Thematic| NBFCs | 24th November 2010

Indian Microfinance

Story of 3Ps "Poor, Profit and Politics"

After its golden era of 2006-10, the microfinance industry ('MFI') is now going through a turbulent phase hit by negative publicity from the media and political intervention in Andhra Pradesh. However, we continue to see substantial scope in this business and expect the inherent strength of the business model to help the industry overcome the current problems. We are positive about the prospects of the industry and see substantial upside in future albeit with some hiccups coming from political quarters

Political risk remains the threat for business

Evidenced by Andhra events and as highlighted in our pre-IPO research on SKS, political risk is the main concern for the Microfinance industry given its target segment is also the main vote bank for the political parties. The industry currently faces risks from multiple regulators, curtailed credit flows and reduced collections in Andhra. Until the Malegam Committee report, which examines the various aspects of MFI business (including priority sector status), is released later this year; much remains uncertain. But we believe this is a transition phase for the microfinance industry with bigger and better players coming out stronger. With the government's financial agenda being at the core and the MFI bill expected within a few months, we expect the MFI sector to play a key role in inclusion of the rural population to the mainstream. We expect the industry to grow and prosper for the following reasons:

- **Inherent strength of business model:** The current microfinance model which is based on the "Grameen model", pioneered by Prof. Mohammed Younus has demonstrated its robustness over the last 3-4 decades. This business model has flourished even in the turbulent states of Africa, Pakistan, Indonesia etc.
- **Scope for growth and diversification:** India has a population over 1bn, with c.37% of them earning less than $1.25 (c.Rs.60) per day per family and c.77% unable to spend more than Rs 20 per day per person. These people have little access to formal sources of credit and are exploited by moneylenders. Microfinance arguably remains the only source of credit at reasonable cost. Our conservative estimates suggest a market size of Rs 2.9trn ($65bn), of which only 15% is penetrated by MFIs and Self-Help-Groups (SHGs). As MFIs expand their reach and diversify their product portfolio, they have the potential to emerge as the 'core' platform of an ecosystem to promote the government's high-priority inclusive growth agenda.
- **Inclusion agenda**: The importance of the inclusion agenda to the central government and lack of viable alternatives to MFI, makes us believe that political intervention is likely to act as speed bumps for the industry, not a dead end; as long as MFIs balance shareholder returns with social good.
- **ROEs to remain robust:** With the current pressure from various quarters to reduce lending rates, MFIs have decided to voluntarily reduce rates by 1-2.5% (recommended by industry body MFIN). This has raised concerns on the sustainability of the high ROEs (20%-50%). We expect average lending rates for the top MFIs to stabilize at around 23%-24% (i.e. 2-3% less than current average rates), which would lead to moderation in ROEs for some, but we do not expect ROEs to fall below 20% given the operating leverage and scope of increased services.

Bullish on bigger MFIs with SKS being our top pick

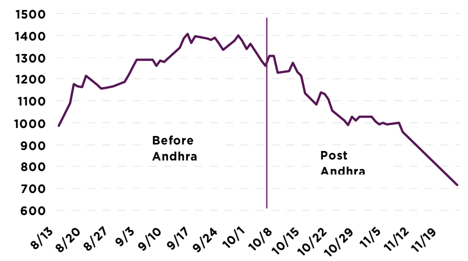
After SKS's **(SKS.IN, Buy)** IPO, it was speculated that other large MFIs like Spandana, Share Microfin amongst others would list on the bourses. However, the current Andhra situation is likely to delay this process by a few months. We are positive about the longer term prospects of these bigger MFIs and with our pre IPO concerns now priced in we initiate with a Buy on SKS, given its post IPO balance sheet strength and geographically diversified portfolio. We previously highlighted Manappuram **(MGFL.IN, Sell)** as a proxy play on microfinance, but the stock has run up 30% since then and post 15% dilution trades at 3.1xFY12E book value. Hence our Sell stance on valuation grounds

Initiating coverage on SKS and MGFL

SKS Microfinance, SKSM.IN	**Buy, 43% upside**
CMP / Fair value (Rs)	708/1011
Mkt cap ($bn)/ ADV ($ m)	1.14/$21m

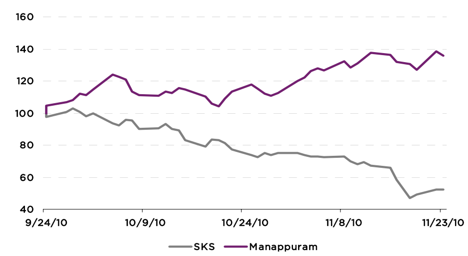
Manappuram General Finance, MGFL.IN	**Sell, 10% downside**
CMP / Fair value (Rs)	178/160
Mkt cap ($bn)/ ADV ($ m)	1.4/$2.3m

Share price performance of SKS since listing



Source: Bloomberg

Relative share price performance- SKS vs. MGFL



Source: Bloomberg

Analyst

Santosh Singh
+91 22 4211 0923
Santosh.singh@execution-noble.com

Aditi Thapliyal
+91 22 4211 0904
Aditi.thapliyal@execution-noble.com

Sales

Pramod Gubbi, CFA
+91 22 4211 0902
pramod.gubbi@execution-noble.com

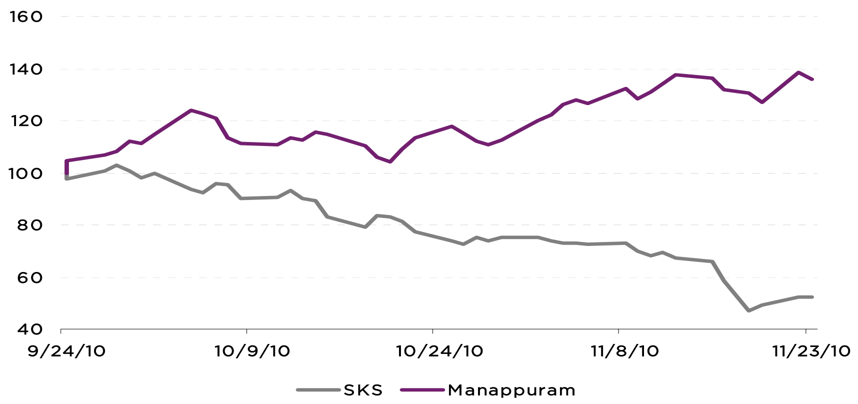
Ashish Goenka
+91 22 4211 0911
ashish.goenka@execution-noble.com

Background

In our pre IPO questions on SKS our concerns were centred on a) downwards pressure on yields due to political pressure and competition b) credit quality risks; c) extent of operational leverage and d) Scope for gearing and ROE increases. Post IPO on 24th September we suggested caution on SKS and playing Manappuram as proxy.

Given, SKS's rollercoaster ride since IPO and many risks increasingly reflected in the price, we have taken a more detailed look at the whole sector, meeting a range of companies and industry experts. Were our concerns valid? To some extent yes, political risk has already manifested itself. But, as we explain in the note we underappreciated the inherent strength of the business model, with room left for growth and sustainability of ROE.

Figure 1: Chart showing relative performance of SKS and Manappuram stock

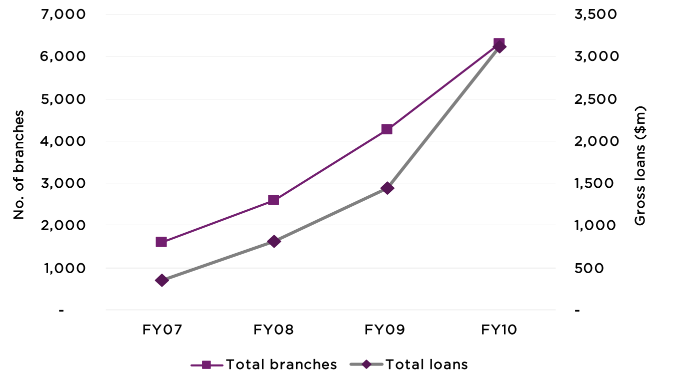


Source: Bloomberg

Organised microfinance in its current form be traced back to 1976 in Bangladesh, when Grameen bank started its operations as a not for profit organisation. In India microfinance started in the late 80s as a not for profit venture with most of the companies were either section 25 companies or NGOs, having the primary objective of alleviating poverty. Government agencies like NABARD (National Bank for Agriculture and Rural Development) through various initiatives i.e. Self help Groups (SHGs) helped the microfinance sector to grow.

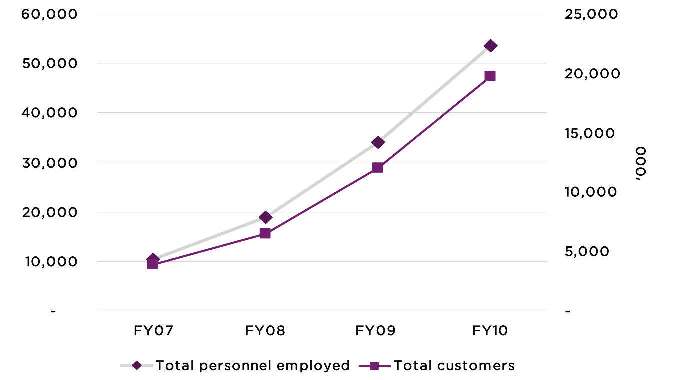
However, with the realisation that money can be made out of microfinance, many of the organisations converted themselves into for profit companies in early 2000 and private capital started to flow in the sector. This resulted in extraordinary growth with microfinance loans outstanding increasing at a c.100% CAGR over 2006-2010. Presently there are more than 150 MFI's with 17 (in 2009) classified as systemically important (more than Rs.1bn (c.$22m) of loan outstanding).

Figure 2 Growth in total branches and loans outstanding for top 6 MFIs*



Source: Mix market * Top six MFIs include SKS, Spandana, Share Microfin, Ashmita, Bandhan and Basix

Figure 3 Growth in no. of employees and branches for the top six MFIs

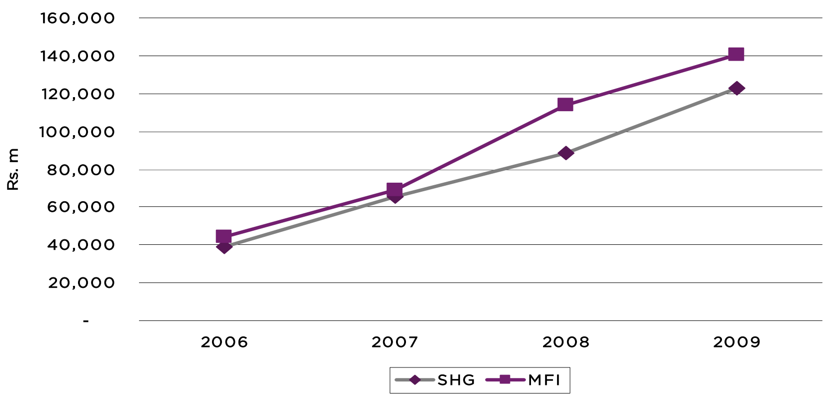


Source: Mix market * Top six MFIs include SKS, Spandana, Share Microfin, Ashmita, Bandhan and Basix

Two microfinance models are currently operational in India: a)SHG (Self Help Group) which is mainly financed by NABARD (see chart below) and B) Micro Finance Institutions (MFIs) operating on the JLG (Joint Liability Group) model. Most of the MFIs are based on the "Grameen model" (see table on the right) pioneered by Prof. Yunus of Grameen Bank, with some modifications.

At present SHG's account for 60% of the total loans outstanding whilst microfinance institutions account for remaining 40%. With MFIs growing at a far higher rate (see chart below) they are expected to overtake SHG's in the short term in the amount of loans outstanding.

Figure 4: Amount distributed by SHG and MFIs



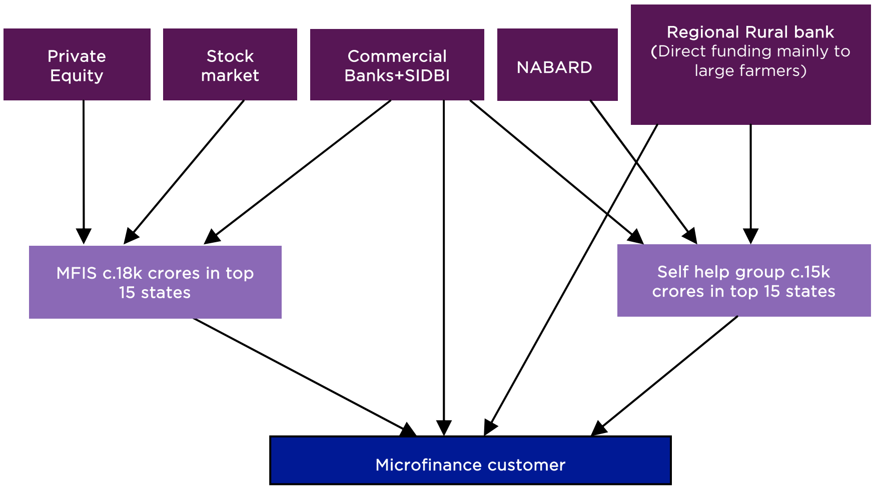
Source: Intellecap, inverting the pyramid report

Table 1 Grameen model

Mastered by professor Yunus, the model is based on Joint Liability Group concept (JLG). Loan is provided to a person who has no previous credit history based on the recommendation of the group members, who jointly take liability to repay in the eventuality of individual failing to pay. The model has worked quite efficiently over the last few decades with credit quality remaining healthy (defaults of less than 2%)

Source: Execution Noble

Figure 5: Funding structure for MFIs



Source: Execution Noble

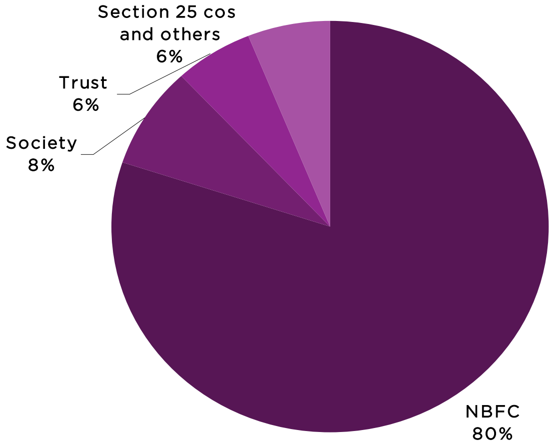
Competitive landscape

The market is dominated by NBFCs which form 80% of the total market and their share is increasing with time. Top 3 NBFCs account for c.50% of the total market due to following competitive advantage enjoyed by larger MFIs;

- **Lower cost of funds:** Larger MFIs given bigger portfolio of loans and a larger Balance Sheet (ability to absorb more losses) are able to get loans at a lower rate from banks and other sources compared to smaller ones.
- **Reputation of the MFI:** Since, the customers want to get associated with those MFIs whom they perceive to be long term players (i.e. will survive to give them loans at various occasions). Hence, bigger MFIs are able to tap customers relatively easily than smaller ones.
- **Reach:** This remains one of the key competitive advantage since the economy of scale plays an important role on determining the profitability of the MFIs

Also, the recent events in Andhra (Andhra Govt passed ordnance) would further increase the gap between the bigger and smaller MFIs, since smaller MFIs would find it hard to operate due to a)They have highly concentrated portfolio in Andhra and b) Smaller MFIs are not able to access funding from the banks.

Figure 6: Distribution of loans by legal structure



Source: Intellecap, inverting the pyramid report

Political risk remains the threat for business

Politics might play a major role in defining the future of the industry

Andhra crisis has clearly demonstrated the impact of political risk on the MFI industry, with the share price of only listed player tumbling by more than 50% and many of the small/big microfinance companies facing liquidity crisis/default worries. Hence, it is important to examine the risk before the scope to conclude if the sector is investable or not.

Political: Given the nature of the customer base (poor people who are exploitable and also form majority of the vote bank) of the MFIs, politics might play a major role in defining the future of the industry. We see it as a major threat given the populist politics. The current government sees financial inclusion as major agenda and it sees MFIs as a means to achieve it. However, we have seen enough evidence to suggest that the regional governments might give in to populist politics. Evidence of this is Andhra Pradesh using higher interest charged by the MFIs as a tool to pass an ordinance to regulate MFIs (which has been currently challenged in the court). Across the globe majority of losses to the microfinance industry has occurred due to the political reasons. Hence regional political will keep on causing disruptions and share price volatility, but global evidence suggest that the companies should be able to survive

Table 2 Mass default due to political and macroeconomic factors

Country	Year	Events which triggered the mass default	Impact
Andhra Pradesh	Late-2010	Some suicides in the state were assigned to the coercive recovery practices of the MFIs and multiple lending done by them, leading to state government passing a highly restrictive ordnance	The extent of losses is still unknown, however the current situation in Andhra could lead to big defaults for MFIs since more than 30% of the loan book of the MFIs is in the state of Andhra Pradesh.
Nicargua	Mid-2008	In mid 2008, a movement began in Nicaragua called "Movimiento No Pago" (a movement for non-payment of loans). This movement, supported mostly by farmers of the north of Nicaragua with ties to the left-wing party in Nicaragua.	PAR increased to ~15% in the northern region and forced many MFIs to close their shops.
Morocco	Late-2008	MFIs have started experiencing rising delinquencies but problem escalated when the merger and acquisition of a large distressed MFI became public	PAR increased to ~10%
Bosnia and Herzegovina	Late-2008	Recession in Europe	PAR increased to ~7% despite aggressive write-offs by MFIs
Pakistan	Late-2008	A loan waiver proclamation by a local politician, and the spread of false loan waiver news stories, gave momentum to the mass defaults.	PAR increased to ~12%
Kolar, India	Mid-2009	A decree issued by some religious leaders to not pay back the loans taken from micro-finance institutions.	This led to defaults in the range of 25%-80% of the outstanding loans as per industry sources
Krishna District India	Early-2006	Krishna district authorities close down 54 branches of micro finance companies in and around Vijaywada, alleging that they were charging high rate of interest and indulging in forced recoveries.	

Source: Consultative Group to Assist the Poor (CGAP), Various media sources, Execution Noble

Regulatory: In India there are three types of microfinance companies a)NBFC, which are regulated by the RBI b) Not for profit organisations and c)MFIs which are not registered with RBI but are for profit. We have kept the sope of the note restricted to the first one (i.e. NBFCs) as they form 90% of microfinance market by lending size. The sector has been subject to various regulatory changes in the past, biggest being the outsourcing regulation (see table on the right) in 2006, Also there are various other regulatory changes in the pipeline which can impact the microfinance companies prominent amongst them being:

Table 3 Outsourcing regulation

Before 2006, some of the MFIs were using banks Balance Sheet to underwrite loans. In Nov.2006 RBI came out with outsourcing guidelines restricting the banks from outsourcing sanction of loans to any other agencies, strangulating the source of fund to some extent for these MFIs.

Source: Execution Noble

Securitisation regulation: The microfinance industry has been using securitisation and assignments as a major source of financing as it allows the MFIs to transfer their assets from their Balance Sheets leading to higher leverage (see table below). Assignments are far more prominent source of funding than securitisation in India.

Table4 Securitisation/assignment by different MFIs

	Loans Outstanding including assigned loans (Rs m) (A)	Securitised + assigned loans (Rs m) (B)	Securitised/assigned portfolio as a % of total loan outstanding C= (A)/(B)
SKS	43,210	13,839	32%
Spandana	35,268	12,956	37%
Basix	10,038	2,282	23%
Bandhan	11,950	3,068	26%
Equitas	6,120	1,337	22%
Asmitha	14,855	4,027	27%
Share Microfin	9,446	NA	NA
Ujjivan	3,707	NA	NA

Source: Execution Noble

We have tried to discuss the impact of current securitisation bill in table below and conclude that in the worst scenario also, there could be some impact to the highly levered players. However, players like SKS who are working on c.3-4x leverage would not be impacted.

Table 5 Comments on securitisation bill and microfinance companies

Scenario 1	Scenario 1 (most likely)	Scenario 2 (Possible)	Scenario 3 (Unlikely)
Nine months of seasoning of the portfolio in the originators book before securitisation	Included in the securitisation bill	Excluded in the securitisation bill	Included in the securitisation bill
Bilateral assignment	Excluded in the securitisation bill	Included in the securitisation bill	Included in the securitisation bill
Comments	No impact since most of the transactions are bilateral assignments	Little impact since, securitisation/assignment can be done without waiting for nine months of seasoning	MFIs would not be able to use securitisation/assignment route. However, industry sources suggest that most of the loans would be converted into term loans. Hence, MFIs with higher leverage would be impacted since rik weight age on off Balance Sheet items is 50% compared to 100% for on Balance Sheet.

There has also been an argument that if the microfinance industry is allowed to securitise its assets, the defaults rates would increase as the presence of the microfinance companies is leading borrowers to repay their money. These concerns are well founded given the structure of the business, however most of the assignment/ securitisation transaction are done with first loss guarantee with the originator bearing the initial portion of the defaults. (See table on the right for a recent securitisation transaction) This implies that microfinance companies are not really interested in just transferring the risk on the Balance Sheet, but are ready to act as a partner in any eventuality. We think that this maturity of the microfinance companies as well as the past performance should bode well with regulators and even if the assignment transactions are covered within the scope, RBI could allow them to use the securitisation/assignment as the source of financing.

Table 6 Securitisation example

At Rs.1.06bn this is the largest securitisation in the microfinance industry. Gamma Pioneer IFMR Capital 2010, the Special Purpose Vehicle created for the transaction, has issued three tranches of securities rated by Crisil, India's foremost rating agency: a 53% senior tranche rated P1+ (so) that was subscribed to by UTI Mutual Fund, 32% senior tranche rated AA (so) that was subscribed to by HDFC Bank and Reliance Capital and a 15% junior tranche rated BBB (so) that was subscribed to by Reliance Capital and IFMR Capital.

The structure created by IFMR Capital ensures that the incentives of the originator, servicer and structure are aligned. While the originator and servicer, Equitas, provides cash collateral of 9.4% of the pool principal, the structurer, IFMR Capital, has invested in the subordinated junior tranche

Source: IFMR and company

Business correspondent: RBI came out with a discussion paper in 2006 that it would allow the banks to use the partnership model and distribute there products by appointing business correspondents, with the intent of driving financial inclusion. However, the RBI has not specified NBFCs as business correspondents. This could lead to higher competition since, banks can leverage on the reach of the BCs to distribute their products. With banks having greater muscle in terms of pricing they could eat into market share of the MFIs. However, we think that eventually the RBI could allow MFIs to act as BCs given their reach and the government's intent to increase in financial inclusion. However, if this were not to happen it would represent a risk for the MFIs.

Table 7 Anecdotal data on Reserve Banks views to allow MFIs to become BCs

Source/date	
Microfinance focus/ 7th June 2010	As for the microfinance companies acting as business correspondents of banks for branchless banking, RBI is currently examining the proposition and is evaluating the risks such as conflicts of interest, co-mingling of funds, misrepresentation and other agency related risks to safeguard the interests of the consumers. Ms. Usha recognized the fact that non-bank non-financial entities have also emerged as active players in financial inclusion by offering banks customised payments and remittance services to their customers based on innovative ICT solutions. There performance however may deteriorate if combined with financial businesses due to conflicting interests, she added.
Microfinance focus/ 30th Sept 2010	For extending banking services to the underserved, the Reserve Bank of India (RBI) has decided to permit banks to engage for-profit companies registered under the Indian Companies Act, 1956, excluding Non Banking Financial Companies (NBFCs), as Business Correspondents (BCs) in addition to the entities permitted earlier.
Microfinance focus/ 19th Aug 2009	A Reserve Bank of India Working Group has recommended appointing non-deposit taking NBFCs, whose microfinance portfolio is not less than 80 per cent of their loan outstanding in the financially excluded districts, as Business Correspondents (BCs) for banks in rural and semi-urban areas, among others.
Microfinance Focus/ 5th August 2010	The paper (RBIs discussion paper on "Engagement of for-profit companies as Business correspondents") highlights the observations made by the Committee on Financial Inclusion under Dr C. Rangarajan, which said that NBFCs engaged in micro finance could be recognized as BCs of banks for providing only savings and remittance services. The rationale is that in case of such services there will not be any conflict of interest as NBFCs are not permitted to undertake such business.

Source: Various media sources, Execution Noble,

The Malegam Committee report expected in next couple of months

Other than these regulatory risks discussed above, the Reserve Bank of India has formed the Malegaon committee to examine the reasons for the Andhra debacle and to suggest actions. The suggestion would include examining the possibility of taking away priority sector lending status from the microfinance industry, which could increase the cost of funding for the industry. Also, the extent of interest rate charged and ROE and ROAs for MFIs are being examined by the committee. The microfinance bill is also pending and the centre can also appoint a central regulator for the industry. In our opinion appointing a central regulator could be advantageous for the industry, specifically for the bigger players (most of them are already regulated by RBI) since all the MFIs can be regulated and the risk of regional regulations can be avoided.

Macroeconomic: Since the MFIs are dependent on short term financing from the market any liquidity crisis in the market might lead to a slowdown. Also, since the basic incentive for microfinance customer to repay his loan is his ability to get higher loan/another loan, if the customers believe that due to any reason the microfinance company would not be able to provide them with another loan it could lead to defaults. Researchers and authors have found that the incentive of getting a new loan has been basic reason why the customers seldom default. However, bigger MFIs with a more stable and diverse source of fund and a more diversified source of income are more immune to this risk.

Credit: Although the current credit quality of the MFIs remains robust, investors have been concerned about sustainability of the credit quality:

1. **Multiple lending:** There have been reports of one customer being financed by multiple lenders, fuelling concerns that once the debt levels for a customer become high, they will start defaulting on their loans. We think that this a risk, since the industry currently has no central data base to access a customer's credit history. However, our discussions with various market participants and experts suggest that this is not such a major risk at this point given that part of the multiple lending is in line with the MFIs expectation, since they do not finance the entire requirement of a borrower (see table on the right). However, in the longer term this might act as a source of default as well as an irritant for the MFIs. Given, that borrowers are women and are poor, any trial of recovery might prove costly for the MFIs. See table below. To overcome this issue the MFI industry is trying to form a central agency which would maintain full information about the credit history of a borrower (see table below)

Table 8 Multiple borrowing example

i.e. a person would require Rs. 17,000 for a buffalo but one MFI would not give more than Rs.10,000 forcing him to borrow from some other MFI/source, so although it is multiple lending but not a risk from overborrowing point of view

Source: IFMR and company

Table 9 Anecdotal evidence suggesting formation of new credit bureau by MFIs and no control on customers if they default

Date and source	
Economic Times/ 22 oct 2010	According to Kurnool police, Ammulu borrowed a total of Rs 70,000 from SKS and Spandana and later defaulted on payments. "She has been avoiding the collections officials of the companies for the past two months. According to the complaint lodged with us she is being harassed by the company officials for the repayment. We inquired in to the matter and registered cases,"
Hindu Business Line/ 3rd July 2010	As part of its efforts to share data on defaults, MFIN has invested in Alpha Micro Finance Consultants to set up a credit bureau. The credit bureau, planned for launch later this year, will help improve credit risk management within the sector. The approval from the RBI is pending. The idea is to provide borrowers' names, addresses and loan details to Credit Information Bureau (India) Ltd, and High Mark Credit Information Services
India Microfinance Business news/ 9th August 2010	MFIN has already begun recording of client data of the top 10 MFIs in India and this is expected to be over by August 2010.The data from other microfinance companies will be recorded by end of September 2010. However, the same may be available to the public only by next quarter, said Mr Vijay Mahajan, the chairman and president, MFIN in a press release to the media.

Source: Consultative Group to Assist the Poor (CGAP), Various media sources, Execution Noble,

2. **Contagion effect:** This is one of the bigger risks since default by one customer can lead to defaults by other customers as; If one customer defaults the credit history of the entire group with the particular MFI takes a hit leading to lower motivation amongst the group members to pay their loan. We believe to curb this from happening regulations are required to curb both the MFIs (from taking coercive action) and borrowers (from defaults).

3. **Cash flow mismatch:** This is more prevalent in the cases of loans for agriculture, since the cash inflows are concentrated towards the end of the harvest season with little or no cash flow in between. Hence, the borrower would not able to pay their loans at regular interval. Also, the borrowers do not have savings accounts where they can save and repay there loan. Our discussion with Industry experts suggest that although this is a risk, MFIs curb it by a) giving lower loans for agricultural activity (SKS has only 6% of its portfolio in agriculture sector) and b) Giving loans to individuals who also have some other regular source of income.

4. **Borrowing to repay:** There have been concerns that the borrowers repay loans by borrowing from other MFIs, creating a vicious cycle which once broken can cause flurry of defaults and significant increase in credit costs. Whilst theoretically possible, practically it seems improbable since the repayment of the MFIs is done over a period of time, whereas loans can be taken at one go and these people don't have bank accounts to help them make monthly repayments. Borrowing to repay would have been possible if the cash flow pattern would have been similar i.e. Bullet structure, however with loans following a bullet structure and repayments following a barbell structure this is difficult.

Is for-profit microfinance sustainable?

there is still a great deal of potential left for microfinance institutions however with a reduced ROE

As is apparent from our analysis above the main risk associated with the microfinance industry is political risk. This has been well highlighted by ongoing Andhra event. If the global and past experience is anything to go by the microfinance model has faced the political events and the bigger players have come out stronger. However, we believe that the recent events would lead to reduction in the interest rates and MFIs reassessing their strategy and realigning their interest with that of their customers (there was some deviation in the last few years with profit being the primary motive). We have tried to examine in detail in the coming section the sustainability of microfinance industry which suggests that; there is still a great deal of potential left for microfinance institutions however with a reduced ROE in mid twenties for a well functioning MFI.

Scope for growth: Since the inflow of private money in 2006 microfinance companies have grown at c.100% CAGR, without being substantially impacted by the liquidity crunch generated by the credit crisis. There remains enough potential for microfinance companies to grow and thrive despite competition from the SHG's financed by NABARD and regional rural banks and direct competition from commercial banks:

We conservatively estimate the market size at 2,889bn with 15% penetration achieved

- **Size of the market:** We assume that people below the poverty line are the addressable market segment for microfinance companies. We have tried to use Tendulkar Committee and Sengupta Committee criteria's to assess the total potential of the market (see table). Using Tendulkar Committee's ultra conservative report 37% of the Indian population is below poverty line surviving at less than $1.25 per day this leaves us at an addressable market segment of 430 million people. If we increase our threshold for classification of poor from $1.25 (c.Rs60) per family to $1.35 (c. Rs.65), more than 60% of the people can be classified as poor with the addressable market size increasing to 2,889bn and with a total loan distribution of Rs433bn the microfinance companies are able to reach only 15% of the addressable demand, leaving substantial scope of growth.

Table 10 Estimating the market size

Description	According to Tendulkar committee report	Increasing the household income threshold to $1.35	Sengupta Committee (Population not able to spend Rs20 per day)	Comments
Population below poverty line (mn)	430	650	830	We think that Sengupta committee's classification should be more relevant for microfinance companies.
Average size of the household	5	5	5	
Total addressable household (mn)	96	144	184	We expect 1 loan per household
Loan size	20,000	20,000	20,000	RBI classifies loan of less than Rs.50,000 as micro loans, however we have taken Rs.20,000 as the loan size.
Total market size (Rs bn)	1,911	2,889	3,689	
Current loan book (Rs bn)	183	183	183	
SHG (Rs bn)	250	250	250	
Total loans outstanding (Rs mn)	433	433	433	

Source: Tendulkar Committee report, Sengupta Committee report and Execution Noble estimates

- **Scope for extension of services:** MFIs can leverage on their tremendous reach to provide various other services to its customer base. This is a mutually beneficial way to expand the sources of income for the MFI at the same point in time the customers benefit by access to the services and facilities which they were devoid of at a reasonable rate. Hence, it not only increases the ROE for the MFIs but also helps them in fulfilling their social obligations. Realising this potential some of the MFI's have already started providing some of the products and services and others are in pilot stage with various MFIs. We can divide the services provided by the MFIs in broadly three categories

1. **Expansion of the existing credit lines:** There is tremendous opportunity in this market segment, since the poor population had almost no access to borrowing for housing loans, and little access to other loans i.e. bigger term loans. Based on our conservative estimate that only 10% of the total population eligible for microfinance would be able to access this source, we estimate the market size in the range of Rs1,000bn. Companies like SKS, Equitas and some others have started running pilots on this segment.

2. **Distribution:** We think that microfinance companies can act as a good distribution partner for all the market participants who are trying to enter the rural and poor population of India. One of the areas is insurance distribution, where the meagre penetration is not due to lack of demand but due to suppliers (insurance companies) unwilling to provide insurance policies, since per policy premium is small. Hence, unless there is huge volume, cost of reaching these people would make the business economically unviable for the insurance companies. Microfinance companies with their reach (SKS has more than 7.5m customers) can provide volumes to the insurance companies leading to provisions of insurance at reasonable cost to the ultimate customers. Importance of insurance services could be understood from the fact that our discussions with poor people suggested that a vast proportion of the consumption loan taken by them from moneylenders at high interest rates are for medical treatment or to fund their daily needs when they lose their only bread earner in the family. However, in order to do that even MFIs would have to charge moderate commission for distribution and relying on the volumes to generate profits.

Microfinance if done properly can help achieving government's financial inclusion agenda

3. **Business facilitator:** Given the population group with the companies are targeting are mostly self employed daily wage earners, grocery shop owners etc., the microfinance companies can act as a trainer, supplier etc. This helps the development of the customers as well as earning capacity of the MFIs. Basix is an excellent example, which derives c.30% of its revenue by acting as a business facilitator.

Table 11 Estimating the Scope of extension of services

Description	According to Tendulkar committee report	Increasing the household income threshold to $1.35	Sengupta Committee	Comments
Population below poverty line (mn)	430	650	830	
Average size of the household	5	5	5	
Total adressable household (mn)	96	144	184	
Home loan market				
Loan Size	10,000	100,000	100,000	
Penetration level	10%	10%	10%	We do not expect more than 10-20% population, since we do not expect a vast population would be able to sevice a 100,000 loan.
No. of adressable families	9.6	14.4	18.4	
Total market size (Rs bn)	956	1,444	1844	
Other loans (Rs bn)	956	1,444	1,844	
Distribution				
Life insurance	600	600	600	Based on Rs.20 per week endowment product distributed by SKS
Commission (%)	10%	10%	10%	Current commission levels are much higher, however we think that for growth of the market a much modest 10% rate would be sustainable
Earning potential (Rs bn)	5.73	8.67	11.07	
Other insurance (i.e. health, livestock, crop etc.)	600	600	600	Although the amount is miniscule and the products would be available at much higher rates but we do not want to be overestimating
Commission (%)	5%	5%	5%	We do not expect higher commission levels
Earning potential	2.9	4.3	5.5	
Total earning potential (Rs. Bn)	8.6	13.0	16.6	
Savings	Not estimated but some companies like IFMR are running pilots on Mutual funds distribution and BC model would open additional avenues for Microfinance			
Other services like agri consulting, tuitions, education, distribution etc	Not estimated, however companies like Basix have been able to provide value added services and we think that MFIs/SHGs would be the way to enter the rural population.			

Source: Tendulkar Committee report, Sengupta Committee report and Execution Noble estimates

ROEs to remain robust Over the last 4-5 years the interest charged by various microfinance companies have come down as they have built up scale. With current demands to decrease the interest rates coming from various quarters, we expect the interest rates to fall further (MFIN already suggested 24% interest rate). However, we think that for some of the MFIs with little operating leverage ROEs will reduce, but do not expect ROEs for the industry as a whole to fall below 20% on a sustained basis:

Table 12 How MFIs are making money now

Description	Spandana	Bandhan	Asmitha	Basix	Equitas	SKS	Comments
Gross yield (Interest income/total assets)	25.7%	22.2%	25.6%	21.5%	24.4%	25.6%	Includes assignments
finance expenses (interest expense/total assets)	9.3%	6.7%	9.1%	7.2%	7.3%	8.3%	Different due to different capital structure the average cost is between10-13%
operating expenses	6.1%	4.2%	6.1%	10.1%	6.8%	9.8%	
Total expense	15.4%	10.9%	15.2%	17.3%	14.0%	18.1%	
Credit cost	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	We have standardised it to 1%, which is the average for last 5 years.
ROA	9.3%	10.2%	9.4%	3.2%	9.4%	6.5%	
Tax	33.0%	33.0%	33.0%	33.0%	33.0%	33.0%	
Other income	0.6%		0.7%	4.6%		2.1%	
Post tax other income	0.4%	0.0%	0.5%	3.1%	0.0%	1.4%	
Post tax ROA	6.5%	6.9%	6.6%	4.2%	6.3%	5.3%	
Leverage (including assignments)	7.3	7.5	7.7	5.2	2.3	4.6	
ROE	**47.5%**	**51.5%**	**50.8%**	**22.0%**	**14.2%**	**24.4%**	

Source: Mix market, company reports and Execution Noble

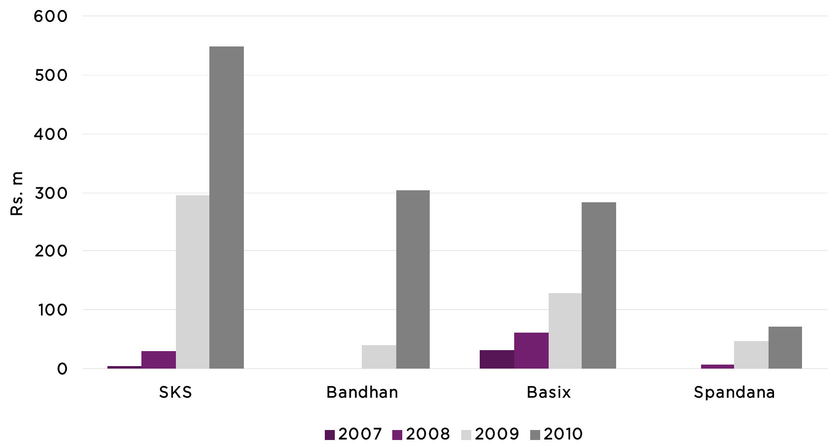
- **Maturity of the branches to help:** With most of the MFIs when they open a branch in any new geography the initial interest rates charged are high due to a) No credit history and b) To recover the initial cost. The later point is the biggest reason as most of these MFIs try to keep there operating margin intact so initial costs charged to the customers are higher. Hence, once the companies recover there initial investment they start reducing interest rates. At present most firms are in expansion phase opening new branches aggressively. With a more settled portfolio we can expect interest rates to come down, without hampering operating margins.

Operating efficiency expected to increase with scale

- **Operating efficiency to help**: As most costs are fixed for an MFI (c.70-80%), margins are dependent on operating efficiency. We expect the operating costs to reduce due to; a) Increased loan portfolio per customer (currently it is around Rs.7,000 per customer which can be expected to grow to more than 10,000 in near term); b)seven companies (like SKS) have opened branches aggressively and hired new employees, with those employees and branches being operational, operating ratios will come down. Hence we can expect a reduction in lending rates compensated by lower operating cost ratios. Given different companies are at different levels of operating efficiency (see table on the top) we expect the impact of operating leverage to be higher on companies like SKS who have expanded aggressively.

- **Economies of scale vs Economies of scope:** As explained on page 8 & 9 we expect substantial scope for expansion of MFIs in different segments given there reach amongst rural poor. Given the distribution and business facilitator aspect requires little capital, It shall enhance ROEs

Figure 7: Increase in income from other operation (other than credit)



Source: Company

As a result we expect average lending rates for the industry as a whole to fall by minimum c.200bps in the next couple of years, as a result of ROEs for companies like Spandana, Asmitha (Super ROE of c.50) (where the strategies have been to penetrate and expand and hence have lower operating leverage) to normalise to around 30%. We do not expect any material ROE impact to SKS (high operating leverage given the expansion) and we expect ROEs of new players (who have raised capital recently) to expand, since they would be able to utilise their capital efficiently (increased leverage).

Table 13 Expected ROE

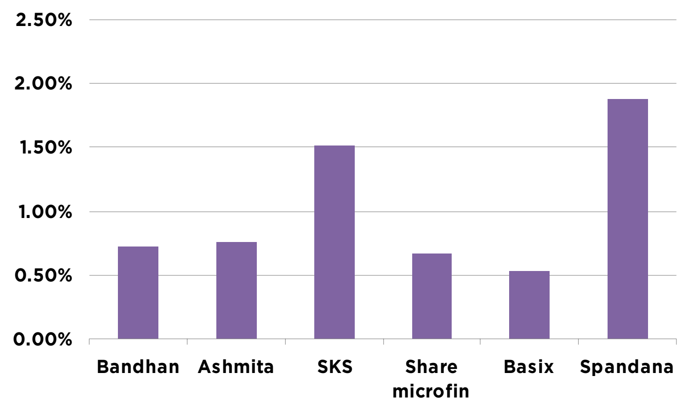
Description	Spandana	Bandhan	Asmitha	Basix	Equitas	SKS	Comments
Gross yield	23.5%	20.2%	23.5%	21.5%	24.5%	23.5%	We expect c. 200bps reduction in interest rates for all the participants, the impact on the gross yield would be different given the current leverage and assignment levels
finance expenses	9.3%	6.7%	9.1%	7.2%	8.3%	9.0%	Don't expect the cost of funds to increase substantially.
operating expenses	6.1%	4.2%	6.1%	10.1%	6.8%	7.9%	Companies like SKS due to their operating leverage would be able to reduce their operating expenses by c.150bps. However, we expect SKS expense ratio to be c.150bps higher than its nearest competitor, given higher admin cost.
Total expense	15.4%	10.9%	15.2%	17.3%	15.0%	16.9%	
Credit cost	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	We have increased our credit cost assumptions to take into account any eventuality
ROA	6.1%	7.3%	6.3%	2.2%	7.5%	4.6%	
Tax	33.0%	33.0%	33.0%	33.0%	33.0%	33.0%	
Other income	0.6%		0.7%	4.6%	2.0%	2.1%	Expect other income to increase substantially, however not included in the calculation (we expect a large extent to incremental income to offset the cost of borrowings for customers)
Post tax other income	0.4%	0.0%	0.5%	3.1%	1.3%	1.4%	
Post tax ROA	4.3%	4.9%	4.5%	3.5%	5.9%	4.0%	
Leverage (including assignment)	7.3	7.5	7.7	5.2	6.0	6.0	Expect the leverage to increase for companies like Equitas and SKS who have raised capital recently
ROE	32%	37%	35%	18%	35%	24%	ROEs would normalise between 20-35%

Source: Mix market and Execution Noble

Credit costs expected to remain low:

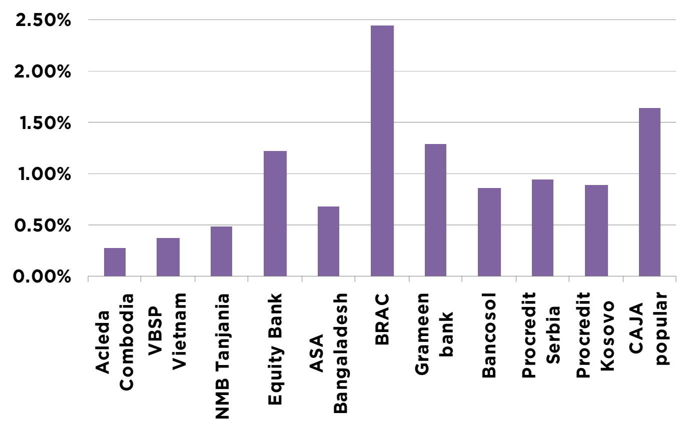
This is one area of concern for many market participants, however microfinance companies have been able to maintain there credit costs even in geographies like Cambodia and Vietnam (volatile political environment) where credit costs have been less than 1% over a period of five years. The main reasons for low credit costs are:

Figure 8 Average credit cost for Indian MFIs over last 5 years



Source: Company filings, Execution Noble.

Figure 9 Average credit cost for worldwide MFIs over last 5 years



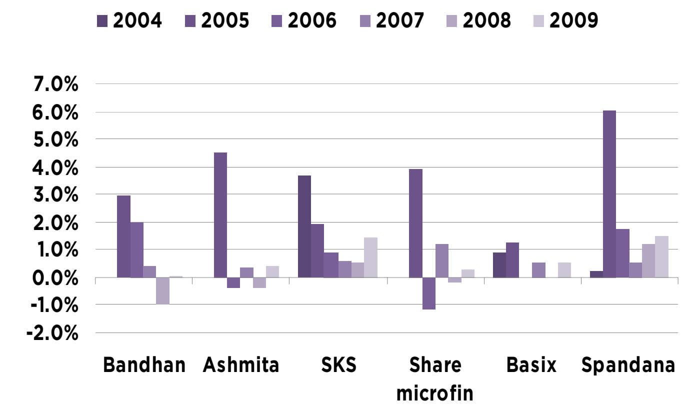
Source: Company filings, Execution Noble

- **Group lending schemes:** The loans are given not based on the credibility of the individual customer but the guarantee of the group and the members are allowed to settle the credit issues between themselves, with MFIs only interested in the final amount receivable from the group. This model makes sure that the MFIs don't interact for recovery with a highly sensitive rural pollution at the same time social stigma associated with defaults result in excellent credit quality.
- **Loan repayment at short durations:** Various researches have suggested that in order to recover from the poor the loan repayments should be at a shorter interval and smaller amount. Since, most of the customers are daily wage earners and provide only for near time obligations. Weekly repayment tenure makes sure that MFIs are collecting there money at a very short duration and the amount of money recoverable from the borrower is quite low in one instalment. However, the current Andhra Ordnance changing the collection cycle to monthly from weekly could impair the credit history in the short run.
- **Strict monitoring by the microfinance companies:** Unlike banks microfinance companies interact with their customers on a regular basis (mostly weekly), this interaction with the customers makes sure that the customers are always aware of their loans and impeding repayments

Andhra ordnance can cause impairment of the credit quality

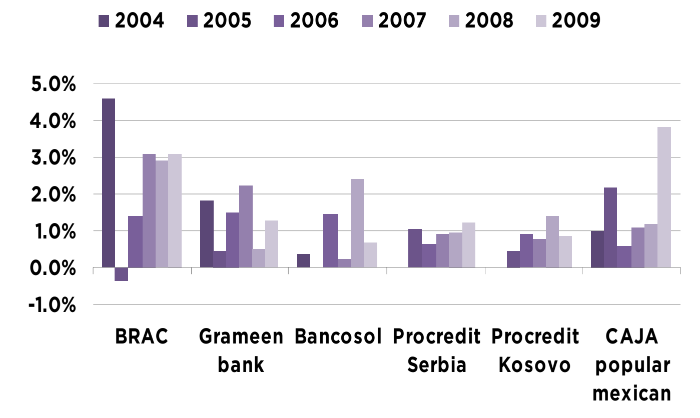
However, we do not expect the ride to be smooth, with periodic spikes in the credit costs (see chart below), given the politically sensitive nature of the population being targeted by MFIs. In the past we have also seen that the MFIs have suffered because of some large political event and then followed by period of smooth operations. We expect 2010 to be the year when there could be a spike in the overall credit costs (due to defaults and NPA provisions) for Indian MFIs given the Andhra situation. We have assumed c.15-20% write off of Andhra portfolio for SKS and higher amount for others given SKS has 27% of its portfolio exposed to Andhra compared to more than 30% for others.

Figure 10 Trend of NPAs for MFIs in India



Source: Company filings, Execution Noble.

Figure 11 Trend of NPAs for MFIs globally



Source: Company filings, Execution Noble

MFIs Vs Banks

Despite, MFIs being financed mainly by the banks (c.90%) they enjoy higher ROEs. Hence, people ask the question why banks don't directly finance their customers. There is merit in this question, and although we accept that banks enjoy some leverage over the MFIs, there are various advantages for the MFIs, which could make direct lending in this segment hard and less profitable for the banks.

Lower interest rates of banks: Since MFIs, borrow from banks to lend to their customers it is obvious that the banks enjoy better cost of funds than the MFIs. Banks currently enjoy an advantage of 3-4% over the microfinance companies (see table on the right). Hence, the banks are able to lend at a lower rate. However, in practice extraneous costs i.e. visiting the branch multiple times, commissions to the intermediaries and the hassles associated with the loan makes it less attractive than loans from MFI.

Reach: This is one area where MFIs score heavily over the banks. Since, MFIs do not need permission from the RBI to open branches and the branch opening cost as well as operating cost per branch is lower for MFIs, they are able to open branches near to the end customers. Also, MFIs business model is based on reaching the customers whereas banks business model requires customers reaching them, hence the banks are not able to reach the masses in the remote locations of the country.

Product base: Banks score more on this metrics since they can offer entire range of products i.e. savings, investments and lending whereas MFIs can offer only lending products. However, banks aversion towards these low profile customers has been one of the reasons why they have not been able to make substantial inroads in this segment (explained in detail on page 5 and 6)

Credit cost: MFIs, given there closeness to the end customer, close following of their loans and a group based business model, enjoy substantially better credit quality of the loan portfolio than the banks (see table below). This is one reason why banks prefer lending through MFIs to satisfy their priority sector lending.

Service levels: This is one more area where MFIs score heavily over the banks. Given this is a qualitative aspect, in order to verify this we have visited various MFI and interacted with potential and actual customers. We were not able to find many people who have bank accounts (loan/deposit) or have event tried to access bank services. However, those who have visited/used bank services, find MFIs services superior. Some of the poor people compare there experience of visiting a bank branch with visiting government departments.

Table 14 cost and sources of funds for Banks and MFIs

Source of financing	Interest rate
Banks	
Current Accounts	0%
Savings Accounts	3.5%
Bank Term deposits	~7%
Weighted avg cost of capital	**~6%**
Micro finance companies	
Bank Loans	~10%-13%
CPs and NCDs	9%-10%
Weighted avg cost of capital	10-12%

Source: Execution Noble

Table 15: Relative strength of banks and MFIs

Parameter	Cost of funding	Reach	Product base	Service level	Credit cost
Strength of the liability franchise	●	◑	●	◔	◑
Outlook for credit quality	◔	●	◑	●	◕

Source: Execution Noble; ● -Strong; ◕ - Relatively strong; ◑ - Average; ◔ - Relatively weak;

Other than the advantages of the MFIs over the banking channel, we think that the banks aversion towards the rural and poor people explains in more detail why the MFIs have been/would be able to flourish in this neglected territory.

Our analysis suggests the no. of branches for banks in rural area have reduced by 1,297

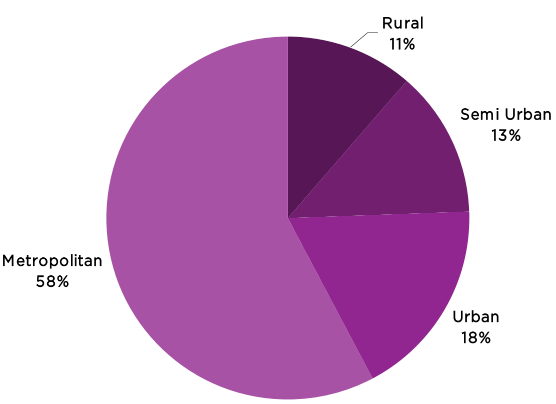
Banks aversion towards rural India: In a report submitted by Pankaj Kumar and Ramesh Golait to RBI in 2009 they commented about the failure of financial inclusion drive of the RBI highlighting how the number of rural branches for banks has gone down. Our analysis of the data until 2009 suggest that the banks added 15,278 branches across India, however in the same period their no. of branches in rural India reduced by 1,297. Also the share of lending to rural India declined within this period from 11% to 7% (see chart below)

Table16 No. of branches of banks population group wise

	1996	2009	Change (nos)	% change
Rural	32,981	31,684	-1,297	-4%
Semi urban	13,731	18,892	5,161	38%
Urban	9,798	15,428	5,630	57%
Metropolitan	7,946	13,731	5,785	73%
Total	64,456	79,735	15,279	24%

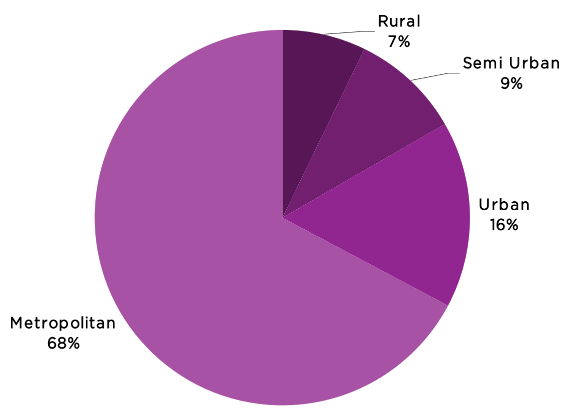
Source: RBI and Pankaj kumar and Ramesh Golait report

Figure 12 Population Group wise loan outstanding for SCBs in 1996



Source: Company filings, Execution Noble.

Figure 13 Population group wise loan outstanding for SCBs in 2009



Source: Company filings, Execution Noble

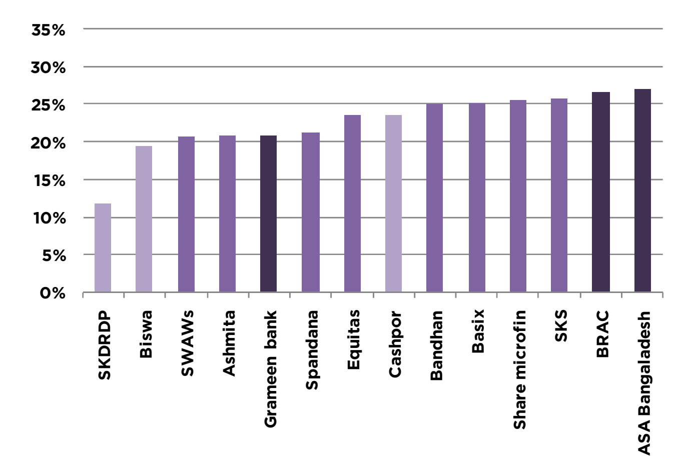
For Profit vs Not for Profit

There has been a constant debate regarding how micro-finance institutions (MFIs) should be not-for-profit so as to prevent them from exploiting the rural poor by charging high interest rates. We compare data of various MFIs comprising of Indian NGOs which are not-for-profit (light color), India for-profit MFIs (medium color) and Bangladeshi NGO's (dark color). Most of the Indian NGO's have a sub $150m loan portfolio, hence comparison with the Bangaladeshi MFIs would be more relevant.

In terms of the interest rates charged by these MFIs, with the exception of SKDRP, the average yields over the past five years have been comparable.

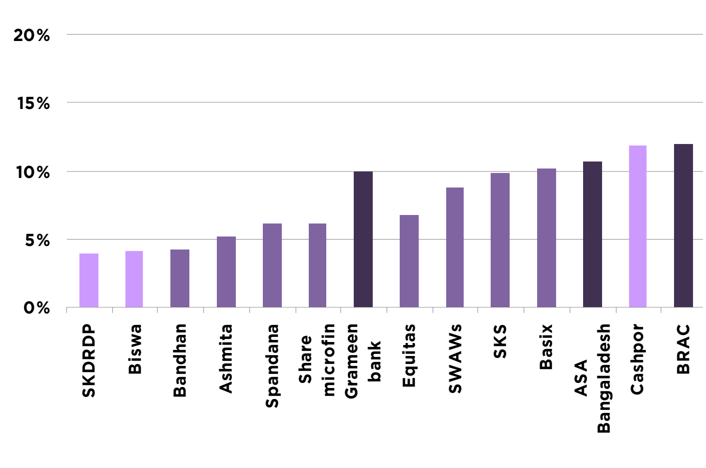
Despite the cost of funds being 250-600bps lower. Surprisingly some of the NGO MFIs operating in Bangladesh charge much higher interest rates than most for-profit MFIs. However, with most of them making losses it seems that the difference could be broadly attributed to higher operating cost for the NGO MFIs.

Figure 14 Average Yields – MFI companies



Source: Company filings, Execution Noble.

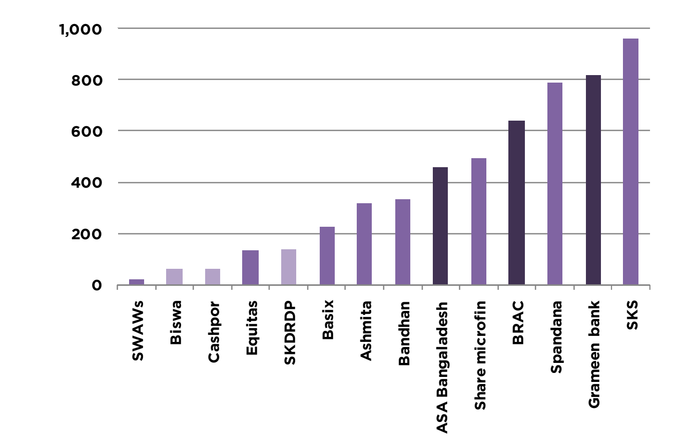
Figure 15 Average Op Exp/Assets ratio – MFI Companies



Source: Company filings, Execution Noble

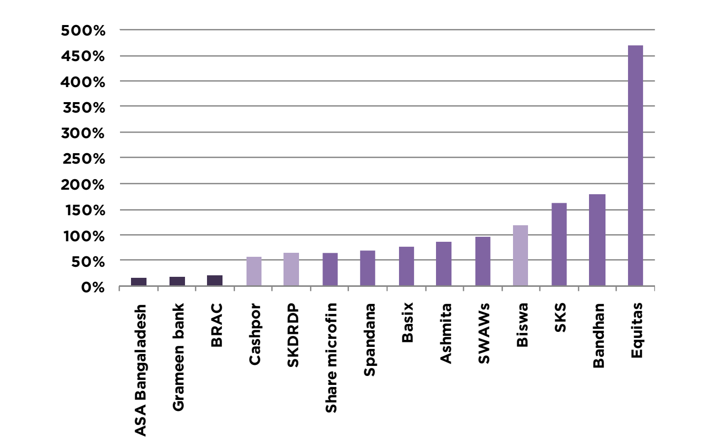
Since there is little differentiation in the interest charged by the not for profit MFIs, we think reaching the target market should be the key criteria for the MFIs in order to provide maximum benefits to its customers. We have compared the growth rates of Indian for profit MFIs with not for profit MFIs in India and Bangaladesh; the NGO's have low growth rates with all of them figuring at the bottom. Only Brac and Gremeen have been able to gain scale given their reputation built over more nearly four decades.

Figure 16 Size of gross loan portfolio of MFI's



Source: Company filings, Execution Noble.

Figure 17 CAGR of MFI's



Source: Company filings, Execution Noble

Conclusion:

Based on our analysis the MFI industry should overcome the current scare and flourish in future given the demography and landscape of financial sector. However, political risk will remain an enduring threat, periodically triggering share price volatility. Right now we think a lot of political risk is already priced into SKS Relative positioning of the MFIs would be based on the following, given risks impact all participants:

- **Reach:** This would be the primary determinant of future growth. MFIs like SKS and Spandana score highly on this front.
- **Geographical diversification:** Given the regional political risk involved, MFIs who are more geographically diversified have an advantage given any event in one area would not impact their business substantially. Also geographic diversification would help faster growth.
- **Sources of funding:** Whilst most of the MFIs score badly on this front, with concentrated funding sources through banks, bigger MFIs and some like Equitas who have been innovative in this respect score higher.
- **Management depth:** Given the scope for future expansion, management depth will become critical for sustainability of growth and profitability. Companies like SKS,Basix and Equitas score well on this.
- **Scope of services:** As highlighted on page 9 we expect that majority of future ROE expansion to come from additional services. The industry as a whole has understood this, however companies like Basix, Equitas and SKS are best placed.
- **Operating efficiency:** Given that we expect the lending rates to remain constant in future, operating efficiency will play an important role in ROE generation and competitiveness. Spandana seems to be best placed on this criterion.

Table 17: Relative positioning of the MFIs

Parameter	SKS	Spandana	Share microfin	Ashmita	Basix	Bandhan	Equitas
Reach	Strong	Strong	Relatively strong	Relatively strong	Relatively strong	Relatively strong	Relatively strong
Geographical diversification	Strong	Relatively weak	Relatively strong	Relatively strong	Relatively weak	Average	Relatively weak
Funding	Average	Average	Average	Average	Average	Average	Relatively strong
Management Depth	Strong	Average	Average	Average	Relatively strong	Average	Strong
Scope of services	Relatively strong	Average	Average	Average	Strong	Average	
Operating efficiency	Average	Strong	Relatively strong	Strong	Relatively strong	Strong	Relatively strong
Overall	Strong	Relatively strong	Average	Average	Relatively strong	Average	Relatively strong

Source: Execution Noble; -Strong; - Relatively strong; - Average; - Relatively weak;

Figure 18 **Porters analysis- Indian MFI industry**

SUPPLIER POWER (high)

Banks remain only source of funding: Only input required for microfinance companies is money and the microfinance companies derive more than 80% of their funding from the banks, Hence, banks can charge higher interest rates. Also, if the banks stop/reduce funding the growth of the sector stalls as there is no alternative available

BARRIERS TO ENTRY (MEDIUM)

Cost of funds: Banks generally want to fund established players and hence cost of funds for a new entrant is quite high
Diversification: This remains the key for survival of MFIs due to reasons explained earlers and new entrants cannot diversify immediately.
Another potential barrier is brand, since the customers like to take advance from MFIs whom they perceive stable

INTENSITY OF RIVALRY (Low)

The market is large: The MFIs combined withSHG's have been able to penetrate only in 3-4 states out of 28 states and hence there is huge market to tap and intensity of rivalry is low

Andhra regulation would further **reduce the competition** since many of the weaker competitors would not be able to survive

Improving

Deteriorating

Unchanged

BUYER POWER (Low)

MFI's give loan to a population who are not served by any other formal source and the customers of MFIs do not understand the products, hence buyer power is quite low

Extraneous forces like politicians tend to change the equation from time to time for short duration, however there is no permanent change in the buyer power

SUBSTITUTE PRODUCTS (LOW)

There are two substitute products available:
Bank funding: Banks can fund the poor people, however the requirements of the banks are tedious and hence poor generally don't use this alternative
Funding through SHG: These are potential alternatives but are restricted in few states and also processes are a little bit tedious and hence not able to compete with MFIs

Source: Execution Noble, Michael Porter

INDIAN MID CAP

EXECUTION NOBLE

Initiation | NBFC| 24th November 2010

SKS Microfinance

Leader's curse

The stock has fallen by c.40% from its peak led by controversies around the microfinance industry and some corporate governance issues, and is now trading below its IPO price. Whilst political and regulatory factors may continue to weigh on the share price in the short run, we expect SKS to do well in the longer term given its distinct capabilities to capitalize on the huge market opportunity.

Placed to outperform

In our pre IPO note, we highlighted the political risks around the microfinance story. With much of the risk having materialised, SKS share price has fallen below its IPO price. However, we think SKS as the market leader and the only listed player bore the brunt of all the negative news flow (whether relevant to it or not). Hence, we have examined the situation in detail and become more bullish towards the long term prospects of the company due to:

- **Reach and geographical diversification**: SKS has grown its customer base at a c.141% CAGR over the last 5 years and has a customer base of c.7.5m, substantially higher than its peers. Also, the company expanded its branch network and employee strength aggressively and is now present in 19 states (out of 28) with 2407 branches and 27,054 employees. This provides SKS with unparalleled reach and a geographically diversified book which is the key for sustainable growth as: a) concentration of loan book remains the key risk for a microfinance company due to the impact of regional politics and b) it provides potential for growth in different areas of the country.
- **Operating leverage to support ROE:** We expect operating leverage to increase ROE for two reasons a) currently, average loans per customer is amongst the lowest at Rs. 8,156, as SKS acquired most of its customers between 2009-2010, who are in the initial stages of their loan cycle. With maturity of the loan book of these customers, we expect the average loan per customer to increase by more than 10% each year over next 3-4 years and; b) SKS opened 1700 (c.65%) branches in the last 2.5 years, and recruited 80% (c. 20,000) of its employees. Leading to average employee and branch efficiency being one of the lowest in the sector. As the branches mature, we expect a c.3-4% point reduction in operating cost/Assets ratio, offsetting the impact of reduction in loan yields.

Political risk and Gurumani's removal to have an overhang

We are positive about the long term prospects of the industry in general and SKS in particular. However in the short run, the political problems in Andhra Pradesh (AP) and the uncertainty about the outcome of the Malegam Committee report are likely to have an impact on the share price. Also, whilst Mr. Gurumani's removal should not have a material impact on the normal functioning of the company (given he was new and most of the operations team remains intact), the handling of the event could have been better and is likely to linger in investors' memory.

Valuation

Our "Excess Return to equity" valuation, taking into account recent events in AP, values SKS Microfinance **at Rs1011 (43% upside,** implied FY12E BV of 2.9x, FY12E earnings of 15x). Given that there is no listed player in the Indian microfinance market, we have compared SKS with its global peer Compartamos against which SKS is trading at a c.60% discount on FY12E BV. Compared to other listed Indian NBFC's, the company is trading at a 10% to 50% discount to most of them, which we think is unjustified, given c.25% sustainable ROE going forward.

Accounting & corporate governance	Yellow
Franchise Strength	Green
Earnings Momentum	Yellow
Political risk	Red

BUY 43% Upside

Fair Value (Rs)	1011

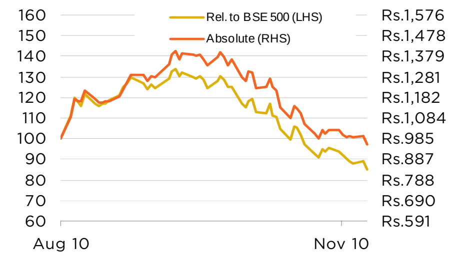
Bloomberg Code	SKSM.IN
Share Price (Rs)	708
Market Cap (Rs bn / US$ bn)	51.8/1.1
Free float	99%
ADV (Rs mn/ $mn)	1237/28

Financial year ended, Rs mn	2010	2011E	2012E	2013E
Total income	6,705	11,654	13,921	19,068
NIM	17%	19%	16%	15%
Pre provision profit	3,194	6,516	7,783	10,984
Op. margin	48%	56%	56%	58%
Credit cost	1.5%	5.5%	2.0%	1.9%
Net profit	1,740	2,314	4,078	5,848
EPS	27.3	31.3	55.1	79.0
ROE	21%	16%	19%	22%

FY ended	2010	2011E	2012E	2013E
P/B (x)	3.9	2.7	2.1	1.7
P/E (x)	25.9	22.6	12.8	9.0

Source: Company filings, Execution Noble

Historic share price performance



Analyst

Santosh Singh
+91 (0) 22 4211 0923
santosh.singh@execution-noble.com

Aditi Thapliyal
+91 (0) 22 4211 0904
Aditi.thapliyal@execution-noble.com

Sales

Pramod Gubbi, CFA
+91 22 4211 0902
pramod.gubbi@execution-noble.com
Ashish Goenka
+91 22 4211 0911
ashish.goenka@execution-noble.com

Company snapshot

SKS was founded in 1997 as Swayam Krishi Sangama or SKS Society to function as a not for profit NGO. In 2003 the NGO was converted into a private limited company with 99.5% shares being held by five newly created mutual benefit trusts, or SKS MBTs. The company later acquired an NBFC license in 2005. From 2006 the group went through four rounds of private equity funding and the stake of MBT was diluted to 14.7%. In August 2010 the company floated on the bourses and raised Rs.7,250m ($164m) of capital to become the only listed microfinance player in India. Its founder Mr. Vikram Akula was named as one of the World's 100 most influential people by Times magazine in 2006.

Table 18 SKS Timeline

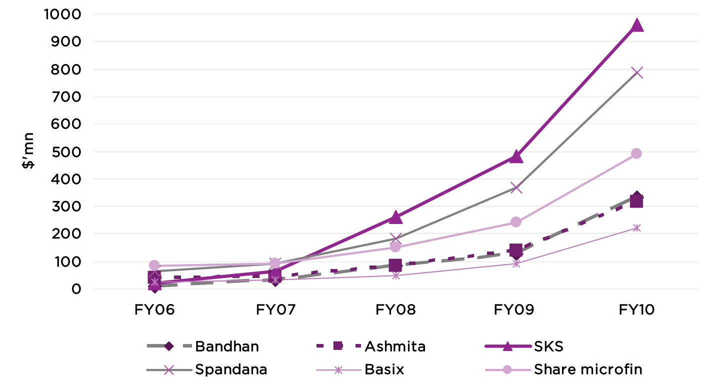
Year	Event
1997	Registered as NGO in the name of Swayam Krishi Sangam
2005	Obtained license to act as a NBFC
2006	1st round of private equity placement
2007	2nd round of private equity placement
2008	Third and fourth round of funding
2010	Company raised Rs. 7,250m ($164m) through its IPO

Source: Company filings, Execution Noble

A period of rapid expansion 2006-10

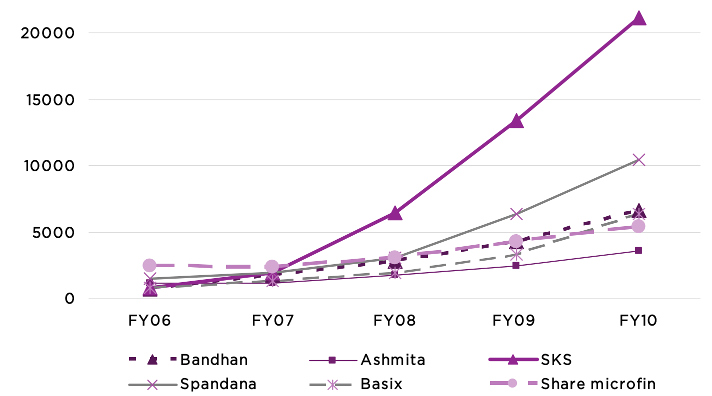
The period between 2006 and 10 has been the golden period for microfinance industry, growing at a rapid pace of c.100% after infusion of capital by private equity funds. SKS became the market leader with its branch network increasing at a 128% CAGR, client base increasing by 141% CAGR and loan base increasing by 162% over the last 5 years. Currently, SKS has 67m active customers and a portfolio of Rs.54 bn of outstanding loans. This growth was achieved without any deterioration in the credit costs for the company and with improved operating efficiency. The company grew its employee base rapidly and currently has more than 20,000 employees compared to c.10,000 for its nearest rival Spandana. Also, SKS expanded its geographical reach to 19 states (out of 28 states) through 2,407 branches (see chart below).

Figure 19 Fastest loan growth



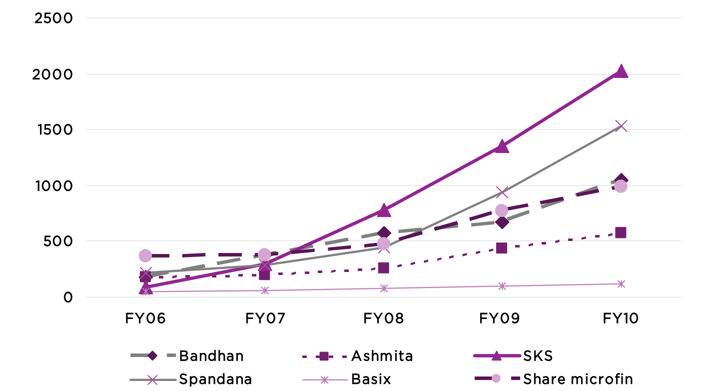
Source: Mix market, Execution Noble *all the numbers are for FY ending 31st March

Figure 20 Total persons employed by SKS and peers



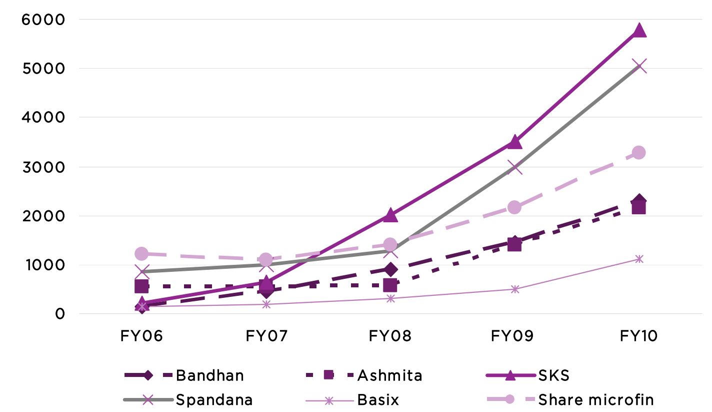
Source: Mix market, Execution Noble *all the numbers are for FY ending 31st March

Figure 21 Growth in branch network for SKS and peers



Source: Mix market, Execution Noble *all the numbers are for FY ending 31st March

Figure 22 Expansion in customer base



Source: Mix market, Execution Noble *all the numbers are for FY ending 31st March

Execution Noble versus consensus

Given that we remain cautious about the impact of Andhra ordnance and its impact on the overall microfinance sector our profit forecasts for FY11 are lower than the consensus consisting of two firms who updated their forecasts after the Andhra event:

Net Income: We expect the loan book to grow by 30% over the next three years compared c.35% for consensus. Also, we expect the interest charged by SKS to fall to 23% compared to 24% for consensus. As a result of this our Net income is 6%-14% lower than the consensus for FY12 and 13

PAT: Our PAT forecast is substantially lower than the consensus for FY11 but broadly in line with consensus for FY12 due to following reasons:

1. Lower total income offset by lower operating costs: As explained earlier we forecast lower loan growth and yields. Hence, our net interest income is lower than consensus. However, we expect the reduction in operating cost to offset the reduction in net interest margins, hence at the profitability level our forecasts are in line with consensus inFY12.
2. Higher Credit cost: Due to the Andhra debacle we expect 15-20% of the loan book to be written off in 2011 compared to 10 % for consensus reducing our FY11 profit forecasts.

Table 19 Execution Noble vs Consensu

	Consensus	Noble	% change
NII			
FY11	10,453	10,453	1%
FY12	13,736	12,908	-6%
FY13	20,536	17,659	-14%
PAT			
FY11	2,683	2,314	-14%
FY12	4,109	4,078	-1%
FY13	6,639	5,848	-8%

Source: Bloomberg, Execution Noble

Key risks and sensitivities

Table 20 Excess Return Valuation sensitivity to key assumptions

	High Case	Base Case	Low Case
Loan disbursements growth (no)	No. of loans disbursed grows at 20% CAGR For next 5 years	No. of loans disbursed grows at 12% CAGR For next 5 years	No. of loans disbursed grows at 5% CAGR For next 5 years
Gross yield on loans	Interest rate charged to customers stabilises at 24% from FY12	Interest rate charged to customers stabilises at 23% from FY12	Interest rate charged to customers stabilises at 22% from FY12
Other income	Other income / closing assets becomes 1.75% (2.5% for FY10)	Other income / closing assets becomes 1.2% (2.5% for FY10)	Other income / closing assets becomes 0.8% (2.5% for FY10)
Loan loss assumptions	Credit cost of 1.6%	Credit cost/average assets of 2.0%	Credit cost / average assets of 2.75%
Cost to assets	Cost as a % of average assets reduces to 5.5% by 2015	Cost as a % of average assets reduces to 6.5% by 2015	Cost as a % of average assets reduces to 8.2% by 2015
Excess Return valuation	**1385**	**1,011**	654
Upside/ (downside)	96% upside	43% upside	(8% downside)
	Implied P/BV of 4.1x of FY12 book	Implied P/BV of 2.9x on FY12 book	Implied P/B of 1.8x on FY12 book

Source: Company filings, Execution Noble,

SWOT analysis

Strengths

- Strong brand name within the MFI space created over many years
- Access to low cost funds compared to other MFIs the cost of funds for SKS is c.10% compared to c.11-13% for other MFIs
- Highest reach with 2,407 offices in 19 states which is highest in the sector

Weaknesses

- Operating cost to assets ratio is higher than its competitor
- Dependence on bank funding is high with 89% of funds from banks.
- Company's inability to handle difficult PR situations, given it being rookie in the stock market, leading to negative publicity.

Opportunities

- Under penetration of MFI market offering tremendous opportunities for growth.
- Given the reach (7.5 m customers) the company can distribute products and provide different services.
- Being the only listed player, there is tremendous opportuinity for SKS to diversify its sources of funds

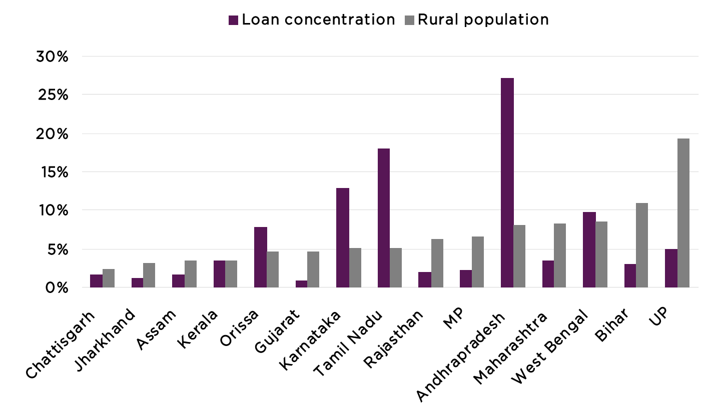
Threats

- Given that SKS caters to poor women (a highly sensitive population), political risk is the biggest threat.
- Demand for lower interest rates could lead to lower margins for the company.
- Threat from the banks to restrict MFIs funding and direct entry in the microfinance market

Well positioned in an Under penetrated market:

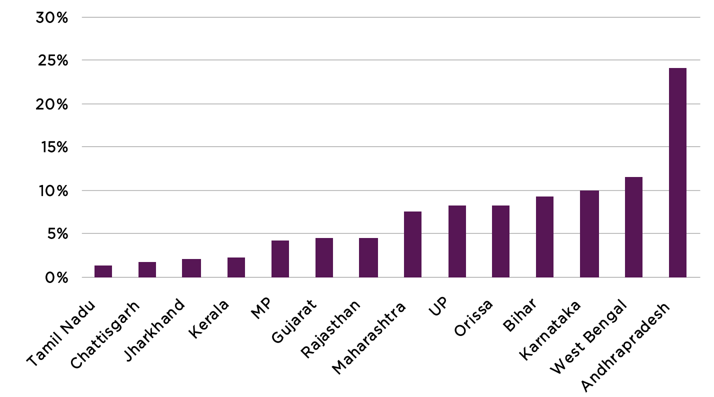
As explained on page 8 of the thematic section, our calculations suggest that there is a Rs.2,889bn potential market considering average loan size of Rs20,000, microfinance institutions along with SHGs (Self Help Group's) have been able to achieve a market penetration of c.15% (market size of c.Rs.450bn and SKS market share of 11%), leaving a vast proportion of the market untapped. Since, most of the penetration has happened in the southern states (given the industry originated in the region), both from the SHGs as well as microfinance companies, poor and populous North Eastern and Eastern states have been left relatively untouched. This offers SKS with tremendous opportunity for growth with its far reaching distribution network (see chart below) as SKS is one of the few large players present in these states.

Figure 23 Loan concentration (SHG+MFI conbined) vs population concentration in rural India



Source: Saadhan and Censusindia.gov.in

Figure 24 Concentration of branches of SKS



Source: Company

Operating leverage to come into play

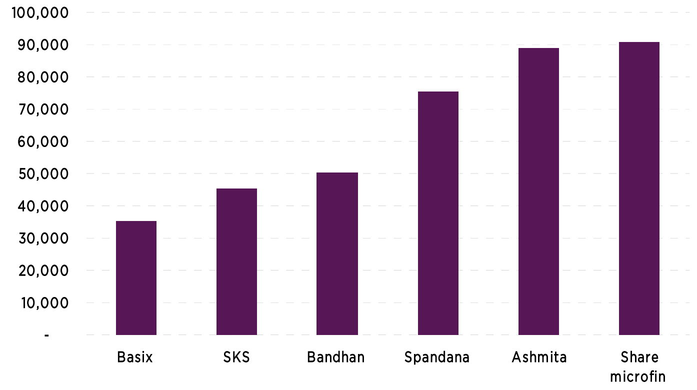
Given rapid expansion in the employee base and branches, SKS has one of the highest operating expenses/assets ratios in the sector at c.10%. We expect this to come down in future due to;

a) Over the last two and half years SKS has added 70% of its active customers. As per the policy of the company in the first year a customer is eligible for upto Rs.10,000 loan, which increases to c.20,000 by the third year. As a result of this SKS has one of the lowest loan per customer outstanding of Rs. 8,156 (compared to an average of more than Rs.10,000 for peers and maximum possible loan of Rs.50,000). We expect the average loan size to increase by 10% each year over the next 3-4 years.

b) Given that the company aggressively opened branches over the last 3 years (70% of branches opened in last three years), its loan per branch as well as no. of loan per employee is one of the lowest in the sector (see chart below). With branches reaching maturity we can expect loan per employee to go up by 10-20% and loan per branch to move up by similar amount.

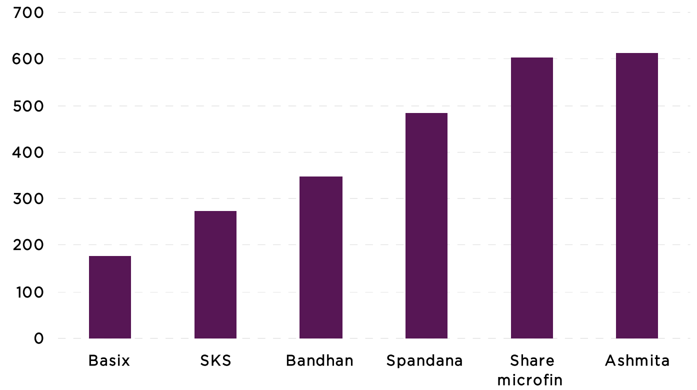
As a result of the above points we expect the operating expenses/ assets ratio to go down by 3-4% points over the next 2-3 years. Compensating for any impact on ROE due to lower yield on loans.

Figure 25 Rapid employee recruitment leading to one of the lowest loan per employee ($)



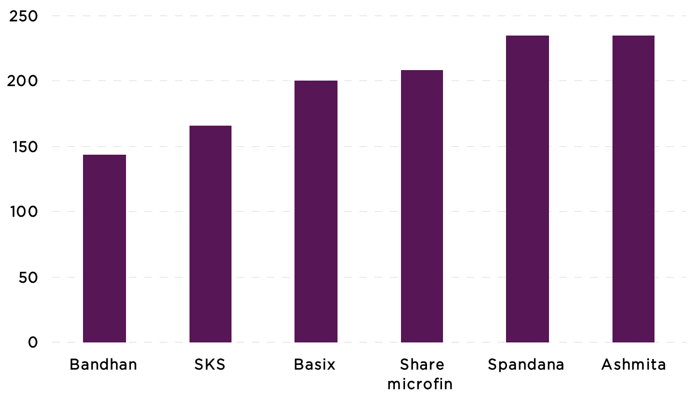
Source: Company, Mix market Execution Noble *all the numbers are for FY ending 31st March'10

Figure 26Rapid employee recruitment leading to one of the lowest no. of loan per employee.



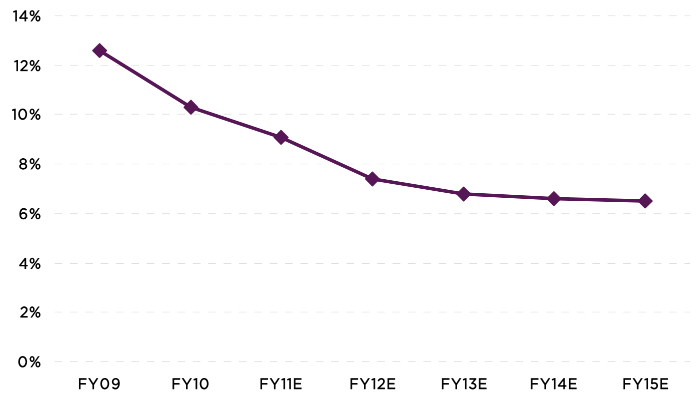
Source: Company, Mix market Execution Noble *all the numbers are for FY ending 31st March'10

Figure 27 Loan amount per customer ($)



Source: Company, Mix market Execution Noble *all the numbers are for FY ending 31st March'10

Figure 28 Expected Operating expenses/ closing loans



Source: Company, Execution Noble

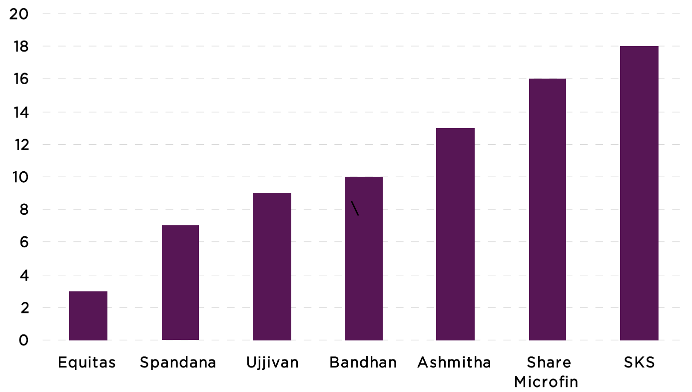
Geographical diversification and reach:

Ability to scale up and geographical diversification and reach in the right areas remain the key for future sustainable growth of the microfinance companies as:

a) Given this is a model where the poor and mainly rural population is financed by microfinance companies, the reach of the MFIs in the rural and poor areas of the country will be the main determinant of future growth potential. SKS has unparallel reach with 2,407 offices across 19 states and 379 districts (133 out of those are poor districts according to FY09 Saadhan data). Also, it has demonstrated in last few years its ability to scale up in right areas by opening offices across country.

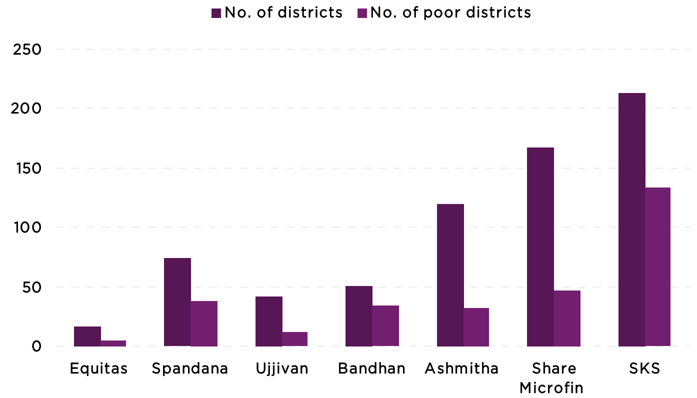
b) As evidenced by the Andhra situation regional politics will play an important role in future performance of the Microfinance companies (explained in detail in thematic section on page 4). Hence, companies with more geographically diversified portfolios are likely to be at a distinct advantage. Hence, SKS's strategy of diversifying its portfolio across different regions might put it at a disadvantage in the short run (higher cost involved with opening branches in new areas), however in the longer run it would help the company to sustain its profitability and viability.

Figure 29 Reach in No. of states



Source: Saadhan

Figure 30 Branches in no. of districts (As of FY09)



Source: Saadhan

New services to help ROE

As highlighted in our thematic section on page 9 there is significant potential for the MFIs to take advantage of their reach and offer other services through the same distribution network with little additional fixed cost. We have seen SKS's revenue from other sources increased exponentially over the last 3 years from Rs.75mn to Rs.854m (see chart on page 11 of thematic section). A major source of this revenue growth was distribution of life insurance products. The company currently offers two life insurance products; a)life insurance for borrower and family members for the loan amount (this is compulsory for all borrowers except in Andhra Pradesh) in addition to this the group offers endowment policies of the same company and has till now sold 2.85m policies to its customers. Also, the company has tied up with Metro cash and carry through which it supplies metro's products to its customers. We expect these services to help SKS's ROE by 4-6% in next 3-4 years (we expect some reduction in income from commissions in FY10 and 11 given Andhra impact). Also, if these initiatives are executed with customer's well being in mind (i.e. by charging lower commissions), we can expect this to have a significant impact on Government's financial inclusion initiatives and help significantly improve the goodwill and earning capacity of MFIs in general and SKS in particular.

Corporate governance

SKS has recently been in news due to removal of its CEO Mr. Gurumani by the board, just after its IPO in August 2010. Our discussion with the industry sources suggest that long lingering differences between Mr. Gurmani and other board members was the main reason why Mr. Gurumani was removed as the CEO of the company and it should not have any significant impact on the working of the company. However, we think that handling and timing post IPO was far from ideal. Even if operational concerns appear manageable, the risk on the corporate governance red flag will linger.

Risks to the investment case

Main risks to our investment case are;

- Political risk (like the current situation in Andhra), given the company caters to highly politically sensitive segment. (see thematic section)
- Liquidity crunch leading to company's inability to disburse further loans, which could cause mass defaults. (see thematic section)

Table 23 Key assumptions & estimates

	FY10	FY11E	FY12E	FY13E	Comments
Yield and margins (%)*					
Gross yield including assignments	25.6%	24.5%	20.7%	20.2%	We expect the interest rates to go down to 23% across India by 2013. Also, we have forecast reduction in membership fees from 2% of total income to 1.5% of total income
Financing cost/ Average gross loan portfolio including assignments	8.4%	5.9%	5.2%	5.4%	We have forecast c.75bps increase in incremental cost of funds from 9.8% to 10.5%
Net interest margin	17.1%	18.6%	15.5%	14.8%	Due to reduction in yields and increased cost of funds we expect NIMs go down by 400bps
Operating exp/closing assets	10.3%	9.1%	7.4%	6.8%	Given a moderated growth we do not expect the company to grow its branch network aggressively. Hence, the ratio would go down
Other income/closing assets	2.5%	2.1%	1.2%	1.2%	Although we remain substantially bullish about the prospects, however conservatively, we have not forecast any additional source of revenue and also we have forecasted moderation in existing source of revenue I.e. insurance commissions.
Credit costs/average assets	1.5%	5.5%	2.0%	1.9%	For FY10 we forecast write off of c.15-20% of assets in Andhra given the current situation. Also, conservatively we have increased our credit cost forecast by c.50-100bps to take into account any Andhra like event

Balance sheet	**FY10**	**FY11E**	**FY12E**	**FY13E**	**Comments**
Disbursement YoY growth (%)	70%	35%	30%	25%	We expect the disbursements to significantly moderate to 21% by 2013 led by 10% growth in numbers and 10% growth in size of the loans (lower than the GDP growth forecast)
Debt to equity ratio (x)	3.8	2.7	3.1	3.5	

Key outputs	**FY10**	**FY11E**	**FY12E**	**FY13E**	**Comments**
Net interest income (NII) (%)	88%	79%	23%	37%	NII growth in FY11 is due to a)c.10bps points increase in NIM and b)35% increase in the loan book
Other income YoY growth (%)	78%	41%	-16%	39%	
Operating expenses YoY growth (%)	58%	46%	19%	32%	Given only 25% of the revenues being variable in nature we expect the operating expenses to grow at a slower rate
Pre-provisioning profit YoY growth (%)	132%	104%	19%	41%	(please refer to above)
Provisions YoY growth (%)	286%	492%	-45%	33%	We expect the gross NPAs to stay at 0.80 bps
Net profit	117%	33%	76%	43%	(please refer to above)

Source: Company, Execution Noble estimates

Absolute valuation

We are valuing the company on "excess return to equity" model. Our Excess return metric is **'Net Profits – (cost of equity*beginning book value)'** for all the future years discounted back to present at cost of equity.

Our Excess Return to Equity model has three distinct phases:

1) **FY11-FY14**: We model each year discretely resulting in disbursements growing at 27% CAGR, resulting into pre provision profit growth of c.35% and an average ROE of 24%.
2) **FY15-20**: Pre provision profit growth moderating to 15% and ROE gradually fading to 20% by FY20.
3) **From FY20:** Further moderation in profit growth to 5% and ROE fading to 15%.

Based on the assumptions shown in the Table on the previous page and assuming; **(a)** a cost of equity of 15%; and **(b)** terminal growth of 5%, our "**Excess Return to Equity**" valuation model values SKS microfinance at **Rs 1,011**(implied FY12E BV of 2.9x, FY12E earnings of 15x) implying an upside of 43% from these levels.

Table24 Valuation sensitivity analysis

	G=3%	G=4%	G=5%	G=6%	G=7%
ROE=13%	1,185	1,268	1,378	1,531	1,760
ROE=14%	1,030	1,097	1,185	1,308	1,492
ROE=15%	890	942	1,011	1,107	1,251
ROE=16%	763	802	854	926	1,035
ROE=17%	648	676	712	764	840

Source: Execution Noble

Comparative valuation

There are no listed microfinance companies in India available for comparison; hence we have compared SKS to different type of NBFCs and its Mexican peer Compartamos. Compared to Compartamos the company is trading at more than a 60% discount on FY12E P/BV multiples, however lower ROEs would justify some of this discount, but we think given the growth opportunity in India a large part of this discount is unjustified.

Compared to Housing finance companies the stock is trading at c.30-40% discount, however a potential of higher growth and higher ROE for SKS suggests that this discount is unjustified.

Compared to other NBFCs the stock is trading at c.30% discount on FY12E book value with a comparable ROE.

Table 25 SKS Microfinance trades at a discount to other HFCs and NBFCs

Company	Market CAP	ROE (%)		ROA (%)		P/BV(x)		P/E (x)	
	($ mn)	FY11E	FY12E	FY11E	FY12E	FY11E	FY12E	FY11E	FY12E
Compartamos	3,278	34.2	31.7	16.4	16.1	7.1	5.4	20.9	16.9
Bank of Ryakat Indonesia	17,300	29.6	29.5	2.7	2.9	4.6	3.8	17.2	14.2
SKS Microfinance	**1,142**	**16.3**	**19.2**	**2.7**	**4.1**	**2.7**	**2.1**	**22.6**	**12.8**
Housing Finance Cos.									
HDFC Ltd.	24,022	19.7	20.9	2.4	2.5	6.5	5.6	27.1	22.6
LIC Housing Finance		22.8	22.7	2.0	1.8	3.2	2.7	14.6	12.5
Average	-	**21.2**	**21.8**	**2.2**	**2.3**	**5.2**	**4.5**	**20.8**	**17.5**
Other NBFCs									
IDFC	4,279	14.8	14.3	3.3	3.2	2.8	2.5	22.9	18.3
Shriram Transport Finance	2,214	28.3	27.2	4.0	4.5	3.3	2.8	12.9	10.5
Mahindra and Mahindra Financial Services	1,694	23.2	22.7	4.5	4.4	4.3	3.8	17.4	14.3
Manappuram (Post QIP) E	1,590	20	20	6.5	6.8	3.6	3.0	28.3	16.2
Average	**-**	**22.1**	**21.4**	**3.9**	**4.0**	**3.5**	**3.0**	**20.5**	**14.7**

Source: Bloomberg, Execution Noble, .

Table 26 Traffic Lights: criteria for judgement

Parameter	Traffic signal	Reasons
Accounting & governance	**YELLOW**	Although the accounting principles adopted by the company is conservative and in the recent times the company has been transparent towards impact of Andhra crisis. However, handling of Mr. Gurumani suggests that the company needs improvement on corporate governance.
Franchise strength	**Green**	SKS is the strongest microfinance company in India with 7.5m customers in 19 states out of 28 states of India. It has strengthened its Balance Sheet by raising Rs.7.25bn from the market
Earnings momentum	**YELLOW**	Due to the Andhra issue there has been some downgrades in earnings for SKS. However, once the issue is resolved we can expect fast growth for the company
Political risk	**Red**	Andhra issue has highlighted the impact of political risk on the sector as a whole with many of the companies struggling to survive. We expect political risk to remain key problem for the company given the customer base

Source: Execution Noble, Bloomberg, Company data. For more details on how the traffic lights work, please refer to our 7 Jan 2010 note

Summary Financials

Income Statement (All figures in Rs.mn)	FY08A	FY09A	FY10A	FY11E	FY12E	FY13E
Net Interest Income	1,060	3,116	5,852	10,453	12,908	17,659
Other Income	75	479	854	1,201	1,013	1,409
Total Income	1,135	3,596	6,705	11,654	13,921	19,068
Operating expenses	(809)	(2,221)	(3,511)	(5,138)	(6,139)	(8,084)
Operating Costs	(281)	(752)	(1,221)	(1,643)	(1,847)	(2,297)
Employee Costs	(478)	(1,360)	(2,164)	(3,370)	(4,166)	(5,660)
Pre Provisioning Profit	326	1,375	3,194	6,516	7,783	10,984
Provisions and Write offs	(37)	(134)	(517)	(3,061)	(1,697)	(2,257)
PBT	289	1,241	2,677	3,454	6,086	8,728
Less:Tax	(123)	(438)	(937)	(1,140)	(2,008)	(2,880)
PAT	166	802	1,740	2,314	4,078	5,848
Basic EPS (Rs)	5.5	17.9	27.3	31.3	55.1	79.0
Diluted EPS (Rs)	0.0	0.0	0.0	0.0	0.0	0.0
Dividend per share(Rs)	1,060	3,116	5,852	10,453	12,908	17,659

Balance Sheet	FY08A	FY09A	FY10A	FY11E	FY12E	FY13E
Sources of Funds						
Equity	446	590	687	687	687	687
Reserves and Surplus	1,679	6,059	8,893	18,133	22,910	28,758
Networth	2,125	6,649	9,580	18,820	23,597	29,443
Borrowings	7,898	21,366	26,947	31,723	50,278	72,666
Total Sources of funds	10,024	28,014	36,527	50,543	73,876	102,108
Application of Funds						
Loan Book	7,937	14,369	29,747	50,543	73,876	102,108

Operating Metrics	FY08A	FY09A	FY10A	FY11E	FY12E	FY13E
Spread analysis						
Yield on Loans	20.0%	28.6%	25.6%	24.5%	20.7%	20.2%
Cost of funds	6.9%	11.0%	8.4%	5.9%	5.2%	5.4%
NIM	13.0%	17.6%	17.1%	18.6%	15.5%	14.8%
Efficiency ratios (%)						
Operating Cost/Loan book	3.4%	4.3%	3.6%	3.3%	2.5%	2.3%
Personnel costs /Loan book	5.9%	7.7%	6.3%	6.0%	5.0%	4.8%
Operating cost/Loan book	9.9%	12.6%	10.3%	9.1%	7.4%	6.8%
Credit Quality (%)						
Provisions and write offs/loan book	0.4%	0.8%	1.5%	5.5%	2.0%	1.9%
Capital ratios (x)						
Debt to Equity	4.7	4.2	3.8	2.7	3.1	3.5
Total CAR ratio	22.9%	34.0%	26.1%	31.6%	27.5%	25.2%
Tier 1 CAR	22.9%	34.0%	26.1%	31.6%	27.5%	25.2%
Return ratios (%)						
ROA	2.4%	2.9%	3.6%	2.7%	4.1%	4.1%
ROE	8%	18%	21%	16%	19%	22%
Valuation ratios						
P/E (x)	128.1	39.6	25.9	22.6	12.8	9.0
P/BV(x)	10.0	4.8	3.9	2.7	2.1	1.7

Source: Company, Execution Noble

Initiation | NBFC| 24th November 2010

Manappuram

Running into customer inertia?

Manappuram has been one of the biggest wealth creators of the decade, driven by stellar loan and profit growth. This growth was supported by the increase in gold price and an under penetrated market. Currently, the stock is pricing in 40-50% growth for next 4-5 years, which we find aggressive. Hence, we initiate on Manappuram with a Sell stance on valuation grounds and a valuation of Rs.160.

An innovative player in a niche market

Manappuram is an innovative firm with a well respected management team. The group has some notable strengths which have allowed it to achieve rapid success (loan book growth at 75% CAGR in last four years) and a strong presence in the niche gold loan market over the last five years:

An **innovative management** team, pioneering new ideas within the space which has been ably supported by an experienced workforce.

Propriety know-how of gold loans and gold with more than 300 criteria for identifying red flags, assisting in fast and efficient distribution of loans

Excellent execution capability with more than 1,100 branches opened in the last 4 years in 16 states, currently the branch network stands at 1,525.

As a result, the stock has moved up 1800x in the last six years and has received excellent response to its recent QIP of Rs 10bn which was oversubscribed.

But share price factors in punchy growth expectations

Currently, the stock is trading at 3.1xFY12E (post QIP) book value, factoring more than 40% loan growth for next 4-5 years after FY12. However, we find this challenging unless gold prices rise significantly:

Market growth hinges on continued gold price rally: Recent spurt in loan growth has been aided by gold stock growing at 26% CAGR by value over the last 5 years. However, the majority (> 80%) of the growth in gold stock came from rising prices with physical demand of gold constant at 4-5% of total stock, contributing less than 20% of the growth.

Success beyond Southern states unproven: Until now, Manappuram's growth has largely come from the Southern states which hold 40% of the gold stock and are conducive for gold loan business. With the **Southern States close to maturity**, future loan growth is largely hinged on successful expansion into other regions where the company faces challenges a) The social stigma attached to gold loans b) Some states in the North and the East are not reachable/conducive to business and c) Manappuram being a new player in this region where market dynamics are very different from the South.

Shorter loan tenure requires higher disbursements: A typical Manappuram loan is churned thrice during the course of a year, implying that the disbursements to be > 2x of the closing book, which we find difficult to sustain given current scale and penetration. Furthermore, with the loan portfolio getting repriced thrice in a year, any gold price decline can lead to a quick downward repricing of the portfolio as much as the gold price rally in the past five years has helped continuous upward repricing of Manappuram's portfolio.

Valuation

Our "Excess Return to equity" valuation values Manappuram at Rs.160 (2.9xFY12 book value and 14x earnings). Given that there is no other listed player in the Indian gold finance market, we have compared Manappuram with other listed NBFCs. The stock is trading at a 10-20% premium to other listed NBFCs who have better ROEs and a stable loan book. Hence, we believe this premium is unjustified. However, rising gold price remains a key risk to our stance, given that loan growth is also geared towards gold prices.

Accounting & corporate governance	Green
Franchise Strength	Green
Earnings Momentum	Green

Sell

10% Downside

Fair Value (Rs)	160

Bloomberg Code	MGFL IN Equity
Share Price (Rs)	178
Market Cap (Rs bn / US$ bn)	63/1.4
Free float	59%
ADV (Rs mn/ $mn)	195/4

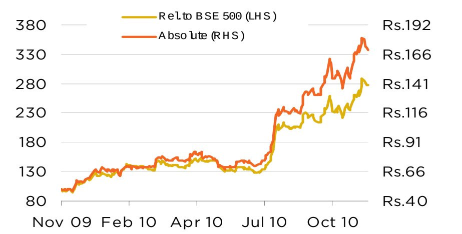
Financial year ended, Rs mn	2010	2011E	2012E	2013E
Total income	4,782	11,426	18,120	25,913
Financial cost	1,369	3,527	5,210	8,087
Operating profit	1,876	3,882	6,709	9,215
Operating margin	39%	34%	37%	36%
Net Profit	1,198	2,524	4,399	6,054
EPS	4.1	6.0	10.5	14.5
ROE	31%	20%	20%	22%

Source: Company filings, Execution Noble;

Financial year ended,	2010	2011E	2012E	2013E
P/E (x)	41.8	28.3	16.2	11.8
P/B (x)	8.2	3.6	3.0	2.4

Source: Company filings, Execution Noble

Historic share price performance



Analyst

Santosh Singh
+91 (0) 22 4211 0923
santosh.singh@execution-noble.com

Aditi Thapliyal
+91 (0) 22 4211 0904
Aditi.thapliyal@execution-noble.com

Sales

Pramod Gubbi, CFA
+91 22 4211 0902
pramod.gubbi@execution-noble.com

Ashish Goenka
+91 22 4211 0911
ashish.goenka@execution-noble.com

Company snapshot

Manappuram Group was founded by Mr. V.C. Padmanabhan in 1949 as a money lending business. The current listed company came into existence in 1992 mainly as a hire purchase and leasing company. However, change in government policies led to group shifting its focus from hire purchase and leasing business to gold loan business in 1999. Between 199-2006 the gold loan business was mainly a partnership with ICICI, however with outsourcing regulations coming into effect from 2006 the company's source of funding from ICICI bank was curtailed and then private equity money in the form of Sequoia was infused. Since, then Manappuram has grown at 75% CAGR and today it is the largest listed gold finance company in India and second largest NBFC involved in the business of gold financing. The company has raised capital by two rounds of QIP with the current one worth Rs.10bn, to finance its future expansion.

Table 27 Manappuram Timeline

Year	Event
1949	Manappuram group formed by Mr. V C Padmanabhan
1992	Current company Manappuram General Finance & Leasing Limited was established
1995	The company went public
1999	Full fledged gold loan financing business started
2007-08	PE funding of Rs.700m
2008-09	PE funding of Rs708m
Feb 2010	QIP of Rs.2.15bn
Nov2010	QIP of Rs.10bn

Source: Company Filings, Execution Noble

Execution Noble versus consensus

Given that our forecasts for loan growth are lower by c.15% for FY12 and 25% for FY13, our profit forecast remains lower by 15% for FY12 and 40% for FY13:

Net Income: We expect the loan book to grow by 86% over FY10-13 compared to c.100% for the consensus. Hence, our Net income forecast is substantially lower than the consensus for FY12 and 13

PAT: As a result of lower loan growth forecast leading to lower income as explained above our profit forecasts are also substantially lower compared to consensus:

Table 28 Execution Noble vs Consensus

	Consensus	Noble	% change
NII			
FY11	11,175	11,426	+2%
FY12	20,951	18,120	-16%
FY13	35,200	25,913	-36%
PAT			
FY11	2,670	2,524	-6%
FY12	4,991	4,399	-13%
FY13	8,471	6,054	-40%

Source: Bloomberg, Execution Noble

Key risks and sensitivities

Table 29 Excess return valuation sensitivity to key assumptions

	High Case	Base Case	Low Case
Loan growth	Loan growth CAGR of 67% from FY11 to 14	Loan growth CAGR Of 55% for FY11-14	No. of loans disbursed grows at 40% CAGR For next 5 years
Gross yield on loans	Gross yield on portfolio loans stabilises at 25% from FY12	Gross yield on portfolio loan stabilises to 24%	Gross yield on portfolio loans stabilises at 22% from FY12
Cost to assets	Cost as a % of average assets reduces to 7.5% by 2012	Cost as a % of average assets reduces to 8% by FY12	Cost as a % of average assets increases to 9%
Excess Return valuation (Rs)	**203**	**160**	81
Upside/ (downside)	19% Implied P/BV of 3.5x of FY12 book	13% Implied P/BV of 2.7x on FY12 book	(53%) Implied P/B of 1.4x on FY12 book

Source: Company filings, Execution Noble

SWOT analysis

Strengths	Weaknesses
• Company is in the niche business segment with strong technical and operational knowledge. • Vast network of branches second only to Muthoot within the gold financing business • Experienced management team with excellent execution ability. Has created a company with 1,525branches and Rs.49.6bn of loan book within 4 years	• Dependence on short term funding, which might cause difficulties to source funding if the liquidity situation is tight. • The churn in the business causes the loan book to reprice at high rate and also requires more than 2x disbursement of the closing book. • Not a well known name in any state outside South India.
Opportunities	**Threats**
• Under penetration outside South India offers opportunity • Rising gold prices could further fuel the demand for gold loan.	• Reduction in gold prices can cause slowdown in the loan book. • Competition from other banks and gold finance companies can cause pressure on the margin and slowdown in the loan growth.

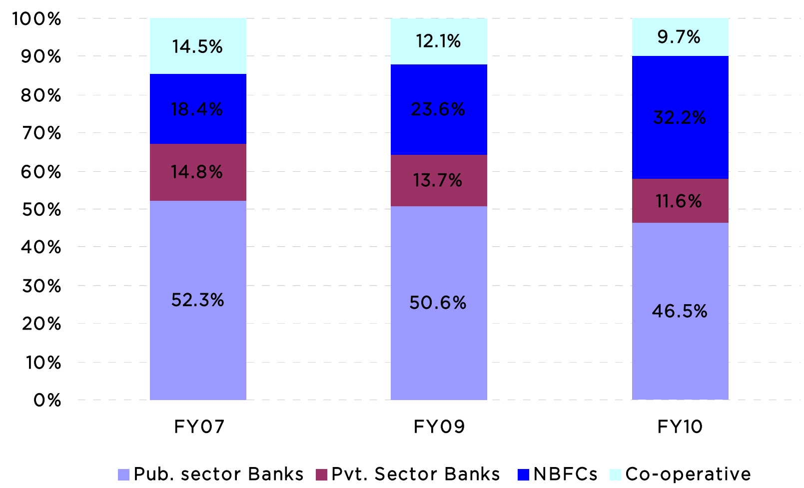
Gold loan market

India is one of the largest consumers of gold in the world using c.25% of the total annual gold production. More than 90% of the gold takes the form of jewellery, generating almost no economic value, given loan against jewellery was seen as a social taboo in most part of the country. However, with changing customer behaviour the gold loan market has grown at 40% CAGR between FY02-10 with the market reaching Rs375bn ($8.5bn) in FY10. However, still gold loan is more prevalent in the southern states of India (c.85-90% of total market) given 40% of the gold is concentrated in that region and people are open to the idea of taking loan against gold.

The main competitors in the market are commercial banks which currently control 58% of the market, followed by gold loan NBFCs. However the share of NBFC's have increased over time (see chart below) and is expected to increase further (if the rich and well to do don't participate in gold loans) due to following reasons

- **Low turnaround time:** NBFCs boast of loans within 15-20 minutes compared to few hours to days for Banks, given their focussed approach towards gold loans.
- **Higher LTVs:** NBFCs generally give highest LTV of more than 80%-85% compared to 65%-70% for banks. As NBFCs have built competencies over the decades on verifying the gold purity.
- **Reach:** Given the lower branch operating cost the NBFCs can reach deeper compared to banks accessing larger population.

Figure 31: Trend of market share of various participants

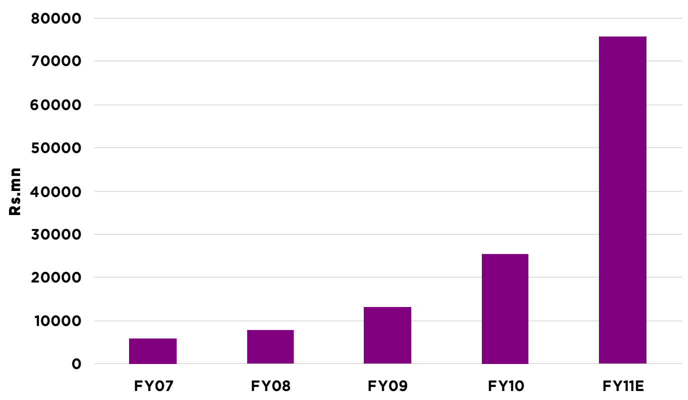


Source: Company

Manappuram's strength

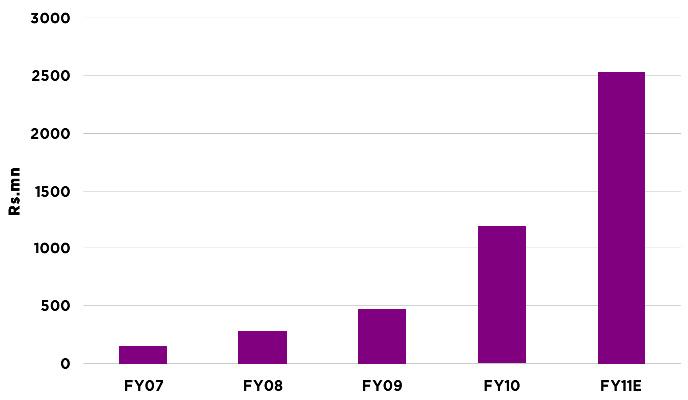
The firm's strategy is to focus on the gold loan market currently dominated by the pawn brokers. The company has been successfully able to implement its strategy in the Southern states leading to a high growth trajectory in the past four years with the loan book growing at 75%. In the last three years income for the company has grown at 144% and profitability at 140% CAGR. Manappuram has some notable strengths which has allowed it to achieve this phenomenal success in the gold loan market

Figure3 2 : Loan book growth for Manappuram



Source: Company and Execution Noble

Figure 33 Profitability growth for Manappuram



Source: Company and Execution Noble

Experienced personnel and innovative management: Mr. Nandakumar has been one of the most innovative managers in the gold loan market. He has been amongst the first to realise the potential in the various segments of the market (opportunity in Hire purchase and leasing in 90s, partnership model with ICICI and realising potential of gold loans). Manappuram was the first one to advertise loans in 80s, and the first NBFC to list on the bourses in 1996. Hence, the company was able to attract Private equity capital as well as raise money from the stock markets on two occasions. Also, realising the under penetration in the North West region Manappuram has innovatively started advertising by appointing brand managers which is the first in the gold loan market.

Combined with the innovative management, Manappuram has a team of experienced personnel who understand gold loan market. In our opinion this is one of the key for success in the market, because although a vast proportion of the processes are automated, faster and efficient distribution of loan depends on the assessment of gold by the person in the branches. Our discussion with the market sources suggest that it would take few years for a new entrant if they want to create an experienced team.

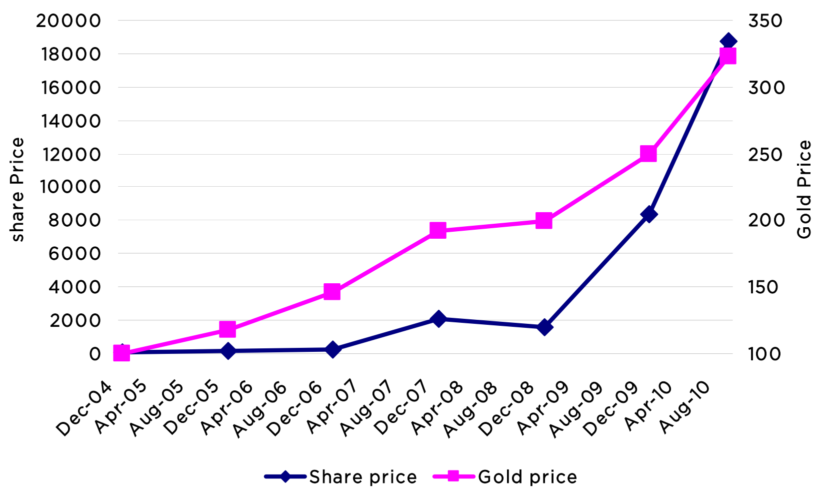
Technical Know How: Manappuram has proprietary technical knowledge on the business (the group has built in more than 300 criterias which act as either red flags or help the personnel in evaluating the jewellery and the data is centrally managed), which we believe is key to provide loans on gold. Without this, banks have found it hard to lend at optimal LTVs (both for being competitive as well as managing risk of fraud) or process loans quickly to attract customers. In addition, MGFL's avg time for disbursal is 5 minutes vs few hours for banks and its LTV is 75-85% vs banks' 60-70%.

Ability to scale up: Management has demonstrated its ability to scale up and manage a growing business in past few years. In last four years the company has increased its number of branches from 436 to 1,525 and now is present in 16 states of India.

Challenges for Manappuram

The share prices has risen 18,000% (compared to 350% rise in the gold price) (see chart below) during the last six years and the stock will trade at 3.1x FY12 P/B multiples post QIP (After pricing in more than 200% loan book growth for FY11 and more than 70% loan book growth for FY12) requiring more than 25% ROE to justify its rating, leading to a growth expectation of more than 40-50% for next 4-5 years after 2012. We expect the group to remain in a high growth phase for next couple of years, driven by lower penetration levels and buoyancy in the gold prices. However, we question whether this level of growth can be sustained for next 4-5 years.

Figure 34: Correlation between share price (LHS) and gold price (RHS)



Source: Bloomberg

The growth in the loan book is dependent on two factors i.e. a) growth in the overall value of the available gold stock and b) Penetration level in that market.

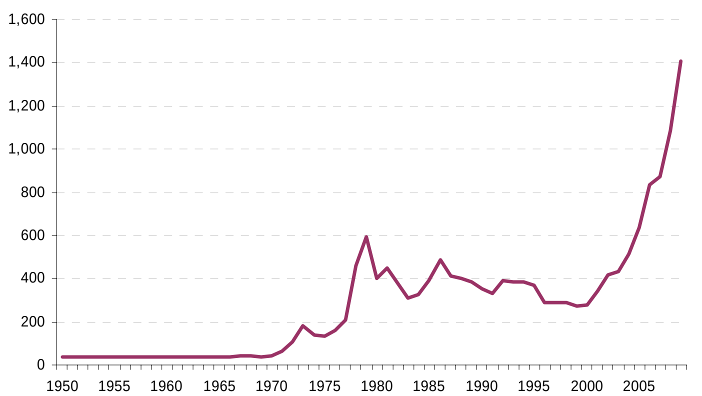
Gold Stock value growth mainly driven by gold prices

In the last ten years the overall gold stock value in India has grown by 6x at 24% CAGR. The growth was driven by two factors:

a) **Growth in physical gold stock:** The annual demand for gold has remained constant at c.600-800 tonnes (3.5%-4.5% of the market) per annum over the last 15 years (see chart below) helping the market to grow by similar amount.

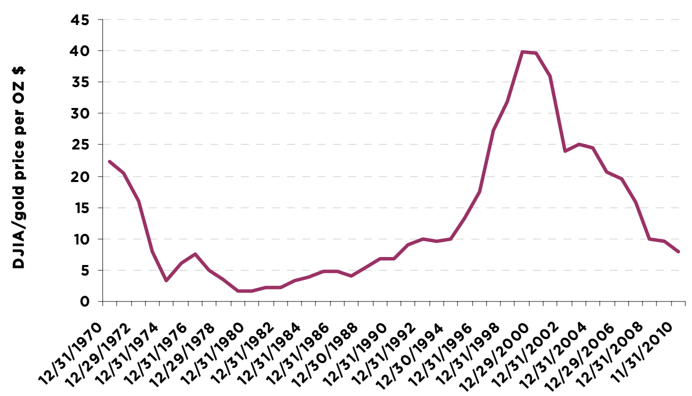
b) **Increasing prices:** As explained earlier part of the rapid growth of the gold stock value can be attributed to increase in gold prices. Prices have increased at 19% CAGR over the last ten years. This is only the second instance of increase in gold prices at such a rapid pace. The other being 70s. Currently gold stands at one of its highest multiple against all asset classes like equities and oil, which has been led by depreciation of the dollar as a global currency and economies diversifying their investments from the dollar to gold. Whilst not claiming to be an expert in forecasting gold prices it may well appreciate further in the short run, however history has shown how volatile gold can be, as seen in the 26 year's bear run after the 1970s (see chart below).

Figure 35 : History of gold prices



Source: Bloomberg

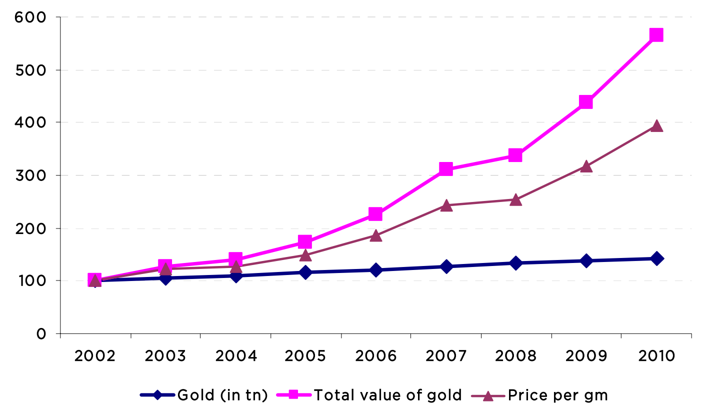
Figure 36: DJIA*/Gold price per Oz ($) movement



Source: Bloomberg *Dow Jones Industrial Average

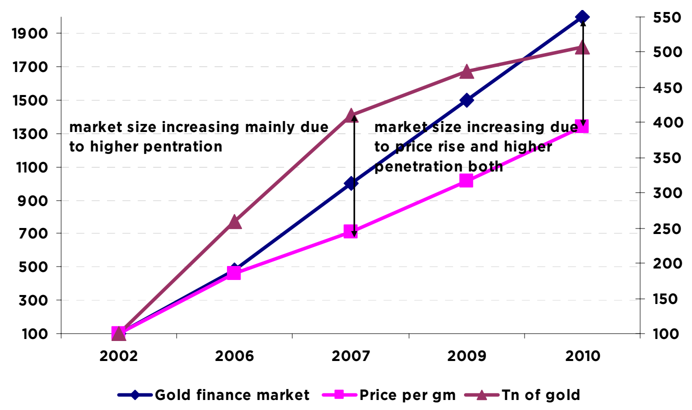
Our analysis suggests that the growth in the gold stock value has predominantly come from increasing gold prices (see chart below). If the prices were to not rise in future, gold stock value is likely to be near 4-5%.

Figure 37 : Gold stock value clearly driven by rise in gold prices



Source: Bloomberg, Company and Execution Noble

Figure 38 Gold loan market driven mainly by higher penetration



Source: Company

Increased penetration level:

The second part to the growth equation is the penetration level of the gold loan industry. In 2002 when the value of gold stock was Rs6,462bn the gold loan companies were holding less than 0.5% of the total market size. However over the period of last ten years the total holding of the gold loan industry has grown to 2%. Most of the incremental growth has happened in Southern states given conducive nature of business with higher gold holding and willingness to monetise gold for loan. However, we do not expect the penetration levels to grow at this rate going forward due to:

Maturing Southern penetration, other regions becoming challenging:

We have tried to calculate the size of the total market based on the assumption that around 80% of the gold (In line with concentration of wealth) would be held by individuals who are either salary earners or with higher income who would not like to mortgage gold. Even if the high earners decide to take loan against gold; we do not expect them to approach NBFCs, since the banks would be more than willing to give them loan at a lower interest rate. Hence, the addressable market segment for NBFCs is the customers who hold c.20% of the remaining gold.

Based on these assumptions our calculations suggest that the penetration levels in southern states have already reached more than 15% (see table below). We do not expect the penetration level to increase more than 25% due to following reasons:

- Generally a person would not mortgage his full available gold jewellery with the lender. We do not expect mortgaged/total available jewellery to exceed 50% for a family, taking out 50% of the addressable market from being available
- Secondly, we expect that it would not be economically viable to reach 20% of the addressable market segment, given that cost of reaching them might be higher.

Hence, as a result of this we do not expect the growth to increase more than 20% after FY12. Since, according to our calculations Manappuram would hold 35% market share amongst NBFCs and in a scenario if we assume that the group would be able to acquire c.40% market share the growth would not be higher than 30% post FY12.

Hence, much of the growth equation would depend on the group's ability to grow in the states outside the Southern states.

Table30 Gold loan penetration in Southern India

Particulars	FY11	FY12	FY13	FY14	FY15
Total gold (Tonnes)	7,200	7,520	7,840	8,160	8,480
Gold price Per gm	2,000	2,000	2,000	2,000	2,000
Market size in Rs bn	14,400	15,040	15,680	16,320	16,960
20% being addressable market (Rs. Bn)	2,880	3,008	3,136	3,264	3,392
Gold loan market	450	595	728	801	881
Market growth rate		32%	22%	10%	10%
% penetration	16%	20%	23%	25%	26%
Market share of NBFCs	40%	45%	50%	50%	50%
Market size for NBFCs	180	268	364	400	440
Manappuram loan book	67.5	96	135	163.8	183
Market share of Manappuram	38%	36%	37%	41%	41%

Source: Execution Noble and Company estimates

Challenges from other states:

Hence, if the gold prices were not to rise we would expect majority of growth to come from states other than southern India. Remaining conscious of the fact that Manappuram has been one of the most innovative company in the gold finance space and has been able to penetrate Southern markets at a fast pace, we think the might have to face stiff challenges in other states where the dynamics are totally different.

1) There is stigma attached with borrowing against gold in the states other than Southern India and hence, people don't prefer borrowing against gold. That is the reason in Western and Northern states there are hardly any registered pawn brokers, most of the lending happens through unregistered money lenders.

2) Unlike Southern states Manappuram is not a known name in the Western and North Eastern states and people generally don't tend to pledge their gold with an unknown entity. Manappuram is working on this by appointing brand ambassador, aggressive advertising and opening new branches near to the end customer. However there are two challenges a) Per Kilometre concentration of gold is lower in the Western and Northern states compared to South India (less than 50% of south); hence for similar volume of business the companies would have to open more branches making it economically less attractive. B) Unlike Southern states film stars do not hold similar brand equity in Western and North Eastern states.

3) It would be hard to do business in majority of the eastern states like Arunachal Pradesh, Mizoram, Meghalaya etc. and some of the Northern states like Jammu and Kashmir and Himachal Pradesh, taking away c.25-30% of the gold market outside South India

As a result of this we do not expect more than 10% penetration in the states outside the Southern Region and that also with comparatively higher cost and more number of branches.

However, our discussion with management suggest that they have not encountered any difference in business in the Southern and other states, we can assume that small number of branches (more than 75% of the branches are in Southern states) which have been recently established could be the reason of this.

Table 31 Concentration of gold

Region	Gold kg/Km
Southern region	11.3
Northern region	7.4
Eastern region	4.0
Western region	5.3

Source: Execution Noble research

As a result of above if the gold prices were not to increase we can expect the loan growth to moderate going forward to the levels of 20-30%.

Churn a problem

Given that the average duration of a loan is c.4 months, the portfolio is churned thrice during the course of the year, hence any slowdown in the business due to any reason would cause a rapid wind down of the portfolio causing the income to decline at a quicker pace. In the past the churn has helped the portfolio grow since the portfolio has been repriced thrice during the course of the year at a higher rate, increasing the available portfolio at a fast pace. However, in a stable/declining gold loan scenario it would adversely affect the growth of the portfolio since a) the portfolio would get repriced downwards thrice in a falling gold price scenario. The industry is yet to see a down trend (gold price) (since the growth has happened only in last ten years) and hence there is no experience on the potential impact of such trend.; and b) The amount of disbursements required to grow the loan portfolio would be more than 2x the closing loan book leading to high disbursements. This would mean that the required penetration level to maintain the loan growth would be far higher than as suggested by the closing loan book.

Competition intensifying

Looking at the success of gold loans competition has started to intensify in the recent times. In the past only regional banks of southern India were competing in the market, however in last one year mainstream banks like HDFC, ICICI, Bank of India etc have started marketing this product aggressively. HDFC is concentrating more on the Western and Northern region. Given the interest rate advantage (on the cost side) these banks are offering loans at a lower rate of c.12-14%. These mainstream banks have higher reach than the regional banks from the southern India. We think that in the rural areas companies like Manappuram would have an advantage (given fast disbursals and limited access to banking), however in urban and semi urban areas mainstream banks will hold the advantage. As a result of this either the market share for Manappuram would be lower in states outside Southern India or it will have to shed some of its yields.

Table 32 Anecdotal data on competition from mainstream banks

Source/date	
Indian Express/ 13th June 2010	This year, we have projected a five-fold growth in loan disbursement. Currently, 60 branches of the bank provide the gold loans. We are planning to involve all the branches of the bank for the business by June," said M Anjaneya Prasad, general manager (Mumbai Zone) of Andhra Bank.
Financial Cronicle / 27th Dec 2009	HDFC Bank disburses gold loans worth around Rs 40 crore to Rs 50 crore per month and it expects more than 50 per cent year-on-year growth in the next couple of years from this segment. “The maximum growth potential is in the North and West. The south Indian market is already a mature region and many NBFCs (non-banking financial companies) are strongly positioned in the segment..”
Financial Cronicle / 27th Dec 2009	Oriental Bank of Commerce is also planning to foray into the gold loan segment. “In the southern part of the country, loans against gold is very popular and there is no reason for a lower appetite in the northern region. States such as Punjab, Haryana and Delhi have immense potential,” H Rathnakara Hedge, executive director, Oriental Bank of Commerce,

Source: Various media sources, Execution Noble,

Risks to the investment case:

Main risks to our investment case are;

- Continued increase in the gold prices would lead to the group’s loan book and profitability rising at higher pace than our expectation.
- If the company is able to penetrate the North and Western markets successfully achieving more than 15-20% penetration then we can expect very fast growth in FUM and profitability

Table 33 Key assumptions & estimates

	FY10	FY11E	FY12E	FY13E	Comments
Yield and margins (%)*					
Gross yield including assignments	25.3%	24%	24%	24%	We expect the gross yields to remain constant at 24%
Financing cost	11.7%	9.3%	6.9%	7.6%	We expect the cost of funds to rise by 50bps, however it would get compensated by the equity raised in FY11 and hence the finance cost would go down in FY12
Net interest margin	13.6%	16.7%	17.2%	16.5%	As explained above
Salary cost/average assets	2.8%	2.8%	2.5%	2.5%	With economies of scale building in we expect the salary cost go down by 25bps
Other operating cost/average assets	5.3%	5.8%	5.8%	5.5%	With economies of scale building in we expect other operating costs to go down by 25bps
Balance sheet	**FY10**	**FY11E**	**FY12E**	**FY13E**	**Comments**
Disbursement YoY growth (%)	447%	268%	77%	39%	We expect the disbursement momentum to continue in FY12 and FY13, however with increase in base and penetration rate rising the disbursement growth would drop
Loan book YOY growth	321%	200%	65%	30%	As a result of above we expect he loan growth rate to remain in the range of 65% for FY12 and 30% for FY13
Debt to equity ratio (x)	4.0	3.1	4.1	4.5	
Key outputs	**FY10**	**FY11E**	**FY12E**	**FY13E**	**Comments**
Total interest income (%)	188%	139%	59%	43%	As a result of higher loan book the Net interest would increase, however increase in finance cost would moderate the increase in FY12 and 13
Operating expenses YoY growth (%)	97%	161%	54%	39%	(please refer to above)
PBT YoY growth (%)	293%	107%	74%	38%	(please refer to above)
Net profit	296%	111%	74%	38%	(please refer to above)

Source: Company, Execution Noble estimates

Absolute valuation

We are valuing the company on an "excess return to equity" model. Our Excess return metric is **'Net Profits – (cost of equity*beginning book value)'** for all the future years discounted back to present at cost of equity.

Our Excess Return to Equity model has three distinct phases:

1) **FY11-FY14**: We model each year discretely resulting in disbursements growing at 43% CAGR, resulting into net profit growth of 46% and an average ROE of 22%.
2) **FY15-20**: Net profit growth moderating to 15% and ROE gradually fading to 18% by FY20.
3) **From FY20:** Further moderation in profit growth to 5% and ROE fading to 15%.

Based on the assumptions shown in the Table on the previous page and assuming; **(a)** a cost of equity of 15%; and **(b)** terminal growth of 5%, our "**Excess Return to Equity**" valuation model values Manappuram at **Rs 160**(implied FY12E BV of 2.9x, FY12E earnings of 14x) implying an downside of 10% from these levels.

Table 34 Valuation sensitivity analysis

	G=3%	G=4%	G=5%	G=6%	G=7%
ROE=13%	177	189	206	228	262
ROE=14%	154	164	177	195	222
ROE=15%	133	140	160	170	186
ROE=16%	113	119	127	138	154
ROE=17%	96	100	105	113	124

Source: Execution Noble

Comparative valuation

There are no listed gold finance companies in India available for comparison, hence we have compared manappuram to different type of NBFCs

Compared to Housing Finance Companies the stock is trading at c.10-20% premium, however housing finance companies like LICHFC would enjoy c.25% ROE and have a stable book and hence we think this premium is unjustified. Also, we think the HFCs and vehicle finance companies are in a structurally better market (i.e. grow with India), compared to Manappuram which is a play on the price and penetration levels of a commodity I.e. gold.

Table 35 Manappuram trades at a premium to other HFCs and NBFCs

Company	Market CAP	ROE (%)		ROA (%)		P/BV(x)		P/E (x)	
	($ mn)	FY11E	FY12E	FY11E	FY12E	FY11E	FY12E	FY11E	FY12E
IDFC	4,279	14.8	14.3	3.3	3.2	2.8	2.5	22.9	18.3
Shriram Transport Finance	2,214	28.3	27.2	4.0	4.5	3.3	2.8	12.9	10.5
Mahindra and Mahindra Financial Services	1,694	23.2	22.7	4.5	4.4	4.3	3.8	17.4	14.3
Average	**-**	**22.1**	**21.4**	**3.9**	**4.0**	**3.5**	**3.0**	**17.7**	**14.3**
Manappuram	1,590	20	20	6.5	6.8	3.6	3.1	28.3	16.2
SKS Microfinance		14	25	1.6	5.8	2.4	1.9	20.5	11.2
Housing Finance Cos.									
HDFC Ltd.	24,022	19.7	20.9	2.4	2.5	6.5	5.6	27.1	22.6
LIC Housing Finance		22.8	22.7	2.0	1.8	3.2	2.7	14.6	12.5
Average	**-**	**21.2**	**21.8**	**2.2**	**2.3**	**5.2**	**4.5**	**20.8**	**17.5**

Source: Bloomberg, Execution Noble,

Summary Financials

Income Statement (All figures in Rs.mn)	FY08A	FY09A	FY10A	FY11E	FY12E	FY13E
Total interest income	797	1,661	4,782	11,426	18,120	25,913
Financing charges	144	386	1,369	3,527	5,210	8,087
Total Income	653	1,275	3,413	7,900	12,910	17,826
Operating expenses	-809	-2,221	-3,511	-5,433	-6,405	-8,039
Operating Costs	198	495	1,001	2,718	4,321	5,920
Employee Costs	116	284	536	1,300	1,879	2,691
Operating profit	339	497	1,876	3,882	6,709	9,215
Depreciation	18	34	57	115	143	179
PBT	321	463	1,818	3,767	6,566	9,036
Less:Tax	103	157	621	1,243	2,167	2,982
PAT	207	303	1,198	2,524	4,399	6,054
Diluted EPS (Rs)	0.0	2.2	4.1	6.0	10.5	14.5
Dividend per share(Rs)	0.0	0.0	0.0	0.0	0.0	0.0

Balance Sheet	FY08A	FY09A	FY10A	FY11E	FY12E	FY13E
Sources of Funds						
Equity	618	242	340	10,340	10,340	10,340
Reserves and Surplus	312	1,436	5,765	9,289	13,688	19,749
Networth	930	1,678	6,105	19,629	24,028	30,089
Borrowings	1,745	4,510	18,357	41,653	74,122	96,139
Total Sources of funds	2,675	6,188	24,462	61,282	98,151	126,228
Application of Funds						
Loan Book	1,849	4,486	18,907	56,721	93,590	121,667

Operating Metrics	FY08A	FY09A	FY10A	FY11E	FY12E	FY13E
Spread analysis						
Gross yield	43.1%	37.0%	25.3%	24.0%	24.0%	24.0%
Cost of funds	8.3%	8.6%	7.5%	9.0%	9.0%	9.5%
NIM	34.9%	28.5%	17.8%	15.0%	15.0%	14.5%
Efficiency ratios (%)						
Operating Cost/Loan book	10.7%	11.0%	5.3%	5.8%	5.8%	5.5%
Personnel costs /Loan book	6%	6%	3%	3%	3%	3%
Capital ratios (x)						
Debt to Equity	2.9	3.7	4.0	3.1	4.1	4.2
Total CAR ratio	50.3%	37.4%	32.3%	34.6%	25.7%	24.7%
Tier 1 CAR	50.3%	37.4%	32.3%	34.6%	25.7%	24.7%
Return ratios (%)						
ROA	17.9%	11.1%	9.7%	6.5%	6.8%	6.5%
ROE	22%	18%	20%	20%	20%	22%
Valuation ratios						
P/E (x)		77.3	41.8	28.3	16.2	11.8
P/BV(x)		13.9	8.2	3.6	3.0	2.4

Source: Company, Execution Noble

Contact details

Nick Paulson Ellis, Country Head, India

t. +91 22 4211 0908 e: nick.paulson-ellis@ execution-noble.com

Sales

Pramod Gubbi	t +91 22 4211 0902	e: pramod.gubbi@execution-noble.com
Ashish Goenka	t +91 22 4211 0911	e: ashish.goenka@execution-noble.com

Sector leads

Economy and Country Research

Sunandan Chaudhuri	t +91 22 4211 0901;	e sunandan.chaudhuri@execution-noble.com

Banks and Financials

Aditi Thapliyal	t +91 22 4211 0904;	e aditi.thapliyal@execution-noble.com
Santosh Singh	t +91 22 4211 0923;	e santosh.singh@execution-noble.com
Nidhesh Jain	t +91 22 4211 0909	e Nidhesh.jain@execution-noble.com

Consumer:

Shantnu Phutela	t. +91 22 4211 0905;	e shantnu.phutela@ execution-noble.com

Healthcare

Chirag Talati	t. +91 22 4211 0907;	e chirag.talati@ execution-noble.com

Technology:

Soumitra Chatterjee	t +91 22 4211 0906;	e soumitra.chatterjee@ execution-noble.com

701 Powai Plaza Hiranandani Gardens Mumbai – 400076	10 Paternoster Square London EC4M 7AL	102 Greenwich Avenue Greenwich CT 06830
t: +91 22 4211 0999	t: + 44 20 7456 9191	t: +1 203 983 3932

e: research.india@execution-noble.com

Analyst Certifications

Each of the research analysts referenced in connection with the section of this research report for which he or she is responsible hereby certifies that all of the views expressed in this report accurately reflect his or her personal views about any and all of the subject securities or issuers discussed herein.

In addition, each of the research analysts referenced in connection with the section of this research report for which he or she is responsible hereby certifies that no part of his or her compensation was, is, or will be, directly or indirectly related to the specific recommendations or views that he or she has expressed in this research report, nor is it tied to any specific investment banking transactions performed by Execution Noble Limited its Group or affiliates thereof.

Group Structure

The Execution Noble Group ("EN Group") comprises of Execution Holdings Limited and its subsidiaries. EN Group regulated subsidiaries are listed below:

- Execution Noble Limited - authorised and regulated by the Financial Services Authority
- Execution Noble & Company Limited - authorised and regulated by the Financial Services Authority
- Execution Noble Research Limited - authorised and regulated by the Financial Services Authority
- Noble Fund Advisers Limited - authorised and regulated by the Financial Services Authority
- Execution Noble LLC - authorised and regulated by FINRA
- Execution Noble (Hong Kong) Limited - authorised and regulated by the Securities and Futures Commission

Explanation of rating system

A rating of Buy indicates that the analyst has a high conviction that the stock will outperform their relevant sector index over the next twelve months.

A rating of Sell indicates that the analyst has a high conviction that the stock will underperform their relevant sector index over the next twelve months.

A rating of Hold indicates that the analyst believes that the stock should perform in line (+ or – 5%) with their relevant sector index over the next twelve months.

The relevant sector index is the DJ Stoxx sector subgroup which includes the subject company.

Distribution of Execution Noble Recommendations for Investment Research (End October 2010 - twelve month rolling average, with the percentage thereof)

	All Stocks*		Corporate Clients*	
Buy	103	45.37%	12	92.31%
Hold	54	23.79%	1	7.69%
Sell	70	30.84%	0	0%

*This distribution of recommendations is data from Execution Noble Limited for the past 12 months. Data from Clear Capital Limited is also excluded prior to 22nd February 2010.

The Corporate relationships disclosed are for the past 12 months.

The historic Clear Capital Limited ratings regime classified stocks as Positive, Negative, Neutral and Corporate. The table below explains how they are now classified

Historic Rating Convention	Current Rating Convention
Positive	Buy
Negative	Sell
Neutral	Hold
Corporate	Either dropped coverage or initiated with a Buy, Sell or Hold rating

Investment Research Disclaimer

This Investment Research is independent and does not constitute a personal recommendation as defined in the Glossary of the FSA Handbook.

This material constitutes "investment research" for the purposes of the Markets in Financial Instruments Directive and as such contains an objective or independent explanation of the matters contained in the material. Any recommendations contained in this document must not be relied upon as investment advice based on the recipient's personal circumstances.

In the event that further clarification is required on the words or phrases used in this material, the recipient is strongly recommended to seek independent legal or financial advice.

This research report has been prepared by Execution Noble and is for information purposes only. This research report does not constitute an offer, invitation or inducement to invest in securities or other investments. Neither the information contained in this research report nor any further information made available with the subject matter contained herein will form the basis of any contract.

This research report does not purport to be comprehensive or to contain all the information on which a prospective investor may need in order to make an investment decision. The information contained herein is based on publicly available information and sources, which we believe to be reliable, but we do not represent it as accurate or complete. The recipient of this research report must make its own investigation and assessment of the information presented herein. No representation, warranty or undertaking, express or implied, is or will be made or given and no responsibility or liability is or will be accepted by Execution Noble Limited or by any of its directors, officers, employees, agents or advisers, in relation to the accuracy or completeness of this presentation or any other written or oral information made available in connection with the information presented herein. Any responsibility or liability for any such information is expressly disclaimed.

In furnishing this research report, Execution Noble Limited undertakes no obligation to provide the recipient with access to any additional information, or to update, or to correct any inaccuracies, which may become apparent in this presentation or any other information made available in connection with the information presented herein.

All prices provided within this research report are taken from the close of business on the day prior to the issue date unless explicitly otherwise stated.

Lloyds Banking Group has a shareholding of 8% in Execution Holdings Limited.

Any opinion reflects the analyst's judgment at the date of publication and neither Execution Noble Limited, nor any of its directors, officers or employees accepts any responsibility in respect of the information or recommendations contained herein which, moreover, are subject to change without prior notice.

This research report is private and confidential and is being made available to the recipient on the understanding that it will be kept confidential and that the recipient shall not copy, reproduce, distribute or pass to third parties this research report in whole or in part at any time. It is intended for the information of clients only and is not for publication in the press nor is it being issued or distributed to persons who are retail clients.

The material in this research report is general information intended for recipients who understand the risks associated with investment. It does not take account of whether an investment, course of action, or associated risks are suitable for the recipient.

The Execution Noble Group provides services (including Corporate Finance, Corporate Broking or Equity Capital Markets advice) where the flow of information is restricted by a Chinese Wall. Accordingly, information may be available to the Execution Noble Group that is not reflected in this document.

This document is intended to be used by market professionals (eligible counterparties and professional clients but not retail clients). Retail clients must not rely on this document and should note that the services of the Execution Noble Group are not available to them.

This research report has been prepared by Execution Noble Research Limited, who is a correspondent of:

Execution Noble Limited, 10 Paternoster Square, London, EC4M 7AL; Execution Noble LLC, 102 Greenwich Avenue, Greenwich, CT06830.

Execution Noble Limited is distributing this research report into the EEA and accepts responsibility for its contents subject to the terms set out herein.

Execution Noble LLC is distributing this research report in the US and accepts responsibility for its contents subject to the terms set out herein. Any US persons receiving this research report and wishing to effect a transaction in any security discussed herein, should do so only with Execution Noble LLC, or an individual registered therewith.

Execution Holdings Limited is registered in England and Wales no. 04916295

Please see UK Equity Research Conflicts Management Policy on http://www.execution-noble.com/ResearchConflictsPolicy

Please see UK Disclosures for Investment Research Recommendations on http://www.execution-noble.com/InvestmentResearchDisclosures