Ujjivan Financial Services

CMP: ₹381; 1-year Target: ₹467

IIFL Premia Research

Sector	Banking
Recommendation	BUY
Upside	22.5%

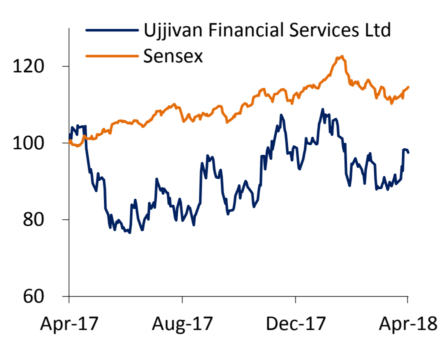
Stock Data	
Sensex	33,940
52 Week h/l (₹)	445 / 285
Market cap (₹Cr)	4,601
BSE code	539874
NSE code	UJJIVAN
FV (₹)	10
Div yield (%)	0.23

Shareholding Pattern

	Jun-17	Sep-17	Dec-17
Promoters	-	-	-
DII+FII	54.3	57.55	56.02
Individuals	45.7	42.45	43.98

Source: www.bseindia.com

Share Price Trend



Prices as on 11/04/2018

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Ujjivan Financial Services' (UFSL) advances would be aided by strong growth outlook in MFI (stabilization post demonetization), MSME and Home Loans (low base). Additionally, comfortable deposit mobilization and declining incremental NPA formation will aid return ratios. Moreover, falling cost of funds due to change in liability profile, improving deposit to advances ratio, declining cost ratios and credit cost would uplift profitability. While UFSL is expected to report loss (higher upfront provisioning) and negative return ratios in FY18E, RoE and RoA would recover to ~13% and ~1.8% by FY20E (close to pre-demonetization levels).

MFI and non-MFI business growth to contribute to advances

Business volume of microfinance is back to normal post demonetization and is expected to grow decently over FY19-20E. Huge market size and lower penetration would aid the performance of UFSL's microfinance loan book. Besides, it has also revamped its MSE and Affordable Housing (non-MFI) segments and the management is aggressively focused on these for overall loan growth. Contribution from non-MFI businesses to advances is expected to improve from 2.4% to 28.6% over FY17-20E. New product introductions would further diversify the portfolio. Moreover, rising bank branch network would lead to new customer additions and cross selling opportunities (from existing and new customers). We expect UFSL's loan book to register ~22% CAGR over FY17-20E to ₹11,458cr.

Attractive valuations: We estimate UFSL to register ~12% earnings CAGR over FY17-20E. The stock is available at attractive valuation of 2.0X FY20E P/BV. Taking into consideration the multiple earnings growth levers, we value UFSL at 2.5x FY20E P/BV. **We recommend BUY with a target price of ₹467.**

Financial Summary

Consolidated ₹cr.	FY17	FY18E	FY19E	FY20E
NII	807	865	1,053	1,342
Total Income	855	999	1,193	1,490
PPOP	397	320	477	626
PAT	208	-2	224	291
Growth (%) yoy	17.2	-	-	29.6
P/BV (x)	2.6	2.6	2.3	2.0
RoE (%)	11.8	-0.1	11.5	13.0
RoA (%)	2.4	-0.0	1.8	1.8

Source: Company, IIFL Research

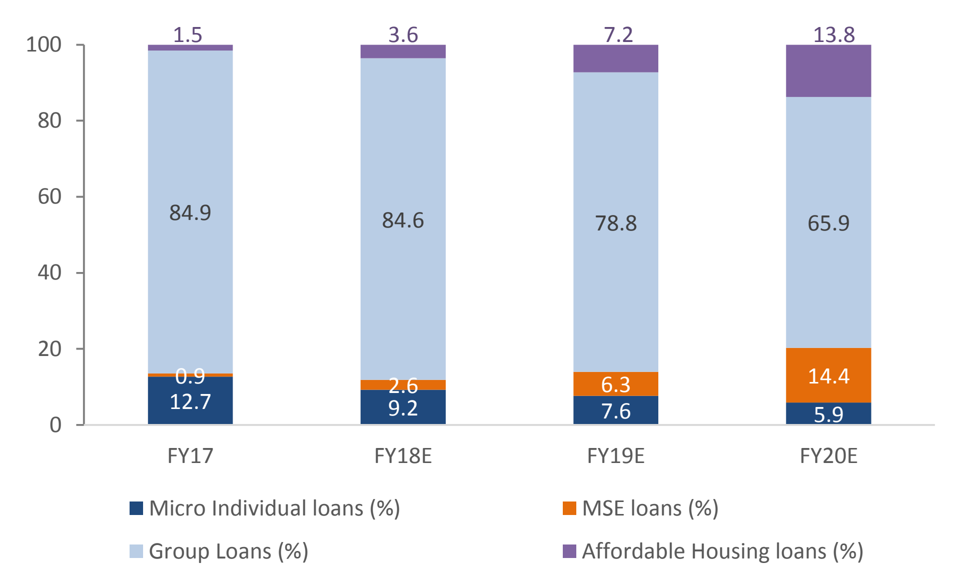
Company Background

Business volumes of microfinance is back to normal post demonetization and is expected to grow decently over FY19-20E

Ujjivan Financial Services is the 100% parent company of Ujjivan Small Finance Bank (Ujjivan SFB). It started banking operations in February 2017 after securing Small Finance Bank (SFB) license from the RBI. It is one of the leading players in India's micro financing segment. Micro Finance, MSME and other retail products constitute 94.4%, 2.3% and 3.2% respectively of its loan book for Q3FY18. Ujjivan Small Finance Bank serves over 37.13 lakh active customers through 441 branches spread across 209 districts and 24 states in India. It has over 121 full-service banking branches with a deposit base of ₹2,437cr as of December 31, 2017. For Q3FY18, its gross loan book was ₹7,095cr; cost-to-income ratio stood at 69.05%; NIMs stood at 11.79% provision coverage ratio at 76.3%. Its GNPA and NNPA ratio for Q3FY18 stood at 4.24% and 1.04%.

Contribution from non-MFI businesses is expected to improve from 2.4% to 28.6% over FY17-20E

Exhibit 1: Business Mix



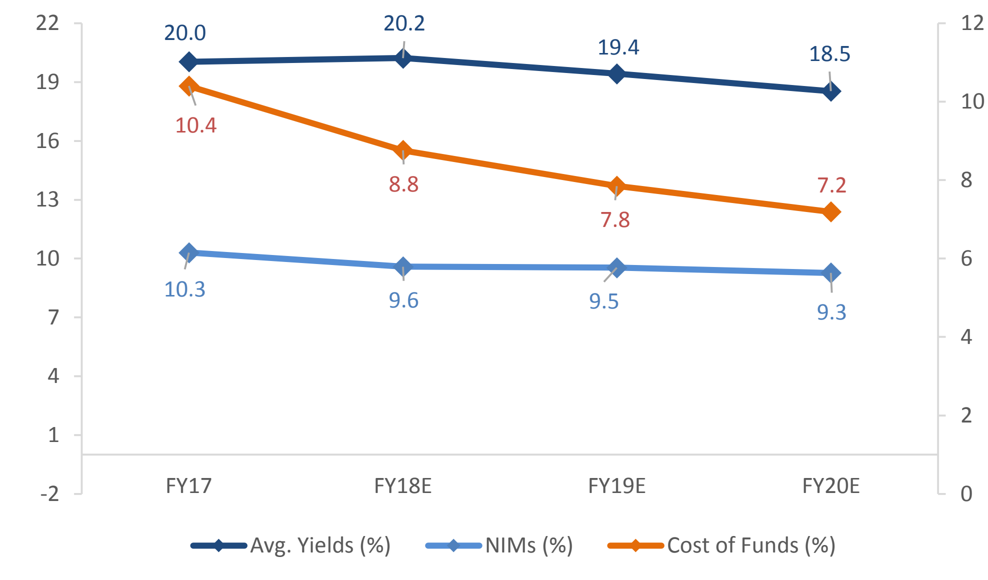
Source: Company, IIFL Research

Its high cost legacy loans are being replaced by low cost deposits, as a consequence its cost of funds would reduce over the next few years

Improving liability profile to support NIMs

Ujjivan's liability profile is altering since it got small finance bank (SFB) license in the year 2015. Its high cost legacy loans are being replaced by low cost deposits, as a consequence its cost of funds would reduce over the next few years. In addition, its CASA ratio over FY17-20E is expected to improve by 799bps to 11%. We expect its cost of funds to decline by 203bps to 7.3% over FY17-20E, aiding NIMs. Its focus is on mobilizing deposits through retail, institutional and certificate of deposits (CDs). UFSL's retail deposits would increase further with conversion of many existing branches into full fledge bank branches (320 branches getting converted to bank branches by 1HFY19E). In addition, mobilization of deposits through existing customer base to also augment deposits base. As of Q3FY18, ~36% of its advances were covered by deposits and we expect this ratio to improve to ~76% by FY20E.

Exhibit 2: Higher deposit funding leading to lower funding cost



Source: Company, IIFL Research

Margins would be supported due to better revenue recognition (lower NPA and cost of funds), as Ujjivan replaces high-cost wholesale borrowings with deposits

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Assuaging asset quality concerns

The collection efficiency continues to be better at 99.7% for 78% of new business portfolio acquired from January to December 2017

Ujjivan has already made adequate provision and write-off (demonetization related) on stressed asset portfolio. Following a total provisioning of ~₹322cr made towards these stressed loans in FY18E, the bank now expects substantial lower provisioning in FY19E and FY20E. The credit cost is expected go back to the normal levels. The loan loss provision, which is expected to be 4.5% in FY18E, is likely to decline to 1.5% in FY20E. The collection efficiency continues to be better at 99.7% for 78% of the new business portfolio acquired from January to December 2017. Whereas, the balance 22% portfolio has 91.6% collection efficiency. Consequently, asset quality is likely to improve going forward.

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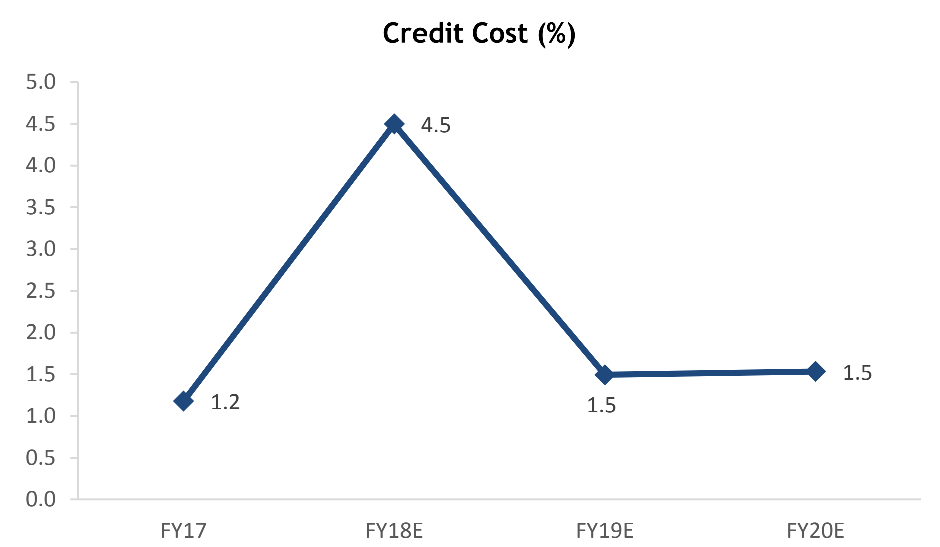
Exhibit 3: Falling credit cost led by higher collection efficiency



Source: Company, IIFL Research

Key Risks

Low cost deposit risk

Inability to mobilize deposits as per the need, would affect its return ratios.

The bank has replaced majority of its bank borrowings with deposits and enjoys lower funding cost. Any inability to generate sufficient funding to support its micro banking activities could result in higher cost of funding and consequently lower yields, impacting the business and financial condition of the bank.

Asset quality risk

Micro finance loans are not generally backed by collateral, hence pose a higher degree of risk than loans secured with physical collateral. The bank may experience increased levels of non-performing loans and related provisions and write-offs, negatively impacting operations.

SFB's deposits funded liabilities to reduce borrowing cost

Funding cost could decline sharply if SFB's were to transform the liability composition substantially towards deposit funding

Launch of SFB operations is likely to catalyze a rapid change in the mix of liabilities. Conversion into SFB provides a sustainable growth model through access to stable retail funding, diversified products and revenues and reduced financial risks significantly. Before conversion into SFB, borrowings from banks and capital markets and securitization of loans were the principal sources of funding. As a SFB, it would not only be able to borrow from banks but also a host of new funding sources would open up for UFSL. This includes refinancing from various apex lending institutions including RBI, MUDRA and NABARD. Such sources of funding would replace bank funding.

Once substantial rollout of SFB branches is complete, deposit funding would likely gather momentum. We expect term deposit funding to emerge as a key source of funding going ahead.

Deposits to advances ratio of SFB's to surge, led by bank branch expansion and cross selling opportunities

Funding cost could decline sharply if SFB's were to transform the liability composition substantially towards deposit funding. Funding cost could show sustained reduction over the long term depending on the bank's progress in building low-cost deposit (CASA deposit) franchise. UFSL's deposits covered 36% of its advances in Q3FY18, which we expect it to cover ~76% of its advances, which will lower its cost of funds by 211bps to 7.2% over FY17-20E. This will be attributed to branch expansion, scheduled commercial bank license and rising CDs and institutional deposits.

NBFC, MFI loan growth stabilizing post demonetization

The total loan portfolio of the microfinance industry stood at ~₹1.23 lakh cr and NBFC, MFIs contributed ~33% of the total industry portfolio with a share of ₹0.4 lakh cr in Q3FY18. Further, supported by an improvement in monthly collection efficiencies, the microfinance industry registered NBFC, MFIs grew ~15% yoy in 9MFY18. Within this, the portfolio outstanding under the NBFC, MFIs, microfinance focused small finance banks (SFBs) grew at a faster pace of ~19%.

Several MFIs reported 98% plus collection efficiency for loans disbursed after January 2017, as against 65-70% in December 2016

The microfinance industry is recovering well from the impact of demonetization. There are visible improvements in asset quality. Several MFIs reported 98% plus collection efficiency for loans disbursed after January 2017, as against 65-70% in December 2016. Ujjivan has reported 99.7% collection efficiency led by lower delinquency due to better collection efforts. Further, its portfolio at risk (PAR) in Q3FY18 had declined from 6.7% to 5.4% qoq.

The credit cost of MFI’s has been trending down quarter-on-quarter, as the demonetization impact has already been largely taken care off. Credit cost impact arising out of the affected portfolio due to demonetization (which would be close to 5-10% of their affected portfolio as of December 2016 for impacted NBFC, MFIs) is tapering off qoq.

Recommendation Parameters for Fundamental/Technical Reports:

Buy – Absolute return of over +10%
Accumulate – Absolute return between 0% to +10%
Reduce – Absolute return between 0% to -10%
Sell – Absolute return below -10%

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