BUY
TP: Rs 1,500 | ⮝ 22%

AU SMALL FINANCE BANK | Banking | 07 April 2021

A budding, high-quality franchise – initiate with BUY

We expect AU Small Finance Bank's (AUBANK) longstanding expertise in vehicle finance and successful extension into secured business loans to aid a 22% loan CAGR over FY20-FY23. The bank's provisioning buffer is healthy at 2% of AUM and collections of >100% suggest ebbing Covid headwinds, even as liabilities are tilting toward low-cost funds. We value the bank at 5.3x FY23E P/BV given its asset quality record, strong growth visibility and potential universal bank transition post FY22 – initiate with BUY, Mar'22 TP Rs 1,500.

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Asset quality indicators improving: We believe AUBANK's GNPAs have peaked and slippages should normalise hereon as collections have crossed 100% and the loan book paying full dues has touched pre-Covid levels of 84% in Dec'20. Further, our channel checks indicate that demand in the CV segment – a meaningful business for the bank – is gradually picking up. We model for credit cost of ~1% in FY22-FY23.

Liabilities scaling up well: Upon conversion from an NBFC to a bank in FY18, AUBANK has successfully transitioned to deposits as its primary source of funding and these now form ~64% of the balance sheet. A higher-yield asset portfolio enables attractive interest rates to customers and has boosted the share of retail deposits to 55% vs. 43% in FY20, indicating improved granularity.

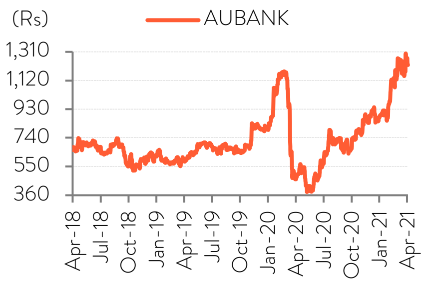
Core retail expertise to fuel growth: We expect a 22% CAGR in AUBANK's loan book over FY20-FY23 fuelled by the retail segment, especially vehicle finance and secured business loans. The recent ~Rs 6bn capital raise will support growth and also signals management's aspirations to become a universal bank.

Initiate with BUY: The stock is trading at 5.2x FY22E BV, ~10% premium to its 4Y average. Our Mar'22 TP of Rs 1,500 is set at 5.3x FY23E P/BV.

Ticker/Price	AUBANK IN/Rs 1,233
Market cap	US$ 5.1bn
Shares o/s	307mn
3M ADV	US$ 16.3mn
52wk high/low	Rs 1,354/Rs 366
Promoter/FPI/DII	29%/33%/38%

Source: NSE

STOCK PERFORMANCE



Source: NSE

KEY FINANCIALS

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
Net interest income	13,425	19,089	23,656	29,425	37,221
NII growth (%)	42.7	42.2	23.9	24.4	26.5
Adj. net profit (Rs mn)	3,818	6,748	12,489	11,811	16,059
EPS (Rs)	13.2	22.6	40.5	37.8	51.5
P/E (x)	93.3	54.5	30.4	32.6	24.0
P/BV (x)	12.2	8.7	6.2	5.3	4.4
ROA (%)	1.5	1.8	2.7	2.1	2.3
ROE (%)	14.7	18.6	23.7	17.5	19.9

Source: Company, BOBCAPS Research

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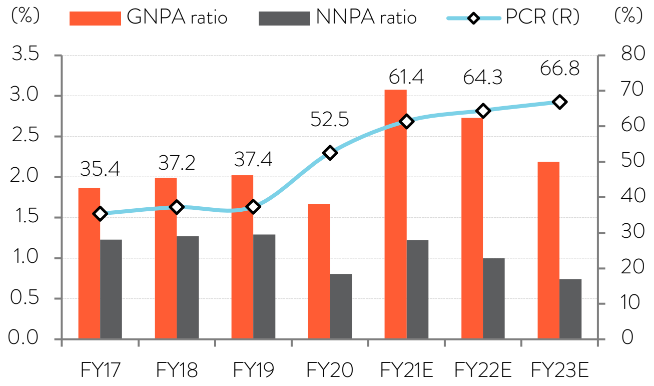
Focus charts

FIG 1 – COLLECTION EFFICIENCY AT 100% IN DEC'20

Product (%)	Dec-20	Q3FY20	Q2FY21	Q3FY21
Secured business loans	113	99	106	108
Vehicle Finance (Wheels)	98	99	89	92
NBFC Loans	99	100	105	99
Business Banking	97	96	105	100
Real Estate loans	105	91	110	102
Agri Loans	146	94	119	113
Home Loans	124	100	112	126
SME Loans	149	88	106	126
Personal Loans	99	95	88	92
Gold Loans	104	100	116	162
Consumer Durable Loans	108	97	85	97
Others	200	100	100	90
Grand Total	**103**	**98**	**96**	**97**

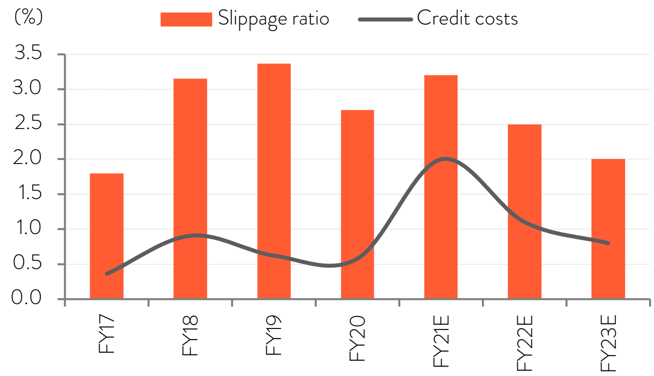
Source: Company, BOBCAPS Research

FIG 2 – HEADLINE NPAs LIKELY TO HAVE PEAKED…



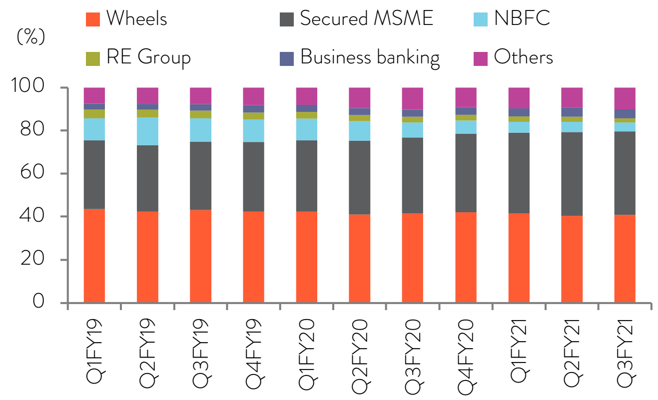
Source: Company, BOBCAPS Research

FIG 3 – …AND SLIPPAGES AND CREDIT COSTS FORECAST TO TREND LOWER FROM FY22E



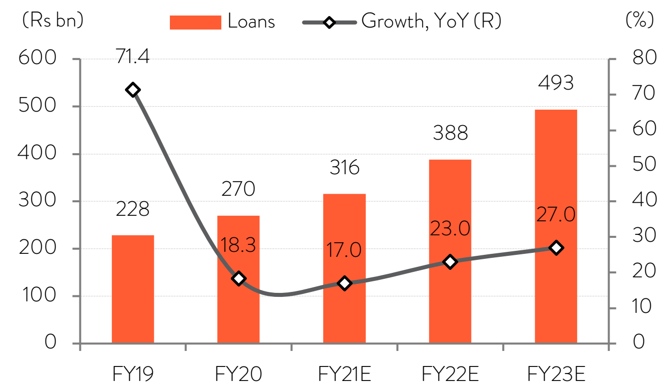
Source: Company, BOBCAPS Research

FIG 4 – GRADUALLY BUILDING A DIVERSIFIED LOAN PORTFOLIO



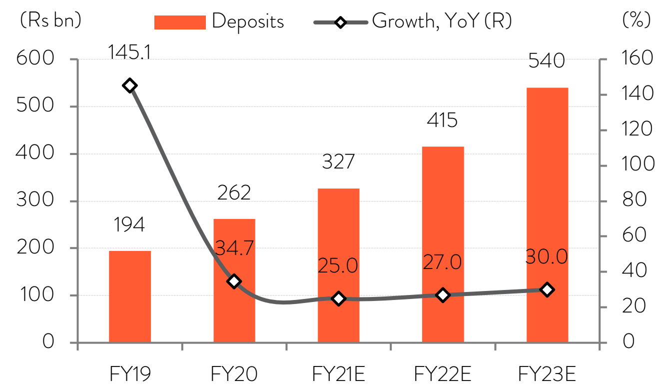
Source: Company, BOBCAPS Research | Note: Wheels – Vehicle finance division, RE Group – Real estate loans

FIG 5 – EXPECT RETAIL SEGMENT TO FUEL STRONG 22% CAGR IN LOAN BOOK OVER FY20-FY23E



Source: Company, BOBCAPS Research

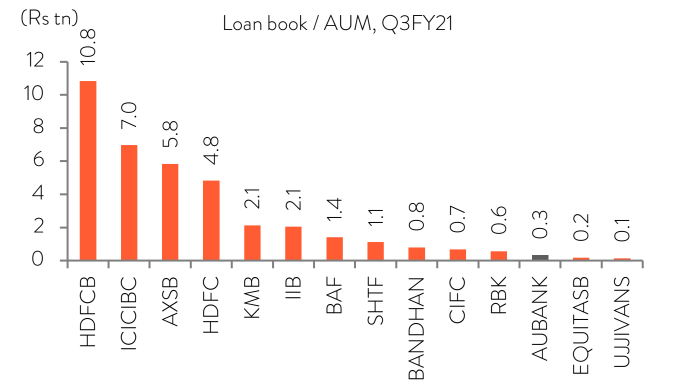
FIG 6 – DEPOSITS PROJECTED TO POST 27% CAGR OVER FY20-FY23E



Source: Company, BOBCAPS Research

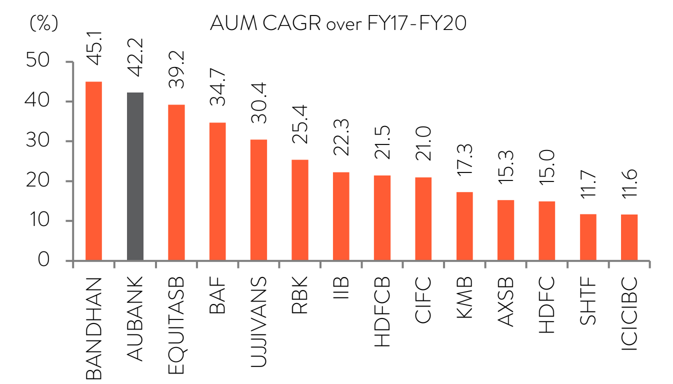
Peer comparison

FIG 7 – LOAN BOOK / AUM, Q3FY21



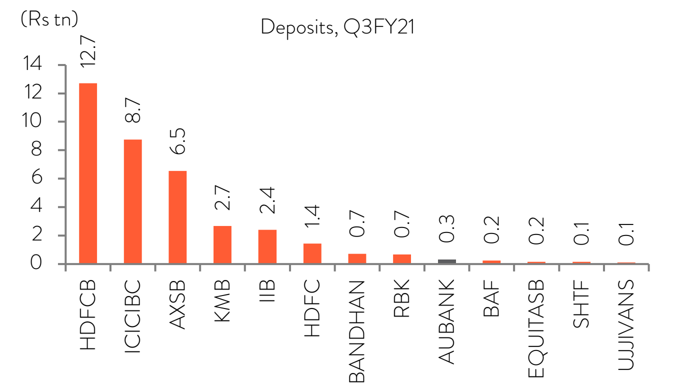
Source: Company, BOBCAPS Research

FIG 8 – AUM CAGR, FY17-FY20



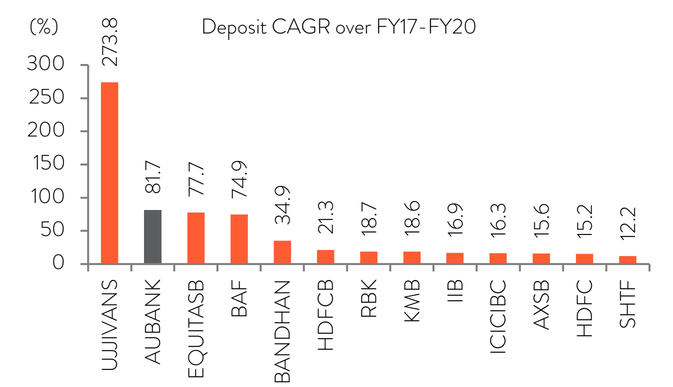
Source: Company, BOBCAPS Research

FIG 9 – DEPOSITS, Q3FY21



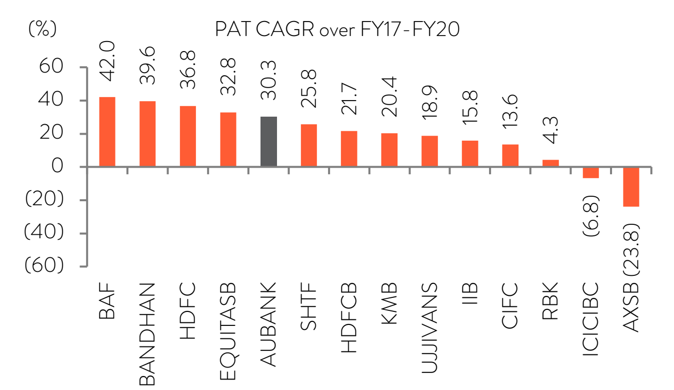
Source: Company, BOBCAPS Research

FIG 10 – DEPOSIT CAGR, FY17-FY20



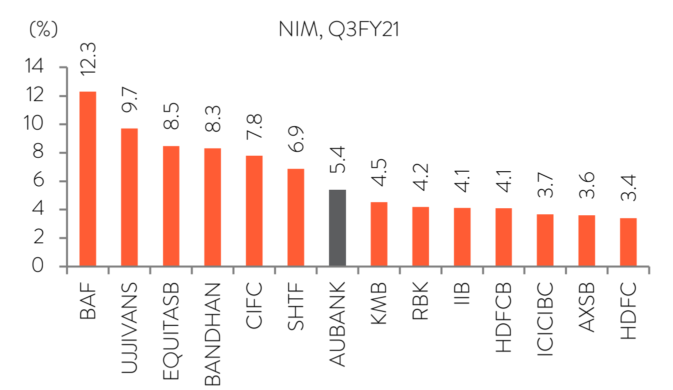
Source: Company, BOBCAPS Research | AUBANK CAGR over FY18-FY20

FIG 11 – PAT CAGR, FY17-FY20



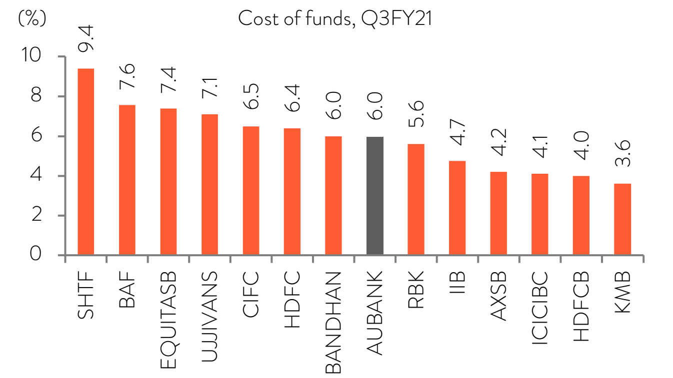
Source: Company, BOBCAPS Research

FIG 12 – NIM, Q3FY21



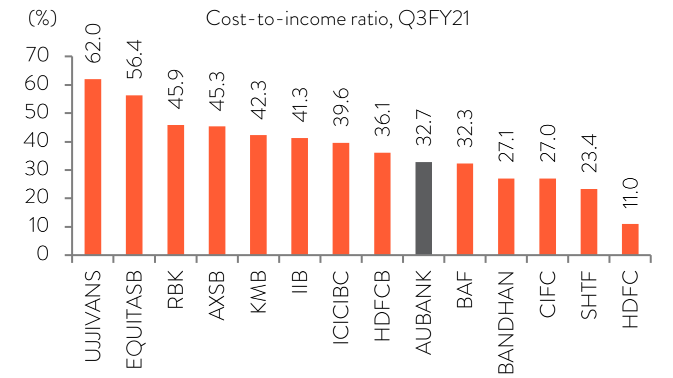
Source: Company, BOBCAPS Research

FIG 13 – COST OF FUNDS, Q3FY21



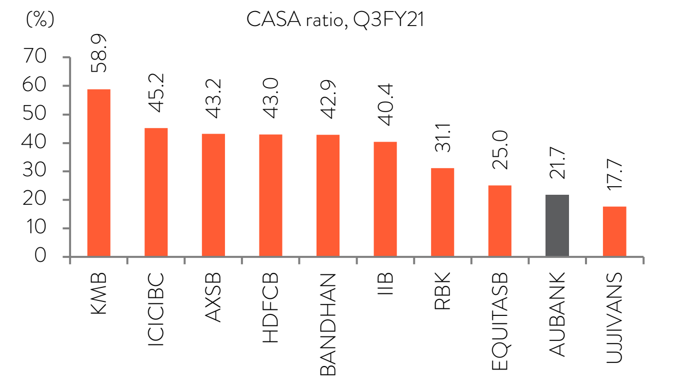
Source: Company, BOBCAPS Research

FIG 14 – COST-TO-INCOME RATIO, Q3FY21



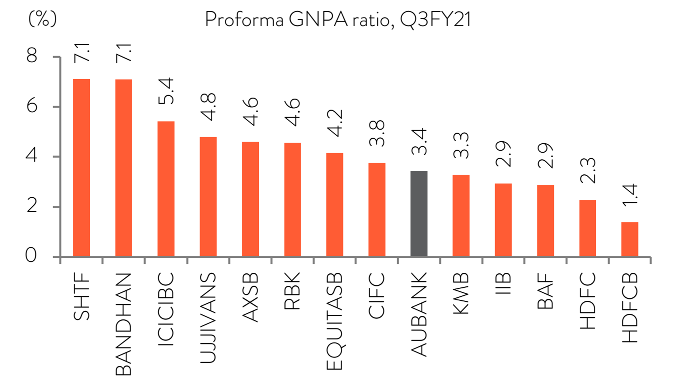
Source: Company, BOBCAPS Research

FIG 15 – CASA, Q3FY21



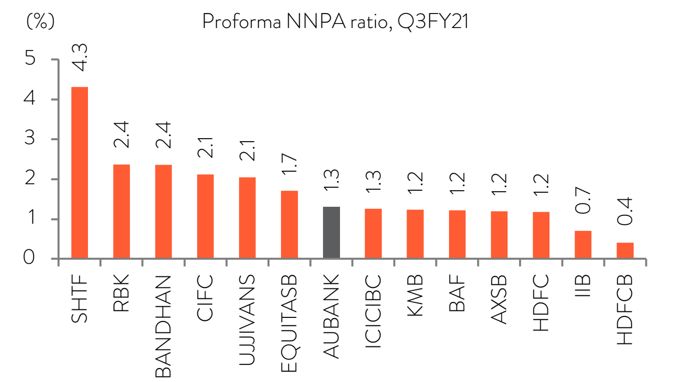
Source: Company, BOBCAPS Research

FIG 16 – PROFORMA GNPA RATIO, Q3FY21



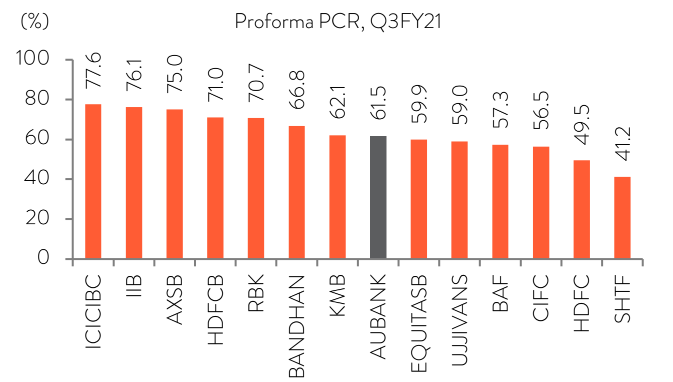
Source: Company, BOBCAPS Research

FIG 17 – PROFORMA NNPA RATIO, Q3FY21



Source: Company, BOBCAPS Research

FIG 18 – PROFORMA PCR, Q3FY21



Source: Company, BOBCAPS Research

BOBCAPS
TRUST | INNOVATION | EXCELLENCE

FIG 19 – PEER COMPARISON SNAPSHOT

Bank	Mkt Cap (Rs bn)	ROA (%)			ROE (%)			P/BV (x)			P/E (x)		
		FY21E	FY22E	FY23E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E
AUBANK	**382**	**2.7**	**2.1**	**2.3**	**23.7**	**17.5**	**19.9**	**6.2**	**5.2**	**4.3**	**30.2**	**32.3**	**23.8**
AXSB#	2,077	0.6	1.4	1.4	6.2	14.0	15.0	2.1	1.8	1.6	34.9	14.0	11.6
ICICIBC#	3,914	1.4	1.5	1.8	12.9	13.4	15.7	2.3	2.1	1.8	22.4	18.8	14.1
HDFCB#	7,940	1.9	2.0	2.0	16.9	18.2	19.1	3.9	3.4	2.9	25.5	20.7	17.1
KMB#	3,504	1.8	1.9	2.0	12.8	12.7	13.3	3.7	3.3	2.9	48.1	41.1	34.8
IIB	702	0.9	1.7	2.0	7.7	13.5	15.5	1.7	1.5	1.3	22.8	11.8	9.1
RBK	127	0.6	1.0	1.2	4.8	8.1	10.4	1.0	0.9	0.9	21.1	11.9	8.7
BANDHAN*	544	2.6	3.5	3.8	16.3	21.3	22.5	3.1	2.6	2.1	20.3	12.5	9.8
EQUITASB*	67	1.6	1.8	1.9	11.2	13.9	16.2	2.1	1.8	1.6	19.4	13.2	10.1
UJJIVANS*	53	0.2	2.1	2.2	0.3	13.7	15.8	1.8	1.6	1.3	87.3	12.1	8.9
CIFC*	443	2.4	2.7	2.8	18.1	19.5	19.6	4.8	4.0	3.3	28.1	21.8	18.2
SHTF*	364	2.1	2.5	2.7	12.2	13.8	14.4	1.7	1.5	1.3	14.6	11.2	9.5
BAF*	3,009	2.7	4.3	4.5	13.0	20.2	21.7	8.6	7.1	5.8	67.6	37.8	29.1
HDFC Ltd*	4,460	2.1	2.1	2.2	11.9	12.3	13.0	4.3	3.8	3.5	39.8	33.8	29.3

Source: Bloomberg, BOBCAPS Research | *Bloomberg estimates #Core P/BV (x)

Investment rationale

Superior risk management profile

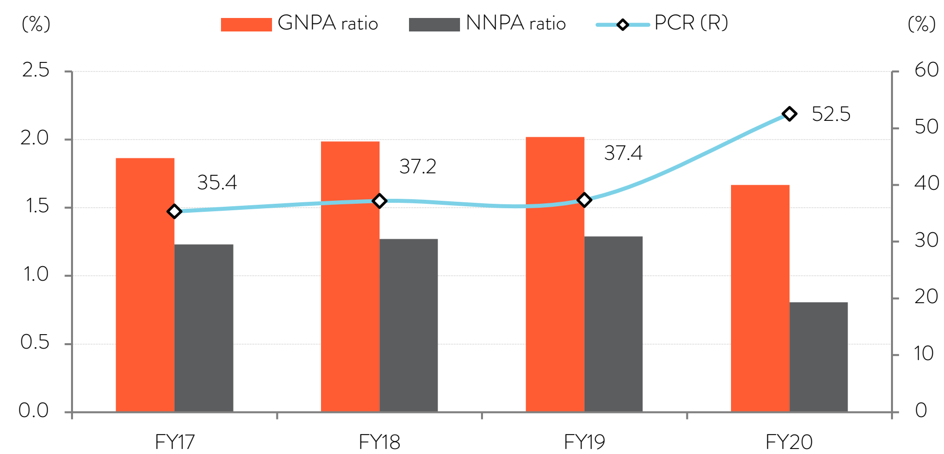
AUBANK has contained its GNPA ratio at manageable levels of sub-2% over FY17-FY20, outperforming its small finance peers by dint of prudent risk management and strict portfolio monitoring. Though Covid-19 headwinds have resulted in near-term asset pressure, we believe losses will be far lower than the industry average and the pace of recovery will be swifter. The bank's collection efficiency has already surpassed pre-Covid levels, crossing the 100% mark in Q3FY21. We estimate that slippages and credit costs will normalise to 2% and 0.8% of loans respectively by FY23E vs. 3.2% and 2% in FY21E.

Focused on secured retail lending

AUBANK offers small-ticket loans (<Rs 2.5mn) to self-employed and low-to-mid-income groups with limited access to credit. Unlike most other small finance banks (SFB), AUBANK does not have significant exposure to unsecured personal loans but instead focuses on the secured retail segment – its book is 98% secured and 90% retail-oriented with a thrust on income-generating loans, thereby lowering its risk profile and supporting stable asset quality across cycles.

GNPA ratio has held steady at ~2% over FY17-FY20 despite servicing a customer segment that is relatively challenging to underwrite and moving to stricter 90dpd NPA recognition norms after transitioning from an NBFC to a bank in FY18.

FIG 20 – GNPA RATIO HAS REMAINED AT SUB-2% OVER FY17-FY20

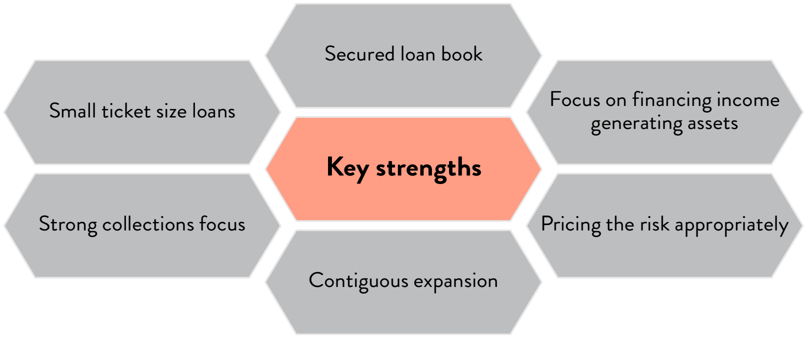


Source: Company, BOBCAPS Research

Robust credit processes

Over the years, AUBANK has associated with various prominent players such as HDFC Bank and Citibank for its financing business. These relationships have helped it develop strong credit screens and effective underwriting skills, resulting in robust asset quality. The bank has also imbibed the credit ethos and procedural rigour of these leading financial institutions.

FIG 21 – PILLARS OF AUBANK'S ASSET QUALITY



Source: Company, BOBCAPS Research

Strong in-house collection team

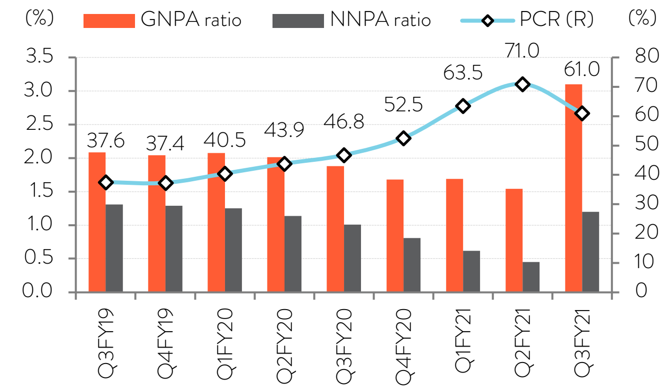
AUBANK mitigates asset risk and ensures functional expertise by assigning separate sub-teams for sales, underwriting, credit, collections and operations to each business vertical. A key feature of the bank's risk management strategy is a robust collection system which is based on geography, delinquency, product, and customer repayment history, among others. It includes a central control room that manages allocations among collection executives and uses analytics for optimum distribution of cases to the team. Regular customer engagement and business-to-employee (B2E) communication help strengthen the collection management function.

The bank also has a specialised team to manage cases where collections are overdue beyond a certain period, besides professional partners in select metro and micro markets for bucket-1 and bucket-2 cases that drives cost efficiency.

Covid-led disruptions manageable

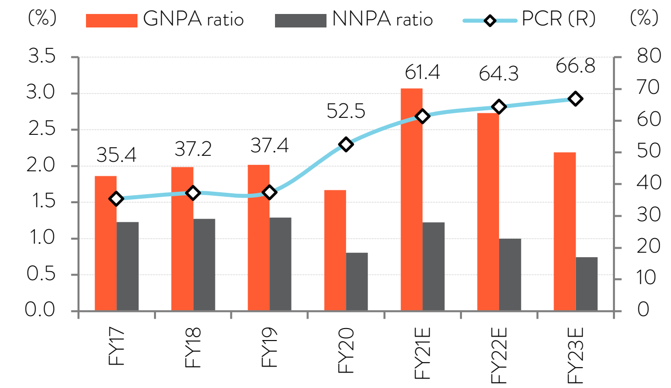
Like most banks, the Covid-19 pandemic has led to a deterioration in AUBANK's asset quality. Aided by the asset classification standstill and heavy write-offs, its reported GNPA ratio declined to 1% in Q3FY21 but proforma GNPAs increased to ~3.3%. The bank expects to restructure a further ~1.5% of loans, of which 0.8% has been implemented so far. This takes overall stressed assets – i.e. restructured book plus proforma GNPAs – to ~4.6% of AUM. A large part of this stress resides in segments such as vehicle finance (specifically taxis and buses) and secured business loans.

FIG 22 – PROFORMA GNPA RATIO SPIKED TO 3.3% IN Q3FY21…



Source: Company, BOBCAPS Research

FIG 23 – …BUT EXPECTED TO NORMALISE TO 2.2% LEVELS BY FY23E



Source: Company, BOBCAPS Research

The bank has created 60% coverage on proforma GNPAs and >40% on overall stressed loans by using a large chunk of the Rs 4.2bn post-tax gain arising from its Aavas stake sale. In our view, AUBANK's provisioning buffer is healthy and should suffice to address losses from the current identified stressed portfolio.

FIG 24 – PCR OF >40% ON STRESSED LOANS

Particulars	Amount (Rs mn)
Proforma GNPAs	10,170
Expected restructured loans	4,983
Total stressed loans	15,153
as a % of AUM	**4.6**
Provisions on NPAs	6,250
Provisions on restructured loans	480
Total provisions	6,730
as a % of AUM	**2.0**
Total coverage on stressed loans (%)	**44.4**

Source: Company, BOBCAPS Research

Besides healthy provisioning buffers, we expect NPAs and credit cost to trend lower in FY22 as the bank's customer activation rate (i.e. those repaying loans against demand) and collection efficiency levels have been improving MoM. In Dec'20, collection efficiency crossed the 100% mark while repayment behaviour returned to pre-Covid levels with 84%/7% of the loan book receiving full/part payment of dues in December compared to normal levels of 80%/5%.

FIG 25 – COLLECTION EFFICIENCY HAS REACHED 100% IN DEC'20

Product (%)	Dec-20	Q3FY20	Q2FY21	Q3FY21
Secured business loans	113	99	106	108
Vehicle Finance (Wheels)	98	99	89	92
NBFC Loans	99	100	105	99
Business Banking	97	96	105	100
Real Estate loans	105	91	110	102
Agri Loans	146	94	119	113
Home Loans	124	100	112	126
SME Loans	149	88	106	126
Personal Loans	99	95	88	92
Gold Loans	104	100	116	162
Consumer Durable Loans	108	97	85	97
Others	200	100	100	90
Grand Total	**103**	**98**	**96**	**97**

Source: Company, BOBCAPS Research

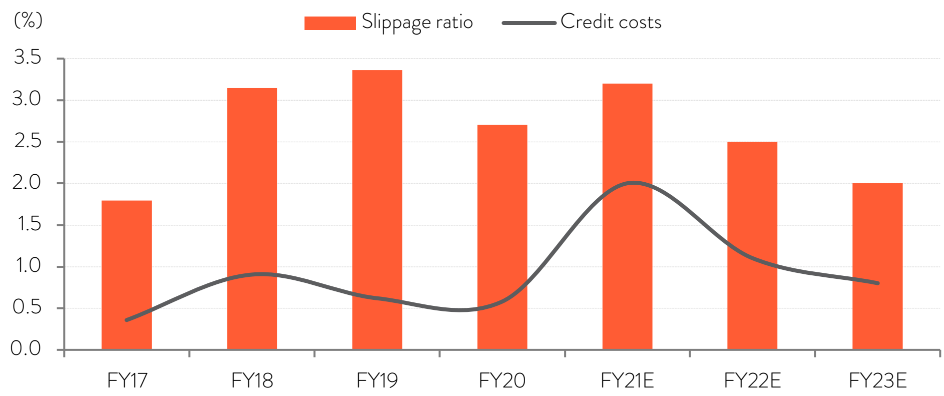
FIG 26 – CUSTOMER ACTIVATION RATES HAVE NORMALISED IN MOST SEGMENTS

Product (%)	Apr'20		May'20		Jun'20		Sep'20		Dec'20	
	Full	Part	Full	Part	Full	Part	Full	Part	Full	Part
Secured business loans	55	25	55	9	67	9	82	5	84	8
Vehicle Finance (Wheels)	42	26	42	6	64	8	72	5	81	6
NBFC Loans	81	13	74	23	89	7	100	0	99	0
Business Banking	78	6	78	4	85	2	94	2	96	2
Real Estate Loans	48	8	42	10	52	3	86	9	86	12
Agri Loans	71	10	72	4	79	3	94	2	93	4
Home Loans	70	22	66	7	83	5	92	4	93	3
SME Loans	40	22	40	10	50	4	78	8	75	14
Personal Loans	52	14	45	6	69	7	81	5	82	8
Gold Loans	61	17	34	14	67	7	72	5	75	6
Others	98	0	100	0	100	0	100	0	100	0
Grand Total	**53**	**23**	**53**	**8**	**67**	**8**	**78**	**4**	**84**	**7**

Source: Company, BOBCAPS Research | Note: Customer activation rate denotes the percentage of customers making repayments during the billing month

In our view, AUBANK will recover from the impact of Covid-19 faster than peers as a large share of its customers are engaged in essential services. Credit cost which has averaged at ~60bps over the last five years will likely start normalising from FY22. We estimate slippages and credit cost at 3.2% and 2% respectively in FY21, before recovering to 2% and 0.8% of loans by FY23.

FIG 27 – SLIPPAGES AND CREDIT COSTS TO TREND LOWER FROM FY22E



Source: Company, BOBCAPS Research

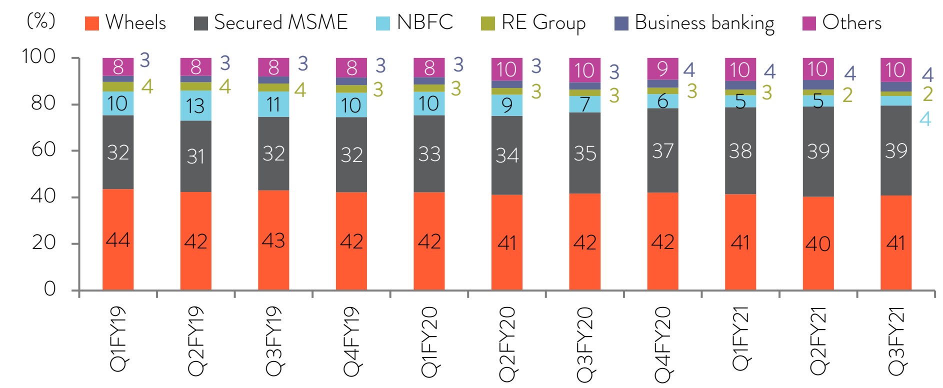
Sustainable retail franchise

AUBANK specialises in small-ticket retail loans to the vast pool of underbanked customers in India's fast-growing tier-2/3 markets. At >Rs 300bn, retail asset AUM forms 90% of the loan book and has clocked a robust 42% CAGR over the last five years. Our channel checks suggest a gradual pickup in used commercial vehicle demand as economic activity improves. We expect the bank's niche credit focus and longstanding expertise in the core segment of vehicle finance (44% of retail AUM, Q3FY21) coupled with successful extension into MSME loans (42%) to underpin a 22% CAGR in overall loan book during FY20-FY23.

Building a diversified portfolio

AUBANK, which began as an NBFC in 1996 with one product (vehicle financing), one location and a small team, transitioned into an SFB in FY18 and today offers more than 30 products at 697 banking touchpoints across 14 markets, backed by a team of 16,700+ employees. 'Wheels' which is the vehicle financing brand and MSME loans remain the bank's core retail asset products, though home loans have been gaining importance as well. Others such as gold loans and digital solution-based products (personal loans, consumer finance) are also seeing good traction.

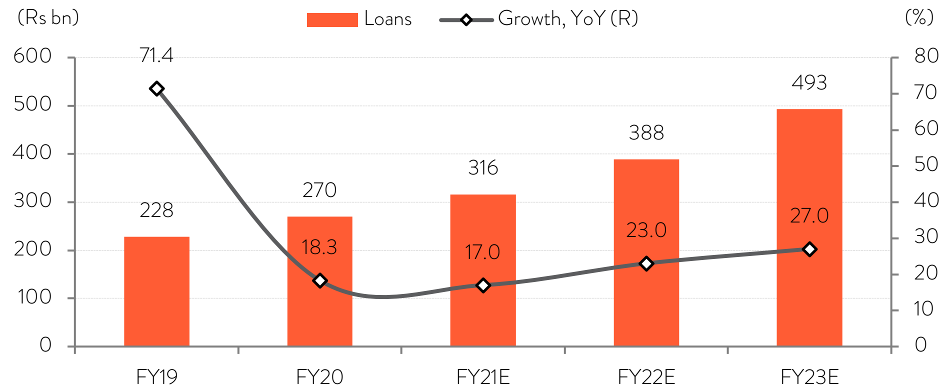
FIG 28 – DIVERSIFYING THE LOAN PORTFOLIO



Source: Company, BOBCAPS Research | Note: Wheels – Vehicle finance division, RE Group – Real estate

Aided by its conversion to a bank and niche customer focus, AUBANK has posted a 42% CAGR in retail asset AUM over the last five years, forming 90% of the loan book. The focus is on providing small-ticket, income-generation loans secured by underlying assets to self-employed and low-to-mid-income groups. The bank caters to new-to-credit borrowers or those with minimal access to formal sources of credit. We believe this largely underpenetrated market segment is an attractive space with substantial headroom for growth.

FIG 29 – EXPECT RETAIL SEGMENT TO FUEL STRONG 22% CAGR IN LOAN BOOK OVER FY20-FY23E



Source: Company, BOBCAPS Research

Vehicle finance a well-seasoned book

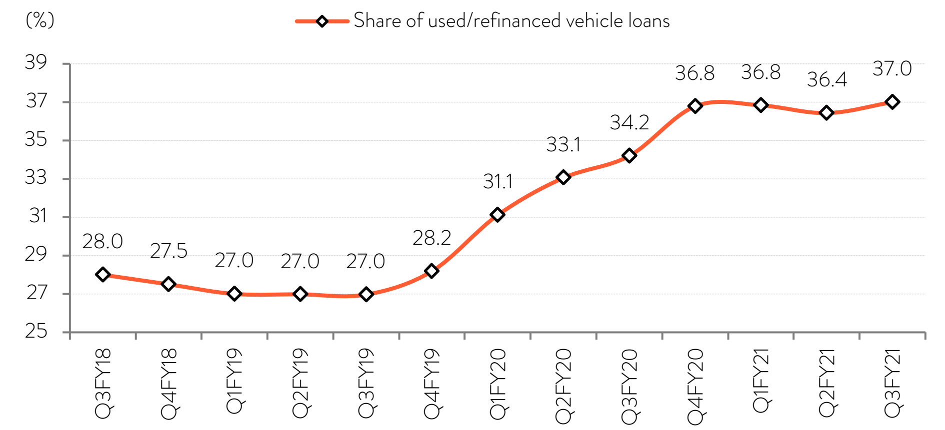
AUBANK's vehicle finance business 'Wheels' began operations over two decades ago in 1996, making this the most seasoned book in its portfolio. Within vehicle loans, the bank has among the most comprehensive product offerings and extends credit for 2- to 22-wheel vehicles, for new as well as used vehicles, and for personal as well as commercial use.

This business forms 41% of the overall loan book and has a strong risk-adjusted return due to its secured and granular nature, complete in-house business model, management's longstanding experience in its primary area of operations, and adequate lending spreads that provide a cushion to cover credit costs.

Increasing share of used vehicle loans to mitigate slowdown

In order to combat slower new-vehicle business in recent years, the bank has increased its focus on the used segment, which offers higher risk-adjusted yields and better profitability. AUBANK is one of the few early lenders to have successfully built a scalable business model in the pre-owned vehicle financing market by rapidly expanding its used-car dealer network and aligning its resources in that direction. This has resulted in a judicious new-to-pre-owned portfolio mix, wherein the contribution of used/refinanced vehicle loans has increased to 37% of segmental AUM in Q3FY21 from 28% as of FY18.

FIG 30 – SHARE OF USED / REFINANCED VEHICLE LOANS HAS INCREASED



Source: Company, BOBCAPS Research

Improving economic activity driving gradual pickup in CVs

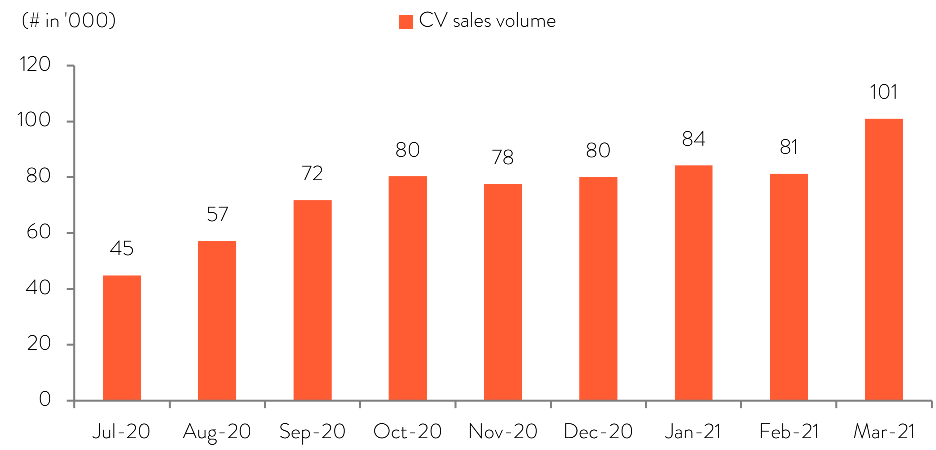
CVs form ~50% of AUBANK's vehicle finance book. Our checks with industry players suggest that overall economic activity has been picking up on a MoM basis. Consumption cargo remained flat in Q4FY21 as Q3 saw festive demand but bulk cargo has picked up QoQ. Operators fear that the current lockdown in Maharashtra will affect last-mile delivery due to timing restrictions, though movement of goods originating from the state would only be marginally affected. Also, the adverse impact on business may not be as severe as that seen during the initial lockdown in Mar'20.

As per one of the largest truck load companies, average fleet utilisation in Q4 has reached the pre-Covid levels seen during Jan-Feb'20. The industry has taken a freight rate hike of ~20% in Q3 and 4-5% in Q4, thereby preserving margins in the face of higher fuel prices. However, operators' working capital is wearing thin due to delayed customer payments.

CV demand has been gradually improving, especially for used CVs, given the improvement in fleet utilisation and rise in economic activity. However, the fear of lockdowns being extended to other states has instilled a degree of uncertainty among buyers as these restrictions can hamper vehicle movement.

Small fleet operators are facing a liquidity crunch but are collaborating with larger players and bringing their fleet to use. However, if movement restrictions impede business activity in Q1 and Q2FY22, we could see a large-scale impact on these operators. Lenders are currently taking a softer approach towards repossessing vehicles on profitable truck routes and are extending support if they find operator cash flows improving. Segments such as taxis, school and private staff buses continue to reel under stress as they await reopening of offices and schools.

FIG 31 – CV SALES VOLUME IN MAR'21 IS UP 24% MOM



Source: BOBCAPS Research | CV sales data for Tata Motors, Ashok Leyland and Mahindra & Mahindra

Secured business loans a natural extension – aiding diversification

Given its access to the self-employed segment and presence in tier-2/3 cities, the bank was able to easily extend its services into the self-employed/secured business loans segment. This portfolio offers a healthy risk-adjusted return and is granular in nature with an average ticket size of ~Rs 1.1mn. Tenure of the book is higher than vehicle finance, which leads to slower rundown of AUM. The share of secured business loans in the overall portfolio has risen from 15% in FY13 to ~39% currently, and we expect the strong growth momentum to continue.

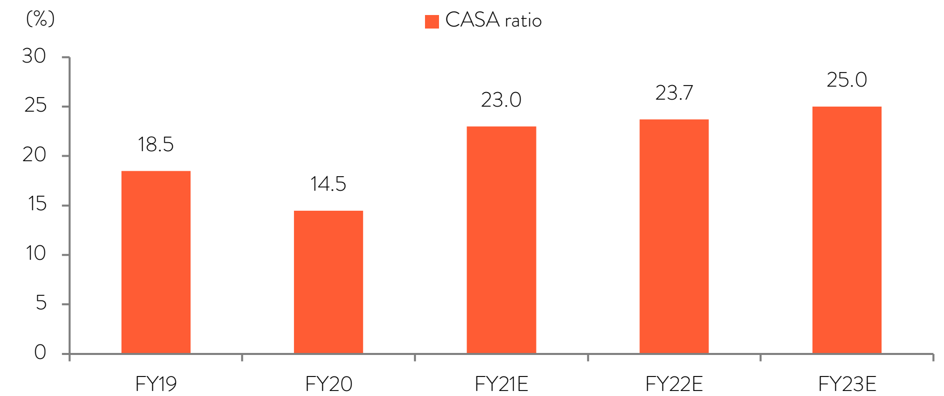
Liability profile gradually scaling up

AUBANK's transition from NBFC to bank in FY18 gave it access to deposits and thus helped contain the cost of funds. The bank has steadily ramped up its deposit franchise to 64% of the balance sheet as of Q3FY21 vs. 53% in Q3FY19. Reduced reliance on bulk funds has also aided ~140bps (over FY20) reduction in incremental cost of funds to 6% in 9MFY21. We believe attractive interest rates, a differentiated customer acquisition strategy and a large presence in high-deposit geographies will aid a 27% CAGR in deposits over FY20-FY23.

Targeting a granular retail deposit franchise

Management's primary focus is to create a granular retail deposit base – to this end, AUBANK offers competitive pricing, product features and customer service vis-à-vis other private banks. CASA and retail term deposits have been increasing steadily and stood at 55% of deposits in Q3FY21 vs. 43% in Q3FY20. This has led to ~140bps (over FY20) reduction in incremental cost of funds to 6% in 9MFY21.

FIG 32 – EXPECT CONSISTENT IMPROVEMENT IN CASA PROFILE



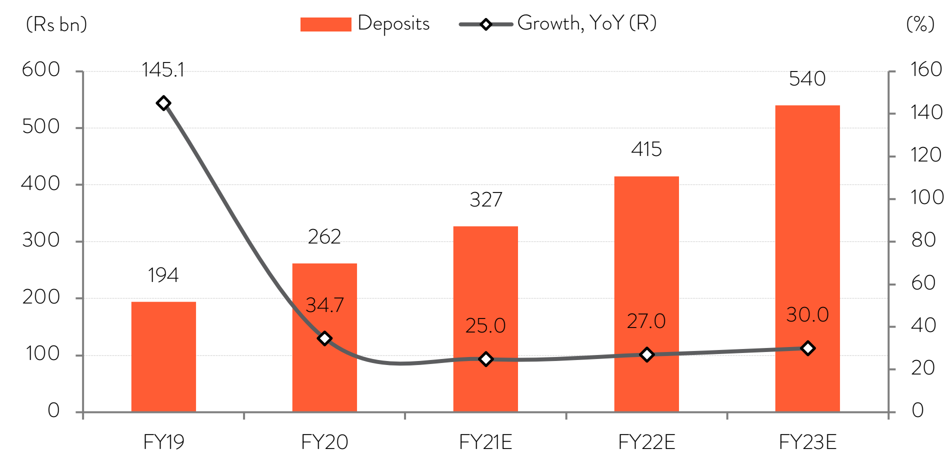
Source: Company, BOBCAPS Research

FIG 33 – HIGH INTEREST RATES AUBANK'S KEY USP IN GARNERING DEPOSITS

Savings account balances	Interest rate (%)
<Rs 0.1mn	3.5
>=Rs 0.1mn to <Rs 0.5mn	5.0
>=Rs 0.5mn to <Rs 1mn	6.0
>=Rs 1mn to <Rs 50mn	7.0
>=Rs 50mn to <Rs 100mn	6.0

Source: Company, BOBCAPS Research

FIG 34 – DEPOSITS PROJECTED TO POST 27% CAGR OVER FY20-FY23E



Source: Company, BOBCAPS Research

Judicious fund sourcing

In order to stabilise the cost of funds, AUBANK is reducing its reliance on inter-bank funds, money market borrowings and bulk deposits. The bank has been actively using its surplus liquidity and healthy CASA accretion to shed bulk deposits and avoid intake of high-cost wholesale deposits.

In addition, management uses the securitisation route to raise long-term, low-cost funds by assigning a part of its retail loan portfolio to various investors. During FY20, the bank securitised a portfolio of Rs 40.4bn, of which ~Rs 10.1bn was securitised in Mar'20 itself.

Differentiated customer growth strategy

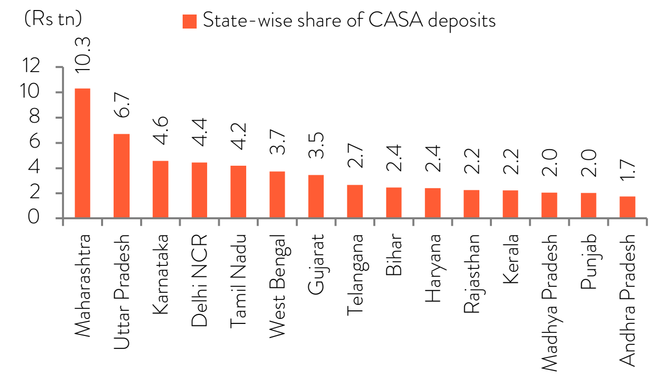
We expect multipronged customer acquisition efforts and improved productivity from the liability infrastructure (branches and people) built by the bank over the past few years to support a sustained 27% CAGR in deposits over FY20-FY23.

- **Targeted client acquisition:** AUBANK uses a sniper strategy rather than carpet-bombing to acquire customers. While its branches concentrate on retail deposits (<Rs 50mn), a separate team focuses on wholesale deposits and government business. The bank has also formed a specialised team for core markets where it has a dominant presence and can provide services more efficiently.
- **Account monitoring:** To deepen existing customer relationships, each new account is monitored for 3-6 months for activation and balance accretion.
- **Digital innovation:** Being a young and agile bank, AUBANK continues to invest in new, innovative digital products and uses technology to enhance customer experience wherever possible. For instance, new customers can open savings accounts using tablets that offer Aadhar validation through biometric identification. In FY20, ~93% of its savings accounts were opened in this way.
- **Creative services:** The bank's liabilities franchise is also credited with unique first-time initiatives, including monthly interest payouts on savings accounts, paperless and digital customer acquisitions, extended banking hours, no 'home branch' concept, no slips for cash deposits or withdrawals, and no form for RTGS fund transfer.
- **Full-service buildout:** In order to become the primary bank for its customers, AUBANK aims to transform into a full-service player across the UPI, bill payment, insurance and mutual fund segments, among others. It is also leveraging partnerships with fintech companies and expanding offerings in the debit card base to diversify the payments ecosystem, besides cross-selling products to existing customers.
- **Wide, tactical presence:** AUBANK has a strong presence across 15 states and 2 union territories and a strategy to deepen penetration in existing high-deposit-yielding geographies (mainly in urban markets). Branch-agnostic sales hubs enable it to expand the liabilities base further away from its branches.

Strategic expansion in states with high CASA market share

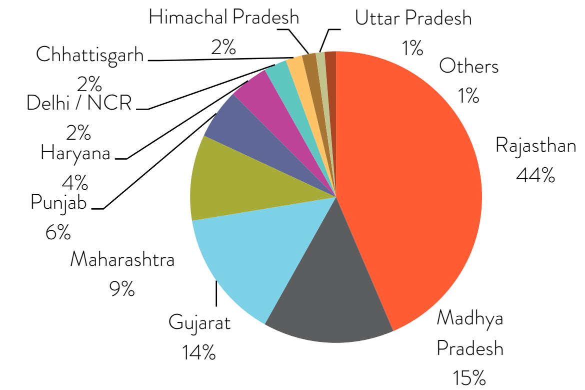
AUBANK's overall deposit market share is low at 0.2%. However, its market share in home state Rajasthan is much better at ~1.7% given strong brand recall. In order to improve its share of low-cost deposits, the bank is strategically building its network in states such as Rajasthan, Gujarat, Madhya Pradesh and Maharashtra that have a better CASA float.

FIG 35 – STATE-WISE CASA DEPOSITS AS ON Q3FY21



Source: Company, BOBCAPS Research

FIG 36 – AUBANK'S DISTRIBUTION NETWORK SPLIT



Source: Company, BOBCAPS Research

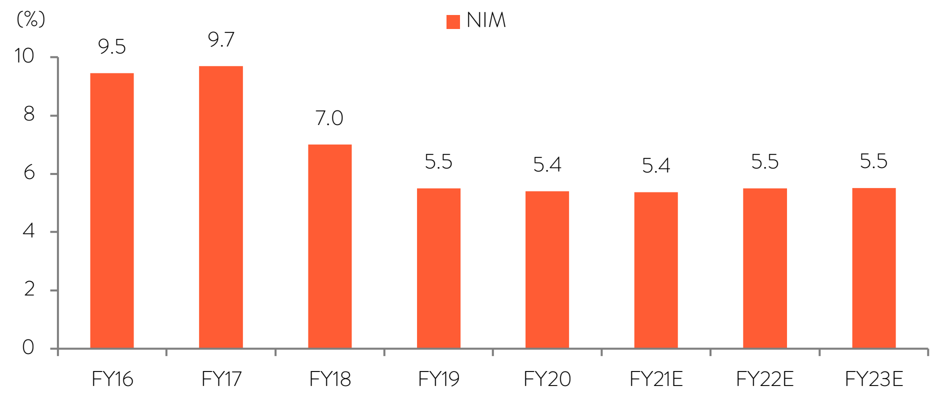
Operating metrics set to improve

Stricter liquidity norms for banks as compared to NBFCs and investments to build out branches and services weakened AUBANK's operating metrics post business transition. Nevertheless, we expect steady moderation in core cost-to-income ratio as the franchise gradually gains scale. NIM is forecast to sustain at ~5.5% over FY20-FY23 based on the expected 22% CAGR in loan book and a cheaper funding mix in favour of retail deposits.

Niche borrower profile provides pricing power and cushions NIMs

After transitioning into an SFB, AUBANK's net interest margin (NIM) dropped to 5.5% in FY19 as yields declined due to regulatory requirements (SLR/CRR/LCR). The bank has maintained higher liquidity over the past few quarters to tide over the turbulent pandemic period, which also weighed heavily on margins. However, cost of funds has improved on the back of a gradual and sustained increase in deposits and lower reliance on inter-bank and money market borrowings. We thus expect NIMs to sustain at current levels of 5.4-5.5% in the medium term.

FIG 37 – NIM EXPECTED TO SUSTAIN NEAR CURRENT LEVELS



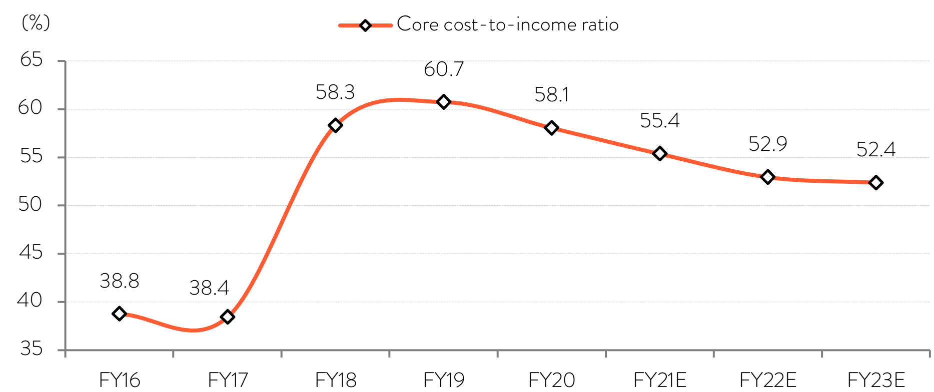
Source: Company, BOBCAPS Research

Cost-to-income ratio should moderate

AUBANK's operating expenses ballooned upon SFB conversion mainly due to its investments in technology, branches, liability centres and employees. The bank is now well positioned with respect to asset branches while liability branches are being planned in metro cities to diversify its retail-focused deposit base. We believe the core cost-to-income ratio would moderate gradually to 52% by FY23 as operating leverage unfolds on the back of stronger loan growth.

About 85% of AUBANK's lending is towards priority sector loans vs. the regulatory requirement of 75%. Hence, the bank can actively participate in the priority sector lending certificate (PSLC) market, where it trades its right of claim on priority loans for a fee. It generated fee income of Rs 160mn from PSLCs sold in H1FY21. Expansion in the payments ecosystem, bancassurance partnerships and introduction of credit cards should provide a further boost to fee income.

FIG 38 – EXPECT GRADUAL MODERATION IN COST RATIO



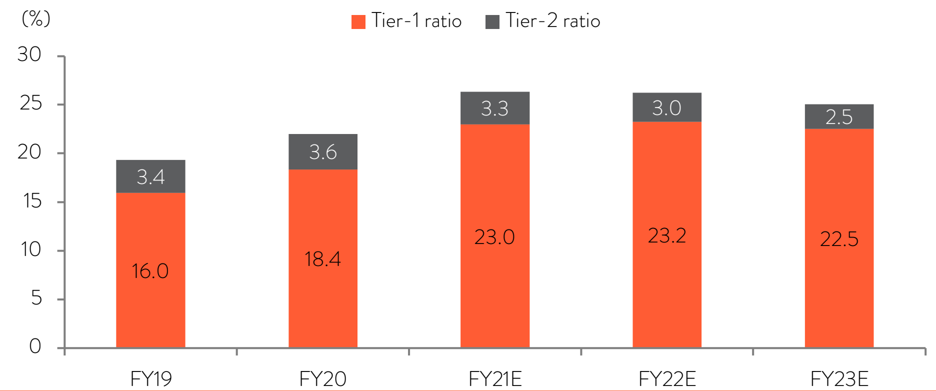
Source: Company, BOBCAPS Research

Recent capital raise provides fuel for growth

AUBANK's tier-1/CRAR ratio dropped to 16.3%/18.8% in Q3FY21 ex-9M profit (20%/23.5% including profits) from 18.3%/21.5% in Q2 owing to a steep rise in risk-weighted assets. Despite its capital ratios being above the regulatory requirement of 7.5%/15%, the bank recently raised ~Rs 6.25bn at Rs 1,251/sh. This is estimated to increase the tier-1/CRAR ratio by 244bps/251bps.

With this, AUBANK has adequate capital to fuel growth for the next 1.5-2 years. We also believe the capital raise is intended as a preparatory measure to apply for a universal banking licence once the bank completes five years of operations as an SFB in Apr'22. In our view, the journey towards becoming a universal bank should be relatively smooth as AUBANK does not have a holding company structure, unlike other SFBs.

FIG 39 – ADEQUATE CAPITAL FOR GROWTH



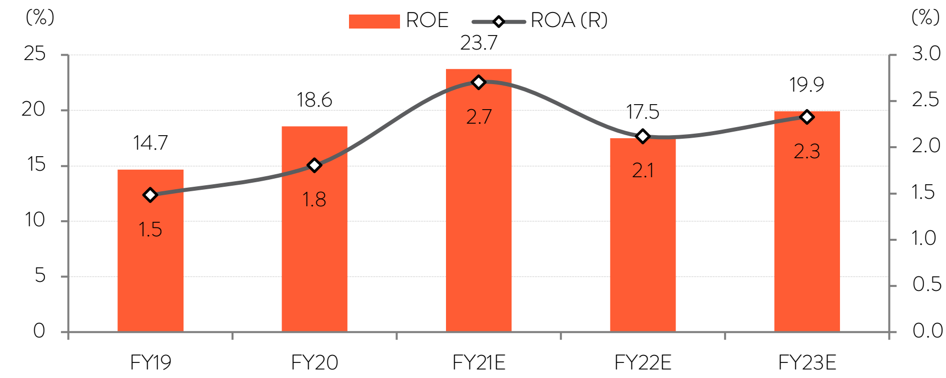
Source: Company, BOBCAPS Research

Valuation methodology

We like AUBANK for its niche focus on small-ticket, secured retail loans to the self-employed and low/mid-income segments. We expect to see healthy earnings traction in coming years and model for a 34% earnings CAGR over FY20-FY23 based on expected loan book growth, moderation in credit cost and healthy margins.

The bank largely caters to bottom-of-the-pyramid customers who are new to credit or have little access to formal loans – an under-served market segment that offers large opportunities for growth. Further, management's focus on strong risk-adjusted returns is reflected in its earnings performance across cycles (38% CAGR over FY13-FY20). We believe return ratios would start improving from FY22 and expect the bank to deliver FY23 ROA/ROE of 2.3%/20%, driven by better loan growth and lower credit cost.

FIG 40 – PROFIT RATIOS EXPECTED TO REMAIN STRONG



Source: Company, BOBCAPS Research

At CMP, the stock is trading at 5.2x on FY22E PBV, ~10% premium to its four-year average of 4.8x. We assign a BUY rating with a Mar'22 target price of Rs 1,500, set at a target multiple of 5.3x FY23E P/BV to reflect the bank's strong asset quality record, sustained profitability, long-term growth visibility and potential conversion into a universal bank post FY22.

FIG 41 – VALUATION SUMMARY

Components of Gordon growth model	Assumptions (%)
Cost of equity (%)	13
Blended ROE (%)	23
Initial high growth period (yrs)	10
Payout ratio of high-growth phase (%)	15
Long-term growth (%)	6.8
Long term dividend payout ratio (%)	70
Justified P/BV Multiple (x)	5.3
Implied BVPS (Rs)	283
Value per share (Rs)	1,500

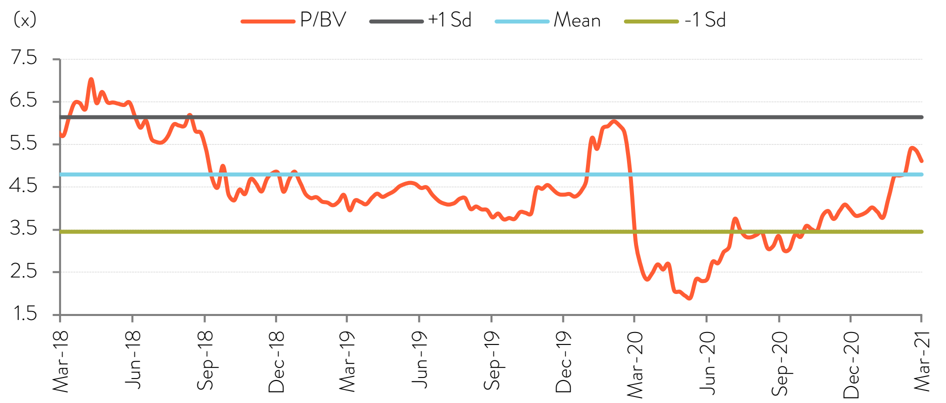
Source: Bloomberg, BOBCAPS Research

FIG 42 – BOBCAPS VS. CONSENSUS ESTIMATES

Particulars	FY21E	FY22E	FY23E
EPS (Rs)			
BOBCAPS estimates	40.5	37.8	51.5
Consensus estimates	33.1	33.2	42.4
BOBCAPS vs. Consensus (%)	22.5	13.9	21.4
BVPS (Rs)			
BOBCAPS estimates	198.7	234.3	282.6
Consensus estimates	178.8	212.2	254.0
BOBCAPS vs. Consensus (%)	11.1	10.4	11.3

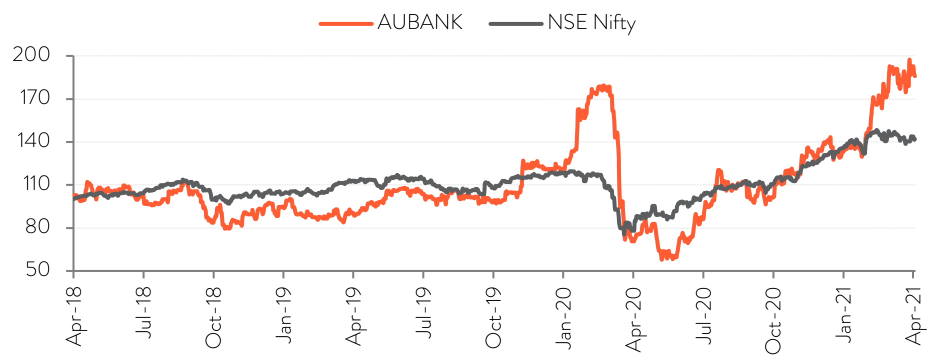
Source: Bloomberg, BOBCAPS Research

FIG 43 – P/BV BAND 1Y FORWARD



Source: Company, Bloomberg, BOBCAPS Research

FIG 44 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

- Any delays in building a strong liability franchise, which is key to our growth and profitability assumptions, can adversely affect valuations.
- AUBANK's asset quality trajectory is dependent on broad-based economic recovery – any risks to this would affect our ROE outlook.

FINANCIALS

Income Statement

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Net interest income	**13,425**	**19,089**	**23,656**	**29,425**	**37,221**
NII growth (%)	42.7	42.2	23.9	24.4	26.5
Non-interest income	4,620	7,061	14,476	8,989	11,470
Total income	18,045	26,150	38,131	38,414	48,691
Operating expenses	10,826	14,179	15,578	18,750	23,695
Operating profit	7,219	11,972	22,553	19,664	24,996
Operating profit growth (%)	25.4	65.8	88.4	(12.8)	27.1
Provisions	1,418	2,832	5,857	3,873	3,527
PBT	5,801	9,140	16,696	15,791	21,469
Tax	1,983	2,392	4,207	3,979	5,410
Reported net profit	**3,818**	**6,748**	**12,489**	**11,811**	**16,059**
Adjustments	0	0	0	0	0
Adjusted net profit	**3,818**	**6,748**	**12,489**	**11,811**	**16,059**

Balance Sheet

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Equity capital	2,924	3,041	3,121	3,121	3,121
Reserves & surplus	26,526	40,206	58,899	69,997	85,085
Net worth	29,449	43,247	62,020	73,117	88,206
Deposits	194,224	261,639	327,049	415,352	539,958
Borrowings	86,134	103,353	90,951	100,046	112,051
Other liabilities & provisions	14,241	12,670	22,173	23,725	26,097
Total liabilities and equities	**324,049**	**420,909**	**502,193**	**612,241**	**766,312**
Cash & bank balance	17,402	33,697	36,580	40,474	46,545
Investments	71,617	106,682	124,818	149,782	187,227
Advances	228,187	269,924	315,811	388,448	493,329
Fixed & Other assets	9,022	11,128	24,983	33,537	39,212
Total assets	**326,228**	**421,431**	**502,193**	**612,241**	**766,312**
Deposit growth (%)	145.1	34.7	25.0	27.0	30.0
Advances growth (%)	71.4	18.3	17.0	23.0	27.0

Per Share

Y/E 31 Mar (Rs)	FY19A	FY20A	FY21E	FY22E	FY23E
EPS	13.2	22.6	40.5	37.8	51.5
Dividend per share	0.5	0.9	0.0	1.9	2.6
Book value per share	100.7	142.2	198.7	234.3	282.6

Source: Company, BOBCAPS Research

Valuations Ratios

Y/E 31 Mar (x)	FY19A	FY20A	FY21E	FY22E	FY23E
P/E	93.3	54.5	30.4	32.6	24.0
P/BV	12.2	8.7	6.2	5.3	4.4
Dividend yield (%)	0.0	0.1	0.0	0.2	0.2

DuPont Analysis

Y/E 31 Mar (%)	FY19A	FY20A	FY21E	FY22E	FY23E
Net interest income	5.2	5.1	5.1	5.3	5.4
Non-interest income	1.8	1.9	3.1	1.6	1.7
Operating expenses	4.2	3.8	3.4	3.4	3.4
Pre-provisioning profit	2.8	3.2	4.9	3.5	3.6
Provisions	0.6	0.8	1.3	0.7	0.5
PBT	2.3	2.4	3.6	2.8	3.1
Tax	0.8	0.6	0.9	0.7	0.8
ROA	1.5	1.8	2.7	2.1	2.3
Leverage (x)	9.9	10.3	8.8	8.2	8.5
ROE	14.7	18.6	23.7	17.5	19.9

Ratio Analysis

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
YoY growth (%)					
Net interest income	42.7	42.2	23.9	24.4	26.5
Pre-provisioning profit	25.4	65.8	88.4	(12.8)	27.1
EPS	28.9	71.3	79.1	(6.6)	36.0
Profitability & Return ratios (%)					
Net interest margin	5.5	5.4	5.4	5.5	5.5
Fees / Avg. assets	1.2	1.1	0.9	1.0	1.0
Cost-Income	60.0	54.2	40.9	48.8	48.7
ROE	14.7	18.6	23.7	17.5	19.9
ROA	1.5	1.8	2.7	2.1	2.3
Asset quality (%)					
GNPA	2.0	1.7	3.1	2.7	2.2
NNPA	1.3	0.8	1.2	1.0	0.7
Provision coverage	37.4	52.5	61.4	64.3	66.8
Ratios (%)					
Credit-Deposit	117.5	103.2	96.6	93.5	91.4
Investment-Deposit	36.9	40.8	38.2	36.1	34.7
CAR	19.3	22.0	26.3	26.2	25.0
Tier-1	16.0	18.4	23.0	23.2	22.5

Source: Company, BOBCAPS Research

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Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

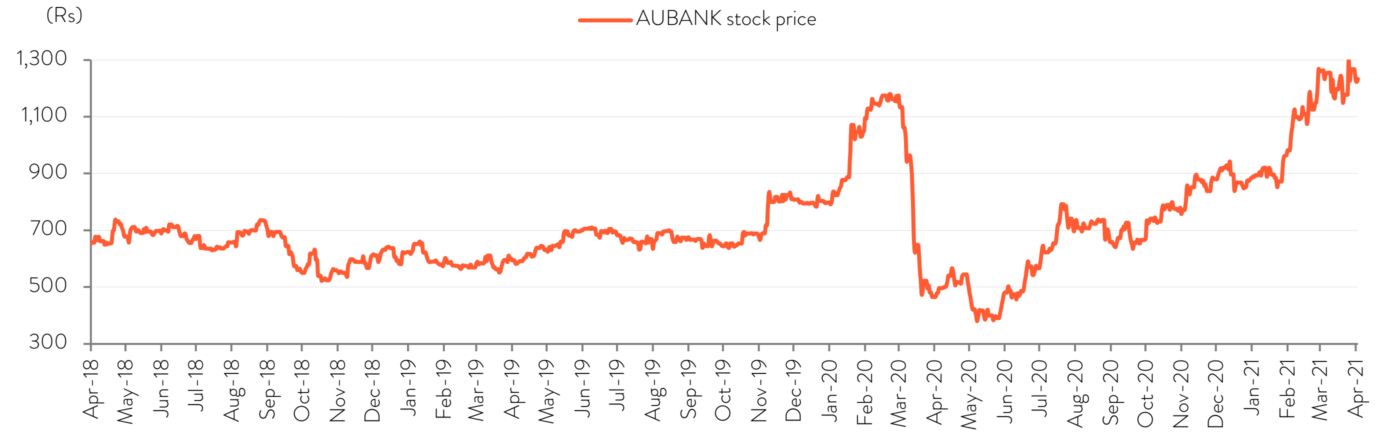
ADD – Expected return from >+5% to +15%

REDUCE – Expected return from -5% to +5%

SELL – Expected return <-5%

Note: Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

RATINGS AND TARGET PRICE (3-YEAR HISTORY): AU SMALL FINANCE BANK (AUBANK IN)



B – Buy, A – Add, R – Reduce, S – Sell

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