SATIN CREDITCARE NETWORK LTD.
Reaching out!

Satin Creditcare Network Ltd

NSE Code: SATIN, BSE Code: 539404, ISIN Code: INE836B01017

2020-12-23

Current price: 72.5 / Target price: 222 / Target date: June 2023

Expected forward return: 56% CAGR

by

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(SEBI Registered Investment Adviser)

Executive Summary

Satin is among the largest MFI (Micro Finance Institution) in India (excluding banks). MFIs cater to the lowest segment of the society in India and regulations require that at least 85% of the lending has to be uncollateralized. Hence, even minor economic disruption has an outsized impact on this sector.

Satin has grown its AUM at 47% cagr between FY 12 and FY 20 and at 29% in the last 3 years. It is currently trading at ~3.4x PE of FY 20 earnings, 0.35x PB (accounting for recent rights issue) having normalized ROE of ~13-15%. Founder management used to own 30% of the company till FY 20. Management significantly increased its stake to 38% through a recent rights offering and also by buying rights entitlement of other shareholders. We are partnering with other marquee investors including MIT Endowment and Nordic Microfinance.

Headwinds

Covid-19 has created significant headwind for the sector. Given the lockdown in India, economic activity came to a standstill in April – June (Q1 FY 21) quarter.

MFI industry went through a similar headwind during the demonetization period in 2016 and 2017. Income for borrowers of MFI was impacted as this segment deals in cash and significant cash was withdrawn from circulation. Market participants are extrapolating the weakness experienced by MFI during demonetization years for the post-Covid period.

The road ahead

Collection efficiency which was 50-60% in Q1 FY 21 has gone to 85-95% in September (Q2) quarter for most of the MFI players. Collection efficiency continues to improve in subsequent months after Q2.

Moratorium from RBI has helped financial players from recognizing stress in the books post Covid lockdown. MFIs have also enjoyed similar benefit. We expect stress as reflected by GNPA will increase significantly in quarter ending December (Q3). Hence, we expect the provision cost will continue to be high over the next few quarters.

Financial sector was suffering from tight liquidity in the last few years. Concerted efforts by RBI and the government have addressed the problem and there is now ample liquidity in the system.

Satin Businesses

Satin is primarily a MFI and >90% of its book is made up of uncollateralized loans. Over the last few years, company has also entered into the collateralized segment of housing finance and loans to MSME.

- MFI lending (₹60 Bn): Focused on JLG (Joint Lending Group) with no collateral.
- Business Correspondence (₹11 Bn): Extending loans to MFI customers on behalf of banks and collecting fees.
- MSME (₹3 Bn): Small ticket loans to entities with property as collateral
- Housing finance (₹2 Bn): Focused on affordable housing.

Satin has consciously diversified its presence across states. From 77% of AUM coming from top 4 states in FY 17 it has come down to 56% in H1 FY 21.

Management

Satin was founded by Harvinder Pal Singh (HP) in 1990. Management adapted well to new regulatory changes and started focusing on rural micro finance vertical in 2008. HP is a chartered accountant and is the Chairman and Managing Director of the company.

Ownership

We prefer investing in NBFC where management has significant stake in the company. Besides, we like prominent investors to be co-owners in the company. Both those criteria are met with Satin.

Shareholder	Ownership*
Promoters (HP Singh and related parties)	38.3%
MIT	3.1%
Nordic Microfinance	6.5%

* Ownership is as of Sept 2020, after the rights issue.

Valuation

Satin trades at 3.4x FY 20 earnings, 3.7x average earnings over FY 18-20 and 6.1x ttm (on a fully diluted basis accounting for rights issue). On a PB basis Satin is valued at 0.35x (again accounting for dilution). This valuation is for a business which has normalized ROE of ~13-15%, ROA of ~2.0-2.5% and CAGR of 15%+ over a business cycle.

Management seems to agree that it is cheap and bought extra rights share at 60/share thus increasing their stake by 8% from 30% to 38% in the last 6 months.

Asset Quality and Capital Adequacy

Satin has maintained superior asset quality with on-book GNPA at 2.9% and NNPA at -1.0% as of Q2 FY 21. Under Ind AS (new accounting standard of India which mirrors IFRS), provision coverage (including standard assets provision) of NPAs was 134%.

Company is well capitalized with total CAR (Capital Adequacy Ratio) of 32.3% including Tier 1 capital of 24.9% as against statutory requirement of 15% and 10% respectively. Given high capitalization we expect that company won't have to raise new capital for the next few years.

Satin is rated A- (Stable) by ICRA and CARE.

Basic Facts

Industry	NBFC-MFI (Non-Banking Financial Corporation-Micro Finance Institution)
Price (23rd Dec 2020)	**72.5 Rs/share**
Market Cap (INR/$ = 73.5)	**$73.5 MM/INR 5,220 MM**
Valuation	**Price/Book: 0.35x** **Price/Earnings (ttm): 6.1x**
Capital Adequacy Ratio (CAR)	**Basel III CAR: 32.3%** **Tier1: 24.9%**
Quality of Assets (Standalone)	**Gross NPA: 2.9%** **Net NPA: -1.0%**
Ownership	**Promoter Holding: 38.4%**
Management – CEO/Promoter	**Harvinder Pal Singh** (Founder, CMD)
Liquidity (Listed on NSE & BSE)	**~$150K/day**

Company Background

Satin Creditcare Network Limited (SCNL) was set up in 1990 to provide individual business loans to urban shopkeepers. It was registered with the Reserve Bank of India (RBI) as a deposit-taking NBFC under the name, Satin Leasing and Finance Company Limited. Following its conversion into a public limited company in 1994, the company was renamed Satin Creditcare Network Ltd. in 2000.

The company stopped accepting public deposits from November 2004 and the RBI changed its classification to Category B (non-deposit taking) from Category A (deposit taking) in February 2009 and converted it into an NBFC-MFI in November 2013. The company's microfinance operations are based on the Grameen Bank joint liability group (JLG) model and were spread across 1,355 branches in the country as on June 30, 2020.

Business Overview

Satin provides financing to bottom of the pyramid customers. After demonetization company has also ventured into secured areas like housing finance and MSME customers. More than 90% of the book comes from uncollateralized loans.

1. SCNL: Parent entity providing micro-financing loan to bottom of the pyramid customers.
2. Taraashna (TFSL): TFSL is a Business Correspondent (BC) allowing banks and NBFCs to reach out to JLG customers. TFSL has collaborated with nine Principal Partners, including six Scheduled Commercial Banks (Yes Bank, DCB Bank, RBL Bank, IndusInd Bank, Jana Small Finance Bank Limited and IDFC First Bank) and three NBFCs (Reliance Commercial Finance, Northern Arc Capital (erstwhile IFMR Capital) and Hiranandani Financial Services Private Limited).
3. SHFL: SHFL provides financing for affordable housing in the retail segment. Its low ticket size ensures that the focus is on rural housing.
4. SFL: NBFC providing loans to MSME (Micro, Small and Medium Enterprises) customers against "immovable property" as collateral.

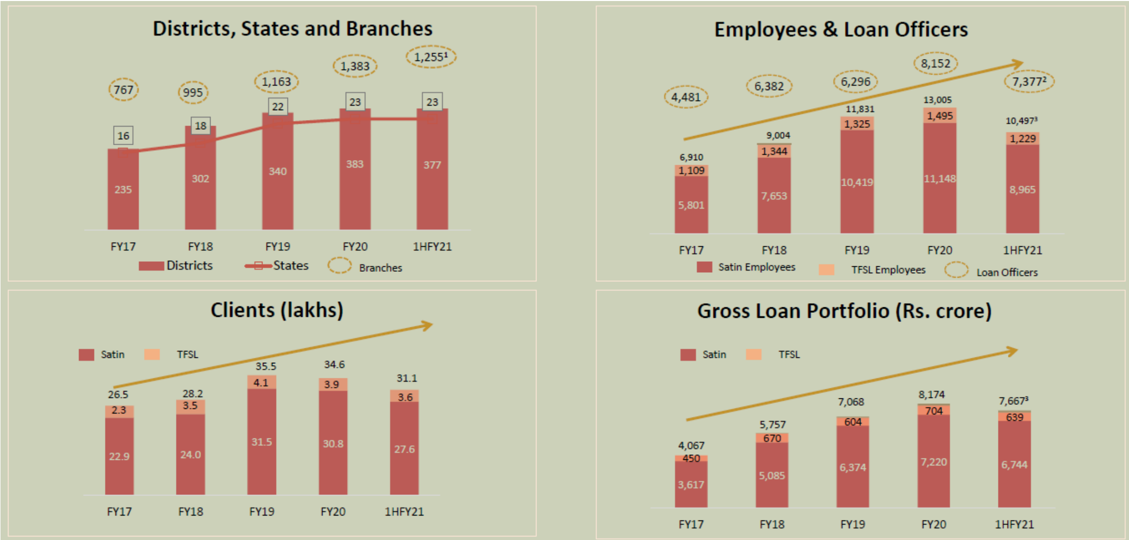
Below table provides an overview of these entities and the AUM as of Q2 FY 21 (end Sept, 2020).

	SCNL	Business Correspondent Services	Housing Finance	SME
Product features as on Sep'20	MFI[1]	Taraashna Financial Services Limited[2]	Satin Housing Finance Limited[3]	Satin Finserv Limited (SFL)[4]
Start Date	May'08 (JLG)	May'12	Feb'18	Mar'19
Ticket Size Range	Upto Rs. 50,000	Upto Rs. 50,000 (JLG - Microfinance)	Rs. 100,000 – 4,000,000	Rs. 100,000 – 100,000,000
Tenure	6 - 24 months	12 - 24 months	24 - 240 months	12 - 120 months
Frequency of Collection	Bi-Weekly	Bi-Weekly	Monthly	Monthly/Quarterly
No. of States/UTs	23	7	4	8
No. of Branches	1,022*	201	14	15
AUM (Rs. crore)	6,448[5]	639	164	120
No. of loan accounts	3,294,318	352,340	1,637	1,205
Avg. Ticket Size for Q2FY21	Rs. 23,000 (JLG)	Rs. 29,700	Rs. 1,213,000	Rs. 432,000 (Retail)[6]

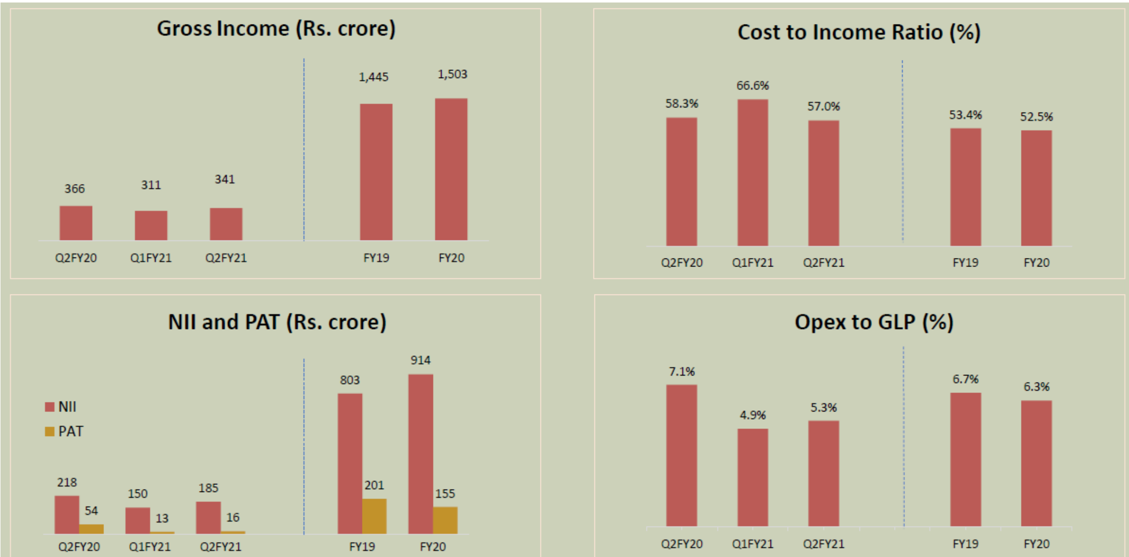
More than 75% of Satin's book is for the rural segment.

Business Performance

Over the last few years Satin along with its subsidiaries has continued to expand its presence across India. This has increased its geographical presence, the customer base that it serves, as well as the total AUM that it manages.



It has also improved the interest income and profitability of the company. However, profitability is impacted by episodic events which are part and parcel of this business model. Hence, a conservative capital structure and low cost structure is paramount to be able to withstand the challenges.



Current challenge of Covid-19 pandemic is likely to impact the company's results in FY 21 and to some extent in FY 22. The extent of impact will depend on how quickly borrowers are able to start generating income and start paying these loans. Usage of Credit bureau checks, strict limits on the maximum amount that a lender can lend, limited instances of political influence and good monsoon has given the confidence to the industry that impact from Covid-19 is unlikely to be as severe as it was during demonetization.

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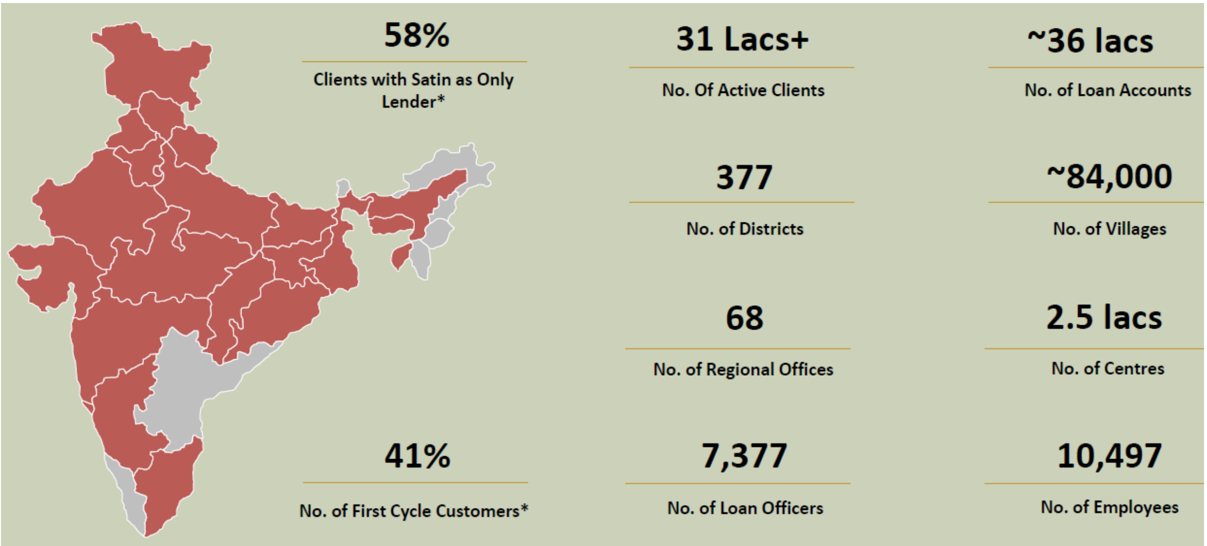
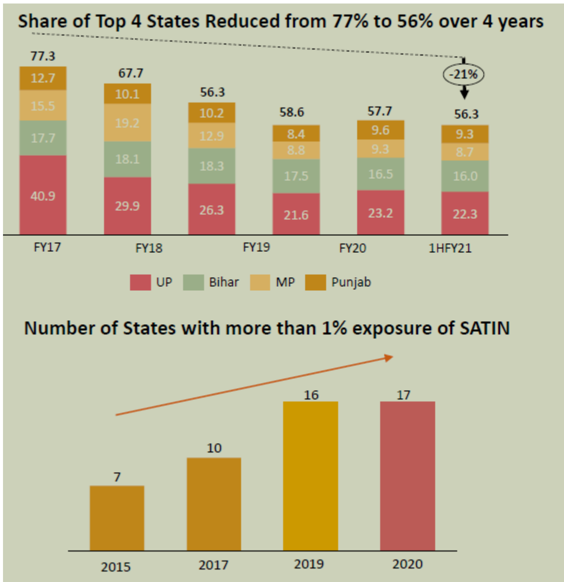
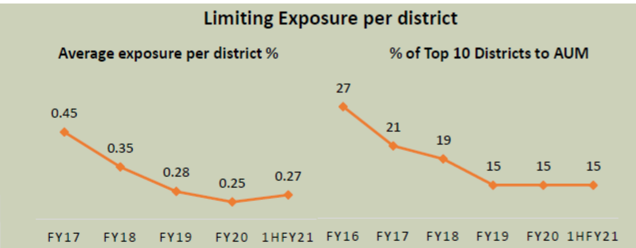
Risk Management

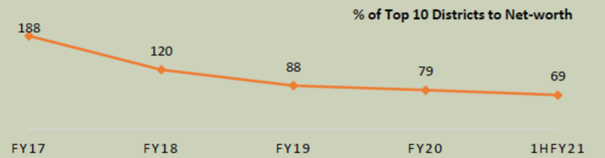
The most important aspect of a financing business is how company manages risk. MFI loans are riskier. They are given based on the cash flows of the customers. However, cash flows are subject to significant variability. Satin manages the risk by distributing it across many customers (akin to insurance firms insuring many people) and across wide variety of geographies (to alleviate issues in one region affecting the overall book). This coupled with small ticket sizes and regular collection (fortnightly for uncollateralized loan in case of Satin) allows them to manage the risk.







Particulars	FY17	FY18	FY19	FY20	1HFY21
No. of Districts - JLG	236	306	359	397	377
% of Districts with <1% exposure	88.1%	92.5%	96.4%	96.5%	96.6%
% of Districts with >2%	2.1%	1.0%	0.6%	0.5%	0.3%

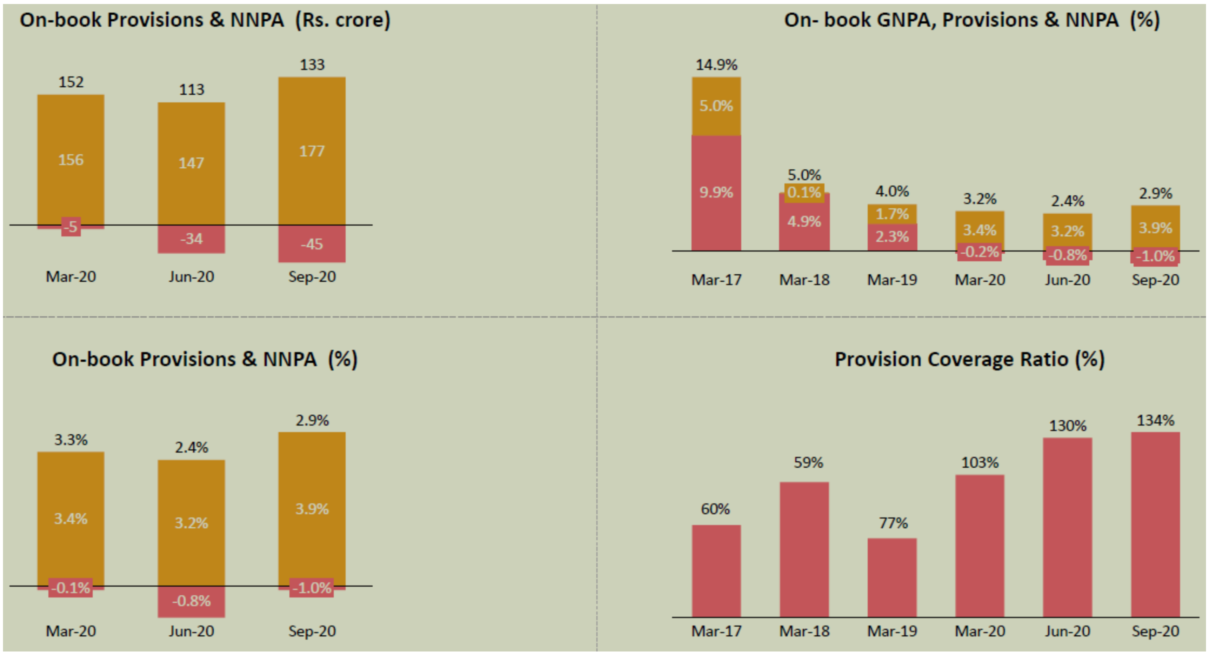


Satin was hit very hard during demonetization years in 2016 and 2017. Satin not only had significant exposure to states like UP, Bihar and MP; these states were also among the worst affected as well. Since then company has been on a journey to reduce concentration of AUM in any particular state.

Diversification of book across states is a work in progress. Company has a stated goal of bringing exposure to any individual state below 20% over the next few years. They are also working to reduce exposure to top 10 districts.

Asset Quality

Company suffered massively during the demonetization period and its GNPA shot up to 15%. Over the last few years company has gradually provided for these NPA. As of Q2 FY21, GNPA on the books is 2.9% against which company is carrying provisions of 3.9% thus having excess provisions of 1%.



Around 10% of the customers have not paid any installment since Covid-19 related lockdown. These customers account for 10% of AUM. It is likely that a good portion of this 10% AUM will turn NPA in Q3. Our expectation based on demonetization experience is:

- Company will be persistent in recovering these dues from their customers well past the 180 dpd (days past due) as they did after demonetization.
- Company is likely to take provisions much more aggressively this time around as compared to demonetization. Hence over the next few quarters company's profitability will be impacted while they work through the bad loan.

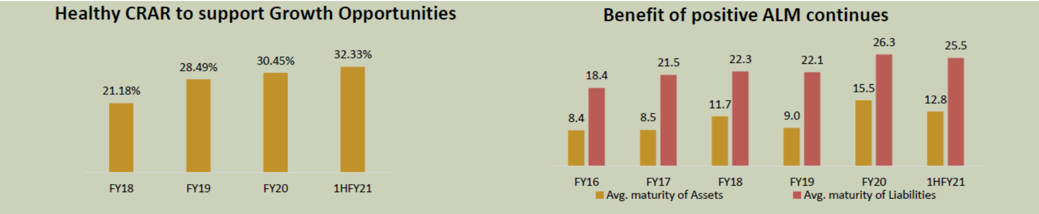
Liquidity

Liquidity is the life-blood of financial organizations. Since default of ILF&S in September 2018, Indian financial system has been under extreme liquidity strain. Covid-19 pandemic further exacerbated the situation as the whole system became extremely risk-averse.

RBI, as the central bank of the country, has taken significant measures to ease liquidity in the system. These measures have dramatically improved the liquidity in the system and most of the creditworthy borrowers are now able to borrow. However, the scars from the liquidity challenges are visible on the balance sheet of most of the financial institutions, especially NBFCs.

Satin is no different. It has taken extra measures to ensure that there is sufficient liquidity. It has a positive ALM for multiple quarters and also carries significant amount of approved but undisbursed sanctions. High capital adequacy of the company also gives comfort for the future borrowings. These factors have mitigated concerns about liquidity for Satin.

As of FY 21 Q2, Satin had liquid cash of 1,962 Crs along with approved and undisbursed credit lines of 1,000 Crs. This is more than enough liquidity for Satin.



Static ALM as on 30th Sep'20 (Rs. Crore)	Oct-20	Nov-20	Dec-20	Jan-21	Feb-21	Mar-21	Total
Inflows							
Liquidity at the beginning of month*	1,962	1,943	2,007	1,917	1,833	1,909	1,962
Principal - Loan portfolio	183	196	259	250	202	223	1,312
Interest - Loan portfolio	64	66	82	76	60	61	409
Total (A)	**2,208**	**2,206**	**2,348**	**2,243**	**2,094**	**2,192**	**3,683**
Outflows							
Principal repayments	229	168	379	381	119	182	1,458
Interest repayments	36	31	52	29	66	37	251
Total (B)	**265**	**199**	**431**	**410**	**185**	**219**	**1,709**
Cumulative Mismatch (A-B)	1,943	2,007	1,917	1,833	1,909	1,973	1,973

Valuation

Company is currently trading at the following metrics:

Metrics	Value
Price-Earnings (ttm – trailing twelve months)	6.1
Price-Earnings (average earnings over 3 years	3.6
Price-Book	0.35

Trailing twelve month number reflects significant provisions company has made in the last 3 quarters on account of Covid-19. We expect that the provisions on account of Covid-19 will continue for a few more quarters. Once the industry has better visibility on how MFI borrowers will behave, we can handicap the provision requirements.

For our valuation purposes, we have assumed that FY 21 will be a washout. We also assume that the cost of provision will continue into FY 22. However, our crystal ball is quite hazy for FY 22. Hence, our valuation of Satin is based on our expectation that the business normalizes in FY 23.

To be conservative, we have assumed that the business generates 200 Cr of PAT in FY 23. A similar amount of PAT was generated in FY 19 when Satin had lower amount of capital. We also assume that a business like this should trade at a multiple of at least 8x Price to Earnings. Hence, the market value of Satin could be 1,600 Cr in FY23.

Assuming that the Rights share are fully paid up and there is no need of additional dilution (as company has high capital ratio), we get an expected value of 222/sh.

From current price of 72.5/sh to an expected value of 222/sh would be a **3.0x in 2.5 years or a cagr of 56%**.

Risks with the thesis

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

Lending business

Satin is in the business of lending money. Most of the surprises in lending are negative. New regulations from the regulators, black swan event like demonetization and loan waiver by government are some of the event risk with the thesis.

These risks have been accentuated by the current Covid-19 crisis and the uncertain economic trajectory for the future.

Unsecured lending – MFI

MFI caters to the low income group. Loans are given without any collateral. Thus there is a risk that these borrowers are not able to service their loans and lenders will not have any recourse to get their money back.

MFI lending practices have evolved over the last decade to significantly reduce the risk of defaults in this segment. All lending is done through SHG and JLG which means that multiple people are responsible for the loan. In addition, no borrower can take more than two loans. Lastly, credit data is now available for the borrower. Hence if a borrower defaults they are cut out from the formal lending channels (and the benefit of lower interest rates) for a long time. Thus borrower has strong incentive to service the loan.

Management Risk

Satin has been founded by HP Singh and he is also the CMD. Thus HP has significant influence on the company and may not act in the best interests of the minority shareholders and the company.

Having observed HP through various crises and through the 30 years journey of the organization gives us the comfort that we are in good hands.

Overall

Satin offers a compelling case of:

- Heads we win with expected CAGR of 53% over the next few years.
- Tails we don't lose much. Even, if some of the unexpected events were to materialize, there is enough Margin of Safety between the book value of the company and the price at which we are buying.
- Our assumption that PAT in FY 23 only goes back to what the company did in FY 19 strikes us as quite conservative. This is especially the case as management has expressed its desire to start growing the book. We expect this AUM growth will translate into material earnings increase over the next few years.
- Applying a low Price Earnings multiple of 8x on future earnings is also very conservative. Low multiple will allow us to tide over any adverse developments.

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
MFI is a poor business model. Significant economic headwinds due to Covid-19 imply that loan default will surge for MFIs. It will cause significant losses for MFI players including Satin.	MFI provide uncollateralized loans. Hence, during economic stress there is a high propensity for borrowers to default. However multiple factors will help MFI industry in the future: 1. Most MFI players now use credit bureau to validate borrowers before extending loans. Hence, if MFI borrowers don't pay the loan they won't be able to get the next one. 2. MFI sector is now regulated by RBI and hence state/regional issues are less relevant. This has reduced involvement of local politicians making the sector more reliable. 3. MFI as a segment has grown significantly. It has translated into better organization of MFI players, better communication and better ability to enforce the contracts.
Satin suffered disproportionately during Demonetization. It will again suffer heavily due to Covid-19 crisis. Hence, Satin business and stock will continue to perform poorly for a while.	Satin was predominantly a north Indian based MFI lender in 2016. Since north Indian states suffered heavily during demonetization, Satin business suffered as well. Overtime Satin has gradually expanded its presence to other parts of India. Geographical expansion has reduced its exposure to any particular state. In addition Satin has streamlined its disbursement and collection processes. These processes now allow Satin to better track the portfolio and address them faster.
Satin credit rating of A-/Stable is weaker than other pure MFI players like CreditAccess and Spandana. Hence, it deserves lower multiple than others.	Satin Credit of A-/Stable is weaker than Spandana's credit rating of A/Stable and CreditAccess rating of A+/Stable. However, a one notch lower rating as compared to Spandana doesn't justify PB multiple of 0.35x for Satin versus 1.7x PB for Spandana. Similarly, a two notch lower rating as compared to CreditAccess doesn't justify PB multiple of 0.35x for Satin versus 4.3x for CreditAccess.
Something is wrong! Otherwise, Mr Market won't price this stock so cheaply!	We agree that the stock is mispriced. We believe that the drawdown in stocks have been driven by demand-supply dynamics rather than due to fundamentals. Many large institutional investors have recently bailed out of Satin stock creating extra supply. Satin has also been a regular issuer of its stock over the last 5 years, creating too much supply in the market. However, we should always remember Warren Buffett's quote, *"Price is what you pay; value is what you get."* After our due-diligence we think that Mr Market is mispricing this stock. Get out your bucket and not a tea spoon!

Trade Feasibility / Idea Practicality

Company's current market capitalization is 554Cr or $75Million. The above market cap assumes fully diluted share count after the rights issue has been fully paid. Satin is listed on both NSE (National Stock Exchange) and BSE (Bombay Stock Exchange). Additional details are provided in the table below:

Attribute	NSE	BSE
Average Daily Volume (in '000s)	124 shares	19 shares
Average Daily Value Traded (in Rs Mn)	17	2

There is reasonable liquidity across NSE and BSE to take advantage of this opportunity.

Disclaimer / Disclosure

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