Sharekhan by BNP PARIBAS

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# AU Small Finance Bank

## All eyes on integration in near term

| Bank | Sharekhan code: AUBANK | | |
|---|---|---|---|
| **Reco/View: Hold** ↔ | CMP: **Rs. 560** | Price Target: **Rs. 700** ↓ | |

↑ Upgrade ↔ Maintain ↓ Downgrade

| 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 | = | ↔ | = |

**Company details**

| | |
|---|---|
| Market cap: | Rs. 37,452 cr |
| 52-week high/low: | Rs. 813 / 548 |
| NSE volume: (No of shares) | 25.8 lakh |
| BSE code: | 540611 |
| NSE code: | AUBANK |
| Free float: (No of shares) | 48.2 cr |

**Shareholding (%)**

| | |
|---|---|
| Promoters | 25.5 |
| FII | 41.1 |
| DII | 20.8 |
| Others | 12.6 |

**Price chart**


**Price performance**

| (%) | 1m | 3m | 6m | 12m |
|---|---|---|---|---|
| Absolute | -6.5 | -23.4 | -23.2 | -5.1 |
| Relative to Sensex | -5.7 | -24.5 | -29.9 | -29.4 |

*Sharekhan Research, Bloomberg*

**Summary**

- We retain a Hold rating on AU SFB with a revised PT of Rs. 700. Near term focus remains on smooth integration with all the verticals of Fincare SFB.
- Most importantly, the management was confident on the asset quality trends across its business verticals and laid down the road map for the merged entity over the next three years.
- Credit cost across business verticals are converging to pre-COVID levels. In the credit cards business, the effect of recalibration in underwriting is visible in early delinquency data for newer origination
- RoA/RoE to improve gradually over the next 3 years for the merged entity. The stock is currently trading at 2.2x/1.9x its FY2025E/FY2026E ABV.

**We attended AU Small Finance Bank's Analyst Day meet, where the bank discussed recent trends and its growth outlook, along with the key levers for RoA/RoE expansion for the merged entity (post merger with Fincare SFB). The near-term outlook looks stable for AU SFB, except for cost of funds. We are not unduly concerned about the high opex growth as we believe accelerated investments continue to uplift the franchise to sustain growth and expand more steams of revenue and activities, with the eventual goal of becoming a universal bank. However, in the current environment, it would be difficult for the bank to maintain differential in terms of growth/ return ratios/ asset quality. Loan growth will be in line with deposit growth (23-25%) with higher share of high yielding business and it does not envisage significant new investments till FY27 and from hereon incremental investments will be more calibrated. Bank remained confident on the asset quality across the portfolio.**

**Levers for RoA expansion:** a) Portfolio mix to shift towards high yielding assets – Faster growth in Wheels, MBL, REG, NBFC, MFI and personal loans, while targeting moderate growth in lower yielding business such as Home loans, Business banking and Agri banking; b.) Higher fee income - AD-I licence, credit cards, wealth and insurance segments would drive incremental fee income; c) Lower Opex growth - savings via investment calibration & operating efficiency. The bank endeavour to achieve RoA of ~1.8% by FY27E.

**Ensuring smooth Integration:** All key asset businesses would continue to function within the Fincare unit. Deposits business would be integrated with AU's Branch Banking group, with AU's products being offered in Fincare branches. Credit, Audit, Risk management and compliance would be centralised. No change in reporting or location of ~13,000 of the ~15,000 Fincare employees; rest to be integrated within AU Branch Banking and central functions teams. Cyclicity of MFI business will be managed via - keeping the MFI business at 10% of AUM over the next 3 years and total credit cost of 2.5% - 3% p.a. on the MFI business would be considered. IT integration to be completed in 9-12 months.

**Asset quality:** AU SFB remained confident on the asset quality across portfolio. Credit cost across business verticals are converging to pre covid levels. In credit cards business also, impact of recalibration in underwriting is visible in early delinquency metrics for newer origination. The bank has shown strong execution track record over several years, driven by steady growth and asset quality in its core segments and endeavors to sustain it.

**Our Call**

**Valuation –** The stock trades at 2.2x/1.9x its FY2025E/FY2026E ABV estimates. Overall business growth and profitability has been lower for the bank in the past one year, which has led to significant derating in the stock. We believe it would be difficult for the bank to maintain differential in terms of growth/ return ratios/ asset quality as it used to maintain earlier in this current environment. Despite a sharp correction, the stock is still expensive for less than 2% RoA / 15% RoE trajectory and for the growth trajectory of 20-25%.

**Key Risks**

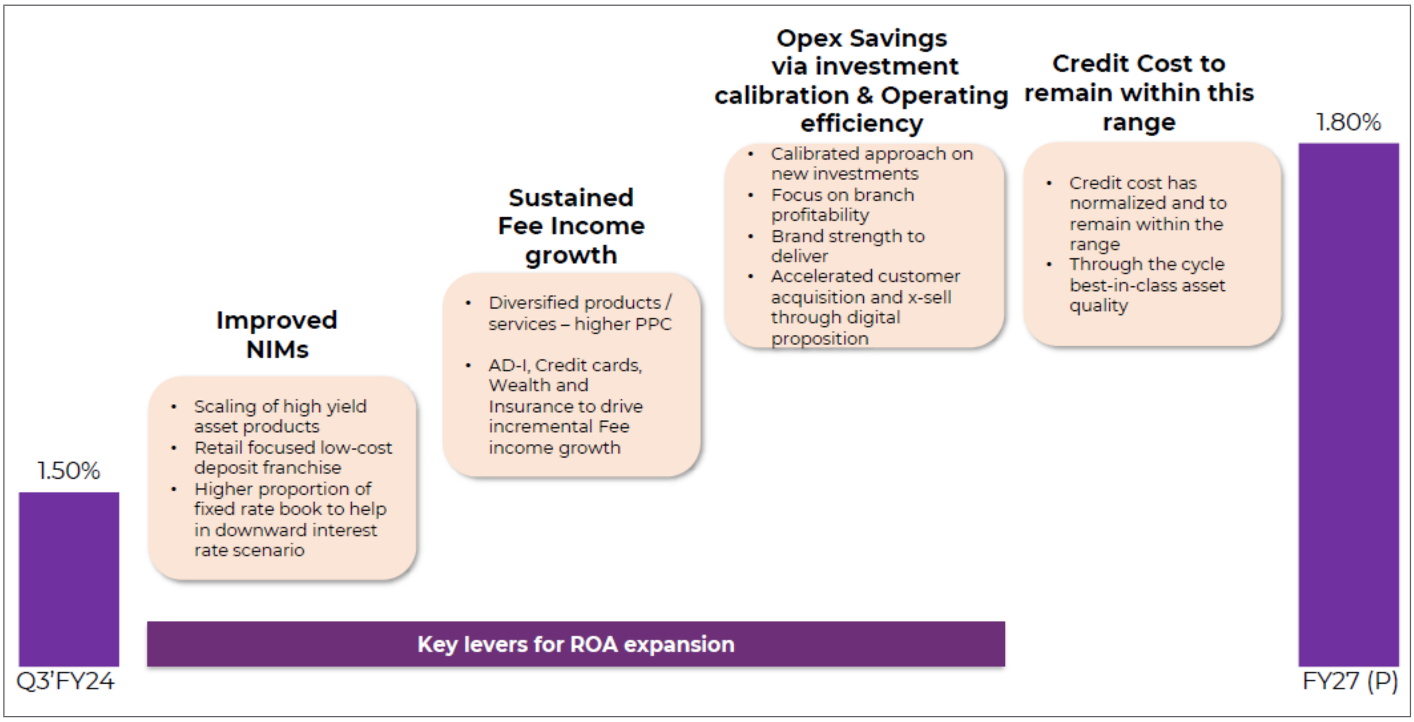
Economic slowdown, lower than expected NIMs, execution risk and higher-than-anticipated credit cost.

**Valuation (Standalone)** Rs cr

| Particulars | FY22 | FY23E | FY24E | FY25E | FY26E |
|---|---|---|---|---|---|
| Net Interest Income | 3,234 | 4,425 | 5,120 | 6,684 | 9,367 |
| Net profit | 1,130 | 1,428 | 1,593 | 1,990 | 2,760 |
| EPS (Rs.) | 17.9 | 21.9 | 23.8 | 26.8 | 37.2 |
| P/E (x) | 31.8 | 26.1 | 23.9 | 21.2 | 15.3 |
| P/BV (x) | 4.9 | 3.5 | 3.1 | 2.2 | 2.0 |
| RoE | 16.4% | 15.4% | 13.5% | 12.4% | 13.1% |
| RoA | 1.9% | 1.8% | 1.6% | 1.6% | 1.7% |

Source: Company; Sharekhan estimates

**Key levers for RoA expansion**




*Source: Compnay*

**Guidance on key metrics**

By 2027

**Deposit growth CAGR** will be ~23-25% with focus on individual and retail deposits

**Asset book growth** will be in line with deposit growth with higher growth from businesses with higher RoA

**Asset quality** to remain within range; PCR incl. tech write-off would be around 65% - 70%

**Unsecured book will be 15-20%** with MFI book capped at 10% of AUM (including securitisation)

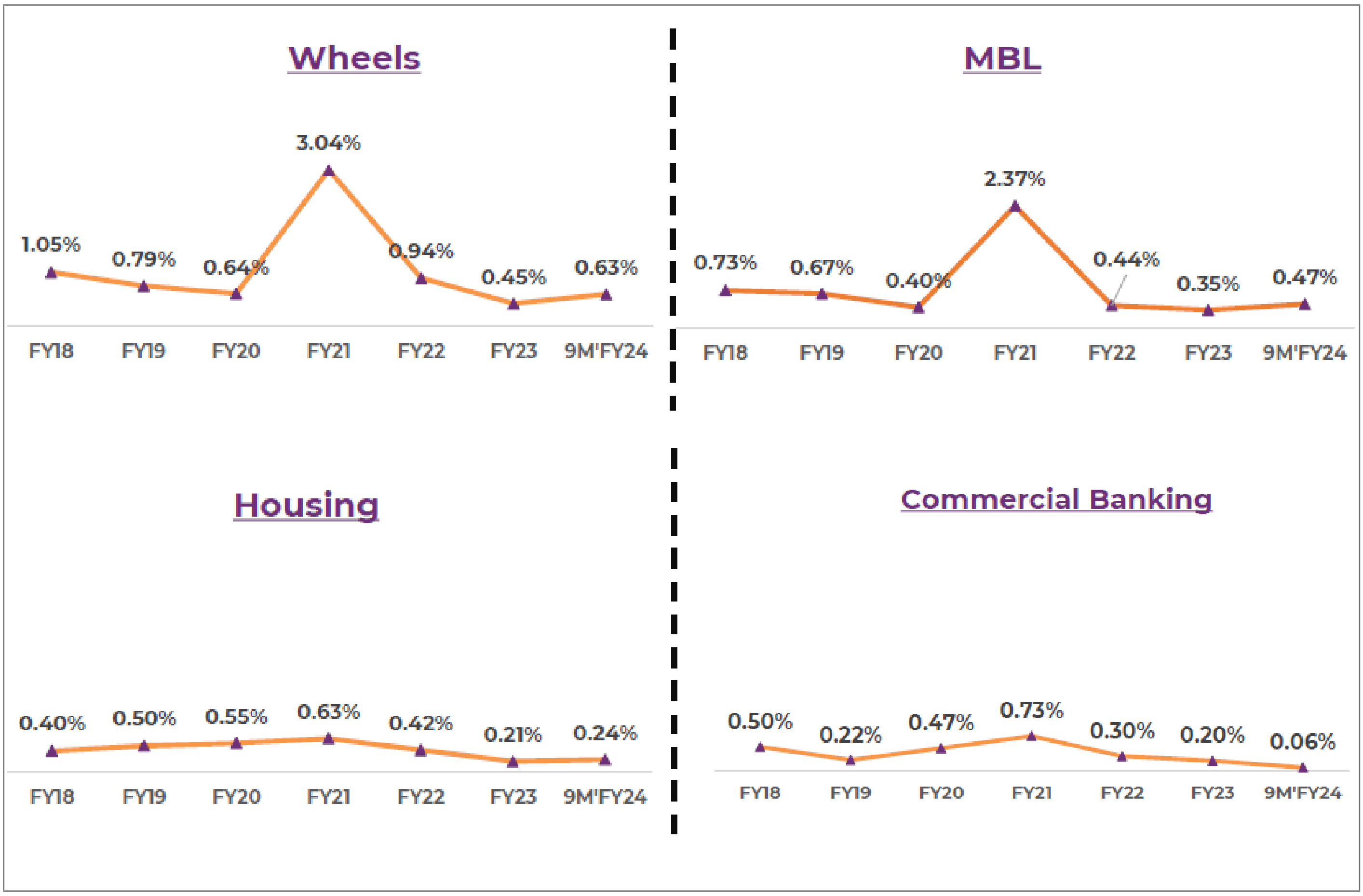
**Annual credit cost on** MFI book to be taken @ 2.5-3% every year

**Increasing mix of high yield, high RoA portfolio assets** to ~75:25

Endeavour to achieve **RoA of 1.8%**

*Source: Compnay*

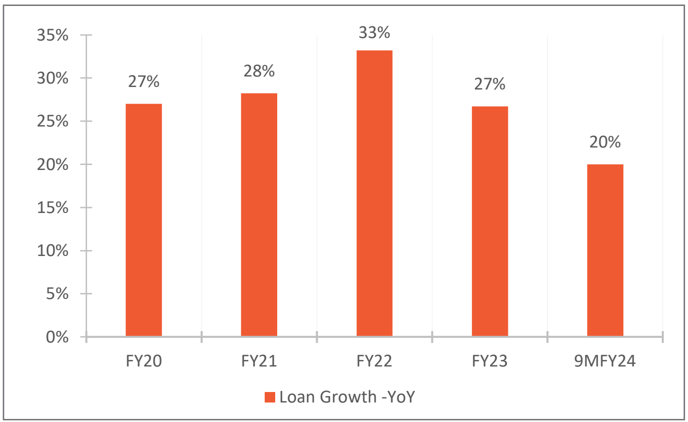
**Credit Costs have started to normalize across existing business verticals post covid**




*Source: Company*

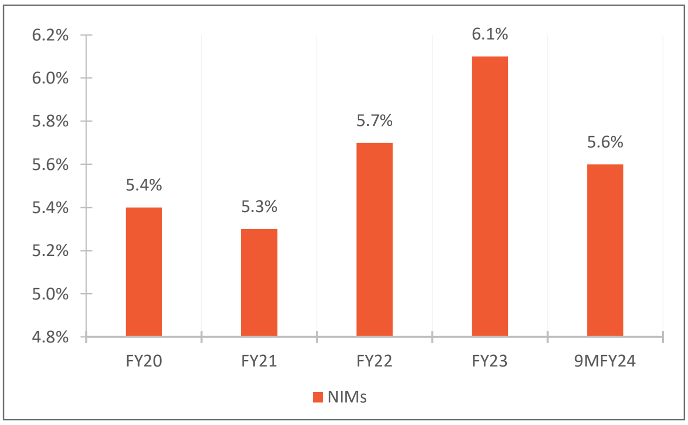
## Financials in charts

### Trend in Loan Growth



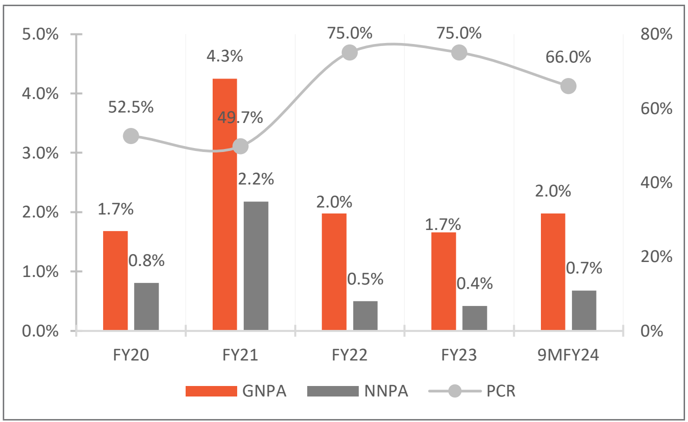

*Source: Company, Sharekhan Research*

### Trend in NIMs



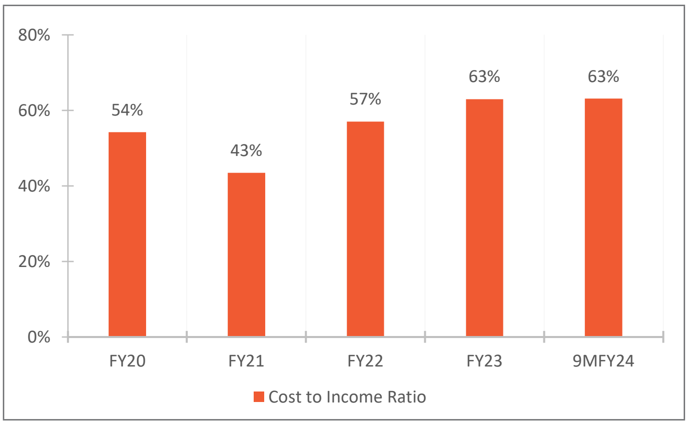

*Source: Company, Sharekhan Research*

### Trend in Asset Quality



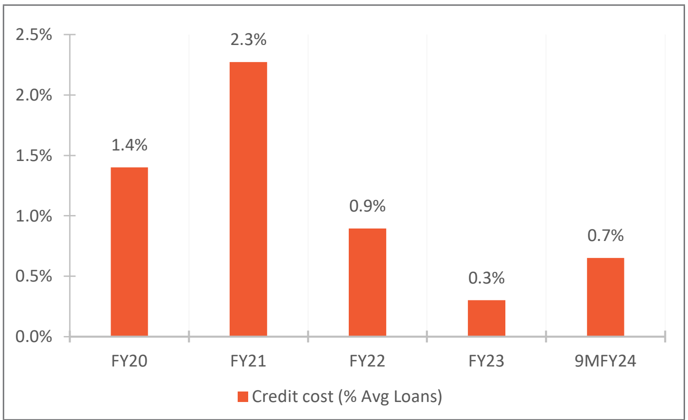

*Source: Company, Sharekhan Research*

### Trend in Cost to Income Ratio



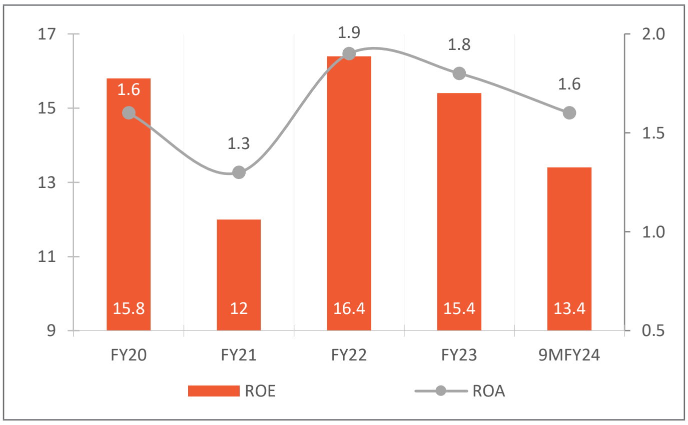

*Source: Company, Sharekhan Research*

### Trend in Credit cost




*Source: Company, Sharekhan Research*

### Trend in Return Ratio




*Source: Company, Sharekhan Research*

## Outlook and Valuation

### ■ Sector View – Outlook stable for SFBs

While financial inclusion has reached a substantial level in India, we believe credit delivery and accessibility continue to lag for both the informal and rural sectors. Therefore, there exists a large market that can be effectively catered to by special entities such as small finance banks (SFBs). We believe SFBs have a structural advantage of access to low-cost deposits as compared to NBFCs, which gives them a competitive advantage to manage spreads and have healthy operating profit growth, with lower inherent liquidity and credit risk relative to NBFCs, translating into sustainable earnings momentum.

### ■ Company Outlook – Valuations expensive vs peers

AUSFB has had a long and successful history (since its days as an NBFC and now as a bank) in secured credit and its underwriting quality, mainly in the under/unbanked self-employed customer segment that lacks formal income documentation. The bank has a strong skill set and deep experience in its core secured segments. The merger with Fincare SFB further reduces the share of core secured segment for the bank. We believe it will be a challenge for the franchise to sustain superior metrics across the economic cycle. Valuations are still expensive vs peers who have better return ratios and similar growth.

### ■ Valuation – Maintain hold with PT of Rs. 700

The stock trades at 2.2x/1.9x its FY2025E/FY2026E ABV estimates. Overall business growth and profitability has been lower for the bank in the past one year, which has led to significant derating in the stock. We believe it would be difficult for the bank to maintain differential in terms of growth/ return ratios/ asset quality as it used to maintain earlier in this current environment. Despite a sharp correction, the stock is still expensive for less than 2% RoA / 15% RoE trajectory and for the growth trajectory of 20-25%.Peer Valuation

**Peer Comparison**

| Companies | CMP (Rs/ Share) | MCAP (Rs Cr) | P/E (x) | | P/B (x) | | RoE (%) | | RoA (%) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | FY25E | FY26E | FY25E | FY26E | FY25E | FY26E | FY25E | FY26E |
| AU Small Finance Bank | 560 | 37,452 | 21.2 | 15.3 | 2.2 | 1.9 | 12.4 | 13.1 | 1.6 | 1.7 |
| City Union Bank | 128 | 9,455 | 9.3 | 8.2 | 1.1 | 0.9 | 11.3 | 11.5 | 1.4 | 1.4 |

Source: Company; Sharekhan Research

## About company

AUSFB has navigated the first six years of its banking operations relatively well despite macro headwinds such as demonetisation, GST implementation, NBFC crisis and COVID-19 pandemic. During this period, the bank has delivered a consistent performance with deposits growing at a CAGR of 54%, advances growing at a CAGR of 35%, and balance sheet growing at a CAGR of 37% over FY2018-FY2023.

## Investment theme

AUSFB has expanded and strengthened its business model to offer a diverse suite of banking products and services by leveraging its asset-based lending strengths. The liability franchise is also shaping up well with shoring up of retail deposits. However, the merger with Fincare SFB would bring volatility in earnings during periods of economic downturn due to the inherent nature of the portfolio acquired.

## Key Risks

Economic slowdown, lower than expected NIMs, execution risk and higher-than-anticipated credit cost.

## Additional Data

**Key management personnel**

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

*Source: Company Website*

**Top 10 shareholders**

| Sr. No. | Holder Name | Holding (%) |
|---|---|---|
| 1 | Sanjay Agarwal | 17.52 |
| 2 | Capital Group Cos Inc. | 9.54 |
| 3 | WESTBRIDGE AIF I | 4.80 |
| 4 | Kotak Mahindra Asset Management Co. Ltd. | 4.52 |
| 5 | CAMAS INV. PTE. LTD. | 4.03 |
| 6 | Jyoti Agarwal | 3.53 |
| 7 | Shakuntala Agarwal | 2.79 |
| 8 | Nomura India Investment Fund | 2.25 |
| 9 | Uttam Tibrewal | 2.06 |
| 10 | Vanguard Group Inc | 1.92 |

*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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