

M&M Financial Services

Rs233
OUTPERFORMER

RESULT NOTE

Mkt Cap: Rs20bn; US\$479m

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Result: Q4FY07

Comment: Result in line: Maintaining Outperformer

Last report: 26 October 2006 (Price Rs244; Recommendation: Outperformer)

Key valuation metrics

Year to 31 March	2005	2006	2007	2008	2009
Net profit (Rs mn)	840	1,091	1,329	1,675	2,092
yoy growth (%)	29.1	29.9	21.8	26.0	24.9
Shares in issue (mn)	70.2	84.1	85.3	85.3	85.3
EPS (Rs)	13.7	15.3	15.6	19.6	24.5
EPS growth (%)	27.4	11.9	1.8	26.0	24.9
PE (x)	17.0	15.2	14.9	11.8	9.5
Book value (Rs/share)	50.9	81.2	91.2	106.8	126.8
P / BV (x)	4.6	2.9	2.5	2.2	1.8
Adj. Book value (Rs/share)	45.1	75.6	85.9	102.4	123.6
P/ Adj. Book (x)	5.1	3.1	2.7	2.3	1.9
ROAE (%)	26.9	20.0	18.1	19.8	21.0

M&M Finance has reported net profit of Rs577m (26% yoy growth), which is ahead of our estimates of Rs549m. The underlying business momentum remains strong with 30% yoy growth in outstanding loan book and 28% yoy growth in NII. Margins appear to have stabilized on the back of increase in lending rates affected by the company in response to increasing cost of funds. Going forward, we expect moderate pressure on margins in a prevailing hardening interest rate scenario. However, we remain convinced about M&M Finance's ability to emerge as preferred financial solutions provider in rural India and maintain our earning estimates for FY08 and FY09. We expect 25% CAGR in profit growth over FY07-09E and average RoE of ~19% over the same period. Stock is currently trading at attractive valuations of 2.3x FY08E and 1.9x FY09E adjusted book with PE of 11.8x FY08E and 9.5x FY09E. We maintain Outperformer with 12-month price target of Rs320.

KEY ISSUES

□ Strong loan growth momentum driving NII growth

M&M Finance has reported Rs1.66 bn NII (28% yoy growth) against our expectation of Rs1.54bn for Q4FY07. Its outstanding loan assets have grown by 30% yoy to Rs58.6bn as on Mar-07. Apart from financing M&M vehicles, company has tied up with Maruti Udyog and is one of the preferred financiers for Maruti cars in the rural India. The car finance business is gathering momentum and company is already financing about 3,500 cars per month. On an average the company is financing 15,000 new vehicles per month now, which is almost 20% higher than a year ago.

Operational details

For the quarter ended	Mar-06	Dec-06	Mar-07
Incremental Contracts	37,677	52,715	45,801
Average monthly incremental contracts	12,559	17,572	15,267
Yoy growth in average monthly contracts	N.A.	39.91	21.56
Value of assets financed (Rs m)	13,260	16,196	14,750

Source: company

❑ Diversifying into other retail asset categories with focus on rural India

In line with its well thought out strategy of becoming preferred financier in rural India, M&M Finance is spreading out into other retail asset financing areas such as 2-wheelers, commercial vehicles, personal loans and mortgages. Its 2-wheeler foray has already begun with pilot projects in the states of Gujarat and Maharashtra, while housing finance is proposed to be done through a 100% subsidiary. For personal loans, company initially plans to leverage its existing customer base of more than 600,000 customers. As the credit profile of these customers is well known to the company, risks associated with its personal loan portfolio are likely to be controlled, while yields would be better as these are unsecured loans.

❑ Fee based revenue streams picking up

M&M Finance has already begun its mutual funds distribution on a pilot basis, while insurance distribution (through its 100% subsidiary Mahindra Insurance Brokers Ltd) is gathering momentum. Incrementally, MIBL adds about 10,000 customers every month, which is almost 70% of new loan contracts done by parent M&M Finance every month.

Performance indicators of insurance broking subsidiary

For the year ended (Rs m)	Mar-06	Mar-07	YoY growth (%)
Premium generated	423	844	100
Total Income	64	119	86
PBT	45	60	33

Source: company

❑ Margins have stabilized , however expected to see some pressure in the medium term

Although loan spreads and overall margins are marginally lower on yoy basis, sequentially margins have improved as the increase in loan rates is being passed on to borrowers. The company has informal policy of absorbing upto 50 bps increase in cost of funds and if costs go up beyond 50 bps, it passes on the same in form of higher lending rates. Going forward we expect some pressure on margins as a fallout of hardening interest rate scenario. During the quarter, company also booked securitization gains of Rs290m (compared to Rs238m in Q4FY06). M&M Finance uses securitization route to access funds at competitive rates and its portfolio of tractor loans in rural India come handy for private / foreign banks, which are in need of meeting their regulatory priority sector lending requirements. The company is clear that it would continue to look at securitization as a strategic tool for meeting its funding requirements. The company has used bilateral assignment route for securitization, whereby it can technically book profits even under revised RBI guidelines on securitization.

For the quarter ended (%)	Mar-06	Dec-06	Mar-07
Yield on loans	16.4	15.1	16.1
Cost of funds	7.0	7.6	8.0
Spreads	9.4	6.7	7.7
NIM	11.1	8.9	10.9
NIM net of securitization gains	9.1	8.4	9.0

Source: SSKI research & company, Reported gross spreads are on cumulative basis

❑ Operating expenses growth in line with expectation

Operating expenses of M&M Finance in the quarter has gone up by almost 29% yoy because of continued network expansion undertaken by the company. It has added almost 101 branches (25% of network) in FY07 and its network now stands at 401 branches as on Mar 07. The company has also recruited about 500 new employees during FY07 taking total headcount to 2,791. Additionally, it has also incurred additional expenses in the form of hiring outsourced recovery agencies for its 2-wheeler business.

The company has indicated that traditionally it adds up about 50 to 60 branches every year. With its entry in 2-wheeler and personal loan businesses, the company would also want to remain closer to its customer clusters as these businesses involve recovery of lower ticket loans from customers and by their nature require closer interactions with customers.

❑ Asset quality in line with the past trend

M&M Finance's asset quality is in line with its track record with gross NPAs of 5.5% and net NPAs of 2.5% as on Mar-07 (from 4.9% and 2.5% respectively as on Mar-06). The company follows prudent provisioning practices with accelerated (than required by RBI) provisioning norms. Its provisioning expense at 2.2% of average assets for the quarter is in line with our estimates. Typically, the provisioning expenses of the company are higher in first half of the fiscal while second half of fiscal witnesses recoveries in line with better cash flow in the hands of its customers in rural India.

❑ Maintain earning estimates and outperformer

We continue to remain convinced about M&M Finance's ability to emerge as diversified financial services provider in rural India and believe that the company has the right business model in place to tap into growing rural opportunity. We expect 25% CAGR in profit growth over FY07-09E and average RoE of ~19% over the same period. Stock is currently trading at attractive valuations of 2.3x FY08E and 1.9x FY09E adjusted book with PE of 11.8x FY08E and 9.5x FY09E. We maintain Outperformer with 12-month price target of Rs320.

Quarterly results

(Rs m)	Q4FY06	FY06	Q1FY07	Q2FY07	FY07E	FY08E	FY09E
Interest income	1,958	5,930	1,595	1,938	8,291	10,936	14,216
of which income from securitization	237	489	-	166	538	389	408
Net interest income	1,301	3,794	919	1,187	5,050	6,342	7,852
yoy growth (%)	52.8	38.9	42.2	28.9	33.1	25.6	23.8
Other income	7	49	56	28	155	271	380
Operating expenses	443	1,382	415	456	1,955	2,434	3,015
yoy growth (%)	N.A.	59.1	107	52	41.5	24.5	23.9
Operating profit	865	2,462	559	758	3,250	4,179	5,217
yoy growth (%)	N.A.	28.5	15.8	17.6	32.0	28.6	24.8
Provisions and write-offs	182	816	292	271	1,223	1,622	2,022
Profit before tax	683	1,646	267	487	2,028	2,557	3,194
yoy growth (%)	N.A.	21.4	2.8	13.4	23.2	26.1	24.9
Profit after tax	457	1,091	192	303	1,329	1,675	2,092
yoy growth (%)	N.A.	29.9	13.2	8.4	21.8	26.0	24.9
Ratios (%)							
Spread on loans	9.4	8.9	6.7	6.8	8.4	8.4	8.4
Net interest margin (NIM)	11.1	9.3	7.3	9.0	8.9	8.8	8.5
NIM net of securitization gains	9.1	8.1	7.3	7.7	8.0	8.3	8.1
Other income / avg assets	0.1	0.1	0.4	0.2	0.3	0.4	0.4
Employee expenses / avg assets	1.1	1.0	1.3	1.2	1.1	1.2	1.2
Other operating expenses/avg assets	2.6	2.3	1.9	2.2	2.2	2.1	2.0
Total operating exp / avg assets	3.8	3.4	3.3	3.4	3.5	3.4	3.3
Cost-Income ratio	33.8	35.9	42.6	37.6	37.6	36.8	36.6
Provisions / avg assets	1.6	2.0	2.3	2.0	2.2	2.3	2.2
PBT/Avg assets	5.8	4.0	2.1	3.7	3.6	3.5	3.5
Tax/PBT	33.1	33.7	27.9	37.8	34.5	34.5	34.5
PAT/avg assets	3.9	2.7	1.5	2.3	2.4	2.3	2.3

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1. Outperformer: More than 10% to Index
2. Neutral: Within 0-10% to Index
3. Underperformer: Less than 10% to Index

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