Scaling new heights

Here's a stunning fact. Eight times more people perish at Mount Everest on the way down than on the way up. This is not because it gets more slippery (the slopes are the same both ways!), but because expedition teams often do not know when to quit. The descent is surely trickier, and hence the best climbers work with 'turnaround times'. What is a turnaround time? It is the time at which a climber must stop ascending, and return to camp, even if they haven't reached their goal. Everyone wants to get to the top, but as narrated by Annie Duke in her book *Quit – The Power of Knowing When to Walk Away*, turnaround times exist on the Everest to prevent people from making poor decisions. She says it is a reminder that in the truest sense, the goal is not to reach the Everest summit, but to return safely to the base of the mountain. A war movie hero would call this *living to fight another day*.

One of our portfolio companies - Cholamandalam Investment and Finance Company (CIFC, or Chola) – a non-banking financial company (NBFC) started in the business of vehicle and home-equity financing. CIFC is part of a renowned conglomerate from South India called Murugappa Group, with history dating back to over 120 years. Interestingly, Murugappa Group's headquarters is called Dare House, although the company is known for its prudence, astuteness and conscientious decision-making. In 2005-06, well after building out a successful vehicle-financing franchise, CIFC entered a strategic partnership with DBS Bank of Singapore by selling a 37.5% stake to the latter. The aim was to grow the personal finance business and the asset management business for which it launched 10 branches. But the Global Financial Crisis hit and by September 2008, the company's personal loan portfolio saw major delinquencies, resulting in GNPA jumping to ~3% in FY09 (from 0.7% in the previous year). Credit losses increased, 75 branches in India were closed and 200 employees laid off. For the tightly-run family-owned group where employees are treated as extended family, the layoffs made the optics worse. Shares nosedived ~95% between Jan 2008 and Mar 2009. The Murugappa group decided to exit the JV and bought out DBS' stake. Both partners had good intentions, but for reasons partly beyond their control, things did not work out as expected. Instead of slogging away forever, there was enough foresight to keep a 'turnaround time' in mind and quit before it was too late.

Cut to today, and CIFC is one of India's fastest growing NBFCs. It's not just a flash-in-the-pan either. With a 10-year growth rate of ~20% and 30% CAGR on top-line and bottom-line respectively, the firm has reinforced their focus on growing and diversifying their vehicle finance book. But first, what is an NBFC? As the name 'Non-Banking Financial Company' suggests, NBFCs are not banks, but financial *aka* lending institutions. How they differ from banks in India is that NBFCs are not allowed to raise demand deposits from the public like banks can. This means NBFCs do not have access to low-cost CASA (Current Account Savings Account) deposits. However, not being a bank also has some advantages, such as needing to set aside lesser capital to meet regulatory requirements. Where do NBFCs raise money from then? Typically, from banks and money markets. For example, for CIFC, ~60% of their funding comes from banks, ~15% from debentures and only a very small portion (<5%) from commercial papers. As you can imagine, NBFCs with sustainably low cost of funds will deliver highest margins. This is because the lending yield (rate at which money is lent out) less cost of funds (rate at which money is raised) and less opex (employee expenses, rent, loan origination costs etc.) is the income earned by an NBFC. Here is where CIFC shines, because its cost of funding at <6.5% (average over FY21-23) is well below that of most peers across verticals, whether vehicle financing, home financing or consumer financing. While the group's parentage (more below) helps with its lower cost of funds, the real game is in pricing power and underwriting capability, for both of which CIFC is a leader in its target segments.

A little about the Group's history. The Murugappa family's story is a fascinating tale of entrepreneurship and perseverance. Originating from the enterprising Chettiar community known for their business acumen in Tamil Nadu and Kerala, the family's founder A.M.M. Murugappa Chettiar embarked on a journey to build a financial empire in Burma in 1900, expanding across Southeast Asia and Sri Lanka. However, the family faced a setback in the 1920s when anti-India riots forced them to return to their roots and rebuild their wealth. With a focus on asset-building and manufacturing, the family established companies like Coromandel Engineering and TI Cycles, and diversified into agri-business through acquisitions like EID Parry and Coromandel International. The Group got into financial services relatively late, launching CIFC only in 1978. While the family explored opportunities in tea, travel services, rubber, and textiles, they have always remained true to running their legacy businesses profitably.

Back to CIFC now – what exactly does Chola Finance do? The company is a lending powerhouse focused on providing financial solutions to the suburban and rural areas, or the "top of the bottom of the pyramid," as they themselves term it. With a total book AUM of around ~USD 13bn, CIFC's primary focus is on vehicle financing, including light commercial vehicles (LCVs) where they are market leaders. Other areas of focus include lending for construction equipment, tractors, cars, and used commercial vehicles. Together, these segments make up ~63% of the company's book, which is further divided into LCVs, HCVs, and other vehicles, with a ratio of 21:7:72. Around ~20% of the book is in LAP, or Loans Against Property, which is loans for business purposes against property pledged as collateral. ~8% of the AUM is in home loans (typically housing mortgages for self-construction) or top-ups for salaried and non-salaried customers. The new business lines CIFC launched last year such as small ticket personal and business loans makes up the balance ~9% of AUM.

Chola has ~1,200 branches across India and hence has a solid on-ground presence. These branches are also very well diversified – with roughly 25% of its branches in each of North, East, West and South India. To really cater to grassroots India (*aka* Bharat), nearly 80% of its branches are in rural areas, and another ~15% are in semi-urban areas. This is how a successful NBFC like Chola manages to thwart competition from banks – as the latter have a strong footprint primarily in the urban areas of the country.

CIFC's vehicle finance business has been its bread and butter for decades. The question that comes to mind here is what the reason for existence of any CV financier is. What do they provide to customers that other financial institutions cannot provide? The answer, interestingly, is a high-touch relationship. For vehicle dealers, a reliable relationship is of utmost importance. Chola has over the decades managed to establish and cultivate deep relationships with dealers, helping with working capital financing, which has in turn helped them push products. Not just with dealers though, as Chola begins its relationships right at the OEM (Original Equipment Manufacturer, such as Tata, Mahindra & Mahindra, Eicher Motors, Ashok Leyland etc.) level.

CIFC were unique in being one of the financiers most exposed to Light Commercial Vehicles (LCVs) in the Indian fleet owner/freight industry. For context, most of the large-fleet truck owners (having more than say 50 or 100 trucks) tend to borrow from banks (and not NBFCs) like Indusind Bank, Kotak Bank, HDFC Bank given the scale of their operations. This is not the segment that CIFC is primarily present in. Why? Because large truck operators tend to present a combination of low yield and low NPA (Non-Performing Assets) like say ~12% RoE and ~2% NPA. The opposite end of the spectrum is 'used trucks', where the yield is very high, but NPAs are also high (like ~7.5% GNPA). Is there a market for LCVs to grow in India? The ratio of LCVs to HCVs in India is only 2:1, but in other parts of the world both developing and developed, the ratio is closer to 3:1. This suggests the LCV market in India could grow sustainably. However, it's not necessarily so simple either. Last mile connectivity in rural areas tend to be poor. A trip to the countryside will often present agricultural vehicles like tractors doubling up as taxis – helping ferry villagers from one place to another – while earning some extra income for the tractor owner. Such lack of formalization as well as interoperability of vehicles will change over time, and is a part of India's last mile consumption growth story. But Chola has realized that focusing on one segment alone could be risky. Hence the company has ensured that their product book today is well diversified: ~27% used vehicles, 21% LCVs, 12% cars, 8% tractors, 8% Utility Vehicles, 7% HCVs, and the rest spread across 2-wheelers, 3-wheelers and construction equipment.

Apart from the vehicle financing business, CIFC is also present in the home loans space since 2007. Why would a vehicle financier enter the home loan market? One key reason is to extend the duration of its assets' franchise. Vehicle loans would typically be repaid over a 3-to-5-year period. But home loans? Not only can the loan tenures here be much higher, 10-15 years or more, but loan-to-value ratios of 65%+ are common, resulting in much better risk management as well (credit costs <1%, better RoAs of 2-3%). Thus home loan products tend to be stickier as well compared to plain vanilla vehicle financing.

The final segments where CIFC is growing are in SME Financing and Consumer Financing. For the former, CIFC began by cross-selling to the multitude of small businesses which their parent – the Murugappa Group - already work with. For reference, the Group is one of India's leading conglomerates, known for their high ethical standards, employing over 50,000 people across 29 businesses including 10 of which are publicly listed. Their companies span verticals like abrasives, auto components, transmission systems, cycles, sugar, farm inputs, fertilizers, plantations, bio-products and nutraceuticals. CIFC has quickly scaled up this piece of the pie too, and now works with the small business ecosystems across many of the top 100 corporates in the country.

For the other segment, Consumer Financing, Chola has either partnered with or invested strategically in fintechs for payments, loan origination, collection and to drive greater financial inclusion. Has anything changed today in 2023 from their prior JV foray into personal finance back in 2007? Yes indeed. The availability of individual borrower data (credit score) is far more robust today – something that was practically non-existent in 2007. This data has even been stress tested, given one of the worst shocks ever in the form of the pandemic. The company understands that while returns and growth in this segment could be much higher than their traditional business, they should be mindful of asset quality and opex, which would be different as well. This is no doubt likely to play into valuations as well, given both affordable home financiers and consumer financiers tend to trade at lofty valuations, and is one of the reasons why the stock has slowly started pricing in higher multiples, in anticipation of future growth in these areas. The stock currently trades at ~4.5x P/B one-year forward - not cheap - but you know if you've been reading our *Access India* notes that a one-year forward valuation multiple does not in our view capture the long-term potential of a capital-efficient high-growth business.

By this point, you'll no doubt intuitively understand some of the risks to our thesis in our Chola investment. The business of vehicle financing in particular, and financing in general - is exposed to adverse impacts arising from an economic downturn. If this fails to result in earnings growth, then the attractiveness of the stock could change. However, the lending opportunity in the country is massive, given India's credit to GDP is <60%. Specific categories are still heavily underpenetrated. A market leader like Chola in our view can continue to grow profitably while gaining market share across segments, and maintaining low NPAs. Chola understands the concept of 'turnaround times' well, and are cautiously aggressive in their approach, which should bode well on their journey to India's financialization summit.

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Data sources: publicly available media articles, sector reports.

Prior Editions of Access India Equity Insights:

1. Changing the stars (link)
2. An electrifying perspective (link)
3. Building with APLomb (link)
4. cARPU diem (link)
5. All's Well That Trends Well (link)
6. 'Foods' for Thought (link)
7. EV Wonder (link)
8. Forest or Trees (link)

Note: *ASK's flagship concentrated ~20-25 stock India equity portfolio is tilted towards financials, consumption, and manufacturing-beneficiary oriented businesses. Our portfolio is biased towards quality companies that can deliver strong earnings growth with exceptional capital efficiency.*

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