

M&M Financial Services**Rs258
OUTPERFORMER**

RESULT NOTE

Mkt Cap: Rs21.7bn; US\$484m

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Result: Q4FY06

Comment: Robust performance, upgrading estimates and price target

Last report: 10 April 2006 (Price Rs237; Recommendation: Outperformer)

Key valuation metrics

Year to 31 March	2004	2005	2006	2007E	2008E
Net profit (Rs m)	650.9	840.0	1,091.3	1,342.8	1,668.1
yoy growth (%)	47.3	29.1	29.9	23.0	24.2
Shares in issue (m)	60.6	70.2	84.1	86.0	86.0
Wt. Avg Shares (m)	60.6	61.4	71.3	86.0	86.0
EPS (Rs)	10.7	12.0	13.0	15.6	19.4
EPS growth (%)	47.3	11.5	8.4	20.3	24.2
PE (x)	24.0	21.6	19.9	16.5	13.3
Market price	258.1	258.1	258.1	258.1	258.1
Networth	2,517.4	3,573.4	6,827.8	7,880.0	9,204.1
Book value (Rs/share)	41.5	50.9	81.2	91.6	107.0
PBV (x)	6.2	5.1	3.2	2.8	2.4
Adjusted RoE (%)	28.5	26.9	20.0	18.1	19.5

M&M Finance has reported Rs1.09bn consolidated net profit for FY06, which is 6.6% higher than our estimates of Rs1.02n. As the company recently got listed, detailed yoy comparison is not possible for Q4FY06. The company has been able to maintain its healthy loan spreads of about 9.0% along with strong momentum in loan growth. Its plans of becoming a diversified financial services provider in rural India are on track with businesses such as 2-wheeler financing, insurance and mutual fund distribution likely to gather traction during FY07. We have upgraded our EPS estimates for FY07 and FY08 by 9.5% and 9.4% to Rs15.6 and Rs19.4 and expect 25.7% CAGR in net profit over FY05-08 with RoE improving to 19.5% by FY08. The stock is presently trading at 2.4 x FY08 book and 13.3 x FY08 EPS. Upgrade 12-month price target to Rs320 (3.0 x FY08E book and 16.5 x FY08 EPS) from Rs300 on the back of upward revision in earning estimates. Reiterate Outperformer.

KEY ISSUES

□ **NII growth better than estimates...**

M&M Finance has reported 53% yoy growth in NII for Q4FY06, which is significantly better than our expectations of 30% yoy growth. During the quarter, the company securitized assets worth Rs3.17bn (mainly tractor portfolio) and with typically strong year end appetite for priority sector assets in the month of Mar-06, it was able to securitize this portfolio at highly attractive rates. As a result, it was able to book securitization income of Rs237m for the quarter, which boosted NII growth. As the company has securitized its assets through direct assignment route – rather than going by PTC route – it has been able to book entire gains upfront. However, even if one looks at NII net of securitization gains, NII growth for Q4FY06 is at 37.6%, which is quite impressive. For FY06, NII has grown at 39% yoy (30.2% yoy net of securitization gains).

□ ...on the back of strong momentum in loan book

Disbursements of M&M Finance have grown at 33.8% yoy to Rs44.74bn for the FY06, while outstanding loan book has grown by impressive 56.7% yoy to Rs41.24bn. During FY06, the company securitized receivables worth Rs5.56bn. The growth has come from both M&M vehicles as well as non-M&M portfolio. Approximately 70% of the outstanding loan book comprises of M&M vehicles while the remaining 30% of loan book is on non-M&M portfolio. With outlook on rural economy remaining buoyant, the loan book growth is likely to remain robust going forward too.

□ Diversifying into other areas of financing as per the original plan

M&M Finance has always maintained that it would like to provide the full spectrum of retail finance products to its customers in rural / semi-urban areas. To this extent, the company has plans of entering into other loan products such as 2-wheeler finance, personal loans and mortgages. It has already soft launched the 2-wheeler financing business and this business is likely to gather momentum over Q2 / Q3 of FY07. The company is in the process of setting up a housing finance subsidiary for entering into mortgage financing business.

On the fee based side, it is going ahead with its strategy of distribution of insurance and mutual fund products. Insurance distribution (through wholly owned subsidiary Mahindra Insurance Brokers) has generated income worth ~Rs38m for FY06. Presently it is offering its insurance products through about 30% of its branches and will increase the reach gradually after sufficient manpower gets trained on insurance sales. M&M Finance has recently got permission from RBI for mutual funds distribution and has tied up with a host of MFs for distributing in rural areas. As per the industry estimates, presently less than 10% of MF mobilization comes from rural areas and there is large untapped opportunity in MF distribution. M&M Finance would initially offer “low capital depreciation” MF products such as liquid / floater funds in order to cultivate habit of investing in MFs in rural areas.

□ Spread on loans likely to remain largely stable for FY07

Although spread on loans have come off over the past three years to about 9.0% for FY06, we expect that for the FY07 loan spreads would stabilize at around present levels as incrementally M&M Finance has also been increasing lending rates in order to pass on the increase in cost of funds. For FY08, we have built in decline in loan spreads by about 50 bps to 8.4% as we expect some compression on yields – mainly due to increasing competition from private sector banks in rural areas. However, even at 8.4%, loan spreads would be more than adequate to generate healthy RoA of about 2.2%

□ Provisioning high due to conservative internal policies

M&M Finance follows conservative provisioning policies whereby it provides for 100% of bad loans for loans remaining overdue for more than 24 months compared to RBI guidelines which require the company to provide only about 50% of bad loan amount even after 48 months of overdues. In line with its conservative policy, the provisions and write-off are about 2.0% of average assets in FY06. However, eventual write-offs for the company are much lower at 1.4% of average assets and have always remained in the range of 1.4-1.8%. Gross NPAs of 4.8% and net NPAs at 2.5% of assets are in line with the business it operates in and the kind of yields it is able to charge.

□ Upgrade earning estimates

Net profit of M&M Finance for FY06 at Rs1.09bn is almost 6.6% higher than our estimates of Rs1.02bn. We have upgraded our FY07 and FY08 EPS estimates by 9.5% and 9.4% respectively to Rs15.6 and Rs19.4 respectively to take into account following

- Continued momentum in loan growth leading to stronger NII growth
- Lesser than expected decline in loan spreads

□ Maintain Outperformer, upgrade estimates

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 its net profits to grow at 25.7% CAGR over FY05-08 with RoE improving to 19.5% by FY08. On the back of upward revision in earning estimates, we revise our 12-month price target to Rs320 from Rs300. The revised price target corresponds to 3.0 x FY08 book value and 16.5 x EPS. Reiterate Outperformer.

Quarterly results

(Rs m)	FY05	9MFY06	Q4FY06	FY06	FY07E	FY08E
Interest income	4,015	3,972	1,958	5,930	8,176	11,004
of which income from securitization	193	252	237	489	-	-
Net interest income	2,731	2,493	1,301	3,794	4,934	6,484
yoy growth (%)	33.1	32.6	52.8	38.9	30.0	31.4
Other income	53	43	7	49	89	137
yoy growth (%)	59.7	N.A.	N.A.	(6.1)	80.2	54.0
of which income from insurance broking	21	34	4	38	76	121
Operating expenses	868	939	443	1,382	1,793	2,365
yoy growth (%)	33.2	N.A.	N.A.	59.1	29.8	31.9
Operating profit	1,916	1,597	865	2,462	3,230	4,257
yoy growth (%)	33.7	N.A.	N.A.	28.5	31.2	31.8
Provisions and write-offs	560	634	182	816	1,164	1,670
Profit before tax	1,356	963	683	1,646	2,066	2,586
yoy growth (%)	33.1	N.A.	N.A.	21.4	25.5	25.2
Profit after tax	840	635	457	1,091	1,343	1,668
yoy growth (%)	29.1	N.A.	N.A.	29.9	23.0	24.2
Ratios (%)						
Spread on loans	11.0	9.0	9.8	9.0	8.9	8.4
Net interest margin	10.6	8.9	11.2	9.4	8.5	8.5
Other income / avg assets	0.2	0.2	0.1	0.1	0.2	0.2
Employee expenses / avg assets	1.1	1.0	1.1	1.0	1.0	1.0
Other operating expenses/avg assets	2.2	2.2	2.6	2.3	2.0	2.0
Cost-Income ratio	31.2	37.0	33.8	35.9	35.7	35.7
Provisions / avg assets	2.2	2.3	1.6	2.0	2.0	2.2
PBT/Avg assets	5.3	3.4	5.9	4.1	3.5	3.4
Tax/PBT	38.0	34.1	33.1	33.7	35.0	35.5
PAT/avg assets	3.3	2.3	3.9	2.7	2.3	2.2

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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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