Equity Research

December 2, 2022

BSE Sensex: 63284

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Company Update

Financials

Target price: Rs1,285

Shareholding pattern

	Mar '22	Jun '22	Sep '22
Promoters	0.0	0.0	0.0
Institutional investors	5.5	6.6	6.6
MFs and others	1.1	1.1	1.3
FI/Banks	0.0	0.0	0.0
FIIs	4.4	5.5	5.3
Others	94.5	93.4	93.4

Source: NSE

ESG disclosure score

Year	2020	2021	Chg
ESG score	**13.1**	**13.1**	**0.0**
Environment	0.0	0.0	0.0
Social	3.2	3.2	0.0
Governance	36.1	36.1	0.0

Note - Score ranges from 0 - 100 with a higher score indicating higher ESG disclosures.
Source: Bloomberg, I-sec research

INDIA

One 97 Communications (Paytm)

BUY
Maintain

Management expects positive FCF generation in 12-18 months; no onerous outcome of regulatory observations

Rs501

One 97 Communications (Paytm) during its analyst meet yesterday (1st Dec'22) reiterated its continued focus on improving profitability. Management stated that the journey to attain operating profitability (EBITDA before ESOP cost) via consistent margin improvement has exceeded its expectations in the past few quarters. It further emphasised its target to become an FCF-generating company in the next 12-18 months. Management also enhanced clarity around the company's business model by providing additional disclosures with respect to net payment take-rate of 7-9bps, average subscription fee (of Rs100 per month per active device), 2.5-3.5% take-rate on loan sourcing and 0.5-1.5% on collections, etc. Besides, the management pointed at growth drivers in the various business segments and threw light on how it plans to generate free cashflow (FCF). Lastly, clarifications provided around regulatory developments with no onerous outcome provide further comfort. Maintain BUY with an unchanged target price of Rs1,285 based on customer lifetime value methodology. We discuss key takeaways from the analyst day below:

- **Ahead of the guided timeline to achieve operating profitability; company to even start generating free cashflow (FCF) in next 12-18 months:** Paytm has been delivering better than our expectations as reflected in its operating performance over the past 2-3 quarters. EBITDA (before ESOP) reduced to -(9%) in Q2FY23 from -(39%) in Q2FY22. This gives visibility around the company turning EBITDA-positive (before ESOP cost) ahead of the guided timeline (Q2FY24). In addition, the management is confident about becoming an FCF-generating company (net of capex) in next 12-18 months driven collectively by improved profitability across payment and financial services distribution, cloud, etc.

- **Payment processing + subscription revenues on devices = Net payment margin:** Through payment processing, Paytm makes a net payment margin of 7-9 bps of GMV. Of this, 3-4bps are earned from UPI transactions and 15-18bps from transactions through other instruments (such as wallet, debit card, credit card, etc). On expectations of faster growth in UPI transactions, management foresees blended margin to stabilise at 5-7bps going ahead. The other margin driver in payment business is subscription revenues earned through device deployment wherein Paytm charges around Rs100 per month per active device. Charges on some high-end devices are higher (up to Rs250 per month). Furthermore, select installations get additional incentives from partner banks, RBI, NABARD, etc. Paytm designs and manufactures the devices through an Indian company in which it has a minority shareholding and which is exclusive to Paytm. This gives Paytm the advantage of being less dependent on other companies and also being more innovative with devices. For example, it is planning to launch a soundbox with card payment acceptance. Paytm takes aggressive depreciation (2 years for soundbox and 3 years for EDC) and expects to generate enough cash in next 12-18 months to fund net capex.

Market Cap	Rs325bn/US$4bn
Bloomberg	PAYTM IN
Shares Outstanding (mn)	649.2
52-week Range (Rs)	1700 / 441
Free Float (%)	100.0
FII (%)	5.3
Daily Volume (US$/'000)	29,760
Absolute Return 3m (%)	(31.6)
Absolute Return 12m (%)	(69.4)
Sensex Return 3m (%)	7.9
Sensex Return 12m (%)	11.1

Year to Mar (Rs mn)	FY21	FY22	FY24E	FY26E
Revenue from operations	28,024	49,742	99,016	1,56,424
Contribution Profit	3,625	14,981	45,546	78,103
- Contribution margin (%)	*12.9%*	*30.1%*	*46.0%*	*49.9%*
EBITDA	-17,673	-23,402	-18,567	4,093
- EBITDA margin (%)	*-63.1%*	*-47.0%*	*-18.8%*	*2.6%*
PAT	-17,010	-23,964	-21,633	-869
Diluted EPS (Rs)	-28.1	-34.4	-31.0	-1.2
GMV (Rs bn)	4,033	8,520	17,564	30,597
Price / Sales (x)	10.8	7.0	3.5	2.2
Price / Book (x)	4.6	2.5	2.7	2.6

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- **Lending business margins to trend upward with scale as per management:** On disbursement of loans, Paytm makes 2.5% to 3.5% of loan value upfront (net of GST). This is highest in merchant loans followed by personal and then Paytm postpaid loans. In addition to sourcing, it also collects loans for its lending partners mainly through mobile and digital capabilities. Hence by design, the collection cost is very less for it. In collection, the company makes 0.5% to 1.5% of current disbursement value. The take rate looks low as it has been calculated on current disbursement value which has grown significantly wherein collection fee is earned post portfolio closure: typically, 12-14 months for personal and merchant loans, and 3 months for postpaid loans. While majority of the collections happen digitally, the company has a collection force of around 170 people to collect money from defaulted customers of personal and merchant loans. For Paytm Postpaid, given low ticket-size, it does not encourage physical collection mechanism.

- **Piloting new products in lending business:** Paytm is mainly experimenting on launching 2 new products in the lending business. One is EMI @ POS as now it has a huge base of customers desiring such type of products mainly for lifestyle financing. This could be rolled out over next 10 to 12 months. Secondly, there is a certain set of good customers who have completed few cycles of personal loans and are demanding high ticket-size / high-tenure loans. For this, the company is experimenting slightly high ticket and high tenure product for selected cohort of customers. Apart from lending business, Paytm will focus on stock brokerage offerings in financial services business. Herein, it will target to cross-sell trading products to existing payment customers.

- **Strong focus on credit risk management as well:** Paytm does not have any kind of FLDG agreement for loans sourced through its platform with its lending partners. Additionally, the company does not select customers and then refer to lenders. White listed customers are selected by lenders bi-annually basis their criteria who are then provided the options of getting the loan from that lender. Based on last exercise of selecting white listed customers conducted during Sep'22, the total number of such customers are around 35mn.

- **No plans to become NBFC:** Firstly, the management sees more benefits from its current business model wherein it earns fees on sourcing and collection of total disbursements. This is different from NBFC model wherein most of the income is earned on outstanding book with interest rate and credit risk. Secondly, it does not desire to become another large NBFC within the financial service space wherein it would have to compete with other big players whereas in current business model it works with the same players as partners which benefits both parties.

- **Commerce and cloud businesses are beneficiaries of Paytm app traffic:** In cloud business, apart from providing cloud-based and advertising / marketing services to merchants, it also earns fee by distributing co-branded credit cards. Credit cards give Paytm upfront distribution revenue and lifetime usage fee based on spends per card. Currently it has ~300k cumulative active cards as of Sep'22 with average retail spend per active card being Rs22-24k per month with both showing healthy growth (in Oct'22, it activated around 48k new cards). Due to multiplicity usage of Paytm, credit card activation is as high as 90% on Paytm platform. In commerce business, Paytm helps merchants sell their tickets, gift vouchers and deals, etc. This business is run with cash profitability as it has ~6% take rate on commerce GMV (this was Rs20.21bn in Q2FY23).

- **Building / expanding the platform and payment processing charges are the key costs:** Within platform, the two key costs are building it, which means hiring more manpower and expanding existing platform which means marketing/sales that are directly driven by revenue opportunity in market. Cost of building platform was Rs2.01bn in Q2FY23 and management expects 10-15% YoY increase in current base, unless it enters new business, which is very unlikely over the near to medium term. Expanding platform cost was Rs3.09bn in Q2FY23 (Rs1.37bn in marketing and Rs1.72bn in sales cost). Marketing cost tends to be volatile as company has provided sponsorship for certain sports events. The company would continue investments in sales and marketing, however, it believes that it will improve profitability despite that.

  As far as payment processing charges are concerned, management believes that it will trend downwards as percentage of GMV mainly because of: 1) higher UPI mix, and 2) routing and rate optimisation. However, from Q3FY23 onwards, postpaid charges will be reported in payment processing charges (earlier reported under Promotional cashback and incentives). While this might increase payment processing charges a bit, however, the impact on contribution margin will be nil.

- **ESOP charges to be at around Rs10bn-14bn run-rate until FY25, post which it will start trending downwards:** Management gave clear expected ESOP charges going ahead based on currently issued ESOPs. It expects the same to around Rs7.5bn / Rs14.1bn / Rs10.bn / Rs4.4bn / Rs1.4bn in H2FY23 / FY24/ FY25/ FY26/ FY27, respectively. Consequently, total number of diluted shares stands at around 695mn. We are building in Rs10-18bn ESOP charges from FY23E till FY26E indicating upside risks.

- **Large TAM in every segment is key growth driver for Paytm:** Despite strong digital adoption, management believes that it is still early days as there are only 250mn registered UPI users and 10mn total devices. Furthermore, Paytm also believes that India could have potential of 100mn merchant entities and more than 500mn payment customers in near term. It plans to keep on helping merchants in expanding their businesses by offering coupons, deals, marketing and loyalty which will in turn create more revenue & profit for its commerce business. Bank Partnerships for selling their products is another area wherein it sees great opportunity. FASTag and Co-branded credit card are already a success, and EMI aggregation on PG, remittance among others could be next. Lastly, in financial services, it will focus on growing loan and stock brokerage offerings.

- **No major negative business impact of regulation is expected:** Recently, Paytm has been engaged with regulators on three fronts. 1) Ban on customer on-boarding on Paytm Payment Bank (PPBL) due to RBI audit: there are no onerous findings as they are related to strengthening operating processes like KYC, etc. and IT sharing activities between Paytm and PPBL, 2) Ban on online merchant on-boarding for 100% subsidiary, Paytm Payment Services Ltd (PPSL). Herein, RBI has asked PPSL to seek necessary approval for past downward investment from the company into PPSL, to comply with FDI guidelines and then resubmit payment aggregator (PA) license within 120 calendar days. This is expected to have no material impact on its business and revenue as it can continue to on-board new offline merchants and offer them payment services. Similarly, PPSL can continue to do business with existing online merchants, and 3) Digital lending guidelines: As far as this regulatory interference is concerned, Paytm did not have to make any changes to its existing processes because of the same.

- **No immediate plans for mergers and acquisitions:** While Paytm currently has high cash reserves of around Rs92bn as of Sep'22, yet, it does not plan to do any mergers and acquisitions. This is mainly due to the fact that the company is currently focused on growing profitably and secondly, it believes in growing organically as it allows to understand the business and leverage technology expertise in a better manner. Apart from that, currently, company does not plan to do any buy back of shares.

- **Key Risks:** 1) Slower than anticipated scale up in financial services revenue, 2) Pressure on take rate in lending business, and 3) slower GMV growth

Table 1: Building / expanding platform and payment processing charges are two key costs

(Rs bn)	Q2FY22	Q1FY23	Q2FY23
Cost of building platform (Employees (excluding sales))	**2.73**	**3.92**	**4.01**
Cost of expanding platform	**1.96**	**3.36**	**3.09**
Marketing	1.02	1.75	1.37
Sales employees	0.94	1.61	1.72

Source: Company reports, I-Sec research

Table 2: ESOP charges expected by management going forward

Total ESOP Cost (Rs bn)	Q1	Q2	Q3	Q4	Total
FY23	-	-	3.8	3.7	**7.5**
FY24	3.6	3.6	3.4	3.4	**14.1**
FY25	3.3	2.7	2.3	1.8	**10.1**
FY26	1.5	1.5	0.7	0.7	**4.4**
FY27	0.7	0.7	0.1	0.1	**1.4**

Source: Company reports, I-Sec research

Note:

1) The above table illustrates expected ESOP cost for all ESOPs granted so far, as of November 2022
2) Above cost assuming all granted ESOPs are vested and no new ESOPs are granted
3) For any lapses of unvested ESOPs, normally on attrition, the cost of unvested ESOP recorded so far is reversed in that quarter
4) Actual charges might be different based on incremental issuances as well as lapses
5) For new ESOP grants, the total estimated charge would be number of options granted times the fair value per share, which is based on the share price on the day of the grant, among other factors. The charge is front-ended with approximately 38% in Year 1, 28% in Year 2, 18% in Year 3, 11% in Year 4 and 5% in Year 5
6) Movements of share price after the date of the grant do not affect the ESOP charge for already granted ESOPs

Table 3: Estimated fully diluted shares

As of Sep'22	mn
Basic share outstanding	648.9
ESOPs vested and unexercised	3.5
ESOPs granted and unvested	33.1
ESOPs available for distribution	10.6
Estimated fully Diluted shares	**695.0**

Source: Company reports, I-Sec research

Financials

Table 4: Income statement

(Rs mn)	FY19	FY20	FY21	FY22	FY23E	FY24E	FY25E	FY26E
P&L								
Payment and financial services	**16,955**	**19,068**	**21,092**	**38,577**	**64,478**	**79,112**	**1,02,441**	**1,24,255**
Payment Service revenue	15,711	17,778	19,808	34,205	48,812	57,669	72,793	84,737
- Payment services to consumers	*10,851*	*10,120*	*9,692*	*15,286*	*23,039*	*25,778*	*31,083*	*34,488*
- Payment services to merchants	*4,860*	*7,658*	*10,116*	*18,919*	*25,773*	*31,891*	*41,710*	*50,249*
Financial Service revenue	1,244	1,290	1,284	4,372	15,666	21,442	29,648	39,518
Commerce and cloud services	**15,365**	**11,188**	**6,932**	**11,048**	**14,966**	**19,905**	**25,951**	**32,169**
-Commerce revenue	*11,915*	*7,109*	*2,452*	*3,736*	*5,501*	*6,820*	*8,318*	*9,733*
-Cloud revenue	*3,450*	*4,079*	*4,480*	*7,312*	*9,465*	*13,085*	*17,633*	*22,435*
Other operating revenue	-	2,552	-	117	170	-	-	-
Revenue from operations	**32,320**	**32,808**	**28,024**	**49,742**	**79,614**	**99,016**	**1,28,392**	**1,56,424**
Payment processing charges	22,574	22,659	19,168	27,538	32,005	39,892	50,103	58,978
Promotional cashbacks and incentives	27,937	9,592	2,357	3,781	6,813	7,370	10,095	11,812
Connectivity and content fees	1,071	1,561	1,819	2,259	3,501	3,922	4,314	4,745
Content, ticketing and FASTag expenses	680	1,221	681	516	722	831	930	1,023
Logistic, deployment and collection cost	38	153	374	667	1,301	1,457	1,602	1,763
Contribution Profit	**-19,980**	**-2,378**	**3,625**	**14,981**	**35,271**	**45,546**	**61,348**	**78,103**
Other Marketing & promotional expenses	6,146	4,379	2,968	4,773	7,381	9,380	12,848	15,033
Employee benefits expense excluding ESOP	7,016	9,532	10,724	16,094	23,314	26,764	31,606	34,786
Software, cloud and data centre expenses	3,096	3,603	3,498	4,999	6,899	7,726	8,499	9,179
Other expense	5,877	4,791	2,983	4,292	4,143	4,618	5,064	5,332
Adjusted EBITDA	**-42,115**	**-24,683**	**-16,548**	**-15,177**	**-6,466**	**-2,942**	**3,331**	**13,773**
ESOP Expense	1,546	1,661	1,125	8,225	17,799	15,625	11,977	9,680
EBITDA	**-43,661**	**-26,344**	**-17,673**	**-23,402**	**-24,265**	**-18,567**	**-8,647**	**4,093**
Depreciation and amortisation expense	1,116	1,745	1,785	2,473	4,451	5,564	6,399	7,039
Finance costs	342	485	348	394	383	391	385	374
Other income	3,477	2,599	3,844	2,901	3,597	3,304	2,833	2,824
PBT	**-41,642**	**-25,975**	**-15,962**	**-23,368**	**-25,502**	**-21,219**	**-12,597**	**-495**
Share of profit / (loss) of associates / joint ventures/Others	93	-560	-740	-459	-436	-414	-394	-374
Exceptional items	-825	-3,047	-281	-24	-	-	-	-
Tax Expense	-65	-158	27	113	-	-	-	-
PAT	**-42,309**	**-29,424**	**-17,010**	**-23,964**	**-25,938**	**-21,633**	**-12,991**	**-869**

Source: Company data, I-Sec research

Table 5: Balance sheet

(Rs mn)	FY19	FY20	FY21	FY22	FY23E	FY24E	FY25E	FY26E
Share Capital	575	604	605	649	655	662	669	675
Reserves &Surplus	56,674	80,448	64,743	1,40,867	1,32,785	1,26,825	1,25,843	1,34,660
Minority Interest	862	-140	-186	-221	-273	-316	-342	-344
Networth	**58,111**	**80,912**	**65,162**	**1,41,295**	**1,33,168**	**1,27,171**	**1,26,169**	**1,34,992**
Non-current liabilities	2,338	5,459	4,799	5,296	5,687	6,106	6,560	7,052
Current liabilities	27,219	16,660	21,552	33,325	44,479	39,883	35,846	40,065
Total equity & liabilities	**87,668**	**1,03,031**	**91,513**	**1,79,916**	**1,83,334**	**1,73,161**	**1,68,576**	**1,82,109**
PP&E incl. right to use of assets and WIP	5,260	5,421	4,483	8,663	9,213	8,880	7,939	5,947
Goodwill	2,930	467	467	443	443	443	443	443
Investment in JV/Associate	2,462	3,230	2,317	2,233	2,283	2,283	2,283	2,283
Investments	1,051	2,276	341	10,062	9,559	10,037	10,539	11,066
Non-current Deposits	30	13,517	2,506	40,688	18,645	32,662	28,107	32,003
Other non-current assets	9,226	13,763	7,401	10,377	12,136	13,529	14,912	16,011
Total Non-current assets	**20,959**	**38,674**	**17,515**	**72,466**	**52,278**	**67,834**	**64,223**	**67,752**
Investments	24,979	31,894	1,472	-	16,780	1,519	1,307	1,489
Cash & cash equivalents	3,255	4,232	5,468	13,790	20,509	11,394	9,805	11,164
Bank balances other than cash and cash equivalents	1,358	1,170	23,296	38,230	37,289	30,383	26,146	29,770
Other current assets	37,117	27,061	43,762	55,430	56,477	62,031	67,096	71,935
Total current assets	**66,709**	**64,357**	**73,998**	**1,07,450**	**1,31,055**	**1,05,327**	**1,04,354**	**1,14,357**
Total Assets	**87,668**	**1,03,031**	**91,513**	**1,79,916**	**1,83,334**	**1,73,161**	**1,68,576**	**1,82,109**

Source: Company data, I-Sec research

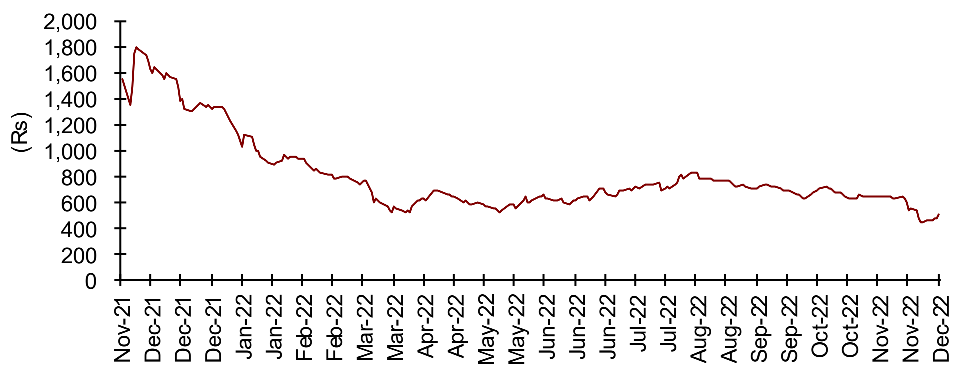
Table 6: Key ratios

Growth ratios	FY19	FY20	FY21	FY22	FY23E	FY24E	FY25E	FY26E
Total revenue from operations		1.5%	-14.6%	77.5%	60.1%	24.4%	29.7%	21.8%
Payment processing charges		0.4%	-15.4%	43.7%	16.2%	24.6%	25.6%	17.7%
Marketing and promotional expenses		-59.0%	-61.9%	60.6%	65.9%	18.0%	37.0%	17.0%
Employee benefits expense		30.7%	5.9%	105.2%	69.1%	3.1%	2.8%	2.0%
Software, cloud and data centre expenses		16.4%	-2.9%	42.9%	38.0%	12.0%	10.0%	8.0%
Other expense		0.8%	-24.2%	32.0%	25.0%	12.0%	10.0%	8.0%
EBITDA		-39.7%	-32.9%	32.4%	3.7%	-23.5%	-53.4%	-147.3%
Adjusted EBITDA		-41.4%	-33.0%	-8.3%	-57.4%	-54.5%	-213.2%	313.5%
EBIT		-37.3%	-30.7%	33.0%	11.0%	-16.0%	-37.7%	-80.4%
PBT		-37.6%	-38.5%	46.4%	9.1%	-16.8%	-40.6%	-96.1%
PAT		-30.5%	-42.2%	40.9%	8.2%	-16.6%	-40.0%	-93.3%
Contribution Profit		-88.1%	-252.4%	313.3%	135.4%	29.1%	34.7%	27.3%
As a % of GMV								
GMV (Rs bn)	2,292	3,032	4,033	8,520	13,619	17,564	23,730	30,597
Payment and financial services	0.74%	0.63%	0.52%	0.45%	0.47%	0.45%	0.43%	0.41%
- Payment services to consumers	*0.47%*	*0.33%*	*0.24%*	*0.18%*	*0.17%*	*0.15%*	*0.13%*	*0.11%*
- Payment services to merchants	*0.21%*	*0.25%*	*0.25%*	*0.22%*	*0.19%*	*0.18%*	*0.18%*	*0.16%*
- Others including financial services revenue	*0.05%*	*0.04%*	*0.03%*	*0.05%*	*0.12%*	*0.12%*	*0.12%*	*0.13%*
Revenue from operations	**1.41%**	**1.08%**	**0.69%**	**0.58%**	**0.58%**	**0.56%**	**0.54%**	**0.51%**
Payment processing charges	*0.98%*	*0.75%*	*0.48%*	*0.32%*	*0.24%*	*0.23%*	*0.21%*	*0.19%*
Marketing and promotional expenses	*1.49%*	*0.46%*	*0.13%*	*0.10%*	*0.10%*	*0.10%*	*0.10%*	*0.09%*
Contribution	*-0.87%*	*-0.08%*	*0.09%*	*0.18%*	*0.26%*	*0.26%*	*0.26%*	*0.26%*
EBITDA	*-1.90%*	*-0.87%*	*-0.44%*	*-0.27%*	*-0.18%*	*-0.11%*	*-0.04%*	*0.01%*
Adjusted EBITDA	*-1.84%*	*-0.81%*	*-0.41%*	*-0.18%*	*-0.05%*	*-0.02%*	*0.01%*	*0.05%*
Margin								
Contribution margin	-61.8%	-7.2%	12.9%	30.1%	44.3%	46.0%	47.8%	49.9%

Growth ratios	FY19	FY20	FY21	FY22	FY23E	FY24E	FY25E	FY26E
EBITDA margin	-135.1%	-80.3%	-63.1%	-47.0%	-30.5%	-18.8%	-6.7%	2.6%
Adjusted EBITDA margin	-130.3%	-75.2%	-59.0%	-30.5%	-8.1%	-3.0%	2.6%	8.8%
PAT margin	-130.9%	-89.7%	-60.7%	-48.2%	-32.6%	-21.8%	-10.1%	-0.6%
RoE	0.0%	-42.3%	-23.3%	-23.2%	-18.9%	-16.6%	-10.3%	-0.7%
Per share ratios								
EPS (Basic)	-73.0	-47.2	-28.1	-36.9	-39.5	-32.6	-19.4	-1.3
EPS (Diluted)	-73.0	-47.2	-28.1	-34.4	-37.2	-31.0	-18.6	-1.2
BVPS	100.0	134.7	108.4	203.6	192.0	183.4	182.0	194.7
EBITDA per share	-76.3	-43.8	-29.3	-33.7	-34.9	-26.7	-12.4	5.9
Op. revenue per share	56.4	54.5	46.5	71.6	114.6	142.5	184.7	225.1
Valuation ratios								
Price / Sales	8.9	9.2	10.8	7.0	4.4	3.5	2.7	2.2
EV / EBITDA	-8.5	-14.9	-22.2	-19.3	-18.7	-24.4	-52.3	111
Price / Book	5.0	3.7	4.6	2.5	2.6	2.7	2.8	2.6
Price / Earnings	-6.9	-10.6	-17.8	-14.6	-13.5	-16.1	-26.9	-401.8

Source: Company data, I-Sec research

Price chart



Source: Bloomberg

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