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Indian Banking & Financials Sector

Retail Therapy: Time to Reboot

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Banking & Financials Sector

26 March 2018

Sector Report

Retail Therapy: Time To Reboot

We believe that the outlook on a long-term secular uptick in small-ticket ('retail') lending in India is still significantly favourable as: (1) Despite the retail lending 'boom' that ensued in recent years, India remains an economy that is grossly under-penetrated on the retail credit side from an over-arching '30,000-feet' view perspective. (2) Specific small-ticket loan segments are egregiously under-penetrated. (3) There is significant government support in addressing small-ticket credit supply gap. At the same time, we stress that our list of beneficiaries from this trend (which we have enumerated below) are driven primarily by idiosyncratic stock-specific factors first and then have a secondary macro overlaying tailwind to benefit from.

Despite retail lending 'boom', India remains grossly under-penetrated on the retail credit side: PFCE (Private Final Consumption Expenditure), which is the portion of the economy relevant from a retail credit perspective, has always been a major contributor to India's GDP and its share has inched up from 56.2% in FY12 to 58.9% in FY18E. Importantly, specified retail credit as a proportion of relevant portion of GDP (PFCE) stands at 28.8% as of FY18E whereas specified wholesale credit as a proportion of relevant portion of GDP (GDP less PFCE) stands at 64.1%, indicating significantly lower generic leverage for the former.

Specific loan segments including small-ticket housing, micro and small enterprise lending, microfinance and gold loans are egregiously under-penetrated: According to the MoHUPA, 95% of urban housing shortfall in India falls under EWS/LIG sections. Similarly, the NSSO Survey states that 96% of micro and small enterprises in India do not have access to formal lending. Further, 75% of rural Indian households have their highest earning member making less than Rs5,000 a month, making loans to them potential 'qualifying assets' from a microfinance perspective. Also, the potential addressable size of the gold loan market is derived from as much as ~20,000tn of Indian household gold holdings, of which only ~10% is being used as collateral and, further, of this, the share of formal lenders is just one-fourth.

Central government is whole-heartedly focused on addressing credit supply gap in small-ticket lending: The Pradhan Mantri Awas Yojna aims to address low house ownership in India lower down the income pyramid by way of targeted credit subsidy for EWS/LIG and MIG consumers. Similarly, the Pradhan Mantri Mudra Yojna aims to create employment lower down the pyramid by way of supporting credit supply to micro and small enterprises via a refinancing reservoir. In fact, the government is hugely supportive of the MSME segment across the board (not just micro enterprises) and a raft of measures augment the opportunity size of formal lending to the MSME segment. Also, importantly, the Indian government remains focused on social and rural spending, regardless of political affiliation, a trend that may accelerate going into an election year.

Our list of potential beneficiaries are driven primarily by idiosyncratic stock-specific factors and aided further by the macro overlaying tailwind: Our list of beneficiaries include highly retailised mid-cap banks (DCB Bank, City Union Bank); mid-cap banks that are quoting at unjustified distressed valuations (South Indian Bank, Karnataka Bank) and a mid-cap bank with unconstrained DNA (RBL Bank), all three of which are re-orienting their loan book towards retail; a mid-cap bank with a balanced strategy (Federal Bank); housing finance companies with inherent small-ticket lending strength (CanFin Homes, Repco Home Finance) and unconstrained strategy (PNB Housing Finance); a small finance bank to benefit from business model transformation (Ujjivan Financial Services); gold loan NBFCs emerging from back-to-back crises (Manappuram Finance, Muthoot Finance) and an MSME-focused NBFC that is engaging in a highly synergistic merger with IDFC Bank (Capital First). We initiate coverage on all of them with a Buy Rating, barring Capital First, on which we have assigned an Accumulate rating.

View: Positive

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Valuation and Metrics tables

Universal Banks

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Company	CMP (Rs)	TP (Rs)	Current Rating	M-cap (US$mn)	Net Interest Income (Rsmn)			Op Profit (Rsmn)			PAT (Rsmn)			CAGR FY18E-FY20E		
					FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	NII	PPOP	PAT
RBL Bank	462	579	Buy	2,986	19,377	25,994	32,817	14,015	18,779	23,838	6,660	9,677	12,360	30.1	30.4	36.2
South Indian Bank	23	28	Buy	631	21,109	26,447	34,037	13,891	17,391	24,471	4,111	5,743	9,223	27.0	32.7	49.8
DCB Bank	160	196	Buy	760	9,597	12,557	15,427	4,955	7,205	9,248	2,569	3,736	4,830	26.8	36.6	37.1
Karnataka Bank	117	147	Buy	677	21,378	27,206	32,660	13,911	18,525	22,335	4,375	6,713	8,845	23.6	26.7	42.2
City Union Bank	168	216	Buy	1,713	15,044	18,500	22,343	12,011	14,254	16,649	6,112	7,315	8,833	21.9	17.7	20.2
Federal Bank	91	112	Buy	2,749	30,526	37,593	47,054	19,250	25,216	32,544	8,309	11,295	16,350	24.2	30.0	40.3

Company	EPS (Rs)			P/E (X)			P/BV (X)			*RoE (%)*			*RoA (%)*		
	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E
RBL Bank	16.0	23.3	29.7	28.8	19.8	15.5	2.7	2.4	2.1	*11.7*	*12.9*	*14.4*	*1.2*	*1.4*	*1.4*
South Indian Bank	2.3	3.2	5.1	9.9	7.1	4.4	0.8	0.7	0.6	*8.2*	*10.7*	*15.3*	*0.5*	*0.6*	*0.8*
DCB Bank	8.3	12.1	15.7	19.2	13.2	10.2	1.7	1.6	1.4	*10.2*	*12.4*	*14.2*	*1.0*	*1.2*	*1.2*
Karnataka Bank	15.5	23.8	31.3	7.5	4.9	3.7	0.6	0.6	0.5	8.3	11.9	14.1	0.6	0.8	0.9
City Union Bank	9.2	11.0	13.3	18.2	15.2	12.6	2.7	2.4	2.0	*16.0*	*16.6*	*17.2*	*1.6*	*1.6*	*1.7*
Federal Bank	4.8	5.8	8.4	19.0	15.6	10.8	1.8	1.4	1.3	9.8	10.7	12.6	0.8	0.9	1.1

Housing Finance Companies

Shivaji Thapliyal (shivaji.thapliyal@nirmalbang.com)

Company	CMP (Rs)	TP (Rs)	Current Rating	M-cap (US$mn)	Net Interest Income (Rsmn)			Op Profit (Rsmn)			PAT (Rsmn)			CAGR FY18E-FY20E		
					FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	NII	PPOP	PAT
Can Fin Homes	504	638	Buy	1,035	5,608	6,756	8,235	5,264	6,410	7,897	3,089	3,932	4,993	21.2	22.5	27.1
PNB Housing Finance	1,146	1,410	Buy	2,941	16,415	22,903	31,077	14,500	19,384	26,166	8,501	11,513	15,850	37.6	34.3	36.5
Repco Home Finance	551	684	Buy	532	4,377	5,246	6,516	3,944	4,790	6,027	2,039	2,553	3,243	22.0	23.6	26.1

Company	EPS (Rs)			P/E (X)			P/BV (X)			*RoE (%)*			*RoA (%)*		
	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E
Can Fin Homes	23.2	28.2	35.8	21.7	17.9	14.1	5.0	4.1	3.2	*25.4*	*25.6*	*25.6*	*2.1*	*2.1*	*2.1*
PNB Housing Finance	51.3	69.5	95.7	22.3	16.5	12.0	3.0	2.6	2.2	*14.3*	*16.9*	*19.6*	*1.6*	*1.5*	*1.6*
Repco Home Finance	32.6	40.8	51.8	16.9	13.5	10.6	2.6	2.2	1.8	*16.4*	*17.6*	*18.8*	*2.1*	*2.1*	*2.2*

Small Finance Banks

Shivaji Thapliyal (shivaji.thapliyal@nirmalbang.com)

Company	CMP (Rs)	TP (Rs)	Current Rating	M-cap (US$mn)	Net Interest Income (Rsmn)			Op Profit (Rsmn)			PAT (Rsmn)			CAGR FY18E-FY20E		
					FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	NII	PPOP	PAT
Ujjivan Financial Services	343	459	Buy	638	7,649	9,474	11,831	3,264	5,027	7,194	227	2,747	3,647	24.4	48.5	300.4

Company	EPS (Rs)			P/E (X)			P/BV (X)			*RoE (%)*			*RoA (%)*		
	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E
Ujjivan Financial Services	1.9	23.0	30.5	180.1	14.9	11.2	2.3	2.0	1.7	*1.3*	*14.5*	*16.5*	*0.2*	*2.4*	*2.5*

Other NBFCs

Shivaji Thapliyal (shivaji.thapliyal@nirmalbang.com)

Company	CMP (Rs)	TP (Rs)	Current Rating	M-cap (US$mn)	Net Interest Income (Rsmn)			Op Profit (Rsmn)			PAT (Rsmn)			CAGR FY18E-FY20E		
					FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	NII	PPOP	PAT
Manappuram Finance	106	136	Buy	1,371	24,266	27,920	33,282	12,902	14,100	16,239	7,111	8,326	9,558	17.1	12.2	15.9
Muthoot Finance	381	500	Buy	2,347	41,523	43,271	47,499	29,673	30,375	33,213	17,619	18,328	20,582	7.0	5.8	8.1
Capital First	619	843	Acc	942	18,414	24,046	30,729	10,605	13,789	17,928	3,058	4,153	5,474	29.2	30.0	33.8

Company	EPS (Rs)			P/E (X)			P/BV (X)			*RoE (%)*			*RoA (%)*		
	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E
Manappuram Finance	8.4	9.9	11.4	12.5	10.7	9.3	2.3	2.0	1.7	*19.6*	*19.8*	*19.7*	*4.3*	*4.1*	*3.8*
Muthoot Finance	44.1	45.9	51.5	8.6	8.3	7.4	1.9	1.6	1.4	*24.4*	*21.1*	*20.1*	*5.6*	*5.4*	*5.4*
Capital First	31.4	42.6	56.2	19.7	14.5	11.0	2.3	2.0	1.7	*12.5*	*15.0*	*17.0*	*1.5*	*1.6*	*1.7*

N.B. Banking and Financials stocks also under coverage of Nirmal Bang Institutional Equities, but which do not form part of this report, are ICICI Bank, Axis Bank, Yes Bank, HDFC Bank, Indusind Bank, State Bank of India, Punjab National Bank, Bank of Baroda and Bharat Financial Inclusion.

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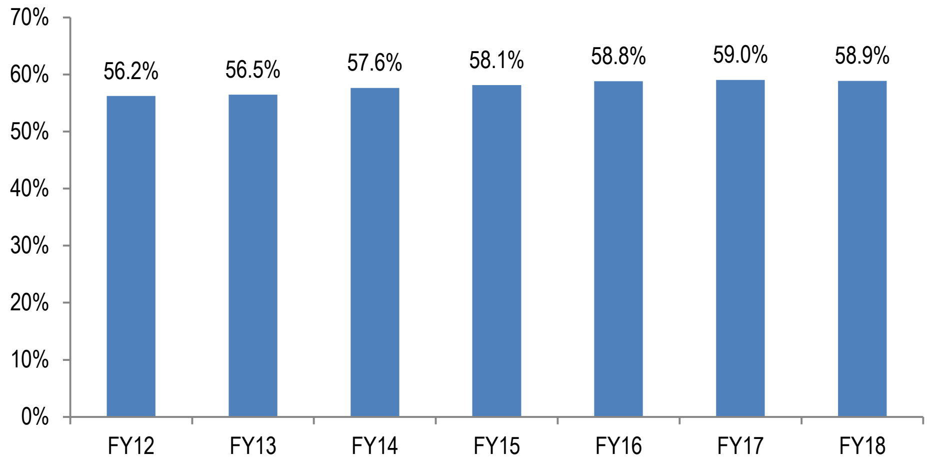
India remains an economy that is grossly under-penetrated on the retail credit side

India remains a household consumption-driven economy and its share is only inching up

PFCE (Private Final Consumption Expenditure) has always been a major contributor to India's GDP (Gross Domestic Product) and its share has inched up from 56.2% in FY12 to 58.9% in FY18.

Exhibit 1: Share of PFCE in total GDP –FY12-FY18



Source: CMIE, Nirmal Bang Institutional Equities Research

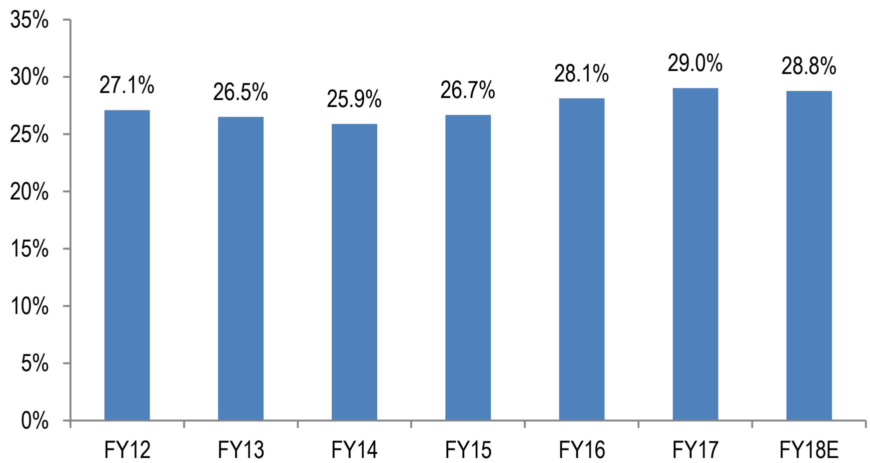
PFCE is the broad addressable portion of the economy which forms the basis for retail credit in terms of the size to "lend against." The more the size of PFCE, the more the scope for retail credit without creating leverage risks for the economy.

Despite 'boom' in retail credit, the segment remains grossly under-penetrated as a proportion of relevant portion of economy

We look at relevant RBI data and find that personal and agriculture loans have posted a CAGR of 13.5% over FY12-FY18E. [By "personal loans", RBI denotes non-agri retail loans relevant to the household consumption economy and are not personal loans used in the parlance of banking business (as denoted in various company presentations).] In comparison, total non-food credit excluding personal and agri loans posted a CAGR of 6.9% over the same period.

High system growth for retail credit has raised concerns regarding saturation of the retail credit market, but from an over-arching '30,000-feet' view, **retail credit is still grossly under-penetrated as a size of the relevant portion of the economy**.

Exhibit 2: Personal and agri loans as a percentage of PFCE – FY12-FY18E

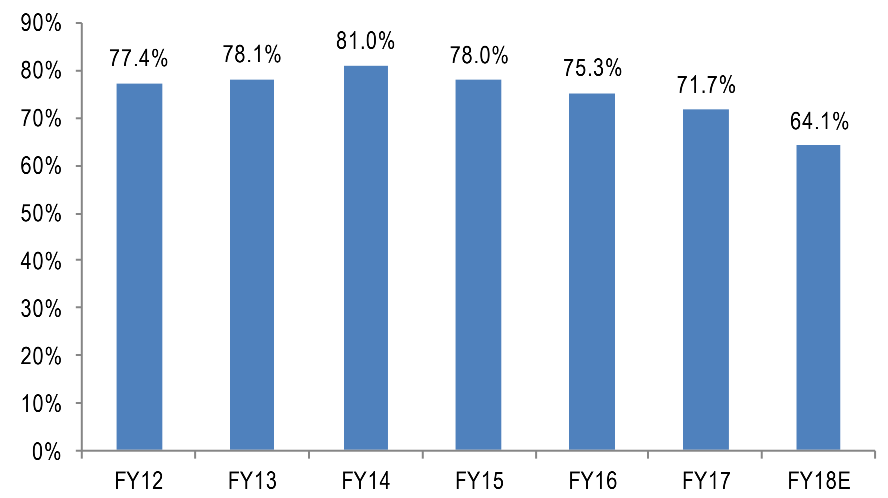


Source: RBI, CMIE, Nirmal Bang Institutional Equities Research

It may noted that there are small-ticket loans ('retail credit') other than personal and agri loans viz. trade loans and micro and small industrial loans but these have not been considered in the numerator in Exhibit 2 as they are not relevant to the denominator, PFCE. Also, not all agri loans would be retail in nature but this approximation only makes our number (retail and agri loans as a percentage of PFCE) more conservative.

Importantly, **personal and agri loans are still just 28.8% of the portion of GDP that is relevant to them (PFCE)**. Note that we have used January 2018 data for FY18 credit data but this is an admissible approximation that does not alter broader conclusion. **In comparison, total non-food credit excluding personal and agri loans is as much as 64.1% of the portion of GDP relevant to them (GDP – PFCE)**, indicating the higher leverage outside retail credit.

Exhibit 3: Non-food credit excluding personal and agri loans as a percentage of GDP ex-PFCE – FY12-FY18E



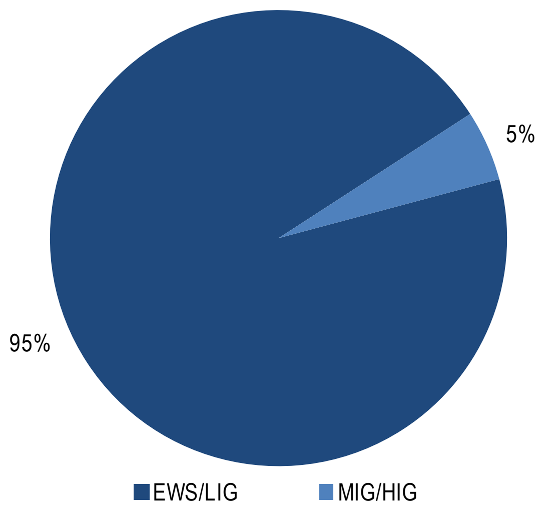
Source: RBI, CMIE, Nirmal Bang Institutional Equities Research

Specific small-ticket loan segments egregiously under-penetrated

The generic opportunity in housing finance is significantly large

The Ministry of Housing and Urban Poverty Alleviation has earlier indicated that **~95% of housing shortfall in urban India is under EWS (Economically Weaker Section) and LIG (Lower Income Group) categories**, which is indicative of the significantly large housing finance opportunity that exists lower down the income pyramid.

Exhibit 4: Proportion of urban housing shortfall falling under EWS/LIG sections



Source: MoHUPA, Nirmal Bang Institutional Equities Research

Based on the current shortfall in housing units in urban and rural India, **the housing credit opportunity in India could be as large as Rs58.3trn**. This indicates significant upside from the housing finance market size of Rs14.4trn as of FY17-end.

Exhibit 5: Total housing credit opportunity on the basis of shortfall

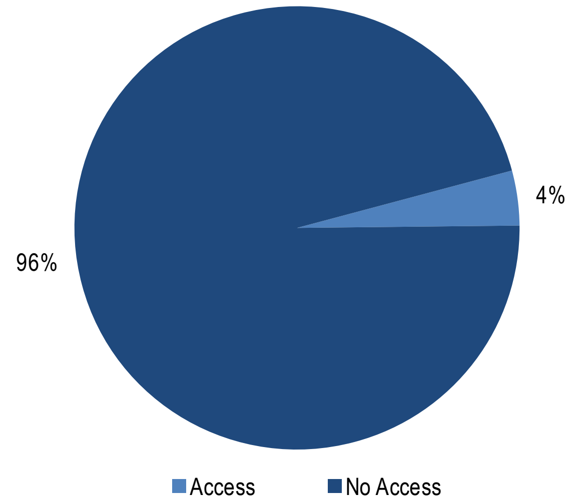
Housing unit shortfall in urban India (mn)	18.8
Loan per housing unit in urban India (Rsmn)	1.4
Opportunity size in urban India (Rstrn)	26.3
Housing unit shortfall in rural India (mn)	40
Loan per housing unit in tural India (Rsmn)	0.8
Opportunity size in tural India (Rstrn)	32.0
Total opportunity size in India (Rstrn)	58.3

Source: MoHUPA, Arihant Superstructures, Nirmal Bang Institutional Equities Research

Micro and small enterprises have very limited access to formal lending

A Press Information Bureau (PIB) release dated 1 March 2015 cited the NSSO Survey 2013, stating that **of the 57.7mn small business units in India, only 4% have access to institutional finance**. This highlights the deep under-penetration of formal lending in the micro enterprise area.

Exhibit 6: Proportion of small business units with access to institutional finance



Source: NSSO Survey 2013, Nirmal Bang Institutional Equities Research

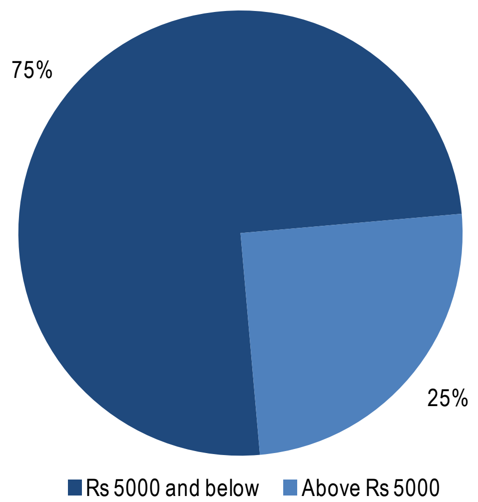
Contrary to some commentary, microfinance is still an under-penetrated area

There is an understanding that has emerged in some quarters that, since microfinance penetration in some key states has reached figures that are close to the proportion of poor people in those states, microfinance as a loan segment has, therefore, reached a saturation level. **This concern is unfounded as only the officially poor cannot be said to be the sole target client set for microfinance lending**.

The **latest definition of poverty in India is as per the C. Rangarajan panel** that set Rs32 and Rs47 spending per day as the thresholds, in rural and urban India, that define the poverty line. These thresholds imply a monthly spending of Rs910 and Rs1,410, respectively. As per this poverty line definition, 29.5% of Indians are living below the poverty line. As the penetration level of microfinance has reached figures similar to this (29.5%) in some key states (it is 14% on pan-India basis), it led to concerns regarding market saturation.

The definition of qualifying asset, on the other hand, for microfinance is that the loan needs to be made to a family whose annual income does not exceed Rs0.1mn and Rs0.16mn in rural and urban centres, respectively. These thresholds imply a monthly income of Rs8,333 and Rs13,333, respectively, which are far above the poverty line thresholds. So, **the proportion of Indians who qualify for microfinance would be a lot higher than those that fall below the poverty line**. In fact, it may be noted that the proportion of Indian households where the highest earning member earns less than Rs5,000 is as high as 75% at an all-India level in rural areas

Exhibit 7: Proportion of rural Indian households where the highest earner earns less than Rs5,000



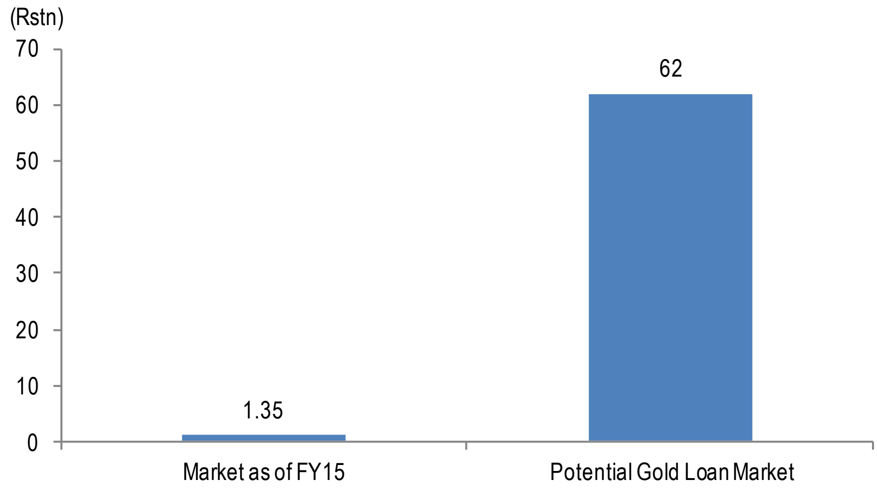
Source: NSSO Survey 2013, Nirmal Bang Institutional Equities Research

Most Indian households' gold holdings still to be tapped as loan collateral

A simple back-of-the-envelope estimate entails the following considerations: (1) Quantum of physical gold held in total by Indian households is 20,000tn.(2) Indian price of gold per gram: Rs3,100. Consequently, **the potential addressable gold loan market in India is Rs62trn**. While we acknowledge that this market size is an outer limit and the key is to sensitise more Indian households to get them to no longer regard as taboo the use of their household gold as loan collateral, the potential addressable gold loan market size looks significantly large.

It is known that **the organised gold loan market size stood at Rs1.35 trn as of FY15-end**. Regardless of growth in this number over the past three years, we believe it is a small proportion of the market size estimated above.

Exhibit 8: Potential gold loan market today vis-à-vis organised gold loan market as of FY15-end



Source: Manappuram Finance, Nirmal Bang Institutional Equities Research

Union government is whole-heartedly focused on addressing credit supply gaps in small-ticket lending

It has made the eco-system extremely conducive for small-ticket housing credit

The environment is particularly conducive for small-ticket housing credit because of (1) the government's flagship scheme Pradhan Mantri Awas Yojna aiming at **Housing for All by 2022** (2) Apart from Section 80C, Section 24 and Section 80EE of the Income Tax Act **ease taxation for home loan borrowers** (3) there are **housing infrastructure initiatives** like Smart Cities Mission and Atal Mission for Rejuvenation and Urban Transformation addressing supply side problems (4) grant of **infrastructure status to affordable housing**.

Specifically, the central government is aware that home ownership is acutely low in India and has, therefore, oriented its policies to address this gap. We note that **Pradhan Mantri Awas Yojna (PMAY)** is structured to specifically address the low home ownership level among lower income groups. It applies to MIG-II and lower income groups only. Also, the extent of credit subsidy improves as one progresses lower down the income pyramid. Interest subsidy is 6.5% for LIG/EWS and 4%/3% for MIG-I/MIG-II categories, respectively.

Exhibit 9: Structure of interest subsidy under the aegis of PMAY

	EWS	LIG	MIG - I	MIG - II
Household income range (Rsmn)	0 to 0.3	0.3 to 0.6	0.6 to 1.2	1.2 to 1.8
Interest subsidy in %	6.5%	6.5%	4.0%	3.0%
Maximum loan tenure in years	20	20	20	20
Maximum eligible loan quantum (Rsmn)	0.6	0.6	0.9	1.2
Housing unit maximum carpet area (sqm)	30	60	120	150
Discount rate to arrive at NPV (%)	9.0	9.0	9.0	9.0

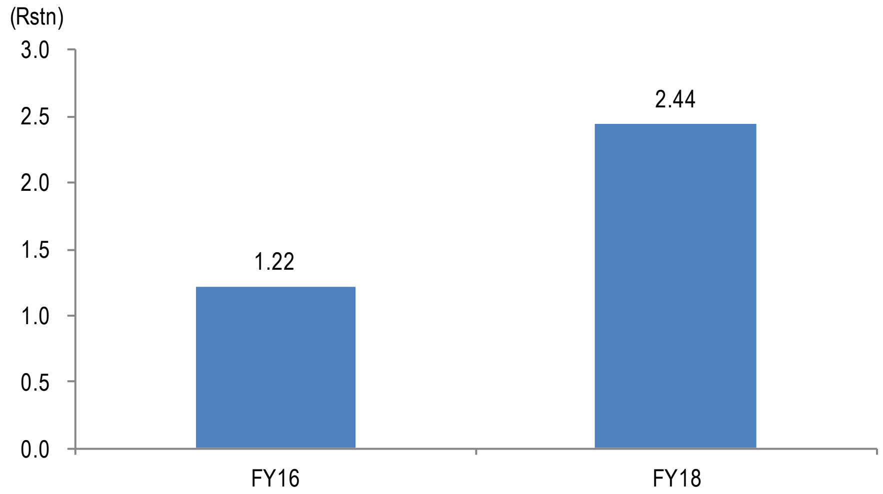
Source: National Housing Bank, Nirmal Bang Institutional Equities Research

We further note that the proportion of borrowers actually availing PMAY is currently low, but can rise materially as **awareness regarding the programme** grows and lending institutions develop processes to seamlessly initiate the education of borrowers regarding PMAY.

The Pradhan Mantri Mudra Yojna is structured to specifically support micro enterprises via credit

The Pradhan Mantri Mudra Yojna (PMMY) is structured in a manner that allows for micro-ticket credit flow to micro enterprises. The products under the aegis of PMAY are termed as **Shishu, Kishor and Tarun** for ticket sizes up to Rs50,000, between Rs50,000 and Rs0.5mn and between Rs0.5mn and Rs1mn, respectively.

Exhibit 10: Target under PMMY doubled over FY16-FY18



Source: Union Budget documents, Nirmal Bang Institutional Equities Research

The financing target under PMMY has been doubled from Rs1.22trn in FY16 to Rs2.44trn in FY18. The target for FY19E has been further enhanced to Rs 3 trn.

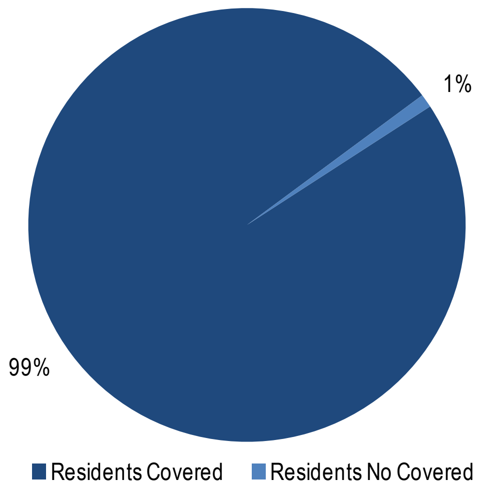
Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) is helpful for collateral-free micro enterprise lending

Collateral/third party guarantee free credit is available from eligible lending institutions to new and existing Micro and Small Enterprises. The enterprises are covered by this programme up to a maximum credit limit of Rs20mn.

Formal bottom-of-the pyramid lending to get tremendous fillip from Aadhaar coverage

A key reason for bottom-of-pyramid borrowers to opt for informal/unorganised lenders (moneylenders/ pawnbrokers) is lack of identity proof, which is a necessary documentary requirement from formal/organised lenders. However, the **penetration of Aadhaar has significantly changed the scenario** in this regard. Even as early as the 25 January 2017 (as mentioned in a Press Information Bureau release), Aadhaar coverage had reached the 1.11bn mark, which covered as much 99% of adult residents in India.

Exhibit 11: Proportion of adult residents covered by Aadhaar as of January 2017



Source: Press Information Bureau (GOI), Nirmal Bang Institutional Equities Research

With growing awareness about formal lending, borrowers would increasingly start to move to the former as moneylenders/pawnbrokers charge usurious interest rates of 3%-6% per month (36%-72% per annum) compared with ~2% charged by gold loan NBFCs/NBFC-MFIs/small finance banks. While the marginal bottom-of-pyramid borrower is not known to be interest rate-sensitive for a quantum that differs by 2%-4% per annum (0.16%-0.32% per month), the **differential in monthly card rates of formal and informal lenders is fairly significant in terms of affecting behavior**.

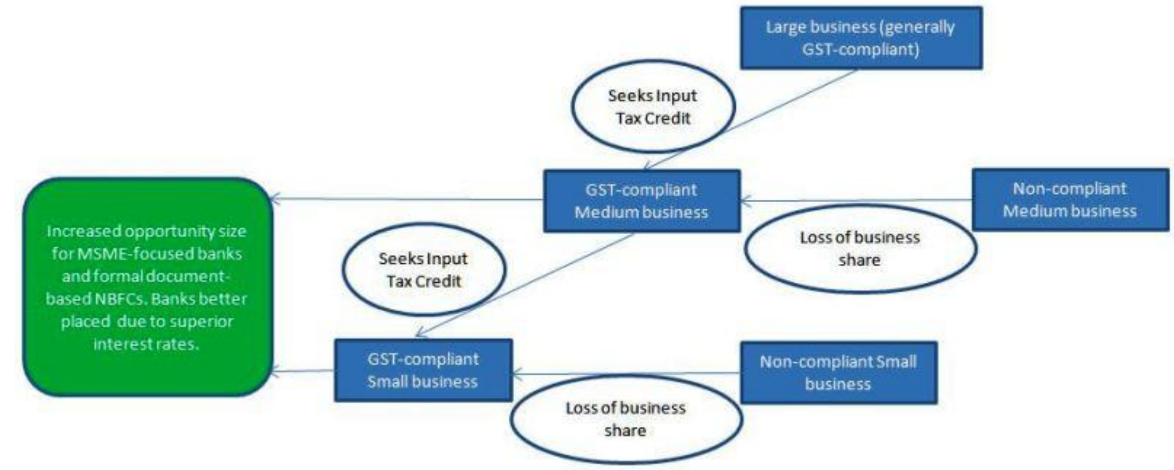
It is known that informal lenders currently control as much as ~75% of the overall gold loan market and there is **significant headroom for transfer of gold loan business from unorganised lenders to formal lending entities**, of which gold loan NBFCs will be key beneficiaries, given their deep physical distribution network. The proportion of microfinance controlled by informal lenders could be similar.

Regulatory regime providing significant incremental fillip for bank lending to broader MSME segment

Formalisation of MSME segment due to GST increases the opportunity size for bank lending

With the advent of GST regime and the ongoing **formalisation of the broader MSME segment**, a rising quantum of MSME business would be backed by formal documentation, which directly enhances the opportunity size in favour of MSME-focused banks, diverting business away, on balance, from NBFCs disbursing loans to the MSME segment.

Exhibit 12: GST will increase the opportunity size for banks focused on MSME lending



Source: Nirmal Bang Institutional Equities Research

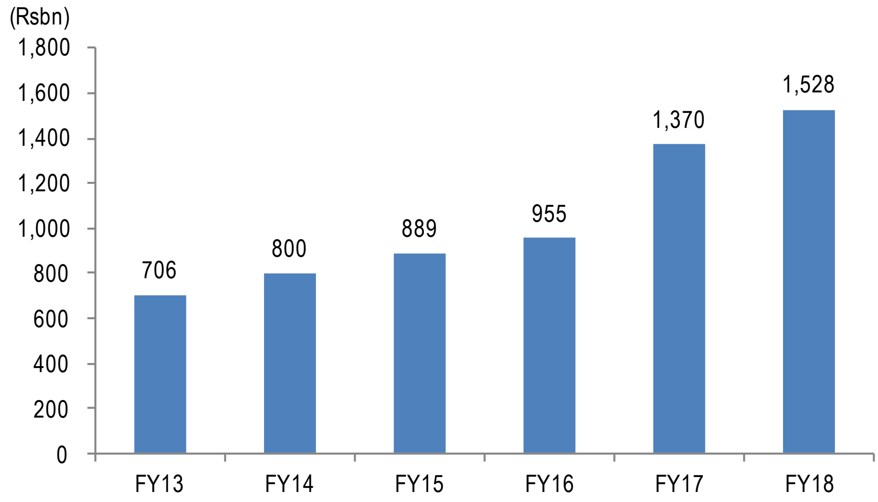
Central government has acute focus on MSME segment as a driver of employment

Job creation is a key mandate for the central government and they realize full well that **supporting the MSME segment is necessary to kickstart job creation for the ever-growing Indian youth base**. There is clear regulatory support for the MSME segment, which will have a positive second order impact for bank lending to the MSME segment. The steps taken by the government include (1) augmentation of MUDRA lending target from Rs 1.22 trn in FY16 to Rs 2.44 trn in FY18 and then to Rs 3 trn for FY19E (2) reducing corporate tax rate for companies with annual turnover below Rs2.5bn (in FY17) to 25% (the limit was Rs 0.5bn earlier) (3) Rs 38bn allocated towards credit support, capital, credit subsidy and innovation in the MSME segment for FY19E (4) Credit guarantee scheme for micro and small enterprises covers collateral free credit upto Rs 20 mn per borrowing unit.

Rural spending an independent vector that augments small-ticket lending opportunity

As time has passed, the rural spending allocated by the NDA government has been augmented by an increasing quantum. **An improving rural economy is an independent factor that enhances small-ticket lending opportunity** including in bottom-of-the pyramid loan segments such as microfinance, gold loans and micro enterprise lending.

Exhibit 13: Rural spending from the NDA government now seeing a steeper rise



Source: Union Budget, Nirmal Bang Institutional Equities Research

We think that rural spending will remain a focus area of the central government, regardless of which political formation occupies power at the centre. This is a function of the broad over-arching aspect of the Indian economy that **increased bottom-of-the-pyramid spending (of which rural spending is a part) will continue to be carried out by Indian governments** till the time such an approach will continue to pay electoral dividend.

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Company Section

RBL Bank

26 March 2018

Initiating Coverage

Reuters: RATB.NS; Bloomberg: RBK IN

Unconstrained DNA Coupled With Sound Risk Management

RBL Bank (RBL) is a mid-cap private sector bank with a network of 248 branches and loan book size of Rs369bn. We are bullish on RBL as: (1) It possesses an unconstrained DNA that eschews a geographically strait-jacketed growth pattern. (2) The same DNA actuates it to build a high-yield small-ticket loan franchise along with being a key player in large corporate lending, while also being a fee income champion. (3) It ensures sound underlying asset quality. (4) Its digital strategy is witnessing tremendous traction on the ground. We initiate coverage on RBL with a Buy rating and a target price of Rs579, which values the stock at 3.0x/2.6x FY19E/FY20E P/BV, respectively.

RBL has a truly pan-Indian growth pattern which augurs well from a long-term scalability perspective: RBL's branch share in its top geographical region has fallen by 8.2 percentage points over FY14-Feb 2018 compared with 0.2%-(1.3%) for mid-cap private sector peers, barring DCB Bank at 13.7%. RBL's branch share in its top region now stands at 54% compared with 70%-96% for mid-cap peers (barring DCB Bank/IDFC Bank at 31%/44%). Lack of a true 'home state' (any longer) for RBL augurs particularly well for scalability from a long-term perspective. RBL, unsurprisingly, had registered loan growth of 48% over FY12-FY17 compared with 10%-28% for mid-cap private sector banks when they were at a similar base to RBL's in FY12.

RBL has built a unique bouquet of businesses focused on generating incremental revenue streams: RBL's unconstrained DNA has led it to build: (1) A high-yield micro-banking loan franchise which will be further augmented as partnership with Utkarsh is monetised. (2) A successful high-value card business that significantly aids fee income. (3) An entrenched corporate lending business that also bolsters fee income, especially from capital-light non-funded book. Yield on non-wholesale book is attractive (13.3% in 9MFY18) and relatively sticky (was 13.5% in 9MFY17) and its share in loans is slated to rise rapidly to ~50% from 40% currently. RBL's core fee income as a percentage of assets is significantly higher at 1.2% in 9MFY18 compared with 0.3%-0.9% for mid-cap private sector peers.

While its approach is unconstrained, RBL's asset quality outcomes are top notch: Despite being a (hitherto) corporate-focused bank, RBL's exposure to ultra-stressed sectors, viz. metals and infrastructure, remains contained at 5.9% of 1HFY18 funded credit book, compared with 7.5%-27.6% for mid-cap peers, barring DCB/FED/CUB at 2.5%/4.2%/5.5%. Importantly, stressed asset pipeline for RBL by way of standard restructured, SDR, S4A, 5/25 and SR book is limited at 0.2% of loan book compared with 0.9%-13.3% for mid-cap peers, barring DCB at 0.1%. Further, RBL has negligible exposure to the RBI's twin IBC /NCLT lists. A small divergence in asset quality assessment for FY17 with the RBI amounting to just 17bps of 3QFY18 loans lends further comfort.

RBL is a new-age bank with a best-in-class digital strategy that is witnessing significant traction: We looked at key RBI data and noted that on key aspects pertaining to traction for digital channels, RBL stands 4th, 1st, 2nd and 1st among our expanded peer set of 10 mid-cap private sector banks on POS transaction value per debit card, NEFT transaction value, RTGS transaction value and mobile transaction value as a proportion of deposits, respectively. This indicates that RBL's digital strategy is already witnessing significant traction on the ground and augurs well from an opex control perspective.

Valuation and outlook: We have used the residual income model to value RBL and arrive at a target price of Rs 579. RBL currently trades at 2.4x/2.1x FY19E/FY20E P/BV and we believe that our target price is reasonable, given RBL's RoE profile of 12.9%/14.4% for FY19E/FY20E and long-term outlook.

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Net Interest Income	8,192	12,213	19,377	25,994	32,817
Pre-Provision Profit	5,424	9,204	14,015	18,779	23,838
PAT	2,925	4,460	6,660	9,677	12,360
EPS (Rs)	9.0	11.9	16.0	23.3	29.7
BV (Rs)	92.1	115.6	170.2	192.2	220.8
P/E	51.3	38.9	28.8	19.8	15.5
P/BV	5.0	4.0	2.7	2.4	2.1
Gross NPA (%)	*1.0*	*1.2*	*1.5*	*1.8*	*1.5*
Net NPA (%)	*0.6*	*0.6*	*0.9*	*1.0*	*0.7*
ROA (%)	*0.9*	*1.0*	*1.2*	*1.4*	*1.4*
ROE (%)	*11.2*	*12.2*	*11.7*	*12.9*	*14.4*

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: Banking

CMP: Rs462

Target Price: Rs579

Upside: 25%

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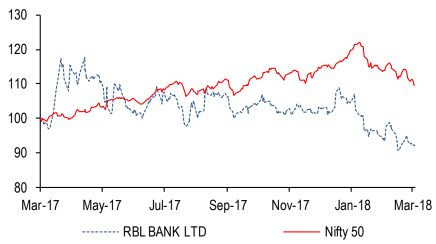
Key Data

Current Shares O/S (mn)	419.4
Mkt Cap (Rsbn/US$bn)	193.3/3.0
52 Wk H / L (Rs)	601/443
Daily Vol. (3M NSE Avg.)	1,266,215

Shareholding (%)	3QFY18	2QFY18	1QFY18
Promoter	-	-	-
FII	100.0	100.0	100.0
Others	-	-	-

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
RBL Bank	(5.5)	(10.9)	(7.8)
Nifty Index	(4.8)	0.3	10.0

Source: Bloomberg

RBL possesses a significantly differentiated growth DNA compared with mid-cap peers

It is important, we believe, to understand the differentiated DNA of RBL to adequately appreciate its long-term potential. **It is a bank, we stress, that possesses a truly unconstrained strategy** that is focused on: (1) Maximizing the number of revenue streams. (2) Maximising the revenues from a given income stream. The bank is able to execute its strategy without unduly diluting risk management practices.

Its unconstrained approach is typified by: (1) Rapid geographical diversification. (2) Presence in loan products across the ticket size curve. (3) A highly robust fee income engine.

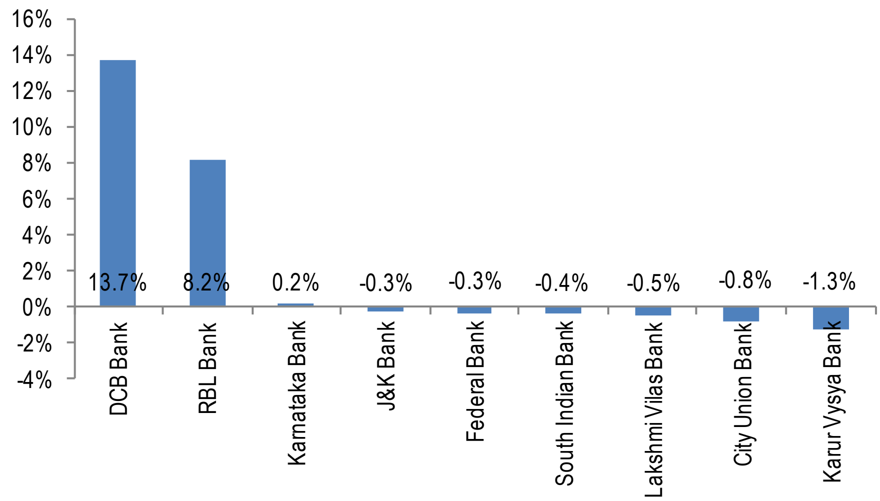
Intent and ability to become a truly pan-India bank brand augurs well for RBL from a scalability perspective

When RBL's previous avatar of Ratnakar Bank witnessed management change (current CEO Mr. Vishwavir Ahuja joined in July 2010), the latter was a regional bank of limited ambition. The acquisition was a watershed moment as it effectively gave the new management a carte blanche to execute **a strategy that was not held back by legacy and rather started off with a new slate in what was effectively a greenfield endeavour**.

Several mid-cap banks have a regional flavour to their operations and the same is reflected in the composition of staff, both junior and senior, and in a geographically contiguous growth pattern. Such banks lack the ambition of becoming a truly pan-India bank brand, but RBL has done away with such legacy **and this augurs well for it from a scalability perspective**.

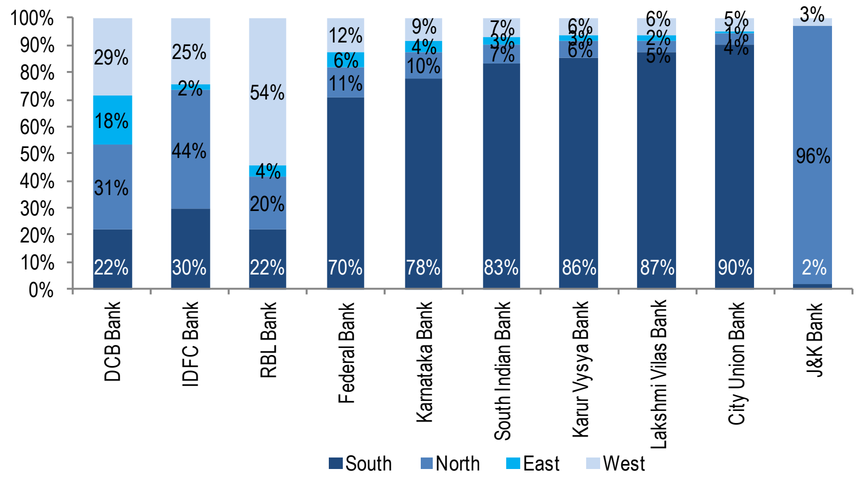
The intent and ability of RBL to diversify geographically is underlined by the fall in branch share of its primary region (West India) by 8.2% over FY14-Feb 2018 compared with (1.3)%-0.2% for our expanded set of private sector midcap peers, barring DCB Bank at 13.7%.

Exhibit 1: Fall in branch share of primary geographical region for key mid-cap banks



Source: RBI, Nirmal Bang Institutional Equities Research

Exhibit 2: Branch share of geographical regions for key mid-cap



Source: RBI, Nirmal Bang Institutional Equities Research

RBL is now the third most balanced bank from a geographical branch distribution perspective, with **branch share in the top region at 54% compared with 70-96% for mid-cap peers, barring DCB Bank and IDFC Bank at 31% and 44%, respectively**.

RBL is building a dynamic Non Wholesale franchise that is witnessing strong traction

RBL has presence across the ticket size curve which indicates its unconstrained DNA

As discussed above, RBL is building its presence across the ticket size curve with ticket size buckets representing largely unique client sets. RBL has: (1) A significant presence in the **micro banking/micro enterprise** space in which several mid-cap peers are absent or do not have a meaningful presence. (2) It is a significant player in the **credit card** space, which is again something several mid-cap peers are either absent from or have seen limited traction. (3) It is a key player in **large corporate lending**, which is an area some mid-cap players have consciously limited their exposure as a proportion of overall business (we will discuss large corporate lending business in a separate section). The bottom-line is that **the DNA of RBL is such that it does not restrict itself from lending in loan segments due to white spaces in capability**.

High proportion of unsecured lending not a concern from an asset quality perspective

A consequence of RBL's focus on microfinance and credit cards is that its proportion of unsecured lending in overall loan book is high at 32% as of 3QFY18-end. This may optically look like a high-risk strategy, but we believe that the presence of collateral is not key in either of these businesses. What is critical in these businesses is the **appraisal of the expected behaviour of the borrower**, which is a function of information available and the quality of processing of the said information.

GNPA ratio for the card business of RBL is ~1.1% whereas the market has a GNPA ratio ranging between ~1.5%-1.8% for this business. This is indicative of superior appraisal process followed at RBL. The card book at RBL is relatively seasoned, resulting in **superior scorecards**, which in turn implies superior origination. Secondly, cards sourced through the **Bajaj Finance** relationship, which accounts for ~42% of card count and ~30% of cards book, are obtained from a significantly credit-tested source.

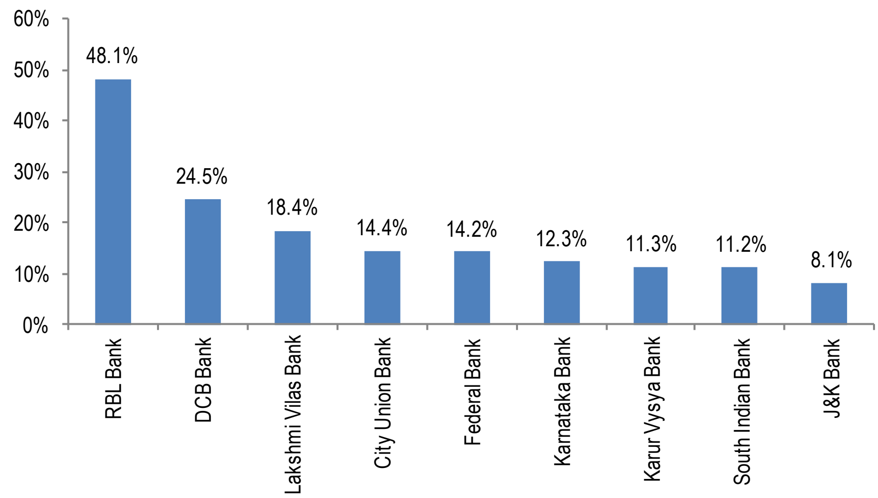
It may be noted that the Bajaj Finance relationship is slated to **turn profitable** in 4QFY18, as per the management. This will provide an incremental profitability kicker to the overall card business going forward.

The micro-banking book, again, is created on the basis of **sound MFI credit bureau infrastructure** available. RBL follows the two-borrower and Rs60,000 rule when it comes to vetting potential microfinance borrowers. This is despite the RBI having raised the total indebtedness limit per borrower from Rs60,000 to Rs100,000 (similar conservativeness is also followed by some other key MFI players). We acknowledge that the credit bureau infrastructure was not helpful in the aftermath of demonetisation, but we discuss, in a subsequent section, that the latter was a **one-off black swan** scenario.

Unconstrained approach has led to high advances growth for RBL compared with mid-cap peers

RBL's unconstrained approach has led to high advances growth for RBL when compared to the growth for mid-cap peers **from a similar base**. We have compared the loan growth of RBL over FY12-FY17 and compared it with the five-year CAGR of mid-cap peers when they were at a loan base similar to where RBL was at the end of FY12. We found out that RBL's CAGR was 48% compared with 10%-28% for mid-cap peers.

Exhibit 3: Advances CAGR from a similar base – RBL vs. mid-cap peers



**South Indian Bank CAGR from a base of ~Rs 80bn*

Source: Company, Nirmal Bang Institutional Equities Research

We acknowledge that factors such as efficiency gains post 2010-management change had its role to play, but we also opine that RBL's unconstrained (and ably risk-managed) approach was also a **key overarching factor** contributing to high asset growth. We stress that this factor stays in place and will continue to aid balance sheet growth going forward for RBL, on balance, compared with mid-cap peers.

Overall there is strong traction for non-wholesale business and this augurs well from an yield-accretion perspective

While, on the face of it, the share of non-wholesale business has remained static at 39.5% in 3QFY18 compared with 39.4% in FY16, there is strong traction in small-ticket businesses for RBL. Importantly, the **share of retail loans (individual consumer loans) has risen from 16.3% in FY16 to 21.2% in 3QFY18**.

Share of DB&FI (Development Banking and Financial Inclusion) has fallen from 14.8% to 13% over the same period as: (1) A significant chunk of key NBFC-MFIs have turned into small finance banks and no longer need lending from universal banks like RBL (this does not preclude RBL from direct or BC-driven micro lending, which will also augments yield). (2) The period also saw a debilitating microfinance crisis (which is now in the past). **Share of DB&FI can inch up going forward on the back of micro credit (direct / BC) and micro enterprise loans**.

Share of agriculture loans have fallen from 8.3% to 5.4% because of problems with non-retail agriculture loans in the commodities segment and large value chain companies after farm loan waiver. **Reorientation of agriculture loan book away from non-retail agriculture loan book is largely over**.

Overall, **the share of each component of Non wholesale book is set to either rise (retail, DB&FI) or remain stable (agri), going forward**.

Exhibit 4: Evolution of share of non-wholesale book – FY16 to 3QFY18 - of RBL Bank

(Rsmn)	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
C&IB	81,860	88,740	105,920	115,440	123,390	130,790	138,950	156,060
CB	46,890	46,510	46,240	50,340	55,100	54,990	61,030	67,070
Wholesale	**128,750**	**135,250**	**152,160**	**165,780**	**178,490**	**185,780**	**199,980**	**223,130**
Retail	34,650	37,330	43,420	47,890	53,690	60,680	69,070	78,190
DB and FI	31,330	31,720	36,400	36,590	41,220	41,960	46,140	47,810
Micro Banking	-	-	-	-	-	22,340	25,330	28,860
IFI	-	-	-	-	-	15,770	16,160	13,580
MSME	-	-	-	-	-	3,850	4,650	5,360
Agri	17,560	18,340	16,760	17,470	21,090	22,660	20,570	19,770
Non Wholesale	**83,540**	**87,390**	**96,580**	**101,950**	**116,000**	**125,300**	**135,780**	**145,770**
Total	212,290	222,650	248,750	267,730	294,490	311,080	335,760	368,900

Source: Company, Nirmal Bang Institutional Equities Research

From a steady-state perspective, the share of non-wholesale book is expected to rise to ~50% by ~FY20/FY21. This is **salutary from a yield perspective** as non-wholesale yield has been more sticky compared with wholesale yield for RBL. While wholesale yield has fallen from 10% in 9MFY17 to 8.9% in 9MFY18, non-wholesale yield remained largely stable, inching lower from 13.5% to 13.3% over the same period.

RBL is a key player in large corporate lending unlike most key mid-cap peers

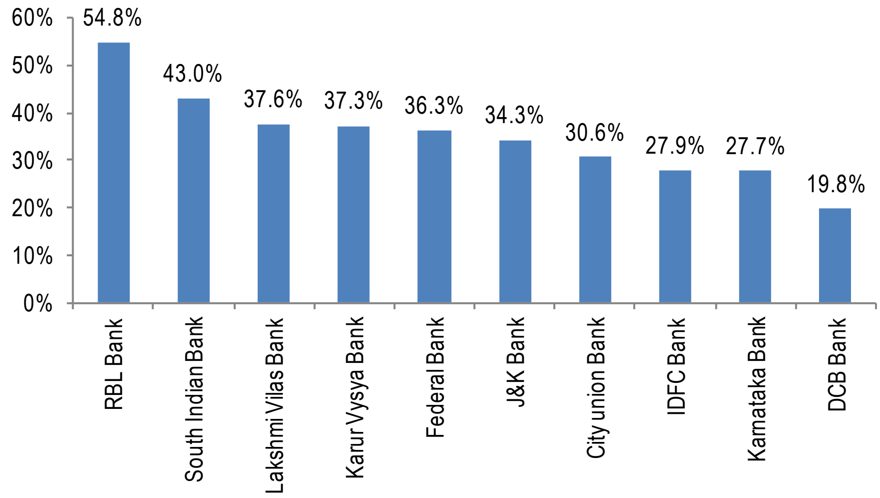
RBL's ability to underwrite large corporate risk is highlighted by: (1) Its high share of Top 20 borrowers as a percentage of total advances. (2) Its high advances per branch. While this may be perceived to be theoretically indicative of concentration risk, we stress that it is indicative, more than anything else, of strong large corporate lending capabilities. **Strong large corporate lending business, while keeping one eye firmly fixed on risk management, is an incremental advantage from the perspective of long-term scalability**.

It is true that the generic macro opportunity in large corporate lending is constricted on a risk-adjusted basis given: (1) Relative stagnation of the capex investment cycle. (2) Persistent asset quality risk in key industrial sectors. However, the **impact of these macro factors on RBL is mitigated** by: (1) Focus on working capital lending rather than on project term lending. (2) Prudent sector focus. (3) Focus on highly-rated corporates.(4) Focus on fee income generation making corporate relationships more attractive from a risk-return perspective. (5) Focus on non funded exposure.

RBL's focus on working capital lending is low risk and less dependent on capex revival

An examination of the maturity profile of loan book for our expanded set of key mid-cap banks reveals that **RBL is most heavily focused on working capital lending** as loan with tenure ranging up to one year accounting for 55% of total loans as of 3QFY18-end compared with 20%-43% for key mid-cap peers. While this data point applies to the entire loan book and not merely the corporate loan book, it is indicative of RBL's significant focus on working capital lending.

Exhibit 5: Share of loans of tenure less than 1 year in total loans – 3QFY18 - RBL vs. key mid-cap peers



Source: Company, Nirmal Bang Institutional Equities Research

Focus on working capital lending as opposed to project term lending has inherently lower macro risk as there is superior cash flow visibility (and hence, credit appraisal is more straightforward) for the former as opposed to the latter. Long-gestation projects have seen more cash flow problems crop up, on balance.

Winning market share in working capital lending is also less dependent on capex cycle recovery than project term lending, which would be more dependent on revival of capex cycle and concomitant greenfield projects emerging.

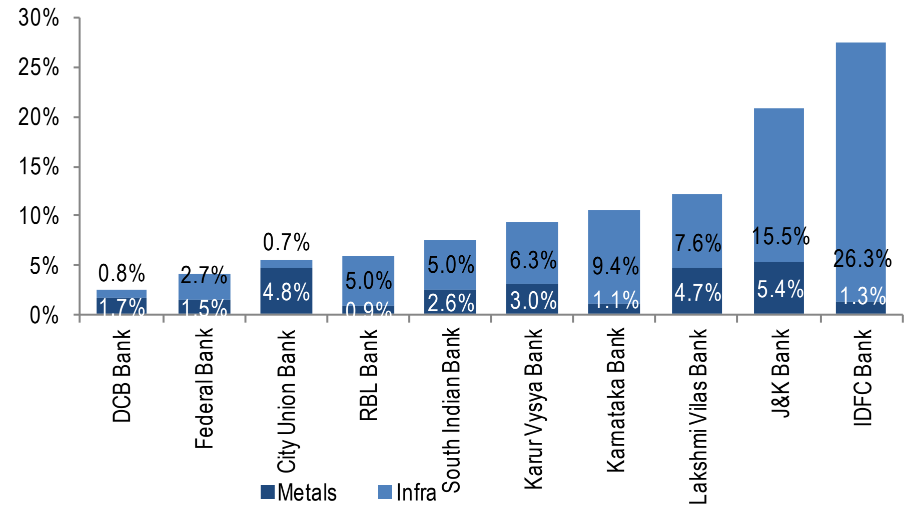
We acknowledge that focus on working capital as opposed to term lending is, on balance, yield dilutive, but we stress that the same should be **viewed from a risk-adjusted prism and the overall RoA tree for RBL would still look attractive**. In this backdrop, the choice between high balance sheet growth on the working capital side and on the term lending side is therefore straightforward to make. Over and above this aspect, **incremental fee income streams from the same corporate relationship as well as revenues from non-funded book** are also mitigating factors that we shall discuss in subsequent sections.

RBL's risk management practices ensure underlying asset quality risk is under control

RBL's sector focus has been prudent and indicates low underlying asset quality risk

RBL's exposure to key stressed sectors, viz. infrastructure and metals, is 5.9% of credit book compared with 7.5%-27.6% for our expanded set of key mid-cap peers, barring DCB Bank/Federal Bank/City Union Bank at 2.5%/4.2%/5.5%, respectively. This underlines RBL's sound risk management practices which entail avoidance of stressed sectors and is indicative of lower underlying asset quality risk, ceteris paribus.

Exhibit 6: Sectoral break-up of credit book – 1HFY18 - RBL vs. key mid-cap peers



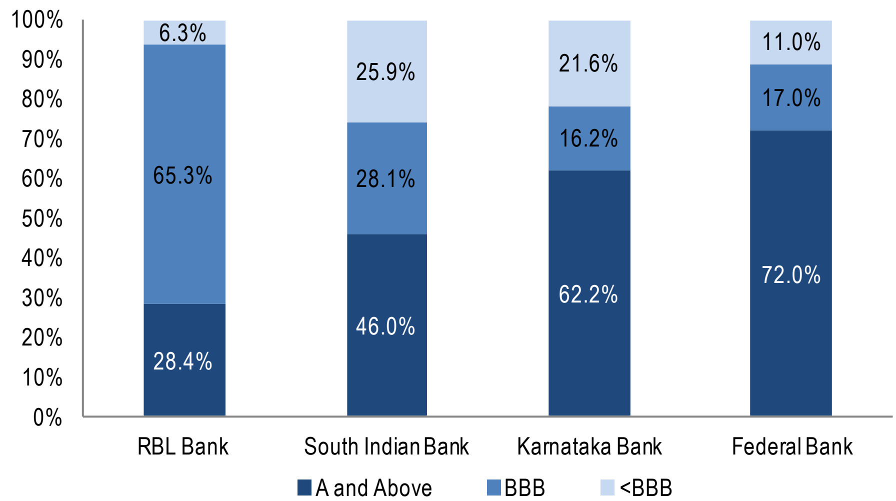
Source: Company, Nirmal Bang Institutional Equities Research

In fact, RBL's new avatar emerged after the Great Recession of 2008-09 and the **question of participating in the credit binge of 2003-07 does not arise**. On evidence of sectoral break-up of credit book, RBL **remained prudent with regard to sectoral focus following the re-emergence of risk-love during 2010-13**, during which RBL's quantum of lending would, in any case, have been small in the overall context of the size of its current loan book.

RBL's focus on highly-rated corporates further mitigates corporate lending risk

The proportion of RBL's corporate loan book to below investment grade borrowers is 6.3% as of 3QFY18-end compared with 11%-26% for mid-cap peers. This underlines the fact that RBL's approach to corporate lending is judicious and reduces associated underlying asset quality risk.

Exhibit 7: Break-up of borrower credit ratings for corporate book – 3QFY18 - RBL vs. key mid-cap peers

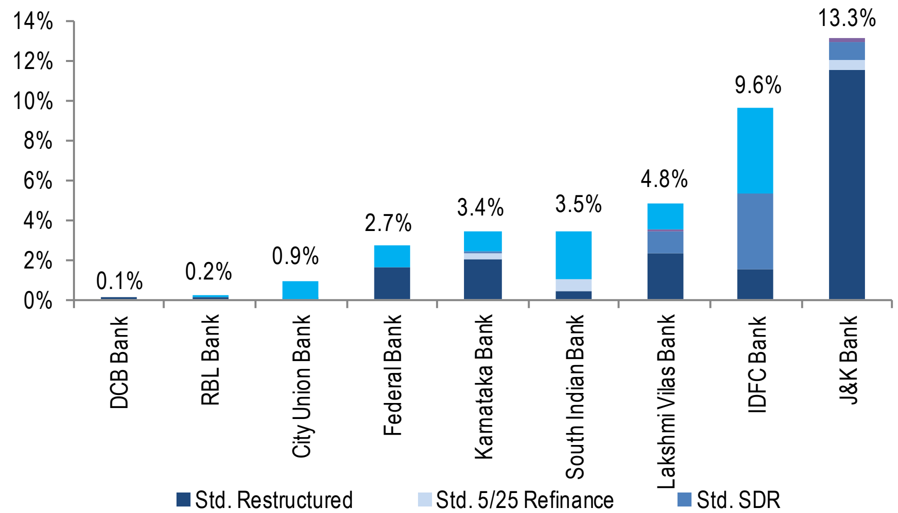


Source: Company, Nirmal Bang Institutional Equities Research

RBL's stressed asset pipeline is minimal which is also indicative of sound underlying asset quality

RBL's stressed asset pipeline consisting of standard restructured accounts, 5/25 (flexible structuring), SDR, S4A and security receipts book is minimal at 0.2% of loan book compared with 0.9%-13.3% for midcap peers, barring DCB Bank at 0.1%. While there can always be slippage from outside the stressed asset pipeline, the **said pipeline is a reasonable indicator of underlying asset quality**.

Exhibit 8: Stressed asset pipeline net of overlaps – RBL vs. key mid-cap peers



N.B. Stress pipeline is the standard non-overlap loan book exposure to traditional restructured loans (CDR, JLF), SDR, flexible structuring (5/25), S4A and net book value of security receipts.

Source: Company, Nirmal Bang Institutional Equities Research

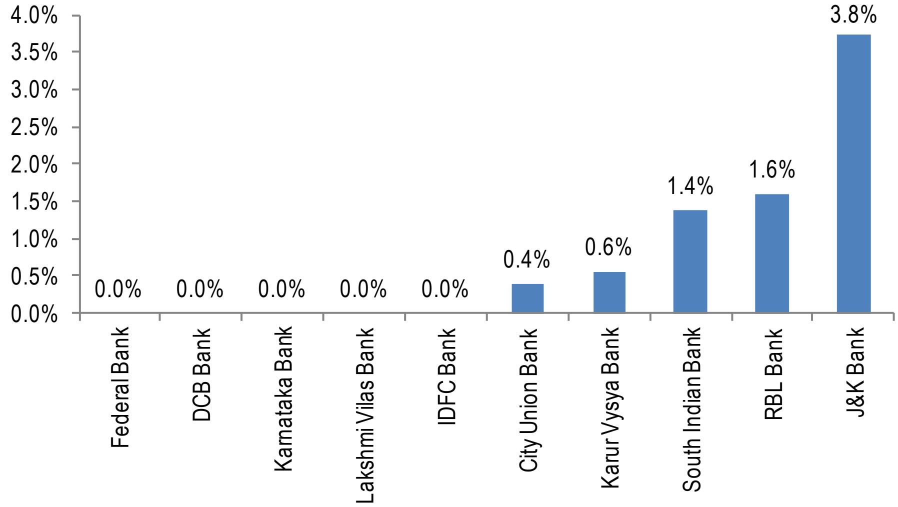
There is no impact on RBL from RBI's IBC twin lists for potential NCLT process

RBI, in its wisdom, earmarked 12 borrowers (List 1) and then 40 borrowers (List 2) for priority resolution outside NCLT within a deadline, failing which these accounts would have to be referred to the NCLT. These are key stressed accounts that the RBI deemed fit for priority resolution. However, **RBL's exposure to List 1 is nil and there is a near negligible exposure to List 2**. Importantly, the P&L account impact from these is nil. This is also indicative of RBL's prudent risk management framework.

Impact from divergence with RBI on FY16 GNPAs also minimal

The divergence with the RBI on FY16 gross NPAs for RBL stood at 1.6% of FY16 advances. This minimal divergence is not unexpected for RBL given its focus on large corporate lending, but is **not significant enough to be a cause for concern**.

Exhibit 9: Divergence with the RBI on FY16 GNPAs as a percentage of advances – RBL vs. key mid-cap peers



Source: Company, Nirmal Bang Institutional Equities Research

The **RBI's risk-based supervision exercise for assessing asset quality as of FY17-end threw up an even smaller quantum of divergence** which amounted to an exposure of Rs0.64bn, which is equivalent to just 17bps of 3QFY18 loan book, not material enough for disclosure, but prudently RBL has (while disclosing the quantum) recognised these accounts as NPA (includes an SDR account worth Rs0.53bn).

Minimal divergence with the RBI on asset quality also **augurs well for RBL from a perspective of possible impact from the RBI's recent notification** regarding asset quality recognition that effectively works to reduce divergence in NPA recognition across banks for the same stressed account.

RBL's bet on micro banking positive from a long-term perspective

We believe that RBL stands to benefit considerably over the long run from its high yield micro banking franchise it is building, for a variety of reasons.

Micro banking portfolio has stabilised in consonance with the rest of MFI industry

The micro banking book, which is a key piece within the overall non-wholesale book, has stabilised. The **collection efficiency of the 'new book'** created post 31 December 2016 is above 99%, indicating the loan book stress is contained within the legacy book. Also, the stress on the legacy book itself is not rising and the proportion of micro banking book **between 30dpd to 90dpd** is less than 1%, as of 3QFY18-end. This also implies that remaining bad loan recognition for the book is also minimal.

Two MFI crises in seven years may have turned some entities into microfinance bears, but this view may be psychological

Our view is that both the Andhra Pradesh MFI crisis on 2010 and the Demonetisation of 2016 were one-off black swan events that would not be repeated. The Andhra Pradesh crisis of 2010 was actuated by an institutionalised crackdown on the MFI industry initiated by state government. Today, the formal MFI industry has the **support of all relevant institutions** viz. the central government, the various state governments and the sole regulator, RBI. Demonetisation, for its part, impacted the MFI industry immensely as it caused a cash crunch that affected not only collection but also disbursement, and also disrupted the cash cycle of borrowers. We do not see any similar exercise being repeated. The central government does intend to promote cashless transactions, but **not via banning or penalising cash transactions**.

One key listed NBFC-MFI turned small finance bank, Equitas Holdings, has consciously decided to prune its microfinance book by turning away renewal customers. We believe this decision may have been taken because of psychological exhaustion from the collateral damage suffered from both MFI crises (Equitas had a significant exposure to Andhra Pradesh during 2010). Another key listed NBFC-MFI turned small finance bank, Ujjivan Financial Services (under our coverage) does not share Equitas' view and will not consciously prune its microfinance exposure.

Universal banks with a focused approach for microfinance to benefit from reduced competitive intensity

The Demonetisation event had a two-fold impact that served to reduce competitive intensity in the formal micro lending industry: (1) **Weak microfinance institutions** that lack adequate capital (all in the unlisted space) have either ceased operations or significantly withdrawn from the micro lending industry (2) Key erstwhile NBFC-MFIs which have successfully obtained **small finance bank licences** have scaled back growth aspirations in the microfinance segment as the transformation into a bank entails: (a) Egregiously high opex for building bank franchise and infrastructure (b) Allocation of capital into areas other than microfinance.

This leaves universal banks with a focused approach, i.e. those which have actively built reach either directly or through partnerships, and standalone NBFC-MFIs to benefit from the significantly reduced competitive intensity. It would be in order to mention here that while NBFC-MFIs would be beneficiaries from a growth perspective, universal banks would be even better off since **constraining regulations** such as margin cap are not applicable to the latter.

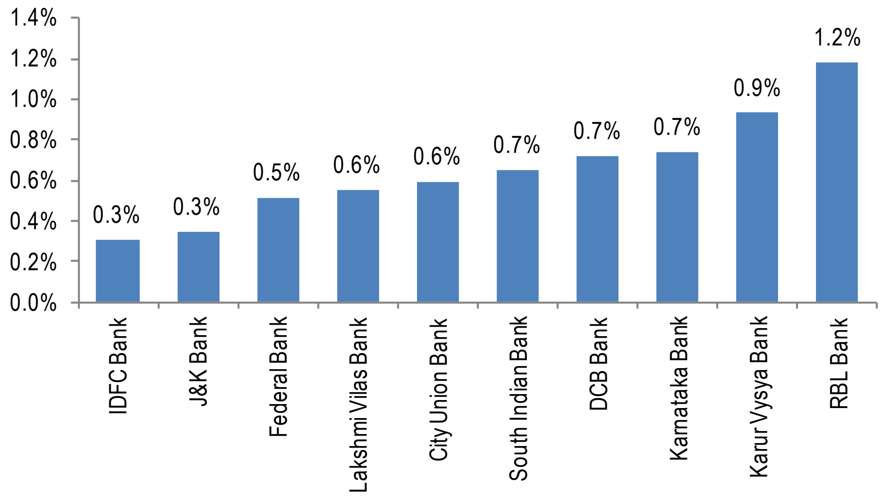
RBL will finally get to utilise Utkarsh Microfinance's distribution network to provide incremental fillip to micro-banking business

An **incremental kicker for the micro banking book will come from joint services that are on the anvil with an associate company, Utkarsh Microfinance**. RBL holds 9.99% stake in Utkarsh Microfinance but so far Utkarsh has not even acted as a BC for RBL as the former was preoccupied with dealing with Demonetisation. Now, over the next six months or so, some joint services are expected with Utkarsh on the micro-banking front.

RBL is a fee income champion among private sector mid-cap peers

The ability to derive core fee income from asset and liability relationships is key to augmenting RoA without unduly expanding balance sheet and RBL has achieved significant success on this front. **Fee income as a proportion of average assets for RBL stood at 1.2%in 9MFY18 compared with 0.3%-0.9%** for our expanded set of mid-cap peers. By "fee income", we refer to core fee income, which is other income excluding trading profit, exchange gains and other similar market-related non-linear income.

Exhibit 10: Core fee Income as a percentage of average assets – 9MFY18 - RBL vs. peers

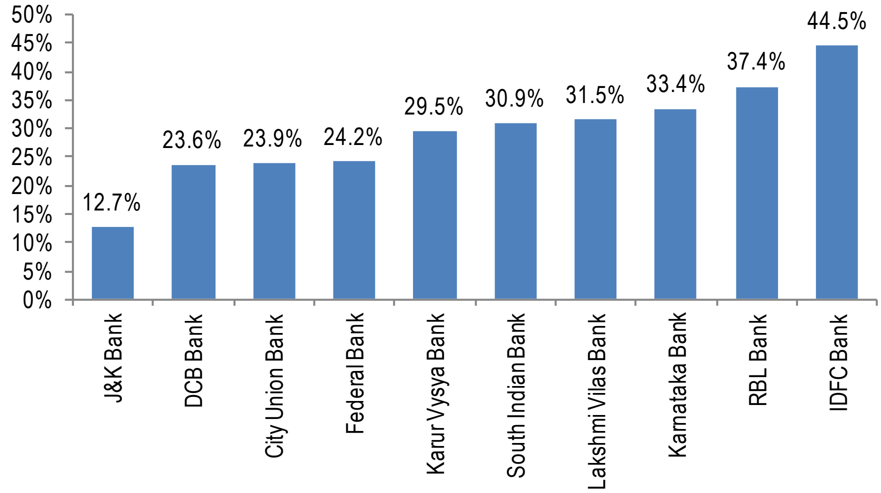


Source: Company, Nirmal Bang Institutional Equities Research

RBL is able to generate a significant proportion of its total income from other income

The proportion of total income contributed by other income is 37.4% in 9MFY18 for RBL compared with 12.7%-33.4% for midcap peers, barring IDFC Bank at 44.5%,. Though we believe that fee income to assets is the best metric to judge ability to generate fee income, to be exhaustive we also cite other income as a proportion to total income. Like in the case of the earlier metric, we found that RBL earmarks itself as having the strong ability to generate incremental revenue streams over and above interest income. IDFC Bank and Lakshmi Vilas Bank score optically attractive metrics in this case because of egregiously large trading profits during this period. Hence, we shall also look at share of core fee income in other income.

Exhibit 11: Other income as a proportion of total income in 9MFY18 - RBL vs. peers

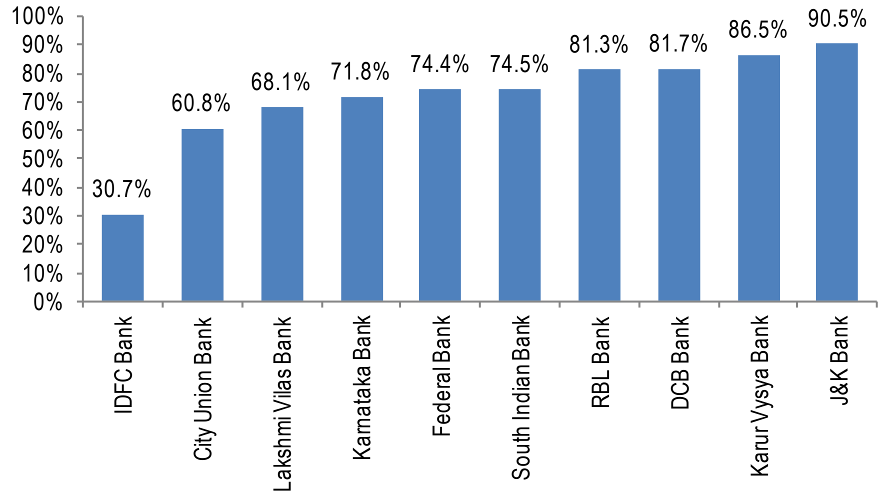


Source: Company, Nirmal Bang Institutional Equities Research

RBL is less dependent on non-linear trading gains for generating other income

Fee income as a proportion of other income stood at 81.3% for RBL in 9MFY18 compared with 30.7%-74.5% for our expanded set of mid-cap peers, barring DCB Bank/Karur Vysya Bank/J&K Bank at 81.7%/86.5%/90.5%, respectively.

Exhibit 12: Fee income as a percentage of other income in 9MFY18 - RBL vs. peers

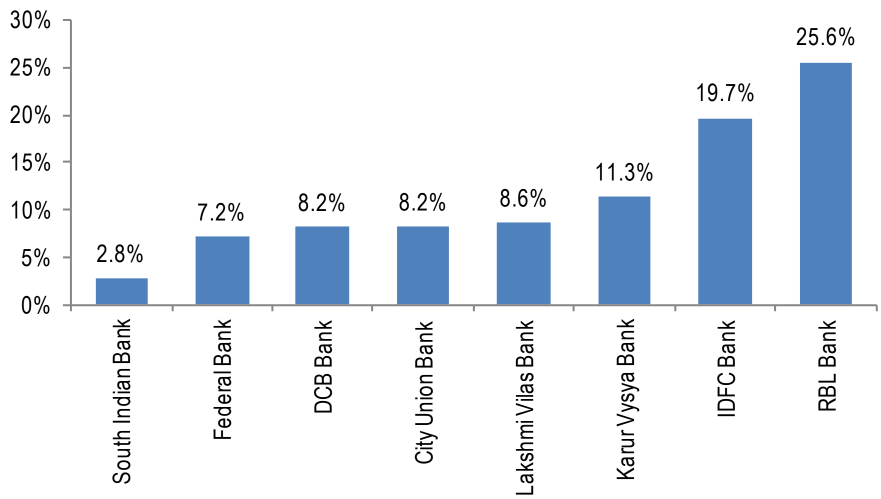


Source: Company, Nirmal Bang Institutional Equities Research

RBL's focus on non-fund business is an incremental fillip for fee income and efficient utilisation of capital

The proportion of non-funded credit in total credit for RBL is 25.6% as of 1HFY18-end compared with 2.8%-19.7% for mid-cap peers, which is indicative of RBL's **efficient utilisation of capital as well as ensuring incremental fee income stream**.

Exhibit 13: Non-funded credit as a percentage of total credit book in 1HFY18 - RBL vs. peers



Source: Company, Nirmal Bang Institutional Equities Research

RBL's **credit appraisal process for non-funded credit is the same as it is for its funded credit accounts** and we do not believe the existence of a high proportion of non-funded credit poses undue risk from an asset quality perspective because of devolvement events.

Tweaking of SA and TD card rates an incremental lever for RBL to bring down cost of funds

Cost of funds has fallen for RBL from 6.9% in 3QFY17 to 6.1% in 3QFY18 on the back of: (1) A fall in market rates (2) Reduction of deposit rates from higher levels (3) CASA traction. While, in the coming quarters, cost of funds may remain stable or inch up, high card rates on SA and TD remain a lever that RBL can tweak incrementally to reduce cost of deposits, ceteris paribus. RBL plans to retain a certain premium to peers on the SA card rate as means of client acquisition, but the **quantum of the premium** can be tweaked lower.

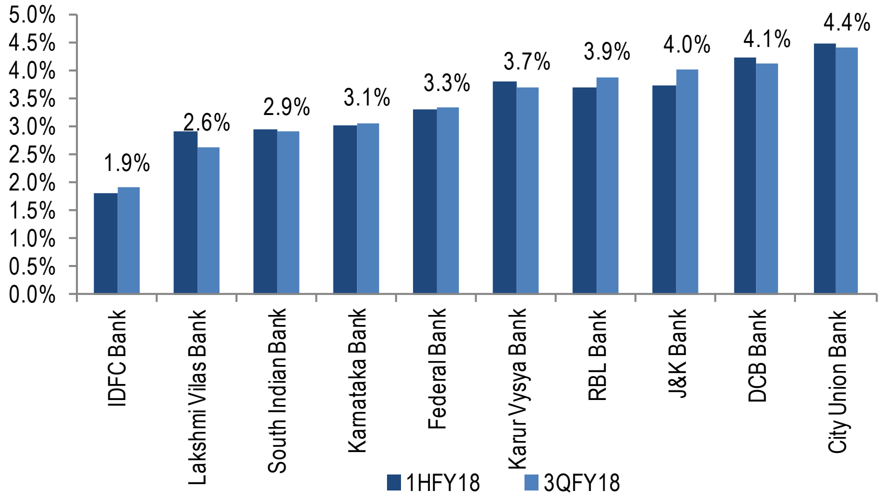
Share of wholesale deposits currently high, but a consequence of having to meet vast asset side opportunities

About 65% of RBL's term deposits are wholesale in nature. RBL would like to bring down this share going forward on the back of continued CASA deposit traction. We stress that relatively high dependence on wholesale funding is a consequence of the **vast asset product opportunities that RBL has garnered for** itself and need to be funded from available liability resources.

RBL's cost of funds needs to be viewed from the perspective of net interest margin

When viewed from the **margin perspective**, we believe that RBL is doing a good job overall with NIM expanding from 2.6% in FY16 to 3.9% in 3QFY18. RBL expects to broadly maintain NIM at the current level which is creditable given that cost funds would inch up. This would be achieved on a rising share of non-wholesale lending in overall loan book.

Exhibit 14: Net interest margin in 3QFY18 - RBL vs. peers

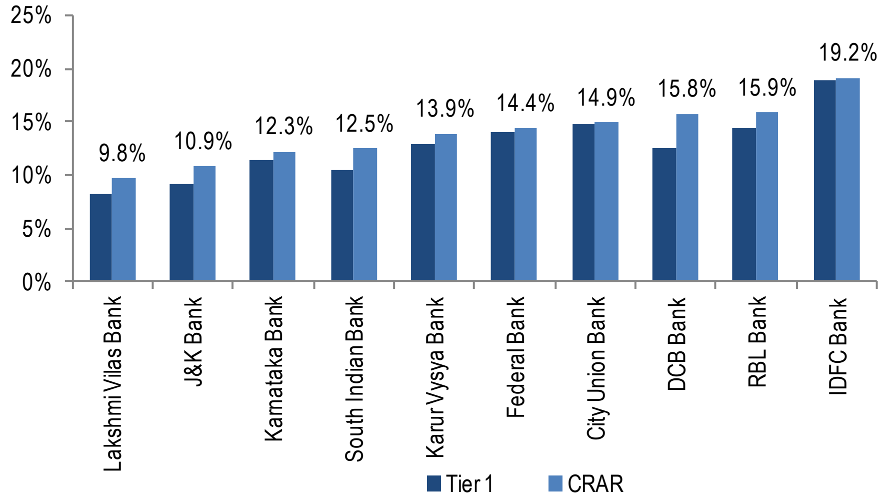


Source: Company, Nirmal Bang Institutional Equities Research

Near-term pressure to garner deposits low as RBL is particularly well-capitalised

Though RBL will continue all efforts to garner granular CASA deposits going forward, near-term requirement to do so is low on the back of sound capital levels.

Exhibit 15: Total and Tier 1 capital ratio in 3QFY18 - RBL vs. peers



Source: Company, Nirmal Bang Institutional Equities Research

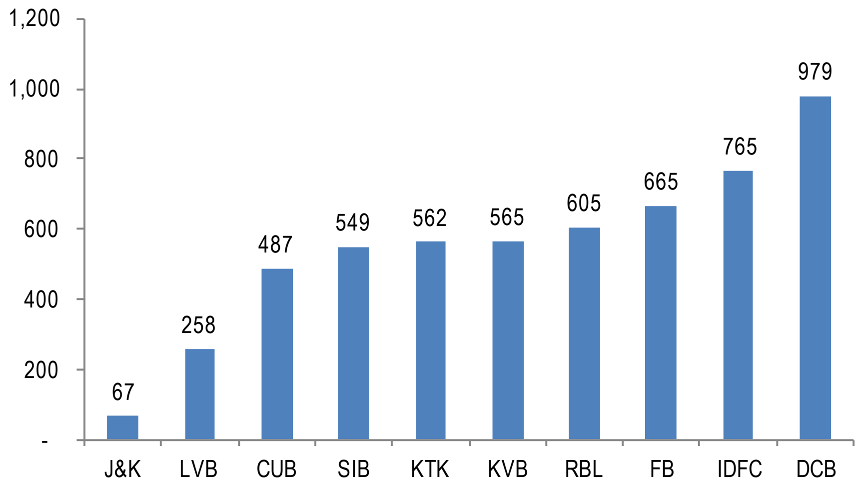
Given the fact that Tier 1 capital ratio is 14.5% for RBL as of 3QFY18-end compared with 7.9%-18.8% for mid-cap peers, the probability of diluting existing shareholders, therefore, is also lower, ceteris paribus. From this perspective as well, it serves as a good entry point for new shareholders. It is likely that RBL will not raise equity capital till FY20-end.

RBL is a new-age bank fully cognisant of the importance of technology

RBL has carried out several technology initiatives that are indicative of its commitment to using technology to save on opex and generate incremental business as well. (1) RBL has launched Abacus, an online savings account product, similar to Kotak Mahindra Bank's 811 product, in 10 select cities (2) RBL sources about 30% of personal loans online and this share is set to rise going forward (3) Published APIs in the public domain that allows wholesale clients to link to their payment systems in a matter of days. These are a cross-section of initiatives and achievements on the technology front that earmark RBL as bank cognisant of the use of technology from a strategic perspective.

We examined some key RBI data pertaining to digital channels and we note that, **considering all factors taken together**, along with IDFC Bank, Karur Vysya Bank and Federal Bank, RBL is seeing good traction for its digital strategy on the ground. **Even among the Top 4 banks, RBL's metrics stand out** when taken together. RBL's traction in mobile transactions typifies it as a new-age bank.

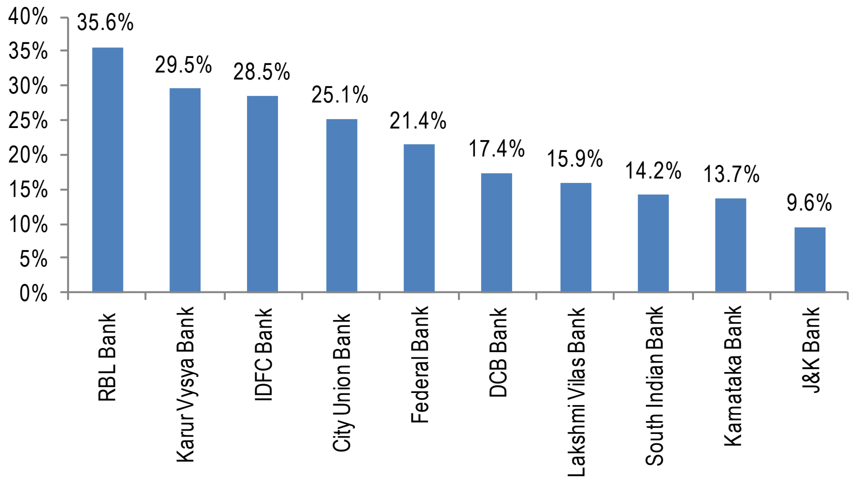
Exhibit 16: POS transaction value (Rs) per debit card in December 2017 - FBL vs. peers



Source: RBI, Nirmal Bang Institutional Equities Research

We note that RBL is also the fourth best on the above metric among 10 peer mid-cap banks.

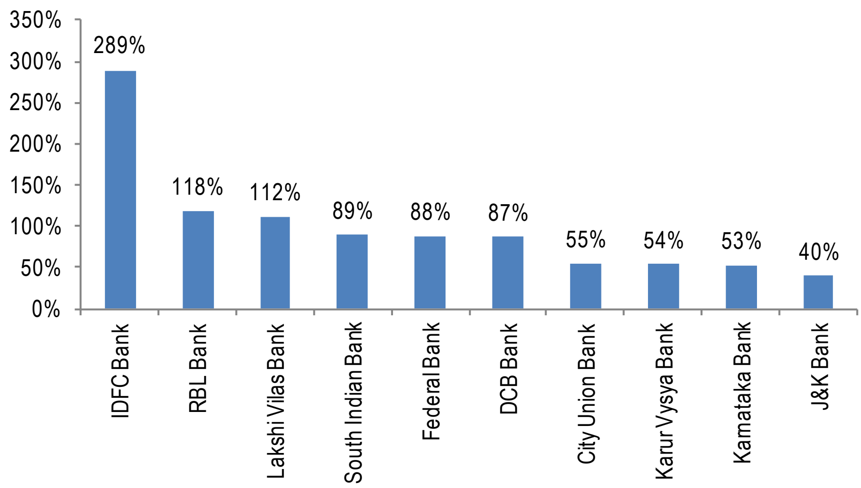
Exhibit 17: NEFT transaction value as a percentage of deposits in January 2018 - FBL vs. peers



Source: RBI, Nirmal Bang Institutional Equities Research

We note that RBL is the best on the above metric among 10 peer mid-cap banks.

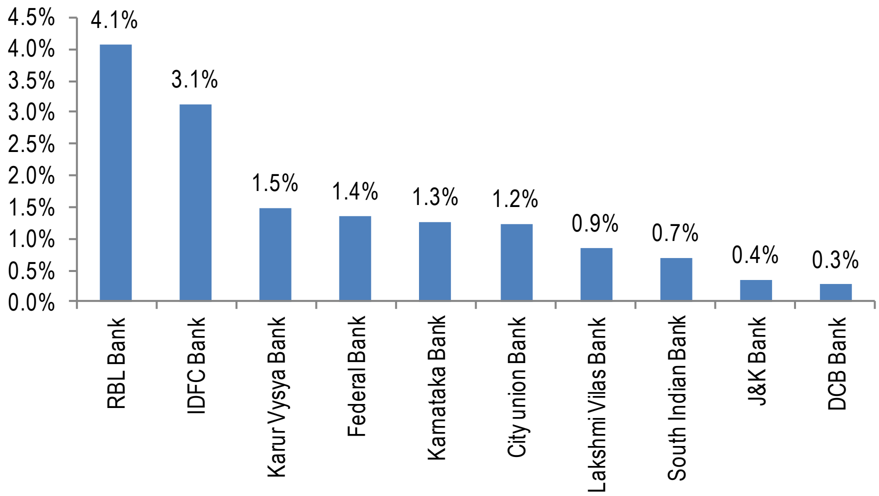
Exhibit 18: RTGS transaction value as a percentage of deposits in January 2018 - FBL vs. peers



Source: RBI, Nirmal Bang Institutional Equities Research

We note that RBL is second best on the above metric among 10 peer mid-cap banks.

Exhibit 19: Mobile transaction value as a percentage of deposits in October 2017 - FBL vs. peers



Source: RBI, Nirmal Bang Institutional Equities Research

We note that RBL is the best on the above metric among 10 peer mid-cap banks.

Valuation and Outlook

We use the Residual Income Model to arrive at a first-principles' fair value for RBL. We assume a long-term sustainable average risk-free rate of 7% for India, an Adjusted Beta of 0.99 for SBL and an India-specific Equity Risk Premium of 6% and arrive at the overall Cost of Equity of 12.9% for SBL. On this basis, **we arrive at a price target of Rs 579, at which the stock will trade at 3.0x/2.6x FY19E/20E book value**.

SBL **currently trades at a FY19E/20E P/BV of 2.4x/2.1x, which makes it significantly under-valued** given its FY19E/20E RoE profile of 12.9%/14.4% and long-term outlook. Consequently, we believe that the multiple of 3.0x/2.6x implied by our price target of Rs 579 is reasonable.

Exhibit 20: Consensus vs Our Estimates

	Our estimate			Bloomberg estimate			*% Variance*		
(Rsmn)	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	*FY18E*	*FY19E*	*FY20E*
Net interest income	19,377	25,994	32,817	17,126	21,879	28,100	*13.1*	*18.8*	*16.8*
Operating profit	14,015	18,779	23,838	12,508	16,302	22,591	*12.0*	*15.2*	*5.5*
Profit after tax	6,660	9,677	12,360	5,891	8,576	11,866	*13.1*	*12.8*	*4.2*

Source: Nirmal Bang Institutional Equities Research

Key risks

Recent RBI notification overhauling stress resolution is a system-wide risk for all banks with material corporate lending business

The recent RBI notification overhauling stressed asset resolution and promoting consonance (rather than divergence) across banks is a system-wide risk for all banks that have a material corporate lending business. However, we do not think RBL should be significantly impacted given that the divergence disclosed with RBI's assessment of its asset quality in the FY17 Annual Report was minimal (1.6% of FY16 loan book).

Microfinance caters to the bottom-of-the-pyramid and theoretical risk of political interference remains

Local, junior-level politicians remain a theoretical risk and may attempt to influence microfinance borrowers to default in times of crises. Mitigating factors for RBL are (1) although there have been two crises in microfinance (a) Andhra Pradesh crisis in 2010 (b) Demonetisation, both are essentially non-repeatable black swan scenarios. Andhra Pradesh crisis was an institutionalized crackdown on the formal microfinance industry carried out by the then state government. Since then, no state government, central government or regulator (RBI) has carried out any such move since the **institutions now realize** that formal bottom-of-the-pyramid lenders serve to prevent the exploitation of low income groups by moneylenders / pawnbrokers who charge usurious interest rates far higher than formal lenders. Also, Demonetisation events are not frequent and have tended to be carried out in **gaps** of several decades. Furthermore, there is now awareness on the ground that default has severe consequences in terms of **credit history** being spoilt and borrowers have wisened up in terms of repayment behavior.

RBL's non funded business is a significant proportion of its total credit creating devolvement and business erosion risk

Off-balance sheet business can, potentially, see NPA accretion by way of devolvement. Secondly, post the fraud at Punjab National Bank, the RBI has discontinued Letters of Undertaking (LuT) and Letters of Comfort (LCom). However, our base case is that NPA risk from devolvement is not significant given credit appraisal, which is best-in-class at RBL, is **identical** for non-funded business compared with funded business at RBL. Secondly, impact from discontinuation of LuT/LCom will be minimal as Letter of Credit (LC) and Bank Guarantee (BG) instruments **continue as is** and trade finance can be conducted via the latter.

Company Overview

RBL Bank is a midcap private sector bank with a branch network of 249 branches and 394 ATMs. It has a loan book of Rs 370bn, of which the Retail, Agri, MSME and Corporate split is 20%, 5%, 14% and 61%, respectively (own classification). On Basel III basis, 31% of Retail and Corporate assets comprise Retail. RBL Bank has displayed a loan CAGR of 48% over FY12-17. Its yield on advances in its latest reported quarter was 10.4%.

RBL Bank has a CASA ratio of 24% and its cost of funds is 6.1% and, as a result, it registered a net interest margin of 4%. Its cost to income ratio stood at 54%. Consequently, it delivered a return on assets of 1.2% and a return on equity of 10.97%, implying a financial leverage of 9.1. Its employee count stood at 5,336. Its Capital Adequacy Ratio was 15.9% and its Tier I Capital Ratio was 14.5%.

Exhibit 21: Management team/ Key executives

Name	Designation	Experience
Vishwavir Ahuja	MD and CEO	Vishwavir Ahuja, is a veteran in the Banking industry with close to 35 years of experience.Mr. Ahuja joined RBL Bank in 2010 when it was a small, regional, southern Maharashtra based old-age private sector Bank. He has since transformed the institution into a vibrant, professionally run, new-age Bank with a high degree of competitiveness and scale. During his tenure he has been instrumental in growing the Bank's balance sheet close to 25 times making it one of India's fastest growing private sector Banks. Prior to joining RBL Bank, Mr. Ahuja was the Managing Director & CEO of Bank of America, India from 2001 to 2009. At Bank of America, he successfully managed assignments in USA, Hong Kong and all four regional offices in India. He held various positions in the Credit and Risk Management Group, Treasury and Foreign Exchange, Corporate Planning and Finance, and Head - Corporate and Investment Banking, before eventually becoming CEO at the age of 41.
Rajeev Ahuja	Executive Director	Rajeev Ahuja, Executive Director at RBL Bank, brings over 28 years of experience in the financial services industry. He has been an integral part of the company's transformation journey and is responsible for building the overall strategy of the Bank while managing the Retail Banking, Transaction Banking and Financial Inclusion businesses of the Bank. He is also responsible for the company's capital raising, development of new businesses, partnerships and investor relations functions.
R. Gurumurthy	Head of Risk & Governance	R. Gurumurthy, is Head of Risk & Governance at RBL Bank. He brings over 25 years of exposure in the Banking sector both in India and in Hong Kong. He is responsible for the Risk, Compliance & Legal functions in the Bank. He also oversees the Technology, Operations Administration functions in the Bank and is responsible for the regulatory interface for the Bank. He has been in this role since mid 2016 prior to which he was responsible for the Corporate & Institutional Banking group for the Bank from mid 2011.In his earlier role, as Head – Corporate & Institutional Banking at RBL Bank, Gurumurthy was responsible for driving relationships with large corporates, Public sector undertakings, Financial Institutions, government departments and local administration set-ups by growing the deposits, loans and transactional business portfolio of the Bank.
Vincent Valladres	Head - Commercial Banking	Vincent Valladres, is Head - Commercial Banking at RBL Bank and brings over 22 years of experience in financial services across sales, relationship management and credit. His focus areas include client management and cross selling across transaction banking, lending and fixed income, currencies and commodities (FICC).In his current role, Vincent overlooks the Commercial Banking (CB) coverage franchise which includes the SME and Mid Corporate segments. Prior to joining RBL Bank, Vincent held various roles at Citibank India and UAE.
Brijesh Mehra	Head - Corporate, Institutional and Transaction Banking	Brijesh Mehra is Head of Corporate, Institutional and Transaction Banking at RBL Bank. He is a veteran in the Banking industry with over 30 years of experience across several capacities including overseeing businesses across India and multiple South Asian geographies.In his current role at RBL Bank, Brijesh will be responsible for developing and managing relationships with large corporates, MNCs, public sector undertakings, financial Institutions, government departments and local administration etc. In addition to the client coverage role he will also oversee the development and growth of the transaction Banking engines of the bank.
Neeta Mukerji	Chief Credit Officer	Neeta Mukerji holds a Bachelors (Honours) degree in Economics from Lady Shri Ram College, Delhi University and a post graduate diploma in business management from the Indian Institute of Management, Kolkata. She has over 26 years' experience in the Banking and financial services sector and has previously worked with GE Capital Services India, Asset Reconstruction Company (India) Limited and ICICI Bank Limited. In her current role as Chief Credit Officer, she is responsible for managing the quality of the Bank's credit portfolio and the recovery and management of the stressed assets portfolio.

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 22: Board members

Name	Designation	Experience
Narayan Ramachandran	Non-Executive Chairman	Narayan Ramachandran has been a Director since May 20, 2010. He holds a management degree from University of Michigan, Ann Arbor, B. Tech from IIT, Mumbai and Certified Financial Analyst from USA. He has wide experience of over 23 years in the areas of finance and Banking across geographies. He possesses an understanding of regulations in various leading financial markets. He was also the CEO and Country Head of Morgan Stanley in India.He was instrumental in establishing several new businesses in India including Morgan Stanley 's NBFC and primary dealership entities.
Vishwavir Ahuja	MD and CEO	Vishwavir Ahuja, is a veteran in the Banking industry with close to 35 years of experience.Mr. Ahuja joined RBL Bank in 2010 when it was a small, regional, southern Maharashtra based old-age private sector Bank. He has since transformed the institution into a vibrant, professionally run, new-age Bank with a high degree of competitiveness and scale. During his tenure he has been instrumental in growing the Bank's balance sheet close to 25 times making it one of India's fastest growing private sector Banks. Prior to joining RBL Bank, Mr. Ahuja was the Managing Director & CEO of Bank of America, India from 2001 to 2009. At Bank of America, he successfully managed assignments in USA, Hong Kong and all four regional offices in India. He held various positions in the Credit and Risk Management Group, Treasury and Foreign Exchange, Corporate Planning and Finance, and Head - Corporate and Investment Banking, before eventually becoming CEO at the age of 41.
Rajeev Ahuja	Executive Director	Rajeev Ahuja, Executive Director at RBL Bank, brings over 28 years of experience in the financial services industry. He has been an integral part of the company's transformation journey and is responsible for building the overall strategy of the Bank while managing the Retail Banking, Transaction Banking and Financial Inclusion businesses of the Bank. He is also responsible for the company's capital raising, development of new businesses, partnerships and investor relations functions.
Rama Bijapurkar	Independent Director	Rama Bijapurkar is one of India's most respected thought leaders on market strategy and India's Consumer Economy. She is also considered to be the most insightful commentator on the social and cultural changes that are transforming India. She is closely involved with the Indian Institute of Management, Ahmedabad(IIM A),her alma mater, where she has been a regular visiting faculty and also serves on its board of governors. She is also a member of the governing council of the Banking Codes and Standards Board of India(set up by the Banking regulator),the Insurance Information Board(by the insurance regulator), and is a member of the Eminent Person Advisory Group of the Competition Commission of India
D. Sivanandhan	Independent Director	D. Sivanandhan is Director on the Board since December 18, 2012. He is an economics graduate with a distinguished career in the Indian Police Services. After retiring as Director General of Police (DGP) of the Maharashtra State on 28th Feb, 2011, Sivanandhan has been nominated on the PMO's Special Task Force for completely revamping the internal security scenario of the country. His involvement in the CSR Committee will be an extension of his uncompromised commitment to serve the nation and its people.
Prakash Chandra	Independent Director	Mr. Prakash Chandra is Director on the Board since January 25, 2016. Mr. Chandra joined the Income Tax Department in 1973 as a member of Indian Revenue Service, and retired as Chairman, Central Board of Direct Taxes (CBDT) on July 31, 2011. He has held important positions in the Government at various places viz., Assistant Commissioner/ Joint Commissioner/ Commissioner and Chief Commissioner of Income Tax. Retired as Member/ Chairman, CBDT. He was Ombudsman, Income Tax Department, Delhi for 2 years till December 31, 2013 as a post retirement assignment. He has also worked as Director, Department of Supply, Ministry of Commerce (1988-1991). Director, Border Roads Development Board, Ministry of Defence (1991-1993) and Director General of Income Tax (International Taxation), Delhi.
Jairaj Purandare	Independent Director	Jairaj Purandare has been a Director on our Board since September 16, 2011. Mr. Purandare is fellow a member of the Institute of Chartered Accountants of India and also holds Bachelor's degree in Science (Hons) from Bombay University. He is the Founder Chairman of JMP Advisors Pvt Ltd, a leading advisory, tax and regulatory services firm, based in Mumbai, India. Mr. Purandare has over three decades of experience in tax and business advisory matters and is an authority on tax and regulation. Mr. Purandare was Regional Managing Partner, Chairman–Tax and Country Leader–Markets and Industries of PricewaterhouseCoopers India. Mr. Purandare was earlier Chairman of Ernst & Young India (EY) and was the Country Head of the Tax & Business Advisory practice of Andersen India, before joining EY.
P. Sudhir Rao	Independent Director	P Sudhir Rao has been Director on Board since January 30, 2012. He is currently associated with over 25 companies in India including Aditya Birla Money Ltd. and Radhakrishna Foodland Pvt. Ltd. (a leading Supply Chain Solutions company), nurturing early / growth stage enterprises to assisting listed entities in the areas of Strategic Direction, Business Research and Revenue Management, Performance and Capital Management and Stakeholder Relations as also providing India-entry services. As an active non-executive observer he gets them to focus on enhancing Customer and Organisation Capital to deliver superior triple bottom line returns to all stakeholders. He has invested and advised a number of Technology Ventures that impact Education, Healthcare & Financial Services from incubation through to listing them on Public Markets.
Vimal Bhandari	Independent Director	imal Bhandari has been a Director since September 14, 2010. He is a Chartered Accountant from the Institute of Chartered Accountants of India. He is currently the Managing Director & CEO of Indostar Capital Finance Pvt Ltd.
Ishan Raina	Independent Director	Mr. Ishan Raina is an Independent Director on the board of RBL Bank since April 30, 2016. Mr. Raina was the Founder and CEO of Out of Home Media (OOH Media) and has previously been associated with Ignitee Digital Solutions, JWT Contract Advertising (India) and Lintas Advertising (India). He has also served as a member of the Euro RSCG, India and Member of Havas Media Management Board Worldwide.

Source: Company, Nirmal Bang Institutional Equities Research

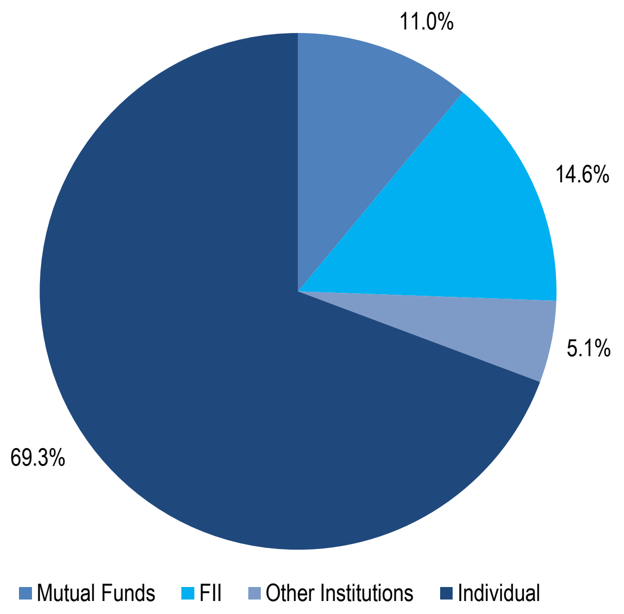
Shareholding Information

Exhibit 23: Key shareholders

	(%)
Promoter	0.0
Non - promoter	
Foreign Companies	19.83
Bodies Corporate	12.05
Cdc Group Plc	6.77
Director Or Director's Relatives	4.24
Asian Development Bank	3.44
Kotak Select Focus Fund	3.37
Cartica Capital Ltd	3.08
Asia Capital Financial Opportunities Pte Ltd	2.42
Vishwavir Ahuja	2.37
Government Pension Fund Global	2.19
International Finance Corporation	2.13
Housing Development Finance Corporation Limited	2.11
Motilal Oswal Most Focused Multicap 35 Fund	2.06

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 24: Shareholding pattern



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 25: One-year forward P/BV

Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 26: Income statement

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Interest Income	27,443	37,132	49,662	64,742	82,799
Interest expense	19,251	24,918	30,286	38,748	49,982
Net interest income	**8,192**	**12,213**	**19,377**	**25,994**	**32,817**
Fees	3,440	4,912	6,891	9,483	12,327
Other Income	1,465	2,642	2,401	2,776	3,380
Net Revenue	13,097	19,768	28,669	38,253	48,525
Operating Expense	7,673	10,564	14,654	19,474	24,687
-Employee Exp	3,699	4,461	5,466	7,147	8,661
-Other Exp	3,974	6,102	9,188	12,327	16,026
Pre-provision Profit	**5,424**	**9,204**	**14,015**	**18,779**	**23,838**
Provisions	924	2,362	3,924	4,117	5,110
-Loan Loss Provisions	1,039	1,975	3,645	3,834	4,784
-Provisions for investment	132	352	279	282	327
-Other Provisions	(246)	35	-	-	-
PBT	4,500	6,842	10,091	14,662	18,728
Taxes	1,575	2,382	3,431	4,985	6,367
PAT	**2,925**	**4,460**	**6,660**	**9,677**	**12,360**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 27: Balance sheet

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Equity Capital	3,247	3,752	4,156	4,156	4,156
Reserves & Surplus	26,645	39,604	66,562	75,739	87,598
Shareholder's Funds	**29,892**	**43,356**	**70,718**	**79,895**	**91,754**
Deposits	**243,487**	**345,881**	**487,236**	**610,922**	**771,714**
-Current deposits	27,796	37,541	39,466	49,790	63,281
-Saving deposits	17,582	38,486	87,703	122,184	154,343
-Term deposit	198,108	269,854	360,068	438,948	554,091
Borrowings	105,362	79,798	22,212	45,393	74,891
Other liabilities	12,870	17,713	26,738	35,464	46,575
Total liabilities	**391,611**	**486,748**	**606,904**	**771,674**	**984,934**
Cash/Equivalent	24,499	41,936	30,921	40,198	52,257
Advances	212,291	294,490	412,287	535,972	696,764
Investments	144,359	134,815	147,676	178,935	218,762
Fixed Assets	1,773	2,587	2,846	3,130	3,443
Other assets	8,688	12,917	13,175	13,439	13,707
Total assets	**391,609**	**486,746**	**606,904**	**771,674**	**984,934**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 28: Key ratios

Y/E March	FY16	FY17	FY18E	FY19E	FY20E
Growth (%)					
NII growth	47.2	49.1	58.7	34.2	26.2
Pre-provision profit growth	50.6	69.7	52.3	34.0	26.9
PAT growth	41.2	52.5	49.3	45.3	27.7
Business (%)					
Deposit growth	42.4	42.1	40.9	25.4	26.3
Advance growth	46.9	38.7	40.0	30.0	30.0
Business growth	44.5	40.5	40.5	27.5	28.0
CD	87.2	85.1	84.6	87.7	90.3
CASA	18.6	22.0	26.1	28.2	28.2
Operating effeciency (%)					
Cost-to-income	58.6	53.4	51.1	50.9	50.9
Cost-to-assets	2.3	2.4	2.7	2.8	2.8
Productivity (Rs mn)					
Business per branch	2313.6	2679.4	3459.7	3887.8	4518.4
Business per employee	117.7	130.6	164.7	176.7	205.4
Profit per branch	14.8	18.7	25.6	32.8	38.0
Profit per employee	0.8	0.9	1.2	1.5	1.7
Spreads (%)					
Yield on advances	10.9	10.4	11.0	11.1	11.1
Yield on investments	6.1	7.0	7.1	7.2	7.0
Cost of deposits	7.3	6.7	6.4	6.6	6.6
Yield on assets	8.8	9.0	9.7	10.0	10.0
Cost of funds	6.5	6.4	6.5	6.6	6.7
NIMs	2.6	3.0	3.8	4.0	4.0
Capital adequacy (%)					
Tier I	11.1	11.4	13.9	12.1	10.7
Tier II	1.8	2.3	1.7	1.4	1.3
Total CAR	12.9	13.7	15.6	13.5	11.9
Asset Quality (%)					
Gross NPA	1.0	1.2	1.5	1.8	1.5
Net NPA	0.6	0.6	0.9	1.0	0.7
Provision coverage	40.2	46.8	38.7	43.6	56.8
Slippage	1.1	2.1	2.0	1.9	1.5
Credit-cost	0.4	0.6	0.8	0.8	0.8
Return (%)					
ROE	11.2	12.2	11.7	12.9	14.4
ROA	0.9	1.0	1.2	1.4	1.4
RORWA	2.1	1.4	1.5	1.6	1.6
Per share					
EPS	9.0	11.9	16.0	23.3	29.7
BV	92.1	115.6	170.2	192.2	220.8
ABV	88.2	110.5	161.2	179.0	209.7
Valuation					
P/E	51.3	38.9	28.8	19.8	15.5
P/BV	5.0	4.0	2.7	2.4	2.1
P/ABV	5.2	4.2	2.9	2.6	2.2

Source: Company, Nirmal Bang Institutional Equities Research

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South Indian Bank

26 March 2018

Reuters: SIBK.NS; Bloomberg: SIB IN

Initiating Coverage

Price Is What You Pay

South Indian Bank (SIBL) is a mid-cap private sector bank with a network of 852 branches and loan book size of Rs524bn. We are bullish on SIBL since: (1) While SIBL has a somewhat extended stressed asset pipeline, it is trading at a significantly cheap valuation even if one were to adjust book value comprehensively for the stressed asset pipeline (2) Drag from gold loan book decline is no longer a factor (3) NRI business resurgence is salutary for deposit accretion. We initiate coverage on SIBL with a Buy rating and a target price of Rs28, which values the stock at 0.9/0.8 FY19E/FY20E P/BV.

Comprehensive evaluation of stressed asset pipeline reveals SIBL is significantly undervalued: The somewhat extended stressed asset pipeline of SIBL adds an element of opacity to its stressed asset picture. SIBL's stressed asset pipeline consists of Rs2.5bn of standard restructured, Rs3.04bn of 5/25 refinance (which do not overlap with each other) and Rs10.2bn of Security Receipts book. However, we have adjusted SIBL's book value part by part for all forms of stressed assets and note that it trades at an FY19E/FY20E P/BV of 0.9x/0.7x, making the stock starkly undervalued for its FY19E/FY20E RoE profile of 10.7%/15.3% and long-term outlook.

Drag from gold loan book decline no longer a factor for SIBL: Gold loans, which accounted for 22% of the loan book in FY13, rapidly declined at a CAGR of (34%) over FY13-FY17, dragging down overall loan growth. Consequently, gold loans now form just 2.6% of loan book and their proportion is now too small to move the needle negatively for SIBL. In fact, the vicious downward spiral has given way to 2.9% growth YoY for gold loan book in 9MFY18, with the froth having exited global physical gold prices. There could be an improving trend here on the back of: (1) Improved conditions in the bottom-of-the-pyramid gold loan market. (2) Some client poaching from unlisted NBFCs on the back of the Rs20,000 limit on cash disbursement.

NRI remittances from GCC nations are a key funding advantage for SIBL: Remittances into India have witnessed a marked acceleration since this financial year, growing 15% YoY in July 2017 (compared with -11% a year ago). A key reason for this is improved remittances from GCC (Gulf Cooperation Council) nations, which form 54% of total remittances into India, on the back of relatively stable crude oil prices. SIBL is a key beneficiary, with NRI deposits as a share of its total deposits growing to 39.4% as of 1HFY18-end compared with 37.3% as of FY17-end.

Valuation and outlook: We have used the residual income model to value SIBL and arrive at target price of Rs28. SIBL currently trades at 0.7x/0.6x FY19E/FY20E P/BV and we believe that our target price is reasonable, given SIBL's RoE profile of 10.7%/15.3% for FY19E/FY20E and long-term outlook.

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Net Interest Income	15,097	16,754	21,109	26,447	34,037
Pre-Provision Profit	8,794	12,163	13,891	17,391	24,471
PAT	3,333	3,942	4,111	5,743	9,223
EPS (Rs)	2.5	2.2	2.3	3.2	5.1
BV (Rs)	28.5	26.9	28.6	31.2	35.6
P/E	9.4	10.6	10.2	7.3	4.5
P/BV	0.8	0.9	0.8	0.7	0.7
Gross NPA (%)	*3.8*	*2.5*	*3.5*	*3.8*	*3.5*
Net NPA (%)	*2.9*	*1.5*	*2.5*	*2.8*	*2.3*
ROA (%)	*0.5*	*0.6*	*0.5*	*0.6*	*0.8*
ROE (%)	*9.0*	*9.1*	*8.2*	*10.7*	*15.3*

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: Banking

CMP: Rs23

Target Price: Rs28

Upside: 26%

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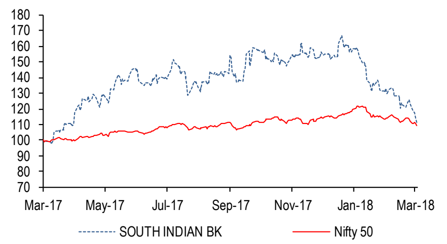
Key Data

Current Shares O/S (mn)	1,808.8
Mkt Cap (Rsbn/US$mn)	40.9/628.6
52 Wk H / L (Rs)	35/20
Daily Vol. (3M NSE Avg.)	12,823,760

Shareholding (%)	3QFY18	2QFY18	1QFY18
Promoter	-	-	-
Public	100.0	100.0	100.0
Others	22.7	18.8	15.4

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
South Indian Bank	(16.0)	(22.9)	11.9
Nifty Index	(4.7)	0.3	10.0

Source: Bloomberg

SIBL is at an ultra-cheap valuation even after adjusting for comprehensive stressed asset pipeline

SIBL's profitability and loan growth has been under strain since several quarters because of persistent loan book stress on the corporate side. However, the cycle of deleveraging and provisioning has now bottomed out and now the market would be able to better appreciate SIBL's undervaluation, even if one adjusts for the **residual stress** that sits on its balance sheet. Here, we draw a broad parallel with another mid-cap bank viz. Karnataka Bank.

Over a period of four quarters, SIBL has: (1) Moved stressed assets materially from the Standard Restructured book to NPA with concomitant higher provisioning. (2) Sold NPAs to ARC at a significant upfront discount and further provided prudently on SR book on account of exposure to IBC-linked cases (3) Moved stress from other quasi-recognised stress components (SDR, 5/25, S4A) to NPA (4) Extinguished completely its self-created corporate stressed asset watch list via NPA recognition.

Having undergone this prolonged period of stressed asset recognition and provisioning, SBL now **trades at a starkly cheap valuation** even if one were to adjust its book value for all residual stressed assets, whether recognised or sitting in its quasi-recognised stressed asset pipeline.

Change in stressed assets picture has been significant over 3QFY17-2QFY18

Over 3QFY17-2QFY18, SIBL has reduced its **Standard Restructured** book by 61% to Rs 2.52bn via NPA recognition. Standard Restructured book is now just 0.5% of 2QFY18 loan book.

Standard SDR book of Rs3.85bn (0,9% of 3QFY17 loan book) has also been recognised as NPA completely.

Also, importantly, the **watch list** worth Rs12.04bn (2.7% of 3QFY17 loan book) comprising stressed corporate loan accounts that did not form a part of quasi-recognised stress (5/25, SDR, S4A), has also been completely extinguished over this period via NPA recognition.

There is still an exposure of Rs3.04bn (0.6% of 2QFY18 loan book) of **Flexible Structuring (5/25 Refinance)**, which consists of loan accounts of relatively sound asset quality, which is being serviced but whose cash flows are back-ended. This book, which in any case is only 0.6% of 2QFY18 loan book, has a low risk of slippage into the NPA pool.

Security Receipts book has seen a provision of Rs2.52bn being made in 2QFY18. Net book value of SR book is 2.1% of 2QFY18 loan book (notionally as SR book sits within Investments). We believe that incremental bulky provisions on SR book is not likely going forward.

There is no exposure to the **Scheme for Sustainable Structuring of Assets** (S4A) in case of SIBL.

Exhibit 1: Change in stressed asset picture over 3QFY17-2QFY18

Standard Restructured	1.4%	0.5%
5/25 Refinance	0.8%	0.6%
SDR	0.9%	0.0%
S4A	0.0%	0.0%
SR (net book value)	2.8%	2.1%
Watch list	2.7%	0.0%
Total	**8.6%**	**3.2%**

Source: Company, Nirmal Bang Institutional Equities Research

To summarise, the **stressed asset pipeline for SBIL has fallen from 8.6% of 3QFY17 loan book to a significantly lower 3.2% of 1HFY18 loan book**.

SR book does not portend a risk of high incremental provisioning

Gross Security Receipts book of Rs12.75bn now has a **provision** of Rs2.52bn, which reduces the net book value of SR book to Rs10.23bn or 2.1% of 2QFY18 loan book.

Importantly, it is to be noted that gross Security Receipts book itself is significantly lower than the original loan outstanding as a **material haircut was taken during the time of sale to ARC**. A major portion of the current SR book was created in 4QFY17 itself, when a sale to ARC of loans outstanding of Rs17.76bn was made. During this sale, an upfront haircut of as much as 33% was taken. Following this, a provision of Rs2.52bn was made on this portion of Security Receipts because of a conservative view taken by the rating agency on IBC-linked cases contained within this. Consequently, the net book value of this portion of Security Receipts as a proportion of original loan outstanding sold stands at a conservative 43% i.e. 57% of this loan exposure has been written down. Of the Rs12.75bn of gross Security Receipt book, the sale made in 4QFY17 accounts for Rs10.1bn or 79% of total.

Exhibit 2: Major portion of Security Receipt book has already suffered a significant haircut

Original loan outstanding during sale in 4QFY17 (Rs mn)	17,760
Value of Security Receipts generated (Rs mn)	11,880
Implied upfront discount / haircut (%)	33%
Share of SIBL in Security Receipts (%)	85%
Security Receipts held by SIBL (Rs mn)	10,098
Provision made on this in 2QFY18 (Rs mn)	2,520
% Provision made on this in 2QFY18	25%
Net book value of this portion (Rs mn)	7,578
Net book value as % of original loan o/s	43%

Source: Company, Nirmal Bang Institutional Equities Research

Valuation picture on the basis of book value adjusted for all forms of stress looks significantly attractive

The current provision coverage ratio for SIBL stands at 44.1%. This is on the lower side as a significant portion of the NPA pool is relatively fresh, thereby requiring lower provisioning as per regulations. We have taken a prudently conservative stance and assumed that SIBL would, eventually, have to make **70% provision against the current gross NPA pool**.

Secondly, we assume that the provision required for current **Standard Restructured book would be 50%** of the respective outstanding book. We believe this is reasonable as the Standard Restructured book is seasoned and has already undergone 61% depletion over the past three quarters.

Thirdly, we have assumed that the provision required for **5/25 exposure would be 35%** of the respective outstanding book. We note that the management has stated that these accounts are “healthy” paying accounts, but have back-ended cash flows. Hence, we believe the 35% assumption is reasonably conservative.

Lastly, we have assumed **20% provisioning requirement on net book value of Security Receipts**. We believe this is sufficient given that a major portion (79%) of gross Security Receipts has already witnessed a significant write-down of 57% of original loan outstanding.

Exhibit 3: Calculation of book value adjustment on the basis of residual stress

Provision coverage ratio (PCR)	44.1%
Target PCR	70%
Provisions to meet PCR (Rs mn)	4,576
% Haircut on Std. Rest	50%
Haircut on Std. Rest (Rs mn)	1,260
% Haircut on 5/25	35%
Haircut on 5/25 (Rs mn)	1,064
% Haircut on SR book	20%
Haircut on SR book (Rs mn)	2,046
Total book value shave-off (Rs mn)	**8,946**

Source: Company, Nirmal Bang Institutional Equities Research

Summing up, all **incremental provisioning requirement taken together** amounts to Rs8.95bn, which would shave off 16%/14% of FY19E/FY20E book value. This implies that SIBL trades at 0.9x/0.7x FY19E/FY20E book value adjusted conservatively for all forms of recognised and quasi-recognised stressed assets. We believe this makes SIBL starkly cheap, given its current return ratio profile.

Drag on overall loan growth from previously declining gold loan book is no longer a factor

Banks having material exposure to gold loans (mainly certain Kerala/Tamil Nadu-focused banks) **suffered a consistent drag on overall loan book growth** from the decline of gold loan book over FY13-FY17 as a consequence of (1) Sustained global bear market in gold prices. (2) Worsening of regulatory regime for gold lending because of (a) Cap on loan-to-value ratio (LTV) at 60% and (b) Removal of priority sector status for gold loans. Now, we note that: (1) Gold prices have stabilised with froth having exited the system (2) Regulatory regime has improved with: (a) Increase in cap on LTV to 75% and (b) Cap on cash disbursement of Rs 20,000 on NBFCs, which is positive for banks.

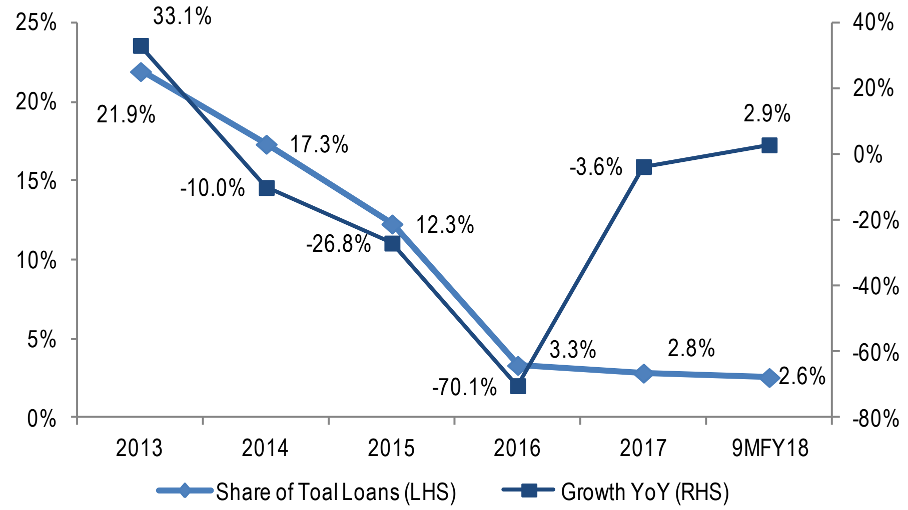
Consequently, banks such SIBL, City Union Bank and Federal Bank, which suffered a drag on overall loan book growth because of the decline in gold loan book are **no longer impacted by this factor** as: (1) Gold loans have reverted to growth path from a period of decline. (2) Gold loans are now a smaller portion of the overall loan book and hence, gold loans no longer move the needle as much, in any case, from an overall growth perspective.

Specifically, in the case of SIBL, gold loans formed 22% of total loans in FY13. Then, after rapidly declining at a CAGR of –34% over FY13-FY17, gold loans formed just 2.8% of total loans in FY17. In 3QFY18, gold loans grew 2.9% YoY and formed 2.6% of total loans. This growth, albeit tepid, is a **significant departure from the downward spiral witnessed over FY13-FY17**.

We further note that the **past 12 months have been a very poor macro environment for gold lending** in general on account of: (1) The body blow that bottom-of-the-pyramid lending received because of Demonetisation. (2) Drought conditions in parts of South India, where the bulk of gold loans are disbursed. We expect gold loan disbursement to improve going forward.

Most importantly, being just 2.6% of total loans as of 3QFY18 for SIBL, **gold loans no longer move the needle from an overall loan growth perspective** and can no longer be a drag like it was in the past.

Exhibit 4: SIBL's gold loan YoY growth and share in total loans – FY13-9MFY18



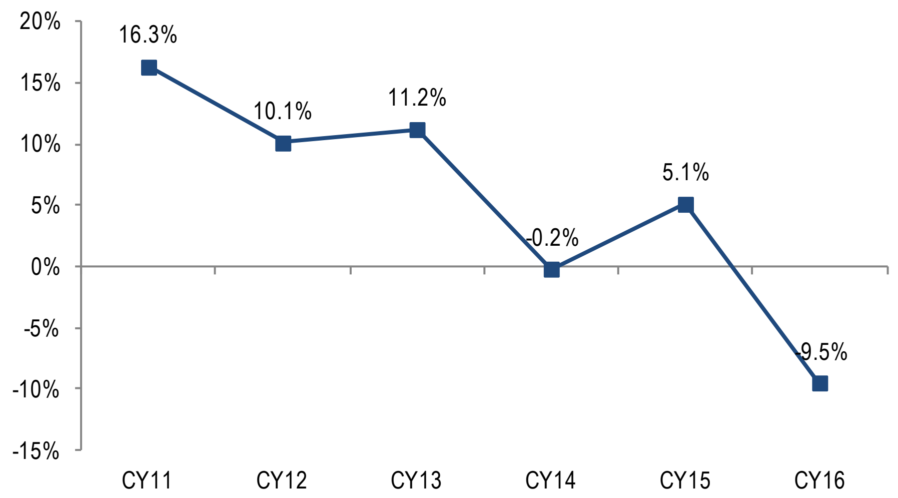
Source: Company, Nirmal Bang Institutional Equities Research

NRI business no longer under stress because of stabilisation of crude oil prices

Another aspect of certain Kerala/Tamil Nadu (particularly Kerala) focused banks is the relatively high share of NRI business, particularly from the Indian diaspora based in the Middle East. **The global bear market in crude oil prices had a direct impact on the economies of the nations in the Middle East** and, ultimately, on the job prospects and salary levels of the Indian diaspora working in the Middle East. This in turn affected the quantum of remittances from the Middle East into India, of which key Kerala-focused banks have a significant share.

Remittances from the GCC (Gulf Cooperation Council) nations dipped -9.5% in US dollar terms in calendar year 2016 on the back of a lag effect of crude oil price collapse. Remittances from the GCC formed as much as 53.7% of total remittances into India in CY16 (54.0% in CY15) and **significantly move the needle as far as total remittances into India are concerned**.

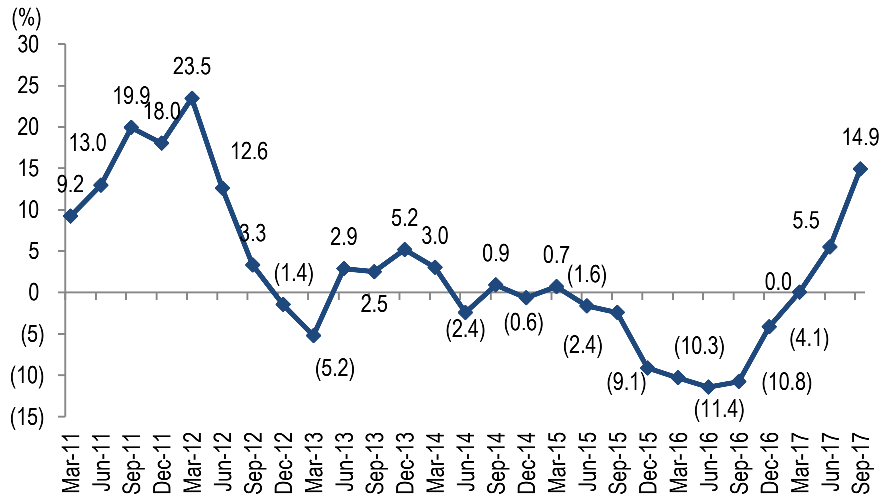
Exhibit 5: Remittances from GCC nations into India – YoY growth – CY11-16



Source: Company, Nirmal Bang Institutional Equities Research

Crude oil prices, however, have stabilised since and this has led to improved remittances into India with a **marked acceleration in 2QFY18**.

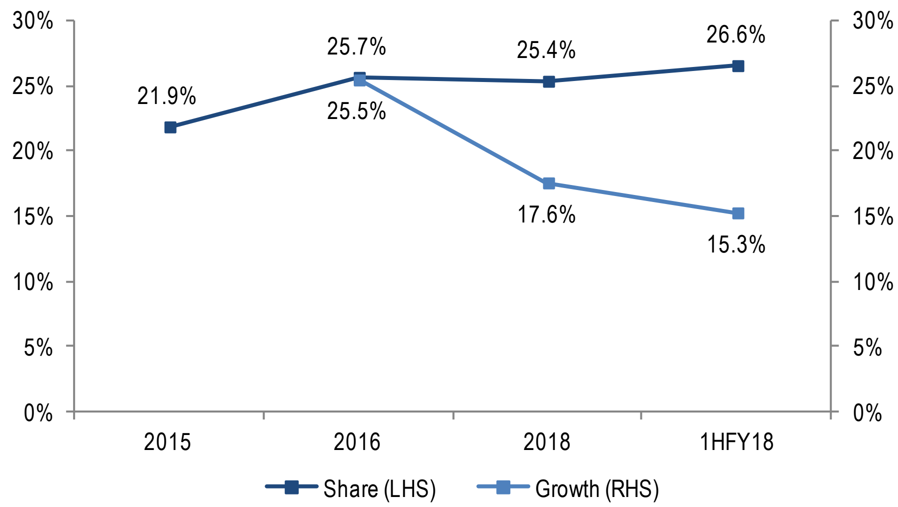
Exhibit 6: Total remittances into India –YoY growth – 1QCY11-3QCY17



Source: Company, Nirmal Bang Institutional Equities Research

This augurs well for SIBL (and also Federal Bank), which has significant NRI business, particularly on the deposits side. NRI deposits of SIBL formed 25.4% of total deposits in FY17 and this share has risen to 27% in 2QFY18.

Exhibit 7: NRI deposits – Share in total deposits and YoY growth - SIBL



Source: Company, Nirmal Bang Institutional Equities Research

While absolute growth of NRI deposits slowed to 12.6%YoY in 9MFY18 compared with 17.6% in FY17, the growth has to be viewed on the context of overall deposit growth of 7.1% YoY in 9MFY18 and consequent rising share of NRI deposits. Thus, strong **NRI deposit business is a competitive advantage for SIBL from a deposit generation perspective**.

Valuation and Outlook

We use the Residual Income Model to arrive at a first-principles' fair value for SBL. We assume a long-term sustainable average risk-free rate of 7% for India, an Adjusted Beta of 1.14 for SBL and an India-specific Equity Risk Premium of 6% and arrive at the overall Cost of Equity of 13.8% for SBL. On this basis, **we arrive at a price target of Rs 28, at which the stock will trade at 0.9x/0.8x FY19E/20E book value**.

SBL **currently trades at a FY19E/20E P/BV of 0.7x/0.6x, which makes it significantly under-valued** given its FY19E/20E RoE profile of 10.7%/15.3% and long-term outlook. Consequently, we believe that the multiple of 0.9x/0.8x implied by our price target of Rs 28 is reasonable.

Exhibit 8: Consensus vs Our Estimates

	Our estimate			Bloomberg estimate			*% Variance*		
(Rsmn)	**FY18E**	**FY19E**	**FY20E**	**FY18E**	**FY19E**	**FY20E**	***FY18E***	***FY19E***	***FY20E***
Net interest income	21,109	26,447	34,037	20,004	22,986	26,620	*5.5*	*15.1*	*27.9*
Operating profit	13,891	17,391	24,471	15,284	16,716	19,499	*(9.1)*	*4.0*	*25.5*
Profit after tax	4,111	5,743	9,223	3,440	6,500	8,461	*19.5*	*(11.7)*	*9.0*

Source: Company, Nirmal Bang Institutional Equities Research

Key Risks

Recent RBI notification overhauling stress resolution is a system-wide risk for all banks with material corporate lending business

The recent RBI notification overhauling stressed asset resolution and promoting consonance (rather than divergence) across banks is a system-wide risk for all banks that have a material corporate lending business. However, we do not think SBL should be significantly impacted given that the divergence disclosed with RBI's assessment of its asset quality in the FY17 Annual Report was minimal (1.4% of FY16 loan book).

A re-emergence of the crude oil bear market can put pressure on the NRI deposits business

If crude oil starts to revisit a bear market scenario on the back of a renewed China slowdown or other reasons, it could affect NRI deposits business. However, this is not our base case.

Company Overview

South Indian Bank is a midcap private sector bank with a branch network of 852 branches and 1328 ATMs. It has a loan book is Rs 524bn, of which the Retail, Agri, MSME and Corporate split is 25%, 14%, 25% and 36%, respectively (own classification). On Basel III basis, 40% of Retail and Corporate assets comprise Retail. South Indian Bank has displayed a loan CAGR of 11% over FY12-17. Its yield on advances in its latest reported quarter was 9.9%.

South Indian Bank has a CASA ratio of 24.9% and its cost of funds is 5.5% and, as a result, it registered a net interest margin of 2.9%. Its cost to income ratio stood at 45%. Consequently, it delivered a return on assets of 0.58% and a return on equity of 9.11%, implying a financial leverage of 15.7. Its employee count stood at 7,447. Its Capital Adequacy Ratio was 12.5%.

Exhibit 9: Management team/ Key executives

Name	Designation	Experience
V. G. Mathew	MD, CEO, and Executive Director	Mr. V. G. Mathew has been Managing Director, Chief Executive Officer and Executive Director of The South Indian Bank Ltd. since October 1, 2014. Mr. Mathew served as Chief General Manager of Corporate Accounts Group at State Bank of India. He served as Executive Vice President of The South Indian Bank Ltd. since January 2014. Mr. Mathew holds bachelor's degree and a master's in science from the University of Kerala Additionally, he is a certified associate of the Indian Institute of Bankers.
C. P. Gireesh	CFO and Joint GM	Mr. C. P. Gireesh has been Chief Financial Officer of The South Indian Bank Ltd since July 1, 2012 and serves as its Joint General Manager. Mr. Gireesh served as an Assistant General Manager of The South Indian Bank Ltd. until July 2012 and served as its Deputy General Manager.
Joseph K. Thomas	Executive Vice President of Operations	Mr. Thomas K. Joseph has been an Executive Vice President of Operations at The South Indian Bank Ltd. since August 17, 2017. Mr. Joseph served as Executive Vice President of Administration at The South Indian Bank Ltd. since December 31, 2015 until August 17, 2017. Mr. Joseph served as Chief General Manager at The South Indian Bank Ltd. Mr. Joseph served as General Manager of Mumbai Regional Office, Deputy General Manager and Assistant General Manager at The South Indian Bank Ltd. Mr. Joseph heads Departments such as Risk Management, Technology, Marketing, Corporate Financial Management, Human Resource and Inspection & Vigilance. He was the Head of Credit in the Chief General Manager (CGM) cadre and handling a portfolio of Rs.400bn. He was instrumental in the execution of the Retail Strategy of the Bank which saw significant growth in the MSME & Agriculture Sectors. He joined the bank as an Industrial Officer in 1984 and has vast experience in heading major Branches, Regional Offices etc.
Biju E. Punnachalil	Chief Risk officer	Mr. Biju E. Punnachalil has been the Chief Risk Officer at The South Indian Bank Limited since April 27, 2017.
G. Sivakumar	Executive Vice President of Credit	Mr. G. Sivakumar has been an Executive Vice President of Credit at The South Indian Bank Ltd. since December 15, 2015. Mr. Sivakumar heads Credit and Legal Departments. He has over 35 Years of Experience in Domestic and International Banking in India and abroad. Before joining South Indian Bank, he served as the General Manager and Head of Private Equity Verticalin State Bank of India where he was responsible for Private Equity and Venture Capital Investments made by the Bank. He also served as Head of Project Finance - South and Head of Corporate Banking and Trade Finance Department in Bahrain for State Bank of India. He has in depth exposure in Corporate Finance, Project Appraisal, Trade Finance and Credit Management functions. He served as a Nominee Director on the Board of Directors of Bill Desk, SBI Macquaire Infrastructure Trustee private limited, Oman Indian joint Investment Fund and CSIR Tech Pvt Ltd and Investment Committee of more than ten Alternative Investment Funds.

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 10: Board members

Name	Designation	Experience
V. G. Mathew	MD, CEO, and Executive Director	Mr. V. G. Mathew has been Managing Director, Chief Executive Officer and Executive Director of The South Indian Bank Ltd. since October 1, 2014. Mr. Mathew served as Chief General Manager of Corporate Accounts Group at State Bank of India. He served as Executive Vice President of The South Indian Bank Ltd. since January 2014. Mr. Mathew holds bachelor's degree and a master's in science from the University of Kerala Additionally, he is a certified associate of the Indian Institute of Bankers.
Salim Gangadharan	Non-executive part time Chairman	Mr. Salim Gangadharan has been the Non-Executive Part-Time Chairman of The South Indian Bank Ltd. since November 2, 2016 and its Independent Director since January 16, 2014. He served as Regional Director of Kerala and Lakshadweep at Reserve Bank of India since April 2012 until October 2013. Mr. Gangadharan has been working with the Reserve Bank of India (RBI) from over 30 years. In his career in Reserve Bank of India, he has worked in various Operational Departments, particularly in bank supervision and financial markets. He served as Chief General Manager of Reserve Bank of India. Mr. Gangadharan served as a Director at Central Bank of India from July 30, 2010 to March 13, 2014. He was also a Member Faculty in the Bankers' Training College of the Reserve Bank of India, for five years and handled several seminars and conferences on Risk Management, Payment Systems and Treasury Management etc. He was also on secondment to the Central Bank of Oman for five years.
John Joseph Alapatt	Independent non-executive Director	Dr. John Joseph Alapatt serves as Chairman of C.E.P.A.B. Dr. Joseph serves as a Director in Janakshemam Kuries Pvt. Ltd., Thrissur. Dr. Alapatt has been an Independent Non-Executive Director of The South Indian Bank Ltd. since September 24, 2012. He served as an Independent Non-Executive Director of The South Indian Bank Ltd. from December 2, 2002 to February 12, 2010. He is an industrialist, managing a SSI unit. Dr. Alapatt holds a Bachelor of Medicine and Bachelor of Surgery degree as well as a Post-Graduate diploma from Bangalore University.
Mohan E. Alapatt	Independent non-executive Director	Mr. Mohan E. Alapatt has been an Independent Non-Executive Director of The South Indian Bank Ltd. since March 1, 2010 and previously served as its Independent Non-Executive Director until April 23, 2007. Mr. Alapatt holds a bachelor's degree in engineering from PSG College of Technology, Tamil Nadu.
K. Thomas Jacob	Independent non-executive Director	Mr. K. Thomas Jacob has been an Independent Non-Executive Director of The South Indian Bank Ltd. since August 31, 2010. Mr. Jacob holds a bachelor's degree in science from University of Kerala. He is also a fellow of the Institute of Chartered Accountants of India. Further, he has completed practical training and passed the Information Systems Audit ("ISA") assessment test conducted by the Institute of Chartered Accountants of India.
Francis Alapatt	Independent non-executive Director	Mr. Francis Alapatt has been an Independent Non-Executive Director of The South Indian Bank Ltd. since November 1, 2013. Mr. Alapatt holds a bachelor's degree in science.
Ranjana S. Salgaocar	Independent non-executive Director	Mrs. Ranjana S. Salgaocar serves as a Director of Pyramid Finance Ltd. Mrs. Salgaocar has been an Independent Non-Executive Director of The South Indian Bank Ltd. since October 1, 2014. She served as a Director of Syndicate Bank Limited until February 25, 2006. She has vast experience in serving as member of various Government and Non-Governmental Bodies. She authored a book "The Pleasure of Your Company" on Personality, Enrichment, Etiquette and Entertaining.
Achal Kumar Gupta	Non-Executive Additional Independent Director	Mr. Achal Kumar Gupta has been a Non-Executive Additional Independent Director at The South Indian Bank Limited since January 11, 2017. He has served as Deputy Managing Director at IFCI Limited since December 12, 2013 until December 11, 2016. Mr. Gupta served as the Managing Director of State Bank of Patiala. He served as Managing Director, Chief General Manager (Corporate Accounts Group) and Chief Executive Officer of SBI Funds Management Private Limited. He served as Whole Time Director at IFCI Limited since December 12, 2013 until December 11, 2016. He served as an Executive Officer of Corporate Banking Division at State Bank of India. He was responsible in the Corporate Banking Division at State Bank of India. He served as Company Secretary of The State Trading Corporation of India Ltd. from September 2010 to December 9, 2010. He served in various areas such as credit administration, international banking operations, branch management, agricultural banking and relationship banking at State Bank of India. Mr. Gupta served as Regional Manager at State Bank of India.
Parayil George John Tharakan	Independent non-executive Director	Mr. Parayil George John Tharakan has been an Independent Non-Executive Director at The South Indian Bank Ltd. since November 25, 2014. Mr. Tharakan served as an Additional Director at The South Indian Bank Ltd. since November 25, 2014. He holds a bachelor's degree in commerce from the University of Kerala and a LLB degree from Bangalore University.

Source: Company, Nirmal Bang Institutional Equities Research

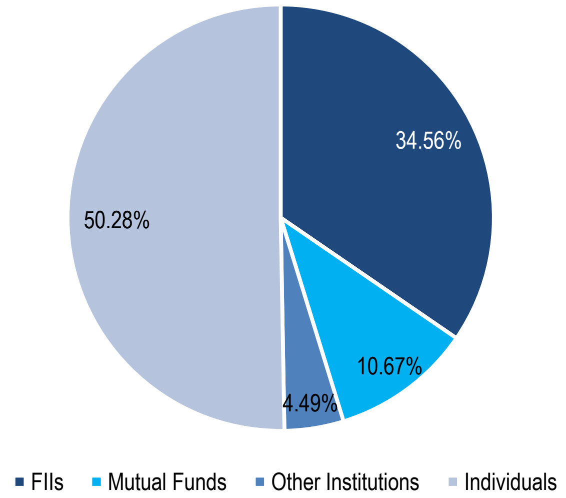
Shareholding Information

Exhibit 11: Key shareholders

	(%)
Promoter	
Non - promoter	
Yusuffali Musaliam Veettil Abdul Kader .	4.9
Lavender Investments Limited	4.9
First Carlyle Ventures Mauritius	4.9
Bodies Corporate	4.8
Life Insurance Corporation Of India	3.2
Iva International Fund	2.6
Cx Securities Limited	2.0
Acacia Banyan Partners	1.7
Quant Foreign Value Small Cap Fund	1.5
Acacia Partners, Lp	1.4
Acacia Institutional Partners, Lp	1.2
Icici Prudential Banking And Financial Services Fund	1.1
Alternate Investment Funds	0.5

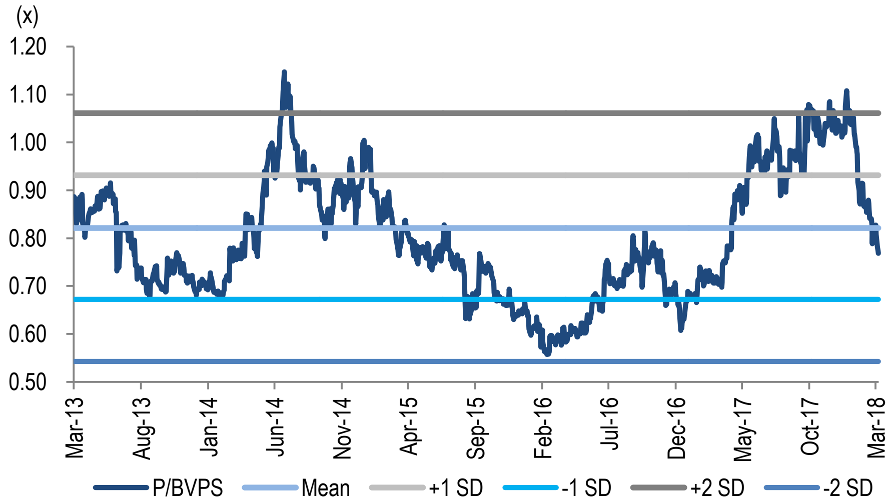
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 12: Shareholding pattern



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 13: One-year forward P/BV



Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 14: Income statement

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Interest Income	55,572	58,471	65,005	77,544	95,263
Interest expense	40,475	41,716	43,896	51,097	61,226
Net interest income	**15,097**	**16,754**	**21,109**	**26,447**	**34,037**
Fees	519	550	758	1,024	1,458
Other Income	4,656	6,623	5,832	6,581	8,116
Net Revenue	20,272	23,927	27,700	34,051	43,611
Operating Expense	11,478	11,764	13,809	16,660	19,140
-Employee Exp	6,923	6,765	7,741	9,434	10,391
-Other Exp	4,556	4,999	6,068	7,226	8,750
Pre-provision Profit	**8,794**	**12,163**	**13,891**	**17,391**	**24,471**
Provisions	3,696	6,144	7,663	8,690	10,497
-Loan Loss Provisions	3,911	6,201	6,808	7,718	9,400
-Provisions for investment	432	422	854	972	1,097
-Other Provisions	(647)	(478)	-	-	-
PBT	5,097	6,019	6,228	8,701	13,974
Taxes	1,764	2,077	2,118	2,958	4,751
PAT	**3,333**	**3,942**	**4,111**	**5,743**	**9,223**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 16: Balance sheet

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Equity Capital	1,350	1,803	1,803	1,803	1,803
Reserves & Surplus	37,106	46,682	49,794	54,387	62,289
Shareholder's Funds	**38,456**	**48,485**	**51,596**	**56,190**	**64,092**
Deposits	**557,207**	**661,175**	**757,201**	**888,576**	**1,061,991**
-Current deposits	19,831	27,526	37,860	46,206	58,410
-Saving deposits	104,758	129,938	151,440	195,487	233,638
-Term deposit	432,618	503,712	567,901	646,883	769,944
Borrowings	26,150	19,578	5,835	31,762	53,553
Other liabilities	12,936	13,884	28,430	45,161	63,738
Total liabilities	**634,749**	**743,122**	**843,063**	**1,021,690**	**1,243,374**
Cash/Equivalent	32,745	38,877	46,529	55,834	68,118
Advances	410,857	463,895	547,396	656,875	801,387
Investments	147,439	194,297	194,531	244,173	296,894
Fixed Assets	4,870	6,561	7,217	7,939	8,733
Other assets	38,837	39,492	47,390	56,868	68,242
Total assets	**634,749**	**743,122**	**843,063**	**1,021,690**	**1,243,374**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 15: Key ratios

Y/E March	FY16	FY17	FY18E	FY19E	FY20E
Growth (%)					
NII growth	10.5	11.0	26.0	25.3	28.7
Pre-provision profit growth	(0.4)	38.3	14.2	25.2	40.7
PAT growth	8.2	18.3	4.3	39.7	60.6
Business (%)					
Deposit growth	7.3	18.7	14.5	17.4	19.5
Advance growth	9.9	12.9	18.0	20.0	22.0
Business growth	8.4	16.2	16.0	18.5	20.6
CD	73.7	70.2	72.3	73.9	75.5
CASA	22.4	23.8	25.0	27.2	27.5
Operating effeciency (%)					
Cost-to-income	56.6	49.2	49.9	48.9	43.9
Cost-to-assets	1.9	1.7	1.7	1.8	1.7
Productivity (Rs mn)					
Business per branch	1,160.7	1,323.6	1,482.5	1,698.3	1,982.3
Business per employee	138.2	161.3	176.5	188.7	227.2
Profit per branch	4.0	4.6	4.7	6.3	9.8
Profit per employee	0.5	0.6	0.6	0.7	1.1
Spreads (%)					
Yield on advances	11.1	10.2	10.0	10.1	10.2
Yield on investments	6.4	7.2	7.3	7.4	7.5
Cost of deposits	7.1	6.5	6.1	6.1	6.0
Yield on assets	9.9	9.5	9.1	9.3	9.4
Cost of funds	7.2	6.6	6.1	6.1	6.0
NIMs	2.7	2.7	3.0	3.2	3.3
Capital adequacy (%)					
Tier I	9.8	10.9	9.9	9.5	9.1
Tier II	2.0	1.5	2.3	1.9	1.8
Total CAR	11.8	12.4	12.2	11.4	10.9
Asset Quality (%)					
Gross NPA	3.8	2.5	3.5	3.8	3.5
Net NPA	2.9	1.5	2.5	2.8	2.3
Provision coverage	22.6	39.1	30.3	29.1	33.3
Slippage	4.1	3.9	3.0	2.5	2.1
Credit-cost	1.0	1.4	1.3	1.2	1.2
Return (%)					
ROE	9.0	9.1	8.2	10.7	15.3
ROA	0.5	0.6	0.5	0.6	0.8
RORWA	1.0	1.0	0.9	1.0	1.4
Per share (Rs)					
EPS	2.5	2.2	2.3	3.2	5.1
BV	28.5	26.9	28.6	31.2	35.6
ABV	19.5	23.0	21.1	21.1	25.1
Valuation (x)					
P/E	9.4	10.6	10.2	7.3	4.5
P/BV	0.8	0.9	0.8	0.7	0.7
P/ABV	1.2	1.0	1.1	1.1	0.9

Source: Company, Nirmal Bang Institutional Equities Research

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DCB Bank

26 March 2018

Reuters: DCBA.NS; Bloomberg: DCBB IN

Initiating Coverage

Enter Harvest Mode

DCB Bank (DBL) is a mid-cap private sector bank with a network of 314 branches and loan book size of Rs186bn. We believe it is ripe for investment entry as: (1) It has entered harvest mode post accelerated branch augmentation phase (2) It will benefit from being the most retailised mid-cap private sector bank on the asset side (3) It has eschewed a catchment area approach which augurs well for long-term scalability (4) It maintains pristine asset quality on the back of sound risk management approach. We initiate with Buy rating to DBL with a target price of Rs196, which values the stock at 1.9x/1.7x FY19E/FY20E P/BV.

DBL has entered harvest mode after an accelerated branch expansion phase: DBL's two-year plan (announced in October 2015) of augmenting branch count by 150+ from the then branch count of 160 stands complete as of 3QFY18-end. The transient constriction in return ratios stands to revert back to the pre-plan level of 14%+ and potentially higher on the back of: (1) Low incremental branch addition run-rate of 10-15 per year (which is lower than pre-plan) (2) An 'all branches – all products' strategy that will maximise the benefit from augmented asset capacity.

DBL has the most granular retailised loan portfolio in the private sector basket: The proportion of DBL's retail assets in total retail and corporate assets (as per Basel III definition that enables apple-to-apple comparison) is 79% compared with 10%-69% for mid-cap peers. This results in yield leadership as the retailised loan portfolio is not the result of hyper-competitive salaried home loans, but of loans against property (42% of loan book) with mostly MSME-end use and MSME loans (12% of loan book).

DBL is not fettered by any legacy home-state considerations: A key aspect of DBL's DNA is that it not bound by a contiguous region-focused expansion pattern. A judicious branch expansion pattern has seen its branch share in top geographical region's fall by 14% points over FY14-February 2018 compared with -1%-8% for mid-cap peers. Consequently, its branch share in top regions stands at 31% compared with 44%-96% for mid-cap peers, underlining its balanced approach which augurs well for long-term scalability.

DBL maintains pristine asset quality on the back of sound risk management approach: DBL has maintained a low stressed assets ratio (GNPAs + standard restructured) of 2.0% as of 3QFY18-end compared with 3.3%-19.0% for mid-cap peers, barring RBL Bank at 1.7%. The sound underlying asset quality will sustain because of: (1) Low ultra-stressed sector exposure at 2.5% compared with mid-cap peers at 4.2%-27.6%. (2) Insistence of formal documents for all MSME loan business (3) Limited stress pipeline comprising standard restructured, SDR, 5/25, S4A and Security Receipts book at just 0.1% compared with 0.2%-13.3% for midcap peers.

Valuation and outlook: We have used the residual income model to value DBL and arrived at a target price of Rs196. DBL currently trades at 1.6x/1.4x FY19E/FY20E P/BV and we believe that our target price is reasonable given DBL's RoE profile of 12.4%/14.2% for FY19E/FY20E and long-term outlook.

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Net Interest Income	6,195	7,971	9,597	12,557	15,427
Pre-Provision Profit	3,490	4,182	4,955	7,205	9,248
PAT	1,945	1,997	2,569	3,736	4,830
EPS (Rs)	6.8	7.0	8.3	12.1	15.7
BV (Rs)	63.0	77.3	92.2	103.1	117.6
P/E	23.9	23.4	19.6	13.5	10.4
P/BV	2.6	2.1	1.8	1.6	1.4
Gross NPA (%)	*1.5*	*1.6*	*1.8*	*1.7*	*1.5*
Net NPA (%)	*0.8*	*0.8*	*1.2*	*1.2*	*1.0*
ROA (%)	*1.1*	*0.9*	*1.0*	*1.2*	*1.2*
ROE (%)	*11.5*	*10.0*	*10.2*	*12.4*	*14.2*

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: Banking

CMP: Rs160

Target Price: Rs196

Upside: 23%

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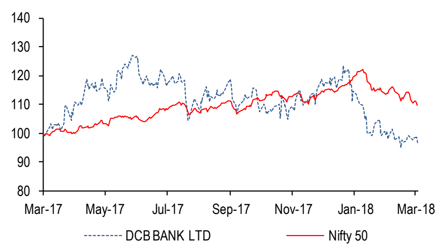
Key Data

Current Shares O/S (mn)	308.1
Mkt Cap (Rsbn/US$mn)	49.0/753
52 Wk H / L (Rs)	213/155
Daily Vol. (3M NSE Avg.)	1,494,572

Shareholding (%)	1QFY18	2QFY18	3QFY18
Promoter	15.0	15.0	15.0
Public	85.0	85.0	85.0
Others	-	-	-

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
DCB Bank	(3.2)	(13.9)	(3.8)
Nifty Index	(4.8)	0.3	10.0

Source: Bloomberg

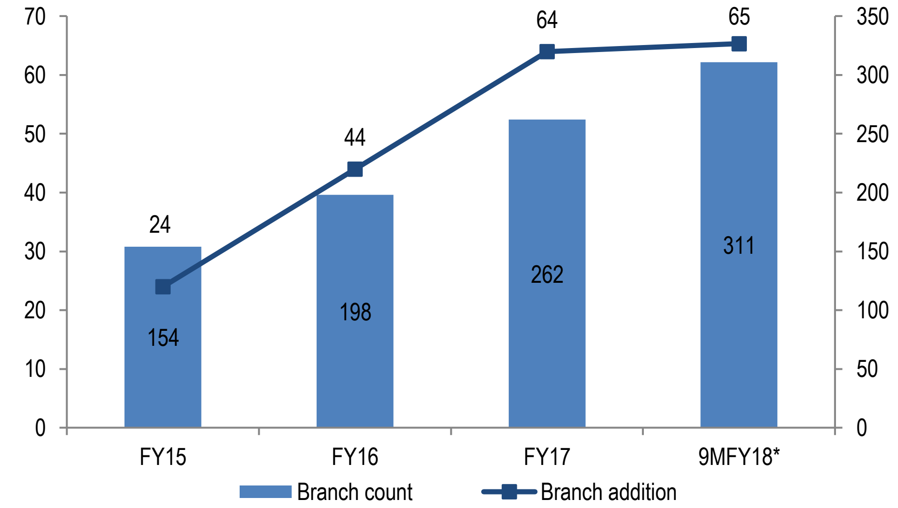
DBL has entered harvest mode post accelerated branch addition phase

In October 2015, DBL had announced a two-year plan of accelerated branch expansion to add required asset product capacity, which led to an increase in opex level and a concomitant constriction in return ratios. In 3QFY18, this **process of accelerated capacity addition was complete** with spillover effects to be felt till 4QFY18. Branch infrastructure and relationship managers added would start performing at expected level with a roughly six-month lag and the full impact of DBL's capacity augmentation strategy would be felt in FY19.

The stated plan of DBL was to add 150+ branches to its then branch count of 160, which it has now achieved, taking the branch count to 311 as of 3QFY18-end. For the next two years, DBL will settle into a lower opex profile given the fact that the management has expressed its satisfaction with the current network capacity and stated that, going forward, branch addition would take place at a **rough run-rate of 10-15 branches per annum**, which is significantly lower than current levels and even lower than the pre-plan number of 24 in FY15.

Importantly, augmented capacity will fetch a higher quantum of business than pre-plan capacity. DBL has an '**all-branches-all-products'** strategy and every branch (other than rudimentary URC branches) are manned by personnel equipped to deliver a wide bouquet of asset products. The management had given guidance of a C/I ratio of 55% and RoE of 14% by 4QFY19, which we find credible and would mark a reversion to pre-plan return ratio level.

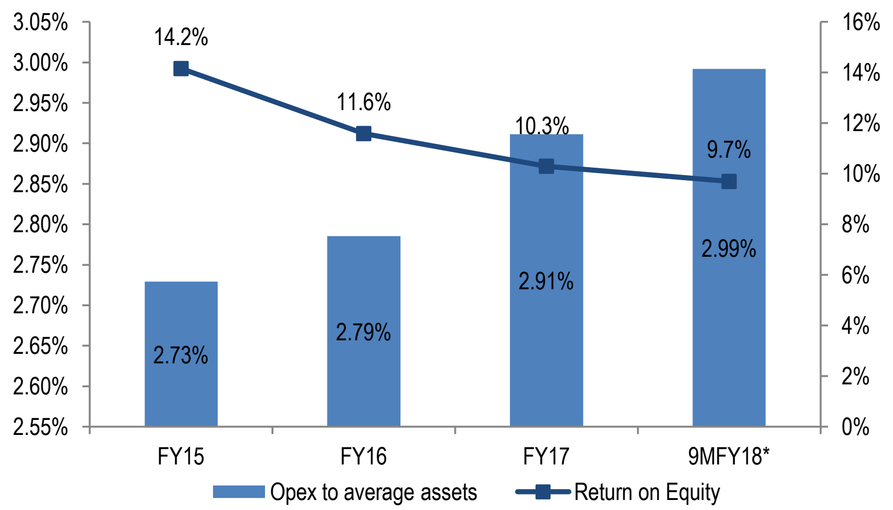
Exhibit 1: Pace of branch addition during the accelerated branch augmentation plan



**Branch addition annualised*

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 2: Accelerated branch augmentation plan was a period of rising opex-falling RoE



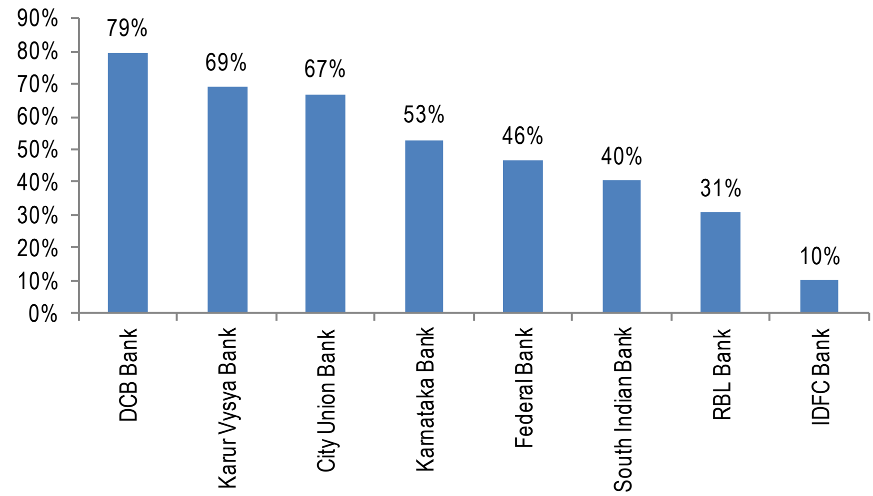
**RoE annualised*

Source: Company, Nirmal Bang Institutional Equities Research

DBL is the most retailised mid-cap bank on the asset side

Each bank has its own way of **defining small-ticket lending** for the purpose of disclosure in company presentations and it may not be straightforward to compare the proportion of small-ticket lending across banks using the respective banks' presentation disclosures. To make an appropriate apple-to-apple comparison, we have compared the segmental break-up of assets as provided in the respective banks' stock exchange releases, where the **Reserve Bank of India's (Basel III) definition for retail and corporate loans** is followed. This analysis reveals that DBL is the most retailised mid-cap bank on the asset side in our expanded peer set of key mid-cap banks.

Exhibit 3: Proportion of retail assets in total retail and corporate assets – 1HFY18



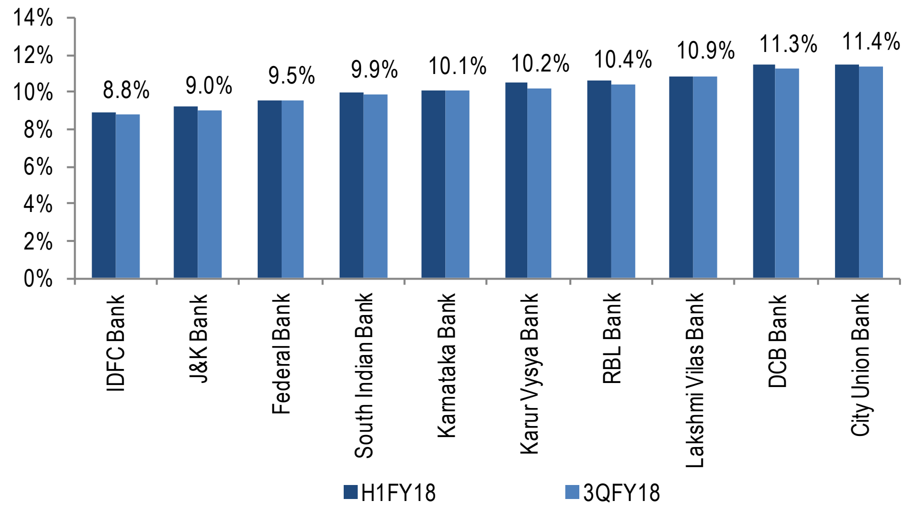
Source: Company, Nirmal Bang Institutional Equities Research; Karnataka Bank as of FY17

The proportion of retail assets in total retail and corporate assets of DBL is 79% compared with 10%-69% for key peers as of 1HFY18-end. **High retail proportion is attractive** as it implies, ceteris paribus, a high loan yield franchise.

DBL possesses high-yielding loan franchise because of a high proportion of MSME loans

17% of DBL's loan book is explicitly classified as SME + MSME. Of the 42% proportion for mortgages, a lion's share comes from loans against property, for which the **end use is MSME**. Hence, a significant proportion of loan book is focused on high-yielding MSME loans. Consequently, DBL's loan yield is at 11.4% for 1HFY18 compared with 8.9%-10.9% for our expanded set of mid-cap peers, barring City Union Bank at 11.5%.

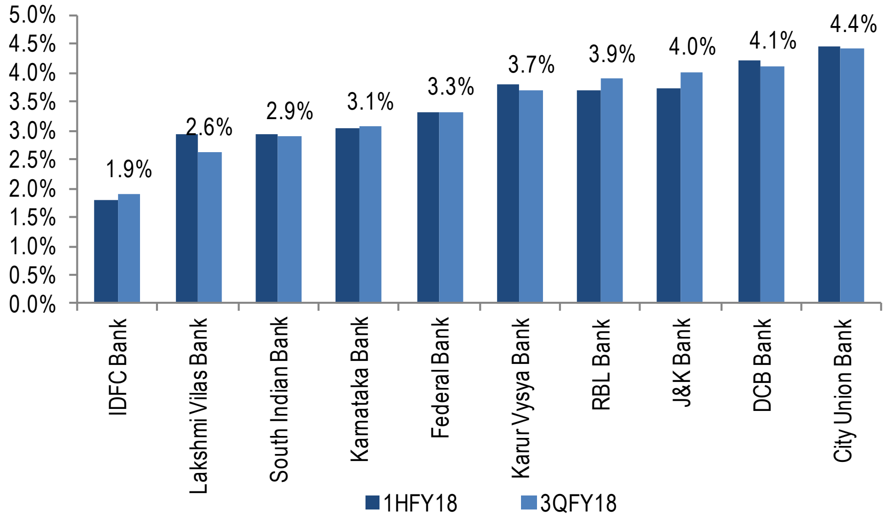
Exhibit 4: Loan yield – 1HFY18 and 3QFY18 – DBL versus peers



Source: Company, Nirmal Bang Institutional Equities Research

Higher loan yields also translate into **higher net interest margin** for DBL at 4.2% for 1HFY18 compared with 1.8%-3.7% for mid-cap peers, barring City Union Bank at 4.5%.

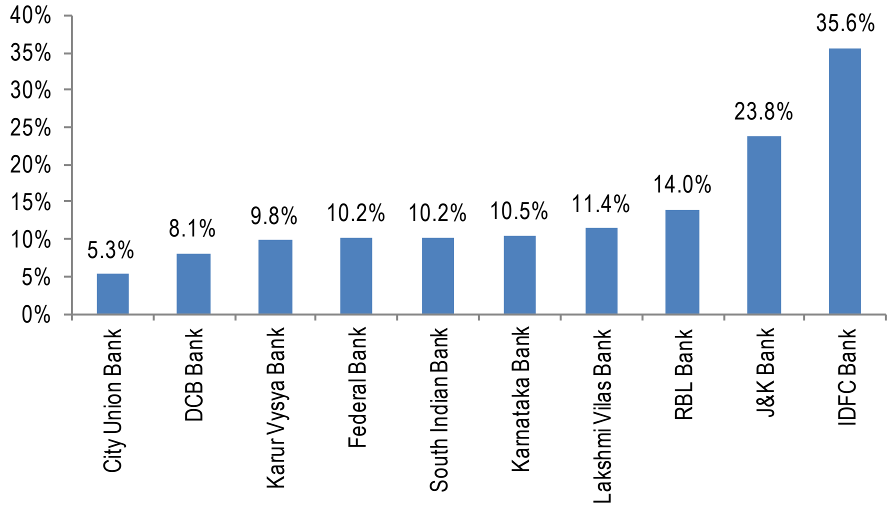
Exhibit 5: Net interest margin – 1HFY18 and 3QFY18 – DBL versus



Source: Company, Nirmal Bang Institutional Equities Research

High loan yields for DBL are also a function of **higher loan book granularity**. It is not straightforward to make an exact apple-to-apple comparison of loan book granularity, but the best available information is the concentration of Top 20 borrowers. Proportion of Top 20 borrowers in total loan book was 8.1% for DBL in FY17 compared with 9.8%-35.6% in case of mid-cap peers, barring City Union Bank whose proportion was lower at 5.3%.

Exhibit 6: Share of Top 20 borrowers in total loan book – FY17 – DBL versus peers

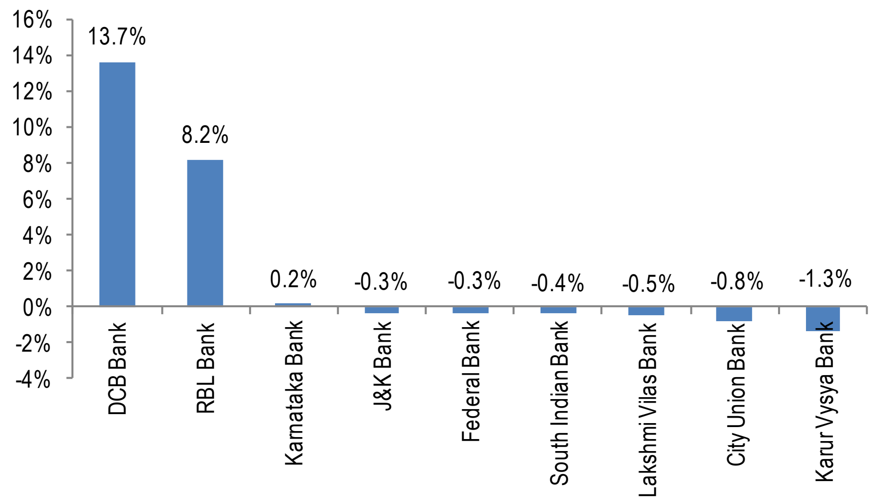


Source: Company, Nirmal Bang Institutional Equities Research

DBL will benefit from its policy of having a truly pan-India approach

In our expanded peer set of mid-cap banks, we note that two banks, viz. RBL Bank and DBL, have a truly pan-India approach. We note that this aspect is key from a long-term balance sheet growth perspective. Banks with a **contiguous region-focused growth pattern** because of legacy or other reasons would have lesser growth opportunities, ceteris paribus, than banks with a pan-India growth approach.

Exhibit 7: Chart showing reduction in branch share of primary geographical region

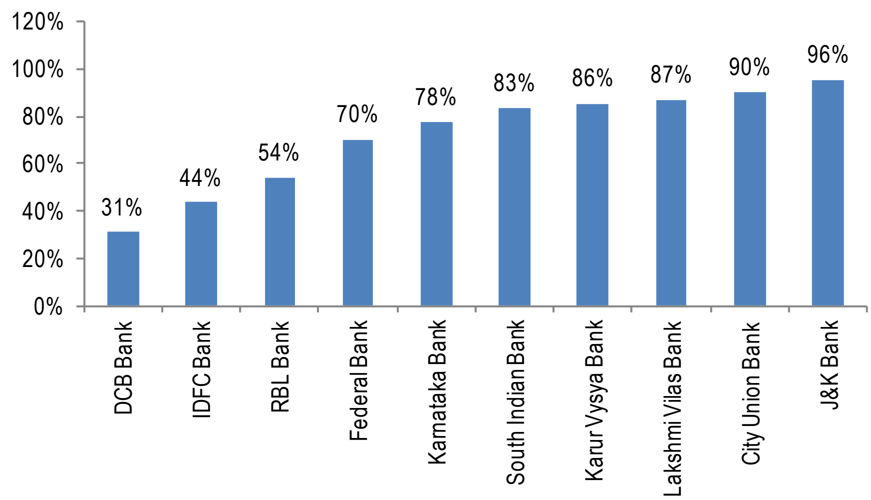


Source: RBI, Nirmal Bang Institutional Equities Research

DBL already had a reasonably balanced branch distribution back in FY14, but it **actively added branches in a manner whose by-product is the reduction of branch share in its then top region** (western region) from 42% (as of FY14-end) to 29% as of end-February 2018.

As a result, **DBL's exposure to its top region (now, northern region) is 31% compared with 44-96% for mid-cap peers**. This underlines the balanced, pan-India approach of DBL, which augurs well from a long-term scalability perspective.

Exhibit 8: Branch share of top region – February 2018 – DBL versus peers



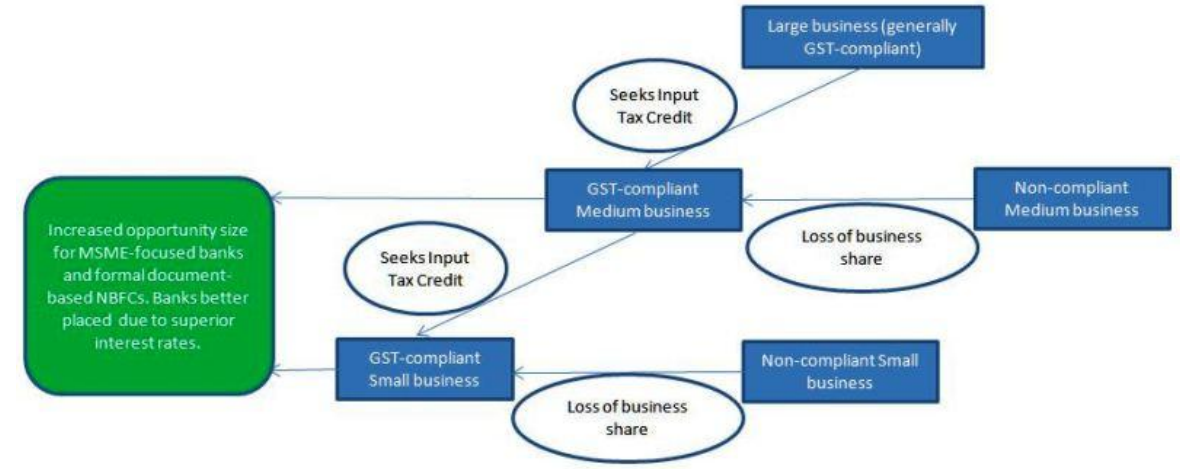
Source: RBI, Nirmal Bang Institutional Equities Research

Regulatory regime providing significant incremental fillip for bank lending to MSME segment, on which DBL is most focused

Formalisation of MSME segment due to GST increases the opportunity size for bank lending

With the advent of GST regime and the ongoing **formalisation of the MSME segment**, a rising quantum of MSME business would be backed by formal documentation, which directly enhances the opportunity size in favour of MSME-focused banks such as DBL, diverting business away, on balance, from NBFCs disbursing loans to the MSME segment.

Exhibit 9: GST will increase the opportunity size for banks focused on MSME lending



Source: Nirmal Bang Institutional Equities Research

Central government has acute focus on MSME segment as a driver of employment

Job creation is a key mandate for the central government and they realize full well that **supporting the MSME segment is necessary to kickstart job creation for the ever-growing Indian youth base**. There is clear regulatory support for the MSME segment, which will have a positive second order impact for bank lending to the MSME segment. The steps taken by the government include (1) augmentation of MUDRA lending target from Rs 1.22 trn in FY16 to Rs 2.44 trn in FY18 and then to Rs 3 trn for FY19E (2) reducing corporate tax rate for companies with annual turnover below Rs2.5bn (in FY17) to 25% (the limit was Rs 0.5bn earlier) (3) Rs 38bn allocated towards credit support, capital, credit subsidy and innovation in the MSME segment for FY19E (4) Credit guarantee scheme for micro and small enterprises covers collateral free credit upto Rs 20 mn per borrowing unit.

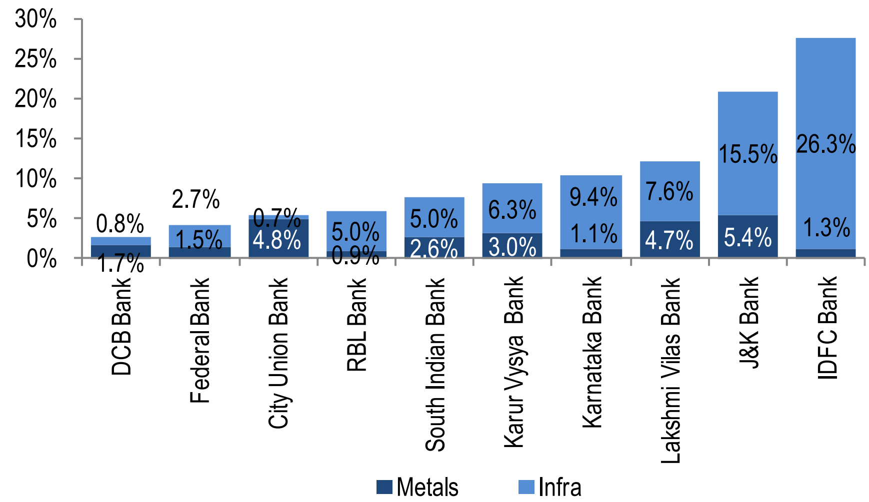
DBL's loan against property business, which is mostly for MSME-end use is 42% of total loans and MSME loans, explicitly, are a further 12% of total loans. So, nearly **~50% of DBL loan book is towards MSME-end use** and the bank is, hence, a key beneficiary of the government's thrust on the MSME segment.

DBL's superior asset quality is a result of tight underwriting standards

DBL has been prudent in its sectoral choices and has the lowest credit exposure to metals and infrastructure sectors

DBL's credit exposure to the most stressed sectors of the Indian economy, viz. metals and Infrastructure, stood at 2.5% of total funded credit as of 1HFY18-end compared with 4.2%-27.6% for mid-cap peers. In fact, DBL is not disbursing any major **new loans to the infrastructure sector**.

Exhibit 10: Share of metals and infrastructure sectors in total funded credit – 1HFY18 – DBL versus peers



N.B. Metals include iron & steel and non-ferrous metal segments. Infrastructure sector includes energy / power, telecom, transport and other related segments.

Source: Company, Nirmal Bang Institutional Equities Research

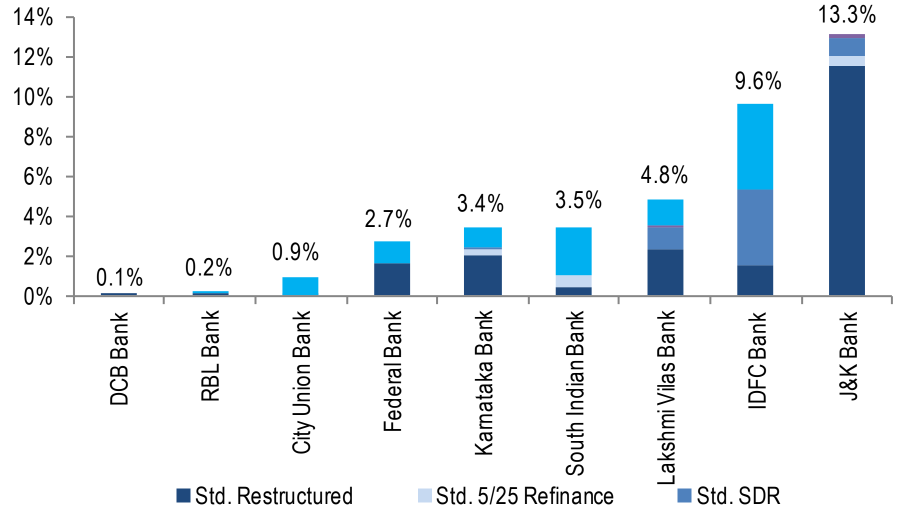
DBL is a small-ticket MSME-focused lender having strong preference for formal documents

DBL's average MSME loan ticket size is about Rs4mn-Rs5mn, which earmarks it as a particularly small-ticket focused MSME lender. At the same time, despite being a small-ticket MSME lender and even prior to the Goods and Services Tax (GST) regime kicking in, DBL's MSME lending was based on formal value added tax or VAT receipts. In effect, DBL operates in a **sweet spot of the yield and credit cost trade-off**.

DBL has a limited stressed asset pipeline which indicates superior underlying asset quality

Apart from low stressed sector loan exposure, a small stressed asset pipeline of DBL is also indicative of its superior underlying asset quality. DBL's stressed asset pipeline as of 3QFY18-end stood at 0.1% of loan book compared with 0.2%-13.1% for mid-cap peers. This clearly shows that DCB was nearly absent from the corporate credit binge of the mid-noughties or the re-emergence of risk-love during 2010-13.

Exhibit 11: Stressed asset pipeline net of overlaps – 3QFY18 – DBL versus peers



N.B. Stressed asset pipeline is the standard non-overlap loan book exposure to traditional restructured loans (CDR, JLF), SDR, flexible structuring (5/25), S4A and net book value of Security Receipts.

Source: Company, Nirmal Bang Institutional Equities Research; IDFCB "Other stressed assets excl restructured" shown as SDR

Other sound risk management practices underline the low-risk DNA of DBL

A variety of processes and practices followed by DBL in various segments in which it operates in earmarks it as a risk management champion that understands the importance of **sustainable growth at a reasonable velocity while creating minimal asset quality friction**. Some of these aspects we like to highlight are: (1) Collateral used for disbursing SME loans also comprises property (2) Mortgaged properties (in the business line designated 'mortgages') are mostly self-occupied (3) Exclusion of certain customer categories post GST implementation (4) Utmost caution with regard to the type of builders taken on as clients (under construction finance business line) (5) Personal loans limited to small-ticket size.

While cash-flow financing is also of utmost importance in SME lending, DBL retains the wisdom of having **collateral that will act as a sound psychological deterrence** reducing, ceteris paribus, the probability of borrower default. Hence, DBL insists on having property as collateral for SME lending. Here, we draw a parallel with City Union Bank when it comes to SME lending.

Secondly, while there is concern regarding LAP mortgages of ticket size more than Rs30mn, the management highlighted that a major portion of LAP book comprises collateral that is self-occupied and, hence, has **lower probability of default**.

Thirdly, DBL is a nimble bank that **takes risk management actions well in advance** of potential asset quality problems cropping up. Owing to GST, DBL has acted to exclude certain client categories that the bank feels may not, in the future, pass muster from a credit worthiness perspective. At the same time, DBL has **created a 'GST package'** that will act as a sort of turnkey solution for clients, current and new, who wish to transition smoothly into the new GST regime. This package has attracted a lot of interest including from relatively smaller SME players who wish to participate in the value chain created by larger players. Overall, it is important to stress that GST is a significant net positive for an MSME-focused bank like DBL.

In construction finance business, DBL exclusively lends to builders that have a sound track record of project implementation. Further, DBL carries out external agency verification of the builder and also a thorough site visit. Also, the loan ticket size is kept in check at Rs30mn-Rs150mn. Construction finance accounts for 3% of total loan book.

In personal loan segment, DBL is mostly trying to cross-sell to existing customers. The ticket sizes are kept small at Rs0.3mn-Rs0.5mn and DBL does not disburse large business installment loans. This loan book is small at about Rs500mn, which is about 0.3% of total loans. In the long run, personal loans would not account for more than 3%-5% of total loans, as an outer limit.

Valuation and Outlook

We use the Residual Income Model to arrive at a first-principles' fair value for DBL. We assume a long-term sustainable average risk-free rate of 7% for India, an Adjusted Beta of 1.05 for DBL and an India-specific Equity Risk Premium of 6% and arrive at the overall Cost of Equity of 13.3% for DBL. On this basis, **we arrive at a price target of Rs 196, at which the stock will trade at 1.9x/1.7x FY19E/20E book value**.

DBL **currently trades at a FY19E/20E P/BV of 1.6x/1.4x, which makes it significantly under-valued** given its FY19E/20E RoE profile of 12.4%/14.2% and long-term outlook. Consequently, we believe that the multiple of 2.0x/1.7x implied by our price target of Rs 206 is reasonable.

Exhibit 12: Consensus vs Our Estimates

	Our estimate			Bloomberg estimate			*% Variance*		
(Rsmn)	**FY18E**	**FY19E**	**FY20E**	**FY18E**	**FY19E**	**FY20E**	***FY18E***	***FY19E***	***FY20E***
Net interest income	9,597	12,557	15,427	9,888	11,865	14,365	*(2.9)*	*5.8*	*7.4*
Operating profit	4,955	7,205	9,248	5,100	6,341	8,033	*(2.8)*	*13.6*	*15.1*
Profit after tax	2,569	3,736	4,830	2,465	3,188	4,088	*4.2*	*17.2*	*18.1*

Source: Company, Nirmal Bang Institutional Equities Research

Key Risks

Loan book stress due to loan against property business

It is known that large-ticket loan against property (LAP) business has undergone stress at an industry level due to dilution of underwriting standards on the back of hyper-competition. However, our base case is that DBL is known for tight underwriting standards including on LAP business.

Proportion of corporate loans is kept within a band

Corporate loans are 17% of total loan book and management intends to keep the proportion similar going forward. This, ceteris paribus, could be somewhat negative from a scalability perspective. However, on the other hand, scalability is aided by DBL's pan-Indian DNA.

Company Overview

DCB Bank is a midcap private sector bank with a branch network of 314 branches and 530 ATMs. It has a loan book is Rs 186bn, of which the Retail, Agri, MSME and Corporate split is 52%, 17%, 12% and 19%, respectively (own classification). On Basel III basis, 79% of Retail and Corporate assets comprise Retail. DCB Bank has displayed a loan CAGR of 125% over FY12-17. Its yield on advances in its latest reported quarter was 11.3%.

DCB Bank has a CASA ratio of 25.7% and its cost of funds is 6.4% and, as a result, it registered a net interest margin of 4.1%. Its cost to income ratio stood at 62.3%. Consequently, it delivered a return on assets of 0.9% and a return on equity of 9.3%, implying a financial leverage of 10.8. Its employee count stood at 4928. Its Capital Adequacy Ratio was 15.8% and its Tier 1 Capital Ratio was 12.5%.

Exhibit 13: Management team/ board members

Name	Designation	Experience
Murali M. Natrajan	Managing director and chief executive officer	Mr. Natrajan served as the Global Head for SME banking in Standard Chartered Bank. He was responsible for providing strategic context and business development capabilities to drive a distinctive and consistent business model across 27 markets in Asia, Africa and the Middle East. Mr. Natrajan joined Standard Chartered Bank, India to head the Mortgage & Auto Business. In November 2004, he was promoted as Head of Consumer Banking for India & Nepal overseeing business that include Mortgages, Wealth Management, Branches, ATMs, Credit Cards, Personal Loans and SME.
Bharat Sampat	Chief Financial Officer	Mr. Sampat has over 25 years of experience in senior positions with reputed organizations such as ABN Amro Bank, ANZ Grindlays Bank, Standard Chartered Bank, Hoechst India and Larsen & Toubro. He has worked in diverse industries such as manufacturing, banking, finance and shared services with oversight for financial accounting, financial control and reporting, and management accounting both in India and abroad.
Abhijit Bose	Chief Credit Officer	Mr. Bose has over 26 years of experience in Banking & Financial Services sector. He has managed Sales and Distribution, Products, Credit Risk Management and Audit in markets such as India, Asia Pacific, Middle East and Africa. Previously, he was with Standard Chartered Group and the last position held was as Risk Head - Consumer Banking for Southern African markets. Prior to which he has worked in Citibank, GIC Housing Finance Ltd & Eldeco Group. He joined DCB Bank in June'08 and was appointed as Chief Credit Officer in April '17
J. K. Vishwanath	Head - Corporate Banking	Mr. Vishwanath has over 19 years of rich experience in all aspects of Credit Risk Management. At the Bank, he spearheads the mid-Corporate Banking vertical. His prior expertise in managing the credit requirements of mid-Corporate, Retail, MSME and SME customers helps the Bank drive the mid-Corporate Banking business vertical. Prior to joining DCB Bank, he has worked with Fullerton India Credit Company Ltd. and Citigroup. He began his professional career with Eicher Ltd.
Praveen Kutty	Head - Retail & SME Banking	Mr. Kutty brings with him around 19 years of banking experience. He has worked with Citibank's Indian and international operations where he successfully managed multiple consumer banking businesses including Credit Cards, Personal Loans, Home Loans, Branch Banking and Wealth Management. As Area Director for Bangalore for Consumer Banking, he was instrumental in scaling up the remote banking Suvidha experiment into a highly profitable customer proposition. Prior to joining the Bank, he was the Area Director for Citibank's NRI Business in North America. Mr. Kutty holds a B.Com and an MBA degree.
Rajesh Verma	Head - Treasury, Correspondent Banking & Trade Finance	Mr. Verma comes with 31 years of experience within Banking & Investment Banking in State Bank of India. His rich experience spans across the various functions of Treasury, Credit, Loan Syndications, Project Finance, Investment Banking, General Administrations and IT Project Management in India and UK. In his last role, he was working as a Deputy General Manager, Global Market Department for SBI in Mumbai.

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 14: Board members

Name	Designation	Experience
Nasser Munjee	Chairman	Ex-Executive Director – HDFC, instrumental in setting up IDFC. Sits on 9 Corporate Boards in India including HDFC, Tata Motors, Tata Chemicals, Tata Motor Finance Ltd. (Chairman), Britania Industries Ltd., Go Airlines (India) Ltd., Cummins India, ABB India Ltd. and Ambuja Cements (now part of the HOLCIM group). He is also Chairman of other Aga Khan institutions in India – Aga Khan Rural Support Programme (AKRSP) and Muniwar-Abad Charitable Trust (MACT). He was the President of the Bombay Chamber of Commerce and Industry – the city's oldest Chamber of Commerce and he has served on numerous Government Task Forces on Housing and Urban Development.
Murali M. Natrajan	Managing director and chief executive officer	Mr. Natrajan served as the Global Head for SME banking in Standard Chartered Bank. He was responsible for providing strategic context and business development capabilities to drive a distinctive and consistent business model across 27 markets in Asia, Africa and the Middle East. Mr. Natrajan joined Standard Chartered Bank, India to head the Mortgage & Auto Business. In November 2004, he was promoted as Head of Consumer Banking for India & Nepal overseeing business that include Mortgages, Wealth Management, Branches, ATMs, Credit Cards, Personal Loans and SME.
Altaf Jiwani	Director	Mr. Altaf Jiwani is qualified as B.E. (Production) and MMS (Finance). He has more than 20 years of experience in Corporate Finance across industries such as electrical, textile and automobile. He has developed expertise in the areas of Foreign Exchange, Risk Management and Trade Finance and received the 'Outstanding Achiever' Award within RPG Group in 2007-08. He has significantly contributed in derisking the business model of Phillips Carbon Black Limited in his role as CFO. Mr. Jiwani is currently Chief Financial Officer of Welspun India Limited and on the Boards of Welspun Zucchi Textiles Limited and Welspun Flooring Limited.
Amin Manekia	Director	Mr. Amin Manekia is an MBA (from Babson College, USA), and completed his graduation in Commerce. He has over 30 years of experience and specialized in the field of marketing, finance, co-operation and banking. He has pioneered the concept of automatic beverage vending machines in India. He has more than a decade of experience on the Boards of listed and unlisted entities in India, Currently he is on the Boards of IVP Limited & Platinum Jubilee Investments Limited. Mr. Manekia has worked for more than 20 years in various capacities in different institutions of the AKDN for the social-economic upliftment of the poor. Earlier, Mr. Manekia has served on Bank's Board for 8 years from September 30, 2000 up to September 30, 2008.
Chakrapany Narasimhan	Director	Mr. Chakrapany Narasimhan was previously with the State Bank of India (SBI).He has over 39 years of rich banking experience in corporate treasury, corporate strategy, M&A, private equity, new business conceptualization and roll out, investments (stocks, mutual funds and fixed income securities), credit appraisal and administration, branch management, forex operations, IT operations and client relationship management. He has been involved in the conceptualization and implementation of several new businesses including general insurance, debit cards, merchant acquiring, custodial services, mobile banking, payment systems group, private equity and venture capital funds.
Imran Contractor	Director	Mr. Imran Contractor is a qualified chartered accountant (placed in the merit lists) and a cost accountant. He also holds a Certificate in Software Technology from the National Centre for Software Technology. Currently, Mr. Contractor manages his own investments. His previous experience of 17 years include association with W. I. Carr (Far East) Limited and Stratcap Securities India Private Limited as head of research, advisor to several corporate managements and high net worth individuals on investment strategy and a consultant with Reliance Mutual Fund.
Iqbal Ishaq Khan	Director	Mr. Iqbal Ishaq Khan is a Partner at Shardul Amarchand Mangaldas & Co., a leading firm of Solicitors and a member of the Private Equity and Mergers & Acquisitions Practice Group. He advises some of the largest sovereign wealth funds, global private equity funds and strategic corporates, and specializes in private equity investments, private and public mergers and acquisitions (both domestic and cross-border), joint ventures and foreign investment laws.
Jamal Pradhan	Director	Mr. Jamal Pradhan is a Commerce Graduate and has specialized in the areas of exports and small scale industry. He is a promoter director of Pradhan Mercantile Private Limited and has experience of over two decades in export and small & medium manufacturing industry.
Nalin Shah	Director	Nalin Shah retired as partner of Deloitte Haskins & Sells and S. B.. Mr. Shah is a Gold Medalist at University of San Francisco (1969). He is on the Boards of ABC Bearings Limited, Artson Engineering Limited, Cholamandalam Investment & Finance Company Limited, Tata Capital Ltd., Cholamandalam Distribution Services Ltd. and EIMCO Elecon (India) Limited.
Rupa Devi Singh	Director	Ms. Rupa Devi Singh has been a non-executive independent director of the Bank from January 22, 2015. She has over 35 years of rich experience in various sectors viz. commercial banking, project structuring, infrastructure, etc. She was the founder Managing Director and CEO of Power Exchange India (PXIL). Prior to joining PXIL, she had worked with CRISIL as Director – Power Practice and subsequently, as Director Corporate & S E Asia at CRISIL.
S. Sridhar	Director	Mr. S .Sridhar retired as the Chairman & Managing Director of Central Bank of India, amongst India's oldest and largest public sector banks. Mr. Sridhar was also the Chairman & Managing Director of National Housing Bank (NHB), the regulator of housing finance companies. Seminal initiatives launched during his tenure include NHB Residex, India's first official residential property index, central electronic registry of mortgages, reverse mortgage of senior citizens and rural housing fund.
Shaffiq Dharamshi	Director	Mr. Shaffiq Dharamshi is a professional banker with over twenty years of senior management experience in the Middle East and Africa. He is Head of Banking for Aga Khan Fund for Economic Development (AKFED), and responsible for providing oversight on operations of financial institutions in the AKFED portfolio across Asia and Africa.

Source: Company, Nirmal Bang Institutional Equities Research

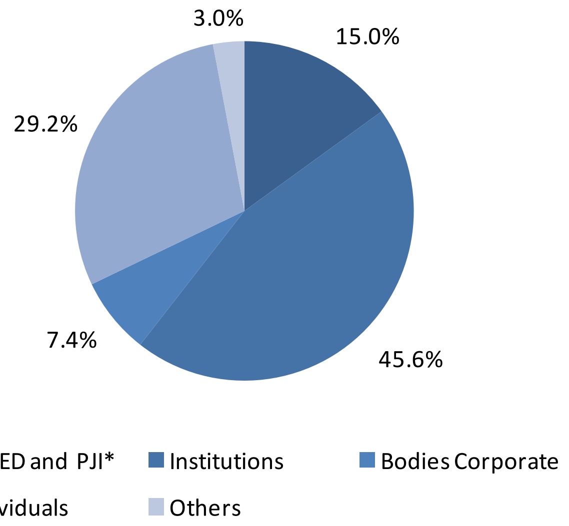
Shareholding Information

Exhibit 15: Key shareholders

	(%)
Promoter	
AKFED and PJI	15.00
Non - promoter	
Premji Invest	3.95
Sundaram Mutual Fund	3.92
Matthews India Fund	3.76
Tano Mauritius India FVCI II	3.46
Aditya Birla Sunlife Mutual Fund	3.01
DSP Blackrock Micro Cap Fund	2.64
Motilal Oswal AMC	2.33
Ambit Group	1.80
Apax Global Alpha	1.52
Reliance Mutual Fund	1.46
Steinberg India Emerging Opportunities Fund Limited	1.36
Tata Mutual Fund	1.10
ICICI Prudential Asset Management Company Limited	1.08
Caisse de depot et placement du Quebec	1.06

Source: Company, Nirmal Bang Institutional Equities Research

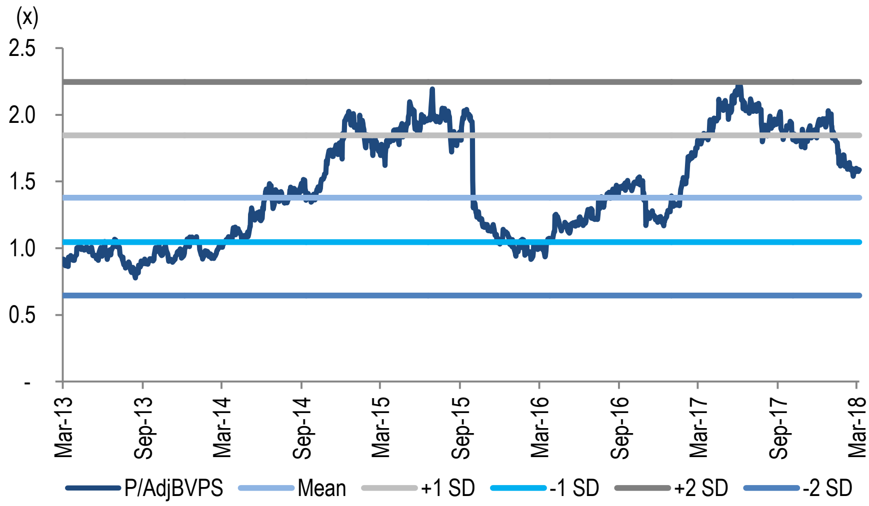
Exhibit 16: Shareholding pattern



*PJI: Platinum Jubilee Investment Ltd.
*AKFED: Aga Khan Fund for Economic Development

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 17: One-year forward P/BV



Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 18: Income statement

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Interest Income	16,985	20,761	24,881	31,073	38,337
Interest expense	10,790	12,791	15,283	18,516	22,910
Net interest income	**6,195**	**7,971**	**9,597**	**12,557**	**15,427**
Fees	1,405	1,657	2,046	2,669	3,476
Other Income	799	838	852	1,252	1,494
Net Revenue	8,400	10,465	12,496	16,478	20,396
Operating Expense	4,909	6,283	7,541	9,273	11,149
-Employee Exp	2,451	3,080	3,804	4,379	5,032
-Other Exp	2,458	3,203	3,737	4,894	6,117
Pre-provision Profit	**3,490**	**4,182**	**4,955**	**7,205**	**9,248**
Provisions	879	1,115	1,062	1,545	1,929
-Loan Loss Provisions	652	944	1,052	1,532	1,915
-Provisions for investment	36	(1)	10	12	14
-Other Provisions	191	172	-	-	-
PBT	2,611	3,067	3,892	5,661	7,318
Taxes	666	1,070	1,323	1,925	2,488
PAT	**1,945**	**1,997**	**2,569**	**3,736**	**4,830**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 20: Balance sheet

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Equity Capital	2,844	2,854	3,078	3,078	3,078
Reserves & Surplus	15,077	19,195	25,297	28,662	33,122
Shareholder's Funds	**17,922**	**22,049**	**28,375**	**31,740**	**36,200**
Deposits	**149,260**	**192,892**	**236,391**	**285,821**	**347,608**
-Current deposits	11,771	15,347	19,148	23,294	28,504
-Saving deposits	23,127	31,545	42,550	57,164	69,522
-Term deposit	114,361	146,000	174,693	205,362	249,583
Borrowings	11,479	12,758	7,079	15,557	25,976
Other liabilities	12,525	12,765	17,043	21,620	26,978
Total liabilities	**191,185**	**240,464**	**288,888**	**354,738**	**436,763**
Cash/Equivalent	8,916	11,925	14,829	18,536	23,170
Advances	129,214	158,176	197,720	247,151	308,938
Investments	43,333	58,179	63,521	75,547	90,407
Fixed Assets	2,480	4,886	5,374	5,912	6,503
Other assets	7,242	7,298	7,444	7,593	7,744
Total assets	**191,185**	**240,464**	**288,888**	**354,738**	**436,763**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 19: Key ratios

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Growth (%)					
NII growth	21.9	28.7	20.4	30.8	22.9
Pre-provision profit growth	25.8	19.8	18.5	45.4	28.3
PAT growth	1.7	2.6	28.7	45.4	29.3
Business (%)					
Deposit growth	18.4	29.2	22.6	20.9	21.6
Advance growth	23.5	22.4	25.0	25.0	25.0
Business growth	20.7	26.1	23.7	22.8	23.2
CD	86.6	82.0	83.6	86.5	88.9
CASA	23.4	24.3	26.1	28.2	28.2
Operating effeciency (%)					
Cost-to-income	58.4	60.0	60.3	56.3	54.7
Cost-to-assets	2.8	2.9	2.8	2.9	2.8
Productivity (Rs mn)					
Business per branch	1,406.4	1,340.0	1,348.2	1,581.5	1,865.2
Business per employee	65.6	71.2	77.0	90.4	106.6
Profit per branch	9.8	7.6	8.0	11.1	13.7
Profit per employee	0.5	0.4	0.5	0.6	0.8
Spreads (%)					
Yield on advances	11.6	11.5	11.3	11.4	11.4
Yield on investments	7.0	7.8	7.0	7.5	7.5
Cost of deposits	7.3	6.9	6.7	6.7	6.7
Yield on assets	10.5	10.6	10.3	10.5	10.5
Cost of funds	7.2	7.0	6.8	6.8	6.8
NIMs	3.8	4.1	4.0	4.3	4.2
Capital adequacy (%)					
Tier I	12.8	11.9	12.6	11.8	10.5
Tier II	1.3	1.9	2.9	2.4	2.1
Total CAR	14.1	13.8	15.5	14.2	12.7
Asset Quality (%)					
Gross NPA	1.5	1.6	1.8	1.7	1.5
Net NPA	0.8	0.8	1.2	1.2	1.0
Provision coverage	49.1	50.0	30.8	26.8	29.6
Slippage	1.9	1.8	2.0	1.8	1.5
Credit-cost	0.5	0.5	0.5	0.6	0.6
Return (%)					
ROE	11.5	10.0	10.2	12.4	14.2
ROA	1.1	0.9	1.0	1.2	1.2
RORWA	1.6	1.3	1.4	1.7	1.7
Per share (Rs)					
EPS	6.8	7.0	8.3	12.1	15.7
BV	63.0	77.3	92.2	103.1	117.6
ABV	59.5	72.8	84.2	93.1	107.3
Valuation (x)					
P/E	23.9	23.4	19.6	13.5	10.4
P/BV	2.6	2.1	1.8	1.6	1.4
P/ABV	2.8	2.2	1.9	1.8	1.5

Source: Company, Nirmal Bang Institutional Equities Research

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Institutional Equities

Karnataka Bank

26 March 2018

Reuters: KNBK.NS; Bloomberg: KBL IN

Initiating Coverage

Value Is What You Get

Karnataka Bank (KBL) is a mid-cap private sector bank with a network of 773 branches and loan book size of Rs411 bn. We are bullish on KBL because: (1) While KBL has a somewhat extended stressed asset pipeline, it is trading at a significantly cheap valuation even if one were to adjust book value comprehensively for the stressed asset pipeline (2) It is dynamically addressing opex control, which was a low-hanging fruit, via a robust digital strategy (3) It has a particularly well-managed funding profile with low dependence on wholesale deposits and borrowings. We initiate coverage on KBL with a Buy rating and a target price of Rs147, which values the stock at 0.7x/0.6x FY19E/FY20E P/BV.

A comprehensive evaluation of stressed asset pipeline reveals KBL is significantly undervalued: The somewhat extended stressed asset pipeline for KBL adds an element of opacity to its stress picture. KBL's stressed asset pipeline consists of Rs8.9bn of standard restructured book, Rs 69bn of 5/25 refinance (Rs 0.36bn overlapping), Rs1.83bn of SDR (Rs1.42bn overlapping), Rs3.47bn of S4A (all overlapping) and a Rs4.5bn security receipts book as of latest quarter. However, we have adjusted KBL's book value part by part for all forms of stress and noted that it trades at FY19E/FY20E P/BV of 0.8x/0.6x which makes the stock starkly undervalued for its FY19E/FY20E RoE profile of 11.9%/14.1% and long-term outlook.

Opex control is improving rapidly at KBL on migration of customers to digital channels: One of the low-hanging fruits identified by the bank has been actuating customers to shift to ADC (alternate digital channels) and there has been significant traction on this front with the share of ADC rising from 44.5% as of FY15-end to 66.5% as of 3FY18-end. There is significant headroom in this regard with the management planning to take the share to ~80% in the near to medium term. Among other factors, this has aided KBL's cost-to- income ratio to dip by ~10% in 9MFY18 to 49.5%, compared with 9MFY17.

KBL has a standout funding profile on the back of superlative asset-liability management: KBL's share of high-cost bulk deposits in total deposits is low at 1% as of 1HFY18 compared with 10%-81% for mid-cap private sector peers. Similarly, the share of generally high-cost borrowings in deposits and borrowings for KBL is also low at 1.8% compared with 2.2%-60.7% for mid-cap peers, barring KVB/J&K at 1.2%/1.6%. CASA ratio is also relatively superior at 28.6% compared with 10.1%-28.1% for mid-cap peers, bar FED/J&K at 33.0%/49.9%.

Valuation and outlook: We have used the residual income model to value KBL and arrive at a target price of Rs147. KBL currently trades at 0.6x/0.5x FY19E/FY20E P/BV and we believe that our target price is reasonable, given KBL's RoE profile of 11.9%/14.1% for FY19E/FY20E and long-term outlook.

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Net Interest Income	13,029	14,906	21,378	27,206	32,660
Pre-Provision Profit	8,545	9,958	13,911	18,525	22,335
PAT	4,153	4,523	4,375	6,713	8,845
EPS (Rs)	22.0	16.0	15.5	23.8	31.3
BV (Rs)	195.8	182.0	191.4	209.2	234.4
P/E	5.4	7.4	7.6	5.0	3.8
P/BV	0.6	0.6	0.6	0.6	0.5
Gross NPA (%)	*3.4*	*4.2*	*4.0*	*3.9*	*3.8*
Net NPA (%)	*2.4*	*2.7*	*2.7*	*2.6*	*2.6*
ROA (%)	*0.8*	*0.7*	*0.6*	*0.8*	*0.9*
ROE (%)	*11.7*	*10.2*	*8.3*	*11.9*	*14.1*

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: Banking

CMP: Rs117

Target Price: Rs147

Upside: 26%

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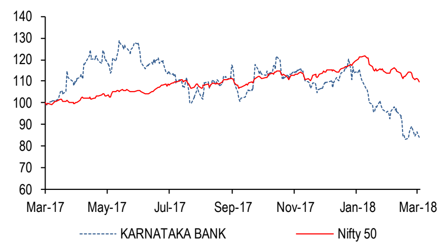
Key Data

Current Shares O/S (mn)	282.6
Mkt Cap (Rsbn/US$mn)	32.9/505.2
52 Wk H / L (Rs)	181/108
Daily Vol. (3M NSE Avg.)	3,684,339

Shareholding (%)	3QFY18	2QFY18	1QFY18
Promoter	-	-	-
Public	100.0	100.0	100.0
Others	-	-	-

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
Karnataka Bank	(12.9)	(23.4)	(15.7)
Nifty Index	(4.8)	0.3	10.0

Source: Bloomberg

KBL at ultra cheap valuation even after adjusting for comprehensive stressed asset pipeline

KBL's profitability and loan growth has been under strain since the past several quarters because of persistent loan book stress on the corporate side. However, the cycle of deleveraging and provisioning has now bottomed out and now the market will be able to better appreciate KBL's under-valuation, even if one adjusts for the **residual stress** that sits on its balance sheet. Here, we draw a broad parallel with another mid-cap bank viz. South Indian Bank.

Over the past 12 months, KBL has (1) Meaningfully diminished its Standard Restructured book by 32.5% (2) Has seen SMA2 (Special Mention Accounts, which are 60 days past due and an equivalent for 'watch list' that some other corporate-focused banks have disclosed) loans fall by 23.3% (3) Alternative restructuring dispensations (5/25, SDR, S4A) have, in total, stayed broadly flat at 1.6% of loans compared with 1.4% earlier. As a result, the **total stressed asset pipeline for KBL (including watch list) has fallen materially** over this period. This means that the underlying stressed asset pipeline for KBL is not increasing, but is rather on a decreasing trend. Consequently, it is safe to assume that KBL has to, at worst, negotiate the current stressed asset pipeline through its P&L account.

The moot point now is that, having undergone this prolonged period of stressed asset recognition and provisioning, KBL now **trades at a starkly cheap valuation** even if one were to adjust its book value for all residual stress, whether recognised or sitting in its quasi-recognised stressed asset pipeline.

Change in stressed asset picture has been significant over 3QFY17-3QFY18

Over 3QFY17-3QFY18, KBL has reduced **Standard Restructured** book by 32.5% to Rs 8.98bn. Standard Restructured book is now 2.0% of 3QFY18 loan book.

Loans in **SMA2 category**, which are the effective 'watch list' for KBL, have decreased 23.3% over the same period to Rs12.bmn, now comprising 2.7% of total 3QFY18 loan book.

Alternative restructuring dispensations of the RBI (**5/25, SDR, S4A**) have moved from being 1.4% of loans as of 3QFY17-end to 1.6% of loans as of 3QFY18-end. We do not view this quantum of increase as concerning.

Net book value of **Security Receipts** has moved from being 1.1% of 3QFY17 loans to 1.0% of 3QFY18 loans.

Total stressed asset pipeline (excluding SMA2) has, therefore, fallen meaningfully to 3.4% of 3QFY18 loans. In other words, the underlying stress on the loan book is not accreting and is rather seeing a decidedly falling trend. Therefore, it is **reasonable to use the existing stressed asset pipeline** (including SMA2) to adjust the book value to arrive at a comprehensive adjusted book value for KBL. It may well be that the current stress pipeline itself may diminish meaningfully going forward, but, for the purpose of this analysis we shall be conservative.

Exhibit 1: Change in stressed asset picture over 3QFY17-3QFY18

GNPAs (Rs mn)	15,600	17,840
NNPAs (Rs mn)	10,660	12,630
Standard Restructured (Rs mn)	13,300	8,976
5/25 Refinance (Rs mn)	-	1,695
SDR (Rs mn)	4,510	1,825
S4A (Rs mn)	470	3,470
SR (Net book value) (Rs mn)	4,019	4,501
Watch list (SMA2) (Rs mn)	15,891	12,182

N.B. The S4A exposure of Rs470 mn under 3QFY17 was declared in the 3QFY17 conference call but was yet to be carried out. The SR book outstanding under 3QFY17 has been taken from the FY17 Annual Report.

Source: Company, Nirmal Bang Institutional Equities Research

There is significant overlap between exposure to newer restructuring dispensations and traditional standard restructured book

It is important to mention here the extent of overlap the exposure to newer restructuring dispensations have to traditional restructuring. The entire S4A exposure of Rs 3.47bn overlaps with the standard restructure book. Of the Rs1.83bn exposure to SDR accounts, there is an overlap of Rs1.42bn with the standard restructured book. Of the Rs 1.69bn exposure to 5/25 refinance, Rs0.36bn overlaps with standard restructured book. **These considerations are incrementally key to understanding the true remaining stressed asset pipeline of KBL**.

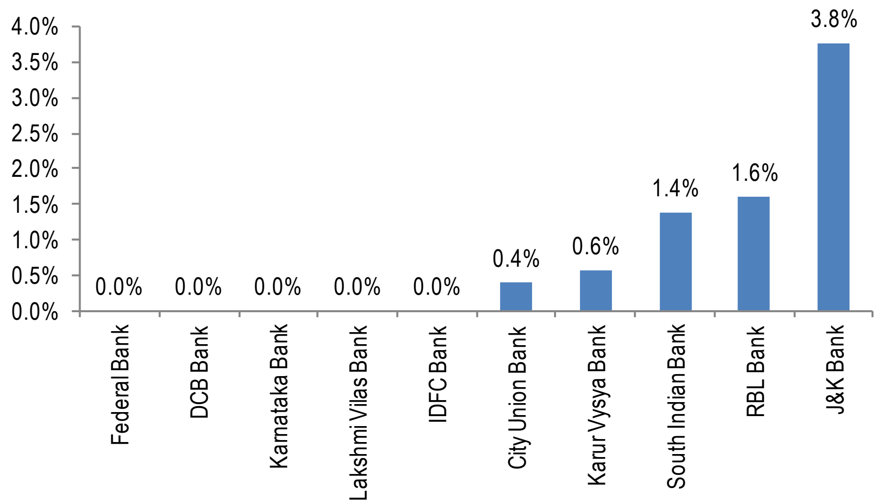
IBC / NCLT accounts in RBI List 1 as well as List 2 already recognised as NPAs

KBL also has an **IBC/NCLT exposure** of Rs3.2bn as of 3QFY18-end, but this exposure has been entirely recognised as NPA and hence, is not being considered separately. KBL has exposure to one account in RBI List 1 (of 12 accounts) and to three accounts in RBI List 2 (extended list of 40 accounts).

No reportable divergence with RBI on assessment of asset quality as of FY16-end underlines disciplined NPA recognition policy

KBL did not report any divergence with the RBI on assessment of asset quality as of FY16-end (which is reported, as per rule, in FY17 annual report) as it was nil or below the required threshold. FY16-end was a time when banks were coming around to RBI's concern that there may be undue divergence across banks in terms of recognition of stressed accounts as bad loans. The fact that there was no reportable divergence as of FY16-end for KBL means the **bank was disciplined when it came to duly recognising truly stressed accounts as bad loans even back then**. This is positive from the perspective of potential impact from the recent RBI notification overhauling stress recognition and which actuates banks to move away from divergence to a point where these is consonance across banks in terms of bad loan recognition.

Exhibit 2: Divergence with RBI in GNPA recognition as a percentage of FY16 loan book – KBL vs. peers



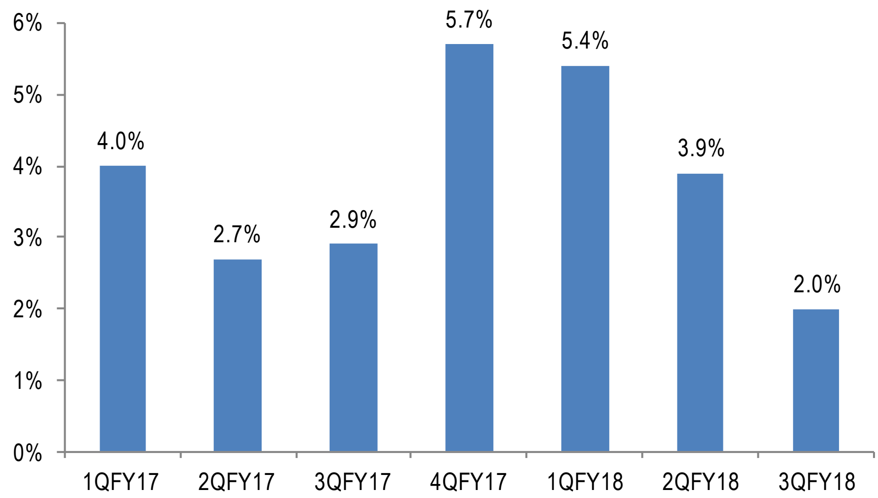
Source: Company, Nirmal Bang Institutional Equities Research; 0% figures may mean no reportable divergence

The final report on the RBI's assessment of divergence (if any) in bad loan recognition as of FY17-end for KBL is awaited, but our base case is that we do not expect any significant divergence.

Decline in slippage ratio already underway this financial year

This financial year has seen a declining loan slippage ratio for KBL. While slippages are inherently lumpy and volatile, especially from the corporate side, investors need to focus on the fact that the stressed asset pipeline has not only been contained but is also witnessing a materially declining trend. Importantly, as discussed earlier, even if one were to adjust the book value of KBL for provisioning arising out of the entire stressed asset pipeline (assuming, conservatively, it does not diminish further), then also its valuation is significantly cheap, given its return ratio profile. Nevertheless, it is important to separately highlight a **falling slippage ratio this financial year**.

Exhibit 3: Gross slippage ratio (annualised) seems to have peaked over 4QFY17-1QFY18



Source: Company, Nirmal Bang Institutional Equities Research

The management, during the 3QFY18 results conference call, sounded confident of maintaining or bettering the gross slippage quantum of Rs2.1bn that was registered during the quarter. Even so, we stress again that the nature of corporate slippage is lumpy and **whether the upcoming recognition (assuming it is necessitated) of stressed asset pipeline is up-fronted or back-ended is ultimately inconsequential**, in our view, as the stock trades at starkly cheap valuation adjusted for even the said extended stressed asset pipeline.

Valuation picture on the basis of book value adjusted for all forms of stress looks significantly attractive

The current provision coverage ratio for KBL stands at 44.9%. This is on the lower side as a significant portion of the NPA pool is relatively fresh, thereby requiring lower provisioning as per regulations. We take a prudently conservative stance and assume that KBL would, eventually, have to make **70% provision on current gross NPA pool**. We believe this is reasonable as the average recovery rate in India has been 26%, as per the World Bank.

Secondly, we are assuming that the provisioning required for the current **Standard Restructured book would be 50%** of the respective outstanding book. We believe this is reasonable as the Standard Restructured book is seasoned and has already undergone a 59% depletion over the past two years (since 3QFY16).

Thirdly, we assume that provisioning required for the **5/25 exposure would be 35%** of respective outstanding book. Secondly, we are assuming provisioning required on **SDR and S4A exposure would be 50%** in each case. We believe that flexible structuring under 5/25 scheme are for accounts that have inherently somewhat superior asset quality than other alternative restructuring dispensations (SDR, S4A) as the former are loans backed by projects that have back-ended cash flow and may otherwise be relatively sound.

Lastly, we have assumed a 40% provisioning requirement on net book value of Security Receipts. We believe this is sufficient given that Security Receipts are usually sold at an upfront discount. In fact, in case of KBL, the **upfront discount is particularly high at ~60% of loan value outstanding** (prior to sale). So, our 40% incremental provisioning requirement is significantly conservative.

Exhibit 4: Calculation of book value adjustment on the basis of residual stress

Provision coverage ratio	49.1%
Target PCR	70%
Provision to meet PCR (Rs mn)	3,723
% Haircut on std. rest	50%
Haircut on std. rest net of overlaps (Rs mn)	1,866
% Haircut on 5/25	35%
Haircut on 5/25 (Rs mn)	593
% Haircut on SDR	50%
Haircut on SDR (Rs mn)	913
% Haircut on S4A	50%
Haircut on S4A (Rs mn)	1,735
% Haircut on SR book	40%
Haircut on SR book	1,800.2
% Haircut on SMA2	40%
Haircut on SMA2 (Rs mn)	4,873
Total book value shave-off (Rs mn)	**15,503**

Source: Company, Nirmal Bang Institutional Equities Research

Summing up, all the **incremental provision requirement taken together** amounts to Rs15.5bn, which is a shave-off of 26%/23% of FY19E/FY20E book value, respectively. This implies that KBL trades at 0.8x/0.6x FY19E/FY20E book value adjusted conservatively for all forms of recognised and quasi-recognised stress. We believe this underlines that KBL is starkly cheap at current levels, given its current return ratio profile.

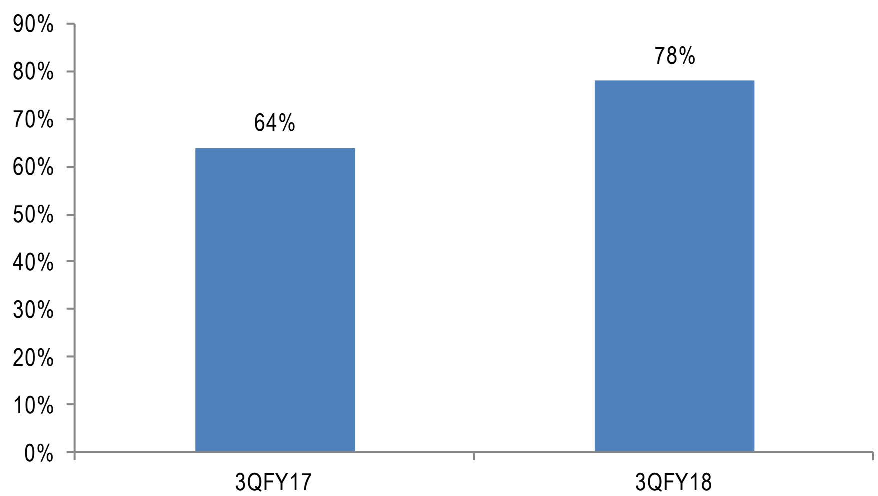
We have conducted a similar exercise for South Indian Bank (SIB), but we note that there is a difference between the watchlists for the two banks. SIB's watchlist was self-defined (and now extinguished) whereas, KBL states entire SMA2 as a watch list. Not including KBL's SMA2, the aforementioned book value shave-off would stand a lot lower at Rs10.6bn but we have opted for the Rs 15.5bn figure for our adjustment. **True watch list for KBL could be a lot lower than the SMA2 figure, but we are being conservative in our analysis**.

Fresh build-up of risk on corporate loan book is unlikely

Fresh build-up of risk on corporate loan book is unlikely as: (1) The management has been consciously "overcautious" (as stated during 3QFY18 conference call) in corporate lending and focused on lending to **higher-rated corporates.** (2) The management, on balance, will focus **less on large corporate** (ticket size > Rs150mn) to grow overall loan book.

The **share of investment grade borrowers** in externally rated corporate credit has risen from 64% in 3QFY17 to 78% in 3QFY18. It may be noted, in addition, that the share of externally rated corporates in gross bank credit has itself risen from 20% in 3QFY17 to 29% in 3QFY18, indicating that incremental corporate lending is focused on high-rated corporates with a proven track record.

Exhibit 5: Share of investment grade borrowers in externally rated corporate credit



Source: Company, Nirmal Bang Institutional Equities Research

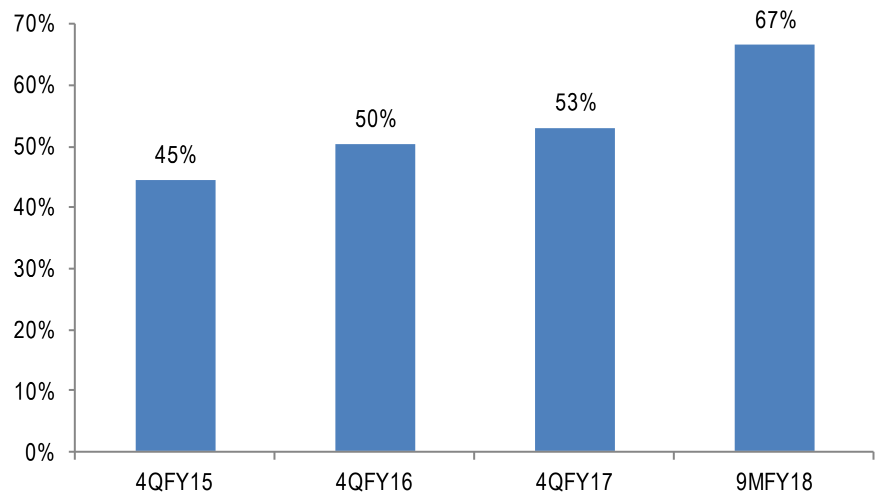
Further, the management has stated that the **share of large corporate loans** will fall to 40% of total loans from 44% as of 3QFY18-end, while the share of retail (ticket size < Rs50mn) and mid-corporate (Rs50mn < ticket size < Rs150mn) will rise to 60% "gradually". This means the management will be cautious on large corporate lending as such and focus incrementally on small-ticket lending, where the macro risk is lower.

Opex control on rapidly improving trend

KBL's **cost-to-income ratio has been falling sharply** and has moved lower from 59.3% in 9MFY17 to 49.5% in 9MFY18.

KBL has been attempting to become more cost-efficient and one of the low-hanging fruits on this front was the **shifting of transactions from branches to alternate digital channels (ADC)**. The traction on this front has been very significant and the share of digital channels has risen ~22 percentage points from 44.5% in 4QFY15 to 66.5% in 3QFY18. There is more headroom on this front and the management plans to take the share of digital channels to ~80% by FY20.

Exhibit 6: Share of alternate digital channels in transaction value

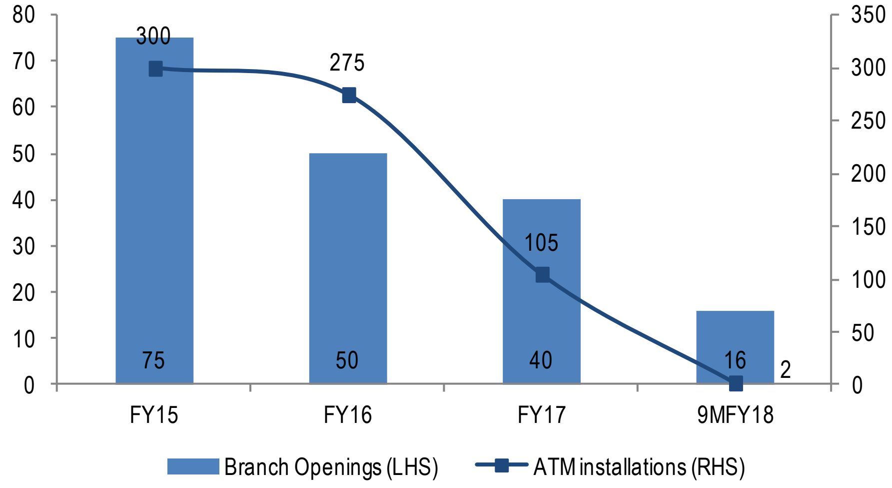


Source: Company, Nirmal Bang Institutional Equities Research

Traction in **migrating transactions to alternate digital channels has accelerated** with ~13.4 percentage point jump in the three quarters of FY18 itself compared with 8.6 percentage point improvement over eight quarters of FY15-FY17.

Over the same period, KBL's management has understandably found a **lower requirement for branch openings and ATM installations**. Branch openings and ATM installations have fallen from 75 and 300, respectively, in FY15 to 16 and 2, respectively, in 9MFY18. At a total branch count of 781 as of 3QFY18-end and with increased ability to migrate/execute transactions seamlessly over digital channels, incremental requirement for brick-and-mortal outlets will be lower, **ceteris paribus**, with concomitant salutary impact on opex. Migration of transaction value to digital will also mean lower personnel requirement, ceteris paribus. Further, it would also imply increased re-deployment of existing staff to sales activity, which would have a positive impact on business.

Exhibit 7: Quantum of branch openings and ATM installations



Source: Company, Nirmal Bang Institutional Equities Research

Over the rest of FY18, KBL plans to take the branch count to 800, implying total branch openings of 35 for FY18 as a whole. KBL has empanelled management consulting major BCG for developing a **business transformation strategy** and several key suggestions in approach have emerged. Among them is a continued focus on technology and low dependence on brick-and-mortal channels for transaction delivery.

It may noted, however, that the **annual run-rate for branch openings may rise** from the current level over FY19-FY20 because of an overall requirement to augment physical capacity as per Vision 2020.

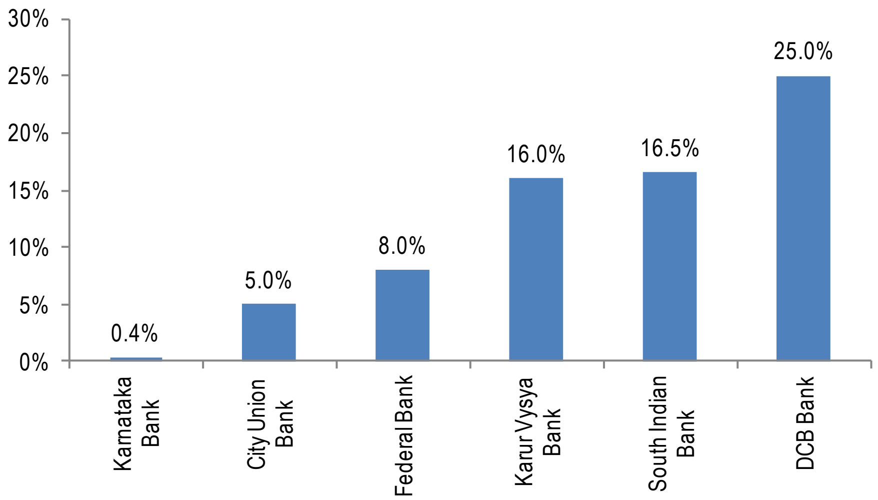
Well-managed funding profile ensures cost of funds remains under control

KBL enjoys some key advantages on the funding profile front: (1) Low dependence on wholesale/bulk deposits. (2) Low dependence on borrowings. (3) Superior CASA ratio among key mid-cap bank peers. All of these combine to deliver superior cost of funds (average cost of deposits and borrowings) for KBL.

Low dependence on wholesale deposits indicative of prudent asset liability management

Prudent asset-liability management is a hallmark of KBL that manifests itself in low dependence on higher-cost wholesale/bulk deposits. The proportion of bulk deposits for KBL stood at 0.4% as of 1HFY18-end compared with 5%-25% for key mid-cap bank peers.

Exhibit 8: Share of bulk deposits in total deposits – 1HFY18 – KBL vs peers

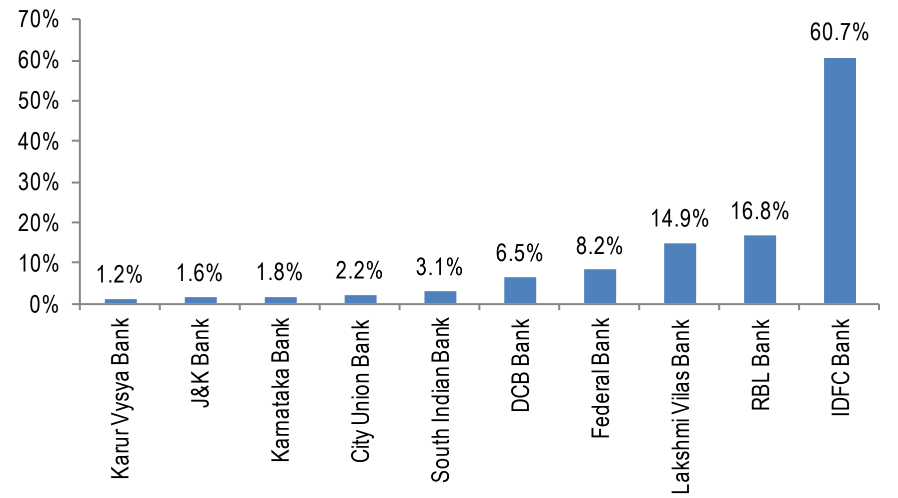


Source: Company, Nirmal Bang Institutional Equities Research

Low dependence on borrowings also a salutary outcome of superior asset liability management

Dependence on generally higher-cost borrowings is also low for KBL at 1.8% of total deposits and borrowings as of H1FY18-end compared with 1.2%-60.7% for mid-cap peers.

Exhibit 9: Borrowings as a percentage of total deposits and borrowings



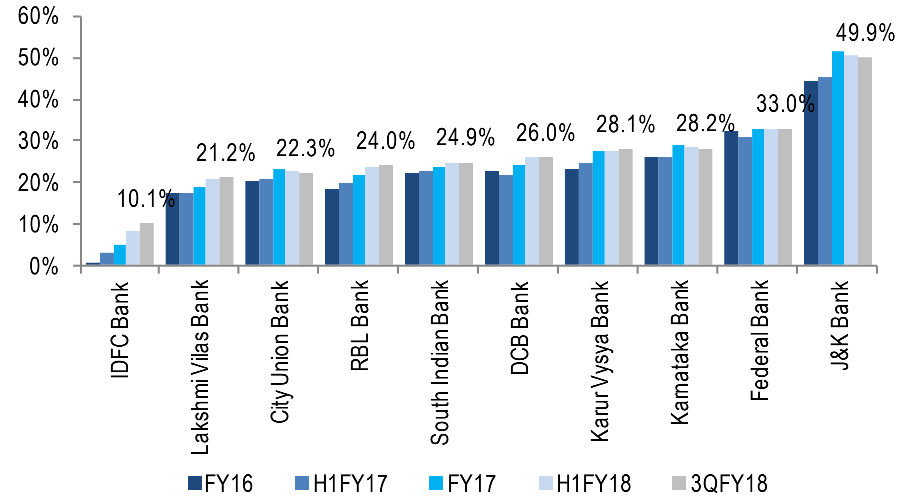
Source: Company, Nirmal Bang Institutional Equities Research

Not all borrowings are necessarily higher cost compared with retail term deposits, especially if the borrowings entail refinance raised from refinancing institutions, especially special refinancing at low interest rates. Aside of this, borrowings are generally higher cost that even retail term deposits.

Superior CASA ratio of KBL is an incremental reason for superior cost of funds

CASA ratio for KBL at 28.2% as of H1FY18-end is also superior compared with key mid-cap bank peers ranging between 10.1%-28.1%, barring FED/J&K at 33%/49.9%. KBL has also largely refrained from participating in SA card rate competition and has maintained a prudent SA card rate break-up.

Exhibit 10: CASA ratio in FY16-3QFY18 – KBL vs. peers



Source: Company, Nirmal Bang Institutional Equities Research

Overall, KBL is able to maintain cost of funds at a reasonable level of 6.1% as of 1HFY18. This is despite KBL offering a slight premium on their term deposit rates.

Valuation and Outlook

We use the Residual Income Model to arrive at a first-principles' fair value for KBL. We assume a long-term sustainable average risk-free rate of 7% for India, an Adjusted Beta of 1.25 for KBL and an India-specific Equity Risk Premium of 6% and arrive at the overall Cost of Equity of 14.5% for KBL. On this basis, **we arrive at a price target of Rs 147, at which the stock will trade at 0.7x/0.6x FY19E/20E book value**.

KBL **currently trades at a FY19E/20E P/BV of 0.6x/0.5x, which makes it significantly under-valued** given its FY19E/20E RoE profile of 11.9%/14.1% and long-term outlook. Consequently, we believe that the multiple of 0.7x/0.6x implied by our price target of Rs 147 is reasonable.

Exhibit 11: Consensus vs Our Estimates

	Our estimate			Bloomberg estimate			*% Variance*		
(Rsmn)	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	*FY18E*	*FY19E*	*FY20E*
Net interest income	21,378	27,206	32,660	17,859	20,612	23,848	*19.7*	*32.0*	*37.0*
Operating profit	13,911	18,525	22,335	12,659	14,542	16,904	*9.9*	*27.4*	*32.1*
Profit after tax	4,375	6,713	8,845	4,333	5,688	7,137	*1.0*	*18.0*	*23.9*

Source: Company, Nirmal Bang Institutional Equities Research

Key risks

Recent RBI notification overhauling stress resolution is a system-wide risk for all banks with material corporate lending business

The recent RBI notification overhauling stressed asset resolution and promoting consonance (rather than divergence) across banks is a system-wide risk for all banks that have a material corporate lending business. However, we do not think KBL should be significantly impacted given that it did not have any divergence with RBI's assessment of its asset quality material enough for disclosure in their FY17 Annual Report.

KBL has high exposure to Karnataka state and there is a theoretical associated concentration risk

498 of 806 branches of KBL are located in Karnataka state indicating theoretical concentration risk. However, our base case is that Karnataka is a stable state from a business prospects perspective.

Company Overview

Karnataka Bank is a midcap private sector bank with a branch network of 795 branches and 1382 ATMs. It has a loan book is Rs 411bn, of which the Retail, Agri, MSME and Corporate split is 51%, 13%, 25% and 11%, respectively (own classification). On Basel III basis, 53% of Retail and Corporate assets comprise Retail. Karnataka Bank has displayed a loan CAGR of 12.3% over FY12-17. Its yield on advances in its latest reported quarter was 10.1%.

Karnataka Bank has a CASA ratio of 28.6% and its cost of funds is 6.1% and, as a result, it registered a net interest margin of 3.1%. Its cost to income ratio stood at 50.2%. Consequently, it delivered a return on assets of 0.53% and a return on equity of 6.5%, implying a financial leverage of 12.3. Its Capital Adequacy Ratio was 12.5% and its Tier I ratio was 11.4%

Exhibit 12: Management team/ Key executives

Name	Designation	Experience
V. G. Mathew	MD, CEO, and Executive Director	Mr. V. G. Mathew has been Managing Director, Chief Executive Officer and Executive Director of The South Indian Bank Ltd. since October 1, 2014. Mr. Mathew served as Chief General Manager of Corporate Accounts Group at State Bank of India. He served as Executive Vice President of The South Indian Bank Ltd. since January 2014. Mr. Mathew holds bachelor's degree and a master's in science from the University of Kerala Additionally, he is a certified associate of the Indian Institute of Bankers.
C. P. Gireesh	CFO and Joint GM	Mr. C. P. Gireesh has been Chief Financial Officer of The South Indian Bank Ltd since July 1, 2012 and serves as its Joint General Manager. Mr. Gireesh served as an Assistant General Manager of The South Indian Bank Ltd. until July 2012 and served as its Deputy General Manager.
Joseph K. Thomas	Executive Vice President of Operations	Mr. Thomas K. Joseph has been an Executive Vice President of Operations at The South Indian Bank Ltd. since August 17, 2017. Mr. Joseph served as Executive Vice President of Administration at The South Indian Bank Ltd. since December 31, 2015 until August 17, 2017. Mr. Joseph served as Chief General Manager at The South Indian Bank Ltd. Mr. Joseph served as General Manager of Mumbai Regional Office, Deputy General Manager and Assistant General Manager at The South Indian Bank Ltd. Mr. Joseph heads Departments such as Risk Management, Technology, Marketing, Corporate Financial Management, Human Resource and Inspection & Vigilance. He was the Head of Credit in the Chief General Manager (CGM) cadre and handling a portfolio of Rs.400bn. He was instrumental in the execution of the Retail Strategy of the Bank which saw significant growth in the MSME & Agriculture Sectors. He joined the bank as an Industrial Officer in 1984 and has vast experience in heading major Branches, Regional Offices etc.
Biju E. Punnachalil	Chief Risk officer	Mr. Biju E. Punnachalil has been the Chief Risk Officer at The South Indian Bank Limited since April 27, 2017.
G. Sivakumar	Executive Vice President of Credit	Mr. G. Sivakumar has been an Executive Vice President of Credit at The South Indian Bank Ltd. since December 15, 2015. Mr. Sivakumar heads Credit and Legal Departments. He has over 35 Years of Experience in Domestic and International Banking in India and abroad. Before joining South Indian Bank, he served as the General Manager and Head of Private Equity Verticalin State Bank of India where he was responsible for Private Equity and Venture Capital Investments made by the Bank. He also served as Head of Project Finance - South and Head of Corporate Banking and Trade Finance Department in Bahrain for State Bank of India. He has in depth exposure in Corporate Finance, Project Appraisal, Trade Finance and Credit Management functions. He served as a Nominee Director on the Board of Directors of Bill Desk, SBI Macquaire Infrastructure Trustee private limited, OmanIndian joint Investment Fund and CSIR Tech Pvt Ltd and Investment Committee of more than ten Alternative Investment Funds.

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 13: Board members

Name	Designation	Experience
V. G. Mathew	MD, CEO, and Executive Director	Mr. V. G. Mathew has been Managing Director, Chief Executive Officer and Executive Director of The South Indian Bank Ltd. since October 1, 2014. Mr. Mathew served as Chief General Manager of Corporate Accounts Group at State Bank of India. He served as Executive Vice President of The South Indian Bank Ltd. since January 2014. Mr. Mathew holds bachelor's degree and a master's in science from the University of Kerala Additionally, he is a certified associate of the Indian Institute of Bankers.
Salim Gangadharan	Non-executive part time Chairman	Mr. Salim Gangadharan has been the Non-Executive Part-Time Chairman of The South Indian Bank Ltd. since November 2, 2016 and its Independent Director since January 16, 2014. He served as Regional Director of Kerala and Lakshadweep at Reserve Bank of India since April 2012 until October 2013. Mr. Gangadharan has been working with the Reserve Bank of India (RBI) from over 30 years. In his career in Reserve Bank of India, he has worked in various Operational Departments, particularly in bank supervision and financial markets. He served as Chief General Manager of Reserve Bank of India. Mr. Gangadharan served as a Director at Central Bank of India from July 30, 2010 to March 13, 2014. He was also a Member Faculty in the Bankers' Training College of the Reserve Bank of India, for five years and handled several seminars and conferences on Risk Management, Payment Systems and Treasury Management etc. He was also on secondment to the Central Bank of Oman for five years.
John Joseph Alapatt	Independent non-executive Director	Dr. John Joseph Alapatt serves as Chairman of C.E.P.A.B. Dr. Joseph serves as a Director in Janakshemam Kuries Pvt. Ltd., Thrissur. Dr. Alapatt has been an Independent Non-Executive Director of The South Indian Bank Ltd. since September 24, 2012. He served as an Independent Non-Executive Director of The South Indian Bank Ltd. from December 2, 2002 to February 12, 2010. He is an industrialist, managing a SSI unit. Dr. Alapatt holds a Bachelor of Medicine and Bachelor of Surgery degree as well as a Post-Graduate diploma from Bangalore University.
Mohan E. Alapatt	Independent non-executive Director	Mr. Mohan E. Alapatt has been an Independent Non-Executive Director of The South Indian Bank Ltd. since March 1, 2010 and previously served as its Independent Non-Executive Director until April 23, 2007. Mr. Alapatt holds a bachelor's degree in engineering from PSG College of Technology, Tamil Nadu.
K. Thomas Jacob	Independent non-executive Director	Mr. K. Thomas Jacob has been an Independent Non-Executive Director of The South Indian Bank Ltd. since August 31, 2010. Mr. Jacob holds a bachelor's degree in science from University of Kerala. He is also a fellow of the Institute of Chartered Accountants of India. Further, he has completed practical training and passed the Information Systems Audit ("ISA") assessment test conducted by the Institute of Chartered Accountants of India.
Francis Alapatt	Independent non-executive Director	Mr. Francis Alapatt has been an Independent Non-Executive Director of The South Indian Bank Ltd. since November 1, 2013. Mr. Alapatt holds a bachelor's degree in science.
Ranjana S. Salgaocar	Independent non-executive Director	Mrs. Ranjana S. Salgaocar serves as a Director of Pyramid Finance Ltd. Mrs. Salgaocar has been an Independent Non-Executive Director of The South Indian Bank Ltd. since October 1, 2014. She served as a Director of Syndicate Bank Limited until February 25, 2006. She has vast experience in serving as member of various Government and Non-Governmental Bodies. She authored a book "The Pleasure of Your Company" on Personality, Enrichment, Etiquette and Entertaining.
Achal Kumar Gupta	Non-Executive Additional Independent Director	Mr. Achal Kumar Gupta has been a Non-Executive Additional Independent Director at The South Indian Bank Limited since January 11, 2017. He has served as Deputy Managing Director at IFCI Limited since December 12, 2013 until December 11, 2016. Mr. Gupta served as the Managing Director of State Bank of Patiala. He served as Managing Director, Chief General Manager (Corporate Accounts Group) and Chief Executive Officer of SBI Funds Management Private Limited. He served as Whole Time Director at IFCI Limited since December 12, 2013 until December 11, 2016. He served as an Executive Officer of Corporate Banking Division at State Bank of India. He was responsible in the Corporate Banking Division at State Bank of India. He served as Company Secretary of The State Trading Corporation of India Ltd. from September 2010 to December 9, 2010. He served in various areas such as credit administration, international banking operations, branch management, agricultural banking and relationship banking at State Bank of India. Mr. Gupta served as Regional Manager at State Bank of India.
Parayil George John Tharakan	Independent non-executive Director	Mr. Parayil George John Tharakan has been an Independent Non-Executive Director at The South Indian Bank Ltd. since November 25, 2014. Mr. Tharakan served as an Additional Director at The South Indian Bank Ltd. since November 25, 2014. He holds a bachelor's degree in commerce from the University of Kerala and a LLB degree from Bangalore University.

Source: Company, Nirmal Bang Institutional Equities Research

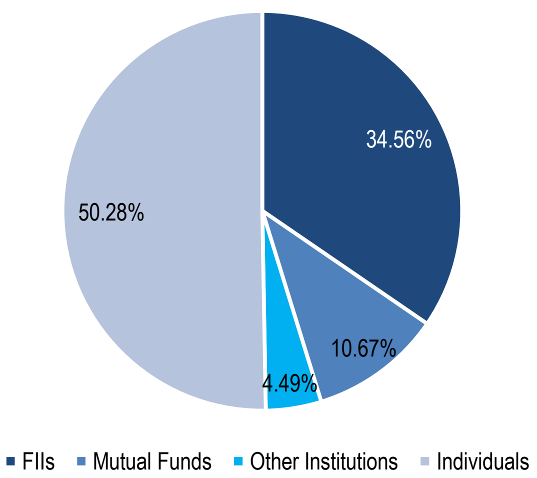
Shareholding Information

Exhibit 14: Key shareholders

	(%)
Promoter	0.0
Non - promoter	
Yusuffali Musaliam Veettil Abdul Kader .	4.9
Lavender Investments Limited	4.9
First Carlyle Ventures Mauritius	4.9
Bodies Corporate	4.8
Life Insurance Corporation Of India	3.2
Iva International Fund	2.6
Cx Securities Limited	2.0
Acacia Banyan Partners	1.7
Quant Foreign Value Small Cap Fund	1.5
Acacia Partners, Lp	1.4
Acacia Institutional Partners, Lp	1.2
Icici Prudential Banking And Financial Services Fund	1.1
Alternate Investment Funds	0.5

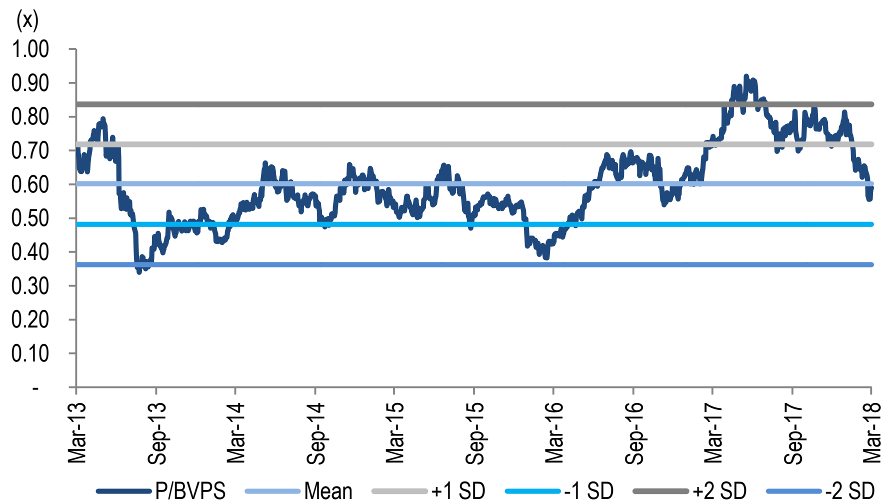
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 15: Shareholding pattern



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 16: One-year forward P/BV



Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 17: Income statement

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Interest Income	49,922	51,854	60,865	73,314	87,353
Interest expense	36,893	36,948	39,487	46,108	54,693
Net interest income	**13,029**	**14,906**	**21,378**	**27,206**	**32,660**
Fees	2,379	2,711	3,122	3,851	4,698
Other Income	3,049	5,383	3,128	4,362	4,973
Net Revenue	18,457	23,000	27,628	35,419	42,331
Operating Expense	9,912	13,042	13,718	16,893	19,996
-Employee Exp	4,430	6,010	6,641	7,652	8,721
-Other Exp	5,482	7,031	7,077	9,242	11,275
Pre-provision Profit	**8,545**	**9,958**	**13,911**	**18,525**	**22,335**
Provisions	3,265	5,279	7,281	8,354	8,934
-Loan Loss Provisions	2,857	5,358	7,245	8,312	8,888
-Provisions for investment	132	40	36	42	46
-Other Provisions	276	(119)	-	-	-
PBT	5,280	4,680	6,629	10,172	13,401
Taxes	1,127	157	2,254	3,458	4,557
PAT	**4,153**	**4,523**	**4,375**	**6,713**	**8,845**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 19: Balance sheet

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Equity Capital	1,885	2,826	2,826	2,826	2,826
Reserves & Surplus	35,021	48,600	51,273	56,283	63,426
Shareholder's Funds	**36,906**	**51,426**	**54,099**	**59,110**	**66,252**
Deposits	**504,882**	**567,331**	**659,840**	**761,600**	**885,747**
-Current deposits	32,435	36,233	46,189	62,070	72,631
-Saving deposits	100,172	128,498	131,968	152,320	177,149
-Term deposit	372,275	402,600	481,683	547,210	635,967
Borrowings	10,515	8,326	14,699	34,328	56,747
Other liabilities	12,701	14,182	28,017	42,152	57,910
Total liabilities	**565,003**	**641,265**	**756,655**	**897,190**	**1,066,656**
Cash/Equivalent	30,449	32,740	41,629	49,659	58,518
Advances	339,024	370,036	462,546	564,306	688,453
Investments	162,567	202,197	214,887	244,246	279,228
Fixed Assets	3,066	7,206	7,926	8,719	9,591
Other assets	29,897	29,086	29,667	30,261	30,866
Total assets	**565,003**	**641,265**	**756,655**	**897,190**	**1,066,656**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 18: Key ratios

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Growth (%)					
NII growth	11.5	14.4	43.4	27.3	20.0
Pre-provision profit growth	10.5	16.5	39.7	33.2	20.6
PAT growth	(8.0)	8.9	-3.3	53.4	31.8
Business (%)					
Deposit growth	9.7	12.4	16.3	15.4	16.3
Advance growth	7.0	9.1	25.0	22.0	22.0
Business growth	8.6	11.1	19.7	18.1	18.7
CD	67.1	65.2	70.1	74.1	77.7
CASA	26.3	29.0	27.0	28.2	28.2
Operating effeciency (%)					
Cost-to-income	53.7	56.7	49.7	47.7	47.2
Cost-to-assets	1.8	2.2	2.0	2.0	2.0
Productivity (Rsmn)					
Business per branch	1,164.0	1,225.3	1,403.0	1,597.5	1,830.5
Business per employee	108.3	117.4	134.9	152.1	174.3
Profit per branch	5.7	5.9	5.5	8.1	10.3
Profit per employee	0.5	0.6	0.5	0.8	1.0
Spreads (%)					
Yield on advances	11.3	10.7	10.8	10.8	10.7
Yield on investments	7.4	7.1	7.1	7.2	7.2
Cost of deposits	7.4	6.7	6.3	6.2	6.1
Yield on assets	10.0	9.5	9.6	9.7	9.7
Cost of funds	7.5	6.8	6.3	6.3	6.3
NIMs	2.6	2.7	3.4	3.6	3.6
Capital adequacy (%)					
Tier I	10.6	12.2	10.9	10.3	9.4
Tier II	1.5	1.1	0.9	0.8	0.8
Total CAR	12.0	13.3	11.8	11.1	10.2
Asset Quality (%)					
Gross NPA	3.4	4.2	4.0	3.9	3.8
Net NPA	2.4	2.7	2.7	2.6	2.6
Provision coverage	31.4	36.8	33.5	33.3	32.0
Slippage	3.4	3.8	3.5	3.2	3.0
Credit-cost	0.8	1.6	1.6	1.5	1.3
Return (%)					
ROE	11.7	10.2	8.3	11.9	14.1
ROA	0.8	0.7	0.6	0.8	0.9
RORWA	-	2.3	1.0	1.2	1.3
Per share (Rs)					
EPS	22.0	16.0	15.5	23.8	31.3
BV	195.8	182.0	191.4	209.2	234.4
ABV	152.9	146.6	147.3	156.6	170.6
Valuation (x)					
P/E	5.4	7.4	7.6	5.0	3.8
P/BV	0.6	0.6	0.6	0.6	0.5
P/ABV	0.8	0.8	0.8	0.8	0.7

Source: Company, Nirmal Bang Institutional Equities Research

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City Union Bank

26 March 2018

Reuters: CTBK.NS; Bloomberg: CUBK IN

Initiating Coverage

Running The Tightest Ship

City Union Bank (CUBL) is a mid-cap private sector bank with a network of 563 branches and loan book size of Rs261bn. We are bullish on CUBL as: (1) It is the yield and margin leader on the back of its granular MSME loan franchise (2) It is a cost of funds leader on back of (a) low dependence on wholesale funding and (b) borrowings, and (c) eschewing SA rate competition. (3) It has a sound loan growth outlook as (a) the drag from gold loan book is in the past and (b) it is a regional champion in Tamil Nadu. (4) It has done a stellar job on both opex control and ensuring sound underlying asset quality. We initiate coverage on CUBL with a Buy rating and a target price of Rs 216, which values the stock at 3.0x/2.6x FY19E/FY20E P/BV.

Firm focus on granular MSME loans gives yield and margin leadership to CUBL: MSME loans (own classification) account for 52% of total loans at CUBL compared with 7%-34% for mid-cap private sector peers. CUBL's loan franchise is truly retailised and granular with the proportion of retail in retail and corporate assets at 67% as of 1HFY18-end compared with 10%-53% for private sector mid-cap peers, barring DCB Bank/Karur Vysya Bank at 79/69%. Also, its share of top 20 borrowers in FY17 loan book stood at 5.3% compared with 8.1%-35.6% for mid-cap peers. Consequently, CUBL is the margin leader with NIM of 4.4% in 3QFY18 compared with 1.9-4.1% for mid-cap peers.

Prudent asset-liability management results in low cost of funds: Prudent asset-liability management results in low dependence on high-cost wholesale deposits for CUBL at 5% of 1HFY18 deposits compared with 8%-25% for mid-cap peers, barring Karnataka Bank at 0.4%. Share of borrowings, which are generally higher-cost, in deposits and borrowings was 2.2% as of 1HFY18 compared with 3.1%-60.7% for mid-cap peers, barring Karur Vysya Bank/J&K Bank/Karnataka Bank at 1.2%-1.8%. CUBL has also eschewed SA rate competition so far and managed well with it.

Loan growth outlook is sound given the drag from gold loans is history and CUBL remains a regional champion: Over FY13-FY17, gold loans declined at a CAGR of (11%) dragging down overall loan growth. However, the drag from gold loan book is a thing of the past given: (a) Its share of gold loans has fallen from 22% in FY13 to 9% as of 3QFY18-end and no longer moves the needle. (b) Gold loan book has started to grow at 11% YoY as of 3QFY18. Secondly, CUBL has ample growth opportunities within Tamil Nadu (TN) given (a) its low branch share there at 3.7% (b) public sector banks - including TN-focused Indian Overseas Bank - rapidly losing market share (c) large private sector banks operating at higher mutually-exclusive ticket sizes and (d) key TN-focused mid-sized private sector banks, viz. Lakshmi Vilas Bank, Karur Vysya Bank and TN Mercantile Bank all having significant asset quality problems.

CUBL has done a stellar job on the opex control front as well as ensured sound underlying asset quality: CUBL has a cost-to-income ratio of 39% in 3QFY18 compared with 45%-81% for midcap peers. Superior opex control is the result of: (a) Successful migration of transactions from branches to digital channels with digital share rising from ~60% to ~80% in about two years. (b) Low employee costs because of (i) a young workforce with average age of ~27 years and (ii) non-IBA bi-partite settlement with employees. CUBL has maintained sound underlying asset quality with (a) low exposure to ultra-stressed sectors and (b) limited stressed asset pipeline.

Valuation and outlook: We have used the residual income model to value CUBL and arrive at the target price of Rs 216. CUBL currently trades at 2.4x/2.1x FY19E/FY20E P/BV and we believe that our target price is reasonable given CUBL's RoE profile of 16.6%/17.2% for FY19E/FY20E and long-term outlook.

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Net Interest Income	9,810	11,988	15,044	18,500	22,343
Pre-Provision Profit	8,333	9,937	12,011	14,254	16,649
PAT	4,447	5,028	6,112	7,315	8,833
EPS (Rs)	7.4	8.4	9.2	11.0	13.3
BV (Rs)	51.0	59.4	61.7	71.3	83.1
P/E	23.3	20.7	18.8	15.7	13.0
P/BV	3.4	2.9	2.8	2.4	2.1
Gross NPA (%)	*2.4*	*2.8*	*3.0*	*3.0*	*3.1*
Net NPA (%)	*1.5*	*1.7*	*1.7*	*1.5*	*1.4*
ROA (%)	*1.5*	*1.5*	*1.6*	*1.6*	*1.7*
ROE (%)	*15.5*	*15.2*	*16.0*	*16.6*	*17.2*

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: Banking

CMP: Rs171

Target Price: Rs216

Upside: 26%

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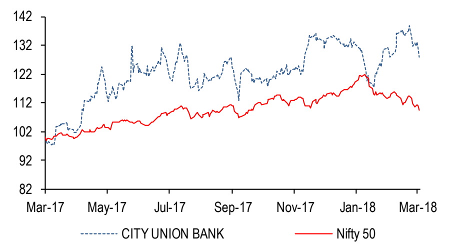
Key Data

Current Shares O/S (mn)	663.5
Mkt Cap (Rsbn/US$bn)	112.8/1.7
52 Wk H / L (Rs)	208/128
Daily Vol. (3M NSE Avg.)	1,010,900

Shareholding (%)	3QFY18	2QFY18	1QFY18
Promoter	-	-	-
Public	100.0	100.0	100.0
Others	-	-	-

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
City Union Bank	(0.2)	6.1	31.2
Nifty Index	(4.8)	0.3	10.0

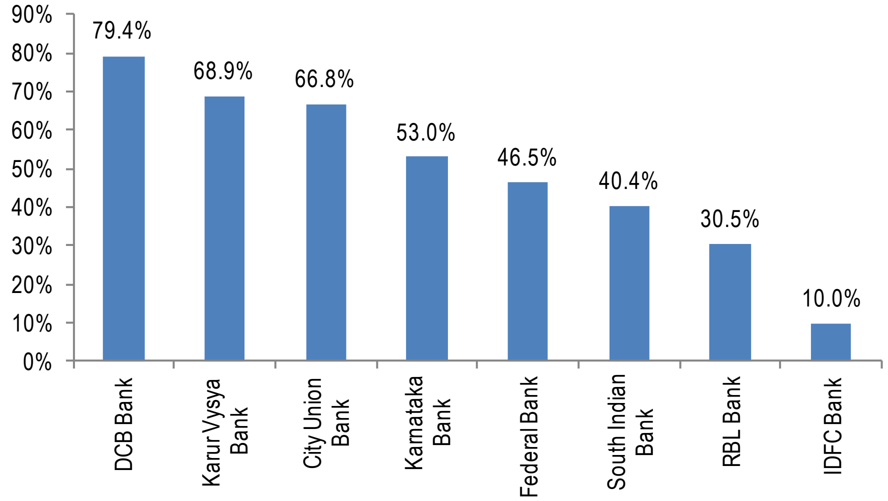
Source: Bloomberg

CUBL possesses a sticky high-yield loan franchise that gives it yield leadership

CUBL is the most retailised bank on the asset side among our expanded peer set of mid-cap banks on the Basel III metric, barring DCB/KVB. CUBL's share of retail assets in retail and corporate assets is 67% as of 1HFY18 compared with 10%-53% for mid-cap peers, barring DCB Bank/KarurVysya Bank at 79%/69%. Ceteris paribus, **this granular loan franchise leads to higher loan yield for CUBL**.

CUBL is one of the most retailised mid-cap banks on the asset side on comparable Basel III definition

Exhibit 1: Share of retail in retail and corporate assets – 1HFY18 – CUBL vs. peers

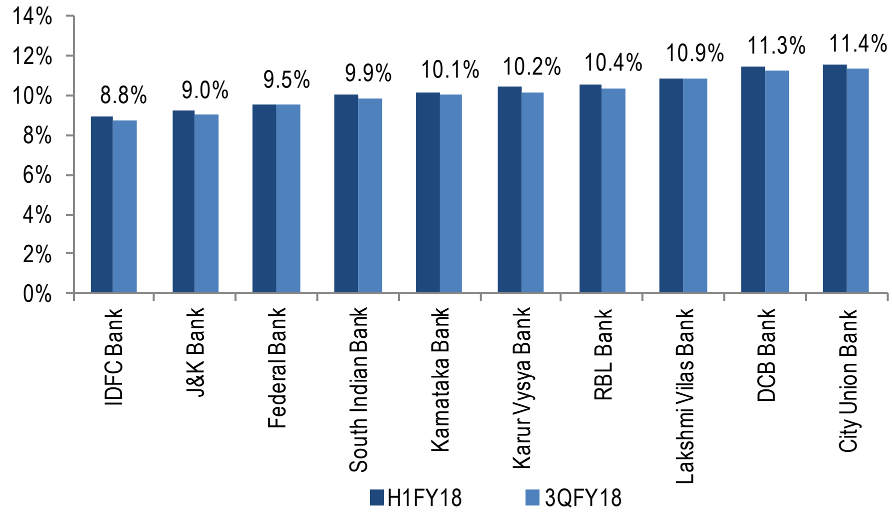


Source: Company, Nirmal Bang Institutional Equities Research

CUBL enjoys the highest loan yield among mid-cap banks

CUBL has the higher **loan yield** of 11.4% in 3QFY18 compared with 8.8%-11.3% for mid-cap bank peers.

Exhibit 2: Yield on loans in 3QFY18 – CUBL vs. peers

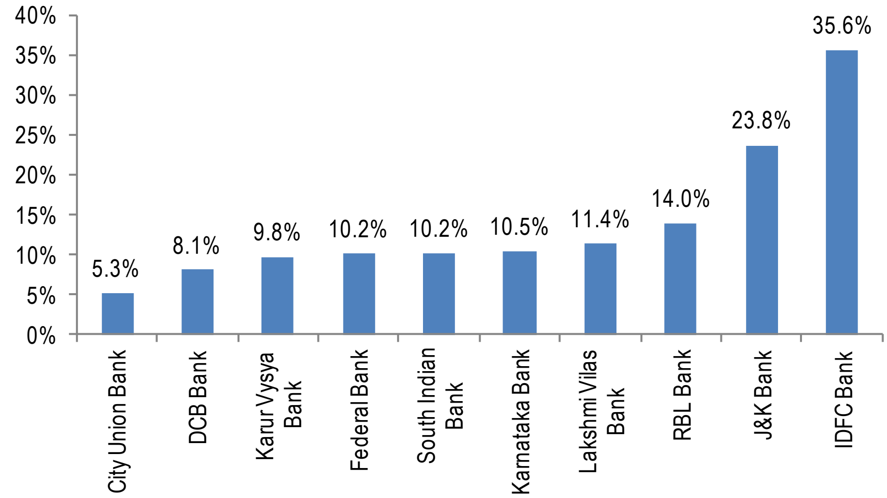


Source: Company, Nirmal Bang Institutional Equities Research

CUBL has the most granular loan franchise among mid-cap banks

CUBL's **granularity of loans is typified by its share of top 20 borrowers in total loans**, which stood at just 5.3% in FY17 compared with 8.1%-35.6% for mid-cap banks.

Exhibit 3: Share of top 20 borrowers in FY17 loan book – CUBL vs. peers

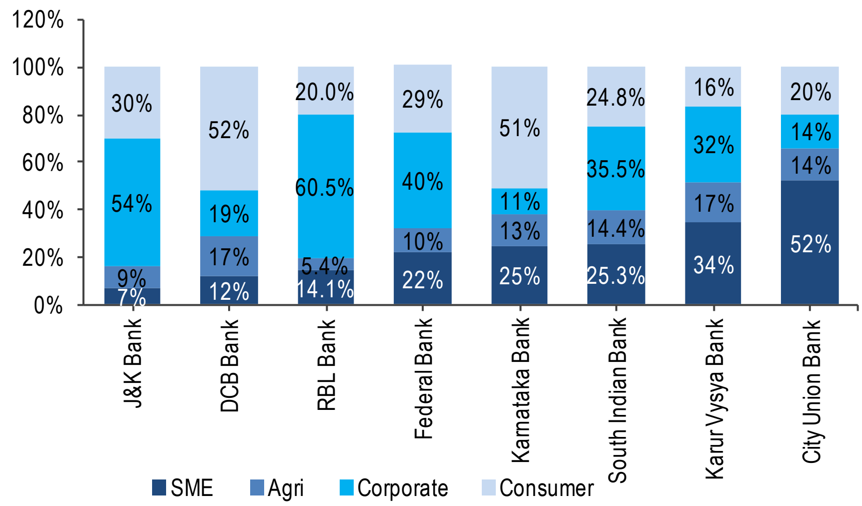


Source: Company, Nirmal Bang Institutional Equities Research

Sticky MSME loan franchise is what drives higher yield for CUBL

While loan granularity could be an independent metric driving loan yield, ceteris paribus, granularity alone is not a recipe for a high-yield loan franchise. CUBL's **small-ticket loan franchise consists mainly of high-yield MSME loans** (52% of total loans) and does not have much of home loans to high-rated individuals.

Exhibit 4: Loan book break-up (respective banks' classification) for 3QFY18 – CUBL vs. peers



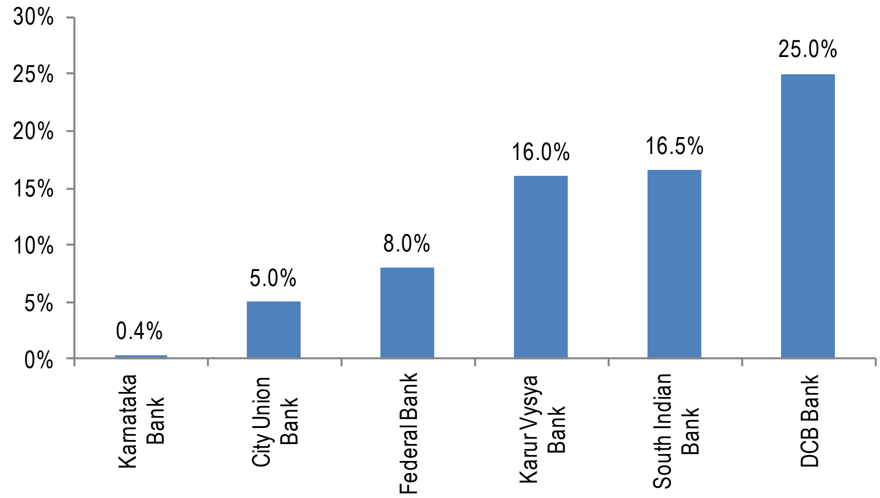
Source: Company, Nirmal Bang Institutional Equities Research

Tight asset-liability management leads to low overall cost of funds for CUBL

CUBL has low dependence on wholesale deposits compared with mid-cap bank peers

CUBL's share of wholesale deposits in total deposits is 5% as of 3QFY18 compared with 8%-25% for mid-cap banks, barring Karnataka Bank at 0.4%. **Wholesale deposits/bulk deposits are typically high-cost large-ticket deposits** that banks need to fall back on to address asset-liability mismatch. Low dependence on wholesale deposits is a key reason why CUBL has low cost of funds.

Exhibit 5: Share of wholesale deposits in total deposits in 3QFY18 – CUBL vs. peers

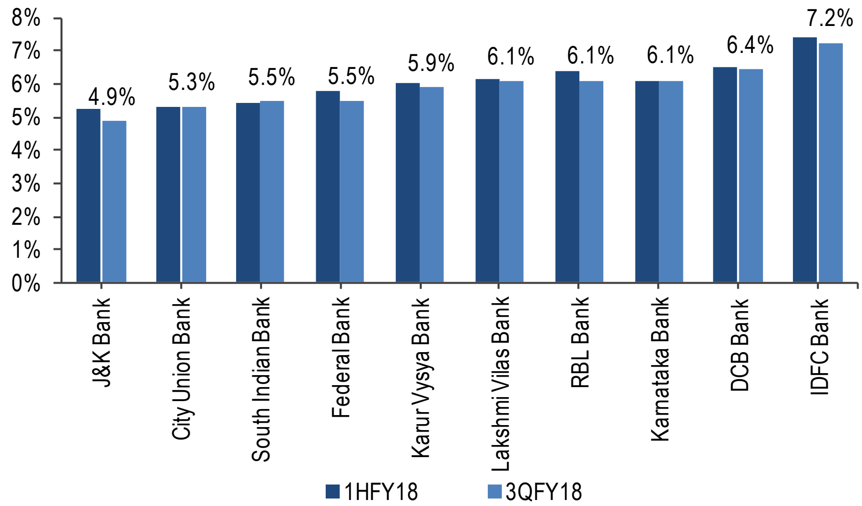


Source: Company, Nirmal Bang Institutional Equities Research

CUBL has one of the lowest cost of funds among mid-cap banks

CUBL has the lowest cost of funds (cost of deposits and borrowings) at 5.3% in 3QFY18 compared with 5.5%-7.2% for mid-cap banks, barring J&K Bank at 4.9%.

Exhibit 6: Cost of funds in 3QFY18 – CUBL vs. peers

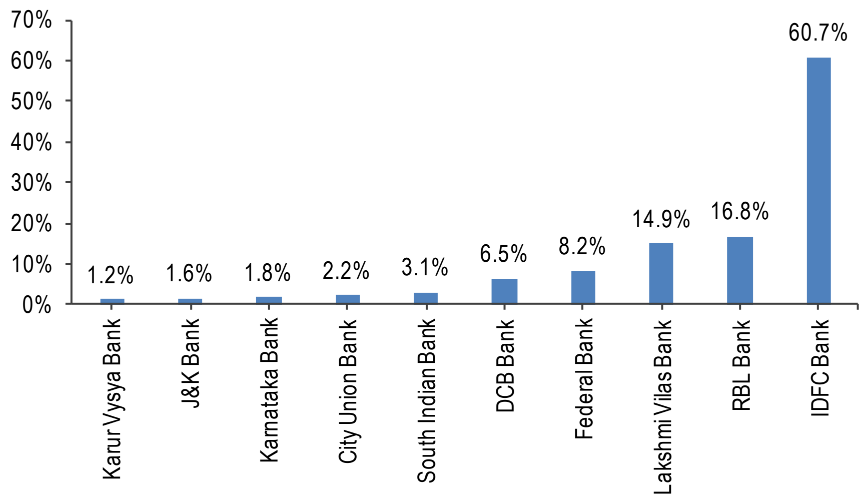


Source: Company, Nirmal Bang Institutional Equities Research

CUBL has low dependence on borrowings as a share of total funding

CUBL's share of borrowings in deposits and borrowings in 3QFY18 stood at 2.2% compared with 3.1%-60.7%% for mid-cap banks, barring Karur Vysya Bank/J&K Bank/Karnataka Bank at 1.2%/1.6%/ 1.8%, respectively. Low dependence on generally high-cost interbank borrowings is **another salutary outcome of superior asset-liability management** on the part of CUBL and contributes to low overall cost of funds for the bank.

Exhibit 7: Share of borrowings in deposit and borrowing in 1HFY18 – CUBL vs. peers

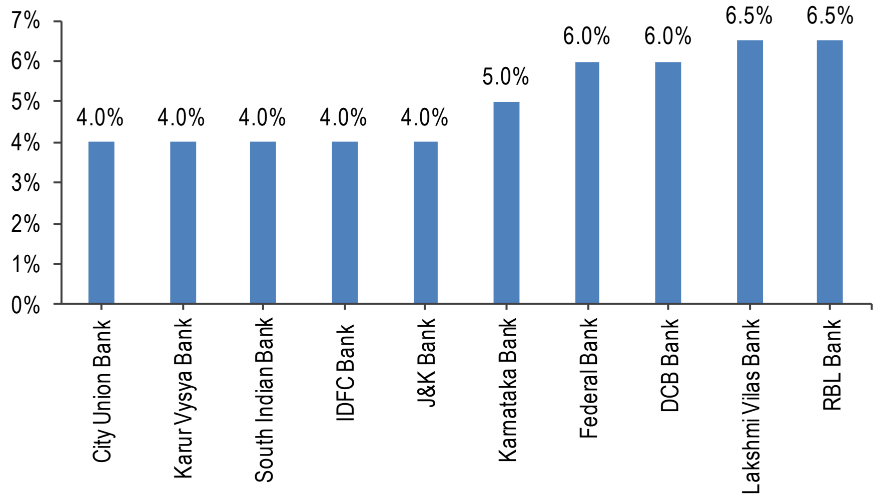


Source: Company, Nirmal Bang Institutional Equities Research

CUBL is not a participant in savings account interest rate competition

CUBL's strategy does not entail offering high card rates on savings accounts (SA) to entice new customers. This is an incremental reason (albeit of lesser importance) that keeps overall cost of funds in check.

Exhibit 8: Highest savings account rate – CUBL vs. peers



Source: Company, Nirmal Bang Institutional Equities Research

CUBL is poised to move into a higher loan growth trajectory on the back to several factors

Drag on overall loan book growth because of gold loan book de-growth is a thing of the past

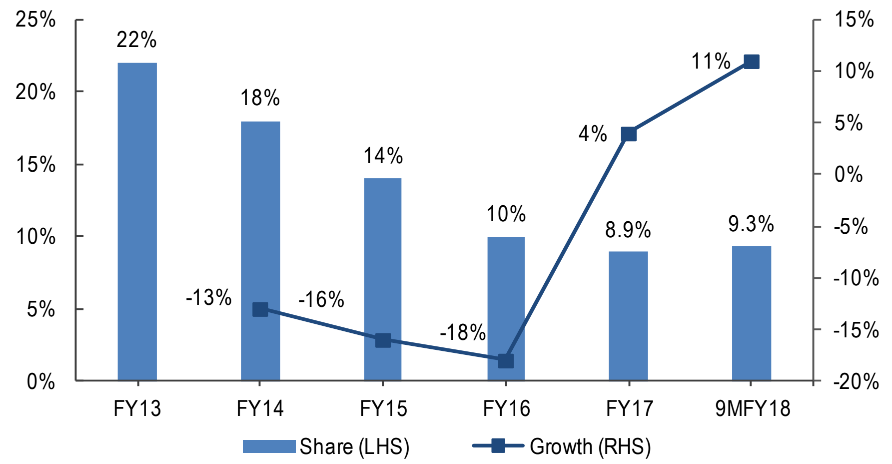
Banks having material exposure to gold loans (mainly certain Kerala-Tamil Nadu focused banks) **suffered a consistent drag on overall loan book growth** due to decline of gold loan book over FY13-FY17 as a consequence of (1) sustained global bear market in gold prices (2) worsening of regulatory regime for gold lending because of cap on loan-to-value ratio (LTV) at 60% and (3) removal of priority sector status for gold loans. Now, we note that (1) gold prices have stabilised with froth having exited the system (2) The regulatory regime has improved with increase in cap on LTV to 75% (3) a cap on cash disbursement of Rs20,000 has been introduced for NBFCs, which is positive for banks.

Consequently, banks such South Indian Bank, City Union Bank and Federal Bank, which suffered a drag on overall loan book growth because of decline in gold book are **no longer impacted by this factor** since (1) Gold loans have reverted to growth path from a period of decline (2) Gold loans are now a smaller portion of overall loan book and hence, no longer move the needle as much, in any case, from an overall growth perspective.

Specifically, in the case of CUBL, gold loans formed 22% of total loans in FY13. Then after declining at a CAGR of (11%) over FY13-FY17, gold loans formed 8.9% of total loans in FY17. In 3QFY18, gold loans grew 11% YoY and form 9.3% of total loans. This growth, albeit tepid, is a **significant departure from the downward spiral witnessed over FY13-FY17**.

We further note that the **past 12 months have been a very poor macro environment for gold lending** in general on account of (1) the body blow that bottom-of-the-pyramid lending received because of Demonetisation and (2) drought conditions in parts of South India, where bulk of the gold loans are disbursed. We expect gold lending disbursement to improve going forward.

Exhibit 9: CUBL gold loan YoY growth and share in total loans – FY13-9MFY18



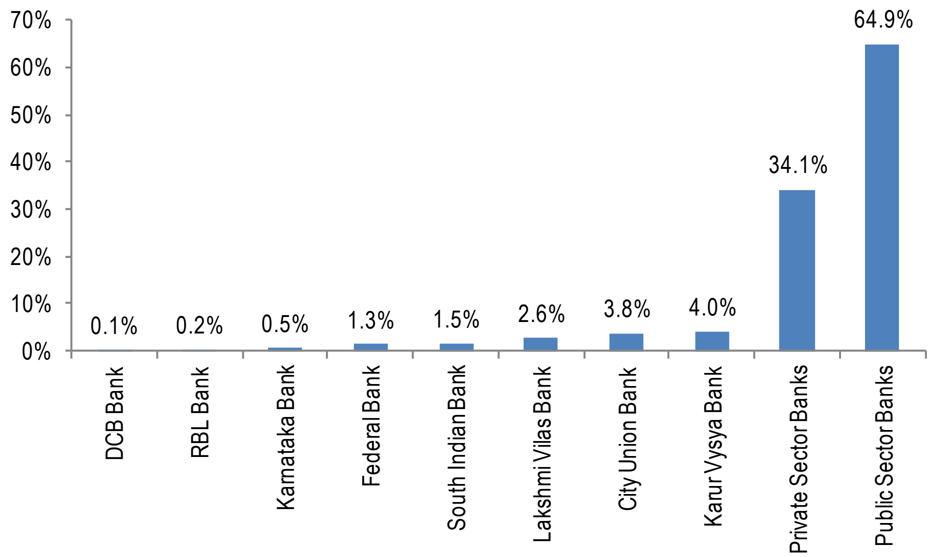
Source: Company, Nirmal Bang Institutional Equities Research

Although CUBL is Tamil Nadu-focused, there is significant headroom for growth from a market share perspective

CUBL does not currently have a strategy of rapidly becoming a pan-India bank and chooses to focus primarily on South India and, within that, on its home state of Tamil Nadu. However, we note that CUBL still has a lot of headroom in terms of penetrating Tamil Nadu itself. **CUBL's branch share in Tamil Nadu**, which could be regarded as a very rough proxy for market share, is 3.7% as of 1HFY18-end compared with 65% for public sector banks and 30% for private sector banks.

With as many as 12 public sector banks under RBI's **Prompt Corrective Action (PCA)** regime and despite Bank Recapitalisation Plan, which will largely only be able to cover **incremental bad loan provisions**, public sector banks will continue to lose market share to the likes of CUBL. It may further be noted that **Indian Overseas Bank**, a key relatively large Tamil Nadu-focused public sector bank, is beset with particularly significant asset quality problems and may take longer, on balance, to come out of the PCA regime.

Exhibit 10: Branch share in Tamil Nadu – CUBL vs. peers and bank groups



Source: State Level Banking Committee – Tamil Nadu, Nirmal Bang Institutional Equities Research

CUBL's average MSME ticket size is largely mutually exclusive to large private sector banks' SME businesses

CUBL's **average MSME ticket size is relatively low at ~Rs3.5mn**, which is significantly lower than ticket sizes for large private sector banks, which tend to operate at a **much larger ticket size range of Rs10mn-50mn**. At the same time, Small Finance Banks do not pose a real threat as they operate at a **much lower loan ticket size range of Rs 0.1mn-Rs0.5mn**.

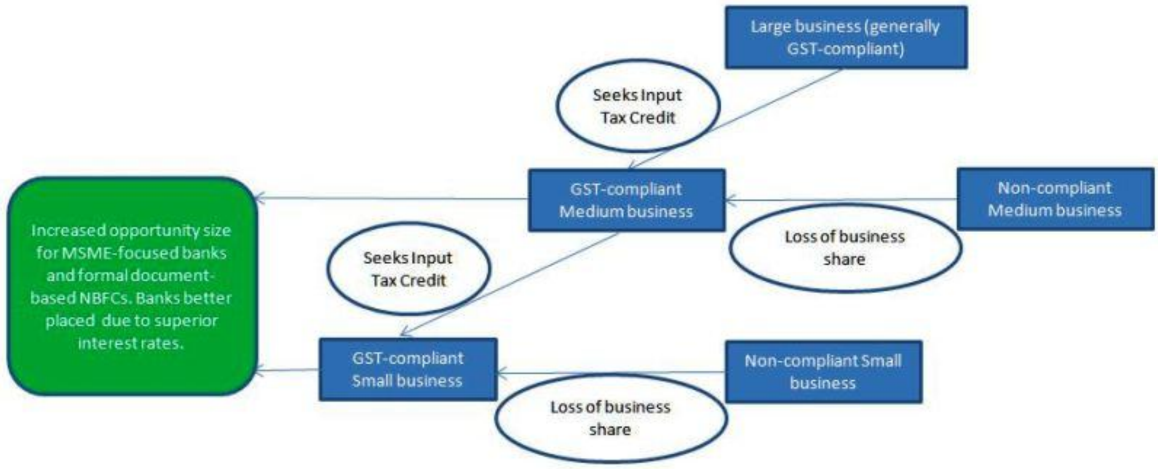
The main competitors for CUBL, therefore, are its key Tamil Nadu-focused mid-sized peers viz. Karur Vysya Bank, Lakshmi Vilas Bank and unlisted Tamilnad Mercantile Bank. Among the **key TN-focused peers**, we believe CUBL is better placed owing to its relatively superior asset quality.

Regulatory regime providing significant incremental fillip for bank lending to MSME segment, on which CUBL is most focused

Formalisation of MSME segment due to GST increases the opportunity size for bank lending

With the advent of GST regime and the ongoing **formalisation of the MSME segment**, a rising quantum of MSME business would be backed by formal documentation, which directly enhances the opportunity size in favour of MSME-focused banks such as CUBL, diverting business away, on balance, from NBFCs disbursing loans to the MSME segment.

Exhibit 11: GST will increase the opportunity size for banks focused on MSME lending



Source: Nirmal Bang Institutional Equities Research

Central government has acute focus on MSME segment as a driver of employment

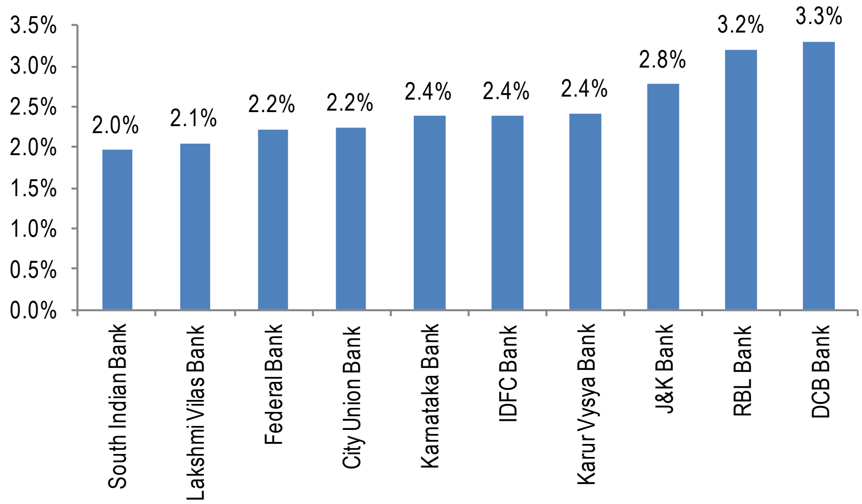
Job creation is a key mandate for the central government and they realize full well that **supporting the MSME segment is necessary to kickstart job creation for the ever-growing Indian youth base**. There is clear regulatory support for the MSME segment, which will have a positive second order impact for bank lending to the MSME segment. The steps taken by the government include (1) augmentation of MUDRA lending target from Rs 1.22 trn in FY16 to Rs 2.44 trn in FY18 and then to Rs 3 trn for FY19E (2) reducing corporate tax rate for companies with annual turnover below Rs2.5bn (in FY17) to 25% (the limit was Rs 0.5bn earlier) (3) Rs 38bn allocated towards credit support, capital, credit subsidy and innovation in the MSME segment for FY19E (4) Credit guarantee scheme for micro and small enterprises covers collateral free credit upto Rs 20 mn per borrowing unit.

52% of CUBL loan book is towards MSME (including retail trade and wholesale trade) and the bank is, hence, a key beneficiary of the government's thrust on the MSME segment.

CUBL's operating expense control is best-in-class among mid-cap banks

CUBL's operating expenses (opex) as a percentage of average loans is 2.2% for 1HFY18 compared with 2.4%-3.3% for mid-cap peers, barring South Indian Bank/Lakshmi Vilas Bank/Federal Bank at 2%/2.1%/2.2%, respectively.

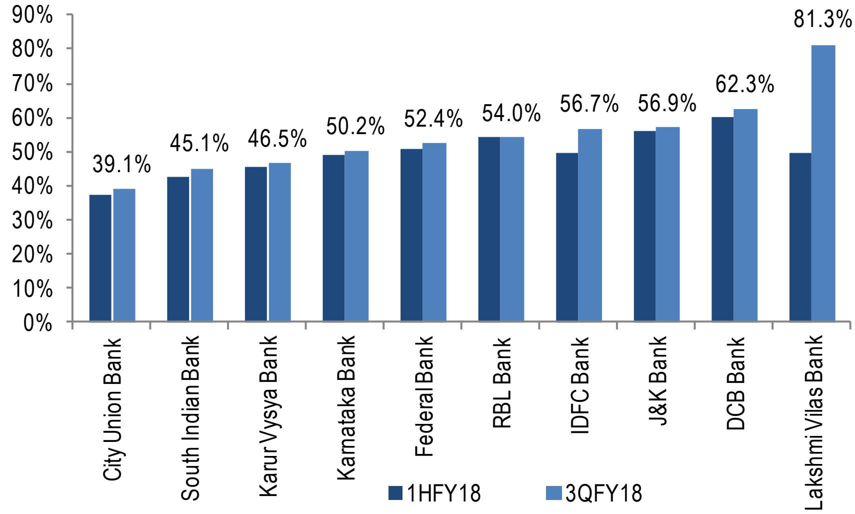
Exhibit 12: Opex to average loans in 1HFY18 - CUBL vs. peers



Source: Company, Nirmal Bang Institutional Equities Research

Similarly, CUBL's cost-to-income ratio, which is more commonly used metric, stood at 39% in 3QFY18 compared with 45%-81% for mid-cap peers.

Exhibit 13: Cost-to-income ratio in 9MFY18 - CUBL vs. peers

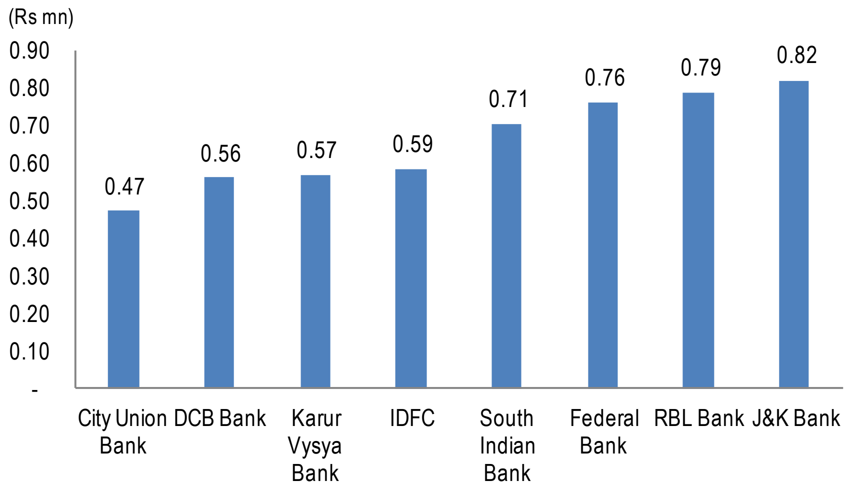


Source: Company, Nirmal Bang Institutional Equities Research

There are **several reasons behind superior opex control** displayed by CUBL. These include (1) non-IBA bi-partite agreement with employees (2) HR strategy working to keep a young, efficient workforce (2) a contained, focused branch expansion strategy and (2) strong traction for digital strategy.

CUBL has a **bi-partite settlement with its employee force** that is outside the purview of IBA (Indian Banks Association). Further, CUBL's HR strategy works to actively maintain a young and efficient workforce having **average age of ~27 years**. Consequently, CUBL's cost per employee for 9MFY18 stands at Rs 0.47mn compared with Rs0.56mn-Rs0.82mn for mid-cap peers.

Exhibit 14: Cost per employee in 9MFY18 - CUBL vs. peers



Source: Company, Nirmal Bang Institutional Equities Research

Further, CUBL has a focused branch expansion strategy that is centered around Tamil Nadu first and then South India. Going forward, it plans to expand branches at a rough ratio of 50% of incremental branches in Tamil Nadu, 25% in South India excluding Tamil Nadu and 25% in rest of India. This is helpful from an opex ratio perspective as **branches within catchment areas where the bank is previously active and has better brand recall tend to break even faster**.

CUBL's digital strategy working well and aiding opex control materially

Though an old generation private sector bank (as per RBI classification) that has been in existence since 1904 (in its earlier avatar as The Kumbakonam Bank), CUBL has been fairly cognisant of the importance of technology. Significantly, CUBL has managed to shift transaction value materially from branches to non-branch channels. **Share of non-branch channels has risen from ~60% about three years ago to ~80% currently**.

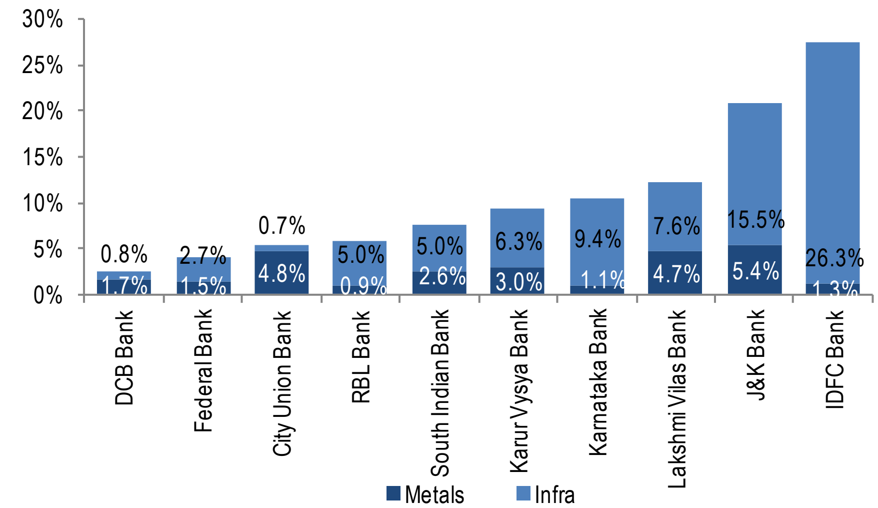
Conservative approach provides comfort on underlying asset quality

CUBL's approach to business has conservativeness writ large and while such an approach sacrifices balance sheet growth to an extent, ceteris paribus, it lends comfort as far as underlying asset quality is concerned. Some aspects of this conservative approach include (1) limited large corporate lending (2) negligible consortium lending or multiple banking arrangement (3) avoidance of ultra-stressed sectors of the Indian economy (4) tight credit appraisal process and (5) limited stressed asset pipeline.

CUBL has been prudent in its sectoral choices and has lowest credit exposure to metals and infrastructure sectors

CUBL's credit exposure to the most stressed sectors of the Indian economy, viz. Metals and Infrastructure, stood at 5.5% of total funded credit as of 1HFY18-end compared with 5.9%-27.6% for mid-cap peers, barring DCB Bank/Federal Bank at 2.5% and 4.2%, respectively.

Exhibit 15: Share of metals and infrastructure sectors in total funded credit in 1HFY18 – CUBL vs. peers

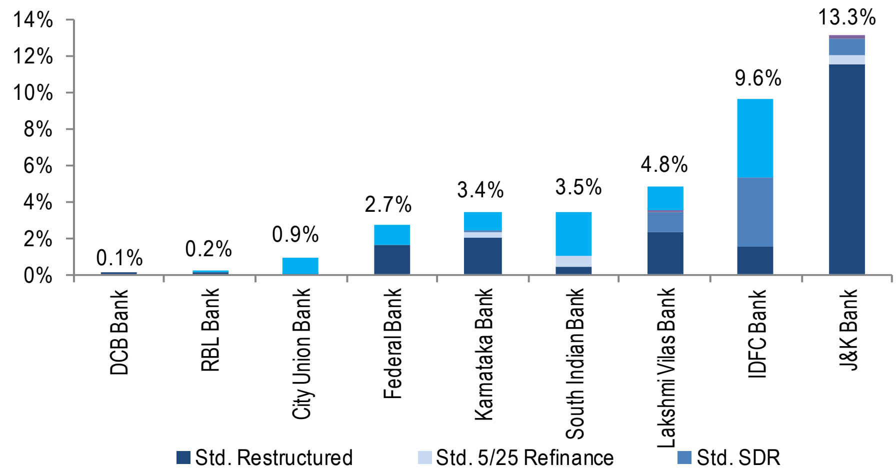


N.B. Metals includes Iron & Steel and Non Ferrous Metals segments. Infrastructure includes Energy / Power, Telecom, Transport and other related segments. Source: Company, Nirmal Bang Institutional Equities Research

CUBL has limited stressed asset pipeline which is indicative of superior underlying asset quality

Apart from low stressed sector exposure, a limited stress pipeline for CUBL is also indicative of its superior underlying asset quality. CUBL stressed asset pipeline, as of 3QFY18-end, is at 0.9% of loan book compared with 2.7%-13.3% for mid-cap peers, barring DCB Bank/RBL Bank at 0.1%/0.2%, respectively.

Exhibit 16: Stressed asset pipeline net of overlaps in 3QFY18 – CUBL vs. peers



N.B. Stress pipeline is the standard non-overlap loan book exposure to traditional restructured loans (CDR, JLF), SDR, flexible structuring (5/25), S4A and net book value of security receipts.

Source: Company, Nirmal Bang Institutional Equities Research; IDFCB "Other stressed assets excl restructured" shown as SDR

Valuation and Outlook

We use the Residual Income Model to arrive at a first-principles' fair value for CUBL. We assume a long-term sustainable average risk-free rate of 7% for India, an Adjusted Beta of 1.05 for CUBL and an India-specific Equity Risk Premium of 6% and arrive at the overall Cost of Equity of 13.3% for CUBL. On this basis, **we arrive at a price target of Rs 216, at which the stock will trade at 3.0x/2.6x FY19E/20E book value**.

CUBL **currently trades at a FY19E/20E P/BV of 2.4x/2.1x, which makes it significantly under-valued** given its FY19E/20E RoE profile of 16.6%/17.2% and long-term outlook. Consequently, we believe that the multiple of 3.0x/2.6x implied by our price target of Rs 216 is reasonable.

Exhibit 17: Consensus vs Our Estimates

	Our estimate			Bloomberg estimate			*% Variance*		
(Rsmn)	**FY18E**	**FY19E**	**FY20E**	**FY18E**	**FY19E**	**FY20E**	***FY18E***	***FY19E***	***FY20E***
Net interest income	15,044	18,500	22,343	14,268	16,235	18,792	*5.4*	*14.0*	*18.9*
Operating profit	12,011	14,254	16,649	12,508	13,968	15,145	*(4.0)*	*2.0*	*9.9*
Profit after tax	6,112	7,315	8,833	5,891	6,967	8,371	*3.8*	*5.0*	*5.5*

Source: Company, Nirmal Bang Institutional Equities Research

Key Risks

Proportion of corporate loans is kept within a band leading to possible scalability issues

Corporate loans are 7% of total loan book (own classification) and there is no great intention of ramping up corporate lending, going forward. This, ceteris paribus, could be somewhat negative from a scalability perspective. However, on the other hand, scalability is aided by the fact that (1) City Union Bank is a regional champion in Tamil Nadu where its branch share is still low (2) drag from gold loan book is in the past.

Company Overview

City Union Bank is a midcap private sector bank with a branch network of 561 branches and 1584 ATMs. It has a loan book is Rs 261bn, of which the Retail, Agri, MSME and Corporate split is 20%, 14%, 52% and 14%, respectively (own classification). On Basel III basis, 67% of Retail and Corporate assets comprise Retail. City Union Bank has displayed a loan CAGR of 14.4% over FY12-17. Its yield on advances in its latest reported quarter was 11.4%.

City Union Bank has a CASA ratio of 22.3% and its cost of funds is 5.3% and, as a result, it registered a net interest margin of 4.4%. Its cost to income ratio stood at 39%. Consequently, it delivered a return on assets of 1.58% and a return on equity of 15.24%, implying a financial leverage of 9.65. Its employee count stood at 6,689. Its Capital Adequacy Ratio was 15.31% and its Tier I Ratio was 14.86%.

Exhibit 18: Management team/ Key executives

Name	Designation	Experience
N. Kamakodi	MD and CEO	Dr. N. Kamakodi, has been a Managing Director and Chief Executive Officer of City Union Bank Ltd. since May 1, 2011. and served as its Executive President since January 3, 2011. Dr. Kamakodi served as Executive Director of City Union Bank Ltd. since October 2006. He served as the General Manager of City Union Bank Ltd. since March 2005. He was actively involved in the various aspects of banking. He has been a Director of City Union Bank Ltd. since April 27, 2011. Dr. Kamakodi was associated with Reliance Industries Limited as an Assistant Manager. Thereafter, he was associated with Bupro, a business processes outsourcing company. He has been associated with Bank since 2003. He is in charge of the overall operations of the Bank. Dr. Kamakodi has a bachelor of technology degree in chemical engineering from Bharathidasan University, a master of business administration degree from the Chinese University of Hong Kong, a doctorate of philosophy in e-banking from Sastra University and is also a certified associate of the Indian Institute of Bankers.
V. Ramesh	CFO and Company Secretary	Mr. V. Ramesh has been Chief Financial Officer at City Union Bank Ltd. since July 01, 2015. Mr. Ramesh serves as Compliance Officer and Company Secretary at City Union Bank Ltd., and has been its General Manager of Central Office since August 26, 2016. Mr. Ramesh served as General Manager of City Union Bank Ltd. since July 31, 2015 until August 26, 2016. Mr. Ramesh served as Deptuy General Manager of City Union Bank Ltd. until July 31, 2015. He served as Assistant General Manager, Company Secretary and Compliance Officer at Stanpacks (India) Limited until February 23, 2012.
R. Venkatasubramanian	Senior GM and COO	Mr. R. Venkatasubramanian has been the Chief Operations Officer at City Union Bank Limited since August 21, 2017 and serves as its Senior General Manager. Mr. Venkatasubramanian served as a General Manager of City Union Bank Ltd. since June 2011 and served as its Deputy General Manager since October 14, 2009.

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 19: Board members

Name	Designation	Experience
S. Mahalingam	Non Executive Chairman	Mr. S. Mahalingam is a well known person in Indian IT industry having 43 years of service with TCS. He retired as Chief Financial Officer and Executive Director of Tata Consultancy Services and was involved in myriad aspects of the company's operation and growth and also played a key role in helping TCS become a $ 11.60 billion global company with over 2,76,000 employees. He is a graduate in Commerce and Associate member of Institute of Chartered Accountants of India. At present he is a Director in Nani Palkhivala Arbitration Centre, Tata Reality and Infrastructure Limited, CMC Limited, CSI Publications, National Skill Development Corporation, Kasturi Sons and Sundaram Finance.
Dr N. Kamakodi	M.D & C.E.O	Dr. N. Kamakodi is serving as MD & CEO of the Bank from May 2011. He is a Bachelor of Technology in Chemical Engineering, an MBA from Chinese University of Hong Kong, Ph.D. in e-Banking and a CAIIB. He joined the Bank as DGM in the year 2003 was elevated to the post of GM in 2005 and later as Executive Director in 2006. He has excellent academic background and also acquired hands on experience on the overall operations of the Bank
V.Kamakodi	Director	Dr. Veezhinathan Kamakoti is the youngest person to adorn the post of Professorship in one of the prestigious Engineering Institutions of India namely I I T, Madras in the Department of Computer Science and Engineering. He holds Bachelor of Engineering and Ph.D. in Computer Science. He is an expert in Computer Science and Technology. His forte is Information Technology related Secured Systems Engineering and Security related software engineering.
Shri. R. Mohan	Director	Mr. R. Mohan is a career banker with 4 decades of vast experience in banking industry. He is a bachelor of Science, Master of Business Administration and a CAIIB. Prior to joining the Board, he served as Chief General Manager of the Bank. Mr. R. Mohan has been appointed on the Board under the majority sector of Banking, Agriculture and Small Scale Industry.
Smt. Abarna Bhaskar	Director	Smt. Abarna Bhaskar is a qualified Chartered Accountant by profession and the first woman director of the Bank. She has served in senior positions with a Foreign Bank abroad and a large private sector bank in India. She has practical experience in Banking, more particularly in the finalization of bank accounts and is a practicing chartered accountant for 7 years.
Shri. M. Narayanan	Director	Shri. M Narayanan is graduated in B.Sc (Mathematics) from Loyola College, Chennai and is a professionally qualified Chartered Accountant cum Cost Accountant (Grad.) and DISA. Being a Chartered Accountant by profession now, he has handled Finance, Accounts & Taxation while in service for over 20 years in companies of repute viz. BHEL, Dalmia Cements, Fenner, RAMCO Cements and Dishnet. He was handling the Corporate Finance and Accounts in Ramco Cements Ltd. and was the Chief Financial Officer in Dishnet DSL Ltd., before taking up Chartered Accountancy Practice in 2003.
Shri. S. Bernard	Director	Shri. S. Bernard is graduated in Bachelor of Commerce from Madras University and is professionally qualified as Chartered Accountant. Shri. Bernard started his career with M/s Eastern Coal Fields, Kolkata, a subsidiary of Coal India Ltd., as an Accountant. Thereafter, he joined M/s Best & Crompton Engineering Ltd., Chennai and headed three divisions therein viz., Carbon brush factory, Cine arc carbon factory and Marketing division as a divisional accountant from the year 1979 to 1984. During the year end of 1984 he started his own practicing Chartered Accountancy firm at Mayiladuthurai.
Shri. Subramaniam Narayanan	Director	Mr. Subramaniam Narayanan is one of the pioneers of private equity in India since 1997. He is 56 years old and he is a Chartered Accountant, Cost Accountant, Company Secretary and MBA from IIM (A). He has spent 12 very successful years as founding partner with Baring Partners (India) handling the entire private equity life cycle from sourcing, Investing, value addition to exit. He has over 31 transactions and 8 exit to his credit and investment experience across multiple asset classes including currencies, bonds, listed equities and private equity. Prior to his stint at Barings, he was CEO of First India Asset Management Company Ltd., and handled treasury services for Bank of America and Abu Dhabi Commercial Bank, UAE. He has two decades experience in Capital Maket activites predominantly in fund management, private equity investments. He is the founding Chairman of Venutre Capital Association of India (VCAI).
Dr.T.S.Sridhar	Director	Dr. T.S. Sridhar, M.A., Ph.D, aged 62 years, is a Retired IAS officer possessing over 35 years of diverse experience in all levels of administration at the Secretariat level including planning, execution and monitoring of various Government schemes. He has intimate knowledge in the field of Banking, Rural Economy, MSME, Small Savings, Industry & Finance and Agriculture & Co-operatives sector. Shri. Sridhar was appointed into the Board as Additional Director on 07th February 2018.
Shri.V.N.Shiva Shankar	Director	Shri. Shiva Shankar, aged 47 years, is qualified as B.Com, ACS., AICWA and BL, with over 25 years of rich experience in the Indian corporate sector. He is also the founder of M/s. VNS Legal, corporate law firm based in Chennai, which focuses on legal advisory services on capital market regulations, takeover offers, compliance issues, corporate litigation etc. Shri. Shiva Shankar has an in depth understanding of Corporate Laws, Mergers, Capital Markets and allied subjects. Shri. Shiva Shankar was appointed into the Board as Additional Director on 07th February 2018

Source: Company, Nirmal Bang Institutional Equities Research

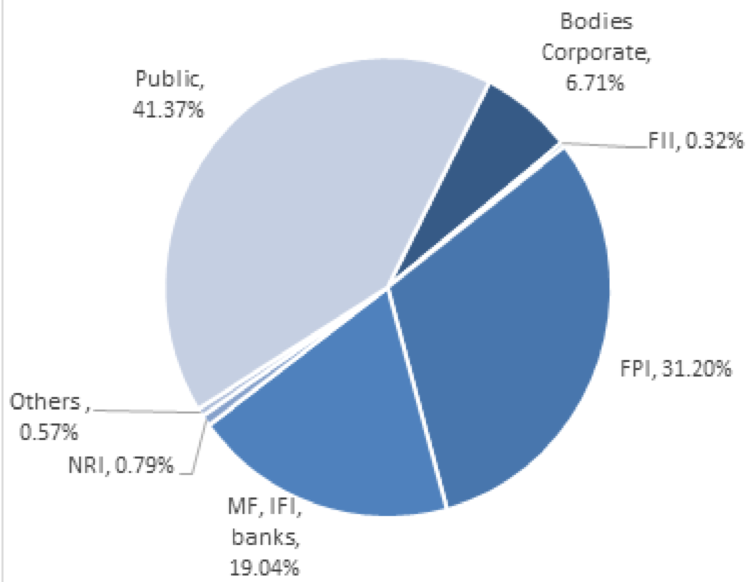
Shareholding Information

Exhibit 20: Key institutional shareholders

	(%)
Promoter	0.0
Non - promoter	
NT Asian Discovery Master Fund	3.98
Life Insurance Corporation of India	3.69
Small cap World Fund INC (Capital Group)	3.31
GKFF Ventures (Argonaut Ventures)	2.99
HDFC Midcap Opportunities Fund	2.83
Aberdeen Global–Asian Smaller Companies Fund	2.11
TVF Fund Ltd	1.64
HDFC Standard Life Insurance Company Ltd	1.36
Bank Muscat India Fund	1.24
HDFC Balanced Fund	1.21
Faering Capital India Evolving Fund	1.10
Wasatch Core Growth Fund	1.10
Somerset Emerging Markets Small Cap Fund	1.08
Lavender Investments (Chrys Capital)	1.05

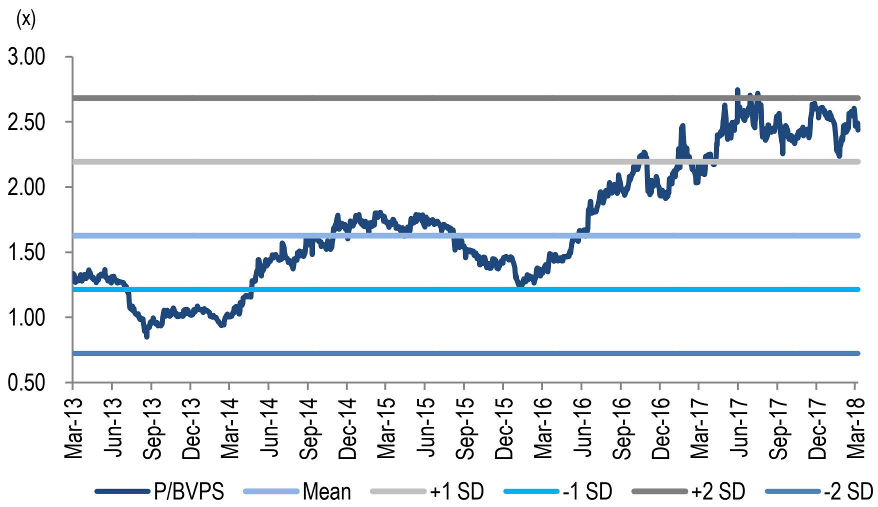
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 21: Shareholding pattern



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 22: One year forward P/BV



Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 23: Income statement

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Interest Income	29,442	31,738	35,810	42,198	50,201
Interest expense	19,632	19,750	20,767	23,698	27,858
Net interest income	**9,810**	**11,988**	**15,044**	**18,500**	**22,343**
Fees	446	439	520	681	817
Other Income	3,654	4,400	4,187	4,876	5,816
Net Revenue	13,910	16,827	19,750	24,057	28,976
Operating Expense	5,577	6,890	7,738	9,803	12,326
-Employee Exp	2,132	2,981	3,322	3,925	4,531
-Other Exp	3,446	3,908	4,416	5,878	7,796
Pre-provision Profit	**8,333**	**9,937**	**12,011**	**14,254**	**16,649**
Provisions	2,306	3,010	3,639	4,233	4,550
-Loan Loss Provisions	2,262	2,595	3,084	3,656	4,387
-Provisions for investment	-	490	554	577	163
-Other Provisions	44	(75)	-	-	-
PBT	6,027	6,928	8,373	10,021	12,100
Taxes	1,580	1,900	2,261	2,706	3,267
PAT	**4,447**	**5,028**	**6,112**	**7,315**	**8,833**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 25: Balance sheet

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Equity Capital	598	601	663	663	663
Reserves & Surplus	29,922	35,101	40,255	46,612	54,486
Shareholder's Funds	**30,520**	**35,702**	**40,918**	**47,275**	**55,150**
Deposits	**271,581**	**301,157**	**346,201**	**405,821**	**480,065**
-Current deposits	19,192	24,092	28,042	33,480	40,325
-Saving deposits	36,133	46,297	54,007	64,526	78,251
-Term deposit	216,256	230,768	264,152	307,815	361,489
Borrowings	6,645	5,310	7,026	9,276	11,976
Other liabilities	9,293	10,538	11,594	23,904	35,256
Total liabilities	**318,040**	**352,708**	**405,739**	**486,276**	**582,446**
Cash/Equivalent	26,501	28,790	32,341	38,809	46,571
Advances	210,569	238,327	281,226	337,471	404,965
Investments	68,265	70,315	74,056	88,492	105,366
Fixed Assets	2,176	2,151	2,366	2,602	2,863
Other assets	10,530	13,126	15,751	18,901	22,681
Total assets	**318,040**	**352,708**	**405,739**	**486,276**	**582,446**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 24: Key ratios

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Growth (%)					
NII growth	21.5	22.2	25.5	23.0	20.8
Pre-provision profit growth	20.3	19.3	20.9	18.7	16.8
PAT growth	15.8	13.1	21.6	19.7	20.7
Business (%)					
Deposit growth	12.8	10.9	15.0	17.2	18.3
Advance growth	17.2	13.2	18.0	20.0	20.0
Business growth	14.7	11.9	16.3	18.5	19.1
CD	77.5	79.1	81.2	83.2	84.4
CASA	20.4	23.4	23.7	24.2	24.7
Operating effeciency (%)					
Cost-to-income	40.1	40.9	39.2	40.7	42.5
Cost-to-assets	1.9	2.1	2.0	2.2	2.3
Productivity (Rs mn)					
Business per branch	918.4	980.9	1,100.7	1,238.8	1,382.9
Business per employee	106.7	115.1	123.7	137.6	157.6
Profit per branch	8.5	9.1	10.7	12.2	13.8
Profit per employee	1.0	1.1	1.2	1.4	1.6
Spreads (%)					
Yield on advances	12.1	11.5	11.6	11.5	11.4
Yield on investments	8.2	7.8	7.4	7.5	7.5
Cost of deposits	7.5	6.8	6.3	6.2	6.2
Yield on assets	10.7	10.3	10.3	10.4	10.3
Cost of funds	7.5	6.8	6.3	6.2	6.1
NIMs	3.6	3.9	4.3	4.5	4.6
Capital adequacy (%)					
Tier I	15.1	15.4	11.5	11.1	10.8
Tier II	0.5	0.5	0.4	0.4	0.3
Total CAR	15.6	15.8	11.9	11.4	11.1
Asset Quality (%)					
Gross NPA	2.4	2.8	3.0	3.0	3.1
Net NPA	1.5	1.7	1.7	1.5	1.4
Provision coverage	36.5	39.6	42.5	49.7	57.2
Slippage	2.2	2.1	2.0	1.8	1.8
Credit-cost	1.1	1.1	1.1	1.1	1.1
Return (%)					
ROE	15.5	15.2	16.0	16.6	17.2
ROA	1.5	1.5	1.6	1.6	1.7
RORWA	-	4.0	2.1	1.9	1.9
Per share (Rs)					
EPS	7.4	8.4	9.2	11.0	13.3
BV	51.0	59.4	61.7	71.3	83.1
ABV	45.6	52.5	54.3	63.5	74.9
Valuation (x)					
P/E	23.3	20.7	18.8	15.7	13.0
P/BV	3.4	2.9	2.8	2.4	2.1
P/ABV	3.8	3.3	3.2	2.7	2.3

Source: Company, Nirmal Bang Institutional Equities Research

Federal Bank

26 March 2018

Initiating Coverage

Reuters: FED.NS; Bloomberg: FB IN

Big Boys' Club Beckons

Federal Bank (FBL) is a mid-cap private sector bank with a network of 1,252 branches and loan book size of Rs850bn. We are bullish on FBL as: (1) FBL's acceptance in the market has helped it build a low-cost funding profile of significant scale that helps remain competitive in loan markets of large generic opportunity: (a) salaried home loans and (b) high-rated corporate loans. (2) It is a key beneficiary of the turnaround in remittances into India (3) Its underlying asset quality lends significant comfort (4) Its digital strategy is witnessing significant traction on the ground. We initiate coverage on Federal Bank with a Buy rating with a target price of Rs112, which values the stock at 1.6x/1.4x FY19E/FY20E P/BV.

FBL has a deposit franchise that can help it become the first bank to break away from the mid-sized bank basket: FBL is a behemoth in terms of occupying the mind space in South India which has helped it build a deposit franchise of true scale (~Rs1trn), which is the largest in our expanded set of 10 mid-cap private sector peers. Importantly, FBL has: (1) A superior CASA ratio without (till recently) high SA card rate (2) Low dependence on high-cost bulk deposits (3) A deep, granular deposit base that enables it to have low cost of funds at 5.5% in 3QFY18 compared with 5.9%-7.2% for mid-cap peers (barring J&K Bank, City Union Bank and South Indian Bank at 4.9%-5.5%), which is particularly commendable given the scale. We believe there are incipient signs of FBL discarding its somewhat regional focus and moving decisively to becoming a pan-India bank and expand on its funding base.

NRI remittances from GCC nations are a key funding advantage for FBL: Remittances into India have witnessed a marked acceleration since this financial year, growing 15% YoY in July 2017 (compared with -11% a year ago). A key reason for this is improved remittances from GCC (Gulf Cooperation Council) nations, which form 54% of total remittances into India, on the back of relatively stable crude oil prices. FBL is a key beneficiary, with NRI deposits as a share of total deposits growing to 39% as of 1HFY18-end compared with 37% as of FY17-end.

FBL remains an asset quality champion maintaining sound underlying asset quality: FBL's exposure to ultra-stressed sectors, viz. metals and infrastructure, remains contained at 4.2% of 1HFY18 funded credit book compared with 5.5%-27.6% for mid-cap peers (barring DCB Bank at 2.5%). Importantly, the stressed asset pipeline for FBL by way of standard restructured, SDR, S4A, 5/25 and SR book is relatively limited at 2.7% of loan book compared with 3.4%-13.3% for mid-cap peers (barring DCB Bank/RBL Bank/City Union Bank at 0.1%/0.2%/0.9%, respectively). No reportable divergence in asset quality assessment with the RBI as of FY16-end lends further comfort.

FBL has laid out a high-quality digital strategy that is witnessing significant traction: We looked at key RBI data and note that on key aspects pertaining to traction for digital channels, RBL stands 3rd, 3rd, 5th, 5th and 4th, respectively, on ATM and POS transaction value per debit card, NEFT transaction value, RTGS transaction value and mobile transaction value as a proportion of deposits, respectively, among our expanded peer set of 10 mid-cap private sector banks. This indicates that FBL's digital strategy is already witnessing significant traction on the ground and augurs well from an opex control perspective.

Valuation and outlook: We have used the residual income model to value FBL and arrive at our target price of Rs112. FBL currently trades at 1.3x/1.2x FY19E/FY20E P/BV and we believe that our target price is reasonable given FBL's RoE profile of 11.3%/13.1% for FY19E/FY20E and long-term outlook.

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Net Interest Income	25,041	30,526	37,642	47,152	57,178
Pre-Provision Profit	14,237	19,250	24,440	32,132	40,581
PAT	4,756	8,309	10,783	14,729	19,031
EPS (Rs)	2.8	4.8	5.5	7.5	9.7
BV (Rs)	47.1	51.3	63.2	69.6	78.2
P/E	32.9	19.1	16.6	12.2	9.4
P/BV	1.9	1.8	1.4	1.3	1.2
Gross NPA (%)	*2.1*	*2.3*	*2.4*	*2.4*	*2.5*
Net NPA (%)	*1.6*	*1.3*	*1.3*	*1.2*	*1.1*
ROA (%)	*0.5*	*0.8*	*0.8*	*0.9*	*1.0*
ROE (%)	*6.0*	*9.8*	*10.1*	*11.3*	*13.1*

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: Banking

CMP: Rs91

Target Price: Rs112

Upside: 25%

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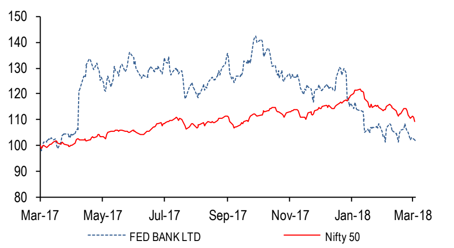
Key Data

Current Shares O/S (mn)	1,970.8
Mkt Cap (Rsbn/US$bn)	178.4/2.7
52 Wk H / L (Rs)	128/87
Daily Vol. (3M NSE Avg.)	10,947,080

Shareholding (%)	3QFY18	2QFY18	1QFY18
Promoter	-	-	-
Public	100.0	100.0	100.0
Others	-	-	-

One Year Indexed Stock Performance



Price Performance (%)

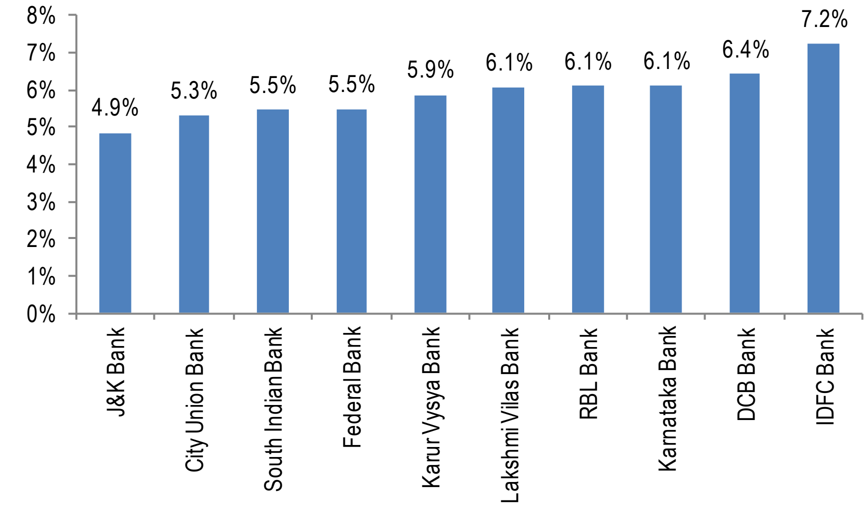
	1 M	6 M	1 Yr
Federal Bank	(4.5)	(20.5)	2.5
Nifty Index	(4.8)	0.2	9.9

Source: Bloomberg

FBL has acceptance in the market to build a low-cost deposit book of scale

FBL is the largest (balance sheet size) among the banks in our expanded peer set of mid-cap banks and seems to have gained strong acceptance in the market, particularly South India. This is reflected in: (1) Superior **CASA traction** (2) Low dependence on **bulk deposits** (3) **Granularity** in deposits. As a consequence, FBL enjoys low cost of funds at 5.5% in 3QFY18 compared with 5.9%-7.2% for mid-cap peers, barring J&K Bank, City Union Bank and South Indian Bank at 4.9%-5.5%.

Exhibit 1: Cost of funds in 3QFY18 – FBL vs. peers



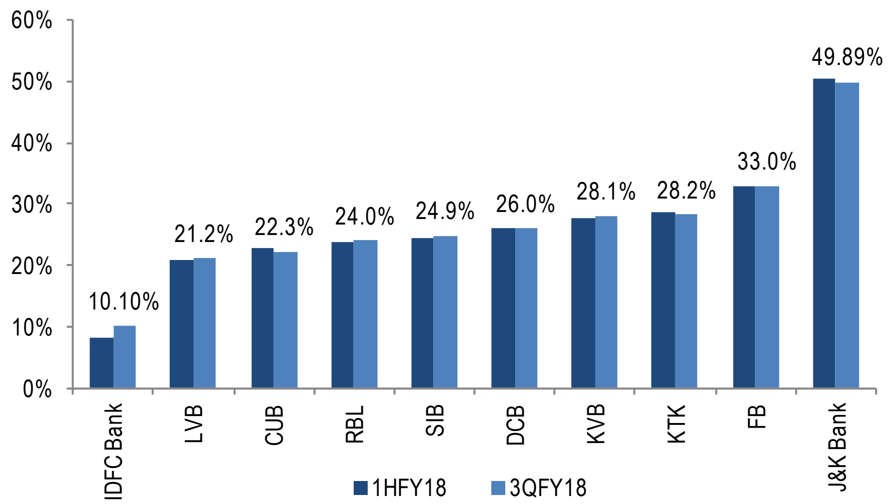
Source: Company, Nirmal Bang Institutional Equities Research

It is important to appreciate that the superior deposit base has been achieved on a significantly larger scale than mid-cap peers and is a **key advantage from the perspective of scalability** as key loan markets of large generic opportunity viz. high-rated corporates and prime home loan borrowers are highly competitive from an interest rate perspective. Low cost of funds also **reduces the need, on balance, to chase high-yield and potentially high-risk loan businesses**.

FBL has witnessed reasonably sound CASA traction on the deposit side

FBL has a CASA ratio of 33.0% as of 3QFY18-end compared with 10.1-28.2% for mid-cap peers, barring J&K Bank at 49.9%. The fact that this CASA ratio has been achieved on a **large deposit base** of ~Rs1trn, which is significantly larger than that of mid-cap peers and also despite **no participation in savings account card rate competition till recently** shows that the acceptance of FBL in the market, as a brand, is significant.

Exhibit 2: CASA ratio in 3QFY18 – FBL vs. peers

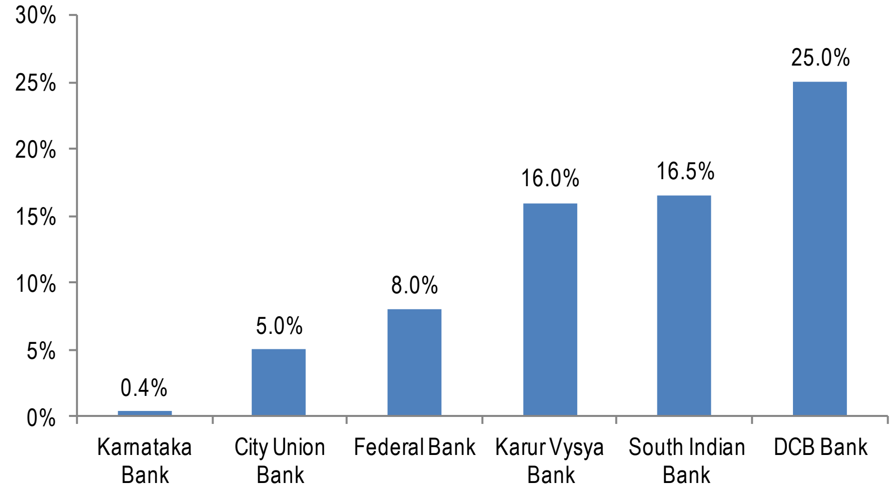


Source: Company, Nirmal Bang Institutional Equities Research

FBL has low dependence on bulk deposits, further aiding cost of funds

Superior asset-liability management for FBL resulted in relatively low dependence on bulk deposits at 8% as of 1HFY18-end compared with 16%-25% for mid-cap peers, barring City Union Bank at 5% and Karnataka Bank at 0.4%.

Exhibit 3 Share of bulk deposits in total deposits – 1HFY18 - FBL vs. peers

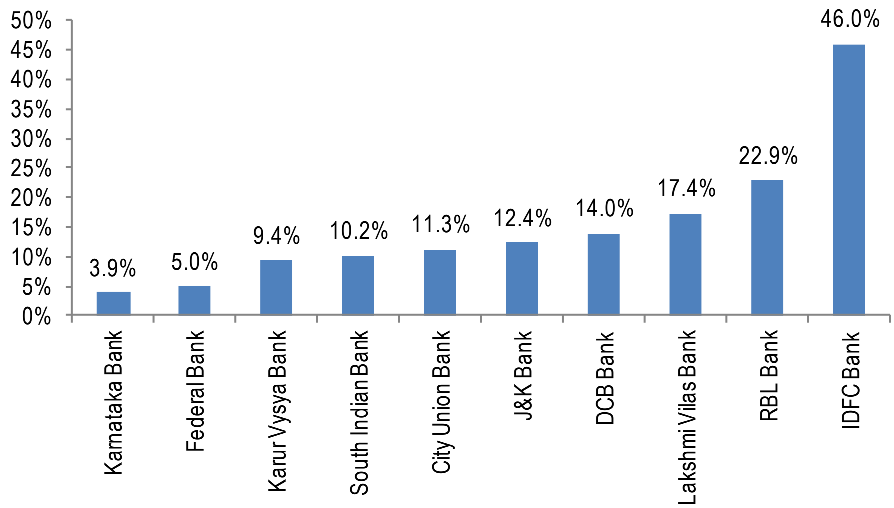


Source: Company, Nirmal Bang Institutional Equities Research

High granularity of deposit base also underlines the quality of franchise

Share of top 20 depositors in the deposit book is 5% as of FY17-end compared with 9.4-46.2% for mid-cap peers, barring Karnataka Bank at 3.9%. High granularity of deposits base is an incremental indicator of the quality of FBL's deposit franchise.

Exhibit 4: Share of top 20 depositors in total deposits – FBL vs. peers



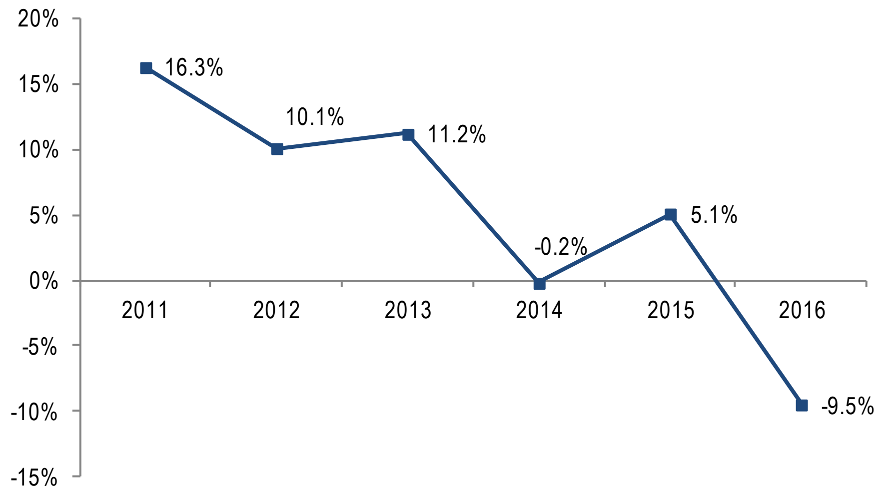
Source: Company, Nirmal Bang Institutional Equities Research

NRI business no longer under stress because of stabilisation of crude oil prices

Another aspect of certain Kerala-Tamil Nadu (particularly Kerala) focused banks is the relatively high share of NRI business, particularly from the Indian diaspora based in the Middle East. The **global bear market in crude oil prices had a direct impact on the economies of the nations in the Middle East** and, ultimately, on the job prospects and salary levels of the Indian diaspora working there. This in turn affected the quantum of remittances from the Middle East into India, of which key Kerala-focused banks capture a significant share.

Remittances from the GCC (Gulf Cooperation Council) nations dipped -9.5% in USD terms in calendar year 2016 on the back of a lag effect of crude oil price collapse. Remittances from the GCC formed as much as 53.7% of total remittances into India in CY16 (54.0% in CY15), and **significantly move the needle as far as total remittances into India are concerned**.

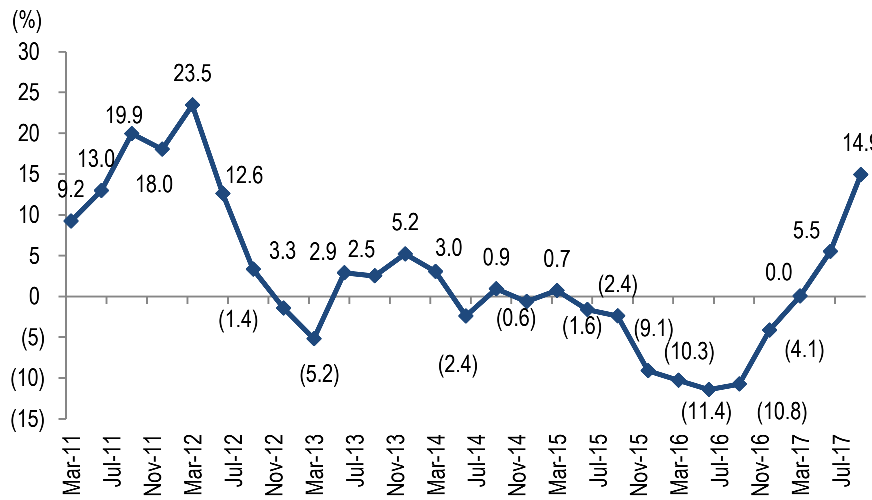
Exhibit 5: YoY growth in remittances from GCC nations to India – CY11-CY16



Source: Company, Nirmal Bang Institutional Equities Research

Crude oil prices, however, have stabilised since and this led to **improved remittances into India with a marked acceleration in 2QFY18**.

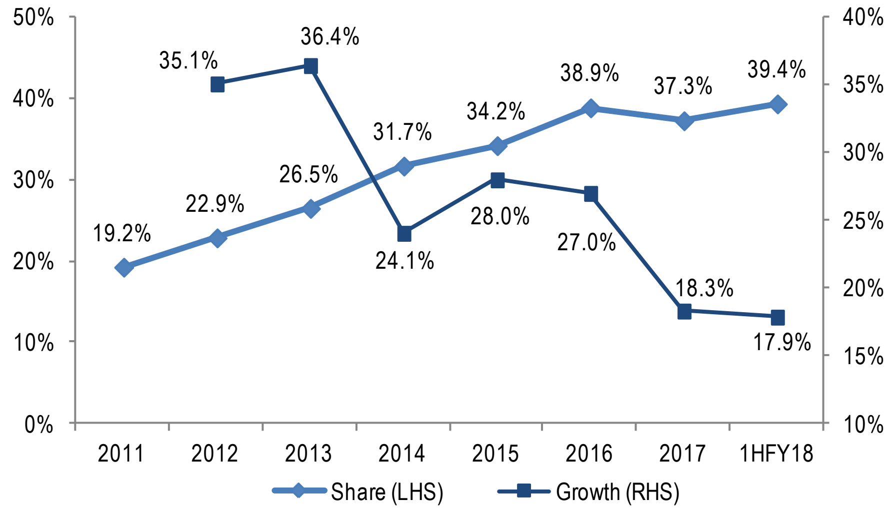
Exhibit 6: YoY growth in total remittances into India – 1QCY11-3QCY17



Source: Company, Nirmal Bang Institutional Equities Research

This augurs well for FBL (and also South Indian Bank), which has a significant NRI business, particularly on the deposits side. NRI deposits of FBL stood at 37.3% of total deposits in FY17 and this share rose to 39.4% as of 1HFY18-end.

Exhibit 7: NRIs have become a key source of deposits for FBL



Source: Company, Nirmal Bang Institutional Equities Research

While absolute growth of NRI deposits inched lower to 17.9% YoY in 1HFY18 compared with 18.3% in FY17, the growth has to be viewed on the context of overall deposit growth of 12.6% in 1HFY18 and consequent rising share of NRI deposits. Thus, strong **NRI deposit business is a competitive advantage for FBL from a deposit generation perspective**.

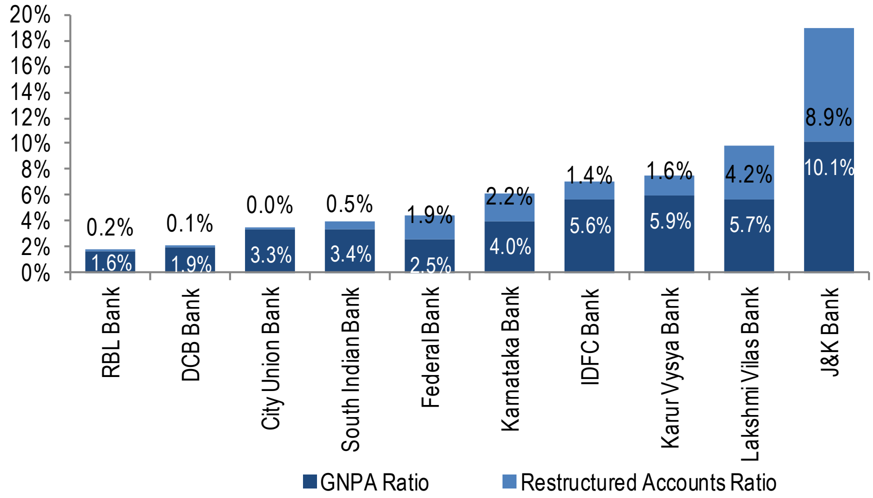
FBL has sound underlying asset quality that will reflect in low provisioning

FBL was one of the **early movers when it came to taking seriously the system-wide bad loan problem** and went into what was, effectively, a phase of accelerated NPA recognition in FY16. This was even prior to the specific recommendation of the RBI, in December 2015, that banks should 'clean up' their balance sheets by FY17-end through NPA recognition. Thus, FY16 was primarily a year of stressed asset recognition for FBL and FY17 an year of stock re-rating driven by high headline profit growth on a low FY16 base. Since the re-rating in FY17, FBL has undergone a stock price consolidation (flat to negative movement from a stock price of Rs 118.55 touched on 8 May 2017 soon after FY17 results). This was on account of chunky corporate bad loan accretion in 1QFY18 and bad loan accretion on the education loan book in 3QFY18. We emphasise that both these events are, as such, **non-recurring** in nature and that FBL's **underlying asset quality is sound,** implying lower bad loan accretion ahead, on average.

Superior underwriting standards result in better headline asset quality for FBL

Headline stressed asset ratio (GNPAs + Standard Restructured) for FBL stood at 4.4% as of 3QFY18-end compared with 6.2%-19% for mid-cap peers, barring RBL Bank, DCB Bank, City Union Bank and South Indian Bank at 1.7%, 2.0%, 3.3% and 3.9%, respectively.

Exhibit 8: GNPA ratio + Standard Restructured – FBL vs. peers

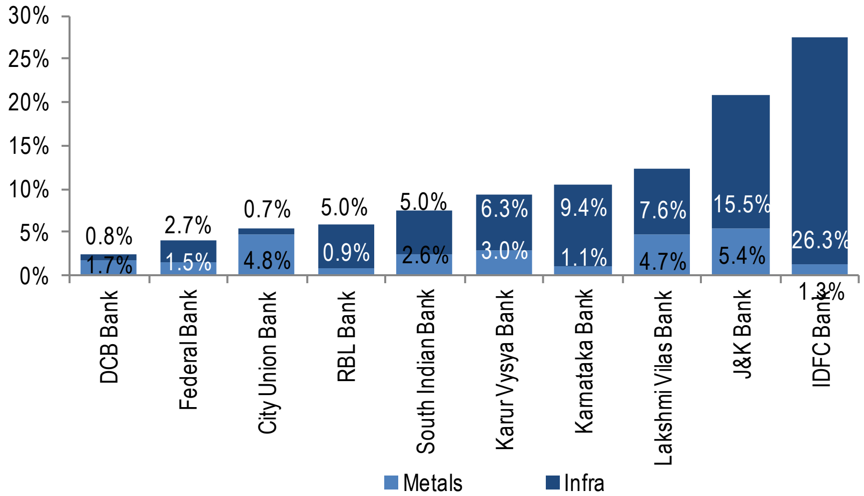


Source: Company, Nirmal Bang Institutional Equities Research

FBL has limited credit exposure to ultra-stressed sectors, indicating prudent risk management approach

FBL has limited exposure to the most stressed sectors of the Indian economy, viz. metals (ferrous and non-ferrous) and infrastructure (power, telecom, transport and other related segments). Its exposure to the said sectors as a percentage of the credit book stood at 4.2% as of 1HFY18-end compared with 5.5%-27.6% for mid-cap peers, barring DCB Bank at 2.5%. While all exposure to the said sectors may not have the potential for tuning stressed, **conscious stressed sector avoidance is an independent vector in bank risk management**.

Exhibit 9: Credit book exposure to metals and infrastructure sectors – FBL vs. peers

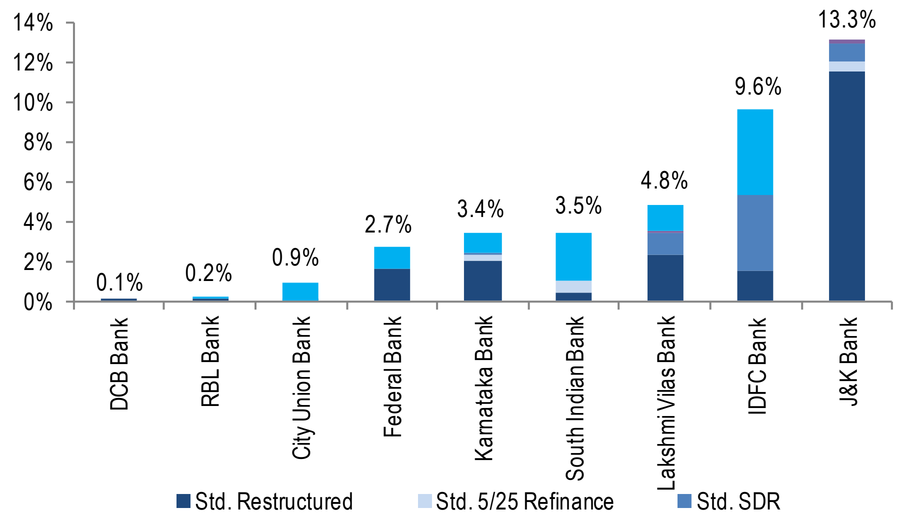


Source: Company, Nirmal Bang Institutional Equities Research

FBL has limited stressed asset pipeline which is also indicative of superior underlying asset quality

Stressed asset pipeline defined as standard restructured loans (CDR, JLF, etc), standard SDR, flexible structuring (5/25 refinance), standard S4A and net book value of security receipts, is limited for FBL at 2.7% of loan book compared with 3.4%-13.3% for mid-cap peers, barring DCB Bank, RBL Bank and City Union Bank at 0.1%, 0.2%, and 0.9%, respectively. There could, possibly, be bad loan accretion from outside the said pipeline, but **the pipeline is a reasonable indicator of the quantum of such accretion in the future**.

Exhibit 10: Stressed asset pipeline net of overlaps – FBL vs. peers



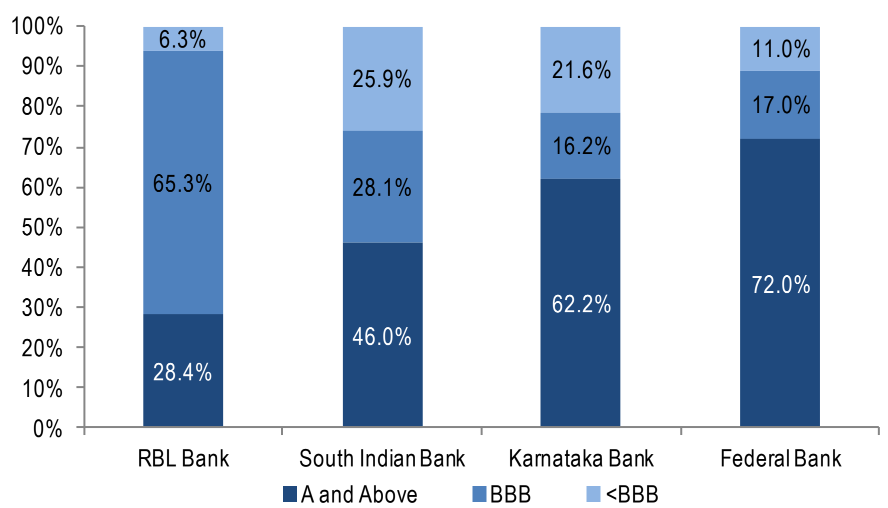
N.B. Stress pipeline is the standard non-overlap loan book exposure to traditional restructured loans (CDR, JLF), SDR, flexible structuring (5/25), S4A and net book value of security receipts.

Source: Company, Nirmal Bang Institutional Equities Research

Risk of stress build-up on corporate loan book in the future is limited

While FBL remains firmly focused on corporate lending, its focus on high-rated corporates lends comfort. **Its share of corporates rated A and above is significantly higher than that of its mid-cap peers active in corporate lending**. While this may be somewhat yield dilutive, it is a good long-term business strategy as: (1) It adds scalability to loan book. (2) Its cost of funds is low enough to deliver adequate net interest margin on such business. (3) Reduces the probability of high provision appearing below the line in the overall RoA tree.

Exhibit 11: Break-up of rated corporate loan book – FBL vs. peers



Source: Company, Nirmal Bang Institutional Equities Research

Other ingredients of FBL strategy are also indicative of augmenting scalability

Apart from low cost of funds facilitating active participation in loan markets with significant interest rate competition but high generic opportunity, other ingredients of FBL strategy also earmark FBL as the next mid-cap bank poised to make a big leap forward in terms of balance sheet scalability.

FBL has shown genuine desire to become a truly pan-Indian bank which augurs well from a scalability perspective

FBL (1) is **trying to build a multi-lingual organisation** away from focus on Malayalam language at the branch level outside Kerala and (2) it has **launched an advertisement campaign ideated by Ogilvy & Mather** which addresses, among other things, its perception as a regional/South India-focused bank.

It is not straightforward to quantify the impact of the aforementioned steps, but it does clearly highlight the **bank's strong intention of becoming a pan-India bank** and augurs well from a balance sheet scalability perspective.

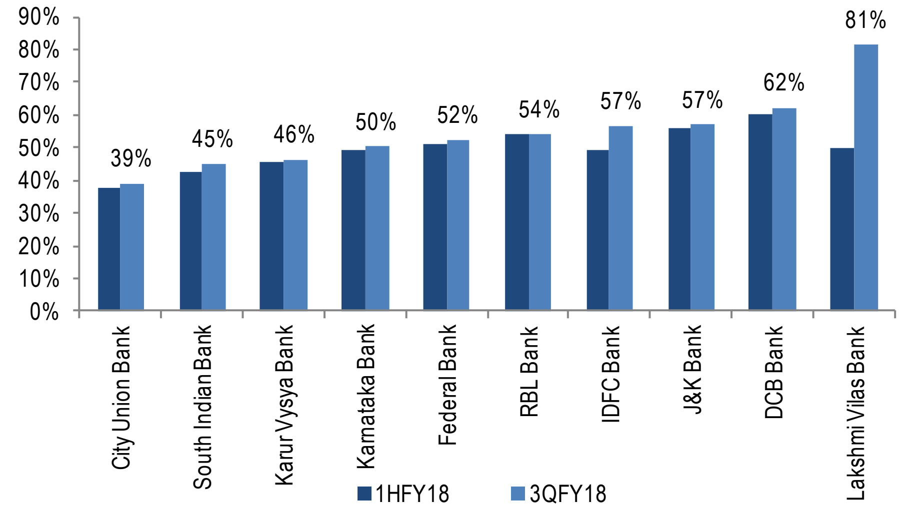
The desire to go pan-India is **not reflected in changing geographical mix for branches** as the branch count has remained static on the back of a 'branch-light, distribution-heavy' model.

FBL's opex should be viewed in the context of upfront investments to achieve the scalability goal

FBL is making upfront investments in: (1) **Branding**, especially with regard to the advertisement campaign mentioned above (2) **A 'branch-light, distribution-heavy' model** leading to increased hiring (3) Focus on technology with the intention of implementing a **robust digital strategy** (4) Becoming **GST-ready**.

Consequently, FBL's somewhat middling cost-to-income ratio should be viewed in the context of the upfront investments specified above. FBL's cost-to-income ratio for 3QFY18 was 52%, which was lower compared with four mid-cap peers ranging between 54%-81%, but higher than four other mid-cap peers ranging between 39%-50%.

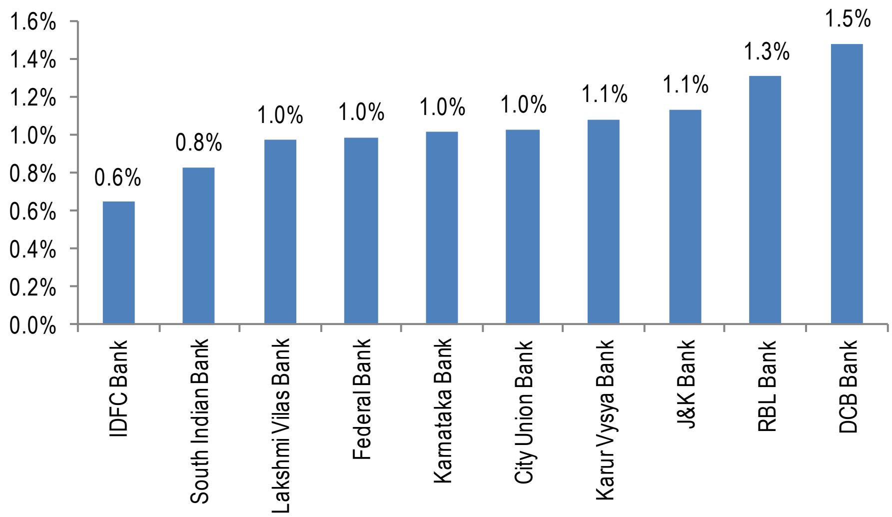
Exhibit 12: Cost-to-income ratio in 2QFY18-3QFY18 - FBL vs. peers



Source: Company, Nirmal Bang Institutional Equities Research

We have also examined opex control for mid-cap banks on the basis of the **opex-to-average-assets metric for 1HFY18**. This is a superior metric than the cost-to-income ratio on two accounts: (1) It looks at a longer period (half year vs. single quarter). (2) It uses a stock denominator rather than a flow denominator. Both reasons make the metric less susceptible to point-in-time considerations.

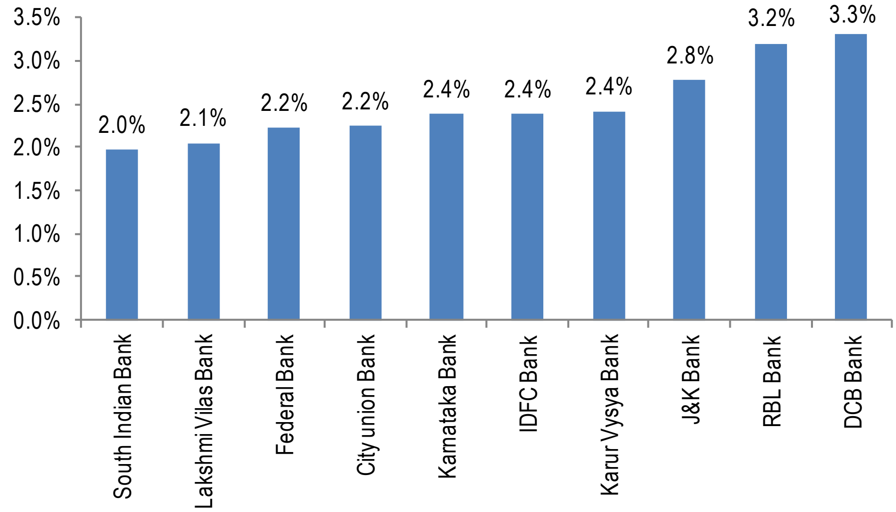
Exhibit 13: Opex to average assets in 1HFY18 - FBL vs. peers



Source: Company, Nirmal Bang Institutional Equities Research

On the above metric, the opex control of FBL looks somewhat better than it does on the cost-to-income ratio. Opex-to-average assets is also not a perfect metric as it presents a more flattering picture for IDFC Bank than it deserves. Assets, as such, for IDFC Bank are inflated from an opex outlay perspective as IDFC Bank has an outsized investment book. To get around this, we also look at the **opex-to-loans metric for 1HFY18**.

Exhibit 14: Opex-to-average loan ratio in 1HFY18 - FBL vs. peers



Source: Company, Nirmal Bang Institutional Equities Research

On the above metric as well, FBL looks reasonably better.

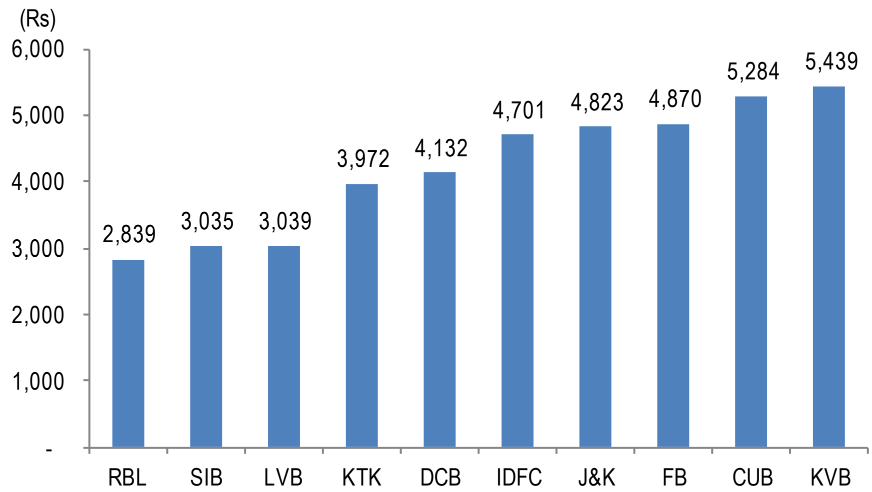
The **importance of the cost-to-income ratio as an independent metric remains** as the link to the bottom-line is closer for total income than it is for assets/loans. Also, total income incorporates an aspect of profitability as it nets out interest expense.

It is, therefore, in order to point out that FBL's cost-to-income ratio is middling since the denominator is, on balance, lower as: (1) FBL's fee income strategy is still a work-in-progress (2) Its digital strategy will augment retail business more meaningfully in future. So, **the middling cost-to-income ratio is more the result of low denominator than a high numerator**.

FBL's best-in-class digital strategy gaining traction on the ground

It can be gauged from a variety of metrics that FBL's technology strategy has gained material currency on the ground. We have examined some key metrics in this regard. We note that **considering all factors taken together**, along with RBL Bank, IDFC Bank and Karur Vysya Bank, FBL is seeing good traction for its digital strategy on the ground.

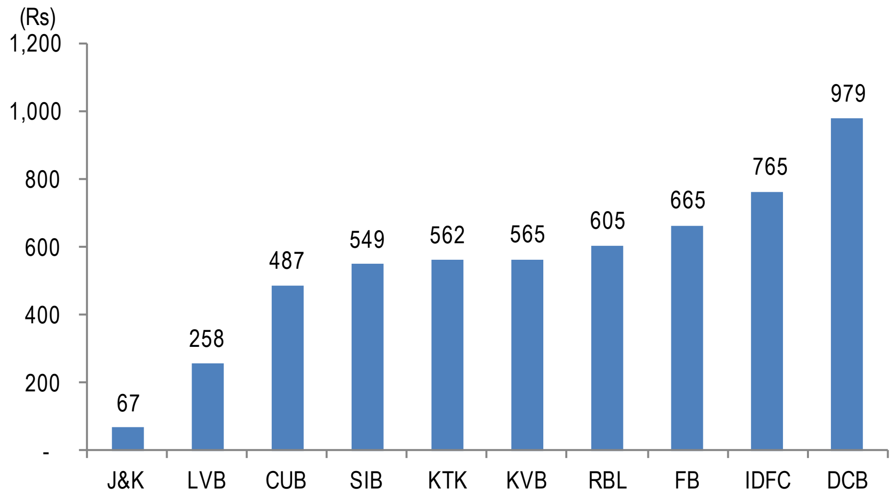
Exhibit 15: ATM transaction value (Rs) per debit card in December 2017 - FBL vs. peers



Source: RBI, Nirmal Bang Institutional Equities Research

We note that FBL is the third best on the above metric among 10 peer mid-cap banks.

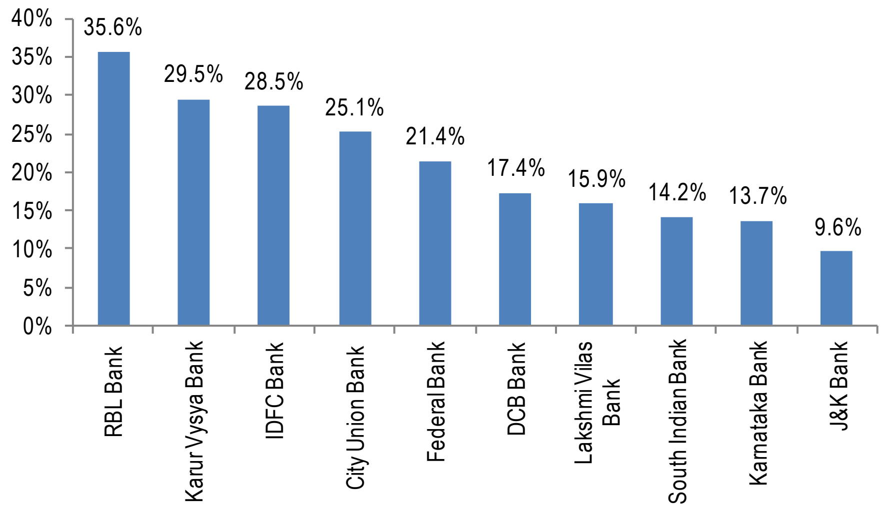
Exhibit 16: POS transaction value (Rs) per debit card in December 2017 - FBL vs. peers



Source: RBI, Nirmal Bang Institutional Equities Research

We note that FBL is also the third best on the above metric among 10 peer mid-cap banks.

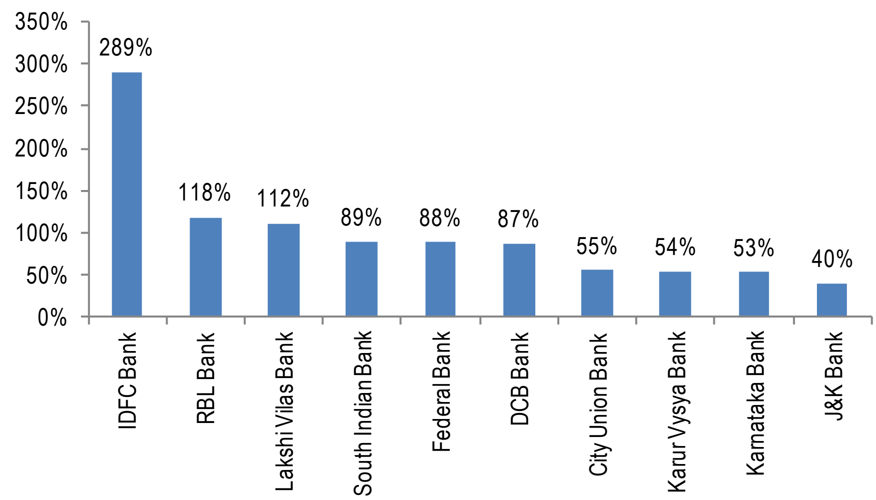
Exhibit 17: NEFT transaction value as a percentage of deposits in January 2018 - FBL vs. peers



Source: RBI, Nirmal Bang Institutional Equities Research

We note that FBL is fifth on the above metric among 10 peer mid-cap banks.

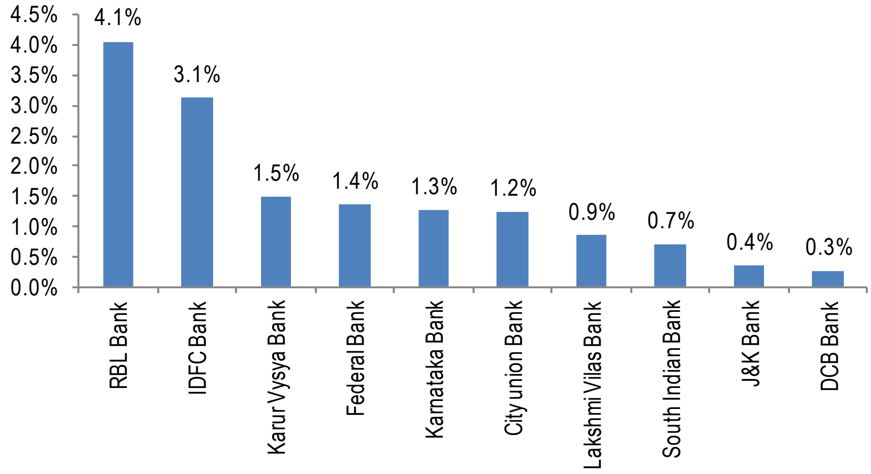
Exhibit 18: RTGS transaction value as a percentage of deposits – January 2018 - FBL vs. peers



Source: RBI, Nirmal Bang Institutional Equities Research

We note that FBL is again fifth on the above metric among 10 peer mid-cap banks.

Exhibit 19: Mobile transaction value as a percentage of deposits in October 2017 - FBL vs. peers



Source: RBI, Nirmal Bang Institutional Equities Research

We note that FBL is fourth on the above key metric among 10 peer mid-cap banks.

FBL's approach to subsidiaries is another indicator of it moving towards an unconstrained business approach

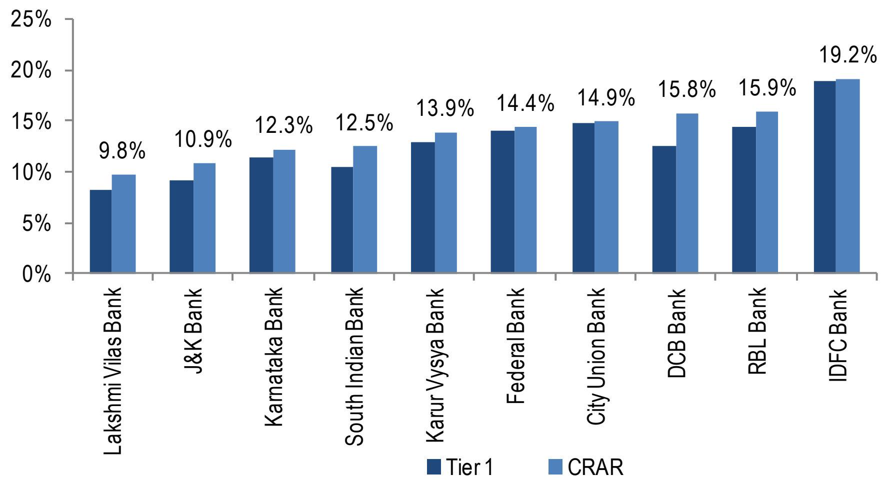
FBL's (1) Presence across loan products (2) Intention to shed regional focus and move towards pan-India banking are key indicators of possessing a DNA that shows intent in moving towards an unconstrained approach. (3) FBL's approach towards developing subsidiaries for incremental financial businesses is an incremental indicator in this regard.

FBL has (1) A **life insurance** associate (26% stake) viz. IDBI Federal Life. (2) Has a **NBFC subsidiary** known as Fedfina (3) Has taken a 26% stake in up-and-coming unlisted **investment banking** firm Equirius Capital. (4) Is mulling a foray into **mutual fund** business (5) Mulling on acquiring a stake in a **microfinance**-focused firm. This is key from FBL's perspective as other mid-cap peers do not seem to have the management bandwidth to adopt such an unconstrained multi-business approach.

Sound capital level provides a good entry point for long-term investors

FBL's Tier 1 capital ratio as of 3QFY18-end stood at 13.8% compared with 7.9%-12.5% for mid-cap peers, barring RBL Bank, City Union Bank and IDFC Bank at 14.1%, 14.5% and 18.8%, respectively. This **implies lower dilution, going forward, for investors who enter FBL at this point in time**.

Exhibit 20: Total and Tier 1 capital ratio in 3QFY18 - FBL vs. peers



Source: RBI, Nirmal Bang Institutional Equities Research

Valuation and Outlook

We use the Residual Income Model to arrive at a first-principles' fair value for FBL. We assume a long-term sustainable average risk-free rate of 7% for India, an Adjusted Beta of 1.1 for FBL and an India-specific Equity Risk Premium of 6% and arrive at the overall Cost of Equity of 13.6% for FBL. On this basis, **we arrive at a price target of Rs 112, at which the stock will trade at 1.6x/1.4x FY19E/20E book value**.

FBL **currently trades at a FY19E/20E P/BV of 1.3x/1.2x, which makes it significantly under-valued** given its FY19E/20E RoE profile of 11.3%/13.1% and long-term outlook. Consequently, we believe that the multiple of 1.6x/1.4x implied by our price target of Rs 112 is reasonable.

Exhibit 21: Consensus vs Our Estimates

	Our estimate			Bloomberg estimate			*% Variance*		
(Rsmn)	**FY18E**	**FY19E**	**FY20E**	**FY18E**	**FY19E**	**FY20E**	***FY18E***	***FY19E***	***FY20E***
Net interest income	37,642	47,152	57,178	36,682	44,171	52,773	*2.6*	*6.7*	*8.3*
Operating profit	24,440	32,132	40,581	23,278	28,661	34,961	*5.0*	*12.1*	*16.1*
Profit after tax	10,783	14,729	19,031	10,490	13,710	17,298	*2.8*	*7.4*	*10.0*

Source: Nirmal Bang Institutional Equities Research

Key Risks

Recent RBI notification overhauling stress resolution is a system-wide risk for all banks with significant large corporate lending business

The recent RBI notification overhauling stressed asset resolution and promoting consonance (rather than divergence) across banks is a system-wide risk for all banks that have a material corporate lending business. However, we do not think FBL should be significantly impacted given that it did not have any divergence with RBI's assessment of its asset quality material enough for disclosure in their FY17 Annual Report.

FBL has high exposure to Kerela state and there is a theoretical associated concentration risk

643 of 1317 branches (as of February 2018) of FBL are located in Kerela state indicating theoretical concentration risk. However, our base case is that Kerela is a stable state from a business prospects perspective.

A re-emergence of the crude oil bear market can put pressure on the NRI deposits business
If crude oil starts to revisit a bear market scenario on the back of a renewed China slowdown or other reasons, it could affect NRI deposits business. However, this is not our base case.

Company Overview

Federal Bank is a midcap private sector bank with a branch network of 1241 branches and 1679 ATMs. It has a loan book is Rs 849bn, of which the Retail, Agri, MSME and Corporate split is 29%, 10%, 22% and 40%, respectively (own classification). On Basel III basis, 46% of Retail and Corporate assets comprise Retail. Federal Bank has displayed a loan CAGR of 14.2% over FY12-17. Its yield on advances in its latest reported quarter was 9.54%.

Federal Bank has a CASA ratio of 33% and its cost of funds is 5.5% and, as a result, it registered a net interest margin of 3.3%. Its cost to income ratio stood at 52.4%. Consequently, it delivered a return on assets of 0.87% and a return on equity of 8.74%, implying a financial leverage of 10.0. Its employee count stood at 11,950. Its Capital Adequacy Ratio was 14.41% and its Tier I Ratio was 13.84%.

Exhibit 22: Management team/ Key executives

Name	Designation	Experience
Shyam Srinivasan	MD and CEO	Shri Shyam Srinivasan took charge as the Managing Director & CEO of Federal Bank on 23rd September 2010. He joined Federal Bank, equipped with the experience of over 20 years with leading multinational banks in India, Middle East and South East Asia, where he gained significant expertise in retail lending, wealth management and SME banking.
Ashutosh Khajuria	Executive Director and CFO	Mr. Ashutosh Khajuria is the Executive Director and CFO of Federal Bank. He oversees the functions of Treasury, Corporate Planning, Inspection & Audit, Legal and the IFSC Banking Unit(IBU) in GIFT City, Gujarat. He is a Graduate in Science from the prestigious Banaras Hindu University and is a Bachelor in Law as well. Completed Post Graduation in Economics too. Joined Federal Bank in 2011 as President and Head-Treasury and was later entrusted with the additional responsibility of business development in the entire network of branches/offices outside Kerala.
Ganesh Sankaran	Executive Director	Mr. Ganesh Sankaran has taken charge as the Executive Director in charge Wholesale Banking of Federal Bank on 16th September 2015. He is an alumnus of VJTI Mumbai and also has a Master's degree in Business Administration from Symbiosis Institute of Business Management. He also attended a summer school program at IIM Ahmedabad.
Shalini Warrier	COO	Ms. Shalini Warrier has taken charge as Chief Operating Officer (COO) of the Bank on 02nd November 2015. Ms. Shalini Warrier is a member of the Institute of Chartered Accountants of India and was the First Rank Holder in 1989. She is also a Certified Associate of Indian Institute of Bankers.
Sumit Kakkar	Chief Credit Officer	Shri. Sumit Kakkar has joined Federal Bank as Chief Credit Officer effective from August 29, 2016. Prior to Joining Federal Bank, Mr. Kakkar was with Yes Bank where he was the Group President and Chief Credit Officer overseeing Corporate, Institutional and Commercial Banking. Before his stint at Yes Bank, he was with HDFC Bank as its Senior Vice President and Head of Credit Risk for mid market segments. Mr. Kakkar is a seasoned credit specialist who has donned various senior level roles in leading organizations over a career spanning twenty years.

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 23: Board members

Name	Designation	Experience
Shyam Srinivasan	MD and CEO	Shri Shyam Srinivasan took charge as the Managing Director & CEO of Federal Bank on 23rd September 2010. He joined Federal Bank, equipped with the experience of over 20 years with leading multinational banks in India, Middle East and South East Asia, where he gained significant expertise in retail lending, wealth management and SME banking.
Nilesh Shivji Vikamsey	Director	Mr. Nilesh Shivji Vikamsey is a Chartered Accountant by profession, and holds a Diploma in Information System Audit and was also associated with Business Consultancy Studies Course of Bombay Chartered Accountants Society jointly with Jamnalal Bajaj Institute of Management Studies. He is the senior partner of Khimji Kunverji & Co, Chartered Accountants, a firm which has over 75 years of experience in the areas of Auditing, Taxation, Corporate & Personal Advisory Services, Business & Management Consulting Services, due diligence, valuations, inspections, and investigations. Currently he is the President of Institute of Chartered Accountants of India (ICAI). He has also acted as a Speaker/Chairman at various seminars, meetings, lectures held by various Committees. He is a director in India Infoline Holdings Limited, TruNil Properties Pvt Ltd., SBI Life Insurance Company Ltd. and Navneet Education Ltd., Apart from being contributor to various articles, he has been managing audits/consultancy of large nationalized banks, Foreign Banks (Indian Operations), Large Listed Public & Private Limited Companies.
Dilip Gena Sadarangani	Director	Mr. Dilip Gena Sadarangani was co-opted on to the Board of the Bank at its meeting held on 04.06.2013 as an Independent Director. He has wide experience in Banking/Technology/Operations, and includes management, maintenance and support of IT software projects as well as IT operations. He has developed and put in place processes and IT policies and continuity plans in three leading Banks in India, Australia and Kuwait.
Harish H Engineer	Director	Shri. Harish H Engineer is a Science graduate from Bombay University and holds a Diploma in Business Management from Hazarimal Somani College, Mumbai. Shri. Harish has been associated with HDFC Bank since 1994 in various capacities and was also the Executive Director on the Board of HDFC Bank responsible for Wholesale Banking including International Banking. He has over 43 years of experience in the fields of Finance and Banking.
Grace Elizabeth Koshie	Director	Smt. Grace Elizabeth Koshie, a postgraduate in Economics with specialization in the area of Econometrics and Monetary Economics from Bombay University, joined Reserve Bank of India in the year 1976 as a Direct Recruit in Grade B. She also holds a PG Diploma in Higher Education and is a Certified Associate of Indian Institute of Bankers. Before joining Reserve Bank, she had worked as a lecturer in Sophia College, Mumbai. As Secretary to the Central Board of the Reserve Bank of India she was responsible for central bank governance and related compliance matters, matters connected to the Meetings of the Central Board and its Committee, and other senior management meetings. Smt. Koshie carries with her rich and varied experience of over 36 years of central banking in the Reserve Bank of India. Smt. Koshie also held the charge of the Foreign Exchange Department in RBI Central Office from 2001-2004 Smt. Koshie had earlier served as RBI nominee Director on the Boards of Dena Bank and Corporation Bank.
Shubhalakshmi Panse	Director	Smt. Shubhalakshmi Panse has 38 years experience in the field of Banking, particularly in Corporate Credit appraisal, Credit Monitoring, NPA management, Planning, Project appraisal and also in Economics, Finance and Information Technology. She is the former Chairman & Managing Director of Allahabad Bank. Smt. Panse was also the Executive Director of Vijaya Bank for two and half years, managing all the portfolios of that bank.
C Balagopal	Director	Mr.C Balagopal was co-opted on the Board of the Bank on 29.06.2015. He is a post graduate in Economics from Madras University. He then joined the Indian Administrative Service in 1977 and worked in various posts in Manipur and Kerala. He resigned from the IAS in 1983, to set up a company to manufacture indigenously developed biomedical devices for the first time in the country. This came to be known as Terumo Penpol Ltd. and is one of the biggest manufacturers and exporters of blood bag systems in the world. He sold his shareholding in the company to Terumo Corp. of Japan and has retired.
A P Hota	Director	Mr. A P Hota is a post graduate in English Literature and a Certified Associate in Indian Institute of Bankers. He has banking experience of over 27 years across Technology and Payment Systems. He has been the MD & CEO of the National Payments Corporation of India over a period of 8 years (from 2009-2017). He also has experience of working in the Boards of Vijaya Bank and Andhra Bank in the past, as RBI Nominee Director.
Ashutosh Khajuria	Executive Director	Mr. Ashutosh Khajuria is the Executive Director and CFO of Federal Bank. He oversees the functions of Treasury, Corporate Planning, Inspection & Audit, Legal and the IFSC Banking Unit(IBU) in GIFT City, Gujarat. He is a Graduate in Science from the prestigious Banaras Hindu University and is a Bachelor in Law as well. Completed Post Graduation in Economics too. Joined Federal Bank in 2011 as President and Head-Treasury and was later entrusted with the additional responsibility of business development in the entire network of branches/offices outside Kerala.
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Source: Company, Nirmal Bang Institutional Equities Research

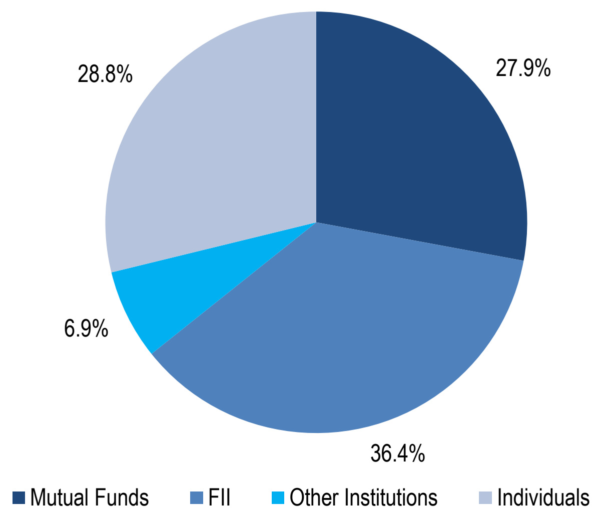
Shareholding Information

Exhibit 24: Key institutional shareholders

	(%)
Promoter	
Non - promoter	
Yusuffali Musaliam Veettil Abdul Kader	3.9
Hdfc Trustee Company Limited	3.9
Amansa Holdings Private Limited	3.3
Icici Prudential	3.3
Reliance Emergent India Fund	2.8
Dsp Black Rock	2.6
East Bridge Capital Master Fund Limited	2.5
Birla Sun Life Trustee Co Private Ltd	2.4
Kotak Mahindra	2.3
Life Insurance Corporation Of India	2.1
Nomura India Investment Fund Mother Fund	2.1
UTI	2.0
Franklin Templeton Investment Funds	2.0
Sbi Mutual Fund	1.9
Jhunjhunwala Rakesh Radheshyam	1.8

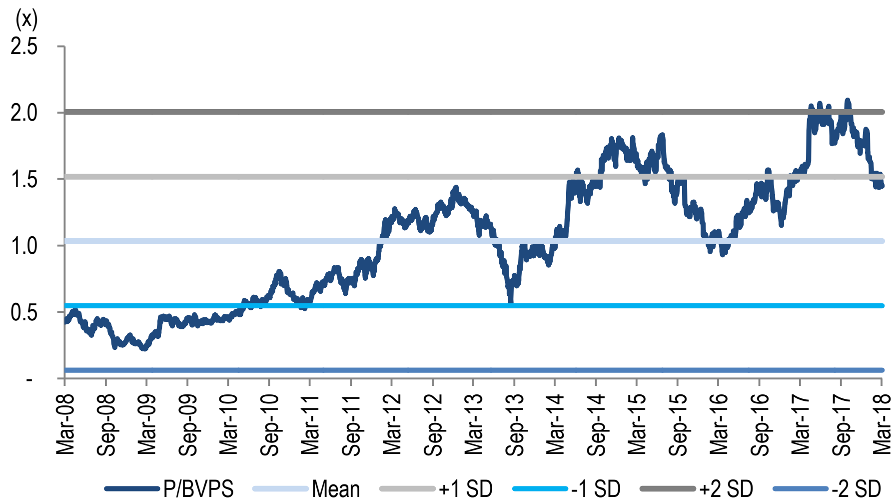
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 25: Shareholding pattern



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 26: One year forward P/BV



Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 27: Income statement

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Interest Income	77,447	86,774	100,223	122,044	146,934
Interest expense	52,406	56,248	62,580	74,891	89,756
Net interest income	**25,041**	**30,526**	**37,642**	**47,152**	**57,178**
Fees	5,703	7,731	9,488	12,265	14,951
Other Income	2,161	3,088	3,516	2,902	3,465
Net Revenue	32,905	41,345	50,647	62,320	75,594
Operating Expense	18,668	22,095	26,207	30,188	35,013
-Employee Exp	10,529	11,638	13,006	14,857	16,947
-Other Exp	8,139	10,457	13,201	15,332	18,066
Pre-provision Profit	**14,237**	**19,250**	**24,440**	**32,132**	**40,581**
Provisions	7,041	6,184	8,101	9,816	11,746
-Loan Loss Provisions	5,848	4,836	7,601	9,316	11,246
-Provisions for investment	801	242	-	-	-
-Other Provisions	392	1,106	500	500	500
PBT	7,196	13,066	16,338	22,316	28,835
Taxes	2,440	4,757	5,555	7,587	9,804
PAT	**4,756**	**8,309**	**10,783**	**14,729**	**19,031**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 28: Balance sheet

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Equity Capital	3,438	3,488	3,930	3,930	3,930
Reserves & Surplus	77,476	85,977	120,284	132,882	149,783
Shareholder's Funds	**80,914**	**89,465**	**124,214**	**136,812**	**153,713**
Deposits	**791,717**	**976,646**	**1,132,486**	**1,396,038**	**1,692,019**
-Current deposits	46,304	56,552	62,287	76,782	93,061
-Saving deposits	214,222	263,977	305,771	376,930	456,845
-Term deposit	531,191	656,117	764,428	942,326	1,142,113
Borrowings	51,145	58,973	116,965	141,039	166,832
Other liabilities	19,898	24,685	30,231	34,852	38,214
Total liabilities	**943,674**	**1,149,769**	**1,403,895**	**1,708,742**	**2,050,777**
Cash/Equivalent	54,199	74,530	91,670	112,755	136,433
Advances	580,901	733,363	916,704	1,127,546	1,364,330
Investments	251,548	281,952	329,605	395,933	470,255
Fixed Assets	5,200	4,895	5,385	5,923	6,515
Other assets	51,826	55,029	60,532	66,585	73,244
Total assets	**943,674**	**1,149,769**	**1,403,895**	**1,708,742**	**2,050,777**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 29: Key ratios

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Growth (%)					
NII growth	5.2	21.9	23.3	25.3	21.3
Pre-provision profit growth	(12.5)	35.2	27.0	31.5	26.3
PAT growth	(52.7)	74.7	29.8	36.6	29.2
Business (%)					
Deposit growth	11.8	23.4	16.0	23.3	21.2
Advance growth	13.3	26.2	25.0	23.0	21.0
Business growth	12.4	24.6	19.8	23.2	21.1
CD	73.4	75.1	80.9	80.8	80.6
CASA	32.9	32.8	32.5	32.5	32.5
Operating effeciency (%)					
Cost-to-income	56.7	53.4	51.7	48.4	46.3
Cost-to-assets	2.1	2.1	2.1	1.9	1.9
Productivity (Rs mn)					
Business per branch	1,096.3	1,365.8	1,573.9	1,866.6	2,180.0
Business per employee	117.0	147.5	169.2	200.7	234.4
Profit per branch	3.8	6.6	8.3	10.9	13.6
Profit per employee	0.4	0.7	0.9	1.2	1.5
Spreads (%)					
Yield on advances	10.4	10.0	9.4	9.3	9.2
Yield on investments	7.1	6.8	6.5	6.5	6.5
Cost of deposits	6.7	6.1	5.6	5.5	5.4
Yield on assets	9.5	9.1	8.6	8.6	8.5
Cost of funds	6.7	6.0	5.5	5.4	5.3
NIMs	3.1	3.2	3.2	3.3	3.3
Capital adequacy (%)					
Tier I	13.4	11.8	13.6	11.5	10.7
Tier II	0.6	0.6	0.5	0.5	0.5
Total CAR	13.9	12.4	14.1	12.0	11.2
Asset Quality (%)					
Gross NPA	2.1	2.3	2.4	2.4	2.5
Net NPA	1.6	1.3	1.3	1.2	1.1
Provision coverage	24.3	43.7	46.8	52.5	57.8
Provision coverage (Incl Tech W/o)	68.2	70.0	70.1	71.9	73.6
Slippage	3.5	1.6	1.8	1.7	1.7
Credit-cost	1.0	0.6	0.8	0.8	0.8
Return (%)					
ROE	6.0	9.8	10.1	11.3	13.1
ROA	0.5	0.8	0.8	0.9	1.0
RORWA	0.9	1.3	1.3	1.4	1.5
Per share (Rs)					
EPS	2.8	4.8	5.5	7.5	9.7
BV	47.1	51.3	63.2	69.6	78.2
ABV	41.5	45.7	57.2	62.9	70.7
Valuation (x)					
P/E	41.1	23.8	20.7	15.2	11.7
P/BV	2.4	2.2	1.8	1.6	1.5
P/ABV	2.7	2.5	2.0	1.8	1.6

Source: Company, Nirmal Bang Institutional Equities Research

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NIRMAL BANG
a relationship beyond broking

Institutional Equities

CanFin Homes

26 March 2018

Initiating Coverage

Reuters: CNFH.NS; Bloomberg: CANF IN

Underwriting Standards Open Multiple Doors

CanFin Homes (CHL) is a housing finance company (HFC) with a network of 170 branches and loan book size of Rs145bn. We are bullish on CHL as: (1) It is a cost of borrowing leader because of (a) superior credit risk perception translating into lower debt capital market and bank borrowing cost (b) it is eligible for significant participation in low-cost NHB funding and (c) at the margin, has some low-cost institutional deposits. (2) Has superior asset quality because of (a) non-salaried book asset quality as pristine as salaried (b) a water-tight credit appraisal process (c) the lowest loan against property LTV and (d) complete avoidance of large-ticket LAP. (3) Has sound growth prospects because of (a) directly addressing under-penetrated small-ticket segment (b) government policies aligned to its business focus (c) minimal impact from GST and RERA (4) Superlative opex control on the back of (a) outsourcing to low-cost DSAs and (b) sound HR strategy ensuring a young workforce. We initiate coverage on CHL with a Buy rating and a target price of Rs 638, valuing the stock at 5.2x/4.1x FY19E/FY20E P/BV.

CHL is a cost of borrowing leader on the back of idiosyncratic aspects: CFH's cost of borrowings for 3QFY18 is 7.7% compared with 7.9%-8.8% for HFCs in our expanded peer set (10 HFCs), barring PNB Housing Finance/HDFC at 7.5/7.6%. Credit rating alone is not a differentiating factor as all HFCs in our peer set are AAA-rated, barring GIC Housing Finance, Repco Home Finance and Reliance Home Finance. Debt capital market and even banks apply a lower credit risk premium to CHL instruments on the back of the latter's sound underwriting standards. Secondly, as much as ~10% of CHL's loan book is eligible for ultra-low cost NHB financing below 5%. Thirdly, being a deposit-taking NBFC, a small portion (~2%) of CHL's funding comes from significantly cheap institutional deposits.

Superior asset quality for CHL is the result of the tightest under-writing standards in the industry: CHL's GNPA ratio for 3QFY18 is 0.5% compared with 0.7%-3.7% for HFC peers, barring PNB Housing Finance at 0.4%. Non salaried book asset quality being just as good as salaried book asset quality typifies CHL's underwriting standards, that are the most conservative in the industry and include: (1) Insistence on formal income-tax documents from non-salaried clients (2) Lowest blended LAP LTV of 40% compared with 46%-55% for peers and (3) Complete avoidance of large-ticket LAP (non-housing average ticket size is Rs0.9mn).

Powerful tailwinds to drive loan growth with no real headwinds to grapple with: CHL is in a sweet spot from a ticket size perspective as 92% of incremental loan approvals are eligible for government subsidy. Impact from GST is minimal as only ~1% of loan book funds under-builder construction properties, on which GST is applicable. Impact from RERA is transient and expected to subside in two quarters. Some RERA impact on CHL is also mitigated by properties falling below the threshold requirement for mandatory compliance.

CHL is frugal with opex, outsourcing to cheap DSAs and keeping workforce young: CHL's opex-to-loan ratio is 0.55% compared with 0.61%-2.64% for key HFC peers, barring HDFC/LIC Housing Finance at 0.25%/0.38%. Thus, CHL's opex control is best in our expanded peer set, barring HDFC and LIC Housing Finance, both of which have non-replicable access to vast networks of associate bank and parent, respectively. While all outsourcing may not be cheap, CHL is able to outsource to DSAs at an average blended commission ratio of just 0.38% (FY17), which is significantly cheaper than the ballpark the industry is known to operate at. CHL also maintains a young workforce with the average employee age below 30 years.

Valuation and Outlook: We have used the residual income model to value CHL and arrive at a target price of Rs 638. CHL currently trades at 4.2x/3.3x FY19E/FY20E P/BV and we believe that our target price is reasonable given CHL's RoE profile of 25.6%/25.6% for FY19E/FY20E and long-term outlook.

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Net Interest Income	3,009	4,221	5,608	6,756	8,235
Pre-Provision Profit	2,732	3,884	5,264	6,410	7,897
PAT	1,571	2,347	3,089	3,932	4,993
EPS (Rs)	11.8	17.6	23.2	28.2	35.8
BV (Rs)	66.0	80.9	101.7	122.7	156.1
P/E (x)	43.3	29.0	22.0	18.2	14.3
P/BV (x)	7.7	6.3	5.0	4.2	3.3
Gross NPA (%)	*0.2*	*0.2*	*0.5*	*0.4*	*0.3*
Net NPA (%)	*0.0*	*0.0*	*0.2*	*0.2*	*0.1*
ROA (%)	*1.6*	*1.9*	*2.1*	*2.1*	*2.1*
ROE (%)	*19.0*	*24.0*	*25.4*	*25.6*	*25.6*

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: NBFCs

CMP: Rs503

Target Price: Rs638

Upside: 27%

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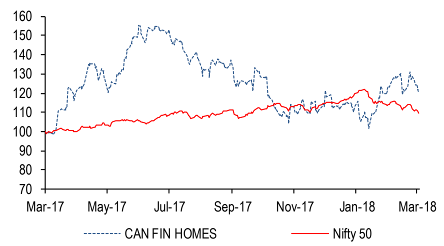
Key Data

Current Shares O/S (mn)	133.2
Mkt Cap (Rsbn/US$bn)	66.7/1.0
52 Wk H / L (Rs)	667/403
Daily Vol. (3M NSE Avg.)	1,493,798

Shareholding (%)	3QFY18	2QFY18	1QFY18
Promoter	30.4	30.7	30.7
Public	69.6	69.3	69.4
Others	-	-	-

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
CanFin Homes	(4.4)	(5.8)	21.0
Nifty Index	(4.8)	0.3	10.0

Source: Bloomberg

CHL is a cost of borrowings leader which is key in the housing finance segment

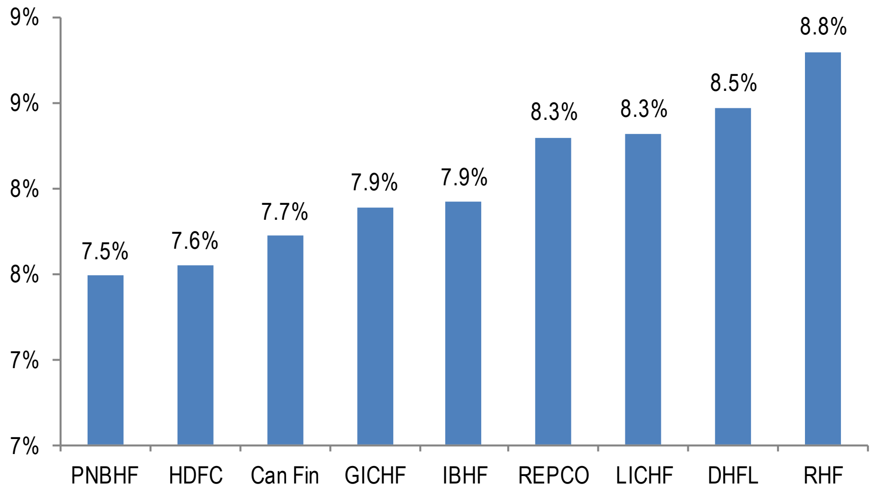
CHL is a cost of borrowings (CoB) leader among key HFC peers with CoB at 7.7% for 3QFY18 compared with peers at 7.9%-8.8% because of **competitive advantages unique to CHL**. PNB Housing Finance and HDFC have comparable CoB at 7.5% and 7.6%, respectively.

Credit risk premium applied by market is a function of perception and not merely of headline credit rating

Although all HFCs in our expanded peer set are AAA-rated, barring Repco Home Finance, GIC Housing Finance and Reliance Home Finance, the actual cost of debt capital market (DCM) borrowing is lower for CHL because of **superior credit risk perception**. This superior credit risk perception is the direct result of CHL's tight under-writing standards, which is the underlying cause for its best-in-class asset quality.

The average cost of DCM borrowing for CHL has been 7.75% for 2QFY18. The same for LIC Housing Finance is 8.38% and for DHFL it is 8.75%. The high cost of DCM borrowing for DHFL is partly because it has not tapped the NCD market for quite some time with the last issue being in June 2016. Nevertheless, the basic conclusion is that **CHL's access to DCM is generally superior** and also managed better, resulting in lower average on-book cost of DCM borrowing.

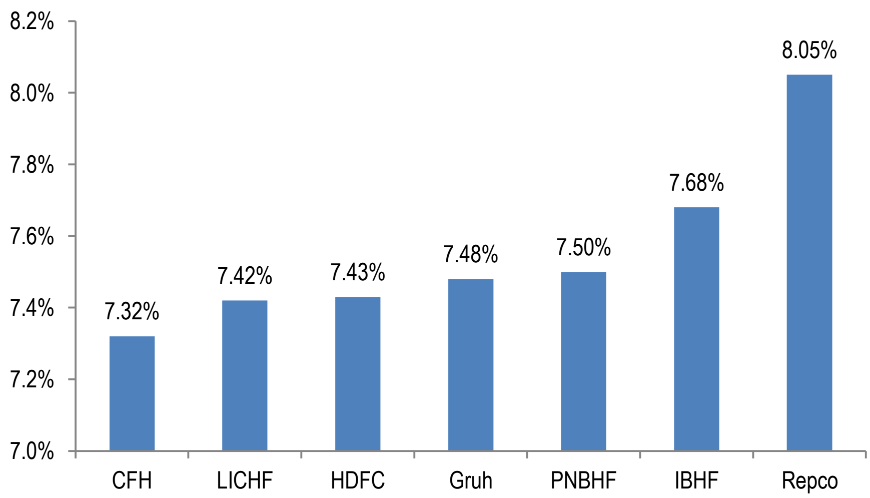
Exhibit 1: Cost of borrowing - CHL vs. HFC peers - in 3QFY18



Source: Company, Nirmal Bang Institutional Equities Research

We have examined a **cross-section of recent NCD instruments** and noted that CHL was able to successfully issue its NCDs at 7.32% compared with HFC peers at 7.42%-8.05%. There is similarity in timing and the tenure of these NCD issuances and are, hence, generally comparable with each other.

Exhibit 2: Cross section of NCD instrument interest rates



Source: Rating Agencies, Nirmal Bang Institutional Equities Research

Cost of bank borrowings also on the lower side for CHL compared with key HFC peers

Lower credit risk premium is also visible in bank rates applied to CHL with the average cost of bank borrowing for CHL in 2QFY18 at .8%. In comparison, this number for LIC Housing Finance was 8.31% and for DHFL, the same was 8.64%.

While we acknowledge that lower bank funding cost for CHL is an advantage incrementally bolstered by its parentage (so far) as Canara Bank is a key member of the PSU bank eco-system, we stress that the key reason, however, for lower cost of bank borrowing remains a superior credit risk perception for CHL that allows banks to apply a **lower (or nil) spread (credit risk premium) over internal MCLR** while lending to CHL.

CHL is a significant participant in schemes eligible for ultra-cheap NHB funding

Any or all funding from NHB may provide no advantage to an HFC from a cost of borrowing perspective. Vanilla borrowing from NHB against lending not eligible for special cheaper rates is roughly similar to interest rates available from banks. For example, average cost of NHB borrowing for LIC Housing Finance stands at 8.22% in 2QFY18, only 9bps lower than its average cost of bank borrowing.

CFH, however, is able to participate materially in schemes eligible for ultra-low cost NHB funding at 4.86%. As much as **10% of CHL's loan book is eligible for NHB funding at this special interest rate**. The schemes of NHB under which it offers such ultra-cheap funding are Rural Housing Fund and Urban Housing Fund. There are several criteria that an HFC needs to satisfy in order to be eligible for this category of NHB funding and CHL is able to meet them for a significant proportion of its loan book. The lion's share of this portion of CHL's loan book eligible for ultra-cheap NHB funding falls under Rural Housing Fund.

Institutional deposits an incremental albeit proportionally small reason for lower cost of borrowings

Being a deposit-taking NBFC, CHL also raises cheap Institutional deposits although this is a small portion of overall funding at 2% as of 2QFY18-end. CHL can theoretically raise low-cost deposits from retail depositors as well, but does not wish to as it will add to a negative line item elsewhere on the RoA tree (opex) and ultimately be sub-optimal. However, this does not prevent it from raising Institutional deposits in a piecemeal manner at **attractive interest rates generally below 7%**. This portion of the funding book is kept small as these instruments are redeemable at the discretion of the funding agency and CHL believes in reining in overall liquidity risk. It may further be noted that institutional deposits do not mandate HFCs to main SLR on this source of funding unlike retail public deposits, which require SLR coverage.

Possible Canara Bank stake sale not a long-term negative for CHL's credit rating

Canara Bank obtained board approval for sale of its entire stake in CHL in November 2017. It empanelled investment bankers to find buyers and this led India Ratings to put CHL's credit rating for Commercial Paper, Sub-ordinated Debt and Non-Convertible Debentures on Rating Watch Negative (RWN). India Ratings awaits futher clarity of the impact of potential stake sale on the credit profile of CHL. **We believe the RWN announcement is technical in nature** and we do not feel a change in ownership is going to be negative for the credit profile of CHL from a long-term perspective.

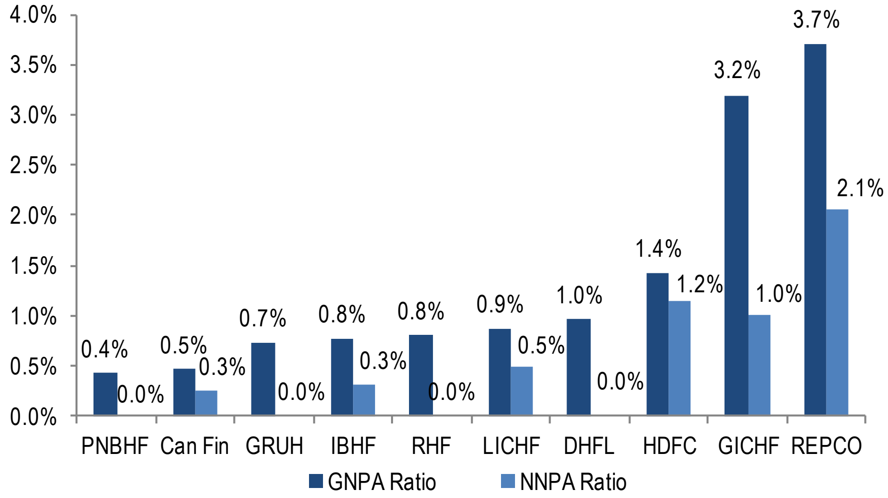
In December 2017, as per a regulatory filing on the stock exchange, a 4% stake sale to unnamed buyers via a block deal was arranged. Further, in February 2018, it has been learnt that through a media report that Canara Bank is **engaged in talks with potential buyers** for the sale of its entire 30% stake in CHL.

Ownership could move from a relatively capital-constrained Canara Bank to (1) A **deep-pocketed strategic buyer from the private sector** (HDFC, Kotak Mahindra Bank and RBL Bank have been mentioned in media reports) or (2) A **long-term oriented global private equity fund** (Warburg Pincus, Baring Private Equity, Temasek, KKR and Bain Capital have been mentioned in media reports). Neither of these transactions would have an impact on the credit profile of CHL from a long-term perspective, in our view. The primary reason for superior credit rating as well as credit market perception, as discussed earlier, is **tight underwriting standards underlying the superior asset quality of** CHL, which should stay intact.

CHL is the asset quality champion of HFC industry

CHL has the lowest GNPA ratio of 0.5% as of 3QFY18-end among our expanded set of key HFC peers, which have GNPA ratio ranging between 0.7%-3.7%, barring PNB Housing Finance which has a GNPA ratio of 0.4%.

Exhibit 3: GNPA ratio - CFH vs. key HFC peers - in 2QFY18



Source: Company, Nirmal Bang Institutional Equities Research

GNPA ratio of CHL's non-salaried book being as good as that of salaried portion typifies underwriting standards

Superior GNPA ratio of CHL is the result of a culture of tight underwriting standards steadfastly maintained by the company at all times. Underwriting standards are typified by CHL's GNPA ratio for non-salaried portion of loan book being as good (actually marginally superior) to GNPA ratio of salaried portion. **This is in stark contrast to the rest of the HFC industry** where non salaried GNPA ratios are typically significantly higher and this typifies the tight underwriting standards at CHL.

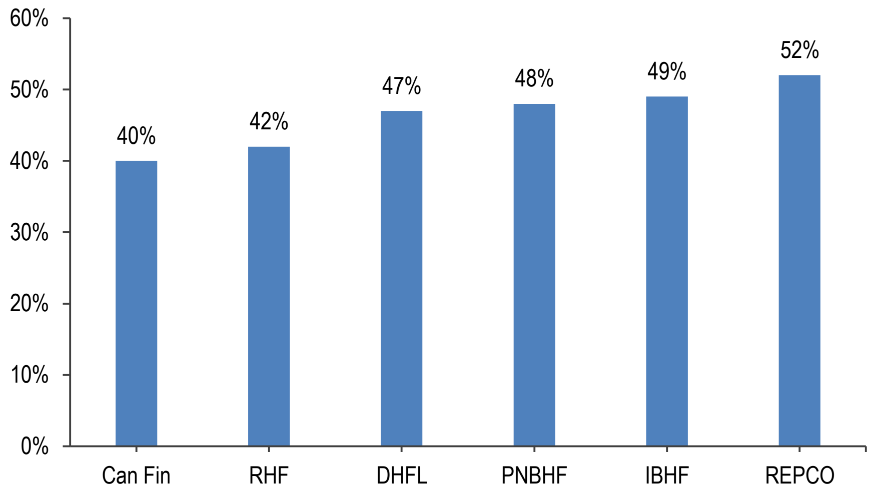
Credit appraisal method highlights prudent conservativeness at each stage of process

Credit appraisal method of CHL is prudently conservative with (1) **Non-salaried clients** also (in addition to salaried clients) asked to submit last three years' income-tax returns as mandatory documents in order to avail a home loan. (2) The last three years' **average income** (not last year's income) then becomes the primary basis for the loan quantum. (3) While site visit is carried out for non-salaried clients, if such a visit indicates a higher income than that declared in the formal Income Tax (IT) return document, then utmost conservativeness is adhered to and the **lower IT return number** is taken as the basis for loan quantum. (4) In some cases, a prospective client may submit spouse's IT return along with his own. While the document itself has formal status as a standalone document, it is not considered as incremental family income for the purpose of loan quantum considerations unless it can be **clearly established what the source of the spouse's income** is.

CHL's LAP LTV is the lowest in our set of key HFC peers and is indicative of prudent caution

CHL keeps LAP LTV on a tight leash at 40%. This is **significantly lower than key HFC peers** ranging between 46%-55% and indicative of CHL's prudent caution with regard to LAP loans. LAP loans, in recent years, have been a higher risk segment within the broader housing loan segment because of hyper-competition ensuing in the segment and concomitant dilution of underwriting standards. Hence, we note that CHL's caution with respect to this segment is warranted and goes hand-in-hand with its culture of being an underlying asset quality champion.

Exhibit 4: LAP LTV - CHL vs. key HFC peers - in 2QFY18



Source: Company, Nirmal Bang Institutional Equities Research

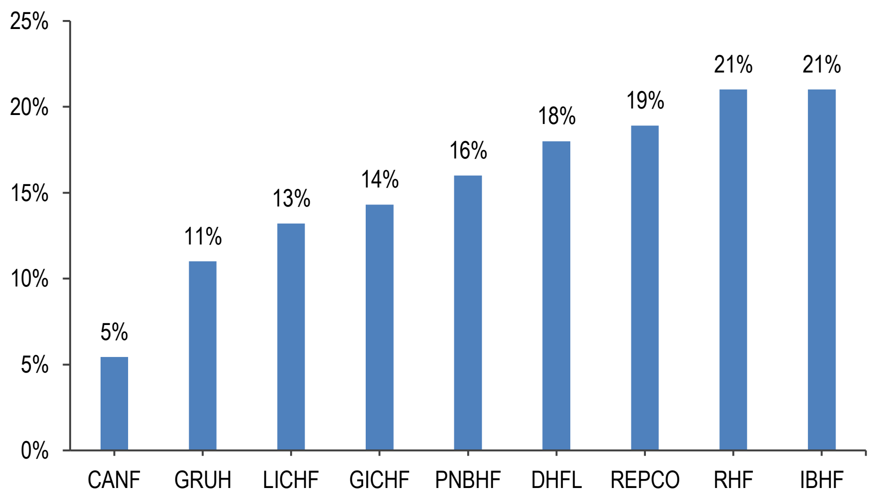
CHL's average ticket size for non-housing loans is low, indicating it has altogether avoided the large-ticket LAP segment

It has been generally noted that LAP book risk has risen as HFCs move up the ticket size curve with materially higher asset quality risk witnessed as the Rs5mn ballpark is crossed. CHL's **average ticket size for non-housing loans is particularly low** at Rs0.9mn. The major portion of CHL's non-housing loans is LAP, indicating that CHL has not, as such, participated in large-ticket LAP lending.

CHL has the lowest exposure to LAP as a proportion of loan book in our HFC peer set

LAP, as a share of 3QFY18 loan book, for CHL stands at 5.4% compared with 11%-21% for key HFC peers. Whether this is the optimal strategy for a generic HFC depends on the overall impact on the RoA tree but keeping LAP proportion low has served CHL well from an asset quality perspective. It may be emphasised though that choice of the business segment is not the key reason for CHL's superior asset quality, but as discussed earlier, tight underwriting standards are.

Exhibit 5: LAP as a percentage of loan book - CHL vs. key HFC peers - in 3QFY18



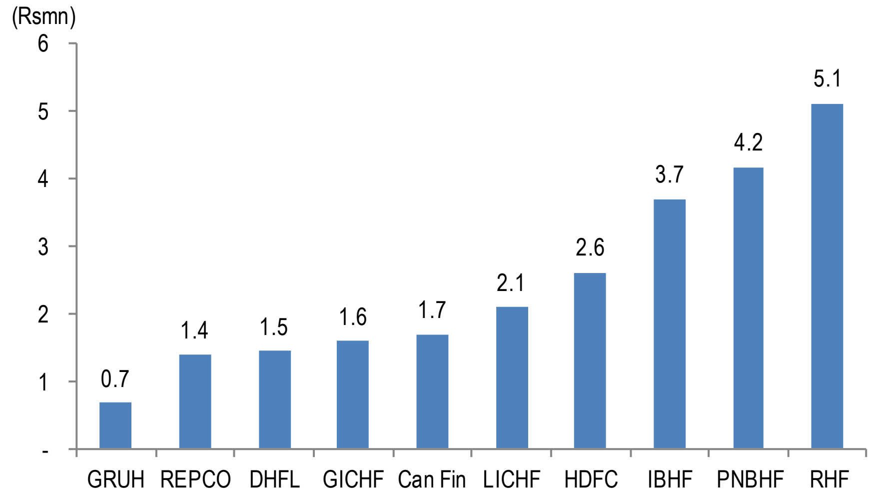
Source: Company, Nirmal Bang Institutional Equities Research

Regulatory environment is aligned to drive CHL's loan book growth

Low average ticket size indicates CHL is focused on clients lower down the income pyramid, where the generic opportunity is significantly large

Given that CHL's overall average ticket size is low at Rs1.7 mn, it caters largely to the significant generic opportunity that exists lower down the income pyramid. The Ministry of Housing and Urban Poverty Alleviation had earlier indicated that **~95% of the housing shortfall in urban India falls under the EWS (Economically Weaker Section) and LIG (Lower Income Group) categories**, which is indicative of the significantly large housing finance opportunity that exists lower down the income pyramid.

Exhibit 6: Overall average ticket size - CHL vs. key HFC peers - in 2QFY18



Source: Company, Nirmal Bang Institutional Equities Research

Significant proportion of CHL's incremental housing loan approvals fall under EWS/LIG/MIG categories

Indeed, as indicated by its average ticket size, a significant portion (40%) of incremental housing loan approvals by CHL fall under the LIG or EWS categories. An LIG family has an income between Rs0.3mn - Rs0.6mn and an EWS family has an income of Rs0.3mn or lower. Further, **91% of incremental housing loan approvals by CHL fall under the MIG-II or lower income category** and are hence, eligible for credit subsidy under PMAY. An MIG-II family and MIG-I family have family income of Rs1.2mn-Rs1.8mn and Rs 0.6mn-Rs1.2mn, respectively.

Government policies are tailored to address the low home ownership among lower income groups

The central government is aware that home ownership is acutely low in India and has, therefore, oriented its policies to specifically address this gap. We note that **Pradhan Mantri Awas Yojna (PMAY)** is structured to specifically address the low home ownership level among lower income groups. It applies to MIG-II and lower income groups only. Also, the extent of credit subsidy improves as one progresses lower down the income pyramid. Interest subsidy is 6.5% for LIG/EWS and 4%/3% for MIG-I/MIG-II categories.

We further note that the proportion of borrowers actually availing PMAY is currently low, but can rise materially as **awareness regarding the programme** grows and lending institutions develop processes to seamlessly initiate the education of borrowers regarding PMAY.

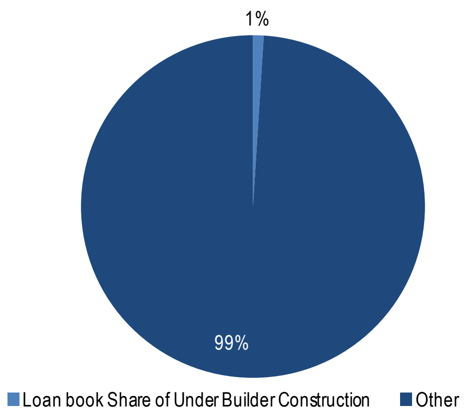
CHL minimally impacted by the disruption caused by the advent of GST

The introduction of GST (Goods and Services Tax) has created an **asymmetrical property market** on the ground since GST is applicable to Under (Builder) Construction properties (as they fall under the purview of Work Contracts) whereas, so far, it is not applicable to completed/ready-to-move-in properties. The applicable effective tax rate on Under (Builder) Construction properties is 12% (18% with land abatement on up to one-third of project cost) whereas the earlier tax regime applies to completed properties, meaning the applicable tax is 5.5%-6.5% (4.5% of Service Tax and 1-2% of VAT) depending on which state one is operating in. This differential taxability is causing home buyers to, on balance, **shift their preference to completed properties** i.e. where Completion Certificate has been granted.

Here, we differentiate between Under (Builder) Construction properties and properties being constructed by prospective home owners / borrowers themselves (classified as **Self Construction**) as the latter are not being sold to anyone and there is no comparative decision to be made by the borrower carrying out self construction.

This phenomenon of home buyers shifting preference to completed properties, however, has little impact on CHL as its **loan book exposure to Under (Builder) Construction properties is only about 1%**. The nature of CHL clientele has always been such that they have rarely opted for Under (Builder) Construction properties.

Exhibit 7: Proportion of CHL loan book backed by under (builder) construction properties



Source: Company, Nirmal Bang Institutional Equities Research

GST problems will resolve over the long run as the government will prevent the incidence of profiteering

The differential between Under (Builder) Construction and completed properties will not exist in the long run as the thought process of the Union government will ensure the same. As delineated in significant detail in a press release by the Ministry of Finance, **Input Tax Credit (ITC) will be available to builders to a far higher extent in the GST regime** compared with the earlier tax regime. As long as builders pass on these ITC benefits to home buyers, the prices on which GST is applied would, on balance, be lower under the GST regime implying that the aforementioned differential will no longer persist. In order that builders do pass on the ITC benefits to home buyers, there is an **anti-profiteering clause enshrined in GST law**, as formulated by the Union government. In order to effectively implement this clause, the Union government is mulling the National Anti-Profiteering Authority (NAA), for which Cabinet approval has already been obtained.

Differential treatment for affordable housing home buyers with regard to GST applicability positive for CHL

As per the GST Council, the **applicable effective tax rate for Under (Builder) Construction properties qualifying for the definition of 'affordable housing' would be 8%** instead of 12% for non-qualifying properties. In this case, 'affordable housing' would mean housing qualifying for the Credit Linked Subsidy Scheme (CLSS) under the aegis of the Pradhan Mantra Awas Yojna and have a carpet area of up to 60sqm.

Secondly, the Ministry of Finance has, additionally, clarified in a statement that **builders should not charge GST to affordable housing home buyers** (on whom the effective GST rate of 8% is applicable) unless they (the builders) reduce the home price (on which GST is levied) by the amount of Input Tax Credit availed.

CHL, being a focused affordable housing financier, is a direct beneficiary of the government's support for the affordable housing buyer.

RERA is a near-term concern, but will resolve over the medium term

We note that the introduction of RERA (Real Estate (Regulation and Development) Act 2016) has proved to be a near-term dampener on housing finance disbursement, but we expect its impact to abate in the medium term. From our conversations with various HFCs, **on-ground impact of RERA could abate as soon as ~2 quarters after the 3QFY18 quarter**.

The reason for generic negative impact on housing loan disbursement is non-compliance of a section of the builder community with RERA norms. **Small builders/contractors with lesser sophistication** have found compliance with RERA onerous and some of them, so far, have not been able carry out the formalities, paperwork and system installations to be in line with RERA requirements.

Particularly small builders/contractors need not comply with RERA norms

It may be noted that the particularly small contractors are generally not required to comply with RERA as the **ballpark sizes of their projects are likely to fall below the minimum threshold** above which RERA compliance requirement kicks in. These thresholds are (1) 500sqm and (2) 8 house units i.e. only projects where land area exceeds 500sqm or where the number of house units to be constructed exceeds 8 will have to register with RERA authority and smaller-sized projects will be exempt.

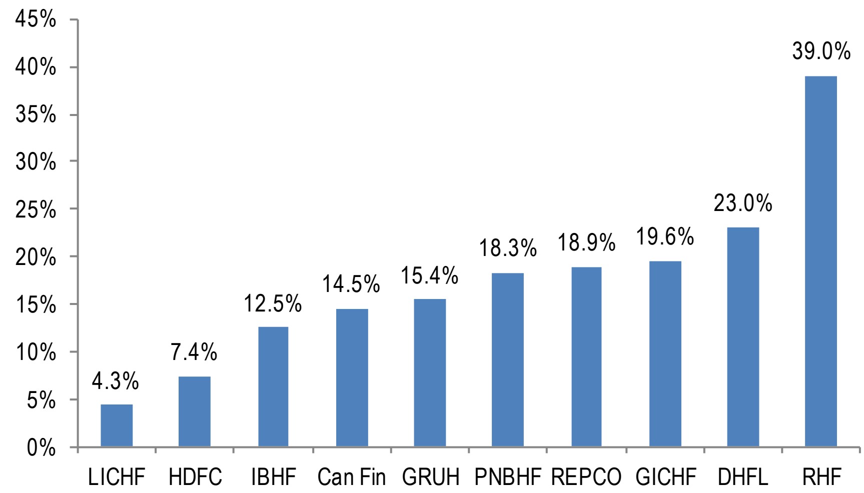
Current and future impact of RERA on CHL not particularly significant

Importantly, RERA compliance is not a matter of 'whether' but of 'when' and most small builders who have found compliance difficult will eventually fall in line. In particular, we do not see significant difficulties for CHL which **sources 90% of loans in its loan book from Tier 1 centres** and is, currently, not operating in an eco-system where builder sophistication is so low that compliance takes an exceedingly long time.

CHL has done a stellar job on the opex control front

Cost-to-income ratio for CHL at 14.5% in 3QFY18 is superior to most HFC peers ranging between 15.4%-39%. LIC Housing Finance (4.3%) and HDFC (7.4%) have better cost-to-income ratio as these have non-replicable access to agency network of parent (LIC) and employee base of associate (HDFC Bank), respectively, which source loans without most of the associated employee costs being booked on the respective HFC's P&L account. Indiabulls Housing Finance (12.5%) also enjoys superior cost-to-income ratio as 22% of loans are eHome Loans (and also due to a high total income base). Apart from these three HFCs, CHL has the best C/I ratio in our expanded set of key HFC peers.

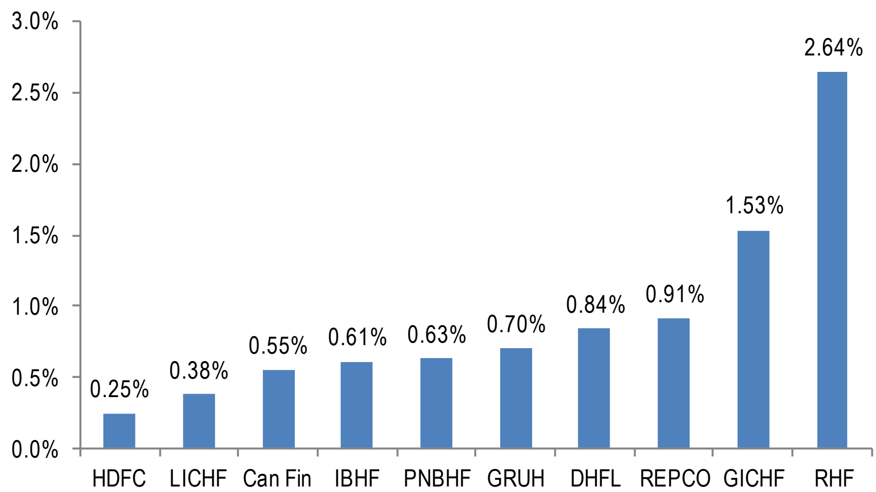
Exhibit 8: Cost-to-income ratio - CHL vs. key HFC peers - in 3QFY18



Source: Company, Nirmal Bang Institutional Equities Research

Opex to average loans, which is, in a sense, **a better metric to measure the operating frugality** of a lending institution also indicates that CHL is superior to all HFCs on opex control, barring LIC Housing Finance and HDFC. Opex to loans in case of CHL is 0.55% (annualised) in 9MFY18 compared with 0.61%-2.64% for key HFC peers. Only LIC Housing Finance (0.38%) and HDFC (0.25%) have better metrics in this regard.

Exhibit 9: Opex to average loans - CHL vs. HFC peers - in 9MFY18

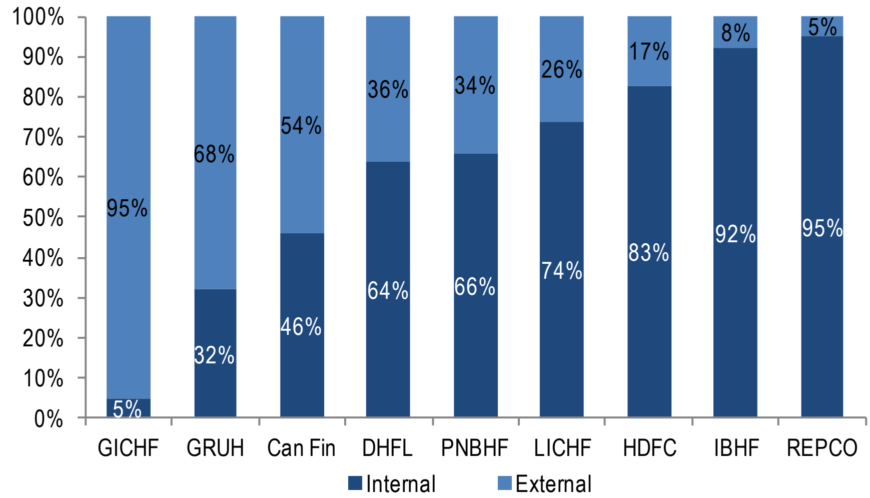


Source: Company, Nirmal Bang Institutional Equities Research

CHL has successfully outsourced its loan sourcing activity to low-cost external DSAs

The share of external sourcing in case of CFH is 54% of total sourcing, which is higher than most HFC peers for whom the range is between 5%-36%, barring Gruh Home Finance (68%) and GIC Housing Finance (95%). By "External", we mean sourcing through a channel whose human resources are neither on the rolls of the respective HFCs nor affiliated to the HFCs in a manner that would cause them to charge low commission rates. For example, LIC (parent) and HDFC Bank (associate) are "Internal" channels for LIC Housing Finance and HDFC, respectively. **External channels, if cheap, are beneficial from an opex control perspective**.

Exhibit 10: Sourcing split - CHL vs. HFC peers - in 3QFY18



Source: Company, Nirmal Bang Institutional Equities Research

The 54% external sourcing done by CHL is all DSA and has proved to be attractive for CHL from an opex control perspective. However, not all external / DSA sourcing proves beneficial (for HFCs in general) and we note from the chart above that there is no clear relationship between high share of external sourcing and opex ratio. In CHL's case, it has proved to be beneficial **as CHL manages to keep DSA commission rates on the lower side**. We have calculated the DSA commission ratio for CHL at 0.38% in FY17 which, we note is much lower than the ballpark for other players in the HFC industry.

CHL's HR strategy works to achieve a young, low-cost but efficient workforce

CHL's human resources strategy has actively worked to keep its workforce young and therefore, low-cost while achieving adequate sales goals. **CHL's average employee age is less than 30 years** and this is reflected in its low cost per employee at Rs0.50mn for 9MFY18 compared with Rs0.50-1.43mn for HFC peers. This is the key reason behind low opex to average assets for CHL compared with HFC peers.

Exhibit 11: Cost per employee in 9MFY18 - CHL vs. HFC peers

Source: Company, Nirmal Bang Institutional Equities Research

Valuation and Outlook

We use the Residual Income Model to arrive at a first-principles' fair value for CHL. We assume a long-term sustainable average risk-free rate of 7% for India, an Adjusted Beta of 1.0 for CHL and an India-specific Equity Risk Premium of 6% and arrive at the overall Cost of Equity of 13.0% for CHL. On this basis, **we arrive at a price target of Rs 638, at which the stock will trade at 5.2x/4.1x FY19E/20E book value**.

CHL **currently trades at a FY19E/20E P/BV of 4.2x/3.3x, which makes it significantly under-valued** given its FY19E/20E RoE profile of 25.6%/25.6%. Consequently, we believe that the multiple of 5.2x/4.1x implied by our price target of Rs 638 is admissible.

Exhibit 12: Consensus vs Our Estimates

	Our estimate			Bloomberg estimate			*% Variance*		
(Rsmn)	**FY18E**	**FY19E**	**FY20E**	**FY18E**	**FY19E**	**FY20E**	***FY18E***	***FY19E***	***FY20E***
Net interest income	5,608	6,756	8,235	5,115	6,172	7,675	*9.6*	*9.5*	*7.3*
Operating profit	5,264	6,410	7,897	5,068	6,157	7,523	*3.9*	*4.1*	*5.0*
Profit after tax	3,089	3,932	4,993	3,062	3,709	4,525	*0.9*	*6.0*	*10.4*

Source: Company, Nirmal Bang Institutional Equities Research

Key Risks

Competition from banks can rise significantly in a scenario of increased interest rate differential between banks and NBFCs

Bank interest rates are tied to cost of funds in the MCLR regime and this can lead to increased differential between bank and NBFC interest rates, leading to high competitive intensity in salaried home loans, where CFH is most active. However, CFH operates at a **low incremental home loan average ticket size** of Rs 1.9mn, at which it can able fend off bank competition.

Full stake sale by Canara Bank can have ramifications for CFH credit rating

CFH parent (Canara Bank) is undergoing a capital crisis to an extent given its deteriorated asset quality. This, theoretically, puts a full stake sale of Canara Bank's stake in CFH (to raise capital) on an accelerated path. The impact from a full stake sale, however, may not be significant since CFH's superior credit rating is derived from the **most conservative under-writing standards**, which will stay intact.

Company Overview

Can Fin Homes is a housing finance company with a branch network of 170 branches and a loan book of Rs 151bn. Con Fin Homes has displayed a loan CAGR of 38% over FY12-17 and its yield on advances in its latest reported quarter was 10.4%.

Can Fin Homes has a cost of funds of 7.7% and, as a result, it registered a net interest margin of 3.6%. Its cost to income ratio stood at 14.5%. Consequently, it delivered a return on assets of 2.1% and a return on equity of 23.8%, implying a financial leverage of 10.5. Its employee count stood at 632 and its Capital Adequacy Ratio was 19.2%.

Exhibit 13: Management team/ Key executives

Name	Designation	Experience
Sarada Kumar Hota	MD, and Whole time Director	Shri. Sarada Kumar Hota has been the Managing Director of Can Fin Homes Ltd. since May 19, 2016. Shri. Hota served as Deputy General Manager in the Recovery wing of Canara Bank, Head Office, Bengaluru. Shri. Hota started his career as an Officer in Canara Bank in the year 1990. Shri. Hota is a senior banker with over 25 years of commercial banking experience having served across the Country. During his service in the Bank, he has headed different branches, Circle Offices and various departments at the Circle and Corporate level. He was heading the Jaipur and Nagpur Circles of Canara Bank. He also carries with him the experience of working in the areas of Human Relations, Strategic Business Planning and Profit Planning at the Head Office of the Bank in Bengaluru. He has been Additional & Whole-Time Director of Can Fin Homes Ltd. since April 28, 2016.
Atanu Bagchi	CFO and Deputy GM	Mr. Atanu Bagchi serves as Chief Financial Officer and Deputy General Manager of Can Fin Homes Ltd. and served as its Chief Manager.

Source: Company, Nirmal Bang Institutional Equities Research

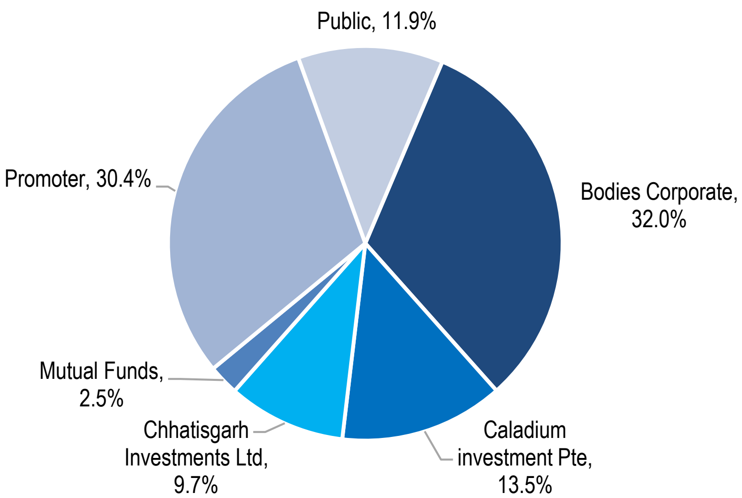
Exhibit 14: Board members

Name	Designation	Experience
Kokkarne Natarajan Prithviraj	Chairman	Mr. Kokkarne Natarajan Prithviraj serves as the Chairman of Management Board at Shinsei Trustee Company (India) Private Limited. Mr. Prithviraj has more than 38 years of experience in the banking industry. He serves as Chairman and Member of the Management Board of Daiwa Trustee Company (India) Private Limited. He served as the Chairman and Managing Director of Oriental Bank of Commerce from April 2006 to June 4, 2007. He served as General Manager of Punjab National Bank Corporate Credit & Human Resource Department and General Manager of Punjab National Bank - Western Zone. He has been the Chairman and Independent Non-Executive Director of Can Fin Homes Limited since June 04, 2014. He has been Independent Non executive Director at Dwarikesh Sugar Industries Ltd. since November 30, 2009. He has been an Independent director of Axis Finance Limited since July 04, 2016. He serves as a Director of Brickwork Ratings India Pvt. Ltd. He served as Independent Director of Surana Industries Ltd. from May 2, 2008 to February 04, 2016. He served as Director of The Oriental Insurance Company Limited. He served as a Director of AXIS Bank Limited since January 9, 2008 until January 8, 2016. He served as an Executive Director of United Bank of India. He served as the Whole time Director of Oriental Bank of Commerce until March 31, 2007. He served as Independent Director of Falcon Tyres Limited from June 28, 2008 to March 31, 2014. He served as a Director of DUNLOP India Ltd. since June 28, 2008.
P. V. Bharathi	Non-Executive Director	Mrs. P. V. Bharathi has been Executive Director of Canara Bank Limited since September 15, 2016 and serves as the firms's General Manager in the Risk Management Wing. Mrs. Bharathi has more than 31 years of experience in the banking industry. She has served in different branches in the NCR region and also in Tamil Nadu State. She has experience in rural, semi-urban, urban and metro branches of the bank. She also served in administrative offices of the bank. Mrs. Bharathi has been a Non-Executive Director of Can Fin Homes Ltd. since September 22, 2014. Mrs. Bharathi serves as a Member of Board of Directors of Canbank Venture Capital Ltd. She served as Additional Director of Can Fin Homes Ltd. since September 22, 2014. She is a Certified Associate of the Indian Institute of Bankers (CAIIB).
Ganesan Naganathan	Independent Director	Mr. Ganesan Naganathan, FCA, has been Independent Director of Can Fin Homes Ltd. since September 7, 2016. Mr. Naganathan is a Chartered Accountant.
Srinivas Ananthacharya Kadur	Non-Executive Director	Mr. Srinivas Ananthacharya Kadur serves as a General Manager of Canara Bank, Head Office, Bangalore. Mr. Kadur has been a Non-Executive Director of Can Fin Homes Ltd., since June 07, 2013. Mr. Kadur started his career as a Technical Field Officer in Canara Bank in February, 1984. During his service in the Bank over a period of 30 years, he has served in different branches of the Bank, including Prime Corporate branch at Pune and Chennai, Circle Office, Mumbai, Corporate Merchant Banking Division, Mumbai and Risk Management Wing at the Head Office.

Source: Company, Nirmal Bang Institutional Equities Research

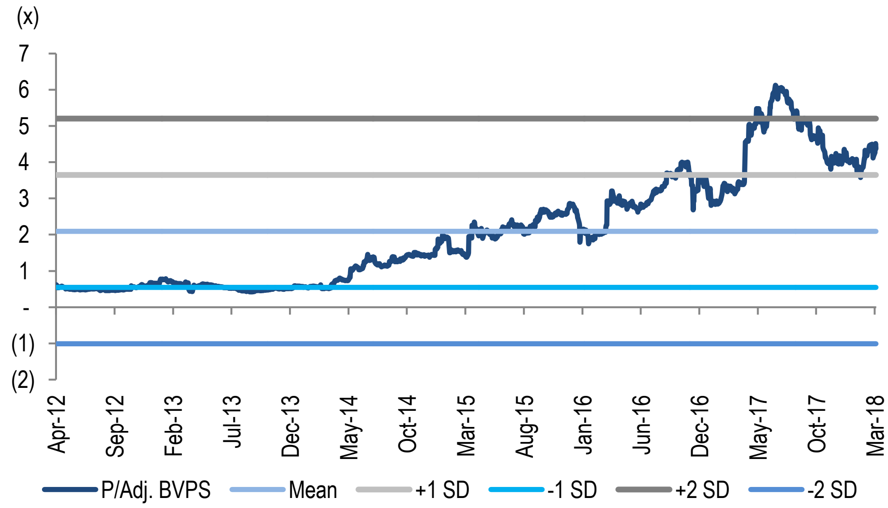
Shareholding Information

Exhibit 15: Shareholding pattern



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 16: One year forward P/BV



Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 17: Income statement

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Interest Income	10,444	13,061	15,499	19,388	24,982
Interest Expense	7,435	8,840	9,892	12,632	16,747
Net Interest Income	**3,009**	**4,221**	**5,608**	**6,756**	**8,235**
Non Interest Income	391	470	566	736	956
Net Revenue	**3,400**	**4,691**	**6,173**	**7,491**	**9,192**
Operating expenses	668	807	909	1,082	1,295
-Employee expenses	331	394	421	506	615
-Other expenses	337	414	488	576	679
Operating profit	**2,732**	**3,884**	**5,264**	**6,410**	**7,897**
Provisions	194	188	438	266	94
PBT	2,538	3,696	4,827	6,143	7,802
Tax	968	1,349	1,738	2,212	2,809
PAT	**1,571**	**2,347**	**3,089**	**3,932**	**4,993**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 19: Balance sheet

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Share capital	266	266	266	279	279
Reserves & surplus	8,514	10,497	13,266	16,861	21,519
Networth	**8,780**	**10,763**	**13,532**	**17,141**	**21,798**
Borrowings	86,251	112,335	134,960	176,936	231,519
Other liability & provisions	12,915	11,478	13,713	16,681	20,553
Total liabilities	**107,945**	**134,576**	**162,204**	**210,757**	**273,870**
Fixed Assets	89	102	112	123	135
Investments	149	159	159	159	159
Loans	107,532	134,113	161,688	210,156	273,162
Cash	174	200	243	315	410
Other assets	2	3	3	4	4
Total assets	**107,945**	**134,576**	**162,204**	**210,757**	**273,870**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 18: Key ratios

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Growth (%)					
Net Interest Income	69.4	40.3	32.9	20.5	21.9
Operating Profit	80.1	42.1	35.5	21.8	23.2
Profit After Tax	82.2	49.4	31.6	27.3	27.0
Business (%)					
Advance Growth	29.5	24.7	20.6	30.0	30.0
Spreads (%)					
Yield on loans	11.0	10.8	10.5	10.4	10.3
Cost of Borrowings	9.6	8.9	8.0	8.1	8.2
Spread	1.4	1.9	2.5	2.3	2.1
NIMs	3.2	3.5	3.8	3.6	3.4
Operational Effeciency (%)					
Cost to Income	19.6	17.2	14.7	14.4	14.1
Cost to AUM	0.7	0.7	0.6	0.6	0.5
Productivity (Rsmn)					
Loan per Branch	768.1	788.9	800.0	900.0	1,000.0
Loan per Employee	194.5	232.0	266.7	300.0	333.3
Employee per Branch	4.0	3.4	3.0	3.0	3.0
CRAR (%)					
Tier I	17.6	16.0	16.7	15.7	14.8
Tier II	3.1	2.5	2.3	2.2	2.1
Total	20.7	18.5	19.0	17.9	16.8
Asset Quality (%)					
Gross NPA	0.2	0.2	0.5	0.4	0.3
Net NPA	0.0	0.0	0.2	0.2	0.1
Provision Coverage	100.3	100.0	60.0	60.0	60.0
Credit Cost (excluding std asset)	0.2	0.2	0.3	0.1	0.0
Credit Cost (including std asset)	0.4	0.2	0.3	0.1	0.0
Return Ratio (%)					
ROE	19.0	24.0	25.4	25.6	25.6
ROA	1.6	1.9	2.1	2.1	2.1
Per Share (%)					
EPS	11.8	17.6	23.2	28.2	35.8
BV	66.0	80.9	101.7	122.7	156.1
ABV	66.0	80.9	99.6	120.3	153.7
Valuation (x)					
P/E	43.3	29.0	22.0	18.2	14.3
P/BV	7.7	6.3	5.0	4.2	3.3
P/ABV	7.7	6.3	5.1	4.2	3.3

Source: Company, Nirmal Bang Institutional Equities Research

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Institutional Equities

PNB Housing Finance

26 March 2018

Initiating Coverage

Reuters: PNBH.NS; Bloomberg: PNBHOUSI IN

Playing It Large, Prudently

PNB Housing Finance (PNBHF) is a housing finance company (HFC) with a network of 63 branches and loan book size of Rs463bn. We are bullish on PNBHF as: (1) The HFC is geared towards high asset growth driven by (a) meaningful presence in large-ticket businesses (b) pan-India focus (c) affiliation to PNB umbrella brand and (d) operating at an 'efficient frontier' in terms of loan ticket size. (2) It maintains cost of borrowings leadership because of superior credit risk perception in debt capital market. (3) It (a) maintains pristine asset quality even when viewed from a seasoning prism (b) is a cautious construction finance lender and (c) maintains ultra-high provision cover. We initiate coverage on the stock with a Buy rating and a target price of Rs1410, which values the stock at 3.2x/2.7x FY19E/FY20E P/BV.

PNBHF strategy and DNA geared towards high risk-managed asset growth: PNBHF meaningfully conducts the entire gamut of ultra-large-ticket businesses that a 'monoline' HFC can, which account for 21% of 1HFY18 loans. Secondly, PNBHF eschews geographically contiguous growth in any catchment area and has a truly pan-India approach, which lends scalability. Exposure to North India has fallen from 71% in FY12 to 35% in 1HFY18. Thirdly, PNBHF benefits from the PNB umbrella brand, which will stay despite fraud at the parent. Fourth, PNBHF operates, from its perspective, at an optimal average ticket size of Rs2.6mn for salaried home loans, where it can fend off competition from banks.

PNBHF is the cost of borrowings leader among key listed HFCs for idiosyncratic reasons: Credit rating alone is not a differentiating factor as all HFCs in our expanded peer set (10 HFCs) are AAA-rated, barring GIC Housing Finance, Repco Finance, and Reliance Home Finance. Debt capital markets as well as banks apply lower credit risk premium to PNBHF instruments on the back of the latter's sound underwriting standards. Cost of borrowing at PNBHF for 3QFY18 stood at 7.5% compared with 7.6%-8.8% for HFC peers.

PNBHF is an asset quality champion despite high balance sheet growth: PNBHF has a GNPA ratio of 0.4% for 3QFY18 compared with 0.5%-3.7% for key HFC peers. This is the result of superior underwriting standards and not due to of the portfolio not being seasoned as the two-year lagged GNPA ratio for PNBHF in FY17 (well into PNBHF's high-growth phase) stood at 0.5% compared with 1.1% for the rest of the HFC industry. PNBHF is particularly cautious with construction finance, adhering to the most stringent standards including funding only those projects that are within six months to completion. PNBHF also makes prudent contingent provisions on its book, taking provision coverage ratio to 174% as of 3QFY18-end compared with 46%-124% for key HFC peers, barring IBHF at 180%.

Valuation and Outlook: We have used the residual income model to value PNBHF and arrived at the target price of Rs1410. PNBHF currently trades at 2.6x/2.1x FY19E/FY20E P/BV and we believe that our target price is reasonable given PNBHF's RoE profile of 16.9%/19.6% for FY19E/FY20E and long-term outlook.

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Net Interest Income	7,585	11,297	16,415	22,903	31,077
Pre-Provision Profit	5,838	9,015	14,500	19,384	26,166
PAT	3,265	5,237	8,501	11,513	15,850
EPS (Rs)	25.7	31.6	51.3	69.5	95.7
BV (Rs)	169.1	336.7	380.8	443.1	531.6
P/E (x)	44.3	36.0	22.2	16.4	11.9
P/BV (x)	6.7	3.4	3.0	2.6	2.1
Gross NPA (%)	*0.2*	*0.2*	*0.4*	*0.5*	*0.5*
Net NPA (%)	*0.1*	*0.2*	*0.1*	*0.1*	*0.1*
ROA (%)	*1.3*	*1.4*	*1.6*	*1.5*	*1.6*
ROE (%)	*17.5*	*13.6*	*14.3*	*16.9*	*19.6*

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: NBFCs

CMP: Rs1,139

Target Price: Rs1,410

Upside: 24%

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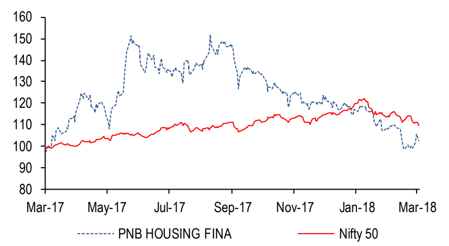
Key Data

Current Shares O/S (mn)	166.6
Mkt Cap (Rsbn/US$bn)	189.2/2.9
52 Wk H / L (Rs)	1,718/1,006
Daily Vol. (3M NSE Avg.)	196,868

Shareholding (%)	3QFY18	2QFY18	1QFY18
Promoter	33.0	38.9	38.9
Public	67.0	61.1	61.0
Others	-	-	-

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
PNB Housing	(6.5)	(27.3)	2.7
Nifty Index	(4.8)	0.3	10.0

Source: Bloomberg

PNBHF's long-term strategy is built to deliver high asset growth without diluting underwriting standards

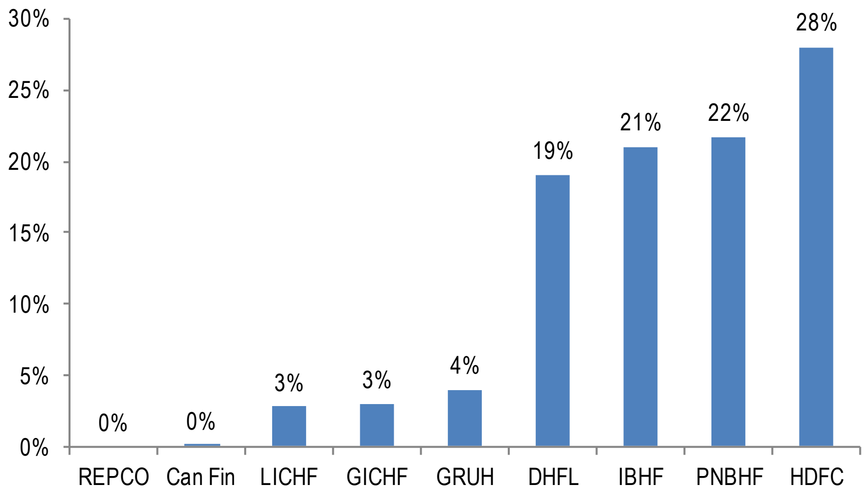
PNBHF is the fastest-growing HFC in our expanded peer set of HFCs, posting a CAGR of 57% over FY12-FY17 compared with key HFC peers ranging between 15%-38% over the same period. PNBHF's strategy is designed to deliver high asset growth because of a variety of factors. We enumerate these key factors as follows (1) PNBHF conducts, efficiently and meaningfully, the **entire gamut of possible lending businesses** that a 'monoline' HFC can operate in (2) It is a **truly pan-India** HFC with a geographically diversified distribution network and sans a constrictive contiguous approach to business growth (3) It is a **beneficiary of the PNB umbrella brand** which has a wider recall value than most of its HFC peers (4) It **operates roughly at the 'efficient frontier'** that balances large ticket size for individual housing loans with manageable competitive intensity from banks.

PNBHF's addressable opportunity size is larger as it is meaningfully pursuing all possible areas that a 'monoline' HFC is allowed to

PNBHF has **meaningful ultra-large ticket non-housing non-LAP lending businesses** that comprises 21.2% of 1HFY18 loan book (of this, 19.8% is officially classified as corporate/wholesale lending). This includes (a) Residential Construction Finance (11.8% of total loan book), (b) LRD (Lease Rental Discounting) (5.0% of loan book) and (c) CTL (Corporate Term Loan) (4.4% of total loans).

We note that **several other key HFC peers are either absent or have a small presence in ultra-large ticket lending**. CanFin Homes and Repco Home Finance do not, as such, conduct ultra-large ticket business. CanFin Homes has Builder Loans worth 0.05% of total loans and Repco Home Finance has nil exposure. LIC Housing Finance, GIC Housing Finance and Gruh Finance have some presence in ultra-large ticket lending, but it is not a focus area for them and account for 2.8%, 3% and 4% proportion of total loans, respectively.

Exhibit 1: Ultra large-ticket non-housing non-LAP loans as % of 1HFY18 loan book – PNBHF vs. peers



Source: Company, Nirmal Bang Institutional Equities Research

Presence in ultra-large ticket lending is symptomatic of high achievement orientation and, **of the four largest HFC loan books in the industry, 3 (HDFC, IBHF and DHFL) have meaningful ultra-large ticket businesses**. LIC Housing Finance is a special case as it has non-replicable access to parent LIC's vast individual agent network that has helped shape a large individual lending business.

Presence in ultra-large ticket lending implies taking on risks that are different in nature (and generally somewhat higher) than in individual loans. The associated concern, therefore, from the investor community's perspective, is **whether the underwriting standards followed by the HFC while conducting the ultra-large ticket lending are adequate**. We shall discuss this key aspect in a subsequent section and note that the standards followed by PNBHF are particularly prudent.

A key incremental reason for PNBHF's faster growth is a clear strategy to grow in a geographically diversified manner

PNBHF has a clear intention to be a truly pan-India HFC and not remain bound by a contiguous growth pattern that would have lopsided focus on a specific region. The current growth strategy for PNBHF entails, on balance, higher branch openings and concomitantly higher opex ratio, but it creates a diversified geographical network base for PNBHF. Thus, **a foundation for balanced approach to future growth has been laid that will also lend itself to a faster pace of growth**, ceteris paribus, compared with HFCs that have relatively contiguous approach to growth.

It may be noted that PNBHF currently does not have presence in Eastern India, which is the smallest housing finance market. However, the management has stated that it would **shift focus incrementally to Eastern India going forward** and complete the final lap of its geographical diversification strategy.

In comparison, some other HFCs have continued their focus on specific regions and states. For example, Repco Home Finance derives 88.2% of 2QFY18 loan book share from South India, of which 61.5% is from Tamil Nadu alone. Similarly, Can Fin Homes has 67% branch share in South India as of 2QFY18, of which 27% is from Karnataka state. Can Fin Homes derives 37% of loan book from Karnataka state, of which 33% is from Bangalore city alone. GICHF derives ~40%-45% of its loan book from Western India (branch share is more balanced with 32% share for Western India). These **contained growth patterns are positive from a opex control perspective in the near to medium term**, as branches in and around the region of focus generally break even faster and generate superior business returns, but a diversified growth pattern (followed by PNBHF) is more suited to loan book growth, both current and prospective, from a long-term perspective.

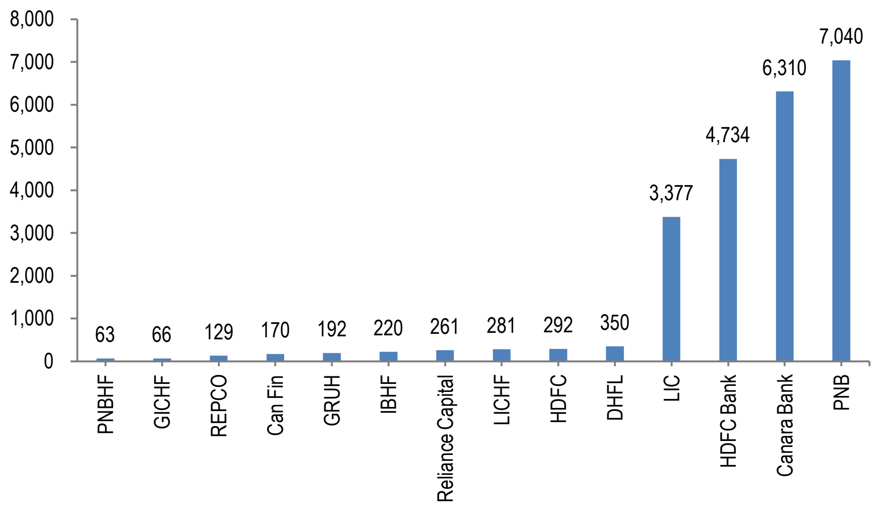
In fact, PNBHF has displayed particularly high delta in terms of moving away from its initial geographical focus on North India. **Exposure to North India has fallen from 71% of loan book in FY12 to 35% in 1HFY18** as part of a conscious plan to diversify geographically (under the comprehensive Business Process Re-engineering plan called 'Kshitij').

PNBHF benefits significantly from its affiliation to the Punjab National Bank umbrella brand

While it is not straightforward to quantify the impact of PNBHF's affiliation to the Punjab National Bank umbrella brand, we believe PNBHF benefits significantly from this association. The HDFC Bank and LIC brands have significant reach and recall value but, **aside of these, Punjab National Bank brand can be said to be generally stronger than those of other HFCs** (or their parent companies) in our expanded peer set.

We have compared the branch count of the parent companies or specific HFCs to get a sense of their reach on the ground. While we would not aver that branch count is a proxy for brand recall per se, it would give us a sense of the extent of the respective organisations' touch points on the ground, which can be said to have a **second order impact on the respective brand's recall value** from the individual consumer's perspective.

Exhibit 2: Branch count – PNB vs. HFC/HFC parent



Source: Company, Nirmal Bang Institutional Equities Research

PNBHF's individual home loan business operates at an 'efficient frontier' from a ticket size perspective

While the overall individual home loan book for PNBHF has an average ticket size of Rs3.1mn, the average ticket size for the salaried portion is Rs2.6mn and that for self employed portion is Rs3.6. The Rs2.6 mn average ticket size for PNBHF has, so far, proved to be a 'efficient frontier' for PNBHF from the perspective of loan book growth in the salaried segment as **bank competition, while present at the Rs2.6mn ballpark, is particularly intense at ticket sizes in excess of Rs3mn**, particularly during periods when there is widened interest rate differential between banks and NBFCs.

PNBHF's hitherto Tier 1 centre focus has resulted in ticket size being on the higher side so far. However, the management has stated that **overall individual loan book ticket size would trend lower from the Rs 3.1mn average currently to about Rs2.6mn over the next two to three years** on the back of incremental focus on Tier 2 centres.

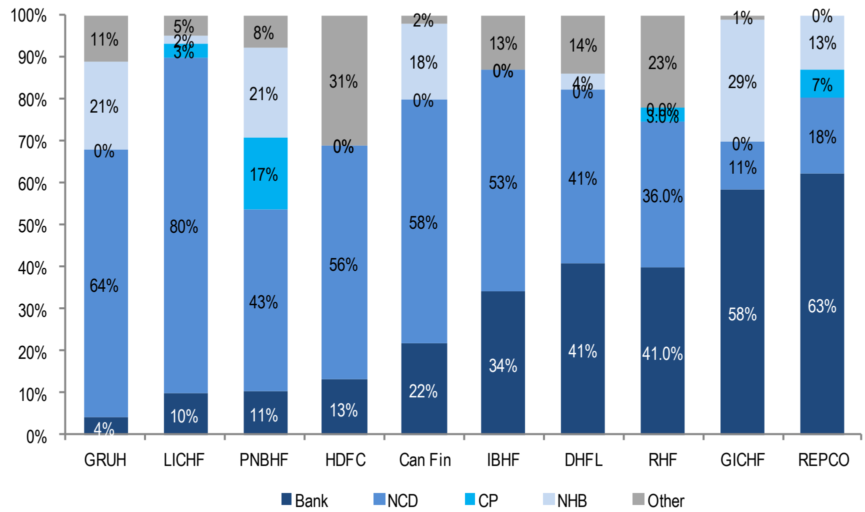
PNBHF enjoys a low cost of borrowings profile owing to idiosyncratic reasons

PNBHF cost of borrowings in 3QFY18 was 7.5% compared with 7.6%-8.8% for HFC peers. Like Can Fin Homes, this boils down to **superior credit risk perception arising from sound asset quality** and not merely, a AAA credit rating, which all key listed HFCs in our expanded peer set enjoy, barring Repco Home, GIC Housing and Reliance Home.

PNBHF has a low share of generally high-cost bank borrowings

Superior credit risk perception affords **superior access to debt capital markets** for PNBHF. For a while, interest rates have tended to be lower on the debt capital market side compared with bank funding, particularly for companies with superior credit risk perception like PNBHF. The share of bank borrowings for PNBHF is 11% as of 3QFY18-end compared with 13-63% for HFC peers, barring Gruh Finance/LIC Housing Finance at 4/10%, respectively.

Exhibit 3: Borrowing mix – PNBHF vs. HFC peers in 3QFY18



Source: Company, Nirmal Bang Institutional Equities Research

Fraud at parent Punjab National Bank does not impact PNBHF credit risk profile from a long-term perspective

PNBHF's parent Punjab National Bank (PNB) has been hit with a major fraud, which essentially entails unauthorised siphoning out of ~Rs136bn from a single Mumbai branch. While this does put pressure on PNB's capital level in the near term, **PNB's management has clarified on a conference call that even a worst case scenario materialising will not deplete capital level below the regulatory requirement**.

While **capital constraints at PNB theoretically** mean (1) Lower capital support for PNBHF from parent, ceteris paribus. (2) Greater urgency on the part of PNB to offload stake completely in PNBHF to raise capital for itself in this time of need and thereby, result in permanent comprehensive disassociation with PNBHF and also, possibly, loss of PNB umbrella brand for PNBHF.

These theoretical possibilities, however, are not likely to play out in any negative manner for PNBHF. Lower capital support from PNB, ceteris paribus, will not be a major factor as: (1) **PNBHF itself is well-capitalised** with a Tier 1 capital ratio of 13.3% as of 3QFY18-end and does not need to return to equity capital markets for capital raise in the near to medium term. (2) PNBHF has strong long-term prospects that will allow it to raise capital from (a) other existing investors including key private equity shareholders like **Carlyle Group (largest shareholder) and General Atlantic** as well as (b) New investors (3) Parent **PNB has other significant non-core equity ownerships** like PNB Metlife, UTI Asset Management and PNB Gilts. (4) Government of India has already indicated it would infuse Rs54.7bn in equity capital into PNB via the **recapitalisation bond** structure. (5) PNB has raised equity capital amounting to Rs50bn as recently as December 2017 via a **Qualified Institutional Placement**.

Parent PNB, also, cannot offload full stake in PNBHF right now as the latter listed on 7th November 2016 and, as per SEBI rules, PNB has to wait till at least three years (till 7th November 2019) before it can reduce its stake below a minimum of 20%. We do not believe that reduction of stake to a possible 20% will entail a comprehensive disassociation (from a capital support perspective) with PNBHF nor a loss of PNB umbrella brand for PNBHF. We further aver that the current capital crisis at parent PNB will abate well before 7th November 2019.

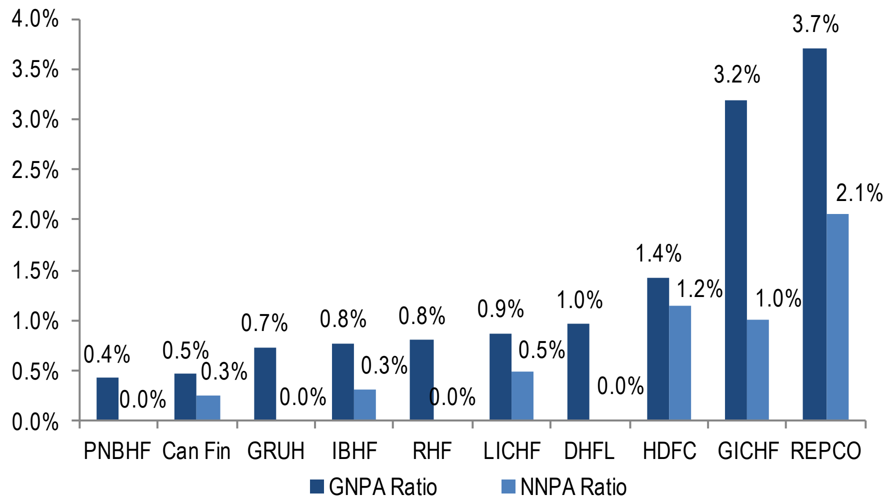
For the record, PNB had reduced its stake in PNBHF from 51% to 39% via the IPO. It further reduced its stake to 32.96% by selling ~6% stake sale in December 2017. The Carlyle Group held majority stake in PNBHF at 37.55% of equity. General Atlantic holds a 8.36% stake in PNBHF.

High balance sheet growth for PNBHF by no means implies dilution of underwriting standards

Superior GNPA ratio of PNBHF not because of portfolio being unseasoned

GNPA ratio for PNBHF in 3QFY18 stood at 0.4% compared with 0.5%-3.7% for HFC peers and is indicative of superior underwriting standards and not lack of seasoning on the portfolio created.

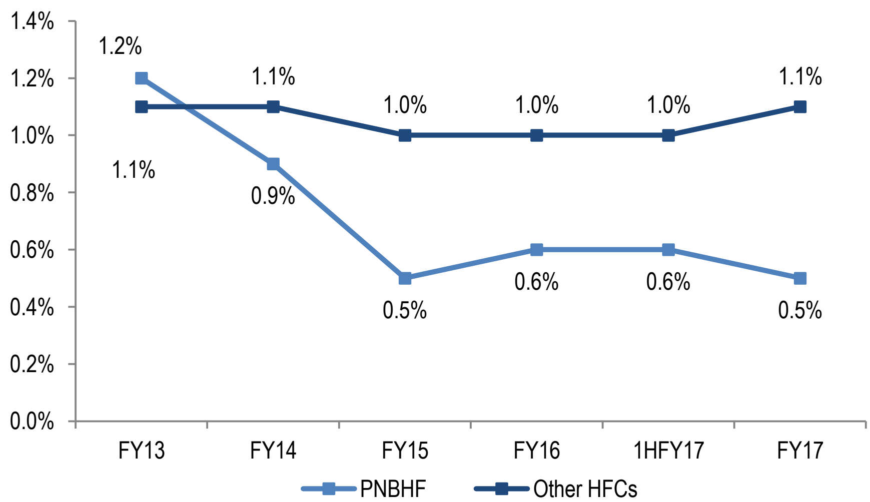
Exhibit 4: GNPA and NNPA ratio – PNBHF vs. HFC peers in 3QFY18



Source: Company, Nirmal Bang Institutional Equities Research

In fact, **the lagged GNPA ratio for PNBHF is 0.5% compared 1.1% for rest of the HFC industry** as of FY17-end, which is well into the high-growth trajectory for PNBHF.

Exhibit 5: Two-year lagged GNPA ratio – PNBHF vs. HFC industry



Source: PNBHF 1QFY18 presenation (citiing CRISIL), Nirmal Bang Institutional Equities Research

This aspect should **alleviate any investor concern that headline GNPA ratio for PNBHF looks good as its portfolio is yet to be seasoned**.

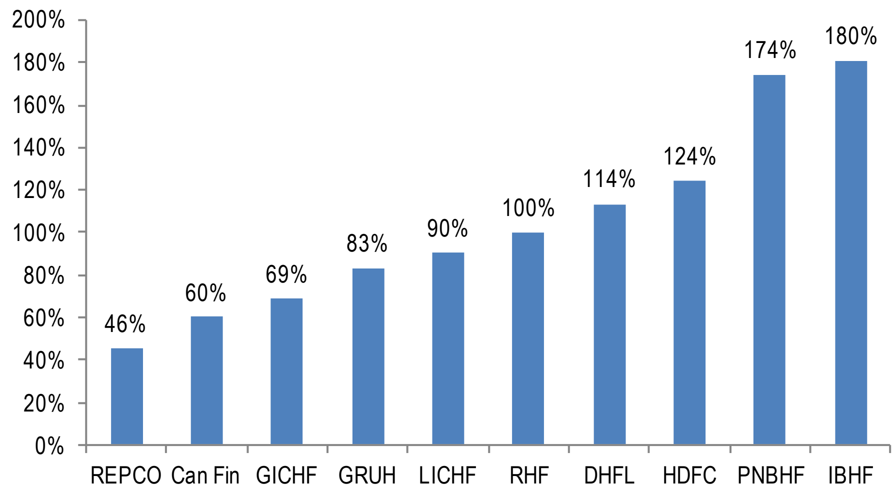
PNBHF exercises utmost caution in construction finance business

Unbridled pursuance of yield may lead to dilution of underwriting standards in the construction finance business for an HFC, but PNBHF exercises utmost caution in this regard. **PNBHF only disburses construction finance (developer/builder loans) when** (1) the project has already been launched and is generally much closer (~six months) to completion, (2) all permissions and licences have been obtained, (3) land has been aggregated, (4) titles have been duly transferred, (5) adequate security coverage is available and (5) stringent debt-to-equity, debt-service-coverage and other metrics are satisfied.

Prudent provisioning approach means PNBHF enjoys higher provision coverage among HFCs

PNBHF believes in building a **sound provision coverage buffer** for itself when the times are good. Over and above specific provisions worth Rs2,790mn, PNBHF also carried standard asset provisions worth Rs490mn and, importantly, added incremental cumulative contingency provisions worth Rs760mn. This allows PNBHF to have the best gross provision coverage ratio of 174% compared with 46%-124%% for HFC peers, barring Indiabulls Housing Finance at 180%.

Exhibit 6: Gross provision coverage ratio – PNBHF vs. HFC peers 3QFY18



Source: Company, Nirmal Bang Institutional Equities Research

Valuation and Outlook

We use the Residual Income Model to arrive at a first-principles' fair value for PNBHF. We assume a long-term sustainable average risk-free rate of 7% for India, an Adjusted Beta of 1.02 for PNBHF and an India-specific Equity Risk Premium of 6% and arrive at the overall Cost of Equity of 13.1% for PNBHF. On this basis, **we arrive at a price target of Rs 1410, at which the stock will trade at 3.2x/2.7x FY19E/20E book value**.

PNBHF **currently trades at a FY19E/20E P/BV of 2.6x/2.1x, which makes it significantly under-valued** given its FY19E/20E RoE profile of 16.9%/19.6% and long-term outlook. Consequently, we believe that the multiple of 3.2x/2.7x implied by our price target of Rs 1410 is reasonable.

Exhibit 7: Consensus vs Our Estimates

	Our estimate			Bloomberg estimate			*% Variance*		
(Rsmn)	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	*FY18E*	*FY19E*	*FY20E*
Net interest income	16,415	22,903	31,077	-	-	-	-	-	-
Operating profit	14,500	19,384	26,166	13,866	18,646	24,727	*4.6*	*4.0*	*5.8*
Profit after tax	8,501	11,513	15,850	8,351	11,266	14,612	*1.8*	*2.2*	*8.5*

Source: Company, Nirmal Bang Institutional Equities Research

Key Risks

Competition from banks can rise significantly in a scenario of increased interest rate differential between banks and NBFCs

Bank interest rates are tied to cost of funds in the MCLR regime and this can lead to increased differential between bank and NBFC interest rates, leading to high competitive intensity. However, PNBHF operates at the 'efficient frontier' in terms of **ticket size** where it is able to maximize revenue while holding off bank competition.

Loss of PNB umbrella brand can reduce instant pan-Indian appeal

PNBHF parent (PNB) is undergoing a capital crisis to an extent given the fraud that has taken place. This, theoretically, puts a full stake sale of PNB's stake in PNBHF (to raise capital) on an accelerated path. This, however, is precluded by **SEBI listing norms** that do not allow full stake sale within 3 years of listing date.

Company Overview

PNB Housing Finance is a housing finance company with a branch network of 63 branches and a loan book of Rs 553bn. Of the loan book, the home loan, loan against property, and other loans split is 57%, 16%, and 27% respectively. PNB housing finance has displayed a loan CAGR of 57% over FY12-17 and its yield on advances in its latest reported quarter was 10%.

PNB housing finance has a cost of funds of 7.5% and, as a result, it registered a net interest margin of 3%. Its cost to income ratio stood at 18.3%. Consequently, it delivered a return on assets of 1.6% and a return on equity of 13.9%, implying a financial leverage of 8.6. Its employee count stood at 1254 and its Capital Adequacy Ratio was 17.4%.

Exhibit 8: Management team/ Key executives

Name	Designation	Experience
Sanjaya Gupta	MD, and Exective Director	Mr. Sanjaya Gupta serves as Managing Director of PNB Housing Finance Limited and has been its Executive Director since June 25, 2010. Mr. Gupta serves as Managing Director of Nexus Venture Partners. His professional career started with HDFC Ltd. in 1987 as a Management Trainee. He worked there for 16 years in various geographies at a variety of strategic and functional positions lastly assignment with HDFC was as the Head of Business Development & Distribution. He worked with ABN AMRO Bank NV as India Business Head of Retail Mortgages and later got elevated as the Mortgage Operations Head for North America and other geographies. He has been a Nominee Director of Satin Creditcare Network Limited since August 21, 2017. He serves as ADB nominated Director on the Board of HDFC Plc., Maldives. He is also a Fellow of the Royal Institution of Chartered Surveyors. Mr. Gupta holds a Post Graduate Degree in Business Management.
Nitant Desai	Chief Operations & Technology Officer	Mr. Nitant Desai serves as Chief Centralised Operation and Technology Officer of PNB Housing Finance Ltd. Mr. Desai is an astute professional with more than 25 years of varied and relevant experience in retail finance with leading banks and financial institutions in India and the Middle East. He has vast knowledge in operations management, client servicing, quality & compliance and business process re-engineering. Prior to PNBHFL, he has worked with reputed organisations like HDFC Life Insurance Co. Ltd., Union National Bank - Abu Dhabi, ICICI Bank Ltd., GE Countrywide, TATA Finance Ltd. and HDFC Ltd.
Ajay Gupta	Chief Risk Officer	Mr. Ajay Gupta serves as the Chief Risk Officer at PNB Housing Finance Ltd. Prior to PNBHFL, Mr. Gupta served with Religare Finvest Ltd. as Director and CRO. Mr. Gupta served at India Bulls Financial Services as Risk Head and also served with GE Money, ANZ Grindlays Bank & Standard Chartered Bank in various roles. Mr. Gupta is an accomplished risk management professional with over 22 years of rich experience in credit cycle management across a diverse product group comprising SME Loans, Loan Against Property, Home Loans, Builder Finance, Construction Equipment Loans, Commercial Vehicle Loans, Business/ Personal Loans and Auto Lease. His areas of expertise include Credit Policy & Underwriting, Collection Management, Fraud Control, Risk Analytics & Portfolio Management.
P. K. Jain	Executive Vice President of Credit	Mr. P. K. Jain serves as Executive Vice President of Credit at PNB Housing Finance Ltd
Shaji Varghese	Business Head	Mr. Shaji Varghese serves as Business Head of PNB Housing Finance Ltd. Mr. Varghese served as Business Head of Secured Assets - Consumer Banking at IndusInd Bank Limited from January 2011 to January 2012 and served as its Senior Vice President from June 2008 to January 2012. He has more than 17 years of experience in retail assets, liabilities and wealth management. He is an integral contributor in setting up large successful businesses across geographies and managing high performance teams. His forte is retail distribution and managing sustainable and profitable business. Prior to this assignment, he served as the Senior Vice President and Business Head, Secured Assets at Indusind Bank. He has also handled assignments with leading financial institutions and banks like ABN AMRO Bank NV, ICICI Bank Ltd. and Transamerica Apple Distribution Finance Ltd

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 9: Board members

Name	Designation	Experience
Sunil Mehta	Chairman – Non-Executive	Shri. Sunil Mehta has been the Managing Director and Chief Executive Officer of Punjab National Bank since May 5, 2017. Shri. Mehta served as General Manager of Allahabad Bank since January 2, 2016 until February 3, 2016 and served as its Field General Manager of North - New Delhi until January 2, 2016. He served as an Executive Director of Corporation Bank from January 22, 2016 to May 5, 2017. He started his banking career in May 1982 as an Agriculture Field Officer of Allahabad Bank and rose to the post of General Manager in the Bank in the year 2012. He has been Non--Executive Chairman and Part Time Non-Official Director at Punjab National Bank since March 16, 2017. He has been the Chairman of PNB Housing Finance Limited since May 12, 2017. He has been Chairman of PNB Gilts Ltd. since May 24, 2017 and has been its Non-Executive and Non-Independent Director since May 12, 2017. He has been a Nominee Director of India Infrastructure Finance Company Limited since August 26, 2017. He has been Director at Punjab National Bank since May 2017. He served as an Independent Director at State Bank of India from June 26, 2014 to March 15, 2017.
Sanjaya Gupta	Managing Director	Mr. Sanjaya Gupta holds a Post Graduate Degree in Business Management. He is also a Fellow of the Royal Institution of Chartered Surveyors.His professional career started with HDFC Ltd. in 1987 as a management trainee. He worked there for 16 years in various geographies at a variety of strategic and functional positions. His last assignment with HDFC was as the Head of Business Development & Distribution.Thereafter he worked with ABN AMRO Bank NV as India Business Head, Retail Mortgages and later got elevated as the Mortgage Operations Head for North America and other geographies.His last assignment before PNB Housing was with United Guarantee (AIG Inc.) as the Country Head for India, a joint venture of NHB, ABD and IFC Washington DC.
Shital Kumar Jain	Independent Director	Mr. Shital Kumar Jain was the Division Credit Officer for Canada including the real estate portfolio. Previously, Mr. Jain served in Citibank and spent several years overseas in Senior Management positions in Hongkong, Taiwan, Philippines, Thailand and Canada. He was at Citibank in June 2000 after working for more than 31 years. He held the post of Senior Credit Officer for more than 18 years. He has been an Independent Director of R.S. Software (India) Limited since February 19, 2001. Mr. Jain serves as Director of Lotus Asset Trustee Company Pvt. Limited. Mr. Jain serves as a Director of Centurion Bank Ltd. He serves as a Director of Lotus India Trustee Company Private Limited. He has been an Independent Director of PNB Housing Finance Limited since August 2014. He serves as an Independent Director of Canara Robeco Asset Management Company Ltd. Mr. Jain served as a Director of Centurion Bank of Punjab Ltd. He served as a Director of Clutch Auto Limited from July 07, 2005 to March 2009.
Ramakrishnan Chandrasekaran	Independent Director	Mr. Ramakrishnan Chandrasekaran has been an Executive Vice Chairman of Cognizant India at Cognizant Technology Solutions Corporation since December 4, 2013. Mr. Chandrasekaran served as the Group Chief Executive of Technology and Operations at Cognizant Technology Solutions Corporation from February 6, 2012 to December 4, 2013 and served as its President of Global Delivery from August 2, 2006 to February 6, 2012 and served as its Managing Director of Global Delivery from January 20, 2004 to February 6, 2012. He has been the Chairman of The Executive Council at National Association of Software and Service Companies since April, 2014 and served as its Vice Chairman of The Executive Council from April 8, 2013 to April 2014. He has been Vice Chairman of NASSCOM since 2012. He has been an Independent Director of PNB Housing Finance Limited since October 7, 2015.
Sunil Kaul	Non-Executive Director	Shri Kaul has served as president of Citibank Japan, overseeing the bank's corporate and retail banking operations. He concurrently served as the chairman of Citi's credit card and consumer finance companies in Japan. He was also a member of Citi's Global Management Committee and Global Consumer Planning Group.He has over 25 years' experience in corporate and consumer banking of which more than 15 years have been in Asia. In his earlier roles, he has served as the Head of Retail Banking for Citi in Asia Pacific. He has also held senior positions in Business Development for Citi's Global Transaction Services based in New York, Transaction Services Head for Citi Japan and Global Cash Business Management Head for ABN Amro, based out of Holland.Shri Sunil Kaul is presently the Managing Director of the Carlyle Group, advising and providing oversight for its investments in the financial services sector across Asia and other emerging markets. He is based in Singapore.
Nilesh S Vikamsey	Independent Director	Mr. Nilesh S Vikamsey is a senior partner at KHIMJI KUNVERJI & CO., Chartered Accountants, Mumbai since 1985.Khimji Kunverji & Co. is in practice since 1936, having over 79 years of experience in the areas of Auditing, Taxation, Corporate & Personal Advisory Services, Business & Management Consulting Services, Due diligence, Valuations, Inspections, Investigations, etc. He is not paid any remuneration except for sitting fees for attending the meetings of the Board or Committee thereof and has been appointed for a term of 5 years.
Gourav Vallabh	Independent Director	Prof. (Dr) Gourav Vallabh is FRM (GARP, USA), CA, CS, Ph.D. (UoR, India), M.Com. (Gold Medalist), LL.B. and B.Com. (F) (Gold Medalist). He is Professor of Finance XLRI Jamshedpur, Xavier School of Management, Jamshedpur.He was ex Director – The Institute of Chartered Accountants of India, ex Professor – Management Development Institute, was nominated as a Visitor's Nominee (Nominee of President) in Banaras Hindu University (BHU) for calendar year 2015, 2016 and 2017, was nominated as a Member of Board of Governors of Indian Institute of Forest Management, Bhopal (IIFM, Bhopal) and IIFM Society by Ministry of Environment, Forest and Climate Change, Government of India.
Ashwani Kumar Gupta	Independent Director	A member of the Institute of Chartered Accountants (1977 batch), Ashwani Kumar Gupta has an experience of over 30 years in corporate finance, treasury, capital management and asset reconstruction. After being a Whole Time Director (Finance) for more than 15 years, he is currently a Non-Executive Director on the Board of The Dhampur Sugar Mills Limited, a leading sugar manufacturer in India. He is also experienced in private equity investing and real estate development. He has been appointed for a term of 5 years.
Shubhalakshmi Panse	Independent Director	Mrs. Shubhalakshmi Panse has 38 years' experience in the field of Banking, particularly in Corporate Credit appraisal, Credit Monitoring, NPA management, Planning, Project appraisal and also in Economics, Finance and Information Technology. She is the former Chairman & Managing Director of Allahabad Bank. She was also the Executive Director of Vijaya Bank for two and half years.

Source: Company, Nirmal Bang Institutional Equities Research

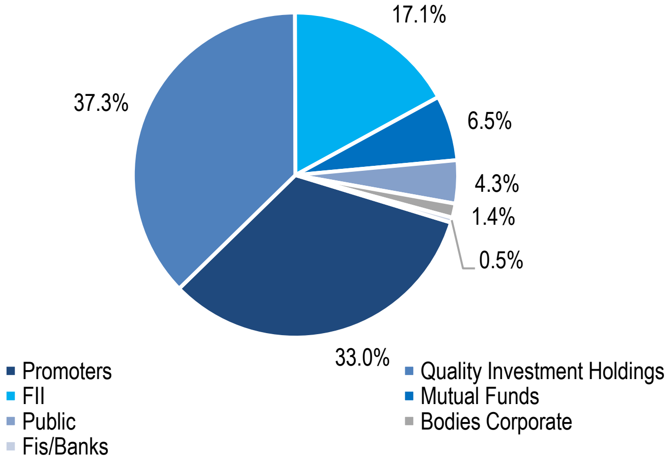
Shareholding Information

Exhibit 10: Key shareholders

	(%)
Promoter	
Punjab National Bank	39.1
Non - promoter	
Quality Investment Holdings	37.3
General Atlantic Singapore Fund Fii Pte Ltd	6.9
Motilal Oswal Mutual Fund	1.5

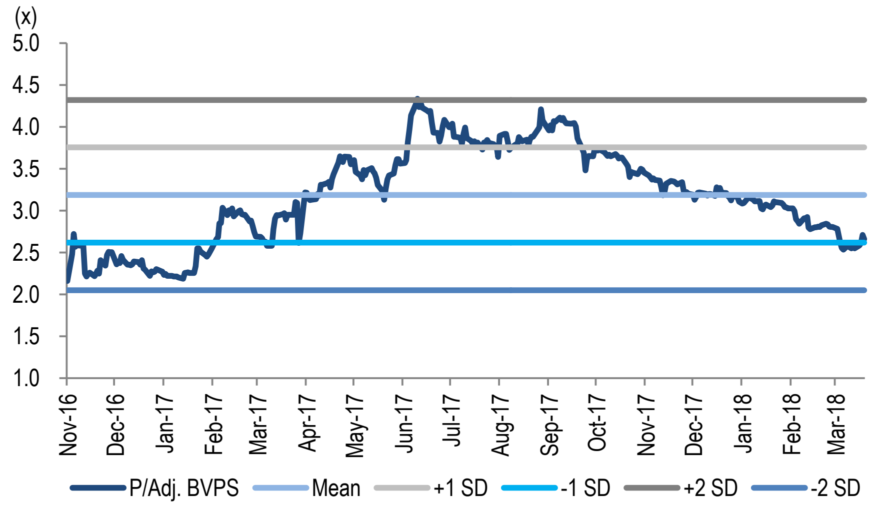
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 11: Shareholding pattern



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 12: One year forward P/BV



Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 13: Income statement

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Interest Income	25,461	36,401	51,021	73,216	98,971
Interest Expense	17,876	25,104	34,606	50,313	67,894
Net Interest Income	**7,585**	**11,297**	**16,415**	**22,903**	**31,077**
Non Interest Income	1,525	2,678	4,335	6,069	7,889
Net Revenue	**9,111**	**13,975**	**20,750**	**28,972**	**38,966**
Operating expenses	3,273	4,959	6,250	9,588	12,801
-Employee expenses	753	1,013	1,432	1,959	2,565
-Other expenses	2,520	3,947	4,818	7,629	10,236
Operating profit	**5,838**	**9,015**	**14,500**	**19,384**	**26,166**
Provisions	807	975	1,216	1,395	1,400
PBT	5,031	8,040	13,283	17,989	24,766
Tax	1,766	2,803	4,782	6,476	8,916
PAT	**3,265**	**5,237**	**8,501**	**11,513**	**15,850**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 15: Balance sheet

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Share capital	1,269	1,656	1,656	1,656	1,656
Reserves & surplus	20,190	54,117	61,421	71,738	86,392
Networth	**21,459**	**55,773**	**63,078**	**73,394**	**88,048**
Borrowings	260,137	354,971	532,354	741,392	955,955
Other liability & provisions	15,114	18,851	31,235	47,883	67,700
Total liabilities	**296,710**	**429,596**	**626,667**	**862,669**	**1,111,703**
Fixed Assets	622	604	610	616	623
Investments	7,821	9,614	12,017	15,021	18,776
Loans	281,953	385,713	577,970	809,158	1,051,905
Cash	2,485	1,515	2,312	2,427	3,156
Other assets	3,829	32,150	33,758	35,446	37,243
Total assets	**296,710**	**429,596**	**626,667**	**862,669**	**1,111,703**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 14: Key ratios

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Growth (%)					
Net Interest Income	68.4	48.9	45.3	39.5	35.7
Operating Profit	75.4	54.4	60.8	33.7	35.0
Profit After Tax	66.5	60.4	62.3	35.4	37.7
Business (%)					
Advance Growth	67.4	36.8	49.8	40.0	30.0
Spreads (%)					
Yield on loans	11.1	10.6	10.4	10.4	10.4
Cost of Borrowings	8.4	8.2	7.8	7.9	8.0
Spread	2.6	2.5	2.6	2.5	2.4
NIMs	3.3	3.3	3.4	3.3	3.3
Operational Effeciency (%)					
Cost to Income	35.9	35.5	30.1	33.1	32.9
Cost to AUM	1.5	1.5	1.3	1.4	1.4
Productivity (Rs Mn)					
Loan per Branch	-	6,122.4	7,200.0	7,600.0	8,300.0
Loan per Employee	-	386.1	450.0	506.7	553.3
Employee per Branch	-	15.9	16.0	15.0	15.0
CRAR (%)					
Tier I	9.0	16.5	13.0	11.1	10.3
Tier II	3.7	5.1	3.6	3.1	2.6
Total	12.7	21.6	16.6	14.2	12.9
Asset Quality (%)					
Gross NPA	0.2	0.2	0.4	0.5	0.5
Net NPA	0.1	0.2	0.1	0.1	0.1
Provision Coverage	36.2	31.2	64.2	71.2	81.3
Credit Cost (excluding std asset)	0.0	0.0	0.0	0.0	0.0
Credit Cost (including std asset)	0.2	0.2	0.3	0.2	0.2
Return Ratio (%)					
ROE	17.5	13.6	14.3	16.9	19.6
ROA	1.3	1.4	1.6	1.5	1.6
Per Share (%)					
EPS	25.7	31.6	51.3	69.5	95.7
BV	169.1	336.7	380.8	443.1	531.6
ABV	166.1	333.2	375.8	436.0	525.6
Valuation (x)					
P/E	44.3	36.0	22.2	16.4	11.9
P/BV	6.7	3.4	3.0	2.6	2.1
P/ABV	6.9	3.4	3.0	2.6	2.2

Source: Company, Nirmal Bang Institutional Equities Research

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Institutional Equities

Repco Home Finance

26 March 2018

Reuters: RHFL.NS; Bloomberg: REPCO IN

Initiating Coverage

Where Banks Fear To Tread

Repco Home Finance (RHF) is a housing finance company (HFC) with a network of 129 branches and loan book size of Rs95bn. We are bullish on RHF as: (1) Debilitating but transient issues create temporary undervaluation and cloak its differentiated business model: (a) Sand supply crunch in Tamil Nadu (b) Ban on property registration on unapproved layouts in Tamil Nadu (c) Demonetisation providing a body blow to the informal sector. (2) RHF has expertise in lending to the informal segment handing it yield and margin leadership. (3) RHF operates 'below the radar' and is barely impacted by the GST and RERA upheaval. We initiate coverage on RHF with a Buy rating and a target price of Rs684, valuing the stock at 2.7x/2.3x FY19E/FY20E P/BV.

RHF is undergoing a perfect storm because of problems that are decidedly temporary: The High Court of Tamil Nadu banned sand mining in the state (thus affecting construction activity) because of ecological concerns, but mitigating factors include: (a) Allowing import of sand, (b) Allowing use of artificial sand (M-sand) and importantly, (c) The Supreme Court, in its considered view, has stayed the initial High Court order. Secondly, the High Court had banned property registration in unapproved layouts in Tamil Nadu but has, since, effectively grandfathered the impact of the earlier ruling. Thirdly, demonetisation was a body blow to the informal segment, where RHF is most active, but a recovery is underway. We stress that point-in-time asset quality can be misleading for an entity such as RHF as cash flows of its marginal borrower do not have regularity but the key metrics to note are: (a) Relatively low proportion of doubtful assets at 19% of total bad loans, and (b) Minimal cumulative write-off figure of Rs65mn over 15 years.

RHF is an informal segment champion where bank competition is meaningfully low: Proportion of loan book exposure to non-salaried segment is 59% for RHF as of 3QFY18-end compared with 17%-52% in our expanded set of key peers (10 listed HFCs), barring Reliance Home Finance at 73%. RHF is further differentiated by: (a) Focus on Tier 2 and smaller centres, (b) Self construction comprising ~45% of loan book, and (c) Low ticket size at Rs 1.4mn as of 3QFY18-end compared with Rs1.5-5.1mn for HFC peers, barring Gruh Housing Finance at Rs0.7mn. Bank competition is significantly low in the businesses that RHF is active in, allowing relatively high and sticky yield and margin leadership with NIM at 4.6% as of 3QFY18-end compared with 2.3%-4.4% for HFC peers.

RHF operates in areas of housing finance that remain unscathed from GST and RERA: Given RHF's differentiated business model, its share of Under Builder Construction properties in loan book is ~6% and impacted portion is ~2%. Secondly, as a vast majority of RHF loan book funds construction that does not require RERA compliance at all since the construction falls below threshold requirements that kick in mandatory RERA compliance. The portion of loan book impacted by RERA is just ~1% of total.

Valuation and outlook: We use the residual income model to value RHF and arrive at the target price of Rs 684. RHF currently trades at 2.2x/1.8x FY19E/FY20E P/BV and we believe that our target price is reasonable given RHF's RoE profile of 17.6%/18.8% for FY19E/FY20E and long-term outlook.

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Net Interest Income	3,043	3,682	4,377	5,246	6,516
Pre-Provision Profit	2,738	3,290	3,944	4,790	6,027
PAT	1,501	1,823	2,039	2,553	3,243
EPS (Rs)	24.0	29.1	32.6	40.8	51.8
BV (Rs)	154.0	183.7	213.3	251.1	300.0
P/E (x)	23.0	18.9	16.8	13.4	10.6
P/BV (x)	3.6	3.0	2.6	2.2	1.8
Gross NPA (%)	1.3	2.6	3.5	3.0	2.5
Net NPA (%)	0.5	1.4	1.8	1.0	0.3
ROA (%)	2.2	2.2	2.1	2.1	2.2
ROE (%)	16.9	17.3	16.4	17.6	18.8

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: NBFCs

CMP: Rs549

Target Price: Rs684

Upside: 25%

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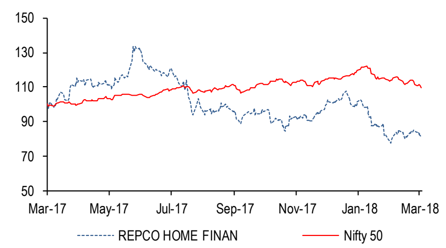
Key Data

Current Shares O/S (mn)	62.6
Mkt Cap (Rsbn/US$mn)	34.3/527.3
52 Wk H / L (Rs)	924/510
Daily Vol. (3M NSE Avg.)	358,258

Shareholding (%)	3QFY18	2QFY18	1QFY18
Promoter	37.1	37.1	37.1
Public	62.9	62.9	62.9
Others	-	-	-

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
Repco Home Finance	0.3	(11.3)	(19.5)
Nifty Index	(4.7)	0.3	10.0

Source: Bloomberg

Transient problems currently cloak RHF's differentiated business model

RHF is currently beset with loan growth and asset quality challenges arising out of: (1) Sand supply crunch (2) Ban on specified properties' registration and (3) Lagged residual impact from Demonetisation. The simultaneous occurrence of these problems have created a perfect storm for RHF but we stress that **all these problems are transient in nature and only serve to cloak RHF's differentiated business model**, which is particularly well placed over the long run.

We will first establish as to why we opine that the impact from the negative issues is temporary and then elaborate on how RHF's business model is differentiated and well placed to tap the generic housing finance opportunity.

Sand supply crunch currently having second-order impact on disbursals but will resolve in the long run

Owing to the depletion of river bed and other associated environmental impact, the NGT (National Green Tribunal) had banned sand mining in several areas of Tamil Nadu. Finally, in November 2017, the Madurai bench of the Madras High Court, in its considered view, decided that all current sand quarries in the state must stop operation within six months.

Sand supply crunch and concomitant spike in sand prices by 3x led to slower construction activity in Tamil Nadu and impacted, particularly, the self construction loan book of RHF. There are, however, **several mitigating factors for this from the perspective of RHF disbursements**:

(1) Current impact on RHF disbursements is a **second-order impact.**

(2) State government has launched a website to allow **online booking of sand** by lorry owners, thus ensuring quicker turnaround time in approval for sand supply.

(3) **Trucks would be equipped with GPS** to monitor the movement of sand across the state and also improve supply chain and inventory management of sand across the state

(4) State government has decided (in May 2017) to **take over all current sand quarries** over a period of three years.

(5) State government has further decided to **open 70 new sand quarries** across Tamil Nadu, which is comparable to the existing number of 90 sand quarries in the state.

(6) The High Court, in its judgment of November 2017 itself, has allowed **import of sand from Malaysia.**

(7) Import of sand from **other nations** such as the Philippines and Cambodia is also being explored.

(8) Use of **M-sand (artificial manufactured sand)** has been allowed in Tamil Nadu.

(9) The latest and most significant development has been the **interim stay order granted by Supreme Court** on 5th February 2018 on the earlier High Court order in November 2017 that directed the Tamil Nadu government to shut sand quarries in the state within six months.

(10) On 16 February 2018, **Madras High Court refrained from instituting any fresh ban on sand quarrying,** but ordered the installation of modern camera technology on excavator machines as well as close-circuit television cameras at quarry sites to enable efficient monitoring of sand mining activity.

(11) Subsequently, Public Works Department (PWD) of Tamil Nadu government has initiated the bidding process to open sand quarries in the state again. Importantly, an e**-tender process is being considered to ensure transparency and curb the possibility of illegal sand mining**.

From the above considerations, it seems that **the apex court has taken cognisance of the importance of construction activity to achieve the long-term goal of Housing for All by 2022** in Tamil Nadu and is not in favour of disruption of activity leading to the said overarching goal. Prior to Supreme Court stay order, RHF management has given guidance of overall loan book growth of 18%-20% in FY18 and, further, guided long-term overall loan book CAGR of 0.25%.

Ban on registration of properties in unapproved layouts mitigated by High Court clarification

On 16 September 2016, Madras High Court first banned registration of all properties which lay in unapproved layouts. On 16 June 2017, Madras High Court clarified that the initial ruling does not apply to plots in unapproved layouts already registered as house sites before 21 October 2016. With this **effective grandfathering of plots across Tamil Nadu**, most of the impact from the initial ruling has been taken care of.

The initial ruling not only impacted disbursement, but was also particularly deleterious for the asset quality of the large-ticket LAP book. The defaulters from the large-ticket LAP book essentially consisted of borrowers who themselves conducted business in the commercial real estate segment. The inability to register (and offload) properties prevented such borrowers from raising cash to make repayments on time. As a consequence of this, GNPA ratio on the LAP book had shot up to 6.4% at the end of 1QFY18 and overall GNPA ratio to 4.0%. Excluding LAP GNPA, the overall GNPA ratio would have been 2.7% at the end of 1QFY18.

Specifically, within LAP book, large-ticket LAP (>Rs10mn ticket size) contributed to 18.1% (Rs32 bn) of total LAP book and 32.8% of LAP GNPAs (Rs3.7bn) as of 1QFY18. **RHF has de-focused large-ticket LAP book** as a consequence of which this book declined from Rs50bn as of 2QFY17 to Rs28.5bn as of 2QFY18, a reduction of 43% over 12 months. While LAP GNPA ratio has been somewhat sticky, standing at 5.9% as of 3QFY18-end, we stress that this is the **combined impact of Demonetisation and High Court ruling on layouts is something we are now looking at from the rearview mirror and will normalize going forward**.

Demonetisation severely impacted the informal sector, but is a non-recurring black swan event

As can be garnered from the discussion in the previous section, a major portion of loan slippage in 1QFY18 was from outside the large-ticket LAP book. This is mainly attributable to the **residual impact of Demonetisation on the informal sector, to which RHF has significant exposure** (60% of loan book as of 1QFY18/2QFY18 is to non-salaried customers). We view demonetisation as a non-recurring black swan event that severely disrupted the cash cycle of those operating in the informal sector, which is cash-intensive.

On the rough assumption that LAP book is entirely in the non-salaried portion, we have calculated GNPA ratio on non-salaried home loans as 4.9% in 1QFY18, which is also at an elevated level. Non-salaried home loans GNPA ratio stands at 4.7% as of 3QFY18-end, but we expect this to **normalise lower going forward**.

Point-in-time asset quality can be particularly misleading for RHF

Not only did Demonetisation severely disrupt the cash cycle of those operating in the informal sector, it is also to be noted that the informal sector is not comparable with the formal/organised segment when it comes to regularity of cash flow. Hence, ceteris paribus, **a borrower from the unorganised segment is more likely to be in temporary default compared with one from the formal segment**, even though the ability of the former to repay loan quantum may be identical to the latter, when considered over a period in excess of 90-day norm.

It is, therefore, to be kept in mind that of the total GNPAs for RHF as on 1QFY18-end, **only 19% assets fall under the doubtful category (overdue > 1 year)** whereas, the remaining majority 81% fall under the sub-standard category (>90 dpd but < 1 year).

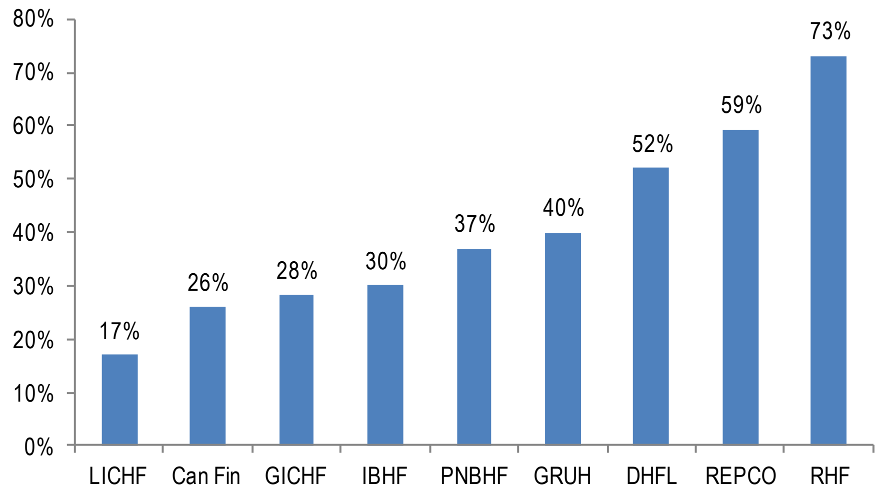
Further, it may be noted that till date, over about 15 years, RHF has only seen cumulative write-offs amounting to a miniscule Rs65mn. This is indicative of the **high ultimate recoverability of the bad loan accretion** witnessed by RHF.

High exposure to informal segment positive for RHF from competitive intensity perspective

Demonetisation and GST have impacted the informal sector significantly and point-in-time loan book growth and asset quality look inferior for RHF, but this transient phase cloaks the underlying aspect that the **informal segment is most insulated from bank competition**.

The only banks that have decided to operate in the informal segment meaningfully are small finance banks, but owing to their NBFC-MFI pedigree, are operating at a ticket size range (~Rs 0.5mn) that is significantly lower, so far, compared with that of RHF at Rs1.4mn.

Exhibit 1: Loan book exposure to non-salaried segment – RHF vs. key peers in 3QFY18



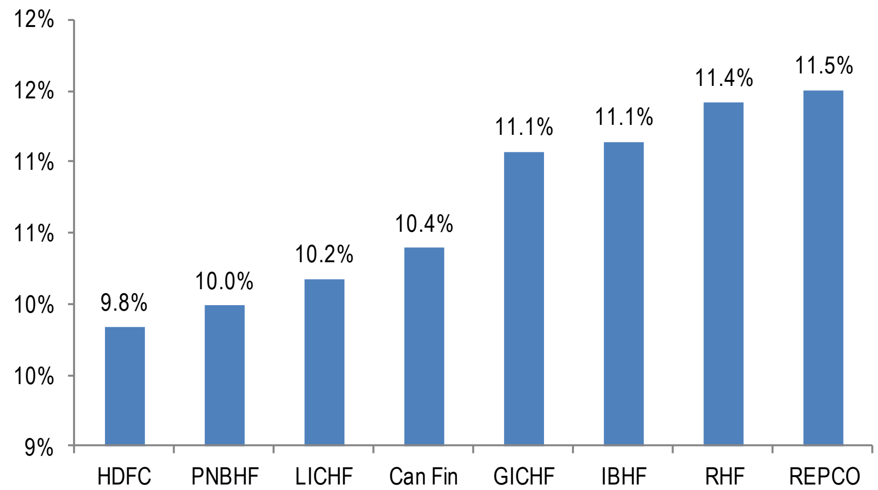
Source: Company, Nirmal Bang Institutional Equities Research

N.B. "RHF" in the text denotes Repco Home Finance whereas, on the charts, it denotes Reliance Home Finance.

RHF will maintain yield and margin leadership on the back of its non-salaried segment focus

As a consequence of RHF's differentiated focus on the non-salaried class, RHF enjoys the highest loan yield of 11.5% in our expanded peer set of key HFCs as of 3QFY18-end compared with 9.2%-11.4% for key HFC peers. We believe this **yield leadership for RHF is largely protected** as bank competition is low in the non-salaried segment and will remain low even in scenarios of elevated bank vs HFC lending rate differential.

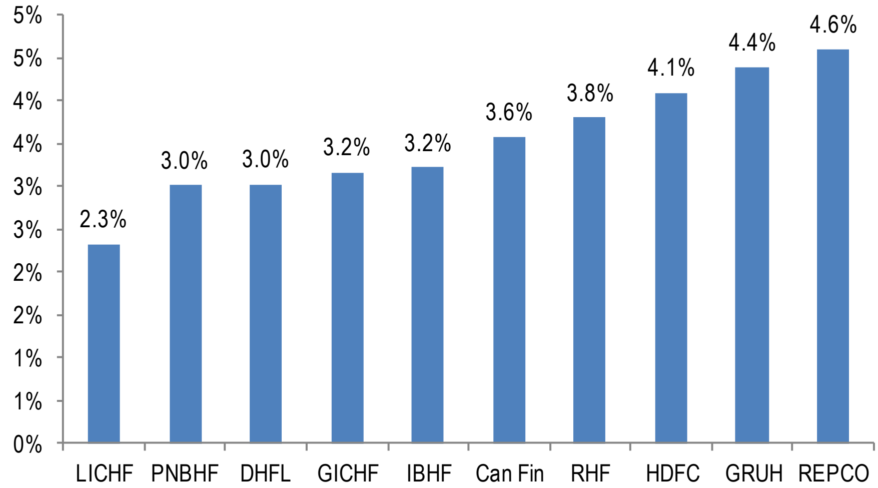
Exhibit 2: Loan yield – RHF vs. HFC peers in 3QFY18



Source: Company, Nirmal Bang Institutional Equities Research

On the back of its loan yield leadership and despite the highest cost of borrowings (barring DHFL) in our peer set, **RHF enjoys highest NIM** of 4.8% in 2QFY18 compared with HFC peers ranging between 2.4%-4.4%. We, therefore, note that RHF's overall strategy of focusing on the non-salaried class is NIM-accretive.

Exhibit 3: Net interest margin – RHF vs. HFC peers in 3QFY18

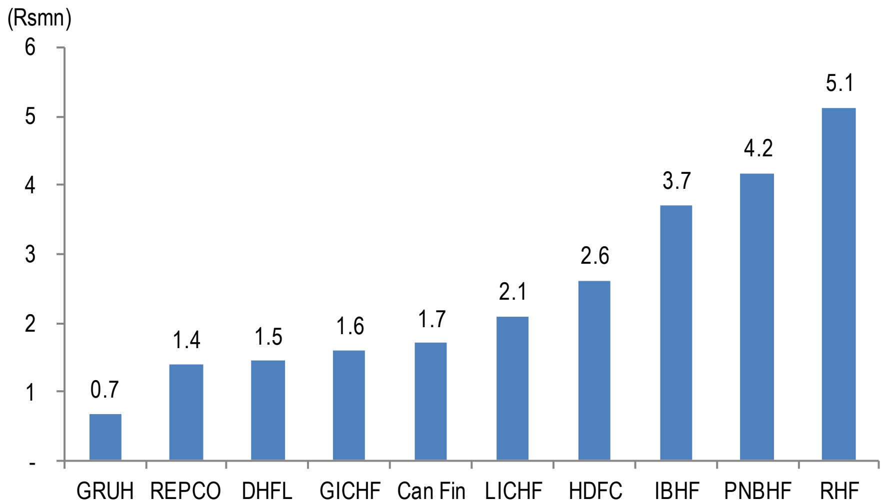


Source: Company, Nirmal Bang Institutional Equities Research

RHF is a key beneficiary of under-penetrated small-ticket housing finance opportunity, which also has significant government support

RHF is focused on significantly small-ticket lending and has an average ticket size of just Rs 1.4mn compared with Rs1.5mn – Rs5.1mn for HFC peers, bar Gruh at Rs0.7mn, earmarking it as a key beneficiary of the outsized small-ticket housing finance opportunity. An extended discussion on this topic is available in first section (sector theme body) of this report.

Exhibit 4: Average ticket size – RHF vs. HFC peers in 3QFY18

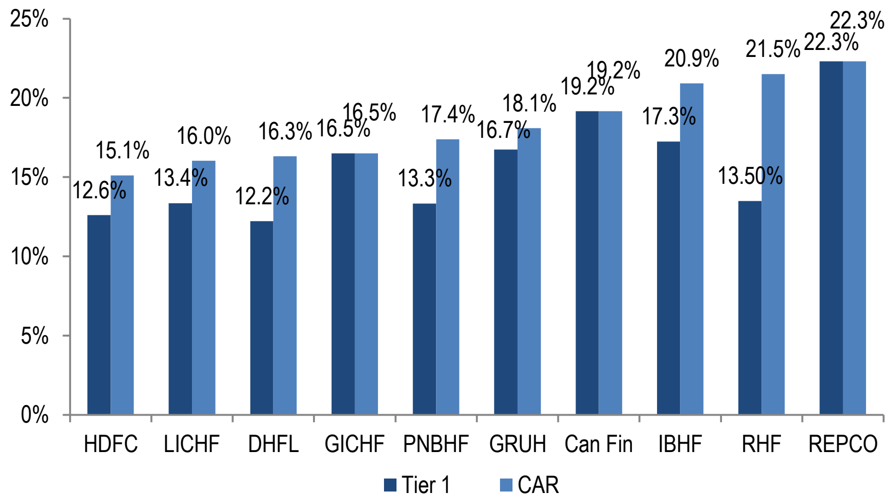


Source: Company, Nirmal Bang Institutional Equities Research

RHF is the best capitalised HFC in our expanded set of HFC peers

RHF has a capital adequacy ratio of 22.3% as of 3QFY18-end compared with 15.1%-21.5% for HFC peers. This implies **lower dilution** for investors going forward, ceteris paribus.

Exhibit 5: Capital adequacy ratio and Tier 1 capital ratio – RHF vs. HFC peers in 3QFY18



Source: Company, Nirmal Bang Institutional Equities Research

RHF is minimally impacted by both GST and RERA regulations

RHF is minimally impacted by GST owing to the nature of its business focus

The introduction of GST has created an asymmetrical property market on the ground as GST is applicable to Under (Builder) Construction properties (as they fall under the purview of work contracts) whereas, so far, it is not applicable to completed/ready-to-move-in properties. The applicable effective tax rate on Under (Builder) Construction properties is 12% (18% with Land Abatement on up to one-third of project cost) whereas the earlier tax regime applies to completed properties, meaning the applicable tax is 5.5%-6.5% (4.5% of Service Tax and 1-2% of VAT) depending on which state one is operating in. This **differential taxability is causing home buyers, on balance, to shift their preference to completed properties** i.e. where Completion Certificate has been granted.

Here, we differentiate between Under (Builder) Construction properties and properties being constructed by prospective home-owners / borrowers themselves (classified as **Self Construction**) as the latter are not being sold to anyone and there is no comparative decision to be made by the borrower carrying out self construction.

This phenomenon of home buyers shifting preference to completed properties, however, has little impact on RHF as its loan book exposure to Under (Builder) Construction properties is only about 5%-6%. Even of this 5-6% (which is an outer limit), the **impacted portion could, at most, be 1%-2% from a disbursement perspective**.

Exhibit 6: Detailed break-up of RHF loan book-1HFY18

LAP	20%
Self Construction	45%
Home Improvement	11%
Resale	12%
New property - Completed	6%
New property - Under Builder Construction	6%

Source: Company, Nirmal Bang Institutional Equities Research

RERA is a near-term concern, but will resolve over the medium term

We note that the introduction of RERA (Real Estate (Regulation and Development) Act 2016 has proved to be a near-term dampener on housing finance disbursement, but we expect its impact to abate in the medium term. From our discussions with various HFCs, **on-ground impact of RERA could abate as soon as two quarters after 3QFY18**.

The reason for negative impact on housing loan disbursement at an industry level is the non-compliance of a section of the builder community with RERA norms. **Smaller builders/contractors with lesser sophistication have found compliance with RERA onerous** and some of them, so far, have not been able carry out the formalities, paperwork and technology installations needed to be up-to-speed with RERA requirements.

Small builders/contractors need not comply with RERA norms and RHF mostly operates under the RERA radar

It may be noted that **particularly small contractors are generally not required to comply with RERA** as the ballpark sizes of their projects are likely to fall below the minimum threshold above which RERA compliance requirement kicks in. These thresholds are (1) 500sqm and (2) 8 house units i.e. only projects where land area exceeds 500sqm or where the number of house units to be constructed exceeds 8 will have to register with RERA authority and smaller-sized projects will be exempt.

Most of RHF loan book, as such, is not impacted by RERA as the small builders/contractors work on projects that fall below the project size thresholds discussed above that make them exempt from RERA registration altogether. The **portion of RHF business impacted of RERA, at most, is 1-2% of disbursements**.

Valuation and Outlook

We use the Residual Income Model to arrive at a first-principles' fair value for RHF. We assume a long-term sustainable average risk-free rate of 7% for India, an Adjusted Beta of 1.19 for RHF and an India-specific Equity Risk Premium of 6% and arrive at the overall Cost of Equity of 14.1% for RHF. On this basis, **we arrive at a price target of Rs 709, at which the stock will trade at 2.8x/2.4x FY19E/20E book value**.

RHF **currently trades at a FY19E/20E P/BV of 2.2x/1.8x, which makes it significantly under-valued** given its FY19E/20E RoE profile of 17.6%/18.8%. Consequently, we believe that the multiple of 2.8x/2.4x implied by our price target of Rs 709 is admissible.

Exhibit 7: Consensus vs Our Estimates

	Our estimate			Bloomberg estimate			*% Variance*		
(Rsmn)	**FY18E**	**FY19E**	**FY20E**	**FY18E**	**FY19E**	**FY20E**	***FY18E***	***FY19E***	***FY20E***
Net interest income	4,377	5,246	6,516	4,255	4,775	5,577	*2.9*	*9.9*	*16.8*
Operating profit	3,944	4,790	6,027	3,741	4,227	4,990	*5.4*	*13.3*	*20.8*
Profit after tax	2,039	2,553	3,243	1,971	2,451	2,910	*3.5*	*4.2*	*11.5*

Key risks

Asset quality could deteriorate due on RHF's large-ticket LAP book

Loan against property as a segment has seen higher level of stress due to hyper-competition and concomitant dilution of under-writing standards, particularly on the large-ticket LAP side and RHF has exposure to large-ticket LAP. However, the stress on RHF's large-ticket LAP book is **no longer rising** and, as an HFC, they have also **reduced exposure** to this business significantly.

RHF has high exposure to the informal segment which remains vulnerable to a shock like Demonetisation

Most of RHF's clientele belong to the informal segment where income is not regular and transactions are significantly based on cash and, hence, vulnerable to a cash crunch brought about by a note ban. However, our submission is that Demonetisation is an essentially non-repeatable black swan scenario with such events being frequent and tended to be carried out in **gaps** of several decades.

Company Overview

Repco home Finance is a housing finance company with a branch network of 129 branches and a loan book of Rs 95bn. Of the loan book, the home loan and loan against property split is 81%, and 19%, respectively. Repco home finance has displayed a loan CAGR of 26% over FY12-17 and its yield on advances in its latest reported quarter was 11.5%.

Repco home finance has a cost of funds of 8.3% and, as a result, it registered a net interest margin of 4.6%. Its cost to income ratio stood at 18.9%. Consequently, it delivered a return on assets of 2.2% and a return on equity of 17.8%, implying a financial leverage of 8.1. Its employee count stood at 718 and its Capital Adequacy Ratio was 22.3%.

Exhibit 8: Management team/ Key executives

Name	Designation	Experience
R. Varadarajan	MD, CEO, and Director	Mr. R. Varadarajan has been the Managing Director of REPCO Home Finance Limited since October 1, 2010 and serves as its Chief Executive Officer. Mr. Varadarajan serves as the Managing Director of Repco Bank Limited. He has been the Managing Director of Repatriates Cooperative Finance and Development Bank Limited since November 24, 2010. He is responsible for the overal strategy and direction of REPCO and plays a significant role in as listing the Board for the systematic and planned growth of REPCO, in key areas such as risk management, expansion, credit quality, formulation of key systems and policies and overal guidance in operations. He has approximately 35 years of work experience in the banking industry. Prior to joining REPCO Home Finance Limited, he was associated with Syndicate Bank in various capacities for around 23 years. Mr. Varadarajan served as General Manager and Executive Director of Repatriates Cooperative Finance and Development Bank Limited for over six and four years respectively. He has been a Director of REPCO Home Finance Limited since October 1, 2010. He serves as a Director at Repco MSME, Repco Infrastructure Development Company Limited, Repco Bank Limited and Repco MSME Limited. He is a Post-Graduate in Agriculture with CAIIB and Diploma in Management. He holds a Master's degree in science from Tamil Nadu Agricultural University
T. Karunakaran	CFO	Mr. T. Karunakaran serves as the Chief Financial Officer of REPCO Home Finance Limited and serves as its Head of Finance and Deputy General Manager of Accounts Department. Mr. Karunakaran has been associated REPCO Home Finance since 2004. He has approximately 20 years of experience in housing finance. He worked for 14 years with the Housing and Urban Development Corporation Limited and Ind Bank Housing Limited. He holds a Bachelor's degree in Zoology from Madras University.
K. Ashok	Chief GM & Executive Director	Mr. K. Ashok has been the Chief General Manager and Executive Director of REPCO Home Finance Limited since October 08, 2012 and December 01, 2016 respectively. Mr. Ashok has been associated with REPCO Home Finance since 2005 and is in charge of the credit department. Mr. Ashok has around 24 years of experience in the banking industry. He served as a General Manager of REPCO Home Finance Limited. He worked with Syndicate Bank in certain of its regional offices and branches. Mr. Ashok received a Post Graduate in Agriculture from Annamalai University.

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 9: Board members

Name	Designation	Experience
R. Varadarajan	MD, CEO, and Director	Mr. R. Varadarajan has been the Managing Director of REPCO Home Finance Limited since October 1, 2010 and serves as its Chief Executive Officer. Mr. Varadarajan serves as the Managing Director of Repco Bank Limited. He has been the Managing Director of Repatriates Cooperative Finance and Development Bank Limited since November 24, 2010. He is responsible for the overal strategy and direction of REPCO and plays a significant role in as listing the Board for the systematic and planned growth of REPCO, in key areas such as risk management, expansion, credit quality, formulation of key systems and policies and overal guidance in operations. He has approximately 35 years of work experience in the banking industry. Prior to joining REPCO Home Finance Limited, he was associated with Syndicate Bank in various capacities for around 23 years. Mr. Varadarajan served as General Manager and Executive Director of Repatriates Cooperative Finance and Development Bank Limited for over six and four years respectively. He has been a Director of REPCO Home Finance Limited since October 1, 2010. He serves as a Director at Repco MSME, Repco Infrastructure Development Company Limited, Repco Bank Limited and Repco MSME Limited. He is a Post-Graduate in Agriculture with CAIIB and Diploma in Management. He holds a Master's degree in science from Tamil Nadu Agricultural University
Taruvai Subbayya Krishna Murthy	Non-Executive and Independent Chairman	Mr. Taruvai Subbayya Krishna Murthy has served as an advisor to the International Monetary Fund in Ethiopia and Georgia. Mr. Murthy served as the Chief Election Commissioner of India and had been with it since 2008. He served as Secretary of Ministry of Corporate Affairs. He served as the Chief Commissioner of Income Tax, Secretary to the Government of India, Department of Company Affairs, Additional Secretary, Department of Expenditure, Ministry of Finance, amongst other things. He served the GOI at various levels. In 2005, he was also appointed by the Supreme Court of India to conduct elections to the Board of Control for Cricket in India. He has several years of experience in the securities market. Mr. Murthy has over 50 years of work experience. He serves as Chairman of Central Depository Services (India) Limited and has been its Public Interest Director since March 30, 2016. He serves as Non-Executive & Independent Chairman at REPCO Home Finance Limited and has been its Non-Executive & Independent Director since September 13, 2011.
Ganapathy Ramasamy Sundaravadivel	Non-Executive and Independent Director	Mr. Ganapathy Ramasamy Sundaravadivel serves as Banking Ombudsman for the states of Kerala & Union Teritory. Mr. Sundaravadivel has more than 37 years of experience in various nationalized banks such as Indian Bank, out of which 15 years at top management cadre and Four and Half years as an Executive Director in United Bank of India which was appointed by Ministry of Finance, Government of India. He serves as a Director at Gilt Securities Trading Corporation, a subsidiary of Canara Bank. He has been a Independent Non-executive Director of Indbank Merchant Banking Services Limited since November 20, 2013. He has been a Non-Executive & Independent Director of REPCO Home Finance Limited since April 3, 2012 and served as its Director from September 13, 2011 to February 22, 2012.
V. Nadanasabapathy	Non-Executive and Independent Director	Mr. V. Nadanasabapathy served as a Deputy General Manager at Syndicate Bank. Mr. Nadanasabapathy has around 38 years of experience cumulatively, out of which around 35 years were in the banking sector. He served as the Chairman of North Malabar Gramin Bank for 3 years. Mr. Nadanasabapathy has been a Non-Executive & Independent Director of REPCO Home Finance Limited since July 22, 2005. He holds a Bachelor's Degree in Agriculture Science from Annamalai University and is a certified associate of the Indian Institute of Bankers.
L. Munishwar Ganesan	Non-Executive and Independent Director	Mr. L. Munishwar Ganesan has been Non-Executive & Non Independent Director at Repco Home Finance Limited since February 2, 2015.
R. S. Isabella	Additional Director	Mrs. R. S. Isabella has been an Additional Director of Repco Home Finance Limited since November 8, 2016
K. Sridhar	Independent Additional Director	Mr. K. Sridhar, M.A. Economics, LLB, served as an Insurance Ombudsman of IFCI Limited since July 7, 2006. Mr. Sridhar served as Managing Director of Life Insurance Corporation of India from December 9, 2004 to January 31, 2006. He has also held the position of Director/CVO of General Insurance Corporation and New India Assurance Company Limited respectively. . He served as the Managing Director of LIC Housing Finance Ltd. since December 22, 2004. He has been an Independent Additional Director at Repco Home Finance Limited since September 21, 2017. He served as a Director of Industrial Finance Corp. of India Ltd. (now IFCI Ltd.) from December 21, 2004 to July 7, 2006, ABB Ltd. India, a subsidiary of ABB Ltd. from July 2005 to June 23, 2006 and Essar Oil Limited from September 2005 to June 30, 2006. He served as Director of LIC Housing Finance Ltd. since December 22, 2004. He served as a Director of Life Insurance Corporation of India.
Dinesh Ponraj Oliver I.A.S.	Additional Non-Executive & Non-Independent Director	Mr. Dinesh Ponraj Oliver, I.A.S. has been Additional Non-Executive and Non-Independent Director at Repco Home Finance Limited since November 03, 2017. Mr. Oliver holds BSc in Agriculture and M.A. Economics.

Source: Company, Nirmal Bang Institutional Equities Research

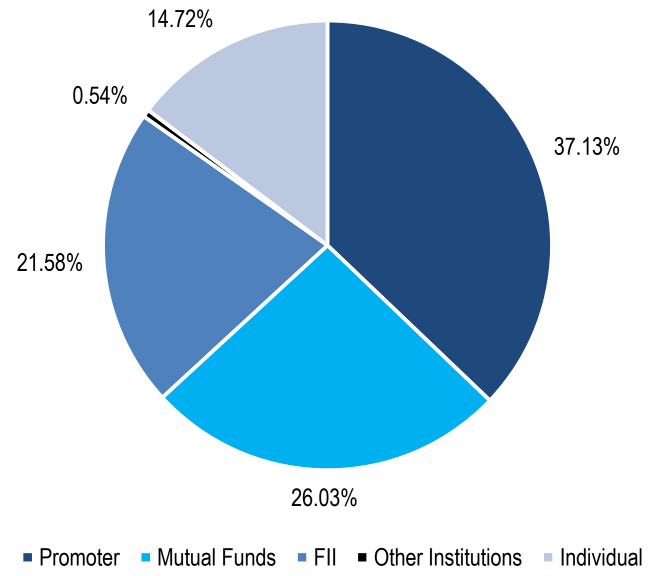
Shareholding Information

Exhibit 10: Key shareholders

	(%)
Promoter	
Repatriates Co Operative Finance & Development Bank Ltd	37.1
Non - promoter	
Aditya Birla Sun Life Trustee Private Limited	7.3
Franklin Templeton Mutual Fund	7.2
Dsp Blackrock Micro Cap Fund	6.2
India Capital Fund Limited	2.2
Parvest Equity India	2.1
Hsbc Global Investment Funds - Asia Ex Japan Equity Smaller Companies	2.1
Alliancebernstein India Growth (Mauritius) Limited	1.8
Nomura India Investment Fund Mother Fund	1.8
Sundaram Mutual Fund	1.7

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 11: Shareholding pattern



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 12: One year forward P/BV

Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 13: Income statement

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Interest Income	8,525	10,145	11,393	13,871	17,278
Interest Expense	5,483	6,463	7,016	8,625	10,763
Net Interest Income	**3,043**	**3,682**	**4,377**	**5,246**	**6,516**
Non Interest Income	293	314	373	529	661
Net Revenue	**3,336**	**3,996**	**4,751**	**5,775**	**7,177**
Operating expenses	597	706	806	985	1,151
-Employee expenses	409	431	477	590	676
-Other expenses	188	275	330	396	475
Operating profit	**2,738**	**3,290**	**3,944**	**4,790**	**6,027**
Provisions	438	488	758	800	959
PBT	2,301	2,802	3,186	3,990	5,068
Tax	800	979	1,147	1,436	1,824
PAT	**1,501**	**1,823**	**2,039**	**2,553**	**3,243**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 15: Balance sheet

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Share capital	625	626	626	626	626
Reserves & surplus	9,007	10,870	12,721	15,086	18,141
Networth	**9,632**	**11,495**	**13,346**	**15,711**	**18,766**
Borrowings	65,379	75,604	89,470	111,113	139,178
Other liability & provisions	2,705	3,457	4,921	6,688	8,798
Total liabilities	**77,716**	**90,557**	**107,738**	**133,512**	**166,743**
Fixed Assets	72	71	72	72	73
Investments	208	279	307	338	372
Loans	77,049	89,578	106,615	132,259	165,324
Cash	200	225	320	397	496
Other assets	187	404	424	445	478
Total assets	**77,716**	**90,557**	**107,738**	**133,512**	**166,743**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 14: Key ratios

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Growth (%)					
Net Interest Income	28.0	21.0	18.9	19.8	24.2
Operating Profit	28.9	20.1	19.9	21.4	25.8
Profit After Tax	21.9	21.4	11.9	25.2	27.0
Business (%)					
Advance Growth	27.9	16.3	19.0	24.1	25.0
Spreads (%)					
Yield on loans	12.4	12.1	11.6	11.6	11.6
Cost of Borrowings	9.4	9.2	8.5	8.6	8.6
Spread	3.0	3.0	3.1	3.0	3.0
NIMs	4.4	4.4	4.5	4.4	4.4
Operational Effeciency (%)					
Cost to Income	17.9	17.7	17.0	17.1	16.0
Cost to AUM	0.9	0.8	0.8	0.8	0.8
Productivity (Rs Mn)					
Loan per Branch	-	570.6	650.0	750.0	900.0
Loan per Employee	124.5	133.7	151.2	166.7	200.0
Employee per Branch	-	4.3	4.3	4.5	4.5
CRAR (%)					
Tier I	20.8	21.3	21.6	20.1	19.2
Tier II	0.0	0.0	0.0	0.0	0.0
Total	20.8	21.3	21.6	20.1	19.2
Asset Quality (%)					
Gross NPA	1.3	2.6	3.5	3.0	2.5
Net NPA	0.5	1.4	1.8	1.0	0.3
Provision Coverage	63.5	47.3	49.8	67.0	87.6
Credit Cost (excluding std asset)	0.6	0.6	0.7	0.6	0.6
Credit Cost (including std asset)	0.8	0.6	0.8	0.7	0.6
Return Ratio (%)					
ROE	16.9	17.3	16.4	17.6	18.8
ROA	2.2	2.2	2.1	2.1	2.2
Per Share (%)					
EPS	24.0	29.1	32.6	40.8	51.8
BV	154.0	183.7	213.3	251.1	300.0
ABV	148.1	164.1	183.4	230.2	291.7
Valuation (x)					
P/E	23.0	18.9	16.9	13.5	10.6
P/BV	3.6	3.0	2.6	2.2	1.8
P/ABV	3.7	3.4	3.0	2.4	1.9

Source: Company, Nirmal Bang Institutional Equities Research

Ujjivan Financial Services

26 March 2018

Reuters: UJVF.NS; Bloomberg: UJJIVAN IN

Reinitiating Coverage

The Big Small Finance Opportunity

Ujjivan Financial Services (UFSL) is a NBFC-MFI turned Small Finance Bank with a network of 441 asset branches and loan book size of Rs71bn. We are bullish on UFSL as: (1) The company's transformation into a small finance bank is (a) a salutary metamorphosis from a business model perspective (2) It has made sound choices of expanding into loan segments, viz. micro enterprise lending and small-ticket affordable housing, where (a) there is significant under-penetration (b) whole-hearted government support and (c) where it is a participant of ticket size range largely mutually exclusive to other key non-SFB players. (3) Its (a) microfinance asset quality crisis is firmly in the past and (b) microfinance remains an under-penetrated loan segment. We initiate coverage on UFSL with a Buy rating and a target price of Rs437, valuing the stock at 2.6x/2.2x FY19E/FY20E P/BV.

Business model transformation for UFSL is significantly under-appreciated by the market: As an NBFC-MFI, UFSL was constrained to focus primarily on microfinance (keep >85% assets 'qualifying'). It is now free to diversify into any loan segment, augmenting scalability. It also gets to move away from NBFC-style funding and build a deposit base, which has grown from nil to 37% share in funding over 12 months. Refinance (which requires no CRR/SLR cover) cost is lower by up to ~200bps from its NBFC days and its share has risen from 9% to 24% in a year. Further, cost of funds benefits need not be mandatorily passed on to borrowers since no margin cap applies to SFBs.

Micro enterprise lending and small-ticket affordable housing are areas of vast opportunity, which UFSL is optimally oriented to tap: Only 4% of micro enterprises in India are said to have access to formal lending. Similarly, 95% of urban housing shortfall is said to fall under EWS/LIG segments. Pradhan Manti Mudra Yojna and Pradhan Mantri Awas Yojna specifically aid micro-ticket lending to address the aforementioned gaps. With a ticket size of Rs0.3mn compared with Rs1mn-Rs1.8mn for MSME peers and a ticket size of Rs0.6mn compared with Rs0.7mn-Rs5.1mn for HFC competitors, UFSL is directly addressing areas that are the most under-served within the respective broader segments.

Not only is the microfinance crisis firmly in the past, the loan segment still remains under-penetrated: That the microfinance crisis is firmly in the past can be gauged by the fact that the stress is contained within its legacy book as lending since 1January 2017 (78% of total loan book) has a pristine collection efficiency of 99.7%. The stress on legacy book itself is on the decline since PAR0 has fallen from Rs6.5bn in 4QFY17 to Rs 3.4bn in 3QFY18. Importantly, penetration of microfinance is still low at 14% an all-India level compared with 75% of families in rural India having the highest earning member earning less than Rs5000 per month.

Valuation and outlook: We have used the residual income model to value UFSL and arrive at a target price of Rs437. UFSL stock currently trades at 2.1x/1.7x FY19E/FY20E P/BV and we believe that our target price is reasonable given UFSL's RoE profile of 13.6%/16.5% for FY19E/FY20E and long-term outlook.

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Net Interest Income	5,075	6,831	7,649	9,474	11,831
Pre-Provision Profit	2,973	3,969	3,249	4,845	6,907
PAT	1,772	2,077	82	2,543	3,575
EPS (Rs)	17.5	17.4	0.7	21.3	29.9
BV (Rs)	118.4	147.0	146.7	167.1	196.0
P/E (x)	19.8	19.9	504.2	16.2	11.5
P/BV (x)	2.9	2.4	2.4	2.1	1.8
Gross NPA (%)	*0.2*	*0.3*	*3.8*	*2.2*	*1.5*
Net NPA (%)	*0.0*	*0.0*	*0.8*	*0.4*	*0.3*
ROA (%)	*3.7*	*2.9*	*0.1*	*2.3*	*2.5*
ROE (%)	*18.3*	*14.1*	*0.5*	*13.6*	*16.5*

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: Small Finance Banks

CMP: Rs343

Target Price: Rs437

Upside: 28%

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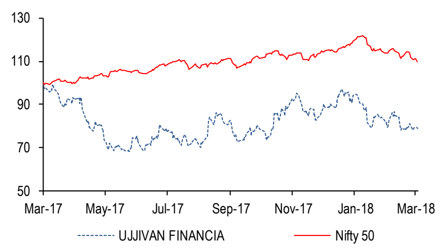
Key Data

Current Shares O/S (mn)	120.8
Mkt Cap (Rsbn/US$mn)	41.4/637.3
52 Wk H / L (Rs)	445/285
Daily Vol. (3M NSE Avg.)	1,277,772

Shareholding (%)	3QFY18	2QFY18	1QFY18
Promoter	-	-	-
Public	100.0	100.0	100.0
Others	-	-	-

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
Ujjivan Financial	(4.6)	1.9	(19.1)
Nifty Index	(4.7)	0.3	10.0

Source: Bloomberg

Transformation into small finance bank key from a business model perspective

The market, at the moment, under-appreciates UFSL's transformation from an NBFC-MFI to a small finance bank (SFB), which provides UFSL **several advantages from a regulatory standpoint**. Some of the key advantages are (1) complete flexibility regarding loan mix as opposed to restriction on NBFC-MFI (2) ability to build a deposit base unlike an NBFC-MFI (3) no interest rate cap, margin cap and processing fee cap like in the case of an NBFC-MFI.

UFSL now has an unconstrained approach to loan mix compared with its NBFC-MFI days

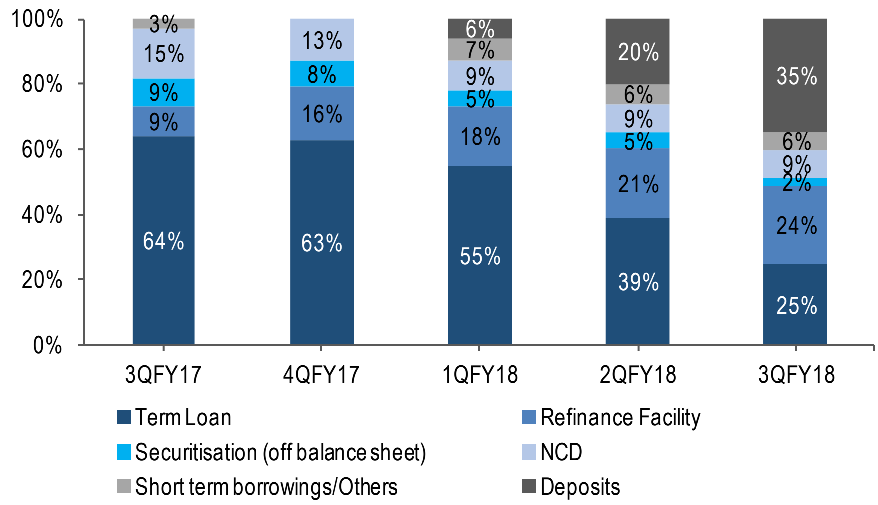
When UFSL was an NBFC-MFI, it was constrained to keep a minimum of 85% of assets as 'qualifying assets' i.e. a **minimum of 85% of loan book needed to be in microfinance**. In other words, there was little flexibility to grow other businesses and UFSL was forced to be a largely monoline business and, as such, ignore other business opportunities. Having transformed into an SFB (UFSL holds 100% in Ujjivan Small Finance Bank), UFSL has complete flexibility to pursue other loan businesses.

UFSL's funding profile is transforming after having obtained the SFB license

Having turned into an SFB, UFSL can, unlike in its NBFC days, create a lower-cost deposits book by: (1) actively participating in the **institutional deposits market** and raise certificates of deposit and other institutional deposit. (2) Build a granular **retail deposits franchise** over a period of time.

The traction on the deposits front has already been particularly significant for UFSL. **Deposits are as much as 37% of funding as of 3QFY18-end** compared with nil contribution as of 3QFY17-end.

Exhibit 1: Transformation of funding profile over 12 months – 3QFY17-3QFY18



Source: Company, Nirmal Bang Institutional Equities Research

Further, **dependence on high-cost term loans (mostly from banks) has fallen** from 64% share in funding as of 3QFY17-end to 25% share as of 3QFY18-end as UFSL is actively running down this book. Similarly, **NCDs**, another element of relatively higher-cost NBFC-style funding, has seen its share fall from 15% to 8.5%.

Significantly, **refinance, which was accounted for 9% of funding as of 3QFY17-end has seen its share rise to 24% as of 3QFY18-end**. Refinance is the funding raised from refinancing agencies such as SIDBI, NABARD, MUDRA and NHB against lending that is eligible for such refinance. This is significant as refinance does not require a bank to maintain CRR/SLR cover. Further, it may be noted that the interest rates charged by NABARD to SFBs is ~200bps lower than that to NBFC-MFIs.

Gains for UFSL on cost of funds largely need not be passed on to borrowers

It is clear from the above discussion on funding profile that UFSL has seen and will continue to see declining cost of funds. While there is an implicit understanding with the regulator (RBI) that some of these gains may be passed on to microfinance borrowers, the specific interest rate and margin caps on NBFC-MFIs (that necessitated passing on the decline in cost of funds) does not apply to SFBs. **NBFC-MFIs have a formula-based interest rate cap and a margin cap of 10%** (a capped spread over its own cost of funds).

Average cost of funds (borrowings and deposits) for UFSL has declined from 10.4% in FY17 to 9.3% in 3QFY18. Also, notably, the marginal cost of funds has declined from 9.7% in FY17 to 7.4% in 3QFY18.

Incremental regulations for UFSL as an SFB licencee are straightforward for it to adhere to

As an SFB, the stipulations UFSL needs to adhere to are (1) A minimum of 50% of loan book has to have a ticket size of Rs2.5mn or lower. (2) A minimum of 75% of adjusted net bank credit (ANBC) has to be priority sector loans (as opposed to 40% for universal banks). (3) Minimum capital adequacy ratio, tier 1 capital ratio and common equity tier 1 ratio are 15%, 7.5% and 6%, respectively, (as opposed to 9%, 7% and 5.5% for a universal bank). (4) Maintain CRR, SLR ratio as any universal scheduled commercial bank. These 'constraints' are particularly straightforward for UFSL to adhere to as (1) it operates at ticket sizes **significantly lower** than Rs2.5mn, (2) has priority sector loans (PSL) **well in excess** of regulatory requirement, (3) remains well capitalised and, (4) it may further be noted that, total and tier 1 capital requirements **are the same** as applicable to NBFC-MFIs, and (5) UFSL has achieved required CRR, SLR goals by **due participation** in the government bond market.

UFSL is operating at ticket sizes well below the Rs 2.5mn ballpark

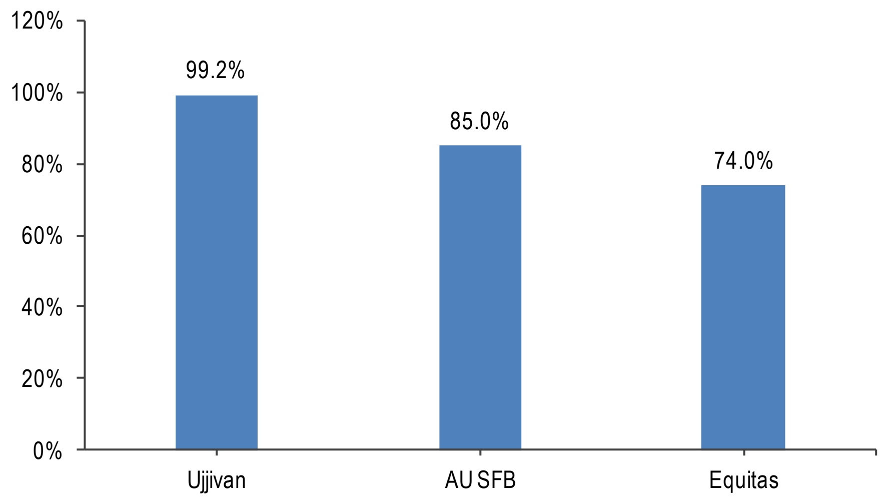
The average ticket size for **microfinance** loans for UFSL is ~Rs23,000. The average ticket sizes for the **micro and small enterprise** (MSE) lending book are ~Rs 69,000 for MSE-unsecured loans and ~Rs 0.4mn for MSE-secured loans. For the **small-ticket affordable housing loan** book, the average ticket sizes are ~Rs 67,000 for Housing-unsecured loans and ~Rs0.38mn for Housing-secured loans. This clearly shows that UFSL is operating well below the Rs2.5mn ticket size ballpark.

Low ticket-sizes also imply UFSL is **catering to clientele that is largely under-served by universal banks and even key NBFCs**. We shall discuss this aspect in greater detail in a subsequent section.

UFSL's excess over PSL requirement is the highest among listed SFBs

Other than UFSL's tiny micro-LAP book, which sits inside its small-ticket affordable housing book, the entire portfolio for UFSL is PSL-compliant. This means **about 99% of UFSL loan book is PSL-compliant** as against a requirement of 75% (of ANBC).

Exhibit 2: Proportion of PSL compliant loan book – UFSL vs. listed SFB peers



Source: Company, Nirmal Bang Institutional Equities Research

This also means higher **incremental fee income stream from the sale of priority sector lending certificates** (PSLC) to banks which fall short of PSL compliance targets.

UFSL remains well capitalised and is aided further by exemption for SFBs

UFSL has a capital adequacy ratio (CRAR) of 22.05% as of 3QFY18-end as against a regulatory requirement of 15% for SFBs. It may be noted that, on 8 November 2017, the RBI made a change to the computation for CRAR for SFBs, **eliminating the requirement of providing capital charge for market and operational risk-weighted assets**, thereby reducing the denominator for the computation. While the total capital requirement for SFBs remains higher compared with universal banks, this capital charge exemption is not applicable to the latter. Capital adequacy ratio as of 2QFY18-end stands revised higher from 19.11% to 22.20%.

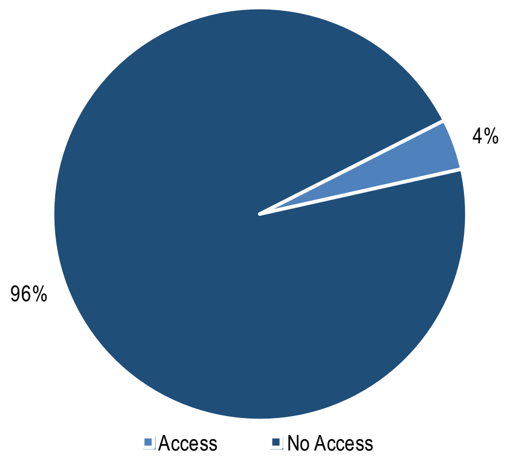
UFSL has made logical choices for new loan businesses to expand into

UFSL has decided to expand into two new key loan businesses which are, in a sense, logical extensions given its bottom-of-the-pyramid pedigree. These businesses are micro and small enterprises (MSE) lending and small-ticket affordable housing loans.

Both MSE and small-ticket affordable housing are highly under-penetrated loan segments

A Press Information Bureau (PIB) release dated 1 March 2015 cited the NSSO Survey 2013, stating that **of the 57.7mn small business units in India, only 4% have access to institutional finance**. This highlights the deep under-penetration of formal lending in the micro enterprise area.

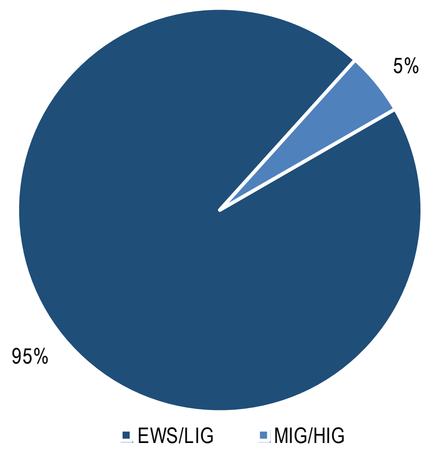
Exhibit 3: Proportion of small business units with access to institutional finance



Source: NSSO Survey 2013, Nirmal Bang Institutional Equities Research

Similarly, the Ministry of Housing and Urban Poverty Alleviation (MHUPA) has, earlier, indicated that **95% of the housing shortfall in urban India falls under the EWS (Economically Weaker Sections) and LIG (Lower Income Group)**. This underlines the housing finance opportunity lower down the income pyramid, which UFSL is specifically targeting. The **proportion of UFSL housing clients that fall under EWS/LIG is as high as ~95%**, which is far higher than even a small-ticket focused HFC like Can Fin Homes at 40%.

Exhibit 4: Proportion of urban housing shortfall falling under EWS/LIG sections



Source: MHUPA, Nirmal Bang Institutional Equities Research

Both MSE and small-ticket affordable housing loans have significant government support

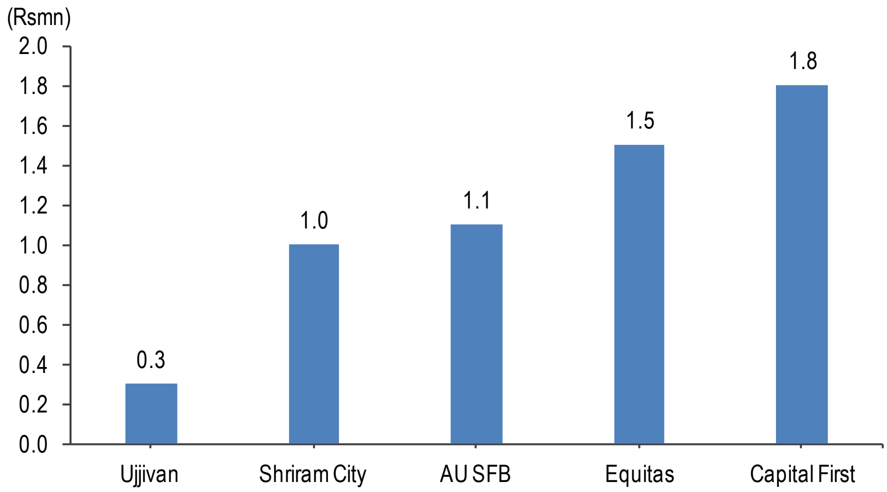
Being bottom-of-the-pyramid loan segments, both MSE and small-ticket affordable housing loans have significant government support. **Both loan segments are driven by flagship programmes of the central government** viz. Pradhan Mantri Mudra Yojna and the Pradhan Mantra Awas Yojna, respectively, both of which effectively address the under-penetrated MSE and small-ticket affordable housing loan segments, respectively.

The Pradhan Mantri Mudra Yojna is structured to support micro enterprises via credit

The Pradhan Mantri Mudra Yojna is structured in a manner that allows for micro-ticket credit flow for micro enterprises. The products under the aegis of PMAY are termed as **Shishu, Kishor and Tarun** for ticket sizes upto Rs50,000, between Rs50,000 and Rs0.5mn and between Rs0.5mn and Rs1mn, respectively.

Given its low average ticket size for MSE segment, we note, UFSL is focused specifically on benefiting from the under-penetration of this segment (discussed in the previous section) as well as from government support, both of which are greater lower down the income pyramid.

Exhibit 5: Average MSME loan ticket size – UFSL vs. MSME-focused peers



Source: Company, Nirmal Bang Institutional Equities Research

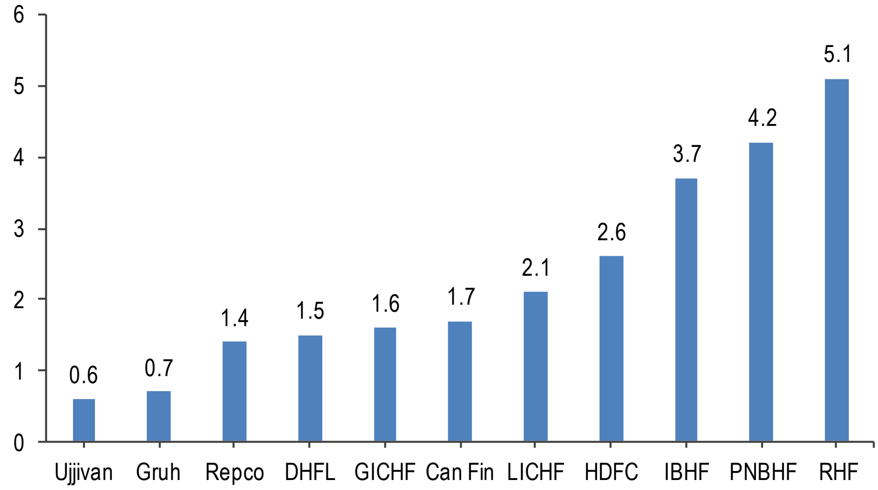
The Pradhan Mantri Awas Yojna is specifically designed to support credit flow towards small-ticket affordable housing ownership

Similarly, we note that **Pradhan Mantri Awas Yojna (PMAY)** is structured to specifically address the low home ownership level among lower income groups. It applies to MIG-II and lower income groups only. Also, the **extent of credit subsidy improves as one progresses lower down the income pyramid**. Interest subsidy is 6.5% for LIG/EWS and 4%/3% for MIG-I/MIG-II categories. This directly translates to improved opportunity for small-ticket affordable housing loans.

We further note that the proportion of borrowers actually availing PMAY is currently low, but can rise materially as **awareness regarding the programme** grows and lending institutions develop processes to seamlessly initiate the education of borrowers regarding PMAY.

Similarly, given its low average ticket size for the small-ticket affordable housing segment, UFSL is focused specifically on benefiting from the under-penetration of this segment (discussed in the previous section) as well as from government support, both of which are lower down the income pyramid.

Exhibit 6: Average housing ticket size – UFSL vs. HFC peers



Source: Company, Nirmal Bang Institutional Equities Research

Asset quality crisis for UFSL is now firmly in the past

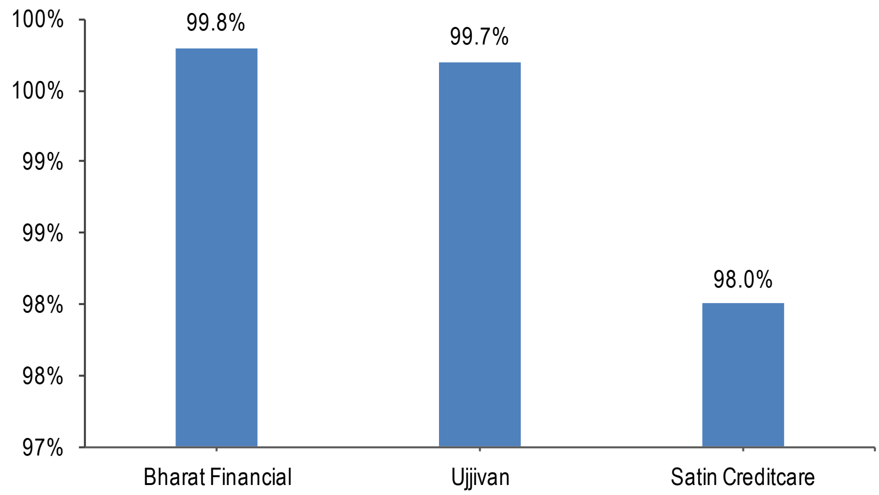
We stress that the asset quality crisis afflicting UFSL is firmly in the past on account of two primary reasons: (1) Stress on microfinance portfolio is contained within the legacy book and asset quality of new lending remains pristine. (2) Underlying stress on the legacy book is not rising, but rather displaying a declining trend as indicated by the portfolio at risk (PAR).

Collection efficiency of 'new lending' is firmly above 99% harking back to pre-crisis days

Collection efficiency for UFSL for its 'new loan book' i.e. **loan book created after 31 December 2016** is as much as 99.7%, which means it is business as usual as far as the new lending is concerned, from an asset quality perspective. Further, this 'new loan book' forms as much as 78% of UFSL's total microfinance portfolio.

Normalisation of microfinance portfolio is essentially an industry-wide phenomenon.

Exhibit 7: Collection efficiency of 'new loan book' – microfinance players



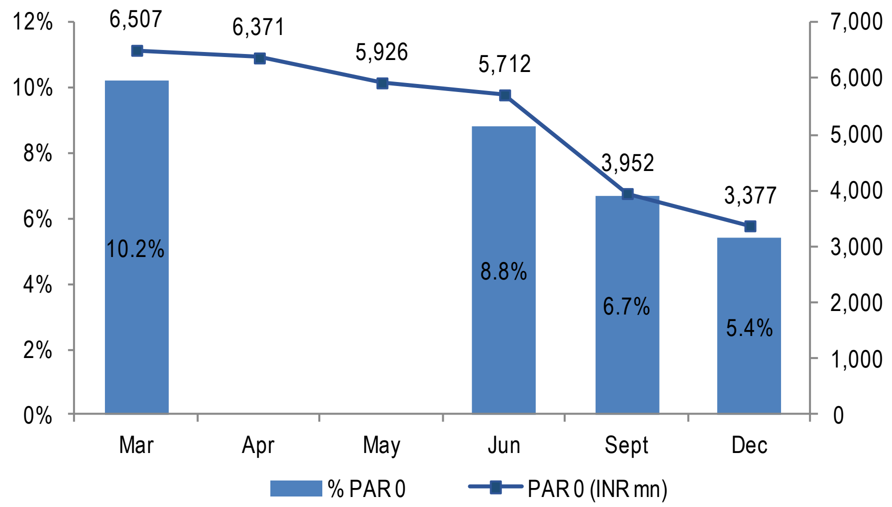
Source: Company, Nirmal Bang Institutional Equities Research

Falling PAR0 is an indicator of waning stress on legacy microfinance portfolio

Almost all stress of the microfinance portfolio of UFSL lies within the legacy portfolio and the key indicator that measures this stress is **PAR0, which is the portfolio at risk as measured on the basis of all overdue loans, regardless of how long they have been overdue**. This number has been steadily falling both in absolute terms as well as in terms of proportion of AUM, indicating that underlying stress is no longer accreting but rather is on a falling trend.

PAR0 has fallen from 8.8% as a percentage of AUM of 1QFY18-end to 5.4% as of 3QFY18-end.

Exhibit 8: PAR0 – absolute number and as a percentage of AUM - UFSL



Source: Company, Nirmal Bang Institutional Equities Research

Contrary to some commentary, UFSL's legacy business of microfinance is still an underpenetrated area

There is an understanding that has emerged in some quarters that as microfinance penetration in some key states has reached figures that are close to the proportion of poor people in those states, microfinance as a loan segment has, therefore, reached a saturation level. **This concern is unfounded as only the officially poor cannot be said to be the sole target client set for microfinance lending**.

The **latest definition of poverty in India is as per the C. Rangarajan panel** that set Rs32 and Rs47 spending per day as the thresholds, in rural and urban India, that define the poverty line. These thresholds imply a monthly spending of Rs910 and Rs1,410, respectively. As per this poverty line definition, 29.5% of Indians were living below the poverty line. As the penetration level of microfinance has reached figures similar to this (29.5%) in some key states (it is 14% on pan-India basis), it led to concerns regarding market saturation.

The definition of qualifying asset, on the other hand, for microfinance is that the loan needs to be given a family whose annual income does not exceed Rs0.1mn and Rs0.16mn in rural and urban centres, respectively. These thresholds imply a monthly income of Rs8,333 and Rs13,333, respectively, which are far above the poverty line thresholds. So, **the proportion of Indians who qualify for microfinance would be a lot higher than those that fall below the poverty line**. In fact, it may be noted that the proportion of Indian households where the highest earning member gets less than Rs5,000 is as high as 75% at an all-India level in rural India.

Valuation and Outlook

We use the Residual Income Model to arrive at a first-principles' fair value for UFSL. We assume a long-term sustainable average risk-free rate of 7% for India, an Adjusted Beta of 1.2 for UFSL and an India-specific Equity Risk Premium of 6% and arrive at the overall Cost of Equity of 14.2% for UFSL. On this basis, **we arrive at a price target of Rs 437, at which the stock will trade at 2.6x/2.2x FY19E/20E book value**.

UFSL **currently trades at a FY19E/20E P/BV of 2.1x/1.7x, which makes it significantly under-valued** given its FY19E/20E RoE profile of 13.6%/16.5% and long-term outlook. Consequently, we believe that the multiple of 2.6x/2.2x implied by our price target of Rs 437 is reasonable.

Exhibit 9: Consensus vs Our Estimates

	Our estimate			Bloomberg estimate			% Variance		
(Rsmn)	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	*FY18E*	*FY19E*	*FY20E*
Net interest income	7,649	9,474	11,831	7,825	10,081	12,558	*(2.3)*	*(6.0)*	*(5.8)*
Operating profit	3,249	4,845	6,907	2,968	4,451	6,097	*9.5*	*8.8*	*13.3*
Profit after tax	82	2,543	3,575	(102)	2,144	2,984	-	*18.6*	*19.8*

Source: Company, Nirmal Bang Institutional Equities Research

Key Risks

Micro and small enterprise lending and small-ticket affordable housing are new areas of lending

UFSL does not have past track record or known expertise in micro and small enterprise lending and small-ticket affordable housing. Specifically, for small-ticket affordable housing below ticket sizes of ~Rs 0.3-0.4mn, which is also part of UFSL's fledgling housing loan book, there has been a systemic build up of stress. However, our base case is that UFSL's understanding of the bottom-of-the-pyramid will help them navigate these newer businesses adequately.

Microfinance caters to the bottom-of-the-pyramid and theoretical risk of political interference remains

Local, junior-level politicians remain a theoretical risk and may attempt to influence microfinance borrowers to default in times of crises. Mitigating factors for UFSL are (1) although there have been two crises in microfinance (a) Andhra Pradesh crisis in 2010 (b) Demonetisation, both are essentially non-repeatable black swan scenarios. Andhra Pradesh crisis was an institutionalized crackdown on the formal microfinance industry carried out by the then state government. Since then, no state government, central government or regulator (RBI) has carried out any such move since the **institutions now realize** that formal bottom-of-the-pyramid lenders serve to prevent the exploitation of low income groups by moneylenders / pawnbrokers who charge usurious interest rates far higher than formal lenders. Also, Demonetisation events are not frequent and have tended to be carried out in **gaps** of several decades. Furthermore, there is now awareness on the ground that default has severe consequences in terms of **credit history** being spoilt and borrowers have wisened up in terms of repayment behavior.

Company Overview

Ujjivan Financial Services is a Small Finance Bank with a network of 441 asset branches and has an AUM of Rs 71bn, of which the Microfinance, Housing and MSME split is 95%, 3% and 2%, respectively (own classification). Ujjivan Financial Services has displayed a loan CAGR of 53% over FY12-17. Its yield on advances in its latest reported quarter was 20.3%

Ujjivan Financial Services' cost of funds is 9.7% and, as a result, it registered a net interest margin of 11.1%. Its cost to income ratio stood at 69%. Consequently, it delivered a return on assets of 1.4% and a return on equity of 7%, implying a financial leverage of 5.0. Its customer base stood at 3.7mn. Its Capital Adequacy Ratio was 22.1%.

Exhibit 10: Management team/ Key executives

Name	Designation	Experience
Ms. Sudha Suresh	Managing Director and Chief Executive Officer	Sudha Suresh is a Chartered Accountant with a rich corporate career spanning over two decades. She received the 'CFO 100 - Recognition of Excellence' award in 2013. She is also a qualified Cost Accountant and Company Secretary. During her association with Ujjivan, she has been responsible for areas of Strategic Business Planning and Budgetary Controls, Equity Capital and Debt Syndication, Treasury Management, Accounts and Taxation as well as management of Board and regulatory compliances.
Mr. Ittira Davis	Chief Operating Officer and Head of Transition	He is an international banker with over 36 years of Corporate and Investment banking experience having worked extensively in the Middle East and Europe. He was with the Europe Arab Bank from July 2008 to October 2012 as Managing Director – Corporate and Institutional banking and then as an Executive Director of the Europe Arab Bank. He joined Ujjivan in March 2015.
Arunava Banerjee	Chief Risk Officer	Mr. Arunava Banerjee has been the Chief Risk Officer of Ujjivan Financial Services Limited (formerly Ujjivan Financial Services Private Limited) since July 31, 2015. Mr. Banerjee has over 36 years' experience, having worked in both Banking and the Retailing Industry. Starting his career with State Bank of India, he later worked with Standard Chartered Bank in their Merchant Banking unit in both Mumbai and New Delhi where he was part of the advisory and international banking team. He moved to Bahrain in 1996 to head the Corporate Banking department at the Bahraini Saudi Bank, before making a career shift to work as the Chief Financial Officer with Remza Investment Company which has diverse interests in the retailing sector in the Middle East.
Abhiroop Chatterjee	Head of Microfinance Business	Mr. Abhiroop Chatterjee serves as Head of Microfinance Business at Ujjivan Financial Services Limited. Mr. Chatterjee served as the Chief Operating Officer of East at Ujjivan Financial Services Limited (formerly Ujjivan Financial Services Private Limited) since April 2014. Mr. Chatterjee joined Ujjivan in April 2008 as part of the first batch of Management Trainees and served as its Chief of Staff for the Eastern Region since January 2014. His first assignment was to establish operations at Jharkhand as Area Manager and served as its Distribution Manager since May 2010. He worked across all the states of operations in East.
S. Aryendra Kumar	Head of Housing and MSE	Mr. S. Aryendra Kumar, also known as Aryean, serves as Head of Housing and MSE at Ujjivan Financial Services Limited. Mr. Kumar served as Head of Housing Finance of Ujjivan Financial Services Limited (formerly Ujjivan Financial Services Private Limited) since September 3, 2014. Mr. Kumar has over 20 years of Professional experience spread across the spectrum of Businesses in service sector.
Manish Kumar Raj	Head of Microfinance & Branch Banking - North and West	Mr. Manish Raj has been the Head of Microfinance & Branch Banking - North and West at Ujjivan Financial Services Limited since January 6, 2017 and served as its Chief Operating Officer of North since October 2015 until January 6, 2017. Mr. Raj joined Ujjivan Financial in 2010. His first assignment was as an Area Manager at Dhanbad, Jharkhand. Thereafter, he was elevated to regional vigilance manager role wherein he was part of settingup vigilance department in East. Since November 2013, he was managed the business for NCR and Madhya Pradesh in North region. Since December 2014, he was Regional Business Manager of GL, handling group lending business for the North region.

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 11: Board members

Name	Designation	Experience
MR. K.R. Ramamoorthy	Non-executive Chairman and Independent Director	Former chairman and managing director, Corporation Bank and former chairman & chief executive officer, ING Vysya Bank Served as an advisor to CRISIL and as consultant to The World Bank. Independent director on the boards of National Securities Clearing Corporation Limited, Subros Limited, and Nilkamal Limited. Trustee of Canara Robeco Mutual Fund.
Mr. Abhijit Sen	Non-Executive, Independent Director	Former managing director - chief financial officer, Citibank N.A. India. Former director of Citicorp Services India Limited and other Citi entities. Serves on the board of IDFC Bank and Trent Limited
Ms. Vandana Viswanathan	Non-Executive, Independent Director	Co-founder of Cocoon Consulting, a management and human relationship consulting firm
Ms. Sudha Suresh	Managing Director and Chief Executive Officer	Was responsible for areas of Strategic Business Planning and Budgetary Controls, Equity Capital and Debt Syndication, Treasury Management, Accounts and Taxation as well as management of Board and regulatory compliances within the company
Mr. Jayanta Basu	Non-Executive Director	19 years of experience in the fields of investments. He is currently a Designated Partner at CX Advisors LLP. He has previously worked with Citibank India.
Mr. Amit Gupta	Non-Executive Director	Founding partners and chief operating officer of NewQuest Capital Advisors (HK) Limited.

Source: Company, Nirmal Bang Institutional Equities Research

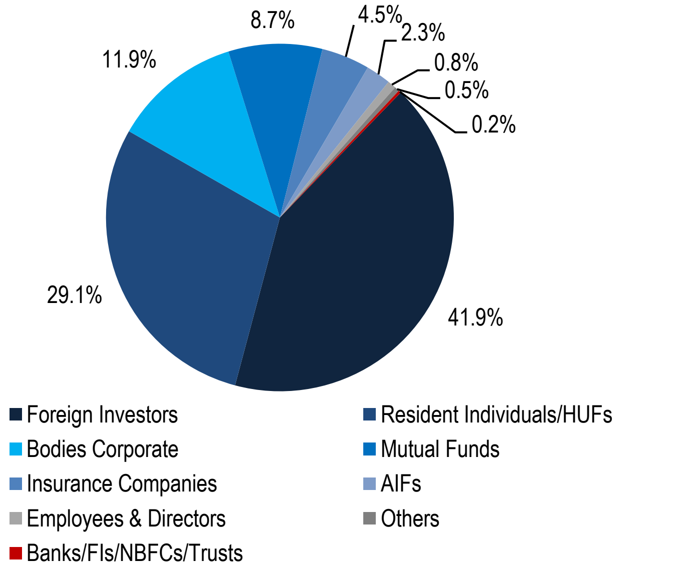
Shareholding Information

Exhibit 12: Key shareholders

	(%)
Promoter	
Non - promoter	
Alena Private Limited	8.95
International Finance Corporation	5.92
Newquest Asia Investments Ii Limited	5.83
Ardisia Limited	4.95
Sequoia Capital India Investments Iii	3.48
Shriram Life Insurance Company Limited	2.45
Sundaram Mutual Fund	2.44
Alternate Investment Funds	2.31
Cx Partners Fund 1 Limited	2.16
Mousseganesh Limited	2.07
Cdc Group Plc	1.89
Elevar Equity Mauritius	1.67
Iifl Focused Equity Strategies Fund	1.5
Uti-Mid Cap Fund	1.25
Kotak Equity Arbitrage Fund	1.04
Morgan Stanley (France) S.A.	1.03

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 13: Shareholding pattern



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 14: One year forward P/BV

Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 15: Income statement

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Interest income	9,310	12,258	14,066	16,804	20,943
Interest expenses	4,235	5,427	6,417	7,330	9,112
Net interest income	**5,075**	**6,831**	**7,649**	**9,474**	**11,831**
Loan origination fees	708	776	1,273	1,625	2,184
Other Income	258	943	1,607	1,970	2,494
Net revenues	**6,041**	**8,550**	**10,529**	**13,069**	**16,509**
Operating expenses	3,068	4,581	7,279	8,224	9,602
-Employee expenses	1,967	2,716	4,016	3,981	4,086
-Other expenses	1,102	1,865	3,264	4,243	5,516
Operating profit	**2,973**	**3,969**	**3,249**	**4,845**	**6,907**
Provisions	253	751	3,123	932	1,406
PBT	2,720	3,218	126	3,912	5,501
Tax	948	1,141	44	1,369	1,925
PAT	**1,772**	**2,077**	**82**	**2,543**	**3,575**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 17: Balance sheet

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Share capital	1,012	1,194	1,194	1,194	1,194
Reserves & surplus	10,966	16,359	16,326	18,754	22,214
Networth	**11,978**	**17,553**	**17,520**	**19,948**	**23,408**
Deposits	-	1,064	20,899	38,397	64,643
Borrowings	43,380	62,914	55,949	61,722	69,153
Other liability & provisions	1,915	3,255	5,331	6,076	6,767
Total liabilities	**57,273**	**84,786**	**99,698**	**126,143**	**163,972**
Fixed Assets	242	1,398	2,374	3,100	3,826
Investments	1	14,467	16,129	21,102	27,533
Loans	50,643	58,712	68,629	86,127	112,374
Cash	4,913	7,601	9,437	12,058	15,732
Other assets	1,475	2,608	3,130	3,756	4,507
Total assets	**57,273**	**84,786**	**99,698**	**126,143**	**163,972**
AUM	**53,885**	**63,795**	**76,255**	**95,697**	**124,860**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 16: Key ratios

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Growth (%)					
Net Interest Income	81.6	34.6	12.0	23.9	24.9
Operating Profit	119.3	33.5	(18.1)	49.1	42.6
Profit After Tax	133.8	17.2	(96.1)	3,005.4	40.6
Business (%)					
Deposit Growth	-	-	1,864.1	83.7	68.4
CASA	-	3.0	3.0	4.0	7.0
Advance Growth	57.3	15.9	16.9	25.5	30.5
AUM Growth	64.6	18.4	19.5	25.5	30.5
Spreads (%)					
Yield on AUM	21.5	20.8	18.7	18.3	17.8
Yield on BS loans	22.5	22.4	20.5	20.3	19.7
Cost of Funds	11.4	10.8	9.1	8.3	7.8
Core Spreads	11.1	11.7	11.4	12.0	11.9
NIMs	12.3	12.5	9.7	9.9	9.6
Operational Effeciency (%)					
Cost to Income	50.8	53.6	69.1	62.9	58.2
Cost to AUM	7.1	7.8	10.4	9.6	8.7
Productivity (Rs Mn)					
AUM per Branch	114.9	139.6	172.9	217.0	283.1
AUM per Employee	6.7	6.3	7.0	9.1	11.9
Employee per Branch	17.2	22.2	24.6	23.8	23.8
CRAR (%)					
Tier I	22.4	16.8	19.4	17.6	15.8
Tier II	1.8	1.4	1.6	1.4	1.2
Total	24.1	18.2	21.0	19.0	17.1
Asset Quality (%)					
Gross NPA	0.2	0.3	3.8	2.2	1.5
Net NPA	0.0	0.0	0.8	0.4	0.3
Provision Coverage	74.3	89.3	80.0	80.0	80.0
Credit Cost (excluding std asset)	0.2	1.4	4.4	0.9	1.1
Credit Cost (including std asset)	0.6	1.4	4.9	1.2	1.4
Return Ratio (%)					
ROE	18.3	14.1	0.5	13.6	16.5
ROA	3.7	2.9	0.1	2.3	2.5
Per Share (%)					
EPS	17.5	17.4	0.7	21.3	29.9
BV	118.4	147.0	146.7	167.1	196.0
ABV	118.2	146.9	142.4	163.8	193.2
Valuation (x)					
P/E	19.8	19.9	504.2	16.2	11.5
P/BV	2.9	2.4	2.4	2.1	1.8
P/ABV	2.9	2.4	2.4	2.1	1.8

Source: Company, Nirmal Bang Institutional Equities Research

Manappuram Finance

26 March 2018

Reuters: MNFL.NS; Bloomberg: MGFL IN

Initiating Coverage

Twice Bitten, Not Shy

Manappuram Finance (MFL) is a gold loan NBFC with a network of 4,185 branches and loan book size of Rs147bn. We are bullish on the company as the mini crisis because of demonetisation stalled the largely unfinished re-rating process that began after the long-term gold loan crisis of FY12-FY16 (which had caused valuation to turn egregiously low). (2) Its strategy of capping loan tenure at three months is a significant long-term positive. (3) The company's truly vast and strategically located branches are a key advantage that cannot be replicated in a short time span (4) Its non-gold loan businesses are synergistic and are delivering robust growth (5) Gold loans remain a large under-penetrated loan market and Aadhaar coverage is driving a shift of business from informal lenders. We initiate coverage on MFL with a Buy rating and a target price of Rs 128, valuing the stock at 2.4x/2.0x FY19E/FY20E P/BV.

Long-term and short-term crises over, MFL can now focus on growth: Demonetisation caused a seemingly persistent but transient growth crisis for the company as (a) gold loans are a truly bottom-of-the-pyramid loan business with average ticket size at Rs32,300 (b) the sound long-term strategy of capping loan tenure at three months backfired on it during the cash crunch and (c) drought conditions in parts of South India were an incremental factor. This stalled the largely unfinished re-rating for MFL that had started after the long-term gold loans crisis of FY12-FY16. Now, after a -13% decline in AUM over 3QFY17-1QFY18, and flattish 0.3% growth QoQ in 2QFY18, MFL has delivered 5.3% growth QoQ in 3QFY18, which is significantly encouraging from an annualised perspective.

Strategy of capping loan tenure at three months is a masterstroke from a risk mitigation perspective: Though this strategy had backfired during the demonetisation black swan event, it reduces the risk linked to gold price movement dramatically as (a) the quantum of gold price decline would normally be lower over three months than 12 months and (b) interest accrual over three months would also be lower. Both these aspects reduce the probability of it becoming economically beneficial for the gold loan borrower to default.

Vast and strategically located branch network is a key advantage: MFL has 3,318 gold loan branches compared with 399-1,252 for key private sector gold loan players, barring HDFC Bank/Muthoot Finance at 4,734/4,303. Further, 54% of MFL's AUM was derived from rural/semi-urban locations as of 3QFY17-end, underlining its superior reach, which is key given that ~65% of Indian household gold holdings are in rural India. Replicating MFL's network size and deep penetration is not straightforward for competitors from an opex perspective.

Non-gold loan businesses are synergistic and have high operating leverage: Given MFL's bottom-of-the-pyramid pedigree, it made sense for it to expand into microfinance, vehicle finance, and small-ticket housing. Without any attempt at cross-selling (which will now be focused on), ~20%, ~10% and ~50% of commercial vehicle, housing and two-wheeler customers have emanated from the company's gold loan client base. Vehicle finance is being disbursed entirely via gold loan branches, pointing to tremendous operating leverage. Asirvad is a best-in-class NBFC-MFI that is a key subsidiary from a long-term perspective.

Valuation and outlook: We use the residual income model to value MFL to arrive at a target price of Rs128. Currently, MFL trades at 2.0x/1.7x FY19E/FY20E P/BV and we believe our target price is reasonable given its RoE profile of 20.4/20.7% for FY19E/FY20E and long-term outlook.

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Net Interest Income	14,016	22,075	24,266	27,920	33,282
Pre-Provision Profit	5,907	12,749	12,957	14,499	17,172
PAT	3,552	7,584	7,146	8,585	10,164
EPS (Rs)	4.2	9.0	8.5	10.2	12.1
BV (Rs)	31.9	37.3	43.4	50.0	58.1
P/E (x)	24.4	11.4	12.1	10.1	8.5
P/BV (x)	3.2	2.8	2.4	2.1	1.8
Gross NPA (%)	*0.9*	*2.3*	*2.5*	*2.8*	*2.9*
Net NPA (%)	*0.7*	*1.6*	*1.5*	*1.6*	*1.6*
ROA (%)	*2.9*	*5.4*	*4.3*	*4.2*	*4.1*
ROE (%)	*13.2*	*24.8*	*19.7*	*20.4*	*20.7*

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: NBFCs

CMP: Rs106

Target Price: Rs128

Upside: 21%

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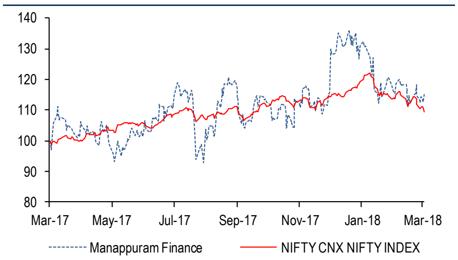
Key Data

Current Shares O/S (mn)	842.0
Mkt Cap (Rsbn/US$bn)	88.3/1.4
52 Wk H / L (Rs)	126/82
Daily Vol. (3M NSE Avg.)	6,352,360

Shareholding (%)	3QFY18	2QFY18	1QFY18
Promoter	34.7	34.7	34.7
Public	65.3	65.3	65.3
Others	-	-	-

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
MFL	(3.1)	5.3	12.1
Nifty Index	(4.8)	0.2	9.9

Source: Bloomberg

Mini crisis following long-term crisis cloaks unfinished re-rating journey

Re-rating had started for MFL when it began to emerge from the **long-term crisis that stretched over FY12-FY16**. However, this re-rating was stalled because of the mini crisis that began because of Demonetisation, but, importantly, **in 3QFY18 this mini crisis too has played out** and investors can now look forward to the resumption of the earlier re-rating journey, which has still a long way to go before it is complete.

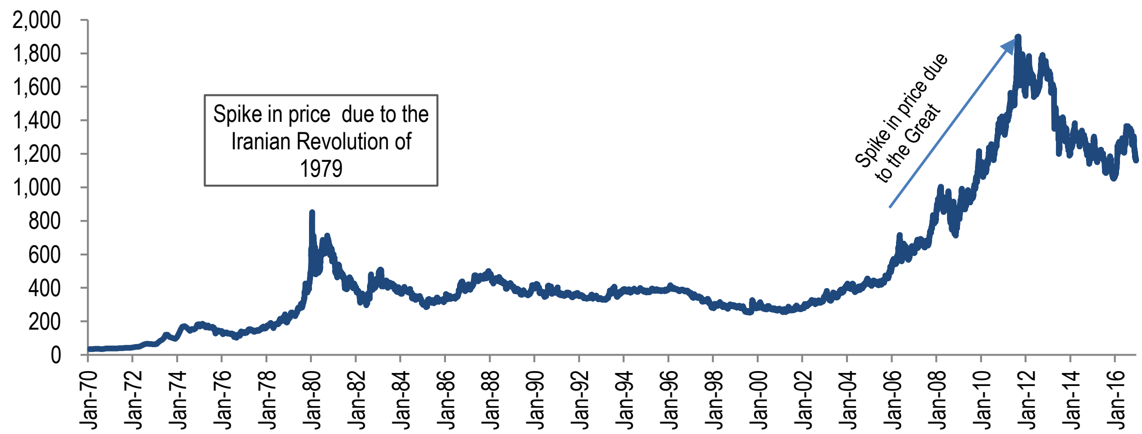
Long-term crisis created a truly distressed valuation level from where re-rating had initially begun and we do not expect a similar long-term crisis to repeat

The long-term crisis for MFL over FY12-FY16 was the result of (1) a **sustained bear market** in gold prices, (2) a **worsening of the regulatory regime** for gold loans because of (a) capping of loan-to-value (LTV) ratio at 60% and (b) removal of priority sector status for gold loans. We stress that this long-term crisis will not re-emerge as (1) the sustained bear market in gold prices of the nature that occurred over 2011-16 is a **once-in-a-generation phenomenon** and (2) the regulatory regime, on balance, has improved with LTV cap being increased to 75%.

What the long-term crisis did, however, was that it brought the MFL's valuation to a truly distressed level from where the re-rating initially began. Consequently, **even after the stock price had risen significantly from a long-term low**, the re-rating, as dictated by fundamentals, was far from complete.

We believe the probability of a sustained bear market (i.e. with a significant overall drawdown) in gold prices of the nature witnessed over 2011-16 (overall drawdown from peak to trough was 45%) is low as (1) The **previous such phenomenon was witnessed as far back as the early 1980s** (2) Gold retains its property as (a) a **store of value/safe haven** over the long-term including from risk assets and central-bank administered fiat currencies (especially more so after unbridled volatility in crypto-currencies) and (b) a **hedge against inflation** over the long-term since, while global inflation remains tepid, it is still positive with deflation scare having been averted.

Exhibit 1: Generational gold price chart – 1970-2016



Source: Company, Nirmal Bang Institutional Equities Research

Mini crisis that resulted from demonetisation also behind MFL now

Demonetisation announced on 8 November 2016 was a body blow to the gold loan business of MFL as (1) **gold loans are a truly bottom-of-the-pyramid business** hugely impacted by the cash cycle disruption caused by demonetisation and (2) the company's strategy of **capping loan tenure at three months** (which is sound from a long-term perspective) backfired as it actuated forced auctions of gold collateral, loss of clientele and AUM decline. (3) An incremental factor negatively impacting gold loan AUM traction was **drought conditions in key parts of South India at the time** where the MFL is operative on the ground.

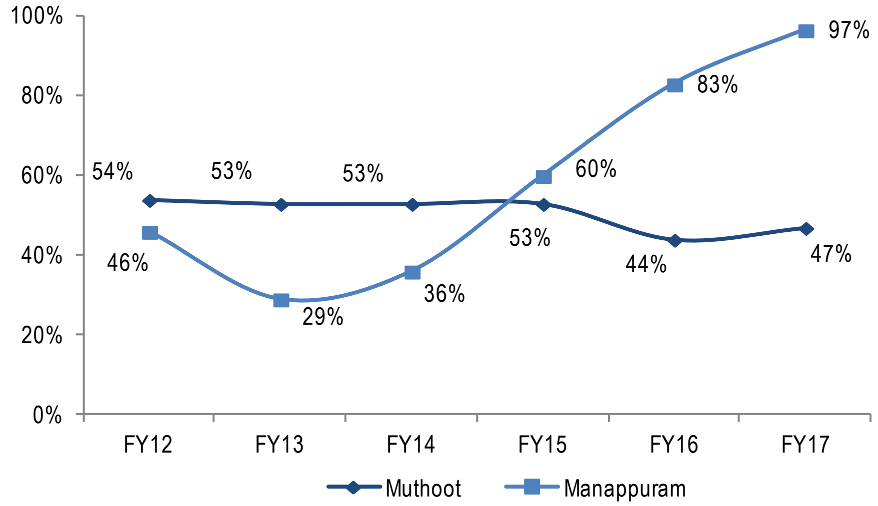
However, in 3QFY18, **green shoots are clearly visible with gold loan AUM growing 5.3% QoQ**. This came after a -13% absolute decline over two quarters (3QFY17-1QFY18) and flattish 0.3% growth QoQ in 2QFY18. A continued QoQ growth as registered in 3QFY18 would be significantly above track on an annualised basis.

The fact that gold loans for MFL are a truly bottom-of-the-pyramid can be gauged from the fact that the average ticket size for MFL gold loans is Rs32,300 and ~50% of gold loan book comprises loans with ticket size exceeding Rs0.1mn. This implies that the **other half of the book is truly small ticket size with average ticket below Rs 20,000**. This is lower than even microfinance ballpark average loan ticket size of ~Rs25,000.

Strategy of capping loan tenure at three months positive from a long-term perspective for MFL

The strategy of the two key listed gold loan NBFCs viz. MFL and Muthoot Finance **regarding loan tenures has diverged** in recent years. While the former capped loan tenures at three months, Muthoot Finance offered full flexibility with regard to loan tenures with tenures ranging up to 12 months.

Exhibit 2: Proportion of gold loan with residual maturity < 3 months – FY12-FY17



Source: Company, Nirmal Bang Institutional Equities Research

We have acknowledged that this strategy backfired on MFL in the aftermath of Demonetisation. This is because the three-month loan tenure cap meant that the entire loan book became due for renewal after three months or less, which was **operationally impossible for borrowers to comply with during the cash crunch** that ensued after Demonetisation.

However, from a long-term perspective, what this strategy does is that it dramatically reduces asset quality risk linked to gold price movement. This is because: (1) The **quantum that gold price can normally move** in a period of three months is significantly lower than that in 12 months. (2) While monthly card rates may be the same for a three-month and a 12-month gold loan, the **quantum of interest that will accrue** over three months is significantly lower than the quantum over 12 months. These two reasons ensure that the **probability that a three-month loan can go 'out-of-the-money'** (become economically beneficial for the borrower to default) is a lot lower than that for a 12-month loan.

Exhibit 3: Table showing the impact of changes in MFL's product structure

Phase	Before product modification	After product modification			
Product (Loan tenure)	**12 months**	**3 months**	**6 months**	**9 months**	**12 months**
Value of Gold borrowed against (Rs)	100	100	100	100	100
Loan to Value Ratio (%)	*75*	*75*	*70*	*65*	*60*
Loan disbursed (Rs)	75	75	70	65	60
Annualised Interest Rate (%)	*24*	*24*	*24*	*24*	*24*
Tenure in months	12	3	6	9	12
Simple Interest (Rs)	18.0	4.5	8.4	11.7	14.4
Total repayment at end of tenure (Rs)	93.0	79.5	78.4	76.7	74.4
Gold drawdown that would put borrower out of money (%)	*7.0*	*20.5*	*21.6*	*23.3*	*25.6*
Time taken to Auction in months	2	2	2	2	2
Simple Interest over Auction period (Rs)	3	3	2.8	2.6	2.4
Target recoverable at Auction (Rs)	96.0	82.5	81.2	79.3	76.8
Auction discount (% Loss on Recovery)	*10*	*10*	*10*	*10*	*10*
Gold drawdown that would result in loss to lender	*-6.7*	*8.3*	*9.8*	*11.9*	*14.7*

Source: Company, Nirmal Bang Institutional Equities Research

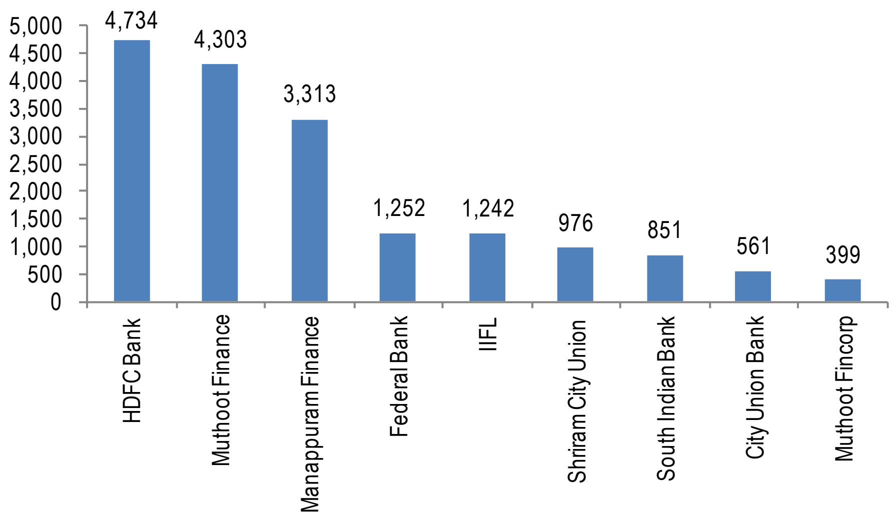
The above table shows that, a standard three-month loan would fall out of money when gold price witnesses a drawdown of -20.5% in three months whereas a standard 12-month loan would fall out of money when the gold price witnesses a drawdown of -7% over 12 months. Clearly, the former scenario is an event of **significantly lower probability** than the latter.

It may noted that, owing to the company's experience during the cash crunch immediately after Demonetisation, MFL **decided not to have an absolutely rigid strategy** of capping virtually all loans at three-month tenure, while still largely remaining focused on three-month tenure loans.

MFL branch network is a competitive advantage that competitiors cannot replicate overnight

The total branch count of MFL is 3,313 compared with 399-1252 for key players in the formal gold loan industry, barring HDFC Bank (4,734) and Muthoot Finance (4,303). This is a key advantage for the company which competitors cannot replicate rapidly.

Exhibit 4: Branch count – MFL vs. key gold loan players – 3QFY18



Source: Company, Nirmal Bang Institutional Equities Research; SCUF figure for 1QFY17

Rural / semi-urban reach key advantage compared with competitors

Reach is key for disbursing gold loans as a significant chunk of Indian households' gold holdings are located outside metro / Tier 1 centres. It is estimated that **rural India holds ~65% of India's physical gold stock**. 43% of the MFL's gold AUM is derived from rural / semi-urban centres as of 3QFY18-end. This share was even higher at 54% of AUM 12 months ago since Demonetisation disrupted the cash cycle of the marginal borrower more meaningfully in the hinterland.

Presence in the South also an advantage vis-à-vis competition

A separate, independent, vector that hands the company superior reach is its significant presence in South India. 61% of the company's gold loan AUM is sourced from South India. It is estimated that **~40% of India's gold demand emanates from South India**.

MFL built its hard-to-replicate branch network over the years as it was a monoline company for long

While there are certainly several lending institutions operating in rural India as well as those that are focused on South India, there may not be many which have a large branch count, have rural focus and have a South India focus, all simultaneously. In that, MFL is somewhat unique along with fellow listed gold loan NBFC, Muthoot Finance. **Such a branch network for MFL has been the result of it being in existence (in its current avatar) as a focused monoline gold loan player (till recently) since 1992** adding branches steadily to suit its monoline strategy. Banks and diversified NBFCs which compete with MFL did not build a similar branch network over the years as theirs was not a monoline business and were focused on high-value (non-gold loan) customers in tier 1 centres with a smaller branch count. Moreover, in any case, mere presence of bank branch at a given location may not mean competition as the branch may not even be 'activated' (readied) to make gold loans.

MFL has a nimble management which has led it to actively diversify into synergistic non-gold loan businesses

MFL is now a multi-product player having diversified into microfinance, vehicle loans (mainly commercial vehicles), small-ticket affordable housing, and insurance broking. The key similarity in all these new businesses is that they are **significantly synergistic to the company's gold loan business from a reach and type of clientele perspective**.

Of the four businesses, vehicle loan business is conducted entirely from gold loan branch premises, which underlines **tremendous operating leverage** available to this business.

Other means of synergy include **access to current gold loan client base for alternate loan products**. ~20% of commercial vehicle customers, ~10% of housing loan customers and ~50% of two-wheeler loan customers (newest line of business) are existing gold loan customers. These were not customers to whom alternate products were sold, but customers who themselves approached the company because of its strong brand. MFL plans to actively execute a **cross-selling strategy** going forward

Worst is behind MFL's microfinance subsidiary Asirvad, a best-in-class MFI

Asirvad was a major reason that dragged down overall profitability at MFL

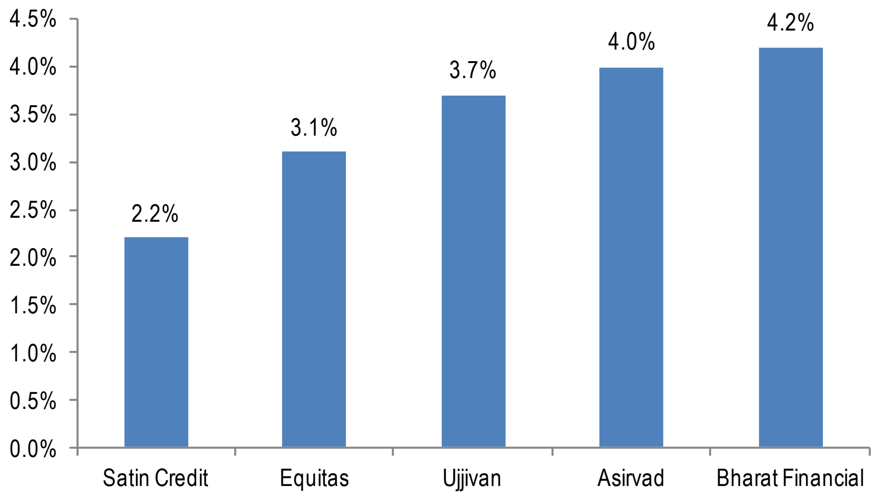
MFL suffered collateral damage as a consequence of its microfinance subsidiary, Asirvad Microfinance, already accounting for as much as 11% of group AUM as of 2QFY17-end. While the company had moved before Muthoot Finance in terms of inorganically diversifying into microfinance and had acquired a controlling stake in Asirvad, the microfinance subsidiary was laid low by Ddemonetisation, just like the rest of the leading NBFC-MFIs in an industry-wide crisis.

The impact of asset quality crisis at Asirvad on overall profitability of MFL's consolidated business can be gauged from the fact that the **total bad loan provision the of consolidated business for 9MFY18 was Rs1,669mn, while those at Asirvad alone was Rs1,414mn**. MFL holds 90% stake in Asirvad.

Asirvad is a truly best-in-class MFI-focused player and holds significant embedded value for MFL from a long-term perspective

Asirvad Microfinance is a best-in-class NBFC-MFI founded by S.V. Raja Vaidyanathan of IIT-IIM background (B. Tech., IIT Madras; MBA, IIM Kolkata). Asirvad had **a RoA of ~4% prior to Demonetisation** and, hence, in terms of profitability, was similar to Bharat Financial Inclusion, India's leading listed NBFC-MFI.

Exhibit 5: Pre-demonetisation (FY16) RoA of leading NBFC-MFIs*

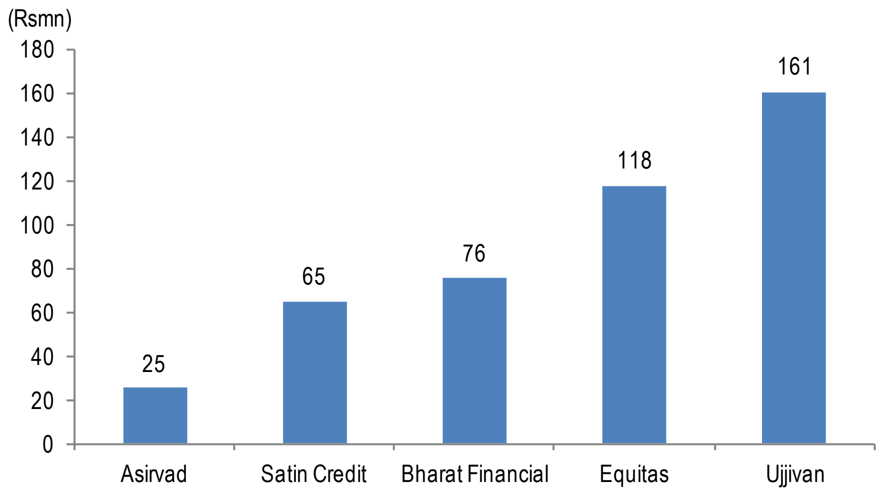


*Source: Company, Nirmal Bang Institutional Equities Research; *entity at the time*

It may further be noted that, prior to demonetisation, rating agency CRISIL had assigned A1+ credit rating to Asirvad's commercial paper programme, the **highest credit rating assigned by CRISIL to any NBFC-MFI** at the time. CRISIL retains the said rating for Asirvad as on date.

As of 3QFY18, Asirvad is the sixth largest NBFC-MFI in the country with a gross loan portfolio of Rs21.1bn. It still has to sweat its branch network fully and is, therefore, a **potential beneficiary of high operating leverage**. This potential can be gauged from its low AUM per branch of Rs25mn compared with Rs65mn-Rs 161mn for key listed microfinance-focused players.

Exhibit 6: AUM per branch – leading MFI-focused players – 3QFY18



Source: Company, Nirmal Bang Institutional Equities Research

Key metrics indicate that the asset quality crisis for Asirvad has subsided

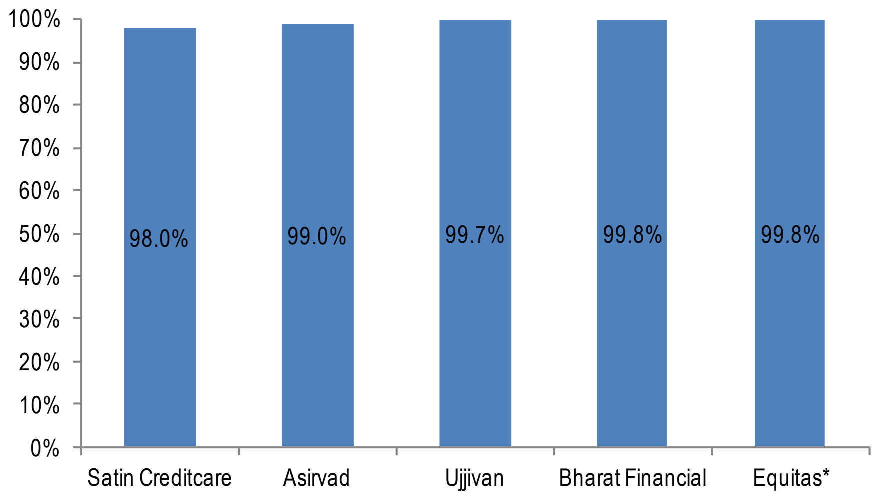
We stress that the asset quality crisis afflicting Asirvad is firmly in the past on account of two primary reasons: (1) Stress on microfinance portfolio is contained within the legacy book and **asset quality of new lending remains pristine.** (2) **Underlying stress on the legacy book is not rising,** but rather displaying a declining trend as indicated by the portfolio at risk (PAR).

Collection efficiency of 'new lending' is firmly above 99%, harking back to pre-crisis days

Collection efficiency of Asirvad for its 'new loan book' i.e. **loan book created after 31 December 2016** is as much as 99.04% (January to December 2017), which means it is business as usual as far as the new lending is concerned, from an asset quality perspective. The collection efficiency for nine months from April to December 2017 is 99.5%.

Normalisation of microfinance portfolio is essentially an industry-wide phenomenon.

Exhibit 7: Collection efficiency of 'new loan book' – microfinance players



**For Equitas, collection efficiency is for the period January to June, 2017*

Source: Company, Nirmal Bang Institutional Equities Research

Falling PAR0 an indicator of waning stress on legacy microfinance portfolio

Almost all the stress of the microfinance portfolio of Asirvad lies within the legacy portfolio and the key indicator that measures this stress is **PAR0, which is the portfolio at risk as measured on the basis of all overdue loans, regardless of how long they have been overdue**. This number has been steadily falling both in absolute terms as well as in terms of proportion of AUM, indicating that underlying stress is no longer accreting, but rather is on a falling trend.

Exhibit 8: PAR0 and provisioning – Asirvad – 1QFY18-3QFY18

(Rsmn)	1QFY18	2QFY18	3QFY18
GLP	18,270	19,650	21,120
PAR0	2,192	1,260	1,145
% PAR0	*12*	*6.4*	*5.4*
Provision	720	380	310
Excess over RBI requirement	338	270	260
Cumulative provision	720	1,100	1410
Cumulative excess provision	338	608	868
GNPA ratio (%)	*6.9*	*2.8*	*3.8*
NNPA ratio (%)	*0.8*	*0.9*	*0.5*

Source: Company, Nirmal Bang Institutional Equities Research

It may further be noted that **Asirvad follows a policy of provisioning that is more conservative than the RBI's requirement**. For loans 90 dpd, Asirvad provides 50% cover as stipulated by the RBI, but Asirvad provides 100% cover as soon as loans are 120dpd whereas the RBI required this only if loans are 180 dpd.

Asirvad has broken into the black as of 3QFY18 and the management expects a small residual provision on legacy stressed book in 4QFY18. Post this, **FY19 onwards, Asirvad can deliver a normalised return ratio** and drive overall profitability at the consolidated entity.

Macro opportunity in gold loans still far from being milked

Transient stagnation of gold loan AUM raised false spectre of saturation

Stagnation of gold loan AUM growth (till 2QFY18) raised a lingering doubt about gold loan market reaching a saturation point. While the QoQ growth in 3QFY18 is certainly encouraging, it is in order that one gets a sense of the potential market size for gold loans. A simple back-of-the-envelope estimate entails the following considerations: (1) Quantum of physical gold held in total by Indian households: 20,000tn. (2) Indian price of gold per gram: Rs3100. Consequently, **the potential addressable gold loan market in India is Rs62trn**. While we acknowledge that the key is to sensitise more Indian households to get them to no longer regard as taboo the use of their household gold as loan collateral, the potential addressable gold loan market size looks significantly large.

Transfer of business from informal lending sector to formal lending is a powerful trend that will gain ground

A key reason for bottom-of-pyramid borrowers to opt for informal/unorganised lenders (moneylenders/ pawnbrokers) is lack of identity proof, which is necessary documentary requirement from formal/organised lenders. However, the **penetration of Aadhaar has significantly changed the scenario** in this regard. Even as early as the 25 January 2017 (as mentioned in a Press Information Bureau release), Aadhaar coverage had reached the 1.11bn mark, which covered as much 99% of adult residents in India.

With growing awareness for formal lending, borrowers will increasingly start to move to the former as moneylenders/pawnbrokers charge usurious interest rates of 3%-6% per month (36%-72% per annum) compared with ~2% for gold loan NBFCs. While the marginal gold loan borrower is not known to be interest rate-sensitive for a quantum that differs by 2%-4% per annum (0.16%-0.32% per month), the **differential in monthly card rates of formal and informal lenders is fairly significant in terms of affecting behaviour**.

It is known that informal lenders currently control as much as ~75% of the overall gold loan market and there is **significant headroom for transfer of gold loan business from unorganised lenders to formal lending entities**, of which gold loan NBFCs will be key beneficiaries, given their deep physical distribution network.

Valuation and Outlook

We use the Residual Income Model to arrive at a first-principles' fair value for MFL. We assume a long-term sustainable average risk-free rate of 7% for India, an Adjusted Beta of 1.2 for MFL and an India-specific Equity Risk Premium of 6% and arrive at the overall Cost of Equity of 14.2% for MFL. On this basis, **we arrive at a price target of Rs 128, at which the stock will trade at 2.4x/2.0x FY19E/20E book value**.

MFL **currently trades at a FY19E/20E P/BV of 2.0x/1.7x, which makes it significantly under-valued** given its FY19E/20E RoE profile of 20.4%/20.7% and long-term outlook. Consequently, we believe that the multiple of 2.4x/2.0x implied by our price target of Rs 128 is reasonable.

Exhibit 9: Consensus vs Our Estimates

	Our estimate			Bloomberg estimate			*% Variance*		
(Rsmn)	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	*FY18E*	*FY19E*	*FY20E*
Net interest income	24,266	27,920	33,282	20,973	23,805	27,063	*15.7*	*17.3*	*23.0*
Operating profit	12,957	14,499	17,172	11,694	13,211	15,533	*10.8*	*9.7*	*10.6*
Profit after tax	7,146	8,585	10,164	6,896	8,357	9,813	*3.6*	*2.7*	*3.6*

Source: Company, Nirmal Bang Institutional Equities Research

Key Risks

Loss of business share or cannibalization of gold loan business by microfinance

Since certain clientele of gold loan business may belong to bottom-of-the-pyramid low income groups, such customer set may be attracted to microfinance since the latter is collateral-free at similar interest rates. Mitigating factors for Manappuram are (1) not all gold loan clientele would **qualify** for microfinance, given strict definition of microfinance 'qualifying asset' (2) Manappuram has itself meaningfully **diversified** into microfinance and can cater to those clients who are intent on shifting over (3) gold loan business does not entail credit appraisal and hence, **all clients are welcome** as long as they possess gold collateral, even those who have been shut of microfinance due to default during Demonetisation and otherwise, enabling a shift from microfinance to gold loans.

Since some gold loans and all of microfinance caters to the bottom-of-the-pyramid, theoretical risk of political interference remains

Local, junior-level politicians remain a theoretical risk and may attempt to influence borrowers to default in times of crises. Mitigating factors for Manappuram are (1) although there have been two crises in microfinance (a) Andhra Pradesh crisis in 2010 (b) Demonetisation, both are essentially non-repeatable black swan scenarios. Andhra Pradesh crisis was an institutionalized crackdown on the formal microfinance industry carried out by the then state government. Since then no state government, central government or regulator (RBI) has carried out any such move since the **institutions now realize** that formal bottom-of-the-pyramid lenders serve to prevent the exploitation of low income groups from moneylenders / pawnbrokers who charge usurious interest rates far higher than formal lenders. Also, Demonetisation events are not frequent and have tended to be carried out in **gaps** of several decades. Furthermore, there is now awareness on the ground that default has severe consequences in terms of **credit history** being spoilt and borrowers have wisened up in terms of repayment behavior.

Company Overview

Manappuram Finance is a Gold Loan NBFC with a branch network of 4815 branches and has an AUM of Rs 147bn, of which the Gold, Microfinance, and other Loans split is 77%, 14%, and 9%, respectively (own classification). South Indian Bank has displayed a loan CAGR of 7.3% over FY12-17. Its yield on advances in its latest reported quarter was 24.7%.

Manappuram Finance's cost of funds is 8.6% and, as a result, it registered a net interest margin of 17.4%. Its cost to income ratio stood at 51%. Consequently, it delivered a return on assets of 4.5% and a return on equity of 19.8%, implying a financial leverage of 4.2. Its customer base stood at 2.2mn. Its Capital Adequacy Ratio was 27.8%.

Exhibit 10: Management team/ Key executives

Name	Designation	Experience
Mr. V. P. Nandakumar	Managing Director & CEO	Chief Promoter of Manappuram Group, Certified Associate of Indian Institute of Bankers.
Mr. Kapil Krishan	Chief Financial Officer	24 years experience with organizations such as CRISIL, HSBC, Standard Chartered, Hewitt Associates, India Infoline
Mr. Subhash Samant	CEO – Housing Finance	Mr. Subhash Samant is the CEO of the Housing Finance subsidiary of Manappuram Finance.
Mr. K. B. Brahmadathan	Chief Technology Adviser	Mr. K. B. Brahmadathan serves as Chief Technical Advisor at Manappuram Finance Ltd. Mr. Brahmadathan served as Chief General Manager of BSNL.
Mr. Raja Vaidhyanathan	MD-MFI	Erstwhile Promoter of Asirvad Microfinance, IIT IIM Alumni with over 33 years of experience across industries
Mr. K Senthil Kumar	Head –Commercial Vehicle	Over 19 years experience in Business Development, Credit & Risk and Profit Centre operations.

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 11: Board members

Name	Designation	Experience
Mr. Jagdish Capoor	Chairman, Independent & Non-Executive Director	Former Chairman of HDFC Bank, former Deputy Governor of Reserve Bank of India, former Chairman of UTI and BSE Ltd
Mr. B.N. Raveendra Babu	Executive Director	Director since July 1992, Worked in a senior role with Blue Marine International in U.A.E
Mr. Shailesh J Mehta	Independent Director	Over 38 years of experience, was President of Granite Hill Capital Ventures, Chairman and CEO of Providian Financial Corporation
Mr. E.A. Kshirsagar	Independent Director	Associated with the Management Consultancy division of A F Ferguson for over three decades
Mr. Gautum Narayan	Additional Director	Partner with Apax Partners and leads investments in financial services and business services in India
Mr. P. Manomohanan	Independent Director	Over 38 years of work experience in the RBI and in the regulatory aspects of NBFCs
Mr. Rajiven V. R.	Independent Director	Wealth of experience in areas like Leadership, Staff management, Strategic Management, Financial Control / Budgeting, Team Development etc
Dr. Amla Samanta	Independent Director	Managing Director of SamantaOrganics Pvt Ltd, Tarapur& AshishRang UdyogPvt Ltd.
Mr V. R. Ramchandran	Independent Director	Over 32 years of work experience and is a civil lawyer enrolled with the Thrissur Bar Association

Source: Company, Nirmal Bang Institutional Equities Research

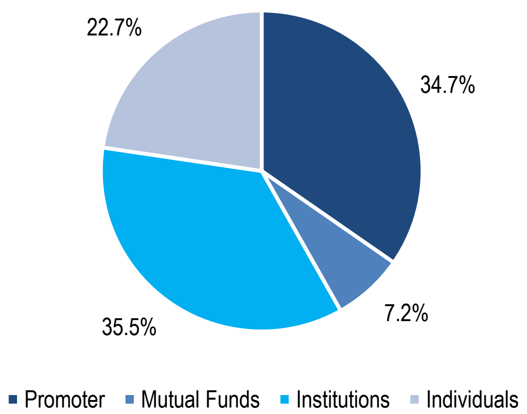
Shareholding Information

Exhibit 12: Key shareholders

	(%)
Promoter	
Nandakumar V P	28.43
Sushama Nandakumar	5.7
Non - promoter	
Quinag Acquisition (Fpi) Ltd	6.21
Baring India Private Equity Fund Iii	5.66
Wf Asian Reconnaissance Fund Limited	4.14
Barclays Merchant Bank (Singapore) Ltd.	3.77
Baring India Private Equity Fund Ii Limited	3.14
Dsp Blackrock Micro Cap Fund	2.22
Mousseganesh Limited	1.39
Alternate Investment Funds	0.55

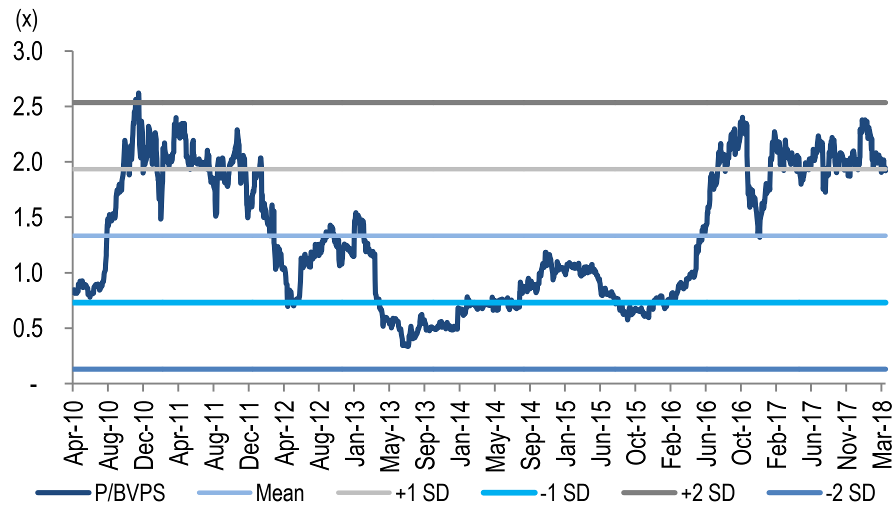
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 13: Shareholding pattern



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 14: One year forward P/BV



Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 15: Income statement

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Interest Income	23,490	33,762	35,481	41,656	50,176
Interest Expense	9,474	11,687	11,216	13,736	16,894
Net Interest Income	**14,016**	**22,075**	**24,266**	**27,920**	**33,282**
Non Interest Income	249	326	570	508	619
Net Revenue	**14,265**	**22,401**	**24,836**	**28,428**	**33,901**
Operating expenses	8,358	9,652	11,879	13,929	16,729
-Employee expenses	4,327	5,026	6,097	7,279	9,081
-Other expenses	4,031	4,626	5,783	6,650	7,647
Operating profit	**5,907**	**12,749**	**12,957**	**14,499**	**17,172**
Provisions	423	1,093	1,963	1,291	1,535
PBT	5,484	11,656	10,994	13,208	15,637
Tax	1,932	4,072	3,848	4,623	5,473
PAT	**3,552**	**7,584**	**7,146**	**8,585**	**10,164**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 17: Balance sheet

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Share capital	1,682	1,684	1,684	1,684	1,684
Reserves & surplus	25,898	31,934	37,255	43,590	51,299
Networth	**27,580**	**33,618**	**38,939**	**45,274**	**52,983**
Borrowings	96,379	109,861	132,639	167,595	205,751
Other liability & provisions	4,432	8,042	9,632	12,212	15,368
Total liabilities	**128,391**	**151,521**	**181,450**	**225,343**	**274,388**
Fixed Assets	1,948	1,869	2,149	2,472	2,843
Investments	490	50	50	50	50
Loans	113,853	138,417	162,978	203,022	247,761
Cash	6,045	5,227	8,149	10,151	12,388
Other assets	6,055	5,958	8,123	9,648	11,346
Total assets	**128,391**	**151,521**	**181,450**	**225,343**	**274,388**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 16: Key ratios

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Growth (%)					
Net Interest Income	28.5	57.5	9.9	15.1	19.2
Operating Profit	33.7	115.8	1.6	11.9	18.4
Profit After Tax	30.8	113.5	-5.8	20.1	18.4
Business (%)					
Advance Growth	18.3	21.6	17.7	24.6	22.0
Spreads (%)					
Yield on loans	22.4	26.8	23.5	22.8	22.3
Cost of Borrowings	10.4	11.3	9.3	9.2	9.1
Spread	12.0	15.4	14.3	13.6	13.2
NIMs	13.3	17.5	16.1	15.3	14.8
Operational Effeciency (%)					
Cost to Income	58.6	43.1	47.8	49.0	49.3
Cost to AUM	8.0	7.7	7.9	7.6	7.4
Productivity (Rs Mn)					
AUM per Branch	31.1	33.8	38.8	42.2	45.4
AUM per Employee	6.1	6.3	6.8	7.8	8.4
Employee per Branch	5.1	5.4	5.7	5.4	5.4
CRAR (%)					
Tier I	23.5	25.7	24.2	22.6	21.7
Tier II	0.5	0.4	0.6	0.6	0.6
Total	24.0	26.1	24.8	23.2	22.3
Asset Quality (%)					
Gross NPA	0.9	2.3	2.5	2.8	2.9
Net NPA	0.7	1.6	1.5	1.6	1.6
Provision Coverage	22.7	29.7	41.2	42.9	44.3
Credit Cost (excluding std asset)	0.2	0.9	1.1	0.6	0.6
Credit Cost (including std asset)	0.4	0.9	1.3	0.7	0.7
Return Ratio (%)					
ROE	13.2	24.8	19.7	20.4	20.7
ROA	2.9	5.4	4.3	4.2	4.1
Per Share (Rs)					
EPS	4.2	9.0	8.5	10.2	12.1
BV	32.8	39.9	46.2	53.8	62.9
ABV	31.9	37.3	43.4	50.0	58.1
Valuation (x)					
P/E	24.4	11.4	12.1	10.1	8.5
P/BV	3.1	2.6	2.2	1.9	1.6
P/ABV	3.2	2.8	2.4	2.1	1.8

Source: Company, Nirmal Bang Institutional Equities Research

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Muthoot Finance

26 March 2018

Reuters: MUTT.NS; Bloomberg: MUTH IN

Initiating Coverage

The Elephant Can Dance

Muthoot Finance (MUT) is a gold loan NBFC with a network of 4,303 branches and loan book size of Rs283bn. We are bullish on MUT as: (1) The mini crisis because of Demonetisation has stalled the largely unfinished re-rating process that had begun post the long-term gold loan crisis of FY12-FY16 (which had caused valuation to turn egregiously low) (2) MUT's truly vast and strategically located branches are a key advantage that cannot be replicated in a short time span (3) MUT's non-gold loan businesses are synergistic and are delivering robust growth (4) MUT is a branding machine that has ironed out the creases in its brand strategy (5) Gold loans remain a large under-penetrated loan market and Aadhaar coverage is driving a shift of business from informal lenders. We initiate coverage on MUT with a Buy rating and a target price of Rs471, valuing the stock at 2.0x/1.7x FY19E/FY20E P/BV.

Long-term and short-term crises over, MUT can now focus on growth: Demonetisation caused a seemingly persistent, but transient growth crisis at MUT as (a) Gold loans at MUT is a truly bottom-of-pyramid loan business with average ticket size at ~Rs40,000. (b) Drought conditions in parts of South India was an incremental factor. This stalled the largely unfinished re-rating of MUT that had started after the long-term gold loan crisis of FY12-FY16. Now, after flattish absolute growth of 0.5% over four quarters (2QFY17-2QFY18), MUT has delivered 2.0% growth QoQ in 3QFY18, which is significantly encouraging from an annualised perspective.

MUT's vast and strategically located branch network is a key advantage: MUT has 4,303 gold loan branches compared with 399-3,313 for key private sector gold loan players, barring HDFC Bank at 4,734. Further, 70% of MUT's branches are located in rural centres as of 3QFY18-end, underlining its superior reach, which is key given that ~65% of Indian household gold holdings are in rural areas. Replicating MUT's network size and deep penetration is not straightforward for key competitors from an opex perspective.

MUT's non-gold loan businesses are synergistic and have high operating leverage: Given MUT's bottom-of-pyramid pedigree, it made sense for it to expand into microfinance, retail financing in Sri Lanka, small-ticket housing and insurance broking. Non-gold loan businesses, which currently account for 8% of group AUM, as guided by the management, are slated to go up ~15% as a share of group AUM by FY19E. All these businesses (other than Sri Lankan subsidiary) are significantly synergistic to MUT's gold loan business from a reach and clientele perspective.

MUT is a branding machine that has ironed out the creases existing in its brand strategy: MUT has been ranked as India's most trusted financial services brand in 'The Brand Trust Report, India Study 2017'. MUT, in 4QFY18, signed on film star Amitabh Bachchan as its all-India brand ambassador, a celebrity who has a significant pan-India appeal. It has also engaged with IPL cricket team Chennai Super Kings (CSK) as principal team partner. MUT stands to benefit from the performance consistency and brand strength (especially in South India) of CSK.

Valuation and outlook: We have used the residual income model to value MUT and arrive at our target price of Rs471. MUT currently trades at 1.6x/1.4x FY19E/FY20E P/BV and we believe that our target price is reasonable given MUT's RoE profile of 20.6%/20.1% for FY19E/FY20E and long-term outlook.

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Net Interest Income	25,552	33,609	40,965	42,671	47,837
Pre-Provision Profit	14,791	22,026	29,115	29,775	33,551
PAT	8,095	11,798	17,262	17,944	20,799
EPS (Rs)	20.3	29.5	43.2	44.9	52.1
BV (Rs)	140.8	163.1	199.1	236.8	281.6
P/E (x)	18.8	12.9	8.8	8.5	7.3
P/BV (x)	2.7	2.3	1.9	1.6	1.4
Gross NPA (%)	*2.9*	*2.1*	*5.0*	*3.0*	*2.5*
Net NPA (%)	*2.5*	*1.7*	*4.1*	*1.9*	*1.5*
ROA (%)	*3.0*	*4.1*	*5.5*	*5.3*	*5.4*
ROE (%)	*15.1*	*19.4*	*23.9*	*20.6*	*20.1*

Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: NBFCs

CMP: Rs381

Target Price: Rs471

Upside: 24%

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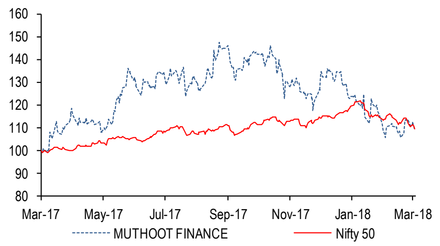
Key Data

Current Shares O/S (mn)	399.9
Mkt Cap (Rsbn/US$bn)	152.6/2.3
52 Wk H / L (Rs)	526/348
Daily Vol. (3M NSE Avg.)	803,645

Shareholding (%)	3QFY18	2QFY18	1QFY18
Promoter	73.6	73.7	73.7
FII	26.4	26.3	26.0
Others	22.7	18.8	15.4

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
Muthoot Finance	(1.6)	(21.8)	7.9
Nifty Index	(4.8)	0.2	9.9

Source: Bloomberg

Mini crisis after FY12-FY16 crisis cloaks unfinished re-rating journey

Re-rating had started for MUT when it began to emerge from the **long-term crisis that stretched over FY12-FY16**. However, this re-rating was stalled because of the mini crisis caused by Demonetisation, but, importantly, **in 3QFY18 this mini crisis too has played out** and investors can now look forward to the resumption of the earlier re-rating journey, which has still a long way to go before it is complete.

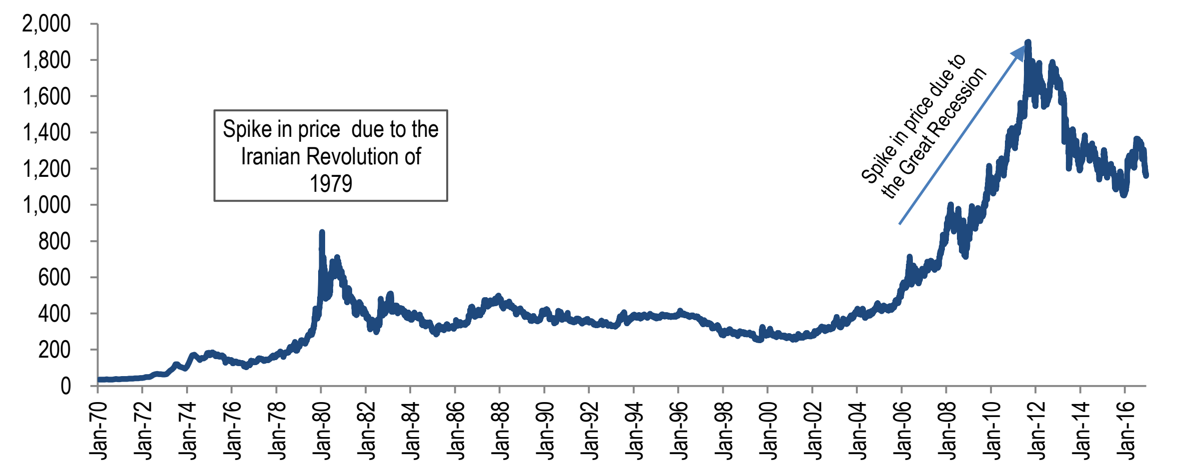
Long-term crisis created a truly distressed valuation level from where re-rating had initially begun and we do not expect a similar long-term crisis to repeat

The long-term crisis for MUT over FY12-FY16 was the result of (1) a **sustained bear market** in gold prices, (2) a **worsening of the regulatory regime** for gold loans because of (a) capping of loan-to-value (LTV) ratio at 60% and (b) removal of priority sector status for gold loans. We stress that this long-term crisis will not re-emerge as (1) the sustained bear market in gold prices of the nature that occurred over 2011-16 is a **once-in-a-generation phenomenon** and (2) the regulatory regime, on balance, has improved with LTV cap being increased to 75%.

What the long-term crisis did, however, was that it brought the MUT's valuation to a truly distressed level from where the re-rating initially began. Consequently, **even after the stock price had risen significantly from a long-term low**, the re-rating, as dictated by fundamentals, was far from complete.

We believe the probability of a sustained bear market (i.e. with a significant overall drawdown) in gold prices of the nature witnessed over 2011-16 (overall drawdown from peak to trough was 45%) is low as (1) The **previous such phenomenon was witnessed as far back as the early 1980s** (2) Gold retains its property as (a) a **store of value/safe haven** over the long-term including from risk assets and central-bank administered fiat currencies (especially more so after unbridled volatility in crypto-currencies) and (b) a **hedge against inflation** over the long-term since, while global inflation remains tepid, it is still positive with deflation scare having been averted.

Exhibit 1: Generational gold price chart – 1970-2018



Source: Company, Nirmal Bang Institutional Equities Research

Mini crisis that resulted from Demonetisation also behind MUT now

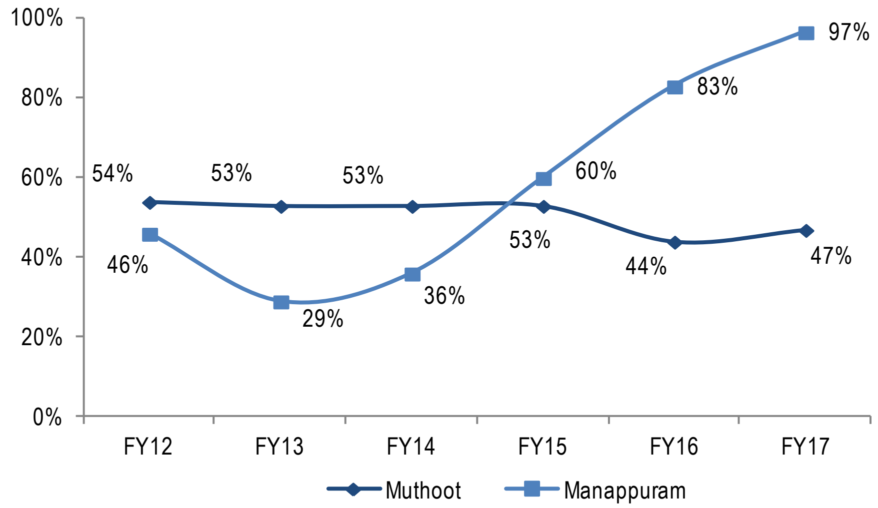
Demonetisation announced on 8 November 2016 was a body blow to the gold loan business of MUT as **gold loans are a truly bottom-of-the-pyramid business** (with average ticket size of ~Rs 40,000), which was hugely impacted by the cash cycle disruption caused by demonetisation.

However, in 3QFY18, **green shoots were clearly visible with gold loan AUM growing 2.0% QoQ**. This came after a flattish 0.5% absolute growth over four quarters, 3QFY17-2QFY18.

Strategy of allowing full flexibility on loan tenure positive from a client retention perspective

The strategy of the two key listed gold loan NBFCs viz. MUT and Manappuram Finance **regarding loan tenures has diverged** in recent years. While Manappuram Finance capped loan tenure at three months, MUT offered full flexibility in loan tenure, with tenures ranging up to 12 months.

Exhibit 2: Proportion of gold loan with residual maturity < 3 months – FY12-FY17



Source: Company, Nirmal Bang Institutional Equities Research

We stress that both strategies have their pros and cons and can co-exist in the gold loan market. While Manappuram Finance's strategy reduces asset quality risk from gold price movement, it runs the risk of client base erosion, especially during times of cash crunch like that after Demonetisation. In the immediate aftermath of Demonetisation, **gold loan AUM of MUT was more resilient,** staying largely flat over the four quarters 3QFY17-2QFY18, growing 0.5% compared with -13% absolute decline for Manappuram Finance over two quarters 4QFY17-1QFY18.

MUT offering extra time to overdue customers is also a positive from customer retention perspective

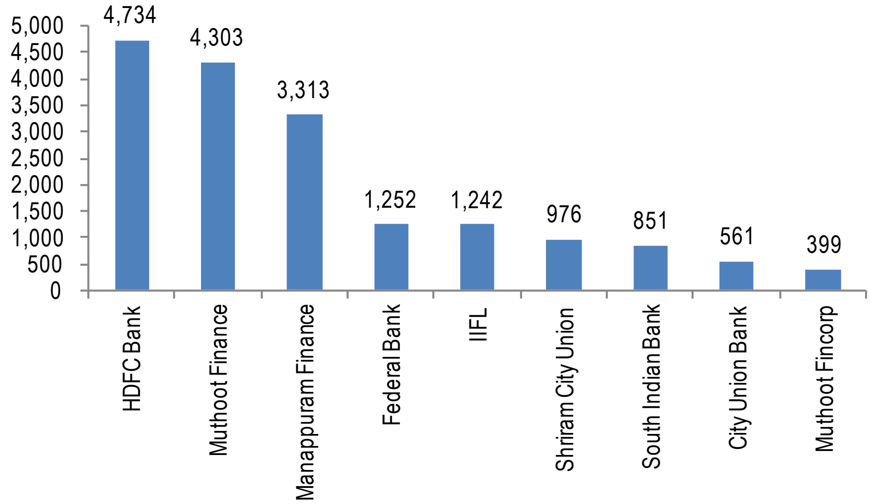
Not only is MUT offering full flexibility on loan tenure, it is also adopting a flexible stand when it comes to auctioning of collateral against gold loans that have fallen overdue. While most loans are of longer tenure (from a gold loan perspective), many still had smaller residual maturity and became due (and ultimately overdue) during the aftermath of Demonetisation. **MUT decided to remain lenient when it came to loans that fell overdue and did not auction the collateral readily**, while offering customers a longer time to repay. As a consequence of this approach, the headline GNPA ratio of MUT at 5.6% as of 3QFY18-end is comparably much higher than 0.7% in case of Manappuram Finance.

High headline GNPA ratio of MUT is not a cause for undue alarm from an investor perspective as the gold loan business is significantly different from other lending business since (1) the collateral is in possession of the lender and (2) the collateral is highly liquid with minimal hair cut (comparatively) experienced during disposal. Hence, the high GNPA ratio is merely technical in nature and **MUT can choose to dispose of the collateral with a minimal loss in case of loan default**.

MUT's branch network is a competitive advantage that competitors cannot replicate overnight

The total branch count of MUT stands at 4,303 compared with 399-3313 for key players, barring HDFC Bank at 4,734 in the formal gold loan industry. This is a key advantage for MUT which competitors cannot replicate rapidly.

Exhibit 3: Branch count – MUT vs. key gold loan players – 3QFY18



Source: Company, Nirmal Bang Institutional Equities Research

Rural/semi-urban reach key advantage for MUT compared with competitors

Reach is key for disbursing gold loans as a significant chunk of Indian households' gold holdings are located outside metro/Tier 1 centres. It is estimated that **rural India holds ~65% of India's physical gold stock**. In its 3QFY16 presentation, MUT had stated that 70% of its branches are present in rural and under-served areas. At that time, their branch count was 4,200+ compared with 4,300+ as of 3QFY18-end implying their branches, een as on date, focus on rural and semi-urban centres.

Presence in southern region also an advantage for MUT vis-à-vis competition

A separate, independent, vector that hands MUT a superior reach is its significant presence in South India. 62% of MUT's gold loan AUM is sourced from South India. It is estimated that **~40% of India's gold demand emanates from South India**.

MUT has built its hard-to-replicate branch network over the years as it was a monoline company for long

While there are certainly several lending institutions operating in rural India as well as those that are focused on South India, there may not be many which have a large branch count, have a rural focus and have a South India focus, all simultaneously. In that, MUT is somewhat unique along with a fellow-listed gold loan NBFC, Manappuram Finance. **Such a branch network for MUT has been the result of it being in existence (in its current avatar) as a focused monoline gold loan player (till recently) since 1939,** adding branches steadily to suit its monoline strategy. Banks and diversified NBFCs which compete with MUT did not build a similar branch network over the years as theirs was not a monoline business and were focused on high-value (non-gold loan) customers in tier 1 centres with a smaller branch count. Moreover, in any case, mere presence of bank branch at a given location may not mean competition as the branch may not even be 'activated' (readied) to make gold loans.

MUT has a nimble management and has actively diversified into synergistic non-gold loan businesses

MUT is now a multi-product player having diversified into microfinance, retail financing in Sri Lanka, small-ticket affordable housing, and insurance broking. The key similarity in these new businesses (other than the Sri Lankan subsidiary) is that they are **significantly synergistic to MUT's gold loan business from a reach and type of clientele perspective**.

Other means of synergy include **access to current gold loan client base for alternate loan products**.

The traction in non-gold businesses is strong and these businesses currently make up 8% of group loan AUM. The Management has given guidance that this is **expected to go up to ~15% by FY19E**.

MUT is a branding machine that has ironed out erstwhile creases on this front

MUT has been ranked as **India's most trusted financial services brand** in 'The Brand Trust Report, India Study 2017' conducted by TRA Research. A client base of ~6mn indicates that MUT has done a superlative job creating a financial services brand over the years.

Some of the key investments of MUT in brand building over the past decade, however, had been sub-optimal. MUT had eschewed using Bollywood actors and relied upon sportsmen as celebrity brand endorsers. MUT's primary brand endorsers during this phase were IPL cricket team Delhi Daredevils and specific individual team members (Virdendra Sehwag, Gautam Gambhir, Dinesh Karthik), and football star Bhaichung Bhutia. These investments proved to be sub-optimal as Delhi Daredevils consistently under-performed as a team in the IPL (Indian Premium League) cricket matches and Bhaichung Bhutia was in the twilight of his playing career and retired from international football in 2011. However, **MUT is likely to bounce back from these disappointments** as it has in 4QFY18 (1) signed on Amitabh Bachchan, someone who has a significant pan-India appeal, as its all-India brand ambassador. (2) It has also engaged with IPL cricket team Chennai Super Kings (CSK) as its principal team partner and stands to benefit from CSK's significant performance consistency and brand strength (especially in South India).

Valuation and Outlook

We use the Residual Income Model to arrive at a first-principles' fair value for MUT. We assume a long-term sustainable average risk-free rate of 7% for India, an Adjusted Beta of 1.1 for MUT and an India-specific Equity Risk Premium of 6% and arrive at the overall Cost of Equity of 13.6% for MUT. On this basis, **we arrive at a price target of Rs 471, at which the stock will trade at 2.0x/1.7x FY19E/20E book value**.

MUT **currently trades at a FY19E/20E P/BV of 1.6x/1.4x, which makes it significantly under-valued** given its FY19E/20E RoE profile of 20.6%/20.1% and long-term outlook. Consequently, we believe that the multiple of 2.0x/1.7x implied by our price target of Rs 471 is reasonable.

Exhibit 4: Consensus vs Our Estimates

	Our estimate			Bloomberg estimate			*% Variance*		
(Rsmn)	**FY18E**	**FY19E**	**FY20E**	**FY18E**	**FY19E**	**FY20E**	***FY18E***	***FY19E***	***FY20E***
Net interest income	40,965	42,671	47,837	41,221	40,929	45,497	*(0.6)*	*4.3*	*5.1*
Operating profit	29,115	29,775	33,551	27,793	28,523	31,835	*4.8*	*4.4*	*5.4*
Profit after tax	17,262	17,944	20,799	17,036	17,356	18,892	*1.3*	*3.4*	*10.1*

Source: Company, Nirmal Bang Institutional Equities Research

Key Risks

Loss of business share or cannibalization of gold loan business by microfinance

Since certain clientele of gold loan business may belong to bottom-of-the-pyramid low income groups, such customer set may be attracted to microfinance since the latter is collateral-free at similar interest rates. Mitigating factors for Muthoot are (1) not all gold loan clientele would **qualify** for microfinance, given strict definition of microfinance 'qualifying asset' (2) Muthoot has itself meaningfully **diversified** into microfinance and can cater to those clients who are intent on shifting over (3) gold loan business does not entail credit appraisal and hence, **all clients are welcome** as long as they possess gold collateral, even those who have been shut of microfinance due to default during Demonetisation and otherwise, enabling a shift from microfinance to gold loans.

Since some gold loans and all of microfinance caters to the bottom-of-the-pyramid, theoretical risk of political interference remains

Local, junior-level politicians remain a theoretical risk and may attempt to influence borrowers to default in times of crises. Mitigating factors for Muthoot are (1) although there have been two crises in microfinance (a) Andhra Pradesh crisis in 2010 (b) Demonetisation, both are essentially non-repeatable black swan scenarios. Andhra Pradesh crisis was an institutionalized crackdown on the formal microfinance industry carried out by the then state government. Since then no state government, central government or regulator (RBI) has carried out any such move since the **institutions now realize** that formal bottom-of-the-pyramid lenders serve to prevent the exploitation of low income groups from moneylenders / pawnbrokers who charge usurious interest rates far higher than formal lenders. Also, Demonetisation events are not frequent and have tended to be carried out in **gaps** of several decades. Furthermore, there is now awareness on the ground that default has severe consequences in terms of **credit history** being spoilt and borrowers have wisened up in terms of repayment behavior.

Company Overview

Muthooth Finance is a Gold Loan NBFC with a branch network of 4303 branches and has an AUM of Rs 283bn, of which the Gold, and other Loans split is 99%, and 1%, respectively (own classification). Muthooth Finance has displayed a loan CAGR of 5% over FY12-17. Its yield on advances in its latest reported quarter was 21.8%

Muthooth Finance's cost of funds is 8.6% and, as a result, it registered a net interest margin of 15.1%. Its cost to income ratio stood at 29.3%. Consequently, it delivered a return on assets of 6.6% and a return on equity of 24.5%, implying a financial leverage of 3.7. Its customer base stood at 7.6mn. Its Capital Adequacy Ratio was 27.7%.

Exhibit 5: Management team/ Key executives

Name	Designation	Experience
Alexander George Muthoot	Director – Operations	MBA graduate in International Management from Thunderbird School of Global Management, USA with a specialization in Marketing
K. R. Bijimon	Chief General Manager	Over 15 years of experience in the field of financial services and is employed in the Company since inception Fellow Member of the Institute of Chartered Accountants of India, New Delhi
Oommen K. Mammen	Chief Financial Officer	Fellow member of the Institute of Chartered Accountants of India Certified Associate of Indian Institute of Banking and Finance, Mumbai.

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 6: Board members

Name	Designation	Experience
M. G. George Muthoot	Chairman	Graduate in engineering from Manipal University, and is a businessman by profession. He is the National Executive Committee Member of the Federation of Indian Chamber of Commerce and Industry ("FICCI") and the current Chairman of FICCI-Kerala State Council
George Alexander Muthoot	Managing Director	Chartered accountant with Bachelor degree in Commerce from Kerala University Chairman of the Kerala Non banking Finance Companies Welfare Association from 2004 to 2007 and is currently its Vice Chairman Member Secretary of Finance Companies Association, Chenna
George Jacob Muthoot	Joint Managing Director	Civil engineer from Manipal University and is a businessman by profession Member of the Trivandrum Management Association, the Confederation of Real Estate Developers Association of India (Trivandrum) and the Trivandrum Agenda Task Force
George Thomas Muthoot	Joint Managing Director	Three decades of operational and management experience in Financial Services and has played a key role in managing the fast growing operations of the company.
Alexander George Muthoot	Whole time Director	MBA Graduate from Thunderbird University (USA), advanced diploma holder in Business Administration from Florida International University, Miami (USA)
John K. Paul	Independent Director	Director of Popular Automobiles Limited, Popular Vehicles & Services Limited, in Kerala and of Popular Mega Motors (India) Limited., the dealer for TATA Commercial Vehicles Trustee of the Kuttukaran Institute for HRD
K. John Mathew	Independent Director	Retired judge of the High Court of Kerala, ex-Chairman of the Cochin Stock Exchange and was a SEBI nominee director of the Cochin Stock Exchange from 2002 to 2007
K George John	Independent Director	ex-Chairman & Managing Director of TBWA india
George Joseph	Independent Director	Former chairman and managing director of Syndicate Bank, Certified associate of the Indian Institute of Banking and Finance
Pamela Anna Mathew	Additional Director	Managing Director of O/E/N India Limited.

Source: Company, Nirmal Bang Institutional Equities Research

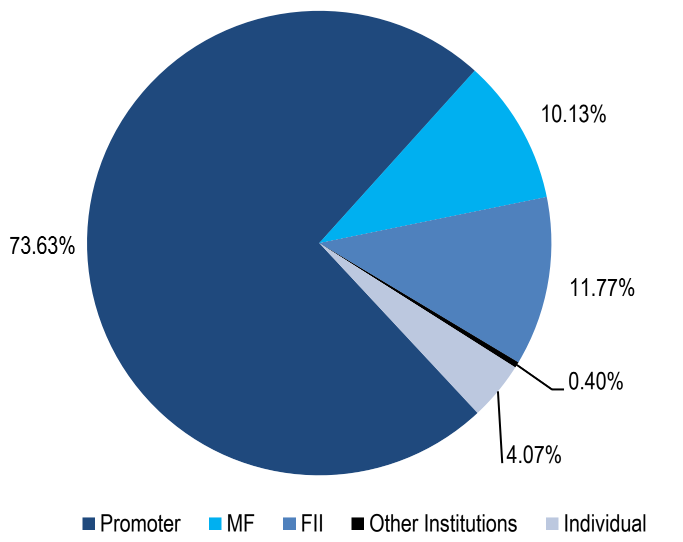
Shareholding Information

Exhibit 7: Key shareholders

	(%)
Promoter	
Promoter and promoter group	73.63
Non - promoter	
Reliance Capital Trustee Company Limited	3.26
Aditya Birla Sun Life Trustee Private Limited	1.59
Icici Prudential Focused Bluechip Equity Fund	1.56
Sbi Magnum Global Fund	1.18
Tata Mutual Fund- Tata Equity P/E Fund	1.07
Goldman Sachs India Limited	1.07
Gmo Emerging Domestic Opportunities Fund	1.06
Alternate Investment Funds	0.28

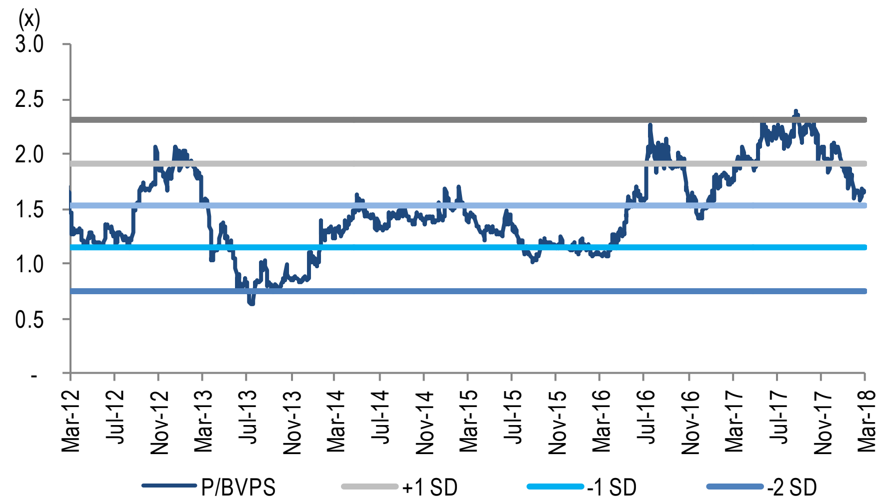
Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 8: Shareholding pattern



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 9: One year forward P/BV



Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 10: Income statement

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Interest Income	48,129	56,547	60,148	63,801	71,852
Interest Expense	22,577	22,938	19,183	21,130	24,015
Net Interest Income	**25,552**	**33,609**	**40,965**	**42,671**	**47,837**
Non Interest Income	621	920	772	786	904
Net Revenue	**26,173**	**34,529**	**41,737**	**43,457**	**48,741**
Operating expenses	11,382	12,503	12,622	13,682	15,190
-Employee expenses	6,419	7,280	6,877	7,362	8,238
-Other expenses	4,963	5,223	5,745	6,320	6,952
Operating profit	**14,791**	**22,026**	**29,115**	**29,775**	**33,551**
Provisions	1,625	2,816	2,143	1,738	1,053
PBT	13,167	19,210	26,972	28,037	32,498
Tax	5,072	7,412	9,710	10,093	11,699
PAT	**8,095**	**11,798**	**17,262**	**17,944**	**20,799**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 12: Balance sheet

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Share capital	3,990	3,995	3,995	3,995	3,995
Reserves & surplus	52,202	61,170	75,547	90,606	108,519
Networth	**56,192**	**65,165**	**79,542**	**94,601**	**112,514**
Borrowings	185,669	209,855	216,443	237,976	278,483
Other liability & provisions	28,626	32,111	27,465	23,166	17,661
Total liabilities	**270,487**	**307,131**	**323,450**	**355,742**	**408,658**
Fixed Assets	2,273	2,182	2,400	2,640	2,904
Investments	983	2,091	2,091	2,091	2,091
Loans	243,355	272,199	285,809	314,390	361,548
Cash	6,791	15,343	17,149	18,863	21,693
Other assets	17,085	15,316	16,001	17,758	20,422
Total assets	**270,487**	**307,131**	**323,450**	**355,742**	**408,658**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 11: Key ratios

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Growth (%)					
Net Interest Income	18.1	31.5	21.9	4.2	12.1
Operating Profit	38.9	48.9	32.2	2.3	12.7
Profit After Tax	20.7	45.8	46.3	3.9	15.9
Business (%)					
Advance Growth	4.2	11.9	5.0	10.0	15.0
Spreads (%)					
Yield on loans	20.2	21.9	21.6	21.3	21.3
Cost of Borrowings	11.9	11.6	9.0	9.3	9.3
Spread	8.3	10.3	12.6	12.0	12.0
NIMs	10.7	13.0	14.7	14.2	14.2
Operational Effeciency (%)					
Cost to Income	43.5	36.2	30.2	31.5	31.2
Cost to AUM	4.8	4.9	4.5	4.6	4.5
Productivity (Rs Mn)					
AUM per Branch	57.0	63.2	72.7	83.6	96.1
AUM per Employee	10.7	11.2	12.8	14.4	16.3
Employee per Branch	5.3	5.6	5.7	5.8	5.9
CRAR (%)					
Tier I	20.9	21.8	25.3	27.4	28.3
Tier II	3.6	3.1	3.4	3.4	3.5
Total	24.5	24.9	28.8	30.8	31.8
Asset Quality (%)					
Gross NPA	2.9	2.1	5.0	3.0	2.5
Net NPA	2.5	1.7	4.1	1.9	1.5
Provision Coverage	14.5	18.1	18.0	36.0	40.0
Credit Cost (excluding std asset)	0.2	0.1	0.7	0.5	0.2
Credit Cost (including std asset)	0.7	1.1	0.8	0.6	0.3
Return Ratio (%)					
ROE	15.1	19.4	23.9	20.6	20.1
ROA	3.0	4.1	5.5	5.3	5.4
Per Share (%)					
EPS	20.3	29.5	43.2	44.9	52.1
BV	140.8	163.1	199.1	236.8	281.6
ABV	125.8	151.6	169.8	221.7	268.1
Valuation (x)					
P/E	18.8	12.9	8.8	8.5	7.3
P/BV	2.7	2.3	1.9	1.6	1.4
P/ABV	3.0	2.5	2.2	1.7	1.4

Source: Company, Nirmal Bang Institutional Equities Research

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Capital First

26 March 2018

Initiating Coverage

Reuters: CAPF.NS; Bloomberg: CAFL IN

A New Beginning

Capital First (CFL) is an MSME-focused NBFC with a network of 229 branches and loan book size of Rs248 bn. We are neutral on CFL because, while the merger with IDFC Bank has significant potential synergies, re-orienting the combined entity adequately towards retail liabilities will take time. We believe the merger, if implemented, will create a combined entity that could benefit from the significant complementarity of client bases of the two amalgamating entities. The combined entity can tap into the cumulative retail client base of CFL (5mn) to push, potentially, the entire gamut of retail loan products, while simultaneously leveraging bank access to low-cost deposits franchise - something that could now be ramped up by selling liability products as well to CFL's client base, particularly CASA. However, while the retail proportion of credit book for the combined entity will be 47% right away, core deposits as a share of funding will be only 7%. We initiate coverage on CFL with an Accumulate rating and a target price of Rs 682, valuing the stock at 2.2x/1.9x FY19E/FY20E P/BV.

Access to low-cost funding is key from CFL's perspective: CFL, being an NBFC, hitherto did not have access to low-cost liability franchise available to banks. Post merger with IDFC Bank, this opportunity will open up for the retail client base (5mn) of CFL and the combined entity will be able to add retail liabilities, including CASA. There will also be incremental opportunity for current account traction, given that CFL is MSME-focused (57% of 2QFY18 AUM). However, on an as-is basis, the combined entity's share of core deposits in total funding will be just 7%.

Complementarity of client base could drive material synergies: IDFC Bank's retail proportion of funded credit book is only 28.8%, whereas as much as 93% of CFL's AUM comprises retail loans. In fact, of the 2.4mn customer base of IDFC Bank, 1.3mn belongs to the erstwhile Grama Vidiyal, which has NBFC-MFI pedigree. For CFL, MSME contributes 57% to AUM, consumer durable loans 14%, two-wheeler loans 11%, home loans 4% and used cars 3%, pointing to very significant client base complementarity. Transfer of significant technology and analytics knowhow from CFL to the combined entity also augurs well for retail lending.

Given recent experience of IDFC Group, amalgamating entities may be well prepared to push through the merger: We believe that IDFC Bank's management may have taken into confidence all key IDFC shareholders, including Government of India and Malaysia sovereign wealth fund-affiliate into confidence, especially with regard to valuation, before making any announcement. Unlike the IDFC Group-Shriram Group deal, the merger swap ratio is explicitly known at the outset (139 IDFC Bank shares per 10 CFL shares). We note that, as per RBI stipulation, IDFC shareholding in IDFC Bank (combined entity) cannot fall below 40% and, therefore, we are likely to get more clarity on this aspect in the near term.

Valuation and outlook: We have used the residual income model to value CFL and arrive at the target price of Rs 682. CFL currently trades at 2.0x/1.7x FY19E/20E P/BV and we believe that our target price is reasonable given CFL's RoE profile of 15.1%/16.5% for FY19E/FY20E and long-term outlook.

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Net Interest Income	8,175	13,009	18,448	24,091	30,503
Pre-Provision Profit	4,884	8,103	10,640	13,834	17,702
PAT	1,661	2,390	3,082	4,184	5,316
EPS (Rs)	18.2	24.5	31.6	43.0	54.6
BV (Rs)	186.8	236.5	265.0	304.9	356.3
P/E (x)	34.1	25.3	19.6	14.4	11.4
P/BV (x)	3.3	2.6	2.3	2.0	1.7
Gross NPA (%)	*1.0*	*0.9*	*1.6*	*1.9*	*2.2*
Net NPA (%)	*0.5*	*0.3*	*0.8*	*0.9*	*1.0*
ROA (%)	*1.3*	*1.5*	*1.5*	*1.6*	*1.7*
ROE (%)	*10.1*	*11.9*	*12.6*	*15.1*	*16.5*

Source: Company, Nirmal Bang Institutional Equities Research

ACCUMULATE

Sector: NBFCs

CMP: Rs619

Target Price: Rs682

Upside: 10%

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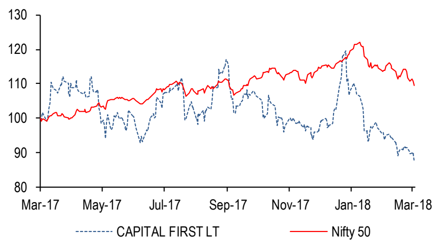
Key Data

Current Shares O/S (mn)	99.0
Mkt Cap (Rsbn/US$mn)	60.9/936.8
52 Wk H / L (Rs)	902/614
Daily Vol. (3M NSE Avg.)	126,852

Shareholding (%)	3QFY18	2QFY18	1QFY18
Promoter	35.6	36.0	36.0
Public	64.4	64.0	64.0
Others	-	-	-

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
Capital First	(8.4)	(20.7)	(14.5)
Nifty Index	(4.8)	0.3	10.0

Source: Bloomberg

Merger with IDFC Bank potentially synergistic but challenges remain

While the merger of CFL with IDFC Bank is potentially synergistic, the **combined entity will be faced with some key challenges** which include (1) Build-up of **retail liabilities** will be contingent on converting CFL loan client base into captive retail liabilities clients. (2) Meeting **priority sector lending** targets could still be a bit of a challenge even with CFL clients on board. (3) **Opex control** is a near-term challenge as the combined entity would still require rapid branch expansion mode, albeit on a low-cost branch model, which IDFC Bank's management espouses. (4) **Growth** could also be a near-term challenge as IDFC Bank is actively reducing its infrastructure loan book. (5) **Asset quality** could become a challenge in the wildcard environment of NCLT end-game, given high infrastructure exposure of IDFC Bank, although the latter is reasonably provisioned on legacy-stressed book that it inherited from IDFC Limited.

We carried out a scenario analysis for **potential CASA as a share of funds** (which is the more relevant metric to track in the near term than CASA ratio) and found that CASA as a share of funds could be 9.2% for the combined entity. This means that the combined entity will still need to significantly source CASA deposits from new clients going forward.

Exhibit 1: Analysis of potential CASA deposits as a percentage of total funding

	CFL	IDFC Bank	Combined
AUM / Funded credit book	247.6	638.7	886.3
Proportion of retail	93.0%	28.8%	46.7%
Retail portion of credit book	230.2	183.9	414.2
CASA	-	42.5	42.5
FD	-	232.6	232.6
Core deposits	-	79.9	79.9
CASA Ratio	NA	10.1%	10.1%
CASA + FD + CD	-	421.2	421.2
Core deposits Ratio	NA	19.0%	19.0%
Funding book	187.3	950.4	1137.7
Core deposits as share of Funds	-	8.4%	7.0%
CASA as a share of funds	-	4.5%	3.7%
Client base (mn)	5.0	2.4	7.4
CASA per client (Rs)	NA	17754.6	5751.8
	Bear case	**Base case**	**Bull case**
Cumulative client base of CFL (mn)	5.0	5.0	5.0
Customer who adopt captive CASA	10%	25%	40%
Steady state CASA per customer (Rs)	25,000	50,000	75,000
CASA accretion due to customer adoption	12.5	62.5	150
Combined funding book	1137.7	1,137.7	1,137.7
Gross potential CASA	55.0	105.0	192.5
CASA + FD + CD	421.2	421.2	421.2
Potential CASA ratio	13.1%	24.9%	45.7%
Potential CASA as a share of funds	4.8%	9.2%	16.9%

Note: It is to be noted that the client base of IDFC Bharat is 1.3mn, which is not a key CASA base. Excluding IDFC Bharat clients, the CASA per customer would be Rs38,814 for IDFC Bank.

Source: Company, Nirmal Bang Institutional Equities Research; Rupee figures are in bn unless otherwise stated

Rationale for merger deal with IDFC Bank

- Our view is that, hitherto, it was understood that banks and NBFCs had complimentary clientele. Banks focused on corporate, SME and retail clients, the latter being regular salaried, larger ticket size, lower opex ratio and located in metro/Tier 1 centres, especially uptown. NBFCs tended to cater more to those who were under-served by banks. However, in search of long-term growth on a risk-adjusted basis, banks are increasingly attracted to the traditional NBFC client base and NBFCs are sensing this increased competition. NBFCs realise that it may be a matter of time that banks build the required reach and then the latter's cost of funds advantage may kick in. Shift of clients to banks could, potentially, be more acute for MSME-focused NBFCs like CFL due to advent of GST. Hence, the **desire to sit inside a bank via the merger and access low-cost funding**. This is the primary broad rationale from CFL's perspective.
- It is to be noted that IDFC Bank is currently not retailised even on the liability side as CASA ratio is just 8.2% as of 2QFY18-end. However, IDFC Bank, post-merger, will be able to **access CFL's retail client base of 5mn customers and build the required CASA franchise rapidly**, if post-merger implementation proceeds desirably.
- There is **significant complementarity in the two amalgamating entities from a business focus perspective**. IDFC Bank has 28.8% retail share in its funded credit book whereas CFL has 93% retail share in its AUM. So, IDFC Bank is a significantly wholesale-focused (so far) bank whereas, CFL is a significantly retailised NBFC. It is IDFC Bank's stated intention to retailise on the asset side and hence, CFL is a natural fit from that perspective and significant synergies could arise for the combined entity going forward.
- **CFL has a cumulative retail client base of 5mn**, which IDFC Bank will tap to sell, potentially, the entire gamut of retail loan products. As discussed above, IDFC Bank will also tap this client base to push liability products, particularly CASA. There could be good traction for current accounts given that CFL is significantly MSME-focused (57% of 2QFY18 AUM).
- While IDFC Bank has 2.4mn customers, of this 1.3mn belong to IDFC Bharat business, which is the erstwhile Grama Vidiyal entity, an NBFC-MFI acquired earlier by IDFC Bank. MFI customers typically have an average loan ticket size close to Rs25,000 whereas CFL MSME customers have an average ticket size of Rs7.4mn, implying the latter's **client base is not only significantly larger but also fairly complementary to IDFC Bank's**. CFL's consumer durable and two-wheeler average ticket sizes are Rs53,000 and Rs22,000, respectively, but typical MFI customers may not be purchasers of such products.
- **CFL has been a robust adopter of technology and analytics** and IDFC Bank will gain these capabilities after the merger. This is something IDFC Bank has explicitly stated in its BSE release on the planned merger. CFL has effectively used analytics for sourcing and credit appraisal of consumer durable loans, two-wheeler loans and personal loans and this has helped control credit costs compared with its own past.
- Incremental reasons cited by IDFC Bank include **cost-effective recovery mechanism and large collection architecture of CFL**, which is linked to third-party entities such as collecting banks, mobile companies and e-wallets, which can also be used to aid the scale-up of businesses of the combined entity.

Shareholding pattern in the combined entity

- Assuming 100% of CFL is being merged and IDFC Limited or affiliates already do not own any stake in CFL, **IDFC's stake in the combined entity will fall to 37.6%**. IDFC currently owns 52.8% in IDFC Bank.
- When IDFC Limited had applied for a universal bank licence and obtained one from the RBI, the latter had stipulated that **IDFC cannot bring down its stake in IDFC Bank below 40% for the next five years**. Hence, we need to (and are likely to) learn more about the structure of this deal.
- **Warburg Pincus affiliates**, which currently owns 35.6% in CFL, will see its ownership in the combined entity dropping to 10.2%.

Exhibit 2: Calculation of change in shareholding pattern

Current ownership structure of IDFCB	
IDFC (through NOFHC)	52.8%
Others	47.2%
Current shares outstanding of IDFC Bank (mn)	**3,402.6**
Shares held by:	
IDFC (through NOFHC)	1,797.5
Others	1,605.1
Current ownership structure of CFL	
Warburg Pincus affiliates	35.6%
Others	64.4%
Current shares outstanding of CFL (mn)	**98.9**
Shares held by:	
Warburg Pincus affiliates	35.2
Others	63.7
Number of IFDC Bank shares for every 10 CFL shares	**139**
Swap ratio (IDFCB: CFL)	13.9
New shares of IDFC Bank to be issued	**1,374.5**
New shares to be given to:	
Warburg Pincus affiliates	489.1
Others	885.5
Total shares outstanding eventually of IDFC Bank (combined Entity)	
Current shares outstanding of IDFC Bank (mn)	3,402.6
New shares of IDFC Bank issued	1,374.5
Total	4,777.2
Final shareholding of IDFC Bank (combined ntity)	
IDFC	37.6%
Warburg Pincus affiliates	10.2%
Others	52.1%

Source: Company, Nirmal Bang Institutional Equities Research

Considerations regarding whether the new deal will face any headwinds

- The primary reason why the previous deal announced by IDFC Group entities with Shriram Group entities fell through, as per media reports, was dissatisfaction on valuation from certain IDFC shareholders. As per the shareholders, that deal was being anchored around the **valuation of IDFC Bank**, which was unduly depressed (according to said shareholders). While Government of India (GoI) holds 16.37% in IDFC as of 2QFY18, investors raising objections, according to media reports, included Sipadan Investments (an arm of Malaysia's sovereign wealth fund, Khazanah Nasional) and Enam Holdings. Sipadan Investments holds 9.47%in IDFC while Enam is outside Top 10 shareholders, as of 2QFY18. **We believe IDFC Bank will be wiser by this experience and could have taken key shareholders into confidence** before making an announcement regarding CFL. Apart from its stake in IDFC, the GoI also holds 7.68% directly in IDFC Bank as of 2QFY18-end.
- As discussed in the previous section, and as per our calculation, **the shareholding of IDFC Limited in IDFC Bank (combined entity)** would fall to 37.6%. Since this is not allowed as per RBI stipulation, we should learn more on this aspect in the near term. We note that, in the case of IDFC Group – Shriram Group deal, Shriram Capital, the holding company for Shriram Group entities, was to be merged with IDFC Limited. Consequently, the ownership of Shriram Capital in Shriram City Union was to be eventually transferred to IDFC, augmenting IDFC's eventual total ownership in IDFC Bank-SCUF combined entity to a figure above 40% (as required by the RBI).
- Though not a headwind for the new deal per se, **CRR/SLR requirements** would kick in for funding raised in the new combined entity, something that was absent in the CFL NBFC structure. **We believe that IDFC Bank would have done its math** in this regard and regard the deal as net positive on the basis of exhaustive internal modeling.

Key contours of the deal

- **Merger share swap ratio:** 139:10 i.e. 139 shares of IDFC Bank for every 10 shares of CFL.
- **Appointed Date:** 1 April 2018 (or other mutually agreed upon date) i.e. "Scheme" of merger comes into force on this date.
- **Period for completion** of scheme: 15 months (or other period mutually agreed upon).
- **Approvals required:** (1) Reserve Bank of India, (2) Competition Commission of India, (3) Stock exchanges, (4) Securities and Exchange Board of India (5) National Company Law Tribunal (6) National Housing Bank.
- **Mr. Vembu Vaidyanathan**, the current CEO of CFL, who has experience in building retail asset franchises, including at ICICI Bank, will assume the post of CEO of the combined entity. Mr. Rajiv Lall, current CEO of IDFC Bank, will become chairman of the combined entity.

Exhibit 3: Key comparative metrics as of 2QFY18-end

	IDFC Bank	CFL
Funded credit book / AUM (Rsmn)	651,770	22,9740
Retail proportion of credit book / AUM	27.5%	93.0%
GNPA ratio	3.9%	1.6%
NNPA ratio	1.6%	1.0%
Restructured Standard	1.0%	n/a
Security Receipts	3.2%	n/a
Customer base (mn)	1.9	5.0
CASA ratio	8.2%	n/a
RoE (2QFY18)	6.1%	13.1%

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 4: AUM break-up for CFL in 2QFY18

Secured SME	40%
Unsecured MSME	17%
Consumer durables	14%
Two-wheeler loans	11%
Home loans	4%
Used Car	3%
Other retail	4%
Wholesale	7%

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 5: Retail proportion of IDFC Bank's funded credit book in 2QFY18

Retail portion of IDFC Bank's funded credit book	180,640
Net advances	488,300
Credit substitutes	163,470
Total funded credit book	651,770
% Retail portion of IDFCB funded credit book	27.5%

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 6: Geographical distribution of network for IDFC Bank

	Branches	ATM
Madhya Pradesh	35	21
West Bengal	1	0
Meghalaya	1	0
Tripura	1	0
Haryana	1	2
Punjab	0	0
New Delhi	2	2
Uttar Pradesh	1	1
Telangana	1	0
Andhra Pradesh	3	0
Karnataka	18	8
Tamil Nadu	2	2
Gujarat	1	2
Maharashtra	7	9
Goa	0	0
Total	74	47

Source: Company, Nirmal Bang Institutional Equities Research

Valuation and Outlook

We use the Residual Income Model to arrive at a first-principles' fair value for CFL. We assume a long-term sustainable average risk-free rate of 7% for India, an Adjusted Beta of 1.1 for CFL and an India-specific Equity Risk Premium of 6% and arrive at the overall Cost of Equity of 13.6% for CFL. On this basis, **we arrive at a price target of Rs 575, at which the stock will trade at 1.9x/1.6x FY19E/20E book value**.

CFL **currently trades at a FY19E/20E P/BV of 2.0x/1.7x, which makes it slightly over-valued** given its FY19E/20E 'as-is no-synergies' RoE profile of 15.1%/16.5% and long-term outlook. When factoring in base case synergies, we arrive at an adjusted, and final, price target of Rs 682, at which CFL would trade at a premium multiple of 2.2x/1.9x FY19E/20E P/BV.

Exhibit 7: Consensus vs Our Estimates

	Our estimate			Bloomberg estimate			*% Variance*		
(Rsmn)	**FY18E**	**FY19E**	**FY20E**	**FY18E**	**FY19E**	**FY20E**	***FY18E***	***FY19E***	***FY20E***
Net interest income	18,448	24,091	30,503	17,623	21,182	25,961	*4.7*	*13.7*	*17.5*
Operating profit	10,640	13,834	17,702	10,899	13,771	17,500	*(2.4)*	*0.5*	*1.2*
Profit after tax	3,082	4,184	5,316	3,095	4,221	5,390	*(0.4)*	*(0.9)*	*(1.4)*

Source: Company, Nirmal Bang Institutional Equities Research

Key Risks

GST will actuate a formalization of the MSME segment which could lead to a shift of business from NBFCs to banks

GST is said to cause a formalization of the economy, particularly of the MSME segment. This would lead to a greater quantum of MSME business being backed by formal documentation, making such business amenable to bank lending at lower bank interest rates in comparison with NBFC interest rates. However, our base case is that Capital First will **successfully merge** with IDFC Bank and combined entity (a bank) would be able to protect shift of business from itself to other banks.

Build-up of retail liabilities necessary to be competitive as bank

Despite merger with IDFC Bank and availability of CASA and retail TD product, build of retail liabilities will require convincing Capital First customer base to acquire captive liability product, which may not be very straightforward to execute on substantial basis.

Company Overview

Capital First is an NBFC with a network of 229 branches and has an AUM of Rs Rs248bn, of which the MSME, Consumer durable loans, 2 wheeler loans, home loans, and used car loans split is 57%, 14%, 11%, 4%, and 3% respectively (own classification). Capital First has displayed a loan CAGR of 28% over FY12-17. Its yield on advances in its latest reported quarter was 18.1%

Capital First' cost of funds is 7.9% and, as a result, it registered a net interest margin of 10.2%. Its cost to income ratio stood at 52.6%. Consequently, it delivered a return on assets of 1.6% and a return on equity of 14.1%, implying a financial leverage of 9.0. Its customer base stood at 5mn. Its Capital Adequacy Ratio was 19.1%.

Exhibit 8: Management team/ Key executives

Name	Designation	Experience
V. Vaidyanathan	Managing Director and Executive Chairman	Mr. V. Vaidyanathan, MBA, AMP (HBS), has been an Executive Chairman and Managing Director of Capital First Limited (CFL) since September 28, 2012 and August 10, 2010 respectively. Mr. Vaidyanathan formed Capital First by way of a Management Buyout of an existing NBFC, by securing a USD 150 million equity backing from Warburg Pincus in 2012.
Pankaj Sanklecha	CFO & Head of Corporate Centre	Mr. Pankaj Sanklecha has been the Chief Financial Officer and Head of Corporate Centre at Capital First Limited (formerly Future Capital Holdings Limited) since November 5, 2012. Mr. Sanklecha serves as Chief Financial Officer of Capital First Home Finance Private Limited. He served as the Chief Risk Officer and Senior Vice President at Capital First Limited. He is a qualified Chartered Accountant with 15 years of experience in Retail and SME banking, where he served leadership positions across risk and business.
Nihal Desai	Chief Risk Officer & Executive Director	Mr. Nihal Desai serves as the Chief Risk Officer of Capital First Limited (formerly-Future Capital Holdings Limited) and has been its Executive Director since April 15, 2016. Mr. Desai has 19 years of experience in leadership positions in financial services and IT industry.
Mahesh Dholiya	National Credit Head of Retail Assets	Mr. Mahesh Dholiya serves as National Credit Head of Retail Assets at Capital First Limited
Sandeep Joshi	Head of Property Services	Mr. Sandeep Joshi serves as the Head of Property Services at Capital First Limited

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 9: Board members

Name	Designation	Experience
V. Vaidyanathan	Managing Director and Executive Chairman	Mr. V. Vaidyanathan, MBA, AMP (HBS), has been an Executive Chairman and Managing Director of Capital First Limited (CFL) since September 28, 2012 and August 10, 2010 respectively. Mr. Vaidyanathan formed Capital First by way of a Management Buyout of an existing NBFC, by securing a USD 150 million equity backing from Warburg Pincus in 2012.
Apul Nayyar	Executive Director	Mr. Apul Nayyar served as the Chief Executive Officer of Retail & SME Business at Capital First Limited (formerly Future Capital Holdings Limited) and served as its Chief Executive Officer of Consumer & Wealth Management Business. Mr. Nayyar serves as the Vice President of Mortgage Business at Citifinancial Consumer Finance India Limited. He has been Executive Director at Capital First Limited since April 15, 2016.
Nihal Desai	Chief Risk Officer & Executive Director,	Mr. Nihal Desai serves as the Chief Risk Officer of Capital First Limited (formerly-Future Capital Holdings Limited) and has been its Executive Director since April 15, 2016. Mr. Desai has 19 years of experience in leadership positions in financial services and IT industry.
Naresh Chand Singhal	Independent Director	Mr. Naresh Chand Singhal serves as the Chairman of Samalpatti Power Company Pvt. Limited. Mr. Singhal served as Independent Director of Max Ventures and Industries Limited from January 15, 2016 to August 10, 2016. He served as an Independent Director of Max India Limited since January 15, 2016 until August 10, 2016. He has been an Independent Director of Capital First Limited since September 23, 2010
Brinda Jagirdar	Independent Director	Mrs. Brinda Jagirdar served as General Manager and Chief Economist at State Bank of India, based at its Corporate Office in Mumbai. Mrs. Jagirdar is an independent consulting economist with specialization in areas relating to the Indian economy and financial intermediation. She is consults with financial institutions, banks and corporates interested in India. She has been an Independent Director of Capital First Limited since September 24, 2014.
Dinesh Hashmukhrai Kanabar	Independent Director	Mr. Dinesh Hashmukhrai Kanabar is the Founder and Chief Executive Officer of Dhruva Advisors LLP. Mr. Kanabar is Founder and Chairman of NovaDhruva Capital, a boutique Investment Bank. He is a renowned professional, entrepreneur and an expert on International Tax. Mr. Kanabar has over 25 years' experience in advising some of the largest corporate houses in India as well as multinational companies. He has been an Independent Director of Capital First Limited since January 6, 2015.
Vishal Kashyap Mahadevia	Non-Executive Director	Mr. Vishal Kashyap Mahadevia serves as the Managing Director and Co-Head of Mumbai office for India Operations at Warburg Pincus LLC. Mr. Mahadevia focuses on investments in media, technology and telecommunications sectors in India. He joined Warburg Pincus in 2006 and is a Member of its executive management group. He has been a Director of LF Brands, Inc. since 2000 and Biba Apparels Pvt Ltd. since September 20, 2013. He has been a Non-Executive Director of Capital First Limited (formerly-Future Capital Holdings Limited) since September 28, 2012
Swaminathan Sundararajan Mittur	Independent Director	Mr. Swaminathan Sundararajan Mittur, MA, A.C.S., CAIIB, served as the Chairman and Managing Director of Indian Bank from June 4, 2007 to April 1, 2010. Mr. Mittur has over 38 years of experience in the banking sector. He has been an Independent Director of Capital First Limited since February 6, 2013
Narendra Ostawal	Non Executive Director	Mr. Narendra Ostawal serves as a Managing Director at Warburg Pincus LLC. Mr. Ostawal joined Warburg Pincus in 2007 and served as its Principal. Since then, Mr. Ostawal has been working with Warburg Pincus Indian affiliate. He is involved in Warburg Pincus investment advisory activities in India and evaluates opportunities in the healthcare and financial services sectors. Prior to joining Warburg Pincus, he served as Associate with 3i, India and McKinsey & Company. He serves as a Director of Laurus Labs Private Limited. Mr. Ostawal has been a Non Executive Director at Capital First Limited since January 06, 2015.

Source: Company, Nirmal Bang Institutional Equities Research

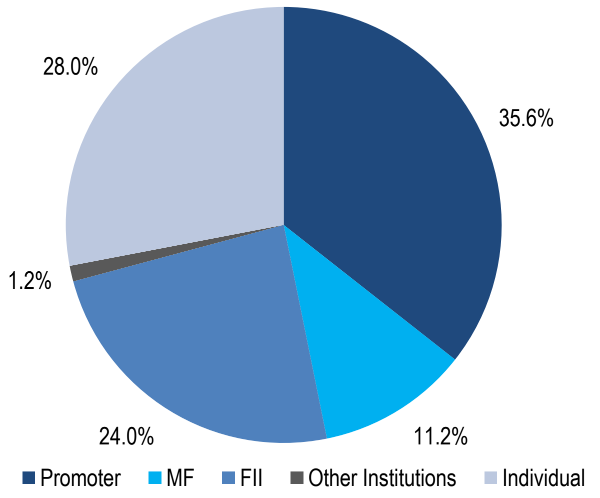
Shareholding Information

Exhibit 10: Key shareholders

	(%)
Promoter	
Non - promoter	
Cloverdell Investment Ltd	34.32
Government Of Singapore	8.87
Aditya Birla Sun Life Trustee Private Ltd A/C Aditya Birla Sun Life Mnc Fund	4.8
V Vaidyanathan	4.59
Hdfc Trustee Company Ltd - A/C Hdfc Mid - Capopportunities Fund	3.46
Government Pension Fund Global	1.95
College Retirement Equities Fund - Stock Account	1.73
Goldman Sachs India Limited	1.66
National Westminster Bank Plc As Trustee Of The Jupiter India Fund	1.37
Foreign Portfolio Investor	1.26
Dayside Investment Ltd	1.26

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 11: Shareholding pattern



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 12: One year forward P/BV

Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 13: Income statement

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Interest Income	17,147	24,615	32,014	41,016	52,091
Interest Expense	8,972	11,606	13,566	16,926	21,588
Net Interest Income	**8,175**	**13,009**	**18,448**	**24,091**	**30,503**
Non Interest Income	1,741	3,393	4,230	5,359	6,766
Net Revenue	**9,916**	**16,402**	**22,678**	**29,450**	**37,269**
Operating expenses	5,032	8,299	12,038	15,616	19,567
-Employee expenses	1,764	2,394	3,181	4,101	5,174
-Other expenses	3,268	5,905	8,858	11,515	14,393
Operating profit	**4,884**	**8,103**	**10,640**	**13,834**	**17,702**
Provisions	2,364	4,529	6,237	7,856	10,108
PBT	2,520	3,574	4,403	5,977	7,594
Tax	859	1,184	1,321	1,793	2,278
PAT	**1,661**	**2,390**	**3,082**	**4,184**	**5,316**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 15: Balance sheet

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Share capital	912	974	974	974	974
Reserves & surplus	16,121	22,064	24,841	28,720	33,730
Networth	**17,033**	**23,038**	**25,815**	**29,694**	**34,704**
Borrowings	119,549	141,081	185,566	237,249	302,444
Other liability & provisions	8,669	12,433	13,826	15,087	16,545
Total liabilities	**145,251**	**176,552**	**225,208**	**282,031**	**353,694**
Fixed Assets	292	646	775	930	1,116
Investments	416	437	437	437	437
Loans	125,246	150,914	196,188	249,159	316,432
Cash	11,127	15,936	18,326	21,075	24,237
Other assets	8,170	8,619	9,481	10,429	11,472
Total assets	**145,251**	**176,552**	**225,208**	**282,031**	**353,694**
AUM	160,408	198,241	259,606	330,334	420,336

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 14: Key ratios

Y/E March (Rsmn)	FY16	FY17E	FY18E	FY19E	FY20E
Growth (%)					
Net Interest Income	52.4	59.1	41.8	30.6	26.6
Operating Profit	79.8	65.9	31.3	30.0	28.0
Profit After Tax	45.3	43.9	29.0	35.7	27.0
Business (%)					
Advance Growth	42.6	20.5	30.0	27.0	27.0
Gross Loan Growth (Incl Securitisation)	34.0	23.6	31.0	27.2	27.2
Spreads (%)					
Yield on loans	16.1	17.8	18.4	18.4	18.4
Cost of Borrowings	8.8	8.9	8.3	8.0	8.0
Spread	7.3	8.9	10.1	10.4	10.4
NIMs	6.9	8.6	9.7	9.9	10.0
NIMs (On AUM)	5.4	6.7	7.5	7.6	7.7
Operational Effeciency (%)					
Cost to Income	50.7	50.6	53.1	53.0	52.5
Cost to Assets	4.0	5.2	6.0	6.2	6.2
Cost to AUM	3.6	4.6	5.3	5.3	5.2
Productivity (Rs Mn)					
Gross portfolio per Employee	113.6	103.0	111.7	121.3	134.6
Profit per Employee	1.2	1.2	1.3	1.5	1.7
CRAR (%)					
Tier I	14.5	15.5	13.2	11.8	10.7
Tier II	5.3	4.6	4.7	4.7	4.7
Total	19.8	20.2	17.9	16.5	15.5
Asset Quality (%)					
Gross NPA	1.0	0.9	1.6	1.9	2.2
Net NPA	0.5	0.3	0.8	0.9	1.0
Provision Coverage	49.0	68.7	50.0	52.6	54.5
Credit Cost (excluding std asset)	2.2	3.2	3.4	3.4	3.5
Credit Cost (including std asset)	2.2	3.3	3.6	3.5	3.6
Return Ratio (%)					
ROE	10.1	11.9	12.6	15.1	16.5
ROA	1.3	1.5	1.5	1.6	1.7
Per Share (%)					
EPS	18.2	24.5	31.6	43.0	54.6
BV	186.8	236.5	265.0	304.9	356.3
ABV	179.4	232.1	248.9	281.8	323.8
Valuation (x)					
P/E	34.1	25.3	19.6	14.4	11.4
P/BV	3.3	2.6	2.3	2.0	1.7
P/ABV	3.5	2.7	2.5	2.2	1.9
Net Interest Income	52.4	59.1	41.8	30.6	26.6
Operating Profit	79.8	65.9	31.3	30.0	28.0
Profit After Tax	45.3	43.9	29.0	35.7	27.0

Source: Company, Nirmal Bang Institutional Equities Research

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