AVENDUS

April 11, 2011

ADD

SKS Microfinance

Target Price (INR) 602

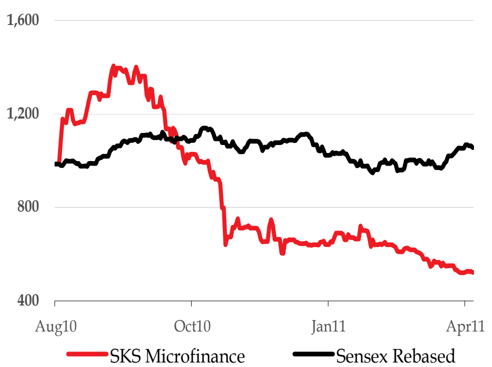
Risk-reward turning favorable

INITIATING COVERAGE

Last Price (INR)	522
Bloomberg code	SKSM IN
Reuters code	SKSM.BO
Avg. Vol. (3m)	0.4
Avg. Val.(3m)(INRmn)	248
52-wk H/L (INR)	1,492 / 518
Sensex	19,451
MCAP (INRbn/USDmn)	37.8 / 857

Shareholding (%)	09/10	12/10
Promoters	37.1	37.0
MFs, FIs, Banks	5.7	5.0
FIIs	17.3	20.6
Public	31.4	29.0
Others	8.5	8.6

Stock Chart (Relative to Sensex)



Stock Perfm. (%)	1m	3m	6m
Absolute	(9.5)	(19.6)	(57.6)
Rel. to Sensex	(15.9)	(20.3)	(52.7)

Financials (INRbn)	03/10	03/11f	03/12f
NII	5,871	8,420	10,752
YoY (%)	88	43	28
Operating profit	3,194	4,631	5,793
A.PAT	1,740	1,837	2,470
Sh o/s (diluted)	687	720	720
A.EPS (INR)	16.4	25.5	34.3
YoY (%)	61	(5)	34
Equity/Assets (%)	5.5	3.7	3.2
P/E (x)	20.1	21.3	15.8
P/B (Adj) (x)	3.7	2.1	1.8
RoA (%)	3.9	3.5	3.9
RoE (%)	21.6	13.0	12.4

Quarterly Trends	03/10	06/10	09/10	12/10
Op. income (INRbn)	NA	1.1	1.4	1.5
PAT (INRbn)	NA	0.7	0.8	0.3

The sharp de-rating of SKSM over the past six months has reflected the concerns of the political clampdown on microfinance institutions in Andhra Pradesh and corporate governance issues. The Malegam Committee recommendations, if implemented, would address the key concerns on asset quality. However, while the Andhra Pradesh MFI Act stays in force, loan-loss provisions could creep in. Even as the dust settles down in AP, the core strength of the business model (joint liability group) remains intact. Despite these issues, we believe SKSM is attractively valued, given its growth outlook and profitability. Even after factoring in margin caps and higher credit costs, RoAs are likely to stabilize near 3.8%. The risk-reward appears favorable. We initiate coverage with an Add rating and a Mar12 price target of INR602.

Growth to moderate; funding stays a challenge

The extent of financial exclusion in India remains high with enough scope for geographic diversification and significant demand for micro credit. The average ticket size per borrower is likely to increase with the rising persistency of the customer base. SKSM has made early efforts to diversify its branch network and loan portfolio – to reduce its concentration towards Southern states. Increase in the average ticket size and market share gains are likely to drive a CAGR of 38% in the loan book over FY11f-FY14f. However, availability of adequate capital to fund this growth is a key challenge.

Regulation a key challenge; nevertheless, a sound business model

The Andhra Pradesh crisis assumes significance as penetration rates here are far higher than that in any other Indian state, with c30% of the outstanding microfinance institution (MFI) portfolio originating from the state. Given the nature of the customer base of MFIs, politics is likely to play a major role in defining the future of the industry. Nevertheless, the basic tenets of the business model remain strong. Bigger players that are well-capitalized are likely to emerge stronger from the crisis, once the dust settles down.

RoAs to remain stable, despite margin caps and higher credit costs

We forecast SKSM to register a CAGR of 34% in net interest income for the three years ending Mar14, driven by strong loan growth. The cap on margins and lending yields is likely to have minimal impact on the lender. With operational leverage kicking in, RoAs are likely to stabilize at 3.8% for the three-year period ending Mar14f, despite higher credit costs and margin caps.

Risk-reward appears favorable; initiate with Add, Mar12 TP of INR602

SKSM's sharp de-rating provides an entry point, considering that the viability of the business model remains strong. Our price target is based on the DCF, P/E and P/B methods. The Mar12 target of INR602 values the stock at 17.5x and 2.1x one-year forward P/E and P/B, respectively. We initiate coverage on the stock with an Add rating.

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Investment Summary

SKSM's sharp de-rating over the past six months has reflected the concerns of political clampdown on microfinance institutions in Andhra Pradesh and corporate governance issues. The Malegam Committee recommendations, if implemented, address the key concerns on asset quality. However, while the Andhra Pradesh MFI Act stays in force, loan-loss provisions could creep in. Even as the dust settles down in Andhra Pradesh, the core strength of the business model remains intact. Despite these issues, we believe SKSM is attractively valued given its growth outlook and profitability. A key risk to growth is resumption of the funding constraints currently experienced by the industry. That said, SKSM is better positioned than its peers due to its higher capital base and a more diverse loan book. The risk-reward appears favorable. We initiate coverage with an Add rating and a Mar12 price target of INR602.

Growth to moderate; funding stays a challenge

The extent of financial exclusion in India remains high with enough scope for geographic diversification and significant demand for micro credit. With the seasoning of the loan book and rising branch maturity, the average ticket size is likely to increase, except in certain pockets, which have high penetration levels. SKS Microfinance (SKSM) added c70% of its branches over the past two years. With a rise in the average ticket size per borrower and market share gains, we estimate SKSM's loan portfolio to register a CAGR of 38% for the three-year period ending Mar14f. However, unavailability of adequate capital to fund this growth is a key risk to our assumption.

Regulation can be potentially game changing

The stringent regulations of the Andhra Pradesh MFI Act contributed to a general environment where MFI ground-level operations were impeded and loan collections for MFIs in Andhra Pradesh dropped dramatically. SKSM too saw higher defaults and a virtual halt of incremental disbursals in the state. The Andhra Pradesh MFI Act continues to remain in force, despite the Malegam Committee advocating its removal. Any delay in resolution of the MFI dispute in Andhra Pradesh and restoration of normal business conditions is likely to pose a risk of significant NPLs. The competitive intensity is likely to decline, as the stringent regulations imposed by the Andhra Pradesh MFI Act are likely to impact smaller MFIs. However, bigger players that are well-capitalized and diversified are better-equipped to withstand the crisis.

Better-placed among peers

SKSM has grown at a rapid pace after having converted to a for-profit model. Despite its aggressive growth, the lender has not compromised on the basic tenets of the joint liability group (JLG) model. SKSM remains focused only on women (generally considered a less risky asset class than men) and lending is strictly for productive use, which is considered relatively safer in terms of asset quality. The end loan usage is monitored strictly, with most loans only given for productive uses rather than for consumption. We believe SKSM's leadership position is likely to give it a distinct advantage to acquire clients over the long term.

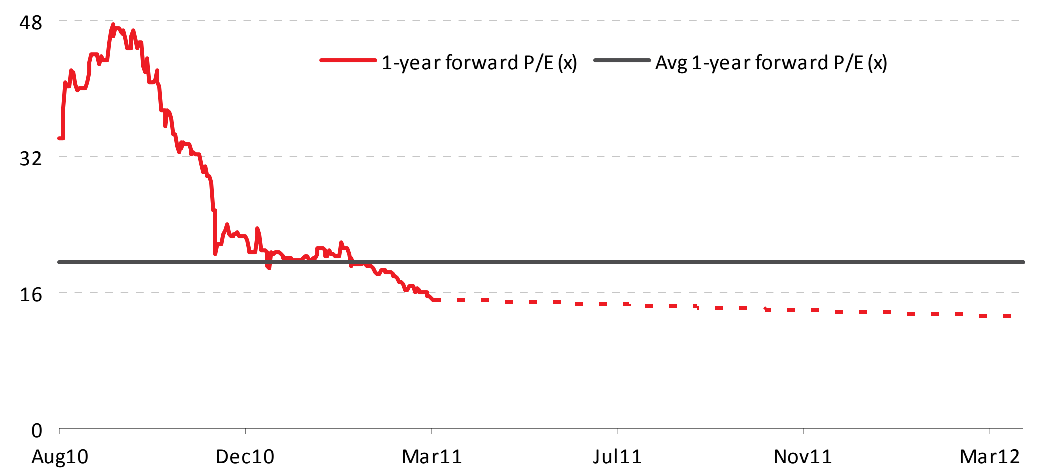
Profitability likely to remain strong, despite pressure

Supported by a CAGR of 38% in the gross loan portfolio, we estimate SKSM to register a CAGR of 34% in net interest income during FY11f-FY14f, despite declining spreads. Fee income growth is likely to remain strong due to higher volumes, even as fee income as a proportion of total loans is likely to decline to 1% from 2%-3% earlier. We estimate SKSM to write off 10% of its loan book in Andhra Pradesh during FY11f due to rising defaults, as repayment levels continue to remain low. We conservatively build in loan-loss provisions (including write-offs) at 5% of the gross loan portfolio in FY11f and, thereafter, at an average of 4.2% over FY12f-FY14f. We estimate a CAGR of 34% in net profit during FY11f-FY14f.

Initiate coverage with Add and Mar12 target of INR602

Our target is based on the DCF, P/E and P/B methods. Our DCF-based fair value stands at INR592, where we assume cost of equity of 14% and semi-explicit and fade period growth of 25% and 3%, respectively. Our Mar12 target price of INR602 values the stock at 17.5x and 2.1x one-year forward P/E and P/B, respectively. We initiate coverage with an Add rating.

Exhibit 1: One-year forward P/E, average P/E and target P/E



Source: Bloomberg, Avendus Research

Exhibit 2: Valuation Summary (as on April 8, 2011)

(INRmn)	Net interest income	Operating income	Operating profit	Net profit	EPS(INR)	P/E(x)	Adj.Book value(INR)	P/B(x)
Mar10	5,871	9,589	3,320	1,740	27	19.3	148	3.5
Mar11f	8,420	12,510	4,811	1,837	26	20.4	260	2.0
Mar12f	10,752	16,102	6,047	2,470	34	15.2	293	1.8
Mar13f	14,252	20,967	8,200	3,312	46	11.3	336	1.5
Mar14f	18,586	27,320	10,900	4,393	61	8.5	385	1.4

Source: Company, Avendus Research

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Growth to moderate; availability of funds a key challenge

The extent of financial exclusion in India remains high with enough scope for geographic diversification and significant demand for micro credit. With the seasoning of the loan book and rising branch maturity, the average ticket size is likely to increase, except in certain pockets, which have high penetration levels. SKS Microfinance (SKSM) added c70% of its branches over the past two years. With an increase in the maturity of branches and a rise in the average ticket size per borrower, we estimate SKSM's loan portfolio to register a CAGR of 38% for the three-year period ending Mar14f. However, unavailability of adequate capital to fund this growth is a key risk to our assumption.

Average ticket size likely to rise

SKS Microfinance's (SKSM) business model allows the customer to take a larger loan after the first is fully repaid. The second loan is typically larger as the customer is likely to have moved up slightly in terms of economic well-being. Persistency, in these terms, is relatively strong, which drives an increase in the average ticket size per borrower. The average ticket size per borrower for the industry is INR6, 060, much below the mandated cap of INR25, 000 as per the Malegam Committee, indicating significant room for expansion. Assuming a growth of 20% CAGR (to INR13,000) in the average ticket size for the industry and the overall client growth at a CAGR of 7% in the three year period ending Mar14f, translates into a potential microfinance demand of INR485bn by FY14f, a CAGR of 28% over the market size in FY11f.

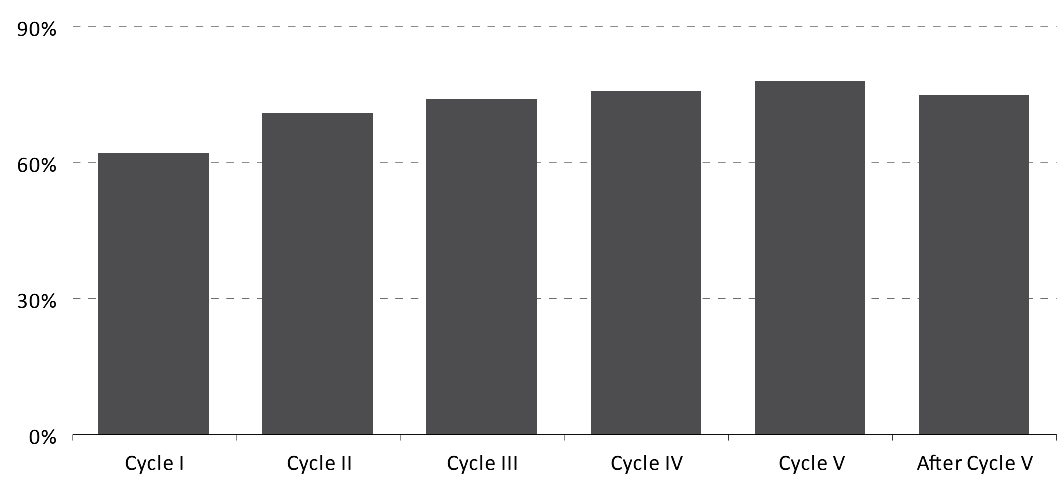
Exhibit 3: Comparison of average loan size

Type (INR)	--------Average loan/ customer*---------		Growth (y-o-y)
	2009	2010	
Self Help Group Member	4120	4570	11%
Microfinance Institution customer	5190	6060	17%

Source: State of the Sector Report 2010, Avendus Research Note: * data includes all lenders in the group

Exhibit 4: Customer retention ratio (persistency) in every loan cycle

Persistency of the customer is relatively strong which drives an increase in the ticket size



Source: Company, Avendus Research

Ticket size to increase except in certain pockets which are highly penetrated

Exhibit 5: Districts with the highest and the lowest ticket sizes in Karnataka

Name	No of clients ('000)	Loan (INRbn)	Ticket Size (INR)
Shimoga	310	3.6	11,530
Dakshin Kannada	185	1.8	9,531
Raichur	61	0.5	8,852
Kodagu	63	0.2	2,443
Dharwad	249	1.0	3,849
Gadag	161	0.7	4,332
Karnataka	4,349	27.6	6,355

Source: State of the Sector Report 2010, Avendus Research

Overall client growth has slowed down

Overall growth in the total number of clients has slowed down significantly in FY10 - much before the AP Micro Finance Institutions (Regulation of Money Lending) Act was introduced - likely due to multiple lending and geographic concentration in the South. Data on the total number of clients suggest that, while outstanding MFI loan accounts increased by 18% for the industry (in FY10), adjusted for overlap with self-help group (SHG) accounts, the number of individual borrowers increased by only 1% (from 70mn in FY09 to 71mn in FY10). While the overlap between SHGs and MFIs is estimated at c10%, the overlap between common borrowers of MFIs is likely to be much higher.

Overall growth in total clients slowed down likely due to multiple lending and geographic concentration in the South

Exhibit 6: Client outreach – borrowers with outstanding accounts (mn)

Segment	Mar07	Mar08	Mar09	Mar10
Banking (self-help groups)	38.0	47.1	54.0	59.6
Microfinance Institutions	10.0	14.1	22.6	26.7
Total	48.1	61.2	76.6	86.3
Adjusted for overlap	45.0	56.0	70.0	71.0
Growth (%)		25	25	1

Source: State of the Sector Report 2010, Avendus Research

Scope for diversification, though with challenges

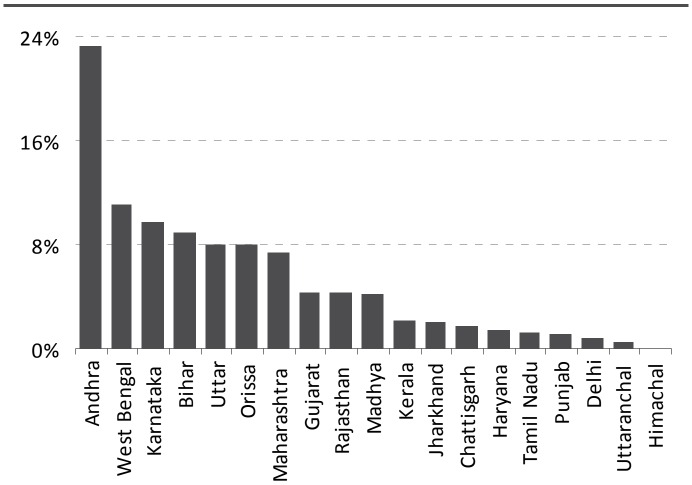
The Andhra Pradesh incident has clearly demonstrated the need for lower concentration among the over-penetrated states of South India. The overall level of indebtedness in Andhra Pradesh remains high, with an estimated 82% of the poor having access to loans through informal sources—according to a study by the Centre for Microfinance. This compares to an estimated less than 20% in other parts of India, signifying a huge potential for growth outside South India. SKSM has made early efforts to diversify its presence beyond the South—in north-eastern areas. The company has c65% of its branches spread across the Central, East and North-east regions, which is likely to aid its growth beyond the over-penetrated areas in the South.

Exhibit 7: Percentage of rural Andhra Pradesh households indebted by source

Source	Estimated share of households with loans from the source
Banks	38%
Self-help groups) + Microfinance Institutions	65%
Informal	82%

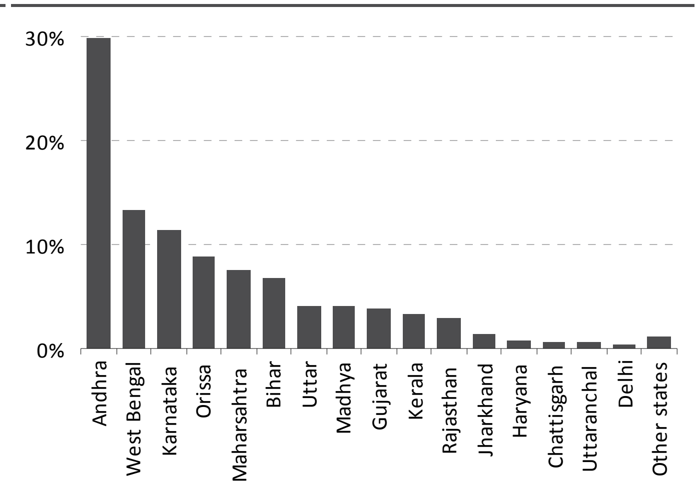
Source: Access to Finance survey - Centre for Microfinance, Avendus Research

Exhibit 8: SKSM's state-wise mix of branches (% of total, Dec10)



Source: State of the Sector Report 2010, Avendus Research

Exhibit 9: SKSM's state-wise mix of loans (% of total as on Dec10)



Source: Company, Avendus Research

Exhibit 10: Average loan per poor household in key states

(mn)	Andhra Pradesh	Tamil Nadu	West Bengal	Orissa
No of households (Mar04-Mar05)	16.0	13.0	16.9	7.7
Number of poor households	2.5	2.9	4.2	3.6
Number of microfinance clients (Self-help groups) + Microfinance Institutions)	23.6	11.9	10.1	6.2
Ratio of microfinance Institution clients to poor households	9.3	4.1	2.4	1.8

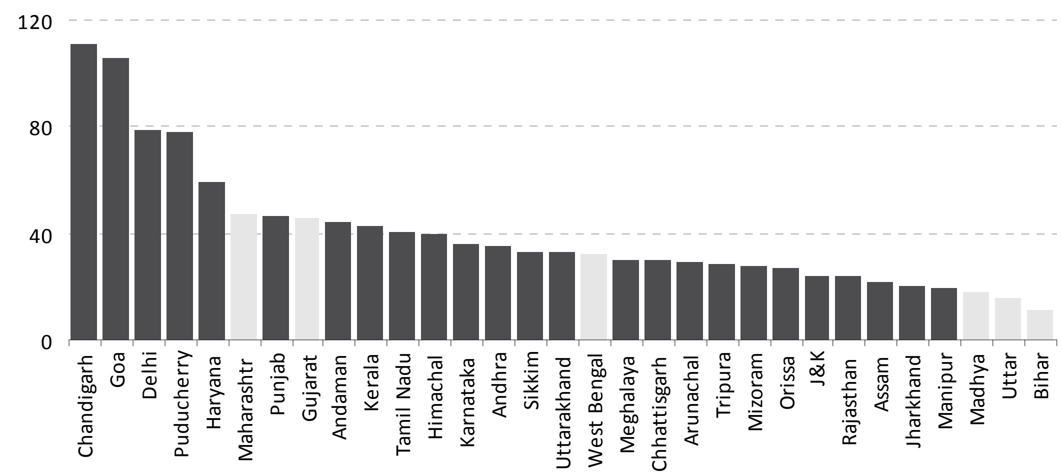
Source: State of the Sector Report 2010, Avendus Research

Increase in ticket size and market share to drive CAGR of 38% in loans

SKSM has expanded its network aggressively outside the home geographies of South India over the past two years, adding branches especially in the Eastern and Western regions with significant demand for microfinance. A CAGR of 19% in the average ticket size to INR13,000 (from INR7,500 in FY11f) and a CAGR of 17% in total clients, combined with a rise in market share, are likely to drive a CAGR of 38% in SKSM's gross loan portfolio for the three-year period ending Mar14f.

SKSM has ramped up its network in low/medium per capita income states in the Eastern and Western with significant demand for microfinance

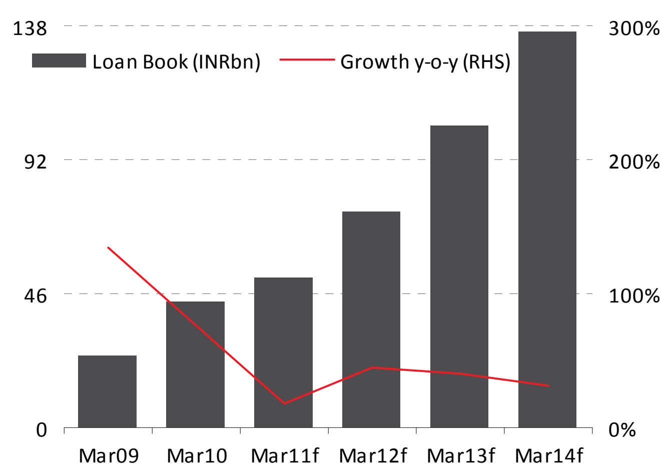
Exhibit 11: Per capita income for select states (INR '000)



Source: RBI, Avendus Research

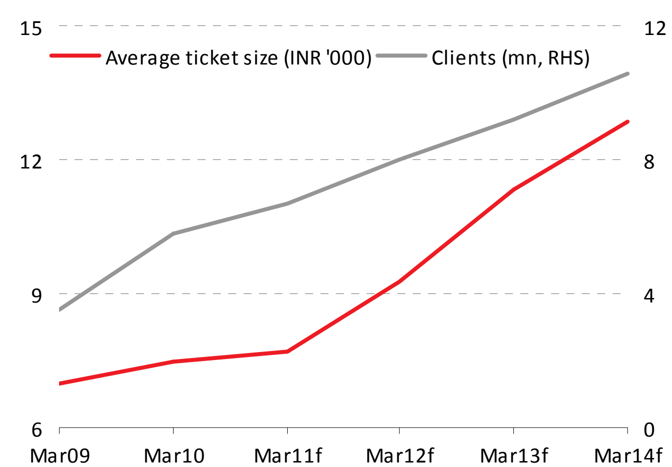
Note: States with low/medium per capita income have been highlighted

Exhibit 12: Gross loan portfolio growth for SKSM



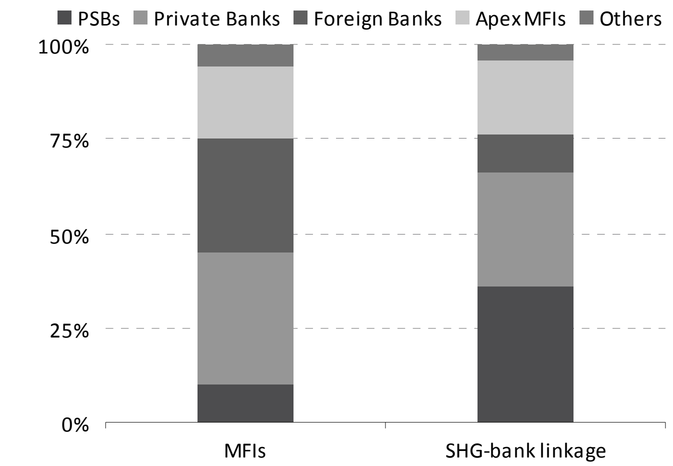
Source: Company, Avendus Research

Exhibit 13: Average ticket size and client base for SKSM



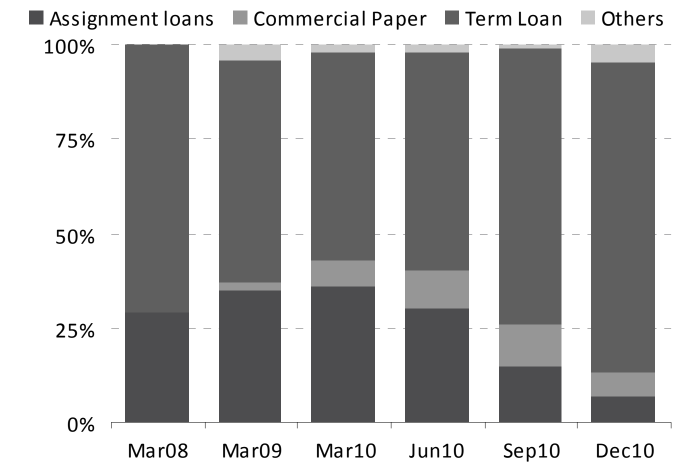
Source: Company, Avendus Research

Exhibit 14: MFIs source of borrowings



Source: State of the Sector Report 2010, Avendus Research

Exhibit 15: Borrowing profile for SKSM



Source: Company, Avendus Research

Lack of adequate funding a constraint to growth

SKSM's relatively large-scale, for-profit model has allowed it to access various sources of funding, enabling rapid growth over the past few years. However, reliance on debt continues to be strong, with most of these funds coming from banks in the form of term loans and securitization transactions based on priority-sector lending arrangements. Securitization and assignment source of financing allows MFIs to transfer their assets from the balance sheet, leading to higher leverage. During the crisis in Andhra Pradesh, both these sources have been at risk of closure. Securitization transactions under priority-sector lending arrangements have virtually halted. Banks have been unwilling to lend to MFIs due to the fear of rising defaults. Unavailability of credit to fund this growth is a key challenge.

Regulation can be potentially game changing

As seen in the Andhra Pradesh situation, the political risk is high in microfinance due to the nature of the borrower. The stringent regulations of the Andhra Pradesh MFI Act contributed to a general environment where MFI ground-level operations were impeded and loan collections in Andhra Pradesh dropped dramatically. SKSM too saw higher defaults and virtual halt of incremental disbursals in the state. The Andhra Pradesh MFI Act continues to remain in force, despite the Malegam Committee advocating its removal. Any delay in resolution of the MFI dispute in Andhra Pradesh and restoration of normal business conditions is likely to pose a risk of significant NPLs. The competitive intensity is likely to decline, as the stringent regulations imposed by the Andhra Pradesh MFI Act are likely to impact smaller MFIs. However, bigger players that are well-capitalized and diversified are better-equipped to withstand the crisis.

Political and regulatory risk continues to remain the key challenge

The Andhra Pradesh incident has clearly demonstrated the impact of politics on the MFI industry, with the share price of SKSM tumbling by more than 50% and many MFIs facing liquidity crisis/default worries. The crisis assumes significance as penetration rates for micro-credit are far higher in Andhra Pradesh than in any other Indian state. Given the nature of the customer base (the poor who are exploitable and also form a majority of the vote bank), politics may play a major role in defining the future of the industry. There have been incidents of mass defaults spurred by political reasons and multiple lending. However, most MFIs have been able to survive them.

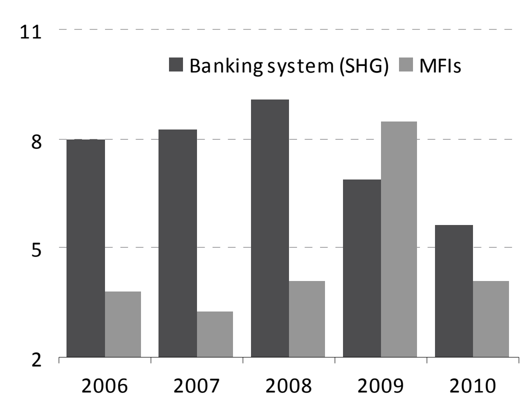
Most MFIs have been able to survive the incidents of mass defaults in the past

Exhibit 16: Incidents of mass defaults in microfinance industry

Area/State	Year	Factors driving the event	Impact
Krishna district	2006	The district government closed 50 branches of four MFIs, following unethical collections and illegal operational practices.	The situation was calmed after MFIs agreed to follow a code of conduct.
Kolar	2009	Mass defaults largely prompted by credible orders from local Muslim organizations banning Muslim borrowers from continuing contact with MFIs.	Defaults in the range of 25%-80% of outstanding loans.
Andhra Pradesh	2010	Few suicides in the state attributed to the coercive recovery practices of MFIs and an attempt to save the flagging government-backed SHG program prompted the state government to implement a highly restrictive ordinance.	Extent of the losses still unknown. Estimated defaults high as 30% of the outstanding loan book is originated in Andhra Pradesh.

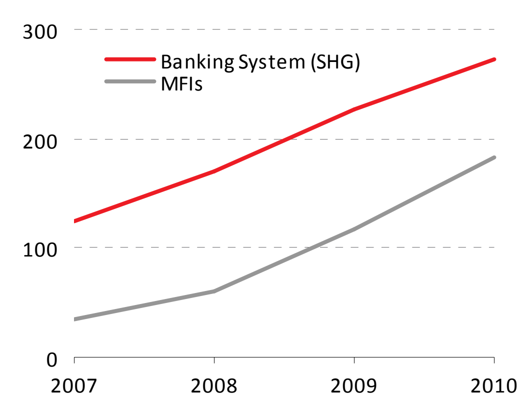
Source: State of the Sector report 2010, Avendus Research

Exhibit 17: Clients sourced each year (mn)



Source: State of the Sector Report 2010, Avendus Research

Exhibit 18: Outstanding loans (INRbn)



Source: State of the Sector Report 2010, Avendus Research

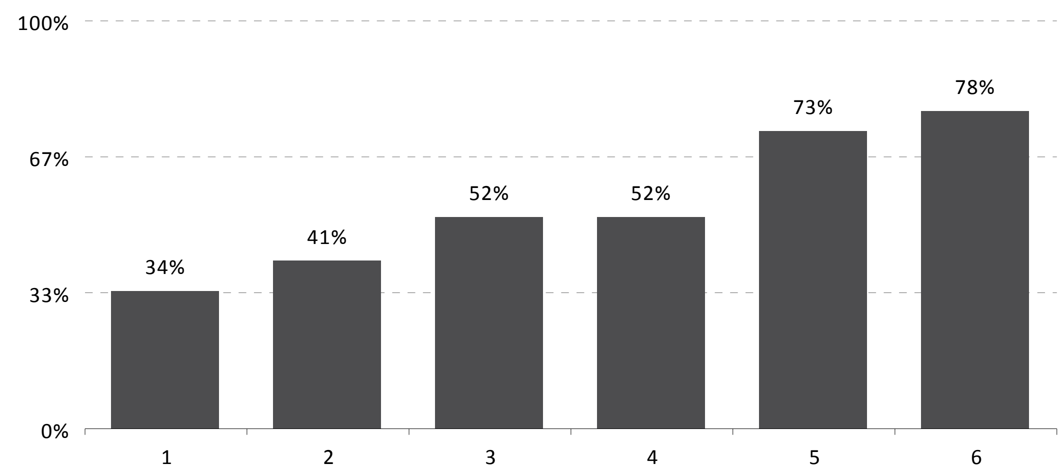
Competitive intensity likely to decline

There have been reports of high competition among MFIs, especially in the southern regions, driving concerns of over-indebtedness of microfinance borrowers to lead to mass defaults. A study carried out by the Association of Karnataka Microfinance Institutions, on the issue of mass defaults in Kolar during

2009 have revealed that defaults were on account of poor customer appraisal and high competition. In comparison of default towns with non-default towns, the findings indicated that repayment levels were much higher than income levels of borrowers. The competitive intensity in the industry is likely to decline, as the adverse liquidity climate is likely to impact smaller MFIs. However, bigger players that are well-capitalized and diversified are better-equipped to withstand the crisis.

Positive co-relation between the number of MFIs in the town and the level of default.

Exhibit 19: Number of MFIs and the extent of loan defaults in Kolar district



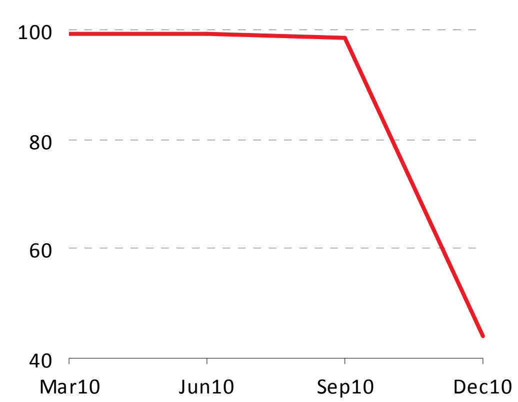
Source: State of the Sector Report 2010, Avendus Research

Losses in Andhra Pradesh likely to mount in the near term

We have factored in write-offs of c10% of the total loan book in Andhra Pradesh.

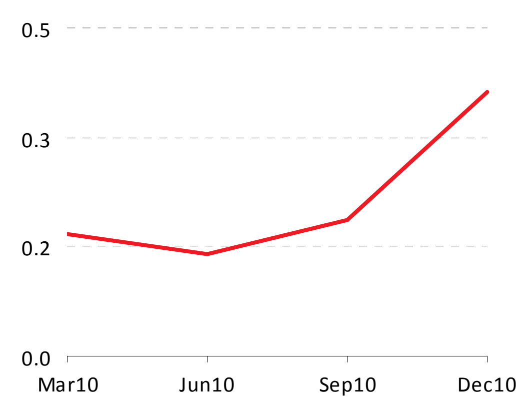
The stringent regulations of the Andhra Pradesh MFI Act contributed to a general environment where MFI ground-level operations were impeded and loan collections dropped dramatically to 30%-40% (from 95%+) since the six months that the was in existence. A delay in resolution of the MFI dispute in Andhra Pradesh and restoration of normal business conditions after another six months is likely to lead to high defaults. SKSM's Andhra Pradesh portfolio currently is at cINR14bn. We factor in write-offs of 10% of the Andhra Pradesh portfolio during the year ending Mar11f.

Exhibit 20: Collection efficiency (%) for SKSM in AP



Source: Company, Avendus Research

Exhibit 21: SKSM's portfolio at risk (Par %) for AP



Source: Company, Avendus Research

The Malegam Committee report does provide hope of a resolution in the near future. Nevertheless, credit losses in the Andhra Pradesh loan book are likely to be higher. Key reasons are the unsecured nature of loans, limited ability of the poor to pay back pent-up loan installments and the likely deterioration in credit discipline (on the back of consistent negative portrayal of MFIs). Loan-loss provisions (including write-offs) are estimated at 5% of outstanding loans at end Mar11f and at 3% for the three-year period ending Mar14f.

Bigger players better-positioned to withstand the crisis

The liquidity crunch for MFIs and the possibility of increased regulation is likely to stifle smaller MFIs due to unavailability of capital and the unwillingness of banks to lend funds. However, bigger players such as SKSM are unlikely to be impacted severely. The lender's relatively large scale and for-profit model has allowed it to access various sources of funding, enabling rapid growth over the past few years. The company is adequately capitalized to withstand the fallout of the Andhra Pradesh crisis.

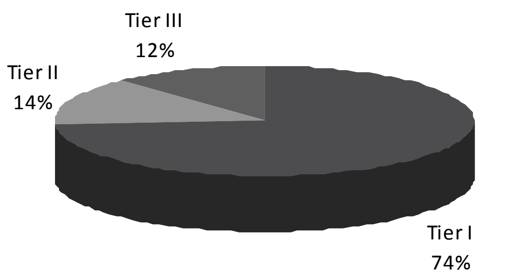
Exhibit 22: Segregating MFIs based on their loan portfolio and age

Category	Phase of growth and entry	MFIs (total 19)
Tier I	Early entrants and high growth	SKSM, Spandana Sphoorty Financial, Share Microfinance, Basix, Bandhan, Asmitha Microfinance, Grameen Kota.
Tier II	Moderate growth	BISWA Microfinance, BSS Microfinance, etc
Tier III	Newer entrants	Arohan Microfinance, Equitas Microfinance India, Ujjivan, etc

Source: Intellecap, Avendus Research

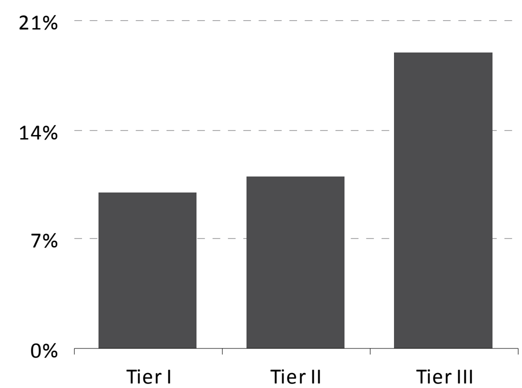
Higher capital base, increased reach and lower operating expenses is likely to benefit bigger MFIs.

Exhibit 23: Loans outstanding by MFI type (FY10)



Source: Intellecap, Avendus Research

Exhibit 24: Operating expenses by MFI type (FY10)



Source: Intellecap, Avendus Research

Better-placed among peers

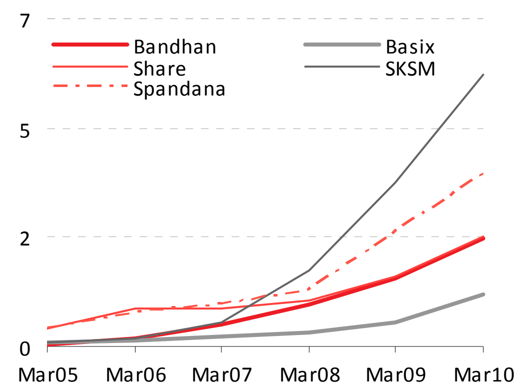
SKSM has grown at a rapid pace after having converted to a for-profit model. The company has grown its reach, distribution and loan book at a quick pace over the past three years and has quickly become the largest microfinance lender in India with a client base of over 7.3mn. Despite its aggressive growth, SKSM has not compromised on the basic tenets of the joint liability group (JLG) model. The lender remains focused only on women (generally considered a less risky asset class than men) and lending is strictly for productive use, which is considered relatively safer in terms of asset quality. The end loan usage is monitored strictly, with most loans only given for productive uses rather than for consumption. SKSM's leadership position is likely to give it a distinct advantage to acquire clients over the long term.

Rapid ascent to the top

SKSM has rapidly grown its reach, distribution and loan book over the past three years and has quickly become the largest microfinance lender in India. Its market share in outstanding MFI loans has increased from 4.8% at end Mar06 to 21% at end Mar09 (12% share, excluding off-balance sheet loans). SKSM's loan book has grown at a CAGR of 148% over FY06-FY10 and its gross loan portfolio (including securitized loans) has grown even faster—at a CAGR of 178%. The key enablers for this rapid expansion in balance sheet are rapid expansion in branches and reach (2,403 branches currently, from just 80 in FY06), access to capital (both equity and debt) and focus on technology.

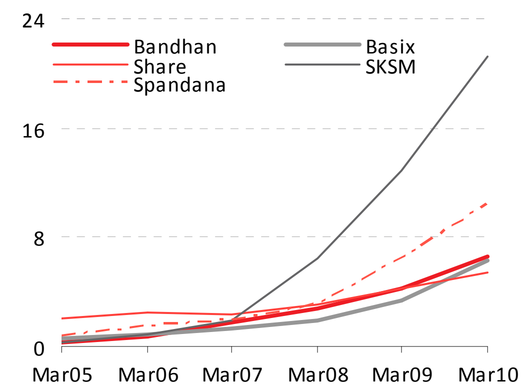
SKSM has been the fastest-growing MFI in India over the past five years on all parameters.

Exhibit 25: Expansion in customer base (mn)



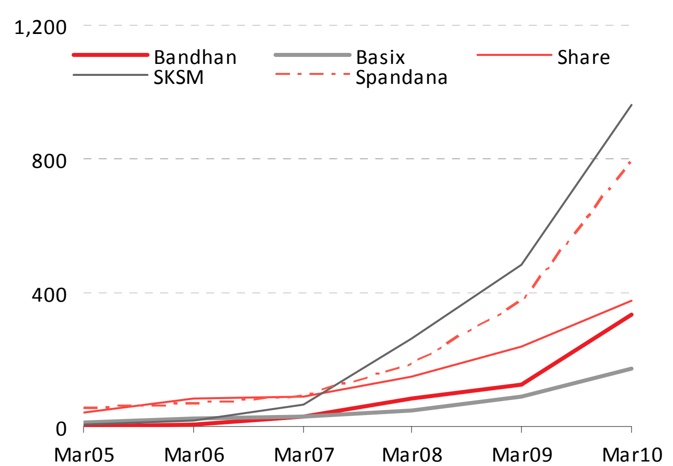
Source: Mix Market, Avendus Research

Exhibit 26: Growth in no. of employees ('000)



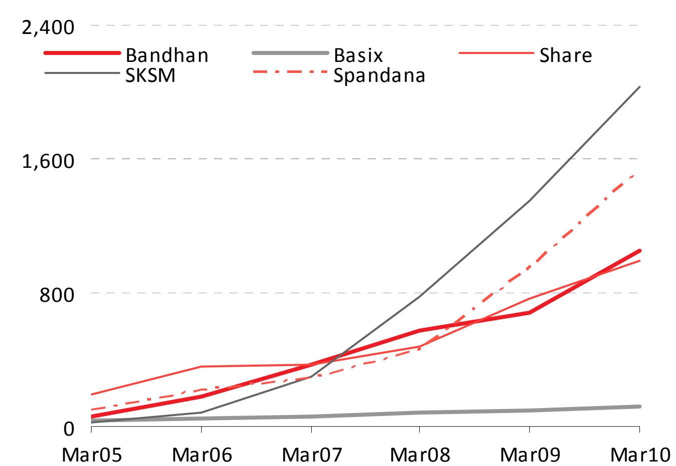
Source: Mix Market, Avendus Research

Exhibit 27: Select MFIs - comparative growth in loans (USDmn)



Source: Mix Market, Avendus Research

Exhibit 28: Select MFIs - comparative growth in branches



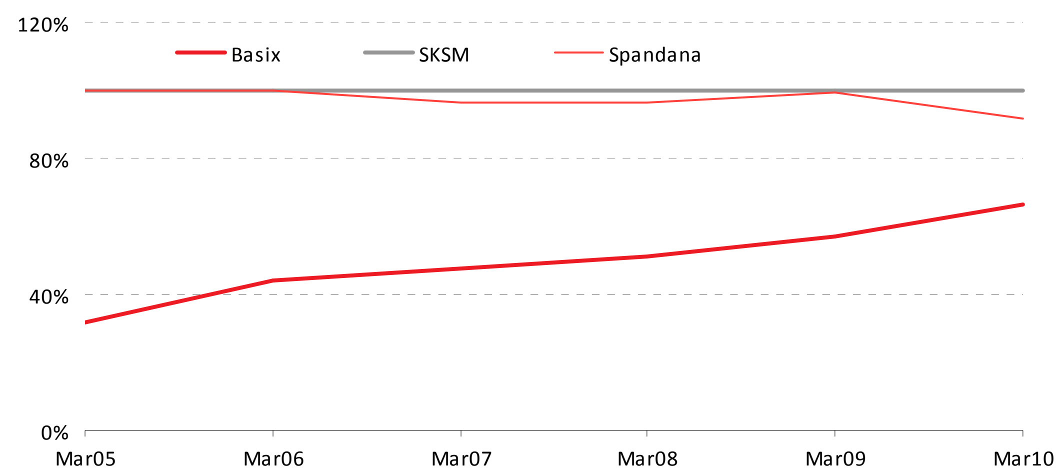
Source: Mix Market, Avendus Research

Basic tenets of the business model not compromised

Despite its aggressive growth, SKSM has not compromised on the basic tenets of the joint liability group model. The lender remains focused only on women (generally considered a less risky asset class than men) and lending is strictly for productive use, which is considered relatively safer in terms of asset quality. Aggressive competition in Andhra Pradesh among MFIs is likely to have led to most MFIs lending for consumption rather than productive use – a concern even echoed by the Malegam Committee report. SKSM is likely to be better-placed than the competition under the new regulations, which mandate enforcement of strict guidelines on end usage of loans.

Lending to women considered safer than lending to men

Exhibit 29: Women borrowers as a percentage of total borrowers for select MFIs



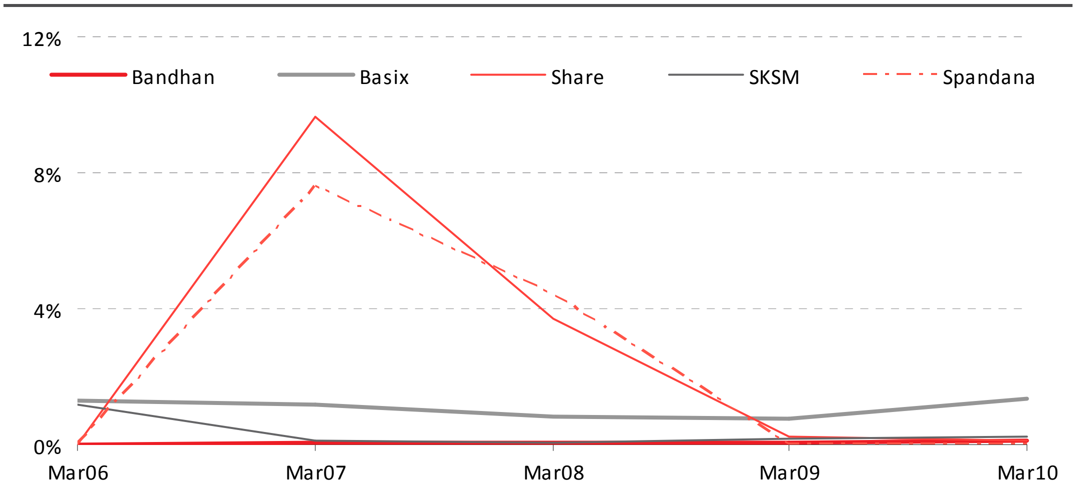
Source: Mix Market, Avendus Research

Asset quality ahead of peers so far

SKSM's asset quality has remained quite healthy so far and well ahead of peers. NPL ratios have been stable at 0.38% at end Dec10, with specific coverage at 51% and overall coverage (including non-specific provisions) well above 100%. The mass defaults in Krishna district and Kolar during 2006 and 2009, respectively, did not impact SKSM to a large extent. Nevertheless, we factor in an increase in gross NPLs over FY11f-FY14f, likely to be driven by rising defaults in Andhra Pradesh.

Asset quality remained stable during the mass defaults in Krishna district in 2006.

Exhibit 30: Portfolio at risk (Par for 90 days) for select MFIs



Source: Mix Market, Avendus Research

Profitability likely to remain strong, despite pressure

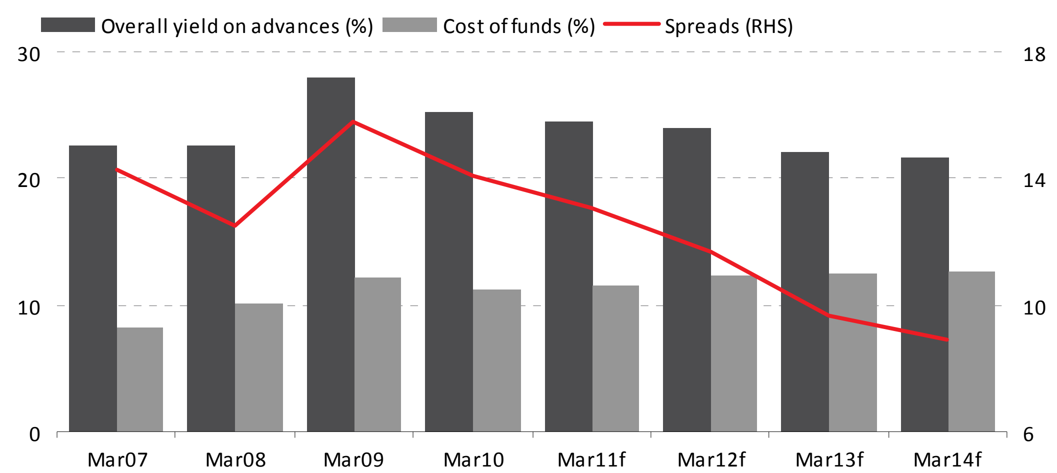
Supported by a CAGR of 38% in the gross loan portfolio, we estimate SKSM to register a CAGR of 34% in net interest income during FY11f-FY14f, despite declining spreads. The cap on lending rate of 24% as per the Malegam Committee recommendations is unlikely to have a significant impact as the company has reduced its lending rate—stands at 24.5% on all loans currently. Fee income growth is likely to remain strong due to higher volumes, even as fee income as a proportion of total loans is likely to decline to 1% from 2%-3% earlier. We estimate SKSM to write off 10% of its loan book in Andhra Pradesh during FY11f due to rising defaults, as repayment levels continue to remain low. We conservatively build in loan-loss provisions (including write-offs) at 5% of the gross loan portfolio in FY11f and, thereafter, at an average of 4.2% over FY12f-FY14f. We estimate a CAGR of 34% in net profit during FY11f-FY14f.

CAGR of 34% in net interest income between FY11f and FY14f

Net interest income is likely to grow at a CAGR of 34% over FY11f-FY14f, supported by a CAGR of 38% in loans. Spreads are likely to have peaked and we estimate some pressure due to margin caps, overall lending cap of 24% and a rise in borrowing costs. SKSM remains dependant on bank borrowings to fund most of its loan book growth. The reduced appetite for securitization after the Andhra Pradesh crisis is likely to increase borrowing costs for SKSM; thus, leading to a decline in spreads.

Overall yields likely to decline due to the lending rate and margin cap as per the Malegam Committee recommendations.

Exhibit 31: SKSM’s yield on advances, cost of funds and spreads



Source: Company, Avendus Research

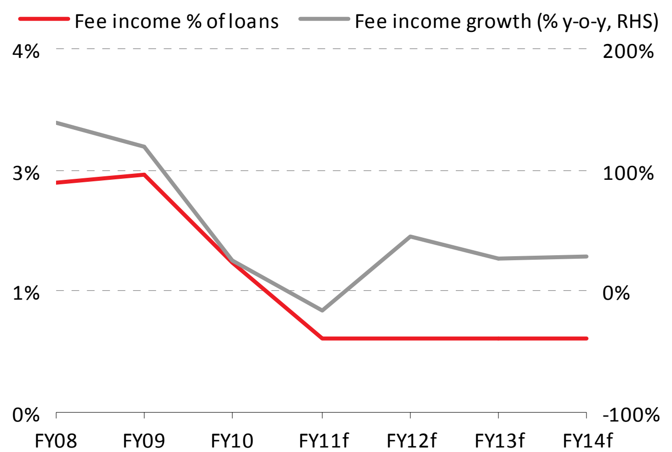
Fee income growth likely to remain strong

SKSM generates fees through a combination of loan processing charges, upfront charges and insurance premiums. We estimate fee income to decline to 0.8% of total loans between FY11f and FY14f (from 2% in FY10), in line with the recommendations of the Malegam Committee. Nevertheless, absolute fee income growth is likely to remain strong with a CAGR of 33% over FY11f-FY14f, driven by the strong growth in the loan book.

Operating leverage to come into play

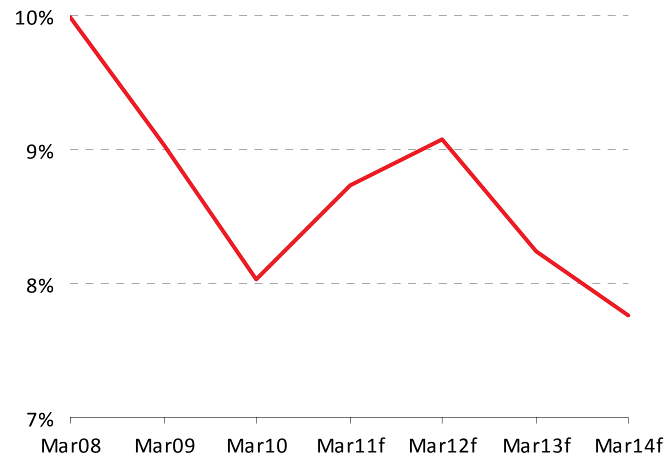
SKSM has been aggressively expanding its branch network over the past three years and has ramped up its employee base, resulting in high cost pressures. With optimum utilization of branches and operating leverage settling in, we estimate operating expenses to trend down to 8% of average assets by Mar14f.

Exhibit 32: SKSM's fee income and growth (y-o-y)



Source: Company, Avendus Research

Exhibit 33: Operating expenses (as a % of total assets)

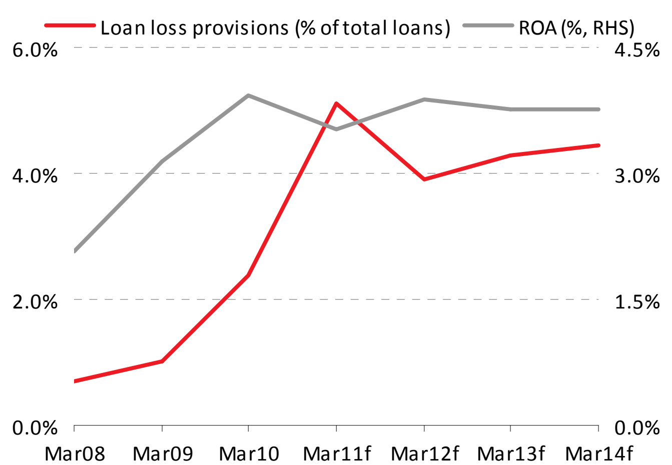


Source: Company, Avendus Research

RoAs to remain stable, despite margins caps and higher provisioning

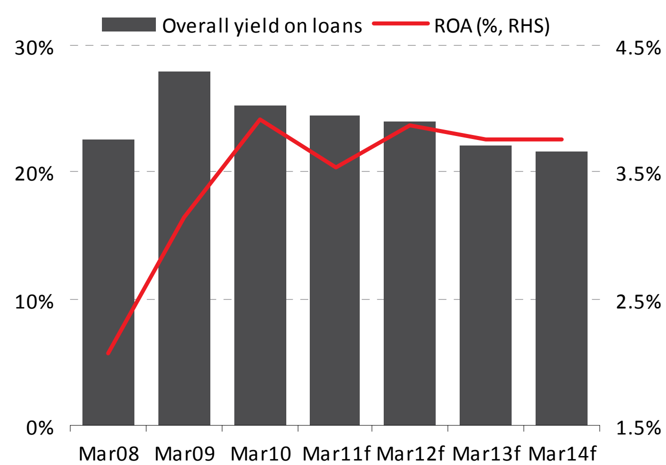
The margin cap of 10%-12% and an overall lending rate cap of 24% for MFIs as per the Malegam Committee recommendations is likely to have a minimal impact as the company has already reduced its overall lending rate to 24.5%. With the possibility of defaults in Andhra Pradesh increasing, we estimate SKSM to write off 10% of its loan book for the region in FY11f. We also conservatively factor in credit costs (including write-offs) at 5% of the gross loan portfolio in FY11f and, thereafter, at an average of 4.2% for the three-year period ending Mar14f. However, despite higher provisions, RoAs are likely to remain stable at 3.8% for the three-year period ending Mar14f.

Exhibit 34: Loan loss provisions and ROA for SKSM



Source: Mix Market, Avendus Research

Exhibit 35: SKSM's yield on AUMs and ROA

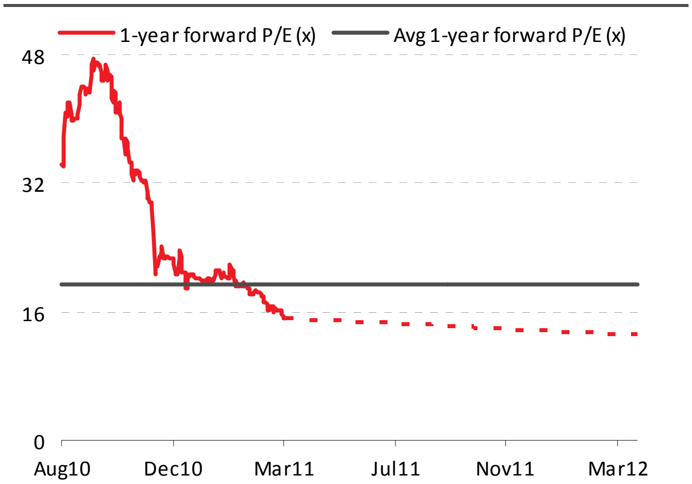


Source: Company, Avendus Research

Potential upside higher than potential downside; initiate with Add

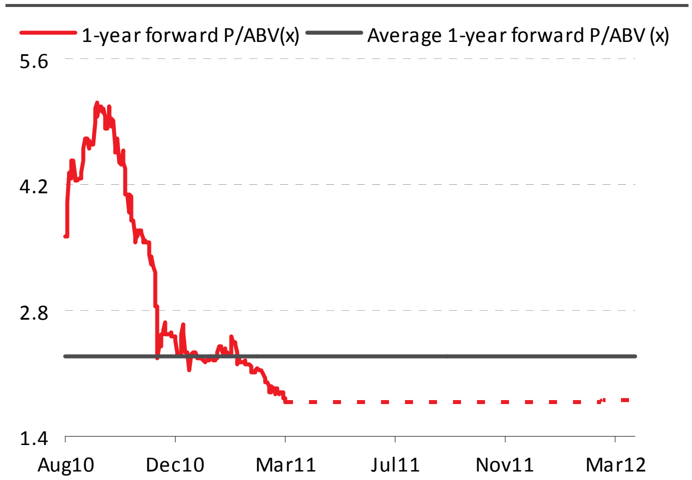
SKSM's sharp de-rating over the past six months has reflected the concerns of the political clampdown on MFIs in Andhra Pradesh and corporate governance issues. We believe, at current levels, the risk-reward appears favorable for SKSM, despite the moderation in growth outlook, profitability and return profile (relative to its own history) and the increased concerns on asset quality, especially in Andhra Pradesh. The lender is better-positioned than its peers due to the higher capital base and a more diverse loan book. Concerns on asset quality are likely to gradually fade with the Malegam Committee recommendations giving the much-needed flexibility. Our target is based on the DCF, P/E and P/B methods. Our DCF-based fair value stands at INR592, where we assume cost of equity of 14% and semi-explicit and fade period growth of 25% and 3%, respectively. A sensitivity of the DCF-based fair value indicates a higher potential upside than a potential downside. Our Mar12 target price of INR602 values the stock at 17.5x and 2.1x one-year forward P/E and P/B, respectively. We initiate coverage with an Add rating.

Exhibit 36: One-year forward P/E, average P/E and target P/E



Source: Company, Avendus Research

Exhibit 37: One-year forward P/ABV, avg P/ABV and target P/ABV



Source: Company, Avendus Research

Target price based on the DCF, P/E and P/B methods

We value SKSM using a combination of the DCF, P/E and P/B methods. Our three-stage DCF uses explicit forecasts until FY14, followed by 10 years of semi-explicit forecasts, where we assume a CAGR of 25% in loans and dividend payout of 22%. Our DCF-based fair value stands at INR592. We also assume the sustainable RoA at the end of the semi-explicit period to converge to 2.5% – lower than the average over the past three years. The final stage of 12 years assumes the convergence of RoE and cost of equity (assumed to be 14%).

Exhibit 38: Key assumptions (%)

RoA at the end of semi-explicit period	2.5
Semi-explicit period growth	25
Fade period growth	3
Dividend payout	22
Cost of equity	14

Source: Company, Avendus Research

Initiate with Add; TP values SKSM at 2.1x one-year forward P/B

We apply the mean P/B and P/E for the past three months to our one-year forward EPS and book value for Mar12 to arrive at P/E and P/B-based fair values of INR648 and INR635, respectively. Our final target price is a weighted average, where we assign a weight of 80% to our DCF-based fair value (INR592) and 5% each to our P/E and P/B-based fair values.

We factor in historical valuations for the past three months, to arrive at our target price, in view of the sharp de-rating in valuations after the Andhra Pradesh crisis. We also assign lower weights to the past three-month average P/E and P/B, considering SKSM's relatively short trading history.

Exhibit 39: Average P/E and P/B

	1-month	3 months	6 months
P/E	16.8	18.9	26.1
P/B	2.0	2.2	2.9

Source: Company, Avendus Research

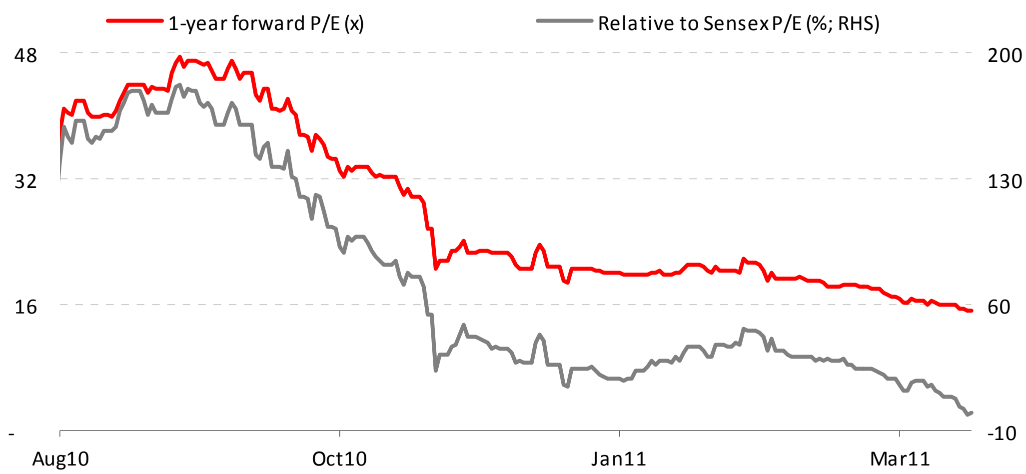
Exhibit 40: P/E, P/B, DCF-based fair values and the weighted average target price

(INR)	P/E	P/B	DCF	
Weights	10%	10%	80%	
Target Price	648	635	592	602

Source: Company, Avendus Research

We initiate coverage on the stock with a Mar12 target price of INR602 and an Add rating.

Exhibit 41: One-year forward P/E for SKSM and relative to Sensex P/E



Source: Company, Avendus Research

Sensitivity of DCF-based fair value to growth

We estimate a worst-case fair value of INR422 for SKSM, if loan growth remains tepid at a CAGR of 25% for the three-year period ending Mar14.

Estimates are based on the following assumptions:

- Yield on advances remain stable at 22% for the three-year period ending Mar14.
- Loan-loss provisions at an average of 4% of the gross loan book for the three-year period ending Mar14 in the base case and bull case.
- Loan-loss provisions at an average of 1% of the gross loan book for the three-year period ending Mar14 in the bear case.

Exhibit 42: Sensitivity of DCF based fair value to loan book growth in the explicit period

CAGR for the three year period ending Mar14f	Bear Case	Base Case	Bull Case
Gross loan portfolio	25%	38%	50%
Net profit	24%	34%	46%
DCF based fair value	450	592	726

Source: Company, Avendus Research

Exhibit 43: Sensitivity of semi-explicit growth and sustainable RoA assumptions to SKSM's DCF values

(INR)		------ Semi explicit period growth -----			
		23%	25%	27%	29%
--- RoA (%) ---	1.5	395	445	500	564
	2.0	459	519	586	663
	2.5	522	592	671	761
	3.0	585	665	756	859
	3.5	648	738	841	957

Source: Company, Avendus Research

Substantial discount to other financials

SKSM is currently trading at a substantial discount to select non-banking financials with a similar customer base/growth profile. While much of this discount is largely due to relatively lower RoEs, we believe it is unjustified, given SKSM's strong profitability outlook.

Exhibit 44: Valuation summary for select financials

	-------- ROA (%) -------			-------- ROE (%) -------			----- Price/Book (x) ----			Loan Book
	Mar10	Mar11f	Mar12f	Mar10	Mar11f	Mar12f	Mar10	Mar11f	Mar12f	CAGR (FY08-FY10)
Shriram Transport Finance	3.4	4.2	4.3	28.4	28.3	27.6	4.8	3.8	3.0	22.3
Manappuram Finance	7.5	5.2	4.6	30.9	20.7	20.8	7.3	2.8	2.3	92.0
M&M Finance	4.3	4.7	4.5	22.0	21.7	21.2	4.3	3.2	2.5	14.7
SKS Microfinance	3.9	3.5	3.9	21.6	13.0	12.4	3.5	2.0	1.8	102.8

Source: Bloomberg, Avendus Research

Key risks to our estimates

- **Regulatory and political:** Political efforts could involve increased regulation of financial services to the poor, impacting asset quality and profitability of MFIs.
- **Asset quality risks:** All of SKSM's loans are unsecured and self-approved. The borrowers also do not have any credit history. In addition, most of the loans are unseasoned due to the rapid growth trajectory of the company. Hence, there is a risk of deterioration in asset quality, but the joint liability group model should cap the risks.
- **Unavailability of adequate funds:** Reliance on debt continues to remain strong for SKSM, with most of these funds coming from banks, based on priority-sector lending arrangements. During the crisis in Andhra Pradesh, this source of borrowing has virtually closed down with banks unwilling to lend fearing rising defaults. Unavailability of adequate capital to fund the growth in the loan portfolio is a key risk to our estimates.
- **Scalability risks:** SKSM's branch network has grown rapidly over the past three years. The number of clients increased from 0.2mn in Mar06 to 5.8mn as of Mar10. The rapid expansion could pose operational and scalability risks, as it penetrates newer geographies and increases its ticket sizes.

Financials and valuations

Income statement (INRbn)

Fiscal year ending	03/10f	03/11f	03/12f	03/13f	03/14f
Interest income	8.6	11.6	15.0	17.3	19.6
Interest expense	2.7	3.2	4.2	4.5	4.8
Net interest income	**5.9**	**8.4**	**10.8**	**12.9**	**14.9**
Fee income	0.4	0.3	0.4	0.5	0.5
Trading profit	0.0	0.0	0.0	0.0	0.0
Other income	0.7	0.6	0.6	0.7	0.7
Total operating income	**6.9**	**9.3**	**11.9**	**14.0**	**16.1**
Total operating expense	3.7	4.7	6.0	7.5	9.4
Employee expense	2.2	2.8	3.5	4.4	5.7
Overhead expense	1.2	1.6	2.0	2.5	2.9
Other operating expense	0.3	0.4	0.5	0.6	0.8
Operating profit	**3.2**	**4.6**	**5.9**	**6.5**	**6.7**
Provision for bad debts	0.1	1.9	1.2	1.4	1.6
Other provision	0.5	0.0	0.0	0.0	0.0
PBT (reported)	**2.7**	**2.7**	**4.7**	**5.1**	**5.2**
Total taxes	0.9	0.9	1.5	1.7	1.7
PAT (reported)	**1.7**	**1.8**	**3.1**	**3.4**	**3.5**
Add: Share of earnings of associate	0	0	0	0	0
Less: Minority interest	0	0	0	0	0
Prior period items	0.0	0	0	0	0
Net income (reported)	1.7	1.8	3.1	3.4	3.5
Avendus net income	**1.7**	**1.8**	**3.1**	**3.4**	**3.5**
Dividend + Distribution tax	6.0	7.7	9.7	12.4	0.0
Shares outstanding (INRmn)	64.5	72.0	72.0	72.0	72.0
Avendus diluted shares (INRmn)	106.3	72.0	72.0	72.0	72.0
Avendus EPS (INR)	**16.4**	**25.5**	**43.6**	**47.5**	**48.2**

Growth ratios (%)

Loans	107.2	51.8	41.6	-10.1	33.3
Total assets	30.2	28.8	33.2	-10.6	30.3
Net interest income	87.9	43.4	28.4	19.0	15.7
Fee income	24.5	-15.6	45.6	11.3	10.4
Employee expense	57.2	27.6	25.8	27.7	27.9
Provision for bad debt	756.6	3068.9	-38.3	18.0	14.2
Avendus net income	116.8	5.6	70.9	8.9	1.4
Avendus EPS	61.0	-5.3	70.9	8.9	1.4

Operating ratios (%)

Net interest income/operating income	85.3	90.1	90.9	91.8	92.2
Operating profit margin	46.4	49.5	49.2	46.2	41.8
Net profit margin	25.3	19.7	26.4	24.4	21.5
Fee income/operating income	5.1	3.2	3.6	3.4	3.3
Effective tax rate	32.9	33.0	33.0	33.0	33.0

Balance sheet (INRbn)

Fiscal year ending	03/10f	03/11f	03/12f	03/13f	03/14f
Equity capital	0.7	0.7	0.7	0.7	0.7
Reserves and surplus	8.9	18.0	21.1	24.5	27.5
Net worth	9.6	18.7	21.8	25.3	28.2
Total borrowings	26.9	28.2	40.7	30.6	44.5
Deferred tax liability	-0.1	0.0	0.0	0.0	0.0
Total liabilities	**36.4**	**46.9**	**62.5**	**55.9**	**72.8**
Current Assets	10.8	4.0	2.6	4.2	4.4
Less: Current Liabilities	4.0	1.9	3.6	5.4	7.6
Investments	0.0	0.0	0.0	0.0	0.0
Advances	29.4	44.6	63.1	56.7	75.6
Fixed assets	0.2	0.3	0.3	0.4	0.4
Other assets	0.1	0.0	0.0	0.0	0.0
Total assets	**36.4**	**46.9**	**62.5**	**55.9**	**72.8**

Decomposition of RoA (%)

Fiscal year ending	03/10f	03/11f	03/12f	03/13f	03/14f
Net interest income	13.2	16.2	17.0	16.7	16.7
Fee income	0.8	0.6	0.7	0.6	0.6
Other income	1.5	1.2	1.0	0.9	0.8
Operating revenue	15.5	18.0	18.7	18.2	18.1
Operating expenses	8.0	8.7	9.1	9.3	10.0
Operating profit	7.5	9.3	9.6	8.9	8.1
Loan loss provisions	1.2	3.6	1.8	1.8	1.8
Depreciation	0.3	0.3	0.4	0.5	0.5
Other provisions	-	-	-	-	-
Tax	2.1	1.7	2.4	2.2	1.9
Net profit	3.9	3.5	4.9	4.4	3.9
RoA	3.9	3.5	4.9	4.4	3.9
Assets / Equity	5.5	3.7	3.1	3.3	3.3
RoE	21.6	13.0	15.5	14.5	13.0

Key Ratios

Fiscal year ending	03/10f	03/11f	03/12f	03/13f	03/14f
Valuation ratios (x)					
P/E (on Avendus EPS)	20.1	21.3	12.4	11.4	11.3
P/B	3.7	2.1	1.8	1.5	1.4
P/Adjusted BV	3.7	2.1	1.8	1.6	1.4
Dividend yield (%)	-	-	-	-	1.2
Per share data					
Basic Reported EPS (INR)	34.0	26.9	43.6	47.5	48.2
Diluted Reported EPS (INR)	14.4	20.6	43.6	47.5	48.2
Reported Book Value (BV)	148.5	260.0	303.6	351.1	392.5
Adjusted Book Value (ABV)	147.7	259.7	302.4	346.7	385.0
Dividend per share (INR)	-	-	-	-	6.8
Business Ratios (%)					
Loan / Borrowings	109.0	157.9	155.2	185.4	169.8
Shares/ Investment	100.0	100.0	100.0	100.0	100.0
Debenture (credit like investments) / Investment	-	-	-	-	-
Return / Profitability Ratios (%)					
Yield on advances	25.3	24.5	23.9	22.3	21.6
Yield on investments	11.2	11.5	12.2	12.5	12.7
Cost of deposits	14.1	13.1	11.7	9.8	8.9
Net interest margin	27.0	22.8	20.1	21.5	22.5
Fee income/ Op revenue	3.7	2.4	2.7	2.6	2.5
Op expense/ Op revenue	37.1	36.3	35.9	38.9	42.7
RoA	3.9	3.5	4.9	4.4	3.9
RoE	21.6	13.0	15.5	14.5	13.0
Capitalization Ratios (%)					
Equity / Assets	23.5	38.3	33.1	41.3	35.1
Loans / Assets	72.4	91.3	95.5	92.6	94.0
Investments / Assets	0.0	0.0	0.0	0.0	0.0
Dividend payout	-	-	-	-	14.0
Internal capital growth	26.6	19.3	16.8	15.6	11.8
Capital adequacy	29.8	44.1	35.4	44.2	37.0
Asset Quality					
Gross NPL ratio	0.3	0.3	0.6	0.9	1.8
Net NPL ratio	0.2	0.2	0.0	0.1	0.6
Net NPL / networth	0.4	0.5	0.1	0.4	1.3
Loan-loss reserve / Gross NPL	14.5	62.1	741.6	215.4	136.0
Loan provisions / NII	0.2	1.0	22.4	10.8	10.7
Loan provisions / Total loans	0.0	0.2	4.2	1.8	2.4
Productivity / Efficiency ratios					
Assets per employee (INRmn)	2	2	2	2	2
Operating revenue / employee (INRmn)	0.5	0.5	0.6	0.6	0.7
Operating expense / employee (INRmn)	0.2	0.2	0.2	0.2	0.3
Net profit per employee (INRmn)	0.1	0.1	0.1	0.1	0.1

Analyst Certification

I, Jaynee Shah, MBA, research analyst and author of this report, hereby certify that all of the views expressed in this document accurately reflect our personal views about the subject company/companies and its or their securities. We further certify that no part of our compensation was, is or will be, directly or indirectly related to specific recommendations or views expressed in this document.

Disclaimer

Disclosure of Interest Statement (as of April 11, 2011)

	Analyst ownership of the stock	Avendus or its associate company's ownership of the stock	Investment Banking mandate with associate companies of Avendus
SKS Microfinance	No	No	No
Shriram Transport Finance	No	No	No
Manappuram General Finance	No	No	No
Mahindra & Mahindra Finance	No	No	No
Spandana Sphoorty Financial	No	No	No
Basix	No	No	No
Bandhan Microfinance India	No	No	No
Share Microfinance	No	No	No
Asmitha Microfinance	No	No	No
Grameen Kota	No	No	No
Biswa Microfinance	No	No	No
BSS Microfinance	No	No	No
Arohan	No	No	No
Equitas	No	No	No
Ujjivan	No	No	No

OUR OFFICES

Corporate office	Institutional Broking	Bangalore
IL&FS Financial Centre,	IL&FS Financial Centre,	The Millenia , Tower A,
B Quadrant, 5th Floor,	B Quadrant, 6th Floor,	# 1&2, 10th Floor, Murphy Road,
Bandra-Kurla Complex	Bandra-Kurla Complex	Ulsoor, Bangalore-8. India.
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