11 October 2017

Update | Sector: Financials

Bajaj Finance

BSE SENSEX	S&P CNX
31,924	10,017

CMP: INR1,924 TP: INR2,300 (+20%) BUY

Heads I win, Tails I don't lose much

Laying the foundation for the next decade

Stock Info

Bloomberg	BAF IN
Equity Shares (m)	574
52-Week Range (INR)	1,989 / 762
1, 6, 12 Rel. Per (%)	2/47/68
M.Cap. (INR b)	1,118.3
M.Cap. (USD b)	17.1
Avg Val, INRm	1,542
Free float (%)	42.1

Financials Snapshot (INR b)

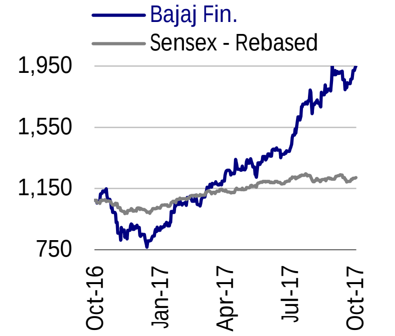
Y/E March	2017	2018E	2019E
NII	54.7	77.6	102.7
PPP	36.4	52.5	70.8
PAT	18.4	26.0	36.1
EPS (INR)	32.0	45.4	62.9
EPS Gr. (%)	43.6	41.6	38.7
BV/Sh. (INR)	167	285	338
RoA (%)	3.5	3.6	3.7
RoE (%)	21.6	20.1	20.2
Payout (%)	14.0	12.5	12.5
Valuations			
P/E (x)	60.1	42.4	30.6
P/BV (x)	11.5	6.8	5.7
Div. Yield (%)	0.2	0.3	0.4

Shareholding pattern (%)

As On	Jun-17	Mar-17	Jun-16
Promoter	57.9	57.9	57.4
DII	5.9	5.4	5.5
FII	19.1	19.8	20.1
Others	17.1	16.9	17.1

FII Includes depository receipts

Stock Performance (1-year)



- **We recently met with the heads of Bajaj Finance's (BAF) SME, Rural, Commercial and Risk Management operations. We were enthused by the company's efforts to lay the foundation for the next phase of its journey – BFL 2.0.**
- **Furthermore, the recent QIP equips the company with the much-needed ammunition to sustain its 30%+ AUM growth trajectory over the foreseeable future, and importantly, without any EPS dilution.**
- **For FY18-20, while our new EPS estimates are marginally accretive, our BVPS estimates have been upgraded by 20-30%. We believe that valuations must be viewed in relation to the overall market and the company's continued outperformance versus peers. Confident about management's planning and execution, we expect BAF to outperform its peers, and thus, do not foresee any meaningful multiple contraction over the medium term. We raise our target price to INR2,300 (6.0x Sep 2019E BVPS). Buy.**

A tech enterprise in the business of finance

One of the key themes resonating in all our meetings was the large-scale use of technology and analytics in all aspects of the business. For example, the company uses the vast digital footprint available, along with other sources of data (such as credit bureaus), to assess customer creditworthiness even before a loan application is made. The company then approaches the customer with a pre-approved loan, which not only improves customer satisfaction, but also significantly reduces the turnaround time. For example, **the turnaround time for a pre-approved mortgage is one day compared to 15 days for peers. BAF has already pre-approved loans for 0.9m doctors across the country, and targets to pre-approve for 2-3m SMEs in the country over the next 18-24 months. BAF has upgraded its data systems, and is improving its lending management systems to scale up the volume of CD loans from 11m per year to 25m per year in the next three years.**

Balancing growth and profitability with a unique strategy

The company categorizes its businesses into two segments: **'scale builders'** and **'profit maximizers'**. Scale builders are segments that have a large runway for growth with minimal asset quality risk and moderate RoE (~15%). These include segments like mortgages and commercial lending, among others. Profit maximizers are the high-RoE (>20%) businesses. These include consumer durables and personal loans, etc. The company balances growth across both segments, with a target to maintain reasonable growth (20-25%) and strong returns (20% RoE). With a high cross-sell ratio, **BAF is one of the few companies that do not look at return ratios per product or segment, but instead per customer.**

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The only constant is change

One of the biggest takeaways from all our meetings is that management does not appear to be complacent. The question always is 'What next?' For example, **BAF reduced the cost of mortgage loan processing from INR45,000 per file a few years ago to INR11,000 per file today. The target is to bring it down to INR6,000 per file in 12-24 months. This has been achieved by abolishing redundant processes in credit appraisal.** Our visit to a consumer durables showroom also confirmed this trait: BAF constantly upgrades its systems, processes and technology every few months, and is way ahead of peers, according to the owner of the showroom. The company also conducts an in-depth benchmarking exercise every year, wherein it studies the systems and processes of some of the best companies in the world and tries to benchmark its processes to theirs. **Some of these companies include HDFC Bank, Wells Fargo, Amazon and Netflix.**

Prevention is better than cure

One of the key aspects of BAF's strategy is the continued focus on asset quality and early warning signals. Management spends almost a third of its time monitoring various asset quality metrics. If a change is required in the asset quality targets (with regard to its product profitability matrix), there has to be consent from both Vice-Chairmen, Mr Pamnani and Mr Bajaj. Also, the diversified product suite allows the company to scale back in a product or segment where there are early warning signals of stress. For example, it has completely exited the infrastructure financing business. In the past, it slowed down on LAP, especially in the north India market. Most recently, **BAF lowered its disbursements in business loans in the Top 20 markets by 35% due to intense competition. Interestingly, it has also pulled back ~15% in Tamil Nadu due to water shortage issues, which management believes could have a second-order impact on small businesses.**

Upgrading estimates and target price to factor in capital raise

We believe the company, post the recent capital raise of INR45b, is well capitalized for growth over the next three years. While our new EPS estimates for FY18-20 are marginally accretive, our BVPS estimates have been upgraded by 20-30% over FY18-20. At 5.2x FY19E BVPS, the stock is richly valued. However, valuations must be viewed in relation to the overall market and the company's continued outperformance versus peers, in our view. Confidence about management's planning and execution, we expect the company to outperform its peers, and thus, do not foresee any meaningful multiple contraction over the medium term. We raise our target price to INR2,300 (6.6x FY19E BVPS). **Buy**.

Exhibit 1: What makes Bajaj Finance stand out among peers

What makes Bajaj Finance stand out?

Most diversified NBFC

- No product accounts for more than 12% of AUM
- 2W/3W lending, which accounted for over 50% of AUM in 2007, now accounts for only 8% of AUM
- Mix of high-RoE products as well as highly scalable products

Growth driven by volumes, not values

Over FY15-17, disbursement volumes of

- CD loans up 65%
- Digital product loans up 4x
- Lifestyle product loans up 4x
- Personal cross-sell loans up 2x

Innovation

- EMI card for existing members reduces sourcing cost to 1/3rd of original
- Database and analytics for pre-approved loans (home loans, personal loans)
- Yearly exercise of thorough benchmarking against best-in-class companies (HDFC Bank, Wells Fargo, Amazon, Netflix)

Focus on early warning signals

- Large scale use of analytics to determine early warning signals
- 1,000+ credit risk metrics
- Top management spends 10 days a month reviewing portfolio quality

Source: MOSL, Company

New products, new branches, new locations

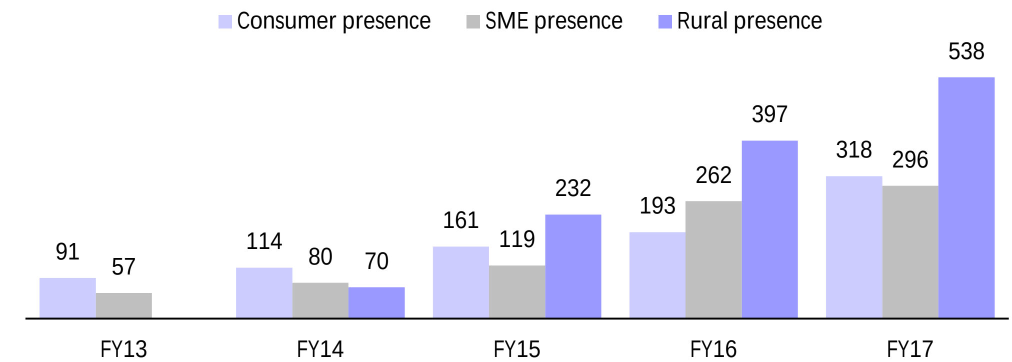
- **One of the key aspects of BAF's growth story has been the introduction of new products and segments, which have helped fuel growth.**
- **The company has over 20+ products across four key business verticals with no product accounting for more than 12% of AUM.**
- **Growth has been driven by widening distribution reach and increasing loan volumes.**

Points of sale for various segments have gone up between 4x-7x over the past four years

Strong growth led by new product introduction and branch expansion

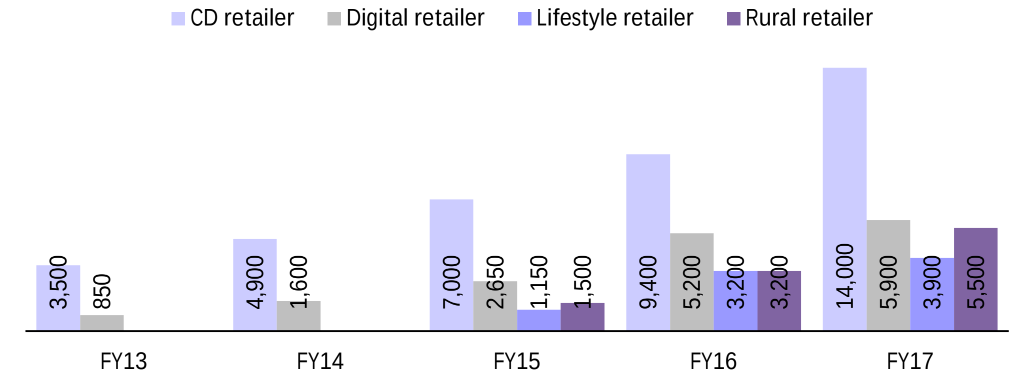
Over FY13-17, BAF registered 36% growth in AUM driven by expanding distribution reach and introduction of new products. Growth has been driven by volumes, rather than values. BAF has increased its consumer branches by more than 3x, SME lending branches by more than 5x and scaled up the rural branch count to more than 500 branches over this time frame. While consumer durable lending has witnessed lower sales volumes with incremental branches, digital and rural lending have witnessed better volumes per branch over the past two years.

Exhibit 2: Trend in branch network for each business segment



Source: MOSL, Company

Exhibit 3: Trend in points of sale



Source: MOSL, Company

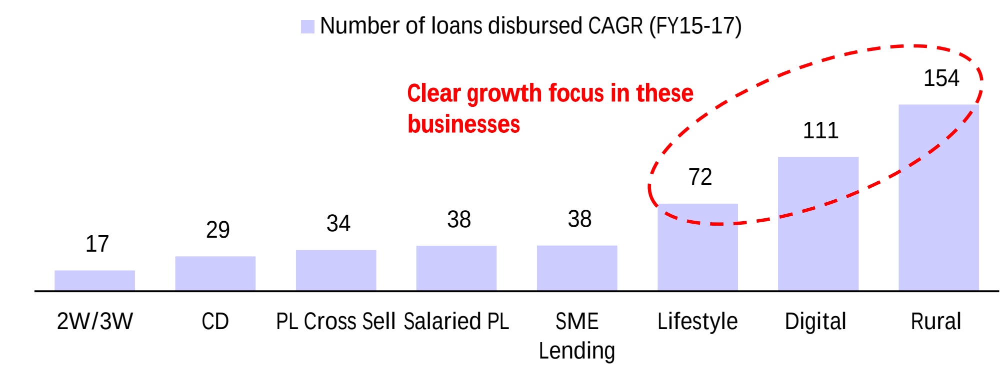
Exhibit 4: Growth driven by volumes

Number of loans disbursed ('000)	FY15	FY16	FY17
CD	3579	4651	5937
Digital Products	293	562	1304
Lifestyle	80	162	238
2W/3W	560	626	769
Personal loans cross-sell	169	162	304
Salaried Personal Loans	38	63	72
SME Lending	31	44	59
Rural lending	131	448	846

Source: MOSL, Company

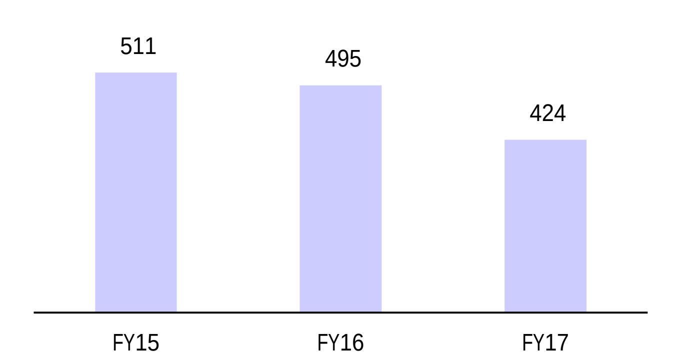
Management has always highlighted its focus on digital (mobile phones), lifestyle and rural lending

Exhibit 5: Growth driven by volumes



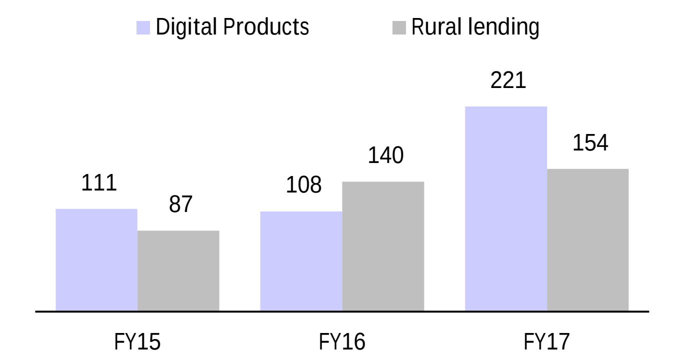
Source: MOSL, Company

Exhibit 6: Number of loans disb per point of sale (CD)



Source: MOSL, Company

Exhibit 7: Number of loans disb per point of sale



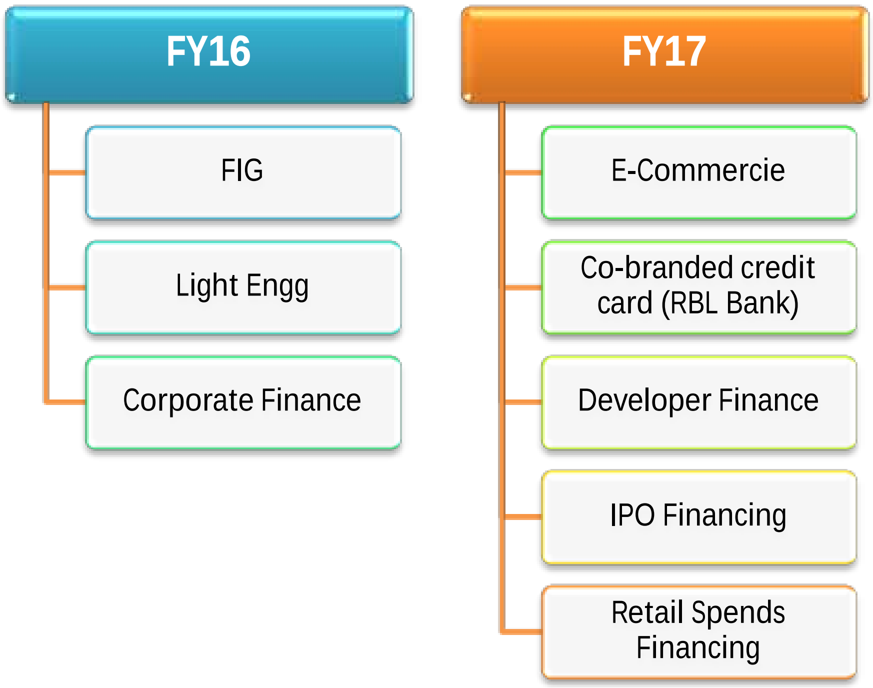
Source: MOSL, Company

8 new products in the past two years

Eight new products introduced in the past two years

BAF continues to innovate on how it can cross-sell more products to its existing customer base. In the past two years, it introduced eight new products, primarily across the consumer and commercial lending segments.

Exhibit 8: Timeline of new product introduction in the past two years



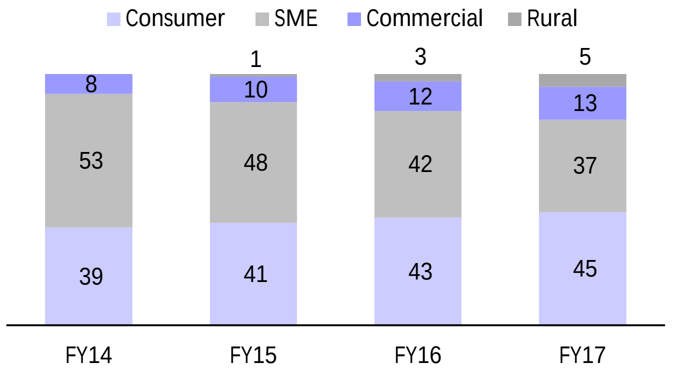
Source: MOSL, Company

Scaled back in LAP and 2W/3W financing in the past few years

While share of consumer financing has increased in the overall pie, the share of 2W/3W financing has declined significantly

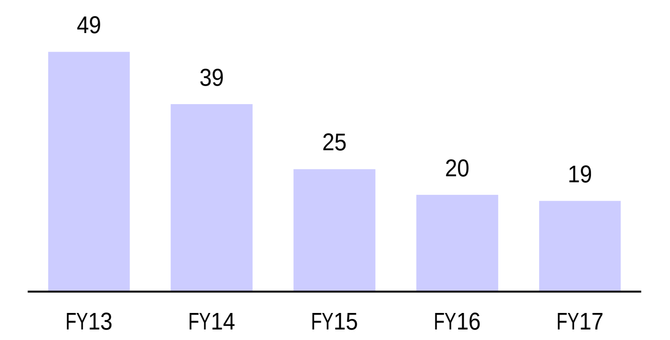
Over the past few years, BAF has consciously scaled back in LAP (especially DSA-sourced LAP) and has focused more on consumer and rural lending verticals. As a result, the share of SME business declined from 53% in FY14 to 37% in FY17. Interestingly, while the share of consumer lending increased over the past few years, the share of 2W/3W lending in the consumer finance book declined sharply due to larger focus on digital product financing, lifestyle financing and personal loans.

Exhibit 9: AUM mix trend (%)



Source: MOSL, Company

Exhibit 10: Share of 2W/3W finance in consumer lending



Source: MOSL, Company

Asset quality - The key differentiator for the company

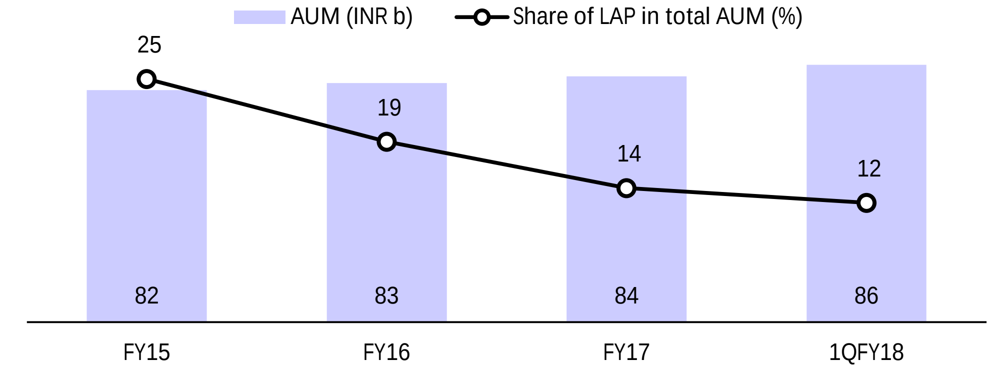
- **About a third of top management's time and effort is spent on monitoring asset quality performance across all products and geographies in great detail.**
- **If a change is required in the asset quality targets (with regard to its product profitability matrix), there has to be consent from both Vice-Chairmen, Mr Pamnani and Mr Bajaj.**
- **Most importantly, since BAF does not depend on just 1 or 2 products for growth, it can effortlessly scale back in any business that has early warning signals without it significantly impacting the overall company performance.**

Having a large number of products and business segments makes it easy for BAF to withdraw from any one product if it deems so.

Asset quality is top priority for management

Management spends almost a third of its time monitoring various asset quality metrics. Also, the diversified product suite allows the company to scale back in a product or segment where there are early warning signals of stress. For example, it has completely exited the infrastructure financing business. In the past, it slowed down on LAP, especially in the north India market. Most recently, BAF lowered its disbursements in business loans in the Top 20 markets by 35% due to intense competition. Interestingly, it has also pulled back ~15% in Tamil Nadu due to water shortage issues, which management believes could have a second-order impact on small businesses.

Exhibit 11: BAF has controlled its LAP product due to early warning signals



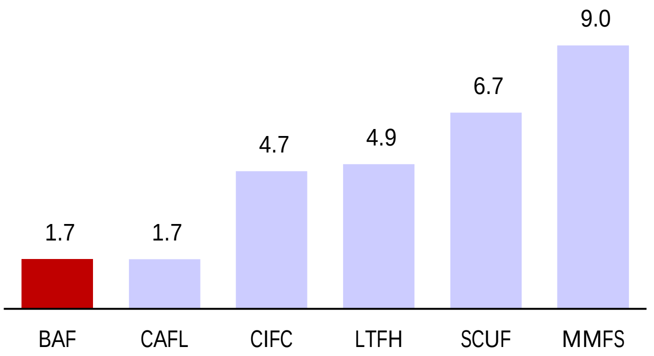
Source: MOSL, Company

Asset quality, on all metrics (GNPL ratio, credit costs), superior to most peers

Asset quality superior to peers

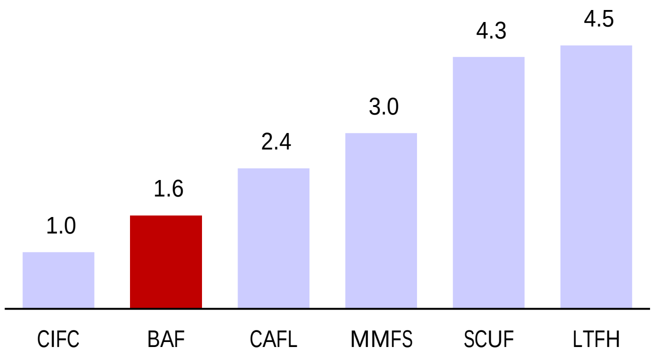
As a result of superior analytical technology as well as continued management focus on asset quality, BAF has witnessed superior asset quality performance compared to peers. Its GNPL ratio of 1.7% and credit costs of 1.6% (both as of FY17) are better than most peers. NPLs have remained benign despite the sharp increase in the share of unsecured lending in the past few years. This lends credence to the superior analytics deployed by the company for underwriting of bulk of its consumer loans.

Exhibit 12: GNPL ratio (FY17, %)



Source: MOSL, Company; Note: CAFL, CIFC NPL at 90dpd, others at 120dpd

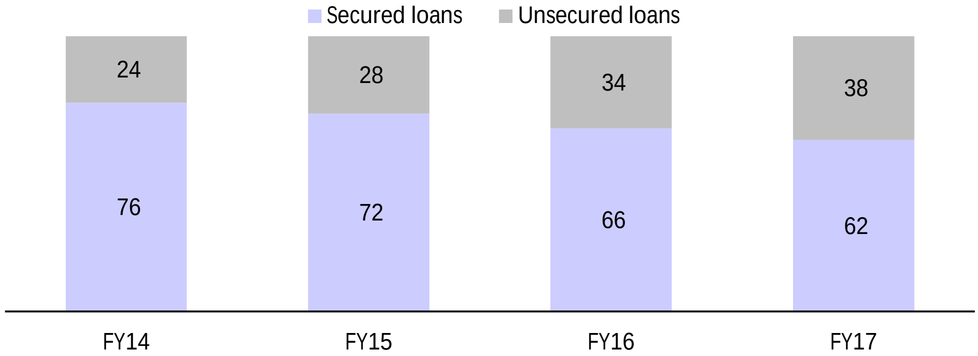
Exhibit 13: Credit costs (FY17, %)



Source: MOSL, Company

Asset quality has remained stable despite the continued increase in share of unsecured lending

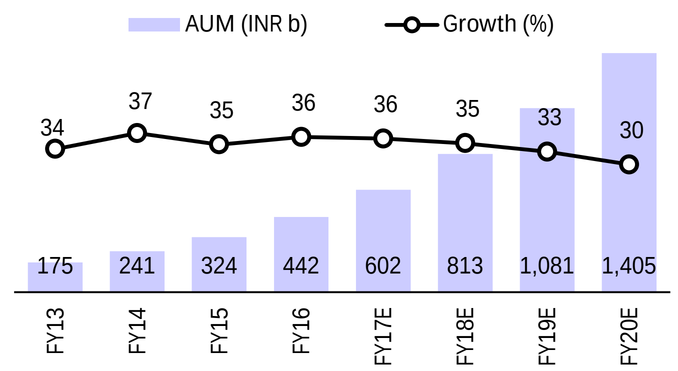
Exhibit 14: Increasing share of secured lending (%)



Source: MOSL, Company

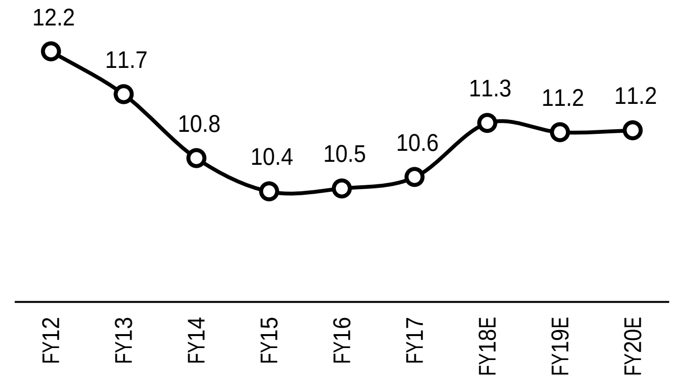
Story in charts

Exhibit 15: AUM growth to remain healthy



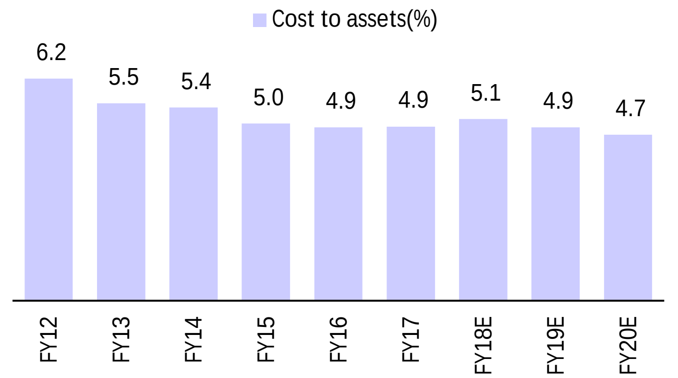
Source: MOSL, Company

Exhibit 16: Margin improvement due to capital infusion



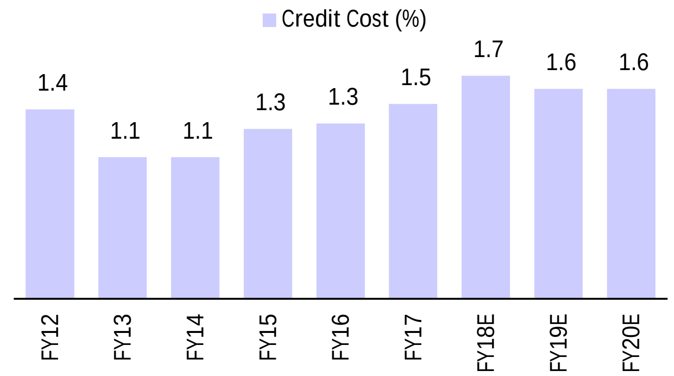
Source: MOSL, Company

Exhibit 17: Opex ratio to remain stable due to tech investments



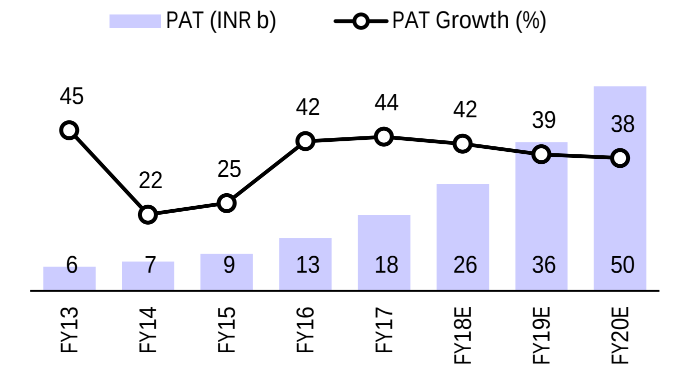
Source: MOSL, Company

Exhibit 18: Robust monitoring to ensure credit costs stay in check



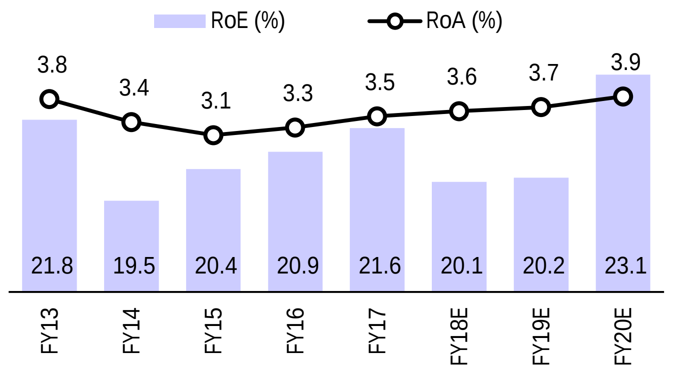
Source: MOSL, Company

Exhibit 19: Robust PAT CAGR over the medium term



Source: MOSL, Company

Exhibit 20: Return ratios stable



Source: MOSL, Company

Appendix – Takeaways from our meetings

SME Segment

TAT of 1 day for pre-approved loans a key differentiator for the company

Mortgages are done from only 50 locations today; Scope to scale it up manifold

Business strategy

- This segment is considered to be a 'scale builder,' where growth opportunities are immense, but profitability is moderate.
- The company follows a differentiated customer targeting approach, wherein it assesses a prospective customer beforehand and then pre-approves a loan. With this, the turnaround time for BAF is 1 day v/s 15-20 days for peers. **Over the next 1-2 years, management targets to have a pool of 2-3m pre-approved SME customers.**
- **The company eliminated a lot of redundancies in its loan underwriting process. Hence, it was able to reduce the loan processing cost from INR45,000 per file three years back to INR11,000 today. The target is INR5,000 per file over the near term. This not only saves money for the company, but also improves TAT.**
- The home loan plus LAP loan book industry-wide is around INR18t, while BAF's customers have home and LAP loans worth INR5.4t outstanding with other players. Management believes that with proper targeting, it will be able to get customers to transfer their loans to BAF. Management mentioned that 7% of its mortgage loans are balance transfers from HDFC Ltd and HDFC Bank.
- Incremental LAP yields are anywhere between 9% and 11%, as against 13% three years ago.
- **70% of business loan sourcing comes from DSAs. It targets to reduce this to 30% over the next 18-24 months.**
- BAF has compiled state-wise regulations on one tech platform. This helps it to serve the local customer better, as sales personnel are well accustomed with document/filing requirements.
- **BAF does mortgages from 50 locations and business loans from 550 locations. It only goes to locations where HDFCB, SBI and at least one other bank are already present. HDFCB is present in 2,657 markets – so that is the scope of expansion the company is targeting.**

Risk management strategies

- BAF has over 1,000+ credit risk metrics.
- **Rajeev Jain, along with senior management, reviews asset quality performance across products and segments thoroughly for 10 days a month.**
- In business loans, the company pulled back in the top 20 locations by 35% due to intense competition.
- For salaried customers, the company targets only the segment with take-home monthly salary of more than INR30,000.
- Cheque bounce rate is 7-8%. However, ~95% of bounce cases are settled before month-end.

Commercial Business

Competitive segment, but low opex makes it a moderate RoE business

Business strategy

- This segment is a ‘scale builder’ – good growth, moderate return ratios and impeccable asset quality (GNPL ratio ~0.05%). RoE in this segment is ~15%, and management expects it to remain in this range.
- **This is a low-margin business (NIM of 2.5-3%). However, opex is low too (expense ratio of 30-40bp).**

Vendor finance

- Target segment comprises borrowers with annual turnover of INR2-20b. BAF caters only to borrowers in certain industries.
- This segment is very competitive with respect to pricing. Key to success in this business is having a low-cost structure.
- The company caters to 120 out of the 250 auto vendors in India.

Regulatory arbitrage over banks in LAS segment

Securities lending

- **In LAS, BAF has a regulatory advantage over banks, as the latter cannot do LAS of more than INR2m ticket size.**
- Borrowers include HNIs, brokers, promoters and regular individuals. **The RBI has capped LTV at 50%** (three years back, it used to be 60-65%). The size of the overall securities lending industry is INR300b. Major players include BAF, IIFL, JM Fin, Edel, ABCL, MOSL and Kotak Prime.

Corporate finance

- In the corporate finance segment, BAF provides loans with a ticket size of INR500-750m to companies with INR10b+ annual turnover. **LRD forms a large portion of this segment.**

Rural Segment

High-growth, high-returns businesses make this segment a key focus area for the company

Business strategy

- **In our view, management is most enthused about this business as it offers immense scalability, low competition and high return ratios. Additionally, management commented that delinquency trends in this segment are better than in the Top 20 markets.**
- Management targets the middle and upper-middle class section in these markets. For example, for personal loans, only people with income greater than INR27,000 per month (take home) are eligible to get a loan.
- **Customers directly or indirectly related to agriculture form only 14% of its rural customer base.**
- **BAF follows a hub-and-spoke model. There are 168 hubs and 390 spokes currently. Management expects to add 40-50 hubs on an annual basis.**
- **Management expects AUM to cross USD1b in FY18 (v/s USD620m in 1QFY18). Over the next five years, there is high probability of this segment continuing to deliver strong growth as competition remains benign.**
- Break-up of the INR41b rural book: Personal loans – INR17b; CD financing – INR10b; LAP –INR4-4.5b; gold loans – INR3.5b; other products comprise the rest.

BAF enters markets with population greater than 1lac and where at least one private sector bank is present

Risk management strategies

- BAF enters only those markets where population is in excess of 100,000 and at least one private sector bank is present.
- To assess income/credit worthiness of a customer who has surrogate income, it uses other means like electricity bill, vehicle owned by the borrower, etc.

Financials and valuations

Income Statement								(INR m)
Y/E MARCH	**2013**	**2014**	**2015**	**2016**	**2017**	**2018E**	**2019E**	**2020E**
Interest Income	29,248	37,896	51,200	69,012	92,723	125,045	166,514	218,480
Interest Expended	12,057	15,732	22,483	29,269	38,034	47,430	63,784	83,283
Net Interest Income	**17,191**	**22,163**	**28,717**	**39,743**	**54,690**	**77,614**	**102,730**	**135,197**
Change (%)	37.5	28.9	29.6	38.4	37.6	41.9	32.4	31.6
Other Operating Income	1,689	2,429	2,618	3,924	7,050	10,928	14,753	19,179
Other Income	177	419	364	398	260	719	999	1,391
Net Income	**19,057**	**25,011**	**31,699**	**44,065**	**61,999**	**89,261**	**118,482**	**155,767**
Change (%)	33.7	31.2	26.7	39.0	40.7	44.0	32.7	31.5
Operating Expenses	8,523	11,511	14,284	18,991	25,642	36,792	47,689	59,371
Operating Income	**10,534**	**13,500**	**17,415**	**25,074**	**36,357**	**52,469**	**70,793**	**96,395**
Change (%)	39.2	28.2	29.0	44.0	45.0	44.3	34.9	36.2
Provisions and W/Offs	1,818	2,588	3,846	5,429	8,182	12,449	15,304	20,025
PBT	**8,716**	**10,912**	**13,569**	**19,646**	**28,175**	**40,020**	**55,489**	**76,370**
Tax	2,803	3,722	4,591	6,861	9,810	14,007	19,421	26,730
Tax Rate (%)	32.2	34.1	33.8	34.9	34.8	35.0	35.0	35.0
PAT	**5,913**	**7,190**	**8,979**	**12,785**	**18,366**	**26,013**	**36,068**	**49,641**
Change (%)	45.5	21.6	24.9	42.4	43.6	41.6	38.7	37.6
Proposed Dividend	747	802	903	1,347	2,296	3,252	4,508	6,205

Balance Sheet								(INR m)
Y/E MARCH	**2013**	**2014**	**2015**	**2016**	**2017**	**2018E**	**2019E**	**2020E**
Capital	498	498	500	1,071	1,094	1,147	1,147	1,147
Reserves & Surplus	33,173	39,411	47,497	72,175	94,909	162,065	192,858	235,238
Net Worth	**33,670**	**39,909**	**47,997**	**74,266**	**96,003**	**163,212**	**194,005**	**236,385**
Borrowings	**133,490**	**197,496**	**266,908**	**370,247**	**492,497**	**671,442**	**903,474**	**1,178,595**
Change (%)	30.5	47.9	35.1	38.7	33.0	36.3	34.6	30.5
Other liabilities & provisions	**11,051**	**8,776**	**13,206**	**6,903**	**8,471**	**11,012**	**14,316**	**18,610**
Total Liabilities	**178,211**	**246,180**	**328,111**	**451,417**	**596,970**	**845,666**	**1,111,795**	**1,433,591**
Investments	53	282	3,323	10,341	40,747	44,822	49,304	54,234
Change (%)	-4.0	436.3	1,077.9	211.2	294.0	10.0	10.0	10.0
Advances	**167,440**	**229,710**	**311,995**	**433,144**	**582,394**	**786,232**	**1,045,688**	**1,359,394**
Change (%)	36.3	37.2	35.8	38.8	34.5	35.0	33.0	30.0
Net Fixed Assets	1,762	2,199	2,492	2,870	3,611	3,621	3,631	3,641
Other assets	8,957	13,990	10,303	5,062	-29,782	10,991	13,171	16,321
Total Assets	**178,211**	**246,180**	**328,112**	**451,417**	**596,970**	**845,666**	**1,111,795**	**1,433,591**

E: MOSL Estimates

Financials and valuations

Ratios								
Y/E MARCH	**2013**	**2014**	**2015**	**2016**	**2017**	**2018E**	**2019E**	**2020E**
Spreads Analysis (%)								
Yield on Advances	20.2	19.1	18.9	18.5	18.3	18.3	18.2	18.2
Cost of borrowings	10.2	9.5	9.7	9.2	8.8	8.2	8.1	8.0
Interest Spread	9.9	9.6	9.2	9.3	9.4	10.1	10.1	10.2
Net Interest Margin	11.7	10.8	10.4	10.5	10.6	11.3	11.2	11.2
Profitability Ratios (%)								
RoE	21.8	19.5	20.4	20.9	21.6	20.1	20.2	23.1
RoA	3.8	3.4	3.1	3.3	3.5	3.6	3.7	3.9
RoA on AUM	3.9	3.5	3.2	3.3	3.5	3.7	3.8	4.0
Int. Expended/Int.Earned	41.2	41.5	43.9	42.4	41.0	37.9	38.3	38.1
Secur. Inc./Net Income	8.9	9.7	8.3	8.9	11.4	12.2	12.5	12.3
Efficiency Ratios (%)								
Op. Exps./Net Income	44.7	46.0	45.1	43.1	41.4	41.2	40.2	38.1
Empl. Cost/Op. Exps.	28.8	29.6	31.6	33.2	36.3	36.0	36.6	36.8
Asset-Liability Profile (%)								
Loans/Borrowings Ratio	125.4	116.3	116.9	117.0	118.3	117.1	115.7	115.3
Net NPAs to Adv.	0.2	0.3	0.5	0.3	0.4	0.0	0.0	0.0
CAR	22.0	21.0	18.0	19.5	20.3	24.1	22.1	21.1
Tier 1	18.7	18.0	14.2	16.1	14.6	18.3	16.4	15.4
Valuation								
Book Value (INR)	59	70	84	128	167	285	338	412
Price-BV (x)					11.5	6.8	5.7	4.7
EPS (INR)	10.3	12.5	15.7	22.3	32.0	45.4	62.9	86.6
EPS Growth (%)	45.5	21.6	24.9	42.4	43.6	41.6	38.7	37.6
Price-Earnings (x)					60.1	42.4	30.6	22.2
Dividend per Share (INR)	1.3	1.4	1.6	2.3	4.0	5.7	7.9	10.8
Dividend Yield (%)					0.2	0.3	0.4	0.6

E: MOSL Estimates

NOTES

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