AU Small Finance Bank **Primary Offer**

Small bank, big prospects

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The offer is not cheap, but this NBFC transitioning into a small bank scores on several metrics

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AU Small Finance Bank (formerly Au Financiers (India)) is one of the 10 players that were granted licence by the RBI to set up small finance banks. With a chunk of the licences being granted to microfinance institutions (MFIs), AU Small Finance Bank is the only non-banking finance company (NBFC) that was allowed to set up a small finance bank.

Still, as far as achieving the goal of extending finance to small businesses and low-income households is concerned, AU Small Finance Bank has notable synergies.

Given its product portfolio and existing customer base, the company is well-placed to meet the regulatory norm of extending 75 per cent of loans to the priority sector and have at least 50 per cent of loans up to ₹25 lakh.

The company's well-diversified portfolio, strong traction in loans, healthy return ratios and good asset quality are key positives. While the asking price for the initial public offer (IPO) is expensive, investors wanting a piece of the action in the differentiated banking space can subscribe to the issue with a long-term horizon, given the sound prospects and business model of the company. The issue is an offer-for-sale of 5.3 crore shares, totalling about ₹1,900 crore.

At the upper end of the price band (₹358), the valuation works out to about 5.1 times the FY-17 book value. A like-to-like comparison with existing listed players may not be possible, given that AU Small Finance is the only NBFC transitioning into a small bank. Also, unlike some small- and mid-sized banks such as RBL Bank and YES Bank, the company is predominantly a retail player.

Good metrics

Nonetheless, on various financial metrics, AU Small Finance Bank appears a sound bet compared with other high-valued stocks in the space. While YES Bank, RBL Bank and Cholamandalam Investment and Finance Company trade at 3-4 times their FY-17 book, Bajaj Finance is a pricey seven times.

AU Small Finance's loan book has grown 30 per cent annually and earnings a robust 47 per cent annually between FY-13 and FY-17 (excluding profit on sale of its stake in subsidiary companies in FY-17). The company's bad loans have also been under check, with gross non-performing assets (GNPAs) at 1.6 per cent of loans.

AU Small Finance Bank sports healthy return ratios — return on assets (ROA) is 3.4 per cent and return on equity (ROE) is 21.7 per cent in FY17 — in sync with other leading NBFCs. This offers it enough room to absorb additional costs on transitioning into a small finance bank.

Both Equitas and Ujjivan — MFIs that transitioned into small finance banks last year — have seen their ROAs dip by 70-100 basis points over the past year. AU Small Finance Bank's post-transition ROA at possibly sub-3 per cent levels would still be better than most other mid-sized banks that sport ROAs of 1-1.8 per cent.

Also, AU Small Finance Bank already has a well-diversified loan book with retail focus — a positive compared to Ujjivan or Equitas (trading at 2.5-2.8 times FY17 book) that rely heavily on MFI business.

Sound business prospects

AU Small Finance Bank operates in three business lines: vehicle finance; micro, small and medium enterprise (MSME) loans, and small and medium enterprises (SME) loans.

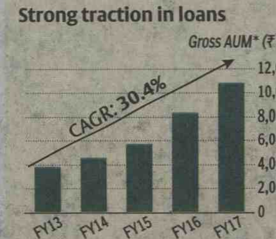
Vehicle loans constituted half the company's gross assets under management (AUM) as of March 2017; they are extended for the purchase of new and pre-owned vehicles and for refinancing of vehicles. A chunk (about 70 per cent) of the portfolio is for financing new vehicles, which mitigates risk. The average loan ticket size for this business is about ₹3.4 lakh.

Within the vehicle finance business, multi-utility vehicles, cars and small commercial vehicles are key segments that constitute 33 per cent, 28 per cent and 22 per cent of loan book respectively. The overall vehicle finance business has grown 16 per cent annually between FY13 and FY-17.

MSME and SME loans have grown at a faster 55 per cent and 78 per cent annually respectively, over the last four years. From about 15 per cent in FY-13, MSME loans now account for about 30 per cent of the company's AUM and SME loans have upped their share in the total AUM to around 20 per cent from 5-odd per cent.

Diversification of the loan portfolio is a positive for the company as it transitions into a small finance bank.

The company also has a significant presence in the rural and semi-urban markets. Of the 300-odd branches, 146 are located in such markets.



*Assets under management

Transitioning costs

While on the asset side, AU Small Finance Bank is well-positioned to make the transition, and the loan book is likely to grow at a healthy clip, profitability in the near term could come under pressure on account of several factors.

One, due to the costs involved in meeting the statutory requirements such as CRR and SLR.

The other headwind is the likely increase in provisioning requirement on account of more stringent asset classification norms kicking in this fiscal. NBFCs in any case were required to tighten their NPA recognition norms and bring them on a par with banks by March 2018.

AU Small Finance Bank that was following a 150-day cut-off as on March 2016 reduced it to 120 days as on March 2017.

This led to GNPAs inching up to 1.6 per cent in FY-17 from 0.64 per cent of loans in FY-16. As a small finance bank, the company will have to comply with the 90-day norm for FY-18. This can result in increase in GNPAs and hence, provisioning, thus impacting earnings.

Also, the company will incur some costs for branch expansion. In addition to the existing branches, the company intends to open 162 additional branches in FY18.

The company's operations are mostly concentrated in Rajasthan, Gujarat and Maharashtra, though it has expanded its business into other geographies such as Madhya Pradesh, Punjab, Haryana and Delhi over the years.

While the ROA could dip below 3 per cent levels in FY-18, earnings are likely to be healthy over the long run on the back of strong traction in loans. While garnering a pie of low-cost deposits could be a challenge, incremental benefits of such deposits trickling in would help cushion some of the erosion in the company's profitability.

IPO rating ★★★★☆

Au Small Finance Bank

Business	1 2 **3** 4 5
Valuation	1 **2** 3 4 5
Financials	1 2 3 **4** 5
Management	1 2 **3** 4 5
Overall	1 2 **3** 4 5

Rankings 1 to 5, 1 denoting lowest and 5 highest

Offer period	**June 28 - 30, 2017**
Price band	**₹355-358**