INITIATION

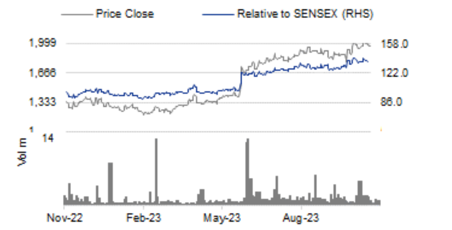
India

ADD *(Initiating coverage)*

Consensus ratings*:	Buy 32	Hold 4	Sell 0

Current price:	Rs1,975
Target price:	Rs2,500
Previous target:	NA
Up/downside:	26.6%
EIP Research / Consensus:	11.3%
Reuters:	SRTR.BO
Bloomberg:	SHFL IN
Market cap:	US$8,896m
	Rs741,452m
Average daily turnover:	US$33.4m
	Rs2784.7m
Current shares o/s:	374.8m
Free float:	74.3%

*Source: Bloomberg



Source: Bloomberg

Price performance	1M	3M	12M
Absolute (%)	5.0	5.3	50.6
Relative (%)	2.7	4.1	42.0

Major shareholders	% held
Shriram Group	25.5
FPI	52.4
LIC of India	3.4

Shriram Finance Limited

Diversified franchise at attractive valuation

- Shriram Finance is aiming to be a diversified retail franchise by cross-selling small ticket non-vehicle loans & maintaining its dominance in vehicle finance.
- Strengthening the liability profile (amid rising retail participation) with a focused approach towards asset quality improvement provides further confidence.
- We initiate coverage on Shriram Finance with an ADD rating and a target price of Rs2,500, corresponding to ~1.8x P/BV and ~10.9x P/E on Mar 2025F.

Cross-selling of retail loans & favourable CV cycle to aid AUM growth

Post-merger, Shriram Finance (SFL) aims at diversifying its loan book for meeting all the credit needs of its customers in semi-urban/rural India. SFL has been improving its dominance in non-vehicle loans due to smaller ticket sizes as well as access to a large customer base (from vehicle finance) with similar requirements. The vehicle loan portfolio of the company is also witnessing momentum amid a favourable demand environment for used vehicles. With the phase II of BS VI norms implemented from Apr 2023, we expect the surge in pricing for used vehicles to continue in the coming quarters. We are building in ~21% AUM CAGR led by ~24% CAGR in disbursements over FY23-26F.

Improved liability profile with focus on increasing retail participation

The Shriram Group has faced a severe liquidity crunch in the past due to its rigid liability profile as well as the cyclicity involved in the business. However, currently SFL manages a decent diversity in its borrowing profile with a rising presence of retail-led liabilities (retail bonds, deposits, etc.), which are relatively of a longer tenure with a stickier liability profile, thereby keeping the cost of funds under check. Apart from this, we are factoring in a rising share of better-yield assets (non-vehicle loans), and NIM at 8.7-8.8% for FY24F-26F.

Favourable macro & ECL assumptions to support lower credit costs

We are keeping future credit costs in the range of ~250-270bp for FY24F-26F amid a healthy collection mechanism and enhanced digital reach of the company. Also, improved asset quality profile in the recent past (last 24 months) will help in reducing the average for calculating Probability of Default (PD) and Loss Given Default (LGD) ratios.

Outlook & valuation

We initiate coverage on SFL with an ADD rating and a target price of Rs2,500, corresponding to ~1.8x P/BV and ~10.9x P/E on Mar 2025F. We have valued the standalone SFL on an excess return on equity (ERoE) basis, with a risk-free rate of 7%, market risk premium of 6% & beta of 1.3 (Bloomberg). We have arrived at a standalone valuation for SFL of Rs2,450 and have added the valuation of Shriram Housing Finance at Rs50/share, which we have valued at ~1.5x FY25F BV. We prefer MMFS over SFL & CIFC as we are confident of its turnaround. However, we also feel that SFL's valuation discount amid the perception issues driven by past volatility in asset quality is likely to ease. Downside risks: Slower-than-expected growth and a spike in fresh slippage.

Financial Summary	Mar-22A	Mar-23A	Mar-24F	Mar-25F	Mar-26F
Net Interest Income (Rsm)	95,209	172,264	202,042	245,182	294,760
Total Non-Interest Income (Rsm)	191	307	369	443	531
Operating Revenue (Rsm)	95,399	172,571	202,410	245,624	295,291
Total Provision Charges (Rsm)	(38,609)	(41,592)	(46,215)	(59,555)	(74,562)
Net Profit (Rsm)	27,079	59,793	71,993	85,812	102,999
Core EPS (Rs)	100.10	159.69	192.27	229.18	275.08
Core EPS Growth	2%	60%	20%	19%	20%
FD Core P/E (x)	19.73	12.37	10.27	8.62	7.18
DPS (Rs)	20.00	15.00	20.00	25.00	30.00
Dividend Yield	1.01%	0.76%	1.01%	1.27%	1.52%
BVPS (Rs)	958.6	1,156.6	1,328.9	1,533.1	1,778.1
P/BV (x)	2.06	1.71	1.49	1.29	1.11
ROE	11.4%	17.3%	15.5%	16.0%	16.6%
% Change In Core EPS Estimates					
InCred Research/Consensus EPS (x)					

SOURCES: INCRED RESEARCH, COMPANY REPORTS

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Comparison of SFL, MMFS & CIFC

Figure 1: Comparison of Shriram Finance, M&M Finance & Cholamandalam Investment and Finance Company (standalone)

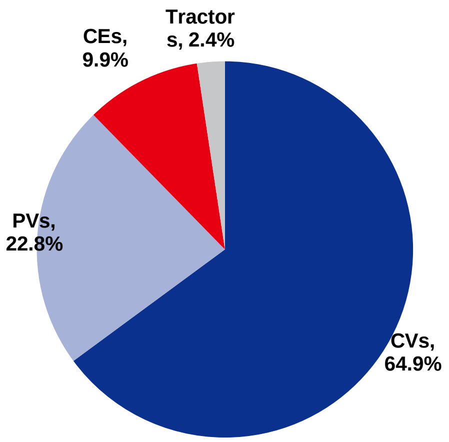
	Shriram	MMFS	CIFC
AUM (Rs bn)	2,026	932	1,147
Branch	2,975	1,368	1,204
Employee	71,373	26,623	48,127
Customers(m)	7.7	9.5	2.7
AUM per branch (Rs m)	681.0	681.3	952.7
AUM per employee (Rs m)	28.4	35.0	23.8
Employees per branch	24.0	19.5	40.0
AUM break-up (%)			
Vehicle	77.3%	88.0%	60.7%
Mortgages	0.0%	0.0%	28.6%
MSME	10.5%	5.0%	0.0%
TW	5.1%	0.0%	0.0%
Gold	2.7%	0.0%	0.0%
PL & Others	4.4%	7.0%	10.7%
RoA-2QFY24	3.2%	1.2%	2.4%
RoE-2QFY24	15.4%	6.9%	19.8%
Yield for FY23	19.1%	14.2%	18.9%
Cost of funds for FY23	8.9%	7.6%	9.4%
Spread	10.3%	6.6%	9.5%
Margin	10.6%	6.5%	11.6%
Net interest income / avg. assets	9.3%	7.4%	7.2%
Opex/ avg. assets	2.8%	3.2%	2.8%
Operating profit / avg. assets	7.1%	4.2%	4.5%
Total provisions / avg. assets	2.4%	1.2%	0.9%
RoA	3.5%	2.4%	2.7%
Leverage	5.0	5.2	7.5
RoE	17.3%	12.5%	20.5%
AUM growth for FY23	19.7%	27.4%	38.0%
P/BV- 1 year forward	1.6	1.8	5.5
Borrowing profile			
Term loan	25.6%	45.0%	61.1%
Public deposits	24.7%	6.8%	NA
NCD	17.5%	30.0%	15.9%
Securitization	15.1%	6.0%	10.2%
Others	17.1%	12.2%	12.8%
Stage-3 assets - gross	5.8%	4.3%	3.0%
Stage-3 assets - net	2.8%	1.7%	1.6%

SOURCE: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG

Cross-selling to drive AUM momentum

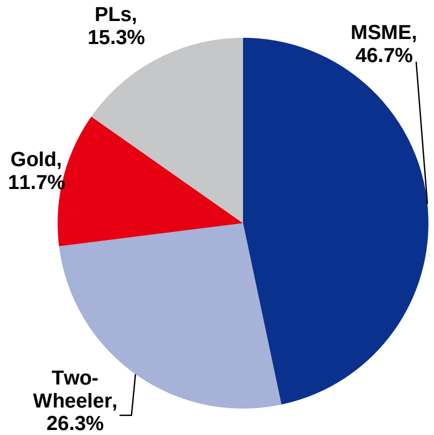
Shriram Finance (SFL), being a merged entity, is engaged in the combined business operations of Shriram Transport Finance (vehicle financing, mainly commercial vehicles, passenger vehicles and tractors - used as well as new) and Shriram City Union Finance (MSME financing, personal loans, two-wheeler financing, gold loans, etc).

Figure 2: AUM of Shriram Transport Finance as of end-Dec 2022 (Rs1.4tr)



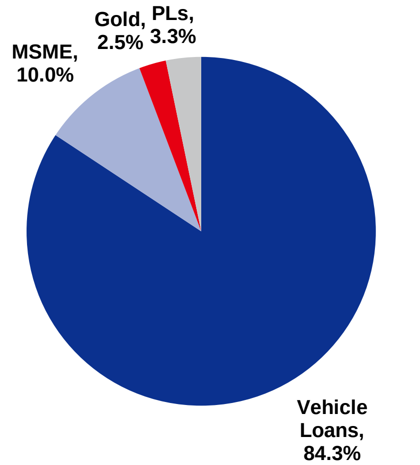
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 3: AUM of Shriram City Union Finance as of end-Dec 2022 (Rs378bn)



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 4: AUM of Shriram Finance as of end-Dec 2022 (Rs1.77tr)



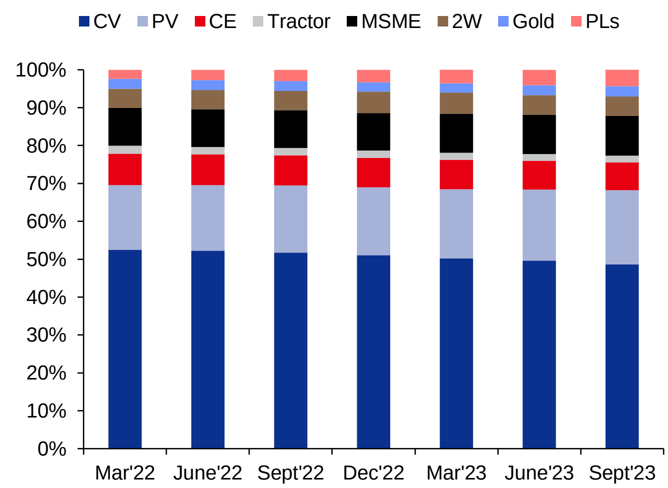
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Post-merger, SFL aims at diversifying its loan book from being a pure vehicle financier to a one-stop destination for meeting all financial services and credit needs of the customers, especially from semi-urban and rural India. With the diversity available in its product profile, the combined entity will be able to avoid the cyclicity attached to the automobile financing business witnessed in the past.

Ideal cross-sell franchise; rising share of non-vehicle loans

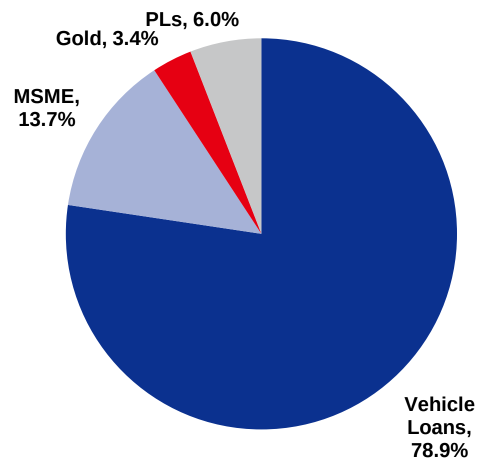
The Shriram Group, being primarily into the vehicle financing business (SHTF), has been improving its dominance in non-vehicle financing (SCUF) because of smaller ticket sizes as well as access to a large customer base with similar requirements. Thus, cross-selling of non-vehicle loans to existing vehicle finance customers will continue to be the key driver of assets under management or AUM growth in the coming quarters. This, coupled with a favourable macroeconomic environment and a rising geographic presence, is an additional plus point.

Figure 5: CV loans are declining while MSME loans are rising



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 6: Share of vehicle finance to decline to ~75% by FY26F

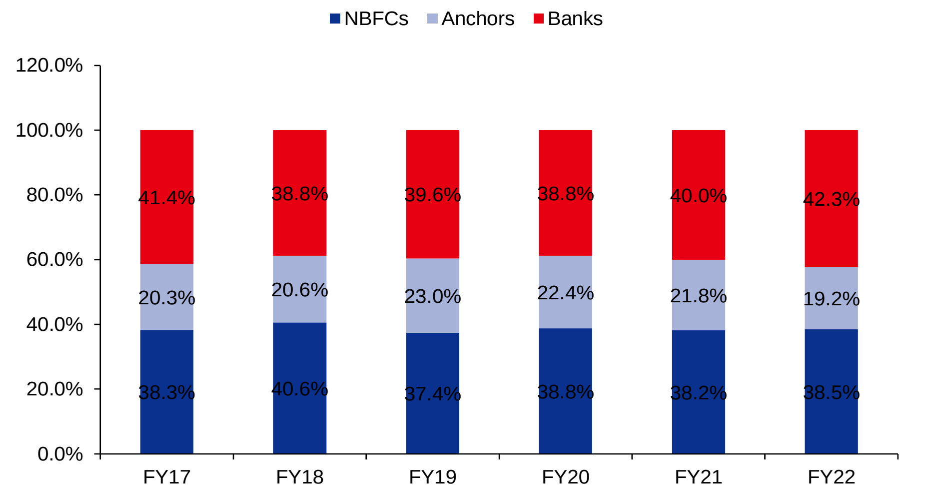


SOURCE: INCRED RESEARCH, COMPANY REPORTS

Vehicle finance business is dominated by NBFCs

As per rating agency CARE's report, the commercial vehicle (CV) finance industry in India (new as well as used CVs) has assets under management (AUM) amounting to approximately Rs.3.6tr as of 31 Mar 2022, with non-banking finance companies (NBFCs) accounting for ~42.3% of the market share.

Figure 7: NBFCs manage a decent market share in the vehicle financing business in India

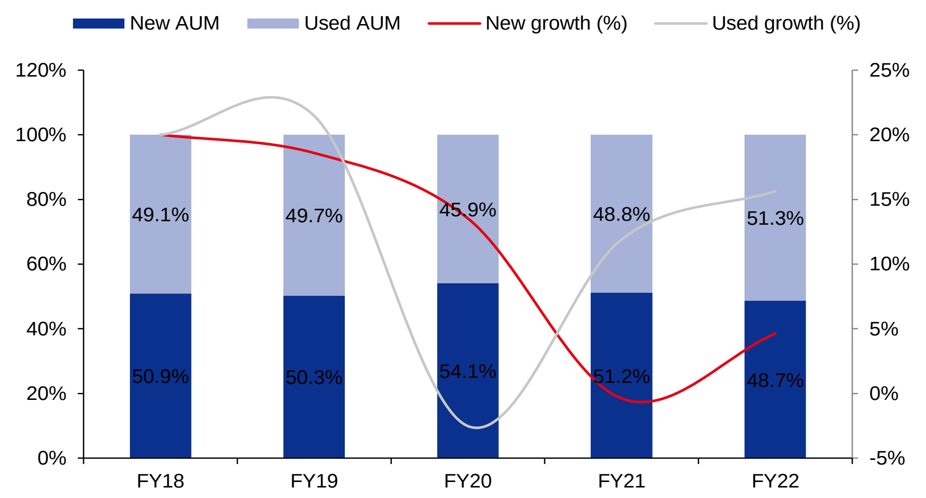


SOURCE: CARE DATA, INCRED RESEARCH

Used vehicle financing is a sizeable business in India

Used commercial vehicle or CV financing business is generally bigger than new CV financing and is largely dominated by NBFCs. The demand also remains supported on account of the used CVs' multi-purpose usage such as for transporting sand, cement, grains etc. as against new CVs which are generally used for specific applications.

Figure 8: The used vehicle business performs better compared to new vehicles



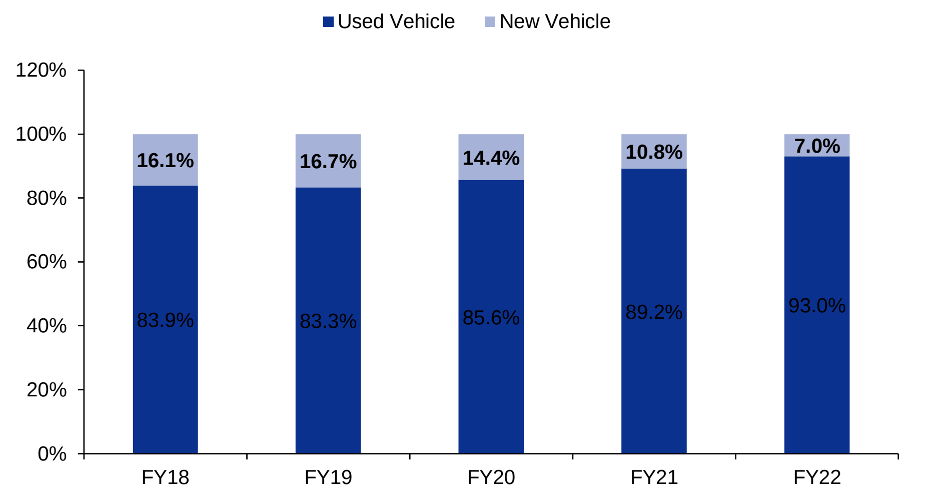
SOURCE: CARE RESEARCH, INCRED RESEARCH, COMPANY REPORTS

Interestingly, after the change in emission norms from BS IV to BS VI, we have observed a surge in pricing and a decline in discounts for used vehicles, which is in sync with the price hikes taken by vehicle manufacturers for new vehicles. Thus, used vehicle financiers have witnessed a surge in volume as well as value of these vehicles, boosting overall credit growth. With the phase II of BS VI norms implemented from Apr 2023, we expect the surge in pricing for used vehicles to continue in the coming quarters as well, supporting disbursement growth.

Shriram Group remains a pioneer in used-vehicle financing

Shriram Finance (earlier Shriram Transport Finance) has been a pioneer in used-commercial vehicle financing and has been present across India. The company's wide presence, along with a tie-up with Shriram Auto Mall (physical and digital platform for the sale of used vehicles), has been a key pillar for the healthy momentum in used-vehicle financing for the company.

Figure 9: Shriram Group has expertise in financing used vehicles

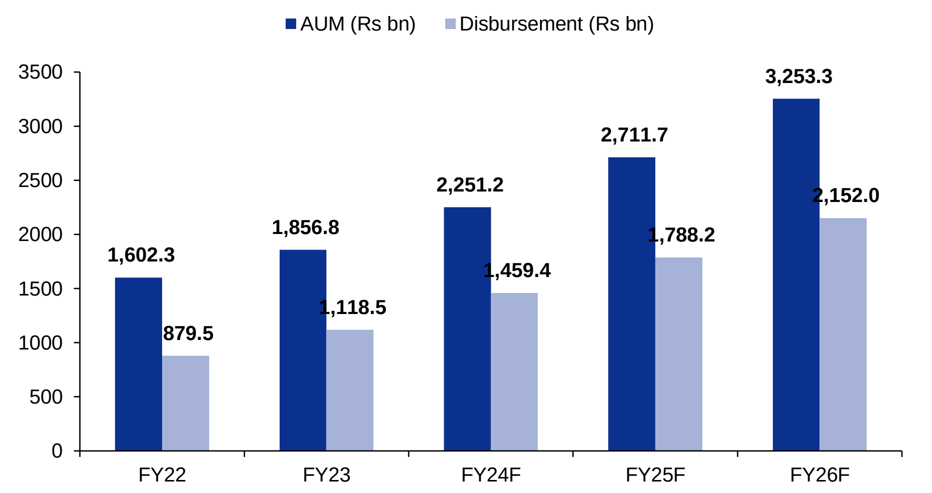


SOURCE: INCRED RESEARCH, COMPANY REPORTS

We are building in ~21% AUM CAGR led by ~24% CAGR in disbursements over FY23-26F

With a diversified product mix, well-improved presence across India, and trained employee force, we believe SFL is well-placed to play the credit demand momentum, which includes vehicle loans (mainly used vehicle financing) as well as non-vehicle financing (MSME/personal/gold loans). The improved leverage (~4.5x), coupled with a heathy RoA (~3.4%), will drive a healthy RoE (~16%) for the company, which should command a valuation premium.

Figure 10: Building in ~21% AUM CAGR led by ~24% CAGR in disbursements over FY23-26F



SOURCE: INCRED RESEARCH, COMPANY REPORTS

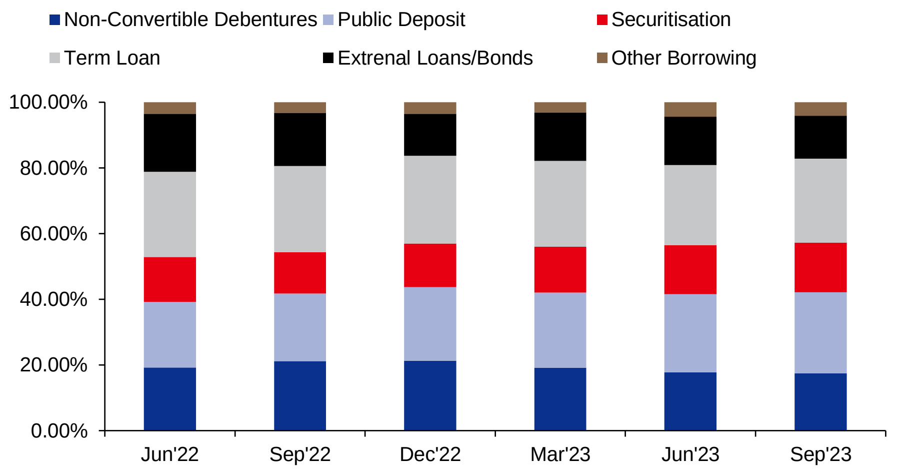
Before the merger, Shriram Transport Finance (SHTF) also had a small portfolio (4-6% of AUM) of unsecured MSME loans which were sourced to the existing well-paying customers of SHTF. Thus, cross-selling Shriram City Union Finance or SCUF products to existing SHTF clients, including unsecured MSME, personal and gold loans, was relatively easier.

Sustainable liability profile is one of the key achievements of SFL's management

The Shriram Group has faced a severe liquidity crunch in the past due to the high-risk, high-reward business model as well as a relatively rigid liability profile of the company, which was more tilted towards the bond market/bank borrowings that are highly interest rate-sensitive amid any macroeconomic adversity. However, things have improved over the years.

The company has witnessed decent diversity in its borrowing profile in recent years whereby instead of relying only on non-convertible debentures, bank borrowings and securitization, it has also relied on public deposits and ECB loans which are relatively of a longer tenure and have a stickier liability profile.

Figure 11: Retail-oriented borrowing profile provides confidence on the liquidity front

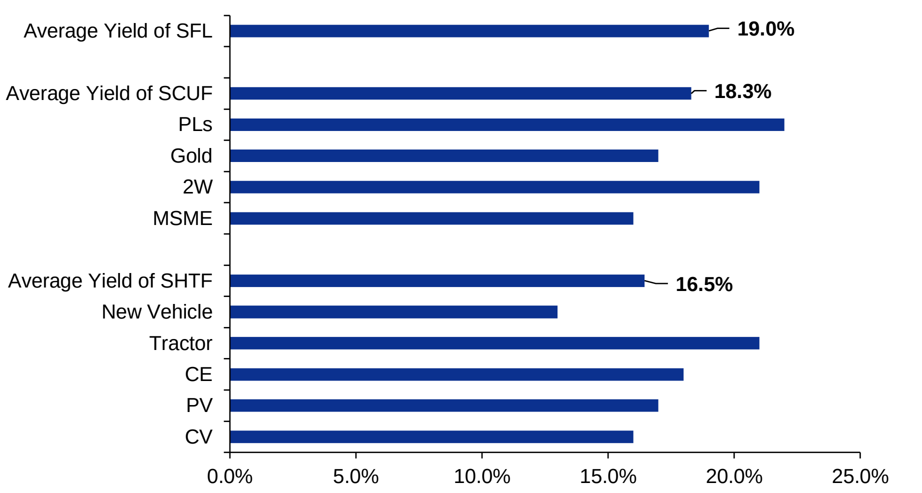


SOURCE: INCRED RESEARCH, COMPANY REPORTS

Yields for the merged entity are superior compared to standalone entities

We observed that, post-merger, the overall yield profile has been superior to standalone companies. Shriram Transport Finance and Shriram City Union Finance, both being in the riskier asset class, had elevated yields, but combined, they can compensate for any low-yield assets held by the company.

Figure 12: Yields for the combined SFL are superior compared to standalone entities



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Cost of funds improving amid better credit rating & diversity

The merged entity has received the benefit of lower cost of borrowing as there has been a difference in the rating for Shriram Transport Finance (AA+) and Shriram City Union Finance (AA). Thus, the merged entity benefited from lower cost of borrowing led by its improved credit rating.

For the current financial year, we are witnessing a rise in margins, despite elevated cost of funds and tighter system-level liquidity, amid improved yields and a better-managed liability profile of the company. Though the company's management has been giving guidance of ~8.5% net interest margin for FY24F, we remain optimistic of a significant positive surprise regarding the same.

SFL has limited impact of the recent RBI circular on risk weight

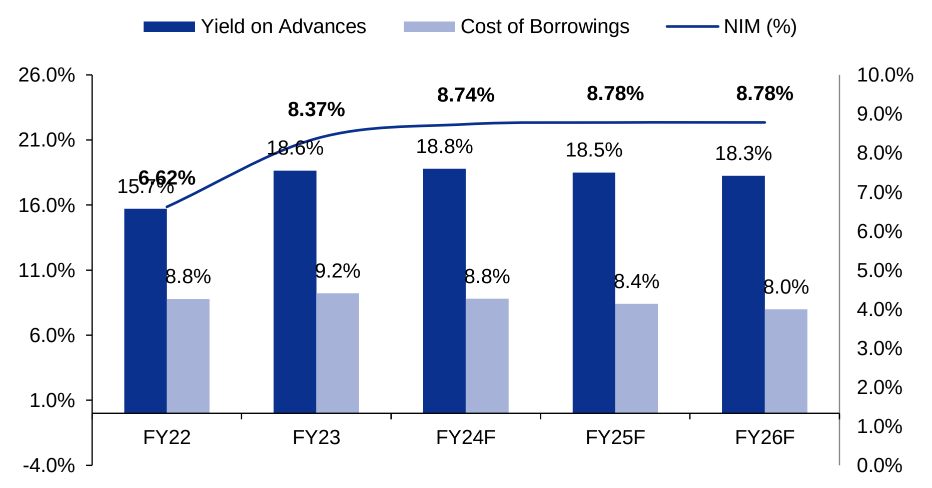
The Reserve Bank of India (RBI) has increased the risk weight on consumer credit exposure of commercial banks as well as NBFCs by 25% with immediate effect. The increase in risk weight is not only applicable to new loans but also to existing loans. Personal loans and credit card receivables are specifically included for the increase in risk weight whereas housing loans, education loans, vehicle loans, gold loans and MFI loans have been excluded. Shriram Finance has ~5% portfolio under the personal loan category which will need higher risk weight, otherwise the circular has no meaningful impact on the company.

The central bank has also increased risk weight by ~25% on banks' exposure to NBFCs but loans to housing finance companies and priority sector loans been excluded. Our discussion with the management indicates that as a major portion of the loans by banks to SFL are categorized under the priority sector lending norms, the impact here as well would be limited, in our view.

We are factoring in steady, yet healthy margins, at around ~8.8%

With the shift towards better-yield assets (including unsecured MSME and personal loans), the yields for SFL are likely to remain healthy but the costs, in recent quarters, have witnessed a spike, which should normalize over the coming quarters. We believe the company can command pricing amid its monopolistic market position as well as a unique customer profile. Also, on the costs front, we expect the trend to improve, despite the tight monetary environment, amid diversified borrowings as well as a superior credit rating of the merged entity.

Figure 13: Factoring in NIM in the range of 8.7-8.8% for FY24-26F, with a gradual improvement in the asset profile



SOURCE: COMPANY REPORTS, INCRED RESEARCH

We are factoring in NIM in the range of 8.7-8.8% for FY24F-26F, with a gradual improvement in the asset profile and a diversified liability profile.

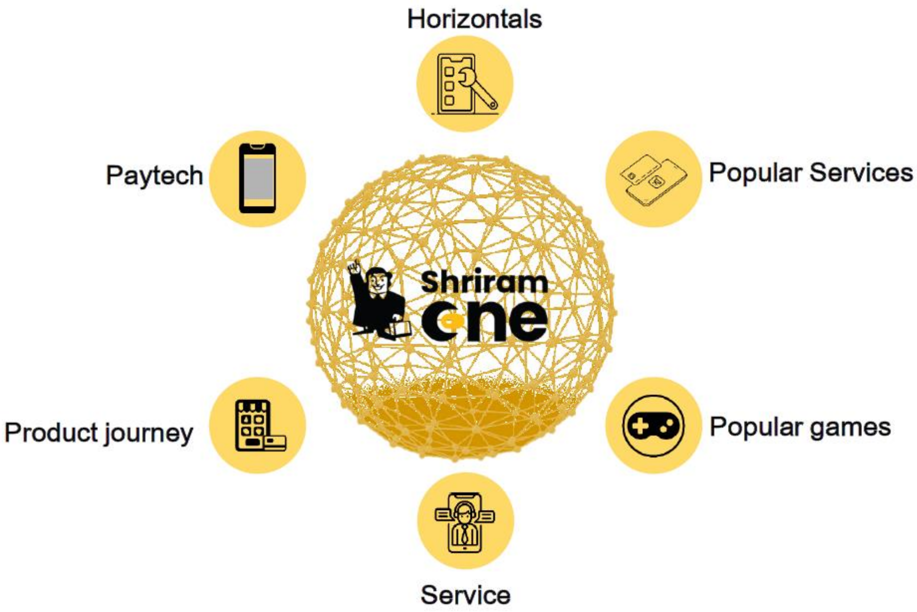
Merger synergies are yet to kick in for SFL

The Shriram Group had a track record of managing operations at the best operating efficiency, resulting in the lowest cost-to-income/cost-to-average assets. However, Shriram Transport Finance has been performing better compared to Shriram City Union Finance. Post-merger, we are witnessing a surge in overall operating expenses due to few merger-related expenses as well as the company's aggressive branch expansion plans and, accordingly, a probable rise in the employee base. However, a gradual normalization is likely over the coming quarters as merger-related synergies come into play.

Tech-driven initiatives to keep operating expenses elevated

Like most peers, Shriram Finance has been investing in various tech-level initiatives to smoothen the overall operational flow, strengthen underwriting practices and improve overall customer experience. The company has already initiated Shriram Super App, 'Shriram One', which was launched in Sep 2023. Shriram One is a one-stop solution for all its customers' financial needs.

Figure 14: Shriram One provides for its customers' entire requirements on a single platform



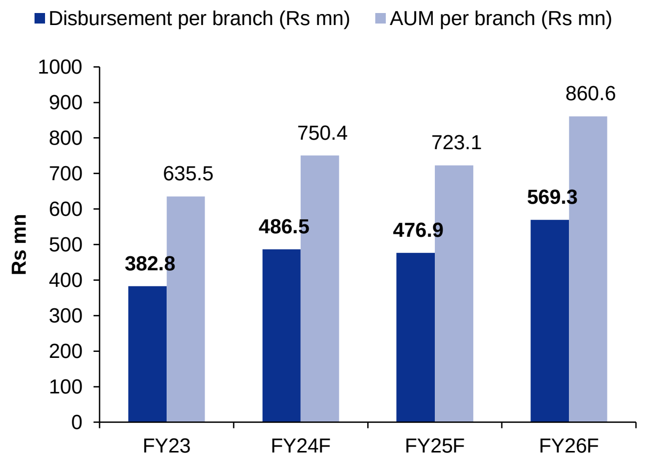
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Shriram Once manages all the needs of a customer as he/she could have at one place loans, payments, investments, insurance, credit score check, etc. This reduces the need to download multiple apps to perform different functions.

Despite the rise in operating expenses, we assume an improvement in branch-level and employee-level efficiency

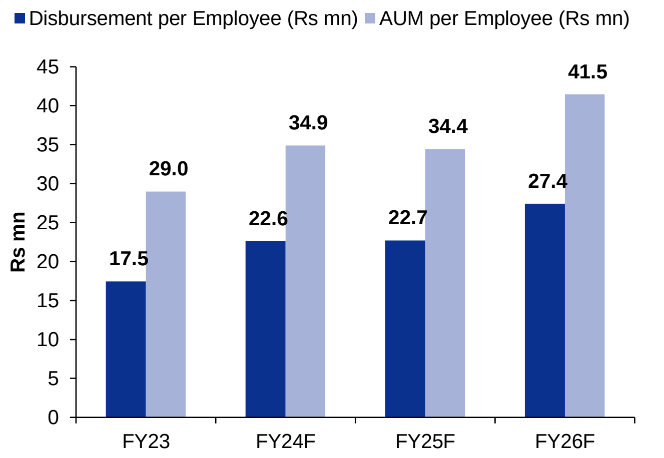
The Shriram Group has a legacy of being over-staffed at several layers, yet it has managed to improve the operating matrices over the years (Fig.15 - disbursement/AUM per branch and disbursement/AUM per employee), with a gradual growth in the business. We are building in a gradual improvement in both these operating matrices in the coming years for SFL as well.

Figure 15: Disbursement/AUM per branch witnesses a rise



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 16: Disbursement/AUM per employee witnesses a rise

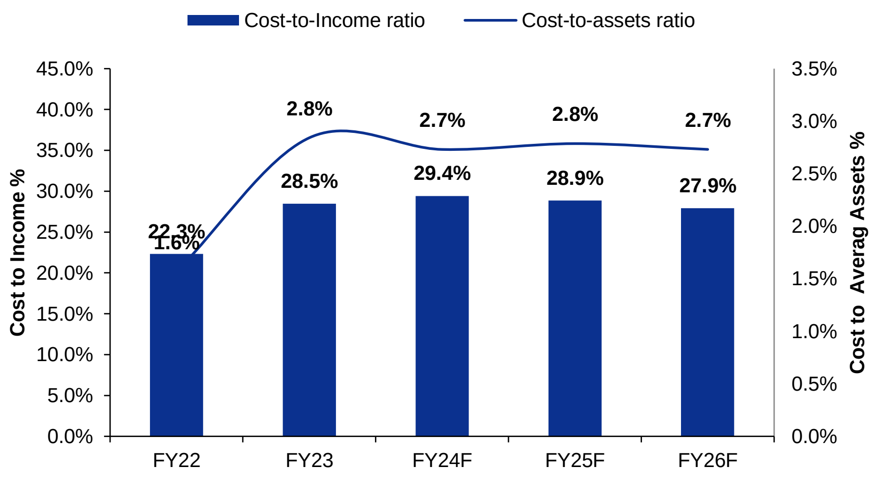


SOURCE: INCRED RESEARCH, COMPANY REPORTS

Consolidation of cost matrices likely in the coming years

We believe that despite the operational efficiency visible at the employee and branch levels, overall operating expenses to grow at par with revenue growth, resulting in consolidation of cost matrices. We are assuming the cost-to-average assets ratio remaining in the range of ~2.7-28% whereas with a rise in revenue, the overall cost-to-income ratio to improve to ~27.9% against ~28.5% in FY23.

Figure 17: Building in consolidation of operating expenses



SOURCE: INCRED RESEARCH, COMPANY REPORTS

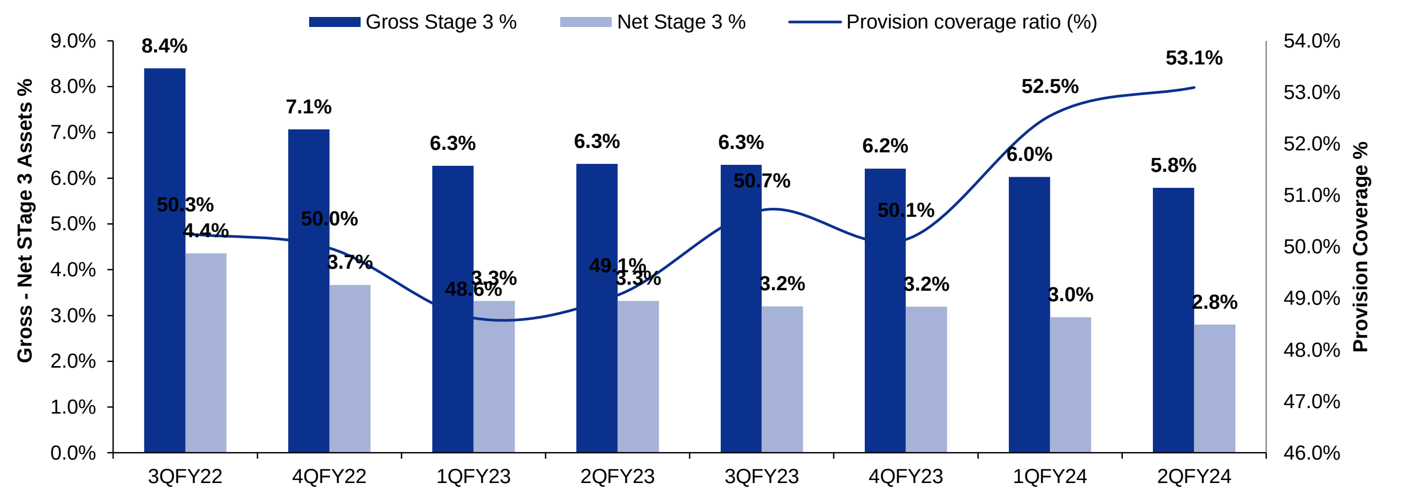
Asset quality improves even during volatility

The Shriram Group has a legacy of having elevated NPAs in the past amid cyclicity attached to automobile demand as well as a higher exposure to the rural India populace that does not have a fixed source of income and cash flow, which keeps the overall repayments volatile. This is applicable to both the companies, Shriram Transport Finance as well as Shriram City Union Finance. However, we have observed that the generalized trend in credit costs has remained range-bound (~1.5-2.5%).

Asset quality perfomance during the past few quarters is a positive surprise

The Covid-19 pandemic had been a nightmare for most lenders amid the spike in fresh slippage and a difficult environment for collections and recoveries. However, while most peers were struggling with their asset quality-related challenges during the pandemic (FY19-FY21), SFL witnessed an improvement in asset quality during the same period. The trend continued to improve post-pandemic, despite Reserve Bank of India (RBI) tightening the norms for daily stamping of NPAs, etc.

Figure 18: Stage-3 NPAs witness a sequential improvement over the past several quarters



SOURCE: INCRED RESEARCH, COMPANY REPORTS

We believe the gradual improvement in the asset quality trend for the company is not merely a coincidence. Our ground channel check indicates that such an improvement is driven by the company management's consistent efforts towards streamlining its underwriting processes and more importantly, improving the overall collection and recovery mechanism, which resulted in outperformance on the asset quality front.

Robust collection mechanism keeps credit costs under check

Historically, SHTF and SCUF have operated at elevated reported asset quality metrics with GNPAs/gross stage-3 assets at 6.9% and 5.9%, respectively, as on 30 Sep 2022. The asset quality metrics have been elevated over the past several years, given the fact that the company largely caters to borrowers with a modest credit profile and relatively under-banked customers.

However, these entities have displayed their ability in the past to ultimately recover from these accounts, even after loan maturity date. Consequently, overall credit costs have been range-bound over the past few years. The Shriram Group has a legacy of being aggressive and upbeat on the collection mechanism, which ensured that such volatile credit quality had a limited impact on profitability of the company as the trend in credit costs remained within a range.

We expect credit costs to stay range-bound in the coming years

We are of the opinion that Shriram Finance or SFL will be able to display a lower credit cost trend in the coming quarters as well, despite some volatility visible on the asset quality front. Going ahead, apart from a healthy collection mechanism, the company's improved digital presence could also support recoveries. The company has been using the digital mode to smoothen its overall operational flow, strengthen underwriting practices and improve the overall customer experience. The digital journey will enhance superior customer tracking, leading to improved collection efficiency. This could be a key trigger for lower credit costs in future.

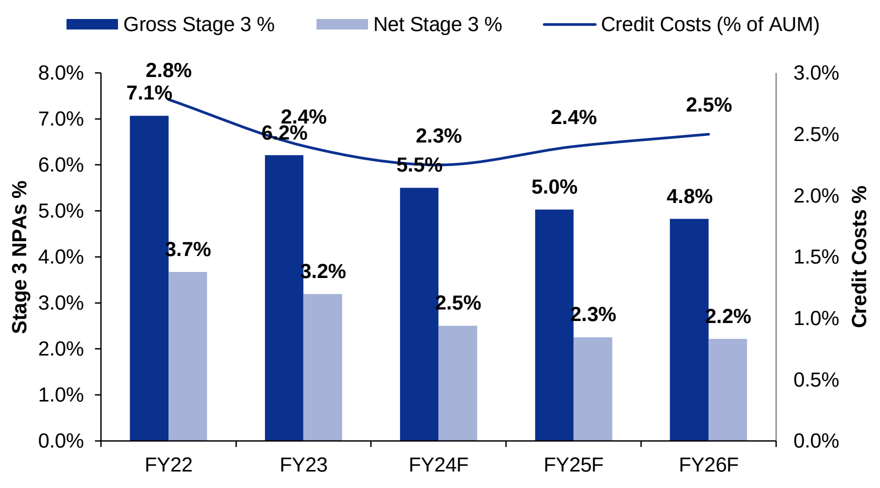
Gradual decline in PD/LGDs to further aid credit costs

Under the ECL methodology, like most peers, the Shriram Group has also been considering its historic five-year performance average for calculating the Probability of Default (PD) and Loss Given Default (LGD) ratios. Being in a cyclical business, the average PD and LGD for the Shriram Group have been elevated but the company has been reporting an improved traction on the asset quality front which, in turn, would support lower credit costs in the coming quarters.

Consolidation in headline NPAs to continue

Based on previous discussions, considering SFL's improved collection and recovery mechanism, along with a favourable macroeconomic environment, there will be a steady trend in stage-3 NPAs whereas the consolidation in credit costs is due to improved average as well as better recoveries.

Figure 19: Consolidation in stage-3 assets and provisioning to continue



SOURCE: INCRED RESEARCH, COMPANY REPORTS

We are building in gross stage-3 assets in the range of ~5.6% whereas net stage-3 assets at around ~2.5%, indicating the overall coverage ratio at ~55%. We are building in flat credit costs of ~2.5% for FY24F-26F amid consistency in collection efficiency.

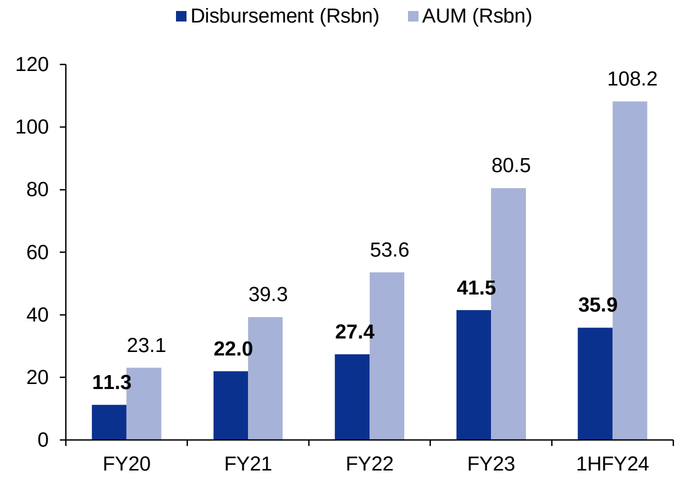
Shriram Housing: Key value addition

Shriram Housing Finance (SHFL) is the third-largest affordable housing finance company in India with a presence across ~16 states in India through ~137 branches with a customer base of ~0.17m and employee count of ~3,032 as of end-Sep 2023. ~78% of total retail customers have a ticket size below Rs2.5m and retail customers contributed ~99% to the live base as of end-Sep 2023.

Operational performance of the company

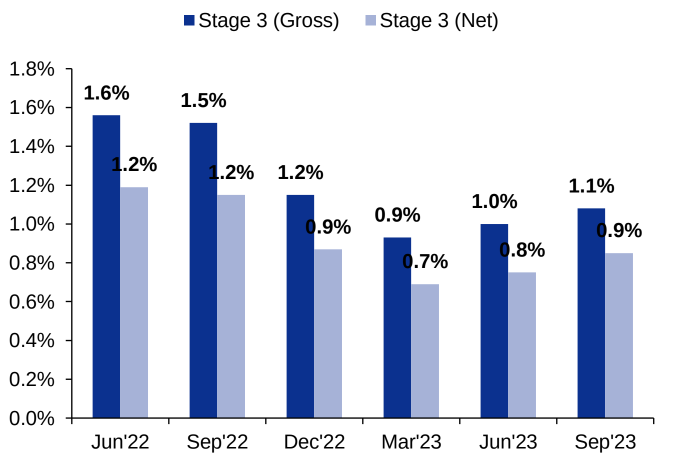
SHFL manages AUM of Rs108.2bn as of end-Sep 2023, registering a growth of ~65% YoY/~13% QoQ. SHFL's disbursals in 1HFY24 stood at Rs35.9bn, a growth of ~95% YoY, the highest-ever 1H disbursal in the history of the company. The company's management aspires to achieve AUM of Rs130bn aided by annual disbursement of Rs75bn in FY24F. The asset quality profile of the company is also well-managed over the years. The company posted ~2.3% RoA and ~13.9% RoE during 1HFY24.

Figure 20: Growth trajectory for SHFL remains healthy



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 21: NPA trend for SHFL remains under check



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Ownership structure and dilution probability

Shriram Finance (SFL) owns ~84.2% stake in Shriram Housing Finance (SHFL) whereas Valiant Partners, with ~14.8% stake, remains another large stake holder. In previous media interviews, SFL's management had indicated that once SHFL crosses the benchmark of Rs100bn AUM, the company may evaluate either an IPO or private equity round of investment options. We believe that in either case, the overall valuation of SHFL will see a sizable boost. As we are valuing SFL on a standalone basis and adding the value of SHFL separately, any valuation growth would be beneficial for our investment thesis.

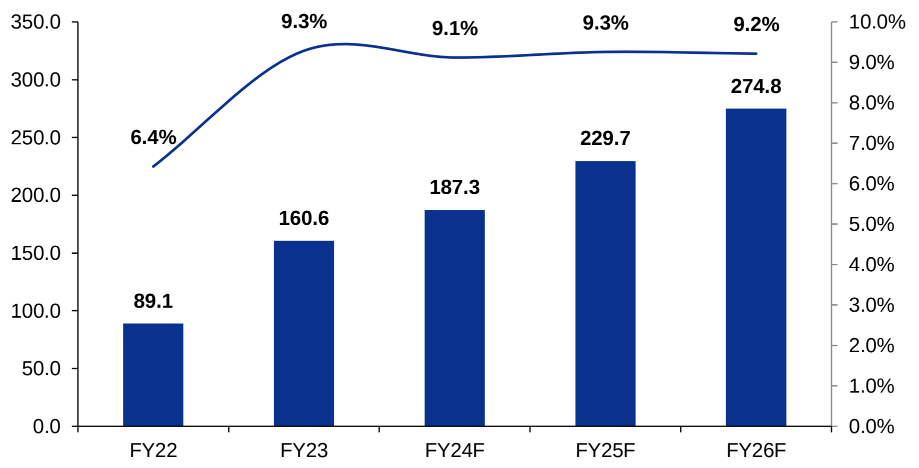
Key managerial personnel at Shriram Housing Finance

- Mr. Ravi Subramanian is the MD & CEO of the company since Nov 2018. He joined the Shriram Group in the year 2010 as an executive director in Shriram City Union Finance and has since then been involved in building and growing the SME-lending business before moving into the current role. He has played a core role in rebuilding the entire subsidiary and making it a strong growth engine.
- Mr. Nagendra Singh is the chief business officer of the company. Mr. Singh joined Shriram City Union Finance in Oct 2017, where he served as the business head of unsecured loans and corporate loans, before moving into this new role at SHFL in Nov 2018. He holds an MBA degree from Symbiosis University, Pune.

Outlook and valuation

- **Shriram Finance (SFL) is a merged entity formed last year, combining the business operations of Shriram Transport Finance and Shriram City Union Finance, having a combined network of 2,975 branches and a workforce of 71,373, servicing over 7.7m customers.**
- Post-merger, SFL has diversified as a financial services provider with a whole suite of financial solutions tailored to underserved customers in underpenetrated rural markets.
- With a diversified product mix suitable to most retail customers' requirement, improved presence across India, and a well-built employee force, we believe SFL is well-placed to play the credit demand momentum, which includes vehicle loans (mainly used vehicle financing) as well as non-vehicle financing (MSME/personal/gold loans).
- With a shift towards better-yield assets (including unsecured MSME and personal loans), the yield for SFL is expected to remain healthy but the cost in recent quarters witnessed a spike, which should normalize over the coming quarters. Also, on the costs front, we expect the trend to improve, despite the recent tight monetary environment amid diversity in its borrowing profile as well as the superior credit rating of the merged entity compared to individual companies.
- **With sustainable growth, improved yields, and a gradually declining cost of funds, we are factoring in ~20% CAGR in net interest income or NII over FY23-26F. We are factoring in the net interest margin or NIM in the range of 8.7-8.8% for FY24F-26F, with a gradual improvement in the asset profile.**

Figure 22: NII to grow at ~20% CAGR with consistency in the margin range of ~9.1-~9.3%



SOURCE: INCRED RESEARCH, COMPANY REPORTS

- **We are keeping the cost-to-average assets ratio estimate elevated at ~2.7% as the company is in an investment phase on the technology side. The company also needs to spend more on collections and recoveries, being present significantly in rural India.**
- **We are factoring in credit costs in the range of ~2.5%% over FY24F-26F as we believe the company will continue to improve its collection mechanism which, coupled with the decline in ECL assumptions, will help on the provisioning front.**
- **Accordingly, we are building in a PAT CAGR of ~20% over FY23-26F backed by healthy AUM growth along with steady margins, and provisioning.**
- **The RoA of SFL is likely to remain in the range of ~3.4% whereas RoE may stay in the ~16% range for FY24F-26F.**

Figure 23: DuPont analysis of Shriram Finance

DuPont Analysis	FY22	FY23	FY24F	FY25F	FY26F
Interest income/avg. assets	13.7%	16.5%	15.7%	16.0%	15.4%
Interest expended/avg. assets	7.2%	7.3%	7.0%	6.8%	6.3%
Net interest Income / avg. assets	**6.6%**	**9.3%**	**8.7%**	**9.2%**	**9.1%**
Securitization income /avg. assets	0.4%	0.7%	0.7%	0.7%	0.7%
Other income / avg. assets	0.0%	0.0%	0.0%	0.0%	0.0%
Income yield / avg. assets	**7.0%**	**10.0%**	**9.4%**	**9.8%**	**9.9%**
Op. cost (staff cost) / avg. assets	0.7%	1.4%	1.5%	1.6%	1.6%
Op. cost (other costs) / avg. assets	0.8%	1.4%	1.3%	1.3%	1.3%
Operating profit / avg. assets	**5.5%**	**7.1%**	**6.6%**	**6.9%**	**7.0%**
Total provisions / avg. assets	2.8%	2.4%	2.1%	2.5%	2.6%
Pre-tax RoA	**2.6%**	**4.7%**	**4.4%**	**4.5%**	**4.5%**
Tax retention rate	76.3%	73.1%	74.5%	74.5%	74.5%
Post-tax RoA	**2.0%**	**3.5%**	**3.3%**	**3.3%**	**3.3%**
Leverage = Avg. assets / avg. equity	5.7	5.0	4.7	4.7	4.9
RoE (leverage * RoA)	**11.4%**	**17.3%**	**15.3%**	**15.7%**	**16.4%**

SOURCE: INCRED RESEARCH, COMPANY REPORTS

- **We have valued SFL on a sum-of-the-parts or SOTP basis.**
  - **We have valued the standalone SFL on an excess return on equity (ERoE) basis with a risk-free rate of 7% (equivalent to banks' five-year fixed-deposit rate), market risk premium of 6% and beta of 1.3 (Bloomberg).**

Figure 24: Valuation parameters

Parameter	Rate	Methodology
Risk-free rate	**7.0%**	Commercial banks' five-year fixed-deposit rate
Risk premium	**6.0%**	Standard for our entire coverage
Beta	**1.3**	From Bloomberg: adjusted daily beta vs. Nifty-50 over last two years.
Cost of equity	**14.8%**	

SOURCE: INCRED RESEARCH, BLOOMBERG

  - **We have arrived at a standalone valuation for SFL of Rs2,450, corresponding to ~1.8x P/BV and ~10.7x P/E on Mar 2025F.**
  - **We have added the valuation of Shriram Housing Finance at Rs50/ share, which we have valued at ~1.5x FY25F BV.**
- Accordingly, we have arrived at a target price of Rs2,500 for SFL, corresponding to ~1.8x P/BV and ~10.9x P/E on Mar 2025F consolidated basis. We initiate coverage on SFL with an ADD rating and maintain our Outperform view on the BFSI sector.
- **We have coverage on three large vehicle-financing non-banking finance companies or NBFCs, which includes Cholamandalam Investment and Finance Company or CIFC (ADD, TP Rs1,350), Mahindra & Mahindra Financial Services or MMFS (ADD, TP Rs370) and SFL (ADD, TP Rs2,500). All these companies are on the path of diversifying their AUM profile, but auto financing will continue to dominate overall AUM.**
- **While comparing SFL on a P/BV basis with its core peers like MMFS and CIFC, we observed that SFL is trading at a discount amid the merger overhang and probable margin pressure (amid the tight liquidity cycle) as well as a spike in fresh slippage (post-merger). However, SFL, after four quarters of the merger, is continuing to perform well on growth, profitability, and asset quality fronts, which will ensure a gradual yet consistent narrowing of the valuation discount for the company compared to its peers.**
- **We prefer MMFS over SFL and CIFC and maintain it as our high-conviction bet as we remain confident of the turnaround happening for the company, which will drive stock outperformance led by lower provisioning and granularity in earnings. However, we continue to believe that all three companies will be beneficiaries of a favourable macroeconomic environment, which will translate into a health demand cycle coupled with improving asset quality and lower provisioning compared to their historic track record.**

Risk to our investment thesis

- **Government policy change – vehicle scrappage policy:** Shriram Finance is primarily engaged in used vehicle financing, which includes financing of 10 year–plus old vehicles as well. The transport ministry had been regularly communicating about introducing the old vehicle scrappage policy across India, which can impact the demand and pricing for used vehicles. Though there is no specific policy announced by the government till date, the introduction of the same can adversely impact growth and margin scenario of Shriram Finance.
- **Lower freight charges and a decline in freight utilization:** The movement in freight charges, along with appropriate freight utilization, remains a key demand driver, especially for the commercial vehicle portfolio. Any adverse movement in freight utilization or freight charges will have an impact on our growth and earnings estimates.
- **Elevated fuel prices:** With SFL being primarily engaged in the business of auto financing, any surge in fuel prices remains a key risk for its overall demand scenario. The rise in fuel prices adversely affects the demand for automobile products which, in turn, results in weak credit demand for the company. This, in turn, impacts earnings and return estimates.
- **Rise in discounting for used vehicles:** Post change in emission norms, we have witnessed a rise in pricing for used vehicles which is in sync with price hikes taken by the manufacturers of new vehicles due to the implementation of BS VI norms. However, with consistent availability of used vehicles, any probable surge in discounts for used vehicles will affect credit growth for the company.
- **Underwriting risks:** Shriram Finance (incl. its group companies) has witnessed a sharp surge in NPAs in the past across different portfolios and during various cycles. We believe any surge in NPAs for the company due to weak underwriting practices is a key risk as that will significantly shake the confidence of its investors.
- **Interest rate risk:** Changes in interest rates remain the key macroeconomic risk which needs to be monitored for all lenders, as it impacts margins as well. SFL has managed a well-balanced liability profile in the past couple of years, yet almost ~90% of its loan book (comprising vehicle, LAP and SME loans) have fixed-rate yields and in case of tightening of the monetary policy, a further rise in interest rates will be an unavoidable event, resulting in margin pressure for the company in the near term.
- **Regulatory risks:** In general, NBFCs encounter relatively softer RBI regulations than banks, mainly as they drive the government’s financial inclusion target and increase credit penetration in India. However, the RBI or any other government regulator can impose stringent norms to keep the entire lending and payments chain in check. Recently, the change in NPA recognition norms resulted in a sharp rise in NPAs for MMFS. Thus, this is the uncertain, yet most probable risk in the medium term.
- **Credit risk:** It mainly arises due to the uncertainty of a counterparty’s (called an obligor's) ability to meet its obligations.

About the company

Shriram Finance (SFL) is an India-based retail NBFC offering credit solutions for purchasing commercial vehicles, two-wheelers, and cars. The company also offers home loans, gold loans, personal loans, and small business loans. SFL is a part of the 49-year-old Shriram Group, a financial conglomerate. Established in 1979, SFL is a holistic finance provider catering to the needs of small road transport operators & small business owners and is a leader in organized financing of used commercial vehicles and two-wheelers.

In Nov 2022, the Shriram Group's entities – Shriram Transport Finance Company, Shriram City Union Finance, and Shriram Capital – merged to form Shriram Finance.

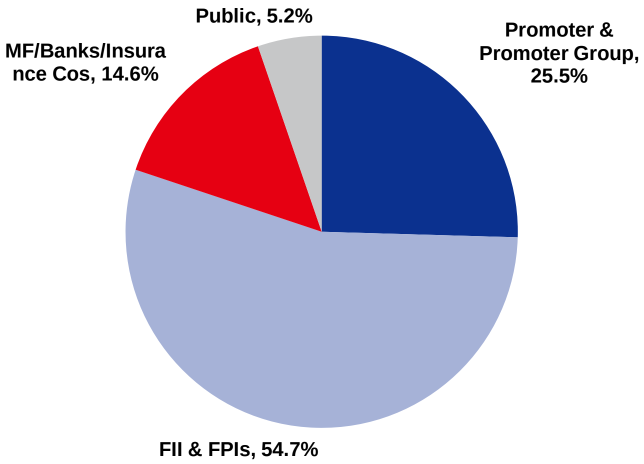
As on 30 Sep 2023, with a network of 2,975 branches and a workforce of 71,373, servicing over 7.7m customers, Shriram Finance has combined assets under management (AUM) worth Rs2.02tr. SFL has diversified into a financial services provider with a whole suite of financial solutions tailored to underserved customers in under-penetrated rural markets.

Figure 25: Key management profile as of end-Sep 2023

Name	Designation	Background
Mr. Umesh Revankar	Executive Vice Chairman	Mr. Revankar holds a bachelor's degree in business management from Mangalore University and a Master of Business Administration (MBA) degree in finance. He has been associated with the Shriram Group for the last 35 years and has extensive experience in the financial services industry. During his stint with the Shriram Group, he has shouldered various responsibilities and worked in several key roles of business operations.
Mr. Y. S. Chakravarti	Vice-Chairman & Managing Director	Mr. Chakravarti is the managing director and CEO of the company. He holds a Bachelor of Commerce degree. He started his career in Shriram Chits Private Limited, Andhra Pradesh ('Shriram Chits') in Jun 1991 as an executive trainee. In the year 2008, he was promoted to take charge as executive director of the erstwhile Shriram City Union Finance Limited (SCUF).

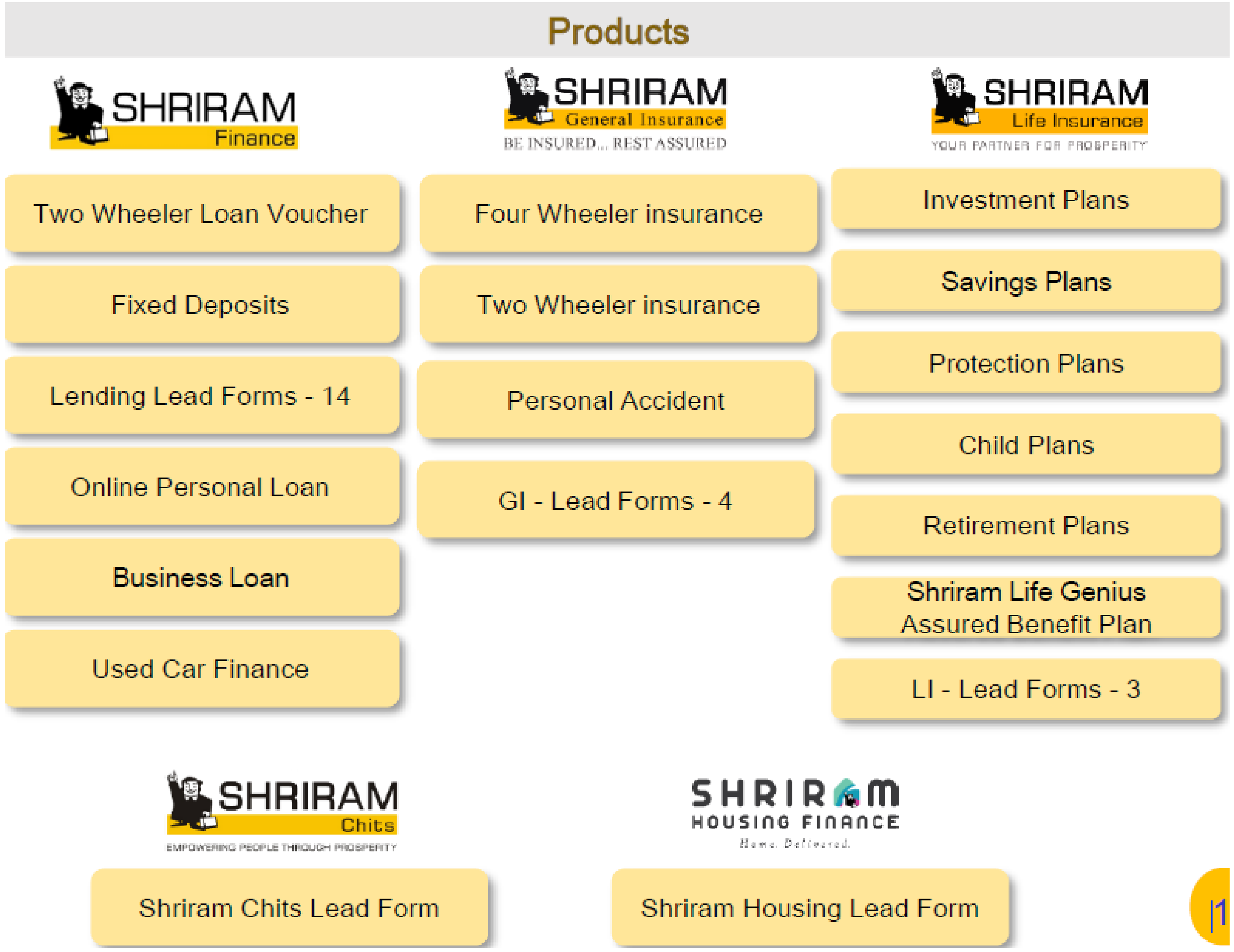
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 26: Shareholding pattern as of end-Sep 2023 (please check the total of all stake hold



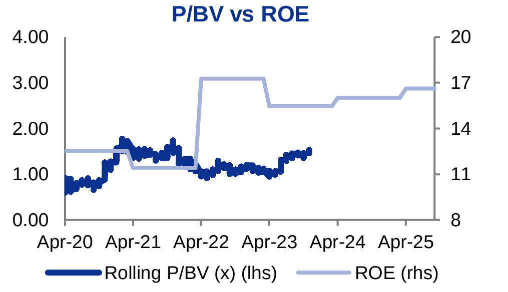
SOURCE: INCRED RESEARCH, BLOOMBERG

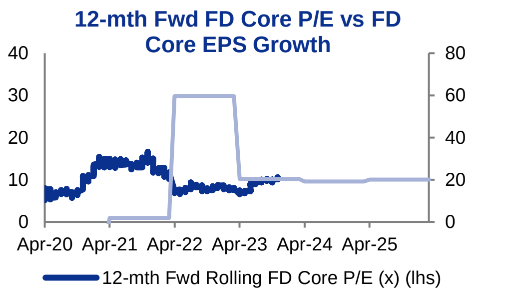
Figure 27: The diversified product profile of the Shriram Group provides ample cross-selling opportunities



SOURCE: COMPANY REPORTS, INCRED RESEARCH

BY THE NUMBERS





Profit & Loss

(Rsm)	Mar-22A	Mar-23A	Mar-24F	Mar-25F	Mar-26F
Net Interest Income	95,209	172,264	202,042	245,182	294,760
Total Non-Interest Income	**191**	**307**	**369**	**443**	**531**
Operating Revenue	95,399	172,571	202,410	245,624	295,291
Total Non-Interest Expenses	**(19,944)**	**(43,889)**	**(53,533)**	**(63,952)**	**(74,502)**
Pre-provision Operating Profit	74,101	123,441	142,849	174,740	212,816
Total Provision Charges	**(38,609)**	**(41,592)**	**(46,215)**	**(59,555)**	**(74,562)**
Operating Profit After Provisions	35,493	81,849	96,634	115,184	138,254
Pretax Income/(Loss) from Assoc.					
Operating EBIT (incl Associates)	35,493	81,849	96,634	115,184	138,254
Non-Operating Income/(Expense)					
Profit Before Tax (pre-EI)	35,493	81,849	96,634	115,184	138,254
Exceptional Items					
Pre-tax Profit	35,493	81,849	96,634	115,184	138,254
Taxation	(8,413)	(22,056)	(24,642)	(29,372)	(35,255)
Consolidation Adjustments & Others					
Exceptional Income - post-tax					
Profit After Tax	27,079	59,793	71,993	85,812	102,999
Minority Interests					
Pref. & Special Div					
FX And Other Adj.					
Net Profit	27,079	59,793	71,993	85,812	102,999
Recurring Net Profit					

Balance Sheet Employment

(Rsm)	Mar-22A	Mar-23A	Mar-24F	Mar-25F	Mar-26F
Gross Loans/Cust Deposits					
Avg Loans/Avg Deposits					
Avg Liquid Assets/Avg Assets	94.7%	91.8%	91.3%	92.3%	93.2%
Avg Liquid Assets/Avg IEAs	**114.6%**	**111.1%**	**106.4%**	**103.6%**	**103.0%**
Net Cust Loans/Assets					
Net Cust Loans/Broad Deposits					
Equity & Provns/Gross Cust Loans					
Asset Risk Weighting					
Provision Charge/Avg Cust Loans					
Provision Charge/Avg Assets					
Total Write Offs/Average Assets					

SOURCE: INCRED RESEARCH, COMPANY REPORTS

BY THE NUMBERS…cont'd

Balance Sheet

(Rsm)	Mar-22A	Mar-23A	Mar-24F	Mar-25F	Mar-26F
Total Gross Loans	**1,166,652**	**1,719,846**	**2,088,609**	**2,515,901**	**3,018,300**
Liquid Assets & Invst. (Current)					
Other Int. Earning Assets					
Total Gross Int. Earning Assets	1,166,652	1,719,846	2,088,609	2,515,901	3,018,300
Total Provisions/Loan Loss Reserve					
Total Net Interest Earning Assets	1,166,652	1,719,846	2,088,609	2,515,901	3,018,300
Intangible Assets					
Other Non-Interest Earning Assets	**15,958**	**87,923**	**84,317**	**80,891**	**77,636**
Total Non-Interest Earning Assets	**26,773**	**107,471**	**104,075**	**100,881**	**97,881**
Cash And Marketable Securities	163,552	158,174	84,878	83,023	83,268
Long-term Investments	**68,092**	**85,651**	**89,810**	**103,253**	**115,450**
Total Assets	1,425,067	2,071,141	2,367,371	2,803,057	3,314,899
Customer Interest-Bearing Liabilities					
Bank Deposits	1,144,967	1,579,063	1,796,204	2,151,095	2,565,555
Interest Bearing Liabilities: Others					
Total Interest-Bearing Liabilities	1,144,967	1,579,063	1,796,204	2,151,095	2,565,555
Banks Liabilities Under Acceptances					
Total Non-Interest Bearing Liabilities	16,772	24,509	31,439	37,494	44,737
Total Liabilities	1,161,739	1,603,572	1,827,643	2,188,590	2,610,293
Shareholders Equity	259,322	433,066	497,570	574,022	665,788
Minority Interests					
Total Equity	259,322	433,066	497,570	574,022	665,788

Key Ratios

	Mar-22A	Mar-23A	Mar-24F	Mar-25F	Mar-26F
Total Income Growth	13.8%	80.9%	17.3%	21.4%	20.2%
Operating Profit Growth	15.5%	70.5%	15.7%	22.0%	21.5%
Pretax Profit Growth	8%	131%	18%	19%	20%
Net Interest To Total Income	99.8%	99.8%	99.8%	99.8%	99.8%
Cost Of Funds	8.78%	9.21%	8.80%	8.40%	8.00%
Return On Interest Earning Assets	16.6%	19.8%	17.6%	17.2%	16.8%
Net Interest Spread	7.79%	10.61%	8.84%	8.78%	8.75%
Net Interest Margin (Avg Deposits)					
Net Interest Margin (Avg RWA)					
Provisions to Pre Prov. Operating Profit	52%	34%	32%	34%	35%
Interest Return On Average Assets	7.00%	9.85%	9.10%	9.48%	9.64%
Effective Tax Rate	23.7%	26.9%	25.5%	25.5%	25.5%
Net Dividend Payout Ratio	19.9%	9.4%	10.4%	10.9%	10.9%
Return On Average Assets	1.99%	3.42%	3.24%	3.32%	3.37%

SOURCE: INCRED RESEARCH, COMPANY REPORTS

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