

Initiating Coverage AU Small Finance Bank

26-November-2020



| Industry | LTP | Recommendation | Base Case Fair Value | Bull Case Fair Value | Time Horizon |
|----------|--------|--|----------------------|----------------------|--------------|
| Bank | Rs.855 | Buy on dips to Rs.795-805 band and add more on dips to Rs.730-738 band | Rs.897 | Rs.965 | 2 quarters |

| | |
|-----------------------|--------|
| HDFC Scrip Code | AUBANK |
| BSE Code | 540611 |
| NSE Code | AUBANK |
| Bloomberg | AUBANK |
| CMP Nov 25, 2020 | 855 |
| Equity Capital (Rsbn) | 3.07 |
| Face Value (Rs) | 10 |
| Equity Share O/S (bn) | 0.31 |
| Market Cap (Rsbn) | 262.14 |
| Book Value (Rs) | 142 |
| Avg. 52 Wk Volumes | 832316 |
| 52 Week High | 1217.7 |
| 52 Week Low | 366.2 |

| Share holding Pattern % (Sep, 2020) | |
|-------------------------------------|-------|
| Promoters | 29.0 |
| Institutions | 46.14 |
| Non Institutions | 24.86 |
| Total | 100.0 |

Fundamental Research Analyst

Nisha Sankhala

Nishaben.shankhala@hdfcsec.com

Our Take:

We like AU Bank's ability to sustain quality growth at a high pace which is mainly driven by its deep domain expertise in servicing low and middle income individuals and businesses. It is a unique retail NBFC with a clear focus on asset-franchise driven growth model which enables strong loan underwriting across a granular retail portfolio (dominated by vehicle finance and MSME). Also over the years, it has been rapidly expanding beyond Rajasthan, its home state. Its loan book from Rajasthan as on Q2FY21 stood at 42% v/s 47% in Q2FY18. Experienced management team along with faster expansion towards used vehicles segment (36% of total wheels AUM as on Sept '20), to bring faster recovery for AU Bank compared to peers in post corona world.

AU Bank is one of the best placed SFBs mainly due to its relatively better deposit franchise, large proportion of secured loan book and strong execution track record. In less than three years, the bank has built a deposit base of ~ Rs.270 bn, which stands out among SFBs in terms of granularity and branch productivity. Also book under moratorium has come down from 11% in June to 5.5% at the end of August which indicates significant improvement. Strong fundamentals and adequate opportunity augur well for the bank's long-term growth prospects.

Valuations & Recommendation:

There seems to be a shift in management focus towards asset quality and away from rigid growth. This augurs well for the next growth phase for AU Bank. This moderated approach will help reaching the earlier high return metrics faster by restricting fresh slippages.

We expect AU Bank to deliver 17% CAGR growth in NII and 9% in Net Profit on the back of higher provisioning requirement between FY20-22E. Despite challenging environment we have estimated Loan growth of 18% looking at its past trend. ROAA is expected at 1.5% in FY22E compared to current 1.6%. It is trading at 5.0x and 4.4x FY21E and FY22E ABV. We think that the bank will keep on getting premium valuation compared to other peers because of its superior track record and strong pedigree.

We feel that investors can Buy AU Bank on dips to Rs.795-805 band (4.15xFY22E ABV) and add more on dips to Rs.730-738 band (3.8xFY22E ABV) for the base case target of Rs.897 (4.65xFY22E ABV) and bull case target of Rs.965 (5.0xFY22E ABV) over next 2 quarters.

Financial Summary

| Particulars (Rsmn) | Q2FY21 | Q2FY20 | YoY-% | Q1FY21 | QoQ-% | FY19 | FY20 | FY21E | FY22E |
|--------------------|--------|--------|-------|--------|-------|--------|--------|--------|--------|
| NII | 5,606 | 4,516 | 24.1 | 5,159 | 8.7 | 13,428 | 19,089 | 22,053 | 26,070 |
| PPOP | 3,220 | 2,777 | 15.9 | 4,183 | -23 | 7,221 | 11,112 | 14,428 | 15,921 |
| PAT | 3,219 | 1,719 | 87.2 | 2,008 | 60.3 | 3,819 | 6,747 | 7,819 | 8,028 |
| EPS (Rs) | 10.5 | 5.9 | 79.2 | 6.6 | 60 | 13.1 | 22.2 | 25.7 | 26.4 |
| ROAE (%) | | | | | | 14.7 | 18.6 | 16.6 | 14.6 |
| ROAA (%) | | | | | | 1.5 | 1.6 | 1.4 | 1.5 |
| Adj. BVPS (Rs) | | | | | | 90.7 | 135.1 | 154.7 | 182.4 |
| P/ABV (x) | | | | | | 8.5 | 6.0 | 5.1 | 4.4 |
| P/E (x) | | | | | | 65.3 | 38.5 | 33.3 | 32.4 |

(Source: Company, HDFC sec)

Recent Developments

Q2FY21 Result Highlight: The bank reported 24% YoY rise in NII and 87% YoY growth in net profit (due to sale of Aavas). Disbursements rebounded QoQ (+188.7%) but were 27.8% lower YoY. Wholesale disbursements were 9.5% higher YoY, while growth in this segment was led by the NBFC (+32.4% YoY) and business banking (+45.6%) sub-segments. Retail disbursements were 36.2% lower YoY. In September, disbursements were just ~1% lower YoY. AUM growth slowed to 9.7/1.8% YoY/QoQ. MSME (+24.7/5.6%), SME (+21/8.7%), and business banking (+39.9/17.2%) were the fastest-growing sub-segments. Absolute GNPA/NNPA declined by 5%/25% QoQ. Fresh slippages came in at Rs.230 mn during the quarter. Increase in the CASA deposit during the quarter has been supported by highest ever jump in saving deposits in a particular quarter. The bank has engaged with e-commerce players such as Amazon, Myntra, Big Basket, etc. as well as with hyperlocal city-based merchants (LMB, Kanji etc.) to provide offers on its Debit Cards.

Including prior periods' receipts, collection efficiency reached 96% in Q2FY21. The proportion of loans under moratorium stood at 5.5% at the end of August (vs. ~11% in June). Of this, 3% did not make any repayment. The management views this as the potential stress pool. However, the customer activation rate (post moratorium) stood at 78% (vs. 80% between April 2019 and February 2020). We continue to conservatively build GNPAAs of 3.0% in FY21E.

AU Bank is in better position compared to its peers because ~98% of its AUM is secured and ~63% of business is in semi-urban and rural locations (less affected). Quarterly results also showed strong Balance sheet growth.

The bank is also well capitalized with Tier-1 Capital ratio of ~18.3% and total Capital Adequacy ratio at ~21.5%. This will help the bank withstand any unexpected asset quality shocks. Though AU is not in immediate need of raising capital, dilution at current valuation multiple can create meaningful Book value accretion.

After trending downward for the last several quarters, margin has now started moving up as the share of higher yielding segments is inching up, and a significant fixed rate book has started giving benefits to AU Bank in falling interest rate scenario.

RBI's one-time restructuring of loans to help borrowers manage the stress caused by the Covid-19 pandemic was a big positive for banking sector. The restructuring of loans has been allowed for retail, MSME and corporate loans. We expect the asset quality concerns and tail risk on earnings for the banks to reduce. Economy is recovering gradually and no major job losses have occurred in the formal sectors. During the result commentary, management has also indicated that the on-ground situation has considerably improved in Q2FY21 and they saw positive momentum across all key metrics which include its Digital Banking journey, activity levels, collection efficiencies, retail deposits, and disbursements.

To combat the problem of slowdown in new vehicles sales, the bank has started focusing on used vehicle segment. This will help them in the time of post corona recovery phase as the demand for used commercial vehicles will emerge first (due to lower cost).

Long term Triggers

Fast growing retail franchise

AU Bank has demonstrated its capability to build a fast growing quality retail franchise. Its AUM has grown at a robust 39% CAGR over FY16-20 to ~ Rs.309 bn, and net profit at a 25% CAGR during the same period. The share of retail loans at ~84% of total loans is one of the highest among private sector banks. The loans are largely for income generation purposes to self-employed and low and middle-income groups and are secured by way of underlying assets. To maintain independence and leverage functional expertise within each business vertical there are separate sub-teams for sales, underwriting and credit, collection and operations.. AU Bank's strong built-in processes and underwriting capabilities coupled with higher proportion of the secured book over the years have resulted in relatively lower levels of

GNPAs. Also Technology and analytics will continue to remain key cornerstones of its strategy as the company has been persistently focusing on cross selling products. In less than three years, the bank has built a deposit base of Rs.261.64 bn (54% retail- CASA+ term deposits as on Q2FY21 v/s 41% in Q2FY20) which stands out among SFBs in terms of granularity and branch productivity. Retail term deposits and Savings Accounts accounted for 29% and 10% of total deposits in FY20 vs. 21% and 13%, respectively, a year ago.

Niche segment

AU Bank's presence is largely in the under banked segments, with a small ticket size in Vehicle Financing, MSME and SME. These underpenetrated segments, coupled with lower financial penetration in its main markets like Rajasthan, Gujarat etc., provide growth opportunities, along with attractive higher yields. In vehicle finance, AU is present across asset verticals and has built its vehicle finance business around serving first-time buyers, small road transport operators and captive users (past customers). The vehicle finance book is granular with average ticket size of Rs. 0.36mn.

Industry beating growth strategy

In the past, management had indicated that the focus for the growth was towards small ticket secured retail loans and granular retail deposits in the rural and semi-urban area. This strategy will bring higher margins for the bank and also lessens the risk of asset quality shocks from corporate lending book. Management has also indicated that medium-term strategy is to deepen its presence in metro cities to acquire new customers and also acquire a greater wallet share of existing customers. We see several factors that point to sustainable industry beating growth like diversification across segments and products (It further aims to expand in the newer segments like Housing Loans, Gold Loans, Consumer Durable Financing, etc.), expansion into newer geographies (faster growth ex-Rajasthan) and fading competition from NBFCs.

Liability profile

In the past, AU bank has raised majority of its funding requirements via term loan or from issuance of capital market instruments. But as it has gradually matured as an SFB, it has started focusing on deposits as the primary source of funding. CASA momentum has picked up and CASA ratio improved to 21% in Q2FY21. This Increase in the in the CASA deposit during the quarter was supported by highest ever jump in saving deposits. AU's target to niche segment for deposit i.e. senior citizens, women, NRIs etc. has helped it in achieving greater SA and TD from individuals.



What could go wrong?

- Vehicle Financing companies were already facing headwinds owing to dull auto demand. And now because of weak economic outlook the loan growth is expected to be subdued as the demand will be lower for new vehicles. Moreover, there might be a spike in slippages on account of expected deterioration in the credit profile of borrowers.
- Moreover, the events at YES and various other Co-operative Banks have impacted depositor sentiment, causing them to become more risk-averse. This will lead to deposit polarization towards large private banks and PSBs and we believe mid-tier banks could face challenges in deposit mobilization.
- Recent COVID-19 issue is likely to have multiple order and far reaching impacts on the banking sector. Credit growth is already heading southwards and given the extensive nature of the lockdown, asset quality issues are likely to spread many sectors. On-going stress in Corporate and SME segment might accelerate and in fact retail loan segment might emerge as new source of stress.
- Lower than expected loan growth and greater than expected deterioration in asset quality remains key risk to our thesis.
- The bank has high regional and product concentration. 40% of its AUM coming from Vehicle Financing and geography wise 42% business comes from Rajasthan alone. Any untoward economic or political development in that state or natural calamity could harm interests of AU.
- Sustainability of improvement in collection efficiency will be key monitorable.
- AU has a relatively moderate contingent provision buffer (~1% of AUM).
- The high current valuations leave very little room for any negative surprise which could arise out of weaker asset quality outcomes.

Company Profile:

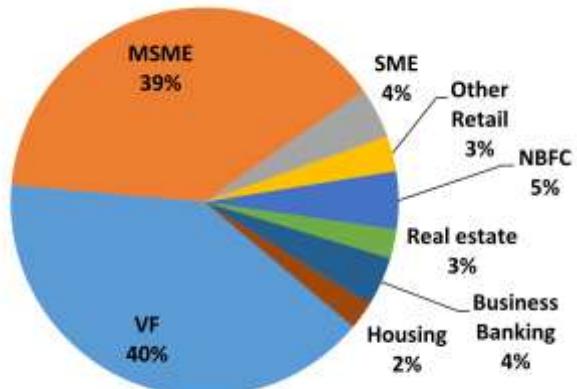
AU Small Finance Bank (AU) was an NBFC till Mar-17. It was incorporated in 1996 by Mr. Sanjay Agarwal. Its loan portfolio of Rs 306 bn (Sep-20) is well diversified across Vehicle Finance (VF), MSME and SME loans. AU's lending is focused on underserved segments in urban, semi-urban and rural India, and offers investors multi-year growth opportunities. Currently, the company has its operations through 686 branches, and 332 ATMs spread across 12 states and 2 Union territories in India, with a significant presence in states such as Rajasthan, Gujarat, Maharashtra and Madhya Pradesh.

AU Bank held 4.57 % stake (as on Sep-20) in AAVAS Financiers Ltd. Most of this stake i.e. 4.5% stake was sold by AU on Nov 23 for Rs.5303 mn. Capital gains arising out of this will be reflected in Q3FY21 results and add to the book value.

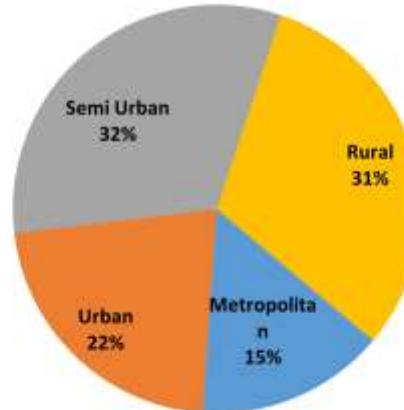
AU Small Finance Bank Ltd



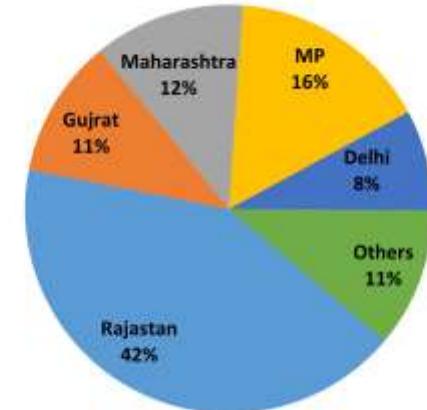
AUM Mix %



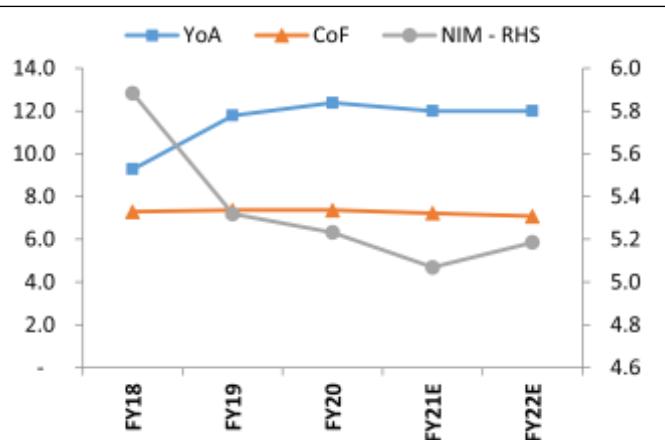
Distribution of Branches



Geographical split of Portfolio



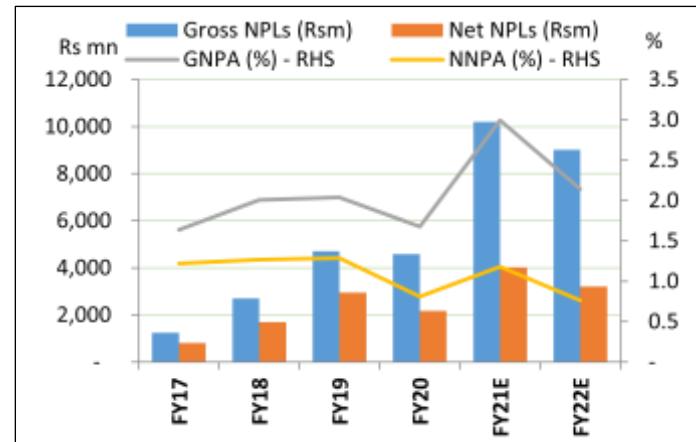
Net Interest Margin %



ROAA



Asset Quality Trend



AU Small Finance Bank Ltd

Income Statement (in Mn)

| | FY19 | FY20 | FY21E | FY22E |
|----------------------------|---------------|---------------|---------------|---------------|
| Interest Earned | 29,491 | 42,859 | 49,974 | 57,687 |
| Interest Expended | 16,064 | 23,769 | 27,920 | 31,617 |
| Net Interest Income | 13,428 | 19,089 | 22,053 | 26,070 |
| Other Income | 4,619 | 6,201 | 7,917 | 8,692 |
| Total Income | 18,047 | 25,290 | 29,970 | 34,762 |
| Total Operating Expense | 10,826 | 14,179 | 15,542 | 18,841 |
| PPOP | 7,221 | 11,112 | 14,428 | 15,921 |
| Provisions & Contingencies | 1,418 | 2,832 | 5,691 | 5,189 |
| PBT | 5,802 | 8,279 | 8,737 | 10,733 |
| Ex. Item | - | 860 | 1,716 | - |
| Provision for Tax | 1,983 | 2,392 | 2,634 | 2,705 |
| PAT | 3,819 | 6,747 | 7,819 | 8,028 |
| APAT | 3,819 | 6,016 | 6,103 | 8,028 |

Balance Sheet (in Mn)

| As at March | FY19 | FY20 | FY21E | FY22E |
|-------------------------------|-----------------|-----------------|-----------------|-----------------|
| SOURCES OF FUNDS | | | | |
| Share capital | 2,924 | 3,041 | 3,041 | 3,041 |
| Reserves and surplus | 28,705 | 40,727 | 48,546 | 56,173 |
| Shareholders' funds | 31,629 | 43,768 | 51,587 | 59,214 |
| Total Deposits | 1,94,224 | 2,61,639 | 2,97,692 | 3,69,025 |
| CASA | 35,901 | 37,873 | 57,144 | 71,947 |
| Total Borrowings | 86,134 | 1,03,353 | 1,10,588 | 1,16,117 |
| Other Liabilities, provisions | 14,241 | 12,670 | 15,838 | 19,797 |
| Total | 3,26,228 | 4,21,431 | 4,75,705 | 5,64,153 |
| APPLICATION OF FUNDS | | | | |
| Cash & Bank Balance | 17,402 | 33,697 | 43,576 | 42,501 |
| Investments | 71,617 | 1,06,682 | 1,13,818 | 1,30,550 |
| Advances | 2,28,187 | 2,69,924 | 3,06,519 | 3,78,489 |
| Fixed Assets | 4,470 | 4,480 | 4,480 | 4,570 |
| Other Assets | 4,552 | 6,648 | 7,312 | 8,044 |
| Total | 3,26,228 | 4,21,431 | 4,75,705 | 5,64,153 |

Source- Company, hdfc securities

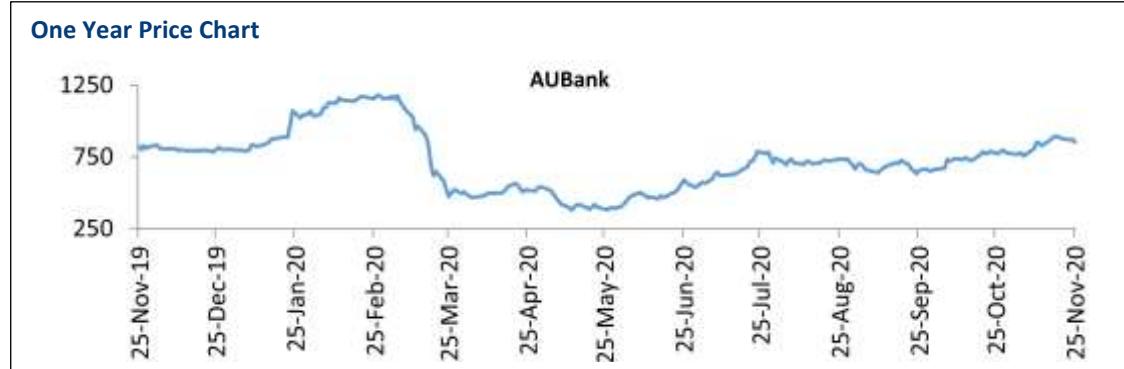
AU Small Finance Bank Ltd

Key Ratios:

| | FY19 | FY20 | FY21E | FY22E |
|-----------------------------|-------|-------|-------|-------|
| VALUATION RATIOS | | | | |
| EPS | 13.1 | 22.2 | 25.7 | 26.4 |
| Earnings Growth (%) | 30.8 | 76.7 | 15.9 | 2.7 |
| BV | 100.7 | 142.2 | 167.9 | 193.0 |
| ABV | 90.7 | 135.1 | 154.7 | 182.4 |
| RoAA (%) | 1.48 | 1.61 | 1.36 | 1.54 |
| ROAE (%) | 14.67 | 18.56 | 16.58 | 14.63 |
| P/E (x) | 65.3 | 38.5 | 33.3 | 32.4 |
| P/ABV (x) | 8.5 | 6.0 | 5.1 | 4.4 |
| PROFITABILITY | | | | |
| Yield on Advances (%) | 11.8 | 12.4 | 12.0 | 12.0 |
| Yield on Investment (%) | 6.5 | 6.9 | 6.9 | 6.9 |
| Cost of Deposits (%) | 6.6 | 7.0 | 7.0 | 6.9 |
| Cost of Funds (%) | 7.4 | 7.4 | 7.2 | 7.1 |
| Core Spread (%) | 5.2 | 5.3 | 5.0 | 5.1 |
| NIM (%) | 5.3 | 5.2 | 5.1 | 5.2 |
| OPERATING EFFICIENCY | | | | |
| Cost/Avg. Asset Ratio (%) | 4.2 | 3.8 | 3.5 | 3.6 |
| Cost-Income Ratio (%) | 60.0 | 56.1 | 51.9 | 54.2 |

Source- Company, hdfc securities

| | FY19 | FY20 | FY21E | FY22E |
|---------------------------------------|--------|--------|--------|--------|
| BALANCE SHEET STRUCTURE RATIOS | | | | |
| Loan Growth (%) | 51.2 | 27.4 | 10.2 | 23.5 |
| Deposit Growth (%) | 145.1 | 34.7 | 13.8 | 24.0 |
| C/D Ratio (%) | 117.49 | 103.17 | 102.97 | 102.56 |
| CASA (%) | 18.5 | 14.5 | 19.2 | 19.5 |
| Total Capital Adequacy Ratio (CAR) | 19.3 | 22.0 | 22.4 | 21.3 |
| Tier I CAR | 16.0 | 18.4 | 18.8 | 18.0 |
| ASSET QUALITY | | | | |
| Gross NPLs (Rsm) | 4,701 | 4,578 | 10,200 | 9,012 |
| Net NPLs (Rsm) | 2,945 | 2,173 | 4,028 | 3,207 |
| Gross NPLs (%) | 2.0 | 1.7 | 3.0 | 2.1 |
| Net NPLs (%) | 1.3 | 0.8 | 1.2 | 0.8 |
| Slippages (%) | 2.22 | 2.24 | 3.00 | 2.10 |
| Coverage Ratio (%) | 37.4 | 52.5 | 60.5 | 64.4 |
| Provision/Avg. Loans (%) | 0.70 | 1.03 | 1.75 | 1.36 |



Disclosure:

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Any holding in stock –No

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HDFC securities Limited, I Think Techno Campus, Building - B, "Alpha", Office Floor 8, Near Kanjur Marg Station, Opp. Crompton Greaves, Kanjur Marg (East), Mumbai 400 042 Phone: (022) 3075 3400 Fax: (022) 2496 5066

Compliance Officer: Binkle R. Oza Email: complianceofficer@hdfcsec.com Phone: (022) 3045 3600

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