Gold Loan NBFCs with stronger balance sheet focusing on diversification

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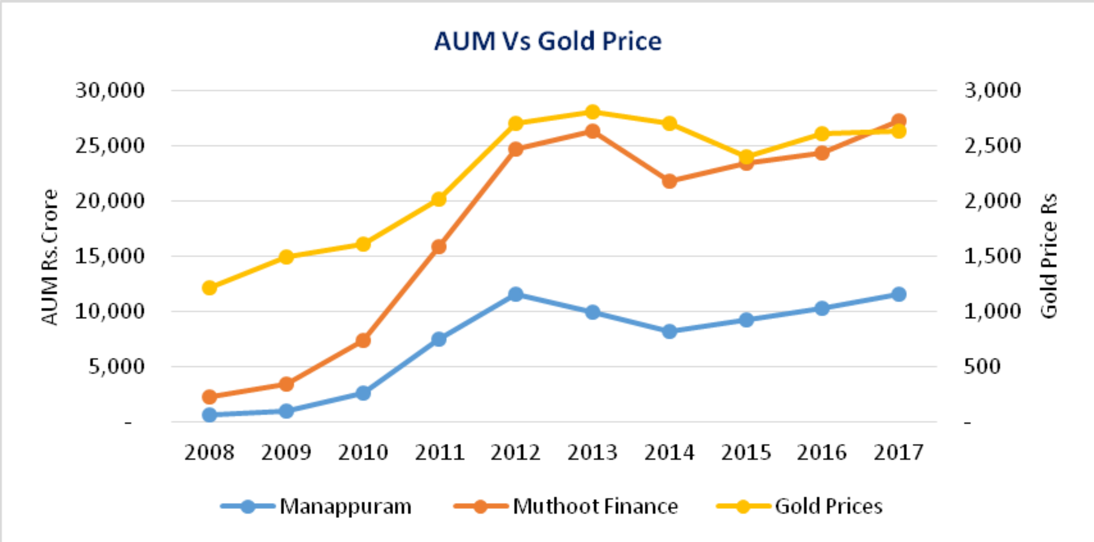
Introduction

The organized Indian gold loan industry is dominated by gold loan NBFCs. The largest gold loan NBFC, Muthoot Finance Limited (MFL), has assets under management (AUM) of Rs.27,608 crore, and Manappuram Finance Limited (Manappuram) has AUM of Rs.11,432 crore as on September 30, 2017. Though banks offer gold loans at relatively lower interest rates, factors such as exclusive focus on gold loans, lower turnaround time, flexible schemes, wider branch network and relatively longer working hours place NBFCs in a better position to attract customers. In the past few years, domestic gold loan industry has undergone various regulatory challenges, which though impacted AUM growth for a brief term (FY13-FY14 [refers to the period April 1 to March 31]) ended up strengthening the industry by minimizing various risks associated with business as highlighted by CARE in its earlier write-up (Gold loan NBFCs: Better placed to handle Gold Price Risk).

Moderate growth in AUM during FY15-FY17 with AUM broadly moving in trend with gold prices

While gold prices increased from 2007 to 2012, established large players in the gold loan NBFC industry reported continuous growth in AUM during that period. AUM of MFL and Manappuram put together grew at a CAGR of 90% from March 2008 to March 2012. Overall the gold loan NBFCs reached their peak AUM during FY12-FY13.

As the gold prices started declining after touching peak in September 2012, the AUM of gold loan NBFCs also started declining. Majority of large gold loan NBFCs witnessed drop in AUM during FY13 and FY14. In addition to fall in gold prices, this could be attributed to regulatory changes including capping of LTV (Loan to Value) ratio. Subsequently, AUM of gold loan NBFCs started increasing again since FY15. Divergence in above trend during FY15 is on account of increase in LTV from 60% to 75% in the month of January 2015 as per RBI guidelines. AUM of MFL and Manappuram put together grew at a CAGR of 9% from March 2014 to March 2017. However, this time there was greater focus on gold price risk mitigation also (detailed in next paragraph). Movement of AUM and trend in gold price is shown in the chart below:

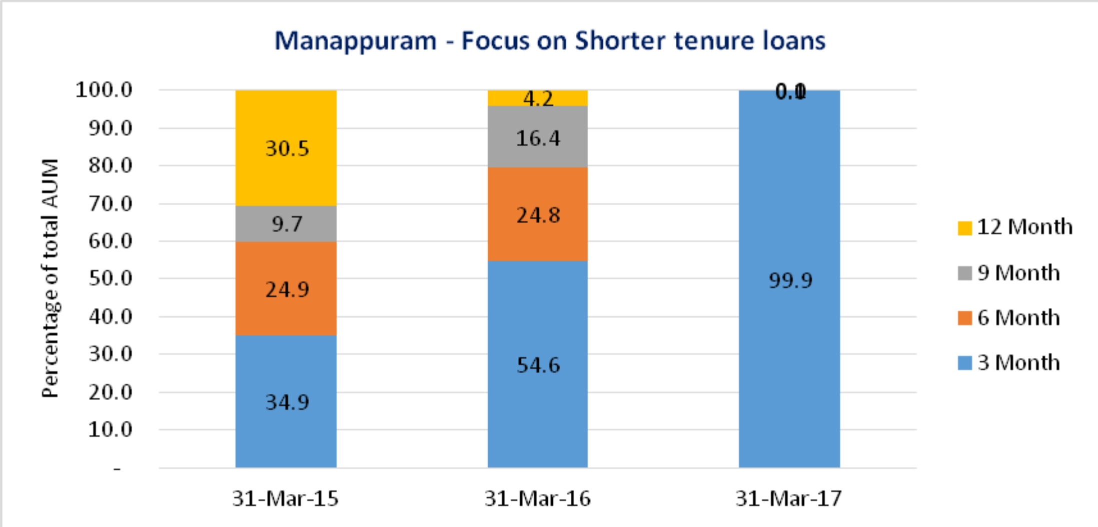


Source: Annual Reports and Investor Presentations

Mitigating gold price risk with focus on relatively shorter tenure loans

Initially, the gold loan NBFCs were lending at LTV of greater than 90%. Correction in gold prices resulted in higher LTV loans becoming vulnerable to losses with value of the pledged gold jewellery going below the loan amount. The industry witnessed significant losses on account of under recovery from overdue/NPA accounts. In view of the continuous increase in gold prices and significant growth in AUM of gold loan NBFCs, RBI had introduced regulation capping the LTV of gold loans to 60% in March 2012 to mitigate risks arising from gold price volatility. Subsequently, during January 2014, RBI issued guidelines with respect to arriving value of gold jewellery pledged as collateral on scrap value of gold basis instead of adding making charges, taxes, etc, and also relaxed the LTV for gold loans by increasing it to 75%.

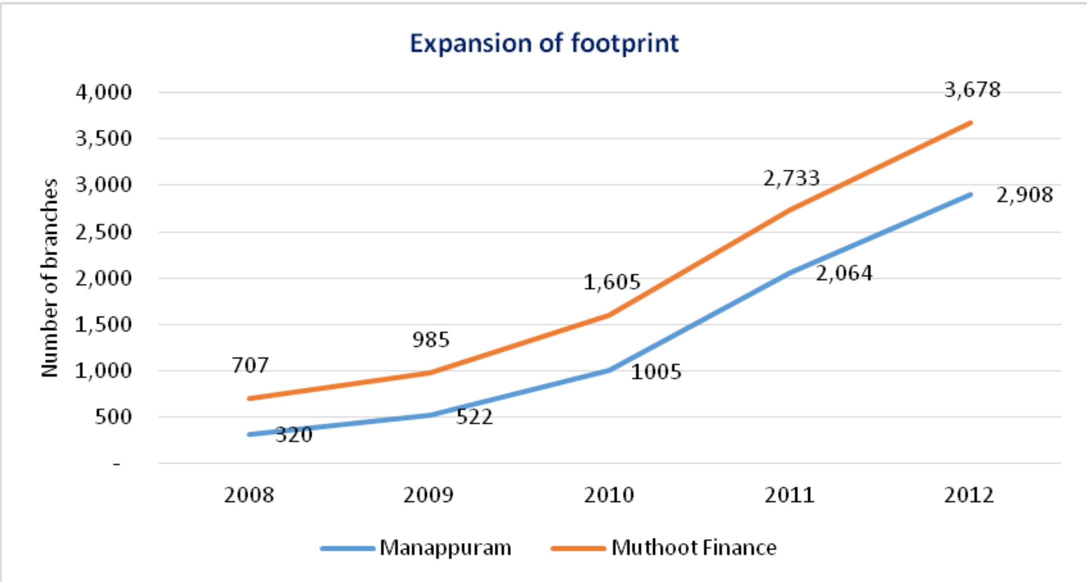
The industry also changed its strategy to mitigate the gold price risk by giving preference to loans at lower LTV, periodical collection of interest and relatively shorter tenure loans. For gold loans with bullet repayment at the end of the tenure of loan, effective tenure of loans remains a major factor impacting the under recovery. Major players adopted the strategy of focusing on relatively shorter tenure loans like three/six/nine-month loans to ensure that the value of the underlying security is higher than the outstanding obligation of the borrower at any point in time so that losses on under recovery are minimized. Also, periodical collection of interest helps gold loan NBFCs to ensure that the outstanding loans are in the money. While following stringent norms with respect to auctioning of gold and recovery, retaining the customer base will be a key challenge for the industry.



Source: Annual Reports and Investor Presentations

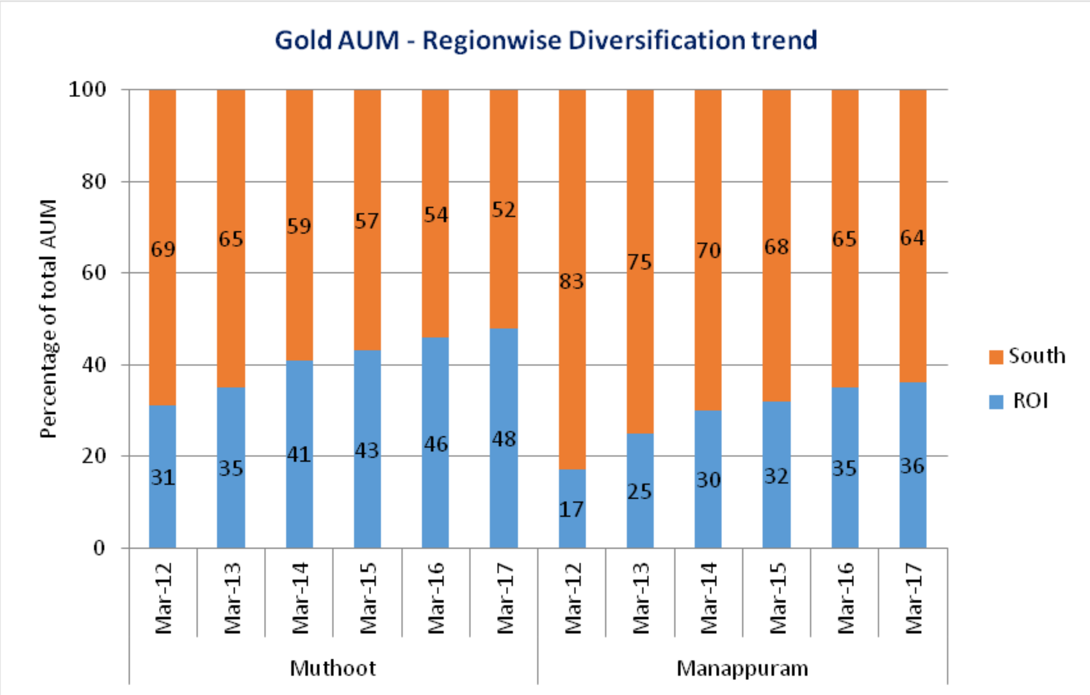
Consolidation of branch network with focus on geographical diversification

The major differentiating factor which enables the growth of gold loan NBFCs is their widespread network and customer service. Gold loan NBFCs have their extensive presence in south India. In trend with the growth in AUM, gold loan NBFCs also started expanding their footprint from 2008 to 2012 aggressively.



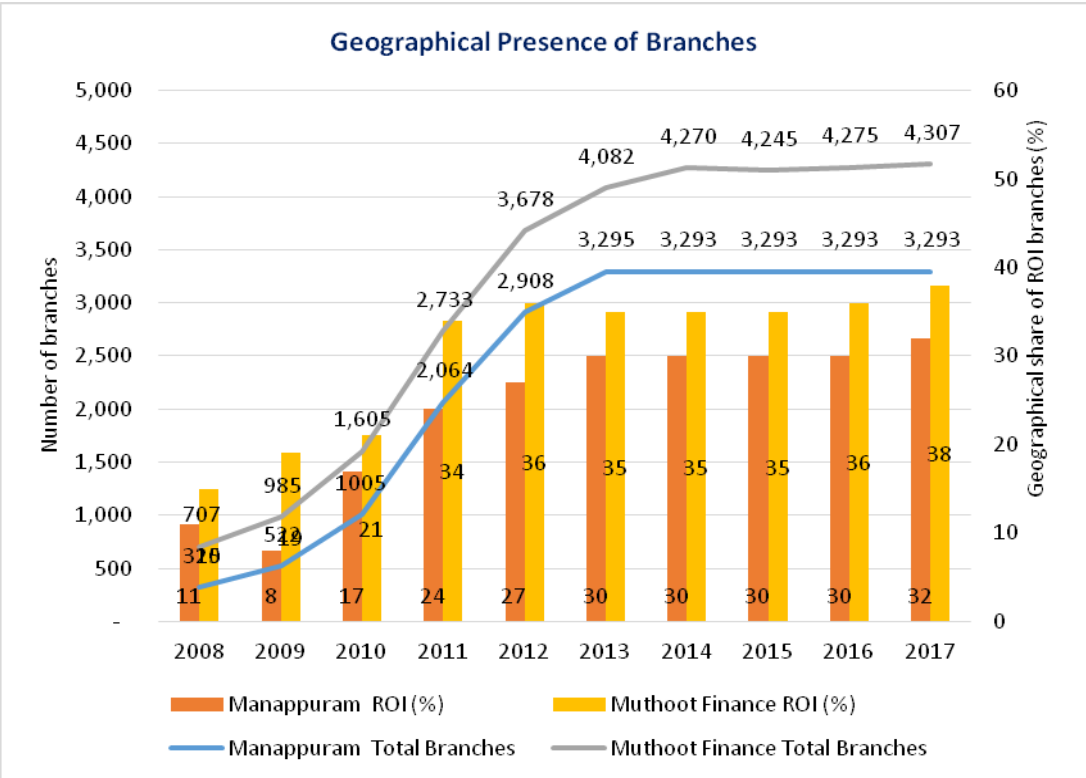
Source: Annual Reports and Investor Presentations

Though these companies took efforts to expand to other regions since 2008, portfolio growth predominantly came in from southern India till 2012. Post 2012, share of Rest of India (ROI) in overall AUM has grown as given in the chart below.



Source: Annual Reports and Investor Presentations

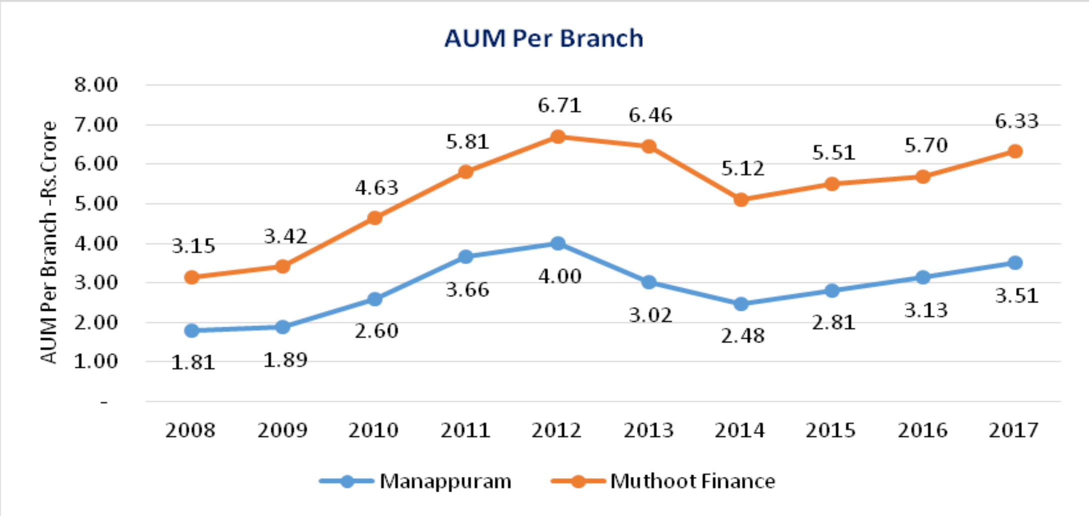
On account of decline in AUM during FY13 & FY14, gold loan NBFCs consolidated branches especially in south India to control the operational cost and have also been cautious on expansion with emphasis on opening branches majorly in regions other than South. The share of branches from ROI in respect of MFL and Manappuram is given in the chart below.



Source: Annual Reports and Investor Presentations

As it can be observed from the aforementioned chart, the share of non-southern regions in branch network has been increasing continuously albeit marginally. At the same time, total number of branches stood almost flat for the period from FY14-FY17.

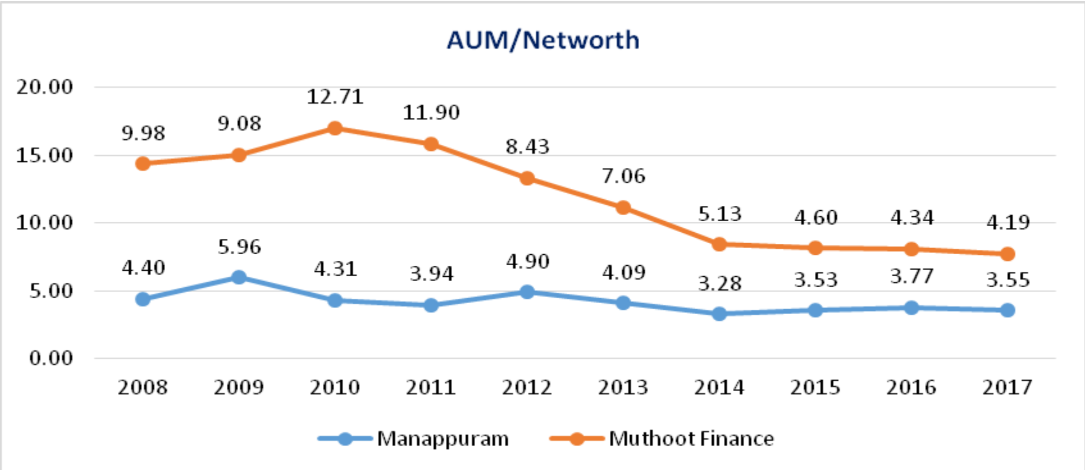
AUM per branch reached its peak level during the year ended March 2012 and it started declining after that primarily due to fall in gold prices and regulatory changes by RBI. AUM per branch started improving again from FY15 as the companies took measures to consolidate the loss making branches and have been cautious in terms of branch expansion.



Source: Annual Reports and Investor Presentations

Price risk mitigation & consolidation leading to stronger credit profile

Moderate growth in AUM and stable operating costs post FY14 enabled gold loan NBFCs to maintain healthy profitability. Also, as a result of retention of profits, networth as well as capital structure witnessed improvement. Hence, the companies were able to maintain their CAR levels comfortably above regulatory requirement. AUM/Networth (times) over the last ten years is shown in the graph below. As it can be observed from the graph below, AUM/Networth (times) is at the lower levels since 2014 as the growth in AUM is relatively moderate as compared with the accruals to networth indicating stronger balance sheet and the ability to absorb losses arising from unfavorable movement in gold prices, if any.



Source: Annual Reports and Investor Presentations

With relatively stable profits & stronger balance sheets and limited scope for expansion, large gold loan NBFCs have started focusing on diversifying into other segments in the past few years.

Focus on diversification to non-gold products

With moderate growth in loan portfolio and availability of capital cushion (as reflected in comfortable CAR levels), gold loan NBFCs started looking at diversification into other asset classes such as Microfinance, SME finance, Affordable housing finance, etc. Operating systems which have been tested, huge customer database and established brand name provides additional comfort to these companies.

Diversification into other segment was either through direct lending or acquisition. Recent acquisition or entry into new asset classes by Manappuram and MFL are given below.

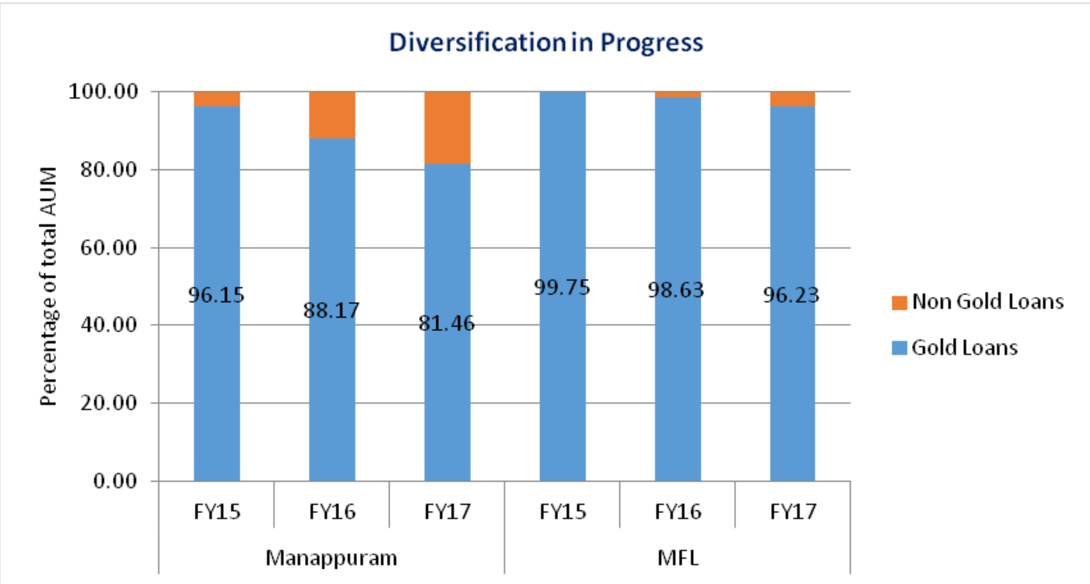
Manappuram Finance Limited

- Ventured into Microfinance by acquiring Asirvad Micro Finance in February 2015.
- Acquired Milestone Housing Company in February 2014 and renamed it as Manappuram Home Finance Limited.
- Also ventured into LAP and Vehicle Finance in own books during FY15.

Muthoot Finance Limited (MFL)

- Acquired Belstar Investment and Finance Pvt Ltd in May 2016.
- Has its presence in housing finance through its subsidiary Muthoot Homefin (India) Limited.

As a result of these diversifications, the product-wise AUM composition over the past three years has changed as shown in the chart below:



Source: Annual Reports and Investor Presentations

Gold loan NBFCs likely to witness moderate growth

On account of higher penetration in the southern region (as evident from consolidation of branches in the south) and slower addition of branches in non-southern region, growth in AUM is likely to be moderate and is likely to be conditioned by movement in gold prices.

The credit risk profile of larger gold loan NBFCs likely to remain stable on account of stronger balance sheet and various risk mitigation strategies adapted by these companies in the past few years. However, the improvement in profitability witnessed by gold loan NBFCs in the past two years due to combination of factors including growth in AUM, risk mitigation strategies, etc, may witness moderation going forward unless operational efficiencies improve further. At the same time, profitability of small gold loan NBFCs is likely to remain moderate at the current levels in view of high competition in the industry.

Diversification – The road for growth

With strong balance sheets and limited opportunity to grow gold loan portfolio, gold loan NBFCs are expected to grow their size with diversification in the non-gold products. Simultaneously, these entities are also expected to focus on increasing geographical diversification. With significant experience of the workforce solely in collateral (gold jewelry) based lending, the alignment of the people and the processes to cash flow based lending remains critical to achieve healthy growth while maintaining the quality of the portfolio.

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