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## IPO NOTE

# AU Small Finance Bank

## An 'A'lternative for 'U'nderserved

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**IPO Details**

Open date	:28-June-2017
Close date	:30-June-2017
Price Band	: 355-358
Fresh Issue (m share)	: 0
Offer for sale (m share)	: 53.4
Post Issue Mcap (bn)	: 101.7

**Key Shareholders (%)**

Promoters	:	36.03%
Others	:	63.97%

**Presence in under-served segments to ensure strong future growth**

Over the years, AU Small Finance Bank (AU SFB) has established itself as a preferred lender to the underserved segment in areas of vehicle, SME and MSME finance present. Given that banks have traditionally ignored this segment on account of lower ticket sizes, high operating costs and difficulty in accessing the credit worthiness of the borrower, there is huge unmet demand. This gives an opportunity to players like AU SFB who have developed business models to grow and operate profitably in these segments.

**Robust processes, well defined strategies ensure "best of both the worlds" for AU SFB**

Given the risks involved in operating in the semi-urban and rural areas, AU SFB adopted a strategy of contiguous expansion across regions, which ensures better risk controls. This coupled with the use of decentralized hub & spoke model ensured that turnaround times are minimal and that risk assessment has an additional layer based on local level inputs. As a result, AU SFB could maintain its high yields and yet report the best-in-class asset quality over FY13-17 (GNPAs at 1.6% vs. more than 5.0% for peers like Shriram, Chola and Magma as on Mar'17).

**Credible management & strong position to ensure that AU remains the best placed SFB**

Over its 20 year history, AU SFB has evolved from being a channel partner to HDFC Bank to an auto NBFC to a diversified NBFC to now a Small Finance Bank. It was able to improve its scale of operations as well as profitability with every successive transition, indicating strong management capabilities. Unlike its peers who are grappling with problems in their microfinance book, AU SFB has little to worry due to the secured nature of its book. Its strong profitability profile will ensure that conversion to a small bank is relatively smooth (through RoEs of 17%).

**Valuations at 3.2x book are attractive give the uniqueness of the business model**

Given the strong presence in niche customer segments, AU SFB's profitability will be remain superior to most conventional banks. Despite the migration to SFB, we estimate that AU will report trough RoEs of ~17% in FY18 this will recover to 20% by FY20. This is significantly better than its listed peers which are currently reporting single digit RoEs. As such, valuations at 3.2x book on FY20 are reasonable, and investors can expect strong upside over the next few years.

**Key financials**

	FY16	FY17	FY18e	FY19e	FY20e
Net interest income (INRm)	6,517	9,167	12,492	14,998	17,832
Net Profit (INRm)	2,472	8,427	3,931	4,885	5,721
% growth	77.2	241.0	(53.4)	24.3	17.1
EPS (INR)	56.1	29.6	13.8	17.2	20.1
BV (INR)	227.0	70.3	81.7	95.9	112.5
P/E	6.4	12.1	25.9	20.8	17.8
P/BV	1.6	5.1	4.4	3.7	3.2
RoA (%)	4.8	10.5	3.6	3.3	2.9
RoE (%)	28.0	56.2	18.2	19.3	19.3

Source: Company, Antique

## About the Company

Au Financiers (India) Limited was incorporated in 1996 as a Systemically Important, Non-Deposit Accepting Asset Finance Company (NBFC - ND - AFC) by Mr. Sanjay Agarwal. The Company received a license from the Reserve Bank of India to set up a Small Finance Bank on December 20, 2016 and commenced its SFB operation from April 19, 2017 with retail focus primarily serving the low and middle-income individuals and businesses that have limited or no access to formal banking channels. As of May '17, the company conducted its operations through 269 branches, 121 asset centers, one central processing center and 10 offices which spread across 10 states and one union territory in India, with significant presence in the states of Rajasthan, Gujarat, Maharashtra and Madhya Pradesh.

### Au Small Finance Bank - Key business

As on Mar 17	AUM (INR m)	AUM (%)	Avg ticket size (INR m)	Loan tenure (in yrs)	5 Years CAGR
Vehicle Finance	53,957	50.3	0.34	Up to 5 years	16.5%
MSME Finance	32,163	30.0	1.08	Up to 12 years	54.7%
SME Finance	21,218	19.8	21.92	Up to 15 years	77.8%

Source: Company, Antique

### Management Team

Name	Work Profile
<b>Mr. Sanjay Agarwal, MD &amp; CEO</b>	Mr. Agarwal is the Promoter, MD and CEO of Company. He has over 21 years of experience in finance, accounting, strategic planning and credit risk management. He has been associated with company since 1996. He holds a bachelor's degree in commerce from the Government College, Ajmer. He qualified as a chartered accountant from the Institute of Chartered Accountants of India. He is also the vice president of Rajasthan Finance Companies Association. Mr. Agarwal is the recipient of the "Rajasthan Entrepreneur and Excellence Award - Personality of the year (finance category)" in the year 2016 and has also been chosen as the "Our Business Leader of the Year" at the ICAI Awards, 2017.
<b>Mr. Uttam Tibrewal, Whole time Director</b>	Mr. Tibrewal is the Whole-time Director of Company. He has been associated with Company since the 2003 as the head of business operations and was appointed as a Whole-time Director in 2008. He has over 13 years of experience in the non-banking finance industry. He holds a bachelor's degree in commerce from the University of Delhi.
<b>Mr. Deepak Jain, CFO</b>	Mr. Jain is the chief financial officer of Company. He has been associated with company since 2010 as the chief financial officer. Prior to joining our Company, he was a practicing chartered accountant. He has over 18 years of experience in the fields of financial, treasury operations and audit functions. He holds a bachelor's degree in commerce from the University Commerce College, Jaipur, Rajasthan. He is a qualified chartered accountant and held a certificate of practice from the ICAI.

Source: Company, Antique

## Key things to watch out as AU SFB converts itself into a small finance bank

Key challenges in conversion to small finance bank include compliance with the shareholding pattern, maintenance of statutory ratios, ability to raise deposits and ramping up the branch network to make in compliant with bank standards. Below is our take on each of them:

- Maintenance of statutory ratios:** Starting Apr'17, AU SFB would have to comply with CRR and SLR norms. This will result in balance sheet expansion on one hand and reduction in margins on the other hand. NIMs can decline from current levels of 8% to 7% over a period of time.
- Ability to raise liabilities:** Once restrictions on inter-bank borrowings kick-in, AU SFB will have to depend on deposits to fund its growth. While garnering low cost CASA deposits will be a slow process, AU SFB could resort to bulk deposits by offering slightly higher rates than commercial banks (a strategy successfully adopted by Bandhan Bank). Currently, it does not look like growth being constrained for the want of resources.
- Ramping up branch network:** AU SFB leveraged its NBFC network of 301 branches to set up 269 SFB branches, 121 asset centers, one central processing center and 10 offices, as of May 31, 2017. It plans to set up additional 162 branches and 7 central processing centers in FY18.
- Product strategy:** In addition to the asset products of vehicle finance, MSME and SME with it offered in the NBFC avatar, AU SFB plans to offer products like gold loans, agri loan, housing loans, etc.

AU Fin (NBFC)	AU SFB (Small Finance Bank)	
<b>Asset Products</b> •Vehicle Finance •MSME Finance •SME Finance	<b>Retail Assets Products</b> •Vehicle finance and 2-wheeler loan •Secured MSME & SME finance •Housing finance •Gold loans •Agriculture related term loan and kisan credit card	<b>Wholesale Asset Products</b> •Working capital facilities like over draft and cash credit. •Unsecured MSME & SME finance •NBFC loan •Construction finance
<b>Liabilities Products</b> Was non deposit taking NBFC.	<b>Liability Products</b> •Current account, Saving accounts, Term deposit and Recurring deposits •Payment wallets and customized prepaid instruments •Collection and payment solution for MSME & SME customers.	

Source: Company, Antiqua

On an overall basis, the risks to AU SFB's transition look rather manageable. The strong cash flows from the existing business will help it absorb the migration related costs. Below is the tentative trajectory that AU SFB could report over next few years.

### Key financials

	NBFC			SFB		
	Mar 15	Mar 16	Mar 17	Mar 18	Mar 19	Mar 20
EPS (INR)	32	56	30	14	17	20
BV (INR)	174	227	70	82	96	113
RoA (%)	4.0	4.8	10.5	3.6	3.3	2.9
RoE (%)	20.4	28.0	56.2	18.2	19.3	19.3

Source: Company, Antiqua

## Key Risks

**Concentration in the state of Rajasthan:** Approximately 56% of its overall portfolio is in the state of Rajasthan. This exposes AU SFB to the risks & rewards of being overly dependent on a single state. Deficient rainfall, unfavorable political environment, slowing state economy could impact its ability to grow and operate in that state. Also, top 20 borrowers account for 8.8% of its overall advances.

**Relatively un-seasoned SME & MSME book:** AU SFB started the MSME and SME products few years back and has not witnessed an adverse cycle. Also, the book is relatively un-seasoned due the fast growth rates over FY13-17.

**Ability to convert itself into a small bank:** Conversion to small finance banks involves multiple challenges such as complying with share holding norms, re-vamping the branch network, ability to manage liabilities and statutory requirements. This will require management band-width that is far different than the one required for managing an NBFC.

## Financials

### Income statement (INRM)

Year-ended	March 31	FY16	FY17	FY18e	FY19e	FY20e
<b>Interest income</b>		<b>10,469</b>	<b>14,170</b>	<b>19,966</b>	<b>25,016</b>	<b>31,445</b>
Interest expenses		3,953	5,003	7,474	10,018	13,614
<b>Net interest income</b>		<b>6,517</b>	<b>9,167</b>	<b>12,492</b>	<b>14,998</b>	<b>17,832</b>
Other income		50	135	169	211	264
<b>Total income</b>		<b>6,567</b>	<b>9,302</b>	<b>12,661</b>	<b>15,209</b>	<b>18,096</b>
Employee Benefits Expenses		1,577	1,928	2,988	3,586	4,303
Other Expenses		875	1,504	2,331	2,797	3,356
Depreciation and Amortisation Expense		85	58	87	104	125
Operating expenses		2,538	3,489	5,406	6,487	7,784
<b>Pre provisioning profits</b>		<b>4,029</b>	<b>5,813</b>	<b>7,255</b>	<b>8,723</b>	<b>10,312</b>
Provisions and Write Offs		257	767	1,208	1,208	1,509
Profit before tax & exceptional		3,772	5,046	6,048	7,515	8,802
Exceptional items		-	6,703	-	-	-
<b>Profit before tax</b>		<b>3,772</b>	<b>11,749</b>	<b>6,048</b>	<b>7,515</b>	<b>8,802</b>
Current Tax Expense		1,301	3,322	2,117	2,630	3,081
<b>Profit after tax</b>		<b>2,472</b>	<b>8,427</b>	<b>3,931</b>	<b>4,885</b>	<b>5,721</b>

### Balance sheet (INRM)

Year-ended	March 31	FY16	FY17	FY18e	FY19e	FY20e
Share Capital		441	2,843	2,843	2,843	2,843
Reserves and Surplus		9,566	17,153	20,394	24,422	29,139
<b>Networth</b>		<b>10,007</b>	<b>19,996</b>	<b>23,237</b>	<b>27,264</b>	<b>31,982</b>
Borrowings		47,826	70,710	79,481	104,049	123,190
Deposits		-	-	11,000	29,000	54,000
from current deposits		-	-	1,000	2,000	3,000
from savings deposits		-	-	3,000	6,000	9,000
from term deposits		-	-	7,000	21,000	42,000
<b>TOTAL</b>		<b>62,730</b>	<b>98,176</b>	<b>122,687</b>	<b>171,081</b>	<b>222,098</b>
Fixed Assets		246	2,758	3,862	5,407	7,569
Deferred Tax Assets (Net)		211	38	54	75	105
Cash and Cash Equivalents		1,234	6,245	13,917	18,717	19,006
Cash with RBI		-	-	4,072	5,987	7,974
Cash with others / self		-	-	9,846	12,729	11,033
Investments		2,316	21,503	19,906	29,271	38,982
Loans		57,893	66,080	102,914	144,458	192,387
Other Non-Current Assets		64	10	12	15	19
Other Current Assets		466	639	798	998	1,247
Short-Term Loans and Advances		210	536	670	837	1,046
Long-Term Loans and Advances		89	368	460	575	718
<b>TOTAL</b>		<b>62,730</b>	<b>98,176</b>	<b>122,687</b>	<b>171,081</b>	<b>222,098</b>

### Other operating details

Year-ended	March 31	FY16	FY17	FY18e	FY19e	FY20e
AUM		82,213	107,339	134,173	167,717	209,646
On-Book AUM		57,893	66,080	102,914	144,458	192,387
Off-Book AUM		24,319	41,259	31,259	23,259	17,259
Borrowings		47,826	70,710	90,481	133,049	177,190
Interest earning assets		85,763	135,087	167,996	215,704	267,634

Source: Company, Antique

### Growth

Year-ended	March 31	FY16	FY17	FY18e	FY19e	FY20e
AUMs		47.7	30.6	25.0	25.0	25.0
NII		60.9	40.7	36.3	20.1	18.9
PPP		57.4	44.3	24.8	20.2	18.2
PAT		77.2	241.0	(53.4)	24.3	17.1

### Margins

Year-ended	March 31	FY16	FY17	FY18e	FY19e	FY20e
Yield on loans		15.2	15.0	15.0	15.0	15.0
Cost of borrowing		10.3	8.4	9.5	9.5	9.5
Spread		4.9	6.5	5.5	5.5	5.5
NIMs		9.0	8.3	8.2	7.8	7.4

### Operating efficiency

Year-ended	March 31	FY16	FY17	FY18e	FY19e	FY20e
Operating cost to income		38.6	37.5	42.7	42.6	43.0
Operating cost to AUM		3.7	3.7	4.5	4.3	4.1

### Asset quality

Year-ended	March 31	FY16	FY17	FY18e	FY19e	FY20e
Gross NPA		371	1,072	2,573	3,611	4,810
Gross NPA / On-Book AUM (%)		0.6	1.6	2.5	2.5	2.5
Net NPAs		222	693	1,544	2,167	2,886
Net NPAs / On-Book AUM (%)		0.4	1.1	1.5	1.5	1.5
Credit Cost		37	81	100	80	80

### Return ratios

Year-ended	March 31	FY16	FY17	FY18e	FY19e	FY20e
RoA		4.8	10.5	3.6	3.3	2.9
RoE		28.0	56.2	18.2	19.3	19.3
Tier 1		13.5	21.1	-	-	-

### Per share data

Year-ended	March 31	FY16	FY17	FY18e	FY19e	FY20e
No. of shares		44.1	284.3	284.3	284.3	284.3
EPS		56.1	29.6	13.8	17.2	20.1
BVPS		227.0	70.3	81.7	95.9	112.5
ABVPS		222.0	67.9	76.3	88.3	102.4

Source: Company, Antique