Small Finance Big Opportunities!

We expand coverage on small finance banks and initiate on **Equitas Small Finance Bank** (EQSFB) and **Ujjivan Small Finance Bank** (UJSFB) with a positive view. Both the banks are well positioned to gain from the SFB transition process, with most of the transitional risks now abated. The transition has paved the way for both the banks to diversify their portfolio thus providing ample growth opportunities and improve their liability mix. We expect the banks to have first movers advantage given the early commencement of business, as both EQSFB and UJSFB have a more diversified product suite as compared to most other SFBs. In terms of deposit traction, we expect both these banks will largely benefit from the strong brand image in the home market to build a sticky customer base.

We believe that the elevated operating costs and pressure on profitability on account of the transition process are now a thing of the past and these banks will now look at achieving operating efficiency and focus on sustainable growth. Robust capitalization in case of both banks will not only fuel strong growth but will also be adequate to absorb any COVID-19 related asset quality shocks.

The compliance with the RBI guidelines regarding dilution of promoter stake to 40% at the end of 5 years of commencement of SFB operations was a major ovehang for both the banks. Currently, the promoter (holdco) holds 82.1% and 83.3% in EQSFB and UJSFB respectively. However, the recent RBI Internal Working Group (IWG) draft report recommends the harmonisation of SFB guidelines issued in 2014 and 2019 on-tap SFB licensing guidelines. The 2019 guidelines state that promoter shareholding for first 5 years should be “at a minimum 40%” of paid-up voting equity share capital vs “brought down to 40%” under 2014 guidelines. **IF this recommendation is accepted without any modification, the 2019 on-tap SFB licensing guidelines would apply to both the banks. We believe this would be positive for both EQSFB and UJSFB as it would imply that the promoter holding should be at a minimum of 40%, which it currently is. Thus the major overhang of reducing the stake to 40%, would be done away with.**

EQUITAS SMALL FINANCE BANK

We initiate coverage on **EQSFB** with a BUY rating given the visibility in improvement in ROA/ROE to upwards of 2%/16% respectively in the long term with operating leverage kicking in. A strong non-microfinance led AUM growth, ramp-up in low-cost deposits on the back of a revamped liability strategy and an experienced and competent management and leadership team are key positives. The bank has in the past (as a NBFC) managed to navigate through unprecedented tough situations like the AP microfinance crisis and demonetization without any major hiccups and has emerged stronger. Despite catering to the low and middle-income individuals with limited or no access to formal banking and operating in segments characterized by higher NPAs (used vehicles form 17% of portfolio), the bank has maintained its asset quality at sub-3% levels, only marginally higher than peers. The cautious lending approach of the management, the cash-flow based profiling and strong credit underwriting and risk management framework give us the confidence that EQSFB would be successful in maintaining its asset quality in the long term. This is evident from the sharp improvement in the collection efficiency from 11% in April’20 to 87% in Oct’20 (94% incl. arrears), as the bank focused only on collections rather than chasing growth in H1FY21. While COVID-19 related disruption would dampen the bank’s near term performance, we believe that the long term prospects for the bank remain attractive.

UJJIVAN SMALL FINANCE BANK

We initiate coverage on **UJSFB** with a BUY rating as we remain positive on the long term prospects of the bank. With the fast paced diversification from a microfinancier to a small finance bank and the recent ramp up in the liability franchise after a slow start, we believe UJSFB is well placed to gain from the transition into a SFB. We expect the management’s focus on technology-driven product expansion and customer sourcing strategy will play out well, helping the bank keep a check on its operating expenses thus improving profitability.The management’s persistent focus on asset quality despite being a microfinancier, a sector prone to higher defaults in case of occurrence of any unprecedented events is visible from the sub-1% NPAs that the bank has witnessed even as a NBFC (except during demonetization). UJSFB has so far fared well in handling the COVID-19 crisis, as is visible from the significant improvement in collections from 5% in April’20 to 88% (93% incl arrears) in Oct’20 which are broadly in-line with peers, despite operating in the urban and metro areas which faced multiple headwinds.

Key Financials (Standalone)

Company	Rating	CMP (Rs.)	Target (Rs.)	Upside (%)	Adj. Book Value(Rs.)			P/ABV (x)		
					FY21E	FY22E	FY23E	FY21E	FY22E	FY23E
Equitas SFB	BUY	34	41	19%	26.2	29.8	34.6	1.3	1.2	1.0
Ujjivan SFB	BUY	38	47	24%	18.7	21.1	24.6	2.0	1.8	1.5

Source: Axis Securities

Evolution of Small Finance Banks

Despite various measures by the Government of India (GoI) to increase financial penetration in India, a significant percentage of India's population does not have access to basic financial services. In order to promote financial inclusion, the Indian banking industry has seen undergone several changes in recent years. Hence, to further its objective the government awarded 10 players licenses to commence small finance banking operations in September'15. The objective of SFBs is to extend banking services to the under-served and un-served population through savings instruments, and providing credit to small business units, small and marginal farmers, micro and small industries, and others in the unorganised sector.

Stage I: Inception to September 2015 – Prior to issuance of SFB licences

Equitas was setup in Dec 2007, with the sole aim of providing MF to households that did not have access to formal sources of funding especially in the unserved areas. Post the AP crisis in 2011, Equitas consciously decided to de-risk the business and diversify the portfolio into Vehicle Finance which was natural extension of the expertise of the management in their previous stints and also into small business loans.

UJSFB commenced operations as a NBFC in 2005 with the mission of providing a full range of financial services to the economically poor who are not adequately served by financial institutions. It mainly funded the joint liability group lending model by providing collateral free, small ticket-size loans to economically active women.

EQSFB and UJSFB were amongst the 10 awardees of a banking license and commenced SFB operations in Sept'16 and Feb'17 respectively.

Stage II: September 2015 – March 2020 - Transition Phase

Transition from a NBFC into a bank provided opportunities for both the lenders to not only diversify their portfolio but also diversify the liability mix. EQSFB further diversified the portfolio to New Vehicles, MSE, NBFC lending. UJSFB forayed into Affordable Housing Loans and SME financing.

The SFB license also gave them the opportunity to garner deposits, with focus on low-cost CASA and retail deposits which helped the banks replace high cost borrowings with low cost deposits.

However, the transition also posed challenges for EQSFB and UJSFB and involved heavy investments in technology, setting up of / conversion of existing branches to liability branches and hiring additional personnel for the SFB operations. This resulted in elevated cost to income ratios impacting profitability. EQSFB witnessed its C-I ratio skyrocket to ~80% in FY18 vs 53% in FY16. UJSFB saw a similar escalation to ~77% in FY18 vs 54% in FY16.

During this heavy investment phase, the banks had to tackle another challenge in the form of demonetization, where they were faced with stress on the asset quality front, given the high default of microfinance which continued to form a sizeable portion of the portfolio. Elevated credit costs coupled with higher opex put further strain on the profitability of these banks.

Stage III: March 2020 onwards – Normalisation of Business Phase

With over 3 years of stable SFB operations, we believe that both EQSFB and UJSFB are now well positioned to benefit from the transition. Opex cycle having peaked out, we believe that the operating leverage will kick-in and will be reflected in the return ratios of the bank over the medium term. EQSFB and UJSFB also have a strategy in place for their liability franchise and going ahead we are likely to witness an uptick in deposits after an initial setback, mainly driven by a robust growth in CASA and retail deposits.

Near term headwinds would be visible on the back of COVID-19 related disruptions, we expect the business to normalise FY22E onwards. Diversification of the loan book, ramp up in deposits, opex moderation and a competent management are key positives. However, the compliance with regulatory requirements of reducing the promoter stake to 40% at the end of 5 years from commencement of operations, would remain a major overhang, in case the recent RBI IWG recommendations are not accepted and implemented.

RBI Regulations

Parameters	Small Finance Banks	Universal Banks
Promoter stake and dilution timeline	If the initial shareholding by the promoter in the bank is >40%, it should be broughtdown to 40% within five years, 30% within10 years, and 26% within 12 years	Shareholding of NOFHC to be brought downto 20% of the paid-up voting equity capital within 10 years and to 26% maximum in 15 years
Listing Requirements	Within 6 years from date of reaching networth equivalent of Rs. 5 bn or 10 years from date of commencement of business *(revision proposed in the RBI IWG report up from after the SFB reaches a net worth of Rs. 5bn, listing will be mandatory within 3 years)*	Within 6 years of commencement of business by the bank
Capital Adequacy Norms	15% (Tier I at 7.5%)	13% for first 3 years of commencement of operations (Tier I at 7%)
Minimum Networth	Rs. 3bn initial paid-up voting equity capital *(revision proposed in the RBI IWG report up from Rs. 2bn)*	Rs. 10bn initial paid-up voting equity capital *(revision proposed in the RBI IWG report up from Rs. 5bn)*
PSL Requirements	75% of ANBC	40% of ANBC
CRR/SLR Requirements	CRR – 3.0% of NDTL SLR – 18.5% of NDTL	CRR – 3.0% of NDTL SLR – 18% of NDTL

Source: Axis Securities

Ready for the next leg of growth!

We initiate coverage on Equitas Small Finance Bank (EQSFB) with a BUY recommendation and a price target of Rs. 41 (~19% upside from CMP). We believe that the bank is well positioned and ready from its transition to a small finance bank (SFB).The SFB transition allowed EQSFB to further diversify its portfolio and access deposits, but resulted in higher opex, thus impacting profitability. The well diversified portfolio provides visibility for long-term scalable and sustainable growth as cost levers stabilise. The bank is now on the right track to build a robust retail-led deposit franchise, post the transitional impact. The past asset quality stress attributable largely to its portfolio mix including used vehicles (17%) and informal customer segment, should come down as macros normalise. Though near term headwinds exist on the back of COVID-19, we believe that the bank would be successful in weathering through these tough times on the back of 1) Its well diversified portfolio, 2) Multiple levers to stabilize NIMs and 3) ROA expansion with operating leverage kicking in. While in H1FY21 EQSFB posted a muted performance due to lower disbursements and elevated COVID-19 related provisions, we remain fairly confident on the bank's ability to bounce back given the near normalization of businesses of its borrowers and improving collections to near normal levels. EQSFB's efforts were visible in H1FY21, as overall collection efficiency improved sharply from 11% in April'20 to 87% in Oct'20 (94% incl. arrears). **We value EQSFB at 1.2x P/ABV on FY23E ABV on the following premises:**

Diversification towards secured book

EQSFB has been ahead of the curve in diversifying away from the group-lending MFI segment after the AP crisis and demonetization, as it made a conscious move towards secured products. We believe the Small Business Loans, MSE Finance and Vehicle Finance to be the major growth drivers for the going ahead. We expect the bank to register a growth of 25% CAGR FY20-23E largely driven by non-microfinance loans growing at 28% CAGR.

Multiple levers to stabilize NIMs

NIMs would witness contraction as the bank does away with the high yielding microfinance book and moves towards the marginally lower yielding Vehicle Financing, MSE and SBL Finance portfolio. However, the steady build up of the liability franchise would result in a drop in CoF, thus supporting NIMs. Strong traction in low cost CASA and retail TDs witnessed in Q2FY21 is encouraging and we expect this momentum to continue. We expect NIMs to range between 8-9% over the medium term.

Opex and credit cost moderation to drive ROA expansion

With a large part of investments made towards setting up of liability branches, technology and hiring personnel during the SFB journey and no near-term branch capex plans on the cards, we expect to witness a downtrend in the opex. The bank also carries COVID-19 provisions of ~1% to Gross AUM and is comfortably placed. Despite a large part of the stress now behind and businesses inching towards pre-COVID levels, we remain conservative and factor in marginally elevated provisions in FY21E with the chances of resurgence of COVID-19 looming. Opex and credit-cost moderation is expected to drive ROA expansion in the medium term.

Asset Quality to improve

As businesses look to normalize, certain sectors such as HCVs and MSE continues to reel under the pressure of disruption due to COVID-19. However, the management's guidance of restructured book being capped at sub 1.5% provides relief. Despite EQSFB largely being out of the woods, with collections at near normal levels, we expect asset quality to face near term pressure on the back of higher slippages.

Non-Microfinance book led growth; Initiate with BUY

We value EQSFB at 1.2x FY23E P/ABV, given the visibility on the improvement in ROA/ROE to upwards of 2%/16% respectively in the long term driven by a strong non-microfinance led AUM growth, ramp-up of low-cost deposits and an experienced and competent management. **We initiate coverage with a 'BUY' rating and a target price of Rs. 41.**

Key Financials (Standalone)

(Rs. Cr)	FY20A	FY21E	FY22E	FY23E
NII	1,495	1,837	2,149	2,596
PPP	598	829	1,003	1,273
PAT	244	332	434	596
NNPA (%)	1.7%	2.3%	1.8%	1.6%
EPS (Rs)	2.3	2.9	3.8	5.2
ABV/Share (Rs)	23.9	26.2	29.8	34.6
P/E (x)	14.9	11.8	9.0	6.6
P/ABV (x)	1.5	1.3	1.2	1.0
RoE (%)	9.7%	10.9%	12.2%	14.6%
RoA (%)	1.4%	1.5%	1.6%	1.8%

Source: Company, Axis Research

(CMP as of Dec 02, 2020)

CMP (Rs)	34
Upside /Downside (%)	19%
High/Low (Rs)	39/30
Market cap (Cr)	3,910
Avg. daily vol. (6m) Shrs.	46,56,289
No. of shares (Cr)	113.8

Shareholding (%)

	Mar-20	Jun-20	Sep-20
Promoter	95.5	95.5	95.5
Institutions	0.0	0.0	0.0
Public	4.5	4.5	4.5

Financial & Valuations

Y/E Mar (Rs. Cr)	FY21E	FY22E	FY23E
NII	1,837	2,149	2,596
PPP	829	1,003	1,273
Provisions	387	422	477
PAT	331	434	596
EPS (Rs)	2.9	3.8	5.2
EPS Growth (%)	*26%*	*31%*	*37%*
ABV/Share (Rs)	26.1	29.8	34.6
P/ABV (x)	1.3	1.2	1.0

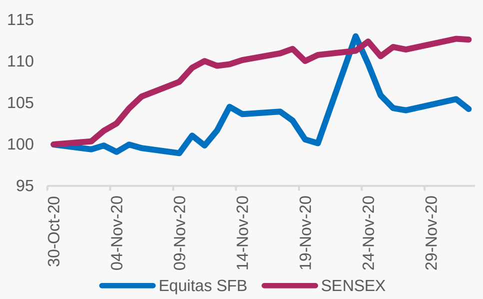
Key Drivers (%)

Y/E Dec	FY21E	FY22E	FY23E
NIM	9.0	8.5	8.2
C-I	60.1	59.0	57.1
Credit Costs	2.5	2.2	2.0

Axis vs Consensus

EPS Estimates	FY21E	FY22E	FY23E
Axis	2.9	3.8	5.2
Consensus	-	-	-
Mean Consensus TP (12M)			**44**

Relative performance



Source: Capitaline, Axis Securities

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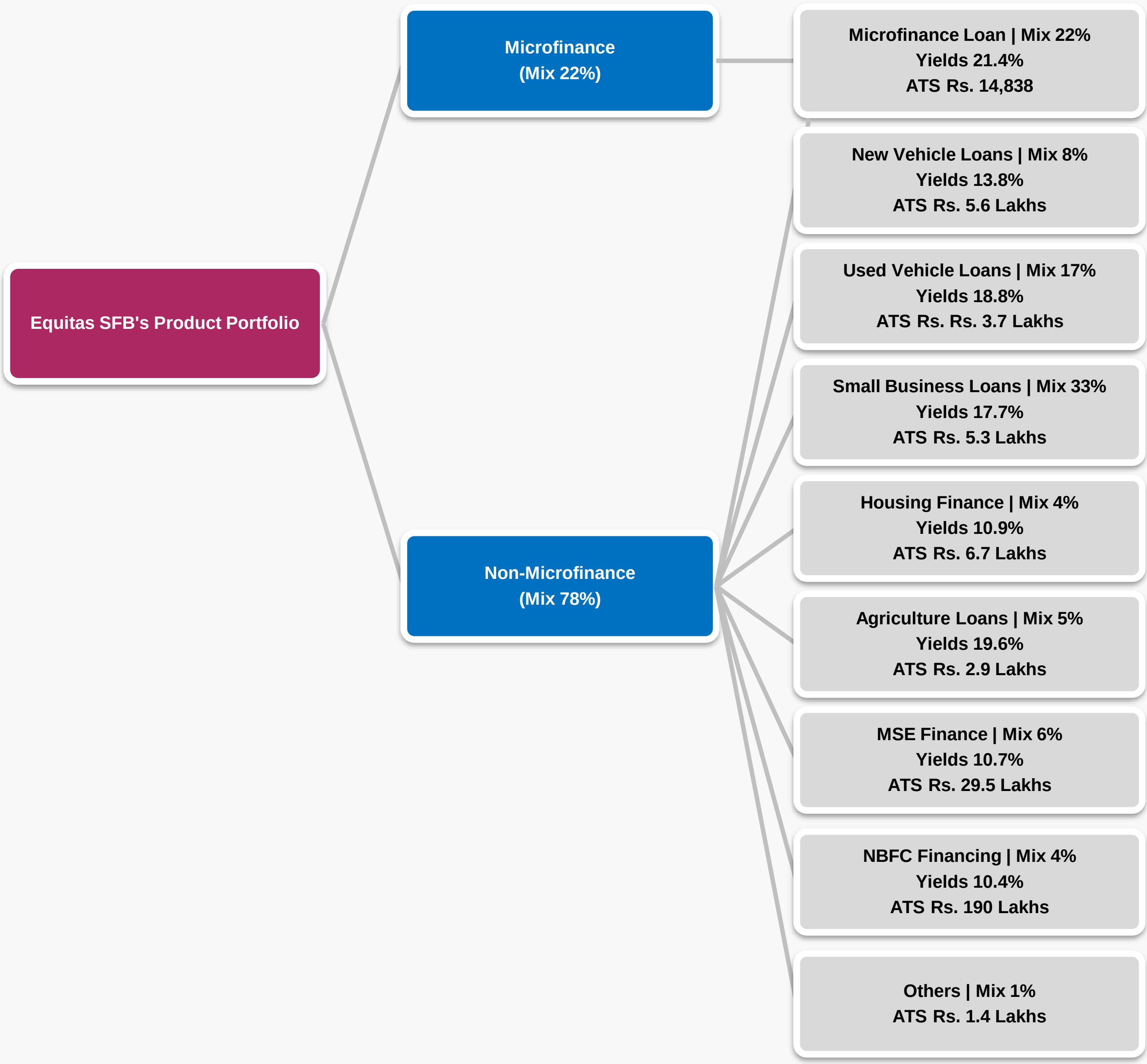
Company Background

Equitas SFB (EQSFB) is a diversified leading SFB which transitioned from a NBFC (Equitas Holdings Ltd.) in Feb'17 offering a diversified suite of products, primarily catering to the low and middle-income individuals and businesses that have limited or no access to formal banking and finance channels.

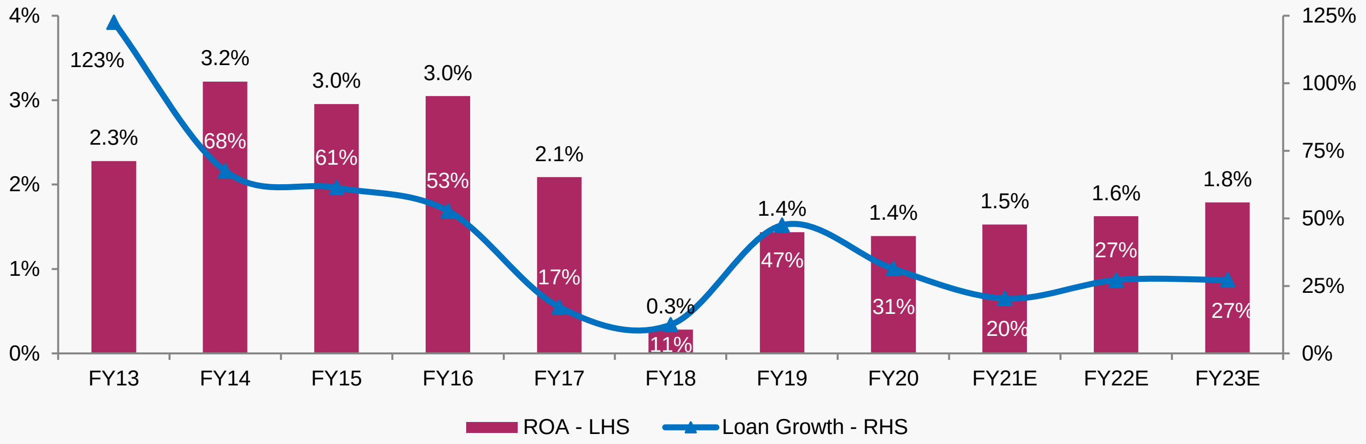
As at the end of H1FY21, EQSFB has a Gross AUM of Rs. 16,731 Cr, spread across Microfinance and secured products such as Used and New Vehicle Finance, MSE Finance, Small Business Loans and NBFC Lending. The liability franchise is shaping up well with deposits presently forming ~68% of the total borrowings. Deposits are dominated by retail deposits forming ~60% of the mixandlow-cost CASA deposits form 25.8% of the deposit base. As at the end of H1FY21, the bank operates through 856 branches. Tamil Nadu, Maharashtra and Karnataka together contribute to 78% of the AUMs and 56% of Deposits.

Exhibit 1: Well - Diversified Product Portfolio (H1FY21)



Source: Company, Axis Securities

Exhibit 2: Equitas SFB's AUM growth over the decade



Source: Company, Axis Securities

Exhibit 3: AUM Mix (H1FY21)

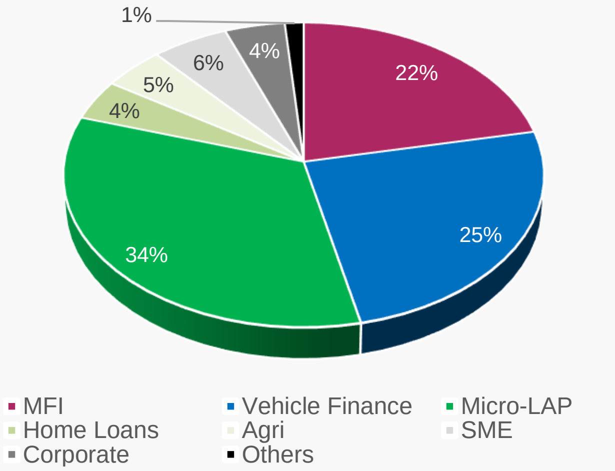
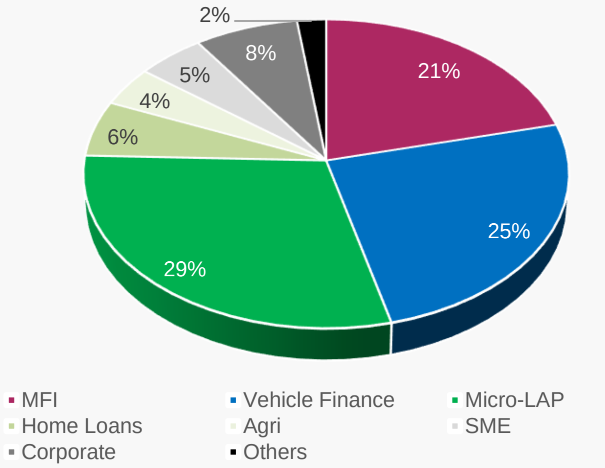


Exhibit 4: Disbursement Mix (H1FY21)



Source: Company, Axis Securities

Exhibit 5: Borrowing Mix (H1FY21)

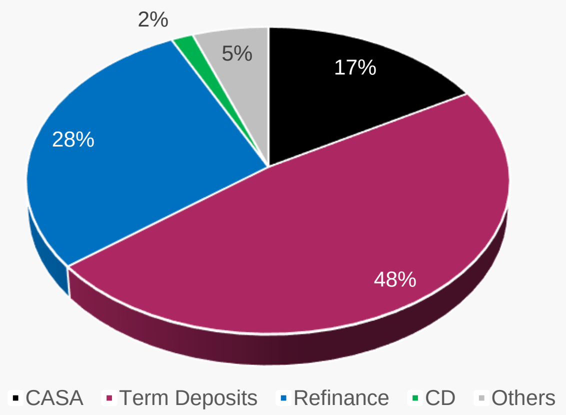
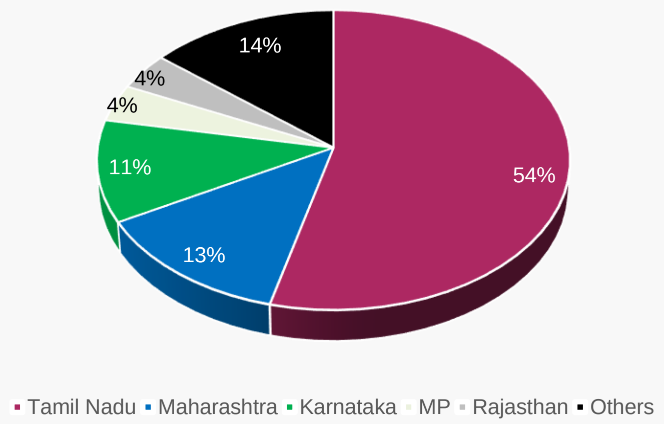


Exhibit 6: Geography-wise AUM Mix (H1FY21)



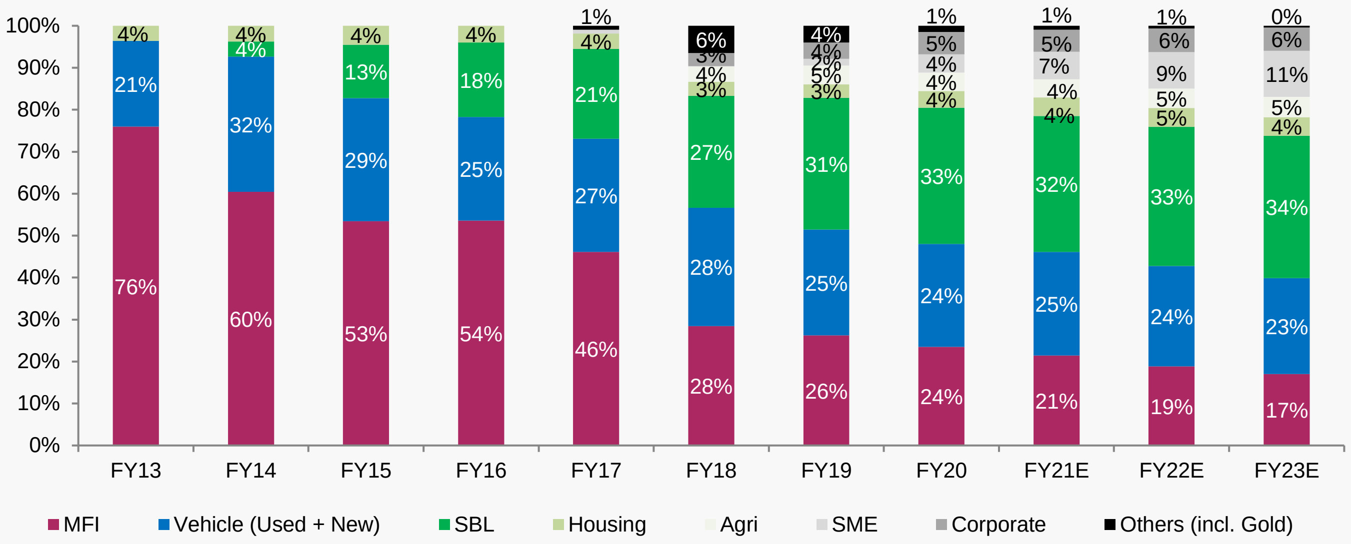
Source: Company, Axis Securities

Well diversified portfolio tilting towards secured lending

Diversifying its product portfolio away from the unsecured microfinance has been the key factor in EQSFB's strong evolution and robust growth as is visible over FY17-20, where the bank registered an AUM growth of 33% CAGR since it transitioned from a NBFC. This was led by a strong growth in the non-microfinance book, mainly the Small buisness loans (48% CAGR) and MSE Financing (almost doubled over FY17-20). **We believe the diversified book provides EQSFB the nimbleness to recover faster from the COVID-19 related disruption.**

The asset mix is spread across microfinance, Used and New Vehicles, Small Business Loans, Home Loans, MSELoans, Agriculture Loans and NBFC lending. This helps the bank to offer a need-based comprehensive suite of products to customers. With the management's focus on de-risking the portfolio, the bank has made significant progress in moving away from the unsecured microfinance book and we expect the share of microfinance loans in the total mix to decline further over the long term.

Exhibit 7: AUM Mix Trend



Source: Company, Axis Securities

Microfinance Loans

Microfinance Loans | H1FY21 Mix 22% | FY20-23E Loan CAGR: 13%

- EQSFB commenced operations as a pure-play microfinancier. Taking cue from the disruption caused due to the AP microfinance crisis, EQSFB decided to de-risk the business and gradually moved away from microfinance. The pace of deceleration in the portfolio further accelerated post demonetization.
- The bank has been conservative in its lending approach to the high yielding portfolio given the high risk it possesses. This is evident from the lower average ticket size of ~Rs. 14500 (vs industry ticket size of ~Rs. 35000). This cautious approach has helped the bank contain the GNPAs in this book in the range of 1-1.2% (except during demonetization), despite shifting to daily NPA recognition.
- Currently, the portfolio yields ~21% and the average tenor of the loans is 2 years. We believe given the banks focus to move towards a secured lending portfolio, over the medium to long term, the mix of microfinance in the total portfolio would range between 15-18%.

Exhibit 8: Declining Share of Microfinance Portfolio

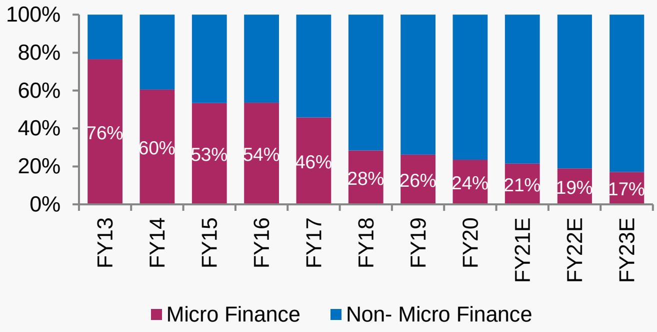
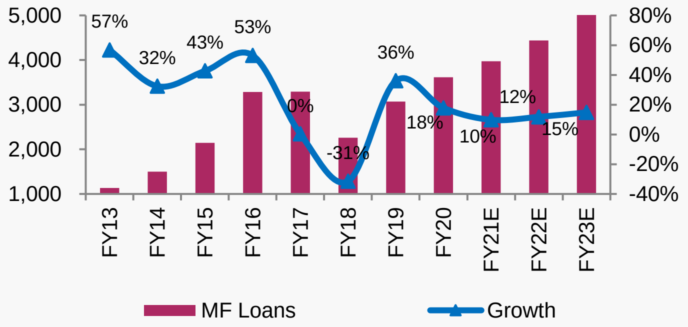


Exhibit 9: Microfinance AUM and Growth



Source: Company, Axis Securities

Non-Microfinance Loans

Small Business Loans | H1FY21 Mix 33% | FY20-23E Loan CAGR 27%

- EQSFB ventured into Small business loans (SBL) in a bid to de-risk the portfolio and this lending can be viewed as an extension of credit to the microfinance borrowers who were in need of higher ticket size loans. These loans are fully secured against the commercial or self-occupied property of the borrower. Avg. LTV on the product is 35-40%.
- In order to be eligible for SBL, the microfinance customer should have successfully completed a minimum of 2 repayment cycles (4 years) without a single default. Initially, most of the customers served were from the microfinance customer base of the bank. Currently, 30-35% of the SBL customer base consists existing microfinance customers, whereas the rest are new to bank.
- SBL are a higher opex, higher TAT loans. Currently the portfolio yields range between 20-22% depending on the ticket sizes and the ATS is ~Rs. 5.32 Lakhs.
- The bank faces minimal competition from peers in SBL from both banks and NBFCs, given the high opex and TAT involved. Other NBFCs such as SCUF which operate in a similar segment cater to the higher ticket size customers (Rs. 25+ Lakhs) and hence are not a direct competition to EQSFB. This provides the bank a strong pricing power.
- We believe that given the low competition in this segment and a huge addressable market provides EQSFB the opportunity to witness robust growth. We expect SBL to be one of the key growth drivers for the bank and expect this portfolio to register a growth of 27% CAGR over FY20-23E.

Exhibit 10: Share of SBL to remain constant

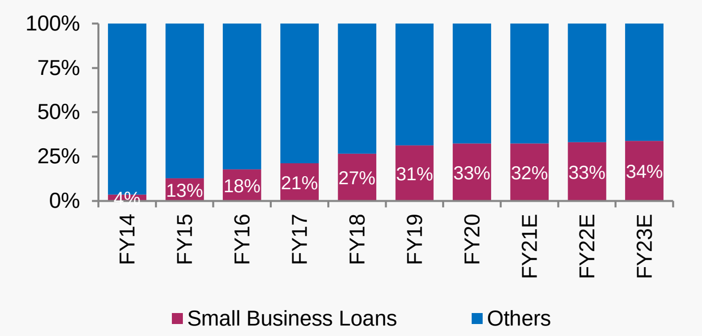
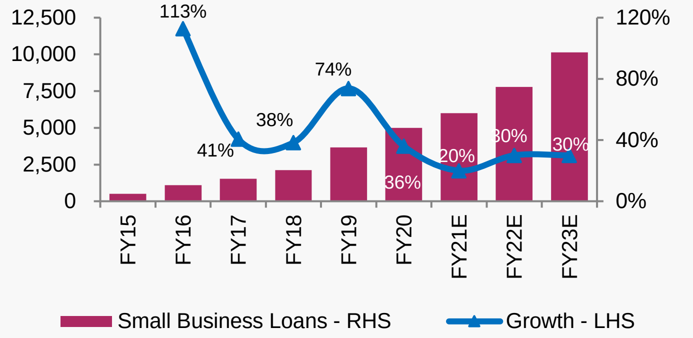


Exhibit 11: SBL Portfolio and Growth



Source: Company, Axis Securities

Other Small Business Loans | H1FY21 Mix 9%| FY20-23E Loan CAGR: 29%

Home Loans

- EQSFB's home financing product offerings are targeted towards self-employed individuals who have limited access to loans from banks and larger housing finance companies. Loans are provided for purchase of plots or house, construction of house, improvement/ restoration/ extension of home.
- The initial strategy of building up of the housing book was not successful. The management has now revamped its product offerings, set up a team and focusing on key geographies which would enable the book to grow.Currently, the portfolio yields range between 11-13% with an average ticket size of Rs. 6.65 Lakhs.

Agri Loans

- Agri loans are generally extended to customers where ~50% of the family income is derived from agriculture or agri related activities and the rest from blue collared jobs. The bank undertakes this lending product in order to meet its PSL requirements.

Exhibit 12: Share of Home + Agri Loans

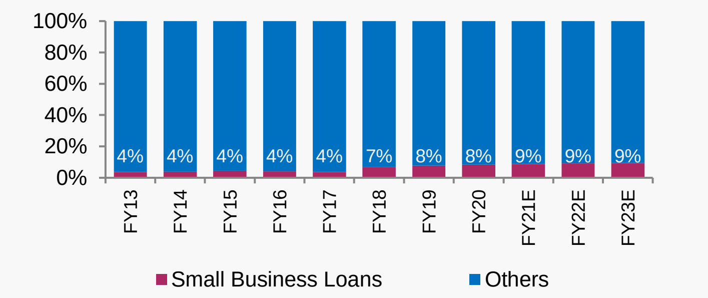
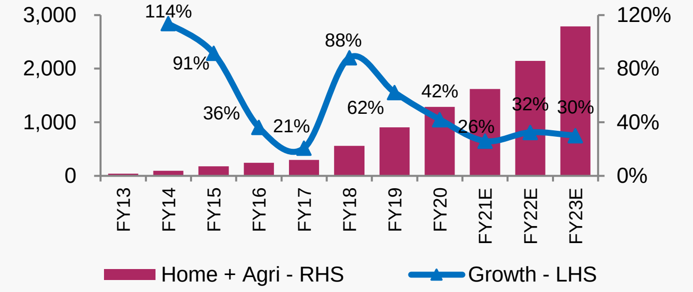


Exhibit 13: Other SBL Book Growth



Source: Company, Axis Securities

AXIS SECURITIES

Vehicle Financing – Used and New | H1FY21 Mix 24%| FY20-23E Loan CAGR: 23%

- The bank's foray into vehicle financing mainly used CVs, can be viewed as the bank (erstwhile NBFC Equitas Holdings) leveraging the vast experience of the management. The bank started with used CV financing and later entered the new CV financing space. The bank has recently introduced used car financing.
- EQSFB primarily began with used CVs financing (69% of the vehicle portfolio at the end of H1FY21) a segment which witnesses higher rundown. The pre-closure on used vehicles is relatively higher as the customers parts way with the old vehicle within a couple of years of taking finance and looks upgrade to a newer model. The company is also present in new CVs (31% of vehicle finance) where the rundown is relatively lower.
- The customer base generally comprises of first-time formal financial channel borrowers purchasing used commercial vehicles, with significant experience in local logistics.

Exhibit 12: Share of Vehicle Finance Book

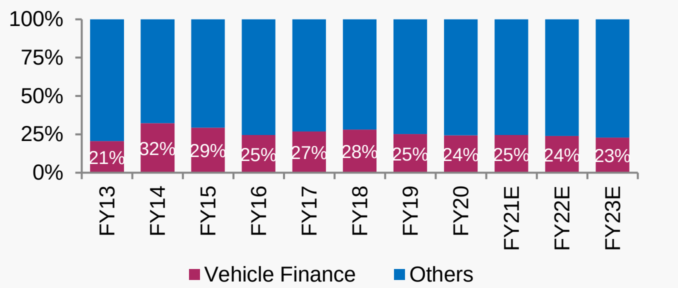
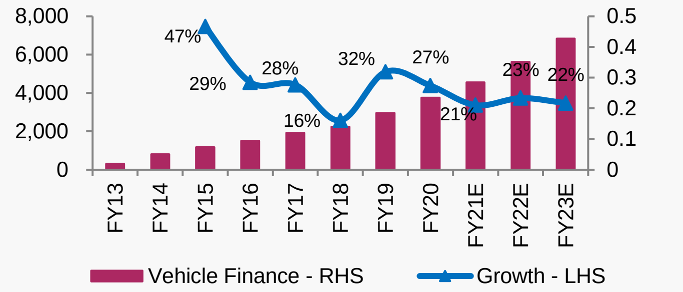


Exhibit 13: Vehicle Finance AUM and Growth



Source: Company, Axis Securities

MSE Financing | H1FY21 Mix 6% | FY20-23E CAGR: 70%

- EQSFB started MSE lending with bulk of the portfolio being unsecured loans. However, it later drifted away towards secured lending and currently undertakes asset backed financing primarily focused on self-employed individuals operating MSEs (micro and small enterprises) with ticket size of Rs. 30-40 Lakhs. The unsecured book currently would be ~Rs. 200 Cr and would run down eventually.
- MSME financing customers are either new to credit or come from unbanked/under-banked areas. Excessive paper-work and lukewarm response from banks to extend credit to MSMEs has resulted in borrowers turning towards SFBs and other financial institutions. EQSFB has capitalised on this opportunity and sourced most of its MSE customers from PSU or the old private sector banks.
- We believe the huge unmet demand in this segment; high funding gap and lower penetration levels of organised players offers EQSFB an opportunity to grow the book.

Exhibit 14: MSE Financing to be the growth driver

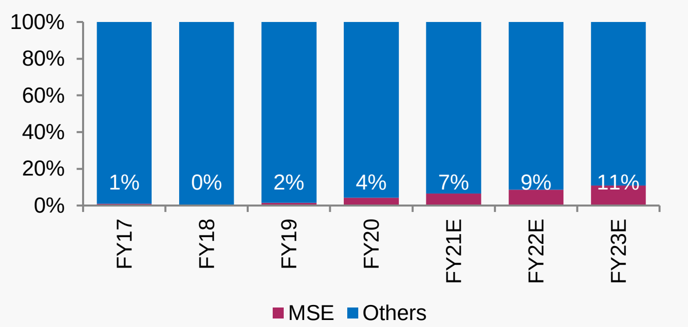
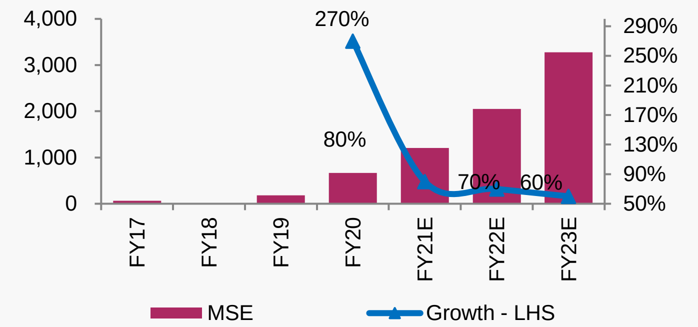


Exhibit 15: MSE Loan book & Growth



Source: Company, Axis Securities

NBFC Financing | H1FY21 Mix 4%| FY20-23E CAGR: 27%

- Under NBFC financing, EQSFB lends to NBFCs in the microfinance, housing finance and asset backed finance space. The bank lends only to rated NBFCs with 70% of the NBFCs are AA rated, 5% are AAA rated and 25% are BB rated from a recognized ratings agency. Currently, the ATS is Rs. 25-50 Cr and the portfolio yields ~10.5-13%.
- The NBFCs that EQSFB lends to have a highly reputed PE investor and are characterized by a good corporate governance practices, no liquidity issues, robust capitalization (~35-40%), good track record and an experienced promoter.
- The bank has capped the mix of NBFC Financing at 10%. We expect the portfolio to witness strong growth however, we believe that the share of NBFC loans will remain stable at 5-6% of the total portfolio over the medium term.

Exhibit 14: NBFC Financing mix

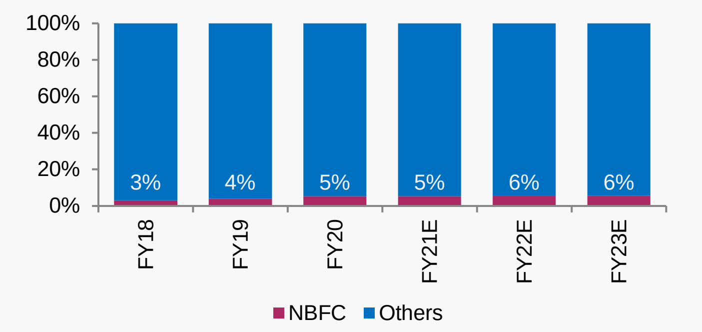
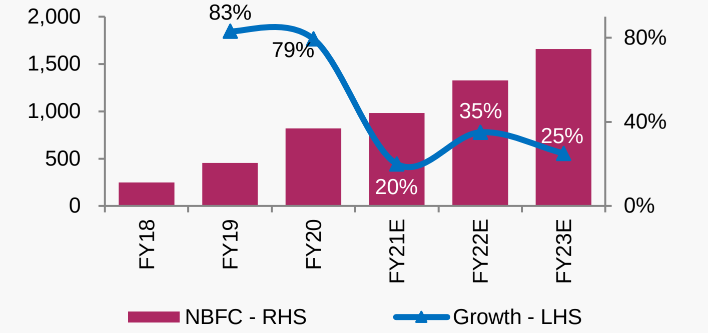


Exhibit 15: NBFC Financing book & Growth



Source: Company, Axis Securities

Disbursements to inch towards pre-COVID levels in H2FY21, AUM Growth to marginally moderate YoY

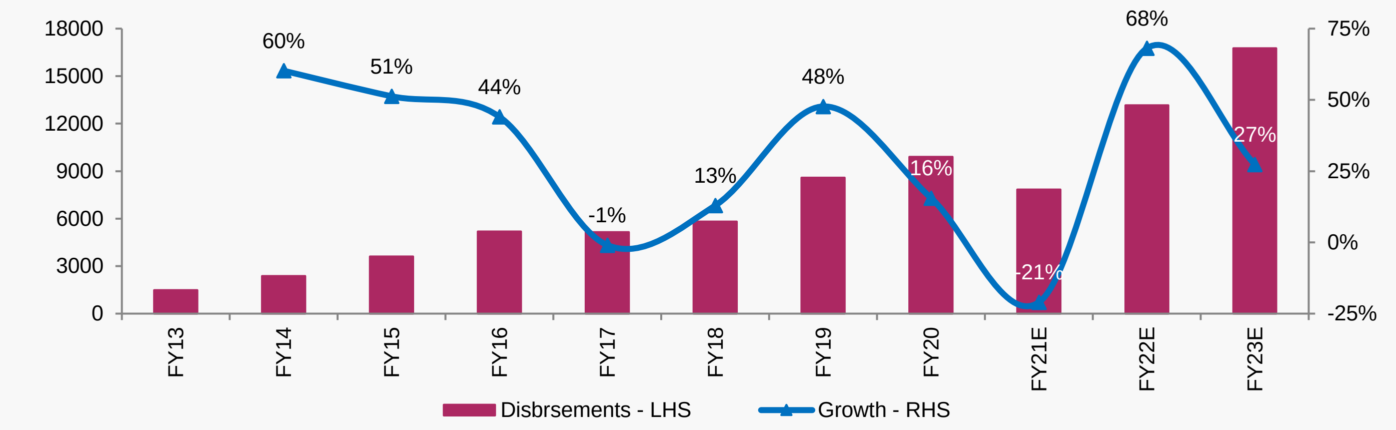
Post the disruption caused due to the pandemic, Q1FY21 was a washout quarter for the bank. However, the disbursements inched-up on a sequential basis and demand in key lending products gradually returned near pre-COVID levels. At the end of Q2FY21, disbursements were at 80% of Q2FY20 levels and the management expects the disbursements to normalise by Q3FY21.

The bank has seen a significant improvement in the business activities of its borrowers, with business activities of microfinance and small business loan customers already reaching near pre-COVID levels, as a majority of the customer were engaged in the manufacturing or selling of essential and daily-use items. The MSE customers business activities are yet to catch up and are broadly seen at 80-85% of the pre-COVID levels. The stagnant order book, stretched out credit cycles, lack of labour etc. are hampering the smooth functioning of the MSE businesses. However, we believe that these customers too would revert back to normalcy in the next couple of quarters.

In the vehicle finance book, given the customer profile wherein a majority of the borrowers are entrepreneurs have been engaged in transportation of essentials and daily-use items. Hence, they remained least affected even during the lockdown. However, the HCV customers continue to remain impacted on the back of muted economic activities, industry-wide slowdown and would take the longest to recover.

We believe, as economic activities and demand for credit pick-up pace, the bank would witness a robust disbursements growth. On back of a muted H1FY21, we have factored in a de-growth of 21% in disbursements over FY20. As demand picks-up, we expect Small Business Loans, MSE lending and Vehicle finance to be the key segment to contribute to a healthy growth for EQSFB. ***We expect the disbursements to grow at 20% CAGR over FY20-23E and AUMs and core Loan book to clock a growth of 26% CAGR over the same period, mainly driven by a strong growth in the non-microfinance segments (29% CAGR over FY20-23E).***

Exhibit 16: Disbursement Trend



Source: Company, Axis Securities

Exhibit 17: Segmental Break-up of the Diversified Loan Book

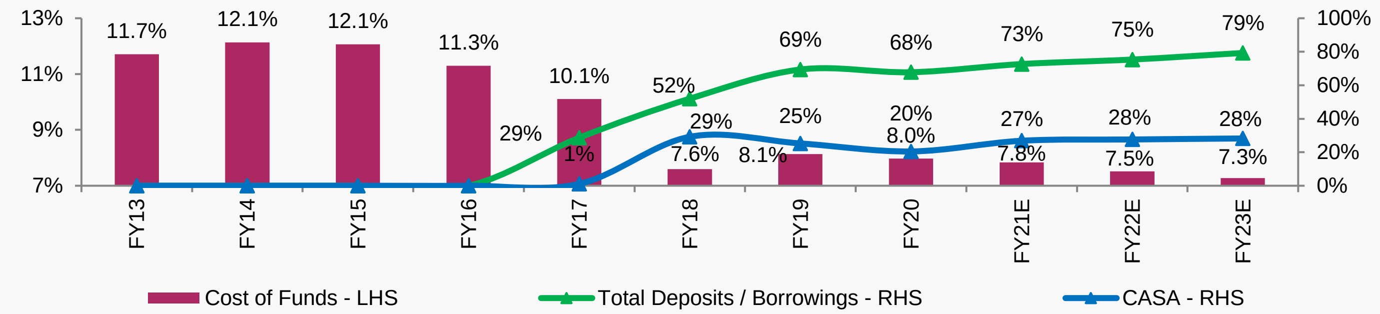
	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21E	FY22E	FY23E
			As NBFC					As SFB			
Microfinance	1,135	1,503	2,144	3,283	3,293	2,257	3,070	3,616	3,971	4,440	5,097
Mix	76%	60%	53%	54%	46%	28%	26%	24%	21%	19%	17%
Vehicle Finance	305	801	1,175	1,510	1,928	2,238	2,951	3,760	4,551	5,614	6,835
Mix	21%	32%	29%	25%	27%	28%	25%	24%	25%	24%	23%
Small Business (M-LAP)		88	511	1,087	1,528	2,113	3,673	4,995	5,994	7,792	10,130
Mix		4%	13%	18%	21%	27%	31%	33%	32%	33%	34%
MSE					63	8	181	669	1,205	2,048	3,277
Mix					1%	0%	2%	4%	7%	9%	11%
Housing	44	94	180	245	265	270	377	604	816	1,060	1,325
Mix	3%	4%	4%	4%	4%	3%	3%	4%	4%	5%	4%
Agri					31	287	528	680	803	1,084	1,463
Mix					0%	4%	5%	4%	4%	5%	5%
Corporate						249	456	818	982	1,325	1,657
Mix						3%	4%	5%	5%	6%	6%
Others					68	514	468	224	168	143	121
Mix					1%	6%	4%	1%	1%	1%	0%
Gross AUM	**1,484**	**2,486**	**4,010**	**6,125**	**7,176**	**7,936**	**11,703**	**15,367**	**18,489**	**23,506**	**29,905**
Growth		***68%***	***61%***	***53%***	***17%***	***11%***	***47%***	***31%***	***20%***	***27%***	***27%***
Non - Micro Finance	**349**	**983**	**1,866**	**2,842**	**3,883**	**5,679**	**8,633**	**11,751**	**14,518**	**19,067**	**24,808**
Growth		*182%*	*90%*	*52%*	*37%*	*46%*	*52%*	*36%*	*24%*	*31%*	*30%*
Mix	24%	40%	47%	46%	54%	72%	74%	76%	79%	81%	83%

Source: Company, Axis Securities

Liability franchise shaping up well after a slowdown

Transition from a NBFC into a bank strengthened the business model by allowing EQSFB access to deposits especially low-cost CASA, enabling the bank to control its CoF. Like most of its peers, EQSFB too built its initial deposit base by garnering bulk deposits and gradually moved towards building a retail deposits base. Currently, retail deposits form ~60% of the total deposits base. As a NBFC the borrowing mix was dominated by high cost borrowings in the form of NCDs and Term loans from banks and other Financial Institutions.

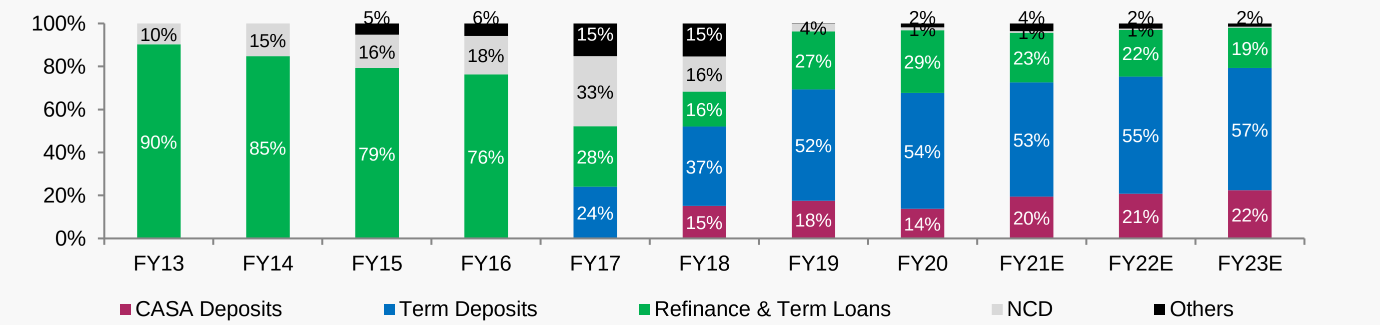
Exhibit 18: Strong Deposit traction will ensure lower CoF



Source: Company, Axis Securities

Post the initial success in building a strong deposit base, the bank witnessed a slowdown in the deposit garnering traction, on the back of a flawed strategy. The levy of charges and fees on deposits and multiple product offerings instead of a comprehensive suite of products were laggards in further strengthening the deposit base. The bank witnessed its CASA ratio drop from 35% in FY18 to 20.5% at the end of Q1FY21. As a corrective measure, there was a rejig in the strategy, wherein the bank waived off all the charges and fees on deposits taking a Rs. 15 Cr one-time hit and re-organised its deposits offerings with laying focus on the “mass” (Rs. 15 Lakh Salary bucket) and “mass-affluent” (Rs. 25 Lakh salary bucket) customer segment. The bank also delineated between the different liability products such as current accounts, savings accounts, salary accounts etc with a strategy chalked out for each of the products, post which there has been an uptick in deposit growth.

Exhibit 19: Borrowing Mix to be dominated by Deposits



Source: Company, Axis Securities

EQSFB’s asset products MSE lending and NBFC Financing help the bank cross-sell its liability products by sourcing salary accounts and TDs for these customers. The bank has recently introduced a ‘Recurring Deposit’ for its MFI customers, wherein the deposit amount is collected from the customers at the same time as their monthly collections.

Exhibit 20: State-wise Deposit penetration (FY20)

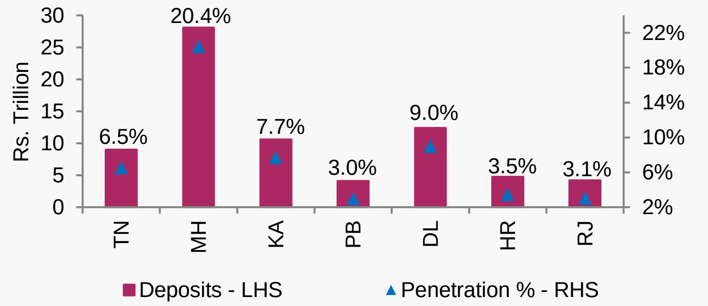
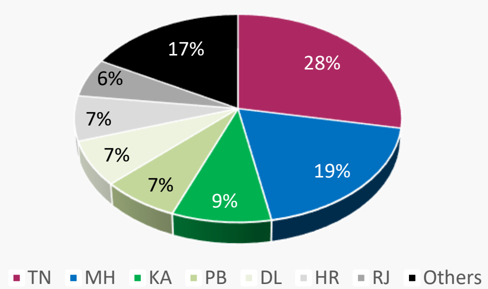


Exhibit 21: Geography-wise Deposit break-up (H1FY21)



Source: Company, Axis Securities

The strong presence in the home state of Tamil Nadu, a good brand image and attractive interest rates offered has helped EQSFB build a healthy deposit base, despite Tamil Nadu being a relatively less penetrated state in terms of deposits. Going ahead, as the high cost grand-fathered debt matures and refinancing happens at a lower rate, we would witness slight moderation in CoF.

With high competitive intensity amongst banks, the differentiation factor for EQSFB is the higher interest rate that it offers and better customer service. Comparatively higher interest rates help the bank is customer retention and help ensure that EQSFB builds a sticky customer base. Post the turmoil in the liquid and debt funds in the recent past, EQSFB has been seeing a pick-up in the number of customers turning towards the high interest paying deposits that the bank offers, given that these are comparatively safe and steady interest yielding. In Q2FY21, deposits registered a growth of 28.7% YoY with CASA ratio improving to 25.8% vs 20.5% in Q1FY21 and 23.3% in Q2FY20. The management expects the traction in the liability products to continue going into H2FY21 and beyond.

Exhibit 23: Retail TD Rates – year-wise vs peers

Retail TD Rate – Tenure wise	Small Finance Banks				Small Private Banks				PSBs
	AU SFB	Bandhan	Ujjivan SFB	Equitas SFB	CUB	Federal	DCB	KVB	SBI
1 Year Retail TDs	5.5%	5.8%	5.2%	6.6%	5.5%	4.5%	6.5%	5.0%	4.4%
2 Year Retail TDs	6.5%	6.0%	6.5%	7.1%	5.8%	5.3%	6.9%	5.5%	4.9%
3 Year Retail TDs	6.8%	6.0%	6.1%	7.2%	5.8%	5.4%	7.0%	5.5%	5.1%

Source: Company, Axis Securities***Note**: *Rates are latest interest rates and effective dates vary for each bank. Dates range between June-Oct'20*

Exhibit 24: SA Rates – slab-wise vs peers

SA Rates - Slab-wise	Small Finance Banks				Small Private Banks				PSBs
	AU SFB	Bandhan	Ujjivan SFB	Equitas SFB	CUB	Federal	DCB	KVB	SBI
< Rs. 1 Lakh	4.0%	4.0%	4.0%	3.5%	3.5%	Repo – 1.5%	3.3%	3.0%	2.7%
Rs. 1 Lakh - 5 Lakh	5.0%	6.0%	5.0%	7.0%	3.8%	Repo – 1.5%	4.0%	3.5%	2.7%
Rs. 5 Lakh - 10 Lakh	6.0%	6.0%	5.3%	7.0%	3.8%	Repo – 1.5%	5.0%	3.5%	2.7%
Rs. 10 Lakh - 5 Cr	7.0%	6.0%	6.3%	7.0%	4.0%	Repo – 1.5%	5.3%	3.5%	2.7%
Rs. 5 Cr - 10 Cr	6.5%	6.0%	6.5%	7.3%	4.0%	Repo – 0.2%	5.5%	3.5%	2.7%
> Rs. 10 Cr	N. A	6.6%	6.5%	7.3%	4.0%	Repo – 0.2%	5.5%	3.5%	2.7%

Source: Company, Axis Securities***Note**: *Rates are latest interest rates and effective dates vary for each bank. Dates range between June-Oct'20*

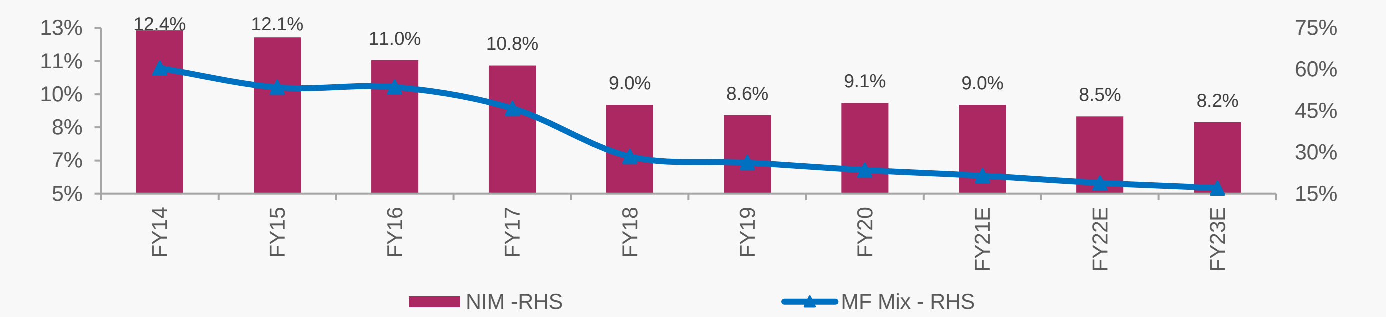
Multiple Levers to support NIMs

As the bank has moved away from high risk high yield microfinance book towards lower yield secured lending, NIMs witnessed compression. Another reason for NIMs compression was on the back of regulatory requirements (SLR requirements).

Post the IPO of the holdco (Equitas Holdings) in April 2016, EQSFB had surplus liquidity which it parked in investments. However, owing to demonetization, Equitas had to slowdown its lending. Even in FY18, investments continued to remain high as Equitas was preparing for the resumption of its loan growth post conversion into a SFB and hence further front loaded its borrowings. The investments-to-deposits ratio was as high as 98.4% (of deposits) at the end of FY18, which has come down to 33% at the end of H1FY21, still significantly higher than the regulatory requirement of 18.5%. Investment yields are significantly lower than advances yields, resulting in NIM compression. However, as the % of investments to deposit and total assets begins to decrease, marginal NIM expansion would be visible in the long term.

As an NBFC, the funding mix primarily consisted of NCDs and term loans resulting in higher borrowing costs. With transitioning into a bank, EQSFB was able to garner low cost CASA deposits and term deposits, resulting in a drop in the CoF. As the proportion of deposits to total borrowing increases with the high cost debt maturing, we will witness a further drop in CoF which would support NIMs.

Exhibit 25: Declining MF portfolio to weigh on NIM, increasing deposit traction to support it



Source: Company, Axis Securities

The bank's conscious decision to park money in liquid assets to maintain a good liquidity position given the turbulent times, has lately weighed on NIMs as investment yields are substantially lower (~6-7%) v/s advances yields of ~18-20%. The LCR stood at 126% much above the regulatory requirement of 80% at the end of H1FY21. ***In the medium term, we expect NIMs to range between 8-9% and tread downwards in the long term as the share of low yielding products namely MSE Finance, Small Business Loans and Vehicle Finance increases in the portfolio.***

Asset quality to stabilise, credit costs to witness compression over the medium term

EQSFB has seen relatively stable asset quality depsite the informal customer segment it serves. Even after commencing operations as a microfinancier, the bank has been extremely conservative in its lending approach. This is visible form the tight control on the ticket size of micro lending, that the bank exercised. The average ticket size of EQSFB is substantially lower at Rs. 14500 vs industry average of Rs. 35000 in the microfinance portfolio. The bank follows daily NPA recognition norms instead of monthly, and hence the NPAs appear to be marginally elevated. However, the cash-flow based profiling of customer and thorough background checks of the customer has been the key for EQSFB maintaining decent asset quality despite operating in categories such as used CV, which is an industry characterised by significantly high NPAs.

Exhibit 26: Asset Quality Trend

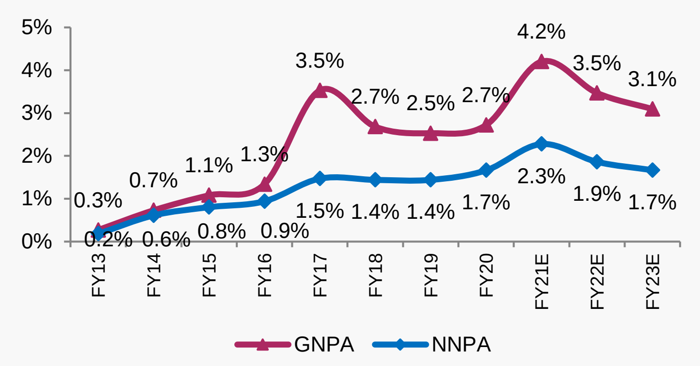
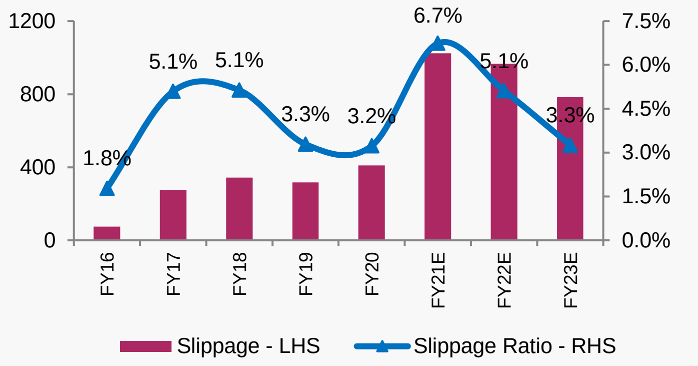


Exhibit 27: Slippages Trend

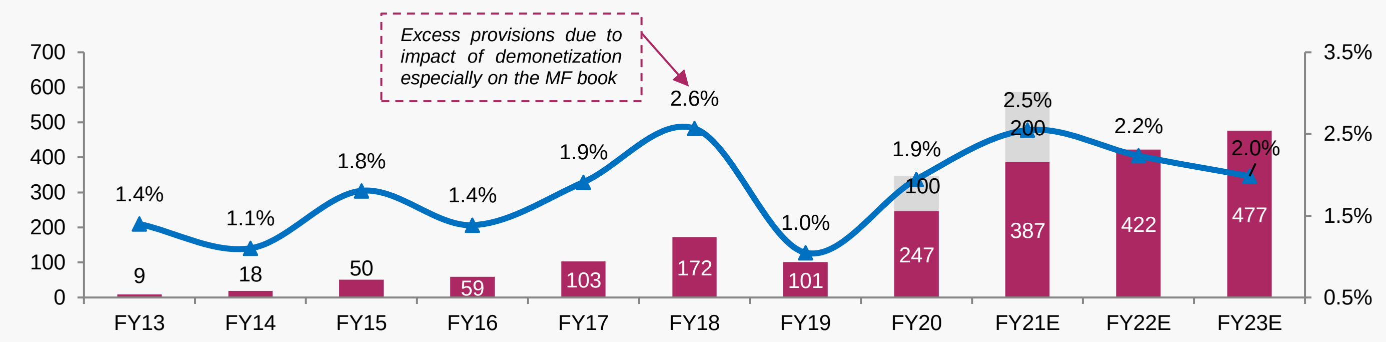


Source: RBI, Company, Axis Securities

Another important aspect in maintaining stable asset quality is the bank's focus on collections. The bank has a strong collection and recovery team of ~7000 collection agents and has put in place separate credit teams for each of its business lines. The credit team evaluates business needs, cash-flow based income generation capabilities, and analyses the borrower's ability to repay the loan. Stringent credit screens have helped EQSFB contain GNPAs despite serving the bottom of the pyramid customers and high NPA characterised lending products, despite having faced unprecedented events like demonetization in FY17 and COVID-19 in FY20.

Demonetisation and the resultant loss of income for some households (especially low-income households) resulted in a significant increase in loan defaults especially in the microfinance segment. With COVID-19 and the lockdown similarly impacting the economic activities of borrowers across segments, with some segments being more vulnerable than the those which cater to the essential or day-to-day activities, we could see a spike in slippages in H2FY21, given that the moratorium has ended.

Exhibit 28: Credit Cost Trend



Source: Company, Axis Securities

EQSFB has witnessed credit costs at sub-2% on the back of robust and comprehensive credit and risk management framework to identify, monitor and manage risks. Credit costs during FY20 were higher as the company made a provision of Rs. 100 Cr towards the impact of COVID-19 in Q4FY20. Additionally, EQSFB has also provided an additional amount of Rs. 71 Cr in H1FY21 towards COVID-19 taking the cummulative provision to Rs. 171 Cr which is ~1.02% of the Gross AUM. Higher provisions for impact of COVID-19 has resulted in an uptick in credit costs. FY21E credit costs are expected to escalate to 2.9% especially with the stressed sectors such MSE and the Vehicle Financing forming a large part of the portfolio.

Weathering through Demonetization

In line with the management's focus to de-risk the portfolio, Equitas Holdings (Equitas) was successful in reducing the share of microfinance in the total portfolio from 76% in FY13 to 46% in FY17. However, with MF still forming a substantial part of the portfolio, Equitas reeled under the asset quality stress faced by the small-ticket segments (especially MFI) due to cash flow pressures. Stress was mainly visible in states like UP, Maharashtra, MP, Gujarat, Punjab and Haryana where Equitas then had ~20% of its MFI book.

On the back of conservative lending policies in the microfinance book, Equitas witnessed significantly lower PAR>0 as compared to industry average. Equitas' PAR>0 was ~6% vs industry average of 20%. The write-offs in the microfinance book on the back of demonetization were significantly high at ~Rs. 150 Cr.

Post demon, the bank further de-risked the portfolio and the pace of deceleration of the mix in the total portfolio accelerated in FY18 and introduced new secured products. During this phase, Equitas disbursed mainly to repeat customers. The bank also shifted to cash-less disbursements and completely stopped disbursing by way of cash to borrowers.

COVID-19 related disruptions to aggravate asset quality pain in near term

The bank had offered moratorium to all its customers and at the end of April'20, 98.3% of the total borrowers (by value) had opted for moratorium as the bank encouraged all its borrowers to opt for moratorium to conserve cash during the lockdown. Strict lockdown and restrictions on movement hindered businesses of customers and the bank's ability to conduct center meetings, carry out cash collection and meet customers.

Collection efficiency was low at 11% as at the end of Apr'20. With the partial easing of the lockdown and businesses picking-up pack gradually,the bank has seen encouraging trends with borrowers coming ahead to repay. The moratorium book by value at the end of August'20 has seen a sharp improvement to 35% from 51% in June'20. Collections further picked-up pace and are near normal levels at the end of Oct'20. Collection efficiency at the end of Oct'20 bounced back to 87% and including arrears to 94% with near normalization in most segments except microfinance, HCVs and MSE.

Exhibit 30: Collection Efficiency improvement trend

	Mar'20	Apr'20	May'20	Jun'20	July'20	Aug'20	Oct'20 (Billing Efficiency)	Oct'20 (Collections incl. arrears)
SBL	72.8%	17.0%	15.9%	60.6%	66.3%	105.2%	88.2%	102.8%
Micro-Finance	77.4%	0.1%	6.6%	42.2%	61.2%	77.1%	91.0%	92.4%
Vehicle Finance	80.5%	13.0%	14.1%	42.0%	48.4%	71.5%	77.9%	87.9%
MSE Finance	34.5%	21.5%	20.5%	19.5%	21.0%	41.0%	83.8%	92.9%
NBFC Financing	99.3%	67.1%	33.3%	91.8%	88.1%	96.3%	96.2%	103.2%
Overall	**78.1%**	**11.0%**	**12.3%**	**49.4%**	**60.5%**	**83.4%**	**87.1%**	**94.3%**

Source: Company, Axis Securities

The management indicated that the microfinance sector would take couple of months to bounce back to normalcy. Though most of the geographies have been performing well, EQSFB has been seeing some stress in certain districts in Maharashtra and Punjab. However the total exposure of the bank to these districts is very low and is not a cause of concern.

The management further indicated that ***~7-8% if the customers have not paid a single instalment*** since the start of moratorium. ~1% of these loans are unsecured (microfinance) while the rest of the loans are secured (mainly from HCV book and a small portion from the MSE book). Till Q2FY21, the bank has received requests for restructuring from HCV customers, whose business activities are yet to reach pre-COVID. Currently, the restructured book stands at 0.5%.

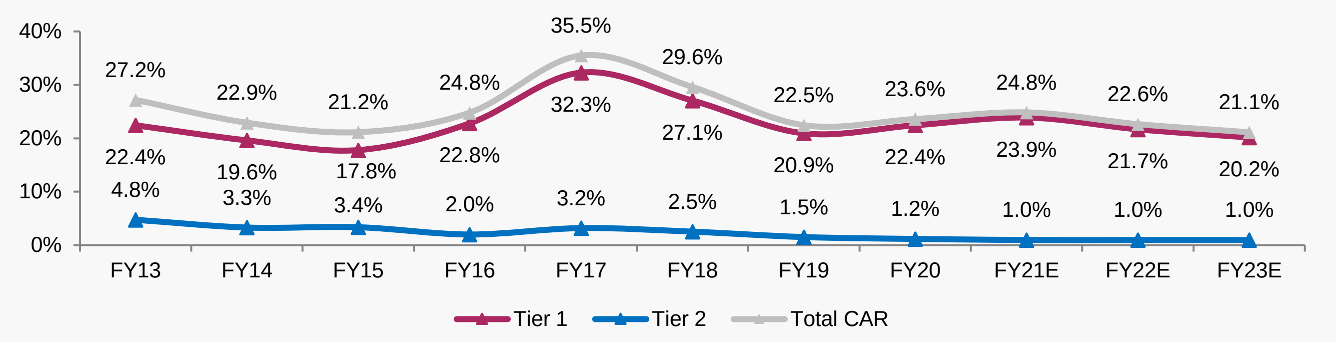
The management has guided that the restructuring book would not exceed 1.5-2% which provides comfort. EQSFB expects that the restructuring requests would mainly be from HCV customers as their business activities have been significantly impacted due to lockdown and slowdown in the economy and from MSE customers who continue to face challenges on the back of dried up order books, extended credit cycles and cash-flow constraints.

We believe that the bank will see an improvement in collections as the macro economic conditions normalise. However, we remain conservative and factor in elevated credit costs, higher slippages and elevated GNPAs in FY21E. We expect EQSFB to exit FY21E to exit with GNPA of 4.2% from 2.39% in Q2FY21 (2.76% without SC dispensation).

High capital adequacy to support growth without dilution

Currently, EQSFB has a healthy CRAR of 20.9% and a Tier 1 ratio of 20.2%, comfortable above regulatory requirements. The funds raised during the IPO in Oct'20 will help the bank further strengthen its capital position. We do not foresee the bank in need to raise Tier 1 capital over the medium term, as growth would be marginally muted on the back of COVID-19. We also expect that the current Tier I ratio is sufficient to handle any credit related shocks that may arise on the back of COVID-19. Over the medium, we believe EQSFB can grow its AUM at a healthy pace supported by robust capitalization.

Exhibit 31: Capital Adequacy Ratio

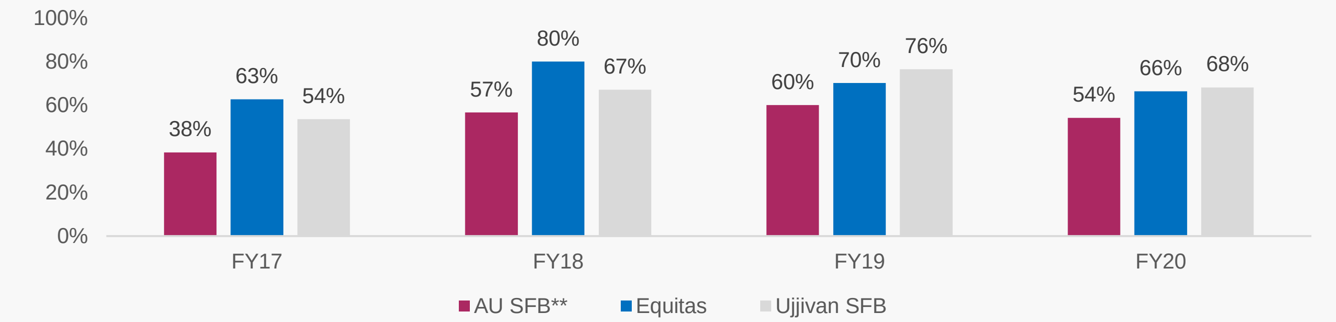


Source: Company, Axis Securities

Operating Leverage to kick-in; ROA improvement visible in the medium term

Until FY16 Equitas' opex was was range bound between 50-55%. In September 2016, Equitas Holdings converted into a small finance bank considering the opportunity to build a diversified, stable and low-cost liability franchise. However, efforts to build the franchise resulted in a quantum jump in opex over FY17-19 as was the case with many of its SFB peers with changes in business model, banking related capex and regulatory costs impacting overall profitability. The primary reason for such a sharp escalation in opex was that the bank decided to open 350+ high-cost liability centres all at one rather than in a phased manner. Higher opex was also a result of aggressive hiring by the bank.

Exhibit 32: C-I Ratio Trend vs Peers



Source: Company, Axis Securities***Note – FY17 C-I Ratio is adjusted for one-time gain on sale of stake in Avaas Financiers*

While transitioning into an SFB the impact on return ratios was visible mainly due to the negative carry due to CRR/SLR requirements. This resulted in investments as a % of deposits increasing to ~98.4% at the end of FY17, resulting in margin compression coupled with higher operating expenses due to investments in technology, branches, liability centres, employees etc impacting profitability. EQSFB is now well positioned with respect to both liability and asset branches, and will look at branch expansion only as operating leverage kicks in. We believe that the opex cycle has peaked out in FY19 and the benefit of operating leverage shall kick-in with an acceleration in loan/NII growth.

With Q1FY21 witnessing low business volumes on the back of lockdown, the bank witnessed savings in the opex on the back of lower variable cost which is ~30% of the total opex. Despite business activities and lending activities resuming as usual, EQSFB was successful in keeping its opex under control and maintaining its C-I ratio at 58% in Q2FY21.

The bank believes that it is well positioned with the liability branches and will not need to open any new liability branches for the next couple of years. EQSFB will look to double the deposits per branch and reach a C-I Ratio of 50% till it considers opening any new liability branches. We believe that as the bank continues to offer all its asset products across all its asset branches the cost saving benefits would be visible. We expect the bank to end FY21E with a C-I Ratio of ~60%, and we believe it would further improve in the medium term. The bank expects the opex growth to be ~12% on a steady state basis.

Exhibit 33: Dupont Analysis

	As a NBFC			SFB Transition phase		As a SFB				
	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21E	FY22E	FY23E
NII	10.8%	10.9%	10.5%	11.0%	7.6%	7.9%	8.5%	8.5%	8.0%	7.8%
Other Income	2.0%	1.9%	1.8%	1.4%	2.1%	1.9%	1.6%	1.1%	1.1%	1.1%
Total Income	12.8%	12.8%	12.4%	12.5%	9.8%	9.9%	10.1%	9.6%	9.1%	8.9%
Opex	7.0%	6.9%	6.6%	7.8%	7.8%	6.9%	6.7%	5.8%	5.4%	5.1%
PPP	5.7%	5.9%	5.8%	4.6%	2.0%	2.9%	3.4%	3.8%	3.7%	3.8%
Provisions	0.8%	1.4%	1.1%	1.3%	1.5%	0.7%	1.4%	1.8%	1.6%	1.4%
PBT	4.9%	4.5%	4.7%	3.3%	0.4%	2.2%	2.0%	2.0%	2.2%	2.4%
Tax Rate	1.7%	1.6%	1.7%	1.2%	0.1%	0.8%	0.6%	0.5%	0.5%	0.6%
ROA	3.2%	3.0%	3.0%	2.1%	0.3%	1.4%	1.4%	1.5%	1.6%	1.8%
Leverage	3.8	3.8	4.4	4.7	5.6	6.8	7.0	7.1	7.5	8.1
ROE	12.2%	11.1%	13.3%	9.9%	1.6%	9.7%	9.7%	10.9%	12.2%	14.6%

Source: Company, Axis Securities

Exhibit 34: Cost-Income & Cost-Assets has peaked out

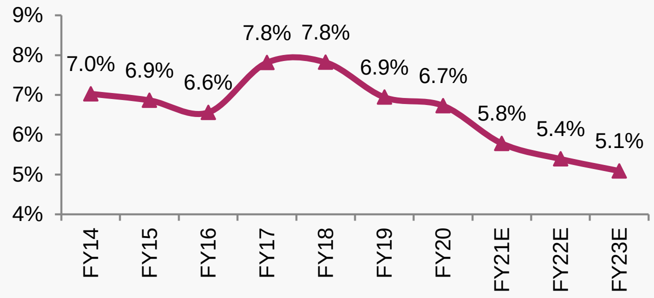
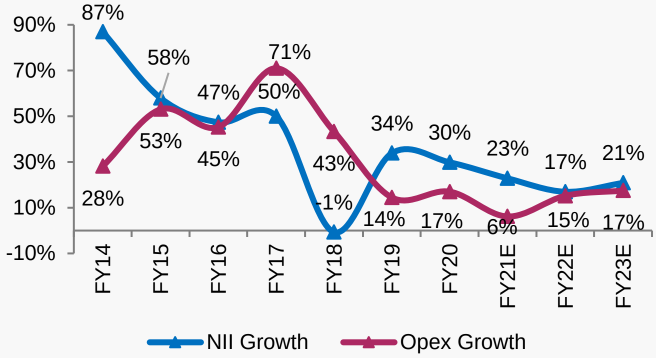


Exhibit 35: NII Growth vs Opex Growth



Source: Company, Axis Securities

Exhibit 36: RoA

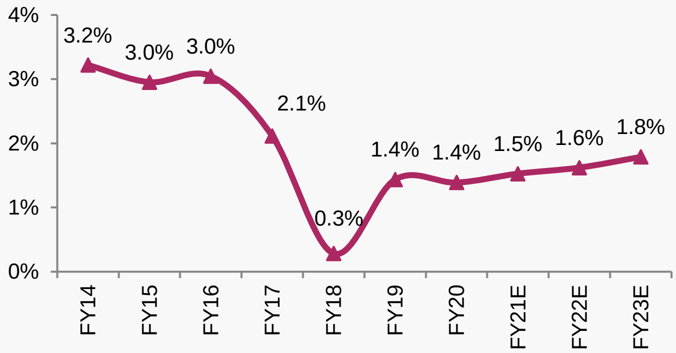
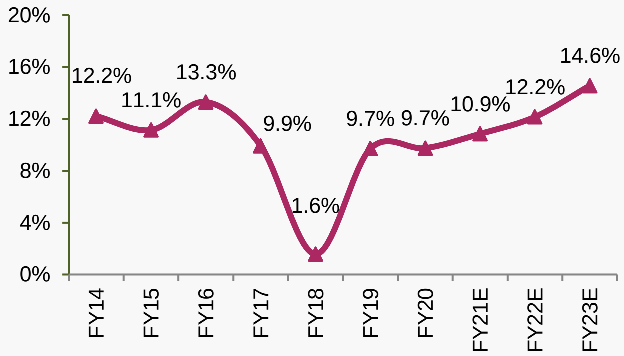


Exhibit 37: RoE



Source: Company, Axis Securities

Key Risk Factors

Compliance with Regulatory requirements remains an overhang

Equitas Holdings had to list the SFB within 3 years from the commencement of the operations, (which has already been delayed in the case of EQSFB, given that the bank listed in Nov'20 instead of Sept'19). As per RBI guidelines, the promoter entity of a SFB is required to reduce its shareholding in the bank to 40% within a period of five years from the date of commencement of business operations as an SFB (Sept 2021), which was September 5, 2016, and thereafter required to reduce its shareholding in the bank to 30% and 26% within a period of 10 years (Sept 2026) and 12 years (Sept 2028), respectively, from the date of commencement of SFB operations. The IPO resulted in dilution of stake of the promoter Equitas Holdings to ~82.1%.

Thus to comply with the guidelines, EQSFB will witness a regular dilution of stake impacting the return ratios of the bank. The options available to the bank to reduce its stake to meet the regulatory guideline are:

- EQSFB could look for a merger with/acquisition of another NBFC and it is currently exploring the same. The bank will look to acquire a NBFC with a similar business model and similar product offerings.
- If such merger/acquisition is not able to bring down the stake to regulatory required levels, Equitas Holdings could also explore the option of OFS.
- The bank is also keen on exploring the option of a reverse merger with Equitas Holdings, subject to approval from the RBI.

However, as per SEBI regulations, stake sale within 1 year of listing is not permitted, which in case of Equitas is completed at the end of Oct'21. This regulation of SEBItimeline clashes with the RBI regulations of bringing down the stake to 40% within 3 years of commencing of operations. The bank will apply for relaxation of the regulation to the SEBI post which it will go ahead to reduce the stake to 40%.

This concern has been addressed by the recently released RBI IWG draft report. However, if the harmonisation of the 2014 and 2019 guidelines for SFBs does not go through, the compliance with the RBI regulatory requirement will continue to be a cause of concern for the bank.

Continuing impact of COVID-19

With COVID-19 and the subsequent lockdown significantly impacting the H1FY21 performance of the bank and business gradually limping back to normalcy, the continuing impact of COVID-19 would impact the credit growth and also the revenue generation from processing fees and documentation charges of the bank.

The moratorium granted to RBI, was given to 100% of the MFI customers. MFI being an unsecured lending product has an inherent risk of higher default. Though the bank has seen an improvement in collections to near normal levels and with businesses too near normalised levels of activity. However, the possibility of resurgence of COVID-19 cases and any future lockdown remains a key risk for the performance of the bank and our estimates. The bank thus remains at a risk of seeing higher NPAs due to possible deterioration in the credit quality of its customers.The bank has been currently facing challenges in the collection from the state of Punjab and certain districts of Maharashtra, however the exposure in these areas is not high.

Higher exposure to informal sector

EQSFB caters to the microfinance customers and an extension of microfinance loans in the form of secured small business loansespeially low and middle-income individuals and businesses who have limited or no access to formal banking and finance channels. The cash flows of these borrowers are dependent on the smooth functioning of their businesses. Any disruptive situation such as COVID-19 would impact business continuity and is likely to trigger higher NPAs.

Regional Dependence on Tamil Nadu

EQSFB faces concentration risk with over ~54% of its AUMs and 28% of its deposits being sourced from Tamil Nadu.Southern India contributes to ~ 68% of the total AUMs and ~40% of deposits. Maharashtra, Karnataka are the next top AUM and deposit contributing states. Any major change in the state's policies or swing in regional environment can immediately affect our earnings estimates for the bank.

Peer Review

EQSFB's direct peers include small finance banks and MFI centric banks such as Bandhan Bank, Ujjivan SFB, AU SFB. We have also reviewed EQSFB against prominent listed MFI and SME players namely CreditAccess Grameen, Spandana Sphoorty and Shriram City Union.

Exhibit 38: Peer Valuation Matrix (FY20)

FY20	ROA (%)				ROE (%)				P/E (x)	P/ABV (x)
	FY20	FY21E	FY22E	FY23E	FY20	FY21E	FY22E	FY23E	FY23E	FY23E
					Small Banks					
Ujjivan SFB	2.2%	1.4%	1.8%	2.4%	15.3%	8.8%	12.0%	17.3%	9.5	1.5
AU SFB	1.8%	1.4%	1.6%	1.8%	17.9%	13.5%	15.8%	19.4%	39.9	3.9
Bandhan Bank	3.6%	2.7%	3.3%	3.5%	21.1%	15.3%	19.5%	20.3%	19.8	2.4
Average	***2.5%***	***1.8%***	***2.2%***	***2.6%***	***18.1%***	***12.5%***	***15.8%***	***19.0%***	***23.1***	***2.6***
					NBFCs – MFI and SME					
Spandana	6.3%	6.0%	6.7%	6.8%	15.6%	13.1%	17.0%	17.5%	14.3	1.2
CreditAccess	3.6%	2.4%	4.1%	4.5%	12.9%	10.9%	18.7%	19.7%	14.8	2.5
SCUF	3.3%	2.4%	3.1%	3.7%	14.7%	10.0%	12.1%	13.3%	5.8	0.7
Average	***4.4%***	***3.6%***	***4.6%***	***5.0%***	***14.4%***	***11.3%***	***15.9%***	***16.8%***	***11.7***	***1.5***
Equitas SFB	**1.4%**	**1.5%**	**1.6%**	**1.8%**	**9.7%**	**10.9%**	**12.2%**	**14.6%**	**6.6**	**1.0**

Source: Bloomberg, Company, Axis Securities

Exhibit 39: Peer Group Review – Operational Parameters (FY20)

FY20	Loan Book	CASA %	NIM %	C-I Ratio %	GNPA %	NNPA %	Loan CAGR FY20-23E	PAT CAGR FY20-23E
				Small Banks				
Ujjivan SFB	14,153	13.5%	10.8%	67.4%	1.0%	0.2%	21.4%	25.4%
AU SFB	30,893	14.5%	5.4%	54.2%	1.7%	0.8%	15.1%	21.7%
Bandhan Bank	71,846	36.8%	8.1%	30.8%	1.5%	0.6%	24.0%	19.1%
Average	***38,964***	***21.6%***	***8.1%***	***50.8%***	***1.4%***	***0.5%***	***20.1%***	***22.1%***
				NBFCs - MFI and SME				
Spandana	6,829	N.A	16.6%	19.9%	0.4%	0.1%	24.9%	15.4%
CreditAccess	11,996	N.A	12.1%	36.6%	1.6%	0.0%	27.7%	36.1%
SCUF	29,085	N.A	12.8%	40.3%	7.9%	4.2%	11.5%	7.0%
Average	***15,970***	***N.A***	***13.8%***	***32.3%***	***3.3%***	***1.4%***	***21.4%***	***19.5%***
Equitas SFB	**13,747**	**20.5%**	**9.1%**	**66.4%**	**2.7%**	**1.7%**	**25.1%**	**34.7%**

Source: Bloomberg, Company, Axis Securities

Valuation and Recommendation

EQSFB is a play on the un/underserved borrower segment with minimal or no access to formal sources of credit, a diversified lending book and a competent management. The bank offers the nimbleness of NBFCs and the deposit garnering capability of a bank. With its strong underwriting capabilities and robust risk management framework EQSFB has been successful in managing its asset quality at sub-3% levels despite its bottom of the pyramid customer profile, serving unsecured portfolio like microfinance and high-NPA segments such as used vehicles.

With the RBI granting 10 small finance bank (SFB) licenses with focus on smaller ticket size lending and sole objective of financial inclusion, in September 2016, EQSFB was the first of the 10 license awardee to commence SFB operations. The transition put pressure on NIMs, profitability and resultantly return ratios with the bank focusing on creating a robust liability franchise resulting in heavy investments in technology, opening of liability branches at once and additional hiring costs. However, this transition paved the way for the bank to further diversify its portfolio along with granting access to low cost CASA and term deposits. During the FY18-20, the bank grew its AUM at 39% CAGR, driven by a robust growth in the non-microfinance portfolio as it looked to de-risk its portfolio.

With near term stress visible on the back of COVID-19, we expect loan growth to moderate slightly on a YoY basis to 20%. However, given the huge unmet demand and now with businesses gradually reaching near normal levels of activity, we expect growth to kick-in FY22E onwards. EQSFB has seen significant progress with collections, with collection efficiency at near normal levels of 87% (94% with arrears) at the end of Oct'20. With ~7-8% of the borrowers (by value) having not paid a single instalment, we expect the vulnerable part mainly from the HCV and MSE book to slip in FY21E. The management's guidance of a restructured book to be contained under 1.5% provides comfort. We continue to remain conservative and factor in higher credit costs and NPAs of 2.9% and 4.2% respectively.

With visible improvement in asset quality in the medium term given the efficient collection mechanism, moderation in opex and credit cost, we expect ROA/ROE to improve to 1.8%/14.6% in FY23E from 1.5%/10.9% in FY21E and further improve in the long term. **We value EQSFB at 1.2x FY23E P/ABV basis given the fast paced shift towards a secured lending book, robust collection and underwriting mechanism, visibility of long runway for sustainable growth given the large addressable market and unmet demand and an experienced and competent management and leadership team. We initiate coverage with a 'BUY' rating with a target price of Rs. 41, implying a 19% upside from the CMP.**

Financials (Standalone)

Profit & Loss (Rs Cr)

Y/E March	FY19	FY20	FY21E	FY22E	FY23E
Interest Income	2,112	2,645	3,239	3,830	4,656
Interest Expenses	960	1,150	1,402	1,681	2,059
Net Interest Income	**1,152**	**1,495**	**1,837**	**2,149**	**2,596**
Change	*34%*	*30%*	*23%*	*17%*	*21%*
Non-Interest Income	280	282	245	297	372
Total Income	**1,431**	**1,778**	**2,082**	**2,446**	**2,968**
Change	*30%*	*24%*	*17%*	*17%*	*21%*
Operating Expenses	1,008	1,180	1,253	1,443	1,695
Change	*14%*	*17%*	*6%*	*15%*	*17%*
Pre-Provision Profits	**423**	**598**	**829**	**1,003**	**1,273**
Change	*92%*	*41%*	*39%*	*21%*	*27%*
Provisions	101	247	387	422	477
Change	*-41%*	*144%*	*57%*	*9%*	*13%*
PBT	**322**	**351**	**443**	**581**	**796**
Tax	113	107	112	146	201
Profit After Tax	**209**	**244**	**331**	**434**	**596**
Change	*553%*	*17%*	*36%*	*31%*	*37%*

Source: Company, Axis Securities

Balance Sheet (Rs Cr)

Y/E March	FY19	FY20	FY21E	FY22E	FY23E
Equity Share Capital	1,006	1,053	1,138	1,138	1,138
Reserves & Surplus	1,248	1,691	2,217	2,651	3,247
Net Worth	**2,254**	**2,744**	**3,355**	**3,789**	**4,385**
Deposits	9,007	10,788	14,463	18,763	25,188
YoY Growth %	*61%*	*20%*	*34%*	*30%*	*34%*
Borrowings	3,973	5,135	5,443	6,141	6,590
Other Liabilities	529	647	764	840	924
Total Liabilities	**15,763**	**19,315**	**24,025**	**29,533**	**37,087**
Cash & Bank balances	1,261	2,537	2,316	2,723	3,278
Investments	2,344	2,343	4,341	4,881	6,049
Loans	11,595	13,747	16,633	21,146	26,903
YoY Growth %	*50%*	*19%*	*21%*	*27%*	*27%*
Fixed Assets & Others	563	688	735	783	858
Total Assets	**15,763**	**19,315**	**24,025**	**29,533**	**37,087**

Source: Company, Axis Securities

Ratio Analysis (%)

Y/E March	FY19	FY20	FY21E	FY22E	FY23E
Asset Quality					
GNPA	296	417	776	814	924
NNPA	167	229	379	394	449
GNPA Ratio	2.5%	2.7%	4.2%	3.5%	3.1%
NNPA Ratio	1.4%	1.7%	2.3%	1.9%	1.7%
PCR	44%	45%	51%	52%	51%
Spread Analysis					
Yield on Advances	19.1%	18.9%	18.5%	17.5%	16.7%
Cost of Borrowings	15.6%	16.4%	15.5%	14.7%	14.3%
Spread	8.1%	8.0%	7.8%	7.5%	7.3%
Net Interest Margin	11.0%	10.9%	10.6%	10.0%	9.5%
Profitability & Efficiency Ratios					
RoE	9.7%	9.7%	10.9%	12.2%	14.6%
RoA	1.44%	1.39%	1.53%	1.62%	1.79%
Cost to Income	70.5%	66.4%	60.2%	59.0%	57.1%
CASA	25.3%	20.5%	26.8%	27.6%	28.2%
CAR	22.5%	23.6%	24.8%	22.6%	21.1%
Tier 1	20.9%	22.4%	23.9%	21.7%	20.2%
Valuation					
BVPS	22.4	26.1	29.5	33.3	38.5
Change	*10%*	*16%*	*13%*	*13%*	*16%*
Price-BV (x)	1.5	1.3	1.2	1.0	0.9
Adj. BVPS	20.7	23.9	26.1	29.8	34.6
Change	*8%*	*15%*	*10%*	*14%*	*16%*
Price-ABV (x)	1.7	1.4	1.3	1.2	1.0
EPS	2.1	2.3	2.9	3.8	5.2
Change	*553%*	*11%*	*26%*	*31%*	*37%*
Price-Earnings (x)	16.6	14.9	11.8	9.0	6.6
Dividend Per Share	-	-	-	-	-
Dividend Yield (%)	-	-	-	-	-

Source: Company, Axis Securities

In a sweet spot, poised to grow!

We initiate coverage on Ujjivan Small Finance Bank (UJSFB) with a BUY recommendation and a price target of Rs. 47 (~24% upside from CMP). We believe that the fast-paced diversification from a microfinancier to a small finance bank and the recent ramp up in the liability franchise after a slow start augur well for the bank. The razor-sharp focus on maintaining asset quality (even as a NBFC) despite operating mainly in the microfinance segment cements our confidence in the bank's ability to navigate through the COVID-19 related headwinds. We believe that that the long-term prospects of the bank remain attractive on the back of 1) Its fast paced diversification towards a secured portfolio, 2) ability to manage asset quality post COVID-19 disruption as witnessed during demonetization and 3) peaking out of the opex cycle and credit cost moderation driving ROA expansion. While FY21E is expected to be muted due to lower disbursements and elevated COVID-19 related provisions, we remain fairly confident on the bank's ability to bounce back mainly on the back of its cautious lending approach and focus on collections, thus enabling it to maintain its asset quality. Collections remained broadly at-par with most of the peer SFBs and MFIs at the end of Oct'20, despite operating in urban and metro markets which continued to face strict and extended lockdowns. The overall collection efficiency improved from 5% in April'20 to 59% in July'20and furthermore to 88% (93% incl. arrears) at the end of Oct'20. **We value UJSFB at 1.9x P/ABV on FY23E ABV on the following premises:**

Diversified portfolio transitioning towards secured lending

UJSFB's efforts to de-risk the portfolio and move towards the SME and Affordable housing space and other newly introduced products such as vehicle finance and gold finance offer the bank ample headroom to grow. We expect the microfinance mix in the portfolio to decline from 77% currently to 64% by FY23E, in line with the bank's strategy. We expect the book to register a growth of 23% CAGR over FY20-23E mainly driven by growth in non-microfinance book growing at 44% CAGR over the same period.

With the strategy to scale down the microfinance business NIMs could witness contraction. However, the slow yet steady building up of the liability franchise and the reducing CoF on the back of an improved CASA and retail TDs would provide some support to NIMs. **We expect NIMs to remain in the range of 9.5-10.5% in the medium term.**

Improving asset quality post the COVID-19 setback

Though a sizeable mix of bank's portfolio consists of microfinance, UJSFB has in the past witnessed credit costs and GNPAs at sub-1% levels (except during demonetization). We believe, the bank will encounter asset quality stress in the near term, but expect GNPA to improve as a result of multiple and flexible repayment options offered by the bank. GNPA/NNPA in Q2FY21 stood at 1.0%/0.1% (12%/0.3% without SC dispensation). We expect GNPAs to escalate to ~2.2% in FY21E and improve thereafter. The cautious lending approach coupled with further tightening of credit screens and strong underwriting practices will help the bank maintain asset quality in the long term.

Opex & credit cost moderation to drive ROA expansion

With a large part of investments already done towards branch expansion to build a robust liability franchise, technology and hiring workforce in the transition phase, a downtrend in the opex/assets will be visible. Though ROA will remain subdued in FY21E on the back of higher COVID-19 related provision, visible improvement is expected from FY22E as opex and credit costs moderate.

Well positioned to gain; Initiate with BUY

We value UJSFB at 1.9x FY23E P/ABV basis on the back of visibility of ROE expansion to 15+% over the long term, efficient risk management framework, visibility of long runway for growth and an experienced and competent management and leadership team. **We initiate coverage with a 'BUY' rating and a price target of Rs. 47.**

Key Financials (Standalone)

(Rs. Cr)	FY20A	FY21E	FY22E	FY23E
NII	1,634	1,963	2,248	2,720
PPP	637	874	936	1,144
PAT	350	334	430	598
NNPA (%)	0.2%	0.4%	0.4%	0.3%
ABVPS (Rs)	17.0	18.7	21.1	24.6
P/ABV (x)	2.2	2.0	1.8	1.5
RoE (%)	15.3%	10.7%	12.2%	14.8%
RoA (%)	2.2%	1.7%	1.8%	2.0%

Source: Company, Axis Research

(CMP as of Dec 02, 2020)

CMP (Rs)	38
Upside /Downside (%)	24%
High/Low (Rs)	63/23
Market cap (Cr)	6,576
Avg. daily vol. (6m) Shrs.	20,75,531
No. of shares (Cr)	172.8

Shareholding (%)

	Mar-20	Jun-20	Sep-20
Promoter	83.3	83.3	83.3
FIIs	5.4	5.1	5.2
MFs	0.8	0.2	0.2
Public	10.5	11.3	11.3

Financial & Valuations

Y/E Mar (Rs. Cr)	FY21E	FY22E	FY23E
NII	1,963	2,248	2,720
PPP	874	936	1,144
PAT	334	430	598
EPS (Rs)	1.9	2.5	3.5
EPS Growth (%)	*-5%*	*29%*	*39%*
ABV/Share (Rs)	18.7	21.1	24.6
P/ABV (x)	2.0	1.8	1.5

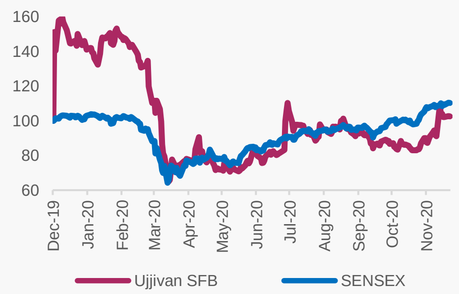
Key Drivers (%)

Y/E Dec	FY21E	FY22E	FY23E
NIM	10.2	9.7	9.4
C-I	60.8	64.1	64.1
Credit Costs	2.9	2.0	1.5

Axis vs Consensus

EPS Estimates	FY21E	FY22E	FY23E
Axis	1.9	2.5	3.5
Consensus	1.8	2.5	3.1
Mean Consensus TP (12M)			39

Relative performance



Source: Capitaline, Axis Securities

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Research Analyst

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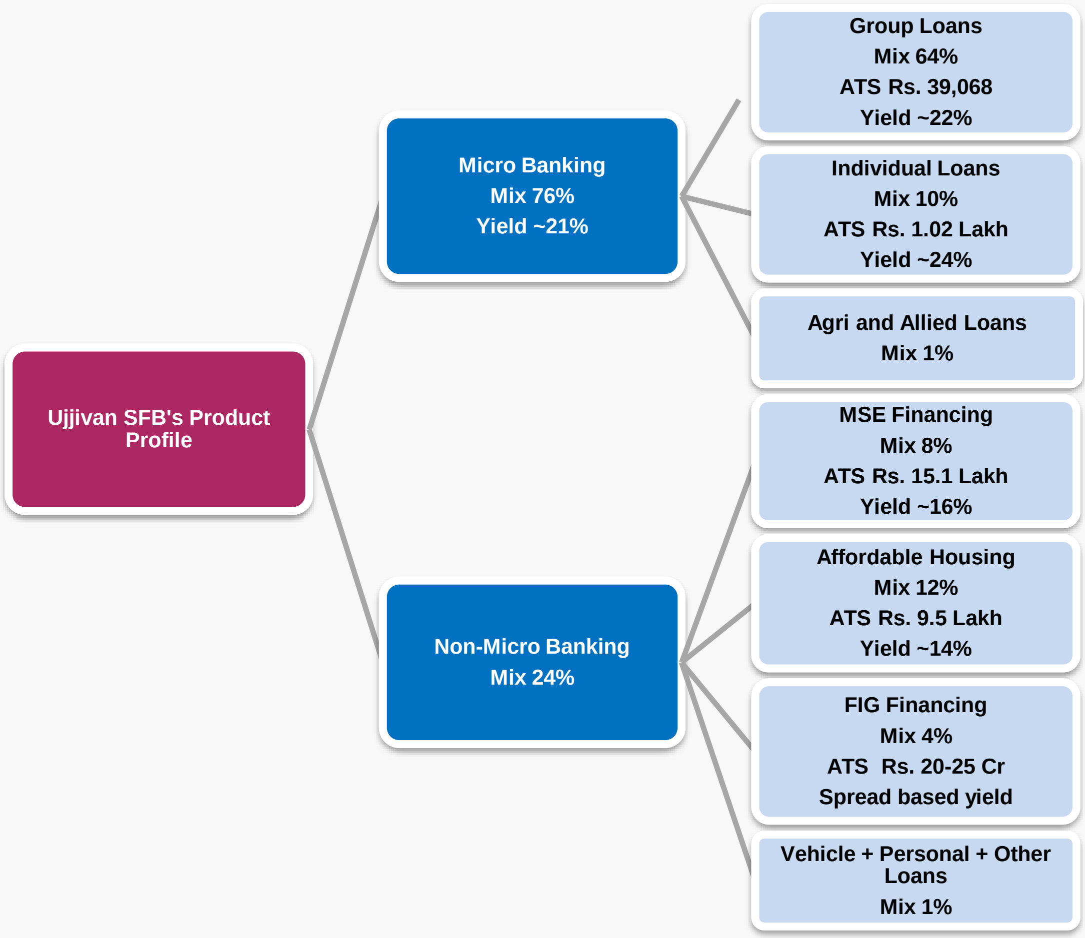
Company Background

Ujjivan SFB (UJSFB) is a diversified leading SFB which transitioned from a NBFC (Ujjivan Financial Services Ltd.) in Feb'17 which primarily catered to the low and middle-income individuals and businesses in the metro and urban areas that have limited or no access to formal banking and finance channels.

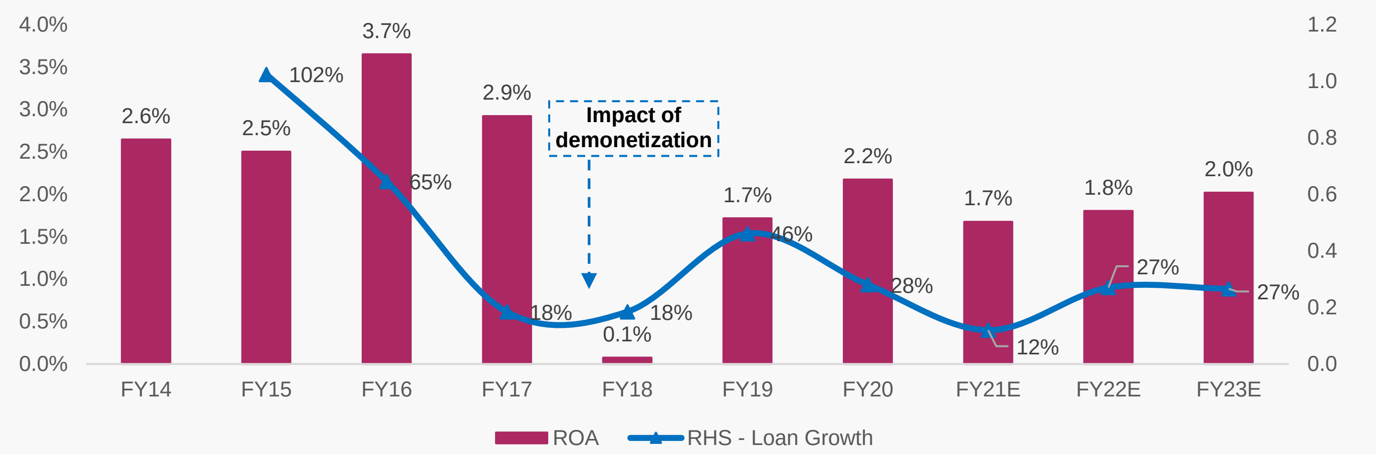
As of H1FY21, UJSFB had total Gross Advances of Rs. 13,890 Cr, spread across Microfinance – group and individual products, MSE Finance, Affordable Housing Finance, FIG Finance and newly introduced products such as personal loans, vehicle loans and gold loans. Post conversion into a SFB, UJSFB's liability franchise is shaping up well with deposits presently forming ~73% of the total borrowings. Retail deposits currently form 49% of the deposit base. The low-cost CASA deposits form 16.5% of the deposit base. The bank operates through 575 branches, with 64% of its branches in the urban and metropolitan areas.

Exhibit 1: Diversified Product Portfolio (H1FY21)



Source: Company, Axis Securities

Exhibit 2: UJSFB's AUM growth over the decade



Source: Company, Axis Securities

Exhibit 3: AUM Mix (H1FY21)

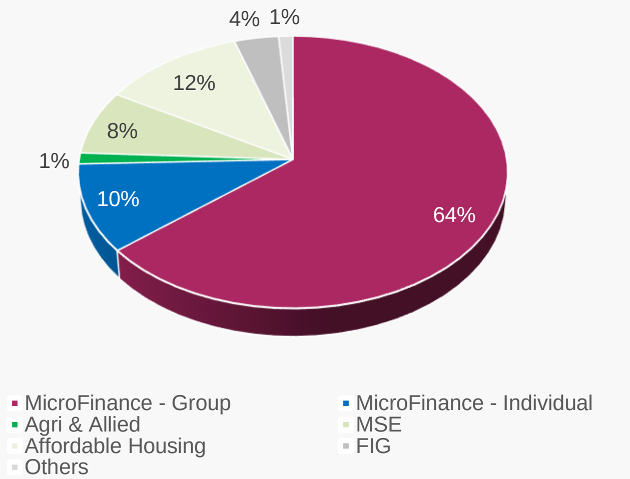
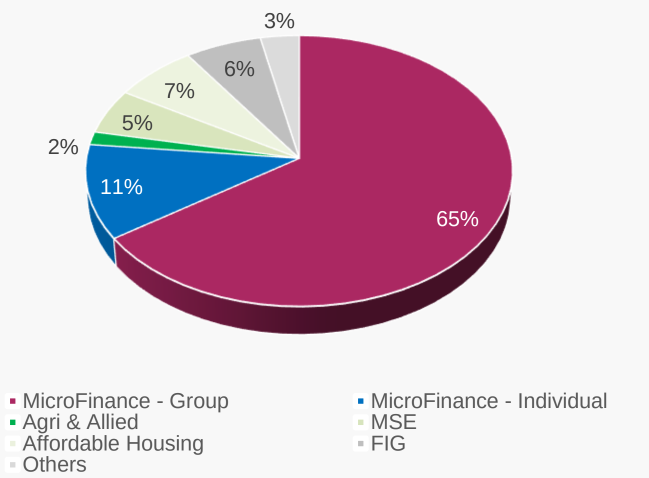


Exhibit 4: Disbursement Mix (H1FY21)



Source: Company, Axis Securities

Exhibit 5: Borrowing Mix (H1FY21)

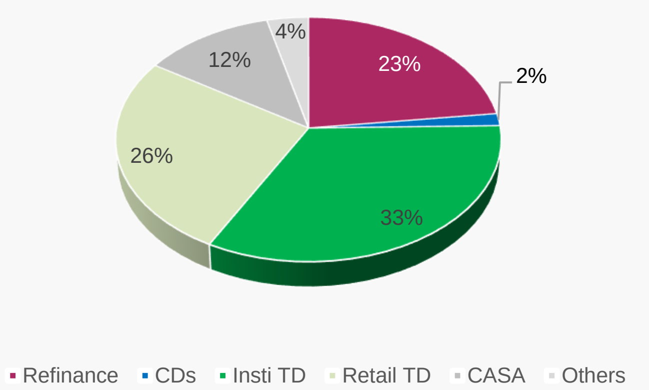
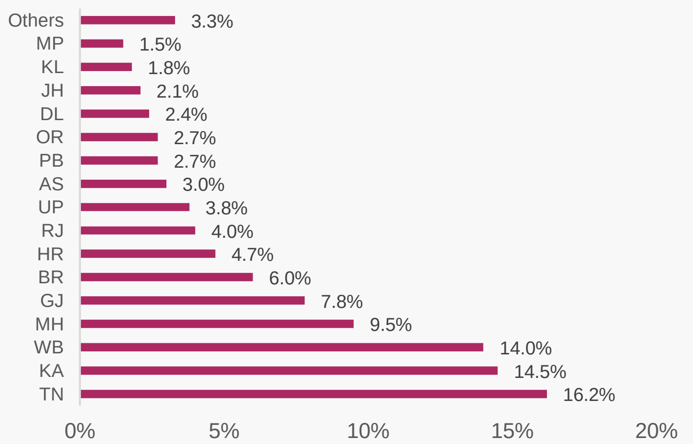


Exhibit 6: Geography-wise AUM Mix (H1FY21)



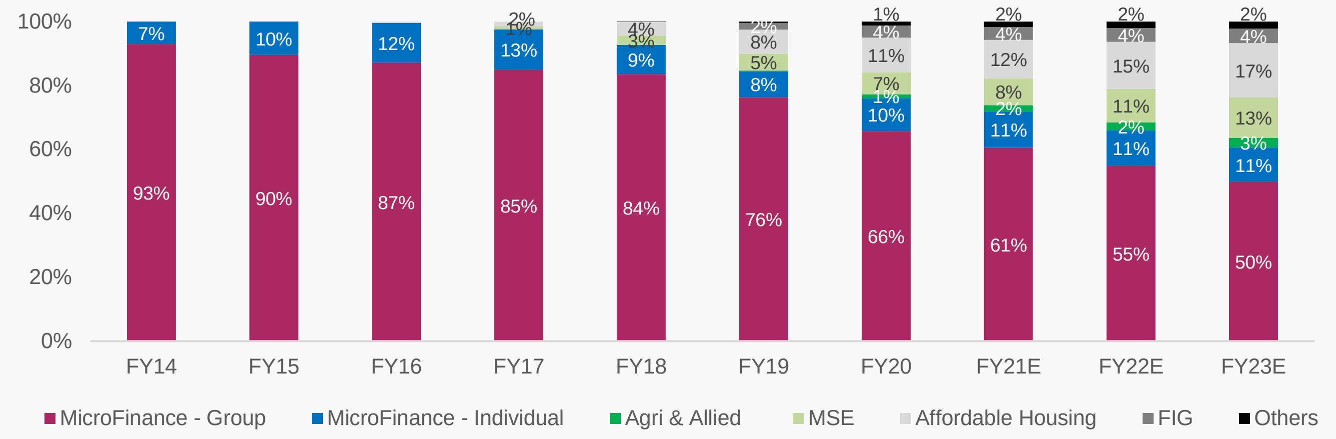
Source: Company, Axis Securities

Diversified portfolio transitioning towards secured products

The management in its effort to de-risk the business from the unsecured microfinance business, diversified into secured lending products such as SME Financing and Affordable housing, thus reducing the share of the microfinance book from ~98% in FY17 to 76% at the end of H1FY21.

The asset mix predominantly consists of high yielding microfinance portfolio to both groups and individuals and comparatively low yielding secured products such as MSE Financing and Affordable Housing Finance. The bank has recently forayed into other products such as vehicle loans, personal loans and gold financing. **The management is focusing on further de-risking the portfolio and will look to achieve a mix of 50:50 between microfinance and non-microfinance over the medium term.**

Exhibit 7: AUM Mix shifting towards secured lending products



Source: Company, Axis Securities

Micro Finance | H1FY21 Mix 76% | FY20-23E Loan CAGR: 14%

Group Lending | H1FY21 Mix 64% | FY20-23E CAGR 11%

- UJSFB commenced operations as a micro-financier; and currently serves the urban poor, unserved and underserved customers to meet various requirements. These loans are provided to customers in need of funding toward supporting business requirements, medical emergencies, home improvement, repayment of high-cost debts availed for family needs, social, religious obligations and purchase of consumer durables.
- The average ticket size of these group loans is ~Rs. 39,000 and the portfolio yields ~22%. The average tenure of these loans is 2 years. The ticket size of these customers is slightly higher than the avg. ticket size in the MFI industry given the area of operations.

Individual Lending | H1FY21 Mix 10% | FY20-23E CAGR 24%

- The individual lending product has a significant overlap with the JLG product as the bank extends individual loans to existing microfinance customers who are in need of higher ticket size loans. The prerequisite for these loans is a good repayment track record and successful completion of repayment of 20 monthly installments.
- The average ticket size of the product is ~Rs. 1.02 Lakh and the portfolio yields a marginally higher than the group lending portfolio and are currently at ~24%. The average tenure of the loans is ~3 years.

Agri and Allied Loans | H1FY21 Mix 1% | FY20-23E CAGR 63%

- UJSFB extends credit to marginal and small farmers including those engaged in allied activities such as dairy activities, animal husbandry, poultry farming, sericulture and purchase renovations and upgradation of farm equipment.
- The average ticket size differs with each product offered and ranges between Rs. 30000-60000 for group loans (yields ~22%), Rs. 60000-1.5 Lakh for individual loans (yield 23-24%). Recently the bank has also introduced a ‘Kisan Pragati Card’ for its customers.

The unmet demand in microfinance, especially in the urban and metropolitan areas, translates into a huge potential to grow. Given the bank’s effort to drift away from the microfinance business to diversify its portfolio, ***we expect the mix of microfinance to decline as a proportion of total advances going ahead***. However, with the increasing need of borrowers to grow their businesses, we believe that the share of individual loans to existing microfinance customers would remain largely stable. We expect the group lending portfolio to register a growth of 11% CAGR and individual portfolio to register a growth of 24% CAGR over FY20-23E, on the back of huge unmet demand in the urban and metro areas.

Exhibit 8: Declining Share of MF Portfolio

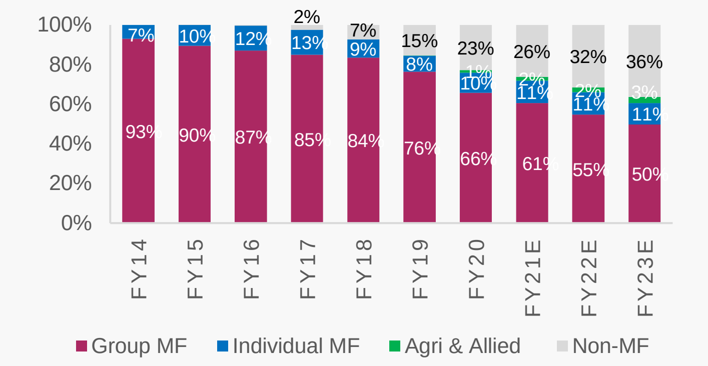
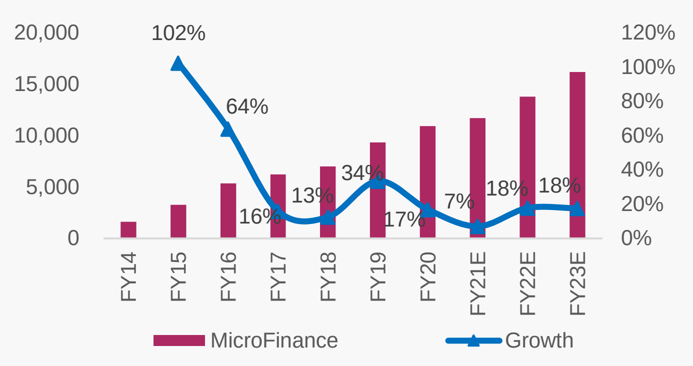


Exhibit 9: MF Portfolio Mix and Growth



Source: Company, Axis Securities

Micro & Small Enterprise Loans | H1FY21 Mix 8% | FY20-23E Loan CAGR 49%

- UJSFB forayed into the MSE business in 2017, in a bid to diversify its portfolio. It started with disbursing unsecured loans and overdraft facility to enterprises engaged in manufacturing and service/ trade activities in the form of investment as well as working capital. However, the bank shifted towards secured MSE Financing and in FY19 discontinued unsecured lending. Currently, the unsecured book is at Rs. 160 Cr and will run down eventually.
- The average ticket size in FY20 was Rs. 15.1 Lacs and the portfolio yields ~14-17%. The LTV on this portfolio ranges between 40-45%.
- MSE financing segment is a relatively under-penetrated segment and also offers attractive yields, as the customers are either new to credit or come from unbanked/under-banked areas. Excessive paper-work and cautious stance of banks to extend credit to MSEs has resulted in borrowers turning towards SFBs and other financial institutions.
- We believe, UJSFB will look to capitalize on this opportunity, thus making us believe that MSE financing will drive growth in the long term.

Exhibit 10: Share of MSE Loans

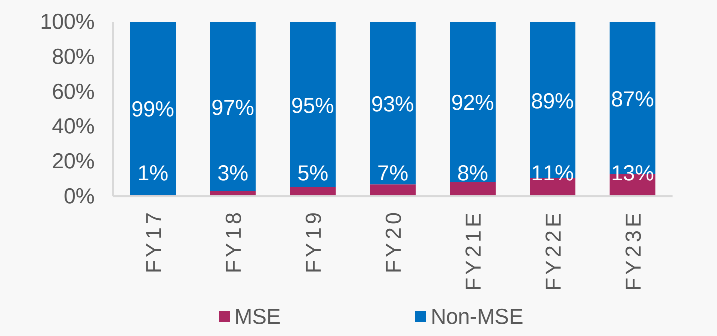
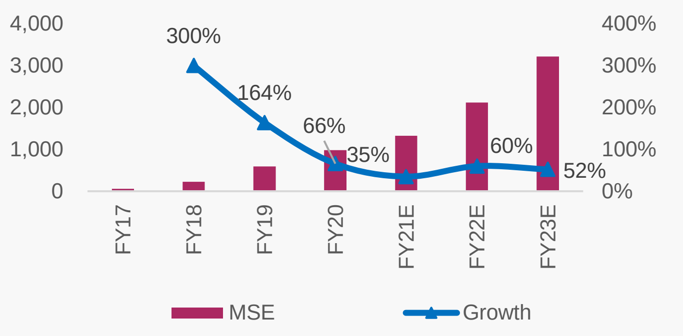


Exhibit 11: MSE Loans and Growth



Source: Company, Axis Securities

Affordable Housing | H1FY21 Mix 12% | FY20-23E Loan CAGR: 42%

- UJSFB's affordable housing financing is targeted towards informal and semi-formal income segments. The bank started off with loans for construction and slowly moved into ready to use houses, home construction, improvement/ restoration/ extension of home. The portfolio also consists of a LAP portfolio which constitutes ~25-26% of the affordable housing book.
- The customer base is predominantly self-employed individuals, however the bank is now seeing a shift in the customer base towards salaried borrowers. Salaried borrowers currently are around 35% of the total housing finance customer base.
- The average ticket size of the book is ~Rs. 9.5 Lakh and the portfolio yields ~14%. The LTV on this portfolio ranges between 50-55%.

Exhibit 12: Share of Affordable Housing AUMs

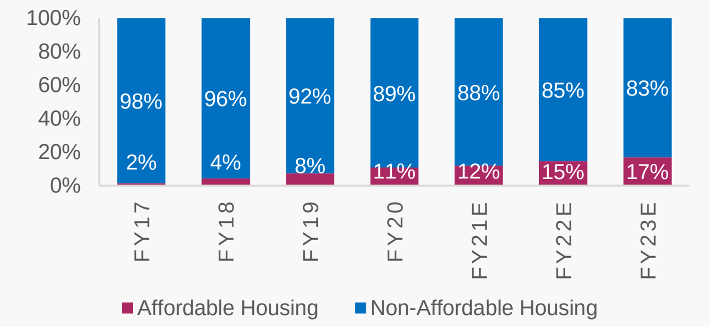
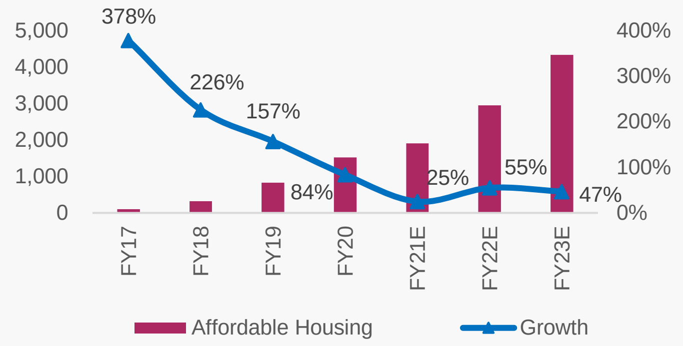


Exhibit 13: Fast paced growth on small base



Source: Company, Axis Securities

Financial Institution Group Lending | H1FY21 Mix 4% | FY20-23E CAGR: 28%

- UJSFB extends term loans to rated NBFCs, mainly MFI, SME NBFCs and vehicle financiers. These NBFCs have a minimum rating of BB+ certified by a credit rating agency. The book has doubled on a YoY basis since the bank introduced FIG lending in FY19.
- Mr. Samit Ghosh (ex-MD & CEO) has a extensive experience in the microfinance business and his experience and expertise in this segment has helped the bank cherry-pick NBFC-MFIs based on their operational performance, credit history, asset quality trends etc.
- The average ticket size ranges between Rs. 20-25 Cr. Since, FIG Lending is an opportunistic product for the bank, yields on this portfolio depend upon the quality of the NBFC the bank is lending to and vary for each NBFC. Broadly yields are arrived at on a spread basis over and above the CoF.
- The bank has a ***cap of 10% of the total portfolio mix*** on FIG lending. We expect the book to grow given the opportunity to grow in the MFI and MSME space, however we do expect the mix of FIG loans to the total book is likely to remain flat at 4% over the medium term.

Exhibit 14: FIG Loans mix to remain flat

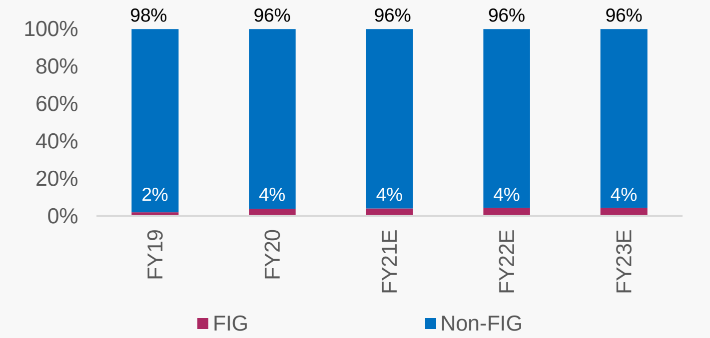
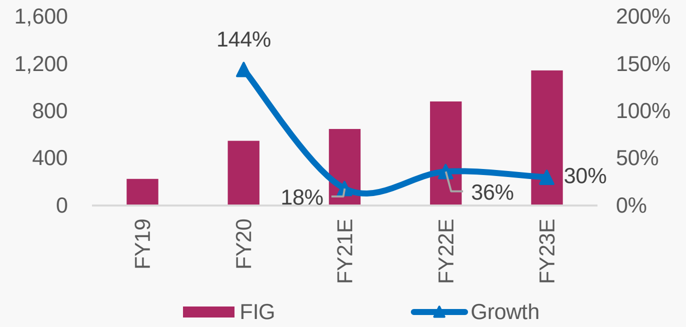


Exhibit 15: FIG Loans & Growth



Source: Company, Axis Securities

Other Loans | H1FY21 Mix 1% | FY20-23E CAGR: 51%

- The bank offers **personal loans** to salaried customers in private, public sector organizations, educational and healthcare sector organizations. The loans are offered to customers in full time employment with good credit behaviour as well as new-to-credit customers. The book yields range between 18-23%, with an average tenure of 12-60 months.
- UJSFB has introduced ***vehicle loans*** wherein it finances two-wheeler loans and electric three-wheeler loans currently only to the existing to bank customers. The ticket size of these loans ranges between Rs. 26000-85000 and the average yield ranges between 22-27%. With the increasing need for personal mobility on the back of the pandemic, we believe the book will witness a robust growth going ahead, though on a smaller base.
- The bank has further introduced a new product in the form of ***gold financing***, which is currently at a nascent stage and will need time to scale up.
- The new product offerings can be seen as the effort of the bank to diversify its product offerings with focus on growing the secured book in order to de-risk the business, rather than opportunistic lending.

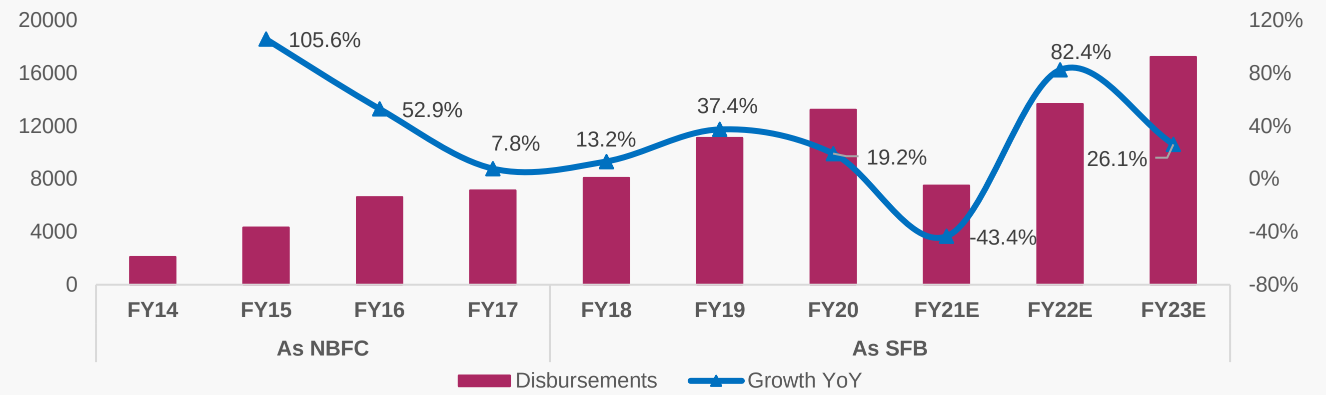
Huge addressable market provides long runway for growth, FY21E to remain muted due to COVID-19

Q1FY21 was a subdued quarter on the back of COVID-19 induced lockdown and the disbursements stood at Rs. 442 Cr, mainly to the microfinance borrowers. With the unlock of the economy, and businesses beginning to pick up pace gradually disbursements in Q2FY21 improves significantly on a sequential basis and stood at Rs. 1458 Cr. However, disbursements remained significantly below Q2FY20 customers as the bank lent only to good customers. The bank was cautious in lending to new customers and hence extended credit only to existing customers as was visible from the mix of disbursements, with only 5% of Q2FY21 disbursements to new customers.

In the ***microfinance book***, a major part of the customers are engaged in essential services (16% of the borrower base) and non-discretionary activities such as agriculture, dairy and manufacturing of frequently used small items (~57% of the borrower base) and we expect disbursements to these customers to bounce back fast, as the revival in these segments would be quick. The category of borrowers to be impacted the most and for a longer time given the extended/intermittent lockdowns in urban areas include employees in the hospitality sector (6% of borrower base), borrowers dependent on the transport business (1% of borrower base) and helpers and maids (~3% of the borrower base). However, the management will continue to remain cautious in its approach while lending to microfinance customers and the bank would apply a more methodical approach while growing the book rather than rushing into growing it.

In the ***non-microbanking book***, the bank indicated that the log-ins for MSE and Affordable housing loans is almost at pre-COVID levels in Q2FY21. We believe it is a positive indicator as these loans will drive growth in the medium term as the bank tries to diversifying the book towards secured lending products. The bank will also look to cross sell its newly introduced vehicle loans and gold loans to its MFI customers. UJSFB will be focusing on growing these businesses through proprietary channels and not using DSAs.

Exhibit 16: Disbursement Trend



Source: Company, Axis Securities

Overall, disbursements remained muted in H1FY21 on the back of the COVID-19 induced lockdown coupled with the bank's cautious approach. In Q2FY21 though the disbursements were higher than Q1FY21, they were considerably lower than the quarterly average of ~Rs. 3000-3300 Cr in FY20. We expect disbursements to pick-up H2FY21 onwards given the demand during the festive season and on the back of businesses getting back on track post the pandemic related disruption especially from the non-microfinance segments. Currently, a large proportion of the MSE borrowers are seeing their business reach pre-COVID level, whereas another large portion of the borrower base is operating at 80-85% of pre-COVID level. We expect disbursements to de-grow by ~43% during FY21E and AUM growth to be at 12% in FY21E.

We estimate AUMs to grow at a 22% CAGR over FY20-23E anticipating encouraging credit demand across all the key segments, especially the secured portfolio FY22E onwards. By the end of FY23E we believe the bank would be able to achieve a mix of 64%:36% between the microfinance and non-microfinance loans from a mix of 76%:24% at the end of H1FY21.

Exhibit 17: Segmental Break-up of the Diversified Loan Book

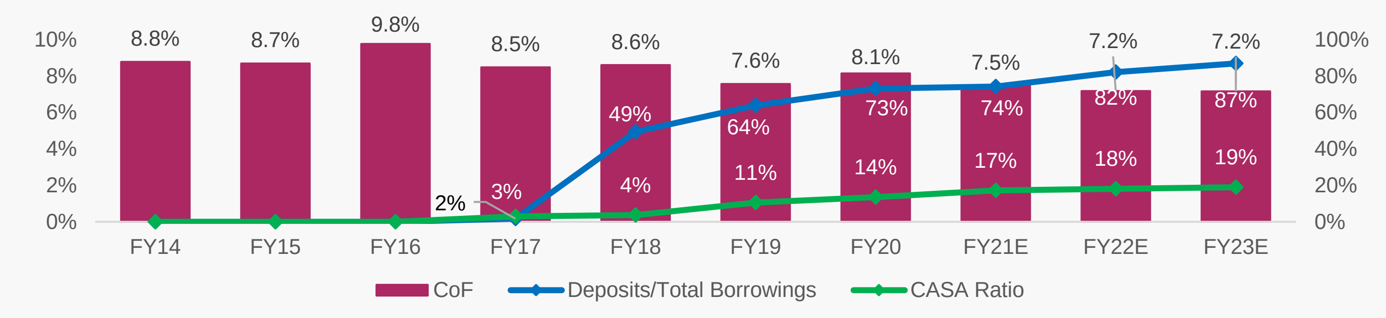
	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21E	FY22E	FY23E
Group MF	1,504	2,931	4,695	5,416	6,317	8,441	9,311	9,590	11,029	12,683
Mix	*93%*	*90%*	*87%*	*85%*	*84%*	*76%*	*66%*	*61%*	*55%*	*50%*
Individual MF	113	343	673	809	688	889	1,446	1,808	2,260	2,758
Mix	*7%*	*10%*	*12%*	*13%*	*9%*	*8%*	*10%*	*11%*	*11%*	*11%*
Agri & Allied						23	176	308	493	764
Mix						*0%*	*1%*	*2%*	*2%*	*3%*
MSE				56	224	591	980	1,323	2,117	3,219
Mix				*1%*	*3%*	*5%*	*7%*	*8%*	*11%*	*13%*
Affordable Housing		0	21	99	323	830	1,524	1,905	2,952	4,340
Mix			*0%*	*2%*	*4%*	*8%*	*11%*	*12%*	*15%*	*17%*
FIG						225	549	648	881	1,145
Mix						*2%*	*4%*	*4%*	*4%*	*4%*
Others					8	50	167	265	397	576
Mix					*0%*	*0%*	*1%*	*2%*	*2%*	*2%*
Total	**1,617**	**3,274**	**5,388**	**6,380**	**7,560**	**11,049**	**14,153**	**15,847**	**20,129**	**25,484**
Growth		*102%*	*65%*	*18%*	*18%*	*46%*	*28%*	*12%*	*27%*	*27%*
Non-MFI Portfolio	**-**	**-**	**21**	**155**	**555**	**1,696**	**3,220**	**4,141**	**6,348**	**9,280**
Mix	*0%*	*0%*	*0%*	*2%*	*7%*	*15%*	*23%*	*26%*	*32%*	*36%*

Source: Company, Axis Securities

Slow but steady improvement in the Liability franchise

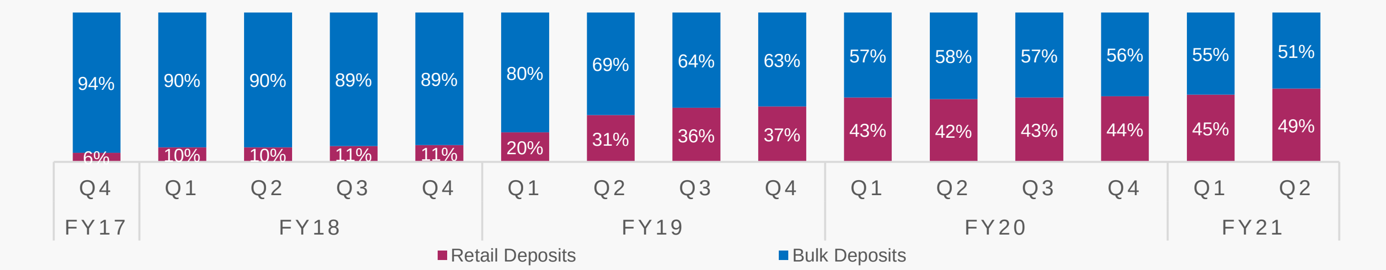
Transitioning into a bank gave UJSFB access to low cost deposits and a chance to keep the cost of funds under check. Deposits currently stand at ~73% of total borrowings at the end of H1FY21. We expect deposits as a proportion of total borrowings to reach ~83% by the end of FY23E. The banks primary focus has been growing the share of retail deposits in both term and savings deposits given the stickiness of the customer base from Tier II and Tier III cities, given lower competition in these areas.

Exhibit 18: Gradual decline in CoF with improving CASA



Source: Company, Axis Securities

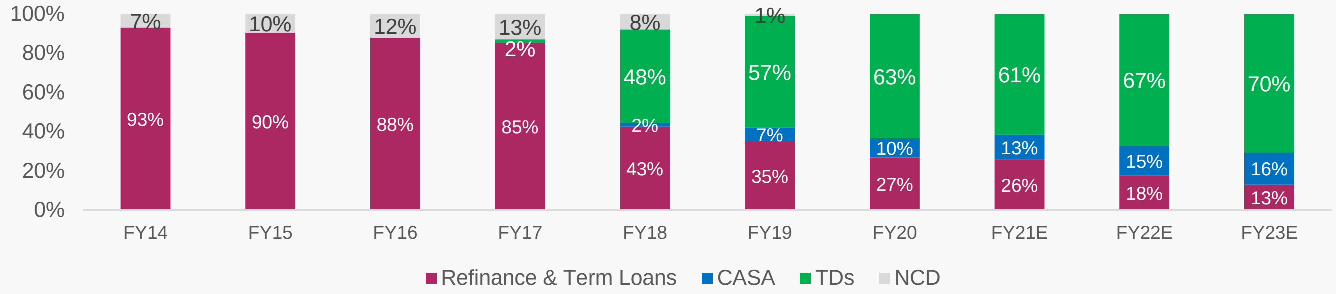
Exhibit 19: Improving share of retail deposits



Source: Company, Axis Securities

As a NBFC, UJSFB relied on term loans from banks, NBFCs and other financial institutions along with issuance of NCDs to meet its funding needs. With the transition into a bank, the bank's focus shifted towards increasing the share of deposits in the borrowing mix. Initially like most SFBs, UJSFB too built its deposit book by garnering bulk TDs, with a view to replace high cost debt. However, as it further built its deposit base, the bank shifted focus from bulk deposits towards retail deposits. Going ahead too, we believe deposit growth will be primarily driven by retail deposits.

Exhibit 20: Deposits to form lions share in the borrowing mix



Source: Company, Axis Securities

The bank has divided its customer base into different categories - youth, students, salaried, professionals, old and elderly, small and medium business owners. UJSFB will look to garner deposits from Tier II and Tier III cities and will not look to build a customer base in the urban areas. Hence, the bank has comparatively lower interest rates than other SFB's which operate mainly in the urban areas, which are characterised by stiff competition from universal banks and deposit taking NBFCs and are forced to offer attractive interest rates to build a healthy deposit base. The customer base in the target market is relatively less rate sensitive, and the comparatively lower rates vs peers will help the bank control its CoF.

Exhibit 21: Retail TD Rates – year-wise vs peers

Retail TD Rate – Tenure wise	Small Finance Banks				Small Private Banks				PSBs
	AU SFB	Bandhan	Ujjivan SFB	Equitas SFB	CUB	Federal	DCB	KVB	SBI
1 Year Retail TDs	5.5%	5.8%	5.2%	6.6%	5.5%	4.5%	6.5%	5.0%	4.4%
2 Year Retail TDs	6.5%	6.0%	6.5%	7.1%	5.8%	5.3%	6.9%	5.5%	4.9%
3 Year Retail TDs	6.8%	6.0%	6.1%	7.2%	5.8%	5.4%	7.0%	5.5%	5.1%

Source: Company, Axis Securities ****Note***: *Rates are latest interest rates and effective dates vary for each bank. Dates range between June-Oct'20*

Exhibit 22: SA Rates – slab-wise vs peers

SA Rates - Slab-wise	Small Finance Banks				Small Private Banks				PSBs
	AU SFB	Bandhan	Ujjivan SFB	Equitas SFB	CUB	Federal	DCB	KVB	SBI
< Rs. 1 Lakh	4.0%	4.0%	4.0%	3.5%	3.5%	Repo – 1.5%	3.3%	3.0%	2.7%
Rs. 1 Lakh - 5 Lakh	5.0%	6.0%	5.0%	7.0%	3.8%	Repo – 1.5%	4.0%	3.5%	2.7%
Rs. 5 Lakh - 10 Lakh	6.0%	6.0%	5.3%	7.0%	3.8%	Repo – 1.5%	5.0%	3.5%	2.7%
Rs. 10 Lakh - 5 Cr	7.0%	6.0%	6.3%	7.0%	4.0%	Repo – 1.5%	5.3%	3.5%	2.7%
Rs. 5 Cr - 10 Cr	6.5%	6.0%	6.5%	7.3%	4.0%	Repo – 0.2%	5.5%	3.5%	2.7%
> Rs. 10 Cr	N. A	6.6%	6.5%	7.3%	4.0%	Repo – 0.2%	5.5%	3.5%	2.7%

Source: Company, Axis Securities ****Note***: *Rates are latest interest rates and effective dates vary for each bank. Dates range between June-Oct'20*

The geography in which UJSFB operates and the customer profile it serves, offers the bank multiple opportunities to cross sell its liability products to its asset customers. The bank has already started cross selling its liability products to its Microfinance customers. This is evident from the improving mix of "asset + liability" customers in the total customer base. We believe cross selling its liability products to the asset customers will help the bank build a sustainable low-cost retail deposit franchise with a low-ticket size sticky customer base.

In H1FY21, the bank has seen strong traction in garnering deposits. Deposits growth was 6% YoY as the bank focused on replacing bulk deposits with retail. The entire focus was on retail customer acquisition and granular FDs and CASA. The proportion of retail deposits improved to 49% in Q2FY21 from 42% in Q2FY20 and 45% in Q1FY21. CASA ratio also improved in Q2FY21 to 16.8% vs 12.8% in Q2FY20 and 14.5% in Q1FY21. We believe the bank's persistent focus on retail deposits and CASA will help UJSFB further improve its CASA ratio. We expect the bank to exit FY21E with a CASA ratio of 17.3% vs 13.5% in FY20.

Exhibit 23: Area-wise Deposit Distribution (H1FY21)

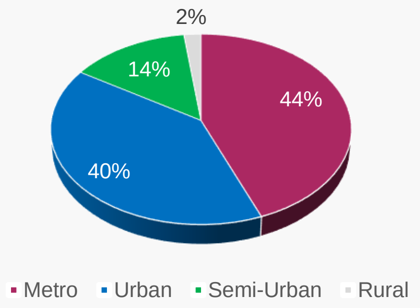
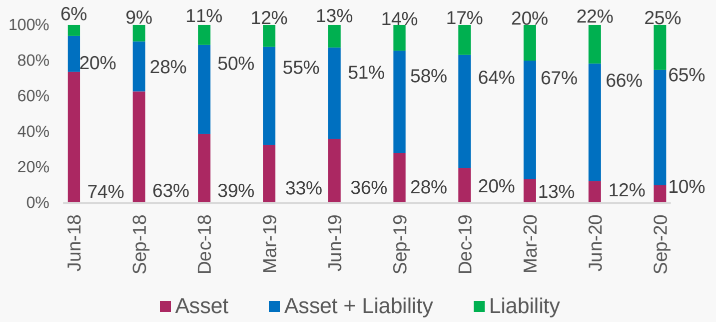


Exhibit 24: Improving liability customers in total customer base



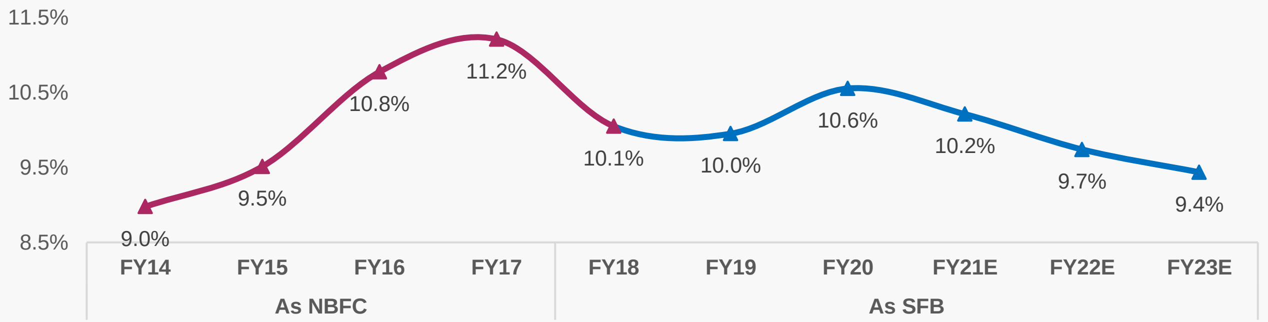
Source: Company, Axis Securities

NIMs compression visible as portfolio moves towards low yielding secured products

As a NBFC, UJSFB primarily lent only to the high yielding microbanking customers wherein yields ranged between 20-23%. As it transitioned into a bank and diversified its product portfolio into low yielding secured products (wherein yields range between 15-18%), NIMs witnessed compression. As the product mix increasingly shifts towards the low yielding secured book, we would witness moderation in NIMs.

As the funding mix tilted from higher borrowing costs borrowings to low cost CASA deposits and term deposits, the bank witnessed a drop in the CoF. As the proportion of low cost deposits to total borrowing increases with the high cost NCDs and loans maturing or getting prepaid and refinancing happening at a lower rate, we will witness a further drop in CoF which would partially offset the compression in yields, thus supporting NIMs.

Exhibit 25: NIMs expected to moderate as portfolio transitions towards low yield secured products



Source: Company, Axis Securities

UJSFB is well placed in terms of liquidity with ~Rs. 1500 Cr on hand (8% of balance sheet) at the end H1FY21. LCR stood at 177% at the end of Sept'20 comfortable above the regulatory requirement of 80%, putting downwards pressure on NIMs. The bank has also seen a drop in the CoF in H1FY21 driven by reduction in deposit rates and concessional rates of refinance availed from DFIs. At the end of H1FY21, NIMs witnessed compression of ~30bps to 10.3% vs 10.6% in H1FY20. **In the long term, we expect NIMs to moderate with a shift in the product portfolio and range between 9.5-10.5%over the medium term.**

Asset quality to continue to remain strong

Despite lending to the unsecured microfinance segment, where risk of default is significantly high in case of an inadvertent event, as evident during demonetization, UJSFB has been successful in maintaining its asset quality and credit cost at sub 1% levels.

Exhibit 26: Asset Quality Trend

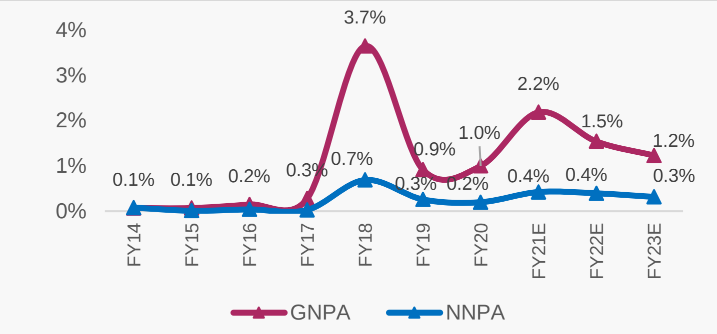
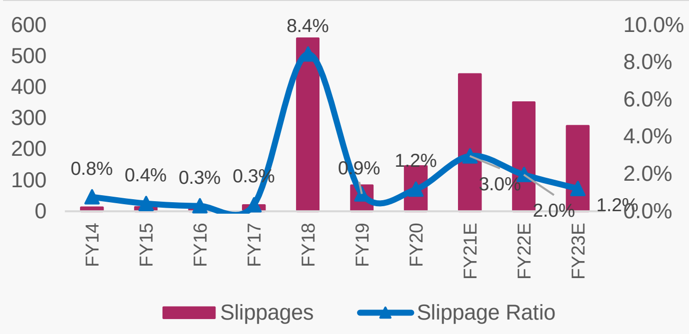


Exhibit 27: Slippages Trend



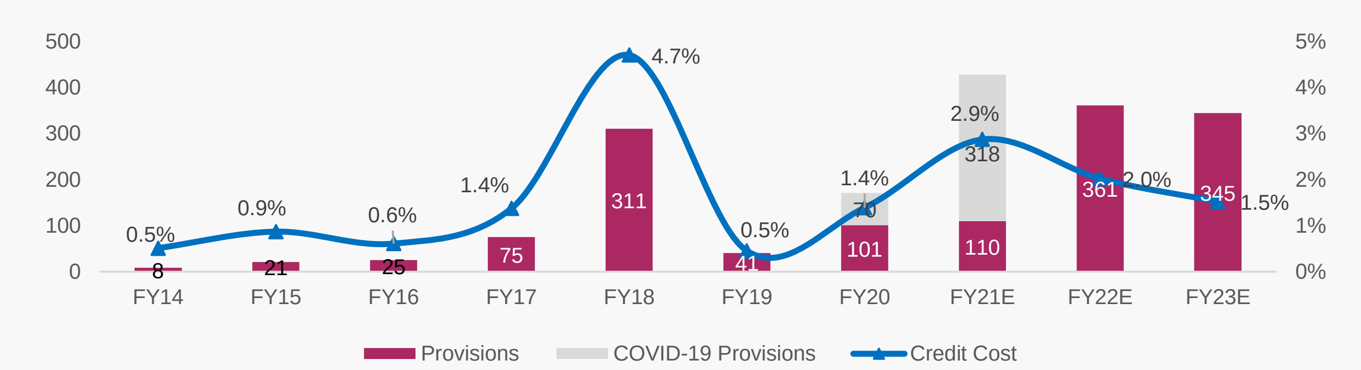
Source: RBI, Company, Axis Securities

An important aspect in maintaining asset quality is the bank's persistent focus on collections. The bank has a strong collection and recovery team and has separate collection teams for each of its business verticals. The credit team evaluates business needs, cash-flow based income generation capabilities of the borrower and the secondary source of income in case of a microfinance borrower and analyses the borrower's ability to repay the loan. Stringent credit screens have helped UJSFB contain GNPAs at sub-1% (except during demonetization).

With a large portion of the loan book being group microfinance loans, the collections are done on a monthly basis. The JLG lending format assures a collective liability of the group and a peer pressure to repay on time. The bank has over the years observed that in case of default by a group member, the other members of the group pitch in to pay for a period of 3 months. From the past trends, the cycle generally tends to normalise from the 4th month onwards, with the defaulting member beginning to pay.

The continuing emphasis on asset quality and collections has helped UJSFB contain slippages over the years with slippage ratio maintained below 1% except during demonetization. However, with COVID-19 and the lockdown impacting the economic activities of borrowers across segments, with some segments being more vulnerable than those which cater to the essential or day-to-day activities, slippages are likely to be elevated now that the moratorium has ended.

Exhibit 28: Credit Cost Trend



Source: Company, Axis Securities

UJSFB has been successful in containing its credit costs below 1% on the back of robust and comprehensive credit and risk management framework to identify, monitor and manage risks, despite catering to the unsecured microfinance borrowers. Credit costs during FY20 were higher as the company made a provision of Rs. 70 Cr towards the impact of COVID-19 in Q4FY20. The bank has also provided an additional amount of Rs. 129 Cr in Q1FY21 and Rs. 100 Cr in Q2FY21 towards COVID-19 taking the aggregate provision to Rs. 299 Cr which is ~3.4% of the Gross Advances. Higher provisions for impact of COVID-19 has resulted in a sharp uptick in credit costs. FY21E credit costs are expected to escalate to 2.9% from 1.4% in FY20, especially with microfinance forming a major part of the portfolio.

Previous experience of tackling asset quality stress

During demonetization, UJSFB witnessed credit costs and GNPAs skyrocket to 4.5%/3.7% in FY18 respectively. The bank saw a sharp increase in the delinquency levels (PAR>0 of 9.9% at the end of Mar'17). With a view to reduce the delinquency levels, UJSFB (then Ujjivan Financial Services) categorized branches between those which were affected and not affected. UFSL picked branches with a PAR of 5%+ and the entire focus of these branches was on collection and recovery.

Proactive steps such as ramp-up of cash-less disbursements and cautiously curating the proportion of fresh and repeat microfinance disbursements helped the bank tide through those tough times. We believe that the bank's highly diversified microfinance portfolio with no state accounting for more than ~16% of the overall portfolio was also a factor which helped UJSFB minimize any asset quality risks which were more local in nature in the microfinance business.

COVID-19 related disruptions to be a drag on FY21E asset quality

The bank had offered moratorium to all customers and at the end of May'20, ~80% of the total book had opted for moratorium, with almost ~86% of the microfinance book opting for moratorium. With the partial easing of the lockdown and businesses picking-up pack gradually in June'20, the bank saw encouraging trends with borrowers coming ahead to repay. The bank saw a significant improvement in the moratorium book by value at to ~47%.

To improve collections, the bank turned towards increasing use of digital payment modes such as Airtel Digital Payment Bank along with emphasis on EMI payment through online payment platforms like ECS, e-wallets, UPI/ QR etc. On the back of focused efforts to improve collections, UJSFB has seen an improvement from 5% in April'20 to 59% in June'20 and furthermore to 88% in Oct'20 (93% incl arrears). Significant improvement is visible in the microfinance book too. This was on the back of the bank's focus on going slow on growth and entirely concentrating on collections and ramping up the collections team. As ground level complexities continue to pose challenge to conduct centre meetings at few locations, UJSFB has strengthened its collection team and has added personnel from other businesses to collection team.

Exhibit 29: Moratorium Book improvement trend (as at the end of June'20)

	March'20			May'20			June'20		
	Loan Book	Morat book (value)	Morat book %	Loan Book	Morat book (value)	Morat book %	Loan Book	Morat book (value)	Morat book %
Micro Finance	10,933	828	*7.6%*	10,874	9,331	*85.8%*	11,150	5,581	*50.1%*
MSE	980	74	*7.6%*	988	730	*73.9%*	1001	455	*45.5%*
Affordable Housing	1,524	76	*5.0%*	1,533	1027	*67.0%*	1,549	708	*45.7%*
Personal Loan	79	5	*6.3%*	78	47	*60.3%*	77	49	*63.6%*
Vehicle Loan	13	0	*0.0%*	13	10	*76.9%*	14	5	*35.7%*
FIG Lending	549	0	*0.0%*	553	115	*20.8%*	523	7	*1.3%*
Others	74	1	*1.4%*	66	1	*1.5%*	52	0	*0.0%*
Total	**14,152**	**984**	***7.0%***	**14,105**	**11,261**	***79.8%***	**14,366**	**6,805**	***47.4%***

Source: Company, Axis Securities

Exhibit 30: Some states yet to reach average collection efficiency

	Maharashtra	West Bengal	Assam	Punjab
Total MFI Portfolio	Rs. 814	Rs. 1570	Rs. 385	Rs. 360
Collection Efficiency	71/79%	74/78%	70/74%	78/83%
Reason for Low Collections	✓ Severe COVID situation ✓ Localized Political Intervention	✓ Protests over Loan Waiver ✓ Lockdown ✓ Unavailability of transportation	✓ Rains & Floods, Impact of protest ✓ Rumors of Loan Waiver	✓ Protests over farm bills by political parties

Source: Company, Axis Securities

Collection efficiency for UJSFB is slightly lower than the average of its peers, mainly as a major part of the book is 'Urban + Metro' areas where lockdowns were more stringent and more frequent due to higher infection cases. Hence the movement of on-field collection teams had been hampered and restricted resulting in lower collection efficiency. Secondly, the customer base mainly comprises of self-employed borrowers who were more impacted due to businesses being non operational during the lockdown and are still operating at a capacity below pre-COVID levels. It was observed that 91% of the customers started paying post the moratorium ended in Aug'20.

Exhibit 31: Collection Efficiency improvement trend (segment-wise)

	March'20	Apr'20	May'20	June'20	July'20	Aug'20	Sep'20	Oct'20
Micro Finance	*93%*	*2%*	*14%*	*53%*	*60%*	*68%*	*83%*	*88%*
MSE	*82%*	*19%*	*17%*	*46%*	*64%*	*64%*	*81%*	*86%*
Affordable Housing	*94%*	*32%*	*33%*	*52%*	*67%*	*71%*	*92%*	*93%*
Personal Loan	*91%*	*44%*	*38%*	*62%*	*62%*	*62%*	*79%*	*88%*
Vehicle Loan	*95%*	*33%*	*23%*	*67%*	*72%*	*68%*	*92%*	*91%*
FIG Lending	*100%*	*77%*	*67%*	*86%*	*100%*	*100%*	*100%*	*100%*
Total	***93%***	***5%***	***16%***	***54%***	***61%***	***69%***	***84%***	***88%***

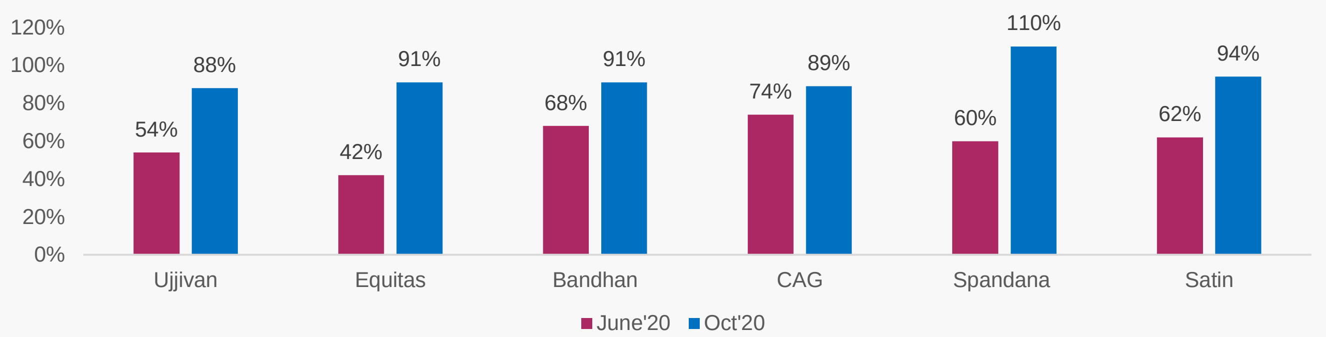
Source: Company, Axis Securities

Microfinance Collection and Moratorium trends

Given the high touch nature of microfinance lending, it was expected that the collections in this business would be impacted to a larger extent on account of COVID-19 related disruptions, as was the case. However, we believe that the bank has done a reasonably good job with the collections by introducing multiple and flexible alternate collection channels to combat the problem rather than persisting with the traditional cash-collection system. UJSFB has seen borrowers opt for these channels as the digital collections increased from a negligible 1% of total collections in Q4FY20 to 16% at the end of Q1FY21 and further to 28% at the end of Q2FY21.

Given that a large portion (~50+%) of the borrowers are engaged in the activities involving essential services or non-discretionary activities, we believe that the microfinance book would fare well and collections would improve going ahead as activities reach pre-COVID levels. The bank has further tightened credit policies to avoid any undue risk and rejection rates have been higher than historical levels. This is reflected in 99.5%+ collection for loans disbursed in H1FY21.

Exhibit 32: Microfinance Collection Trend vs Peers



Source: Company, Axis Securities***Note***: Collection Efficiency for Equitas & Bandhan represent MF book collections; CE for Satin is for Sep'20

Non-Microfinance Collection and Moratorium trends

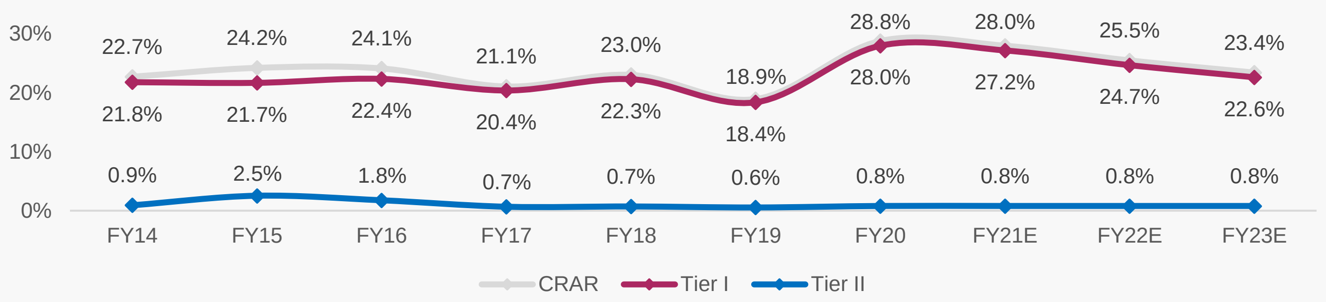
On the affordable housing and SME business the management indicated that the collections in Q1FY21 were lower as the borrowers wanted to conserve their liquidity and not due to cash-flow constraints. However, post the end of the moratorium period, collections in these segments has improved significantly from 57%/53% in June'20 to 86%/93% at the end of Oct'20.

With some parts of the country still seeing surge in COVID-19 cases and lockdown extended by certain state governments, few businesses are either yet to re-start or to reach pre-COVID capacities. As a result, we may see some pressure on asset quality in the near term. Given the strong collection mechanism of the bank where the bank has product specific collection teams along with its effort to further strengthen the team, we expect asset quality to improve as the macro-economic conditions improve.

Well capitalised to support growth without dilution

Currently, UJSFB has a healthy CRAR of 28.7% and a Tier 1 ratio of 27.8%, comfortable above regulatory requirements. The funds raised during the IPO in Dec'19 helped the bank further strengthen its capital position. We do not foresee UJSFB in need to raise Tier 1 capital over the medium term, as growth would be tepid on the back of COVID-19. We also expect that the current Tier I ratio is sufficient to handle any credit related shocks that may arise on the back of COVID-19.

Exhibit 33: IPO proceeds further strengthen capital position

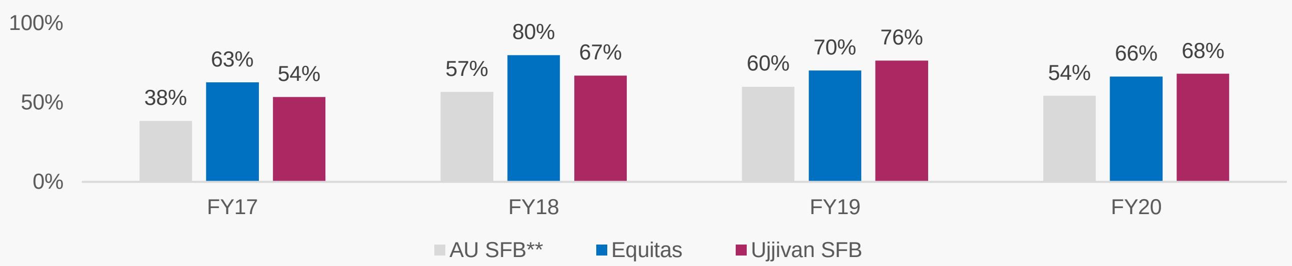


Source: Company, Axis Securities

Opex moderation to drive ROA improvement

Transition into a bank resulted in the bank adding branches (rural branches) in a phased manner, increasing the employee base and investment in technology. This collectively resulted in a quantum jump in opex and drag on the ROA. The opex to assets ratio escalated from 6.4% in FY17 to 8.6% in FY19. We believe, that the management's focus on technology based banking services and customer acquisition coupled with plan to add only a few branches in the medium term should be the key driver in cost moderation.

Exhibit 34: C-I Ratio Trend vs Peers in SFB transition phase



Source: Company, Axis Securities***Note –** *AUJSFB'sFY17 C-I Ratio is adjusted for one-time gain on sale of stake in Avaas Financiers*

The management had earlier guided to reduce the cost-income ratio by 500bps every year and C-I ratio would stand at 55% by the end of FY23E. Due to lower business volumes in Q1FY21 owing to the lockdown, UJSFB's cost to income ratio witnessed a sharp decline to 55.9% vs 64.4% in Q1FY20 and remained stable at 56.6% at the end of Q2FY21. However, we believe that this level of C-I Ratio would not be sustainable. As the business activity picks-up C-I ratio would increase, though it would be significantly lower than FY20. We expect C-I Ratio to improve to 64.1% by FY23E vs 67.4% in FY20.

Exhibit 35: Dupont Analysis

	As a NBFC			SFB Transition phase		On a steady state basis				
	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21E	FY22E	FY23E
NII	8.7%	9.2%	10.5%	9.6%	9.6%	9.5%	10.2%	9.9%	9.4%	9.2%
Other Income	1.5%	2.0%	2.0%	2.4%	1.2%	1.8%	2.0%	1.3%	1.5%	1.6%
Total Income	10.2%	11.2%	12.5%	12.0%	10.9%	11.3%	12.2%	11.2%	11.0%	10.8%
Opex	5.8%	6.8%	6.3%	6.4%	7.3%	8.6%	8.2%	6.8%	7.0%	6.9%
PPP	4.4%	4.5%	6.1%	5.6%	3.6%	2.7%	4.0%	4.4%	3.9%	3.9%
Provisions	0.4%	0.7%	0.5%	1.1%	3.5%	0.3%	1.1%	2.2%	1.5%	1.2%
PBT	4.0%	3.8%	5.6%	4.5%	0.1%	2.3%	2.9%	2.2%	2.4%	2.7%
Tax Rate	34%	34%	35%	35%	22%	26%	25%	25%	25%	25%
ROA	2.6%	2.5%	3.7%	2.9%	0.1%	1.7%	2.2%	1.7%	1.8%	2.0%
Leverage	5.6	4.1	4.1	4.0	6.2	7.6	7.0	6.3	6.8	7.3
ROE	14.8%	10.3%	14.8%	11.8%	0.5%	13.0%	15.3%	10.7%	12.2%	14.8%

Source: Company, Axis Securities

Exhibit 36: Cost-Income & Cost-Assets have peaked out

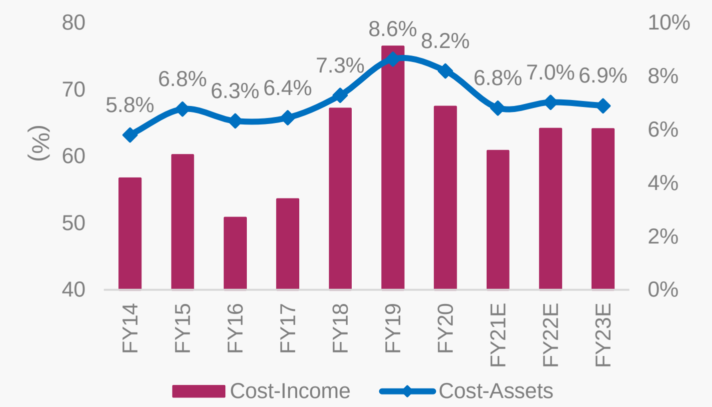
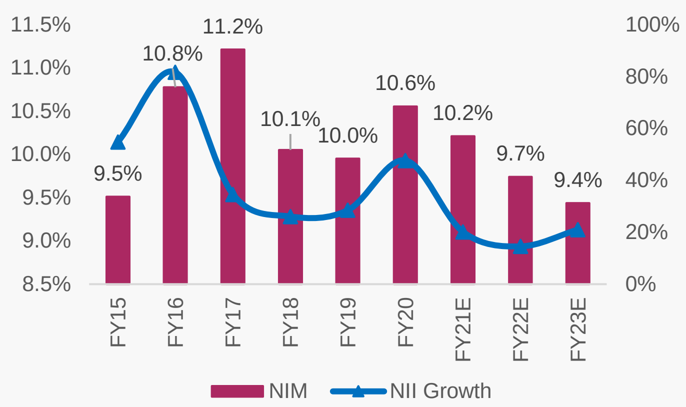


Exhibit 37: NIM contraction with shift towards secured products



Source: Company, Axis Securities

Exhibit 38: Cost moderation to drive ROA

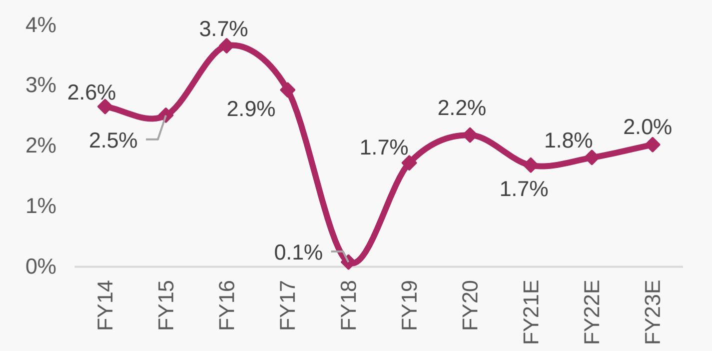


Exhibit 39: Improving RoE trend

Source: Company, Axis Securities

Key Risk Factors

Compliance with Regulatory requirements remains a major overhang

As per 2014 RBI guidelines, the promoter entity of a SFB is required to reduce its shareholding in the bank to 40% within a period of five years from the date of commencement of business operations as an SFB (by Jan 2022), which was February 1, 2017, and thereafter required to reduce its shareholding in the bank to 30% and 26% within a period of 10 years (Jan 2027) and 12 years (Jan 2032), respectively, from the date of commencement of SFB operations. The IPO resulted in dilution of stake of the promoter Ujjivan Financial Services to ~83.3%.

Thus to comply with the guidelines, UJSFB will witness a regular dilution of stake impacting the return ratios of the bank. The options available to the bank to reduce its stake to meet the regulatory guideline are:

- UJSFB could look for a merger with/acquisition of another lending entity – SFB/NBFC/NBFC-MFI.
- If such merger/acquisition is not able to bring down the stake to regulatory required levels, UJSFB could also explore the option of OFS
- The bank is also keen on exploring the option of a reverse merger with UFSL, subject to approval from the RBI

This concern has been addressed by the recently released RBI IWG draft report. However, if the harmonisation of the 2014 and 2019 guidelines for SFBs does not go through, the compliance with the RBI regulatory requirement will continue to be a cause of concern for the bank.

Continuing impact of COVID-19

With COVID-19 and the subsequent lockdown significantly impacting the H1FY21 performance of the bank and business gradually limping back to normalcy, the continuing impact of COVID-19 would impact the credit growth and also the revenue generation from processing fees and documentation chargesof the bank.

The moratorium granted to RBI, was given to 100% of the MFI customers. MFI being an unsecured lending product has an inherent risk of higher default. Restrictions on mobility of the collection/recovery teams along with businesses being impacted of the borrowers, could also result in lower collection efficiencies, especially in the urban and metro areas which have witnessed more stringent and extended lockdowns. This is evident from the data that Maharashtra which is one of the worst impacted states has seen the lowest collection efficiency and still has a higher book moratorium. The bank has been facing challenges in the collection from the state of Punjab, Assam and West Bengal too. The bank thus remains at a risk of seeing higher NPAs due to possible deterioration in the credit quality of its customers.

Higher exposure to informal sector

UJSFB primarily caters to the microfinance customers from the low and middle-income individuals and businesses in the metro and urban areas that have limited or no access to formal banking and finance channels. The cash flows of these borrowers are dependent on the smooth functioning of their businesses. Any disruptive situation such as COVID-19 would impact business continuity and is likely to trigger higher NPAs.

Peer Review

UJSFB's direct peers include Bandhan Bank, AU SFB, Equitas SFB. We have also reviewed UJSFB against prominent listed MFI and SME players namely CreditAccess Grameen, Spandana Sphoorty and Shriram City Union.

Exhibit 40: Peer Valuation Matrix

FY20	ROA (%)				ROE (%)				P/E (x)	P/ABV (x)
	FY20	FY21E	FY22E	FY23E	FY20	FY21E	FY22E	FY23E	FY23E	FY23E
Small Banks										
Equitas SFB	1.4%	0.3%	0.5%	0.7%	9.7%	2.4%	11.0%	15.1%	17.2	1.0
AU SFB	1.8%	1.4%	1.6%	1.8%	17.9%	13.5%	15.8%	19.4%	39.9	4.0
Bandhan Bank	3.6%	2.7%	3.3%	3.5%	21.1%	15.3%	19.5%	20.3%	19.8	2.5
Average	***2.3%***	***1.5%***	***1.8%***	***2.0%***	***16.2%***	***10.4%***	***15.4%***	***18.3%***	***25.6***	***2.5***
NBFCs - MFI and SME										
Spandana	6.3%	6.0%	6.7%	6.8%	15.6%	13.1%	17.0%	17.5%	14.3	1.2
CreditAccess	3.6%	2.4%	4.1%	4.5%	12.9%	10.9%	18.7%	19.7%	35.0	2.6
SCUF	3.3%	2.4%	3.1%	3.7%	14.7%	10.0%	12.1%	13.3%	5.8	0.7
Average	***4.4%***	***3.6%***	***4.6%***	***5.0%***	***14.4%***	***11.3%***	***15.9%***	***16.8%***	***18.4***	***1.5***
Ujjivan SFB	**2.2%**	**1.7%**	**1.8%**	**2.0%**	**15.3%**	**10.7%**	**12.2%**	**14.8%**	**11.0**	**1.5**

Source: Bloomberg, Company, Axis Securities

Exhibit 41: Peer Group Review – Operational Parameters (FY20)

FY20	Loan Book	CASA %	NIM %	C-I Ratio %	GNPA %	NNPA %	Loan CAGR FY20-23E	PAT CAGR FY20-23E
Small Banks								
Equitas SFB	15,367	20.5%	9.1%	66.4%	2.7%	1.7%	20.5%	34.8%
AU SFB	30,893	14.5%	5.4%	54.2%	1.7%	0.8%	15.1%	21.7%
Bandhan Bank	71,846	36.8%	8.1%	30.8%	1.5%	0.6%	24.0%	19.1%
Average	***39,369***	***23.9%***	***7.5%***	***50.5%***	***2.0%***	***1.0%***	***19.9%***	***25.2%***
NBFCs - MFI and SME								
Spandana	6,829	N.A	16.6%	19.9%	0.4%	0.1%	24.9%	15.4%
CreditAccess	11,996	N.A	12.1%	36.6%	1.6%	0.0%	27.7%	36.1%
SCUF	29,085	N.A	12.8%	40.3%	7.9%	4.2%	11.5%	7.0%
Average	***15,970***	***N.A***	***13.8%***	***32.3%***	***3.3%***	***1.4%***	***21.4%***	***19.5%***
Ujjivan SFB	**14,153**	**13.5%**	**10.8%**	**67.4%**	**1.0%**	**0.2%**	**21.7%**	**19.6%**

Source: Bloomberg, Company, Axis Securities

Valuation and Recommendation

UJSFB which started as a pure play micro finance player, later diversified into SME and Affordable housing lending in an attempt to de-risk the portfolio as it transitioned into a SFB. As the bank continued to diversify its portfolio towards low yielding secured products as a SFB, NIMs took a hit. With a view to build a strong liability franchise, UJSFB incurred higher opex with heavy investments in technology, opening of additional branches and additional hiring costs. However, this transition paved the way for the bank access to low cost CASA and term deposits, which partially off-set the drop in NIMs.

The bank has been successful in managing its asset quality and credit costs at sub-1% levels until the disruption caused due to demonetization. However, the bank was quick to bounce back to near normalcy despite its customer profile on the back of a robust underwriting capabilities and robust risk management framework

With near term stress visible on the back of COVID-19, we expect the bank to slow down on growth, with AUM growth at 12% YoY. After a tepid growth in FY21E, we could witness growth picking up FY22E onwards especially in the SME and Affordable housing segments. With moratorium period offered to its customers ending and collections yet to reach normalcy, we expect the vulnerable part of book to slip resulting in higher NPAs and expect GNPAs to escalate to 2.2% in FY21E. COVID-19 related provisions would result in elevated credit costs in FY21E of 2.9%.

With visible improvement in asset quality in the medium term given the efficient collection mechanism, moderation in opex and credit cost, we expect ROA/ROE to improve to 2%/14.8% in FY23E from 1.7%/10.7% in FY21E and further improve in the long term. **We value UJSFB at 1.9x FY23E P/ABV basis on the back of robust collection and underwriting mechanism, efficient risk management capabilities, visibility of long runway for sustainable growth and an experienced and competent management and leadership team. We initiate coverage with a 'BUY' rating with a target price of Rs. 47, implying a 24% upside from the CMP.**

Exhibit 42: UJSFB - 1-Yr Fwd P/ABV Band

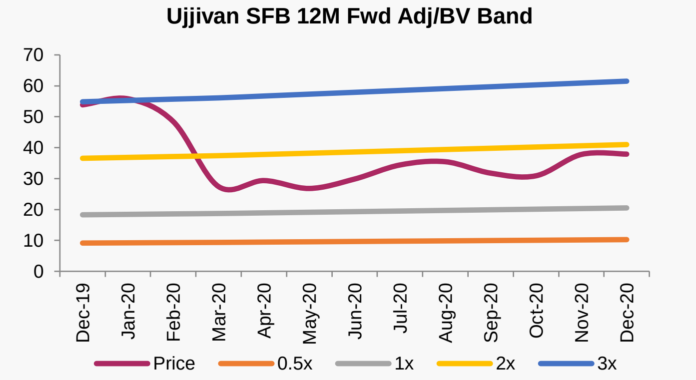
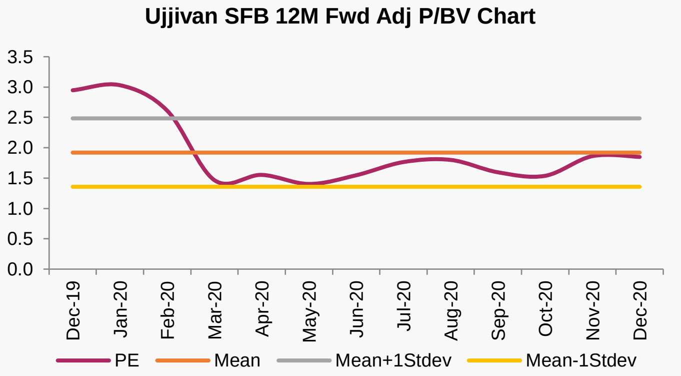


Exhibit 43: UJSFB - 1Yr Fwd P/ABV Chart



Source: Company, Axis Securities

Financials (Standalone)

Profit & Loss (Rs Cr)

Y/E March	FY19	FY20	FY21E	FY22E	FY23E
Interest Income	1,832	2,704	3,159	3,644	4,481
Interest Expenses	725	1,070	1,196	1,396	1,761
Net Interest Income	**1,106**	**1,634**	**1,963**	**2,248**	**2,720**
Change	*29%*	*48%*	*20%*	*15%*	*21%*
Non-Interest Income	206	322	267	361	466
Total Income	**1,312**	**1,956**	**2,229**	**2,609**	**3,186**
Change	*35%*	*49%*	*14%*	*17%*	*22%*
Operating Expenses	1,003	1,319	1,355	1,673	2,042
Change	*54%*	*31%*	*3%*	*23%*	*22%*
Pre-Provision Profits	**309**	**637**	**874**	**936**	**1,144**
Change	*-3%*	*106%*	*37%*	*7%*	*22%*
Provisions	41	171	428	361	345
Change	*-87%*	*321%*	*150%*	*-16%*	*-5%*
PBT	**268**	**466**	**446**	**574**	**799**
Tax	69	116	112	145	201
Profit After Tax	**199**	**350**	**334**	**430**	**598**
Change	*2803%*	*76%*	*-5%*	*29%*	*39%*

Source: Company, Axis Securities

Balance Sheet (Rs Cr)

Y/E March	FY19	FY20	FY21E	FY22E	FY23E
Equity Share Capital	1,440	1,728	1,728	1,728	1,728
ESOPs	-	21	21	21	21
Preference Share Capital	200	200	200	200	200
Reserves & Surplus	180	1,238	1,572	2,001	2,599
Net Worth	**1,620**	**2,966**	**3,300**	**3,730**	**4,328**
Deposits	7,379	10,780	12,852	17,766	23,935
Change	*96%*	*46%*	*19%*	*38%*	*35%*
Borrowings	4,166	3,953	4,453	3,853	3,603
Other Liabilities	377	490	540	690	865
Total Liabilities	**13,742**	**18,411**	**21,367**	**26,260**	**32,952**
Cash & Bank balances	1,094	1,343	1,332	1,259	1,595
Investments	1,527	2,396	3,602	4,269	5,272
Loans	10,552	14,044	15,724	19,974	25,287
Change	*44%*	*33%*	*12%*	*27%*	*27%*
Fixed Assets & Others	569	628	708	758	798
Total Assets	**13,742**	**18,411**	**21,367**	**26,260**	**32,952**

Source: Company, Axis Securities

Ratio Analysis (%)

Y/E March	FY19	FY20	FY21E	FY22E	FY23E
Asset Quality					
GNPA	98	137	336	301	304
NNPA	28	27	65	77	78
GNPA Ratio	0.9%	1.0%	2.1%	1.5%	1.2%
NNPA Ratio	0.3%	0.2%	0.4%	0.4%	0.3%
PCR	72%	80%	81%	74%	74%
Spread Analysis					
Yield on Interest Earning Assets	17.0%	18.0%	17.0%	16.3%	16.1%
Cost of Borrowings	8.6%	8.2%	7.5%	7.2%	7.2%
Spread	8.4%	9.8%	9.5%	9.1%	8.8%
Net Interest Margin	10.0%	10.6%	10.2%	9.7%	9.4%
Profitability & Efficiency Ratios					
RoE	13.0%	15.3%	10.7%	12.2%	14.8%
RoA	1.72%	2.18%	1.68%	1.80%	2.02%
Cost to Income	76.5%	67.4%	60.8%	64.1%	64.1%
CASA	10.6%	13.5%	17.3%	18.1%	19.0%
CAR	18.9%	28.8%	28.0%	25.5%	23.4%
Tier 1	18.4%	28.0%	27.2%	24.7%	22.6%
Valuation					
BVPS	11.2	17.2	19.1	21.6	25.0
Change	*12%*	*53%*	*11%*	*13%*	*16%*
Price-BV (x)	2.9	1.9	1.7	1.5	1.3
Adj. BVPS	11.1	17.0	18.7	21.1	24.6
Change	*14%*	*54%*	*10%*	*13%*	*16%*
Price-ABV (x)	2.9	1.9	1.7	1.5	1.3
EPS	1.4	2.0	1.9	2.5	3.5
Change	*2803%*	*46%*	*-5%*	*29%*	*39%*
Price-Earnings (x)	23.5	16.1	16.8	13.1	9.4
Dividend Per Share	-	-	-	-	-
Dividend Yield (%)	-	-	-	-	-

Source: Company, Axis Securities

About the analyst

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