

Tough calls deliver big payoff at L&T Finance

Leaner business, focus on return ratios make the company an attractive bet

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In an industry where it is tough to trim business verticals, L&T Finance Holdings has set an example of taking bold decisions. Until a year ago, the company was reckoned as an all-in-one financier. From there, it has axed more than half of its verticals, reducing its operations from 22 business verticals to just three major segments. It let go of lending, commercial vehicles, construction equipment, cars, leases, small and medium enterprises, etc.

This business re-engineering was done with the objective of improving its return on equity (ROE), and the company has set a target of 20 per cent by FY20. Trimming operations is already yielding the desired results. The company's ROE has improved from nine per cent at the start of the exercise in FY16 to 13 per cent in the December 2016 quarter (Q3).

Operations are also structured towards this objective. For example, the rural financing segment focuses on farm equipment loans, two-wheeler loans and microfinance lending. Strong tie-ups with original equipment manufacturers, such as TAFE, John Deere and Sonalika for tractors and Honda and Hero MotoCorp for two-wheelers, secure the business for L&T Finance. Even in the microfinance segment, 70 per cent of the company's borrowers are customers who are engaged in cattle rearing or allied activities. Thus, the yield for the rural segment is 15.5-24 per cent, and this is the most profitable business with an ROE of 23.4 per cent in Q3.

As for the housing finance business, home loans to self-employed nonprofessional customers and salaried employees account for 23 per cent of housing loan book, while 40 per cent is accounted by loan against property (LAP) and the rest constituted by loans to project developers. While the lending business has presence in 39 cities, the top five cities — Mumbai, Hyderabad, Delhi, Bangalore and Chennai — account for around 60 per cent of disbursements. While in the home loans category, loan-to-value (LTV) ranges at 60-70 per cent, in case of LAP, LTV is restricted to 45 per cent, thus reducing portfolio



L&T FINANCE: IMPROVEMENT ON THE CARDS

₹ crore	FY17E	% chg*	FY18E	% chg*	FY19E	% chg*
Net interest income	3,240	28.2	3,922	21.1	4,856	23.8
Pre-provisioning profit	2,649	41.9	3,050	15.1	3,629	19.0
Net profit	891	29.2	1,254	40.7	1,686	34.4

Return on	Assets (%)			Equity (%)		
	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E
	1.3	1.6	1.9	12.3	14.8	17.5

E: Estimates, *% change year-on-year

Source: Brokerage reports

risks (or loan defaults).

Given that L&T Finance is largely underpenetrated in the home loan market, analysts at JM Financial are bullish that the segment should sustain 32 per cent annual compound growth rate in the next few years.

The robust wholesale finance business is the most interesting piece for L&T Finance. Diverse loan book, which mitigates the operational risk, is the main advantage of the portfolio. The loan book is spread across segments such as power generation and transmission and distribution, renewable energy, roads, structured corporate finance and supply chain finance. Wholesale book accounts for 61 per cent of total loan book. Here, L&T Finance focuses on selling down of loans rather than accumulating its loan book - a strategy that helps de-risk its portfolio and generates higher fee income, which is ROE

accretive without consuming much capital.

As the change in operations fall in place, L&T Finance offers significant potential for long-term investors, even as the stock has almost doubled in the last one year, outpacing the S&P BSE Sensex's 17 per cent return.

Analysts at Axis Securities feel the new strategy should lead to re-rating of L&T Finance's stock as ROE improvement starts kicking in.

"Strict cost controls, sanguine growth outlook in focus businesses and option value from disposal of defocused businesses all bode well," they add.

Analysts at JM Financial expect L&T Finance to generate 17 per cent ROE in FY17, while for those at Antique Stock Broking, L&T Finance is their top pick in the financials space.