Coverage Stock: Ujjivan Financial Services Ltd

Play the transformation

CMP INR 348 | Target INR 452

Rating: BUY | Upside: 30%

Date: 18th October 2017

Ujjivan Financial Services (UFS) is an NBFC-MFI turned SFB with Gross Loans of INR 6459 cr and 457 asset branches. As an SFB, it will incrementally focus on Micro SME and Affordable Housing, in addition to MFI business. It has undergone a perfect storm that has caused a transient depression in near term return ratios. The subsiding of these transient factors and the transformation from an NBFC-MFI into an SFB together will cause return ratios to expand meaningfully going forward. Given reasonable valuation for forecast return ratios, we initiate coverage with a 'BUY' Rating on the stock.

Current MFI industry crisis is transient in nature whereas high opex spend for building bank franchise will normalize lower

The current MFI industry crisis is transient in nature as on-ground interference is a localized phenomenon actuated sans institutional support. Importantly, MFI-focused players have learnt avoidance of affected districts. Collection Efficiency of 99.8% for the post-December book for UFS indicates a return to normalcy. Furthermore, PAR 0 for UFS has fallen from 10.2% to 8.8% over Q1FY18, indicating improvement in underlying asset quality. While C/I Ratio has spiked to 77-78% in Q4FY17-Q1FY18, it would start to normalize lower to 72% for full year FY18E, to 62% in FY19E and then to 53% by FY21E.

Transformation into Small Finance Bank is a watershed moment for UFS from a business model perspective

As an NBFC-MFI, UFS was constrained to focus mainly on MFI (keep a minimum of 85% assets "qualifying") but, as an SFB, it can pursue the entire gamut of small-ticket asset products, of which it has chosen to focus on Micro SME (MSE) and Affordable Housing, apart from MFI. At an MSE average ticket size of INR 2.96 lacs compared with key peers at INR 10-17.5 lacs, it is a prime beneficiary of the MSE opportunity. Similarly, with a Housing loan average ticket size of INR 4.96 lacs, it sits at a sweet spot of the housing loan opportunity augmented by PMAY. Other NBFC-MFI model constraints such as Margin Cap and Processing Fee Cap are also not applicable to an SFB. Importantly, Cost of Funds are expected to trend lower due to Deposits franchise build as well favourable Refinance opportunities.

Multiple idiosyncratic aspects earmark Ujjivan as an early adopter of best practices underlining high quality management pedigree

Ujjivan has adopted a judicious diversified growth pattern from the outset avoiding riskier geographies such as Andhra Pradesh (prior to 2010 AP Crisis) and has a exposure of 15% to its top state compared with 19-57% for key peers. Currently, UFS is prudently focusing on low-cost BC outlets to fulfil its URC requirement and 47 of 49 URC count for FY18 will be satisfied through BC or existing LWE/NE centres. It has been a pioneer in cashless disbursement with 66% proportion as early as June 2016 quarter. Importantly, its business mix is best placed to deliver RoE delta among key bottom-of-pyramid lenders as it is adequately levered to MFI recovery (97% of Q1FY18 AUM) and is also diversifying into attractive small-ticket businesses. High excess over PSL requirement (24.5%) compared with listed SFB peers (2-10%) indicates significant incremental PSLC fee income opportunity.

Outlook and Valuation: Initiate with BUY, PT of INR 452. UFS undervalued on comprehensive metrics

We use Residual Income Model to arrive at a Price Target of INR 452 for UFS, at which the stock trades at 2.7x FY19E book. We initiate with BUY rating with our PT providing 30% upside to CMP. The stock currently trades at a P/B of 2.1x FY19E book value for an FY19E-21E RoE of 13%-17%.

Year to March (INR cr)	FY16	FY17	FY18E	FY19E	FY20E	FY21E
Net Interest Income	578	761	786	973	1,091	1,369
Profit after tax	177	208	12	243	309	433
Basic EPS	20.1	17.8	1.0	20.4	25.9	34.5
P/E	17.3	19.6	332.8	17.1	13.5	10.1
Book value per share	118	147	147	167	191	207
P/B	2.9	2.4	2.4	2.1	1.8	1.7
RoAE	18.3%	14.1%	0.7%	13.0%	14.5%	17.3%

Bloomberg:	UJJIVAN:IN
52-week range (INR):	476 / 285
Share in issue (cr):	11.7
M cap (INR cr):	4,171
Avg. Daily Vol. BSE/NSE :('000):	771000
Promoter Holding (%)	–

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Ujjivan Financial: MFI Crisis subsiding + Upfronted Opex normalising lower + Transformation into superior SFB business model to result in high RoE delta

Ujjivan Financial Services is expected to bounce back from a depressed FY18E RoE of 0.7% to 13% in FY19E and to 17% by FY21E on the back of MFI crisis subsiding, Bank build opex normalising lower and transformation into Small Finance Bank, that will enable diversification into Micro SME and Affordable Housing, both sound generic opportunities where it would be a prime beneficiary.

Recovery in MFI business plus foray into Micro SME and Affordable Housing to drive Loan CAGR of 23% over FY17-21E

	FY16	FY17	FY18E	FY19E	FY20E	FY21E
NII	578	761	786	973	1,091	1,369
Other Income	26	94	163	193	228	270
Opex	307	458	679	727	765	877
PAT	177	208	12	243	309	433

Credit Costs would fall from 364 bps in FY18E to 80 bps in FY19E with MFI crisis subsiding

	FY16	FY17	FY18E	FY19E	FY20E	FY21E
RoAA	3.7%	2.9%	0.1%	2.3%	2.4%	2.7%
RoAE	18.3%	14.1%	0.7%	13.0%	14.5%	17.3%

Over FY18E-21E, C/I Ratio will normalize lower from 72% to 53% whereas CoF will fall from 9.9% to 8.7%

P/B Multiple	FY19E BVPS	CMP / Target
2.1x (CMP)	167	348
2.7x (Target)	167	452

At CMP, FY19E P/B is 2.1x + **FY19E-21E RoE of 13-17%** + **At Target Price, FY19E P/B is 2.7x**

Upside of 30%

Price Target	**INR 452**	We use the Residual Income Valuation Model to value UFS. We assume a long-term risk-free rate of 7% for India, a Beta of 1.2 for UFS and an India Equity Risk Premium of 6% and arrive at an overall Cost of Equity of 14.2% for Ujjivan. We arrive at a price target of INR 452, at which the stock will trade at 2.7x FY19E book value.
Bull 3.6x 2019E BPS	**INR 603**	Our bull case assumes a faster ability to grow Loans at a FY17-21E CAGR of 26%, a lower C/I profile of 71-52% over FY18E-21E and lower average Credit Costs of 70 bps over FY18E-21E resulting in an FY19E-21E RoE profile of 13.8%-19.0%.
Base 2.7x 2019E BPS	**INR 452**	Our base case assumes a FY17-21E Loan growth CAGR of 23%, a C/I profile of 72-53% over FY18E-21E and average Credit Costs of 80 bps over FY18E-21E resulting in an FY19E-21E RoE profile of 13.0%-17.3%.
Bear 2.0x 2019E BPS	**INR 325**	Our bear case assumes a slower ability to grow Loans at a FY17-21E CAGR of 18%, a higher C/I profile of 75-56% over FY18E-21E and higher average Credit Costs of 100 bps over FY18E-21E resulting in an FY19E-21E RoE profile of 11.7%-15.9%.

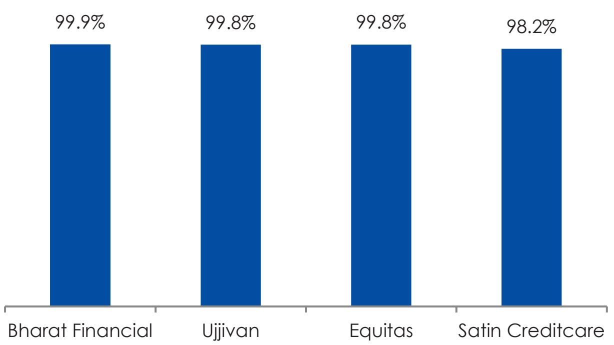
Average Daily Turnover (INR cr)			Stock Price (CAGR)				Relative to Sensex, CAGR (%)			
3 months	6 months	1 year	1 year	3 years	5 years	10 years	1 year	3 years	5 years	10 years
77.1	72.5	59.9	-23%	NA	NA	NA	-41%	NA	NA	NA

Business Value Drivers

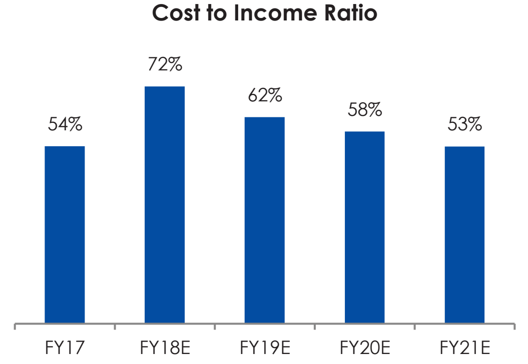
Nature of Industry	SFBs have a regulatory mandate for small-ticket lending to under-served segments of the economy. 8 of 10 SFB licensees are erstwhile NBFC-MFI and therefore, already possess a bottom-of-the-pyramid focus. SFBs with high proportion of MFI loans are undergoing a period of stress due to cash cycle disruption and on-ground interference. However, this is transient and importantly, transformation into SFB opens up new asset product opportunities while cost of funds would trend lower due deposits franchise build-up and favourable refinance.
Opportunity Size	Unlike NBFC-MFIs, which are constrained to focus mainly on MFI (minimum 85% of loan should be "qualifying"), Ujjivan is free to pursue the entire gamut of asset products with the stipulation that 50% of loans should have a ticket size of INR 25 lacs or lower. The two key asset products that Ujjivan will initially pursue would be Micro SME and Affordable Housing, apart from Microfinance, all areas with significant generic opportunity. Going forward, logical additions to the product set could be Vehicle Loans and Gold Loans.
Capital Allocation	Ujjivan does not have an ultra-conservative stance on MFI. At the same time, it plans to allocate capital to its MSE and Affordable Housing businesses and therefore, has one of the best current prospective business mix among peers.
Predictability	Predictability seems optically low as the MFI industry has undergone its second crisis in 7 years. However, we view both the AP Crisis of 2010 and Demonetisation as one-off black swan events.
Sustainability	Ujjivan is a well-capitalised SFB with a CAR of 19.8% against a requirement of 15%. This will sustain growth for the foreseeable future. We do not forsee dilution of existing shareholders till the end of FY20.
Disproportionate Future	Ujjivan's foray into MSE and Affordable Housing opens up the possibility of an outsized rise in its loan book. The MSE opportunity is significant since 96% of small businesses do not have access to formal financing. Furthermore, 95% of the housing units shortfall is under the EWS/LIG segments. Ujjivan may also incrementally foray into other small-ticket businesses like Vehicle Finance and Gold Loans.
Business Strategy & Planned Initiatives	Ujjivan's strategy has consisted of avoiding sensitive districts even prior to Demonetisation. Further, they are depending on low-cost BC outlets to fulfil URC requirement. They have been leaders in cashless disbursement well before Demonetisation. Their current planned initiatives include making a foray into MSE and Affordable Housing.
Near Term Visibility	Ujjivan is likely to make residual provisions on MFI book of about INR 100 cr over the rest of FY18 (mainly in Q2). This is on legacy MFI book as the Collection Efficiency of the 'new book' created post December is 99.8%. Importantly, PAR0 has declined meaningfully.
Long Term Visibility	The acquisition of a banking licence provides significant long-term visibility to Ujjivan as it will enable it to expand into the entire gamut of small-ticket asset products with possibly some exposure to wholesale asset products in the distant future.

Focus Charts – Story in a nutshell

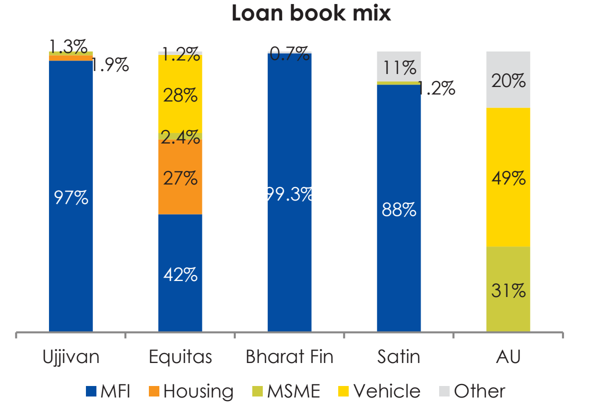
MFI Collection Efficiency of 'new book' (Jan to Jun 2017) shows crisis is in the past



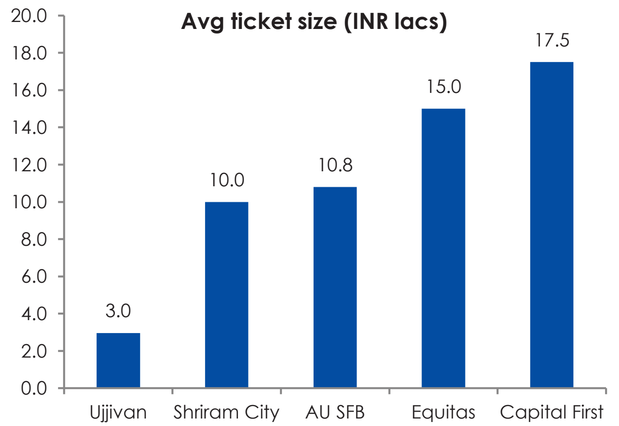
Spike in Cost to Income Ratio is transient since Bank build is temporary



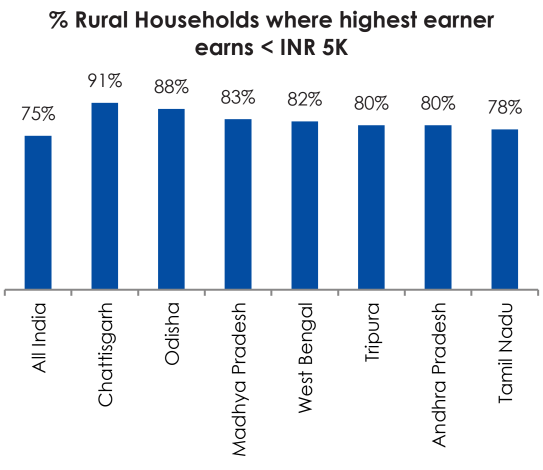
Ujjivan is a play on MFI recovery without NBFC-MFI asset mix constraints



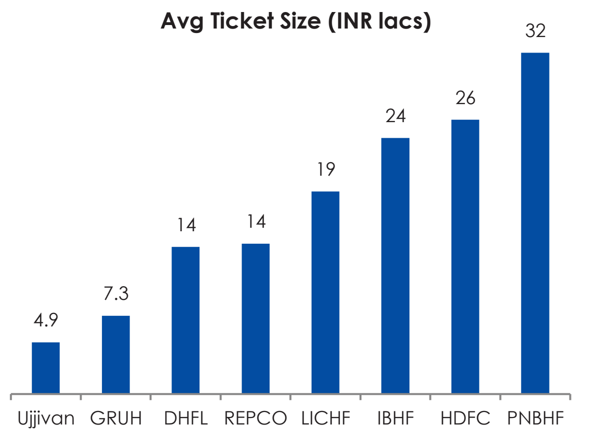
Ujjivan prime beneficiary of Micro SME opportunity from a ticket size perspective



The officially 'poor' are not the only potential client set for MFIs



Ujjivan ticket size falls into sweetest spot of PMAY benefits



Source: Edelweiss Investment Research

I. Stock de-rating driven by transient factors that will subside meaningfully going forward

UFS stock de-rating has been driven primarily by two factors: (1) Microfinance industry up-ended by (a) Demonetisation (b) On-ground interference and (2) Higher cost structure due to the building of banking franchise post acquisition of SFB licence. Both of these factors are transient in nature

MFI industry crisis is temporary in nature on account of several reasons

We note that the Microfinance industry is in the midst of a reasonably strong and durable recovery for a variety of reasons.

Re-monetisation a driver of cash availability once again among MFI borrowers

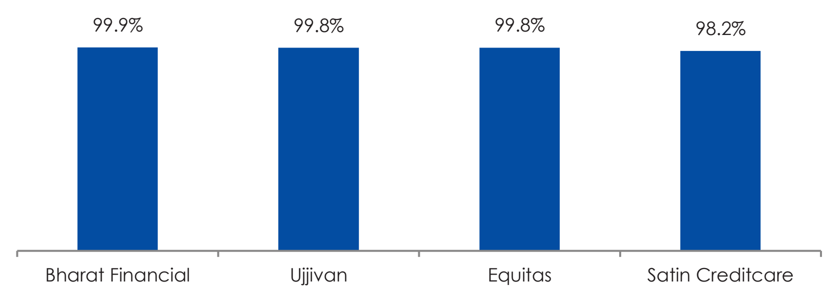
Since Microfinance is cash-intensive both on the disbursal and collection side, the impact from Demonetisation was understandably significant. However, the government and the RBI are focused on Re-monetisation (re-supplying bank notes back into the economy).

On-ground interference transient and localised and actuated by local individual entities sans institutional support

Local individual entities found Demonetisation an opportune time to (a) spread rumours about loan waivers (b) misinform borrowers about the RBI notification granting 90-day forbearance for loans of ticket size lower than INR 1 cr and lead borrowers to believe the same is a loan waiver (c) ask borrowers to outright default on loans prior to key election periods and otherwise.

We stress that interference from such local individuals is a one-off when such functionaries chanced upon an opportunity in the confusion that ensued post Demonetisation to mislead and misguide borrowers. Importantly, the behaviour of such functionaries has not found the support of the state government, central government or the RBI. Hence, a repeat of the institutionalised curbs on MFIs as in Andhra Pradesh in 2010 does not look realistic.

MFI Collection Efficiency of 'new book' – Jan to Jun 2017 - Ujjivan vs Key peers



Source: Company, Edelweiss Investment Research

Credit Bureau infrastructure a significant backstop for the MFI industry from a borrower behaviour perspective

MFIs have worked hard to educate borrowers about the long-term disadvantages of being earmarked as past defaulters on the robust credit bureau systems operating in the country, such as Equifax and High Mark.

MFIs have pressed the reset button and succeeded in building a new clean book by avoiding troubled districts

Importantly, the MFI industry has also identified certain problem districts located primarily in the key problem states of Uttar Pradesh, Maharashtra and Karnataka where they have slowed or aborted MFI lending altogether.

The combined effect of the effort made by MFIs has been very significant. On the 'new' portfolio built by MFI's post December 2016, the collection efficiency of close to 100%, harking back to the days prior to current sector crisis. Importantly, the 6-month vintage of the new book is reasonably long from an MFI lending perspective to judge asset quality. Furthermore, this 'new book' was created as the Farm Loan Waivers were being announced on the ground.

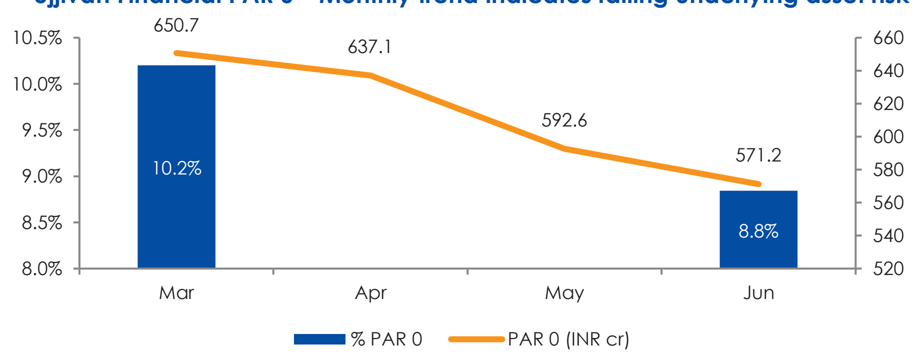
Underlying asset quality of Ujjivan MFI book already showing improving trend

For branches where Portfolio at Risk (PAR) is more than 5%, the focus is solely on collection and recovery and not on disbursement. As a result of the concentrated effort of collection agents and internal teams, the underlying asset quality is showing improving trend.

Headline asset quality worsened in Q1FY18 but PAR0 improved

GNPA Ratio worsened from 3.7% in Q4FY17 to 6.2% in Q1FY18. At the same time, PAR60 worsened from 5.6% to 7% and PAR30 from 7.5% to 7.8%. This was primarily a result of already overdue customers moving to a higher period bucket as time passed. However, PAR0 fell from an absolute amount of INR 650 cr to INR 571 cr, falling from 9.9% to 8.8% on a percentage basis, meaning the overall underlying value of overdue customers has fallen materially even in Q1FY18 itself.

Ujjivan Financial PAR 0 – Monthly trend indicates falling underlying asset risk

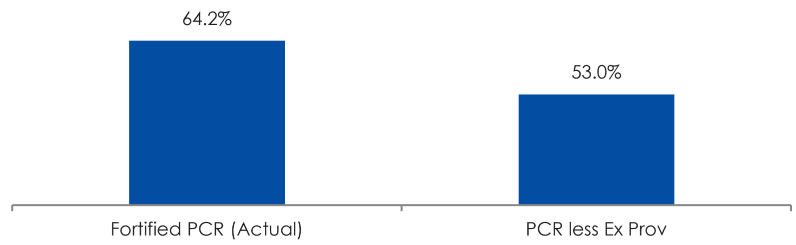


Source: Company, Edelweiss Investment Research

Provisioning by Ujjivan Financial has been conservative

While RBI has explicit provisioning requirements for MFI institutions (as it does for banks), Ujjivan decided to provide in excess of RBI requirement. Provisioning in Q1FY18 was INR 150 cr, which was INR 42 cr above RBI requirement. This put Specific Provision Coverage Ratio at a healthy 64.2% for Ujjivan Financial, which would have been 53% without the excess provision. The policy / reasoning followed by Ujjivan was that they have provided fully for "hard core" NPA i.e. all loans for which they have not received any repayment since Demonetisation

Specific PCR with and without Excess Provision – Ujjivan Financial

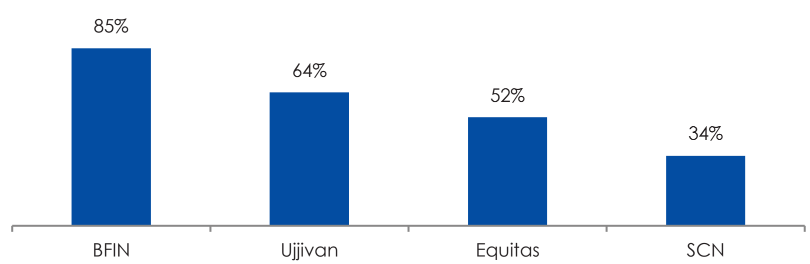


Source: Company, Edelweiss Investment Research

Specific PCR of Ujjivan Financial superior to MFI-focused peers bar BFIN

Among MFI-focused peers, Bharat Financial Inclusion's Specific PCR is most admirable at 85%. We state that, broadly speaking, we prefer the SFB model to standalone NBFC-MFI model from a long-term perspective but, at the same time, idiosyncratic aspects of a given company will always have their significance. Aside of BFIN, Ujjivan's Specific PCR is attratively conservative and superior to those of Equitas and Satin Creditcare Network.

Specific PCR– Ujjivan Financial vs MFI-focused peers



Source: Company data; MFI book PCR for Equitas is 58%

Farm Loan Waivers bear low risk for MFIs from a business perspective

We note that Farm Loan Waivers announced by various states have touted by a section of the media as significant risk for MFI but this conclusion is not borne out by facts.

MFIs not extending Agri Loans per se and hence respective waivers not applicable to them

MFIs are not engaged in Agri Loans per se from a classification perspective even though a significant chunk of MFI loans may well be extended where the livelihood in question is Agri-related. Hence, MFI loans are not eligible for Farm Loan Waiver in the first place.

Deterioration of credit culture due to waivers not observed on the ground

There is a deterioration of credit culture argument which is said to potentially impact borrower behaviour in the future. From a near term perspective, there has been no deterioration of borrower behaviour in states where Farm Loan Waiver has been announced. Here, we differentiate between the falsehood of MFI loan waiver spread by local individuals and the actual announcement of Farm loan Waiver in a state.

MFI collection efficiencies actually improving in states where waiver announced

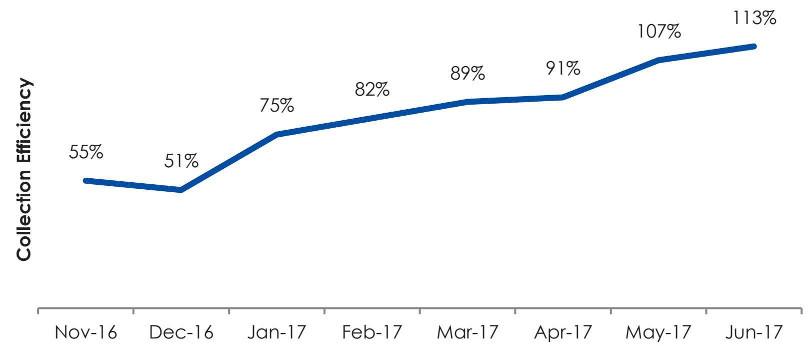
MFIs have actually reported improvement in Collectiion Efficiency in states where Farm Loan Waiver was announced.

Ujjivan Financial has clarified in a public interview that their Collection Efficiency has improved in states where Farm Loan waivers have been announced. The major states to have announced Farm Loan Waivers are Uttar Pradesh, Maharashtra, Punjab and Karnataka. The Madras High Court had directed the Tamil Nadu state government to extend a similar waiver to farmers in the state but the Supreme Court has since statyed this order.

Satin Creditcare has disclosed exact Collection Effieciency trends for UP and Punjab (where they have significant operations) and both states have displayed materially improving trend for both states. This has a readacross for the whole MFI sector.

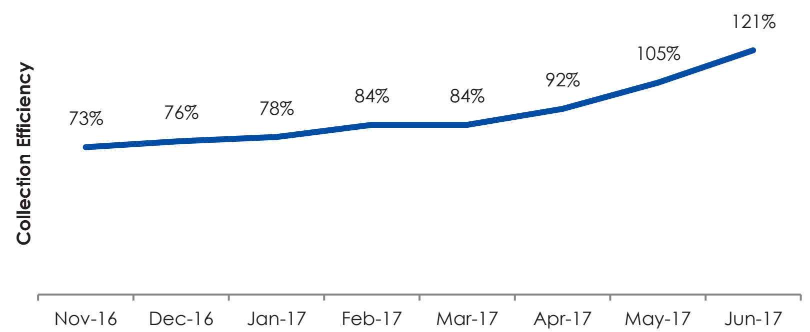
Equitas Holdings has stated that they expect Maharashtra to see improved collections from Q3FY18 onwards.

Collection Efficiency – Monthly trend in Uttar Pradesh – Satin Creditcare



Source: Company data

Collection Efficiency – Monthly trend in Punjab – Satin Creditcare



Source: Company data

II. Prudent risk management has been part of Ujjivan DNA right from outset

Avoidance of sensitive and generally troublesome geographies an early habit

The process of choosing a location for branch opening has been very rigourous for Ujjivan. It involves the Distribution team, the Vigilance team, the Audit team, the HR and Legal teams all working under a fairly detailed process to zero in on a branch location. The inputs of the Vigilance team are critical from a perspective of judging whether a particular geography is sensitive (or generally a difficult area to conduct Microfinance business) for a variety of other reasons.

Ujjivan had avoided starting operations in Andhra Pradesh years before the AP Crisis on 2010

While Ujjivan had started operations in Karnataka, the above judicious approach adopted from the outset led them to avoid starting operations in Andhra Pradesh well before the AP Crisis of 2010, even though it was the adjacent state. Ujjivan had developed the understanding that the relationship of the MFI industry with the State Government in AP was not strong enough as early as 2007.

In the case of Ujjivan's home state of Karnataka, where they first set up operations, the relationship of MFIs with the State Government is sound. MFI institutions find representation in the State Level Bankers' Committee of Karnataka.

Ujjivan had also avoided the Vidarbha and Marathwada regions of Maharashtra unlike Equitas, which has led to a divergence in PAR0 movement

This prudent analytical approach also led to UFS largely avoiding the Vidarbha and Marathwada areas of Maharashtra, where the wider public now knows in hindsight are particularly tough areas to conduct MFI business. While the impact from Demonetisation occurred regardless of sensitivity, the recovery on the ground is swifter and smoother in areas where sensitivity is low or negligible. This also explains the divergence in the PAR0 for Ujjivan and Equitas. While it is has bee discussed in a previous section that PAR0 for Ujjivan has fallen over Q1FY18, that for Equitas has marginally risen over the same period. Equitas has found issues with their Maharashtra exposure particularly sticky (though they have guided for improvement in this geography in Q3FY18). It has to be mentioned though that the MFI PAR0 for Equitas is 7% for Q1FY18, lower than Ujjivan's. It is the directional movement that has diverged. (One reason for Ujjivan's higher PAR0 could be exposure to Individual MFI at 12% of loans, which lacks Group guarantee whereas Equitas does not do Individual MFI business.)

Ujjivan has also prudently avoided riskier parts of Karnataka and other states

Despite being its home state, Ujjivan did not grow in a concentrated fashion in Karnataka. In fact, Ujjivan is present only in c.60% of disricts of Karnataka and has avoided most of the riskier portions of North Karnataka (generally rural North Karnataka).

Ujjivan has also avoided some of the troubled regions of MP. Ujjivan had some presence in Eastern UP but this was small in the overall context.

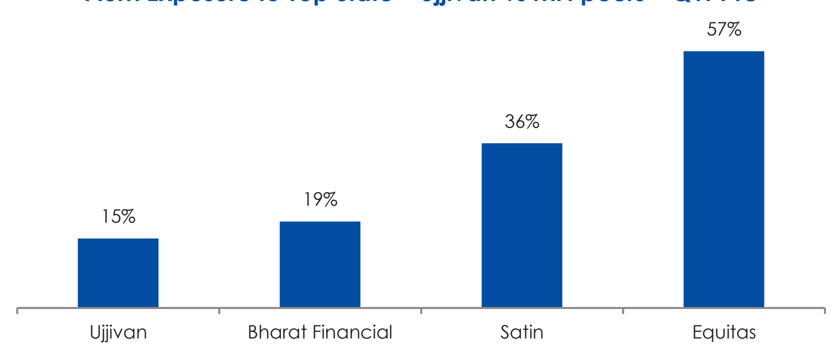
Ujjivan not significantly impacted due to on-ground interference per se

While the impact on Ujjivan's MFI business has been significant post the announcement of Demonetisation, one would need to differentiate between the impact due to disruption of cash cycle and due to on-ground interference per se. In the case of Ujjivan, the impact from the latter is lesser compared to the former and indicative of superior risk management. Demonetisation is a black swan event from the government policy-making side over which MFI institutions had no control. Its impact, importantly, is transient.

Geographical diversification on the part of Ujjivan also typifies superior risk management

As discussed earlier, Ujjivan conscisouly did not grow in a concentrated manner in any state, including its home state of Karnataka. From the very outset, it chose to diversify geographically across the country.

AUM Exposure to Top State – Ujjivan vs MFI peers – Q1FY18



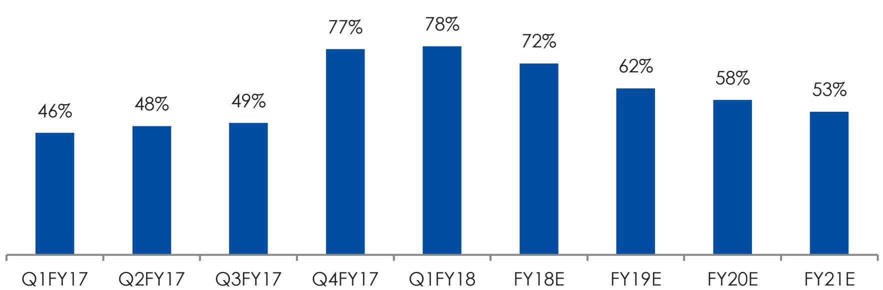
Source: Company data

III. High opex spend to build bank franchise an upfronted investment for the future that will normalize going forward

In order to successfully transition to a fully equipped Small Finance Bank, Ujjivan Financial has had to make and will continue to make opex spends at a much higher run rate than what would be their steady state long-term run rate. This higher level of opex is so egregiously high that it has, incrementally, contributed to the de-rating of UFS stock. Importantly, however, this opex spend would normalize lower materially going forward.

Opex Costs for UFS would start to normalize in FY18 itself
While C/I Ratio has spiked to 77-78% in Q4FY17-Q1FY18, it would start to normalize lower to 72% for full year FY18E, to 62% in FY19E and then to 53% by FY21E.

Cost to Income Ratio trend – Ujjivan Financial Services



Source: Company data; Edelweiss Investment Research

Fixed Costs related to bank franchise build already incurred
It is to be noted that Ujjivan Financial, as disclosed during the Q1FY18 results conference call, has already incurred the various fixed costs related to the banking franchise buildup. In other words, going forward, opex costs will be directly related to branch outlet openings / conversions. This will still be elevated compared with a normalised level of opex, as branch outlet openings / conversions will be upfronted but lower that the level when the aforementioned fixed costs were being incurred.

Ujjivan Financial has been a leader in cashless disbursement and conversion to SFB augurs well in this regard
Ujjivan's Financial proportion of cashless disbursement has been as high as 66% as early as Q1FY17 indicative of its commitment to and success in achieving cashless disbursement well before the Demonetisation exercise that necessitated hurried action from other MFI incumbents. In comparison, Bharat Financial Inclusion, which is a well-run NBFC-MFI that has generally achieved best-in-class metrics in most areas, activated cashless disbursements only in January this year.

It may noted, however, that borrower behaviour changed post Demonetisation and cashless disbursement proportion for Ujjuvan has since fallen to 43% in Q1FY18 whereas, that for Bharat Financial has risen to 76-98% over the 3 quarters of Q1FY18. These numbers, however, cannot be said to be steady state numbers and would evolve in the coming quarters.

Importantly, as Ujjivan transitions MFI borrowers to holding savings accounts in their Small Finance Bank, the proportion of cashless disbursement will only rise and potentially approach 100%. Also, significantly, disbursement into the captive SFB savings account has significant positive ramifications from an opex perspective.

CRR / SLR drag, though permanent, will have lower incremental impact going forward

A Small Finance Bank, like universal banks, is required to keep 4% and 19.5% of NDTL in cash reserves and approved securities due to CRR and SLR requirements, respectively. As such a large proportion of the entire existing Funding base almost suddenly moves to lower-yielding assets, the initial impact is particularly significant but, going forward, only the same proportion of incremental Funding raised will have to comply with CRR and SLR requirements.

Prudent branch opening approach shows management is significantly conscious of cost control

Ujjivan Financial focusing on low-cost BC outlets to fulfil URC stipluation in FY18

As per the RBI norms for the opening of banking outlets, at least 25% of incremental openings have to be in URCs (Unbanked Rural Centres). Management, it seems, realises that this requirement can be fulfilled in a low-cost manner through BC (Business Correspondent) outlets

Furthermore, Ujjivan Financial had some presence in LWE / NE (Left Wing Extremist / North East) areas, which qualify as URCs, regardless of population definition.

How Ujjivan plans to achieve URC requirement in FY18

Branches converted (of which 2 URC)	160
BC equivalent openings (all URC)	29
Total outlet opening / conversion	189
LWE / NE openings (URC)	18
Total URC opening / conversion	49
% URC	25.9%

Source: Company data

47 of 49 URC banking outlets required to be opened in FY18 are through low cost BC outlets or in LWE / NE centres

Ujjivan Financial has a total of 457 asset branches, of which 25 will be merged, leaving a total count of 422. Of the 422, Ujjivan SFB plans to convert a total of 160 banking outlets in FY18. The balance would be converted over the next 2 years. So far, till Q1FY18, it has successfully converted 52 asset branches into liability branches, of which 2 are in URCs. It also plans to open 29 BC outlets in URCs in FY18, which will be considered as banking outlets. Furthermore, 18 of the branch conversions would be in LWE / NE areas, meaning 49 of the total 189 banking outlet openings / conversions would in URCs, implying 25.9% URC achievement, which is meeting requirement. Importantly, 47 of 49 URC conversions / openings will be met through either BC outlets (29 low cost outlets) or LWE / NE centres (18 outlets that automatically satisfy URC requirement regardless of population).

IV. Ujjivan a PSLC Fee Income generator despite high PSL requirement for SFBs

Ujjivan Financial current business mix well over PSL requirement enabling it to generate PSLC Fee Income

As per RBI norms, SFBs are required to disburse a minimum of 75% of Adjusted Net Bank Credit to the Priority Sector. The minimum for universal banks is lower at 40%. Even so, the higher requirement for SFBs is easily met by Ujjivan since almost its entire loan portfolio satisfies PSL defintion. The only non-compliant portion is the Micro LAP book, which is about 0.5% of total loan book.

In Q1FY18, Ujjivan Financial generated INR 6.7 cr of PSLC (Priority Sector Lending Certificate) Fee Income through a sale of INR 400 cr.

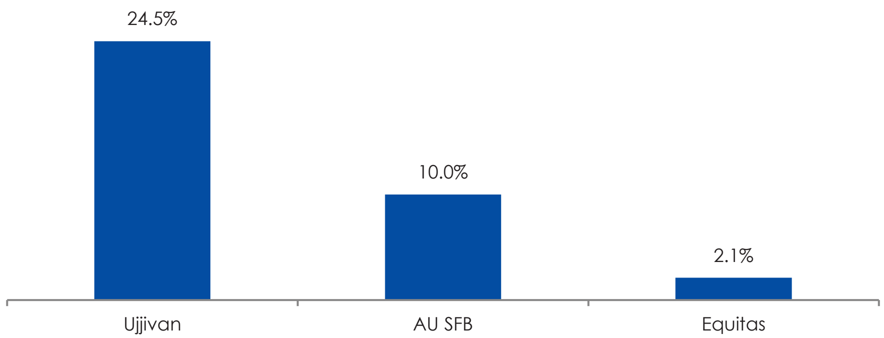
Change in business mix away from MFI not negative for PSLC Fee Income as there is good demand for MSE PSLC

As per management, there is good demand for agri and MSE (Micro and Small Enterprise) PSLC and less so for Weaker Section PSLC. Furthermore, the premium is also higher for the former categories of PSLC. As Ujjivan grows its MSE portfolio, it will be able to generate more MSE PSLC.

Ujjivan's excess over PSL requirement superior to listed SFB peers implying higher PSLC fee income opportunity

Ujjivan's excess over PSL requirement of 75% of ANBC is higher than those of listed peers. Ujjivan expects to maintain about 20% excess over PSL requirement going forward. Segment-wise requirement also need to be kept in mind and Ujjivan needs to address Agri PSL requirment more effectively in the future. Nevertheless, higher excess over PSL requirement for Ujjivan indicates superior ability in generating PSLC Fee Income compared with listed SFB peers.

PSL Excess over 75%* - Ujjivan vs listed SFB peers – Q1FY18



Source: Company data; *Excess over ANBC may slightly vary; AU data is for FY16

V. Ujjivan has a prudent liablity and fee product strategy

Ujjivan's liablity product strategy geared to their client universe

- Savngs Accounts have no minimum deposit charges – This is attactive to lower income customers
- Personalised Rupay Classic Debit Card – This is lower cost (from merchant perspective) compared with MNC payment systems and may be preferred in Tier 2 and lower centres over the long-term
- Ujjivan expects to get more traction on Current Accounts going forward due to increasing focus on MSE business

Ujjivan's initial fee product strategy tries to tap underserved areas

- Ujjivan plans to offer easy and affordable Remittance and Third Party Insurance products both of which are underserved areas of business.

N.B. For more on Small Finance Bank, NBFC-MFI and other related regulations, see the separate Regulations Section nearer to the end of this report.

VI. Robust credit appraisal processes and internals for Micro SME and Affordable Housing provide comfort

Ujjivan has a detailed credit appraisal process for Micro SME

Ujjivan subdivides their Micro SME customers into Unregistered and Registered based on the availability of formal documents. Uregistered customers do not possess Bank Statement or Income Tax Return or even a registered Stock (Inventory) Statement or Audited Balance Sheet. For such customers, Ujjivan Credit Officer visits the site, (1) examines the Stock in person, (2) studies the Shop Front (3) examines 'kacha' bills (4) conducts reference check with buyers as well as suppliers (5) conducts neighbourhood reference check apart from (6) initial KYC document creation. Furthermore, the potential customers' credit history is examined through (7) CIBIL check (8) MFI Credit Bureau report, if available.

EMI to Surplus Income and Leverage key final inputs into deciding loan amount

Considering these inputs, Ujjivan then estimates the Sales and Costs of the customers and prepares a cash flow statement. Following this, the surplus income is calculated and used as a basis for for loan amount. The EMI to surplus income ratio cannot exceed c.65%. The potential customer's outstanding leverage is also taken into account as in input to arrive at cash flow and as an independent input as well.

CIBIL 'hit rate' for Ujjivan MSE customers is reasonable, Share of Registered clients to rise

The CIBIL 'hit rate' (CIBIL data availability) for Unregistered customers is about 70% whereas for Registered customers, it is about c.90%. Unregistered clients are currently c.70% of their fledgeling Micro SME book and this could move lower to about c.50% over the next few years. The Registered customers have formal documents like Bank Statements and IT Returns, which are used as incremental input compared with the process for Unregistered customers.

Ujjivan is able to mine about 15% of MSE clients from their existing Individual MFI client set

Ujjivan is able to source about 85% of Micro SME clients from the open market and, at the same time, about 15% of MSE clients are mined from the existing Individual MFI business.

Collateralisation of Unregistered MSE book to be judiciously decided from a risk-adjusted return perspective

Ujjivan subdivides its MSE book into two parts (1) Unsecured loans of ticket size ranging between INR 1.5-5 lacs for a tenure of 1-3 years and (2) Secured loans of ticket size ranging between INR 10-25 lacs for a tenure of 3-10 years.

From a customer profile perspective, Unregistered customers avail loans of ticket size ranging upto INR 10 lacs and Registered customers customers get loans of ticket size ranging between INR 10-25 lacs. The Unregistered customer loans are further divided into Unsecured and Micro LAP. Micro LAP loans range between a ticket size of INR 3-10 lacs. (There is no strict sub-division here as loans between INR 3-5 lacs could be either Unsecured or Micro LAP).

Proportion of collateralised MSE loan book to rise going forward

Currently, c.30% of MSE loan book is collateralised (this includes Registered client book and Unregistered client Micro LAP book). The proportion of collateralised book could move up to c.50% in a few years.

Micro LAP book a trade off between collateralisation and PSL compliance

A notable point here is that MSE loans below a ticket size of INR 10 lacs, if collateralised, are not PSL compliant (under MSE segment). Micro LAP is about 25% of MSE loan book and not PSL compliant. This is c.0.5% of total loan book.

CGTMSE compliance could become a method of incrementally de-risking unsecured MSE book

The benefit from keeping MSE loans non-collateralised is that such loans could be made to be CGTMSE-compliant, in which case the CGTMSE would provide a government-funded backstop to such loans, if they were to turn delinquent. The extent of CGTMSE-compliant product will depend on the risk-adjusted RoE expected on such business conducted. Though, potentially, all of the Unsecured book could be made CGTMSE-compliant, about 5-10% of MSE book could become compliant in the medium term. The risk-weight requirement on CGTMSE book is also lower compared with non-compliant book.

Credit Appraisal process for Affordable Housing similarly robust

Credit appraisal process for Affordable Housing is similar to the process for MSE. Incrementally, the Employer site visit and reference check is also conducted. Furthermore, a valuation report as well as a legal report for the property in question are also genereated.

Ujjivan's Housing book has a high proportion of Self Construction

The current split of the Affordable Housing book, as of Q1FY18, is 55% in Self Construction, 17% in LAP, 15% in Home Improvement and 14% in Completed Home Purchases. The proportion of Self Construction would inch lower going forward.

The overall LTV for the Housing book is close to c.50%, lending comfort

The LTV for the Self Construction book is c.<50% since the denominator includes both the construction value as well the market value of the land in question. As a result, the LTV of the Affordable Housing book overall is close to c.50%, which lends comfort from a risk perspective.

Ujjivan will maintain a balanced customer split and therefore a finger in both pies

The current customer profile split is c.60% Self Employed (Non Professional) and c.40% Salaried (Professional segment within this is miniscule). This split could move to c.50% Salaried in the medium term.

Ujjivan will utilise its bottom-of-pyramid expertise to create an SENP franchise. At the same, falling of Cost of Funds will increasingly make it more competitive on the Salaried side, particularly in comparison to HFCs, from whom it could wean away business.

Proportion of clients falling in EWS/LIG category as much as c.95% of loans

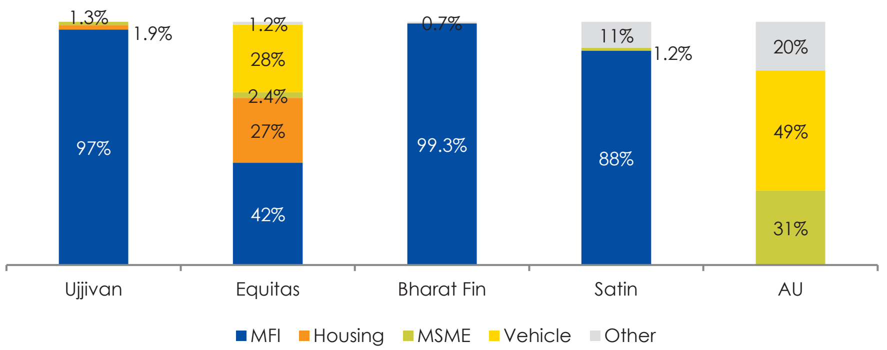
The proportiof of Affordable Housing clients of Ujjivan that fall in the EWS (Economically Weaker Section) and LIG (Lower Income Group) is as high as c.95%. This is particularly significant since the benefits for EWS/LIG home buyers are the most significant from a CLSS perspective when compared with MIG (Middle Income Group) home buyers or non-eligible buyers.

VII. Ujjivan's current and prospective business mix best placed

Ujjivan's loan mix is best placed to deliver high RoE delta in the medium term

We compare the business mix of Ujjivan with 2 listed NBFC-MFIs (BFIN and SCN) and 2 listed SFBs (Equitas and AU) and note that the former is best placed to deliver high RoE delta over F18E-20E.

Loan book mix – Ujjivan vs Peers - Q1FY18



Source: Company data; AU's larger ticket SME book is in Other; Equitas MLAP has largely MSE end use

Equitas, AU less geared to MFI recovery whereas NBFC-MFIs have significant proportion constraints

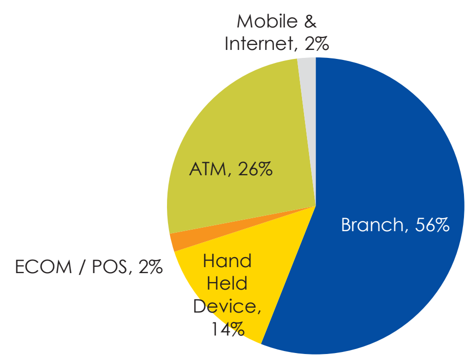
We are belivers in the Microfinance recovery story and hence, stress that Equitas and AU are less geared to that recovery with 42% and nil exposure to MFI, respectively. In fact, Equitas has consciously taken an ultra-conservative stance on MFI and practically de-focused their MFI book. They plan to allow MFI exposure to drop to c.10% over the medium term by not pursuing renewal clients. This may something to do with their significant presence in Andhra Pradhesh during the AP crisis of 2010. The recent crisis, their second in 7 years, may have prompted them to take such a stance. Regarding NBFC-MFIs, while they are obviously geared to MFI, they are forced to be largely MFI-only businesses and are not able to grow in other areas without signifcant proportion constraints.

VIII. Ujjivan's focus on Digital augurs well for future cost control

Ujjivan has seen good traction for non-branch channels from a transaction value perspective

While Branch still has the largest share of transaction value at 56%, Ujjivan has seen good traction for non-branch channels.

Share of transaction value by Channels – Ujjivan - Q1FY18



Source: Company data

Significant on-ground activity now digitially driven

- 98% of Ujjivan's Savings accounts have been opened with e-KYC and hand-held devices
- E-Sign was used to open 37% of MFI customer accounts
- There are 3711 hand-held devices on the field being used for account opening, loan sourcing and providing other services.

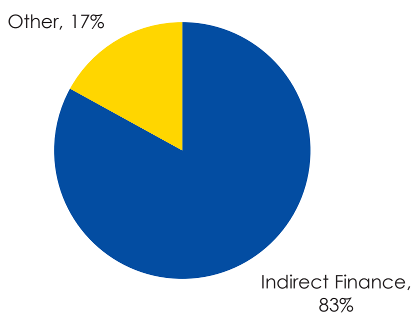
IX. Macro opportunity for Ujjivan's MSE (Micro and Small Enterprise) business driven by government and regulator support

The stated objectives of a Small Finance Bank as per the RBI is to further financial inclusion by (a) provision of savings vehicles, and (ii) supply of credit to small business units; small and marginal farmers; micro and small industries; and other unorganised sector entities, through high technology-low cost operations. It is interesting then, from an investor perspective, that credit flow to the aforementioned sections of society and the ecnonomy is supported significantly by the regulator as well as the govenment. The key All India Term Lending and Refinancing Institutions, SIDBI, NABARD and even Exim Bank and the NHB are focusing on aiding last-mile financial institutions like Ujjivan SFB in achieving braod finanical inclusion goals.

Importantly, Ujjivan's MSE strategy is to focus on particularly small ticket MSME clients and its average ticket size for MSME clients is only INR 2.96 lacs. It is therefore, a potentially significant beneficary of the government's and regulator's thrust on promoting small-ticket micro and small enterprises.

SIDBI (Small Industries Development Bank of India) a key lending institution in providing support to the broader MSME sector
SIDBI's main role is that of a refinancing agency to financial institutions for providing credit to micro and small enterprises. As of FY16, Indirect Finance (Refinance) constituted 83% of total credit outstanding of SIDBI, which was INR 65,632 cr meaning SIDBI does not threaten disintermediatiing Last Mile Financiers. As of FY16, the cumulative disbursement of SIDBI to the MSME sector since inception has been about INR 4.5 lac cr, benefiting as many as 3.5 cr borrowers.

Proportion of Indirect Finance (Refinance) – SIDBI – FY16

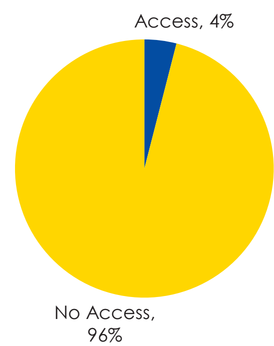


Source: SIDBI

Pradhan Mantri Mudra Yojna (PMMY) a more focused approach under the SIDBI umbrella
While SIDBI's remit is for the wider MSME sector, the current dispensation at centre felt that there should be a more focused approach for the MSE (Micro and Small Enterprise) businesses closer to the bottom of the pyramid, termed Non Corporate Small Business Sector (NCSBS). The refinancing vehicle created for this specific purpose was the MUDRA (Micro Units Development and Refinance Agency) Bank, a wholly owned subsidiary of SIDBI.

Under-penetration of Institutional Finance very severe in Micro Units sector and government focused on rectifying this
As stated in the Press Information Bureau (PIB) release of the Government of India (GOI) on MUDRA Bank dated 1st March 2015, the NSSO Survey of 2013 revealed that there are 5.77 cr small business units of which only 4% get institutional finance. This highlights the deep under-penetration of formal lending in the NCSB sector. Access to institutional finance for such small business units would be driver of GDP growth as well as employment generation and is hence, a key focus area for the government.

Proportion of Small Business Units with Access to Institutional Finance



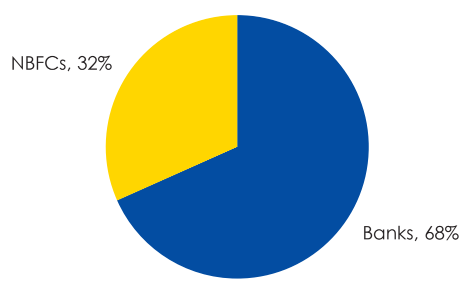
Source: NSSO Survey 2013

In the PIB release, the GOI also notes that Micro Finance is an economic development tool that enable the poor to work their way out of poverty, a primary goal of the GOI. Further, in this regard, the Last Mile Financiers are subdivided into 3 categories: (1) SHG (Self Help Group)-Bank Linkage model run by NABARD (2) NBFCs (primarily NBFC-MFIs) and (3) Others including Trusts, Societies, etc.

It is to be noted that when the GOI uses the term “Micro Finance”, it is more universal and all-encompassing than the Microfinance businesses of NBFC-MFIs, which operate at ticket sizes (c. INR 20,000) that are significantly lower than the generic borrower requirement of the NCSB sector. For the purpose of the analyst and investor community, the terminology is MSE (Micro and Small Enterprise). In fact, pure play MFIs have not been able to cater to the MSE sector due to reasons including borrower limits.

Banks have been a key vehicle in implementing Pradhan Mantri Mudra Yojana
As per the PIB release dated 13th April 2017, loans extended under the PMMY crosses the INR 1.8 lac cr target for FY17, with Sanctions at INR 180,087 cr. Of this amount, INR 1.23 lac cr was lent by Banks and INR 0.57 lac cr by NBFCs, indicating that Banks have been a key vehicle for this program. Small Finance Banks like Ujjivan, with appopriate reach and focused targeting of MSE clients can also become carriers of this program.

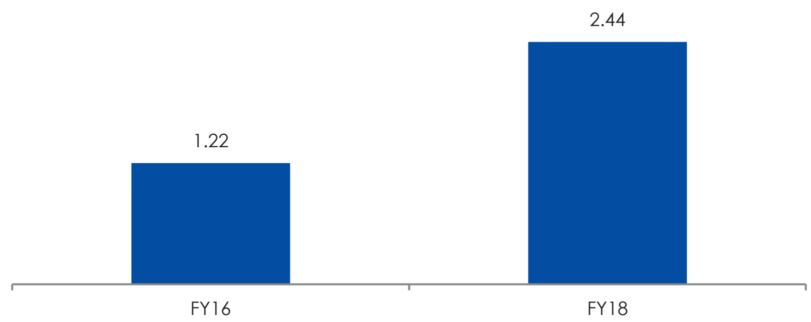
Proportion of PMMY Sanctions – FY17



Source: Press Information Bureau (PIB), GOI

Target for PMMY has been ramped up significantly indicating significant government focus
It is to be noted that the target under the PMMY has been increased to INR 2.44 lac cr for FY18. This is double the FY16 target of INR 1.22 lac cr and underlines the high focus of the GOI in this area.

PMMY Targets (INR lakh)



Source: Union Budgets

X. Mutually exclusive ticket size focus and Reach puts SFBs away from Universal Banks' competition in the Micro SME space

Ujjivan Small Finance's MSE (Micro and Small Enterprise) business has 2 focus areas: (a) Unsecured loans of ticket size ranging from INR 1.5-5 lacs and (b) Secured loans of ticket size ranging from INR 10-25 lacs.

The average ticket size of Ujjivan's small-ticket MSE piece is INR 2.96 lac (both sub-segments taken together). While this may inch up going forward, this underlines one key aspect of UFS' MSME piece which is that they are not in direct competition with Universal Banks as the latter operate in higher ticket size segments.

While smaller old generation private sector banks operate in the INR 25-50 lacs segment, large private sector banks and new generation private sector banks operate in the much higher INR 1-5 cr range. PSU Banks remain severely constricted due to debilitating asset quality issues and adherence to PCA (Prompt Corrective Action).

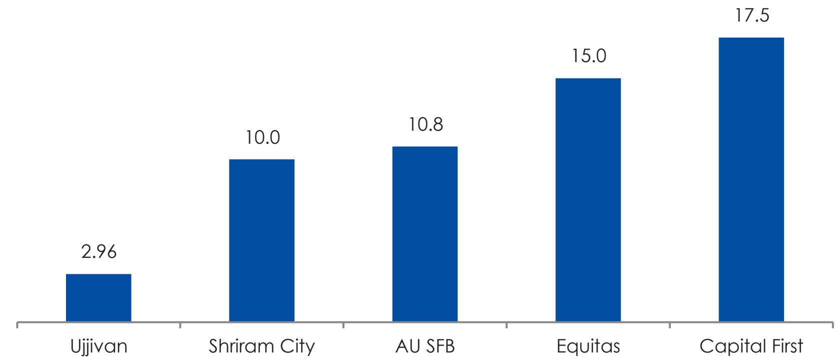
Furthermore, UFS having an NBFC-MFI pedigree also possesses a reach advantage and a deep understanding of the hinterland customer set.

XI. Ujjivan a prime beneficiary of Micro SME opportunity from a ticket size perspective

As the average ticket size of Ujjivan for its Micro SME business is INR 2.96 lacs, it is much lower than those of key SFB and NBFC peers whose average ticket size ranges from INR 10-17.5 lacs, indicating it is best positioned to benefit from the bottom of the pyramid Micro SME opportunity. It may be noted that only the Micro SME book of AU SFB and Capital First have been considered. The average ticket size of AU's larger-ticket SME book is INR 2.2 cr (as of FY16) and Capital First's overall MSME average ticket size is INR 74 lacs (as of Q1FY18).

A broad parallel can be drawn here with the Affordable Housing opportunity since the generic opportunity is best lower down the pyramid from an income group (penetration level) and ticket size perspective in both cases and government and regulatory incentives are also concentrated lower down the pyramid. For instance, the Pradhan Mantra Mudra Yojna, a key scheme for Micro SME, is targeted for loan ticket sizes upto INR 10 lacs.

Micro SME ticket size (INR lacs) – Ujjivan vs key MSE-focused peers



Source: Company data; Capital First MSE range is INR 15-20 lacs

XII. Loan product flexibility and Formalisation of MSME sector places SFBs at an incremental advantage over NBFCs with regard to MSME competition

NBFCs are generally not able to effectively make short-term working capital loans for MSME customers

NBFCs do not possess adequate flexibility to make short-term Working Capital loans and stick to make long-term Term Loans to MSME customers.

GST is actuating a formalisation of the MSME sector that will aid a shift of lending business from NBFCs to SFBs

In addition, we note that the current dispensation at the Centre is highly focused on formalising the Indian economy with a view to removing opportunities for tax evasion and other forms of corruption under the radar. The main arrow in the government's quiver in this regard is GST, which will transform the manner in which MSMEs conduct their businesses. As the MSME space formalises itself, there will be a shift of business from the relatively informal sector-focused NBFCs to Small Finance Banks.

XIII. Ujjivan's borrowing profile evolving in a direction of lower cost of borrowings

Ujjivan has begun building a low-cost Deposits franchise
Being an SFB licencee, Ujjivan's building a low cost Deposits franchise from retail and institutional depositors. While Deposits form only 6% of total borrowings as of Q1FY18, over the long-term (c.5 years and longer), it would be able to fund c.70% of loans from Deposits.

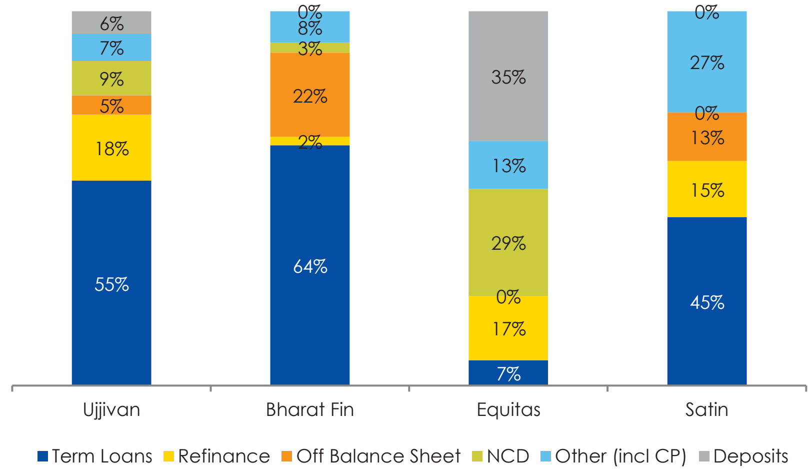
Furthermore, it may also be noted that, of the Deposits, as of Q1FY18, 9.8% is Retail Deposits while the rest (90.8%) is Insititutional Deposits (Wholesale). The Retail proportion will also rise significantly going forward.

Also, of the Deposits, the CASA proportion is 5.3% as Q1FY18 but is expected to rise to c.15% over the long term (c. 5 years). Ujjivan, prudently, does not have a high-cost SA rate and has pegged the same at 4%.

Ujjivan's signifcant access to Refinance to be helpful as it transitions to having a more standardised bank borrowing profile
Ujjivan has access to Refinance from SIBDI, NABARD, MUDRA and other institutions which is also a key component of its borrowing. The significance of Refinancing is understood better upon considering the stipulation that there are no CRR / SRR requirements for Refinance.

As of Q1FY18, Refinance is a significant 18% of total borrowings and is expected to remain a key component of total borrowings over the long term till Deposits become a much more significant proportion of borrowings.

Borrowing profile of Ujjivan vs MFI-focused peers – Q1FY18



Source: Company data

XIV. Macro opportunity for Ujjivan's Microfinance business is still very large

While the debate that was intensified by Demonetisation-related troubles for the MFI industry pertains to credit costs over the long-term cycle, questions have been raised about the prospective (remaining) opportunity size of the MFI industry even prior to Demonetisation, given increasing penetration.

Pan-India MFI penetration is comfortably low at 14% to begin with

The remaining opportunity size as seen by MFI players or investors would really depend on how penetration is defined. One popular way of defining penetration is the percentage of families to which MFI credit has been disbursed. On this metric, the overall pan-India penetration stands at 14% (as given in Q3FY17 Satin Creditcare Network presentation). While this number is relevant and looks comforting from a residual opportunity perspective, penetration levels of individual states is also important.

Certain states have materially higher penetration but not alarmingly high

The MFI penetration levels in certain key states (from MFI perspective) has reached 20% or higher. These states are Karnataka (35%), Tamil Nadu (27%), Odisha (27%), Kerela (23%) and MP (20%). While these penetration levels are significant, they may not look alarmingly high on a headline basis. However, if we compare these penetration levels with the proportion of 'poor' households, the penetration of 'relevant' households may seem egregiously high.

The officially 'poor' are not the only potential client set for MFIs

According to the C Rangarajan panel, in 2014, the definition of poverty line in India was revised higher to spending of INR 32 per day in Rural areas and INR 47 in Urban areas. The Suresh Tendulkar panel had recommended figures of INR 27 and INR 33 for Rural and Urban areas, respectively in FY12. As per the new poverty line definition 29.5% of India lives below the line as at the time of revision compared with 21.9% as per the Tendukar panel defintion. With either defnition, it is implied that the penetration of MFI for relevant (poor) households could be close to or exceeding 100% for certain key states.

However, this reasoning, though informative, is misleading. The potential client set for MFI lenders cannot be said to be restricted to the officially poor.

MFI Penetration and Other Data for Individual States – FY17

	Clients	Penetration	Growth
Karnataka	36	35%	24%
Tamil Nadu	31	27%	60%
Odisha	20	27%	32%
Kerala	7	23%	69%
MP	25	20%	11%
Uttarakhand	3	18%	-7%
Maharashtra	28	17%	20%
Haryana	6	16%	20%
Punjab	7	15%	29%
Chhattisgarh	7	15%	36%
Bihar	22	14%	54%
Jharkhand	7	14%	50%
West Bengal	17	12%	51%
Assam	na	12%	na
Gujarat	10	10%	15%
UP	32	9%	1%
Rajasthan	7	6%	18%
Delhi	1.5	NA	-24%
HP	NA	NA	NA
J & K	NA	NA	NA
Chandigarh	NA	NA	NA

Source: Q1FY18 Satin Creditcare Network Presentation; Client count in lacs

Proportion of Rural Households where highest earning members earns < INR 5K

	Total Households	Proportion
All India	179787454	75%
Chattisgarh	4540999	91%
Odisha	8677615	88%
Madhya Pradesh	11288946	83%
West Bengal	15756750	82%
Tripura	697062	80%
Andhra Pradesh	9344180	80%
Tamil Nadu	10088119	78%
Mizoram	111626	77%
Assam	5743835	77%
Jharkhand	5044234	77%
Telengana	5643739	75%
Meghalaya	485897	75%
Rajasthan	10223073	73%
Sikkim	88723	73%
Arunachal Pradesh	201842	72%
Uttar Pradesh	26015592	72%
Bihar	17829066	71%
Maharashtra	13841960	71%
Kerela	6319215	71%
Nagaland	284310	70%
Puducherry	115249	70%
Dadra and Nagar Haveli	45352	69%
Karnataka	8048664	69%
Gujarat	6920473	69%
Jammu & Kashmir	1601606	67%
Manipur	448163	65%
Uttarakhand	1479742	63%
Haryana	2969509	59%
Punjab	3269467	58%
Himachal Pradesh	1263756	54%
Andaman & Nicobar Islands	68481	51%
Daman and Diu	31795	46%
Chandigarh	15657	45%
Lakshadweep	10929	43%
Goa	220731	40%
NCT of Delhi	1051097	29%

Source: SECC 2011

Proportion of lower income groups high in India and are the real target client set for MFI lenders

To get a better sense of the proportion of households that could potentially be targeted by MFI lenders, we consider the proportion of Rural households where the highest earning member earns less INR 5000 per month. We note that this number, on an all India basis, is as high as 75% and even higher for several key states.

We acknowledge that this reasoning is not complete since since this considers only Rural households and also does not preclude other earning members of a given household taking household income to a higher level. It is to be noted, however, that the proportion of Rural population is reasonably high in India at 69% (Census 2011). Importantly, this reasoning does give us a reasonable idea of the proportion of lower income group households in India and therefore, the potential enlarged target client set for MFI lenders.

Ujjivan caters to the holistic opportunity lower down the pyramid and not merely to Microfinance

It needs to be emphasized separately that lower income groups are not the exclusive target client set for Microfinance alone but also for the other two key businesses of Ujjivan Small Finance Bank viz. MSE (Micro and Small Enterprise) and Affordable Housing. Consequently, the considerations regarding the vast untapped opportunity size lower down the pyramid apply to all of Ujjivan's businesses.

Elsewhere in the report too, a variety of considerations may apply to all Ujjivan's business segments even though the considerations may have been presented in compartmentalised format pertaining to specific business segments.

NABARD (National Bank for Agriculture and Rural Development) a facilitator for rural lending in general but weak competition

NABARD's activities all serve to create an eco-system that facilitates credit flow to the rural sector
NABARD's activitiies include providing refinance support to build rural infrastructure, having financed one-fifth of India's rural infrastructure. It also supervises Cooperative Banks and Regional Rural Banks. Furthermore, it designs new development schemes and also implements the GOI's development schemes. It also trains small business entrepreneurs while providing them with a platform to selling their artciles. Importantly, NABARD also runs the SHG-Bank Linkage Project since 1992. All in all, NABARD's activities support credit flow from Small Finance Bank entities like Ujjivan to the rural sector both on the MSE and Microfinance side.

NABARD has specific Long Term Refinance Policy for Small Finance Banks
As per NABARD's Long Term Refinance Policy for FY18 for Small Finance Banks, the Thurst Areas for which preference would be given for release of refinance include SHG / JLG, rural housing and myriad other livelihood activities. The Interest Rates for refinance specified on the policy range between 8.75-8.95%.

NABARD's lending rates for NBFC-MFIs are at a materially higher level
Lending Rates charged by NABARD to NBFC-MFI categories

NBFC-MFI (mfR1 Grade)	
LT Refinance for 5 years and above	10.50%
LT Refinance for 3 years to less than 5 years	10.60%
LT Refinance for 18 months to less than 3 years	10.70%
NBFC-MFI (mfR2 Grade) / (mfR3 Grade) (N.E / Hilly Region)	
LT Refinance for 5 years and aove	10.75%
LT Refinance for 3 years to less than 5 years	10.85%
LT Refinance for 18 months to less than 3 years	10.95%

Source: NABARD

The interest rates charged by NABARD to NBFC-MFIs are about 200 bps higher than the rates charged to SFBs,

NABARD's support of SHGs not a concern for JLG lenders
While NABARD runs the SHG – Bank Linkage Project, it also provides refinance to JLG lenders. So, to that extent, there is no significant differentiation on NABARD's part between SHG and JLG lenders. In fact, Small Finance Banks like Ujjivan are open to participate in SHG lending. However, they may not focus on the SHG model since lending rates are higher on the JLG side. The question is to what extent can SHG win market share in the SHG vs JLG competitive landscape. We believe that SHG will not be able to compete well with JLG lenders for a variety of reasons.

A variety of factors make JLG a superior Microfinance model to SHG
Firstly, in the SHG model, a group of about 20 members are required to accumulate savings for a period of 6 months before taking a loan is considered. This is step that consumes time and resources and makes the process unattractive from a borrower perspective. Secondly, the loan processing time for SHG as long as 4 months compared with just 1 week for JLG again making things unattractive from borrower perspective. Thirdly, the repayment frequency is monthly for SHG compared with weekly for JLG making asset quality control more difficult for the former compared with the latter, ceteris paribus. Decision making regarding loan quantum to all members rests with the group leader, which is not something that would be appreciated by the rest of the borrowers. Last but not the least, there is a lack of robust information database in the case of SHGs in comparison to the JLG lenders, who have access to Credit Bureau databases which makes credit appraisal more challelnging for the former compared with the latter.

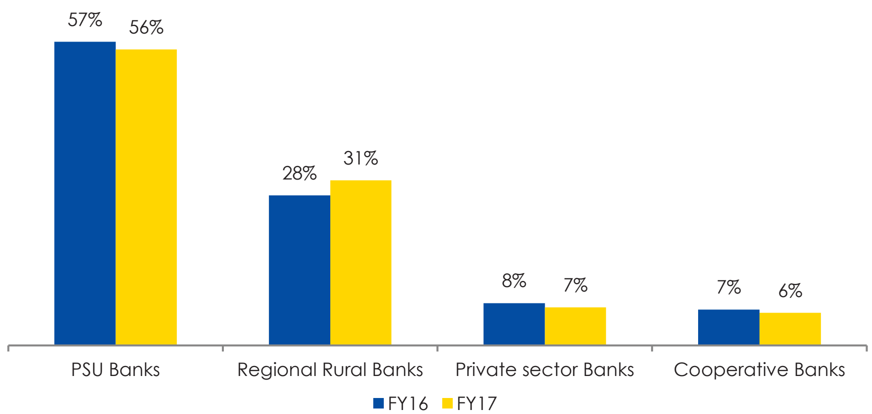
Differences between SHG and JLG model

	SHG	JLG
Whether Savings required	Collective savings for 6 months	No such requirement
Loan processing time	4 months	1 week
Repayment frequency	Monthly	Weekly
Decision making power vests with	Group leader	Entire group
Database availability	Data being shared only since Jul 2016	Credit Bureaus have robust information

Source: Bharat Financial Inclusion Q1FY18 Presentation

Private sector banks have not been drivers for SHGs meaning there is limited private sector bank competition from SHGs for JLG players
The proportion of Private Sector Banks in the SHG – Bank Linkage Project has been 8% and 7% of loans outstanding for all banking lending to SHGs as of FY16 and FY17, respectively. Competitive intensity is often determined by the nature of competition and Private Sector Banks not choosing to be the drivers for the SHG endeavour is positive for JLG lenders.

Share of Commercial Bank categories in loans to SHGs

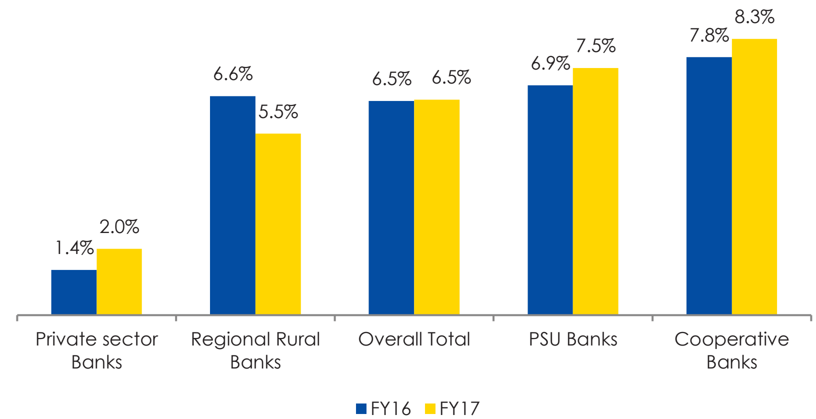


Source: NABARD

PSU Banks, RRBs and Cooperative Banks have been the drivers of SHGs and are not expected to increase competitive pressure for JLG lenders
93% of loans to SHGs, as of FY17, is contributed to from PSU Banks, Regional Rural Banks (RRBs) and Cooperative Banks all of which do not possess the intrinsic efficiency levels of private sector JLG lenders.

Loans to SHGs have been beset with NPA issues prior to Demonetisation
The NPA Ratio in the SHG-Bank Linkage Proejct was as high as 6.5% in FY16 itself, when the MFI industry had not been affected by Demonetisation and on-ground interference. This implies that underlying inefficiency was high in SHG lending universe compared with the JLG lenders.

NPA Ratios – Overall and for various Commercial Bank categories – SHG loans



Source: NABARD

Among SHG lenders, Private sector banks had maintained an NPA Ratio of 1.4% in FY16 indicating superior efficiency levels and risk management but, as explained earlier, Private Sector banks have not been the drivers for SHGs and we do not expect this to change going forward.

PAR 90 (on GLP) for NBFC-MFIs (excluding Bharat Financial and Share Microfin), which are JLG lenders, in FY16 was 0.2%. This has since risen to 8.2% at the end of FY17.

SHG growth has been tepid whereas JLG growth has forged ahead

Evolution of Self Help Groups over FY13-17

	FY13	FY14	FY15	FY16	FY17
SHGs count (lacs) - Savings	73.2	74.3	77.0	79.0	85.8
Deposits (INR cr)	8217	9897	11060	13691	16114
Annual Loan Offtake (INR cr)	20585	24107	27582	37287	38781
Loan outstanding (INR cr)	39375	42928	51545	57119	61581
SHGs count (lacs) - Loans	44.5	42.0	44.7	46.7	48.4
% Loan outstanding to women	83.3%	84.2%	89.1%	90.0%	88.0%

Source: NABARD

The 4-year loan CAGR for loans to SHG has been 12% over FY3-17 to INR 61581 cr whereas the 2-year GLP CAGR over FY15-17 for NBFC-MFIs has been 59% to INR 46848 cr. We use NBFC-MFI GLP CAGR over FY15-17 as the best calculable proxy for JLG growth since several NBFC-MFI's have received bank licences during this period. Importantly, the difference between SHG and JLG growth has been particularly stark in FY16 when loans to SHG grew just 11% whereas NBFC-MFIs (FY17 set) grew 102%.

XV. Small Finance Banks the preferred vehicle for conducting Microfinance and bottom-of-the-pyramid lending

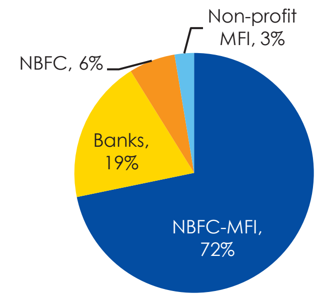
Focused bottom-of-the-pyramid lending the genesis of Small Finance Banks
Traditionally univeral banks have been reluctant to focus heavily on the Microfinance business since the ticket sizes have been too small and the opex prohibitively high in comparison to their larger ticket size SME and corporate businesses. However, if there existed entities that were already focused on MFI and were then tasked to continue to exclusively focus on micro-ticket bottom-of-the-pyramid lending and in lieu of this focus, would be granted differentiated banking licences, then this reluctance could be done away with. This is a key thought process behind the genesis of Small Finance Banks.

Structural long-term reasons favour the Small Finance Bank model
Over the long-term, the ability for Small Finance Banks to build a bank deposits franchise would be particularly beneficial from a cost of funds perspective. Furthermore, the lower cost of funds would enable lower lending rates reducing the potential on-ground risk that comes with high lending rates. Additonally, having capitive savings bank accounts for customers will enable cashless disbursal in a seamless manner and further reduce opex over the long term. The drawbacks of turning into a Small Finace Bank, as discussed in an earlier secton, are all transient in nature.

Unsurprisingly, formal Microfinance industry has shifted to nimble bank model
Prior to new banking licences granted to Bandhan Bank (FY15) and Small Finance Banks (FY16), as much as 72% of the formal MFI industry (ex SHG) was housed in NBFC-MFI. As the RBI under Raghuram Rajan proceeded to grant universal as well as differentiated banking licences, NBFC-MFIs sensed an opportunity and applied for these. The RBI found several such applications worthy and 8 of 10 new Small Finance Bank licencees were NBFC-MFIs. Of the 2 universal bank licencees, 1 was an NBFC-MFI (Bandhan Financial).

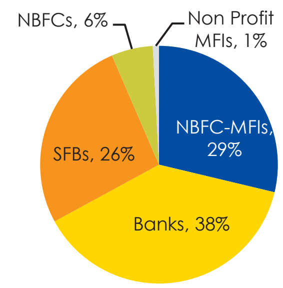
Small Finance banks the best MFI model above universal banks
It may be noted that even universal banks, in some cases, are bullish on the MFI industry. A case in point being Indusind Bank, which has decided to acquire Bharat Financial Inclusion, with RBL Bank and IDFC Bank also reportedly evincing interest previously. It may noted, however, that within the 38% share for univeral banks shown in the chart for post industry transformation, a large share is contributed by Bandhan Bank (was INR 15300 cr in FY16), which has JLG roots and another large share (34% of Banks' MFI book) is contributed to by MFI business sourced by BCs, which are on-ground JLG lenders. So, we do not consider the universal bank model as equivalent to the SFB model when it comes to tapping the generic MFI opportunity.

Formal MFI industry (ex SHG) breakup prior to industry transformation



Source: MFIN; FY16; Bandhan Bank and SFB loan book considered as NBFC-MFI

Formal MFI industry (ex SHG) breakup post industry transformation

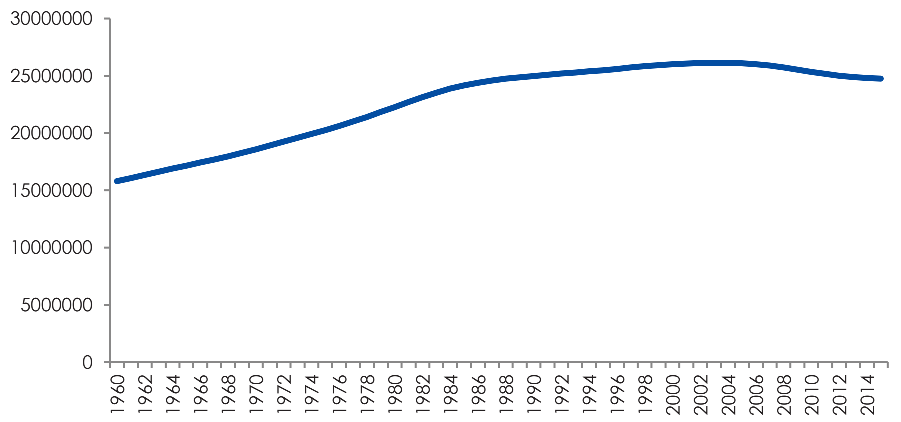


Source: MFIN; FY17; Bandhan Bank shown under Banks'; Disha, JFS and RGVN shown under SFB

XVI. Bottom of pyramid credit requirement set to rise at ground level as Demographic Mound awaits

The actual on-ground credit requirement at the bottom of the pyramid is set to rise as those born 10-20 years ago move into an age group where they will require credit. We analyze the poulation, birth rate and infant mortality rate times series data to calculate and note that the highest absolute numbers of viable (surviving) births took place over an extended period about 10-20 years ago and these individuals are now entering an age where they will require credit.

Absolute viable (surviving) births in India – 1960-2015

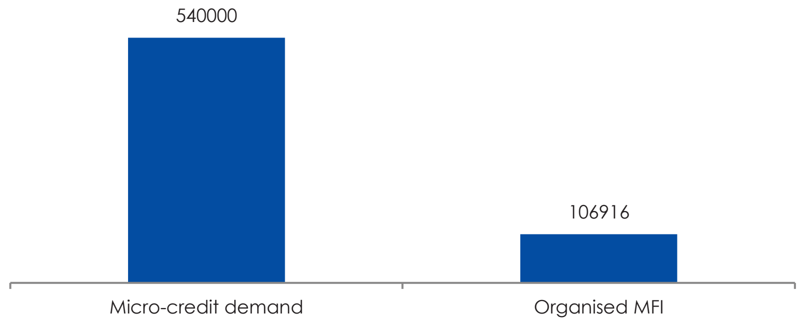


Source: World Bank

XVII. Shift from unorganised to organised lending will remain an enduring theme

As per Satin Creditcare (Q3FY17 Presentation), the current market potential for Microfinance is INR 2.5 lac cr. of which INR 1.07 lac cr is being catered to by formal lending (including SHG). As per Bharat Financial, the current Micro-credit demand is even higher at INR 5.4 lac cr.

Lion's share of micro-credit still not tapped by organised lenders (INR cr)



Source: MFIN (for FY17 Organised MFI book); Bharat Financial (for total Micro-credit demand)

Aadhar coverage a driver of shift from unorganised to organised MFI lending

A key reason for those at the bottom of the pyramid depending to unorganised moneylenders for micro-credit was the lack of identity proof and low awareness. With high Aadhaar coverage across the length and breadth of India, one key roadblock in this regard has been removed. With increasing awareness, bottom of the pyramid borrowers will increasingly adopt formal lending sources. While such borrowers may not be particularly interest-rate sensitive acorss the range of interest rates offered by formal MFI lenders, the usurious interest rates charged by informal moneylenders range upto 3-6% per month (36-72% per annum) and borrowers would significantly appreciate the far lower rates on the formal side. As per the PIB release dated 25th January 2017, Aadhaar coverage reached the 111 cr mark covering 99% of adult residents in India.

XVIII. Government strategy beneficial for bottom-of-pyramid lending not merely through refinancing support but general economic boost

GOI's allocation for the Rural, Agricullture and allied sector for FY18 in the Union Budget was INR 187, 223 cr, which was 24% higher than the previous year. This is indicative of the government focusing on uplifting those at the bottom of the pyramid through comprehensive social spending and not only through refinancing agencies providing credit. This, in the long run, implies a higher contribution to GDP from lower income groups which, in turn, means that government focus is an independent reason why the underlying credit requirement from lower income groups is set to rise.

Some of the key government schemes focused on rural India include National Rural Employment Guarantee Act, Pradhan Mantri Awas Yojana (Rural), National Rural Drinking Water Program, Krishi Sinchai Yojana, Gram Sadak Yojana, Fasal Bima Yojana and Integrated Child Development Services, among others.

XIX. Several restrictions applicable to NBFC-MFIs and NBFCs not applicable to Small Finance Banks

Interest rate cap applicable to NBFC-MFIs is not applicable to Small Finance Banks

As per NBFC-MFI regulations, the applicable Interest rate cap is: Lower of (1) Cost of Funds + Margin (Margin itself if separately capped at 10%) (2) 2.75 times the average base rate of the 5 largest commercial banks by assets. This is not applicable to Small Finance Banks.

While Small Finance Bank may not raise their interest rates to Microfinance customers, they are likely to enjoy higher margins on their MFI book as their Cost of Funds continues to fall over a period of time.

Small Finance Banks have much more business mix flexibility than NBFCs in general

As per NBFC-MFI regulations, not less than 85% of an NBFC-MFI's net assets should be in the nature of "qualifying assets" (Microfinance loans as such). At the same time, an NBFC which does not qualify as an NBFC-MFI cannot have more than 10% of total assets as MFI loans.

Simply put, NBFC-MFIs have to focus a lion's share of their business mix towards Microfinance and all other NBFCs have to focus a vast majority of their business mix towards businesses other than Microfinance. There are no such restrictions on Small Finance Banks. Business mix can change according to business strategy and market conditions, while adhering to other Small Finance Bank regulations.

Processing fee cap applicable to NBFC-MFIs not applicable to Small Finance Banks

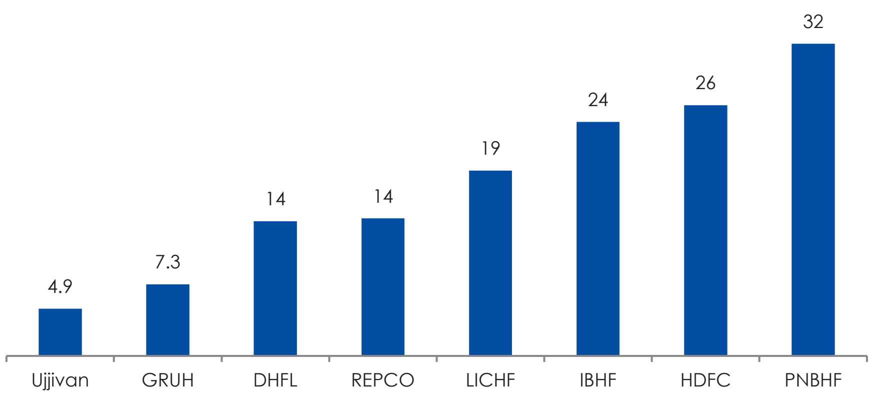
NBFC-MFIs cannot charge a processing fee higher than 1% of Gross Loan amount. This is not applicable to Small Finance Banks.

XX. Ujjivan's Affordable Housing business an outsized opportunity at its effective ticket size

UFS a prime beneficiary of Pradhan Mantri Awas Yojana given their low ticket size in the Housing Loan segment

It is important to note that Ujjivan Financial's ticket size for the Housing Loan segment is INR 4.85 lac, which puts it firmly in the range for being a prime beneficiary of the Pradhan Mantri Awas Yojana (PMAY) scheme. At such a low ticket size, the vast majority of Housing Loans extended by UFS are eligible for subsidy under the PMAY, particularly under EWS/LIG category.

Average Ticket Size – Ujjivan Financial vs Key HFC peers (INR lakh)



Source: Company data; Peer data is as of Q3FY17

Several macro factors at play that create huge underlying housing credit demand

Some of these factors include: -

- 66% of India's population is below 35 years of age indicating strong underlying generic demand
- Shift towards nuclear family setup from joint family structure will further augment demand
- Urbanisation trend to help – % of Indian population living in urban areas to move from 28% currently to 40% by 2020
- Improving affordability rise in disposable income outpaces rise in real estate prices
- Low interest rate regime to incrementally help real estate purchases
- Mortgage penetration in India at 9% of GDP is still low compared with most other nations

The government is acutely focused on house ownership for its citizens

Some of the key steps taken by the government include: -

- Tax (deduction) incentives for first time home borrowers are particularly helpful for low ticket purchases – reduces effective home loan yield from c.9.5% to c.4%
- There is boost to affordable housing through tax incentives as well as granting of infra status
- Govt. schemes like Housing for All by 2022 (Pradhan Mantri Awas Yojna), Smart Cities Mission, Atal Mission for Rejuvenation and Urban Transformation (AMRUT) are game changers
- Real Estate (Regulatory & Development) Act, 2016 will make real estate sector more transparent and attract more buyers
- Funding sources are increasingly available with ECBs for affordable housing, masala bonds and enhanced investment limits for insurance companies for highly-rated HFCs

XXI. Within housing, the main focus area is Affordable Housing and this plays directly into Ujjivan SFB's target clientele

The housing opprtunity is greatest lower down the pyramid
The shortfall in house units by 2020 is expected to be as much 1.9 cr units. Importantly, 95% of this shortfall would fall under Economically Weaker Sections (EWS) and Low Income Groups (LIG)

Significant tax incentives to developers focused on affordable housing

- For developers, 100% deduction for profits from house units below 30 sqm (1 sqm = 10.76 sqft) in 4 metros and below 60 sqm in rest of the cities, with MAT still applicable (deduction applicable to projects approved between Jun 2016 to Mar 2019 and completed within 3 years)
- Furthermore, house units below 60 sqm constructed for Central or State government schemes or PPP schemes will be exempt from service tax

Material tax deduction incentives to first time borrowers of small ticket size

- For property valued less than INR 50 lac and loan amount less than INR 35 lac, an incremental deduction of INR 50,000 over and above the pre-existing INR 2 lac deduction for interest repayment can be availed by first-time home loan borrowers
- It is to be noted that the fall in effective borrowing cost increases significantly as ticket size falls even if we are considering a (hypothetical) scenario where only the tax deduction is being applied and no subsidy has been availed.

Credit Linked Subsidy Scheme particularly attractive for small ticket size borrowers

Interest subsidy under PMAY across household categories

	EWS	LIG	MIG - I	MIG - II
Household Income (INR lacs)	0 to 3	3 to 6	6 to 12	12 to 18
Interest Subsidy (% pa)	6.5%	6.5%	4%	3%
Maximum loan tenure	20 years	20 years	20 years	20 years
Eligible Loan Amount (INR lacs)	6	6	9	12
Dwelling Unit Carpet Area	30 sqm	60 sqm	90 sqm	110 sqm
Discount Rate for NPV (% pa)	9%	9%	9%	9%

Source: NHB

The quantum of interest subsidy as we move lower down the pyramid is higher as the subsidy for EWS / LIG families is 6.5% compared with 4% and 3% for MIG – I and MIG – II categories.

Infrastructure status to Affordable Housing lowers cost of funds for the latter
As per the RBI, banks would not have to maintain CRR / SLR on funds raised through bonds meant for extending credit to the Infrastructure sector.

Affordable Housing has been kept under the ambit of Infrastructure and hence, the above benefit is available to the former. Loans upto INR 50 lacs in Metros for houses of value upto INR 65 lacs and loans upto INR 40 lacs outside Metros for houses of value upto INR 50 lacs are defined as Affordable Housing.

Due to CRR / SLR waiver, the effective cost of funds for banks for Affordable Housing business is lower.

Regulations Section (To be read with rest of the report for better understanding of a variety of related topics)

Regulations related to Branch Expansion

Rules related to Unbanked Rural Centres

- Any banking outlet / part time banking outlet opened in a Tier 3 to 6 centre in an LWE or NE (incl Sikkim) will be regarded as one being opened in an URC.
- An Unbanked Rural Centre is a rural (Tier 5 or 6) centre that does not a CBS-enabled banking outlet offered by a Scheduled Commercial Bank, Small Finance Bank, Payment Bank, Regional Rural Bank or licenced Cooperative Bank.

What constitutes a Banking Outlet

- An outlet providing liability services by bank staff / BC for at least 4 hours a day and 5 days a week is a banking outlet. If the duration of service is lesser, then it is a part time banking outlet.
- Extension Counters, Sattelite Offices, Part-shifted branches, Ultra Small Branches, Specialised Branches shall be treated as Banking Outlet / Part Time Banking Outlet if the above conditions are satisfied.
- ATMs, E-lobbies, Bunch Note Acceptor Machines, Cash Deposit Machines, E-Kiosks, Mobile branches cannot be treated as Banking Outlets at any point.

Definition of Banking Location (Population based)

Tier: -

- Tier 6 - Upto 5000
- Tier 5 - 5000 to 9999
- Tier 4 - 10,000 to 19,999
- Tier 3 - 20,000 - 49,999
- Tier 2 - 50,000 to 99,999
- Tier 1 - 100,000 or above

Type: -

- Rural - Upto 9999 (i.e. Tier 5 and 6)
- Semi Urban - 10,000 to 99,999 (Tier 2, 3 and 4)
- Urban - 100,000 to 999999
- Metro - 1000000 and above

SFB Branch expansion rules

- An SFB has to take permission from RBI for branch expansion for the first 5 years
- An SFB has to adhere to the new RBI rule (applicable to all Banks) that, in a given year, at least 25% of branch expansion has to be in Unbanked Rural Centres

General branch expansion rules (applicable to all banks)

- At least 25% of Banking Outlets opened in a financial year should be in URCs.
- Part Time Banking Outlet to also be considered in numerator and denominator.
- If a fixed point BC outlet is already present in the URC, a 'brick and mortar' branch will be reckoned.

Capital Requirement Regulations

Comparison of Capital Requirements – SFB vs Universal Bank vs Basel III

	RBI		Basel III
	SFB	Universal	
Minimum Common Equity Tier 1 Ratio	6.0%	5.5%	4.5%
Minimum Tier 1 Ratio	7.5%	7.0%	7.0%
Minimum Total Capital Ratio	15.0%	9.0%	9.0%
Trigger (CET1) for AT1 - upto FY19	6.0%	5.5%	5.125%
Trigger (CET1) for AT1 - after FY19	7.0%	6.125%	5.125%
Capital Conservation Buffer (CCB)	NA	2.5%	2.5%
Minimum CET 1 including CCB	NA	8.0%	7.0%
Minimum Total Capital Ratio incl CCB	NA	11.5%	10.5%

Source: RBI, BIS

Other Key Regulations related to Small Finance Banks

Promoter's contribution

- Promoter's initial contribution to Paid Up Equity Capital should be at least 40%.
- If the contribution is in excess of 40%, then it has to be brought down to 40% within 5 years from commencement of operations.
- At the same time, promoter stake should not fall below 40% for 5 years from commencement of operations.
- Promoter stake should fall to 30% within 10 years and 26% within 12 years.

If an SFB reaches a Net Worth of INR 500 cr, it must list within 3 years of reaching this milestone.

Foreign Shareholding

Foreign Shareholding norms as per extant norms for Universal Banks.

Prudential Norms

PSL Norms: -

- 75% of Adjusted Net Bank Credit must be to Priority Sector
- 40% should be as per extant PSL guidelines, the remaining 35% can be as per the Bank's own strategy (and they could choose to lend more where they have a competitive advantage).

Other Prudential Norms

- Maximum loan size and investment limit to a single and group obligor cannot exceed 10% and 15% of capital funds.
- At least 50% of loans should have a ticket size of INR 25 lacs or lower

No forbearance for CRR / SLR requirements.

Conversion of NBFC / MFI / LAB to SFB

- If an NBFC / MFI / LAB is granted an SFB licence, all activities that can be carried out with the SFB will have to be shifted to the SFB and the rest divested.
- The SFB and NBFC cannot co-exist.

Banks are precluded from creating floating charge on their assets. If the NBFC granted SFB licence has floating charges on the day of conversion, these will be grandfathered till maturity as long as additional required capital allocations are made.

Key Regulations related to NBFC-MFIs

- **An NBFC-MFI is a non-deposit taking NBFC that fulfils the following conditions:**
  - Has minimum Net Owned Funds of INR 5 cr
  - Not less than 85% of its net assets are in the nature of "qualifying assets".
  - Assets generated on or after 1st Jan 2012 will have to comply with Qualifying Assets criteria. Earlier assets would be grandfathered and run off as necessary.
  - Net assets are total assets minus cash and cash equivalents
- **Qualifying asset**
  - The borrower's household income should not exceed INR 1 lac if she is from a rural center and INR 1.6 lac if she is from an urban center.
  - The loan amount should not exceed INR 60,000 in the first cycle and INR 1 lac in the subsequent cycles. How is loan cycle defined?
  - Total indebtedness of the borrower should not exceed INR 1 lac. Debt taken for education and medical expenses not to be counted toward calculating indebtedness.
  - Tenure of the loan should not exceed 2 years if the loan amount exceeds INR 15000. There should be no prepayment penalty.
  - Loan to be extended without collateral.
  - Loans given for income generation should be at least 50% of total loans.
  - Loans to be repayable at weekly, fortnightly or monthly instalments at the choice of the borrower
  - The income from the remaining 15% non-MFI assets shall be governed by applicable regulation
  - An NBFC which does not qualify as an NBFC-MFI cannot have more than 10% of total assets as MFI loans.
- **Capital Adequacy**
  - Total Capital Ratio should be at least 15%
  - Tier II should not exceed Tier I.
- **Provisioning**
  - Loan provision should at least be the maximum of (1) 1% of total loans (2) 50% of instalments due for more than 90 days but less than 180 days + 100% of instalments due for more than 180 days

- **Margin cap**
  - Effective 1st April 2014, margin cannot exceed 10% for large MFIs (portfolio exceeding INR 100 cr)
  - 12% for smaller MFIs
- **Interest rate cap**
  - Lower of (1) Cost of Funds + Margin Cap (2) 2.75 times the average base rate of the 5 largest commercial banks by assets
- **Variation cap on interest rate**
  - The maximum variation allowed between minimum and maximum interest rate is 4%.
- **Processing charges**
  - Maximum of 1% of gross loan amount
  - Need not be included in margin cap or interest cap
- **Components of pricing**
  - There can be only 3: (1) Interest rate (2) Processing charges (3) Insurance premium.
- **Multiple lending**
  - A borrower cannot be the member of more than one JLG/SHG
  - The same borrower cannot borrow from more than 2 NBFC-MFIs.
  - The moratorium cannot be less than the frequency of repayment.
  - All sanctioning and disbursement of loans should be from a central location.

Key Regulations related to Priority Sector Lending

Categories under Priority Sector Lending

- Has minimum Net Owned Funds of INR 5 c
- Agriculture
- Micro, Small and Medium Enterprises
- Export Credit
- Education
- Housing
- Social Infrastructure
- Renewable Energy
- Others

Eligibility under Priority Sector Lending

	Loan size (INR cr)	Other stipulation
MSE	5	MSE as per MSMED Act 2006
Medium Enterprise	10	Medium Enterprise as per MSMED Act 2006
Social Infrastructure	5	Schooling, healthcare, etc in Tier II to VI centers
Renewable Energy	15	Solar, biomass, wind, micro-hydel, etc
Education	10 lacs	Loans to individuals
Housing	28 / 20 lacs	In Metro / Other centres for houses of 35 / 25 lacs
Microfinance	All	As per Master Circular dated 1st July 2015

Key Regulations related to Priority Sector Lending (Continued….)

Targets and Sub Targets under PSL

	Universal	SFB
Total	40%	75%
Agri	18%	18%
Small and Marginal Farmers	8.0%	8.0%
Micro Enterprises	7.5%	7.5%
Advances to Weaker Sections	10%	10%

Categories under Agri PSL

Farm credit, Agriculture infrastructure and Ancillary activities.

What is included under Weaker Sections

- Small and Marginal Farmers
- Artisans, village and cottage industries where individual credit limits do not exceed INR 1 lakh
- Beneficiaries under Government Sponsored Schemes such as National Rural Livelihoods Mission (NRLM), National Urban Livelihood Mission (NULM) and Self Employment Scheme for Rehabilitation of Manual Scavengers (SRMS)
- Scheduled Castes and Scheduled Tribes
- Beneficiaries of Differential Rate of Interest (DRI) scheme
- Self Help Groups
- Distressed farmers indebted to non-institutional lenders
- Distressed persons other than farmers, with loan amount not exceeding INR 1 lakh per borrower to prepay their debt to non-institutional lenders
- Individual women beneficiaries up to INR 1 lakh per borrower
- Persons with disabilities
- Overdrafts upto INR 5,000/- under Pradhan Mantri Jan-DhanYojana (PMJDY) accounts, provided the borrowers' household annual income does not exceed INR 100,000/- for rural areas and INR 1,60,000/- for non-rural areas
- Minority communities as may be notified by Government of India from time to time.

Adjusted Net Banking Credit (ANBC)

Bank Credit in India [As prescribed in item No.VI of Form 'A' under Section 42 (2) of the RBI Act, 1934].	I
Bills Rediscounted with RBI and other approved Financial Institutions	II
Net Bank Credit (NBC)*	III (I-II)
Bonds/debentures in Non-SLR categories under HTM category+ other investments eligible to be treated as priority sector +Outstanding Deposits under RIDF and other eligible funds with NABARD, NHB and SIDBI on account of priority sector shortfall + outstanding PSLCs	IV
Eligible amount for exemptions on issuance of long-term bonds for infrastructure and affordable housing as percircular DBOD.BP.BC.No.25/08.12.014/2014-15 dated July 15, 2014.	V
Eligible advances extended in India against the incremental FCNR (B)/NRE deposits, qualifying for exemption from CRR/SLR requirements.	VI
ANBC	III+IV-V-VI

Pradhan Mantri Mudra Yojana - Products and Offerings

The primary product of MUDRA will be refinance for lending to micro businesses / units under the aegis of the Pradhan Mantri MUDRA Yojana. The initial products and schemes under this umbrella have already been created and the interventions have been named 'Shishu', 'Kishor' and 'Tarun' to signify the stage of growth / development and funding needs of the beneficiary micro unit / entrepreneur as also provide a reference point for the next phase of graduation / growth for the entrepreneur to aspire for:

- Shishu: covering loans upto INR 50,000/-
- Kishor: covering loans above INR 50,000/- and upto INR 5 lakh
- Tarun: covering loans above INR 5 lakh and upto INR 10 lakh

Businesses/entrepreneurs/units covered would include proprietorship/partnership firms running as small manufacturing units, shopkeepers, fruits/vegetable sellers, hair cutting saloon, beauty parlours, transporters, truck operators, hawkers, co-operatives or body of individuals, food service units, repair shops, machine operators, small industries, artisans, food processors, self help groups, professionals and service providers etc. in rural and urban areas with financing requirements upto INR10 lakh.

The products initially being launched are as under:

- Sector/activity specific schemes, such as schemes for business activities in Land Transport, Community, Social & Personal Services, Food Product and Textile Product sectors. Schemes would similarly be added for other sectors / activities.
- Micro Credit Scheme (MCS)
- Refinance Scheme for Regional Rural Banks (RRBs) / Scheduled Co-operative Banks
- Mahila Uddyami Scheme
- Business Loan for Traders & Shopkeepers
- Missing Middle Credit Scheme
- Equipment Finance for Micro Units

Credit Plus Approach

MUDRA would also adopt a credit plus approach and take up interventions for development support across the entire spectrum of beneficiary segments. The highlights of such proposed interventions / initiatives are as under:

- Supporting financial literacy
- Promotion and Support of Grass Root Institutions
- Creation of Framework for "Small Business Finance Entities"
- Synergies with National Rural Livelihoods Mission
- Synergies with National Skill Development Corporation
- Working with Credit Bureaus
- Working with Rating Agencies

Other Proposed Offerings: Going forward, offerings as under are also envisaged: MUDRA Card, Portfolio Credit Guarantee, Credit Enhancement

Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE)

Objective

Availability of bank credit without the hassles of collaterals / third party guarantees would be a major source of support to the first generation entrepreneurs to realise their dream of setting up a unit of their own Micro and Small Enterprise (MSE). Keeping this objective in view, Ministry of Micro, Small & Medium Enterprises (MSME), Government of India launched Credit Guarantee Scheme (CGS) so as to strengthen credit delivery system and facilitate flow of credit to the MSE sector. To operationalise the scheme, Government of India and SIDBI set up the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE).

The main objective is that the lender should give importance to project viability and secure the credit facility purely on the primary security of the assets financed. The other objective is that the lender availing guarantee facility should endeavor to give composite credit to the borrowers so that the borrowers obtain both term loan and working capital facilities from a single agency. The Credit Guarantee scheme (CGS) seeks to reassure the lender that, in the event of a MSE unit, which availed collateral free credit facilities, fails to discharge its liabilities to the lender, the Guarantee Trust would make good the loss incurred by the lender up to 50/75/80/85 per cent of the credit facility.

Credit Guarantee

Any collateral / third party guarantee free credit facility (both fund as well as non fund based) extended by eligible institutions, to new as well as existing Micro and Small Enterprise, including Service Enterprises, with a maximum credit cap of of INR 200 lakh (Rupees Two Hundred lakh only) are eligible to be covered. Recently, guarantee coverage made eligible to select NBFCs.

The guarantee cover available under the scheme is to the extent of 75% / 80% of the sanctioned amount of the credit facility, with a maximum guarantee cap of `62.50 lakh / `65 lakh for credit facilities upto `50 lakh. The extent of guarantee cover is 85% for micro enterprises for credit up to `5 lakh. The extent of guarantee cover is 50% of the sanctioned amount of the credit facility for credit above `50 lakh with a maximum guarantee cap of `100 lakh.

The extent of guarantee cover is 80%(i) Micro and Small Enterprises operated and/or owned by women; and (ii) all credits/loans in the North East Region (NER) for credit facilities upto `50 lakh. In case of default, Trust settles the claim up to 75% (or 80%) of the amount in default of the credit facility extended by the lending institution for credit facilities upto `50 lakh. The extent of guarantee would reduce to 50% for the loans above `50 lakh upto `200 lakh.

The lender should cover the eligible credit facilities as soon as they are sanctioned. In any case, the lender should apply for guarantee cover in respect of eligible credits sanctioned in one calendar quarter latest by end of subsequent calendar quarter. Guarantee will commence from the date of payment of guarantee fee and shall run through the agreed tenure of the term credit in case of term loans / composite loans and for a period of 5 years where working capital facilities alone are extended to borrowers, or for such period as may be specified by the Guarantee Trust in this behalf.

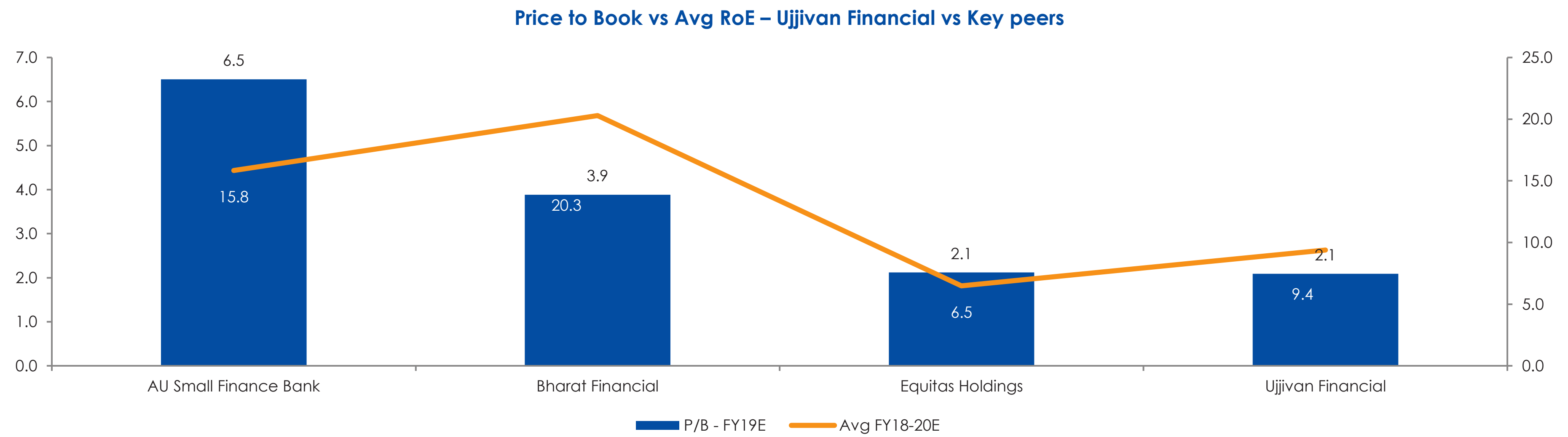
Valuation

We use the Residual Income Valuation Model to value UFS. We assume a long-term risk-free rate of 7% for India, a Beta of 1.2 for UFS and an India Equity Risk Premium of 6% and arrive at an overall Cost of Equity of 14.2% for CUB. We arrive at a price target of INR 452, at which the stock will trade at 2.7x FY19E book value.

At CMP, CUB trades at P/B of 2.1x FY19E book, which we believe is attractive given FY19E-21E RoE of 13-17%. Consequently, we believe the multiple of 2.7x implied by our price target of INR 452 is reasonable.

The stock trades at P/E of 17x FY19E EPS for FY17-21E EPS CAGR of 18% (221% over FY18E-21E). Hence, we conclude that UFS is attractive from P/E basis as well.

UFS looks undervalued compared with key peers and is poised to re-rate



Source: Edelweiss Investment Research; Bloomberg (for peers)

Equitas trades at a similar FY19E P/B for a materially lower RoE profile (having taken an ultra-conservative stance on MFI business) compared with Ujjivan. BFIN trades at nearly 4x FY19E P/B on the back of a 20% RoE profile (which UFS will approach by FY21E) and also due to interest from Indusind Bank (which is an indication of the value of such bottom-of-pyramid franchises). AU SFB trades at 6.5x FY19E P/B even with an RoE profile of 16%. These observations further bolster our belief that Ujjivan is a candidate for re-rating upward to our target valuation of 2.7x FY19E P/B.

Key Metrics

	FY15	FY16	FY17	FY18E	FY19E	FY20E	FY21E
Net Interest Income	327	578	761	786	973	1,091	1,369
Other Income	14	26	94	163	193	228	270
Total Income	340	604	855	949	1,166	1,319	1,640
Operating Expenses	205	307	458	679	727	765	877
Pre-Provisioning Operating Profit	136	297	397	269	439	555	763
Provisions excl for Tax	21	25	75	250	66	80	97
Profit Before Tax	115	272	322	19	374	475	666
Profit After Tax	76	177	208	12	243	309	433
Basic EPS	11.24	20.12	17.76	1.05	20.36	25.87	34.51
P/E	31	17	20	333	17	13	10
Book value per share	86	118	147	147	167	191	207
P/B	4.1	2.9	2.4	2.4	2.1	1.8	1.7
Provisions on Average Advances	0.86%	0.58%	1.28%	3.64%	0.80%	0.80%	0.80%
GNPA Ratio	0.1%	0.2%	3.7%	4.8%	1.1%	1.0%	0.8%
NNPA Ratio	0.02%	0.04%	0.03%	1.7%	0.4%	0.3%	0.3%
C/I Ratio	60%	51%	54%	72%	62%	58%	53%
Yield on Average Advances and Investments	24.5%	24.0%	20.8%	18.3%	17.9%	17.0%	16.8%
Cost of Average Deposits and Borrowings	11.4%	11.4%	10.1%	9.9%	9.1%	9.1%	8.7%
Net Interest Margin	13.4%	13.8%	12.1%	9.7%	10.0%	9.1%	9.2%
Return on Average Assets	2.5%	3.7%	2.9%	0.1%	2.3%	2.4%	2.7%
Return on Average Equity	13.7%	18.3%	14.1%	0.7%	13.0%	14.5%	17.3%

Financials

Income Statement (INR cr)

Year to March	FY16	FY17	FY18E	FY19E	FY20E	FY21E
Interest income	1,002	1,303	1,476	1,745	2,041	2,490
Interest charges	423	543	691	772	950	1,121
Net interest income	578	761	786	973	1,091	1,369
Other income	26	94	163	193	228	270
Net revenues	604	855	949	1,166	1,319	1,640
Operating expense	307	458	679	727	765	877
- Employee exp	197	272	390	401	425	489
- Depreciation / amortisation	8	13	43	54	68	85
- Other opex	102	174	246	271	272	304
Preprovision op. profit	297	397	269	439	555	763
Provisions	25	75	250	66	80	97
PBT	272	322	19	374	475	666
Taxes	95	114	7	131	166	233
PAT	177	208	12	243	309	433
Extraordinaries	0	0	0	0	0	0
Reported PAT	177	208	12	243	309	433
Basic number of shares (cr.)	8.8	11.7	11.9	11.9	11.9	12.5
Basic EPS (INR)	20.1	17.8	1.0	20.4	25.9	34.5
Diluted number of shares (cr.)	9.2	12.1	12.4	12.4	12.4	13.0
Diluted EPS (INR)	19.2	17.1	1.0	19.6	24.9	33.2

Growth Ratios

Year to March	FY16	FY17	FY18E	FY19E	FY20E	FY21E
NII growth	77%	32%	3%	24%	12%	25%
Net Revenues growth	77%	42%	11%	23%	13%	24%
Opex growth	50%	49%	48%	7%	5%	15%
PPOP growth	119%	34%	-32%	63%	26%	37%
Provisions growth	20%	197%	233%	-74%	22%	22%
PAT growth	134%	17%	-94%	1845%	27%	40%

Operating Ratios

Year to March	FY16	FY17	FY18E	FY19E	FY20E	FY21E
Yield on Average Advances and Investments	24.0%	20.8%	18.3%	17.9%	17.0%	16.8%
Cost of Average Deposits and Borrowings	11.4%	10.1%	9.9%	9.1%	9.1%	8.7%
Spread	12.6%	10.7%	8.4%	8.8%	7.9%	8.1%
Net Interest Margin	13.8%	12.1%	9.7%	10.0%	9.1%	9.2%
Cost to Income Ratio	51%	54%	72%	62%	58%	53%
Tax Rate	35%	35%	35%	35%	35%	35%

Balance Sheet (INR cr)

As on 31st March	FY16	FY17	FY18E	FY19E	FY20E	FY21E
EQUITY AND LIABILITIES						
Share Capital	101	119	119	119	119	131
Reserves and Surplus	1,097	1,636	1,637	1,868	2,166	2,586
Total	**1,198**	**1,755**	**1,756**	**1,988**	**2,285**	**2,717**
Share application money pending allotment:	0	1	1	1	1	1
Total Shareholder's Funds	**1,198**	**1,756**	**1,757**	**1,988**	**2,286**	**2,718**
Long-term borrowings	1,733	2,845	3,445	3,962	5,397	6,713
Long-term provisions	13	37	45	52	70	87
Total Non-Current Liabilities	**1,746**	**2,882**	**3,490**	**4,013**	**5,468**	**6,800**
Short-term borrowings	1	100	688	2,436	2,843	4,499
Trade Payables	15	29	29	82	230	437
Other current liabilities	2,704	3,601	3,528	3,064	3,342	3,194
Short-term provisions	63	110	109	95	104	99
Total Current Liabilities	**2,783**	**3,841**	**4,354**	**5,678**	**6,519**	**8,229**
Total Equity and Liabilities	**5,727**	**8,479**	**9,601**	**11,680**	**14,272**	**17,747**
ASSETS						
Total Fixed Assets	**24**	**140**	**168**	**203**	**245**	**297**
Non-current investments	0	357	407	487	574	715
Deferred tax assets (net)	24	47	59	73	92	115
Long-term loans and advances	16	22	42	52	64	80
Other non-current assets	1,304	1,430	1,784	2,226	2,748	3,421
Total Other Non-Current Assets	**1,344**	**1,857**	**2,292**	**2,838**	**3,478**	**4,331**
Current investments	0	1,089	1,222	1,460	1,722	2,145
Receivables under financing activity	3,779	4,481	5,209	6,507	8,037	10,014
Cash and Bank balances	491	760	535	452	520	624
Short-term loans and advances	30	84	97	121	150	187
Other current assets	59	68	78	98	121	150
Total Current Assets	**4,359**	**6,482**	**7,141**	**8,638**	**10,549**	**13,120**
Total Assets	**5,727**	**8,479**	**9,601**	**11,680**	**14,272**	**17,747**

RoAE Decomposition

Year to March	FY16	FY17	FY18E	FY19E	FY20E	FY21E
Net Interest Income / Assets	10.1%	9.0%	8.2%	8.3%	7.6%	7.7%
Other Income / Assets	0.5%	1.1%	1.7%	1.7%	1.6%	1.5%
Net Revenues / Assets	10.5%	10.1%	9.9%	10.0%	9.2%	9.2%
Operating Expense / Assets	5.4%	5.4%	7.1%	6.2%	5.4%	4.9%
Provisions / Assets	0.4%	0.9%	2.6%	0.6%	0.6%	0.5%
Taxes / Assets	1.7%	1.3%	0.1%	1.1%	1.2%	1.3%
Total Costs / Assets	7.5%	7.6%	9.7%	7.9%	7.1%	6.8%
Return on Assets	3.1%	2.4%	0.1%	2.1%	2.2%	2.4%
Assets / Equity	4.8	4.8	5.5	5.9	6.2	6.5
Return on Equity	14.8%	11.8%	0.7%	12.2%	13.5%	15.9%

Valuation Metrics

Year to March	FY16	FY17	FY18E	FY19E	FY20E	FY21E
Basic EPS	20.1	17.8	1.0	20.4	25.9	34.5
EPS growth	79%	-12%	-94%	1845%	27%	33%
BVPS	118	147	147	167	191	207
Basic P/E	17.3	19.6	332.8	17.1	13.5	10.1
P/B	2.9	2.4	2.4	2.1	1.8	1.7

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Rating	Expected to
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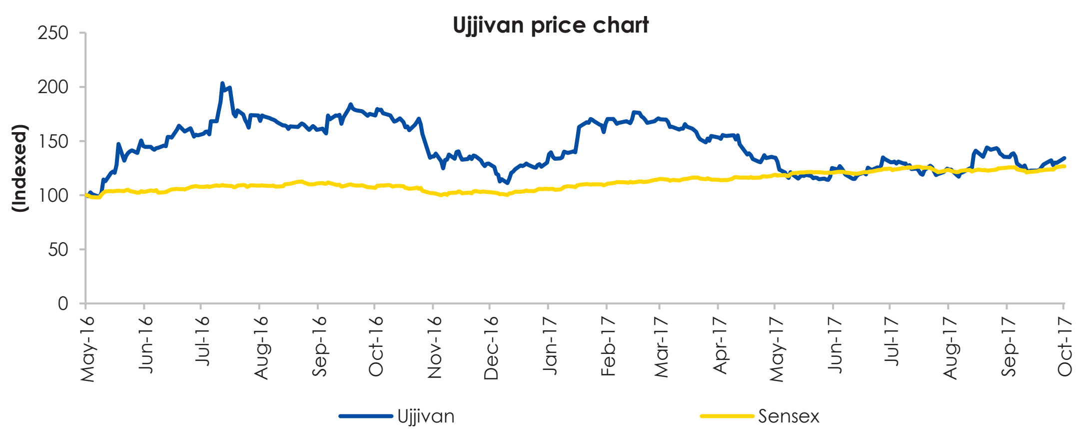
Hold	appreciate between 5-15% over a 12-month period
Reduce	Return below 5% over a 12-month period



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