Bajaj Finance
SELL

COMPANY INSIGHT | BAF IN EQUITY | November 05, 2015

Steep valuations and rising risks

Bajaj Finance's (BAF) current valuations are double their cross-cycle averages due to expectations of current earnings growth sustaining. However, such lofty valuations leave little room for potential disappointments which may arise from: (i) declining profitability in the unsecured business; and (ii) declining real estate prices, jeopardising its asset quality and growth in the low-yielding Loan-Against-Property segment. Our EVA model values BAF at ₹3760/share (implied FY17E PB/PE of 2.4x/12x), implying 28% downside, despite our generous long-term assumptions. We reiterate SELL.

Competitive position: MODERATE   Changes to this position: NEGATIVE

LAP – A profit growth engine that has stopped firing

Loan against property (LAP) has been the key profitability driver for BAF over FY09-14 (from 7% of AUM to 30%). However, BAF's growth and profitability in LAP is coming under pressure due to increasing competition in the segment. Moreover, softening real estate prices could create asset quality challenges for the company given higher share of commercial property in BAF's LAP exposure (~45% for BAF vs peer average of ~30%) and higher ticket sizes of the property (₹17.5mn for BAF vs peer average of ₹12mn).

Unsecured loans compensating for LAP – but headwinds are emerging

To compensate for the lower profitability in the LAP segment, BAF is increasing its exposure to higher-yielding unsecured loans (16% in FY11 to 30% of AUM in 2HFY16). However, as in LAP, BAF's profitability in unsecured loans could also come under pressure due to: **(i)** falling yields in this segment given increasing competition; and **(ii)** BAF's credit cost increasing from cyclically low levels. Whilst there are early signs of delinquencies in this segment, higher growth in the segment is masking some of the deterioration in asset quality.

No longer a play on consumer finance

Whilst BAF is often referred to as a play on consumer durable financing, its exposure to this low-RoA business is only 15% of AUM. Growing online sales of consumer durables continues to be negative for BAF, as it struggles to get subventions from dealers/manufacturers and loses its competitive advantage of being the sole financer available at physical points of sale.

Little room for disappointments amidst rising risks; reiterate SELL

BAF's current valuations of 3.6x/22x 1-year fwd PB/PE are at a 110%/85% premium to their cross-cycle averages due to expectations of sustainability of earnings growth demonstrated in FY11-15. However of late, BAF has been sustaining its earnings growth by growing rapidly in high-yielding but riskier unsecured products. With NPA growth amongst the highest vs peers, BAF's lofty valuations leave little room for disappointments arising from: (i) competition-driven declining profitability in unsecured business; and (ii) declining real estate prices, jeopardising asset quality and growth in low-yielding LAP. Our excess return model values BAF at ₹3,760 (implied FY17E P/B of 2.4x and implied FY17E P/E of 12x), implying 28% downside from CMP, despite our generous long-term assumptions. We reiterate SELL.

Key financials

Particulars	FY14	FY15	FY16E	FY17E	FY18E
Total Income (₹ mn)	25,001	31,700	43,641	54,120	67,208
PAT (₹ mn)	7,190	8,979	12,302	14,445	17,615
Dil. EPS (₹)	144	178	218	255	311
BVPS (₹.)	802	915	1,359	1,584	1,858
ROE (%)	19.5	20.4	19.7	17.4	18.1
P/E (x)	37.2	30.1	24.6	20.9	17.2
P/BV (x)	6.7	5.8	3.9	3.4	2.9

Source: Company, Ambit Capital research

BFSI

Recommendation

Mcap (bn):	₹282/US$4.3
6M ADV (mn):	₹406/US$6.2
CMP:	₹5,345
TP (12 mths):	₹3,760
Downside (%):	28%

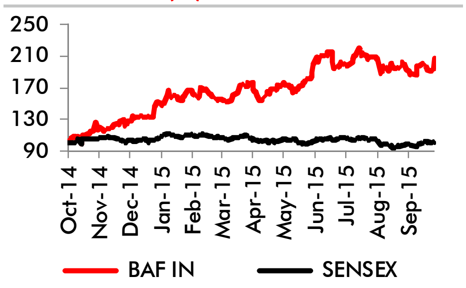
Flags

Accounting:	GREEN
Predictability:	GREEN
Earnings Momentum:	GREEN

Catalysts

- Declining growth over FY17-18E
- Increasing competitive intensity in unsecured loans over FY17-18E

Performance (%)



Source: Bloomberg, Ambit Capital research

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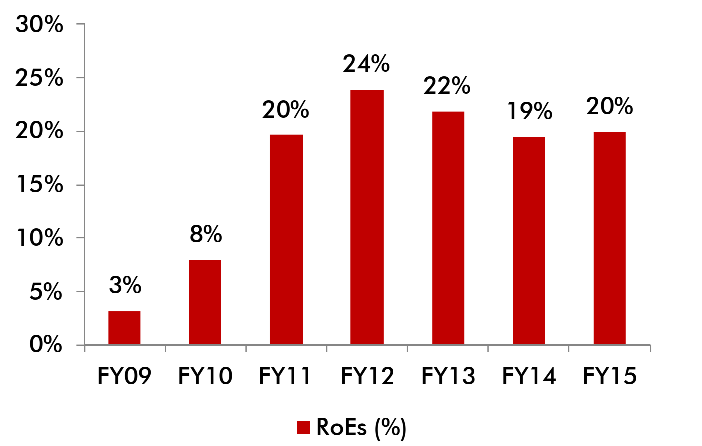
Dream run drives peak valuations

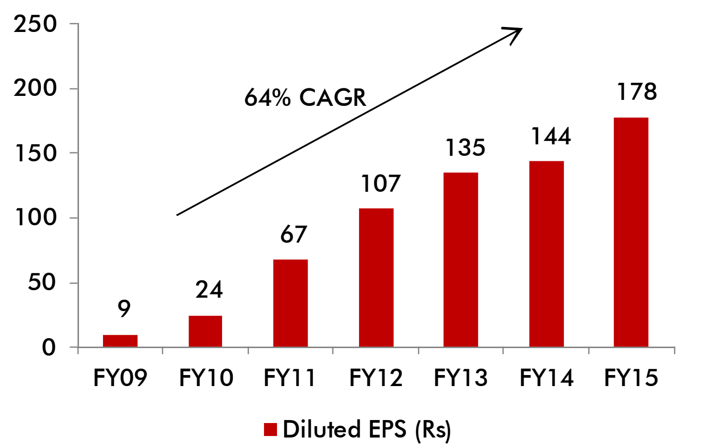
Bajaj Finance has had a dream run over the last 8 years, with RoEs improving from 3% in FY09 to 20% in FY15, leading to an EPS CAGR of 64% during this period.

Exhibit 1: Sustained RoE improvement…



Source: Company, Ambit Capital research

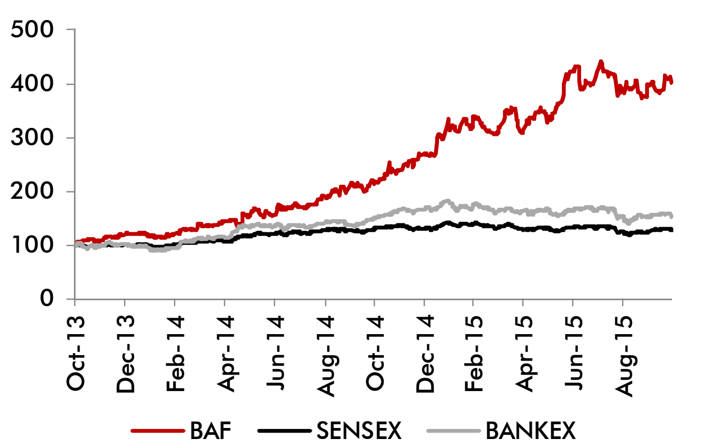
Exhibit 2: …has been led by robust EPS growth



Source: Company, Ambit Capital research

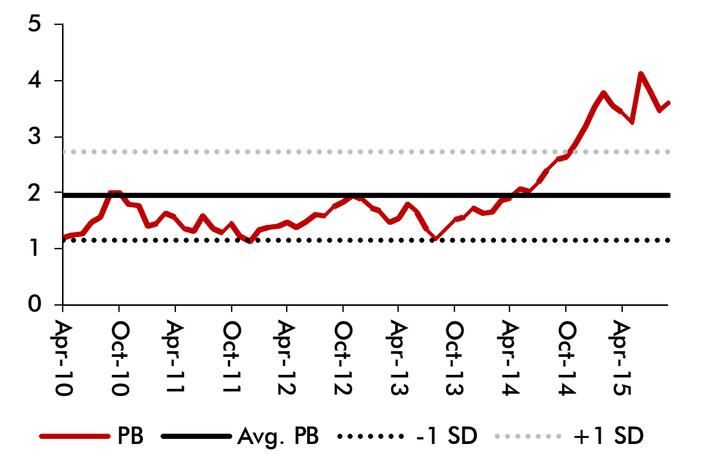
Such improvement in RoEs led to BAF's stock price increasing 100x over FY09-15. In fact, sustained RoE improvement, despite the downturn, has led to continuous outperformance vis-à-vis Sensex (260%) and Bankex (by 230%) over the past two years. With such a rally, BAF has rerated from 1.2x one-year forward P/B in October 2013 to 3.6x one-year forward P/B currently, which is at an 85% premium to the cross-cycle average valuation of the stock. Such peak valuations imply that consensus expects the company to continue sustaining current growth and profitability over the next 3-4 years.

Exhibit 3: BAF has outperformed the Bankex and Sensex…



Source: Bloomberg, Ambit Capital research

Exhibit 4: …and is now trading at historical peak valuations



Source: Bloomberg, Ambit Capital research

Growth vs valuations – Answering the conundrum

In the following sections of note, we delve into the following key questions:

- What were/are the key drivers of BAF's profitability in the past and future?
- What are the risks to BAF's profitability going forward?
- What should be an appropriate valuation multiple for BAF?

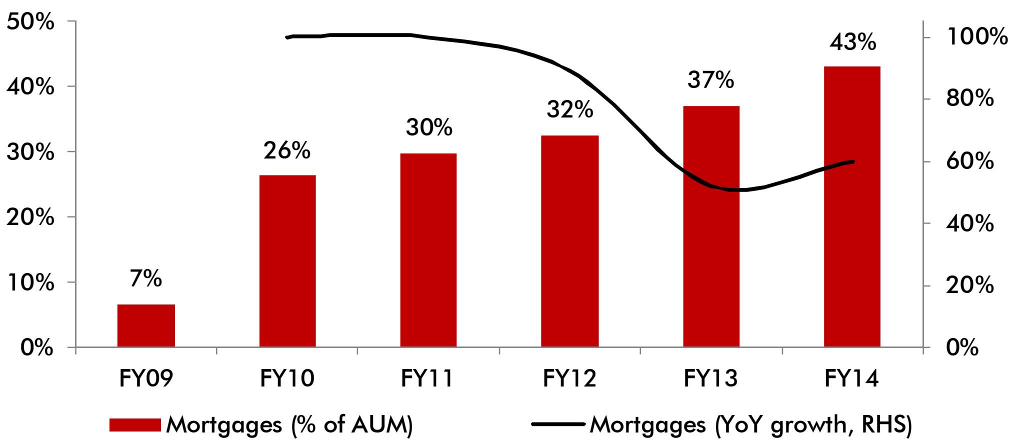
LAP – No longer a profitability driver

BAF's growth and profitability during FY09-14 was driven by the LAP segment. However, BAF's growth and profitability in LAP is declining, as: (i) hyper-competition has led to wafer-thin spreads; (ii) stagnation of real estate prices would result in higher credit costs; and (iii) removal of prepayment penalties on floating rate loans have killed BAF's product differentiation. Moreover, higher ticket sizes and share of commercial property make us wary of BAF's LAP exposure. Whilst BAF's growth in LAP has slowed down, LAP remains its key strategic product with high exposure (~25% of AUM).

FY09-14: LAP – A key driver of profitable growth

BAF is widely considered to be a consumer durable financier given its leadership position in the segment. However, the bulk of its profitability over FY09-14 was driven by the then highly-profitable loan against property (LAP) segment. During this period, the proportion of LAP in BAF's loan portfolio increased from 7% to 30%.

Exhibit 5: LAP's share in BAF's loan portfolio has increased over FY09-14

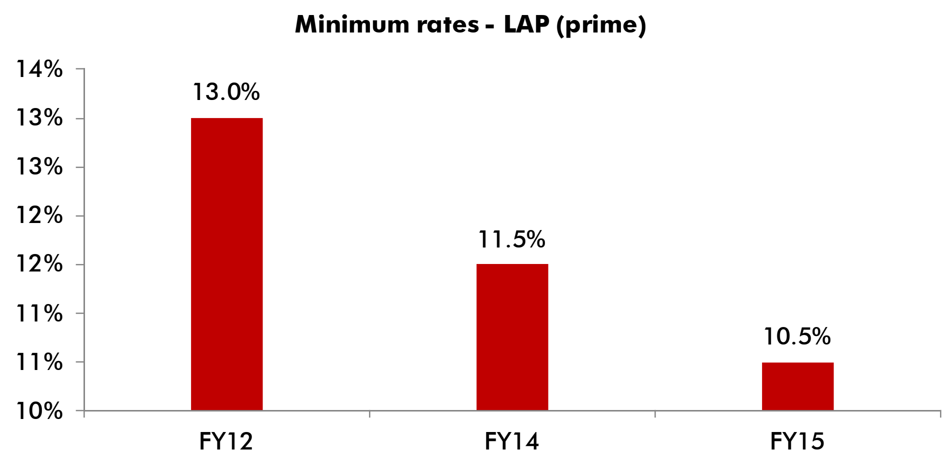


Source: Company, Ambit Capital research. Note: LAP has represented 70-90% of BAF's AUM over FY09-14

Benign competition implied lucrative yields

Over FY11-13, competitive intensity in the loan against property (LAP) segment was relatively benign, as mainstream lenders such as banks were focused on corporate loans for their growth. Consequently, yields in this segment were lucrative at ~14-16%.

Exhibit 6: LAP yields were lucrative before FY13



Source: Industry interactions, Ambit Capital research

Rising property prices resulted in negligible credit costs

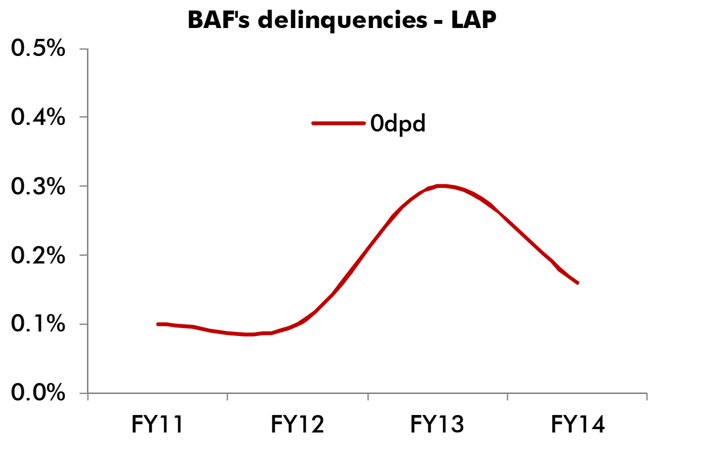
"Stable property prices have provided comfort in the asset quality for LAP"

– CRISIL," The LAP Leap of Non-banks: Potential Hurdles Ahead?", July'15

Asset quality in LAP remained impeccable during this period, as rising property prices over FY11-14 enabled a stressed borrower to seek refinance from other lenders despite lack of adequate cash flows. Moreover, rising property prices also implied that the amount from recovery was higher than the amount lent, thus minimising the loss given default as well. Thus, rising property prices resulted in very low credit costs for this segment due to lowering probability of default as well as loss given default.

Such lucrative yields coupled with low credit mean that BAF's RoEs in this segment were ~20-24% over FY10-13 in the LAP segment, as per our estimates.

Exhibit 7: BAF's delinquencies in LAP have been stable over FY11-14 due to stable property prices...



Source: Ambit Capital research

Exhibit 8: ...leading to healthy RoEs in LAP segment

	RoEs in LAP (FY12)
Yields	14.5%
Cost of funds	7.0%
Net interest margins	**7.5%**
Operating costs	2.0%
Operating profits	5.5%
Credit costs	0.3%
Profit before tax	5.2%
Tax	1.7%
RoAs	**3.5%**
Leverage	6.3
RoEs	**21.9%**

Source: Ambit Capital research

Differentiation, higher ticket sizes and superior servicing drove BAF's growth

Rising property prices increased the loan eligibility of the borrowers, thus driving the robust growth in this segment for all the lenders. That said, BAF specifically outperformed its peers in growth due to the following reasons:

- **Differentiated products:** Up to May 2014, BAF was the only lender which did not levy any prepayment fees on LAP products. This contrasted to the rest of its peers, which charged 2-4% of the amount prepaid. Consequently, the prospects of saving fees on prepayment made BAF's LAP product very attractive to the borrowers and drove its customer acquisition and disbursement growth.
- **Higher ticket sizes:** BAF focused exclusively on higher ticket-sized loans, which drove its AUM growth despite its much lower customer base in the segment – BAF's LAP book of ~₹90bn consists of ~5,100 customers as compared to Repco Finance's much smaller LAP book of ~₹11bn despite consisting of ~5,700 customers.
- **Superior customer servicing:** Our channel checks indicate that BAF has one of the fastest turnaround times in the LAP space. This also drove BAF's popularity with the DSAs (direct selling agents).

FY14 onwards: LAP – No more a profit growth driver

BAF's growth and profitability is under pressure due to increasing competition in the segment coupled with declining property prices.

Hostile competition is squeezing growth and yields

"Loan against property business continued to remain in hyper competitive state."

– Rajeev Jain, CEO, Bajaj Finance, 2QFY16 earnings call.

Slowdown and asset quality risks in corporate lending have resulted in banks re-aligning their focus on retail and SME loans. Moreover, high growth along with stellar asset quality over FY09-14 has made this segment a focus product for many lenders.

Exhibit 9: LAP growth gains momentum for new entrants over the past two years

Mortgages	FY13	FY14	FY15	2QFY16
BAF	52%	60%	17%	21%
HDFC Bank	32%	2%	17%	24%
HDB Financial Services	107%	64%	42%	NA
ICICI Bank	-9%	25%	18%	21%
Kotak Mah. Bank	29%	13%	22%	68%
IndusInd Bank	243%	77%	50%	43%

Source: Company, Ambit Capital research. Business banking numbers have been used for HDFC Bank and ICICI Bank, which includes LAP. For others mortgages are used.

Exhibit 10: New lenders entered/started focussing on the LAP segment over FY12-15

New entrants in LAP
LIC Housing Finance
Magma Fincorp
Hinduja Leyland Finance
Edelweiss Finance
HDB Financial Services
Hero Fincorp

Source: Company, Ambit Capital research

Exhibit 11: PSU banks have started focusing on LAP

Source: Media sources, Ambit Capital research

Exhibit 12: PSU HFCs have also started focusing on LAP

Source: Media sources, Ambit Capital research

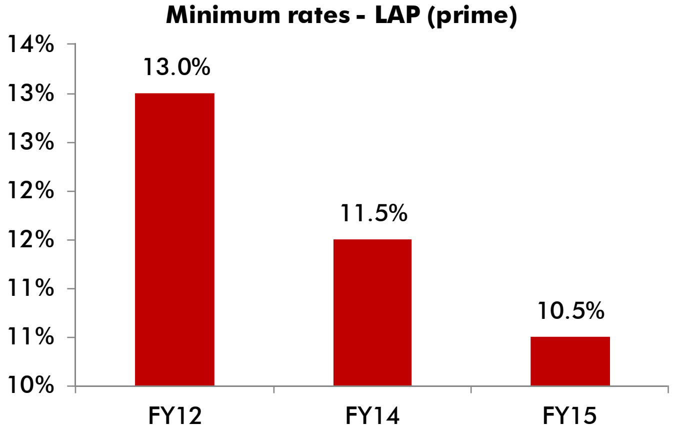
Exhibit 13: Foreign banks (HSBC) are offering cut-throat pricing

Source: Media sources, Ambit Capital research

This increased competition has led to yields compressing in this segment meaningfully; for example, as per our channel checks with the DSAs, the minimum lending rates in LAP has decreased from 13-15% in FY12 to 10.5-13% in FY15. Given that BAF operates in the same segment where banks operate (prime customers in higher ticket sizes), BAF's yields in this segment has decreased since FY15.

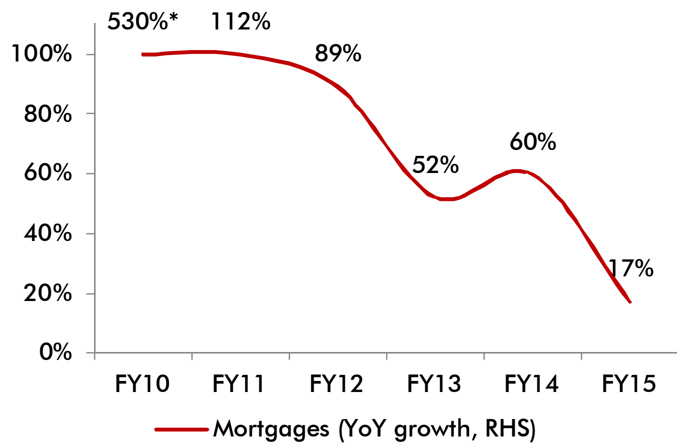
Moreover, the RBI removing prepayment fees on floating rate products to individuals has made it difficult for BAF to incrementally attract/retain customers.

Exhibit 14: Hyper-competition has led to a system-wide decline in yields in the LAP segment …



Source: Industry, Ambit Capital research

Exhibit 15: … slowing BAF's AUM growth in mortgages*



Source: Company, Ambit Capital research; Note: LAP has represented 70-90% of BAF's AUM over FY09-14.

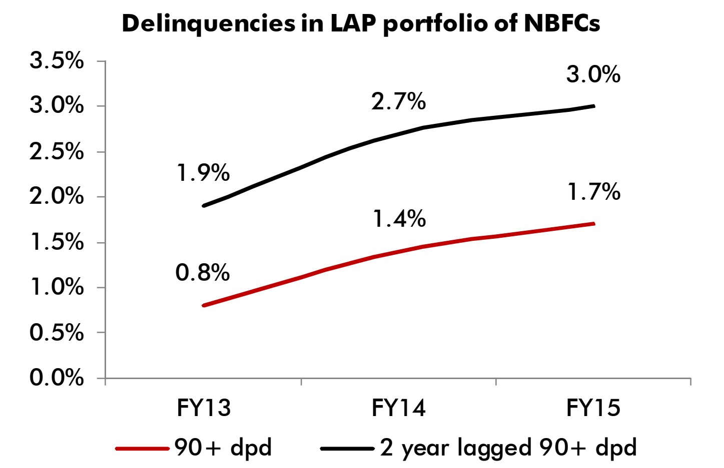
Declining property prices could impair asset quality

A slowdown in real estate prices, as highlighted in our thematic dated 14 July 2015, could be a key catalyst for higher delinquencies and slower growth in the LAP segment, as:

- Lower property prices would make refinancing loans for the stressed borrower difficult, leading to increased delinquencies in the segment.
- Lower property prices would also increase loss given default as lenders tried to offload confiscated property in a muted demand environment.

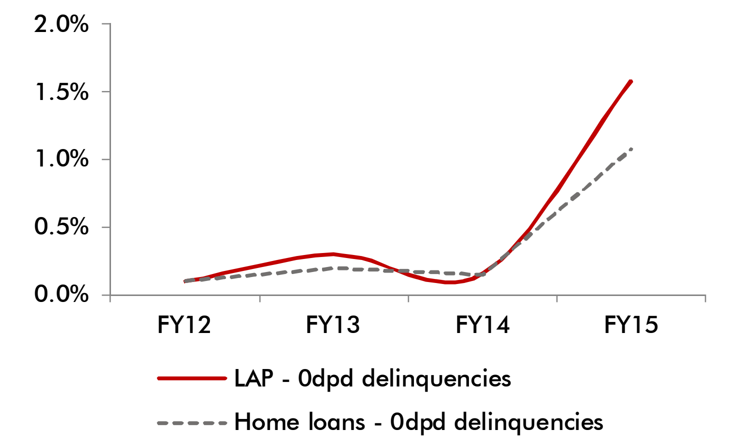
In fact, with the stagnation of real estate prices over FY14-15, we have already seen delinquency trends beginning to deteriorate in the LAP segment for most of the lenders.

Exhibit 16: Delinquencies are increasing for NBFCs in LAP



Source: CRISIL, Ambit Capital research

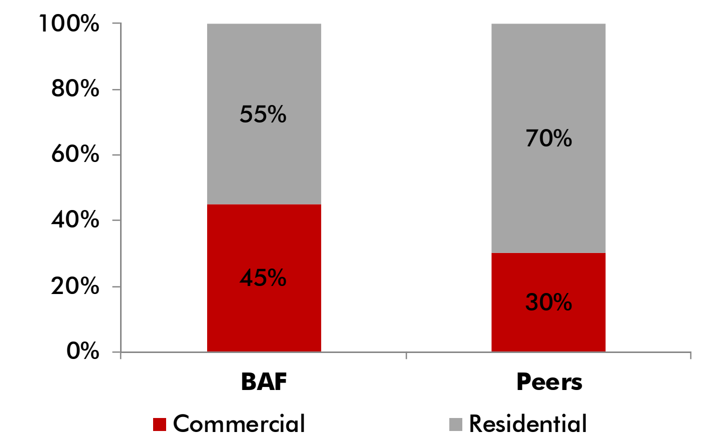
Exhibit 17: Delinquencies are also increasing for BAF



Source: Company, Ambit Capital research

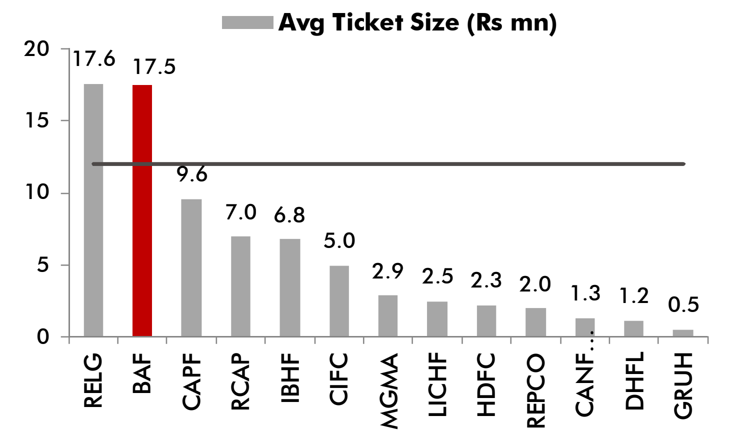
With BAF exposure to relatively higher ticket-sized loans (₹1.7mn for BAF vs ₹1.2mn for the industry) and commercial property, there could be a significant dent on BAF's asset quality going forward.

Exhibit 18: BAF has higher exposure to riskier commercial property as compared to its peers



Source: CRISIL, Ambit Capital research

Exhibit 19: BAF's ticket sizes are much higher than its peers



Source: Company, Ambit Capital research

Pushed towards unsecured loans

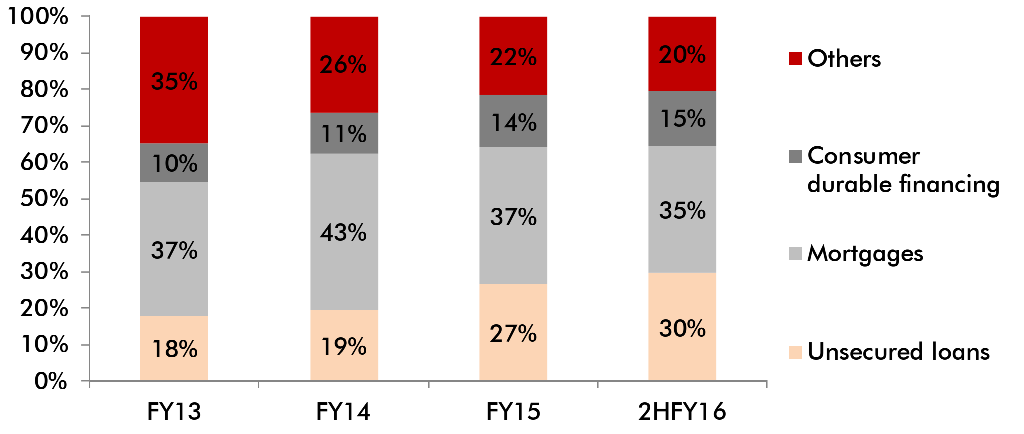
In order to compensate for lower profitability in the LAP segment, BAF is increasing its exposure to unsecured loans (16% in FY11 to 30% of AUM in 2HFY16). However, as in LAP, BAF's profitability in unsecured loans could come under pressure due to: (i) falling yields in this segment given the increasing competition; and (ii) increasing credit costs for BAF from cyclically low levels. Whilst there are early signs of delinquencies in this segment, higher growth in the segment is masking some of the deterioration in asset quality.

Growing share of unsecured compensating for lower profitability in other segments

BAF's management has acknowledged increased competition and growing risk in the LAP segment and has hence slowed down its growth in the LAP segment.

However, it seems that to compensate for the lower profitability in the LAP segment, the company is increasing its exposure to unsecured loans (personal loans – salaried and cross-sell; small business loans). The share of unsecured loans has increased from 19% in FY14 to 30% of AUM in 2HFY16.

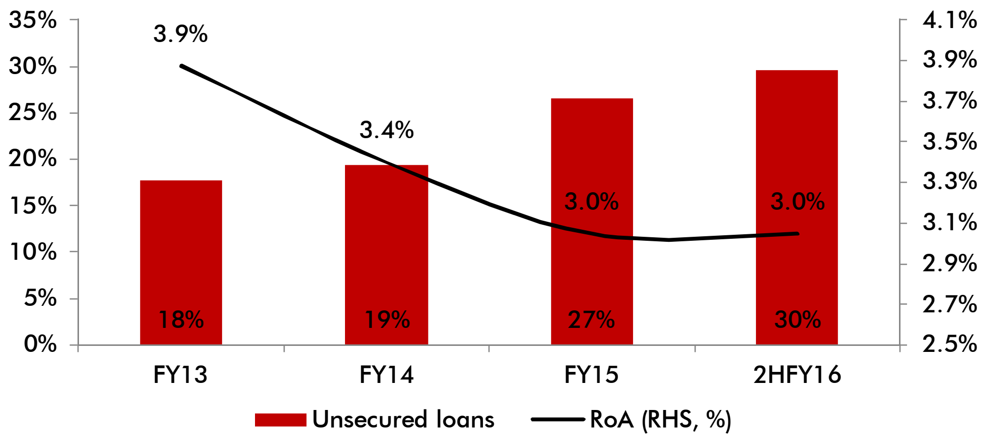
Exhibit 20: BAF's AUM mix has increasingly shifted to unsecured loans



Source: Company, Ambit Capital research

Given that yields are ~300-500bps higher in secured SME loans vs LAP-based loans, essentially BAF is taking higher risk to compensate for declining profitability in LAP. Hence, whilst the company has maintained its RoAs, this is coming at higher risk.

Exhibit 21: BAF has maintained its RoAs by growing its share of unsecured loans



Source: Company, Ambit Capital research

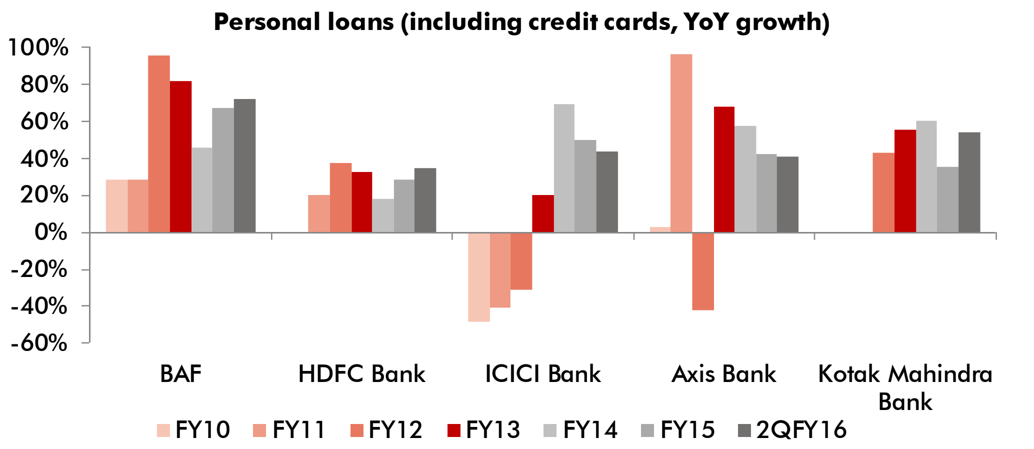
But headwinds emerging in unsecured loans

Despite taking higher risk, BAF has been able to maintain higher profitability in the unsecured loan segment because of lower than cross-cyclical provisioning cost in the segment. The delinquency and NPA levels of BAF in this segment have been coming down over FY09-12 due to: **(i)** Some aggressive players vacating the market post the FY08 washout in personal loans, which meant that the remaining players were able to cherry pick loans in the segment on their own terms; and **(ii)** Increasing penetration of credit bureaus like CIBIL and Equifax, which helped lenders pick the right credit in this segment.

Competition turns hostile – Pricing now under pressure

However, the slowdown in corporate loans over the last couple of years has led to intense competition in retail loans including unsecured loans (especially personal loans). Many banks which had exited the market earlier are back in this market.

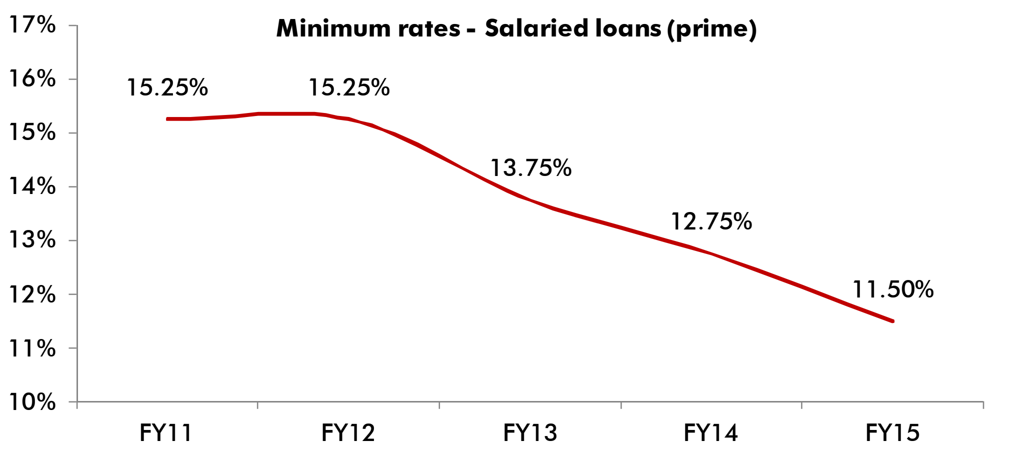
Exhibit 22: Banks have started aggressively disbursing personal loans from FY13 onwards



Source: Company, Ambit Capital research

This increased competition in the segment is leading to pricing pressure reflecting in falling yields in the segment. This compression in yields, we believe, is bringing down risk-adjusted returns for BAF in the segment.

Exhibit 23: Intense competition has led to a decline in pricing for personal loans

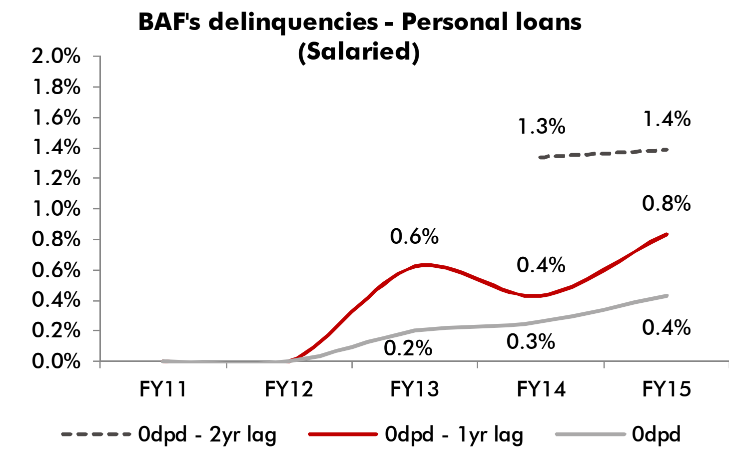


Source: Industry interactions, Ambit Capital research

Delinquencies have bottomed out and are increasing

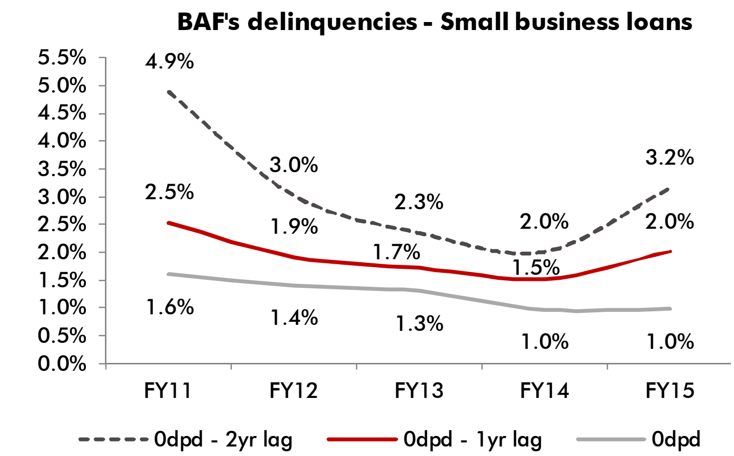
Despite falling yields, BAF is still making money in the business given the low delinquencies in the segment. However, there are early signs of delinquencies increasing in this segment. But higher growth in the segment is masking some of this deterioration in asset quality. Delinquencies/NPA trends adjusted for growth have deteriorated for BAF over the last one year in personal loans as well as unsecured personal loans.

Exhibit 24: BAF's personal loan (salaried) delinquencies have bottomed out and are showing an uptick



Source: Company, Ambit Capital research; Note: 2-year lagged delinquencies = 0+ dpd (t) / AUM (t-2). 0dpd is 0 days past due.

Exhibit 25: BAF's small business loans delinquencies have bottomed out and are now increasing



Source: Company, Ambit Capital research; Note: 2-year lagged delinquencies = 0+ dpd (t) / AUM (t-2). 0dpd is 0 days past due.

With our expectation of muted economic growth in India for the next two years, we expect delinquencies to further increase in the SME segment. Once growth starts slowing down, the delinquency numbers would appear to be very high and start impacting profitability.

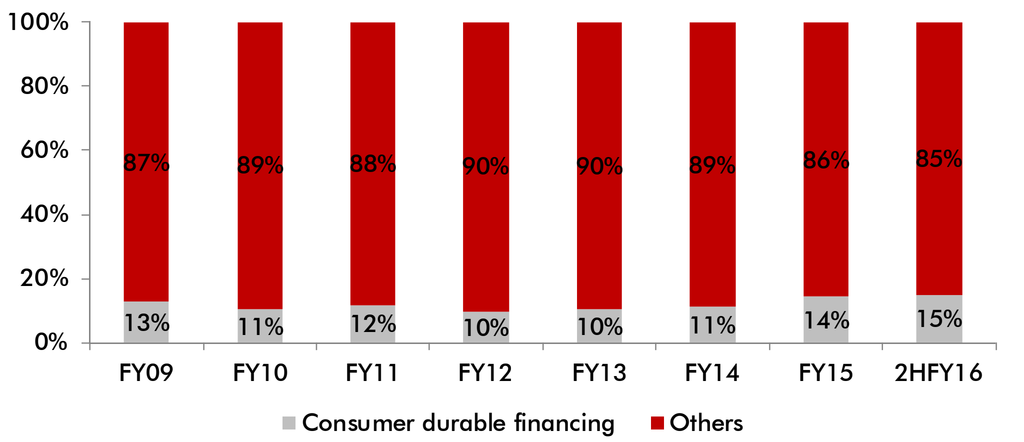
No longer a play on consumer finance

Whilst BAF is often referred to as a play on consumer durable financing, its exposure to this low RoA segment is only 15% of AUM. Growing online sales of consumer durables continues to be negative for BAF, as it will struggle to get subventions from dealers/manufacturers and lose its competitive advantage of being the sole financer available at points of sale.

A very small part of its AUM

Given its dominant position in consumer durable financing, BAF is generally considered as a play on consumer durable financing. However, consumer durable financing is just 15% of the total AUM despite BAF adding new products in the segment (financing of cell-phones, laptops, cameras, furniture, etc). Moreover, consumer financing loans are of very short duration (6-12 months), which would need relatively higher disbursement growth to sustain the current AUM growth. BAF, as its current AUM mix suggests, is at best a play on unsecured lending in India.

Exhibit 26: Consumer finance is not a significant driver of BAF's AUM mix



Source: Company, Ambit Capital research

Shifting sales to online platform is a key challenge

BAF is unlikely to get subvention from dealers and manufacturers on online platforms

With sales of consumer durables increasingly moving to online mode, a general thinking is that BAF could be a key beneficiary of this trend. However, we believe that this trend in fact could be negative for BAF.

BAF makes money in consumer durable financing by getting subvention from the manufacturer rather than charging any interest to the consumer. However, our channel checks suggest that in online platforms, most of the consumer durables are offered by a vast network of fragmented distributors rather than manufacturers. Given that distributors are anyway operating on very thin margins on online platforms, it is very unlikely that BAF could get subvention for consumer durables. Manufacturers are unlikely to offer subventions too, as they are not keen on the online model where their products are being sold at hefty discounts.

With prospects of lower/zero subventions, BAF would have to charge its customers for the consumer durable financing, which will put it on par with other lenders. Thus, an online model would endanger BAF's differentiation relative to other lenders in terms of product proposition and sole presence at points of sale.

For example, despite BAF's tie-up with Apple, which enables it to get subvention on offline sales, BAF does not get subvention for online sales. In the exhibit below, we have highlighted how the consumer needs to pay a higher undiscounted price on a phone if he/she wants to take financing from BAF on online purchases.

Exhibit 27: BAF's offer price for iPhone 5S – ₹49,914/-*

Source: Emibazaar.com, Ambit Capital research; Note: * Prices as of 31/10/15.

Exhibit 28: Non-BAF offer price for iPhone 5S – ₹42,665/-

Source: Emibazaar.com, Ambit Capital research; Note: * Prices as of 31/10/15.

Key assumptions and estimates

Exhibit 29: Key assumptions and estimates (₹ mn unless specified)

Assumptions	FY15	FY16E	FY17E	FY18E	Remarks
YoY AUM growth (%)	34.7	30.9	25.9	25.0	We expect AUM growth to moderate to 27% CAGR over FY15-18E as a higher growth in unsecured SME (42% CAGR) and personal loans (40% CAGR) offsets slower growth in mortgages (17% CAGR).
NIMs on AUM (%)	10.2	10.5	10.1	10.0	We expect BAF's NIMs to decline by ~20bps, as declining cost of funds is offset by declining yields due to competitive pressures.
Opex (as a % AAUM)	5.1	5.1	5.0	4.7	BAF's improvement in operating efficiencies will be marginal at ~40bps as small-ticket loans like consumer durables and digital financing will remain constant as a percentage of AUM.
Credit costs (% of avg loan book)	1.4	1.7	1.8	2.1	BAF's credit costs will increase going forward due to its foray in unsecured products, wherein asset quality has already peaked out.
Key Output					
Net revenues (₹ mn)	31,700	43,641	54,120	67,208	FY16-18E CAGR of 24% vs FY12-16 CAGR of 32%.
Operating profit (₹ mn)	17,415	24,561	30,404	38,970	FY16-18E CAGR of 26% vs FY12-16 CAGR of 34%.
Net Profit (₹ mn)	8,979	12,302	14,445	17,615	FY16-18E CAGR of 20% vs FY12-16 CAGR of 32%.
Diluted EPS (₹)	178	218	255	311	FY16-18E CAGR of 20% vs FY12-16 CAGR of 19%.
Adjusted BVPS (₹)	915	1,359	1,584	1,858	FY16-18E CAGR of 17% vs FY12-16 CAGR of 29%.
RoA (%)	3.0	3.1	2.9	2.8	Decline of ~20bps
RoE (%)	20.4	19.7	17.4	18.1	Decline of ~200bps

Source: Ambit Capital research

Revision in estimates

We upgrade our FY16/17 estimates marginally due to our higher growth expectations.

Exhibit 30: Change in estimates (₹ mn)

Particulars	New estimates			Old estimates			Change		
	FY16E	FY17E	FY18E	FY16E	FY17E	FY18E	FY16E	FY17E	FY18E
Net revenues (₹ mn)	43,641	54,120	67,208	41,622	51,881	NA	5%	4%	NA
Operating profit (₹ mn)	24,561	30,404	38,970	23,246	29,250	NA	6%	4%	NA
Profit after tax (₹ mn)	12,302	14,445	17,615	11,828	14,601	NA	4%	-1%	NA
Diluted EPS (₹)	218	255	311	209	258	NA	4%	-1%	NA
Adjusted BVPS (₹)	1,359	1,584	1,858	1,350	1,575	NA	1%	1%	NA

Source: Ambit Capital research

Ambit vs consensus

Our FY17/18 earnings estimates are broadly lower than consensus estimates due to our expectations of higher credit costs.

Exhibit 31: Ambit vs consensus

Particulars	Ambit	Consensus	Divergence
Total Income (₹ mn)			
FY16E	43,641	41,521	5%
FY17E	54,120	52,769	3%
FY18E	67,208	66835	1%
PAT (₹ mn)			
FY16E	12,302	11,693	5%
FY17E	14,445	14,970	-4%
FY18E	17,615	19083	-8%
EPS (₹ mn)			
FY16E	217.5	219.2	-1%
FY17E	255.4	276.5	-8%
FY18E	311	355	-12%

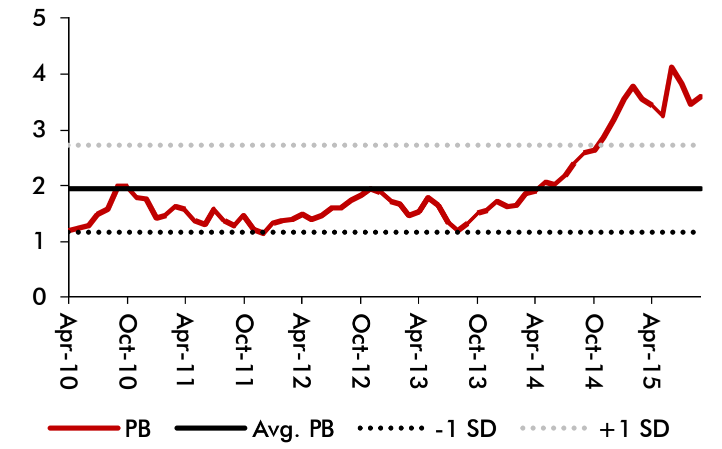
Source: Company, Ambit Capital research

Watertight valuations = Risk > Return

Premium valuations unlikely to sustain

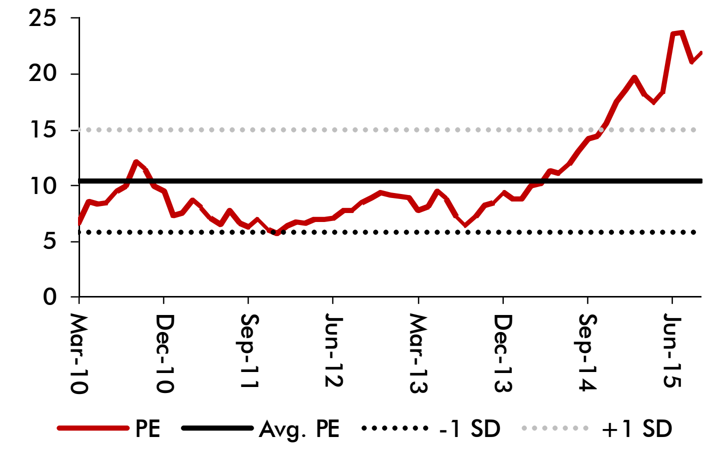
BAF's current 12-month forward P/B of 3.6x and 12-month forward P/E of 22x are at a 110% premium and 85% premium to their cross-cycle averages driven primarily by a robust and sustained earnings growth over FY11-15. In fact, our reverse EVA model suggests that the current valuations are factoring in more than 25% EPS growth beyond the next five years. Given the compressing profitability in the segments in which BAF is currently growing, we do not think that the current multiples could sustain going forward.

Exhibit 32: BAF is trading at a ~85% premium to its one-year forward P/B



Source: Bloomberg, Ambit Capital research

Exhibit 33: BAF is trading at a ~110% premium to its one-year forward P/E

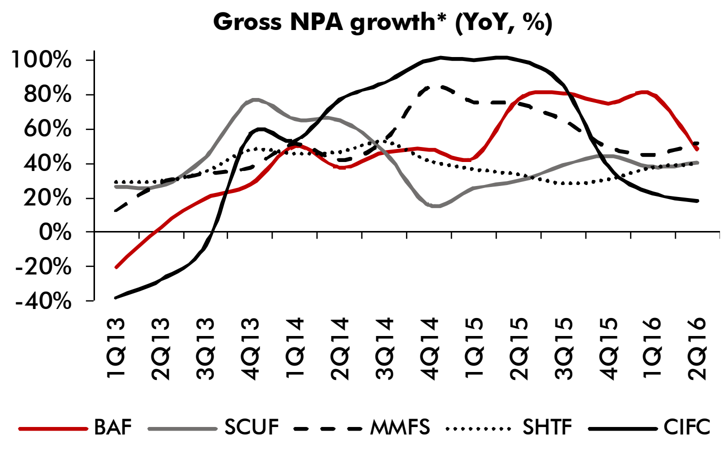


Source: Bloomberg, Ambit Capital research

No room for disappointments – Peer-highest NPA growth with simultaneous growth in unsecured loans

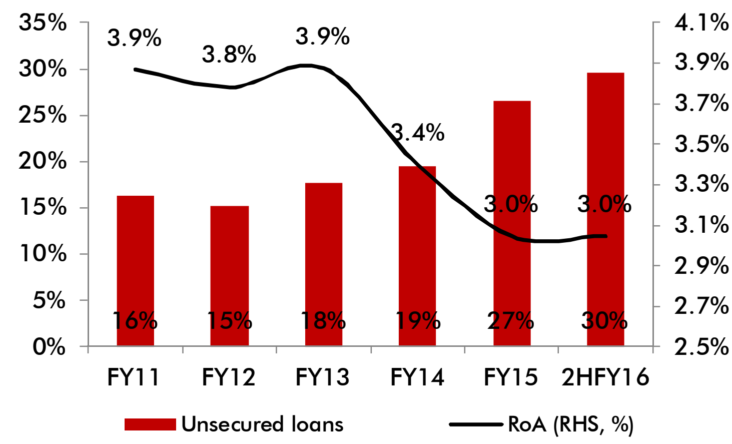
We find BAF's valuation multiple punchy particularly in light of asset quality risks arising from a growing unsecured book. In fact, amongst the retail NBFCs, BAF is already demonstrating one of the highest gross NPA growth vs its peers, despite its unsecured book not being seasoned enough. Whilst such high NPA growth is somewhat offset by high AUM growth, we believe it is a just a matter of time that rising gross NPAs eventually reflect in slower AUM growth as well.

Exhibit 34: BAF's gross NPA growth has been the highest amongst its peers...



*Source: Bloomberg, Ambit Capital research; *NPA growth has been adjusted for one time spikes on migration to revised NPA recognition norms.*

Exhibit 35: ...even as it increases its exposure to unsecured to defend its RoAs from hyper-competition



Source: Bloomberg, Ambit Capital research

Near-term outperformance driving premium to peers

BAF trades at a 50-60% premium on P/B and P/E to its peer-set due to a higher visibility in near-term earnings growth. However, we believe that investors are being myopic in assigning higher multiples to BAF, as BAF is delivering such higher earnings growth mainly by taking higher risks in the form of unsecured lending. With profitability coming down from this segment due to decline in yields and credit costs increasing from cyclically low levels, we expect BAF's relative premium to its peers to contract going forward.

Exhibit 36: Relative valuation snapshot

	Mcap	Reco.	TP	Up/ down	P/B		P/E		EPS CAGR	ROA		ROE	
	US$bn		₹		FY16E	FY17E	FY16E	FY17E	FY15-17E	FY16E	FY17E	FY16E	FY17E
Housing Finance companies													
HDFC	29.4	NA	NA	NA	5.6	5.2	31.8	29.3	5%	1.9%	1.8%	22.2%	21.0%
LIC Housing Finance	3.7	SELL	368	-24%	2.7	2.3	14.8	13.7	13%	1.6%	1.5%	21.2%	19.6%
Indiabulls Housing Finance	4.6	NA	NA	NA	2.9	2.5	11.9	10.0	14%	3.6%	3.5%	27.8%	27.3%
Gruh Finance	1.4	NA	NA	NA	10.6	8.7	37.6	30.9	19%	2.4%	2.4%	29.5%	28.6%
Dewan Housing Finance	1.0	NA	NA	NA	1.2	1.1	8.3	6.7	17%	1.3%	1.3%	15.6%	16.6%
Repco Home Finance	0.7	NA	NA	NA	4.7	3.9	28.4	22.5	25%	2.3%	2.3%	17.7%	19.1%
Average					**4.6**	**3.9**	**22.1**	**18.9**	**16%**	**2.2%**	**2.1%**	**22.3%**	**22.0%**
Asset Financers													
Shriram Transport	3.3	SELL	745	-22%	2.1	1.8	17.8	13.2	25%	2.0%	2.1%	14.5%	15.3%
M&M Finance	2.0	SELL	225	0%	1.9	1.7	14.7	11.5	11%	2.2%	2.5%	13.1%	15.1%
Magma Fincorp	0.3	BUY	133	48%	0.9	0.8	11.4	6.5	25%	0.9%	1.5%	9.4%	13.3%
Sundaram Finance	2.7	NA	NA	NA	5.4	4.7	35.6	30.7	9%	2.8%	2.9%	16.9%	17.2%
Cholamandalam	1.5	BUY	740	15%	2.7	2.4	19.8	14.9	20%	1.8%	2.1%	15.7%	17.4%
Average					**2.6**	**2.3**	**19.8**	**15.3**	**18%**	**1.9%**	**2.2%**	**13.9%**	**15.7%**
Consumer finance													
Bajaj Finance	4.4	SELL	3,760	-28%	4.0	3.4	25.6	20.7	23%	3.0%	2.9%	18.7%	17.7%
Shriram City Union Finance	1.8	BUY	2,456	35%	2.4	2.1	17.5	13.8	21%	3.5%	3.6%	14.7%	16.2%
Manappuram	0.3	NA	NA	NA	0.7	0.7	6.4	5.5	12%	2.5%	2.6%	11.3%	12.6%
Muthoot Finance	1.1	NA	NA	NA	1.3	1.2	9.2	7.6	19%	3.0%	3.2%	14.9%	16.5%
SKS Microfinance	0.9	NA	NA	NA	4.2	3.3	20.5	14.6	38%	5.1%	4.9%	22.8%	25.2%
Average					**2.5**	**2.1**	**15.8**	**12.4**	**22%**	**3.4%**	**3.4%**	**16.5%**	**17.6%**

Source: Bloomberg, Ambit Capital research

Absolute valuations imply downside despite generous assumptions

We have valued BAF using the excess return to equity model which is 'net profit – (cost of equity x average net worth)' for all the future years discounted back to the present using cost of equity.

- We have explicitly forecast net profit for FY15-18E based on the assumptions in Exhibit 29.
- We have assumed 25% CAGR in loan growth for FY19-23, and have faded it to an average 19% over FY23-35.
- We have assumed an average sustainable RoA of 2.3% and sustainable RoE of 17% from FY18 onwards, as BAF's credit costs would increase from the current levels on a cross-cycle basis.
- We have assumed cost of equity of 15% and terminal growth of 5%.

Based on these assumptions our excess return model values BAF at ₹3,760/share (implied FY17E P/B of 2.4x and implied FY17E P/E of 12x), implying 28% downside from current levels. Note that we have revised our target price by 16% primarily due to factoring in higher AUM growth and sustainable RoA estimates in the near term than what we were taking earlier. This is partially offset by increase in cost of equity by 50bps to 15% to factor in higher risk of the business model due to increasing proportion of unsecured products in its AUM.

Exhibit 37: Excess return valuation profile for BAF

Particulars (in mn)	₹ mn, unless mentioned
Current Net worth (Sep'15) – A	68,540
Excess return – B	116,360
Total Fair Value - C = A+B	**184,900**
Shares in issue - D	57
Implied fair value per share - E=C/D	3,269
Cost of equity of the company – F	15%
One-year forward Target price - E*(1+F)	**3,759**

Source: Ambit Capital research

Exhibit 38: Change in long-term assumptions

Particulars	Before	Current
FY18-23E		
AUM CAGR	20%	25%
RoAs	2.3%	2.5%
FY24E onwards		
AUM CAGR	18%	18%
RoAs	2.0%	2.2%
Cost of equity of the company – F	14.5%	15%
One year forward target price	**3,239**	**3,759**

Source: Ambit Capital research

Key catalyst for our SELL stance

Declining growth: Whilst BAF's NPA growth has been highest amongst peers, it continues to deliver robust earnings growth due to a much higher AUM growth. Any decline in AUM growth will lead to a decline in earnings growth, due to higher provisioning growth. BAF's growth could decline due to various factors such as:

- **Competitor actions:** Our channel checks indicate that few of its products are still driven by differentiation in certain product features like no prepayment fees for fixed rate loans. In this regard, a pricing cut in SME business loans and removal of prepayment rates by competitors could further add pressure on BAF's growth and profitability.
- **Higher delinquencies in unsecured loans:** This can result in BAF putting breaks on its growth.

Risks to our SELL stance

Improvement in asset quality: Reversal of delinquency levels in BAF's key products such as LAP and unsecured loans implies that our expectations of higher credit costs will not play out.

Competitive environment turning benign: Uptick in corporate loans could imply that the competitive environment is turning benign in the retail lending segment. This could result in profitability of certain key segments of BAF like LAP and unsecured loans improving going forward.

Forensic accounting

Exhibit 39: BAF is clean on all parameters

Segment	Score	Comments
Accounting	GREEN	With 90dpd provisioning and standard assets provisioning of 0.4%, BAF has been one of the most-prudent providers of NPAs amongst NBFCs. We believe that its accounts are the true representation of the accounts of the company.
Predictability	GREEN	BAF has always guided the markets well in advance and in most cases has not surprised negatively. The company provides adequate information on a quarterly basis and its investor presentations, unlike many larger and smaller peers, provide a very detailed view about the management's approach to its business.
Earnings Momentum	GREEN	We have not seen meaningful downgrades in consensus FY16/17 EPS estimates over the past six months.

Source: Company, Ambit Capital research

Income statement

	FY14	FY15	FY16E	FY17E	FY18E
Net interest income	**22,153**	**28,717**	**39,233**	**48,543**	**60,172**
Interest Income	37,886	51,200	66,966	81,447	100,335
Interest Expense	15,732	22,483	27,733	32,903	40,163
Fee based and other income	2,848	2,983	4,408	5,576	7,036
Total Income	**25,001**	**31,700**	**43,641**	**54,120**	**67,208**
Total expenses	11,511	14,285	19,080	23,715	28,238
Operating and other expenses	8,103	9,778	13,446	16,673	19,435
Employee Cost	3,408	4,507	5,634	7,043	8,803
Pre provision profit	**13,490**	**17,415**	**24,561**	**30,404**	**38,970**
Provisions	2,578	3,846	6,200	8,845	12,680
Profit before tax	**10,912**	**13,570**	**18,361**	**21,559**	**26,290**
Tax	3,722	4,591	6,059	7,115	8,676
PAT	**7,190**	**8,979**	**12,302**	**14,445**	**17,615**

Source: Company, Ambit Capital research

Balance Sheet

	FY14	FY15	FY16E	FY17E	FY18E
Net-worth	40,203	47,997	76,880	89,577	105,060
Borrowings	208,400	291,120	364,445	462,290	581,166
Total liabilities	**248,603**	**339,117**	**441,326**	**551,867**	**686,226**
Fixed assets	2,199	2,492	2,866	3,295	3,790
Investments	282	3,323	2,991	2,692	2,422
Loans and Advances	240,610	324,100	424,125	534,070	667,552
Cash and Bank Balance	7,768	2,197	1,977	1,779	1,601
Deferred tax assets	1,392	2,123	2,654	3,317	4,146
Net working capital	(3,648)	6,715	6,715	6,715	6,715
Total assets	**248,603**	**340,949**	**441,326**	**551,867**	**686,226**

Source: Company, Ambit Capital research

Key Metrics

	FY14	FY15	FY16E	FY17E	FY18E
AUM growth (%)	37.4	34.7	30.9	25.9	25.0
Dil Consol EPS growth (%)	6.6	23.7	22.4	17.4	21.9
Net interest margin (NIM) (%)	10.7	10.2	10.5	10.1	10.0
Cost to income (%)	46.0	45.1	43.7	43.8	42.0
Opex (% of AAUM)	5.54	5.06	5.10	4.95	4.70
Gross NPAs (%)	1.2	1.5	1.7	2.0	2.1
Credit costs (% of AAUM)	1.24	1.36	1.66	1.85	2.11
Provision Coverage (%)	76.4	70.6	70.6	70.6	70.6
Capital adequacy (%)	19.5	18.0	21.3	20.1	19.2
Tier-1 (%)	16.5	14.2	17.5	16.3	15.4
Leverage (x)	5.7	6.7	6.3	6.0	6.4

Source: Company, Ambit Capital research

Valuation Metrics

	FY14	FY15	FY16E	FY17E	FY18E
BVPS (₹.)	802	915	1,359	1,584	1,858
Dil. EPS (₹)	143.7	178	218	255	311
RoA (%)	3.4	3.0	3.1	2.9	2.8
RoE (%)	19.5	20.4	19.7	17.4	18.1
P/E	37.2	30.1	24.6	20.9	17.2
P/BV	6.7	5.8	3.9	3.4	2.9
Dividend yield (%)	0.3	0.3	0.4	0.5	0.6

Source: Company, Ambit Capital research

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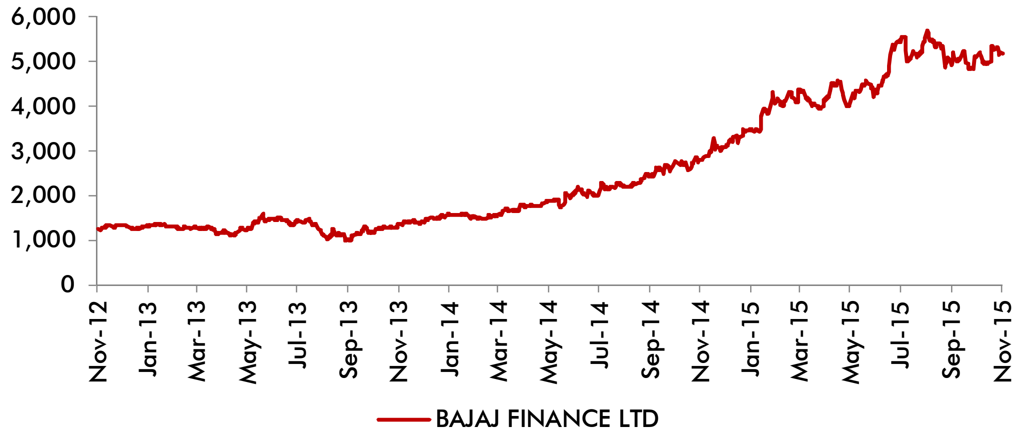

Source: Bloomberg, Ambit Capital research

Explanation of Investment Rating

Investment Rating	Expected return (over 12-month)
BUY	>10%
SELL	≤10%
NO STANCE	We have forward looking estimates for the stock but we refrain from assigning valuation and recommendation
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