JM Financial

NSE Code: JMFINANCIL, BSE Code: 523405, ISIN Code: INE780C01023

2019-03-31

Current price: 94.6 / Target price: 132 / Target date: March 2020

Expected forward return: 39.8% CAGR

by

Rajeev Agrawal, CFA

(SEBI Registered Investment Adviser)

Executive Summary

JM Financial (JMF) is an integrated and diversified financial services group. The Group's primary businesses include:

- Investment banking, wealth management and securities (IWS) which includes fee and fund based activities for its clients.
- Mortgage Lending which includes both wholesale mortgage lending and retail mortgage lending (home loans, education institutions lending and LAP)
- Distressed credit which includes the Asset Reconstruction (ARC) business
- Asset Management which includes the mutual fund (MF) business.

Over the last 8 years (from FY 10 to FY 18) JMF has delivered:

- Revenue growth of 23.5%.
- PAT growth of 19.5%.
- EPS growth of 17.8%
- ROE improvement from 10% to 16%.

Headwinds

In Sept 2018, Indian financial system had a mini Lehman moment. One of the biggest infrastructure NBFCs in India (ILF&S) went from being rated AAA to Default. ILF&S had loan book of more than 100,000 Crores ($15 Billion) and its debt was quite widely held in the financial system. Overnight, liquidity disappeared; NBFCs found it hard to raise funds; NBFC valuation were re-rated in the market; and, the question became who is next!

IL&FS episode also highlighted an important chink in the armor of NBFC – their ALM (Asset Liability Mismatch) with short-term funds being used for long-term lending.

Current situation

JMF is a conservative firm. Since the crisis, it has taken multiple steps:

- Reduced the loan book in Q3 FY 19 and paid off some of the debt.
- Consequently, brought down leverage and profitability in the lending business.
- JMF now has Debt:Equity of 2.2x and CAR (Capital Adequacy Ratio) of 26%.
- Slow-down in capital markets has lowered profitability in IWS business.

Management

JMF was founded by Nimesh Kampani (currently the non-Executive Chairman). Nimesh's son, Vishal Kampani – graduate of London Business School – is now the MD and CEO of JMF. Vishal has been with JMF since 1997 and was promoted to MD in 2016. He has spent a lot of time in the tranches building out various businesses of JMF before being elevated to MD.

Kampani family owns 62.1% of the company. Foreign Portfolio Investors (FPI) own 17.4%. High insider ownership along with past behavior of management gives us comfort that minority investor's interests are aligned with that of the management.

Valuation

JMF currently trades at 94.6/share. Our sum-of-parts calculation gives a conservative valuation of 132/share (Institutional investors paid 162/share in February 2018 to buy a piece of the company). Hence, we think that there is a 40% upside from the current price. We think this gap of 40% should get bridged in the next year because:

- Growth will come back in lending business as liquidity concerns fade.
- Distressed assets (Asset reconstruction) business is in a sweet spot where a lot of distressed assets are getting resolved. Their biggest holding – LeelaVentures – was bought by Brookfield in 19 Q4 and should provide a good trigger for profitability.
- IWS business should regain momentum after national elections in May 2019 as capital markets activity picks up as uncertainty abates.

Basic Facts

Industry	Financial Services
Price (31st Mar 2019)	**94.6 Rs/share**
Market Cap (INR/$ = 70)	**$1,132 MM/INR 79,270 MM**
Valuation	**Price/Book: 1.58x** **Price/Earnings (ttm): 12.5x**
Capital Adequacy Ratio (CAR)	**Basel III: 26%**
Quality of Assets	**Gross NPA: 0.7%** **Net NPA: 0.6%**
Ownership	**Promoter Holding: 62.1%** **FPI Holding: 17.4%**
Management – CEO/Promoter	**Vishal Kampani (CEO), Nimesh Kampani (Chairman)**
Liquidity (Listed on NSE & BSE)	**~$1.4 MM/day**

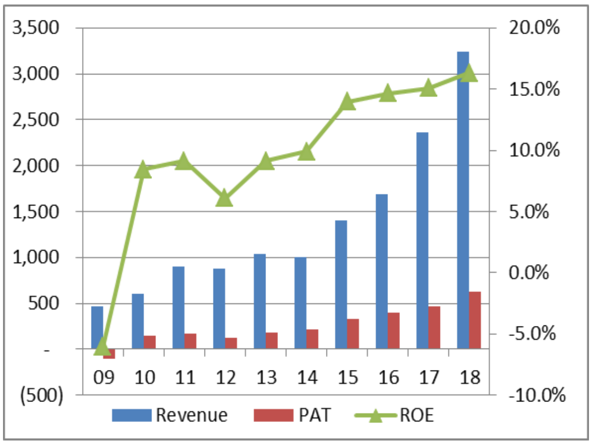
Company Background

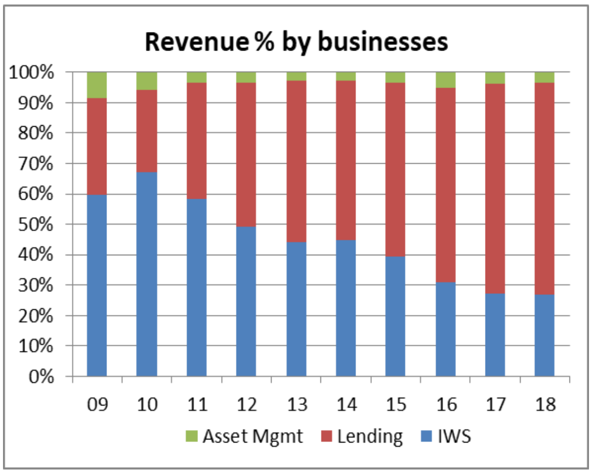
JMF origins go back to 1973 when it was founded by Nimesh Kampani. Through multiple name changes and tie-ups, company has evolved to its present form. Some of the key events in the history of the company include:

Year	Event
1973	Company was founded
1998	Joint Venture with Morgan Stanley
2005-6	Preferential issue of shares to Tiger Global, Blueridge and Azim Premji
2007	Separation from Morgan Stanley
2014	Partnership with Vikram Pandit – ex CEO of Citibank – for real estate lending subsidiary (JMFCS)
2018	Raised 650 Cr through QIP at 162/share
2018	Raised 825 Cr in JMFCS at 2.7x P/B (post raise)

Business Evolution

JFM was primarily a fee based business which started as an advisory firm to its clients. Company has kept the strong roots in advisory and added new segments. From FY 10 to FY 18 JMF has delivered:





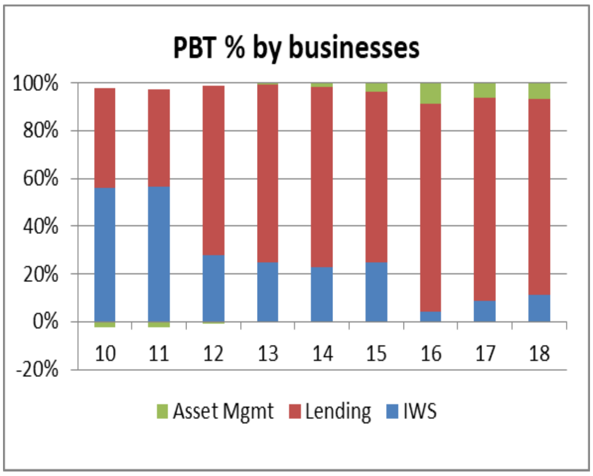
- Revenue growth of 23.5%
- PAT growth of 19.5%
- EPS growth of 17.8%
- ROE improvement from 10% to 16%

This steady growth has been possible as company has built out new businesses which have grown well. The key segment is the lending business which has grown from contributing 30% of revenue in FY 09 to almost 70% in FY 18.

Lending segment in these charts also contains the ARC (Asset Reconstruction) business which has become a meaningful business in itself.

Its original business of IWS (Investment Banking, Wealth Management and Securities) business now constitutes a much smaller portion of the overall revenue.

Asset management contribution has also come down.



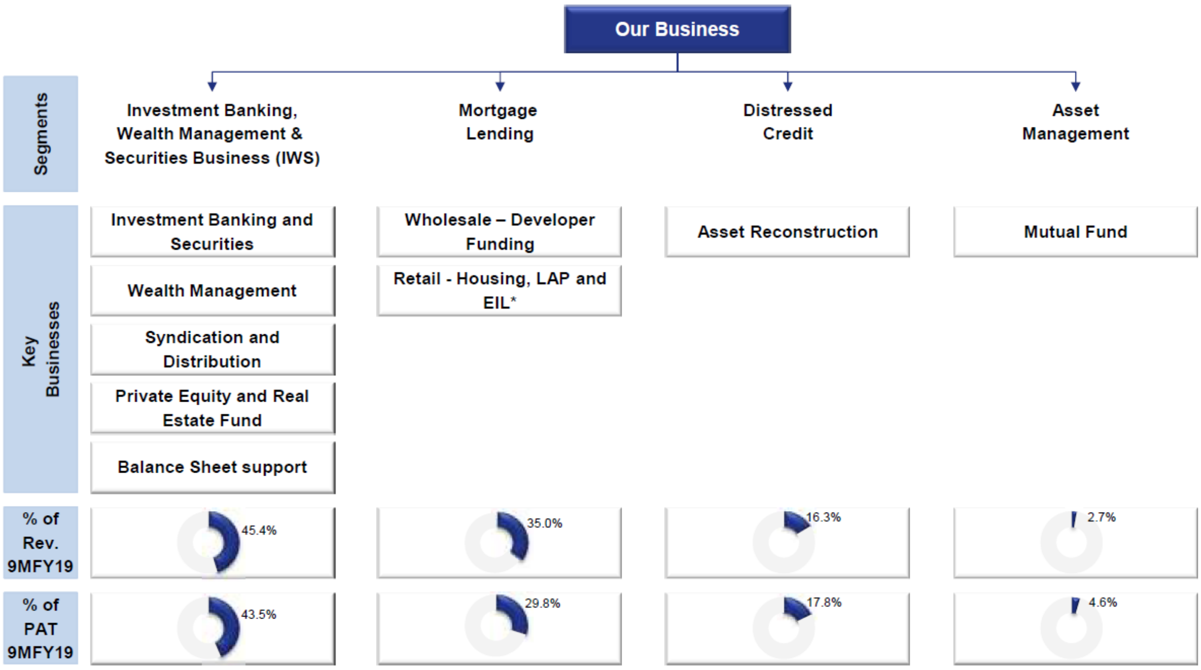
Importance of lending business becomes even more pronounced when we look at its contribution in PBT. From 45% in FY 10 it now contributes 80%.

Asset management business has turned around and has become profitable.

Lastly, IWS business contribution has become a lot more subdued as other businesses has helped drive the growth of the firm.

Business Segments

We will now take a deep dive into the various segments of the company to understand this company better.



Source: JMF Presentation Q3, FY 2019

Above chart shows the various segments and their contribution in the first nine months of FY 19. In the above chart company has added both the fees and fund based activities of its IWS clients. Separating out the fund based activity in its own segment, in our view, aids in understanding the business. Hence, we have moved around one of the business contribution (JMFP – JMF Products) from IWS to Lending to aid in our understanding. The adjusted business segments looks as below.

Rajeev Agrawal, CFA
Founder & Adviser
rajeev.agrawal@doordarshiadvisors.com

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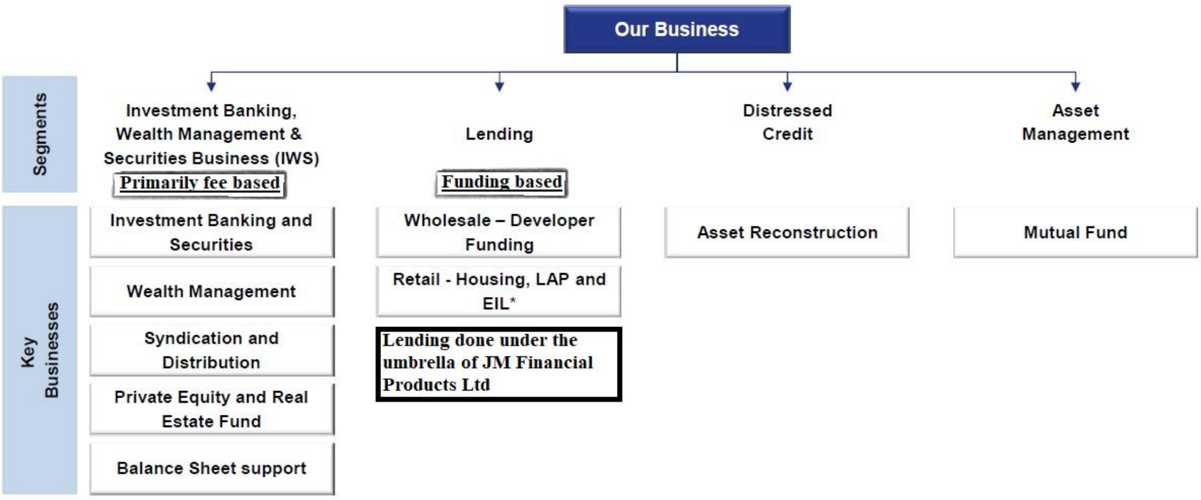
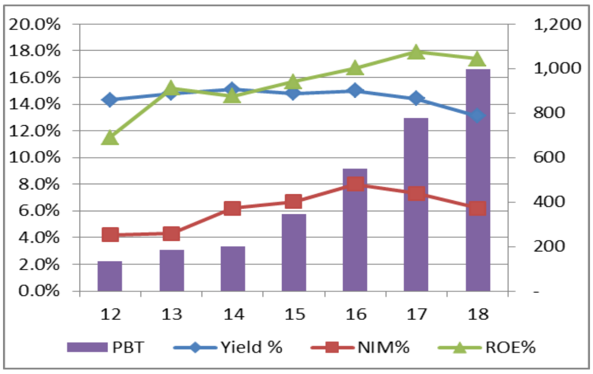


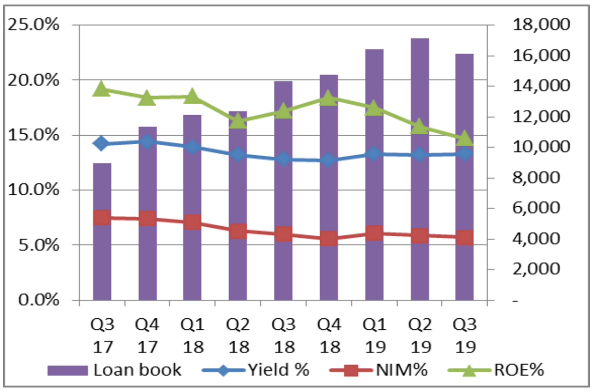
Lending Segment

Company provides lending in the following verticals:

- Wholesale construction financing to Real estate developers.
- Structured finance / corporate lending to Corporates.
- Capital markets lending to high net worth clients.
- Retail Mortgage lending to individual and SME (Small and Medium Enterprise) clients.

Lending book has grown from 2,000 Crores in FY 12 to 16,000 Crores in the latest quarter. This fast growth has helped drive the profitability of the business.

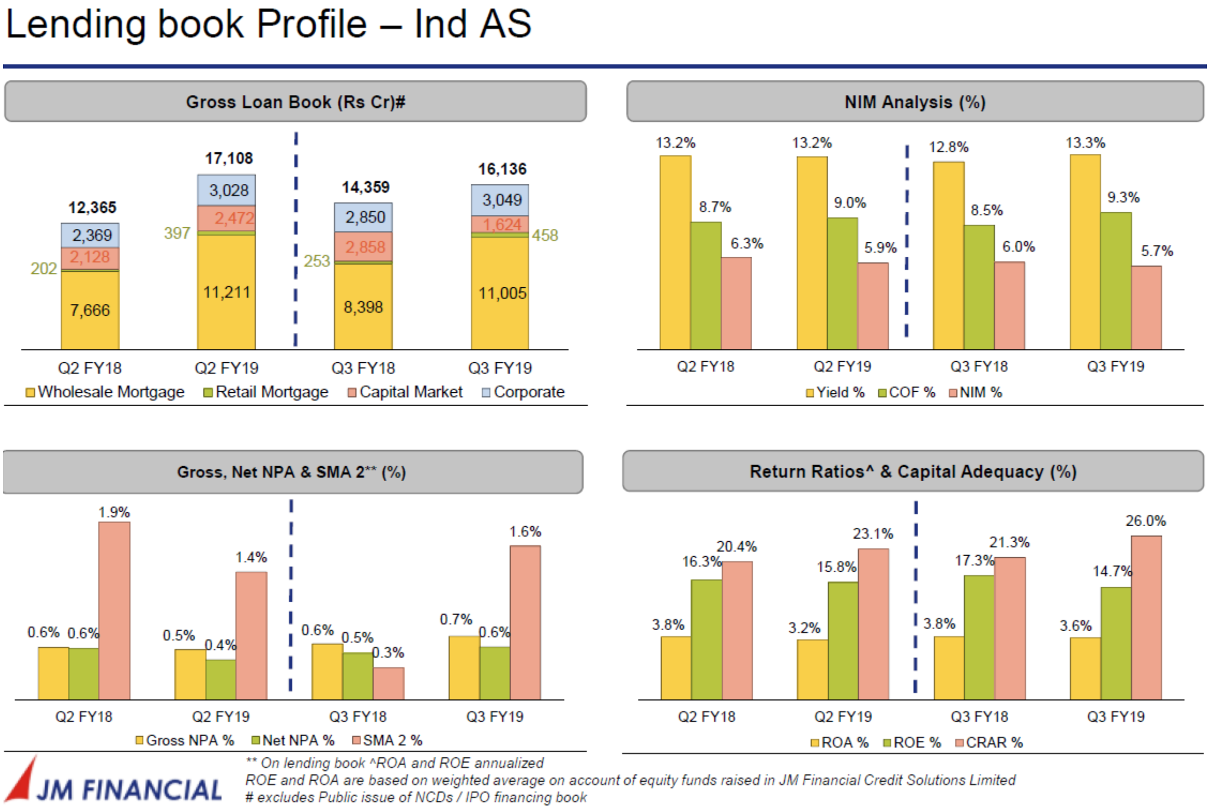




Yields and NIM (Net Interest Margin) have fallen in the last few quarters and years as company has increasingly focused on higher collateral and better quality loans.

Though ROE has held up well till FY 18, it has started to come down in the last three quarters of FY 19. This is because management has taken a conservative stance in the recent market dislocation and de-grown the loan book.

Liquidity in the financial system became very tight during the recent market dislocation. Many NBFCs struggled to fulfill their obligation to their clients. However, steps taken by the company enabled it to tide over the recent crisis. These moves have also reduced the company leverage to a very conservative Debt:Equity of 2.15x.



Source: JMF Presentation Q3, FY 2019

Lending to real-estate developers is the biggest constituent of its loan book. This is also the highest yielding loan book for the company. Corporate loan is the second largest and is a mix of structured finance and promoter finance. Corporate loans are primarily originated in the IWS segment. Capital markets comprise of margin finance and loans for IPO and NCD issues. Retail mortgage is a recent vertical for the company and it will take a while for this is to get built out.

Company follows very conservative lending practices. This has translated into a very high quality of loan book with GNPA (Gross NPA) of 0.7% and NNPA (Net NPA) of 0.6%.

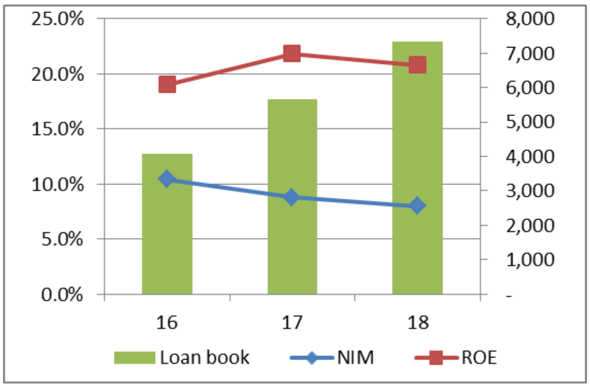
High capital adequacy of 26% (versus RBI mandated 15%) gives company a long runway to build out its loan book without having to raise new equity.

68% of the sources of fund are long-term thus allowing company to maintain duration of assets with duration of liabilities.

We will take a deeper dive into the 2 entities that drive the bulk of lending business:

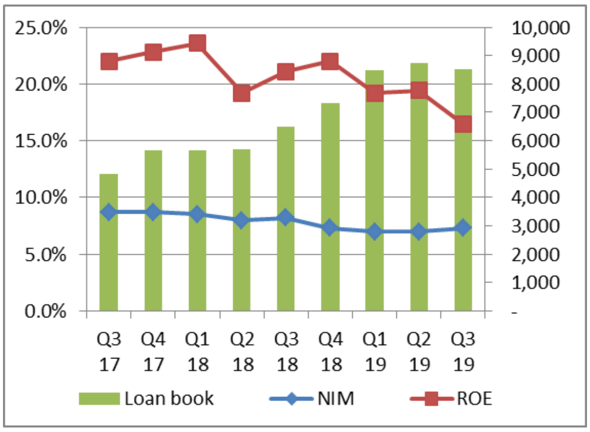
- JMF Credit Solutions (JMFCS) – Real-estate developer finance
- JMF Products (JMFP) – Capital markets, Corporates, Retail & overflow from developer finance.

JMF Credit Solutions (JMFCS)



JMFCS is primarily engaged in the business of extending wholesale credit to developers of real estate projects. Over the last 2.5 years, JMFCS loan book has more than doubled and it has translated into similar growth in profitability.

ROE has come down in the recent quarters as company raised capital and reduced loan book to manage the liquidity crisis.



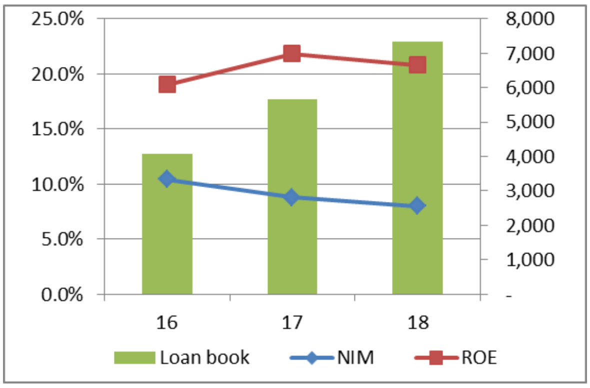
JMFCS raised 875 Crores in 2019 Q2 valuing itself at 7,175 Crores which implied a valuation of 2.7x Price / Book (post raise).

Post the raise Debt:Equity has come down to 2.15x and Capital adequacy has gone up to 30.3%.

JMFCS has high asset quality with GNPA of 1.02% and NNPA of 0.93% in FY 18. 85% of loan book is secured by cash flow of projects.

JMFCS is rated AA by rating agencies in India. Parent (JMF) owns 47.13% of JMFCS.

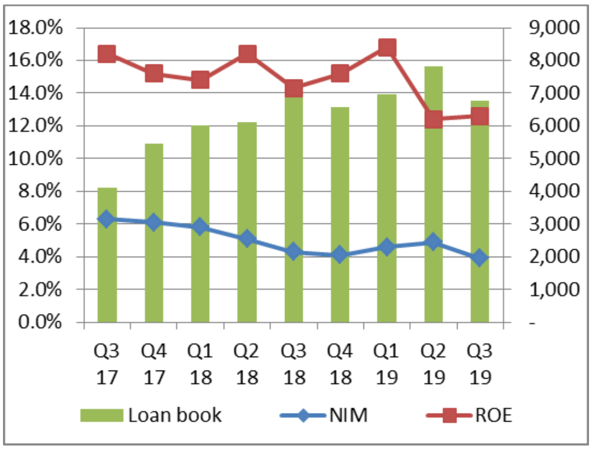
JMF Products (JMFP)



JMFP is in the business of lending to multiple segments:

- Structured finance/ corporate lending to corporates
- Capital markets lending to high net-worth individuals, retail and wealth segment clients.
- Extend large sized loans to real estate developers.

JMFP is in the process of building out its Retail lending segment. Retail segment will provide loans to SME (Small and Medium Enterprise) as well as housing finance to individual clients through a wholly owned subsidiary of JMFP, JM Financial Home Loans Limited (JMFHLL).



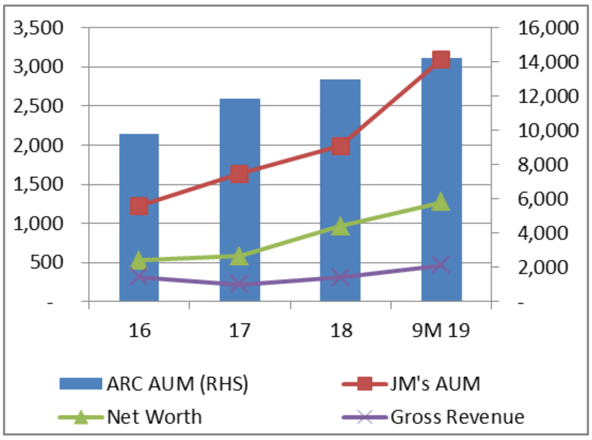
In the last 2.5 years JMFP has doubled its loan book and profitability has moved in tandem with the loan book.

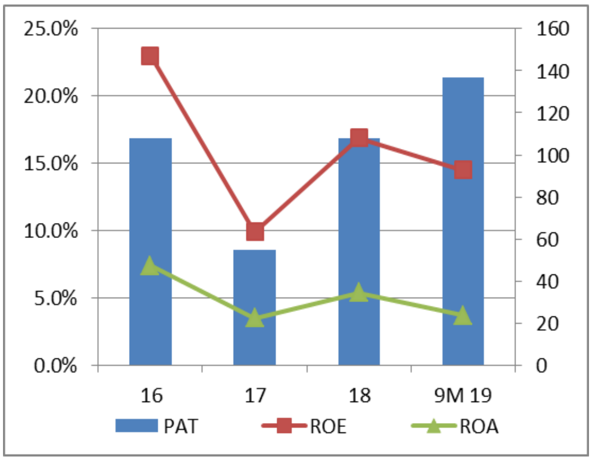
ROE has come down in the recent quarters as JMFP is focusing on secured book resulting in lower NIM. In addition, reduction of loan book in Q3 reduced profitability and hence ROE. Leverage in Q3 FY 19 is down to 3.9x (vs 4.4x last year).

JMFP continues to have pristine asset quality with GNPA of 0.26% and NNPA of 0.23% in FY 18. JMFP is rated AA by rating agencies in India. Parent (JMF) owns 99.35% of JMFP.

Distressed Credit (ARC) Segment

JMF ARC was established in 2008. Overtime regulatory changes have enabled ARC to play a crucial role in resolving distressed assets. Recent regulatory developments streamlining insolvency and bankruptcy proceedings and the regulatory framework around distressed assets in India, are providing attractive opportunities for the acquisition and resolution of distressed assets from banks and other financial institutions at competitive prices.





These changes are providing stronger tailwind to bigger ARCs like JFM ARC. Hence, JMF ARC AUM has grown a lot.

JM's share of AUM has grown as it has taken higher AUM for itself due to deals being done primarily in cash and due to better opportunities in this space.

ARC revenue and profitability varies a lot y-o-y based on resolution of assets. Hence, this business behaves more like a private equity business.

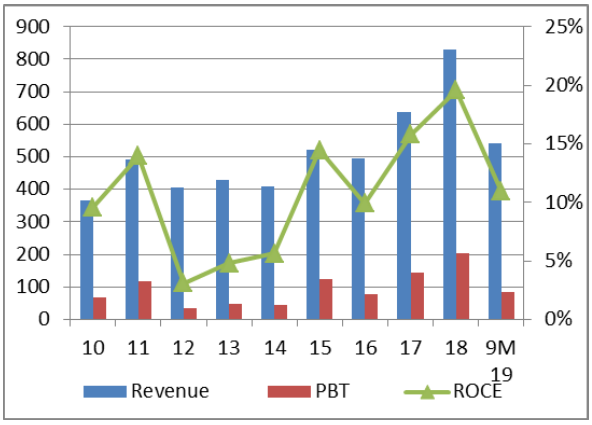
As IBC resolution picks up pace we expect ARC PAT to improve significantly. Biggest asset of ARC – LeelaVentures – has been bought by Brookfield in 19 Q4 which should drive profitability in Q4.

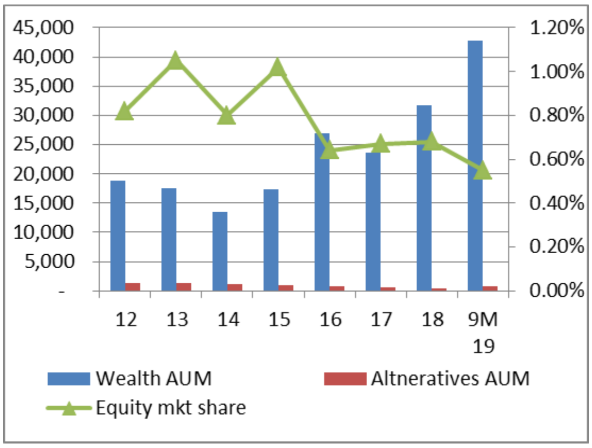
ARC raised 280 Cr in FY 18. JMF ownership of ARC increased to 57.1%

JMFARC is rated AA-

Investment Banking, Wealth management and Securities (IWS) Segment

The investment banking and securities business includes management of capital markets transactions, advising on mergers & acquisitions, and private equity syndication. IWS also provides investment advisory and distribution services, involving equity brokerage services, wealth management and distribution of financial products. This segment also includes the institutional equities business.





In FY 2019 JMF changed its reporting so that all lending to IWS clients was included in IWS business. For our purposes, however, we have kept lending from JMFP as part of the lending business

Business performance varies from year to year as sentiment in capital market changes. Business was muted in FY 12-14 as capital markets were in doldrums. During FY 15-18 business performed well as capital market sentiment improved. Results in 9M FY 19 are however weak due to prevailing sentiment in capital markets

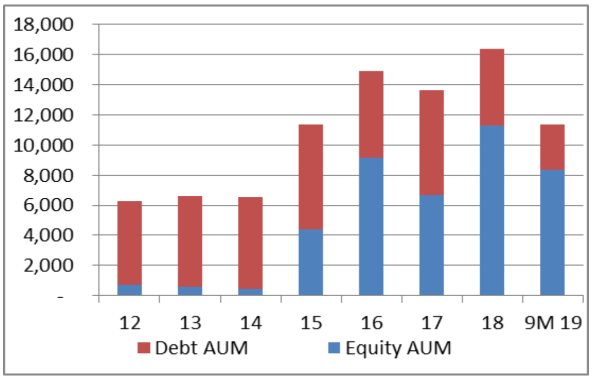
Wealth management AUM has grown well providing stability. Wealth management is a fee based business and the yields are not very high.

Alternatives business (Private Equity and Real Estate fund) AUM has shrunk.

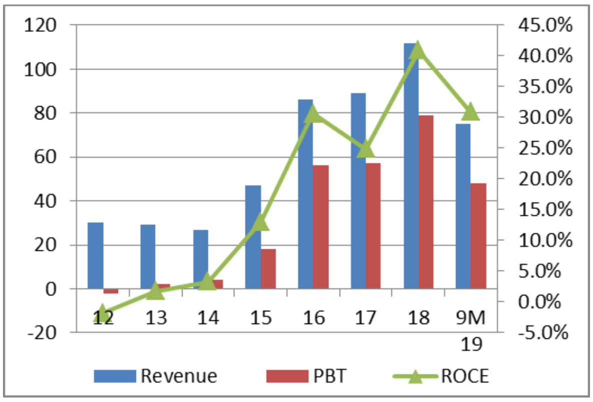
Brokerage business is a highly competitive business and company has lost market share. IWS has these multitudes of business in one segment to provide a bouquet of services to its clients. This allows for stickier relationships with their clients.

Asset Management (MF) Segment

In this segment, company offers mutual funds to cater to the various needs of its customers.



Asset management business has transformed from primarily being a Debt business (in FY 12) to primarily an equity business (FY 18). Since equity mutual funds earn higher fees from its customers, even though the AUM has been flat over the last few years, revenue has continued to improve.



Higher revenues have also translated into higher profitability. Since this business doesn't need much capital, ROCE has also improved with profitability.

JMF MF market share is around 0.5%. Their primary target segment is the high net-worth and corporate customer. They are looking to grow the AUM without sacrificing the profitability.

JMF owns 59.5% of the asset management business.

Having looked at the various business segments in depth, let us turn our attention to the management of the company.

Management

Management is a critical factor in the success of any investment. In an industry like finance, where leverage magnifies management actions, choosing the right management becomes critical.

Nimesh Kampani (Non-Executive Chairman)

Nimesh Kampani is one of the eminent deal makers of India. He laid the roots of the current day JMF by starting an investment bank in 1972. Since then, and many deals later, it has evolved into a strong financial services firm in India.

Nimesh is held in high regard in the industry.

Vishal Kampani (MD, CEO)

Vishal is son of Nimesh. He did his MS from London Business School and joined JMF in 1997. In 2016 he was promoted to MD and CEO.

Vishal has worked in the trenches in various businesses of JMF and has been the driving force behind many others. He is extremely hands on and his interaction with analysts and media gives us a lot of comfort that we are in good hands.

Board of Directors

JMF has strong BOD with 2 Promoter-Directors (mentioned above) and 6 Independent Directors (ID). All IDs are of high repute.

- **E A Kshirsagar**: ID. Specialist in corporate structure and strategy
- **Dr Vijay Kelkar**: ID. Former Finance Secretary, GOI. PhD Univ of California, Berkeley
- **Darius Udwadia**: ID. Founder partner Udwadia & Udeshi, Solicitor & Advocate
- **Keki Dadiseth**: ID. FCA. Former Director, Unilever PLC
- **Paul Zuckerman**: ID. Fmr Chairman, Warburg & Co
- **Jagi Mangat Panda**: ID. MD Ortel Communications.

What we like about the management?

- Management incentives are aligned with that of the shareholders as management owns 62% of the company.
- Management is highly conservative. This is demonstrated through:
  - Low leverage (2.2x) and high capital adequacy (26%).
  - High asset quality (GNPA 0.7%, NNPA 0.6%).
  - Management shrunk the business when cash and asset cover started coming down in the lending business due to competition.
  - Management takes write-downs quickly and through P&L, rather than reserves.
- Management has long-term mindset
  - High level of transparency in reporting and through conference calls.
  - Comment from 19 Q2 CC, *"we are building this business for decades and not for the next quarter."*
- Strong next level leadership
  - Each business segment has a clear leader.
  - Leaders of business in place for many years.
  - Equity culture to align incentive (employee owns 3%-4%).

Valuation

We will value JMF using sum-of-parts valuation since there are many different businesses. For some businesses we use more than one approach and then use the average.

Business	JMFCS	JMFP	JMFP	IWS
Approach	Price to Book	Price to Book	Price to Earning	Price to Earning
Multiple	2.7x	2.5x	18x	16x
Rationale	3rd party investors invested at 2.7x PB in Q2 FY 19	Lower multiple due to lower ROE though more secure book	Good quality book, High growth	High ROCE, Cylical, Depressed earnings
Input Value (Q3 FY 19)	Book Value=2,790 Cr	Book Value=1,565 Cr	Earning ttm*=214Cr	Earning ttm*=114Cr
Total Value	7,505Cr	3,913Cr	3,852Cr	1,824Cr
Ownership	47.05%	99.35%	99.35%	100%
Value for shareholder	**3,531Cr**	**3,887Cr**	**3,827Cr**	**1,824Cr**

*ttm is trailing twelve months.

Business	JMF ARC	JMF ARC	JMF MF	JMF MF	JMF MF
Approach	Price to Earning	Price to Book	Multiple of AUM	Price to Earning	Buyback in FY 2018
Multiple	15x	2.0x	5% of AUM	15x	Buyback price
Rationale	High expected growth as assets get resolved in the next few years	High growth in the next few years	74% of AUM is equity with higher returns	High return on capital, stable earnings	Management assessment of value
Input Value (Q3 FY 19)	Earning ttm=185Cr	Book Value=1,271 Cr	AUM=11,364 Cr	Earning ttm=45Cr	58 Lakh shares for 55.7Cr
Total Value	2,775Cr	2,542Cr	568Cr	675Cr	512Cr
Ownership	57.07%	57.07%	59.54%	59.54%	59.54%
Value for shareholder	**1,584Cr**	**1,517Cr**	**338Cr**	**402Cr**	**305Cr**

Business	Approach	Multiple	Shareholder value (Crs)	Average (Crs)
JMFCS	Price to Book	2.7x	3,531	3,531
JMFP	Price to Book	2.5x	3,887	3,857
	Price to Earning	18x	3,827	
IWS	Price to Earning	16x	1,824	1,824
JMF ARC	Price to Earning	15x	1,584	1,550
	Price to Book	2.0x	1,517	
JMF MF	Price to Earning	15x	402	348
	% of AUM	5%	338	
	Buyback price	1x	305	
Total Value				**11,110 =132/share**

Current price of 94.6/share is significantly lower than the intrinsic price of 132/share. This gives us an upside of 39.8% in the short term.

We expect this gap (current price of 94.6/share) from intrinsic value (of 132/share) should close over the next year for the following reasons:

- Lending business (which slowed down for most of FY 19) will pick up pace in FY 20 as liquidity conditions ease.
- IWS business has been muted as Capital market sentiments are depressed. We think post the national election in India in 2019, capital market sentiments should improve.
- ARC business is expected to do many resolutions which should drive the profitability. Besides, as banks are under ongoing pressure to address distressed bank loans they will continuously provide new supply of distressed assets.

Risks with the thesis

Apart from competition, which is always present in any industry, some of the key risks with the thesis include:

Liquidity situation

JMF along with many others in the industry slowed down loan growth as liquidity vanished from the markets. We think that liquidity situation should ease and many of these institutions will go back to start making loans.

We are starting to see liquidity already ease out in the system. RBI has already provided one rate cut in Q4. RBI is also very eager to ensure that credit is flowing in the system and NBFCs are a critical party of that system.

Real estate lending in JMFCS

Lending to real-estate sector is currently going through a downturn. Many of the real-estate developers are struggling to sell their inventory. Lack of sales is slowing down cash-flows of builders and poses potential risk to lenders.

We believe that JMFCS has been a conservative lender where they have lent out to developers in Bangalore, Chennai and Mumbai. They also have good cash-flow coverage on these loans and are unlikely to be impacted by the slowdown. Lastly, JMFCS raised money from marquee investors in Q2 FY 2019 at 2.7x price to book which gives us comfort that their book is good.

Conservative management doesn't grab growth opportunities

In earlier part of the thesis we have mentioned that management is extremely conservative. One of the risks with the thesis is that management waits too long to disburse loans. In the interim, opportunities to give out best loans with highest yield passes away.

Long tenure of management in the financial services space gives us comfort that management will act when they see opportunities. Vishal (current MD) has built out the lending business and understands this space well.

Regulatory risk

After the liquidity crisis there were concerns about RBI coming up with tighter regulations for NBFC. So far we haven't seen any new regulations (6 months since the crisis erupted). However, the concerns persist.

Given importance of NBFC in credit ecosystem, we think RBI is likely to take a calibrated approach in bringing any tighter norms for NBFC. In the interim, stronger NBFCs will be able to address the short term challenge and will be better positioned for the evolving landscape.

Variant View

In this section we outline some of the reasons why Mr. Market is underpricing this company. We then provide our variant view of the same. This section has been put in the thesis to follow Charlie Munger's dictum, *"I never allow myself to have an opinion on anything that I don't know the other side's argument better than they do."*

While we don't claim that we know the other side of the argument better the next person, we sure as hell do try.

Mr Market View	Our Variant view
NBFC cycle has played out. NBFC won't do well for a long time.	This view comes from investors who think that once a sector has done well it won't come in the limelight for a long time. Credit sector in our mind has a very long tailwind. There are multiple tailwinds for this sector: • Low credit penetration • Growing aspiration of populace • Limited current capacity to service the needs
JMF has been an also-ran in the new financial services space.	We agree that JMF hasn't grown at a fast pace as compared to some of the new players. However, we think that Vishal Kampani, new MD, is quite ambitious. He seems to be eager to build out businesses where scale is possible like lending and ARC. Both of these businesses can do very well for JMF.
Political Risk – India is getting ready for its national election due in the first half of CY 2019. This is likely to create volatility in the markets. So stay away!	We believe volatility is the friend of the investor. If we can assess a business and understand it, identify the incentives of the management and see a long run way in the business we are very comfortable buying more when markets give us an opportunity. So perceived political risk is giving us opportunity to buy a good business at a good price.
There is fierce competition among NBFC. This will reduce margins, growth and return on capital.	Due to liquidity crisis many NBFC players have weakened thus allowing remaining NBFCs to do better. So we do expect competition to come down among NBFCs and hence yields will improve. This should drive higher margin, profitability and ROE. Besides, NBFCs market share of the total lending has grown at a brisk pace in the last decade and we expect the same will continue given their inherent agility.
Other than NBFC, most other businesses of JMF are mediocre.	We think that IWS business allows JMF to provide better loans in the lending business and better deals in ARC business. It is best reflected in the low NPAs across their lending business. We also think that as capital markets pick-up, earnings can grow quickly. On the ARC front we are just now starting to see some good resolutions which should drive strong profitability.

Trade Feasibility / Idea Practicality

Company's market capitalization is 6,365Cr or $1,132Million. JMF is listed on both NSE (National Stock Exchange) and BSE (Bombay Stock Exchange). On an average, around $1.4 Million worth of shares trade every day across the exchange.

Thus there is enough liquidity across NSE and BSE to take advantage of this opportunity.

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