

## Buy Ujjivan Financial Services for a price objective of INR 405

### Stock Info

BSE	539874
NSE	UJJIVAN
Bloomberg	UJJIVAN IN
Reuters	UVJF.BO
Sector	Banks
Face Value (INR)	10
Mkt Cap (INR Cr)	1,329
52w H/L (INR)	262 / 96

### Shareholding Pattern %

(As on Dec, 2021)

Promoters	NIL
Public & Others	100.0

Stock Performance (%)	3m	YTD	12m
Ujjivan Financial	-16.1	-17.2	-49.2
Nifty 50	1.2	-0.9	20.1

### Financial Snapshot (Ujjivan SFB)

INR cr unless stated	FY20	FY21	9MFY22
AUM	14,153	15,140	16,463
Deposits	10,780	13,136	15,563
NII	1,634	1,729	1,230
PPoP	637	809	373
PAT	350	8	-541
Ratios			
GNPA	1.0	7.1	9.8
NNPA	0.2	2.9	1.7
NIM	10.8	9.5	8.4
RoA	2.2	0.0	-
RoE	13.9	0.3	-
CAR	28.8	26.4	19.1

Source: Company, Arihant Research

We recommend Ujjivan Financial services as a tactical buy idea with price objective of INR 405 under base case scenario.

Ujjivan Small Finance Bank (Ujjivan SFB) is a mass market focused SFB in India, catering to underserved segments with focus on digital capabilities, customer-centricity, and financial inclusion, especially in rural areas. Its pan-India presence with no single state contributing >16% of AUM as at Dec'21, would enable it to outpace credit growth once the macro turns conducive. Its journey towards building secured assets is progressing well and liability franchise trending better with retail deposits at 53% of the deposits and CASA ratio at 26.5%. We believe the long-term prospects of the bank remain attractive on the back of 1) diversification towards secured portfolio, 2) ability to manage asset quality post covid and 3) peaking out of the opex cycle 4) credit cost moderation driving ROA expansion and change in management.

### Why the stock was underperformer?

Bank has come out with an IPO in Dec'2019 at INR 36-37 at valuation of 2.3x P/BV which has come down to 1.2x currently. Stock has corrected more than 50% from its IPO price due to bank's higher exposure to vulnerable segments (MFI) which was highly impacted by covid pandemic. Hence, credit cost of the bank increased sharply which has led to decrease in stock valuation. Exit of multiple board members and management executives, including Nitin Chugh has also dampened investors sentiment.

### How the things are shaping up?

Company has appointed Ittira Davis, as MD & CEO after the exit of Nitin Chugh. Management has given higher credit growth guidance of 15-20%. Also stated that, business momentum has not witnessed any major disruption and monthly collections continue to improve and expects the business momentum to remain strong in Q4FY22E. February month was better in terms of collection efficiency and disbursements. Management is looking to bring down the share of MFI to 50% (from 66.7% currently) as bank is looking to grow Affordable housing, MSE and FIG lending segment.

**Business Plan:** Bank is working on three key areas for growth under "100-Day Plan" with a primary focus on (a) Rebuilding business volumes, (b) Improving asset quality, and (c) Retaining talent, the management believes that the bank is currently better placed vs H1FY22 at the time of crisis. The bank will look to launch the credit card business in FY23.

**Asset Quality:** Due to covid related disruption, GNPA of the bank increased from 1% in FY20 to 9.8% as on Q3FY22. With improving collection and positive trends on the asset quality front, the management expects credit costs to normalise over the next 3-4 quarters. The management has retained its credit cost guidance of ~INR 1,000 cr for FY22E. Company carries INR 250 cr of Floating provision. We believe GNPA of the bank to come down to 6% by FY22 end and 1.5-2% by FY23.

**Reverse Merger update:** The bank has applied to the RBI, SEBI and exchanges for the reverse merger in early Nov'21. It will come up with a QIP offering of up to INR 600 Cr to comply with the minimum public shareholding norms. The reverse merger is expected to be completed within 12-15 months.

### We prefer Ujjivan Financials over Ujjivan Small Finance Bank

Currently, the holding company discount is at 43% which is expected to come down on the back of expectation of normalisation in credit cost with reduction in stress, increase in growth, shift from MFI to Non MFI segment and potential reverse merger of Ujjivan Financial with Ujjivan SFB.

**Merger ratio:** Swap ratio of 115 shares of Ujjivan SFB for every 10 shares of Ujjivan Financial are favorable for Ujjivan Financial shareholders.

**Valuation:** On FY24E P/BV (Bloomberg consensus), Ujjivan SFB is trading at discount of 31% over its closest peers Equitas SFB. Equitas SFB FY24E P/BV: 1.2x and Ujjivan SFB FY24E P/BV: 0.9x.

**Holding company discount pre and post merger announcement****i. Holdco discount prior to merger announcement (1 year prior)**

in cr.	Prior to merger announcement	
	Ujjivan	Equitas
SFB Mcap	5,505	6,266
Holding Company stake in SFB	83.3%	81.9%
Value for Holding Company	4,587	5,137
Holding Company Mcap	2,749	2,926
<b>Holdco Discount</b>	<b>-40%</b>	<b>-43%</b>

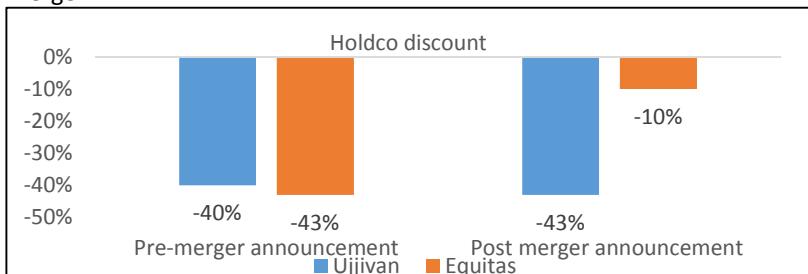
Note: Share price or Mcap are as on 18<sup>th</sup> March 2021.**ii. Holdco discount post merger announcement (As per merger ratio)**

in INR	Post merger announcement (as on 21-3-22)	
	Ujjivan	Equitas
SFB share price	17	53
Holding Company share price	112	108
Merger ratio (Holding:SFB)	10:115	100:226
Holding company value per share as per merger ratio	196	120
<b>Holdco Discount as per merger ratio</b>	<b>-43%</b>	<b>-10%</b>

Source: Arihant Research, Company Filings

Holding company discount for Equitas SFB has come down significantly post merger announcement. However, in case of Ujjivan Financial it has increased from 40% to 43% currently. Holdco discount for Ujjivan Financial is expected to come down on the back of stress reduction in the portfolio, increasing growth, diversification and strengthening the management team.

Below chart indicates the holding company discount prior and post merger.

**Portfolio strategy of Ujjivan SFB – Gradually focusing on formal segment**

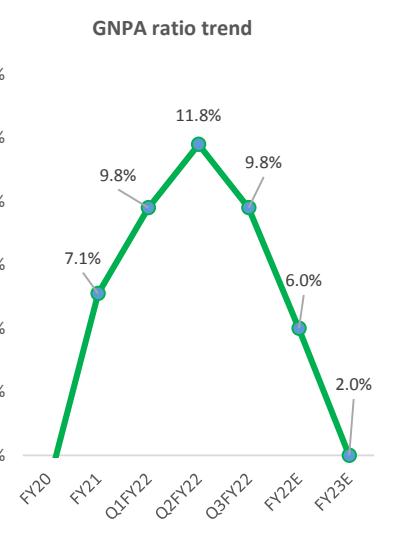
Bank is likely to diversify its portfolio into non-mfi segment. Bank is looking to realign its AUM mix with Micro and non-microbanking shares at 50%-50% over the medium to longer term from currently 67%-33% respectively. Affordable housing and MSE segments to remain key non-microbanking growth drivers in the medium term with focus on the formal segment. Bank has improved its internal processes by way of digitisation and the focus on productivity resulted in all-time higher quarterly disbursement in Q3FY22.

To expand its target market and shift product mix to bring in a better quality of book, it plans to deal with more formal segments rather than only the informal and the semiformal. Bank is expanding its reach via scale-up of existing channels & addition of new channels through Fintech, payments bank, money mitra outlets. Bank has launched product called micro LAP which is currently available in selected branch and targeting to scale it up by Q1FY23.

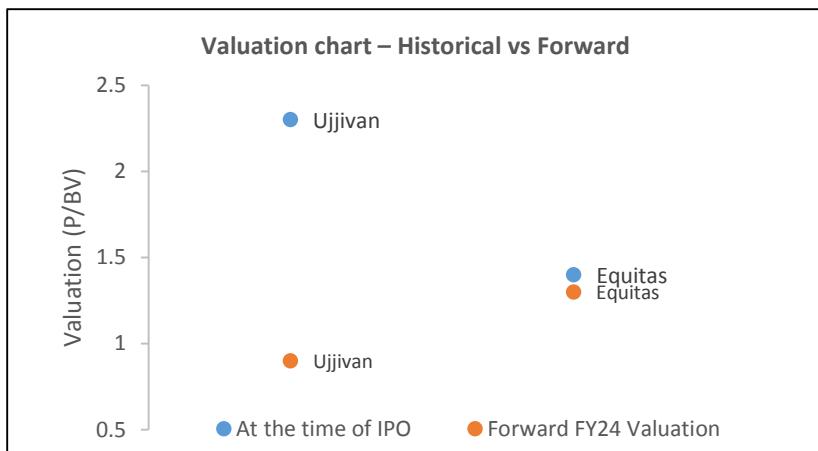
**Asset quality expected to witness meaningful improvement**

GNPA of Ujjivan SFB declined to 9.8% as of Dec'21 vs 11.8% in Sept'21 as the bank wrote off loans worth INR 152 cr. PCR as of Dec'21 stood at 84%. The restructured book stood at INR 1,239 Cr (7.5% of advances) against which the bank holds a provision of INR 550 Cr and the Collection Efficiency (CE) in Dec'21 stood at 80% in that book. As a result, the total stressed asset book reduced from ~22% of advances in Sep'21 to 17.3% in Dec'21.

With improving asset quality trends led by healthy collection efficiency and recovery, we are expecting GNPA to decline to 6% by the end of FY22E.



## Valuation chart and Price objective scenario analysis



Source: Company, Arhant Research

## Price Objective Scenario analysis

Particulars (in cr, unless stated)	Base Case scenrio	Best Case scenrio	Worst Case scenrio
Ujjivan SFB FY24E BV (in INR)	19	19	19
Target multiple -P/BV (x)	2.0	2.5	1.5
<b>Fair Value (in INR)</b>	<b>38</b>	<b>48</b>	<b>29</b>
Ujjivan SFB number of shares (in cr.)	172.8	172.8	172.8
Forward valuation of Ujjivan SFB (in cr)	6,568	8,209	4,926
Ujjivan Financials stake in SFB	83.32%	83.32%	83.32%
Value for Holdco (in cr)	5,472	6,840	4,104
Assigned Holding company discount	10%	10%	10%
Value for Holdco (post discount) (in cr)	4,925	6,156	3,694
Ujjivan Financial No. of shares (in cr)	12.2	12.2	12.2
<b>Value per share for Ujjivan Financial shareholders</b>	<b>405</b>	<b>506</b>	<b>304</b>

Source: Company, Bloomberg consensus taken for Ujjivan SFB book value

## Outlook; Valuation appears to be reasonable in comparison with peers

Ujjivan SFB had started its business as a pure play micro finance player and later diversified into SME and Affordable housing lending in an attempt to de-risk the portfolio. The bank has been successful in managing its asset quality and credit costs at sub-1% levels until the disruption caused due to demonetization. However, due to covid led challenges asset quality of the bank deteriorated significantly. With Improved traction on recoveries and sustaining collection levels, asset quality of the bank expected to witness an improvement with normalizing credit cost.

With a large part of investments already done towards branch expansion to build a robust liability franchise, technology and hiring workforce in the transition phase, a downtrend in the opex/assets will be visible. Bank's efforts to de-risk the portfolio and move towards the SME and Affordable housing space and other newly introduced products offer the bank ample headroom to grow.

The bank is on track to address and resolve the key concerns, strengthening the management team and improving asset quality. Q3FY22 performance of the bank was strong in terms of disbursements growth picking up across the segments. Management remains fairly confident of strong Q4FY22E with improvement in asset quality.

**Most likely, we are expecting conversion of Ujjivan SFB into Full fledged universal bank in the longer run.**

**We prefer Ujjivan Financial services over Equitas. On a forward basis, Ujjivan SFB is trading at nearly 31% discount over its peers Equitas SFB. Our base case scenario indicates a price objective of INR 405 for Ujjivan Financial services.**

**SFBs gaining credit market share at accelerated rate**

India's Small Finance Banks (SFBs) have carved a niche in small-ticket lending (~8% of systemic credit) in a short span of 4 years. They command 6% market share in small loans and incremental market share of >20% pre-covid. Further, SFBs are improving their rural market share at an accelerated pace. Its market share in small loans remains as high as 6% vs 1% total credit market share as at Dec'20. In a short span of 4 years in SFB operations, deposit market share of SFBs increased to 1% with incremental market share remaining higher at 3%. End-to-end digital onboarding process, customised product offerings and relatively higher interest rates helped them gain share from incumbents at an accelerated pace. Fast-evolving liability franchise would ensure sustainable source of funds at competitive rates and would further strengthen SFBs' position in the lending space.

Considering the government thrust on financial inclusion, there is a huge untapped lending opportunity and SFBs' experience in underwriting loans based on unstructured data, SFB's will dominate the small-ticket lending space going ahead.

Within SFBs, industry leaders (e.g. AU, Equitas, and Ujjivan) are likely to lead the growth given their deep distribution networks, competitive rates on the back of lower cost of funds as compared to other SFBs, and wide range of products to cater to changing customer needs.

**Recent change in regulation by RBI have a positive impact for MFI industry**

Recently, RBI released the much awaited final guidelines for the microfinance industry.

Key changes as per the master directions are towards (a) Definition of Microfinance loan, (b) Qualifying assets criteria, (c) Pricing of loans (d) Net Owned Fund (NOF) requirement, (e) Assessment of Household Income, (f) Limit on repayment obligations of a Household, (g) Conduct towards Microfinance Borrowers.

These final regulations, are positive for the microfinance sector, especially NBFC-MFIs given the removal of pricing differential. Further, the increase in annual household income limit criteria to INR 300K to qualify for a microfinance loan bodes well for the sector. We have seen a gradual MoM improvement in collection efficiency and rising trends in disbursals, which points towards normalization for the sector.

Microfinance loan pricing now stands changed against the earlier regulation whereby maximum interest charged can be lower of cost of funds plus a margin cap of 10% for MFIs with loan portfolio of Rs1bn or above and 12% for others. All regulated entities are now required to have a board approved policy regarding the pricing of the microfinance loan which shall consist of the following detail.

**Peer group comparison**

in cr.	CMP	AUM	GNPA	NNPA	NIM	CAR
Ujjivan SFB	17	16,463	9.8%	1.7%	9.1%	19.1%
Equitas SFB	53	19,687	4.4%	2.4%	9.1%	21.9%

in cr.	RoA (%)				RoE (%)				P/BV(x)			
	FY21	FY22E	FY23E	FY24E	FY21	FY22E	FY23E	FY24E	FY21	FY22E	FY23E	FY24E
Ujjivan SFB	-0.2	-2.2	1.2	1.6	-0.9	-15.5	10.6	15.1	1.0	1.2	1.0	0.9
Equitas SFB	1.5	1.1	1.9	2.0	11.2	7.8	13.7	15.7	1.9	1.6	1.4	1.2

Source: Company, Arihant Research (Financials data are as on Q3FY22)

Bloomberg consensus taken for forward projection (RoA, RoE, BV).

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<b>Stock Rating Scale</b>	<b>Absolute Return</b>
BUY	>20%
ACCUMULATE	12% to 20%
HOLD	5% to 12%
NEUTRAL	-5% to 5%
REDUCE	-5% to -12%
SELL	<-12%

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