COMPANY UPDATE

BUY
TP: Rs 3,000 | ⮝ 29%

BAJAJ FINANCE | NBFC | 08 April 2020

Covid-19 to hurt loan growth; recovery only in H2FY22

We expect the Covid-19 crisis to disrupt credit growth in FY21 as lenders turn cautious and customers pare discretionary spends. Growth for Bajaj Finance (BAF) could taper to 11% in FY21 and normalise only by H2FY22, in our view. Pricing power and spreads should remain stable, but we expect higher opex and delinquencies in the next 12-15 months, leading us to raise FY21/FY22 credit cost estimates to 330bps/280bps. We cut FY20/FY21/FY22 earnings by 4%/31%/26% and revise our Mar'21 TP down to Rs 3,000 (vs. Rs 5,200).

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Weak FY21; growth to normalise in H2FY22: We forecast 11%/23% AUM growth for BAF in FY21/FY22 vs. 30%/30% earlier. In our view, the coronavirus impact would be felt over FY21-H1FY22, impeding both supply (as lenders turn cautious) and demand for credit (as customers defer or curb discretionary spend).

Stable pricing power and spreads: Despite stricter credit screens in FY21, we expect BAF to maintain pricing power across segments (ex-mortgages) as competition weakens. We model for stable spreads of ~9% through to FY22 due to the company's diverse sources of funding and surplus systemic liquidity.

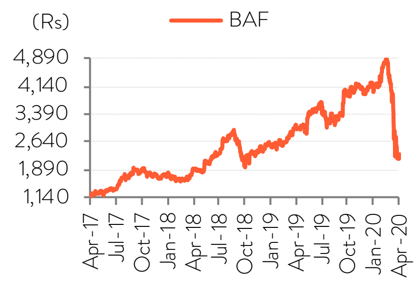
Higher opex and credit cost: BAF's collection infrastructure is robust but designed for 7-10% bounce rates. Amid the current crisis, the company has seen a 2.5x surge in bounce rates and hence will have to spend more for collections – this will more than nullify the guided 7-8% reduction in fixed cost. We raise FY21/FY22 credit cost estimates to 330bps/280bps and lower PAT to Rs 57bn/Rs 78bn.

Maintain BUY: While we cut FY20/FY21/FY22 earnings estimates by 4%/ 31%/26%, we repose confidence in the BAF management which has weathered the retail NPA crisis of FY09-FY10 and demonstrated the ability to make timely course corrections.

Ticker/Price	BAF IN/Rs 2,333
Market cap	US$ 18.4bn
Shares o/s	602mn
3M ADV	US$ 128.0mn
52wk high/low	Rs 4,923/Rs 2,082
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	130,454	155,022	186,367
NII growth (%)	42.2	39.5	34.1	18.8	20.2
Adj. net profit (Rs mn)	24,964	39,950	57,440	56,722	78,442
EPS (Rs)	43.4	69.3	95.5	94.3	130.4
P/E (x)	53.7	33.7	24.4	24.7	17.9
P/BV (x)	8.5	6.8	4.2	3.7	3.1
ROA (%)	3.4	3.8	4.0	3.2	3.8
ROE (%)	20.1	22.5	21.7	15.9	18.8

Source: Company, BOBCAPS Research

Covid-19 impact

Loan growth: Weak FY21; expected to normalise in H2FY22

Due to the Covid-19 impact, we have revised our consolidated AUM growth estimates to 11%/23% for FY21/FY22, down from 30% in each of these years. Given the ongoing unprecedented crisis, we expect credit growth in BAF's B2B consumer finance business (auto and sales finance) to slow to 10-12% in FY21, as (1) onboarding of new customers slackens, (2) lenders turn conservative, offering experiential credit products mainly to the salaried class while hiking down-payments, and (3) customers likely downtrade to cheaper consumer durables and electronics, thus eroding demand.

In B2C consumer finance (lending to existing customers), BAF will be similarly circumspect and increase equity contribution. This will have a dampening effect on fee income generation as well. We expect B2C consumer finance growth of 16% and 25% in FY21 and FY22 respectively. Despite the lockdown and supply chain issues, rural recovery should be faster given a good monsoon last year and government stimulus. We estimate rural growth (B2B + B2C) of 24% and 30% in FY21 and FY22 respectively.

BAF has been cautious on SME and commercial lending for the past 5-6 quarters. Management has attributed this to stress in the SME space post-GST implementation and the economic slowdown. Though the lockdown is likely to have a severe impact on SMEs, management expects healthy demand for working capital loans. We model for back-ended growth of 8%/16% in the SME book in FY21/FY22. Commercial lending (incl. loan against shares portfolio) is estimated to post tepid 5% growth.

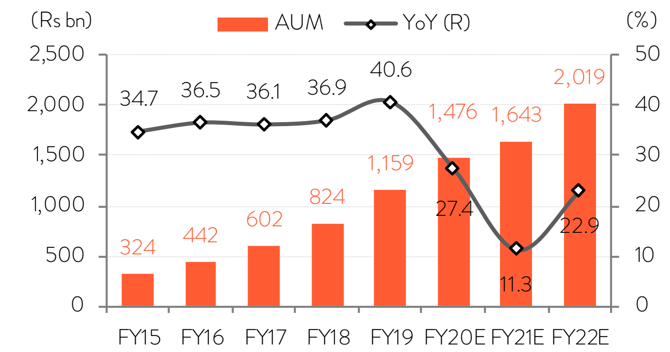
The mortgage business is likely to face higher competition due to cheaper pricing by banks. Though BAF focuses on the salaried class for home loan originations, we expect salaried customers to take a step back due to expectations of a steep property price correction at the retail level and their reluctance to commit to a long-term credit decision in an uncertain environment. We model for 18%/28% growth in the mortgage book for FY21/FY22.

FIG 1 – EXPECTED GROWTH RATES ACROSS BUSINESS VERTICALS

(%)	FY21E	FY22E
Consumer Finance (B2B)	12	20
Consumer Finance (B2C)	16	25
Rural	24	30
LAS	5	5
Commercial (ex-LAS)	5	5
Mortgages	18	28

Source: Company, BOBCAPS Research

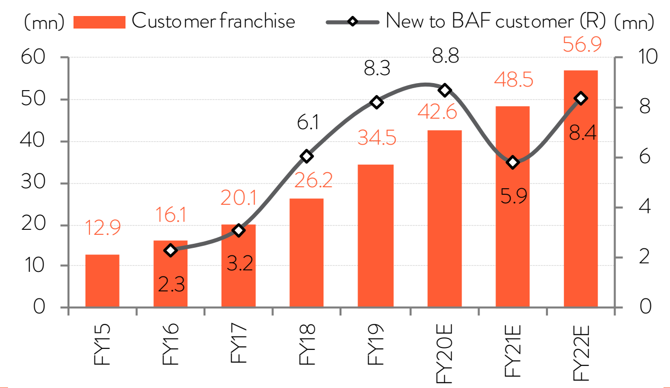
FIG 2 – EXPECT 20% CAGR IN AUM OVER FY19-FY22E



Source: Company, BOBCAPS Research

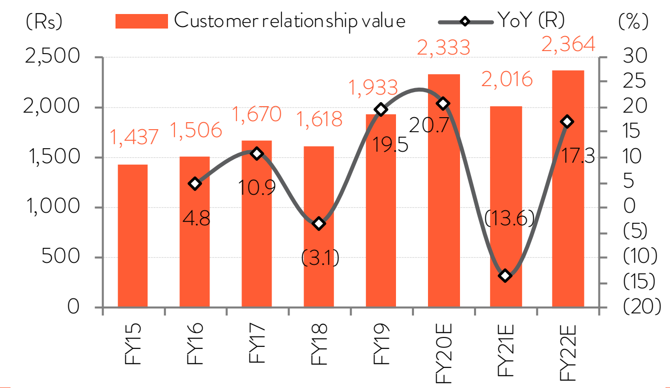
In terms of onboarding new clients, we expect lower cross-selling to mute customer relationship value at a ~7% CAGR to ~Rs 2,400 by FY22. We define customer relationship value as profit divided by cross-sell franchise. As of Q3FY20, BAF's cross-sell franchise was at ~23.5mn. Assuming 60% conversion of new customers to the cross-sell franchise (based on historical average conversion rates), we expect the franchise to grow at ~17% CAGR during FY19-FY22 to ~33mn.

FIG 3 – NEW CUSTOMER ADDITION TO SLOW DOWN IN FY21E



Source: Company, BOBCAPS Research

FIG 4 – CUSTOMER RELATIONSHIP VALUE TO REMAIN STEADY IN FY21-FY22E



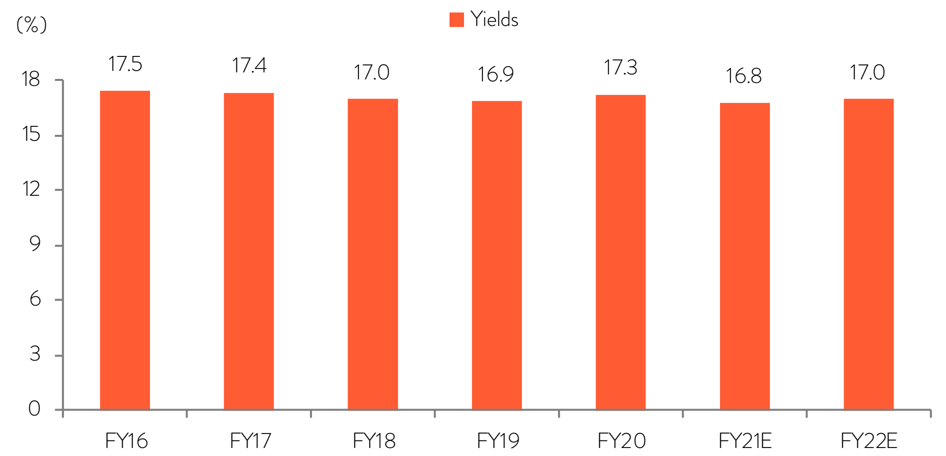
Source: Company, BOBCAPS Research

Pricing power: Largely intact

BAF's consumer and rural financing businesses are fairly granular and we expect competition to retreat given the inability to cater to higher defaults and growth simultaneously. Despite weaker demand-supply dynamics, we expect BAF to maintain pricing power in these two businesses. About 65% of its customers are salaried and have bureau scores of 750+, giving BAF the comfort of risk-adjusted pricing. Sustained demand from SMEs and management's stated intent to only work with existing customers in the commercial segment are also likely to keep pricing power intact.

In the mortgage segment, banks can price home loans at more attractive rates than BAF. We expect increasing competitive intensity in home loans to be an overhang on pricing in both FY21 and FY22.

FIG 5 – EXPECT STABLE YIELDS IN FY21E-FY22E



Source: Company, BOBCAPS Research

Spreads: Balance sheet strength offers stability

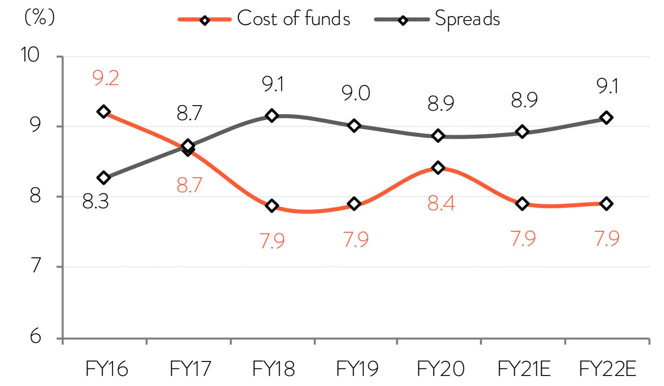
As of FY20, BAF has a consolidated cash position of Rs 159bn and undrawn bank lines of Rs 25bn. Commercial paper borrowing is less than Rs 20bn. Its maturities over the next three months are lower than incremental inflows over the same period. The company is well capitalised with a 25% capital adequacy ratio.

Historically, management has been prudent in making provisions for anticipated losses, as evident from a conscious slowdown in the LAP book post-demonetisation and the winding down of infrastructure lending in FY12-FY13. Management is now looking at accelerated provisioning against large accounts and one-time provisioning for the potential impact of Covid-19.

In terms of fund availability, BAF has demonstrated its ability to raise funds from debt capital markets at good pricing even after the IL&FS crisis. The deposit book totals Rs 214bn as of FY20, with 72% being retail deposits. BAF has been largely accessing long-term funds for the past 5-6 quarters and has consciously lowered its CP exposure. Also, there has been no paucity of bank term loans.

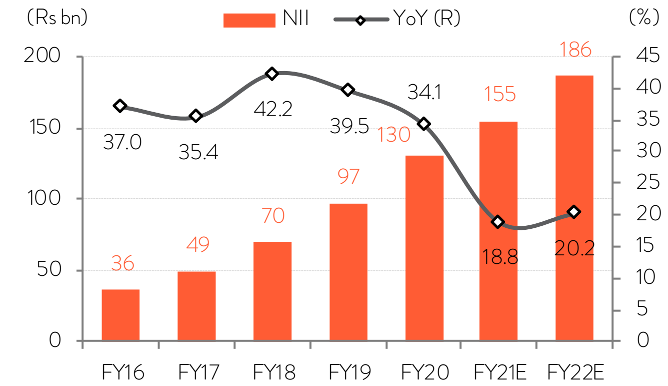
We remain upbeat about the company's ability to raise funds through diversified sources at attractive prices. With surplus systemic liquidity, we expect BAF to benefit in terms of cost of funds, thus keeping spreads stable at 9% through to FY22.

FIG 6 – EXPECT STABLE SPREADS IN FY21E-FY22E



Source: Company, BOBCAPS Research

FIG 7 – EXPECT 24% CAGR IN NII FOR FY19-FY22E

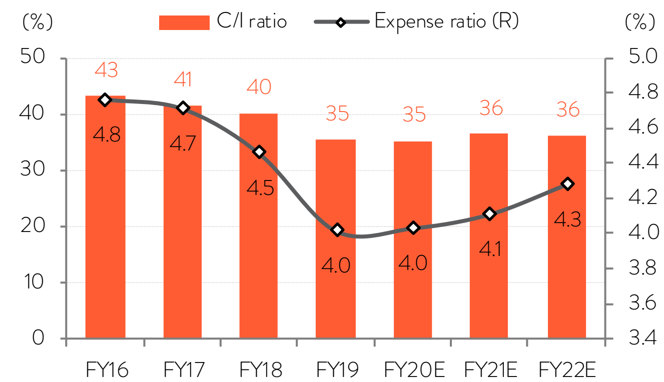


Source: Company, BOBCAPS Research

Opex: Set to increase in FY21-FY22

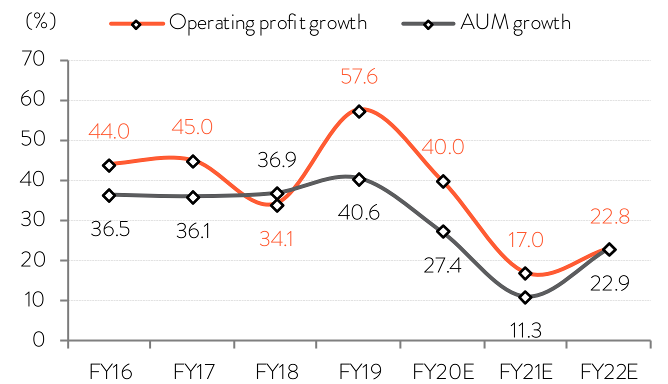
As fee income slows and delinquencies rise, we model for a 21-23% increase in operating expense over FY21-FY22, manifesting in an expense ratio of 4.1-4.3%. Operating profit is thus estimated to log a CAGR of 26% over this period.

FIG 8 – EXPECT EXPENSE RATIO TO INCH UP IN FY21E-FY22E



Source: Company, BOBCAPS Research

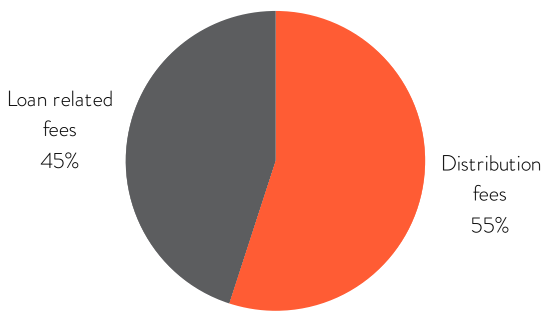
FIG 9 – OPERATING PROFIT GROWTH TO BE SLIGHTLY HIGHER THAN AUM GROWTH



Source: Company, BOBCAPS Research

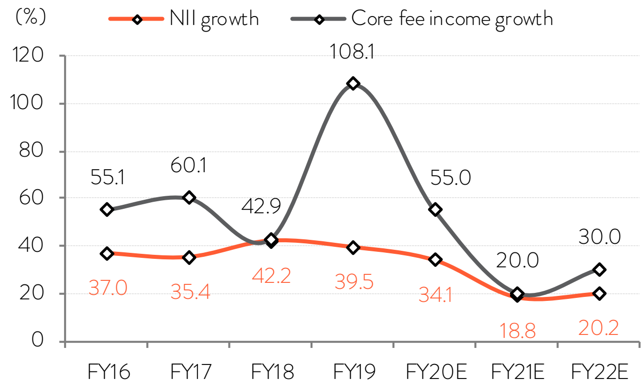
Slower new customer additions and a conservative lending approach would hamper cross-sales, affecting our fee income estimates. We now model for a fee income CAGR of 34% over FY19-FY22 vs. 38% earlier. Nevertheless, we still believe fee income would outpace balance sheet growth as ~55% is distribution-led.

FIG 10 – DISTRIBUTION FEE CONTRIBUTION LIKELY TO REMAIN INTACT



Source: Company, BOBCAPS Research

FIG 11 – CORE FEE INCOME GROWTH TO PICK UP IN FY22E



Source: Company, BOBCAPS Research

BAF has frozen all its fixed costs till Oct'20. Management expects to see a 7-8% reduction in fixed costs (led by a hiring freeze), ~80% reduction in travel expenses, no incremental technology spends and limited incremental capex. Following the Covid-19 lockdown, however, bounce rates have increased 2.5x from the usual 7-10% across all customer categories. The current collection infrastructure (4,500-4,600 own collection managers, 16,000 collection agencies, ~30,000 off-roll collection agents) is only designed for a 20-30% increase in bounce rates.

About 30% of default customers pay via digital channels, but we expect this number to go up as well. Overall, we expect a substantial increase in collection-related expenses, which will nullify any fixed cost reduction undertaken by management.

Credit cost: Expected to spike as delinquencies surge

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 a robust collection infrastructure.

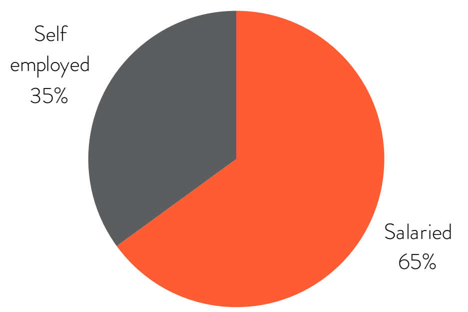
Over the last 5-6 quarters, BAF has gained market share in the financing pie of Bajaj Auto, while consciously going slow on digital products, SME financing and lending to financial institutional groups. Management expects incremental credit costs to emanate out of the two-/three-wheeler business in the near term.

Given the unprecedented nature of the 21-day lockdown, the company is seeing as spike in bounce rates across customer segments – salaried, self-employed, professionals and SMEs. Commercial customers are proactively seeking moratorium. Customers who are unable to pay by the month end will be offered moratorium for that month on a suo-moto basis till 31 May.

In our view, the most vulnerable segments are two-wheeler, new-to-credit and self-employed customers. Salaried borrowers with good CIBIL scores may also default given the uncertainty around job losses or salary cuts. BAF's collection infrastructure will have to be ramped up significantly to address the surge in bounce rates. Our channel checks suggest that while it is possible to scale up collection infrastructure at the field agency level, this will come at a cost and may not be as efficient because the agents will have to cater to other financiers too.

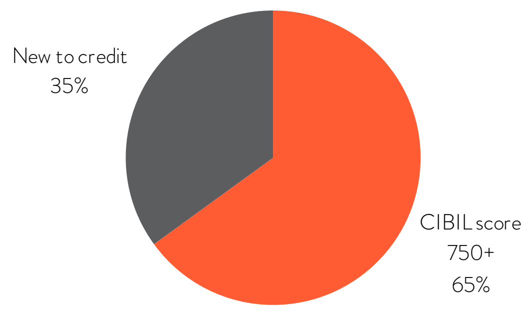
We build in higher credit cost of ~330bps for FY21, which will keep FY21 PAT flat at Rs 57bn. Bounce rates are likely to normalise once the lockdown is lifted and we thus model for credit cost of ~280bps and a recovery in profits to Rs 78bn in FY22.

FIG 12 – CUSTOMER SPLIT



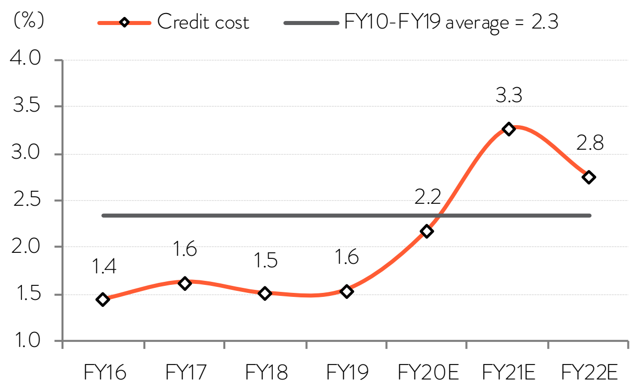
Source: Company, BOBCAPS Research

FIG 13 – 35% OF CUSTOMERS ARE NEW TO CREDIT



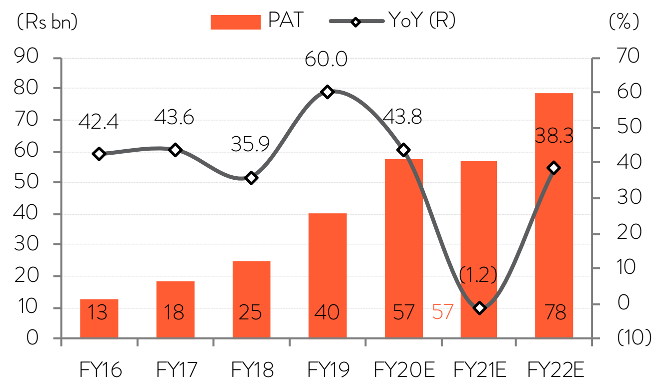
Source: Company, BOBCAPS Research

FIG 14 – CREDIT COST TO NORMALISE BY FY22E



Source: Company, BOBCAPS Research

FIG 15 – EXPECT PROFIT BOUNCE-BACK IN FY22E



Source: Company, BOBCAPS Research

Valuation methodology

BAF is trading at 3.5x/3.0x FY21E/FY22E BV for an estimated ROE of 15.9%/ 18.8%. We cut FY20/FY21/FY22 earnings estimates by 4%/31%/26% to factor in slower growth due to the Covid-19 lockdown alongside higher opex and credit costs. At the same time, we expect the company to maintain its pricing power as financiers vacate the consumer financing space. Spreads are likely to hold firm due to diversified funding sources and liquidity on the balance sheet.

We highlight that management skillfully tided over the retail NPA crisis of FY09-FY10 and has thereafter handled multiple threats to asset quality with timely corrections. This reinforces our positive growth outlook for H2FY22.

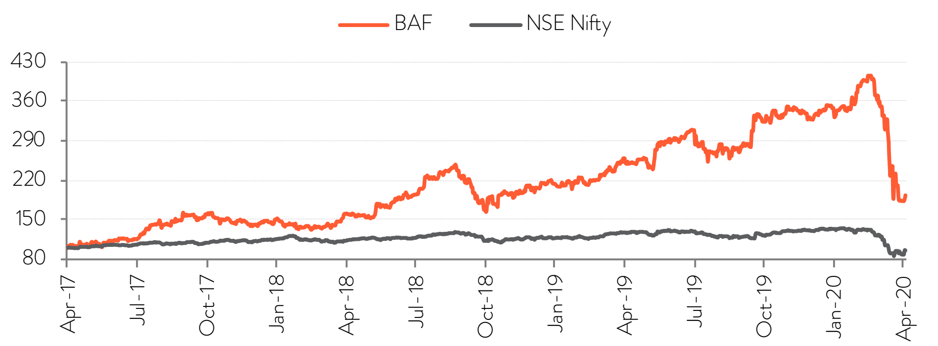
Valuing the stock based on a residual income model, we have a revised Mar'21 target price of Rs 3,000 (vs. Rs 5,200 earlier). Our assumptions include cost of equity of 13.5%, risk-free rate of 7.75%, risk premium of 5%, and a long-term growth rate of 5%. Maintain BUY.

FIG 16 – REVISED ESTIMATES

(Rs bn)	Old			New			Change (%)		
	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E
Net Income	168.9	217.6	279.9	166.0	197.6	241.7	(1.7)	(9.2)	(13.6)
Operating Expenses	58.4	73.1	91.6	58.4	71.8	87.2	0.0	(1.8)	(4.8)
Operating Profits	110.5	144.5	188.3	107.6	125.8	154.5	(2.7)	(12.9)	(18.0)
Provisions	28.2	35.0	46.6	28.2	50.0	49.6	0.0	42.6	6.6
PBT	82.3	109.4	141.8	79.3	75.8	104.9	(3.6)	(30.7)	(26.0)
Tax	22.6	27.6	35.7	21.9	19.1	26.4	(3.3)	(30.7)	(26.0)
PAT	59.6	81.8	106.0	57.4	56.7	78.4	(3.7)	(30.7)	(26.0)
Loans	1,507	1,959	2,546	1,448	1,612	1,981	(3.9)	(17.7)	(22.2)
Borrowings	1,341	1,724	2,241	1,289	1,418	1,744	(3.9)	(17.7)	(22.2)
ROA	4.0	4.2	4.3	4.0	3.2	3.8	(7.7)	(97.5)	(43.5)
ROE	22.4	22.1	23.4	21.7	15.9	18.8	(75.1)	(622.5)	(458.6)
AUM	1,536	1,996	2,595	1,476	1,643	2,019	(3.9)	(17.7)	(22.2)

Source: BOBCAPS Research

FIG 17 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

- Prolonged lockdown
- Higher credit costs than expected
- Longer time to resolve defaults than estimated

FINANCIALS

Income Statement

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net interest income	**69,716**	**97,252**	**130,454**	**155,022**	**186,367**
NII growth (%)	42.2	39.5	34.1	18.8	20.2
Non-interest income	11,713	21,530	35,500	42,600	55,349
Total income	81,429	118,782	165,954	197,621	241,716
Operating expenses	32,690	41,977	58,391	71,811	87,231
Operating profit	48,739	76,805	107,563	125,810	154,485
Operating profit growth (%)	34.1	57.6	40.0	17.0	22.8
Provisions	10,305	15,014	28,232	49,979	49,615
PBT	38,434	61,792	79,331	75,832	104,870
Tax	13,471	21,842	21,891	19,110	26,427
Reported net profit	**24,964**	**39,950**	**57,440**	**56,722**	**78,442**
Adjustments	0	0	0	0	0
Adjusted net profit	**24,964**	**39,950**	**57,440**	**56,722**	**78,442**

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	331,320	381,235	450,265
Net worth	158,478	196,970	332,523	382,439	451,468
Deposits	0	0	0	0	0
Borrowings	665,573	1,015,879	1,288,991	1,418,362	1,743,715
Other liabilities & provisions	23,932	29,476	33,897	38,981	44,829
Total liabilities and equities	**847,983**	**1,242,325**	**1,655,411**	**1,839,782**	**2,240,011**
Cash & bank balance	3,397	3,487	91,170	96,219	107,993
Investments	31,394	85,990	98,889	113,722	130,780
Advances	800,001	1,137,135	1,448,304	1,611,775	1,981,494
Fixed & Other assets	4,703	6,948	6,968	6,978	6,993
Total assets	**847,983**	**1,242,325**	**1,655,411**	**1,839,782**	**2,240,011**
Deposit growth (%)	NA	NA	NA	NA	NA
Advances growth (%)	41.8	42.1	27.4	11.3	22.9

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
EPS	43.4	69.3	95.5	94.3	130.4
Dividend per share	4.0	6.0	9.5	9.4	13.0
Book value per share	275.7	341.4	552.6	635.6	750.3

Source: Company, BOBCAPS Research

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
P/E	53.7	33.7	24.4	24.7	17.9
P/BV	8.5	6.8	4.2	3.7	3.1
Dividend yield (%)	0.2	0.3	0.4	0.4	0.6

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20E	FY21E	FY22E
Net interest income	9.5	9.3	9.0	8.9	9.1
Non-interest income	1.6	2.1	2.5	2.4	2.7
Operating expenses	4.5	4.0	4.0	4.1	4.3
Pre-provisioning profit	6.6	7.3	7.4	7.2	7.6
Provisions	1.4	1.4	1.9	2.9	2.4
PBT	5.2	5.9	5.5	4.3	5.1
Tax	1.8	2.1	1.5	1.1	1.3
ROA	3.4	3.8	4.0	3.2	3.8
Leverage (x)	5.9	5.9	5.5	4.9	4.9
ROE	20.1	22.5	21.7	15.9	18.8

Ratio Analysis

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
YoY growth (%)					
Net interest income	42.2	39.5	34.1	18.8	20.2
Pre-provisioning profit	34.1	57.6	40.0	17.0	22.8
EPS	29.2	59.6	37.8	(1.2)	38.3
Profitability & Return ratios (%)					
Net interest margin	10.2	10.0	10.1	10.1	10.4
Fees / Avg. assets	1.1	1.6	1.8	1.8	2.0
Cost-Income	40.1	35.3	35.2	36.3	36.1
ROE	20.1	22.5	21.7	15.9	18.8
ROA	3.4	3.8	4.0	3.2	3.8
Asset quality (%)					
GNPA	1.4	1.5	1.6	1.4	1.0
NNPA	0.4	0.6	0.6	0.6	0.4
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	24.9	25.5	24.3
Tier-1	18.4	16.3	21.8	22.8	22.2

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

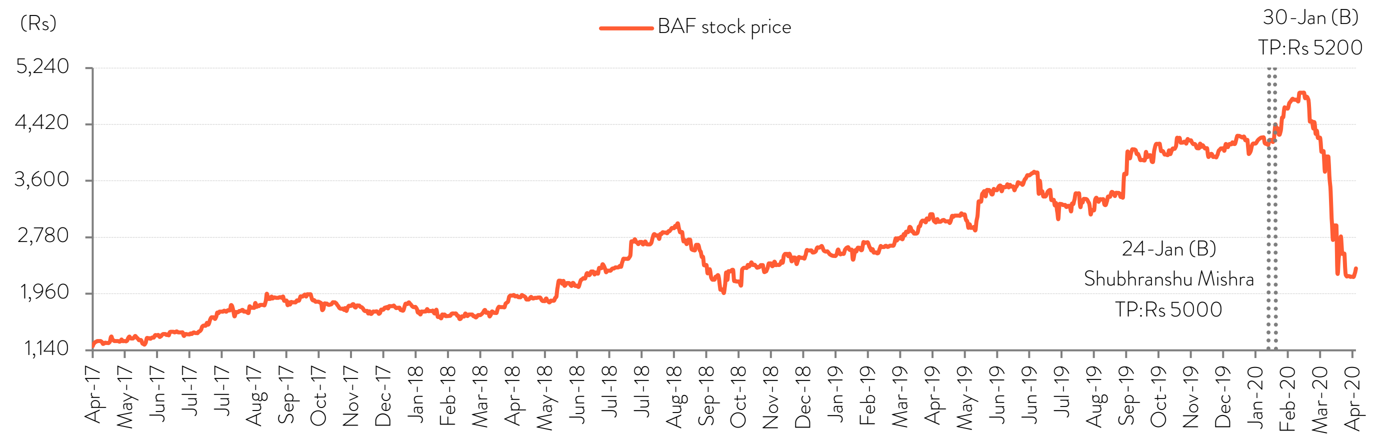
ADD – Expected return from >+5% to +15%

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

Rating distribution

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