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BUY
TP: Rs 5,200 | ⮝ 32%

BAJAJ FINANCE | NBFC | 16 March 2020

Management meet takeaways – Business prospects robust

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Key takeaways from our meeting with the Bajaj Finance (BAF) management: (1) customer additions to be at 2-2.2mn per quarter, (2) addition of a second credit card partner on the cards, (3) mortgage business will largely cater to the salaried class, and (4) credit cost to hold steady, with management seeing downside bias to our 200-210bps estimate through to FY22. We expect BAF's customer relationship value (i.e. profit divided by cross-sell franchise) to log a 16% CAGR for FY19-FY22. Maintain BUY.

Data mining, geographic expansion to augment client base: Management expects customer additions to rise to 2.0-2.2mn per quarter (~8.5mn p.a.) backed by geographic expansion, a pre-approved customer base and deeper mining of existing accounts. Assuming 60% conversion of new customers to the cross-sell franchise, we expect a 19% CAGR in cross-sell client base during FY19-FY22 to ~35mn. Customer relationship value would thus log a ~16% CAGR to ~Rs 3,100.

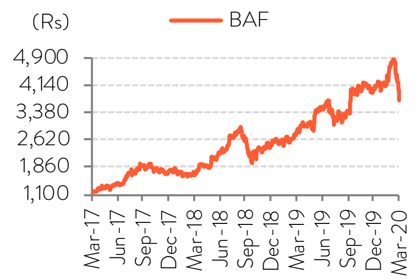
Outlook on credit cards: Under the BAF-RBL Bank arrangement, BAF receives sourcing and other fees related to the cards business and RBL Bank absorbs the entire credit loss. BAF aims to be among the top-3 card issuers by FY24. Management has indicated that a new sourcing partner for credit cards is likely in the near term.

Credit cost estimates: BAF's average credit cost was 240bps over FY11-FY19 and 150bps over FY15-FY19. We conservatively model for 200-210bps during FY20-FY22 – management believes costs could come in below our estimates.

Ticker/Price	BAF IN/Rs 3,953
Market cap	US$ 32.1bn
Shares o/s	602mn
3M ADV	US$ 100.0mn
52wk high/low	Rs 4,923/Rs 3,281
Promoter/FPI/DII	56%/22%/10%

Source: NSE

STOCK PERFORMANCE



Source: NSE

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Net interest income	69,716	97,252	133,404	171,479	219,988
NII growth (%)	42.2	39.5	37.2	28.5	28.3
Adj. net profit (Rs mn)	24,964	39,950	59,646	81,848	106,032
EPS (Rs)	43.4	69.3	99.1	136.0	176.2
P/E (x)	91.1	57.1	39.9	29.1	22.4
P/BV (x)	14.3	11.6	7.1	5.9	4.8
ROA (%)	3.4	3.8	4.0	4.2	4.3
ROE (%)	20.1	22.5	22.4	22.1	23.4

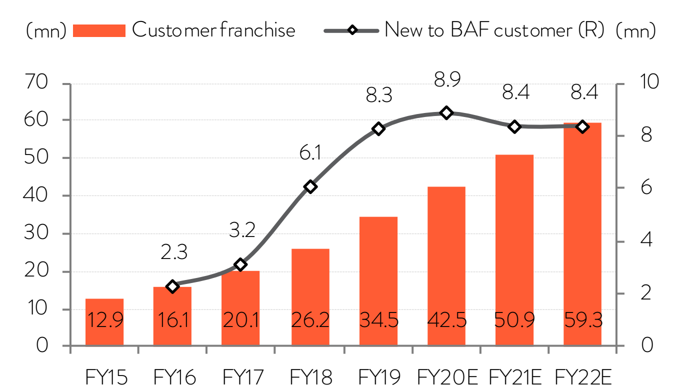
Source: Company, BOBCAPS Research

Top investor concerns

#1 How does the franchise grow?

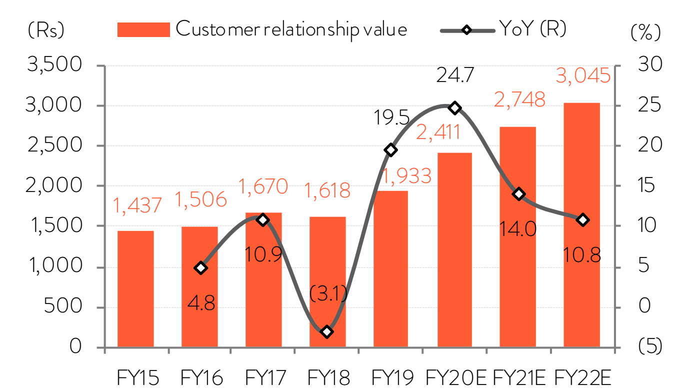
- Management indicated that BAF has increased its credit screens in digital and SME lending post the IL&FS crisis, which explains the recent slowdown in new customer loan growth.
- Quarterly customer additions have averaged ~1.5mn for the last 20 quarters. Management expects this figure to rise to 2.0-2.2mn per quarter (~8.5mn p.a.) driven by geographic expansion, a pre-approved customer base from own records and group company records, and incremental data mining of the existing customer base.
- Uttar Pradesh, Bihar and the Northeast are new growth territories where branches are being set up. BAF has completed due diligence in all these new geographies by collecting data from banking channels about delinquent customer behaviour and collection efficiencies.
- Another strategy for geographic expansion is to enter into towns close to large cities (e.g. Sarnath near Varanasi, Ahmednagar near Pune).
- BAF has a target of five products per customer for SME financing and three per customer for consumer financing. It is on track to meet the SME target and has achieved ~2.7 products per customer in consumer financing.
- **BOBCAPS view:** We define customer relationship value as profit divided by cross-sell franchise. As of Q3FY20, BAF's cross-sell franchise was at ~23.5mn. Assuming 60% conversion of new customers to the cross-sell franchise (based on historical average conversion rates), we expect the franchise to grow at ~19% CAGR during FY19-FY22 to ~35mn. Customer relationship value would thus log a ~16% CAGR to ~Rs 3,100.

FIG 1 – NEW CUSTOMER ADDITION OF ~8.5MN P.A. AS PER MANAGEMENT



Source: Company, BOBCAPS Research

FIG 2 – CUSTOMER RELATIONSHIP VALUE TO GROW AT 16% CAGR OVER FY19-FY22E

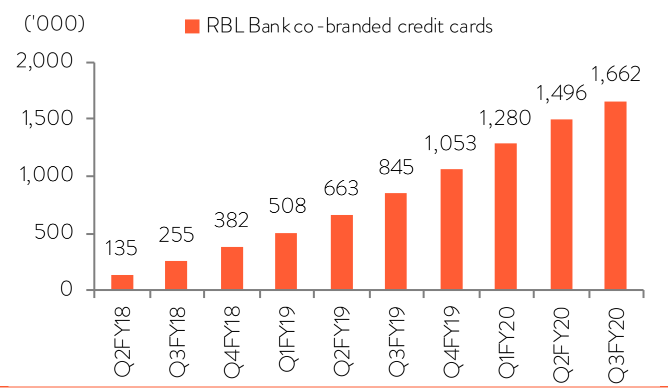


Source: Company, BOBCAPS Research

#2 How does the credit card business work?

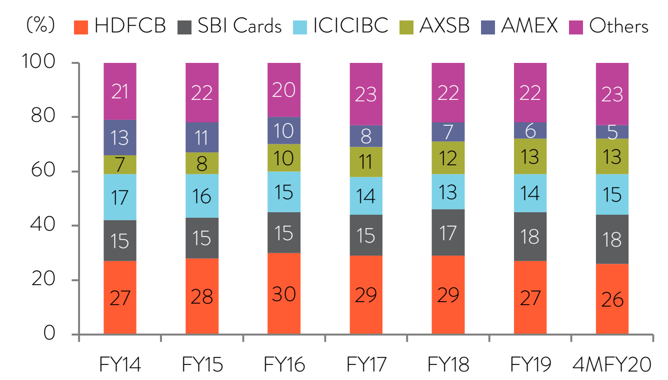
- Under the BAF-RBL Bank arrangement, BAF receives the sourcing fee and other fees related to the credit cards business. RBL Bank absorbs the entire credit loss. BAF has a run-rate of 100,000 new card acquisitions per month and aims to be among the top-3 card issuers by FY24.
- The current credit card portfolio has a vintage of ~24 months. On a like-to-like basis, management believes the quality of this book is a notch below that of HDFC Bank (HDFCB) and significantly above that of SBI Cards. HDFCB's portfolio has ~70% overlap with its depositors; SBI Cards has ~60% overlap and >50% open sourcing.
- About 35% of BAF-RBL Bank customers are first-time cardholders from BAF's pool of vetted clients, while the balance 65% already have a credit card and payment history, implying lower probability of default.
- Management expects to add a new sourcing partner for credit cards in the near term.

FIG 3 – NUMBER OF CREDIT CARDS UP ~8X IN TWO YEARS



Source: Company, BOBCAPS Research

FIG 4 – TOP-5 CREDIT CARD ORIGINATORS HAVE ~80% MARKET SHARE



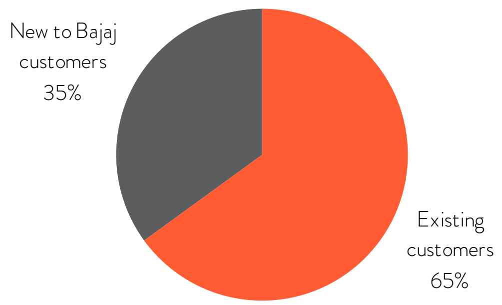
Source: Company, BOBCAPS Research

#3 What is the future of the mortgage business?

- Bajaj Housing Finance (BHFL) operates through a separate branch structure than BAF. As of Q3FY20, BHFL had 33 urban and 100 rural branches. It offers lease rental discounting (LRD) in the top-10 cities and construction finance (CF) in the top-20 cities.
- BHFL's home loan (HL) customers are largely salaried, with a sprinkling of self-employed clients. About 65% of HL borrowers are existing customers of BAF. The balance 35% new-to-BAF clients are either onboarded at the developer premises (funded by BAF) or offered balance transfers. Home loans are 100% sourced through own channels.

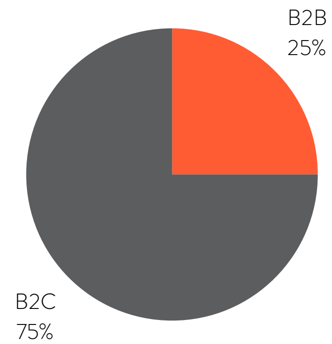
- Management believes BHFL has an edge in turnaround time, underwriting of the risk and pricing of the onboarded risk. According to management, 30% of system-level HL customers (~Rs 6tn) are BAF customers and can potentially be pitched a balance transfer offering at competitive pricing.
- Management is looking to expand this business cautiously and aims to open ~20 more branches in FY21. BHFL also wants to source more customers at developer premises in instances where it has funded the project.
- Credit cost is guided to hold at 15-20bps in the near term and ROA at 1.6-1.8%. With leverage of 8-8.5x, ROE should be in the range of 14-15%.

FIG 5 – CUSTOMER SPLIT FOR BHFL



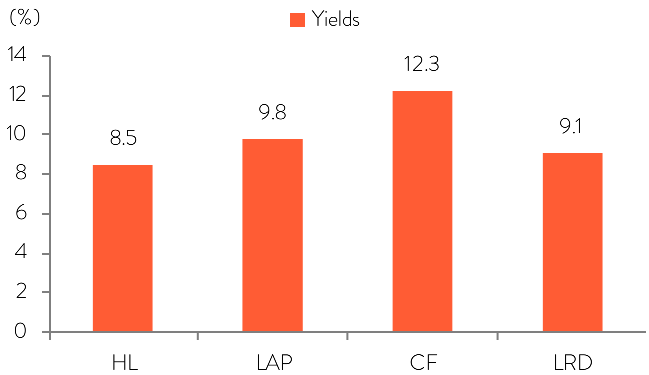
Source: Company, BOBCAPS Research

FIG 6 – SOURCING SPLIT FOR BHFL CUSTOMERS



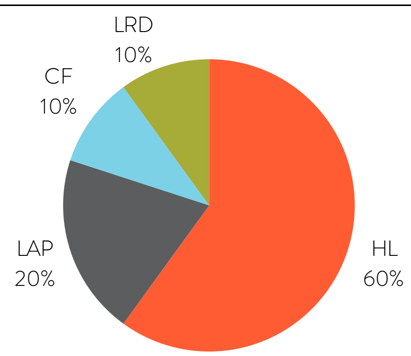
Source: Company, BOBCAPS Research

FIG 7 – YIELDS ACROSS PRODUCTS FOR BHFL



Source: Company, BOBCAPS Research

FIG 8 – AUM SPLIT BY FY22E

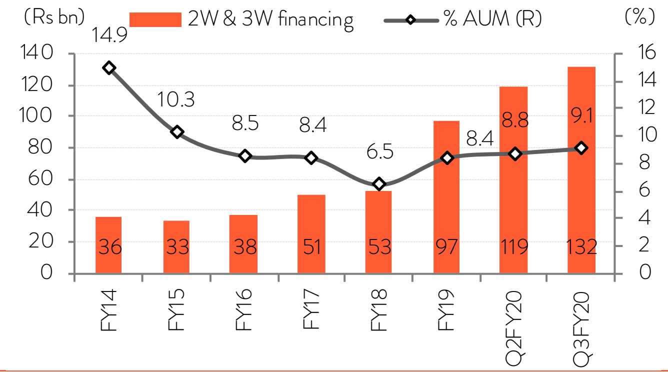


Source: Company, BOBCAPS Research

#4 Why still a captive 2W/3W financier?

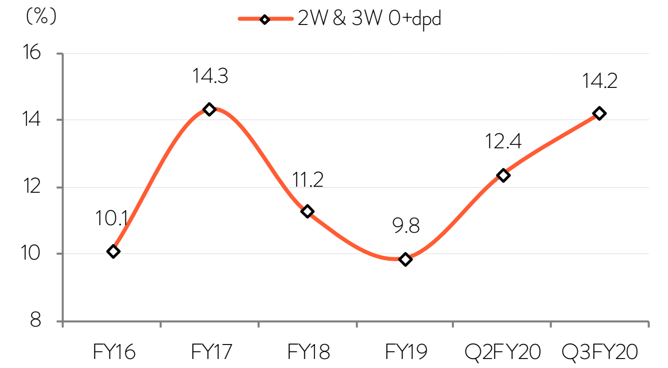
- BAF started as a captive two-wheeler/three-wheeler financier to Bajaj Auto and remains so. One of the core reasons for continuing as a captive financier is the steady-state ROA of ~4% being made on this business.
- Another reason is the unattractive margins on offer by other 2W OEMs such as Royal Enfield and Honda which do not have captive financiers.

FIG 9 – 2W AND 3W FINANCING CONTRIBUTED ONLY ~9% OF AUM IN Q3FY20



Source: Company, BOBCAPS Research

FIG 10 – UPTICK IN DELINQUENCIES DUE TO SECULAR ECONOMIC SLOWDOWN



Source: Company, BOBCAPS Research

#5 How will the borrowing profile pan out?

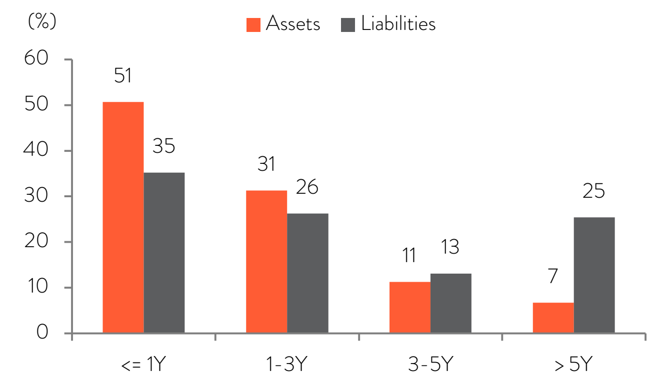
- BAF has a diversified borrowing profile, with 38%/17% of funds sourced from banks/deposits and 42%/3% from money markets/ECB. Management stated that international debt markets have softened amid the Covid-19 crisis as Chinese companies have been vacating the space. BAF is likely to take advantage of this and may raise ECBs to 10% of borrowings in the near term.
- The company has introduced systematic deposit plans (STP), with a minimum sum of Rs 5,000 per month. This helps (a) lower the entry level ticket size (from Rs 25,000 earlier), (b) increase granularity and stickiness in deposit profile. Management intends to shift to a retail-oriented deposit profile and limit corporate deposits.
- BAF remains confident of raising debt through NCDs and CPs given its AAA rating and comfortable asset-liability management profile. Bank funding is at MCLR, as per management.

FIG 11 – CREDIT RATINGS STABLE THROUGH FY16-FY19

	FY16	FY17	FY18	FY19
NCD	IND AAA/Stable	IND AAA/Stable	IND AAA/Stable	IND AAA/Stable
Sub. Debt	IND AAA/Stable	IND AAA/Stable	IND AAA/Stable	IND AAA/Stable
LT Bank Rating	IND AAA/Stable	IND AAA/Stable	IND AAA/Stable	IND AAA/Stable
ST Bank Rating	IND A1+	IND A1+	IND A1+	IND A1+

Source: India Ratings, Company, BOBCAPS Research

FIG 12 – POSITIVE MISMATCH IN ONE-YEAR MATURITY BUCKET (AS OF H1FY20)

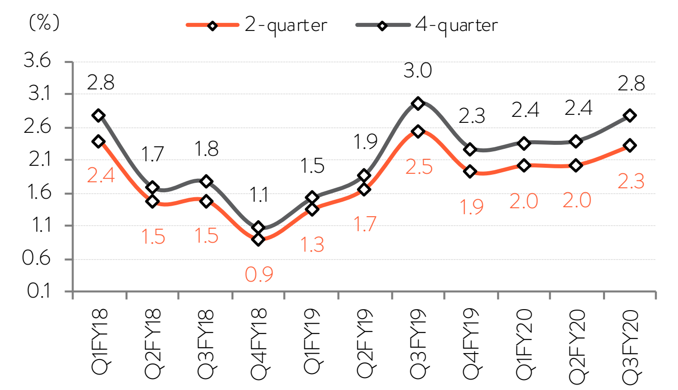


Source: Company, BOBCAPS Research

#6 Will credit cost hold steady?

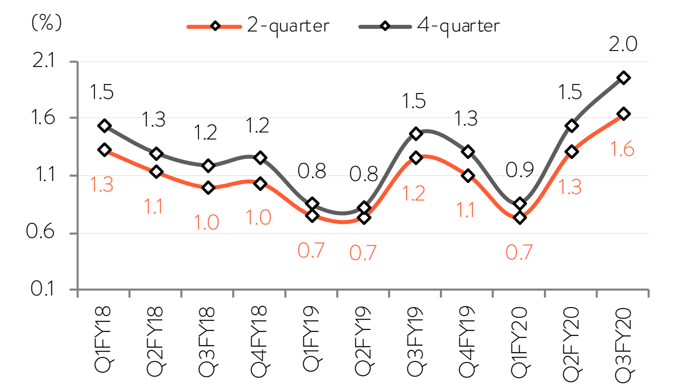
- BAF had peak credit cost of ~800bps in FY10 during the retail NPA cycle. This was also the time when the new management was settling in. Post-FY10, Atul Jain (now CEO-BHFL) set up the collection infrastructure. At present, BAF has ~4,600 personnel who manage 16,000 collection agencies across 2,000+ towns in India. The collections team is organised as per different business lines.
- Over the last 5-6 quarters, BAF has gained market share in the financing pie of Bajaj Auto. Management expects incremental credit costs to emanate out of the 2W/3W business in the near term. The company has consciously gone slow on digital products, SME financing and lending to financial institutional groups in the last 5-6 quarters.
- **BOBCAPS view:** Average credit cost was ~240bps during FY11-FY19 and ~150bps during FY15-FY19. We have been conservative and modelled for 200-210bps of credit cost during FY20-FY22. Management believes there could be a downward bias to our estimates.

FIG 13 – LOW NET SLIPPAGES...



Source: Company, BOBCAPS Research

FIG 14 – ...AND LOW WRITE-OFFS (WITH LAG EFFECT) SHOW THE EFFICACY OF COLLECTIONS



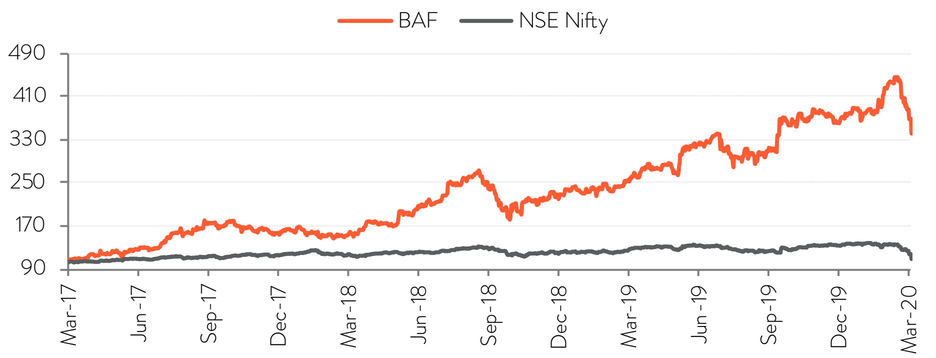
Source: Company, BOBCAPS Research

Valuation methodology

BAF is trading at 7.1x/5.9x FY20E/FY21E BV for an estimated ROE of 22.4%/22.1%. We value the stock based on a residual income model and maintain our Mar'21 target price at Rs 5,200. Our assumptions include cost of equity of 12.8%, risk-free rate of 7.75%, risk premium of 5%, and a long-term growth rate of 5%.

We keep our estimates unchanged and maintain BUY given that we expect (1) consumer financing and cross-sell to remain key moats, (2) SME and commercial financing to form sustainable scale builders, (3) well protected spreads and astute focus on opex to drive profits, (4) the mortgage business to add scale, and (5) well managed asset quality to drive return ratios (see our Jan'20 report: **BAF 2.0 – Revamped growth engine; initiate with BUY**).

FIG 15 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

- Moving into smaller geographic locations could expose BAF to a high proportion of new-to-credit customers, who may not have disciplined banking behaviour.
- Risk of renegotiations by OEMs could hamper subvention income and thereby the high IRRs enjoyed in consumer financing.
- Growing competition from banks and financial technology players in the retail lending space is another key risk.

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FINANCIALS

Income Statement

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net interest income	**69,716**	**97,252**	**133,404**	**171,479**	**219,988**
NII growth (%)	42.2	39.5	37.2	28.5	28.3
Non-interest income	11,713	21,530	35,500	46,125	59,932
Total income	81,429	118,782	168,904	217,603	279,920
Operating expenses	32,690	41,977	58,391	73,136	91,612
Operating profit	48,739	76,805	110,513	144,467	188,308
Operating profit growth (%)	34.1	57.6	43.9	30.7	30.3
Provisions	10,305	15,014	28,232	35,045	46,553
PBT	38,434	61,792	82,281	109,422	141,754
Tax	13,471	21,842	22,635	27,574	35,722
Reported net profit	**24,964**	**39,950**	**59,646**	**81,848**	**106,032**
Adjustments	0	0	0	0	0
Adjusted net profit	**24,964**	**39,950**	**59,646**	**81,848**	**106,032**

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Equity capital	1,150	1,154	1,203	1,203	1,203
Reserves & surplus	157,328	195,817	333,262	405,288	498,596
Net worth	158,478	196,970	334,465	406,491	499,800
Deposits	0	0	0	0	0
Borrowings	665,573	1,015,879	1,340,966	1,723,669	2,240,769
Other liabilities & provisions	23,932	29,476	33,897	38,981	44,829
Total liabilities and equities	**847,983**	**1,242,325**	**1,709,328**	**2,169,141**	**2,785,398**
Cash & bank balance	3,397	3,487	86,688	78,125	87,950
Investments	31,394	85,990	98,889	113,722	130,780
Advances	800,001	1,137,135	1,506,703	1,958,715	2,546,329
Fixed & Other assets	4,703	6,948	6,968	6,988	7,008
Total assets	**847,983**	**1,242,325**	**1,709,328**	**2,169,141**	**2,785,398**
Deposit growth (%)	NA	NA	NA	NA	NA
Advances growth (%)	41.8	42.1	32.5	30.0	30.0

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
EPS	43.4	69.3	99.1	136.0	176.2
Dividend per share	4.0	6.0	9.9	13.6	17.6
Book value per share	275.7	341.4	555.9	675.6	830.6

Source: Company, BOBCAPS Research

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
P/E	91.1	57.1	39.9	29.1	22.4
P/BV	14.3	11.6	7.1	5.9	4.8
Dividend yield (%)	0.1	0.2	0.3	0.3	0.4

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20E	FY21E	FY22E
Net interest income	9.5	9.3	9.0	8.8	8.9
Non-interest income	1.6	2.1	2.4	2.4	2.4
Operating expenses	4.5	4.0	4.0	3.8	3.7
Pre-provisioning profit	6.6	7.3	7.5	7.4	7.6
Provisions	1.4	1.4	1.9	1.8	1.9
PBT	5.2	5.9	5.6	5.6	5.7
Tax	1.8	2.1	1.5	1.4	1.4
ROA	3.4	3.8	4.0	4.2	4.3
Leverage (x)	5.9	5.9	5.6	5.2	5.5
ROE	20.1	22.5	22.4	22.1	23.4

Ratio Analysis

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
YoY growth (%)					
Net interest income	42.2	39.5	37.2	28.5	28.3
Pre-provisioning profit	34.1	57.6	43.9	30.7	30.3
EPS	29.2	59.6	43.1	37.2	29.5
Profitability & Return ratios (%)					
Net interest margin	10.2	10.0	10.1	9.9	9.8
Fees / Avg. assets	1.1	1.6	1.8	1.7	1.8
Cost-Income	40.1	35.3	34.6	33.6	32.7
ROE	20.1	22.5	22.4	22.1	23.4
ROA	3.4	3.8	4.0	4.2	4.3
Asset quality (%)					
GNPA	1.4	1.5	1.5	1.7	1.9
NNPA	0.4	0.6	0.6	0.7	0.8
Provision coverage	69.6	59.8	60.0	60.0	60.0
Ratios (%)					
Credit-Deposit	0.0	0.0	0.0	0.0	0.0
Investment-Deposit	0.0	0.0	0.0	0.0	0.0
CAR	24.0	20.7	24.1	22.3	20.9
Tier-1	18.4	16.3	21.0	20.0	19.3

Source: Company, BOBCAPS Research

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Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

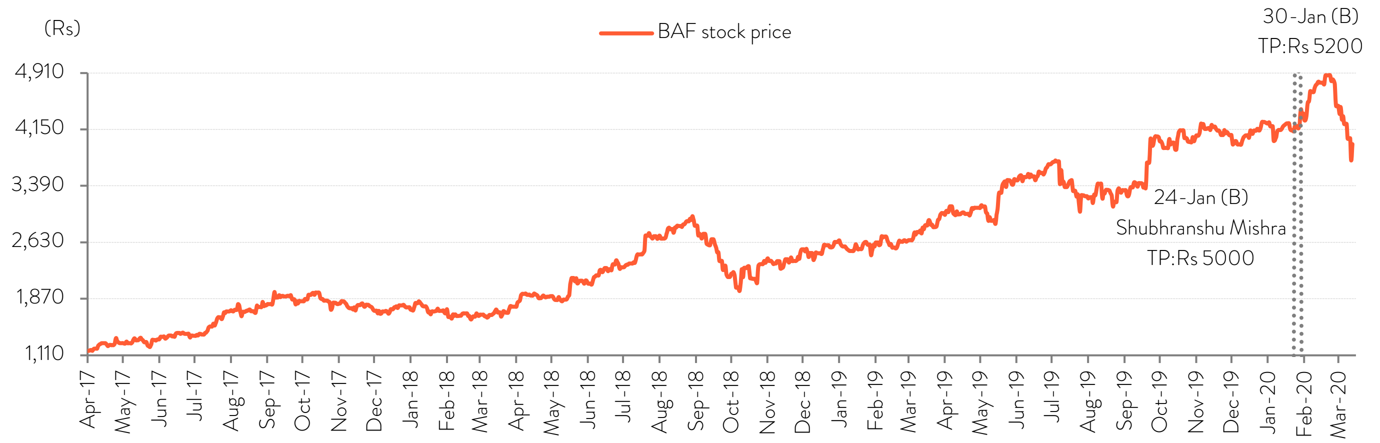
ADD – Expected return from >+5% to +15%

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)

HISTORICAL RATINGS AND TARGET PRICE: BAJAJ FINANCE (BAF IN)



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

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