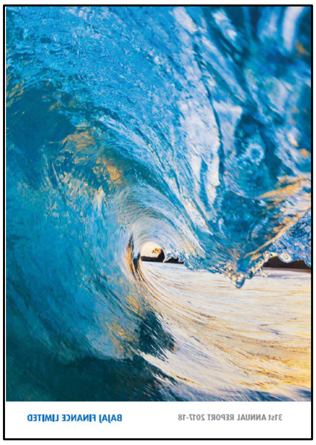
18 September 2018

Annual Report Update | Sector: Financials - NBFC

Bajaj Finance

BSE SENSEX	S&P CNX
37,291	11,279

CMP: INR2,570 TP: INR2,400 (-7%) Neutral



Superior execution

New products showing healthy traction

Superior execution across products, focus to increase new growth/profit avenues (rural lending, housing finance companies (HFCs), cross-selling, etc.) and strong focus on asset quality are the key highlights of the FY18 Annual Report (AR). With the strong treasury management (move towards capital market linked borrowings/deposits), positive assets liability management (ALM) gap and with pricing power on the focused segments, BAF spreads are likely to be stable. However, margins may moderate with the leverage on the balance sheet coming into play. Asset quality performance remains impeccable with GNPA of 1.48% and PCR of 75% (as of FY18). On back of rich valuation, we reiterate Neutral with target price of INR2,400 - 6x PBV–Unchanged.

Strong growth in retail lending; New products showing healthy traction

In the past three years, BAF introduced eleven new products, primarily across the consumer and commercial lending segments. The company **financed 10m (+38% YoY) consumer durable loan contracts in FY18**, which is almost double from the volumes of FY16. It also **financed ~700,000 e-commerce transactions** during the year, which has increased 4x from FY17. **Digital product store outreach** has increased ~3x during FY15-18 to **15,900 stores**. As of FY18, BAF had an outstanding base of ~13m EMI cards and a co-branded credit card with RBL of ~0.4m.

Rural business to grow into 16-17 states

Currently, the rural business targets the affluent class and distribution is present in only the top-10 states through 602 branches. Management has indicated that it wants to grow its distribution reach to 16-17 states, albeit in a calibrated manner. BAF is **focusing on growing its distribution through franchises over branch expansion, thus achieving a wider reach to target customers, but at a low cost.** Rural channel expansion is led by a hub-and-spoke model, with rural-lending franchisees growing ~2.6x during FY15-18.

Bajaj Housing Finance subsidiary carved out to focus on housing market

Bajaj Housing Finance Limited (100% subsidiary of BAF) was granted a housing finance company license by the National Housing Bank (NHB) in September 2015. BHFL started its lending operation from July 2017. Effective **February 2018, all incremental loans sourced** under these products **would be under BHFL. Mr. Atul Jain, who was the enterprise risk officer and has been with BAF for the last 16-years, has been appointed CEO.** As of FY18, **mortgages contribute 29% to the balance sheet, which management expects to grow to 35% of balance sheet by FY21.**

Stock Info

Bloomberg	BAF IN
Equity Shares (m)	575
M.Cap.(INRb)/(USDb)	1485.4 / 20.4
52-Week Range (INR)	2995 / 1514
1, 6, 12 Rel. Per (%)	-8/38/19
12M Avg Val (INR M)	2532
Free float (%)	44.9

Financials Snapshot (INR b)

Y/E March	2018	2019E	2020E
NII	72.3	100.0	133.2
PPP	48.8	69.7	93.2
PAT	25.0	36.1	47.7
EPS (INR)	43.4	62.7	82.9
EPS Gr. (%)	35.9	44.5	32.2
BV/Sh. (INR)	269	325	398
RoA (%)	3.3	3.5	3.6
RoE (%)	20.4	21.1	23.0
Payout (%)	10.1	10.0	10.0
Valuations			
P/E (x)	60.0	41.5	31.4
P/BV (x)	9.7	8.0	6.6
Div. Yield (%)	0.1	0.2	0.3

Shareholding pattern (%)

As On	Jun-18	Mar-18	Jun-17
Promoter	55.1	55.1	57.9
DII	8.8	9.0	5.9
FII	20.4	20.0	19.1
Others	15.6	15.9	17.1

FII Includes depository receipts

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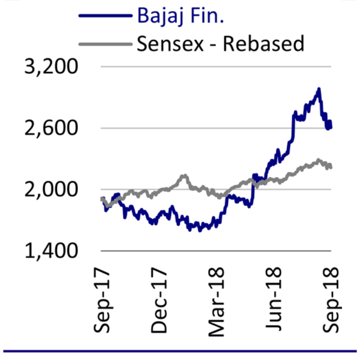
Stock Performance (1-year)



Liability mix shifts to fixed-rate instruments leading to stable spreads

Liability mix has incrementally moved towards fixed-rate instruments leading to lower cost of borrowings and **stable spreads**. Cost of funds has declined by ~70 bp YoY in FY18. BAF is running a **positive gap in the next one year ALM, which should lead to stable-to-improving spreads and return ratios**.

Real estate exposure and top-20 borrower concentration reduced

Residential mortgages as % of AUM have reduced by half to 7.8% during FY17-18. Also, commercial real estate (CRE) exposure declined to 2.7% (vs. 4.5% in FY17) during FY17-18. Concentration of top-20 borrowers reduced to 3.9% (vs. 5.3% in FY17) during FY17-18.

Valuation and view

We believe the company, post the capital raise of ~INR46b, is well capitalized for growth over the next three years. **While we like the business and have confidence in the management's superior execution of strategy, we believe valuations are stretched. Reiterate Neutral with target price of INR2,400 (6x PBV FY20).**

Strong traction in retail lending

Digital products traction improving at a rapid pace

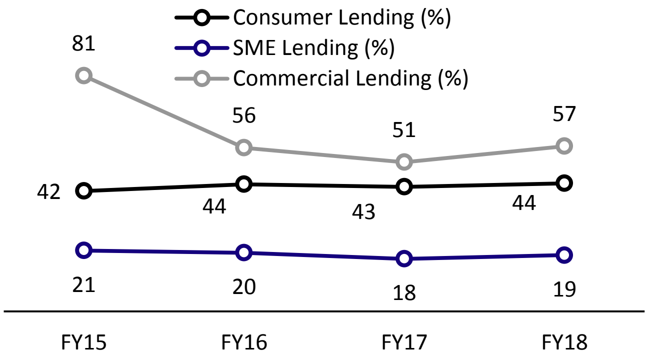
- **BAF continued its growth story with an introduction of new products and segments, which have helped fuel growth.**
- **The company has over 20+ products across four key business verticals.**
- **Growth has been driven by widening distribution reach and increasing loan volumes.**

AUM grew ~4x over FY14-18 by expanding reach and introduction of new products

Growth steady through FY14-18

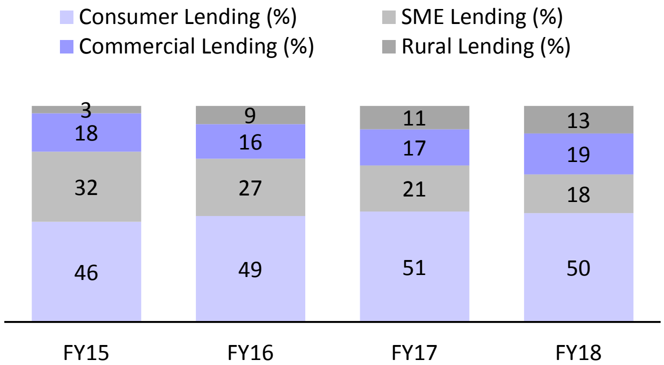
Over FY14-18, BAF registered ~4x growth in AUM driven by expanding distribution reach and introduction of new products. This growth has been largely driven by consumer lending and SME lending, which grew at a CAGR of 33% and 17%, respectively over FY14-18 and contributed 50% and 23% to incremental AUM growth. Rural lending, which was started in FY14 has now started meaningfully contributing to incremental growth (13% in FY18).

Exhibit 1: Segmental growth rates



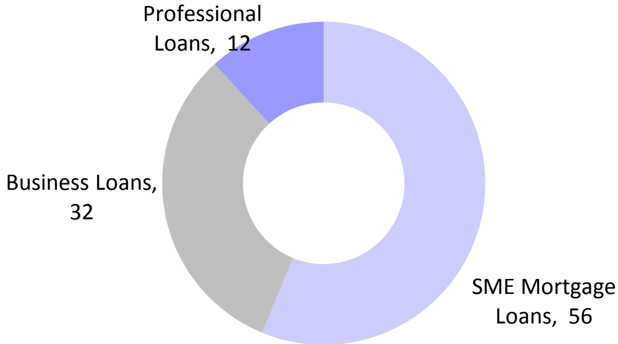
Source: MOSL, Company

Exhibit 2: Rural lending now meaningfully contributing to incremental AUM growth



Source: MOSL, Company

Exhibit 3: Mix of SME lending (%)

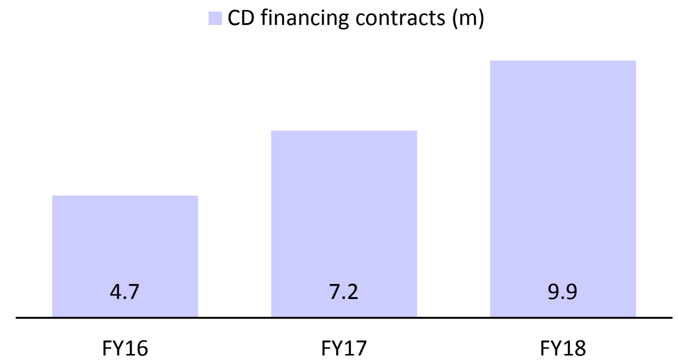


Source: MOSL, Company

Franchise expansion focused on CD and digital products

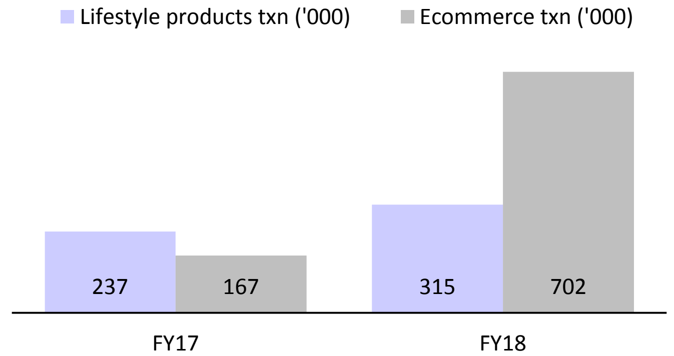
Urban branches grew ~4.5x during FY15-18, while rural branches grew ~2.5x during the same period. The company has focused on increasing points of sale (POS) for consumer durable at both urban (2x) and rural locations (5x) during FY15-18. POS for digital products and lifestyle retail products grew 6x and 5x during the same period. BAF has been cautiously growing POS for 2W.

Exhibit 4: Consumer durables' loan contracts doubled during FY16-18



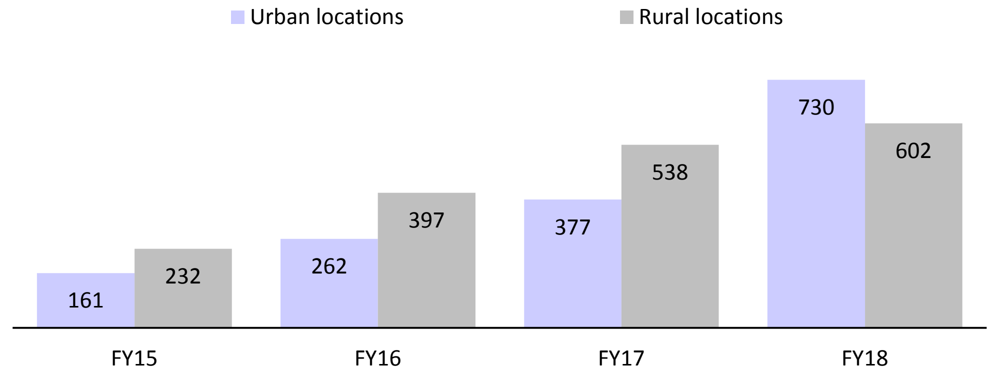
Source: MOSL, Company

Exhibit 5: E-Commerce transactions have grown 4x in FY18



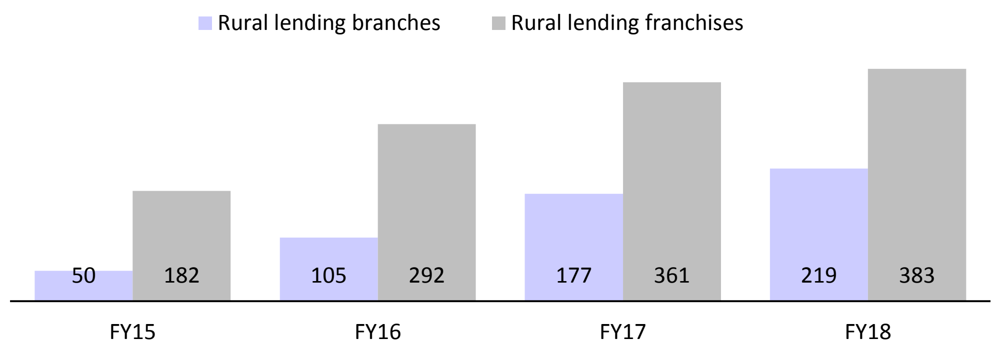
Source: MOSL, Company

Exhibit 6: Urban branches have grown ~4.5x and rural branches have grown ~2.5x during FY15-18



Source: MOSL, Company

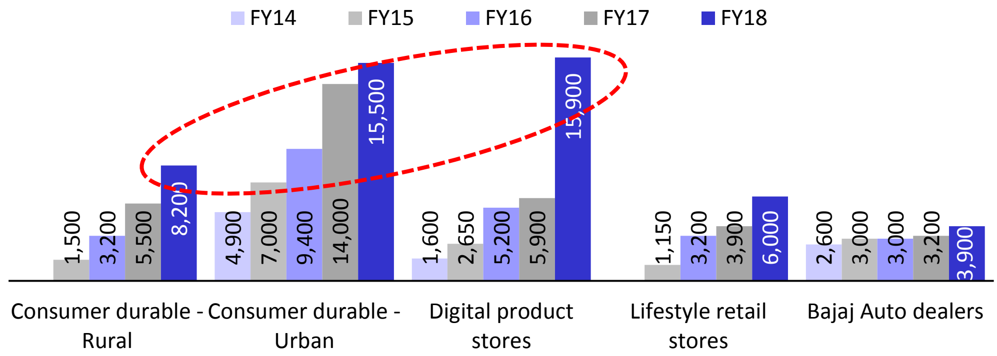
Exhibit 7: Rural channel expansion focused on growing franchises



Source: MOSL, Company

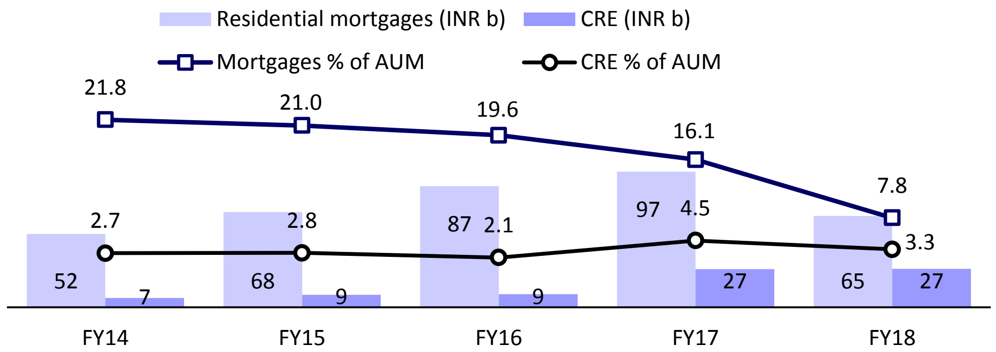
Management has always highlighted its focus on digital (mobile phones), lifestyle and rural lending

Exhibit 8: Focus on increasing CD and digital product POS, slow on 2W POS



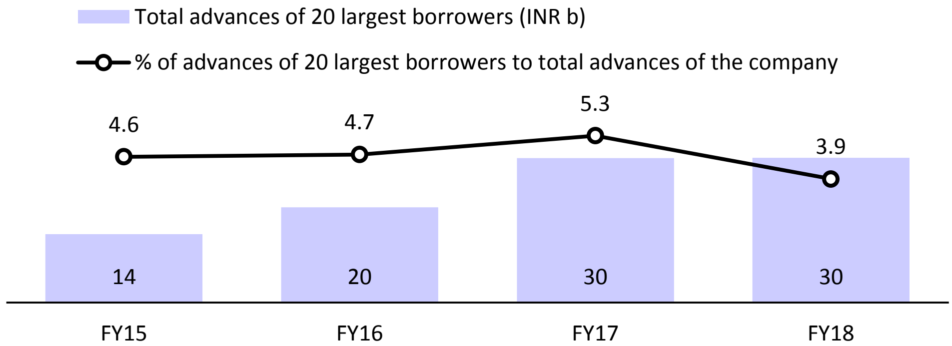
Source: MOSL, Company

Exhibit 9: Real estate exposure has halved from FY14 to 11% in FY18



Source: MOSL, Company

Exhibit 10: Concentration of top-20 borrowers has reduced



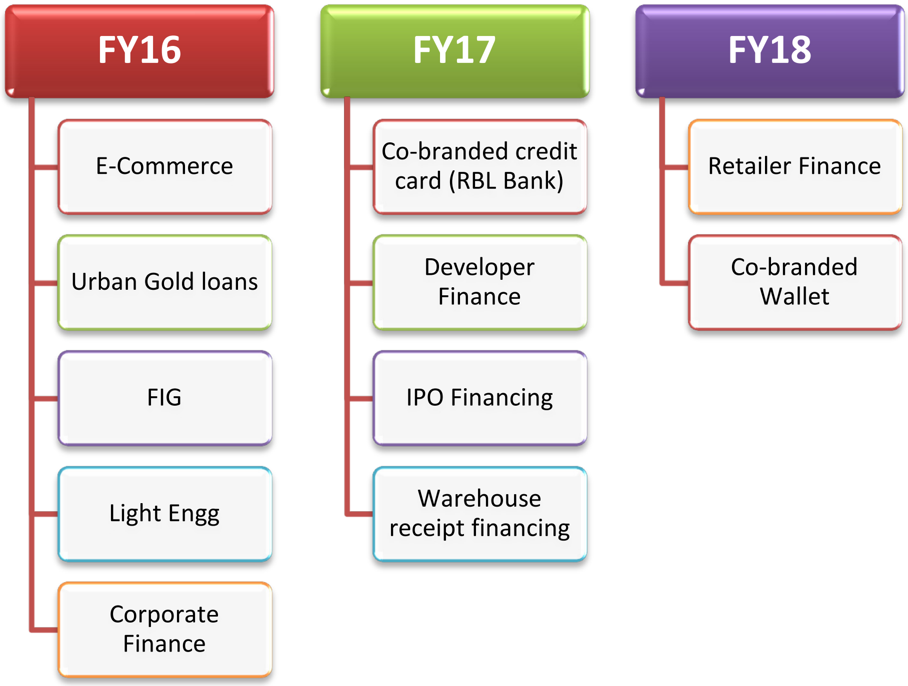
Source: MOSL, Company

11 new products in the past three years

Eleven new products introduced in the past three years

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

Exhibit 11: Timeline of new product introduction over past three 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 loan against property (LAP), especially in DSA-sourced LAP, and has focused more on consumer and rural lending verticals. 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.

Funding the growth juggernaut

Opportunistic in increasing the share of capital market-linked liabilities

- **Liability mix has incrementally moved towards fixed-rate instruments leading to lower cost of borrowings and stable spreads.**
- **BAF should run a positive gap in the next one year ALM, which should in turn lead it to garnering stable- to-improving spreads and return ratios.**

Liability mix incrementally moved towards fixed rate instruments, leading to stable spreads

Liability mix moving towards fixed-rate leading to stable spreads

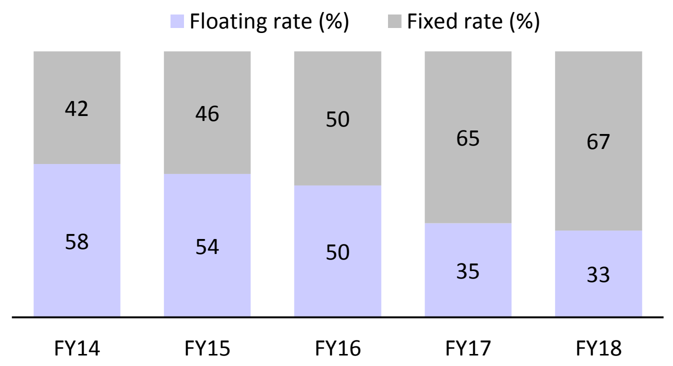
BAF has incrementally replaced its debt mix with fixed-rate instruments as its credit rating profile improved over FY14-18, taking advantage of the secular interest rate falling environment. The cost of borrowings declined ~150 bp over FY14-18. It led to stable spreads, ranging between 9.2-9.5% during the same period. With incremental focus on high yielding digital products financing and lifestyle products financing, we think back-book re-pricing should be faster than liability re-pricing, manifesting in stable/improving spreads over FY19-21.

Exhibit 12: Stable and superior credit rating through FY16-18

	FY16	FY17	FY18
NCD	IND AAA/Stable	IND AAA/Stable	IND AAA/Stable
Sub. Debt	IND AAA/Stable	IND AAA/Stable	IND AAA/Stable
LT Bank Rating	IND AAA/Stable	IND AAA/Stable	IND AAA/Stable
ST Bank Rating	IND A1+	IND A1+	IND A1+

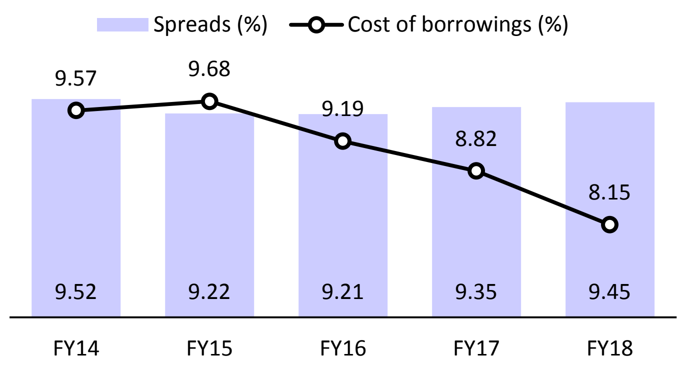
Source: MOSL, Company, India Ratings

Exhibit 13: Liability mix has moved secularly towards fixed rate instruments…



Source: MOSL, Company

Exhibit 14: …leading to lower cost of borrowings and stable spreads



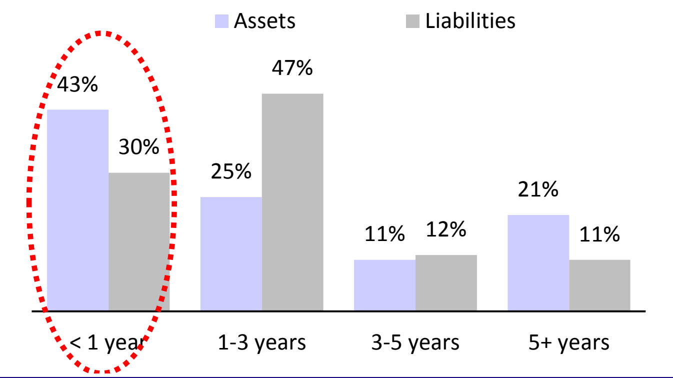
Source: MOSL, Company

BAF is running a positive gap in the next one year in ALM

Positive ALM – a key positive in a rising rate scenario

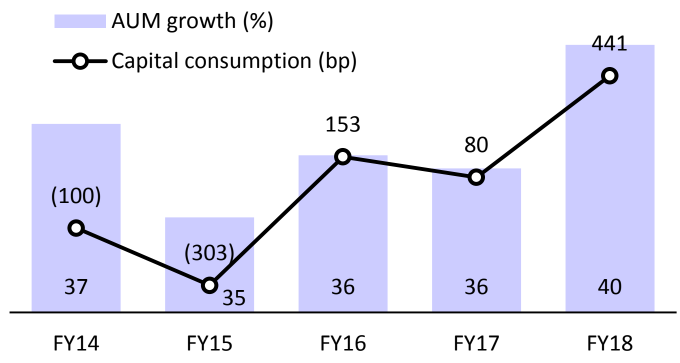
BAF assets maturing in FY19 are worth INR171b, more than its liabilities maturing in the same period, thus manifesting a positive gap in the ALM for the next one year. We believe the positive gap would be sanguine for the company, as it will lead to stable- to-improving spreads and return ratios in FY19. BAF raised capital through qualified institutional placement (QIP) during FY18, leading to higher NIM and capital accrual.

Exhibit 15: BAF is running a positive gap in ALM for next one year, which we believe is great in an interest rate rising environment



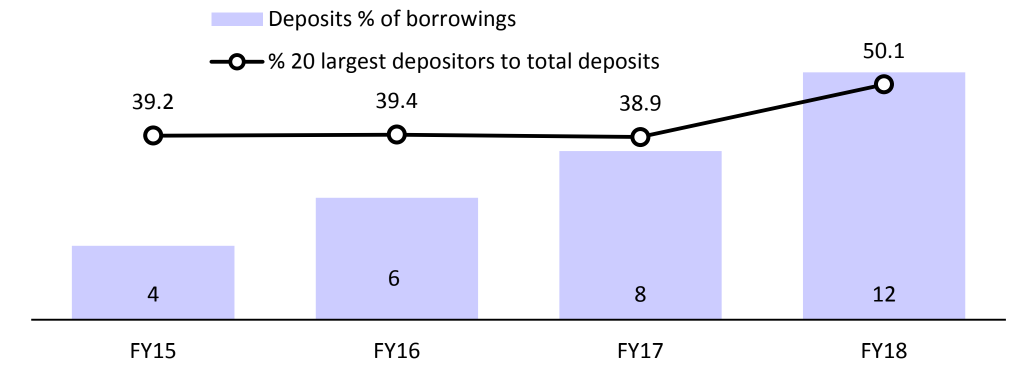
Source: MOSL, Company

Exhibit 16: Capital raise through FY15-18 have largely taken care of AUM growth



Source: MOSL, Company

Exhibit 17: BAF has to work on increasing retail deposits in borrowing profile



Source: MOSL, Company

Asset quality - The key differentiator for the company

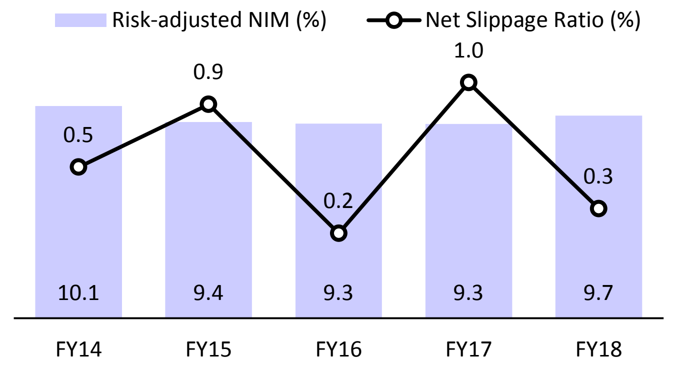
- **Management's focus on monitoring asset quality performance across all products and geographies in great detail.**
- **Risk-adjusted NIM has remained largely stable during FY14-18.**
- **Most importantly, since BAF does not depend on just 1-2 products for growth, it can effortlessly scale back in 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

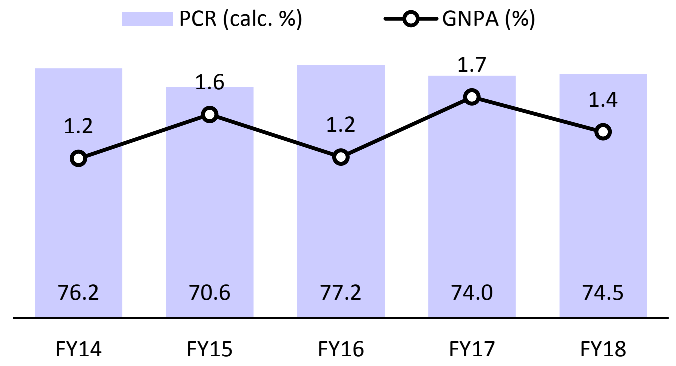
Management focuses vigorously on monitoring various asset quality metrics. Also, the diversified product suite allows the company to scale back in a product or segment where there are early warning signals of stress. For example, it has completely exited infrastructure financing business. Post-demonetization, BAF slowed down on LAP too, especially in the north-India market.

Exhibit 18: Risk-adjusted NIM has been stable over FY14-18



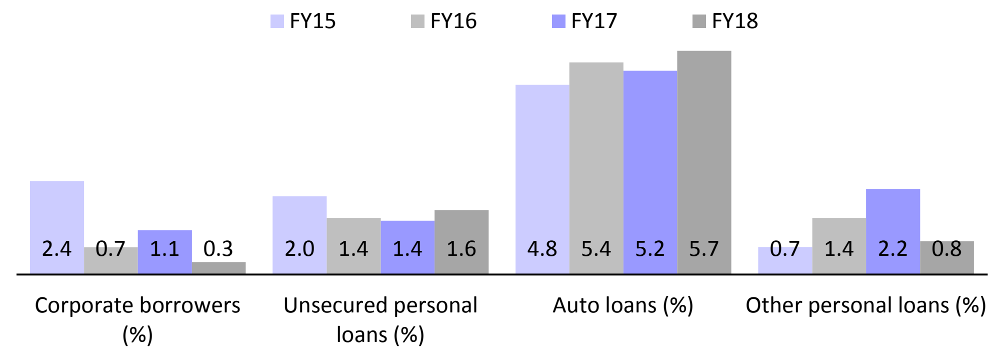
Source: MOSL, Company

Exhibit 19: BAF has maintained high PCR during FY14-18



Source: MOSL, Company

Exhibit 20: Delinquencies in 2W loans have been sticky



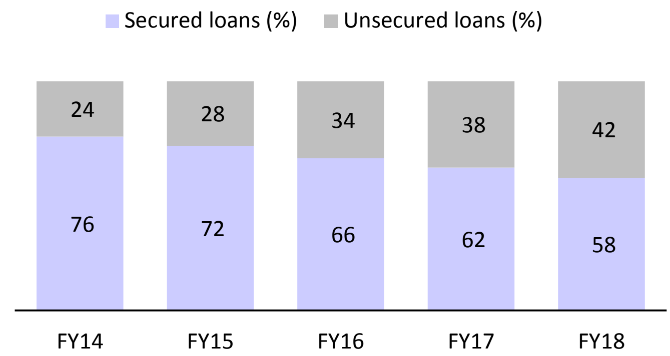
Source: MOSL, Company

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

Asset quality steady due to relentless focus on analytics

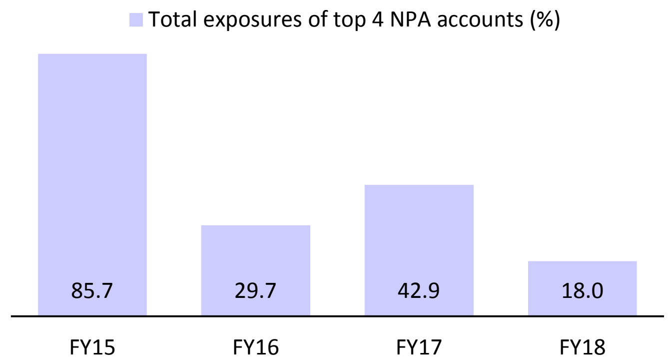
As a result of superior analytical technology as well as continued management focus on asset quality, BAF has witnessed superior asset quality performance during FY14-18. Its unsecured lending proportion has increased to 42% in FY18 vs. 24% in FY14. Despite this, NPLs have remained benign despite the sharp increase in the share of unsecured lending during the same period. This lends credence to the superior analytics deployed by the company for the underwriting of bulk of its consumer loans.

Exhibit 21: Increasing share of unsecured lending



Source: MOSL, Company

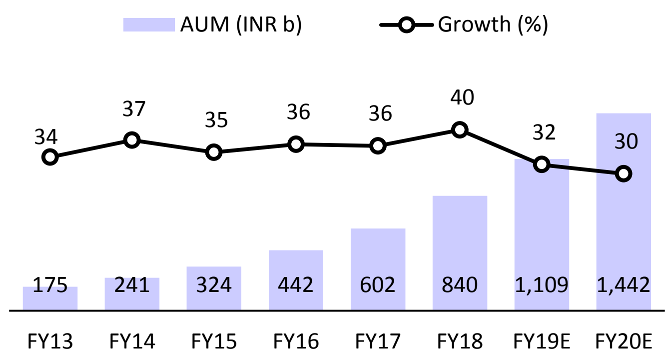
Exhibit 22: Concentration of NPAs has reduced



Source: MOSL, Company

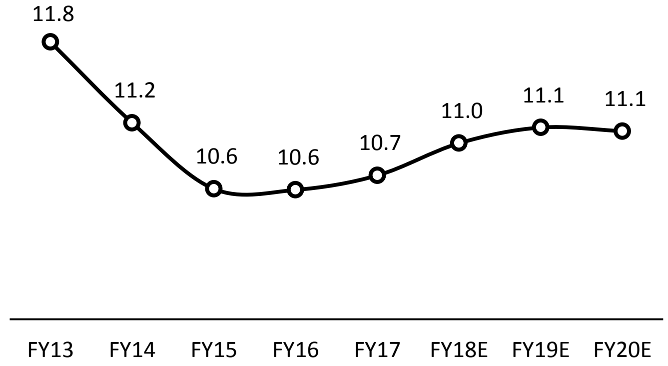
Story in charts

Exhibit 23: AUM growth to remain healthy



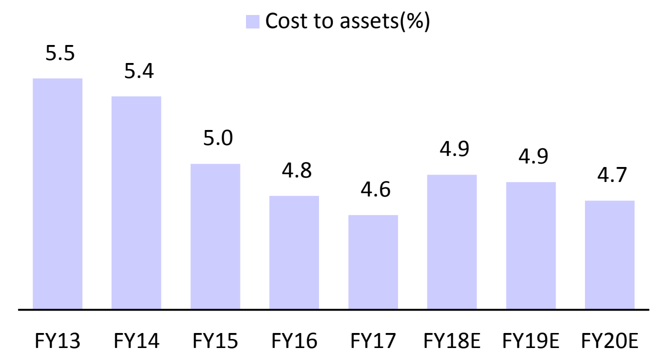
Source: MOSL, Company

Exhibit 24: Margin improvement due to capital infusion



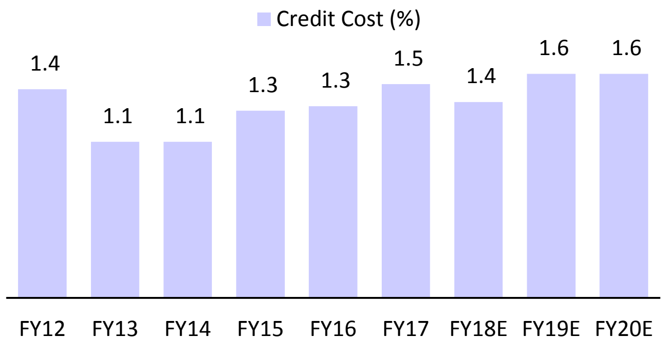
Source: MOSL, Company

Exhibit 25: Opex ratio to remain stable due to tech investments



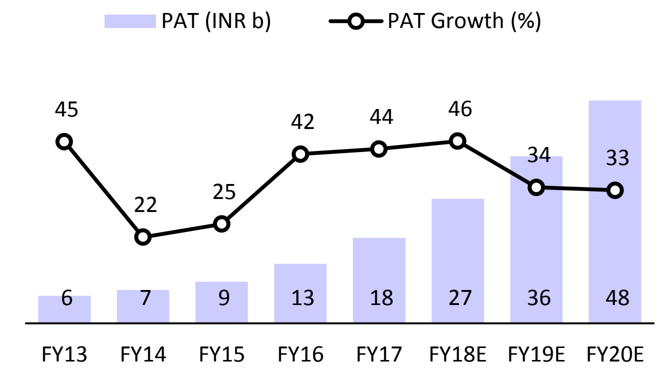
Source: MOSL, Company

Exhibit 26: Robust monitoring to ensure credit costs stay in check



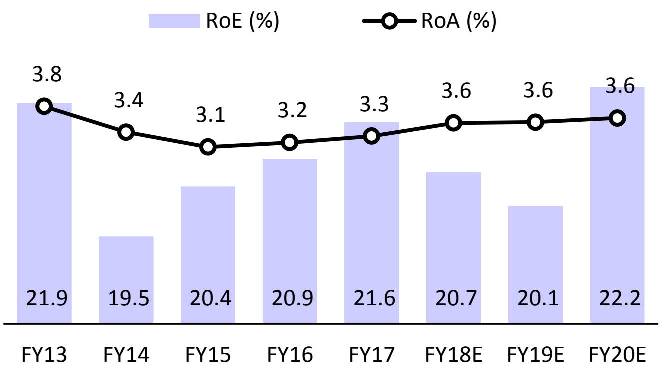
Source: MOSL, Company

Exhibit 27: Robust PAT CAGR over the medium term



Source: MOSL, Company

Exhibit 28: Return ratios stable



Source: MOSL, Company

Financials and valuations

Income Statement								(INR Million)
Y/E MARCH	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019E**	**2020E**
Interest Income	29,248	37,896	51,200	69,012	92,723	118,480	162,367	220,698
Interest Expended	12,057	15,732	22,483	29,269	38,034	46,216	62,405	87,464
Net Interest Income	**17,191**	**22,163**	**28,717**	**39,743**	**54,690**	**72,264**	**99,962**	**133,233**
Change (%)	37.5	28.9	29.6	38.4	37.6	32.1	38.3	33.3
Other Operating Income	1,689	2,429	2,618	3,924	7,050	9,000	12,150	15,795
Other Income	177	419	364	398	260	239	239	286
Net Income	**19,057**	**25,011**	**31,699**	**44,065**	**61,999**	**81,503**	**112,350**	**149,315**
Change (%)	33.7	31.2	26.7	39.0	40.7	31.5	37.8	32.9
Operating Expenses	8,523	11,511	14,284	18,991	25,642	32,719	42,672	56,123
Operating Income	**10,534**	**13,500**	**17,415**	**25,074**	**36,357**	**48,783**	**69,678**	**93,192**
Change (%)	39.2	28.2	29.0	44.0	45.0	34.2	42.8	33.7
Provisions and W/Offs	1,818	2,588	3,846	5,429	8,182	10,349	13,664	19,138
PBT	**8,716**	**10,912**	**13,569**	**19,646**	**28,175**	**38,434**	**56,014**	**74,054**
Tax	2,803	3,722	4,591	6,861	9,810	13,471	19,941	26,363
Tax Rate (%)	32.2	34.1	33.8	34.9	34.8	35.0	35.6	35.6
PAT	**5,913**	**7,190**	**8,979**	**12,785**	**18,366**	**24,963**	**36,073**	**47,691**
Change (%)	45.5	21.6	24.9	42.4	43.6	35.9	44.5	32.2
Proposed Dividend	747	802	903	1,347	2,296	2,159	3,607	4,769

Balance Sheet								(INR Million)
Y/E MARCH	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019E**	**2020E**
Capital	498	498	500	536	1,094	1,150	1,150	1,150
Reserves & Surplus	33,173	39,411	47,497	73,731	88,790	153,645	185,498	227,609
Net Worth	**33,670**	**39,909**	**47,997**	**74,266**	**89,884**	**154,796**	**186,648**	**228,760**
Borrowings	**131,332**	**197,496**	**266,908**	**370,247**	**492,497**	**644,813**	**896,050**	**1,186,437**
Change (%)	28.4	50.4	35.1	38.7	33.0	30.9	39.0	32.4
Other liabilities	**13,209**	**8,776**	**13,207**	**25,216**	**54,909**	**68,635**	**82,362**	**98,835**
Total Liabilities	**178,212**	**246,180**	**328,112**	**469,730**	**637,289**	**868,243**	**1,165,061**	**1,514,031**
Investments	**53**	**282**	**3,323**	**10,341**	**40,747**	**31,460**	**36,179**	**41,605**
Change (%)	-4.0	436.3	1,077.9	211.2	294.0	-22.8	15.0	15.0
Advances	**167,436**	**229,710**	**311,995**	**438,309**	**582,394**	**819,433**	**1,106,235**	**1,438,105**
Change (%)	36.3	37.2	35.8	40.5	32.9	40.7	35.0	30.0
Net Fixed Assets	1,762	2,199	2,492	2,870	3,611	4,703	4,728	4,753
Other assets	8,961	13,990	10,303	18,210	10,537	12,648	17,920	29,568
Total Assets	**178,212**	**246,180**	**328,112**	**469,730**	**637,289**	**868,243**	**1,165,061**	**1,514,031**

E: MOSL Estimates

Financials and valuations

Ratios

Y/E MARCH	2013	2014	2015	2016	2017	2018	2019E	2020E
Spreads Analysis (%)								
Yield on Advances	20.2	19.1	18.9	18.4	18.2	16.9	16.9	17.3
Cost of borrowings	10.3	9.6	9.7	9.2	8.8	8.1	8.1	8.4
Interest Spread	9.8	9.5	9.2	9.2	9.4	8.8	8.8	8.9
Net Interest Margin	11.8	11.2	10.6	10.6	10.7	10.3	10.4	10.5
Profitability Ratios (%)								
RoE	21.9	19.5	20.4	20.9	22.4	20.4	21.1	23.0
RoA	3.8	3.4	3.1	3.2	3.3	3.3	3.5	3.6
RoA on AUM	3.9	3.5	3.2	3.3	3.5	3.5	3.7	3.7
Int. Expended/Int.Earned	41.2	41.5	43.9	42.4	41.0	39.0	38.4	39.6
Secur. Inc./Net Income	8.9	9.7	8.3	8.9	11.4	11.0	10.8	10.6
Efficiency Ratios (%)								
Op. Exps./Net Income	44.7	46.0	45.1	43.1	41.4	40.1	38.0	37.6
Empl. Cost/Op. Exps.	28.8	29.6	31.6	33.2	36.3	44.5	47.8	49.1
Asset-Liability Profile (%)								
Loans/Borrowings Ratio	127.5	116.3	116.9	118.4	118.3	127.1	123.5	121.2
Net NPAs to Adv.	0.2	0.3	0.5	0.3	0.4	0.4	0.4	0.4
CAR	22.0	21.0	18.0	19.5	20.3	24.7	22.6	21.6
Tier 1	*18.7*	*18.0*	*14.2*	*16.1*	*14.6*	*19.7*	*17.6*	*16.6*

Valuation	2013	2014	2015	2016	2017	2018	2019E	2020E
Book Value (INR)	59	69	83	129	156	269	325	398
Price-BV (x)					16.7	9.7	8.0	6.6
EPS (INR)	10.3	12.5	15.6	22.2	31.9	43.4	62.7	82.9
EPS Growth (%)	45.5	21.6	24.9	42.4	43.6	35.9	44.5	32.2
Price-Earnings (x)					81.6	60.0	41.5	31.4
Dividend per Share (INR)	1.3	1.4	1.6	2.3	4.0	3.8	6.3	8.3
Dividend Yield (%)					0.2	0.1	0.2	0.3

E: MOSL Estimates

NOTES

Explanation of Investment Rating	
Investment Rating	**Expected return (over 12-month)**
BUY	>=15%
SELL	< - 10%
NEUTRAL	< - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
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