"Cholamandalam Investment and Finance Company Limited's Q3 FY20 Earnings Conference Call"

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Moderator: Ladies and gentlemen, good day and welcome to the Cholamandalam's Q3 FY'20 Earnings Conference Call hosted by Kotak Securities Limited. As a reminder, all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing '*' then '0' on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Nischint Chawathe from Kotak Securities Limited. Thank you and over to you.

Nischint Chawathe: Hello, everyone. Welcome to the conference call with management of Cholamandalam Investment and Finance Company Limited. To discuss the 3Q FY'20 performance of Chola and share some industry and business updates, have with us today Mr. Arun Alagappan – Managing Director, Mr. Arul Selvan – Executive Vice President and CFO, Mr. Ravindra Kundu – Executive Director; Mr. Shaji Varghese -- - President, Housing Finance and Mr. Rupinder Singh - Senior Vice President and Business Head, Home Equity and SME.

I would now like to hand over the call to Arun for his opening comments.

Arun Alagappan: Good morning, ladies and gentlemen. I have great pleasure in presenting to you the performance of Chola Finance for Q3 FY'20 and YTD December 2019. Because of the QIP and the compliance factors, we have delayed the investor call and are doing it post the silent period.

At the outset, I am happy to state that we ended the quarter with a business asset base of Rs.60,778 crores, registering a growth of 20% over the last year.

The following highlights from Q3 FY20 and YTD December '19 performance reaffirms Chola's steady growth despite the prevailing adversities in the external market. Aggregate disbursements for the quarter ended December 2019 were at Rs.7,475 crores as against Rs.7,644 crores in the same period over the previous year. Aggregate disbursements for YTD December 2019 was at Rs.23,429 crores as against Rs.21,558 crores last year, registering a growth of 9%. Assets under management including incremental cash held in hand grew by 25% from Rs.52,591 crores for YTD December'18 to Rs.65,992 crores for YTD December'19. PBT for the quarter ended December 2019 was Rs.522 crores as against Rs.463 crores last year, registering a growth of 13%. PBT for YTD December 2019 was at Rs.1,528 crores as against Rs.1,362 crores last year, registering a growth of 12%. The PBT-ROTA for Q3 FY20 was at 3.4%. The PBT-ROTA for YTD December '19 was also at 3.4%. PAT stood at Rs.389 crores for Q3 FY20 and for YTD December 2019 PAT was at Rs.1,010 crores. ROE was at 20.3% in Q3FY20. Book value was at Rs.90.21 per share as of Q3FY20, up by 18% from Rs.76.55 in Q3FY19.

We have increased our branch network to 1,073 branches, out of which 81% are in Tier-3, 4, 5 and 6 cities. We are well on our way to reach the 1100 mark by the end of this financial year.

We have maintained continued focus on our efforts to reduce the non-performing assets. As per IND-AS, our Stage-III assets at the end of December 2019 was at Rs.2,024 crores as against

Rs.1,648 crores in December 2018. Stage-III percentage to total gross assets stood at 3.5% in December 2019 as against 3.3% in December 2018. Coverage ratio for Stage-3 was at 33% as of December 2019 as against 35% in December 2018.

Let me also share with you the business level performance of Vehicle Finance and Home Equity divisions. Vehicle Finance has delivered a performance with an improvement in disbursements, asset growth and profits for YTD December '19. The Vehicle Finance business grew by 6% in disbursements for YTD December 2019 and 19% in terms of closing assets year-on-year. The business recorded a PBT of Rs.295 crores for the quarter as against Rs.308 crores last year and on YTD the PBT was at Rs.932 crores against Rs.906 crores last year. The slowdown in disbursements is primarily due to the industry degrowth in commercial vehicle segment. The CV segment at the industry level has grown by about 23% for YTD December '19 against the same period last year. To compensate for this drop, we have consciously increased our product mix in other segments like passenger vehicles, two wheelers, three wheelers and used product segment. CV segment which used to be approx. 39% of our disbursement mix for YTD December '18 as a result has come down to 31% for YTD December '19.

Moving on to the Home Equity business, The Home Equity business grew disbursement by 10% and AUM by 16% for YTD December 2019 over the previous year. PBT grew by 9% for the quarter and 17% for YTD December 2019 over previous year. The business recorded a PBT of Rs.88 crores for the quarter-ended December '19 as compared to Rs.80 crores last year and YTD December '19 at Rs.259 crores as against Rs.221 crores last year. Recoveries continue to be good by leveraging SARFAESI, resulting in higher profitability in this business.

The company's capital adequacy ratio at the end of Q3 FY20 was at 17.04% with Tier-1 at 13%.

Capital Issue: The Board of Directors at the meeting held on 23rd Jan 2020 and subject to the approval of the shareholders approved an issue of equity shares by way of preferential issued to Cholamandalam Financial Holdings Limited, a promoter entity up to an amount not exceeding Rs.300 crores in one or more tranches at such prices in accordance with Chapter-V of SEBI (Issue of Capital Disclosure Requirements) Regulations 2018. And also we have done a QIP of Rs.900 crores, basically to meet both business growth and augment our Tier-1 capital.

Before I conclude, I would like to impress upon you that technology adoption is increasingly becoming more and more critical for our business. We at Chola have continued in our efforts to infuse technology and analytics in today's processes and systems. It is becoming evident that a lot of these capabilities are helping us maintain the quality growth of our assets. Our tech teams have been leveraging the API and micro services platforms to fast track adoption and minimize time to market. Our existing underwriting models are getting augmented by AI and ML Tools including predictive model across credit, sales, collection and risk function. These capabilities have helped us predict and strategize for credit risk, field collection efficiency, sales and productivity, cross-sell efficiency, audit and fraud monitoring. We are confident that all these technological interventions will positively improve the experience of Chola customers in the long run.

Thank you all for attending the call. My colleagues and I would be happy to answer any queries now.

Moderator: Thank you very much. We will now begin the question-and-answer session. The first question is from the line of Nidhesh Jain from Investec. Please go ahead.

Nidhesh Jain: On the asset quality sir, if you can give some color which segment is leading to this increase in asset quality, how is the asset quality experience between housing finance, home equity and vehicle and within vehicle which segment is contributing to this asset quality increase?

Arul Selvan: So the vehicle finance we are at around 2.7% in stage-III numbers as compared to September we were at around 2.34%, it has marginally increased a bit. But considering the market situation, etc., I think this is something which is inevitable. Similarly in the home equity also, it has actually moved up a slight bit from 5.9% to 6%. Home loan it is reduced marginally; 3.8% to 3.7%. Overall, we are at around 3.5% on the December closing in stage-III to total business assets.

Nidhesh Jain: Within vehicle finance, what we understand is the sector is witnessing higher stress in HCV. So is it right to confirm that…?

Arul Selvan: We also see the same trend; HCVs have moved up a bit. That is why also in a way the provision coverage is seeming to be dropping but that is primarily because heavy realization, the LGDs are lower, so that is where the provision coverage will seem to be dropping but that is because of the mix change here. Actually, our performance on the used and the higher risk profiles like tractor, etc., has improved the individual stage-III numbers compared to previous year.

Nidhesh Jain: What will be the commentary or guidance on the asset quality going forward -- should we expect further deterioration because commercial vehicles segment continues to remain under stress?

Ravindra Kundu: Heavy commercial vehicle is under stress for last one year and that is the reason we are reducing our focus on this product, we have reduced our mix from 39% to 31% at overall level for commercial vehicles which is primarily driven by the heavy commercial vehicles. So if you would have done the higher heavy commercial vehicles, our portfolio would have been impacted. But having said this, the market side if we see that last three, four months we have started seeing that the customers have started paying their EMI but still struggling. October-November-December was a very bad period. After that things have started improving. So I think this is going to continue for some time and let us see how far can we change the story. We are expecting that this kind of struggle for heavy commercial vehicles customers will be there for at least eight, nine months.

Nidhesh Jain: On the operating expenses, there is a sharp increase for last two quarters; Q2 and Q3 despite a muted growth in disbursement and a slowing down asset growth. So what is the key reason for operating expense growth for the last two quarters?

Arul Selvan: Post IND AS relating these expenses to disbursement has lost significance because under the IND AS, the sourcing cost gets amortized. So the impact actually is of the past periods booked, amortizing of cost that is what is coming into the sourcing cost. The cost increase is primarily on the collection efforts that is being put which needs to be charged up because that is incurred and that is on the book. So, there are two aspects: So do not try and relate it to disbursement is my only request. Disbursement growth or degrowth will not immediately reflect on the expenses. It will be more on the asset side. And then other aspect is yes, we have increased cost on the collection side and that is what is showing up there.

Ravindra Kundu: One more point actually. If you see that our disbursement has gone up for YTD level for vehicle finance grew by 6% in terms of value but in terms of units it has gone up by 34%. So number of file passes for the similar disbursements has significantly gone up because we have started doing more two wheelers, three wheelers, passenger vehicles, used and older vehicles business. These vehicles businesses required upfront payout to the dealerships and the people who basically work for us as a connector. So therefore one is that the number of people hired for small ticket size has increased in sales and also correspondingly we have added manpower in collection.

Nidhesh Jain: So this OPEX to asset ratio which has increased is slightly structure in nature because the share of high yielding low ticket product is also increasing?

Ravindra Kundu: Correct.

Moderator: Thank you. The next question is from the line of Sivakumar from Unifi Capital. Please go ahead.

Sivakumar: Sir, what would be the capital adequacy ratios post the QIP rise?

Arul Selvan: It will be 20+ including tier-2, on the tier-1 it will be 15+.

Sivakumar: And according to your internal calculations, how long should this capital last when you have to again approach the market for a rise?

Arul Selvan: This capital will be good to sustain 20% growth provided our PBT-ROTAs are in the range of around 3.5%. So, this is a factor of these two; growth of assets and also our internal generations are adequate to feel the group. If we are growing by around 20% or less than 20% and then we still clock 3.5% of PBT-ROTA, then we do not need capital. And I think even otherwise this will sustain us over the next two years even assuming if there are some slowdown on the profitability.

Moderator: Thank you. The next question is from the line of Nischint Chawathe from Kotak Securities Limited. Please go ahead.

Nischint Chawathe: Two parts: one is based on the recent trends, if you could give some outlook for growth in both vehicle finance and home equity business and even in the vehicle finance maybe some outlook for industry volume growth or the OEM volume growth as well? And maybe on the housing finance side if you could articulate the strategy, we saw that Mr. Shaji has joined you, so maybe if you could kind of articulate some strategy on that front as well?

Shaji Varghese: Hi! This is Shaji here. As you know, we already have an existing base within the space of very close to Rs.2,900 crores of AUM which is managed. The whole thought is to create asset, focus and strategy around the housing finance company and as a group it is a very good risk understanding of the LMI segment. So we would like to build housing as a separate business unit within the group. That is the broader thought and a separate license for HFC has received. It is pending with the regulator to finally grant the license. Once that is through, we will firm up the strategy and of course we will come back and update way forward at that stage.

Nischint Chawathe: Any ticket size and yield that you sort of segment that you have in mind?

Shaji Varghese: As a group, the understanding of the risk management of (LMI), Lower and Middle Income group has been time-tested for all these years. So it is more logical to ride on the same where the group has a better understanding, that is one. Second, already we have a large presence across 1,000 plus locations. It is more logical to ride on the same platform. Coming to the ticket size, directionally we do not want to go below the million ticket size. Currently, it is around 14 lakhs is the average ticket size and more interestingly LTV is around 60%. So, very well thoughtful client segment and LTV and the risk profile. So we would like to continue to build on this and build scale. That is the opportunity we are sitting on.

Ravindra Kundu: As far as vehicle finance is concerned, if you see that heavy commercial vehicles sales, September month was a very lowest month; the TIV came down to 10,000 units and after that it is going up every month. And in the month of January, it has reached to 15,000. But the peak number used to be 30,000 and average number used to be 20,000-25,000. So that will take time to reach the level. At overall level, commercial vehicles we have seen that the TIV in the month of January reached to 74,000 level which is a respectable figure and it is growing month-on-month. But this quarter and the next quarter we are moving from BS IV to BS VI. Therefore, all the OEMs and dealers put together, they reduce their inventory to zero and then start building the inventory which is going to be a big task and that is why there is a disruption in the market and it might impact the disbursement in Q4 and Q1. After that it will start picking up and Q2 onwards we can expect that the industry will perform not only because of the numbers, also because of the low base effect will start. Last year Q2 was very smallest number. So as compared to that you optically will start seeing better numbers.

Nischint Chawathe: And you see the rise in tickets as well next year?

Ravindra Kundu: Ticket size for basically heavy commercial vehicles will go up by 10% to 15%. Ticket sizes definitely will be high. Among all three products, in terms of percentages, small commercial vehicles will be high and then the lights and heavy commercial vehicles.

Nischint Chawathe: Just some outlook on growth in the home equity business for next year?

Rupinder Singh: Hi! This is Rupinder. So basically last year specifically we moved to additional 80, 85 branches. So that was the thought when we realized that market is going more towards tier-2, tier-3 and focus is more there than the tier-1. So strategically we plan. And now in last couple of quarters we start beefing up there basically. So eventually, outcome is ticket size will go down. So earlier the ticket size was say in the tune of Rs.54-55 lakhs which is now on the book will be around Rs.40-44 lakhs because the ticket size is on a lower side compared to what in tier-1 market. Secondly, this will also help in building a more team particularly because you get better rates, better fees when you go to the markets which are tier-3, tier-4 particularly, then going to tier-1 like Mumbai, Delhi, Chennai, something like that. So this is the strategy which we are adopting it and this strategy where you have to put more hard work, it will be more concentrated where the in-house built team instead of depending upon channel partners like DSAs and all and obviously result in terms of better ROTA and better NIM is the outcome what we are looking for. In terms of growth, it will take time because market is little sluggish as of now. But we are optimist that maybe in a quarter-to-quarter as soon as it picks up, we are ready in terms of teams which are well placed now and picking up the numbers.

Moderator: Thank you. The next question is from the line of Piran Engineer from Motilal Oswal Securities Limited. Please go ahead.

Piran Engineer: I just have a couple of questions: Firstly, on asset quality, while HCV asset quality has been deteriorating, is there a chance of rub-off on LCVs in the coming quarters, does that typically happen or has that happened in the past?

Ravindra Kundu: Medium commercial vehicles in our portfolio is a part of light commercial vehicles. So above 12.5 ton and to 16 ton is actually called as ICV or MCV, have also been seen as a portfolio quality deteriorating which is along with the heavy commercial vehicles. But rest of the LCVs are better.

Piran Engineer: And it will continue to be so?

Ravindra Kundu: Yes, till market improves it will continue to be like that. But first improvement will come in MCV, then HCV will be followed.

Piran Engineer: Secondly, now that Feb is also almost over, any trends in prebuying that you witnessed across categories, be it HCV or cars or other products?

Ravindra Kundu: During this time actually all dealers and OEMs are completely busy in reducing their inventory and therefore the availability of vehicles are not there across the dealership. Fast moving vehicles are not available and it is very difficult for them to manage to get the vehicle from the other point to the point where the customer is. Because of that there is a logistic issue and that is impacting on the sales. Little bit prebuying is basically because there is a discount and customer also now understood that they have to pay some 10-15% extra from April. So they want vehicles, but vehicles are not available. Second is that finance companies are also not taking call on the cab chassis. Only fully built vehicles are being funded because the registration will not be possible before 31st March. So because of these two reasons, in spite of having some interest in the customers mind to buy the vehicles, sales is not picking up and neither manufacturer and the dealerships are in position to solve this problem.

Piran Engineer: Sir lastly, when you spoke about TIV sales being 15,000. What does it stand for?

Ravindra Kundu: Total industry volume, in the sense, all the OEMs put together for the heavy commercial vehicles for the month.

Moderator: Thank you. The next question is from the line of Pranay Rajani from B&K Securities. Please go ahead.

Pranay Rajani: Your voice was not clear. Can you just repeat the gross NPA number for vehicles segment which is 2.7% stage-III as compared to …?

Arul Selvan: 2.35% in last year.

Pranay Rajani: Home Equity segment was 5.9% previous year and currently it is at 6%?

Arul Selvan: Yes.

Moderator: Thank you. The next question is from the line of Saurabh Dhole from Trivantage Capital. Please go ahead.

Saurabh Dhole: A couple of questions from my end. Firstly, on your NIMs, if you could explain exactly what is causing the improvement in NIMs on a sequential basis – is it the changing mix of the book or have you taken some price hikes for the company as a whole?

Arul Selvan: Frankly, in the company as a whole, what has also happened is there was adequate market for assignment of receivables. So, we could do some direct assignment of receivables. And under the IND AS, because these assets are going off the book, you needed to upfront the profit, we had upfronted some profits on that account. So that has also added to the NIM. The impact of the product mix is yet to show up on NIM primarily in large scale. Having said that, in the home equity, we have clearly seen NIM improvements compared to last year primarily because they were able to reprice the entire book because of the cost of funds, etc., So for example if you have the presentation with you, if you see, the vehicle finance NIM it is still slightly lower while it has improved over Q2, it has improved by 10 bps in Q3, is still lower as compared to last year.

And in the home equity if you see in page 47, you will see that we have consistently seen and now clocking 3.9% which is higher than the 3.6% we were clocking last year.

Saurabh Dhole: Talking of changing mix, you also in your initial comments said that you are consciously moving towards PV, three wheelers and two wheelers. So what impact does this have on the way you are sourcing business today?

Ravindra Kundu: See, we have been doing all these products for quite some time. But for last four years, we have been slow in doing two wheelers, three wheelers and passenger cars in terms of selecting one brand and going with that. During this time when we saw that there is need to do some activity in terms of increasing the disbursement to freeze the gap we are having in commercial vehicles side, we have also added two more brands in both two wheelers and three wheelers. So there is no change in the sourcing strategy with respect to two wheeler and three wheeler. We have a dedicated team available for two wheeler and three wheeler. Only thing is we have added manpower in that vertical which is actually showing up in operating expenses.

Saurabh Dhole: If I remember correctly, in your opening comments, you also mentioned how post-December some of the CV customers have started paying up. And even though they started paying up, for the next eight, nine months, you still see some kind of pressure continuing. So, I just wanted to know what exactly as per you have changed on ground which has enabled some of these customers to start paying up?

Ravindra Kundu: Only collection follow-ups have gone up significantly from our side. October-November-December in fact sales team also working with collection to collect money. So by just putting more effort on collection, we were getting money. Because at this point, the cash flow of the customers have been impacted badly. So whosoever goes to customer first will get the money…

Saurabh Dhole: As I was saying, on-ground as per you, there has been no change in terms of the environment that these players are operating in?

Ravindra Kundu: Yes, there is a slight change. On-ground in October, November-December the capacity utilization was down to the level of 10%-20% which has improved to 50%. But payment cycle has gone up; 60-90-days. During the gap of this rainy season, they exhausted all their receivables and then now they need to bill that. So once they bill their receivables and then start paying comfortably, going to take some more time. As of now, it is hand-to-mouth type of situation. Whatever comes in the month, there we need to collect the EMI.

Moderator: Thank you. The next question is from the line of Amit Rane from Quantum Securities. Please go ahead.

Amit Rane: My question is on the used CV segment. We are seeing improvement in the disbursements in that segment in last four quarters. So going forward what is your outlook on this particular segment?

Ravindra Kundu: Used business is going to further improve because after BS VI launch, the value of the BS IV vehicles will further improve. Those people who are struggling today, they are double mind to sell the vehicles in this period. Next time when they get better price, they will sell it off and close their loan. So, we are expecting that the vehicle repurchase via the finance companies or the vehicle which is excess in fleet with the customer, they will be getting opportunity to sell it off at better price during first quarter. And that is the period we will see that the used business will further improve.

Amit Rane: Sir, in terms of asset quality in this used vehicles segment, what are you seeing, any trend?

Ravindra Kundu: Used vehicles is stable actually. Other than heavy commercial vehicles, the MCV, the high end light commercial vehicles, rest of the products are stable. It has gone up slightly, hardly 5-10 basis points. That is because of the general economy's slowdown. There is a slight slowdown in the economy, which is impacting every product including two wheeler, three wheeler also.

Moderator: Thank you. The next question is from the line of Umang Shah from HSBC. Please go ahead.

Umang Shah: I just had two questions: One is a clarification that although we are formulating strategy for the housing finance business, just wanted to check at the home equity and housing finance business, both will continue to run as independent businesses as they have been so far?

Arul Selvan: Yes, the home equity will continue to be in the main company, home loan will move to the new HFC distribution once we get the license.

Umang Shah: And second is what would be your marginal cost of borrowing now?

Arul Selvan: Marginal cost of borrowing in Q3 was around 8.5%, now it has come down drastically, around 25, 30 basis points, may have late 20.

Umang Shah: So to that extent, we should expect some sort of margin expansion getting into Q4 and Q1 as well, is that a fair assumption?

Arul Selvan: This is not the marginal borrowing. The total borrowing is much more. The book will tend to come off slowly. One good point is we have been able to reprice many of the bank borrowings in this quarter. So that impact and the book also have come, we have earned the marginal borrowings. So both these put together you will certainly see some NIM improvements in Q4.

Moderator: Thank you. The next question is from the line of Shubhranshu Mishra from BOB Capital Markets. Please go ahead.

Shubhranshu Mishra: My first question is just a follow up of some previous questions. One is that you are adding manpower in two wheeler and three wheeler sourcing. These are known to be high cash markets and the LGD considerations are higher and the asset quality is not historically known to be good. So why are we increasing our focus on two wheeler and three wheeler sir?

Ravindra Kundu: So two wheeler and three wheeler, the arrangement what we have with the OEMs we are working is slightly different than the general way things are happening in the market. In 2014, we started with the Royal Enfield and just now we started working with the Honda. And we have been doing it very selectively. And our portfolio quality is much better than the industry and we will continue to do it. As far as three wheeler business is concerned, we have tied up with two OEMs and with the two OEMs we have a loss sharing arrangement. In the case of losses going up beyond that they will actually compensate the losses. So both the cases, we have actually protected our risk.

Shubhranshu Mishra: Can you quantify the loss sharing arrangement with the OEM?

Ravindra Kundu: No-no, that is very technical thing, it is a confidential matter…actually whatever I said is also confidential.

Shubhranshu Mishra: My second question is how many outstanding unique customer relationships you have and the number of people you deploy in collections just wanted to understand, if you have increased your collection effort, how many number of trips you were doing to a customer a year back and number of trips that you are doing to the customer as on date?

Ravindra Kundu: Most of them are unique customers. I would say in a vehicle finance there maybe one customer who may have two or three agreements, but the number of such customers is very less. If you see the segment we are addressing, these are one to five vehicle owners only, they are not the fleet operators, keep on buying hundreds of trucks.

Shubhranshu Mishra: Yes, I get that sir. That is what I am trying to get at. The unique number of customers if you can give me a ballpark number?

Ravindra Kundu: We have around 10,000 executives in collection and where ACR account per customer is around 80. So, you can multiply that. That is what is basically an average.

Shubhranshu Mishra: So why do you need the sales people also to chase the same customer because that is increasingly…?

Ravindra Kundu: The sales guys this time have been actually involved in collection because the delinquency was there from the heavy commercial vehicles and medium commercial vehicles side and these customers profiles are slightly bigger profiles. So when they get into the problem, we need to basically counsel them to understand what is the issue and how can we basically solve their problem. If two wheeler delinquency is going up, sales people will not be able to do anything. You need to run behind and collect it. Here that is the reason we involve sales people.

Shubhranshu Mishra: So if this is going to occur for the next eight to nine months, what is the increase in the OPEX that we should model in because of this …?

Arul Selvan: It has already been done actually. Current rate is going to be the same only. In fact, we are trying to reduce. OPEX is actually also related to the average assets. So if average asset is not growing, then automatically it goes up.

Moderator: Thank you. As there are no further questions, I now hand the conference over to Mr. Nischint Chawathe for closing comments.

Nischint Chawathe: Thank you, everybody for joining us today. We thank the management for giving us an opportunity to host the call.

Management: Thank you.

Moderator: Thank you. Ladies and gentlemen, on behalf of Kotak Securities Limited, that concludes this conference. Thank you for joining us and you may now disconnect your lines.