

Profitable, efficient and balanced growth

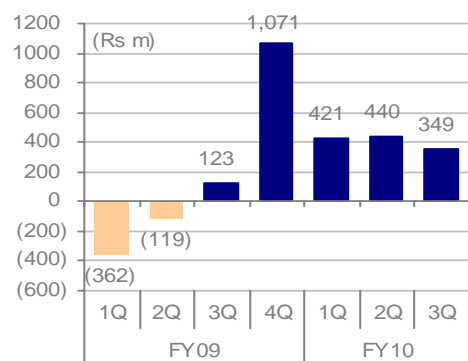
Bajaj FinServ is positioning itself as a full-suite financial services company, with its portfolio including life and general insurance, consumer finance, financial advisory, and soon, asset management. In each business, it has pursued growth without compromising on profitability. With the life insurance business expected to turn profitable this year, all businesses will be profitable, providing a major fillip to the company's consolidated profits. We believe Bajaj FinServ is set for steady long-term growth in the financial services space. We reiterate BUY.

Life insurance business has turned profitable: In the last few years, Bajaj FinServ has pursued profitable and cost-effective growth. Its APE market share declined from 19.9% in FY08 to 11% in January 2010, owing to a conscious strategy to focus on productivity and profitability. It returned a small net profit in 9mFY10, and is expected to generate meaningful profit of over Rs2bn for FY10. The life insurance business has not needed new capital infusion for the past two years, and may not need any in the foreseeable future.

Profit outlook up for all businesses: Over the next few years, both life and general insurance businesses are expected to grow at 12-15% in GWP terms, in line with industry trends. The general insurance business has been profitable since inception, and we expect the life insurance business to be significantly profitable going forward. Bajaj Auto Finance's (BAF) disbursements have picked up significantly over the last 2-3 quarters, and we expect the loan book to reach Rs43bn in FY2010 and Rs65bn-70bn in FY2011. BAF's net profit was up 240% YoY to Rs642m in 9mFY10.

43% upside to our fair value target: Call options with Allianz allow it to raise its stake in life insurance to 74% by 2016, regulations permitting. A hike in Allianz's stake to 49% looks very likely and would occur in the near future. However, if Allianz is not able to raise its stake to 74% because of the cap on foreign holding, Bajaj will end up with a 51% stake in the life business, effectively raising our fair value target by 43% to Rs582.

Consolidated PAT trend



Source: Company, IIFL Research

Sum-of-the-parts valuation – FY11ii

Business	Basis	Rs bn	Multiple (x)	Stake (%)	Value of stake (Rs bn)	% in total	Value / share (Rs)
Bajaj Allianz Life Insurance	EV+	105	12.0	26.0	27	46.5	189
	NBAP						
Bajaj Allianz General Insurance	PAT	1	20.0	50.0	12	21.0	85
Bajaj Auto Finance	BV	13	1.50	42.0	8	13.7	56
Investments	Cost	8	0.9	100.0	8	12.9	53
NPV of 48% stake sale in BALIC to Allianz					2	3.5	14
NPV of 24% stake sale in BAGIC to Allianz					1	2.4	10
Total					59	100.0	407

Source: IIFL Research

12-mth Target price (Rs) 407 (28%)

Market cap (US\$ m)	1,059
52Wk High/Low (Rs)	446/142
Diluted o/s shares (m)	145
Daily volume (US\$ m)	1.3
Dividend yield FY10ii (%)	0.0
Free float (%)	45.6

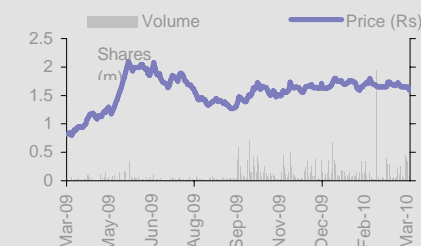
Shareholding pattern (%)

Promoter	54.4
FII	9.8
Domestic MF/Insurance	7.7
Others	28.1

Price performance (%)

	1M	3M	1Y
Bajaj FinServ	-3.7	-2.2	109.5
Rel. to Sensex	-10.9	-6.5	15.3
Max India	4.5	-9.2	99.5
ABNL	5.5	-0.2	117.1
Reliance Capital	6.2	-5.0	148.8

Stock movement



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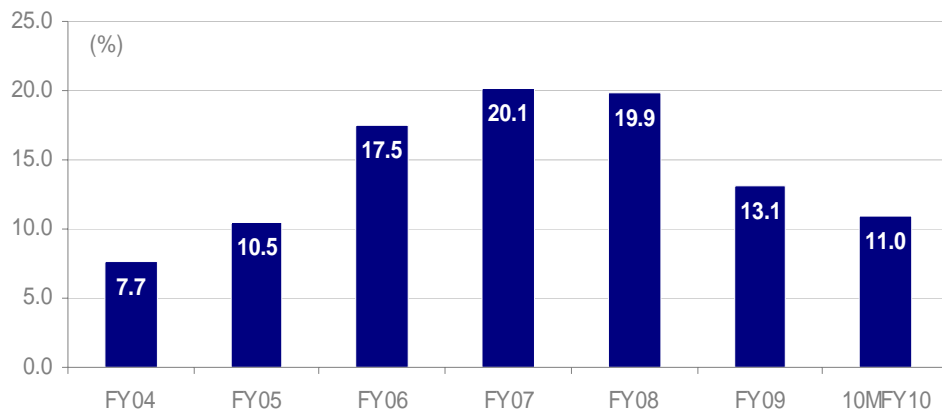
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Life insurance turns profitable: In the last few years, Bajaj Allianz Life Insurance Company (BALIC) has pursued profitable and cost-effective growth. The company’s APE market share declined in the last two years—from 19.9% as at end-FY08 to 11% in January 2010—a fallout of the company’s strategy to focus on productivity and profitability through change in product profile and cost-cutting initiatives. As a result, BALIC reported a net profit of Rs130m over 9MFY10, compared to a loss of Rs2.1bn in FY08. We expect it to generate meaningful profit of over Rs2bn for FY10.

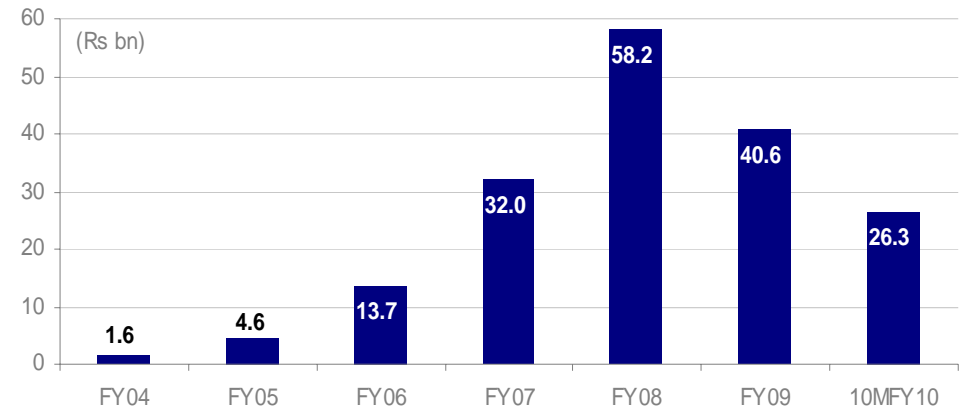
BALIC is among a small group of private life-insurance companies that have turned profitable. The life-insurance company has paid-up capital base of Rs12bn and cumulative losses of Rs9bn. We believe the company will be able to wipe out much of its cumulative losses by the end of next year. In keeping with its renewed focus on profitability, no new capital has been infused into the business since the beginning of FY09. The life-insurance business benefits from a balanced product mix and has a low share of group insurance products.

Figure 1: BALIC APE market share – declining owing to deliberate strategy



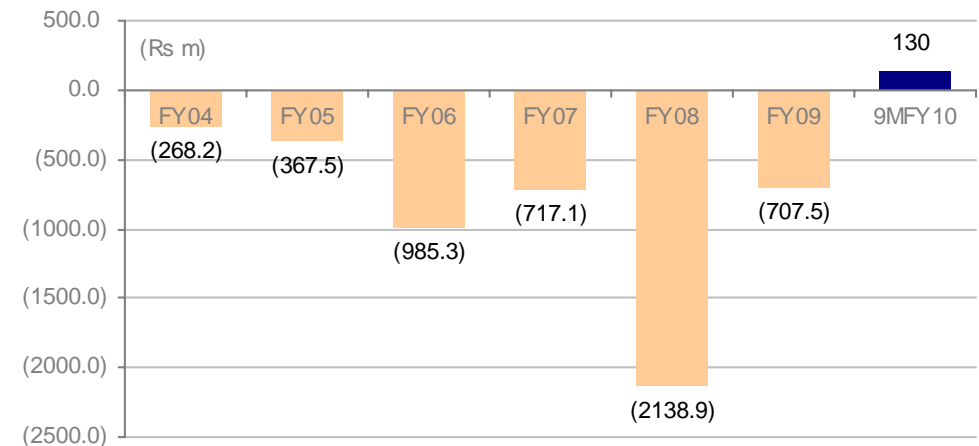
Source: IRDA, IIFL Research

Figure 2: BALIC APE – going slow on new business



Source: IRDA, IIFL Research

Figure 3: BALIC PAT – we expect FY10 PAT to be over Rs2bn

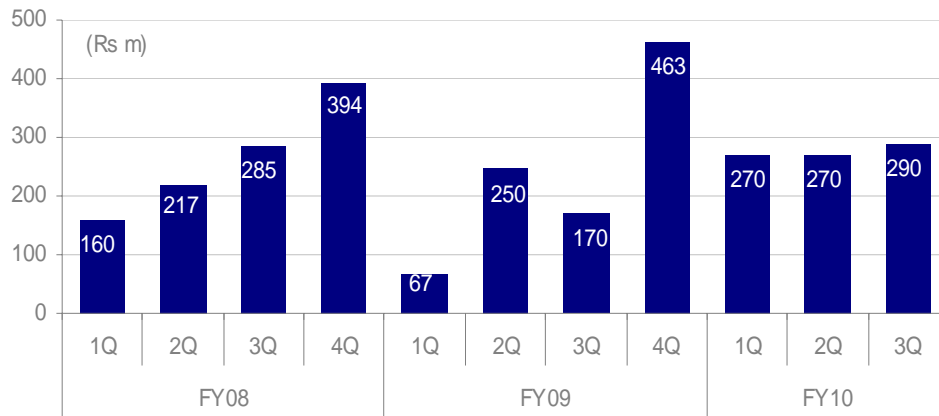


Source: Company, IIFL Research

General insurance market share stable: Bajaj Allianz General Insurance Company (BAGIC) is the second-largest private general insurer in India, with 8.6% industry market share (in FY09). The company has prudently selected businesses and risks, as reflected in both its market share gains and consistent track record of profits since inception. The company continues to concentrate on preserving profitability while trying to maintain market share.

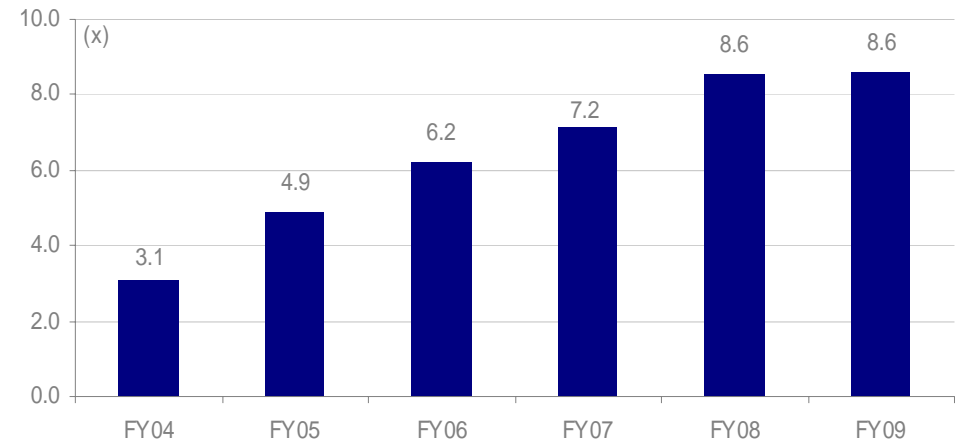
Motor and retail to drive general insurance growth: Management expects the retail business to continue to drive growth through motor and health insurance. The focus remains on selling individual health policies while cutting the number of group-health policies sold, as the latter tend to have wafer-thin margins.

Figure 4: BAGIC quarterly profit trend – has been profitable since inception



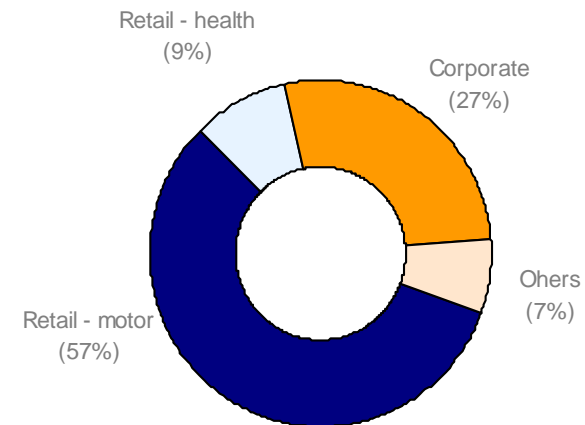
Source: Company, IIFL Research

Figure 5: BAGIC market share – has been steady at 8.6%



Source: IRDA, IIFL Research

Figure 6: General insurance business mix over 9MFY10

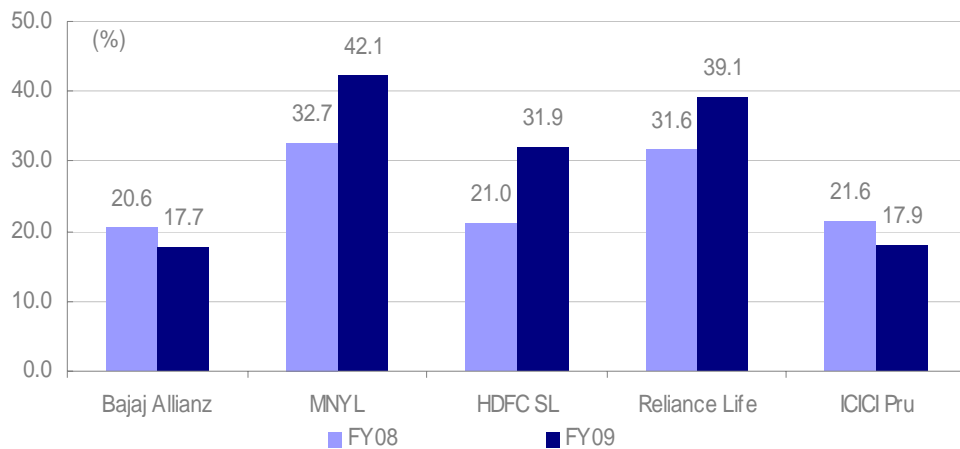


Source: Company, IIFL Research

Superior operating efficiency: Bajaj FinServ’s efficiency ratios in both life and general-insurance business are better than those of its peers. The company expects cost efficiencies to improve further, thanks to a sustained focus on rationalising commissions, branches and overheads. Lower advertising expenses, greater share of non-urban branches and headquarters in Pune (as opposed to high-cost cities such as Mumbai or Delhi) have been crucial in managing costs.

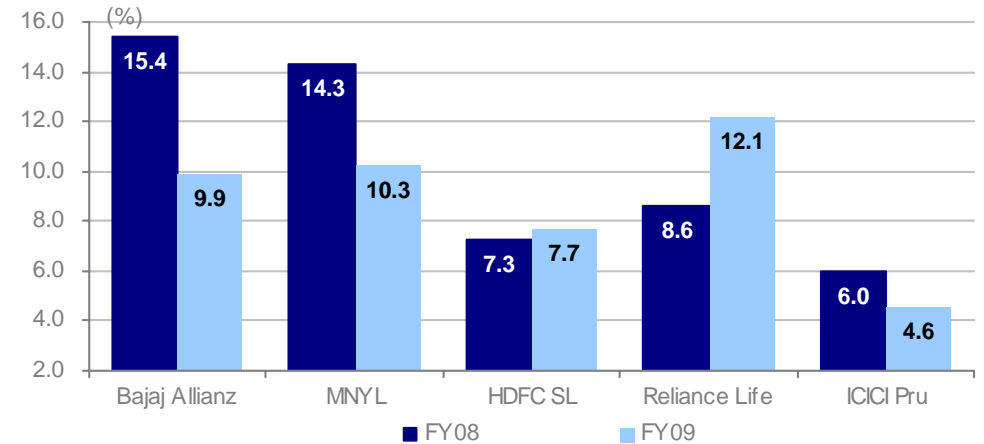
Wide geographical reach: Bajaj FinServ’s life-insurance business sells 60-65% of its policies in locations outside the top-20 cities in India. In these locations, the company has benefited from less competition and better branch operating costs. BALIC has 1,151 branches in 650 locations. The company did most of its distribution network expansion in 2005-06, when establishment costs were relatively low. It is now present in most Tier-III centres. Any expansion beyond this would be to tap the rural customer base. For this, offices in Tier-III centres could be used as bases and sales force could be deployed to cater to rural areas.

Figure 7: Opex ratio for private life-insurance players – has been one of the best among large private players



Source: IRDA, IIFL Research

Figure 8: Commission ratio for private life insurance players – Bajaj Allianz has seen robust sequential improvement



Source: IRDA, IIFL Research

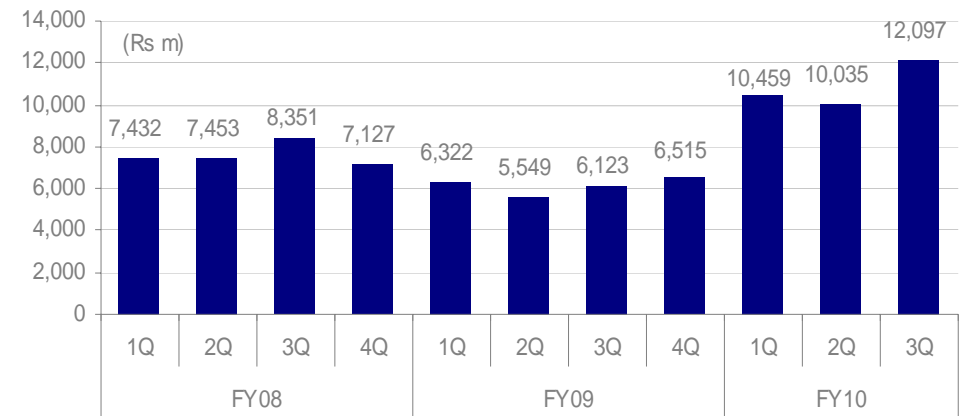
Auto finance: BAF finances about 20-30% of vehicles sold by Bajaj Auto. Dealings with Bajaj Auto are on an arm’s-length basis, and the company provides the same interest rate subvention to BAF as it does to other financiers. The auto-finance business operates from 320 locations across 261 cities and towns.

Consumer finance: In FY08, about half of the loan book was towards consumer finance, including finance for consumer durables, business loans (including SME), loans against property and promoter financing. Since then, the company has made a concerted effort towards increasing the share of consumer finance, and it accounted for about 70% of incremental disbursements this year.

Robust growth over 9MFY10: Disbursements at Bajaj Auto Finance grew 81% YoY over 9MFY10. The increase in disbursements has been driven by consumer finance, with mortgages accounting for 22% of disbursements during 3QFY10. Management expects unsecured retail loans, which constitute about 25% of the total loans, to reach 30% of the book over the next two years. Starting next year, BAF will start a new product line of construction equipment financing. Going forward, management expects to maintain quarterly disbursement of over Rs10bn. We expect the consumer finance book to touch Rs43bn in FY10 and Rs65bn-70bn in FY11.

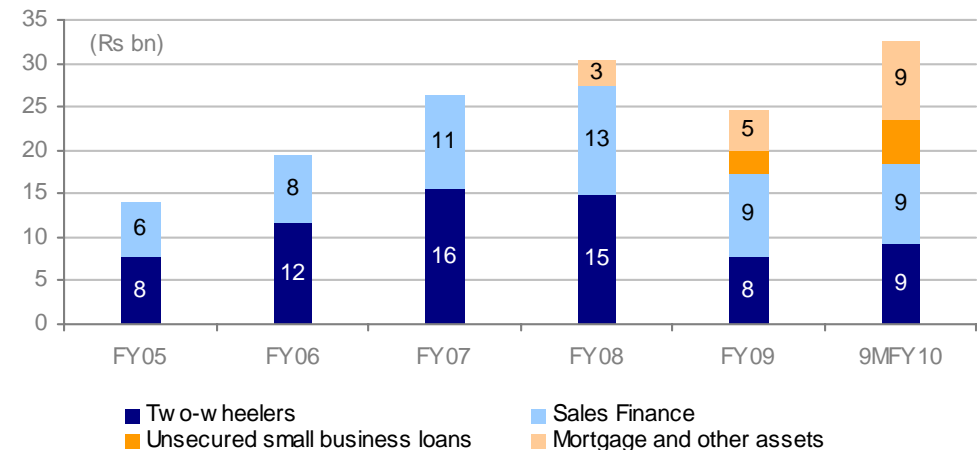
New initiatives: Bajaj has filed an application for an AMC licence and has launched a retail financial advisory business. Bajaj FinServ had earlier entered into an agreement with Allianz Global Investors to set up an equally managed AMC, in which Allianz would hold a 51% stake, with Bajaj FinServ holding the rest. Bajaj FinServ expects to scale up the new operations over the next 3-5 years. It expects to leverage the distribution network and existing infrastructure in building these businesses. The new businesses will take 2-3 years to make any meaningful contribution to the bottomline, but they will help consolidate its position as a complete financial services company.

Figure 9: Bajaj Auto Finance’s quarterly disbursements – up 81% YoY over 9MFY10



Source: Company, IIFL Research

Figure 10: BAF – disbursements break-up – consumer finance share on the rise

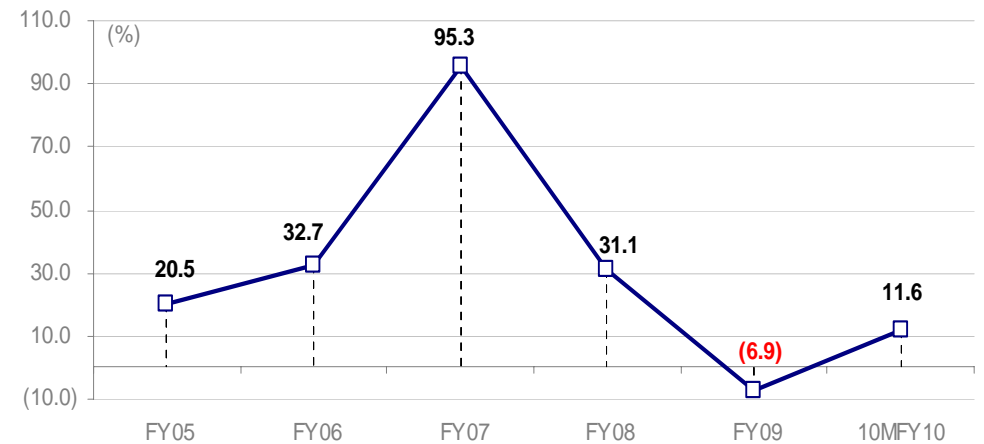


Source: Company, IIFL Research

Modest growth outlook (12-15%): At the insurance panel discussion during IIFL’s Enterprising India Investors’ Conference in February 2010, CEOs of the five largest life-insurance companies concurred that long-term growth in GWP (Gross Written Premium) should be 12-15% annually, in line with the country’s nominal GDP growth.

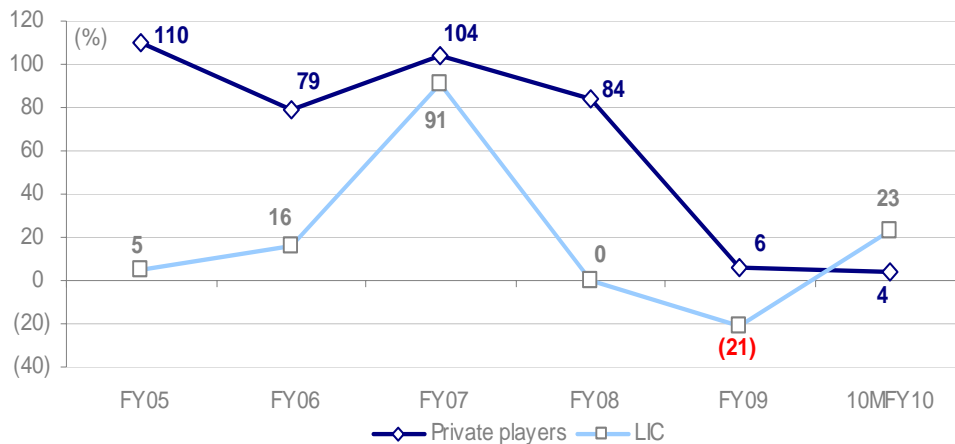
There are currently 250m life policies in force in India, which translates to about 1 policy per Indian household, assuming a population of 1bn and four people per household. In terms of number of policies, the penetration rate may not seem low, but it can grow significantly in terms of value insured. Furthermore, penetration is very low in areas such as pension and children’s education. Bajaj expects both life and general insurance business to grow in line with the industry—a modest 12-15% annual increase in GWP terms over the next few years. We expect the company’s consumer-finance book to touch Rs43bn in FY10 and Rs65bn-70bn in FY11.

Figure 12: APE business growth for the industry



Source: IRDA, IIFL Research

Figure 11: APE YoY growth –growth to be in line with industry



Source: IRDA, IIFL Research

43% upside to valuation, assuming 51% economic interest in life-insurance business: Allianz has an option to raise its stake in the life-insurance business from the current 26% to a maximum of 74%, subject to necessary regulatory approvals. At present, it seems that the foreign-holding limit in private life-insurance companies would be raised to 49% in the near future. However, there is no certainty about the ceiling being raised further to 74%, in which case Bajaj Finserv could end up owning 51% of the life-insurance business, effectively doubling the value of BALIC.

Details of the call options are as follows:

- **Call option in life insurance JV to raise stake up to 74%:** If permissible by law and subject to regulatory approvals, Allianz SE can exercise its call option to increase its holding to 74% from the present 26% in Bajaj Allianz Life Insurance Co Ltd. If Allianz were to exercise this option up to 30 July 2016, the price would be Rs5.42 per share plus interest at 16% per annum, compounded annually from 31 July 2001 to the date of payment.
- **Call option in general insurance JV to raise stake up to 50%:** If permissible by law and subject to regulatory approvals, Allianz SE can exercise its call option to increase its holding to 50% from the present 26% in Bajaj Allianz General Insurance Co Ltd. If Allianz were to exercise this option up to 22 April 2016, the price would be Rs10 per share plus interest at 16% per annum, compounded annually from 23 April 2001 to the date of payment.

In either case, if the call option were to be exercised after 15 years, the option price would such that it is the highest of:

- price per share (Rs10 for general and Rs5.42 for life) compounded at 16% per annum interest for 15 years;
- market price per equity share, if the shares are listed at that time;
- fair value of the company's shares as determined by a mutually accepted accounting firm, if the shares are not listed.

Figure 13: Potential upside from call option

Business	Basis	Rs bn	Multiple (x)	Stake (%)	Value of stake (Rs bn)	% in total	Value/share (Rs)
Bajaj Allianz Life Insurance	NBAP	105	12.0	51.0	54	63.9	372
Bajaj Allianz General Insurance	PAT	1	20.0	50.0	12	14.7	85
Bajaj Auto Finance	BV	13	1.5	42.0	8	9.6	56
Investments	Cost	8	0.9	100.0	8	9.0	53
NPV of 23% stake sale in BALIC to Allianz					1	1.2	7
NPV of 24% stake sale in BAGIC to Allianz					1	1.7	10
Total					82	100.0	582

Source: IIFL Research

Assuming both the call options are exercised by 2016 and the economic interest of Bajaj Finserv falls to 26% in BALIC and 50% in BAGIC, Bajaj Finserv would still receive Rs6.1bn from the stake sale. Out of this, Rs3.6bn would be from the 48% stake sale in BALIC and Rs2.5bn from the 24% stake sale in BAGIC. The NPV of these adds another Rs24 per share to our base-case SOTP valuation. In case only 23% of BALIC stake and 24% of BAGIC is sold, then this will add another Rs17 per share to the SOTP, as detailed above.

Figure 14: Consolidated results summary

Rs m	3QFY09	2QFY10	3QFY10	QoQ (%)	YoY (%)
Revenue					
General Insurance	5,195	4,761	4,728	(0.7)	(9.0)
Life Insurance	5,827	61,849	36,966	(40.2)	534.4
Total Insurance	11,021	66,609	41,694	(37.4)	278.3
Investments & others	280	245	352	43.6	25.6
Windmill	92	195	81	(58.5)	(11.8)
Total revenue	11,393	67,050	42,127	(37.2)	269.7
Pre-tax profit/(loss)					
General Insurance	236	414	460	11.1	95.4
Life Insurance	(214)	87	(41)	n. m.	(81.0)
Total Insurance	21	502	420	(16.3)	1,861.2
Investments & others	187	124	103	(16.8)	(45.0)
Retail financing	46	91	115	25.9	151.0
Windmill	(42)	56	0	(99.8)	n. m.
Profit before tax	212	772	637	(17.4)	200.2
Tax	(100)	(246)	(219)	(10.9)	118.3
Net profit/(loss) before minority	112	526	418	(20.5)	273.6
Minority	11	(86)	(70)	(19.4)	n. m.
Net profit/(loss)	123	440	349	(20.7)	183.4

Source: Company, IIFL Research

Figure 15: Bajaj Auto Finance results summary

Rs m	3QFY09	2QFY10	3QFY10	QoQ (%)	YoY (%)
Total operating income	1,575	2,195	2,493	13.6	58.3
Net interest income	1,157	1,735	1,940	11.8	67.7
Total expenses	(541)	(827)	(914)	10.6	68.9
Pre-provision operating profit	621	910	1,029	13.0	65.7
Provision for doubtful debts and bad debts written off, net	(458)	(585)	(598)	2.1	30.5
Profit before tax	163	325	431	32.6	164.9
Profit after tax	113	217	273	25.9	142.2
Disbursements	6,123	10,035	12,097	20.5	97.6

Source: Company, IIFL Research

Figure 16: Bajaj Allianz Life Insurance results summary

Rs m	3QFY09	2QFY10	3QFY10	QoQ (%)	YoY (%)
Revenue Account (Policyholders' A/c)					
Gross Written Premium	24,200	25,200	27,550	9.3	13.8
Net Earned Premium	24,140	25,100	27,480	9.5	13.8
Investment income	(18,560)	36,530	9,190	(74.8)	(149.5)
Contribution from Shareholders (Contra)	470	120	340	183.3	(27.7)
Total income	6,050	61,750	37,010	(40.1)	511.7
Expenditures & provisions	(5,530)	(60,570)	(35,450)	(41.5)	541.0
Surplus for the period	520	1,180	1,560	32.2	200.0
Profit & Loss A/c (Shareholders' A/c)					
Investment income (Net)	250	210	300	42.9	20.0
Contribution to Policyholders' A/c (Contra)	(470)	(120)	(340)	183.3	(27.7)
Profit before tax	(220)	90	(40)	(144.4)	(81.8)
Profit after tax	(220)	70	(20)	(128.6)	(90.9)
Total Surplus (Shareholders + Policyholders)	300	1,250	1,540	23.2	413.3
Renewal premium	14,320	16,560	16,680	0.7	16.5
Operating expense/ GWP (%)	20.0	19.0	19.0	0.0	(1.0)
Commission expense/ GWP (%)	11.0	9.0	9.0	0.0	(2.0)

Source: Company, IIFL Research

Figure 17: Bajaj Allianz General Insurance results summary

Rs m	3QFY09	2QFY10	3QFY10	QoQ (%)	YoY (%)
Gross Written Premium	5,810	5,830	5,830	0.0	0.3
Net Earned Premium	4,380	4,170	4,140	(0.7)	(5.5)
Underwriting profit/(loss) (excluding Motor pool losses)	(100)	20	40	100.0	(140.0)
Provision for Motor Pool losses	(180)	(180)	(170)	(5.6)	(5.6)
Interest and dividend income	540	550	550	0.0	1.9
Capital gains	(20)	20	40	100.0	(300.0)
Profit before tax	240	410	460	12.2	91.7
Profit after tax	170	270	290	7.4	70.6
Combined ratio (excluding pool losses) (%)	102.3	99.5	98.9	(0.6)	(3.4)
Combined ratio (including pool losses) (%)	106.4	103.8	103.1	(0.7)	(3.3)

Source: Company, IIFL Research



Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.

SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.

Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.

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