AXIS DIRECT

INDUSIND BANK

BANKS & FINANCIAL SERVICES

25 OCT 2017 Company Update

BUY

Target Price: Rs 1,920

IIB-BHAFIN merger a done deal

The long awaited IIB-BHAFIN merger is finally sailing through with the bank acquiring the MFI in a share swap ratio of ~0.64x, entailing 639 shares of IIB for 1,000 shares of BHAFIN. The deal is happening at a premium of 12.6% to BHAFIN's two week volume weighted price. Also, a preferential allotment is being made to the promoters of IIB to arrest their shareholding to 15%.

The deal enables merger of BHAFIN's assets and liabilities with the bank, while its infrastructure (employees, branches) will operate as a business correspondent in the form of a wholly-owned subsidiary. On a merged book, IIB would trade at 3.6x FY19E PBV, and we expect the bank to continue commanding a premium based on the ability of management to deliver on expected lines along with superior financial metrics. **Maintain BUY on IIB with TP of Rs 1,920.**

CMP	: Rs 1,750
Potential Upside	: 10%

MARKET DATA

No. of Shares	: 599 mn
Free Float	: 85%
Market Cap	: Rs 1,048 bn
52-week High / Low	: Rs 1,818 / Rs 1,038
Avg. Daily vol. (6mth)	: 1.1 mn shares
Bloomberg Code	: IIB IB Equity
Promoters Holding	: 15%
FII / DII	: 43% / 13%

Synergies aplenty: The deal unlocks several synergies which are: (a) Merger with BHAFIN will add granularity to IIB's loan book and increase the share of retail loans in the bank to ~45% from current 40%; (b) return ratios are set to improve as capital requirements for banks are lower than NBFC-MFIs; also risk weights for microfinance are lower at 75% for banks vs. 100% for MFIs thus providing higher leverage; (c) the merger would increase IIB's network and ability to cross-sell but the benefits would accrue over time; products would have to be tailored to suit MFI customers and staff would need to be trained; (d) cost of funds are likely to be lower by ~3% and allows IIB to earn 1-1.5% fee income of the excess PSL generated.

Maintain BUY with TP of Rs 1,920 (4.4x FY19 P/ABV): We are enthused by IIB's aggressive 3-year target for FY20, as management has proven its caliber by meeting targets set in previous 3 planning cycles. With growing retail franchise and increasing market share in large corporate segment, IIB is one of few banks reporting robust growth when industry growth is down to single digit. We value IIB at 4.4x FY19 P/ABV, a premium to its peers given the traction expected in retail loans ahead.

Financial summary (Standalone)

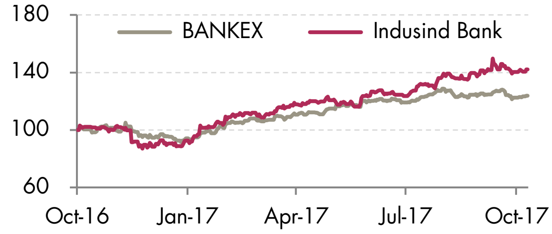
Y/E March	FY16	FY17	FY18E	FY19E
PAT (Rs mn)	22,864	28,679	35,873	44,250
EPS (Rs)	38	47	58	72
EPS chg (%)	13.8	24.5	25.1	23.4
Book value (Rs)	284	331	381	444
Adj. BV (Rs)	281	326	375	436
PE (x)	46.6	37.4	29.9	24.3
P/ABV (x)	6.2	5.4	4.7	4.0
RoE (%)	16.6	15.3	16.4	17.5
RoA (%)	1.8	1.8	1.8	1.8
Net NPA (%)	0.4	0.4	0.4	0.4

Source: Company, Axis Capital

Key drivers

	Q3'17	Q4'17	Q1'18	Q2'18
Loan growth (% YoY)	25	28	24	24
NIM (%)	4.0	4.0	4.0	4.0
CASA (%)	37	37	38	42
GNPA ratio (%)	0.9	0.9	1.1	1.1

Price performance



The deal matrix

IIB is acquiring BHAFIN in a share swap deal, involving a ratio of 0.64x, (639 shares of IIB for 1,000 shares of BHAFIN). This implies premium of 12.6% to BHAFIN's two week volume weighted price. Also, a preferential allotment is being made to the promoters of IIB to arrest their shareholding to 15%. The deal enables merger of BHAFIN's assets and liabilities with the bank, while its infrastructure (employees, branches) will operate as a business correspondent in the form of a subsidiary. Management expects the transaction to take up to 6-9 months for closure, given various regulatory approvals required. There will be no change in the board of the bank post the amalgamation, while the board of BHAFIN will sit as an advisory committee in the wholly-owned subsidiary. Also, there will be no change in people and the reporting structure for BHAFIN.

IIB is acquiring BHAFIN in a share swap ratio of ~0.64x

Exhibit 1: The deal structure

Particulars	
IIB's CMP (Rs)	1,750
Swap ratio (x)	0.64
BHAFIN price considered for merger (Rs)	1,118
BHAFIN's two week VWAP	993
Premium paid over BHAFIN's two week VWAP (%)	12.6
No. of shares to be issued to BHAFIN shareholders (mn)	84
Preferential allotment to IIB's promoters (Rs mn)	22,691
No of shares issued (mn)	13
Total no. of shares in merged entity (mn)	695

Source: Company, Axis Capital

Exhibit 2: Merged pro forma

Particulars (Rs bn)	IndusInd Bank			Bharat Financial Inclusion			Merged Entity		
	FY17	FY18E	FY19E	FY17	FY18E	FY19E	FY17	FY18E	FY19E
Share Capital	6	6	6	1	1	1	6	7	7
Reserves & Surplus	200	231	270	23	28	35	224	282	328
Networth	206	237	276	24	29	37	230	289	335
PAT	29	36	44	3	5	7	32	41	52
Total assets	1,786	2,171	2,652	104	146	204	1,891	2,339	2,879
EPS (Rs)	46.8	58.5	72.1	21.8	33.4	50.2	52.8	58.4	74.4
BVPS (Rs)	330.5	381.1	444.2	177.3	214.0	267.8	383.8	415.4	481.8
RoA (%)	1.8	1.8	1.8	3.3	3.7	4.3		1.9	2.0
RoE (%)	15.3	16.4	17.5	15.1	17.3	21.7		15.7	16.6
PE (x)	37.4	29.9	24.3	46.0	30.0	20.0	33.2	30.0	23.5
PBV (x)	5.3	4.6	3.9	5.7	4.7	3.7	4.6	4.2	3.6

Source: Company, Axis Capital

Valuation

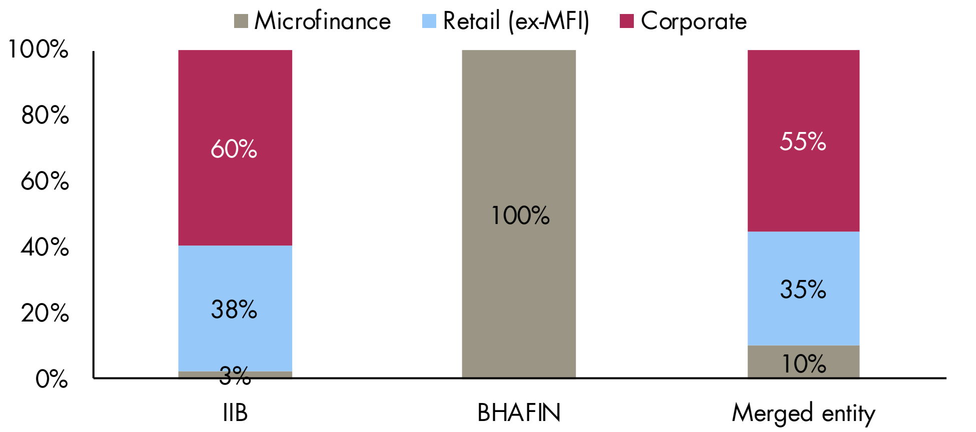
On a merged book, IIB would trade at 3.6x FY19E PBV, and we expect IIB to continue commanding a premium based on the ability of management to deliver on expected lines along with superior financial metrics. **Maintain BUY with TP of Rs 1,920.**

Potential synergies that could arise out of the merger

Merger adds granularity to IIB's loan book: In our view, merger with BHAFIN will add granularity to IIB's loan book. Currently, microfinance loans form ~2.5%, while retail loans (ex-microfinance) form ~38% of IIB's loan book. Management has aspirations to have a retail:corporate mix of 50:50 going forward. More so, within retail, the share of non-vehicle loans is targeted at ~50%. BHAFIN's AUM will add ~7% to IIB's existing loan book which will increase the share of retail loans to ~45%. However, the management expects the share of this segment to come down to ~5% over the next two years given the growth potential from other segments of the loan book.

IIB can grow microfinance portfolio faster than BHAFIN

Exhibit 3: Share of microfinance loans should increase to ~10% in the merged entity

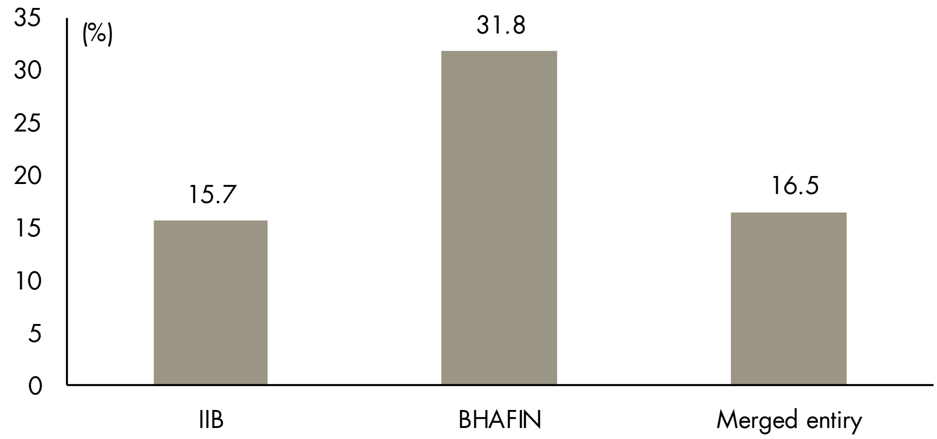


Source: Company, Axis Capital

Higher leverage can improve return ratios over the next few years

Return ratios will improve with immediate release of capital: IIB's FY18E RoA/RoE is ~2%/16%, whereas BHAFIN has RoA/RoE of ~3.8%/17.5% (Bloomberg consensus). In Q1FY18, BHAFIN had CAR of 31.8% which is entirely CET-1. Capital requirements for banks are materially lower than for NBFC-MFIs (CAR requirement of 15%); also risk weights for microfinance are lower at 75% for banks vs. 100% for MFIs thus providing higher leverage on the merged capital base. In our view, improvement in RoA will largely be offset by BHAFIN's higher loan loss provisions and cost structure but increased leverage can improve RoE's materially.

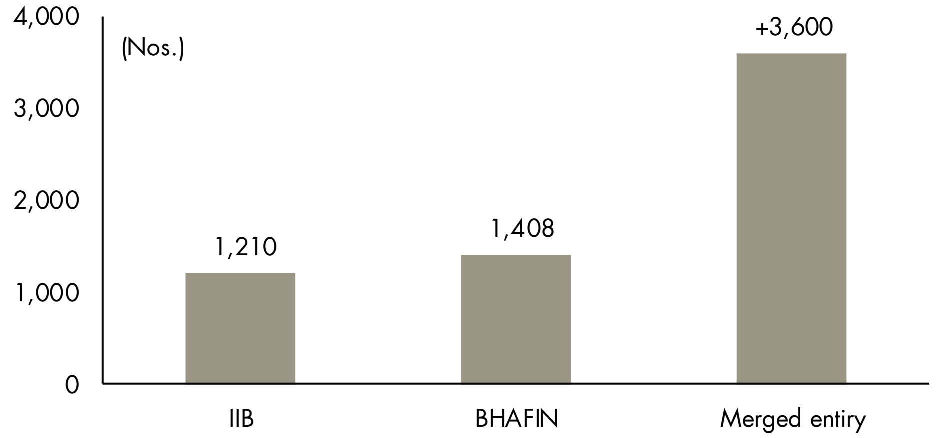
Exhibit 4: Capital ratios set to improve



Source: Company, Axis Capital

Significant reach and ability to cross-sell: The merger would provide IIB access to BHAFIN's pan-India branch network + customer base. IIB, in the past, has demonstrated its ability to convert select NBFC-branches of Ashok Leyland Finance into full service bank branches without bloating cost metrics. This deal will boost the customer base to 16.3 mn from IIB's existing base of 9.5 mn customers. Also, the merged entity is likely to have +3,600 branches and outlets. However, the benefits of cross sell may not be immediate as the bank will have to tailor products that suit MFI customers and train BHAFIN's staff to sell the larger product suite.

Exhibit 5: Network of merged entity to increase meaningfully



Source: Company, Axis Capital

Cost of funds will be lower; impact of SLR/CRR to be negligible: Management expects 3-4% savings in terms of cost of funds as IIB can fund BHAFIN's entire borrowings from day 1 itself. Also, given that BHAFIN's assets can be entirely refinanced, the impact of CRR/SLR will be negligible. BHAFIN's 100% portfolio will be PSL compliant and IIB can earn 1-1.5% fee on the excess PSL it generates via PSLC market.

BHAFIN's relatively small book unlikely to taint overall asset quality: At <1.5% of loans, IIB has one of the lowest proportion of stressed loans in the industry. On the other hand, with gross NPA at 6%, BHAFIN's asset quality has been marred by the recent vagaries in the sector. In our view, BHAFIN's book size is relatively small to move the needle much in terms of the merged entity's asset quality. However, the merger exposes IIB to the structural risks that the microfinance sector inherits. Upon merger, gross NPA ratio would increase from 1.1% for IIB to 1.4% for the merged entity and coverage ratio would increase to ~67% from 60% at present.

Exhibit 6: Asset quality of the merged entity should remain healthy

Particulars	IIB	BHAFIN	Merged entity
Gross NPA (Rs mn)	12,717	4,635	17,352
Gross NPA ratio (%)	1.1	6.0	1.4
Net NPA (Rs mn)	5,083	689	5,772
Net NPA ratio (%)	0.4	1.0	0.5
Calc. PCR (%)	60.0	85.1	66.7

Source: Company, Axis Capital

Stronger regulatory supervision: Although both banks and NBFC-MFIs are regulated by RBI, banks tend to enjoy better regulatory supervision given strict capital, shareholding, prudential and other norms. This would be immensely beneficial given BHAFIN's target customer segments are economically backward and there is high risk of geopolitical and regulatory intervention under NBFC-MFI structure.

Financial summary (Standalone)

Profit & loss (Rs mn)

Y/E March	FY16	FY17	FY18E	FY19E
Interest earned	118,717	144,057	175,622	215,507
Interest expended	(73,552)	(83,431)	(99,673)	(120,786)
Net interest income	**45,166**	**60,626**	**75,949**	**94,721**
Non interest income	32,969	41,715	50,051	59,905
Net income	**78,135**	**102,341**	**126,000**	**154,626**
Operating expenses	**(36,721)**	**(47,831)**	**(57,323)**	**(68,225)**
Staff expenses	(12,361)	(15,210)	(18,380)	(21,458)
Other operating expenses	(24,360)	(32,621)	(38,944)	(46,767)
Operating profit	**41,414**	**54,510**	**68,676**	**86,401**
Provisions & contingencies	(6,722)	(10,913)	(14,323)	(19,356)
Pre-tax profit	**34,692**	**43,597**	**54,353**	**67,046**
Tax expense	(11,828)	(14,918)	(18,480)	(22,796)
Profit after tax	**22,864**	**28,679**	**35,873**	**44,250**
Extraordinary item	-	-	-	-
Minority interest/Associates	-	-	-	-
Adj. PAT	**22,864**	**28,679**	**35,873**	**44,250**

Balance sheet (Rs mn)

Y/E March	FY16	FY17	FY18E	FY19E
Total assets	**1,428,970**	**1,786,484**	**2,171,053**	**2,652,495**
Cash & Balances with RBI	101,119	186,283	202,091	238,366
Investments	340,543	367,021	433,436	514,638
Advances	884,193	1,130,805	1,423,020	1,777,331
Fixed assets	12,553	13,352	13,721	13,701
Other assets	90,561	89,023	98,785	108,460
Total liabilities	**1,428,970**	**1,786,484**	**2,171,053**	**2,652,495**
Equity capital	5,950	5,981	5,981	5,981
Preference capital	-	-	-	-
Reserves & surplus	167,065	196,582	227,598	266,297
Networth	173,152	202,715	233,731	272,431
Borrowings	249,959	224,537	243,991	282,509
Deposits	930,003	1,265,722	1,593,205	1,987,643
Other liabilities & prov.	72,048	89,764	96,380	106,166

Source: Company, Axis Capital

Key ratios

Y/E March	FY16	FY17	FY18E	FY19E
Per share data				
FDEPS (Rs.)	38	47	58	72
BV (Rs.)	284	331	381	444
Adj. BV (Rs.)	281	326	375	436
DPS (Rs.)	4	6	7	8
Dividend payout (%)	12	13	12	11
Yields & Margins (%)				
Yield on advances	11.8	11.4	11.2	11.1
Cost of deposit	6.8	6.3	6.0	5.9
Net interest margin	3.8	4.0	4.1	4.1
Asset quality (%)				
Gross NPAs	0.9	0.9	1.1	1.2
Net NPAs	0.4	0.4	0.4	0.4
Credit cost	0.8	1.0	0.8	0.8
Provisioning coverage	58.6	58.4	61.0	63.0
Capital (%)				
Tier-I	14.9	14.7	13.3	12.5
CAR	15.5	15.3	13.7	12.9
Efficiency (%)				
ROA	1.8	1.8	1.8	1.8
ROE	16.6	15.3	16.4	17.5
Cost to income	47	47	45	44
CASA	35	37	38	39
Effective tax rate	34	34	34	34
Growth (%)				
Net interest income	32	34	25	25
Fee income	27	24	21	20
Operating expenses	28	30	20	19
Profit after tax	27	25	25	23
Advances	29	28	26	25
Deposits	25	36	26	25
Total assets	28	25	22	22

Source: Company, Axis Capital

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