Setting the foundation

India has had the largest unbanked/under banked population in absolute terms globally (2 Bn). Digitization, Jan Dhan Yojana, and Aadhaar have significantly reduced the unbanked and underbanked population in India. Launched in 2014, Jan Dhan Yojana has facilitated the opening of over 43 crore bank accounts, with total balance exceeding INR 1.45 lakh crore.

The Aadhaar system has provided more than 1.25 billion unique identification numbers, supporting the expansion of financial services to previously underserved citizens.

Jan Dhan Yojana, Aadhaar, and mobile technology (also called as JAM) along with UPI has allowed lending and transaction to become increasingly digitized. India by most accounts is ahead of even developed countries in terms of digitization of financial services

Huge unmet credit need

India has a large unmet credit need (credit gap) at lower income levels. There are three main segments in this – Microfinance, small and MSME credit and finally affordable housing credit

Addressable credit gap

₹25.8 trillion
Credit gap in MSME space

₹8.0 trillion
Credit cap in micro enterprises

₹16.8 trillion
Credit gap in small enterprises

Source - IFC

The affordable housing finance segment has a shortage of 50-60 Trillion rupees

If we add all of this, it comes to around 450 billion dollars. There is a large opportunity in this space. The digital layer (JAM) has a been a great foundation to build financial service companies to meet this need

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Regulatory response: Payments and Small finance banks

In response to the above need, GOI setup a committee in 2013 (headed by Nachiket Mor) who came out with a set of recommendations in 2014. Under this recommendation, RBI got around 72 applications for several types of banking licenses (payments and small finance bank). 10 applicants were selected and issued the SFB license that year

SFB License Restrictions vs. Other Commercial Banks:

- **Priority sector credit** - SFBs are mandated to allocate at least 75% of their Adjusted Net Bank Credit (ANBC) to priority sectors such as agriculture, micro, small and medium enterprises (MSMEs), and affordable housing. Regular banks have a lower requirement, with 40% of their ANBC allocated to priority sectors.
- **Loan Size**: SFBs must ensure that at least 50% of their loan portfolio constitutes loans and advances of up to INR 25 lakh to promote financial inclusion. Regular banks do not have such restrictions on loan sizes
- **Branch Expansion**: SFBs must open at least 25% of their branches in unbanked rural areas to extend financial services to underserved regions. Regular banks have more flexibility in branch expansion, depending on the RBI's guidelines.
- **Financial Services**: Unlike regular banks, SFBs cannot offer sophisticated financial services such as credit cards, wealth management, and large corporate loans. They also cannot establish subsidiaries or undertake non-banking financial activities

Equitas bank

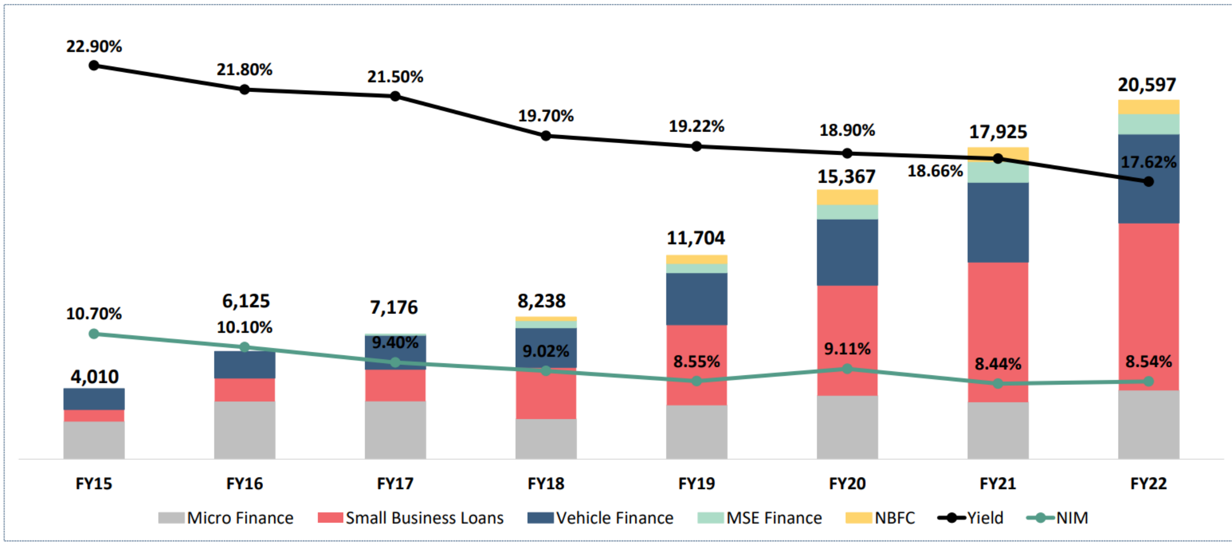
Equitas Small Finance Bank (ESFB) was established in 2007 as Equitas Micro Finance, a microfinance institution focused on providing financial services to the economically weaker sections of society. In 2011, it expanded its services by acquiring the housing finance company Equitas Housing Finance Limited (EHFL) and the non-banking financial company (NBFC) Equitas Finance Limited (EFL).

In 2015, Equitas was one of the ten organizations granted an in-principal approval by the Reserve Bank of India (RBI) to set up a Small Finance Bank. Equitas Small Finance Bank was officially launched in September 2016 after receiving the final banking license from RBI

Evolution from NBFC to a Small Finance Bank

The asset book and its composition have evolved over time, with the bank growing in the informal sector in line with regulatory requirements.

Diversifying across the informal segment

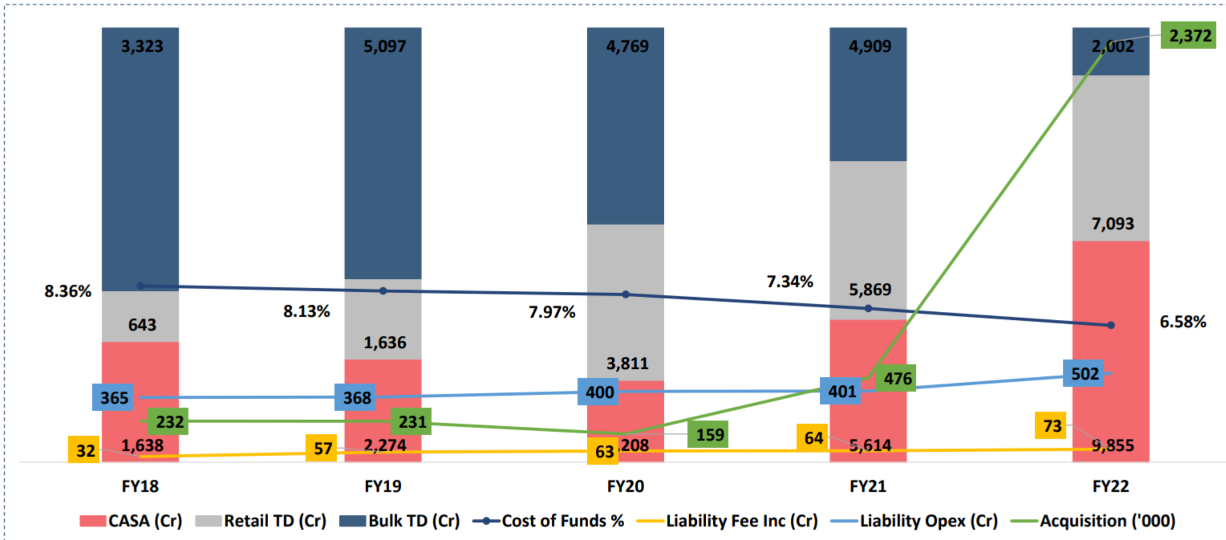


A few points stand out

- The proportion of unsecured MFI lending has remained stable and decreased as a percentage of total loans.
- The bank focuses on small business loans, which it considers its flagship product. These loans are secured in nature.
- Vehicle finance, another secured product, is growing rapidly.
- The bank is diversifying into MSE finance, which is also expanding.

The yield on the book has dropped by 4.3%, while the net interest margin (NIM) has contracted by 2.1% during this period. This is due to a decrease in the cost of funding

Liability franchise evolution



The primary difference between a bank and an NBFC/MFI or any other lender is the cost of funds. Banks can access low-cost deposits from retail customers, which lowers their cost of funds. Large private and PSU banks have a cost of funds below 4%.

Newer banks like Equitas or IDFC, which are scaling up with liability franchises, have a higher cost of around 5.5-6.5%. As the cost of funds drops, these new banks can lend at lower rates while still maintaining their margin. The credit quality is much better at these rates, improving the overall risk-adjusted return on equity (ROE) for the bank.

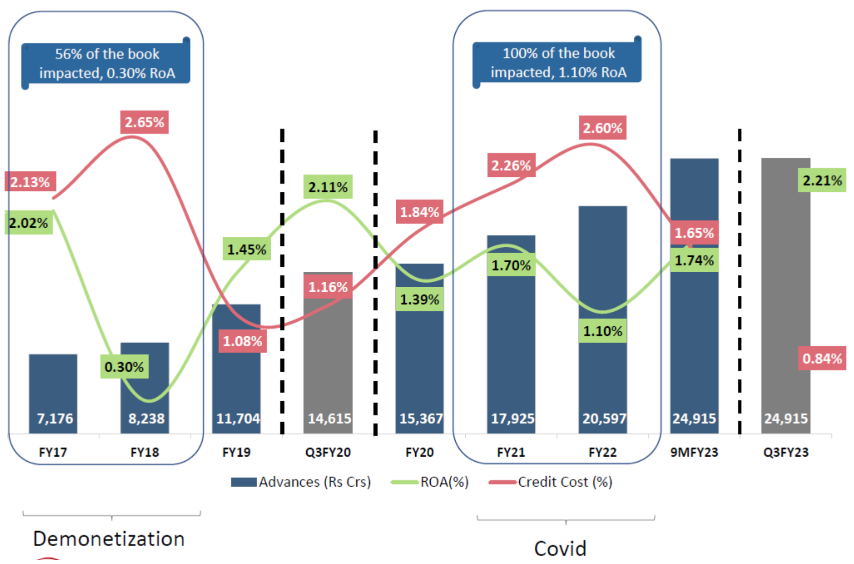
Another aspect of the bank's evolution is the cost of operations. As the bank expanded its network, it incurred upfront costs for setting up full-service branches. Equitas Bank has had a cost-to-income ratio in the 60-65% range, compared to the 40-45% range for larger banks. This is due to the cost of hiring and setting up new branches.

When it rains, it pours

The timing for new banks like Equitas Bank could not have been worse. The financial services sector was hit badly during the 2016 demonetization, the 2018 ILFS crisis, and the 2020 Covid crisis due to higher loan losses and slowing growth.

However, Equitas has been progressing up the quality curve (drop in yields), resulting in lower loan losses in each successive crisis, even though they were much higher than normal.

Bank Performance Over the Cycles



Loan CAGR (FY18-22)	26%
Qtr. Avg PPoP	3.19%

During demonetization, 53% of our advances representing Micro Finance was impacted while the rest of the book had no impact. Our RoA went down to the lowest level of 0.30% for the year ended March 2018. During Covid-19, the entire advances was impacted and yet, the lowest level our RoA went down to, was 1.1% for the year ended March 22.

After demonetization impact, it took us 7 quarters to get to the over 2% annualised RoA for the quarter. After Covid-19 impact, it has taken us just 3 quarters to get over 2% annualised RoA for the quarter.

Inflection

Since its launch in 2015, the bank has grown its loan book by 27% CAGR, despite macroeconomic troubles. The credit cost peaked at 2.6% in FY22 but has been around 1-1.2% during normal economic conditions. Gross NPA peaked in FY22 after the Covid crisis at 4.1%.

The bank has faced three headwinds in its operating history – two internal and one external. The first headwind was the higher cost of funds as it migrated from an NBFC to a bank. This will be a tailwind in the future as the bank deepens its liability franchise, with the cost of funds expected to drop below 6% over the medium term.

The second headwind was the high cost of setting up the bank and branch operations. As the bank grows, these costs as a percentage of income should reduce. The bank will continue to invest in manpower and distribution to drive growth, but operating leverage should act as a tailwind.

The last headwind was the macro issues of the last few years. No one can predict the future, but barring extreme events, asset growth should remain at 25%+ level, and credit costs should normalize.

If we make the above assumptions, it is not a stretch for the bank to double its top-line and profits in the next few years. At around 15 times earnings, the valuations are at the median level and lower than the peer group

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