

SKS Microfinance

Malegam committee report: Some ray of hope, but with stringent conditions; maintain Underweight

- **Much awaited report:** The Malegam committee has submitted its proposal for the MFI sector. The recommendations do provide a ray of hope for the MFIs but impose stringent conditions and caps on operations and profitability of MFIs.
- **Bad news – Stringent conditions:** The committee has proposed (1) interest rate caps (24%) and/or margin caps (10% for large MFIs), (2) linking the repayment period to the loan amount, (3) capping loan values at Rs25,000 and putting the onus of market behavior on MFIs. It noted that MFIs were enjoying supernormal returns and the proposed margin cap leaves a lot of work to be done by MFIs in rationalizing costs.
- **Good news:** The report (1) does not mention collection periodicity but does suggest the repayment tenure should vary with loan size and mentions the need for a moratorium period, (2) recommends the AP Act be repealed, and (3) recommends the continuation of priority sector benefits to the MFI sector.
- **Recommendations only; RBI to make the final call:** We believe the RBI will likely the recommendations, but that the Andhra Pradesh government is unlikely to back down even if RBI accepts the recommendations. However, this report does reduce the risk of other states replicating AP-like policies. We believe these recommendations themselves will depress ROEs to upper-teen levels given the margin caps suggested. Also near-term asset quality risks remain high with a significant impact expected from the AP book.
- **Maintain Underweight:** These recommendations do provide a ray of hope, but SKS still looks expensive at 2.5x FY12E book. We believe things will get worse before they get better, with significant cost rationalization required to generate 16-17% ROEs given the margin cap. We maintain our Underweight rating and Dec-11 PT of Rs550.

Reuters: SKSM.BO; Bloomberg: SKSM IN

Rs in millions, year-end March

	FY09	FY10	FY11E	FY12E	FY13E		
Operating Profit	1,375	3,194	4,767	5,238	5,807	52 week(Rs)	1491-551
Net Profit	797	1,739	2,020	1,108	2,759	Market Cap (Rs mn)	48863
EPS (Rs/shr)	16.6	27.0	28.0	15.2	37.5	Market Cap (\$ mn)	1,086
BPS (Rs/shr)	136.7	147.3	261.9	272.6	301.6	Shares o/s	73
Operating profit growth (%)	314.7%	132.4%	49.2%	9.9%	10.9%	Date of Price	19-Jan-11
Net Profit growth (%)	380.6%	118.3%	16.1%	-45.1%	149.0%	Avg. Daily Value (Rs mn)	1149.2
ROE	18.4%	21.7%	14.2%	5.7%	13.1%	Avg. Daily Value (\$ mn)	25.54
P/E	40.3	24.9	23.9	44.1	17.9	Avg. Daily Vol (mn)	1.3
P/B	4.90	4.55	2.56	2.46	2.22	NIFTY	5863

Source: Company, Bloomberg, J.P. Morgan estimates.

Underweight

SKSM.BO, SKSM IN

Price: Rs669.70

Price Target: Rs550.00

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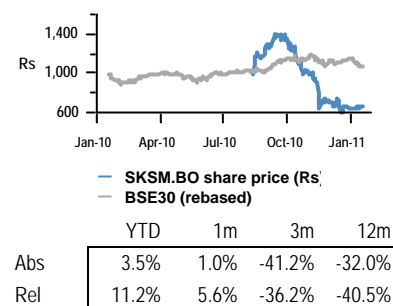
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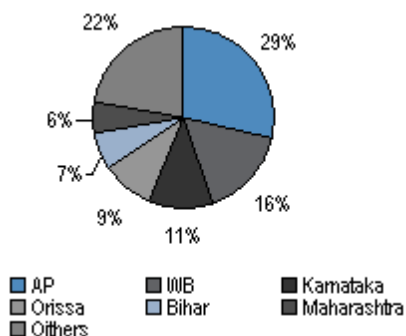
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Company Description

SKS Microfinance is the largest MFI in the country with a loan book of ~US\$1.0B and a market share of ~23%. Started as an NGO in 1997, the company was incorporated in 2003 and was converted into a non-deposit-taking NBFC in 2005. Loan book for SKS has grown by ~15x over the last 4 years and management expectd loan book to grow 4x by FY14.

Geographical mix



Source: Company

EPS: J.P. Morgan vs consensus

	J. P. Morgan	Consensus
FY11E	28.0	38.9
FY12E	15.2	59.0
FY13E	37.5	

Source: Bloomberg, J.P. Morgan.

P&L sensitivity metrics

	PPOP impact (%)	EPS impact (%)
NIMs		
Impact of each 100bps	8.3%	10.0%
Cost to Income		
Impact of each 200bps	4.2%	5.0%
Provisions/Assets		
Impact of each 50bps	0.0%	5.0%

Source: J.P. Morgan estimates

Price target and valuation analysis

Our Dec-11 price target of Rs550 is based on 2.0x Mar-12E book. We believe valuations are expensive for a business model which would face scalability issues and we see significant risks to funding for MFIs.

Mar-12 Book	275
Multiple	2.0
Fair Value	550
Dec-11 PT	550

FY13 ROE (on AUM)

NIM/Assets	15.1%
Non- interest income/assets	2.7%
Revenues/Assets	17.8%
Costs/Assets	9.9%
Provisions/Assets	2.3%
Taxes/Assets	1.9%
ROA	3.8%
ROE	13.1%

Source: J.P. Morgan estimates.

Key risks to our Underweight recommendation and price target include: 1) bank support for the MFI sector; 2) lower-than-expected slippages from the AP book.

Criteria to be complied with to be classified as an NBFC – MFI

- Not less than 90% of its total assets are in Micro-credit
- The loan is given to a borrower who is a member of a household whose annual income does not exceed Rs50,000
- The amount of the loan does not exceed Rs25,000 and the total outstanding indebtedness of the borrower including this loan also does not exceed Rs25,000
- The tenure of the loan is not less than 12 months where the loan amount does not exceed Rs15,000 and 24 months in other cases with a right to the borrower of prepayment without penalty in all cases
- The loan is without collateral
- The aggregate amount of loans given for income generation purposes is not less than 75% of the total loans given by the MFIs
- The loan is repayable by weekly, fortnightly or monthly installments at the choice of the borrower

It was recommended that any NBFC that does not satisfy these conditions should not be allowed to have more than 10% of assets in Microfinance assets.

Restrictions recommended for NBFC- MFIs on Interest rates/margins

The following are some caps on interest rates and margins proposed by the committee report:

- Average “margin cap” of 10% for MFIs having a loan portfolio of Rs1.0B and of 12% for smaller MFIs –*For the last 2-3 years, spreads for SKS have been ~12-17%.*
- A cap of 24% for interest on individual loans – *They have recently reduced interest rates in most states to ~25% from 28-30% earlier.*
- Levy only three charges: (a) processing fee; (b) interest; and (c) insurance charge.
- Not more than two MFIs can lend to a single borrower.

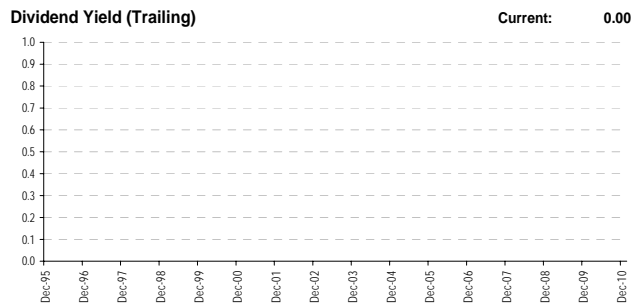
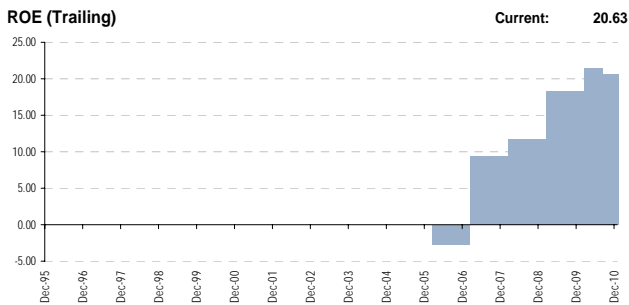
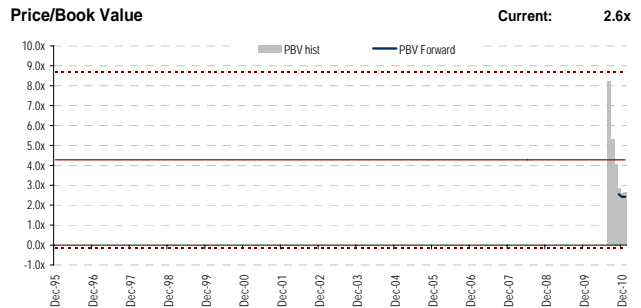
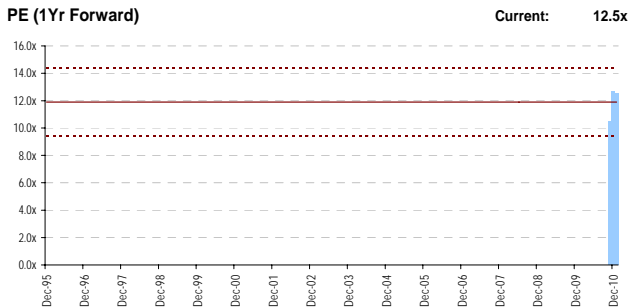
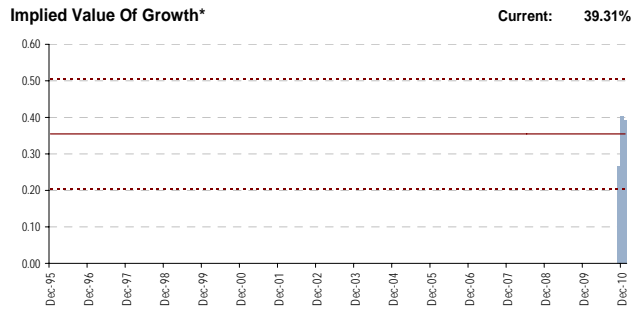
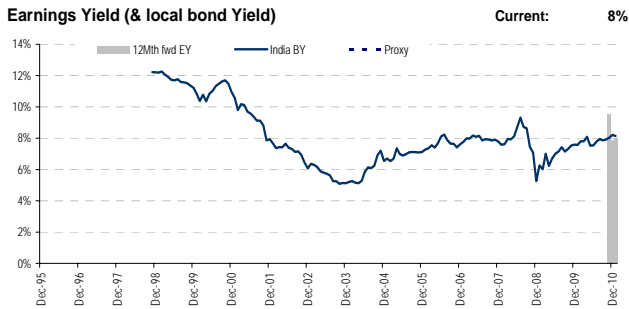
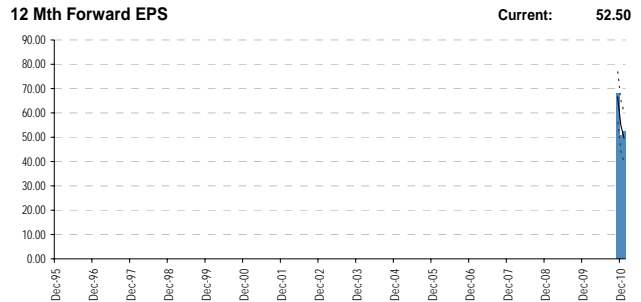
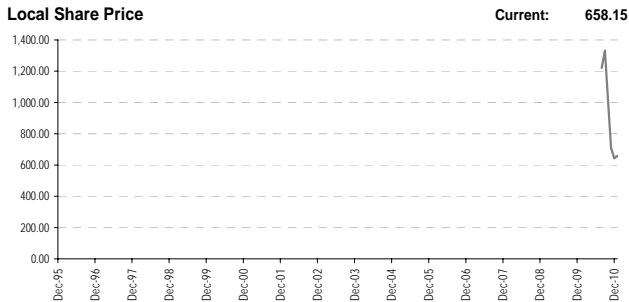
Figure 1: Malegam committee report: Suggested cost structure for an MFI

	<u>% of Loan Portfolio</u>
(a) Staff Costs (say)	5.00
(b) Overheads (other than staff costs) say	3.00
(c) Provision for loan losses, say	<u>1.00</u>
Sub-total	9.00
(d) Return on Equity (say):	
15% post tax i.e. 22.6107% pre-tax on	<u>3.39</u>
15% of Loan Portfolio	
Total internal cost	12.39
(e) Cost of Funds (say)	
12% on borrowings i.e. 85% of 12% on	<u>10.20</u>
Loan Portfolio	
Total of internal and external costs	<u>22.59</u>
Rounded off to	<u>22.00</u>

Source: RBI

JPM Q-Profile
SKS Microfinance Ltd. (INDIA / Financials)
 As Of: 14-Jan-2011

Global Equity Quantitative Analysis
 Quant_Strategy@jpmorgan.com



Summary

SKS Microfinance Ltd.		SEDOL		B4TL227				As Of: 14-Jan-11			
INDIA								Local Price: 658.15			
Financials								EPS: 52.50			
	Latest	Min	Max	Median	Average	2 S.D.+	2 S.D. -	% to Min	% to Max	% to Med	% to Avg
12mth Forward PE	12.54x	10.47	12.67	12.54	11.89	14.36	9.43	-16%	1%	0%	-5%
P/BV (Trailing)	2.63x	2.57	8.23	3.46	4.28	8.70	-0.15	-2%	213%	32%	63%
Dividend Yield (Trailing)	0.00	0.00	0.00	0.00	0.00	0.00	0.00				
ROE (Trailing)	20.63	-2.76	21.44	11.75	11.38	28.11	-5.35	-113%	4%	-43%	-45%
Implied Value of Growth	39.3%	0.27	0.40	0.39	0.35	0.51	0.20	-32%	2%	0%	-10%

Source: Bloomberg, Reuters Global Fundamentals, IBES CONSENSUS, J.P. Morgan Calcs

* Implied Value Of Growth = (1 - EY/Cost of equity) where cost of equity = Bond Yield + 5.0% (ERP)

SKS Microfinance: Summary of financials

Rs in millions, year-end March

Income Statement	FY09	FY10	FY11E	FY12E	FY13E	Growth and Ratios	FY09	FY10	FY11E	FY12E	FY13E
Income Statement											
Net Interest Income	3,164	5,871	8,989	10,130	11,110	Credit growth	80.9%	107.3%	57.2%	28.7%	37.7%
Fees	642	1,011	1,180	1,478	1,968	NII growth	224.6%	85.6%	53.1%	12.7%	9.7%
Net revenues	3,806	6,882	10,169	11,609	13,078	Fees growth	215.1%	57.6%	16.7%	25.3%	33.1%
Operating Expense	2,431	3,688	5,402	6,371	7,271	OP growth	314.7%	132.4%	49.2%	9.9%	10.9%
Operating profit	1,375	3,194	4,767	5,238	5,807	PPP growth	314.7%	132.4%	49.2%	9.9%	10.9%
Investment profits	0.00	0.00	0.00	0.00	0.00	Opex growth	187.1%	51.7%	46.5%	17.9%	14.1%
Preprovision profit	1,375	3,194	4,767	5,238	5,807	PAT growth	380.6%	118.3%	16.1%	-45.1%	149.0%
Provisions	134	517	1,725	3,570	1,652	Loan /Assets	60.7%	80.2%	90.4%	91.2%	92.4%
PBT	1,241	2,677	3,042	1,668	4,155	Cost to income	63.9%	53.6%	53.1%	54.9%	55.6%
Taxes	444	938	1,022	561	1,396	Provisions/PPOP	9.8%	16.2%	36.2%	68.2%	28.4%
PAT	797	1,739	2,020	1,108	2,759	Tax rate	35.8%	35.0%	33.6%	33.6%	33.6%
Balance sheet											
Liabilities						Asset Quality/Capital					
Net worth	6,548	9,503	18,859	19,883	22,204	Gross NPAs	48	96	1100	1408	1905
Borrowings	21,366	26,947	28,638	40,516	59,761	Net NPAs	25	48	495	563	762
Other liabilities	2,384	4,025	5,080	5,909	7,650	Gross NPAs (%)	0.2%	0.2%	2.0%	2.2%	2.3%
Total Liabilities	30,297	40,475	52,576	66,308	89,615	Net NPAs (%)	0.1%	0.1%	0.9%	0.9%	0.9%
Assets						LLP/Loans (%)	0.76%	1.51%	3.50%	6.00%	2.25%
Loans	14,349	29,747	46,755	60,152	82,836	Tier-1 CAR	38.5%	28.6%	37.1%	30.7%	25.1%
Cash/equiv	15,470	9,735	4,571	4,664	4,879	Tier-2 CAR	0.6%	0.0%	0.0%	0.0%	0.0%
Other Assets	569	991	1,248	1,490	1,898	Total CAR	39.0%	28.6%	37.1%	30.7%	25.1%
Total Assets	30,389	40,475	52,576	66,308	89,615	RWA	15388	31131	47580	60536	82836
AUM and Operations						Dupont (based on AUMs)					
On balance sheet	14,349	29,747	46,755	60,152	82,836	NII /Assets	17.9%	17.2%	18.2%	17.0%	15.1%
Off Balance sheet	10,389	13,840	8,251	3,839	0	Other income/Assets	3.6%	3.0%	2.4%	2.5%	2.7%
Total AUM	24,738	43,587	55,006	63,991	82,836	Total Revenues	21.5%	20.1%	20.6%	19.5%	17.8%
Growth (%)	132.7%	76.2%	26.2%	16.3%	29.4%	Employee/Assets	7.7%	6.3%	7.1%	7.0%	6.5%
Securitized (%)	42.0%	31.8%	15.0%	6.0%	0.0%	Other expenses /Assets	6.1%	4.5%	3.9%	3.7%	3.4%
Total Assets	30,389	40,475	52,576	66,308	89,615	Expenses/Assets	13.7%	10.8%	11.0%	10.7%	9.9%
Growth (%)	179.1%	33.2%	29.9%	26.1%	35.1%	PPOPI/Assets	7.8%	9.4%	9.7%	8.8%	7.9%
Members (mn)	4.0	6.8	8.2	9.4	10.6	Provisions/Assets	0.8%	1.5%	3.5%	6.0%	2.3%
Growth (%)	110.4%	71.5%	21.1%	14.6%	12.9%	PBT/Assets	7.0%	7.8%	6.2%	2.8%	5.7%
						ROA	4.5%	5.1%	4.1%	1.9%	3.8%
						ROE	18.4%	21.7%	14.2%	5.7%	13.1%

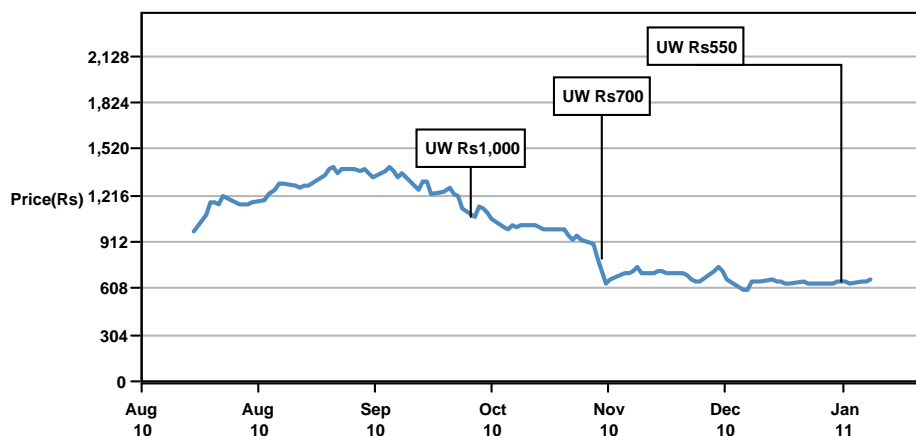
Source: Company, J.P. Morgan estimates.

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SKS Microfinance (SKSM.BO) Price Chart



Date	Rating	Share Price (Rs)	Price Target (Rs)
17-Oct-10	UW	1082.25	1000.00
17-Nov-10	UW	797.50	700.00
12-Jan-11	UW	652.80	550.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Initiated coverage Oct 17, 2010. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period. J.P. Morgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

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