Credit Analysis and Research (CARE)

Quality at a reasonable price

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Issue Open: December 7, 2012
Issue Close: December 11, 2012

Market share gainer, while maintaining best-in-class margins: CARE is the second largest rating agency in India, with large PSU banks such as IDBI, Canara and SBI, being its prominent shareholders (pre-offer combined shareholding of 58.2%). CARE has garnered market share from its globally affiliated peers in the past few years and even while doing so, it has maintained its superior margins. Overall the operating margins for CARE have been significantly higher, as unlike its other two listed peers, its sole business segment currently is rating services, which has enjoyed higher margins than research or any other division. Even comparing the ratings business, CARE has witnessed impressive EBIT margins (71% in FY2012) which are substantially higher than that of its peers (ICRA's 48% in FY2012, and CRISIL's 40% in CY2011), which as per the management, is primarily due to a) lower employee costs owing to its low-cost centralized back office at Ahmedabad (staff costs as a percentage to revenues are almost half vs. peers) and b) relatively lower SME/MSE ratings business (which involves lower margins on account of its lower revenue per customer).

Rating business to primarily drive top-line growth for next few years: Rating business will remain company's sole business segment at least in the next few years. Considering credit growth estimates of 15-17% over the next few years and efforts for growing our nascent debt market, we expect CARE to register at least similar kind of growth in its volume of debt rated. However, considering the fact that its revenue stream has stabilized now, and intention to increase presence in SME/MSE ratings, we expect growth in its revenue to be approx. 200-300bp lower than the growth in its volume. Migration to IRB approach, in our view will affect the most to the rating agency which has major part of its business coming from SME/MSE ratings (as smaller enterprises normally take loan from a single bank as against larger ones which usually avail loan from consortium of banks, all of whom might not be approved for IRB). Having said that, a relatively smaller SME/MSE rating business for CARE (entered only in FY2011) and ample time to develop other alternative revenue streams (as impact of IRB on business will not be before FY2016), gives us adequate comfort to believe that the impact would be manageable for the company.

Outlook and valuation: The stock is valued at 17.9x at upper band on TTM earnings (taking 2HFY2012 earnings to be 60% of entire FY2012), which is at a ~18% discount to ICRA and ~45% discount to CRISIL. Even on a TTM EV/EBITDA basis, it is valued at ~39% discount to CRISIL and ~33% to ICRA. However, on a TTM EV/Sales basis, it is valued at ~27% premium to CRISIL and ~63% premium to ICRA, which is due to its high margins (likely to have a downward bias from here on). The company has reported cash and current investments worth ₹91/share as of 1HFY2013. Overall, considering the high intellectual capital/knowledge oriented and cash generating nature of the business, combined with reasonable 12-15% revenue growth expectation, we believe the IPO is reasonably priced at the upper band. **Hence, we recommend subscribe to the issue.**

Key financials

Y/E March (₹ cr)	FY2009	FY2010	FY2011	FY2012	1HFY13
Net Sales	94	136	166	189	90
% chg	*81.4*	*44.6*	*22.2*	*13.5*	-
Net Profit	52	86	88	116	50
% chg	*97.5*	*63.5*	*2.6*	*31.6*	-
Basic EPS	18.4	30.0	30.8	40.5	17.5
P/E (x) Lower End	38.1	23.3	22.7	17.3	16.0
P/E (x) Upper End	40.9	25.0	24.3	18.5	17.1
EBIT Margins	76.5	78.1	74.2	70.6	64.1
RoE (%)	48.4	49.4	34.6	34.5	34.1

Source: Company, Angel Research, Note: P/E, P/BV and ROE, for 1HFY13 calculated on an annualized basis, assuming 1H:2H mix of 40:60.

Issue Details	
Face Value: ₹10	
Present Eq. Paid-up Capital: ₹28.6cr	
Offer Size: 0.72cr Shares (offer for sale)	
Post Eq. Paid-up Capital: ₹28.6cr	
Issue size (amount):* ₹504-540cr	
Price Band: ₹700-750	
Post-issue implied mkt. cap*: ₹1,999cr-2,141cr	
Promoters holding Pre-Issue: 0.0%	
Promoters holding Post-Issue: 0.0%	

*Note:*At the lower and upper price band, respectively*

Book Building	
QIBs	Up to 50%
Non-Institutional	At least 15%
Retail	At least 35%

Post Issue Shareholding Pattern	
Promoters Group	0.0
MF/Banks/Indian FIs/FIIs/Public & Others	100.0

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Company background

Credit Analysis and Research Ltd (CARE) is the second largest rating company in India (on rating turnover basis). It was the third company to enter the credit rating industry in India (with there being a total of six players as of now), when it commenced operations in 1993. It is the leading credit rating agency in India for IPO grading, having graded the largest number of IPOs since the introduction of IPO grading.

It provides a wide range of rating and grading services across a diverse range of instruments and industries. The company has been rating debt instruments and related obligations covering a wide range of sectors for the last 19 years. Since incorporation, it has completed 19,058 rating assignments and rated ₹44,036bn of debt as of September 30, 2012. It had rating relationships with 4,644 clients as of September 30, 2012.

It has, in the last few years, diversified its income generating pool of products by entering into IPO grading, equity grading, and grading of various types of enterprises, including ESCO, RESCO, shipyards, maritime training institutes, construction companies and rating of real estate projects. It also provides general and customized industry research reports. Its research team actively covers 39 sectors as of September 30, 2012 and releases periodical industry research reports on these sectors.

The company has expanded its footprint outside India in its rating business, apart from providing technical know-how to a credit rating agency each in Mexico and Ecuador for a fee. It has been granted recognition for various levels of rating activities in Maldives, Mauritius and Hong Kong. In Maldives, the company can carry out ratings of debt instruments/bank facilities in respect of Maldivian companies (it has already set up operation there and completed two rating assignments), while in Mauritius its ratings are recognizable for risk weighting for banks' capital adequacy purposes. In Hong Kong, the company has received approval to act as an external credit assessment institution for the purposes of the regulatory capital framework.

Its existing shareholders include domestic banks and financial institutions, such as IDBI Bank, Canara Bank, SBI, IL&FS and Federal Bank (cumulatively they hold 73.4% shareholding, which will reduce to 49.1% post the successful completion of offer for sale).

Details of the issue

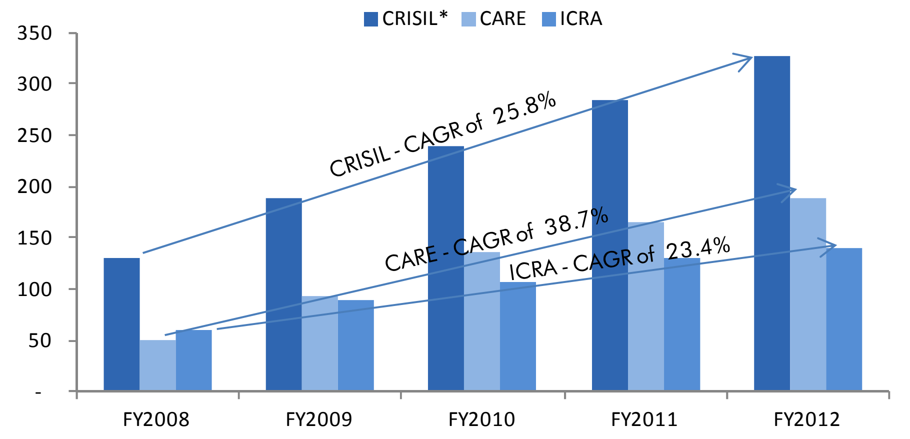
The IPO comprises an issue of 7.2mn equity shares of face value ₹10 each to the public. The issue shall constitute 25.2% of the post-issue paid-up capital. The price band for the issue has been fixed at ₹700–750 per share, valuing the company at ₹2,000cr to ₹2,141cr. The key shareholders who are tendering their shares are IDBI Bank (2.5mn shares), Canara Bank (2.2mn shares), SBI (0.9mn shares), IL&FS (0.9mn shares) and Federal Bank (0.5mn shares). The remaining 0.3mn shares are being offered by Tata Investments, ING Vysya, Milestone Fund and others. CARE will not get any money from this IPO as it is an offer for sale.

Investment arguments

Gained market share, while maintaining best-in-class margins

CARE has been able to garner market share from its globally affiliated peers in the past few years, as it has outpaced them by achieving a rating turnover CAGR of 38.7% over FY2008-12 as against a CAGR of 23.3% for ICRA and 25.8% for CRISIL during the same period. Even while it increased its market share, the company has been able to maintain its superior margins.

Exhibit 1: Grew fastest among top three rating agencies

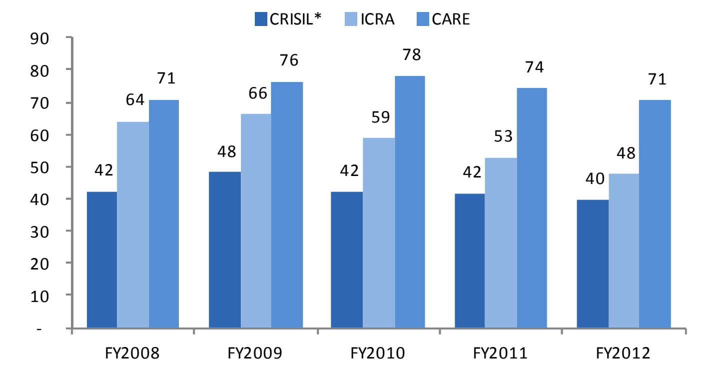


*Source: Company, Angel Research, Note: *December year end*

Its overall operating margins are significantly higher, as unlike the other two listed peers, its sole business segment currently is rating services, which for any rating company has enjoyed higher margins than research or any other division (99.4% of its FY2012 revenues came from the rating business, as against 67.2% for ICRA during the same period and 40.4% for CRISIL during CY2011).

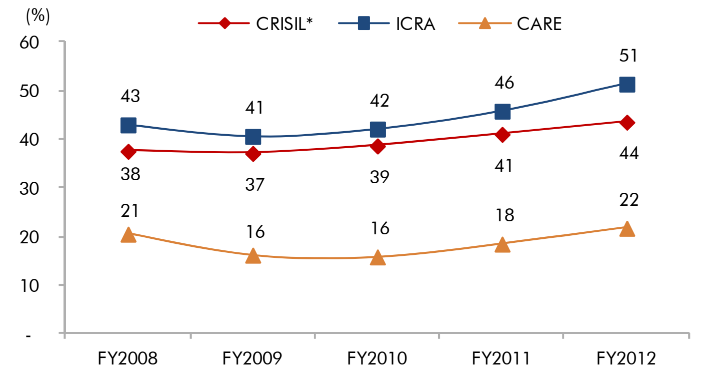
Even in its rating business, CARE posted impressive EBIT margins of 71% in FY2012, which is substantially higher than its peers (ICRA's rating division margins were at 48% in FY2012, whereas for CRISIL they were at 40% in CY2011). Key factors contributing to the impressive margins performance, as per the management are a) lower employee costs owing to its low-cost centralized back office at Ahmedabad (staff cost as % to revenues significantly lower for CARE at 22% in FY2012, compared to 44% for CRISIL in CY2011 and 51% for ICRA in FY2012) and b) relatively lower SME and MSME ratings business which involves lower margins on account of its lower ticket size and lower revenue per customer (as per management, expansion into SME/MSME ratings was the primary reason for decline in EBIT margins for CARE from levels of 78% in FY2010 to 71% in FY2012).

Exhibit 2: Margins# for Rating business



*Source: Company, Angel Research, Note:*calendar year for CRISIL, #PBIT margins considering consolidated segmental breakup for CRISIL and ICRA, whereas EBIT margins for CARE*

Exhibit 3: Staff Costs# as % of Revenues#



*Source: Company, Angel Research, Note:*calendar year for CRISIL, #consolidated numbers have been considered for CRISIL and ICRA*

Going ahead, owing to the expected increase in SME/MSME rating business, focus on developing its research business and limited scope for further operational efficiency, operating margins for CARE are unlikely to sustain at these levels and evidently so they have declined to 64% in 1HFY2013 (however they can be expected to remain much higher for the company compared to its peers).

Growth strategy going ahead

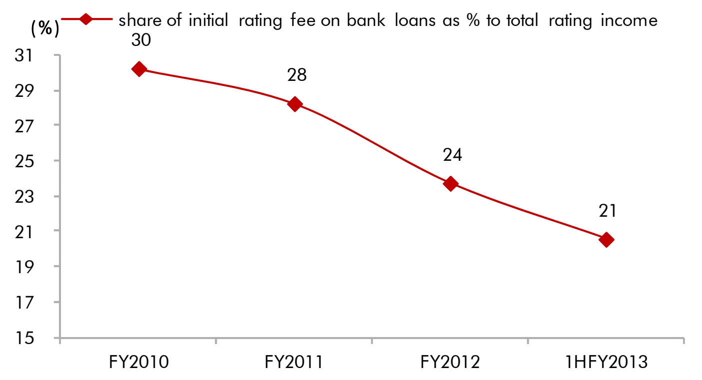
Rating business to primarily drive top-line growth for next few years

CARE's sole business segment currently is rating services (99% of its revenues in FY2012 came from the rating business). Its rating revenues are directly linked to the volume of debt instruments issued and bank loans/facilities provided (as rating income is typically a percentage of the volume rated), which in turn is dependent on clients' current debt position, credit worthiness, prevailing interest rates, investment sentiments and alternative funding options, most of which are directly correlated to the economic growth and credit growth.

Going forward, considering an estimated credit growth range of 15-17% over the next few years and persistent efforts of the Indian government to grow our nascent debt market, we expect CARE to register at least a similar kind of growth in its rating volume of debt instrument issued and bank loan/facilities provided (could be higher if it captures market share as the company has plans to increase its business development managers by ~30%).

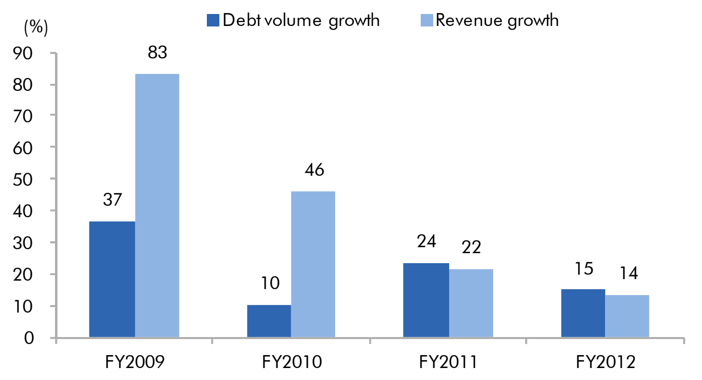
However, considering the fact that its revenue stream has stabilized now, (evident from reducing share of the initial fee income on bank loan/facility rated as percentage of total rating income from 30% in FY2010 to 20% as of 1HFY2013) and its intention to increase presence in SME/MSE ratings, we expect growth in its revenue to be ~200bp lower than the growth in its volume (as surveillance fee/annuitized fee component of its revenue gains prominence and SME/MSE rating business being lower revenue and higher volume based business).

Exhibit 4: Reducing share of initial rating fee, shows...



Source: Company, Angel Research

Exhibit 5: ...revenue growth is stabilizing for CARE



Source: Company, Angel Research

Meaningful contribution from research division only after few years

CARE's research team, which actively covers 39 sectors, currently acts as in-house support to its ratings team. Though the research offerings of the company are available on subscription basis, the revenue from the research division has been negligible till now, owing to lower sector coverage compared to peers, that are particularly associated with international rating agencies, and lesser market awareness of its research capabilities. Going forward, the company intends to focus on expanding its industry research coverage (which is a time consuming exercise and core part of business) and then it would strive to increase the number of subscribers to its research offerings, by leveraging its network of business development managers (150 as of FY2012) and actively targeting financial intermediaries, corporates, and policy makers and marketing its research products to them. Hence, we believe it will take at least the next few years for any meaningful contribution from the research division to come in.

Entry into new business segments to increase product offering

Recently, CARE has acquired a 75.1% stake in Kalypto, a company providing risk management software solutions primarily for BFSI companies. Through this acquisition, the company has acquired a ready product offering in the risk management domain (where it had no presence earlier) and in our view, it can build up an alternate revenue stream which is a time consuming exercise.

Moreover, capitalizing on its strong brand recognition, the company has ambitions to expand into new business segments, such as providing training, knowledge process outsourcing, risk management and other support services to rating agencies and other financial institutions and also providing advisory services in or outside India.

Overseas expansion to add value only after few years

CARE has expanded its footprint outside India in its rating business, apart from providing technical know-how to a credit rating agency each in Mexico and Ecuador for a fee. It has been granted recognition for various levels of rating activities in Maldives, Mauritius and Hong Kong. Also, the company intends to expand its rating business to other countries including Nepal and Mauritius, by form of joint venture/partnership or acquisition. It also has ambitions to set up an international credit rating agency, for which it has signed a non-binding memorandum of understanding with four credit rating agencies, each located in Brazil, Portugal, Malaysia and South Africa.

In our view, international aspirations for the company are likely to bear fruit only after next few years, as it has recently set up operations/is yet to set up operations in the above mentioned countries.

Key risks/concerns

Switch to the IRB approach

Pursuant to use of ratings given by credit rating agencies for measuring credit risk for capital adequacy purposes, rating of bank facilities/loans has become a core part of CARE's operations or for that matter any other rating company operating in India currently (share of only initial rating fee income on bank loan/facility rated as a percentage to its total rating income for CARE was ~21% in 1HFY2013). RBI has allowed banks to apply for migrating to IRB approach and beginning April 2014, it might begin approving them to use its own internal rating for measuring credit risk for capital adequacy purposes, which will run parallel to ratings of external rating agencies for the next eighteen months.

In the event, banks which are large and thus capable enough, get themselves approved for using its internal rating (most of the large private banks and a few large PSU banks have evinced readiness of setup), which in our view, will affect those rating agencies the most which have a major part of their business coming from SME/MSE ratings. Smaller enterprises normally take loan/facilities from a single bank as against larger ones which usually avail loan/facilities from a consortium of banks, all of whom might not be approved for IRB.

Having said that, a relatively smaller SME/MSE rating business for CARE (as it had started this segment only in FY2011) and ample time for developing other alternative revenue streams (as impact on business due to IRB will not be before FY2016), gives us adequate comfort to believe that the impact would be manageable for the company.

Concentration risk

CARE's sole business segment currently is providing rating services (largely debt), which in a way has aided the company to generate superior margins; on the other hand it has led to concentration risk for the company. Though the company has taken several steps to de-risk itself and diversify its business by expanding its income generating pool of products (SME/MSE ratings, Edu-grade, Equi-grade, Real Estate star ratings and many others), developing its business in markets outside India (Maldives, Mauritius and Hong Kong so far) and growing its research business, we believe at least in the medium term the company will continue to depend primarily on the business of providing ratings services.

Margins unlikely to sustain at current levels

CARE has enjoyed significantly higher operating margins as compared to its peers, as its sole business segment has been rating services (compared to others, for whom research and other divisions have been significant contributors to revenues). Margins have been on a declining trend since FY2011, when the company started SME/MSME rating business and going forward they are unlikely to sustain at the current levels, as the company looks to further grow its SME/MSME rating business and increase focus on developing its research business (though they will remain significantly higher than its peers due to its employee cost advantage and the fact that it had maintained margins during the last four years, when it gained market share, gives us additional comfort, in that respect). Hence, though we expect revenue growth for CARE to be reasonably healthy at 12-15%, considering expectation of declining trend in margins, earnings growth would have a downward bias.

Outlook and valuation

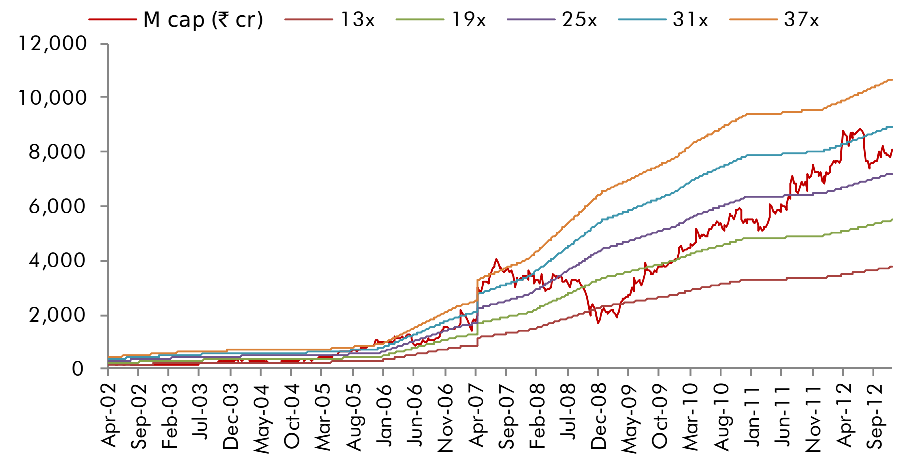
The stock is valued at 17.9x at upper band on trailing twelve month earnings (taking 2HFY2012 earnings to be 60% of entire FY2012), which is at a ~18% discount to ICRA and ~45% discount to CRISIL. Even on a TTM EV/EBITDA basis, it is valued at ~39% discount to CRISIL and ~33% to ICRA. However, on a TTM EV/Sales basis, it is valued at ~27% premium to CRISIL and ~63% premium to ICRA, which is due to its high margins (likely to have a downward bias from here on). The company has reported cash and current investments worth ₹260cr at the end of 1HFY2013, which works out to ₹91/share. Overall, considering the high intellectual capital/knowledge oriented and cash generating nature of the business, combined with reasonable 12-15% revenue growth expectation, we believe the IPO is reasonably priced at the upper band. **Hence, we recommend subscribe to the issue.**

Exhibit 6: Recommendation Summary on TTM (trailing twelve month) basis

Company	M Cap* (₹ cr)	Sales (₹ cr)	EBITDA (₹ cr)	Profit (₹ cr)	RoEs (%)	EV/EBITDA (x)	EV/Sales (x)	EBITDA Margin (%)	P/E (x)
CRISIL	7,087	942	313	216	48.3	21.9	7.3	33.2	32.8
ICRA	1,384	230	65	64	21.1	20.0	5.7	28.4	21.7
CARE	2,141	203	140	119	32.5	13.4	9.3	69.0	17.9

*Source: Company, Angel Research, Note: *at CMP of December 6,2012 for CRISIL and ICRA, and at upper end of its price band for CARE*

Exhibit 7: Sector P/E band on TTM basis



Source: BSE, Company, Angel Research

Income Statement

Y/E March. (₹ cr)	FY2009	FY2010	FY2011	FY2012	1HFY13E
Total operating income	94	136	166	189	90
% chg	*81.4*	*44.6*	*22.2*	*13.5*	-
Total Expenditure	21	28	41	54	31
Other Expenses	6	7	10	13	7
Personnel Expenses	15	22	31	41	24
EBITDA	73	108	126	135	59
% chg	*95.1*	*47.7*	*16.7*	*7.5*	-
(% of Net Sales)	*77.5*	*79.2*	*75.6*	*71.6*	*65.8*
Depreciation & amortization	1	1	2	2	2
EBIT	72	106	124	133	58
% chg	*95.6*	*47.8*	*16.1*	*7.9*	-
(% of Net Sales)	*76.5*	*78.1*	*74.2*	*70.6*	*64.1*
Interest & other Charges	-	-	-	-	-
Other Income	6	16	6	28	13
(% of PBT)	*7.4*	*12.9*	*4.5*	*17.5*	*18.0*
Recurring PBT	78	122	129	162	70
(% of Net Sales)	*82.6*	*89.8*	*77.7*	*85.5*	*78.1*
Tax	25	37	41	46	20
(% of PBT)	*32.6*	*29.9*	*32.0*	*28.4*	*28.8*
Reported PAT	52	86	88	116	50
% chg	*97.5*	*63.5*	*2.6*	*31.6*	-
(% of Net Sales)	*55.6*	*62.9*	*52.8*	*61.2*	*55.7*
Basic EPS (₹)	18.4	30.0	30.8	40.5	17.5
% chg	*97.5*	*63.5*	*2.6*	*31.6*	-

Balance Sheet

Y/E March (₹ cr)	FY2009	FY2010	FY2011	FY2012	1HFY13E
SOURCES OF FUNDS					
Equity Share Capital	8	10	10	29	29
Share Application Money	1	-	-	-	-
Reserves& Surplus	125	204	285	348	398
Shareholders' Funds	**133**	**213**	**294**	**377**	**427**
Total Loans	-	-	-	-	-
Deferred Tax Liability	2	2	3	4	4
Other long term liabilities	-	-	-	-	-
Long term provisions	1	1	2	2	4
Total Liabilities	**137**	**217**	**299**	**383**	**435**
APPLICATION OF FUNDS					
Net Block	**18**	**28**	**42**	**48**	**48**
Investments	**16**	**117**	**53**	**104**	**114**
Long term loans and advances	5	8	7	11	13
Other non-current assets	5	6	5	1	1
Current Assets	**114**	**86**	**228**	**263**	**319**
Cash	6	9	9	69	27
Loans & Advances	0	1	0	1	1
Current Investments	102	69	206	170	232
Debtors	5	7	12	16	52
Other	1	0	1	7	5
Current liabilities & provisions	21	28	37	46	59
Net Current Assets	**93**	**59**	**191**	**217**	**260**
Total Assets	**137**	**217**	**299**	**383**	**435**

Cash Flow Statement

Y/E March (₹ cr)	FY2009	FY2010	FY2011	FY2012	1HFY13E
Profit before tax	78	122	129	162	70
Depreciation	1	1	2	2	2
Change in Working Capital	2	3	1	9	(23)
Less: Other income	5	16	6	28	13
Direct taxes paid	25	37	41	46	20
Cash Flow from Operations	**50**	**75**	**85**	**98**	**16**
(Inc.)/ Dec in Fixed Assets	(9)	(14)	(14)	(8)	(1)
(Inc.)/ Dec in Investments	(44)	(69)	(73)	(11)	(72)
(Inc.)/ Dec in loans and advances	-	-	-	-	-
Other income	5	16	6	22	15
Cash Flow from Investing	**(47)**	**(67)**	**(81)**	**3**	**(57)**
Issue/(Buy Back) of Equity	1	(0)	-	-	-
(Inc.)/ Dec in loans	-	-	-	-	-
Dividend Paid (Incl. Tax)	(3)	(4)	(6)	(40)	-
Cash Flow from Financing	**(2)**	**(4)**	**(6)**	**(40)**	**-**
Inc./(Dec.) in Cash	1	4	(1)	60	(41)
Opening Cash balances	**5**	**6**	**9**	**9**	**69**
Closing Cash balances	**6**	**9**	**9**	**69**	**27**

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