Equity Research

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IPO Note – 20 Oct 2020

Equitas Small Finance Bank Ltd.

Recommendation	Subscribe
Price Band	Rs. 32 – Rs. 33
Bidding Date	20 - 22 Oct
Book Running Lead Manager	JM Fin, Edelweiss, IIFL Sec.
Registrar	K-Fintech
Sector	Banks - SFB

Minimum Retail Application- Detail At Cut off Price	
Number of Shares (bid lot)	450
Minimum Application Money	Rs. 14,850
Discount to EHL shareholders	NIL
Payment Mode	ASBA

Financials (Rs Cr)	FY19	FY20
Net Interest Income	1152	1496
Pre Provisioning Profit	427	598
PAT	211	244

Valuations	Lower Band	Upper Band
Market Cap (Rs. Cr)	3651	3756
EPS*	2.1	2.1
BVPS*	27.3	27.3
P/E *	15.0	15.4
P/Adj. BV *	1.3	1.3

*calculated on FY20

Post Issue Shareholding Pattern	
Promoters	82.1%
Institutions	11.4%
Bodies Corporates & Public	6.5%

Offer structure for different categories	
QIB (Including Mutual Fund)	50%
Non-Institutional Investors	15%
Retail	35%
Post Issue Equity (Rs. in cr)	1138.3
Issue Size (Rs in cr)	510 – 518
Face Value (Rs)	10

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BACKGROUND

Equitas offers a unique opportunity to participate in a business model that offers nimbleness and pricing power of an NBFC on one hand and the deposit generating ability of a bank on the other. Equitas has successfully diversified across eight products with its core focus on self-employed individuals that are underserved by formal financing channels.

Details and Objects of the Issue; Reservation for EHL shareholders

- The public issue consists of (i) offer for sale of Rs. 238 Cr by EHL - Equitas Holdings Ltd (Parent) and (ii) fresh issue of Rs. 280 Cr to augment Tier 1 capital for future growth. Post the IPO, EHL's stake in ESFB would stand reduced from 95.5% to 82.1%.
- Investors who hold EHL (Equitas Holdings Ltd) shares on October 11, 2020, are eligible to apply under the shareholder's category. There is a reservation of 10% of the offer for shareholders (Rs. 51 Cr). The EHL shareholders can apply up to Rs. 2 lac in the shareholders category. EHL shareholders can also apply under the retail category.

Investment Rationale:

- Fast paced diversification towards high-yield secured products.
- Significant scope for improvement in cost efficiency on the back of operating leverage post completion of the SFB branch conversion.
- Robust liability traction to lower borrowing costs & support NIMs.
- Proven track record of stable asset quality.

Valuation and Recommendation

Equitas has successfully reduced the microfinance mix in its loan book from 54% in FY16 to 23% today. Its diversified loan book, adequate capital, experienced management and conservative approach to minimize risk, provides Equitas a long runway for profitable growth. Equitas' transition to a SFB during FY16-18 resulted in lower AUM growth (16% CAGR) and higher opex growth (57% CAGR), translating to lower return ratios. However, post the conversion, Equitas stepped up its loan growth to 37% CAGR over FY18-20, while opex growth remained subdued at 16% CAGR. This resulted in cost/income declining from 80%in FY18 to 66% in FY20 and a simultaneous increase in ROE from ~2% in FY18 to ~9% in FY20. **We believe Equitas SFB can deliver top quartile ROE of 15%+ in the long term (by FY23E) driven by a decline in cost/Income to below 60% from 66% in FY20 and normalization of credit costs to ~1.5% from 1.9% in FY20. Equitas SFB is available at a 30% discount compared to listed peers. We recommend to 'Subscribe for long term'.**

Rs. Cr

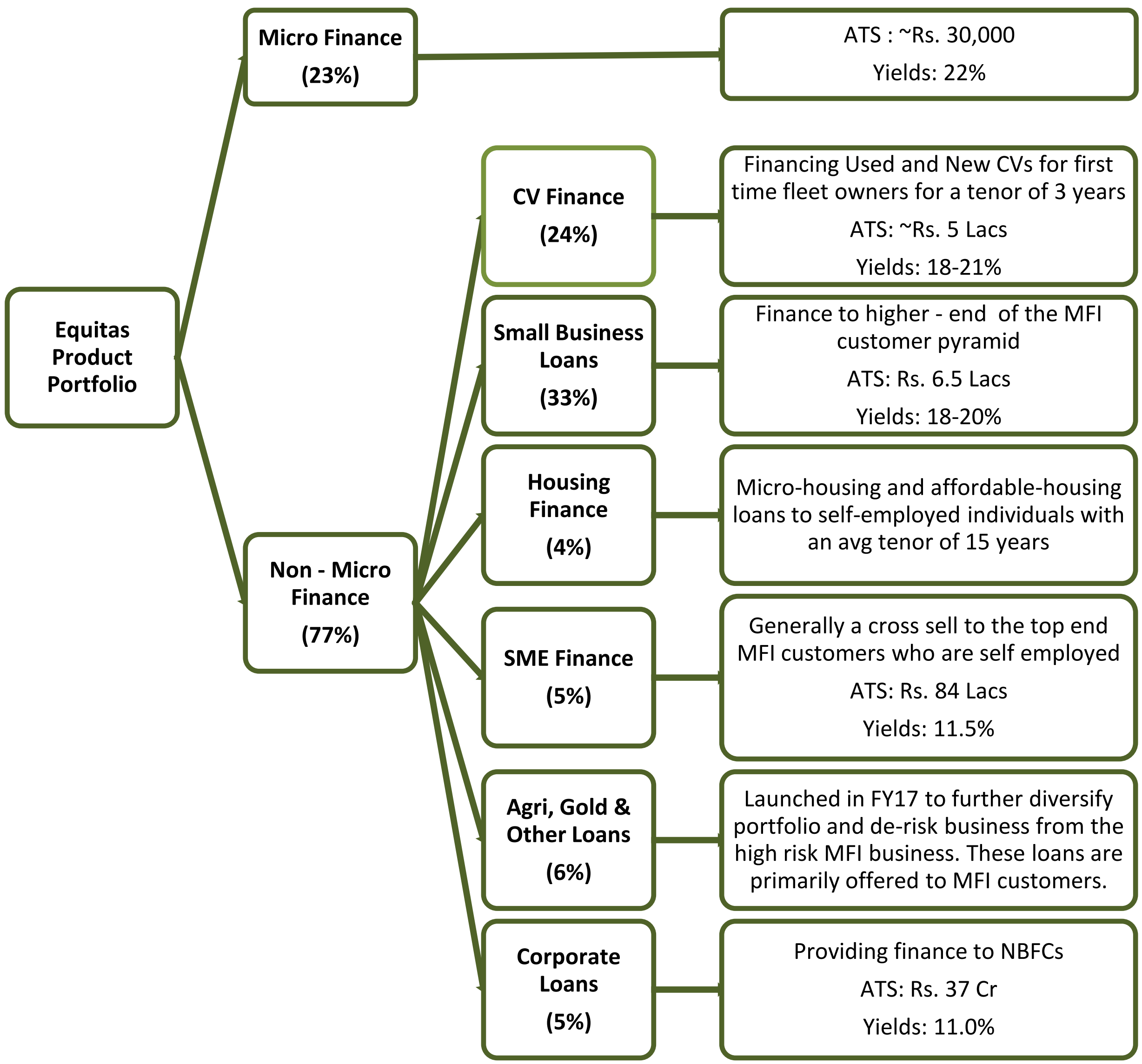
Financial Snapshot	FY18	FY19	FY20	Q1FY21
Net Interest Income	861	1152	1496	404
Growth	*-1%*	*34%*	*30%*	*20%*
Pre Provisioning Profit	221	427	598	142
Growth	*-40%*	*93%*	*40%*	*19%*
PAT	32	211	244	58
Growth	*-80%*	*561%*	*16%*	*1%*
Adj. BVPS #	17.0	18.3	25.3	25.9
ROA	0.3%	1.4%	1.4%	1.1%
ROE	1.6%	9.4%	8.9%	10.0%
P/E	118	17.8	15.4	NA
P/Adj. BV #	1.9	1.8	1.3	1.3

Source: Company, NBRR *# BV for FY20 & Q1FY21 is adjusted for fresh IPO infusion*

Company Background

Equitas SFB is a diversified financial services provider focused on low income groups and economically weaker individuals operating small businesses, as well as SMEs with limited access to formal financing channels on account of their informal, variable and cash-based income profile.

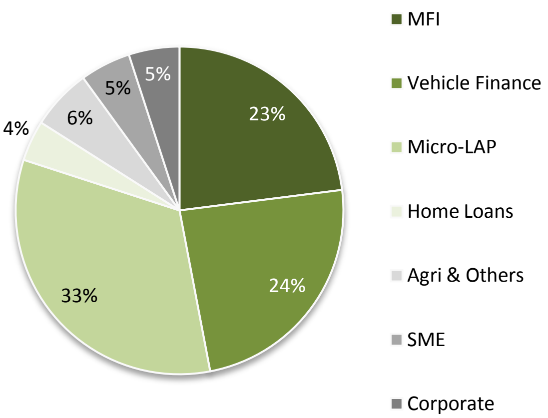
Exhibit 1: Well diversified product portfolio with low ticket size and high yields



Source: Company, NBRR
 # ATS = Avg. Ticket Size

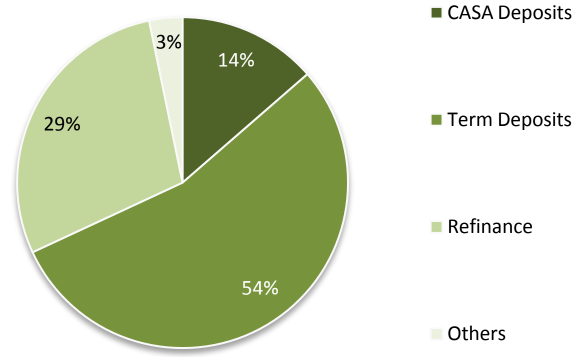
As on Q1FY21, Equitas has a total AUM of Rs. 14,389 Cr, spread across categories such as Micro-Finance, CV, Micro LAP/Small Business, Housing, Agri, Gold, SME and Corporate (NBFCs). The retail liability front is shaping up well, with deposits forming 68% of total borrowings and CASA forming 20% of the deposit base. Equitas operates through a network of 856 branches.

Exhibit 2: Loan Book Mix



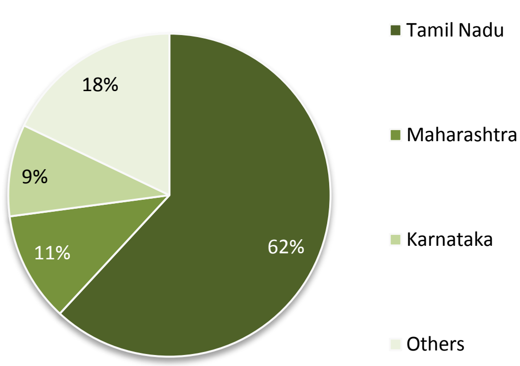
Source: Company, NBRR

Exhibit 3: Borrowing Mix



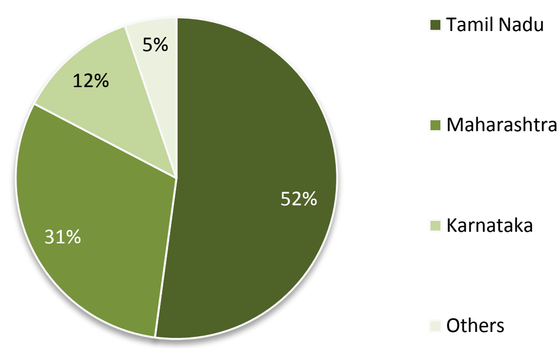
Source: Company, NBRR

Exhibit 4: Advances Mix (Geography-wise)



Source: Company, NBRR

Exhibit 5: Deposits Mix (Geography-wise)



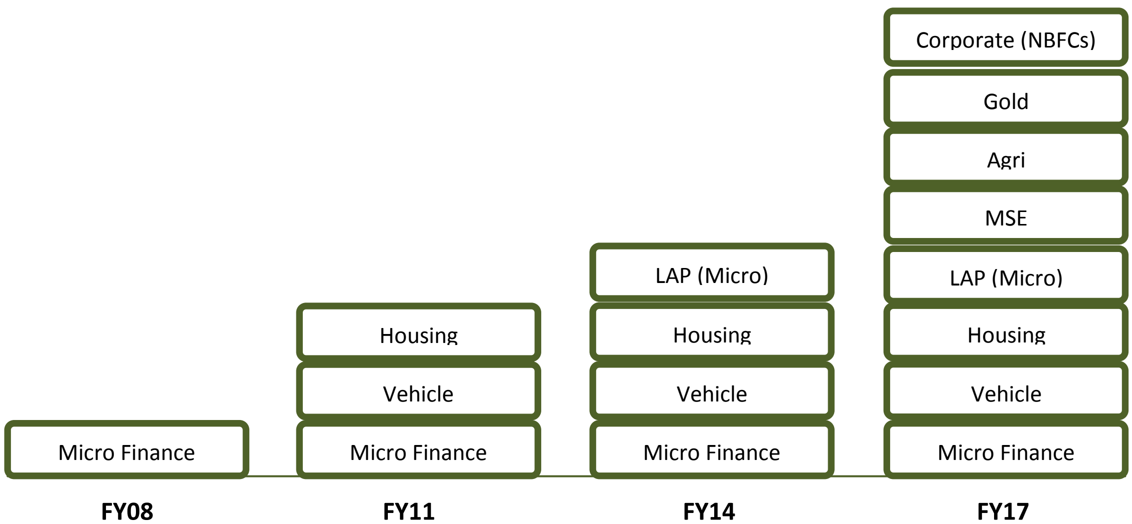
Source: Company, NBRR

Investment Rationale

Fast paced diversification towards high-yield secured products

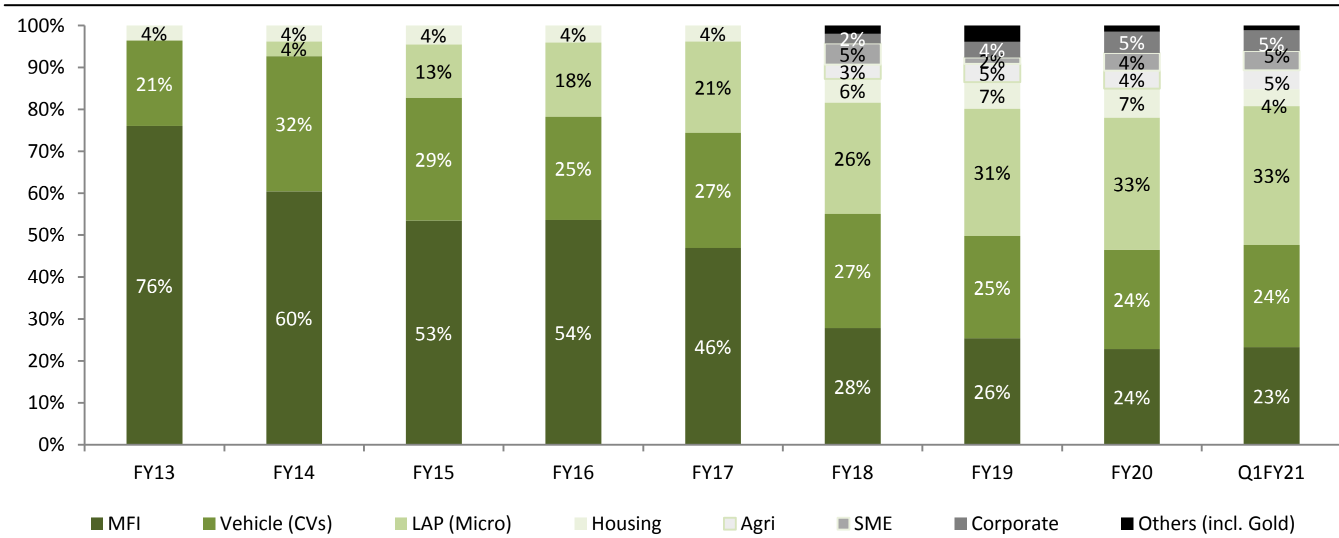
Diversifying its product portfolio over the years has been the key factor in Equitas' strong evolution and robust growth. Equitas' asset mix consists of high yielding portfolios across Micro Finance, Commercial Vehicles, Small business/Micro LAP, Housing, Agri, Gold.

Exhibit 6: Product evolution of Equitas



Source: Company, NBRR

Exhibit 7: Loan Book Mix – Transition towards secured lending



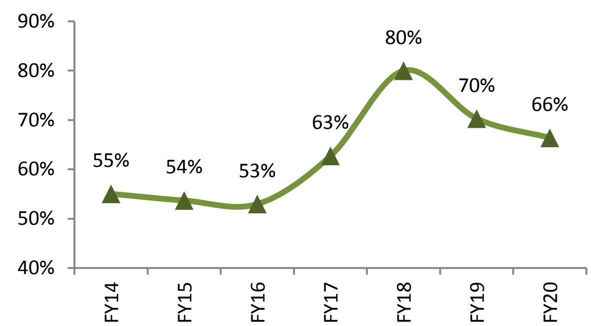
Source: Company, NBRR

Significant scope for improvement in cost efficiency

Until FY16, opex was under control and consistently in the range of 53-55%. Post FY16, Equitas converted into a SFB considering the opportunity to build a diversified, stable and low-cost liability franchise. However, efforts to build the franchise resulted in a quantum jump in opex over FY17-19. Equitas converted 375 of its 856 centres as liability branches for SFB and also added ~3500 branch banking employees. Each branch involved a set-up cost of Rs. 40 lacs and annual operational cost of Rs. 40 lacs.

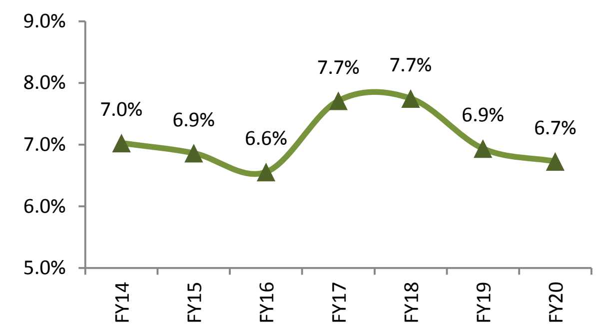
We believe that the operating costs have peaked out as the bank does not intend to scale up/convert further branches and the benefit of operating leverage shall kick-in with an acceleration in loan/NII growth. This opex growth is expected to be significantly lower than loan growth which shall lead to a decline in cost ratios and aid expansion in return ratios.

Exhibit 8: Cost to Income



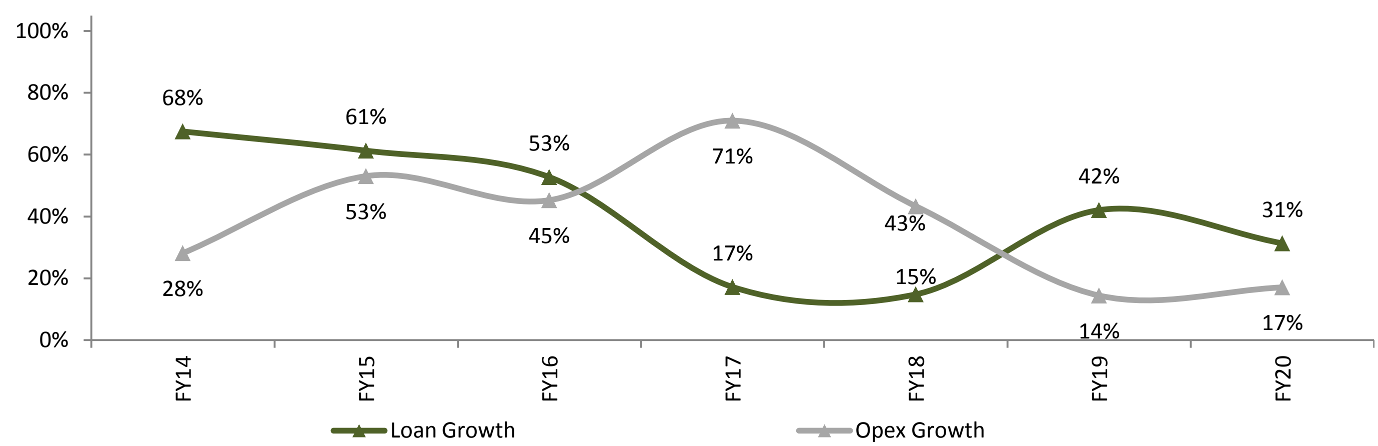
Source: Company, NBRR

Exhibit 9: Opex/Assets



Source: Company, NBRR

Exhibit 10: Loan growth vs. Opex growth

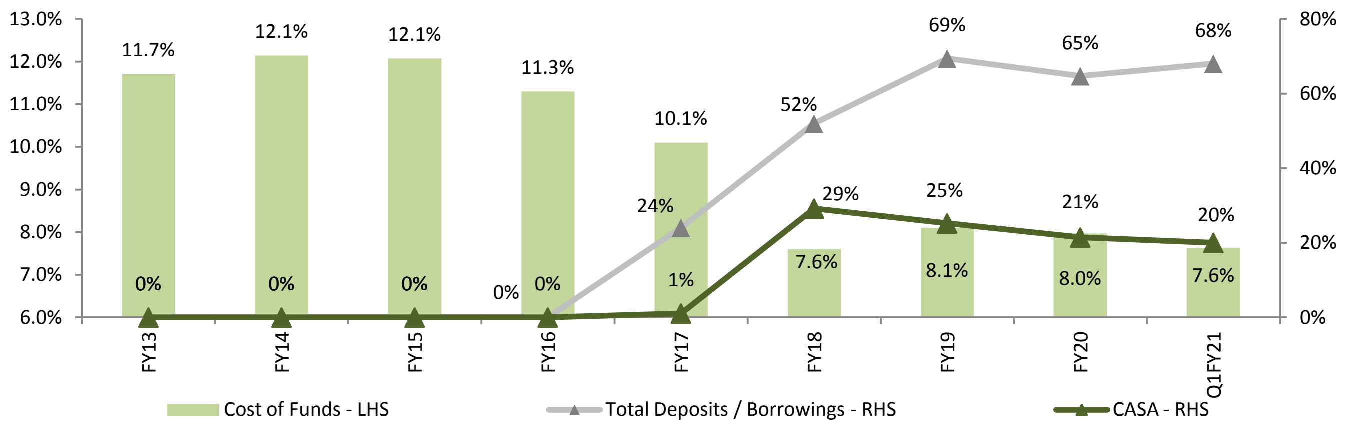


Source: Company, NBRR

Robust liability traction shall ensure lower borrowing costs and support NIMs

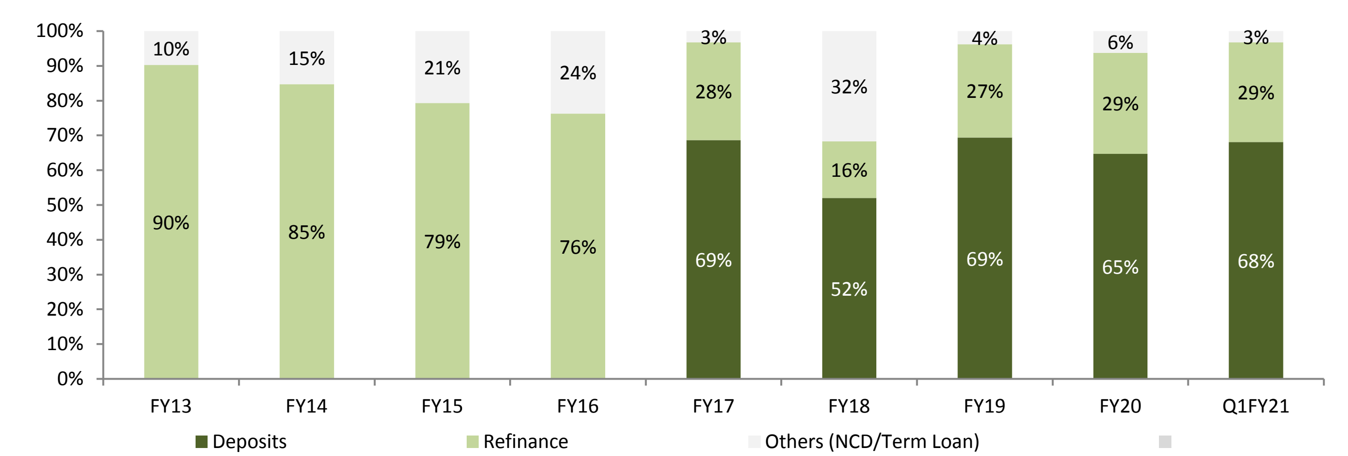
Cost of funds is expected to be under control on the back of a gradual and sustained increase in deposits and lesser reliance on bank and money market borrowings. Since the transition of Equitas into SFB, total deposits have witnessed strong traction which commenced their journey from Q2FY17 and have reached 68% of total borrowings in Q1FY21. We expect it to continue to improve going forward. CASA ratio is currently at 20% and management intends to increase it to average industry levels of ~35-40% in the long run.

Exhibit 11: Strong liability traction to ensure lower cost of funds



Source: Company, NBRR

Exhibit 12: Borrowing mix to shift towards deposits



Source: Company, NBRR

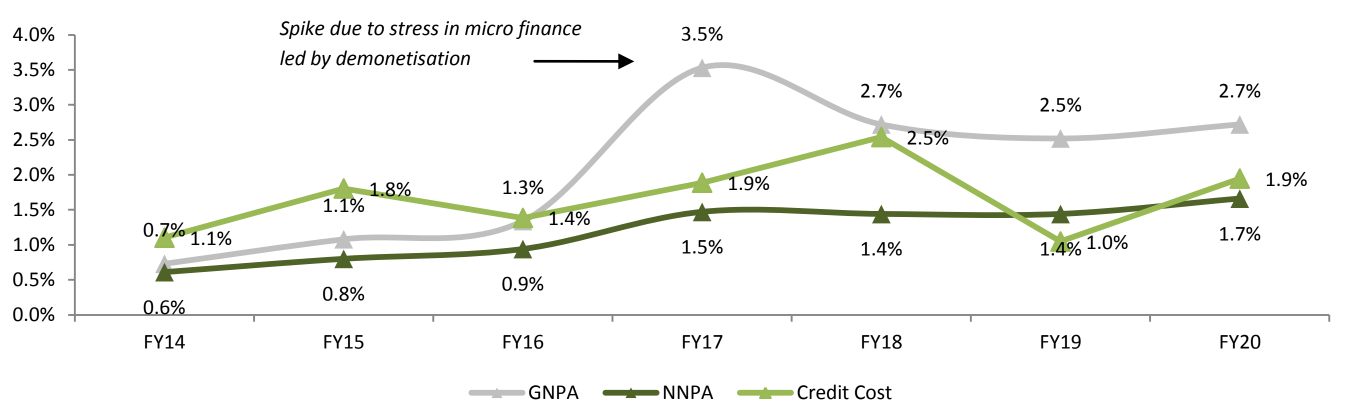
Asset quality has been stable historically …………

Equitas' asset quality has been largely stable despite presence in the lowest strata of borrowers. The company is extremely cautious with the MFI portfolio and tightly controls its ticket size to minimize risks.

The asset quality of the vehicle finance portfolio seems weak primarily due to exposure to used CVs. In order to alleviate this stress, Equitas has ventured into new CV loans over the last three years. Inspite of the high GNPAs of 3.8% in vehicle finance, we believe these are reasonable levels considering that the nature of the used CV financing industry which has even higher levels of GNPAs with the leader Shriram Transport Finance having GNPAs of 8.0% currently.

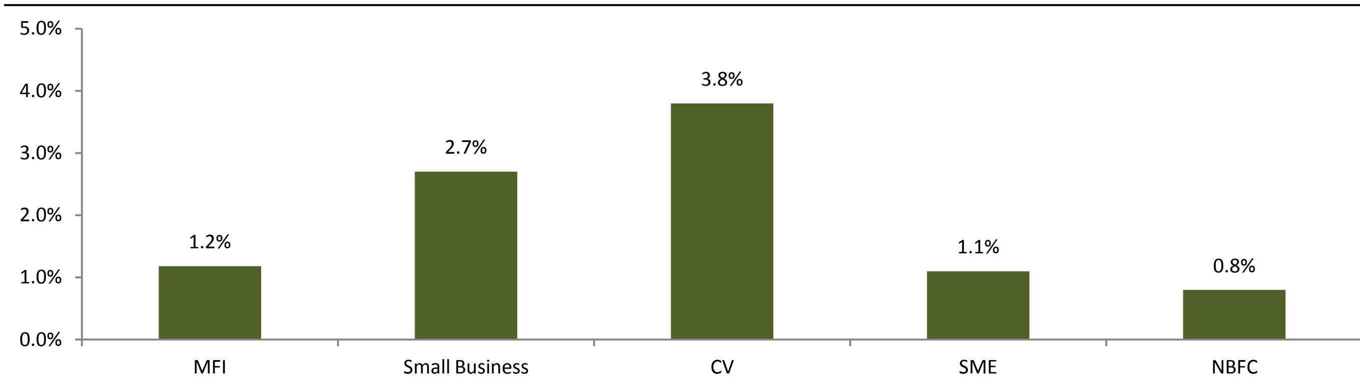
Post demonetization, overall GNPA has been stable in the 2.5-2.7% range which shall increase in FY21E on the back of Covid although the long term levels should continue to be below 3.0% levels.

Exhibit 13: Asset Quality has been stable post demonetisation



Source: Company, NBRR

Exhibit 14: Segment-wise GNPA as on Q1FY21



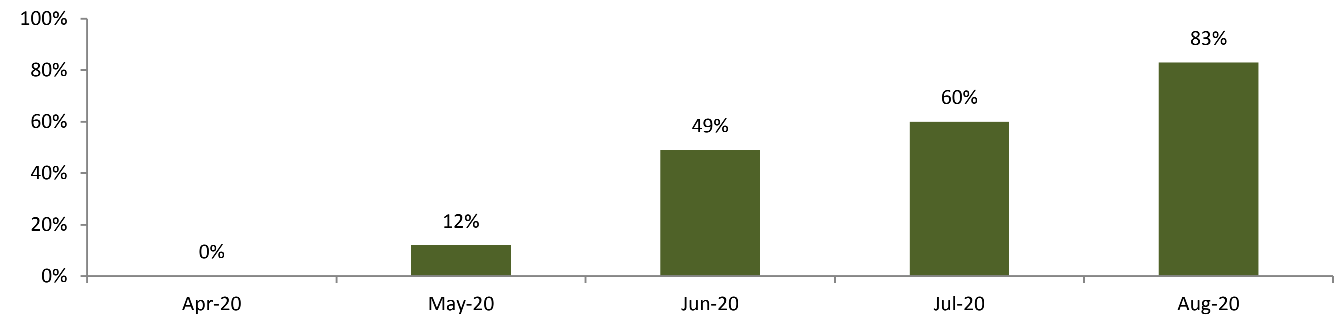
Source: Company, NBRR

……………. although impact of Covid-19 remains uncertain in near term

As the bank is undergoing the IPO process, it has not divulged the September data on moratorium or collection efficiency. As on August 2020, the collection efficiency has improved to 83% which has shown healthy improvement. The final impact on asset quality would only show up in Q3FY21 which would be dependent on the collection figures for the months of Sep, Oct and Nov.

Incoming Q2FY21 data from banks like Bandhan, Karnataka, South Indian and Federal suggests their collection efficiency for the month of September ranges between 80% - 92% and thus Equitas seems to be on track to reach similar levels for the month of September.

Exhibit 15: Trend in collection efficiency



Source: Company, NBRR

Key Risks & Concerns

Regional dependence on Tamil Nadu, Maharashtra & Karnataka
Equitas faces concentration risk with 62% of the advances and 30% of deposits sourced from Tamil Nadu. Equitas also sources 11%/9% of advances from Maharashtra and Karnataka. Any major change in the state's policies or a swing in regional environment can immediately affect the banks future prospects.

Farm Loan Waivers could negatively impact MF book
Although previous farm loan waivers in recent years in the states of UP, Maharashtra, Punjab and Karnataka had no impact on asset quality of MFIs, such waivers could lead to a more severe impact on MFIs in coming years. Currently political parties have declared farm loan waivers in their manifestos for Bihar elections. Although Equitas has almost nil exposure in Bihar, such political actions in other states will continue to be a risk for the MFI segment of Equitas.

Macro headwind: Interest rates
A steep rise in interest rates will have an adverse impact on the cost of borrowings and NIMs of all the banks. A continuous increase in interest rates would result in a compression in NIMs for Equitas.

Compliance with regulatory norms for SFBs could impact the business as well as the stock
In the event of the regulators not approving a reverse merger of the holdco with SFB, RBI norms mandate the promoters of SFBs to reduce their shareholding to 40% by the end of the fifth year of becoming a SFB. This would mean Equitas Holdings would have to reduce its stake in SFB from 82% (post IPO) to 40% by Sep 2021. Management has indicated it would look at acquiring another company via share swap (issuing fresh shares) which would result in dilution of promoter holding as well as consider selling shares in the stock market. This could lead to pressure on the stock price of Equitas SFB.

Valuation and Recommendation

Equitas primarily lends to the underserved areas with minimal or no access to formal sources of credit. Equitas has successfully reduced the microfinance mix in its loan book from 54% in FY16 to 23% today. Its diversified loan book, adequate capital, experienced management and conservative approach to minimize risk, provides Equitas a long runway for profitable growth. Prior to turning into a bank, Equitas grew its AUM at 60% CAGR over FY13-16, way ahead of industry growth.

Equitas' transition to a SFB during FY16-18 resulted in lower AUM growth (16% CAGR) and higher opex growth (57% CAGR), translating to lower return ratios. However, post the conversion, Equitas stepped up its loan growth to 37% CAGR over FY18-20 before Covid-19 started to impact the growth again. During this period, opex growth was subdued at 16% CAGR. This resulted in cost/income declining from 80%in FY18 to 66% in FY20 and a simultaneous increase in ROE from 1.6% in FY18 to 8.9% in FY20.

We believe Equitas SFB can deliver top quartile ROE of 15%+ in the long term (by FY23E) driven by a decline in cost/Income to below 60% from 66% in FY20 and normalization of credit costs to ~1.5% from 1.9% in FY20. Further Equitas has already been growing its AUM well above that of peer banks and NBFCs which is expected to continue. Equitas SFB is available at a 30% discount compared to listed peers. We recommend to 'Subscribe for long term'.

Exhibit 16: Peer Comparison

	Ujjivan SFB	Bandhan Bank	CUB	DCB	Chola	MMFS	Shriram City	Avg.	Equitas SFB
As on Q1FY21									
Loan Book (Rs cr)	14,366	74,331	34,536	25,058	63,504	63,805	28,452	43,436	14,389
CASA	14%	37%	25%	22%	NA	NA	NA	24%	20%
NIM	10.2%	8.2%	4.0%	3.4%	6.1%	8.7%	12.0%	7.5%	8.6%
Cost/Income	56%	28%	40%	50%	35%	25%	35%	38%	67%
GNPA	1.0%	1.4%	3.9%	2.4%	3.3%	9.2%	7.3%	4.1%	2.7%
NNPA	0.2%	0.5%	2.1%	1.0%	1.8%	5.7%	3.9%	2.2%	1.5%
Loan CAGR FY18-20	37%	28%	11%	12%	15%	16%	2%	17%	34%
ROA FY18	0.1%	4.1%	1.6%	0.9%	2.5%	2.1%	2.6%	2.0%	0.3%
ROA FY19	1.7%	4.2%	1.6%	1.0%	2.3%	2.6%	3.5%	2.4%	1.4%
ROA FY20	2.2%	3.6%	1.0%	0.9%	1.6%	1.3%	3.3%	2.0%	1.4%
ROE FY18	0.4%	26.0%	15.4%	9.8%	19.6%	12.7%	12.6%	13.8%	1.6%
ROE FY19	11.5%	19.0%	15.3%	11.0%	21.1%	15.8%	16.6%	15.8%	9.4%
ROE FY20	13.9%	21.1%	9.5%	10.3%	13.8%	8.3%	14.7%	13.1%	8.9%
P/ABV Trailing (x)	1.8	3.4	2.3	0.7	2.7	0.9	0.9	1.8	1.3

Source: NBRR

Annexure

Listing of Equitas SFB

As per RBI guidelines, a small finance bank has to list within a period of three years from the commencement of operations and thus Equitas Holdings had to list the small finance bank by September 4, 2019. However, Equitas Holdings was engaged with RBI and SEBI to permit a reverse merger of the holdco. with the SFB, which was eventually rejected. This led to the delay in the IPO process.

The RBI guidelines state that the promoter ownership has to reduce to below 40% on completion of five years of operations (Sep 2021). The management will again try to reverse merge the holdco into the SFB post the expiry of promoter lock-in of 5 years i.e. Sep 2021, subject to approval from RBI and SEBI. If the merger is not approved, the holdco. will look at acquiring another company via share swap (issuing fresh shares) which would result in dilution of promoter holding as well as consider selling shares in the stock market.

Exhibit 17: Key RBI guidelines for SFBs

Parameter	Guidelines
Objectives	Furthering financial inclusion by - • Providing savings vehicles primarily to unserved & underserved sections of the population • Supply of credit to small business units; small and marginal farmers; micro and small industries; and other unorganised sector entities
Eligible Promoters	• Resident individuals/professionals with 10 years of experience in banking and finance • Existing NBFCs, MFIs, and Local Area Banks (LABs)
Capital Requirement	• The minimum paid-up equity capital for SFBs is Rs. 100 Cr • Required to maintain a minimum capital adequacy ratio (CAR) of 15% of its risk weighted assets (RWA) on a continuous basis • Tier I capital should be at least 7.5% of RWAs; Tier II capital should be limited to a maximum of 100% of total Tier I capital
Listing on stock exchanges	• After the SFB reaches a net worth of Rs. 500 Cr, listing is mandatory within three years of reaching that net worth • SFBs having net worth of below Rs. 500 Cr can also get their shares listed voluntarily, subject to regulatory requirements
Prudential Norms	• To comply with CRR and SLR requirements in line with other banks • To extend 75% of its Net Bank Credit (ANBC) towards priority sector lending (PSL) • At least 50% of its loan portfolio to constitute loans and advances of up to Rs. 25 Lacs
Additional Requirements	• On conversion into an SFB, the NBFC / MFI will cease to exist; all its business should fold into the bank and the activities which a bank cannot statutorily undertake be divested / disposed of • Branches of NBFC/MFI should either be converted into bank branches or be merged/closed

Financials

P&L (Rs. Crs)	FY18	FY19	FY20	Q1FY20	Q1FY21
Interest earned	1,532	2,112	2,645	603	721
Interest expended	671	960	1,150	266	317
NII	**861**	**1,152**	**1,496**	**337**	**404**
Non interest income	241	283	282	59	30
Total income	**1,102**	**1,435**	**1,778**	**396**	**434**
Growth	*12%*	*30%*	*24%*		*9%*
Operating expenses	881	1,008	1,180	277	292
Growth	*43%*	*14%*	*17%*		*5%*
Staff costs	*520*	*551*	*710*	*169*	*194*
Other Op Exp	*361*	*457*	*470*	*107*	*97*
Profit before prov	**221**	**427**	**598**	**120**	**142**
Growth	*-40%*	*93%*	*40%*		*19%*
Provisions	172	101	247	31	24
Growth	*67%*	*-41%*	*144%*		*-23%*
Exceptional items	0	0	0	0	0
Profit before tax	49	325	351	89	118
Taxes	17	115	107	32	61
Net profit	**32**	**211**	**244**	**57**	**58**
Growth	*-80%*	*561%*	*16%*		*1%*

Bal. Sheet (Rs. Crs)	FY18	FY19	FY20	Q1FY21
Equity capital	1,006	1,006	1,053	1,053
Reserves & surplus	1,038	1,248	1,691	1,748
Net worth	2,044	2,254	2,744	2,802
Deposits	5,604	9,007	10,300	11,787
Growth	*256%*	*61%*	*14%*	*29%*
Borrowings	5,177	3,973	5,623	5,526
Other liab and prov	476	529	648	778
Total liabilities	11,257	13,508	16,571	18,090
Total liab and equity	**13,301**	**15,763**	**19,315**	**20,892**
Cash and bank bal	1,211	1,261	2,537	1,926
Investments	3,857	2,344	2,343	3,479
Net Advances	7,706	11,594	13,747	14,389
Growth	*32%*	*50%*	*19%*	*10%*
Other assets	246	327	475	902
Fixed Assets	281	237	213	198
Total assets	**13,301**	**15,763**	**19,315**	**20,892**

Key Ratios	FY18	FY19	FY20	Q1FY20	Q1FY21
Yield on Advances	19.7%	20.8%	18.9%	18.6%	18.8%
Cost of Funds	7.6%	8.1%	8.0%	7.9%	7.6%
Spread	12.1%	12.7%	10.9%	10.7%	11.2%
NIM	8.1%	8.6%	9.1%	8.9%	8.6%

Asset Quality	FY18	FY19	FY20	Q1FY21
GNPA	213	296	417	417
GNPA ratio	2.7%	2.5%	2.7%	2.7%
NNPA	111	167	229	213
NNPA ratio	1.4%	1.4%	1.7%	1.5%
PCR (Reported)	47%	43%	45%	49%
Credit Cost	2.5%	1.0%	1.9%	0.7%

Profitability Ratios	FY18	FY19	FY20	Q1FY20	Q1FY21
Cost / Income	80.0%	70.3%	66.4%	69.8%	67.3%
ROA	0.3%	1.4%	1.4%	1.4%	1.1%
ROE	1.6%	9.4%	8.9%	10.0%	8.3%

Balance Sheet Ratios	FY18	FY19	FY20	Q1FY21
CASA	29.2%	25.2%	21.4%	20.0%
CAR	28.6%	22.4%	23.6%	22.0%
Tier - 1	27.1%	20.9%	22.4%	21.0%

Per Share Data	FY18	FY19	FY20	Q1FY20	Q1FY21
EPS	0.3	1.8	2.1	0.5	0.5
BVPS #	18.0	19.8	27.3	20.3	27.8
Adjusted BVPS #	17.0	18.3	25.3	18.7	25.9

Valuation Ratios	FY18	FY19	FY20	Q1FY21
P/E	118.0	17.8	15.4	-
P/BV	1.8	1.7	1.2	1.2
P/ABV	1.9	1.8	1.3	1.3

Source: Company data, NBRR

 # EPS & BV of FY20 & Q1FY21 accounts for the fresh infusion of IPO funds of Rs. 280 Cr and addition to outstanding shares

Disclosure:

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