Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

AU Small Finance Bank

Earnings momentum to drive strong compounding

Banks & Finance	Sharekhan code: AUBANK

Reco/View: Buy	CMP: Rs. 614	Price Target: Rs. 810	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- We retain our Buy rating on AU SFB with an unchanged PT of Rs. 810. Earnings growth momentum would likely surprise on the upside, led by strong AUM growth and lower credit cost. At CMP, the stock is currently trading at 4.5x and 3.8x its FY2023E and FY2024E ABV, respectively.
- The bank has guided for 25-30% loan growth and deposits growth of 30-35% in FY2023E. In terms of margins, the bank believes margins have peaked out in Q4FY2022 at 6.3% and overall at 5.7% in FY2022.
- Cost-to-Income ratio guided at 55%-57% for FY2023E/FY2024E as management believes opex growth is likely to be higher in-line with revenue growth as the bank continues to invest in constant digital innovation, helping to scale its business, and improve its brand identity.
- Collection efficiency across product lines is similar to healthy levels witnessed in Q4FY2022. Moreover, the bulk of restructured loans is out of moratorium and is performing well on expected lines. Overall, there should be steady improvement in asset quality going forward.

Our interaction with the management of AU SFB reaffirmed our expectation of strong earnings growth momentum going ahead, led by sustainable and healthy loan growth and lower credit cost. The bank has guided for 25-30% loan growth. Loan growth has already started to pick up in the past two quarters and we expect AUM growth to be higher in FY2023E/FY2024E from ~27% in FY2022, led by sharp rebound in economic activity. The bank believes margin should moderate in FY2023E/FY2024E from 5.7% in FY2022 due to repricing of liabilities to an extent taking place in the near term and higher share of fixed rate loan book (~75%). Cost-to-Income ratio has been guided at 55%-57% for FY2023E/FY2024E, as the bank would continue to invest in constant digital innovation and capabilities, helping to scale its business and improve its brand identity. Collection efficiency across product lines and restructured portfolio is similar to healthy levels witnessed in Q4FY2022. This should prevent deterioration in asset quality and would lead to lower credit cost in FY2023E/FY2024E.

Expect moderation in margins ahead: AU SFB has benefited from lower interest rates regime, given a large share of fixed rate loans ~75% (Wheels and SBL). Further, cost of funds improved substantially, which led to sharp improvement in net interest margin (NIM) during FY2022. Margins should moderate in FY2023E/FY2024E from 5.7% in FY2022 as higher rate cycle has kicked in. The bank expects share of floating rate loans to increase gradually over the medium term from ~25%, led by housing loans and commercial banking loans. We believe the bank has the pricing power to pass on rate hikes to end-customers in incremental loans because its end-customer is not rate sensitive, which is a key positive. From here on, we could see disbursement yield inching up, so overall margin compression should be restricted, but we expect moderation in margins going ahead. However, loan growth outlook is improving from here on.

Opex to remain higher on accelerated investments for future growth: Opex growth is likely to be higher as guided by the management, in line with revenue growth as the bank continues to invest in digital innovation and capabilities, investments in brand building, new business (credit card), expanding distribution, and building capacity by employee additions. Constant digital innovation would help the bank to scale the business, improve brand identity, and significantly reduce customer acquisition cost, which is positive over the medium to long term. The bank also articulated that recently launched digital products and channels have given pace of new customer acquisitions a significant uplift. The bank has guided for 55-57% cost-to-income ratio in FY2023E/FY2024E.

Our Call

Valuation – The stock is currently trading at 4.5x and 3.8x its FY2023E and FY2024E ABV, respectively. Factors such as AU SFB's long history, seasoned loan book, and superior underwriting practices are likely to support its asset quality and superior return ratios (ROA: -1.7-2.0%; ROE: 16-18%). There is a long runway for sustainable earnings compounding ahead. Higher provision coverage and contingent buffers provide cushion for any future risk. The bank is on track to become a full-scale universal retail-focused bank adding to its products and features. We maintain our Buy rating on the stock with an unchanged price target (PT) of Rs. 810. We believe growth momentum would surprise on the upside, led by strong AUM growth and lower credit cost.

Key Risks

Economic slowdown due to which slower loan growth and higher-than-anticipated credit cost especially from small business loans portfolio and wheels could affect earnings.

Valuation Rs cr

Particulars	FY22	FY23E	FY24E	FY25E
Net Interest Income	3,234	3,823	4,551	5,617
Net profit	1,130	1,352	1,627	2,116
EPS (Rs)	18.0	21.5	25.8	33.6
ABVPS (Rs)	116.6	137.3	162.1	194.5
P/E (x)	34.1	28.6	23.8	18.3
P/BV (x)	5.3	4.5	3.8	3.2
RoE	16%	17%	17%	18%
RoA	1.9%	1.7%	1.7%	1.7%

Source: Company; Sharekhan estimates

3R MATRIX

	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)		✓	

\+ Positive = Neutral – Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

ESG Disclosure Score NEW

ESG RISK RATING 23.87
Updated Apr 08, 2022

Medium Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

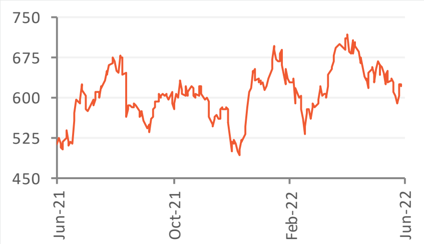
Company details

Market cap:	Rs. 38,697 cr
52-week high/low:	Rs. 733 / 468
NSE volume: (No of shares)	13 lakh
BSE code:	540611
NSE code:	AUBANK
Free float: (No of shares)	44.1 cr

Shareholding (%)

Promoters	28.2
FII	34.3
DII	19.0
Others	18.5

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-6.4	5.5	22.8	19.5
Relative to Sensex	-1.4	16.3	32.3	21.2

Sharekhan Research, Bloomberg

Key takeaways from management interaction

- **Loan growth has started to pick up:** The bank reported loan growth of 27% y-o-y versus 24% y-o-y in H1FY2022. This was largely led by mortgages, agri/gold, NBFCs, and real estate (wholesale assets). While small business loans and wheels, both constituting 35%/36% of the total book, respectively, have lagged on relative basis, they should revive in FY2023E/FY2024E, led by sharp rebound in economic activity and demand uptick in small business loans and auto sector, which would lead to higher loan growth in FY2023E/FY2024E compared to FY2022. The bank has guided for 25-30% loan growth in FY2023E.

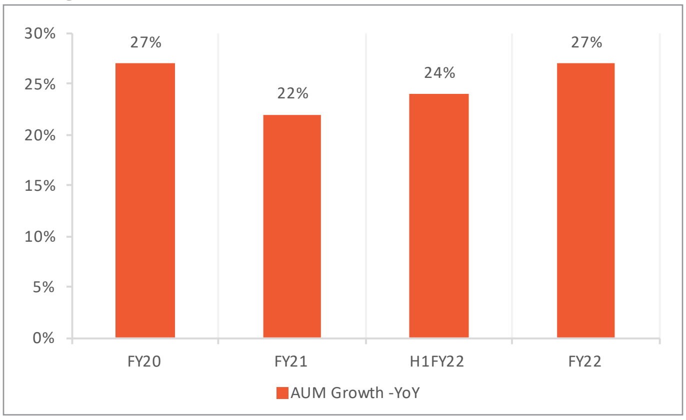
- **Bad loans have moderated; PCR improved on strengthening provision policy:** Overall, impaired loans moderated to 4.5% in FY2022 versus 6.1% in FY2021 and coverage has improved to 51%. Slippages in Q4FY2022 started to moderate at Rs. 195 crore from Rs. 250 crore run rate in the past quarters. Reductions were also higher, led by healthy recovery, leading to a decline in GNPLs in absolute terms. GNPL ratio stood at 1.98% versus 4.5% in FY2021. Restructured loans now stand at 2.6% of loans. PCR improved to 75% in FY2022. The bulk of restructured loans is out of moratorium and is performing well. We expect benign credit costs going forward. The bank has also strengthened its provisioning policy with the aim to build higher buffers on the balance sheet, which is a key positive. Core asset underwriting principles followed by the bank such as small ticket size, secured lending, risk-based pricing and mainly for income generation purpose are the strong pillars for best in asset quality.

- **Strong growth witnessed in retail liability franchise, execution has been better than expectations:** CASA ratio improved to 37% in FY2022 from 23% in FY2021. Robust growth witnessed - SA deposits grew by 156% y-o-y; CA grew by 57% y-o-y and retail term deposits grew by 35% y-o-y in FY2022. Share of CASA and retail term deposits improved to 52% of total funding versus 38% in FY2021. This should bode well for sustainable asset growth. The bank has guided for 30-35% deposits growth in FY2023E.

- **Expected capital raise in FY2023:** The bank guided that it would be looking to raise additional growth capital of Rs. 2,000 crore-3,000 crore in FY2023 in terms of tier I and tier II capital.

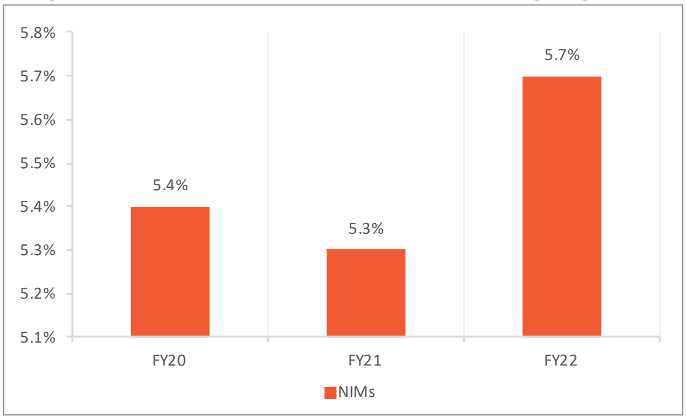
Financials in charts

Loan growth has started to pick up from H2FY22



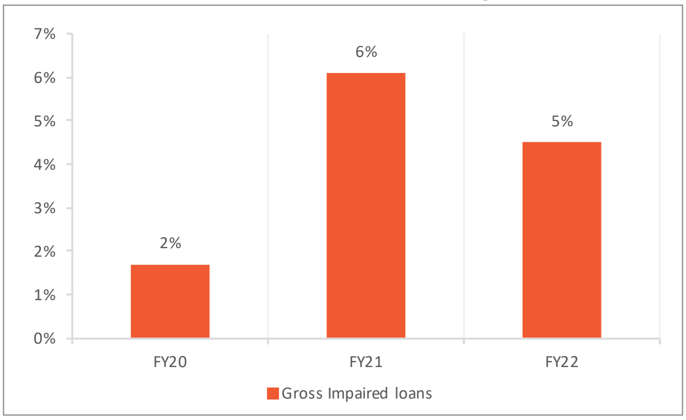
Source: Company, Sharekhan Research

Margins have peaked out. Expected to moderate going forward



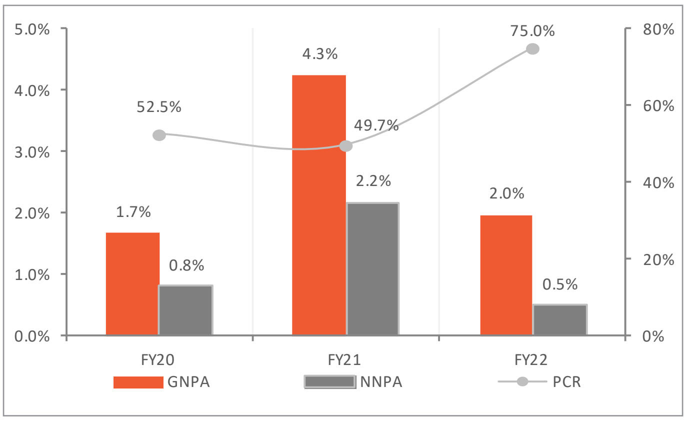
Source: Company, Sharekhan Research

Gross Impaired loans have improved sharply for the bank



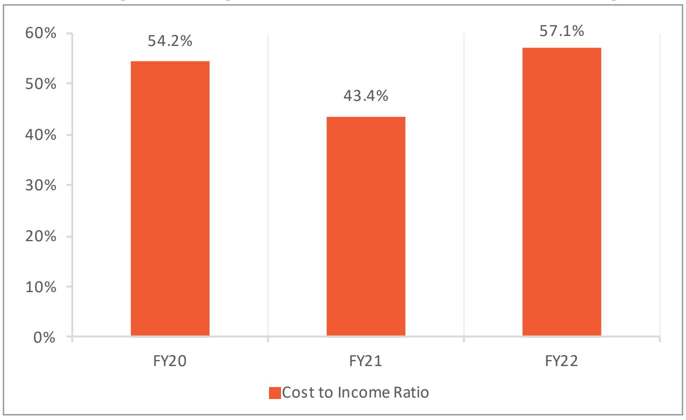
Source: Company, Sharekhan Research

Asset quality has improved sharply along with higher PCR augurs well



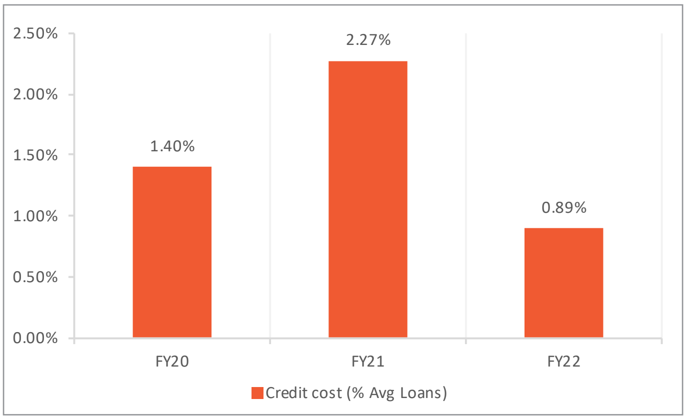
Source: Company, Sharekhan Research

C/I Ratio higher led by accelerated investments for future growth



Source: Company, Sharekhan Research

Credit cost is expected to normalize further



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector View – Long-term positive outlook for SFBs

While financial inclusion (in terms of deposits, bank channels, and services accessibility) has reached a significant penetration level in India, we believe credit delivery and accessibility still lag for the non-salaried as well as non-urban centre clients. Therefore, there exists a large market that can be effectively catered to by special entities such as SFBs. We believe SFBs have a structural advantage of access to low-cost retail deposits (and opportunity for asset growth as well) compared to NBFCs, which gives them a competitive advantage to manage spreads and have healthy operating profit growth, with lower inherit credit risk relative to NBFCs, translating into sustainable earnings momentum. We believe the largely underpenetrated market segment is an attractive space with a large headroom for growth.

■ Company Outlook – Attractive franchise over the long term

AU SFB has had a long and successful history (since its days as an NBFC and now as a bank) in credit underwriting quality, mainly in the under/unbanked self-employed customer segment that lacks formal income documentation. AU SFB is gradually expanding into other geographies across India, which have significantly low credit and deposit penetration. We believe AU SFB's presence in under-penetrated areas provides the bank a competitive advantage to pursue growth, along with its niche customer profile with low competition from peer banks and NBFCs. Drivers for loan growth are expected to remain for the core segments of AU SFB, namely vehicles and small business loans and home loans are expected to pick up meaningfully as strong growth drivers. The bank has a strong skill set and deep experience in its core segments. We find business metrics to be strong with a robust balance sheet and business model strength.

■ Valuation – Maintain Buy with an unchanged PT of Rs. 810

The stock is currently trading at 4.5x and 3.8x its FY2023E and FY2024E ABV, respectively. Factors such as AU SFB's long history, seasoned loan book, and superior underwriting practices are likely to support its asset quality and superior return ratios (ROA: -1.7-2.0%; ROE: 16-18%). There is a long runway for sustainable earnings compounding ahead. Higher provision coverage and contingent buffers provide cushion for any future risk. The bank is on track to become a full-scale universal retail-focused bank adding to its products and features. We maintain our Buy rating on the stock with an unchanged price target (PT) of Rs. 810. We believe growth momentum would surprise on the upside, led by strong AUM growth and lower credit cost.

Peer Comparison

Particulars	CMP	MCAP	P/E (x)		P/B (x)		RoE (%)		RoA (%)	
	Rs/Share	(Rs Cr)	FY23E	FY24E	FY23E	FY24E	FY23E	FY24E	FY23E	FY24E
AU Small Finance Bank	614	38,697	28.6	23.8	4.5	3.8	17.0	17.0	1.7	1.7
City Union Bank	124	9,197	10.2	7.5	1.4	1.2	12.8	15.1	1.4	1.8

Source: Company, Sharekhan research

About company

AU SFB is a scheduled commercial bank and a Fortune India 500 Company. Starting its journey from the hinterlands of Rajasthan, today AU SFB is the largest small finance bank with a deep understanding of the rural and semi-urban markets that have enabled it to build a robust business model facilitating inclusive growth. With a legacy of 25 years as a retail-focused and customer-centric institution, AU SFB started its banking operations in April 2017. The bank has consistently maintained a high external credit rating from all major rating agencies such as CRISIL, ICRA, CARE, and India Ratings.

Investment theme

AU SFB has expanded and strengthened its business model to offer a diverse suite of banking products and services by leveraging its asset-based lending strengths, NBFC customer base, and cost-efficient, technology-driven hub-and-spoke branch operating model to successfully operate its SFB. In addition to its vehicle finance, MSME and SME offerings, the bank's asset product offerings include working capital facilities, gold loans, agriculture-related term loans, Kisan credit cards for farmers, and loans against securities. The liability franchise has shaped up well with shoring up of retail deposits.

Key Risks

Economic slowdown due to which slower loan growth and higher-than-anticipated credit cost especially from small business loans portfolio and wheels could affect earnings.

Additional Data

Key management personnel

Mr. Sanjay Agarwal	Managing Director/CEO
Mr. Uttam Tibrewal	Whole Time Director
Mr. Vimal Jain	Chief Financial Officer
Mr. Deepak Jain	Chief Operating Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Wasatch Advisors Inc.	7.2
2	The Capital Group Cos Inc.	5.9
3	Kotak Mahindra Asset Management	4.7
4	CAMAS INVESTMENTS	4.6
5	St. Jame's Place PLC	4.4
6	Small-cap World Fund	3.8
7	WESTBRIDGE AIF I	3.6
8	Nomura India Invst Fund	2.7
9	Morgan Stanley	2.6
10	HDFC Life Insurance Co. Ltd.	2.1

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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