopeful that with the strong government in place in the state, infrastructure activities will pick up.
- Disbursement and asset quality trends for the CV/CE segment in Maharashtra are not materially different from the rest of India. The sand mining ban in the Konkan region's eco-sensitive zones has affected freight rates and demand for CVs. However, demand for sand mining is likely to improve as the ban was lifted by the new government in Dec'14.

Goa – slow, gradual recovery

Mining ban and economic slowdown have hit the region badly and improvement will be very slow

- Goa had 70-80 working mines which were shut down in Sep'12 post a Supreme Court (SC) order pertaining to allegations of illegal mining activity. The SC thereafter cleared 27 mines and the state government is likely to frame rules for operating these mines in the next 1-2 months.
- Mining activities are likely to start in April or October next year (no mining during the monsoons). Companies believe that the SC will allow other mines to open up separately in a gradual manner (as it did with Karnataka).
- Mining in Goa is concentrated with 5-6 large players – given substantial underutilised capacity with these miners, disbursements will take time to pick up. CV operators have been badly affected as their work is on contract basis and vehicles are lying idle. Resumption of mining loads will help these small CV operators.
- Asset quality should improve gradually from Q1FY16 onwards while disbursements in the state may pick up from late FY16 only. We believe it will take 2-3 years to reach disbursement levels achieved in FY08/FY09.

Southern India – disturbing trends

Southern India showing highest asset quality deterioration as compared to other regions

- Players have indicated that the southern market typically enjoys better growth and asset quality trends than the rest of India. However, in this cycle, delinquencies have been higher in southern India even as disbursements remain poor.
- Operators indicate that a lot of work done by public works departments (PWD) has stopped in Tamil Nadu and Kerala. The real estate sector has also slowed down considerably and this is exacting a toll on CV/CE players.
- In Tamil Nadu, state government interest in the infrastructure/industrial sectors has dwindled and current disbursements by CV/CE lenders are only 25% of the FY08/FY09 numbers. Also, 90-DPD customers have increased to 20-22% of total loans compared to 6-8% in FY08 in some branches in Tamil Nadu.
- In Andhra Pradesh, disbursement and asset quality have taken a severe hit due to political turbulence (the Telangana divide) over the last two years. Many large infrastructure companies are facing a financial crunch as government departments are not clearing their dues. Fleet operators are also defaulting on loans.
- Players are hopeful that with a new government at the centre and state, infrastructure activities will pick up going forward. However, meaningful improvement is still a year away, in our view.

Eastern India – trends mimic rest of India

- CV/CE demand mainly comes from road, mining and urban development – all sectors that remain largely under-developed in India's eastern markets and hence this region contributes only ~20% of the industry loan book.

Things are stabilising and mining activities are expected to improve from Q1/Q2FY16

- Roads and mining activities have been embroiled in environmental/legal hurdles for the last year and a half and disbursements are only 20-25% of FY08/FY09 levels. Coal India's coal production was down 20-22% in the last year which affected CV/CE utilisation rates. In Orissa, due to the SC order, only 7-8 mines are operational (the others will start with a lag).
- Many NBFCs and unorganised players have exited the market in the last one year and hence pricing has improved. Companies are getting better collaterals and loan disbursements are earning higher yields.
- CV lenders indicate that forward-flow delinquencies have stabilised in the last 2-3 months and bucket movements (from say 30-DPD to 60-DPD, or 60-DPD to 90-DPD) for NPL accounts have ceased.
- Improvement in mining activities (recent coal auctions) and revival in the road sector will drive growth going forward. We expect the pick-up to be slow in the next 2-3 quarters but thereafter momentum will improve led by new projects expected to be announced in Q1/Q2FY16.

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SREI a market leader in CE financing

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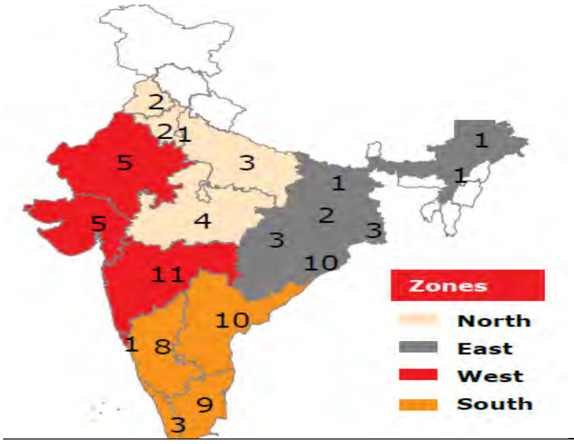
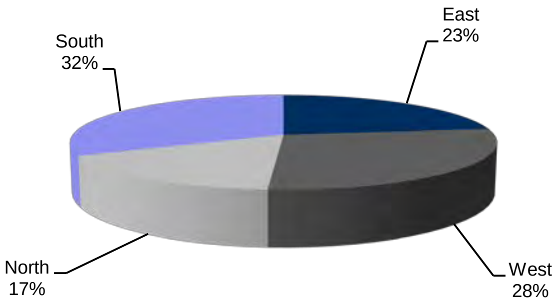
SREI-BNP JV holds 30% market share in equipment finance

Fig 1 - Branch network across India



Source: Company

Fig 2 - South and West India account for 60% of branches



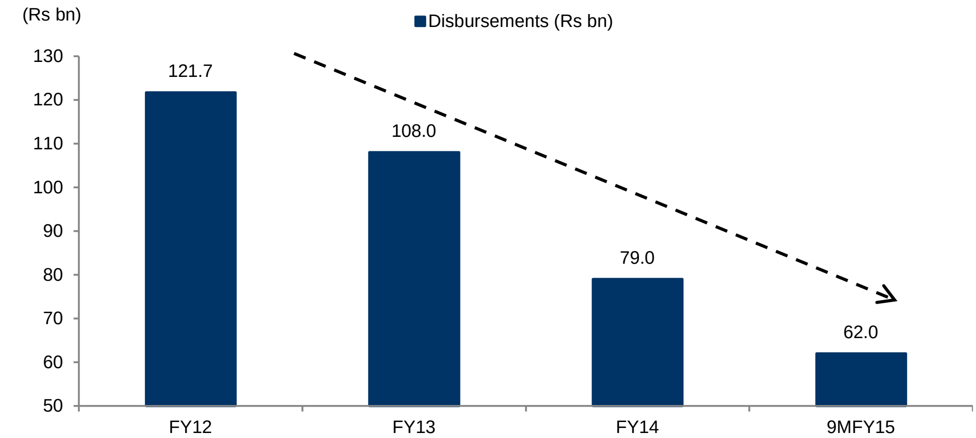
Source: Company

Disbursement growth to remain sluggish

SREI's experience over the last two decades suggests that recovery in the CE cycle always precedes growth. However, there are no clear signs of recovery and utilisation levels for equipment are still poor. Many of the company's regional branches are achieving only a third of their peak capacity (FY08-FY10) disbursements. Therefore, a meaningful recovery in loan growth is still some time away. If there is a broad-based recovery in FY16, management expects 10-15% growth.

Many branches achieving only a third of their peak capacity disbursement

Fig 3 - Considerable slowdown in disbursement



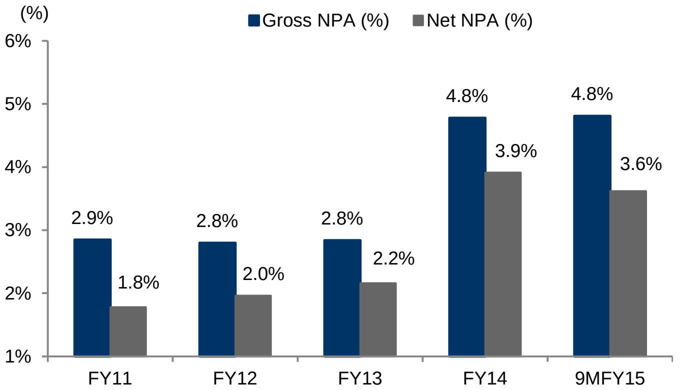
Source: Company

Credit costs likely to remain elevated in FY15/Q1FY16

Management stated that it has seen no improvement on the ground over the last one year, as industrial production (IIP), infrastructure spending (especially on roads) and mining activity remain lacklustre. Slippages are expected to remain elevated and credit cost high in the next 2-3 quarters. SREI is looking to improve its provision coverage ratio in coming quarters. Gross/net NPA on 90-DPD stood at 4.8%/3.6% as at end-Q3FY15.

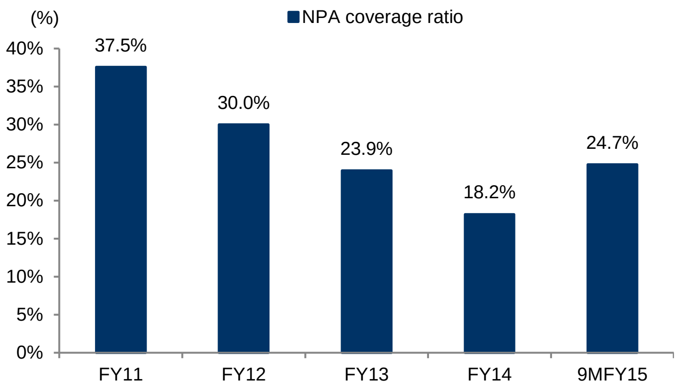
No improvement on the ground over the last one year

Fig 4 - NPA increased amid poor economic growth



Source: Company

Fig 5 - Low coverage ratio to keep credit cost high



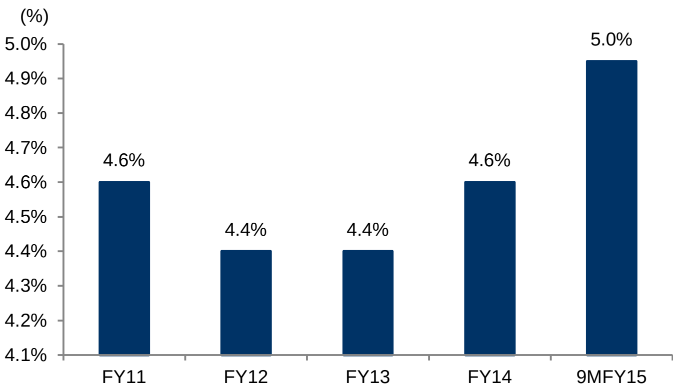
Source: Company

No pricing pressure; cost of funds to ease going forward

Despite weak disbursement trends, management is not seeing any pressure on lending rate (yields) as the business is rather concentrated with only a few large players. Currently, the major source of funding is bank borrowings (working capital at 52% and term loan from banks at 20%), while debentures constitute 7% of total loans (up from 3% in Q2FY15). The company is exploring new avenues to reduce the cost of funds, including higher NCD issuances.

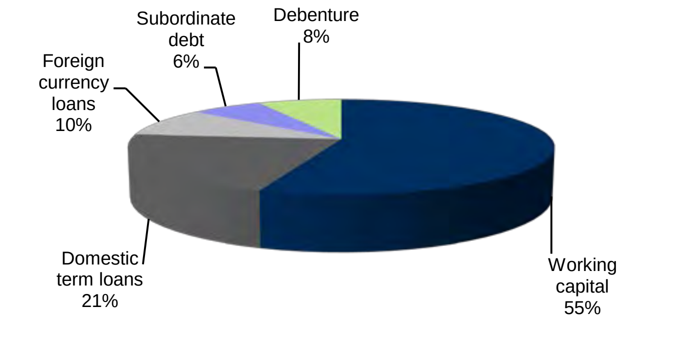
Exploring new avenues to reduce cost of funds, including higher NCD issuances

Fig 6 - NIM to remain in the range of 4.5-5%



Source: Company

Fig 7 - Borrowing profile highly skewed towards banks (Q3FY15)



Source: Company

Fig 8 - SREI Infra – P&L statement

Income Statement (Rs mn)	FY11	FY12	FY13	FY14
Disbursement (Rs bn)	100	122	108	79
Income from finance activities	11,161	16,661	21,470	23,800
Finance charges (excl Forex Impact)	6,552	10,263	13,578	15,324
Net interest Income	**4,610**	**6,398**	**7,892**	**8,477**
Other Income	32	7	89	14
Total Income	4,641	6,405	7,981	8,491
Operating Expenditure	1,525	2,144	2,407	2,316
Operating Profits	**3,116**	**4,262**	**5,574**	**6,175**
NPA Provision & Write off	782	1,004	1,366	2,592
Provision on Standard Asset	200	36	86	2
Forex M2M	1	176	88	5
Profit before tax	2,133	3,046	4,035	3,576
Taxes	825	1,074	1,336	1,322
PAT	**1,308**	**1,972**	**2,699**	**2,254**

Source: Company

Fig 9 - SREI Infra – Key financial ratios

(%)	FY11	FY12	FY13	FY14
Yield on Avg. Funds	13.8	14.7	14.8	14.6
Cost of Funds	9.7	10.6	10.9	11.2
Interest Spreads	4.1	3.9	3.8	3.5
NIM	4.6	4.4	4.4	4.6
Gross NPA	2.9	2.8	2.8	4.8
Net NPA	1.8	2.0	2.2	3.9
Return on Avg. Net Worth	12.6	15.3	16.5	11.3
Return on Avg. Assets on Books	1.6	1.7	1.8	1.3
Return on Avg. Capital Empl.	12.0	12.0	12.0	12.0
Leverage	7.0	7.4	7.2	6.2
CAR	15.8	16.9	16.2	17.1

Source: Company