14 January 2019

Update | Sector: Financials

Bajaj Finance

BSE SENSEX	S&P CNX
35,854	10,738

CMP: INR2,541 TP: INR2,375 (-7%) Neutral

Hitting the pedal on asset-light profitability

Key vectors – rural, cross-sell and retailization of liabilities

- **We are optimistic on Bajaj Finance's (BAF) outlook, given its traction in multiple products, new initiatives in various business segments (on both the asset and liability sides) and able top management.**
- **We are particularly enthused about the new emerging vectors of profitability: (a) asset-light model, (b) operating efficiency, (c) granular retail portfolio, (d) improving risk management parameters led by technology and (e) capital efficiency.**
- **In our view, BAF is structurally moving toward a retail banking structure, with a growing deposit franchise, rising penetration in hinterlands, credit and fee-based product offerings, and management depth to handle bank structure responsibilities.**
- **While we like BAF's superior business model, valuations appear rich at a P/B of 5.9x FY20E. We, thus, maintain our Neutral rating with a TP of INR2,375 (5x Dec'20E BVPS).**

Product extension and cross-sell – key focus areas

BAF has maintained its strong growth trajectory, primarily led by customer addition in the flagship consumer durables business. The company has set a target to broaden its customer base to 75m by FY23 from 30m as of 1HFY19. **Newer products like life-care financing (where the business model is similar to CD financing) are likely to bring in more customers on board.** Encouragingly, BAF has achieved a cross-sell ratio of 59%, which has inched up steadily from 49% in FY15. In our view, this will help accelerate the asset-light income source for the company.

SME business: Professional loans and deeper geography – growth drivers

SME business' geographical reach has increased multifold to 650 cities from 80 cities in FY14 – we expect this footprint to expand by at least 20% per annum. With more room to penetrate, this business has the potential to source incremental AUM from tier-2 to tier-6 locations. **Interestingly and contrary to the conventional logic, as BAF grows deeper in geography, the credit risk reduces as population is largely non-migratory and collaterals have high emotional value.** Moreover, the increasing focus on professional loans is also justified in terms of credit risk, as the client segment is less dependent on macro events. A high-churn, high-IRR and granular SME portfolio, thus, will offer its own advantages. Notably, 1.15m doctors are eligible for pre-approved professional loans.

Hiving off mortgage business to be capital efficient

Post hive off, Bajaj Housing Finance (BHFL) will have (a) access to lower cost of funds, (b) a dedicated team to focus on a large INR23t market (which we assume is expanding at 15% per annum) and (c) opportunity to lever the business 9-10x. BHFL targets a book size of INR850b (24% CAGR) and market share of 2% by FY24. Strong leadership strengthens the growth case – Atul Jain, who is known to be an astute executioner with experience in setting up the rural lending business, heads the housing finance business. Since salaried housing loans is one of the focus customer segments, **lower cost of operations (led by technology) and cross-sell will be the key focus areas.**

Stock Info

Bloomberg	BAF IN
Equity Shares (m)	575
M.Cap.(INRb)/(USDb)	1468.4 / 20.7
52-Week Range (INR)	2995 / 1514
1, 6, 12 Rel. Per (%)	2/5/40
12M Avg Val (INR M)	4189
Free float (%)	44.9

Financials Snapshot (INR b)

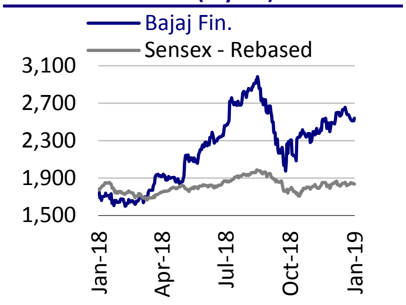
Y/E March	2018	2019E	2020E
NII	72.3	99.8	128.4
PPP	48.8	72.4	95.3
PAT	25.0	37.8	49.2
EPS (INR)	43.4	65.8	85.6
EPS Gr. (%)	35.9	51.6	30.1
BV/Sh. (INR)	269	327	403
RoA (%)	3.3	3.7	3.7
RoE (%)	20.4	22.1	23.5
Payout (%)	10.1	10.0	10.0
Valuations			
P/E (x)	60.3	39.8	30.6
P/BV (x)	9.7	8.0	6.5
Div. Yield (%)	0.1	0.3	0.3

Shareholding pattern (%)

As On	Sep-18	Jun-18	Sep-17
Promoter	55.2	55.1	55.3
DII	8.6	8.8	7.0
FII	20.3	20.4	21.5
Others	15.9	15.6	16.3

FII Includes depository receipts

Stock Performance (1-year)



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Prudent strategy to safeguard margins

In just three months post the IL&FS crisis, BAF has been able garner both NCDs and CPs at pre-crisis levels. This, coupled with positive ALM in the one-year bucket and AAA credit rating, should largely protect margins in a rising interest rate environment. We believe CBLO is an opportunistic liability play, where BAF gets overnight funds without SLR requirements at almost repo rate. Retailization of liabilities, too, will be beneficial in a rising interest rate environment. Rural lending, which is quickly gaining scale, is another avenue to safeguard margins, as **yields in the rural business are 100-150bp higher than those in the urban business.**

Operating profit to grow in tandem with AUM

We expect margins to be largely stable-to-improving, led by the increasing share of high-yielding loans and diversification of liabilities. Furthermore, fee income contribution is likely to increase with new tie-ups already in place. In the top-15 cities, the business has reached scale and generating strong operating efficiency. **Profitability led by operating efficiency is being utilized to invest and penetrate in deeper geographies, expand the share of direct business and further streamline processes to offer best-in-class experience to customers. Hence, we expect operating profits to grow largely in line with AUM growth.**

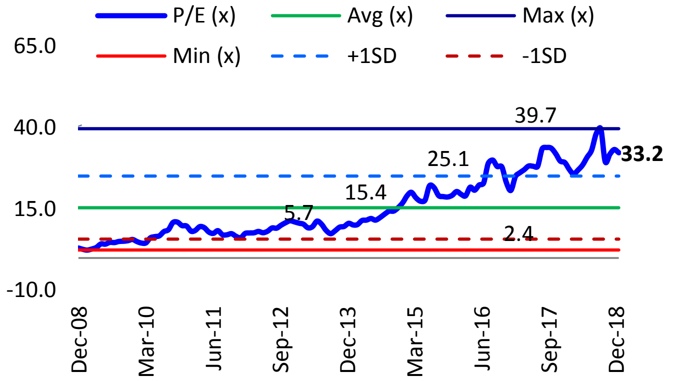
Retail banking structure being carved

We believe BAF is steadily moving toward a **retail banking structure. The key reasons for this are: (a) increasing deposit franchise, (b) priority sector branch infrastructure, (c) move toward a liquidity buffer of 6-8% (v/s 4-5% presently), (d) management cadre being developed to take up key responsibilities in bank structure and (e) multiple credit and fee-based product offerings.**

Superior business model but valuations rich

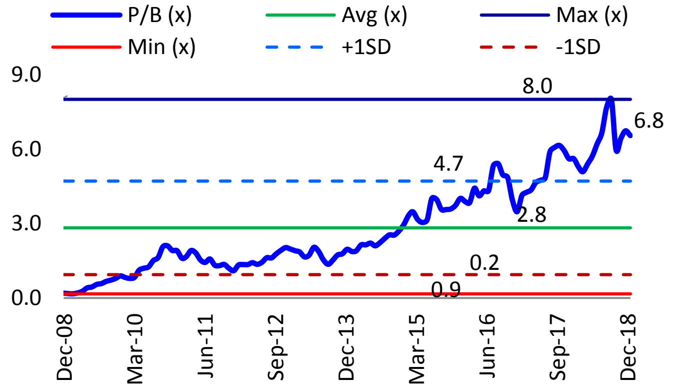
BAF's superior fee-income contribution capability, opex and credit loss benefits from cross-sell opportunities, and changing liability mix strategy will prove advantageous in a rising interest rate environment. Moreover, BAF continues its strong business performance, driven by addition of new product lines, geographical expansion and diversification of liability mix. Notably, the company has done well on growth/profitability despite intensifying competition, while asset quality has been largely stable. Given its parentage and AAA-credit rating, BAF should comfortably tide over the current liquidity situation. **At a P/B of 5.9x FY20E, valuations, however, appear rich. We, thus, maintain our Neutral rating with a target price of INR2,375 (5x Dec'20E BVPS).**

Exhibit 1: One year forward P/E



Source: Company, MOSL

Exhibit 2: One year forward P/B



Source: Company, MOSL

The moat keeps gaining traction

- **BAF recorded AUM CAGR of 34% over FY12-18, driven by its expanding distribution reach and introduction of new products. Consumer finance formed 47% of AUM as of FY18 v/s 38% in FY12.**
- **BAF invested INR12b in technology and processes over FY11-18 (29% CAGR). Over the same period, the number of new customers increased at a CAGR of 32%.**
- **Cross-sell franchise increased ~3x from FY15 to 2QFY19, accounting for 59% of total franchise (v/s 49% in FY15).**

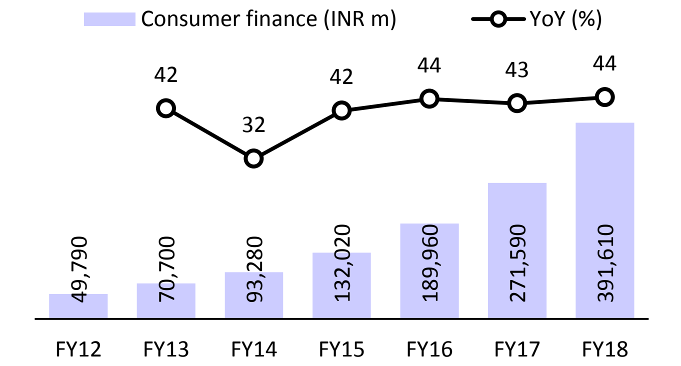
Consumer finance AUM CAGR of 34% over FY12-18

Well begun is half done!

BAF strengthened its focus on the under-penetrated consumer financing segment in FY10. The aim was to capture the growth opportunities offered by a rise in the younger working-class and aspirational population, and higher propensity to spend among the growing middle class population. Banks were vacating this space post-GFC, which provided BAF the opportunity to make a mark with new vigor. **The strategy from the inception has been to increase its product lines, focus on affluent customers and underwrite risk with prudent use of technology platform.**

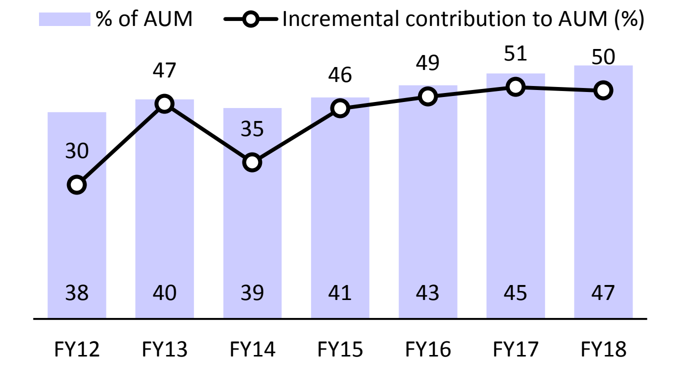
BAF recorded AUM CAGR of 34% over FY12-18, driven by its expanding distribution reach and introduction of new products. Consumer finance formed 47% of AUM as of FY18 v/s 38% in FY12 and accounted for 50% of incremental contribution to AUM v/s 30% in FY12.

Exhibit 3: 34% CAGR over FY12-18



Source: MOSL, Company

Exhibit 4: Contributing ~50% of incremental AUM in FY18



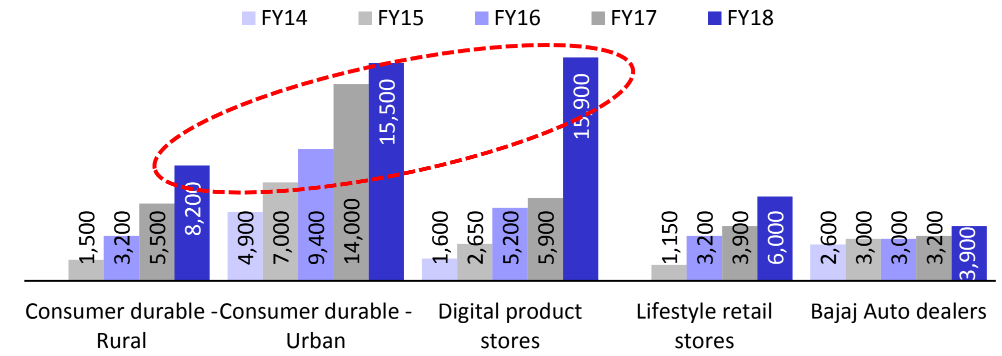
Source: MOSL, Company

Points of sale in the CD financing business increased ~3x over FY14-18

Expanding channels for growth

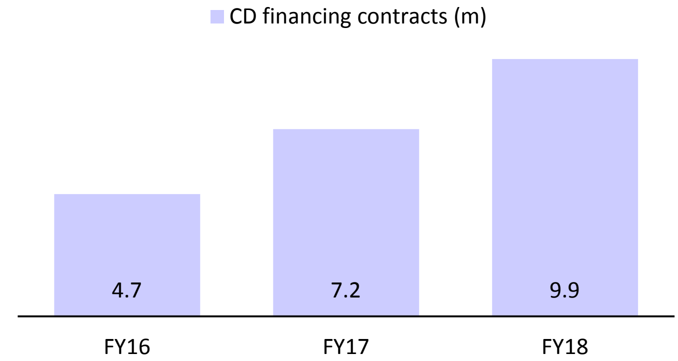
BAF has continually followed a strategy that focuses on deeper penetration of its well-performing product categories. Consequently, its consumer durables (~3x), digital products (~10x) and lifestyle retail point of sale (POS; ~5x) outreach increased considerably over FY14-18.

Exhibit 5: Focus on increasing CD and digital product POS, slow on 2W POS



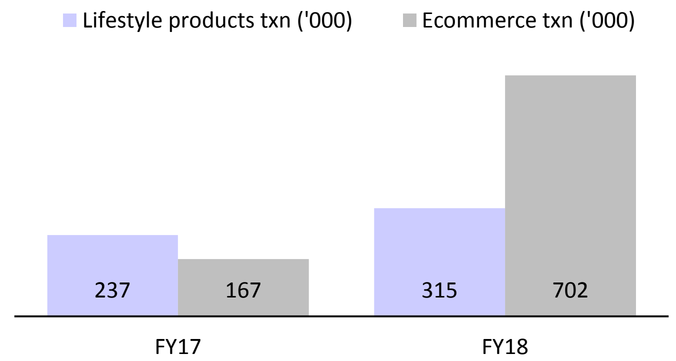
Source: MOSL, Company

Exhibit 6: CD loan contracts doubled over FY16-18



Source: MOSL, Company

Exhibit 7: E-Commerce transactions grew 4x in FY18



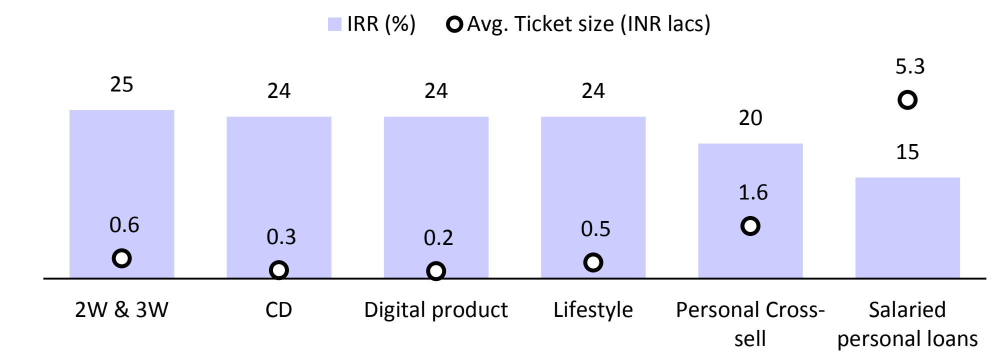
Source: MOSL, Company

Most consumer finance products bear an interest rate of >20%

High-churn products facilitating faster re-pricing of book

In its consumer financing segment, BAF offers high-churn, short-tenor and high-IRR products. This strategy facilitates faster re-pricing of back book, especially in a rising interest rate environment (which mitigates the interest rate risk to ~50% of the book). Although opex for credit acquisition is higher in granular loans, high IRRs offered by these products and operating leverage due to scale largely offset any adverse impact.

Exhibit 8: Consumer financing loans are granular with high IRRs



Note: Data from 3QFY17 presentation

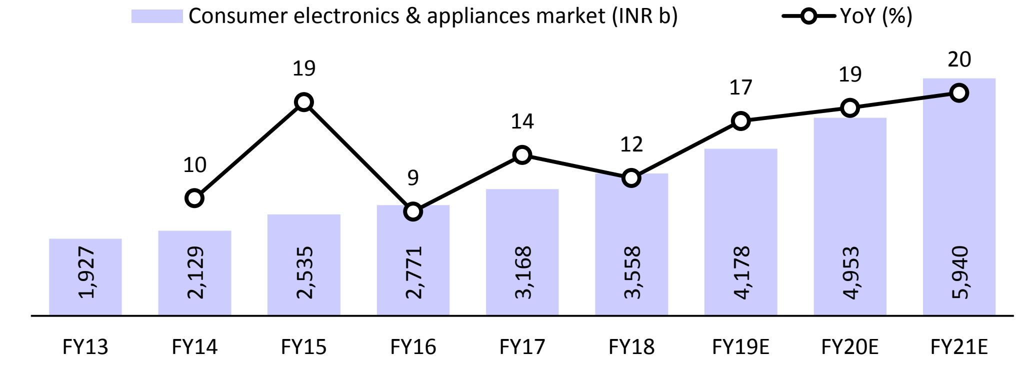
Source: MOSL, Company

Consumer electronics market likely to increase at 18% CAGR over FY18-21

Secular volume and ticket size growth in CEA market through FY18-21

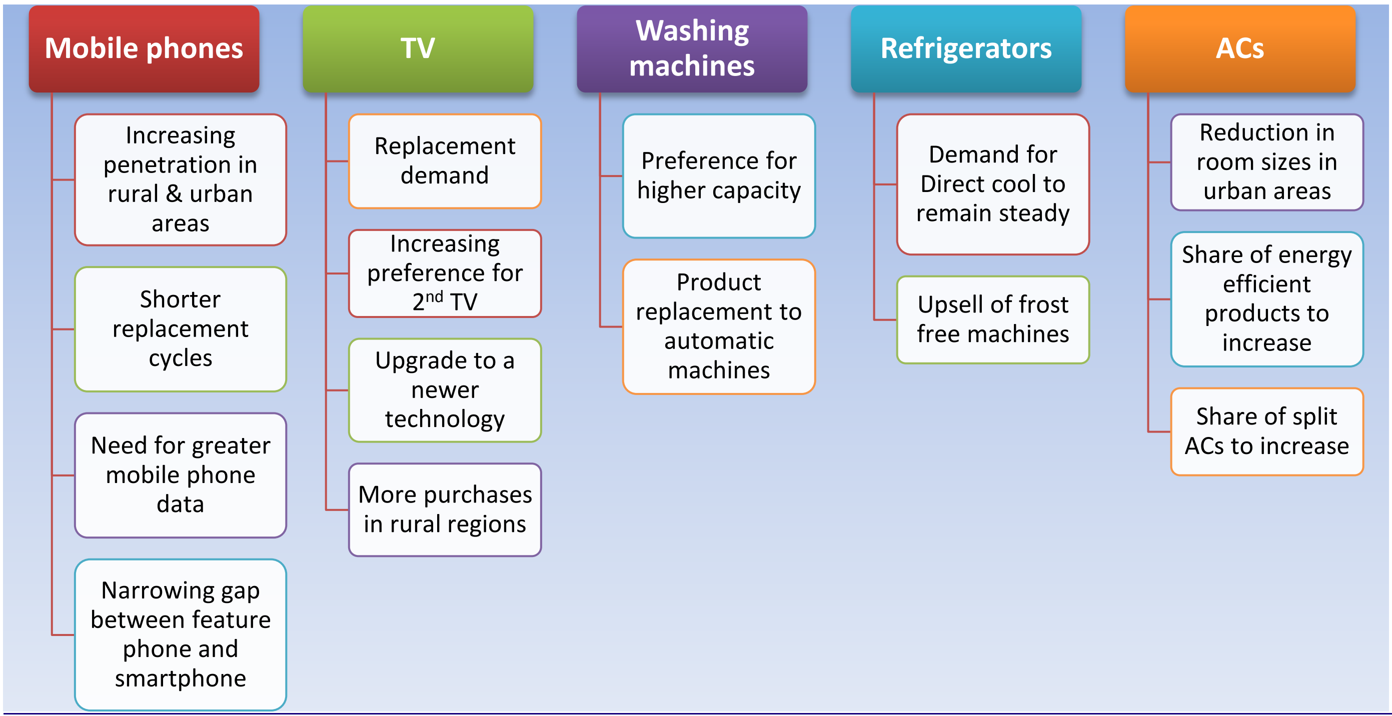
Given the increasing affluence of the middle class, current low penetration levels and growing prominence of the e-commerce industry in new product introduction, the consumer electronics & appliances (CEA) market is expected to grow at a CAGR of ~18% to reach a size of INR6t by FY21.

Exhibit 9: Consumer electronics & appliances (CEA) market to grow at 20% CAGR over FY18-21



Source: MOSL, Company, Dixon Technologies RHP

Exhibit 10: Most CD products will see volume and ticket size uptick



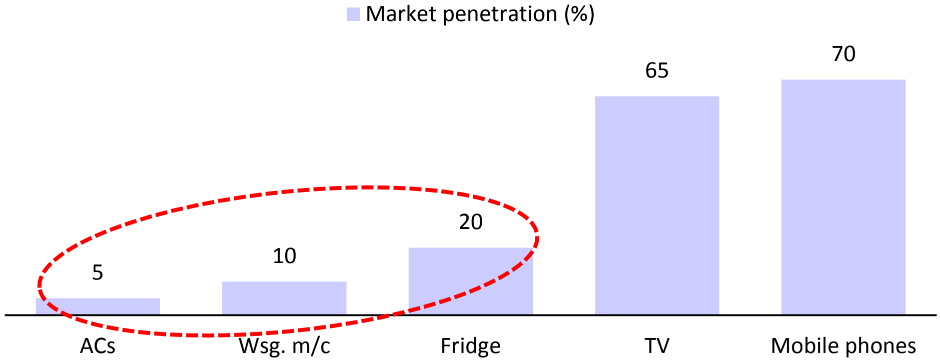
Source: MOSL, Company, Dixon technologies RHP

29% CAGR in spend on technology and processes over FY11-18

Increased use of technology creating a larger cross-sell franchise

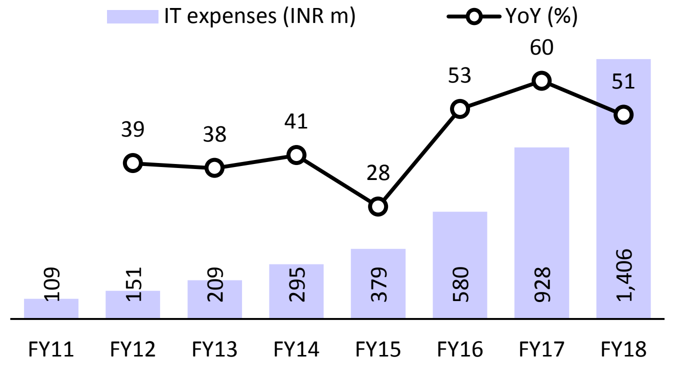
BAF invested INR12b on technology and processes over FY11-18 (29% CAGR). This, along with geographical and product expansion, has led the franchise to grow ~2.5x to 30m by 1HFY19. As most credit products offered by BAF are for consumer products, we believe that acquisition of new customers is paramount and BAF has done well on this front (customer acquisition CAGR of 32% over FY12-18).

Exhibit 11: Low penetration of CD products



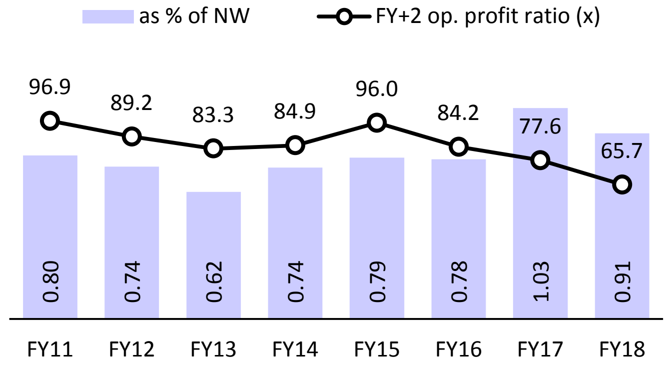
Source: MOSL, Company, Dixon Technologies RHP

Exhibit 12: Technology investment of INR4b over FY11-18



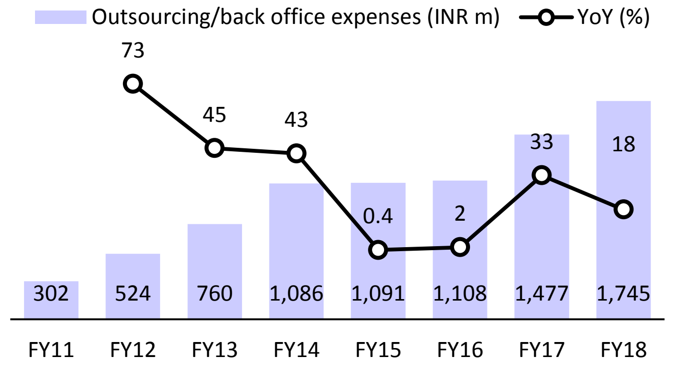
Source: MOSL, Company

Exhibit 13: Spent average of 80bp of net worth over FY11-18



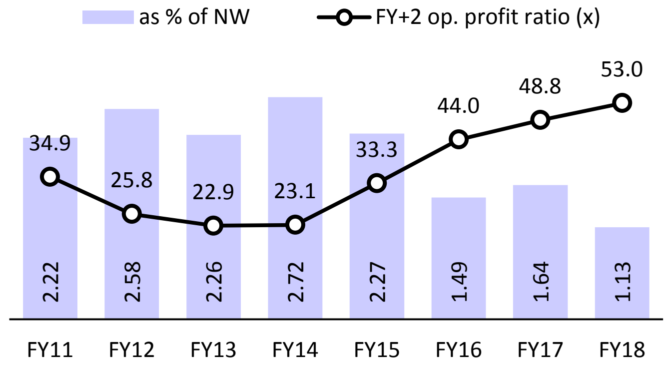
Source: MOSL, Company

Exhibit 14: Outsourcing expenses of INR8b over FY11-18



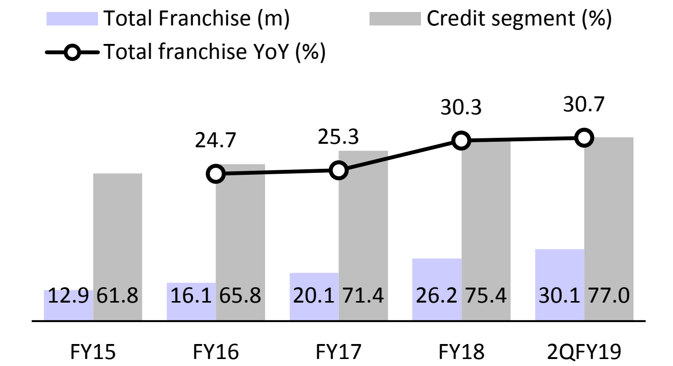
Source: MOSL, Company

Exhibit 15: Spent avg. of 200bp of net worth over FY11-18



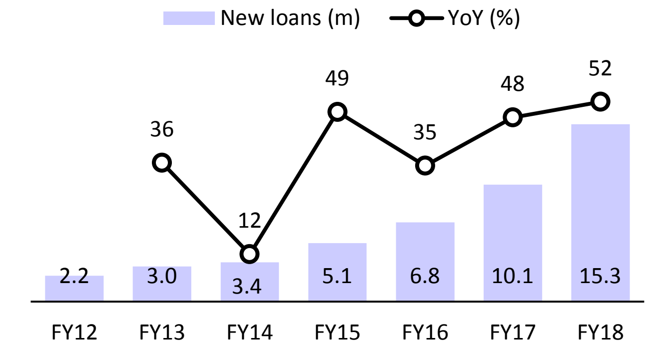
Source: MOSL, Company

Exhibit 16: …thereby increasing total franchise by ~2.5x over last four years



Source: MOSL, Company

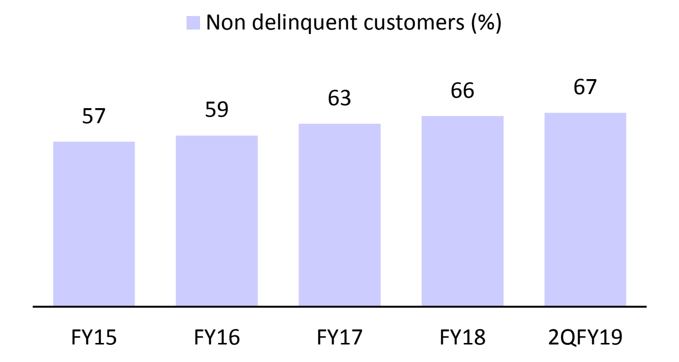
Exhibit 17: New loan acquisitions have increased ~7x over FY12-18



Source: MOSL, Company

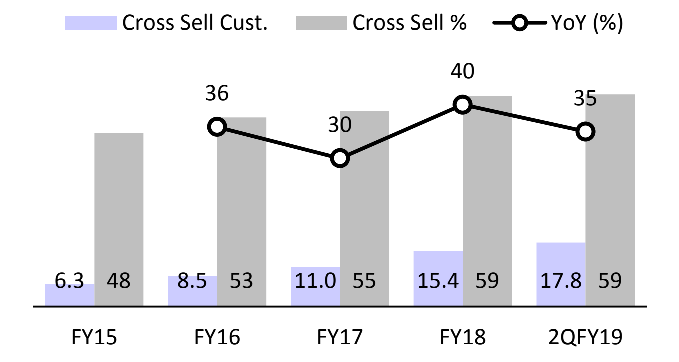
We note that all of this has created a big pool of non-delinquent customers (67% of total franchise as of 2QFY19 v/s 57% in FY15). Consequently, the cross-sell franchise increased by ~3x from FY15 to 2QFY19, accounting for 59% of total franchise (v/s 49% in FY15).

Exhibit 18: Technology has increased the pool of non-delinquent customers



Source: MOSL, Company

Exhibit 19: …thereby increasing cross-sell customer base



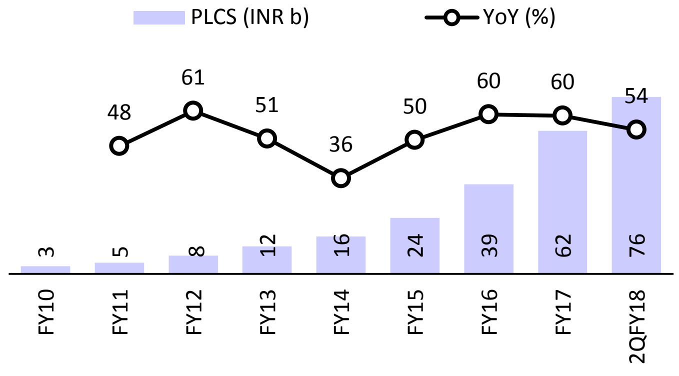
Source: MOSL, Company

Cross-sell personal loans have one-third the credit loss

Conducive risk-reward in cross-sell personal loans

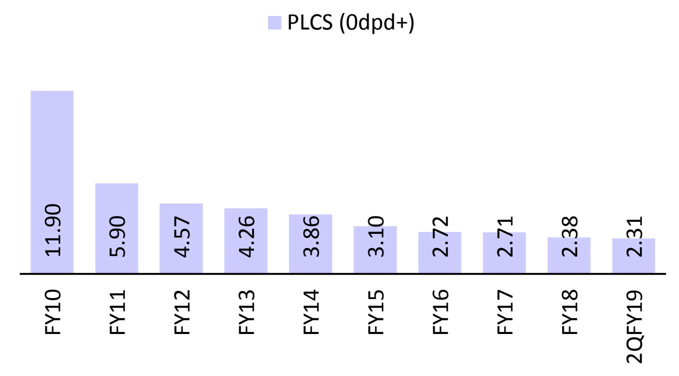
Personal loans cross-sell (PLCS) is offered to customers with good repayment history in either 2W or consumer durable loans, creating stickiness of the customer with the company. **Opex is negligible to offer the cross-sell personal loan product and the credit loss is one-third of the existing customer.** This points to a sustainable risk-reward equation. We believe that the PLCS business will keep growing due to the increasing customer and distribution franchise, robust risk management, and customer-centric loan processing capabilities.

Exhibit 20: Cross-sell personal loans grew ~23x from FY10 to 2QFY18…



Source: MOSL, Company

Exhibit 21: …and increased use of data analytics led to a lower 0+dpd during the same period

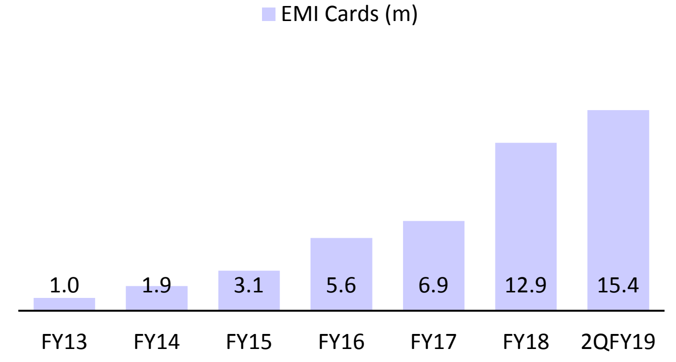


Source: MOSL, Company

Mobikwik wallet to provide more cross-sell opportunities

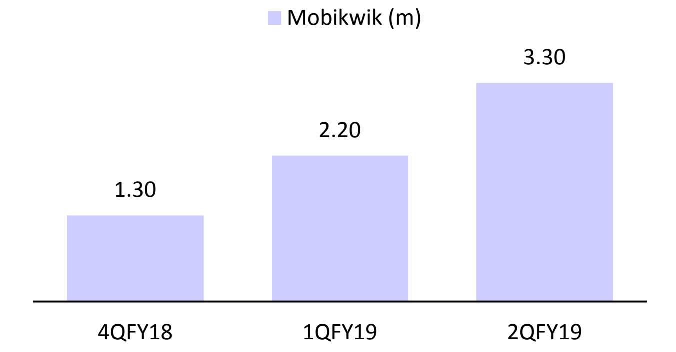
With strategic investment in Mobikwik in 2QFY18, BAF was able to provide both debit and credit engagements. It also launched digitized EMI card for existing and new customers in Oct-2017, decreasing issuance costs. BAF started a pilot in 4QFY18 and offered INR5,000 pre-approved loans to digital EMI card customers. **We believe that this will create an increased pool of sticky granular fee income, as now the customer can fund his/her utilities with a ticket size of INR5,000.**

Exhibit 22: Number of EMI cards grew ~15x from FY13 to 2QFY19



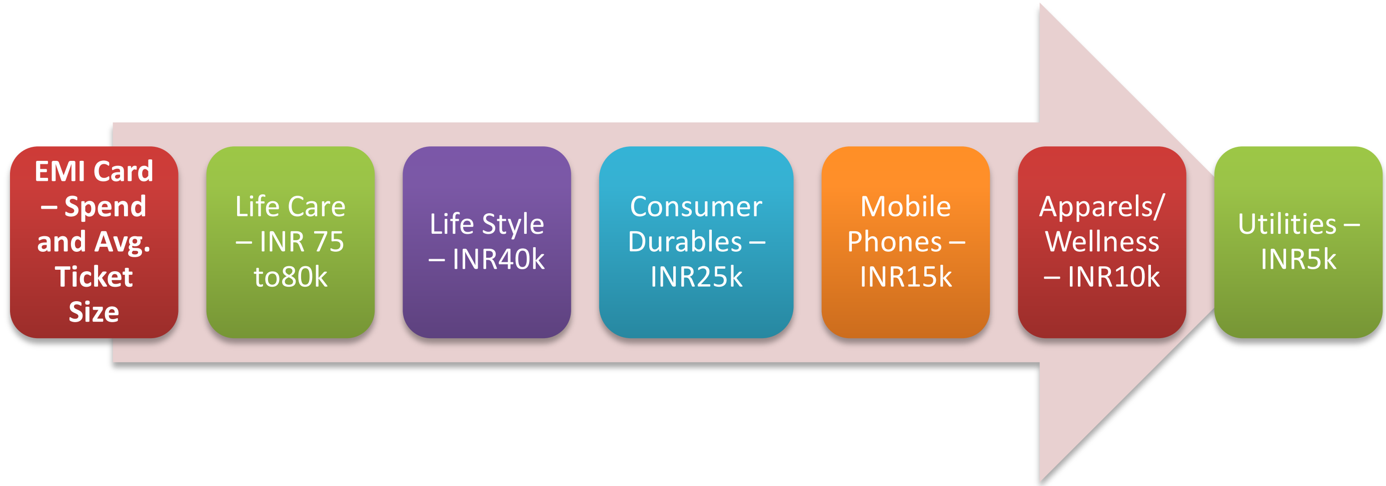
Source: MOSL, Company

Exhibit 23: Mobikwik is a new acquisition that generates sticky fee income



Source: MOSL, Company

Exhibit 24: Product and ticket size hierarchy for EMI cards



Source: MOSL, Company

RBL co-branded credit card to be a key source of fee income over the next 2-3 years

Co-branded credit cards provide further stickiness to fee income

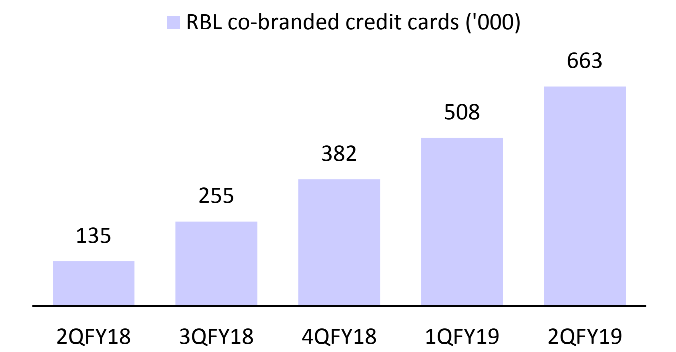
BAF offers co-branded credit cards with RBL to its existing customers. Credit cards are an extension of consumption habits of customers, and by regulations, BAF cannot offer a credit card. Management indicated that by end-FY19, BAF will be the fifth largest domestic issuer of cards (in terms of flow). BAF gets 100% of sourcing fee. All revenue/expense are pooled in common P&L and BAF takes a share of profit.

Exhibit 25: Top-7 domestic credit cards issuers

Credit cards (m)	Sep-17	Dec-17	Mar-18	Jun-18	Aug-18
HDFCB	10	10	11	11	12
SBIN	5	6	6	7	7
ICICIBC	4	5	5	5	6
AXSB	4	4	4	5	5
KMBB	1	1	1	2	2
RBK	**0**	**1**	**1**	**1**	**1**
IIB	1	1	1	1	1

Source: RBI, MOSL, Companies

Exhibit 26: No. of credit cards is up ~5x in less than a year



Source: MOSL, Company

SME – ample scale builders providing profitability support

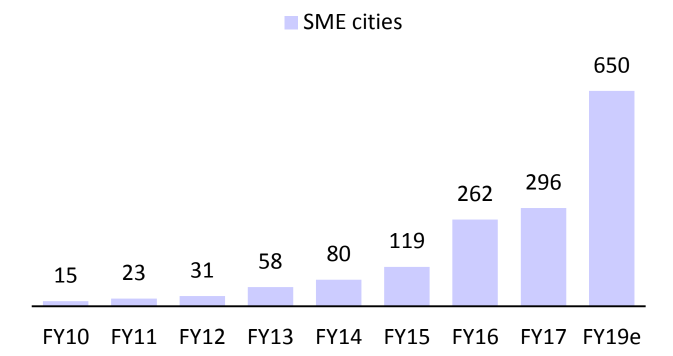
- **Growth from tier-2+ locations makes the SME portfolio more granular and less prone to credit loss, as population there is largely non-migratory and collaterals have high emotional value.**
- **Professional loans provided to chartered accountants (CAs), doctors and engineers make the SME portfolio largely independent of macro events.**

BAF carved out professional loans targeted at CAs, doctors and engineers as a separate business in 4QFY15

SME portfolio getting granular and profitable

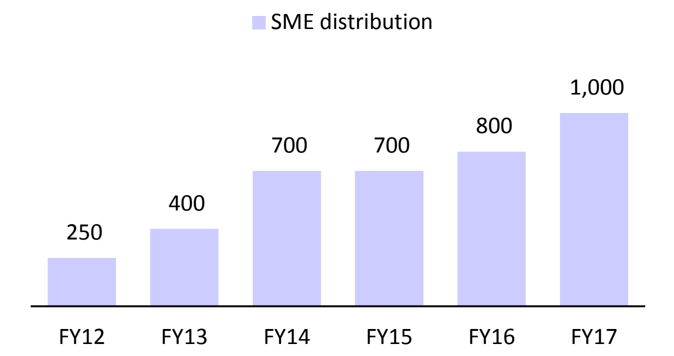
BAF has followed the strategy of focusing on affluent SME customers since FY10. The customers have average annual sales of INR120m. Before hiving off mortgage in FY18, LAP/housing loans to self-employed and lease rental discounting (LRD) loans were part of this business. This business is operated through dedicated relationship mangers (RMs) and sourcing is done via direct sales agents (DSAs), RMs and own website.

Exhibit 27: SME branch expansion



Source: MOSL, Company

Exhibit 28: Distribution outreach through DSAs



Source: MOSL, Company

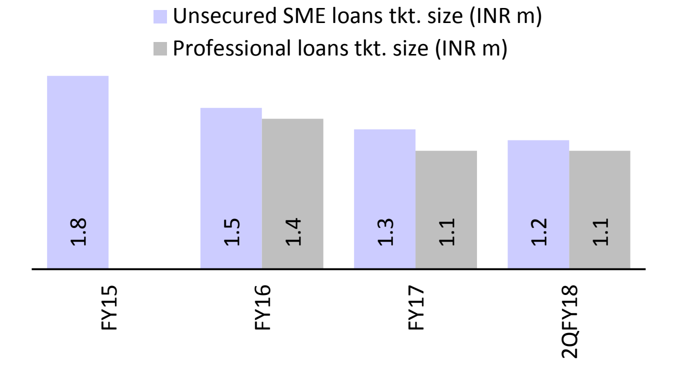
1.15m doctors have already been pre-approved for personal loans

In the standalone balance sheet, the product offering is limited to unsecured working capital loans and professional loans. **BAF carved out professional loans targeted at CAs, doctors and engineers as a separate business structure in 4QFY15.** BAF has 1.15m pre-approved professional loans to doctors, of which 50,000 have been disbursed till date. As professional loans are independent of any macro event, the credit risk is low.

The unsecured SME loan was offered in 80 cities as of FY14, which has now increased to 650 cities. **Although the top-8 cities have the largest number of SME customers, BAF has focused on tier-2+ locations for growth.** Contrary to conventional logic, the credit risk is lower in tier-2 locations, as the population there is non-migratory and collateral has high emotional value. BAF targets a ticket size of INR0.5m with portfolio duration of 1.5 years (v/s 3.5 years now). BAF strategically targets the locations where a large retail bank is present.

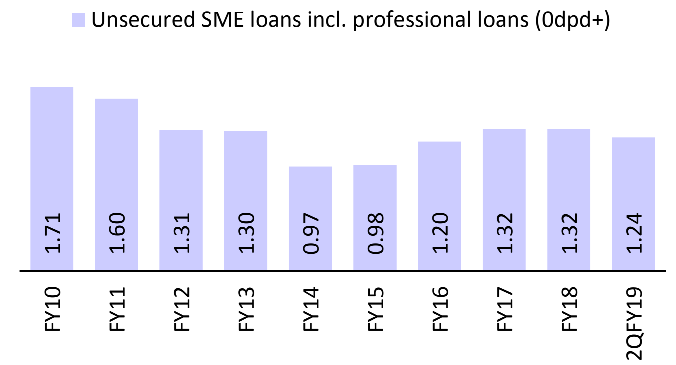
BAF assesses 40+ risk metrics, including bureau scrubs and data analytics. BAF has compiled state-wise regulations on one tech platform. This helps it to serve the local customer better, as sales personnel are well accustomed with document/filing requirements.

Exhibit 29: Increasing granularity through FY15-18



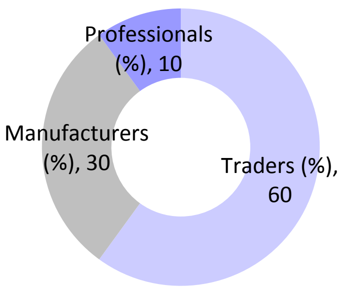
Source: MOSL, Company

Exhibit 30: Low 0dpd+ ratio reflecting prudent underwriting



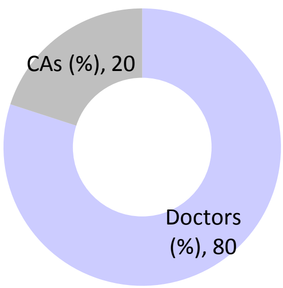
Source: MOSL, Company

Exhibit 31: SME credit portfolio split (%)



Source: MOSL, Company

Exhibit 32: Professional loans split (%)



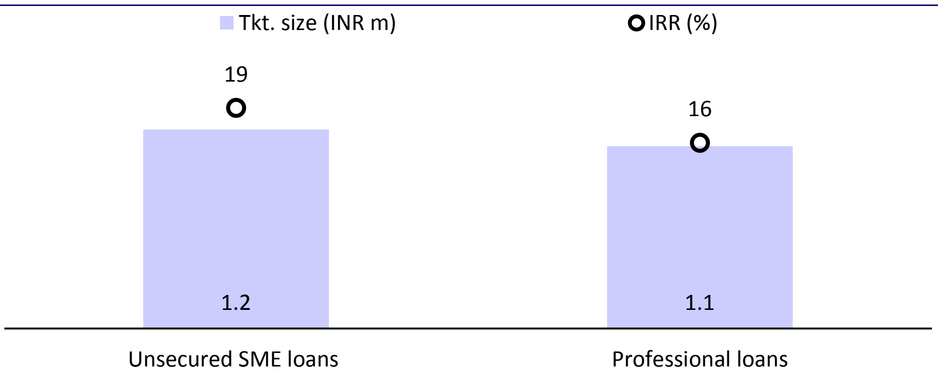
Source: MOSL, Company

SME will become a high-churn, high-IRR and granular portfolio, creating scale and profitability

Way forward for the SME portfolio

For its SME portfolio, the company will incrementally focus on tier-2 to tier-6 locations and professional loans. **This should help create a granular, high-churn and high-IRR portfolio, where credit loss probability is low. We believe the consolidated SME portfolio should grow 25%+ per annum.**

Exhibit 33: High-IRR and granular credit products



Source: MOSL, Company, 3QFY17 presentation

Prudent strategy for sustenance of margins

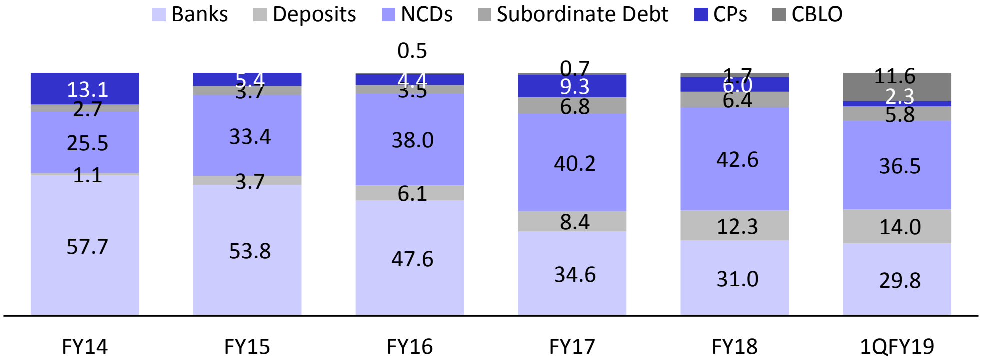
- **BAF has incrementally replaced its debt mix with fixed-rate instruments as its credit rating profile improved over FY14-18, taking advantage of the secular falling interest rate environment. Cost of borrowings declined ~150bp over FY14-18, leading to stable spreads (8.9-9.5%).**
- **BAF's assets maturing in FY19 are worth INR171b, which is more than its liabilities maturing in the year, manifesting in a positive gap in the ALM for the next one year. We believe that this will lead to stable-to-improving spreads and return ratios in FY19.**
- **Yields in the rural business are 100-150bp higher than the urban business, which largely takes care of the high customer acquisition cost.**

Liability mix incrementally moved toward fixed-rate instruments, leading to stable spreads

Increasing share of fixed-rate liabilities in overall borrowings

BAF has incrementally replaced its debt mix with fixed-rate instruments as its credit rating profile improved over FY14-18, taking advantage of the secular falling interest rate environment. Cost of borrowings declined ~150bp over FY14-18, leading to stable spreads (8.9-9.5%). **With an incremental focus on high-yielding digital products financing and lifestyle products financing, we believe that back-book re-pricing should be faster than liability re-pricing, manifesting in stable/improving spreads over FY19-21.** In our view, CBLO is an opportunistic liability play, where BAF gets access to overnight funds without SLR requirements at almost repo rate.

Exhibit 34: Diversification of liability mix underway



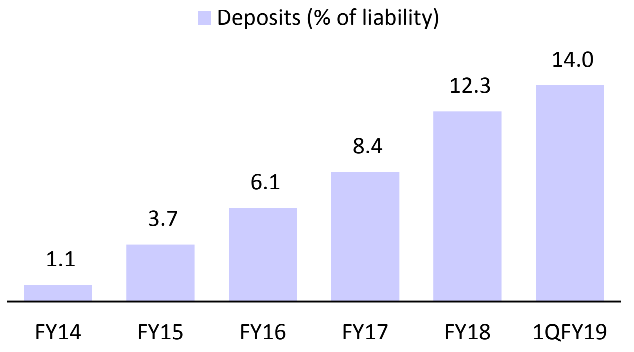
Source: MOSL, Company

Management targets 22% share of borrowings coming from deposits by FY21

Building the deposit franchise – retailization of liability mix

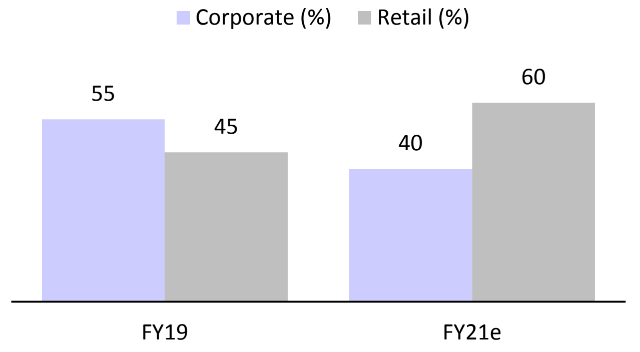
BAF launched its fixed deposit franchise as an anchor wealth management product in FY14 to diversify its liability mix. **Deposits formed ~1% of the liability mix in FY14, which management intends to increase to 22% by FY21.** Around 40% of deposits will be corporate deposits, which do not incur any SLR cost. Increasing deposit franchise will be a meaningful vector in sustenance of margins in a rising interest rate environment.

Exhibit 35: Growing deposit franchise



Source: MOSL, Company

Exhibit 36: Management expects to further granularize deposit franchise



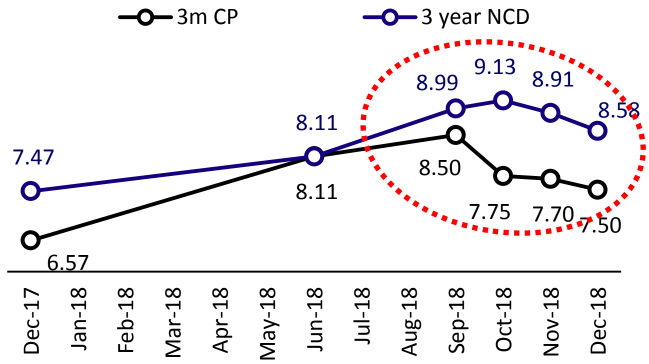
Source: MOSL, Company

Exhibit 37: Sourcing of deposits

Source	Type	Locations	Tkt. size
Direct	Mass Retail	50	3
Direct	HNI	15	NA
Indirect	National distributor	15	4
Indirect	IFAs	30	3
Direct	Corporate	6	NA

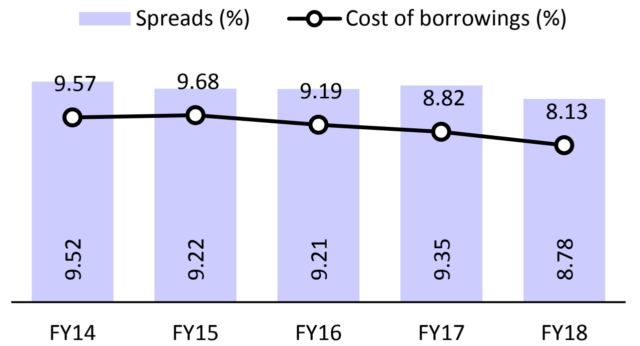
Source: MOSL, Company

Exhibit 38: CPs and NCDs yields are cooling off



Source: MOSL, Company, FIMMDA, Bloomberg

Exhibit 39: Lower cost of borrowings and stable spreads



Source: MOSL, Company

Exhibit 40: Stable and superior credit rating through FY16-18

	FY16	FY17	FY18
NCD	IND AAA/Stable	IND AAA/Stable	IND AAA/Stable
Sub. Debt	IND AAA/Stable	IND AAA/Stable	IND AAA/Stable
LT Bank Rating	IND AAA/Stable	IND AAA/Stable	IND AAA/Stable
ST Bank Rating	IND A1+	IND A1+	IND A1+

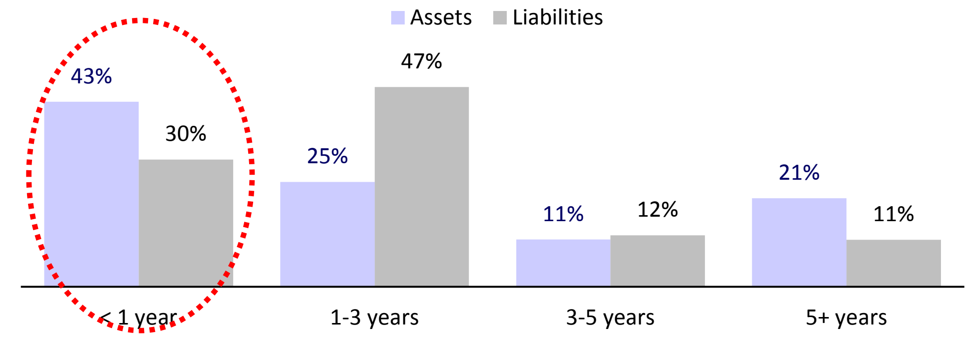
Source: MOSL, Company, India Ratings

Positive ALM – a key positive in a rising rate scenario

BAF is running a positive gap in the next one year in ALM

BAF assets maturing in FY19 are worth INR171b, which is more than its liabilities maturing in the year, manifesting a positive gap in the ALM for the next one year. We believe that this will lead to stable-to-improving spreads and return ratios in FY19.

Exhibit 41: BAF is running a positive gap in ALM for next one year, which we believe is beneficial in an interest rate rising environment



Source: MOSL, Company

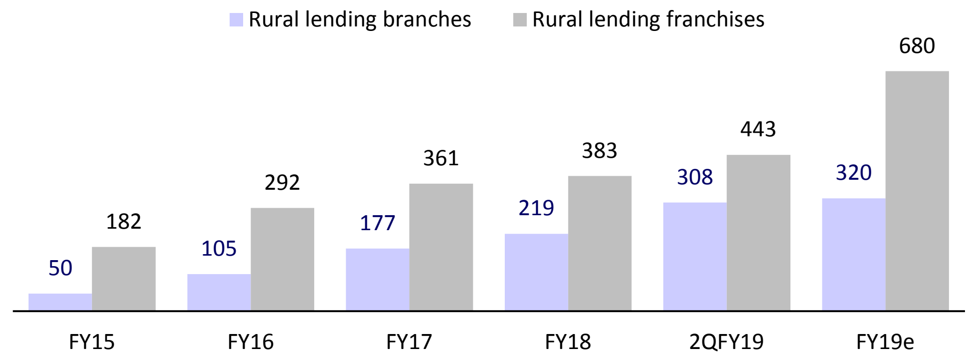
Rural business has higher yield than urban business

Yields in rural business are 100-150bp higher than urban business, which largely offsets the impact of high customer acquisition cost

BAF launched the rural lending business in FY14. It offers consumer durable, lifestyle, personal loans, SME loans, gold loans and fixed deposits in this business. **Rural branches operate through a hub-and-spoke model, where the hub services locations with population of 150,000-175000 and the attached hubs service locations with population of ~50,000-75,000. Branch franchises are exclusive BAF credit outreach points and are usually large traders, gram panchayat leaders, etc.** Product and customer service training is provided by BAF.

Franchises work on fixed income plus variables. The credit loss is borne by BAF. **Although consumer durable ticket sizes are 10% lower than urban branches, the yields are 100-150bp higher than urban branches. This, in turn, offsets the impact of high customer acquisition cost and credit losses.**

Exhibit 42: Rural channel expansion focused on growing franchises

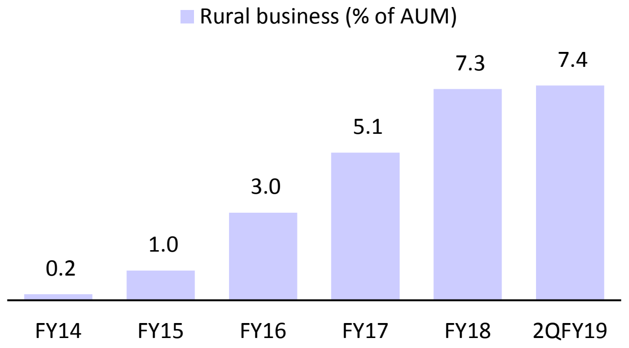


Source: MOSL, Company

Rural business presence to increase from 750 locations currently to 2,500 over the next 4-5 years

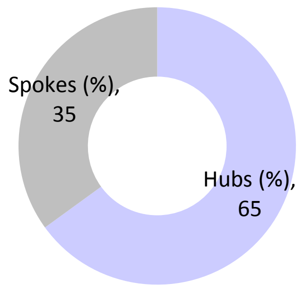
Presently, rural business deploys 3,500 on-roll personnel with an equal three-way split in sales, collection and operations. **Management expects to increase the rural presence to 2,500 locations in 4-5 years. Management has indicated that it wants to grow its distribution reach to 16-17 states, albeit in a calibrated manner.**

Exhibit 43: Growing rural lending franchise



Source: MOSL, Company

Exhibit 44: Rural AUM split



Source: MOSL, Company

Operating profits to grow in sync with AUM growth

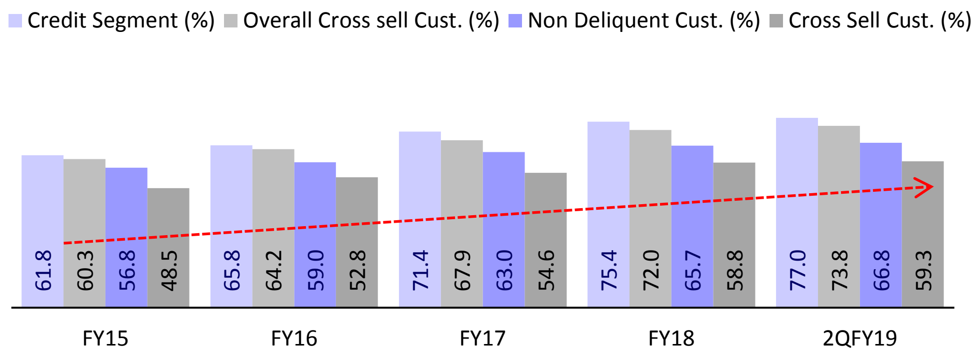
- **BAF caters to 30m customers, which are likely inch up to 75m in 3-4 years. Around 65% of these new customer acquisitions have CIBIL scores of >750, implying significantly low credit loss probability. Around 30% of customers acquired are new to credit, as consumer financing is an experiential credit product.**
- **Cards businesses are asset-light and provide granular fee income. We are optimistic that there could be a further decline in the C/I ratio, given the technology investments over the years. We also see tailwinds for insurance cross-sell fee income from FY19.**

Tailwinds for fee income to keep operating profit growth in sync with AUM growth over FY18-21

Fee income growth could surprise positively

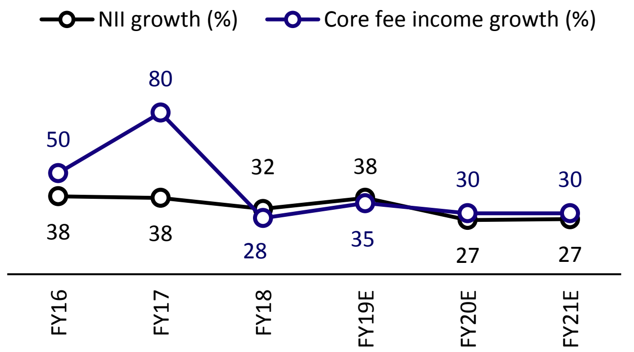
We believe that the consumer durable business has achieved significant scale as a franchise and acts as a funnel for customer acquisition. BAF caters to 30m customers, which are likely to inch up to 75m over 3-4 years. **Around 65% of these new customer acquisitions have CIBIL scores of >750, implying significantly low credit loss probability. Around 30% of customers acquired are new to credit, as consumer financing is an experiential credit product.**

Exhibit 45: Technology and process investments increasing overall credit funnel



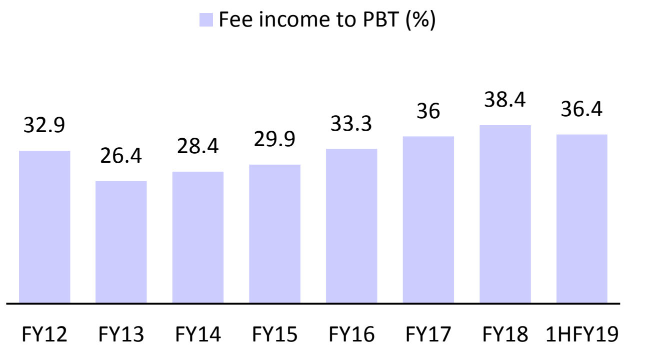
Note: % of total franchise Source: MOSL, Company

Exhibit 46: Fee income growth inching up to NII growth



Source: MOSL, Company

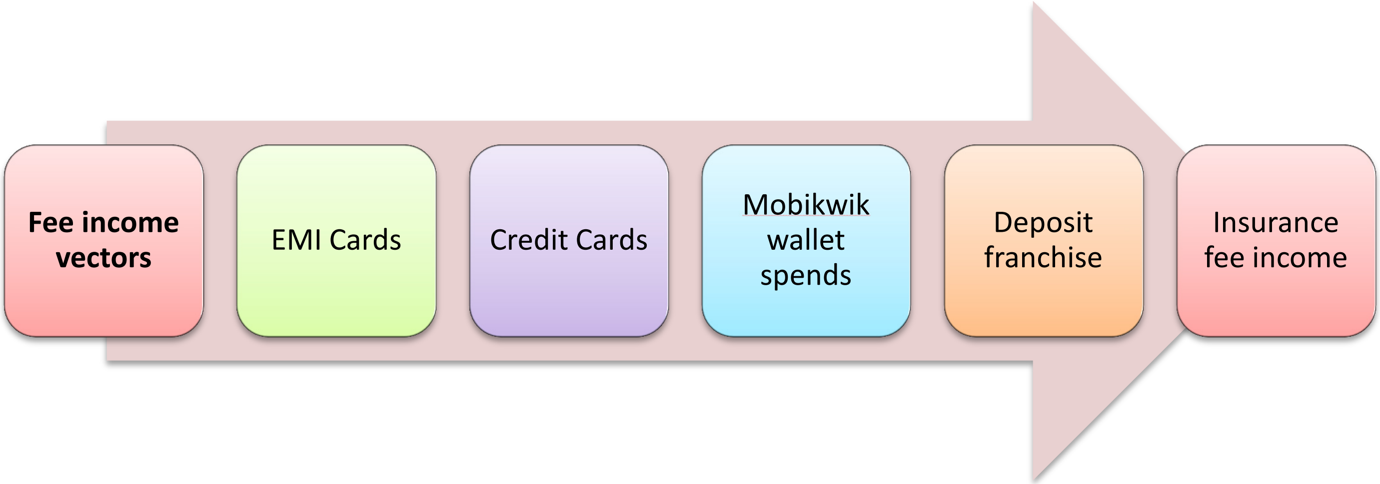
Exhibit 47: Increasing fee income contribution



Source: MOSL, Company

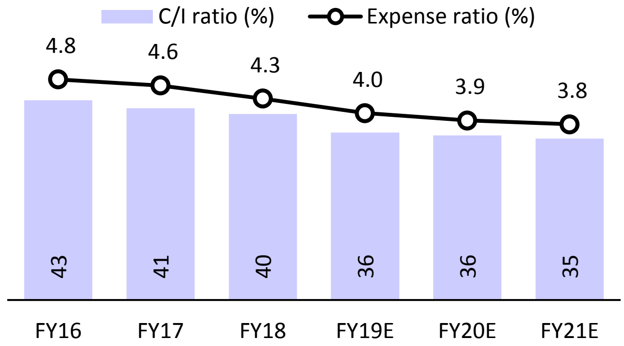
From this funnel, with the help of data analytics, bureau scrubs and alliances with various other databases providers, BAF cross-sells personal loans, EMI cards and co-branded (with RBL) credit cards. Opex is negligible to cross-sell to existing customers and credit loss is around one-third as that of new customers. Cards businesses are asset-light and provide granular fee income. We are optimistic that there could be a further decline in the C/I ratio, given the technology investments over the years. We also see tailwinds for insurance cross-sell fee income growth from FY19.

Exhibit 48: Key fee income vectors



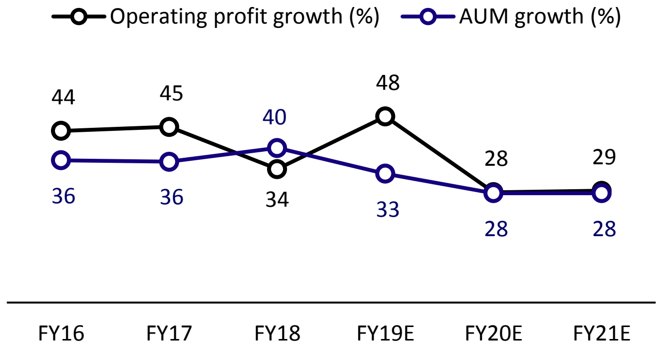
Source: MOSL, Company

Exhibit 49: We believe opex can fall further due to technology investments over the years



Source: MOSL, Company

Exhibit 50: Operating profit growth to be in sync with AUM growth



Source: MOSL, Company

Hiving off mortgage business to be capital efficient

- **Effective February 2018, all incremental loans sourced under the housing, LAP and construction finance segments will be booked in BHFL.**
- **As of FY18, mortgages contributed 29% of the balance sheet, which management expects to grow to 35% by FY21.**
- **Post hive off, BHFL will have (a) access to lower cost of funds, (b) a dedicated team to focus on a large INR23t market (which is expanding at 15% per annum) and (c) opportunity to lever the business 9-10x. This should ensure RoEs in the range of 12-13% for the housing finance business on a conservative basis.**

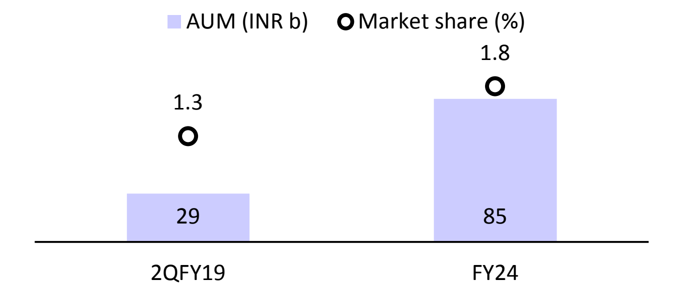
BAF plans to capture ~2% mortgage market share by FY24

Hiving off housing finance to capture the large market opportunity

BAF launched the mortgage product in FY09 with LAP products. In subsequent years, it entered into home loans for self-employed and salaried customers, lease rental discounting loans and construction financing. The company now also offers fee-based products like 'property fitness reports' and 'property search'.

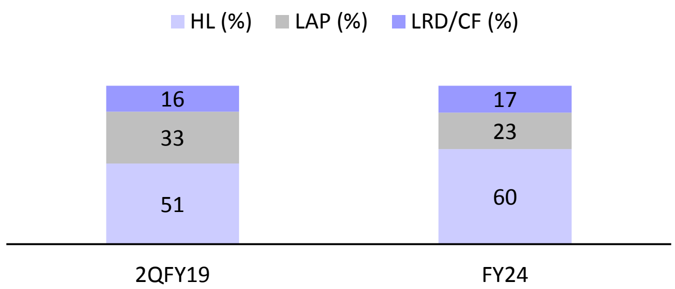
Post hive off, BHFL will have (a) access to lower cost of funds, (b) a dedicated team to focus on a large INR23t market (which is expanding at 15% per annum) and (c) opportunity to lever the business 9-10x. BHFL targets a book size of INR850b (CAGR of 24%) and market share of 2% by FY24 (assuming the mortgage market grows at 15% CAGR).

Exhibit 51: ~2% market share by FY24 does not seem to be a big ask for BAF



Source: MOSL, Company

Exhibit 52: Salaried HL will increase as % of AUM



Source: MOSL, Company

Exhibit 53: Product landscape as of 1HFY19

	HL	LAP	LRD	CF
Avg. tkt size (INR m)	3.6	4.5	200	200
Yield (%)	9.5	11.5	NA	NA
Locations	Top-44	Top-30	Top-8	Top-8

Source: MOSL, Company

Mortgage share of AUM to grow from 29% currently to 35% by FY21

Bajaj Housing Finance limited (100% subsidiary of BAF) was granted a housing finance company license by the National Housing Bank (NHB) in September 2015. BHFL started its lending operations from July 2017. Effective **February 2018, all incremental loans sourced** under these products **will be booked in BHFL**. Atul Jain, who is known to be an astute executioner and has setup the rural lending business, heads the housing finance business. BHFL is already seeing decline of 20% in the C/I ratio on an absolute basis. **With scale, operating leverage will also play out in this business (though a few years away now), thereby meaningfully contributing to the return ratios.** As of FY18, **mortgages contribute 29% of the balance sheet, which management expects to grow to 35% by FY21.**

How does this stack up?

- **Consumer durables business will remain the key moat for the company and will act as an important customer acquisition engine.**
- **Cross-sell, fee-based products, positive ALM mismatch in one-year bucket and an increasing rural franchise will provide fillip to margins and keep operating profit growth in sync with AUM growth.**
- **Hiving off the mortgage business as a separate subsidiary provides the company with access to low cost of funds and enables it to focus on capturing a share of the large mortgage market.**

FY20 onward, fee income could contribute 40% of PBT, according to management

Moving towards a retail bank structure

Consumer durable business is likely to remain the key moat for BAF, given the prospects arising from younger demographics, innovative credit outreach and low penetration of CD products. This business will act as the funnel for customer acquisition, of which vetted customers will be cross-sold credit and fee-based products. SME business will not only act as a scale builder but also drive profitability, given its clientele's low correlation with macro events and further geographical/product expansion.

Prudent liability mix strategy, positive ALM mismatch in one-year bucket and rural lending will meaningfully help sustain margins. Operating profits will be in sync with AUM growth due to the higher contribution from cross-sell and fee-based products and the decline in C/I ratio led by technology investments over the years. We expect fee income to account for 40% of overall PBT (currently at 38%). **Post hive off, BHFL will have (a) access to lower cost of funds, (b) a dedicated team to focus on a large INR23t market (which is expanding at 15% per annum) and (c) opportunity to lever the business 9-10x.**

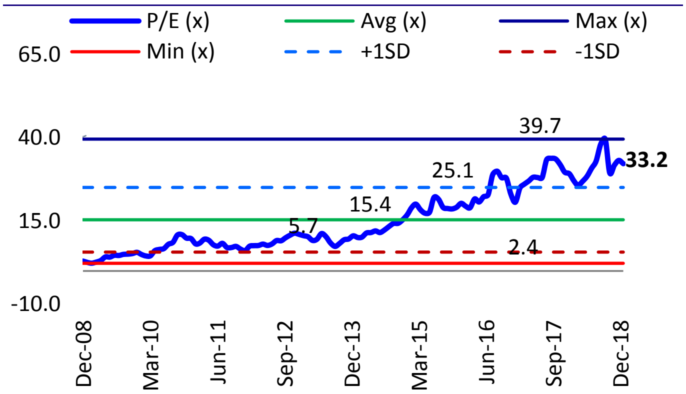
We believe BAF is steadily moving toward a retail banking structure. Key reasons:

- **Increasing deposit franchise**
- **Priority sector branch infrastructure**
- **Moving toward a liquidity buffer of 6-8% (v/s 4-5% presently)**
- **Management cadre being developed to take up key responsibilities in bank structure**
- **Multiple credit and fee-based product offerings**

Valuation and view

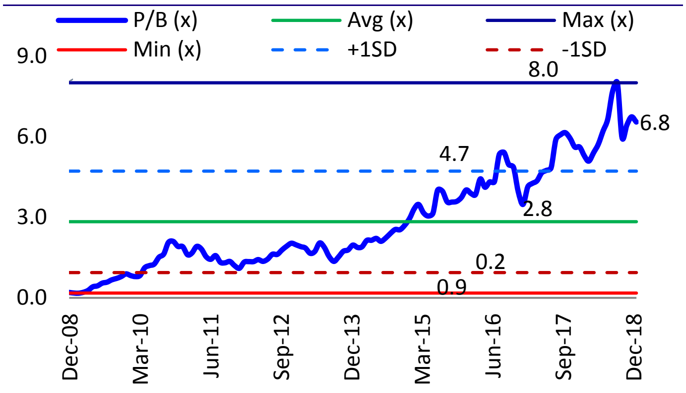
- **Diversified and de-risked portfolio – a key strength of business model:** BAF has also ensured that it has a diverse set of growth drivers in the portfolio versus peers. **A diversified portfolio comprising of profit maximizers and scale builders helps reduce cyclicality in growth and assets quality**. The company's expertise lies in detecting early warning signals of stress in particular segments and adjusting the portfolio accordingly.
- **Cross-sell expert:** A well-diversified credit portfolio, focus on cross-selling, customer acquisition and systematic expansion in delivery channels (both physical and virtual) and selective distribution of products through these channels are likely to sustain robust growth in AUM. These, along with its low market share, are likely to help sustain 30%+ CAGR in AUM over the next three years.
- **Market share gains through customer acquisition and new product launches:** BAF is the largest consumer durables and lifestyle financier in India and has been continuously gaining market share in these businesses. Continuous market share gain and strong distribution have created entry barriers for competitors. One of the key strengths that BAF has built over time is a quick turnaround time unmatched by most other retail financiers. Thus, other than purchases on credit cards of banks, there are very few other competitors that BAF sees in the consumer durables business, which provides it with pricing power.
- **Well-managed asset quality and tested management capabilities:** Despite lower growth and pressure on asset quality witnessed by the peer group, BAF continues clocking healthy growth and has one of the best asset quality among the peer group. Management has not only demonstrated its ability to gain market share in segments, but has been alert to potential asset quality risks as well. It has withdrawn from certain segments like construction equipment, 3W financing and slowed down on LAP in a timely manner.
- **Timely investment in automation and technology**: BAF has been proactive in making timely investments in technology and automation, which, over a period of time, will help reduce operating and delivery cost.
- We maintain our FY19E/20 EPS estimates. We value BAF based on a residual income model assuming Rf of 7.75%, CoE of 13.3% and terminal growth rate of 5% to arrive at a target price of **INR2,355 (5x Dec'20E BVPS)**. Maintain **Neutral**.

Exhibit 54: One year forward P/E



Source: MOSL, Company

Exhibit 55: One year forward P/B



Source: MOSL, Company

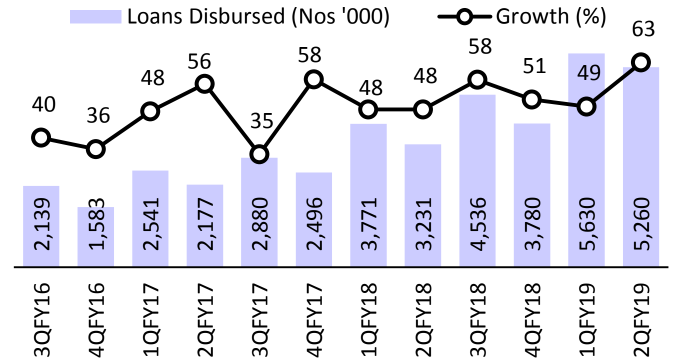
Exhibit 56: DuPont Analysis

Y/E MARCH	2013	2014	2015	2016	2017	2018	2019E	2020E	2021E
Interest Income	19.0	17.9	17.8	17.3	16.8	15.7	16.2	16.4	16.6
Interest Expended	7.8	7.4	7.8	7.3	6.9	6.1	6.4	6.8	7.1
Net Interest Income	**11.2**	**10.4**	**10.0**	**10.0**	**9.9**	**9.6**	**9.8**	**9.7**	**9.5**
Other Operating Income	1.1	1.1	0.9	1.0	1.3	1.2	1.2	1.2	1.3
Other Income	0.1	0.2	0.1	0.1	0.0	0.0	0.1	0.1	0.1
Net Income	**12.4**	**11.8**	**11.0**	**11.0**	**11.2**	**10.8**	**11.1**	**11.0**	**10.9**
Operating Expenses	5.5	5.4	5.0	4.8	4.6	4.3	4.0	3.8	3.7
Operating Income	**6.9**	**6.4**	**6.1**	**6.3**	**6.6**	**6.5**	**7.1**	**7.2**	**7.2**
Provisions/write offs	1.2	1.2	1.3	1.4	1.5	1.4	1.3	1.4	1.5
PBT	**5.7**	**5.1**	**4.7**	**4.9**	**5.1**	**5.1**	**5.8**	**5.8**	**5.7**
Tax	1.8	1.8	1.6	1.7	1.8	1.8	2.1	2.0	2.0
Reported PAT	**3.8**	**3.4**	**3.1**	**3.2**	**3.3**	**3.3**	**3.7**	**3.7**	**3.7**
Leverage	5.7	5.8	6.5	6.5	6.7	6.2	5.9	6.3	6.6
RoE	**21.9**	**19.5**	**20.4**	**20.9**	**22.4**	**20.4**	**22.1**	**23.5**	**24.1**

Source: MOSL, Company

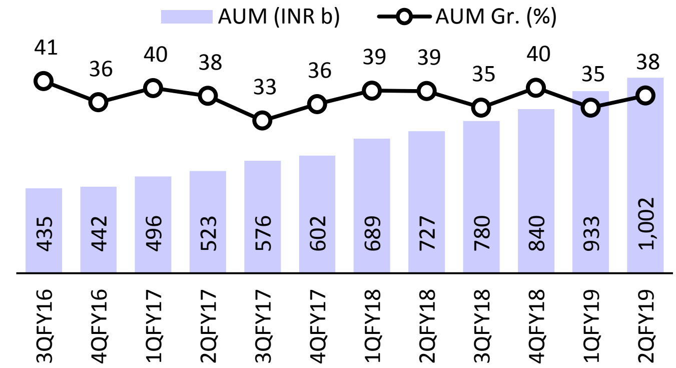
Story in charts

Exhibit 57: No. of loan disb. grew at healthy 63% YoY



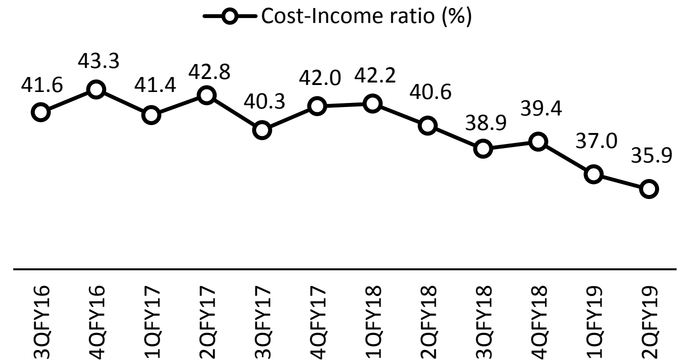
Source: MOSL, Company

Exhibit 58: AUM growth remains strong



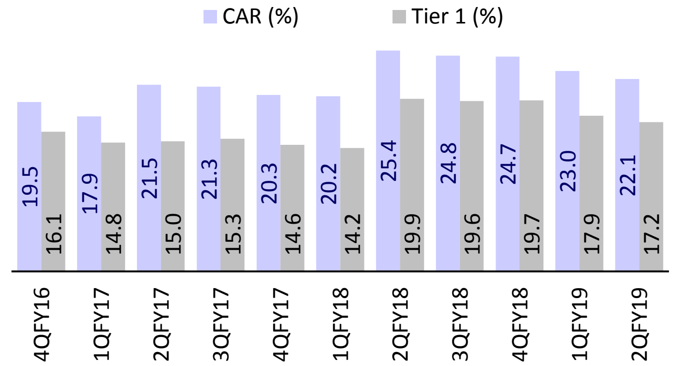
Source: MOSL, Company

Exhibit 59: Cost-to-income ratio on the decline



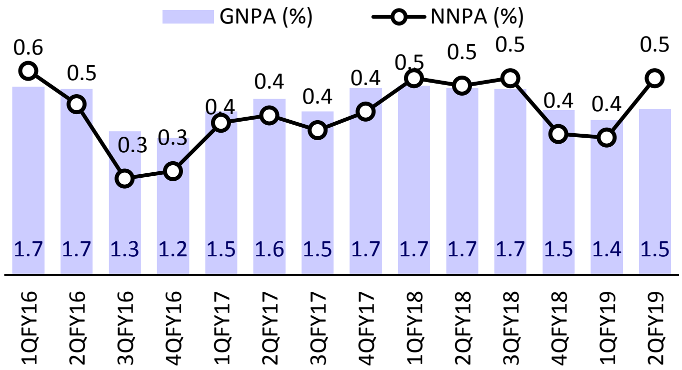
Source: MOSL, Company

Exhibit 60: Well capitalized



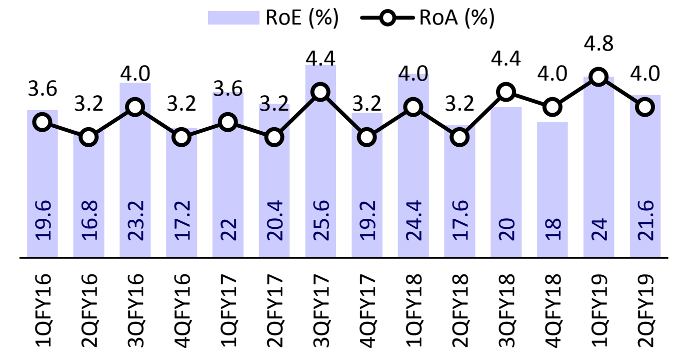
Source: MOSL, Company

Exhibit 61: Asset quality remains healthy



Source: MOSL, Company

Exhibit 62: Return ratios robust



Source: MOSL, Company

Exhibit 63: Financials - Valuation matrix

	Rating	CMP	Mcap	EPS (INR)		P/E (x)		BV (INR)		P/BV (x)		RoA (%)		RoE (%)	
		(INR)	(USDb)	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E
ICICIBC*	Buy	373	34.4	8.0	20.2	33.6	13.3	166	181	1.6	1.5	0.6	1.2	5.0	11.8
HDFCB	Buy	2,101	81.0	79.8	95.9	26.3	21.9	543	621	3.9	3.4	1.8	1.8	16.7	16.5
AXSB	Buy	659	24.2	17.4	37.9	38.0	17.4	265	298	2.5	2.2	0.6	1.1	6.8	13.5
KMB*	Neutral	1,210	32.9	37.4	45.1	32.4	26.9	302	346	4.0	3.5	1.6	1.7	11.9	12.9
YES	Buy	195	6.0	20.2	24.6	9.7	7.9	128	157	1.5	1.2	1.3	1.4	16.9	17.2
IIB	Buy	1,484	12.8	68.8	100.2	21.6	14.8	441	556	3.4	2.7	1.7	2.1	16.5	20.2
FB	Buy	91	2.7	5.8	8.6	15.6	10.5	67	75	1.4	1.2	0.8	0.9	9.0	12.2
DCBB	Neutral	180	0.8	9.7	12.1	18.6	14.9	95	107	1.9	1.7	0.9	0.9	11.0	12.4
SIB	Buy	16	0.4	1.8	3.4	8.4	4.6	29	32	0.5	0.5	0.4	0.6	6.2	10.7
Equitas	Buy	118	0.6	6.3	8.4	18.8	13.9	73	80	1.6	1.5	1.3	1.4	9.0	11.1
RBL	Buy	576	3.5	20.9	27.6	27.6	20.9	176	199	3.3	2.9	1.2	1.2	12.4	14.7
Private Aggregate															
SBIN (cons)*	Buy	301	38.1	8.7	32.3	30.5	8.6	249	276	1.1	1.0	0.1	0.7	2.7	12.3
PNB	Neutral	82	3.5	-17.7	8.0	-4.6	10.3	109	117	0.8	0.7	-0.7	0.4	-13.8	6.8
BOI	Neutral	104	2.5	-1.8	8.6	-57.7	12.0	181	187	0.6	0.6	-0.1	0.2	-0.9	4.3
BOB	Buy	121	4.5	9.3	16.1	13.0	7.5	165	180	0.7	0.7	0.3	0.5	5.6	9.0
CBK	Neutral	278	2.9	17.1	51.7	16.3	5.4	448	493	0.6	0.6	0.2	0.5	3.5	9.9
UNBK	Neutral	94	1.5	4.5	12.8	20.9	7.3	235	245	0.4	0.4	0.1	0.3	2.1	5.5
Public Aggregate															
Banks Aggregate															
HDFC*	Buy	1,969	47.0	42.3	48.7	21.7	18.9	306	341	3.0	2.7	1.8	1.8	15.5	15.0
LICHF	Buy	478	3.4	46.2	56.4	10.4	8.5	324	371	1.5	1.3	1.4	1.5	15.1	16.2
IHFL	Buy	791	4.9	95.6	109.7	8.3	7.2	395	446	2.0	1.8	3.1	3.1	25.6	26.1
PNBHF	Buy	886	2.1	62.2	73.5	14.2	12.0	432	489	2.1	1.8	1.4	1.3	15.3	16.0
REPCO	Buy	423	0.4	40.0	45.1	10.6	9.4	245	287	1.7	1.5	2.4	2.4	17.7	17.0
Housing Finance															
SHTF	Buy	1,168	3.8	109.0	127.9	10.7	9.1	694	804	1.7	1.5	2.3	2.3	16.9	17.1
MMFS	Buy	438	3.9	22.8	26.4	19.2	16.6	173	191	2.5	2.3	2.5	2.4	13.9	14.5
BAF	Neutral	2,541	20.4	65.8	85.6	38.6	29.7	327	403	7.8	6.3	3.7	3.7	22.1	23.5
CIFC	Buy	1,190	2.6	77.2	86.4	15.4	13.8	393	470	3.0	2.5	2.4	2.3	21.5	20.0
SCUF	Buy	1,642	1.5	147.3	162.1	11.1	10.1	952	1,096	1.7	1.5	3.5	3.6	16.6	15.8
LTFH	Buy	136	4.0	11.5	13.4	11.9	10.2	66	78	2.1	1.7	2.3	2.2	18.7	18.6
MUTH	Neutral	532	3.0	50.3	58.0	10.6	9.2	229	270	2.3	2.0	5.8	5.9	23.8	23.3
MAS	Buy	546	0.4	25.3	30.9	21.6	17.7	152	175	3.6	3.1	4.2	4.1	17.8	18.9

UR=Under Review*Multiples adj. for value of key ventures/Investments; For ICICI Bank and HDFC Ltd BV is adjusted for investments in subsidiaries

Div Yield based on FY16 expected dividend; UR: Under Review

Financials and valuations

Income Statement								(INR Million)
Y/E MARCH	**2014**	**2015**	**2016**	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Interest Income	37,896	51,200	69,012	92,723	118,480	165,329	218,384	282,283
Interest Expended	15,732	22,483	29,269	38,034	46,216	65,487	90,000	119,945
Net Interest Income	**22,163**	**28,717**	**39,743**	**54,690**	**72,264**	**99,842**	**128,384**	**162,338**
Change (%)	28.9	29.6	38.4	37.6	32.1	38.2	28.6	26.4
Other Operating Income	2,429	2,618	3,924	7,050	9,000	12,150	16,403	22,143
Other Income	419	364	398	260	239	1,200	1,440	1,728
Net Income	**25,011**	**31,699**	**44,065**	**61,999**	**81,503**	**113,192**	**146,226**	**186,210**
Change (%)	31.2	26.7	39.0	40.7	31.5	38.9	29.2	27.3
Operating Expenses	11,511	14,284	18,991	25,642	32,719	40,771	50,882	63,600
Operating Income	**13,500**	**17,415**	**25,074**	**36,357**	**48,783**	**72,421**	**95,344**	**122,610**
Change (%)	28.2	29.0	44.0	45.0	34.2	48.5	31.7	28.6
Provisions and W/Offs	2,588	3,846	5,429	8,182	10,349	13,664	18,894	25,799
PBT	**10,912**	**13,569**	**19,646**	**28,175**	**38,434**	**58,757**	**76,450**	**96,811**
Tax	3,722	4,591	6,861	9,810	13,471	20,918	27,216	34,465
Tax Rate (%)	34.1	33.8	34.9	34.8	35.0	35.6	35.6	35.6
PAT	**7,190**	**8,979**	**12,785**	**18,366**	**24,963**	**37,840**	**49,234**	**62,346**
Change (%)	21.6	24.9	42.4	43.6	35.9	51.6	30.1	26.6
Proposed Dividend	802	903	1,347	2,296	2,159	3,784	4,923	6,235

Balance Sheet								(INR Million)
Y/E MARCH	**2014**	**2015**	**2016**	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Capital	498	500	536	1,094	1,150	1,150	1,150	1,150
Reserves & Surplus	39,411	47,497	73,731	88,790	153,645	187,058	230,531	285,583
Net Worth	**39,909**	**47,997**	**74,266**	**89,884**	**154,796**	**188,208**	**231,682**	**286,733**
Borrowings	**197,496**	**266,908**	**370,247**	**492,497**	**644,813**	**896,050**	**1,161,104**	**1,504,338**
Change (%)	50.4	35.1	38.7	33.0	30.9	39.0	29.6	29.6
Other liabilities	**8,776**	**13,207**	**25,216**	**54,909**	**68,635**	**82,362**	**98,835**	**118,601**
Total Liabilities	**246,180**	**328,112**	**469,730**	**637,289**	**868,243**	**1,166,620**	**1,491,620**	**1,909,672**
Investments	**282**	**3,323**	**10,341**	**40,747**	**31,460**	**36,179**	**41,605**	**47,846**
Change (%)	436.3	1,077.9	211.2	294.0	-22.8	15.0	15.0	15.0
Advances	**229,710**	**311,995**	**438,309**	**582,394**	**819,433**	**1,106,235**	**1,415,980**	**1,812,455**
Change (%)	37.2	35.8	40.5	32.9	40.7	35.0	28.0	28.0
Net Fixed Assets	2,199	2,492	2,870	3,611	4,703	4,728	4,753	4,778
Other assets	13,990	10,303	18,210	10,537	12,648	19,480	29,282	44,593
Total Assets	**246,180**	**328,112**	**469,730**	**637,289**	**868,243**	**1,166,620**	**1,491,620**	**1,909,672**

E: MOSL Estimates

Financials and valuations

Ratios

Y/E MARCH	2014	2015	2016	2017	2018	2019E	2020E	2021E
Spreads Analysis (%)								
Yield on Advances	19.1	18.9	18.4	18.2	16.9	17.2	17.3	17.5
Cost of borrowings	9.6	9.7	9.2	8.8	8.1	8.5	8.8	9.0
Interest Spread	9.5	9.2	9.2	9.4	8.8	8.7	8.6	8.5
Net Interest Margin	11.2	10.6	10.6	10.7	10.3	10.4	10.2	10.1
Profitability Ratios (%)								
RoE	19.5	20.4	20.9	22.4	20.4	22.1	23.5	24.1
RoA	3.4	3.1	3.2	3.3	3.3	3.7	3.7	3.7
RoA on AUM	3.5	3.2	3.3	3.5	3.5	3.8	3.8	3.8
Int. Expended/Int.Earned	41.5	43.9	42.4	41.0	39.0	39.6	41.2	42.5
Secur. Inc./Net Income	9.7	8.3	8.9	11.4	11.0	10.7	11.2	11.9
Efficiency Ratios (%)								
Op. Exps./Net Income	46.0	45.1	43.1	41.4	40.1	36.0	34.8	34.2
Empl. Cost/Op. Exps.	29.6	31.6	33.2	36.3	44.5	46.4	48.4	50.3
Asset-Liability Profile (%)								
Loans/Borrowings Ratio	116.3	116.9	118.4	118.3	127.1	123.5	122.0	120.5
Net NPAs to Adv.	0.3	0.5	0.3	0.4	0.4	0.4	0.4	0.5
CAR	21.0	18.0	19.5	20.3	24.7	22.8	22.1	21.5
Tier 1	*18.0*	*14.2*	*16.1*	*14.6*	*19.7*	*17.7*	*17.0*	*16.5*

Valuation	2014	2015	2016	2017	2018	2019E	2020E	2021E
Book Value (INR)	69	83	129	156	269	327	403	499
Price-BV (x)				16.7	9.7	8.0	6.5	5.2
EPS (INR)	12.5	15.6	22.2	31.9	43.4	65.8	85.6	108.4
EPS Growth (%)	21.6	24.9	42.4	43.6	35.9	51.6	30.1	26.6
Price-Earnings (x)				81.9	60.3	39.8	30.6	24.1
Dividend per Share (INR)	1.4	1.6	2.3	4.0	3.8	6.6	8.6	10.8
Dividend Yield (%)				0.2	0.1	0.3	0.3	0.4

E: MOSL Estimates

NOTES

Explanation of Investment Rating

Investment Rating	Expected return (over 12-month)
BUY	>=15%
SELL	< - 10%
NEUTRAL	> - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

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