INDIAN EQUITIES

ESPIRITO SANTO Securities

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Quick Insight | Banks and Financials | 07 February 2012

SKS Microfinance

Why are we positive?

After the Andhra crisis SKS stock has plunged more than 90% over 16 months, with most of the Andhra book written off. This crisis was driven by a loose regulatory environment which prompted the AP government to come out with onerous regulations. However, with the RBI's notification already out and central government in the process of finalising an MFI bill, we think further state specific regulation could be avoided. Also, with the majority of the Andhra book written off and the company trying to raise capital, we think that SKS could be one of the few microfinance companies able to grow its business in FY13. Hence, we retain our buy stance with a valuation of Rs.120.

Operating environment getting better

Despite a tumultuous period, during which SKS's share price fell 90% due to the Andhra debacle, we believe the microfinance industry still has its place in Indian finance and, with a more stable and less arbitrary regulatory backdrop, it can grow and in time flourish and we believe SKS will be one of the few survivors.

- **Regulatory clarity:** Loose regulation was one of the main reasons for the Andhra crisis, given that anyone with some capital could start a microfinance business that yielded very high returns. This led to some predatory practices and prompted the AP state government to come out with its own onerous act. With the RBI already notifying on NBFC MFI and central government in the process of coming out with the MFI bill, we see a far better regulatory environment for microfinance institutions now. In the past the RBI's notifications would have changed dynamics of the business, but non acceptance of these notifications led to stock falling. We think that the MFI Bill can settle this once and for all.
- **Operating environment getting better:** Over the last six months there has been some improvement in the operating environment for SKS, with a) negligible competition in the market; b) clarity on the Andhra portfolio with the majority of the loan book written off and c) a proposed capital raising of around Rs.500 crores to strengthen the balance sheet.
- **Positives from Andhra crisis:** Post the AP crisis SKS was able to significantly reduce its loan book in other states without any significant increase in credit costs, which strengthens our view on the microfinance model. This clearly provides evidence that the high credit quality was not due to the ever-greening/multiple lending, but due to the inherent strength of the microfinance model. Our view is further strengthened by research of Microsave, which highlights that 90% of customers still want to repay if they are given a new loan and a majority of the customers highlighted that non payment is due to unavailability of new loans, media reports and political pressure rather than their inability to repay loans.

Risks to the investment case

Whilst we'd suggest that negatives are priced in, investors need to be mindful of:

- **Delay in funding:** Stoppage of funding from banks was one of the major reasons behind the reduction in the loan book outside Andhra. There are indications based on bankers' statements that the funding may restart in future, and with a strengthened balance sheet post the capital raising, bank funding to SKS could substantially increase assuming a regulatory backdrop the banks are comfortable with. However, if there is a delay in bank funding then SKS will struggle to increase its loan book.
- **Delay in regulation:** Whilst RBI regulations significantly reduce the risk of a repeat of Andhra like regulations in other states, only a Central act would totally cement the RBI's position as the central regulator. Media reports suggest that the finance ministry has given a nod to the bill and it can be presented in the budget session. Delay in that could leave scope for populist moves by state governments.

Valuation

SKS is currently trading at 0.9X adjusted FY13E book value, our excess return on equity valuation model assuming total write-off of Andhra book and 16% cost of equity suggests a valuation of Rs.120 (our earlier valuation of Rs.544), 23% upside potential. However, the valuations are assuming no recovery from Andhra and company stopping business in Andhra: if we assume 30% recovery from Andhra and a slightly better funding from banks than our valuation can go up to Rs.271.

Accounting & corporate governance	Amber
Franchise Strength	Amber
Earnings Momentum	Amber

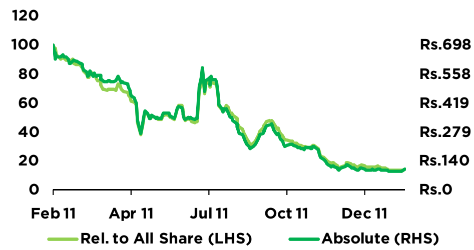
BUY 23% upside

Fair Value (Rs)	120
Bloomberg Code	SKSM IN
Share Price (Rs)	98
Market Cap (Rs bn / US$ m)	7.1 bn/$ 142mn
Free Float / FII holding	65%/15%
ADV ($m)	$ 2 mn

Rs m (unless stated) March YE	2011A	2012E	2013E	2014E
Total Income	9,216	2,903	4,141	6,235
Op. Costs	4,968	3,893	2,945	3,435
Op. Profit	4,248	(991)	1,195	2,800
Provisions	2,362	13,329	989	1,238
PBT	1,724	(14,481)	45	1,400
PAT	1,116	(14,481)	45	1,400
EPS (Rs)	16	-204	0	11

X (unless stated)	2011A	2012E	2013E	2014E
P/E	6.5	-	273	8.7
P/BV	0.4	2.2	1.5	1.2
P/BV Adj.	0.4	0.9	0.9	0.9
RoA (%)	2.9%	-51.5%	0.2%	4.5%
RoE (%)	8%	-137%	1%	15%
Implied P/BV Adj.	0.5	1.1	1.1	1.1

Figure 1 Historical share price performance



Source: Bloomberg

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Going through regulatory transition

SKS Microfinance has been one of the biggest value destroyers since its IPO and from being the darling of investors turned to one of the most hated stories on the street. Whilst there were the initial stock specific issues around the CEO change and questions on promoter dominance, the real deterioration was about the controversy emanating from the Andhra Government's regulations stopping MFIs' business and threatening the very existence of the business model. The model had previously been touted as one of the strongest models for inclusion of the poor within the financial systems. The stock has fallen c.90% since IPO. We had a negative pre-IPO view, but (rather prematurely) turned positive mistakenly assuming that the Andhra regulation was a significant roadblock, but that the microfinance model strong and the sector too important to persist as a populist punch bag. We accept that we underestimated the will of the Andhra State to regulate MFIs, refusing to accept the RBI recommendations on many occasions and even questioning the authority of the central government to regulate the MFI sector (see comments below).

Table 1 Comments by Andhra Pradesh Government officials after key events

Events	Comments by AP Govt. officials	Source
AP MFI Act comes into force	*"There are 450 applications in total, out of which 11 could not be accepted due to incomplete details. More or less, the industry is cooperating in adhering to the provisions of the recent ordinance,"*	Hindu Business Line, 8th November 2010
	"Considering that state governments have been regulating interest rates being charged by money lenders, there is no reason why the state governments should not be regulating the MFI lending rates."	Live Mint, 16th December, 2010
	"Monthly collection system would significantly reduce operational cost of MFIs" and "such benefits could be passed on to the poor."	
RBI releases Malegam committee report	*"The AP Act is here to stay and the RBI is not empowered to ask the Government to repeal the Act"*	
	"This is not viable. The RBI in Hyderabad had about 250 staff. How can it regulate MFI activities in over 40,000 villages? Further, self-regulation of MFIs, as mooted by Malegam, has never worked in the MFI sector till now as a profit motive is involved,"	Hindu Business Line, 16th February, 2011
RBI accepts Malegam Committee recommendations	*"There is no confusion. The AP MFI (Regulation of Money lending) Act will continue to apply for all MFI operations in the State even after RBI's policy announcement today"*	Hindu Business Line, 3rd May, 2011
	"The government got legislation making power from the Indian Constitution while the power of RBI came from executive instructions. "It is a settled principle that constitutional power prevails over statutory power. Therefore, RBI has no power and it is not in (its) domain... to annul the state legislation"	Financial Chronicle, 8th May, 2011
Finance ministry drafts Microfinance Bill	*"A cursory reading of the Bill shows that it does not fulfil constitutional requirements for a Parliament legislation on a subject in the states' list,"*	
	"The concept of treating Microfinance Institutions as extensions of banks is questionable in view of the difference in profit motives,"	
	"We will send a detailed report to the Government of India with formal opinion of the State Government soon,"	Hindu Business Line, 8th July, 2011

Source: As in table and Espirito Santo Investment Bank Research

Plenty of people have questioned our sanity on this call, so why do we persist in our view of better prospects for the company post clarity on the outcome of Andhra crisis and certain regulatory changes?

Strength of the business model proven: Despite seeing almost the entire Andhra book being defaulted and vast amount of negatives coming from the recent turmoil in the sector, we think that the microfinance business model is stronger than now assumed, and without political intervention could be an efficient source of finance and allied services for its customers. As highlighted in our thematic note on 24th November, we still feel that under normal not overly politicized conditions, under JLG (Joint Liability Group) lending we do not expect a significant amount of individual defaults. But defaults are possible only en masse and if the following conditions are prevalent:

- when default is seen as being morally acceptable
- it is perceived that microfinance companies would not be able to lend (i.e. people repay loans if there is the prospect of future funding)
- there are material outside factors motivating people to default (i.e. politicians actively encouraging default).

In our opinion if these three factors are present and if the borrowers are told that a) nobody can take any action if they default and b) people coming for collection would be prosecuted; then most of the borrowers for any type of loan, be it banking or MFI, would not repay.

We visited some locations in Andhra and also met the ground level staff to gauge if our assumption is right or not and our conversations suggested that:

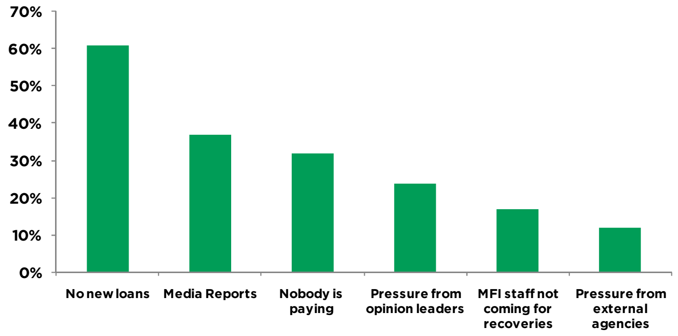
a) although most of the field staff were visibly frustrated over the state of affairs of the company, they seemed convinced about the business model

b) in the opinion of the staff in the field, there were three reasons why they are not seeing any repayment from the borrowers:

- borrowers do not see any purpose in attending the centre meetings if they cannot get any fresh loans.
- peer pressure making borrowers to miss the centre meetings.
- it is a commonly held view among the borrowers that there is no need to repay the loan.

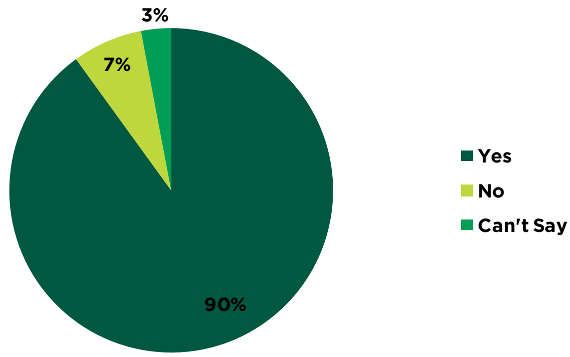
Our observations were further substantiated by a recent survey by MicroSave, which clearly pointed out that 90% of the borrowers still want to repay if they are given fresh loans. Also the majority of the customers highlighted no new loans from the microfinance company being the key reason for default (see figure 1 & 2).

Figure 1 Cause for default by borrowers



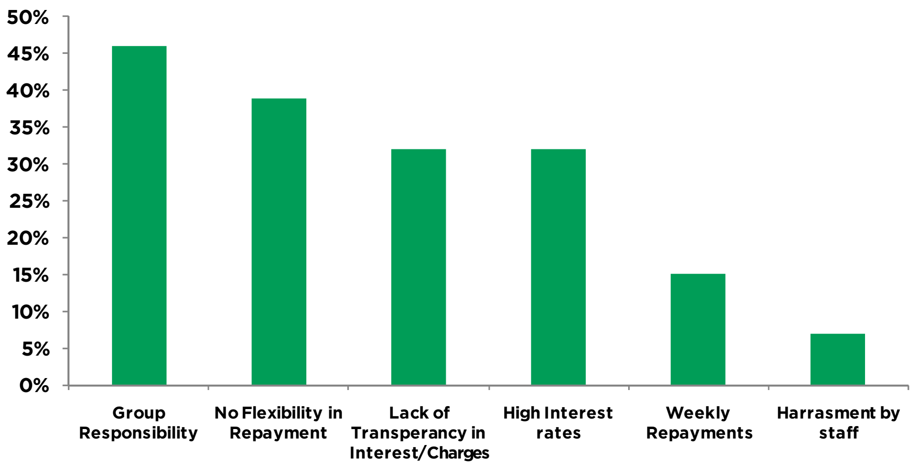
Source: Micro Save2011, Espirito Santo Investment Bank Research

Figure 2 Intention of payment remains high



Source: Micro Save2011, Espirito Santo Investment Bank Research

Figure 3 Complaints of customers against microfinance companies



Source: Micro Save2011, Espirito Santo Investment Bank Research

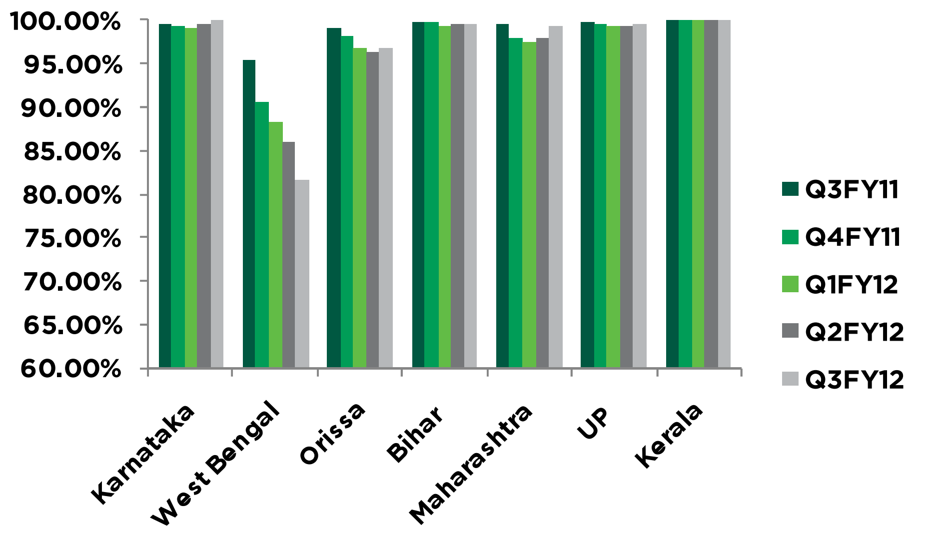
Also, two of the key reasons which were highlighted by many market participants for around 98% - 99% recovery from the customers were:

a) **Evergreening:** There were concerns that the microfinance institutions are giving new loans to get their existing loans repaid, however over the last 16 months new lending across the country was negligible, but SKS was able to maintain more than 98% collection in almost all the states barring two i.e. West Bengal and Gujarat, which we have discussed below.

b) **Multiple lending:** It was also suggested that multiple lending was one of the reasons for high repayment rates, with borrowers taking loans from one to repay another. However a majority of the MFIs were not lending in any of the states, yet SKS was able to maintain high collection rates. Also, other than AP second state where multiple lending was prevalent, in Karnataka SKS has been able to maintain c.99% collection efficiency on a declining book.

This high collection rate, despite negative media publicity and in absence of any new loans, clearly highlights the strength of the business model. Also, the lower collection efficiency level in Bengal started almost at the time of the Andhra crisis and, as explained in the subsequent paragraph, it did not spread substantially suggesting that it was not the fallout of the Andhra regulations. It also highlights that defaults in one region have no significant bearing on other regions.

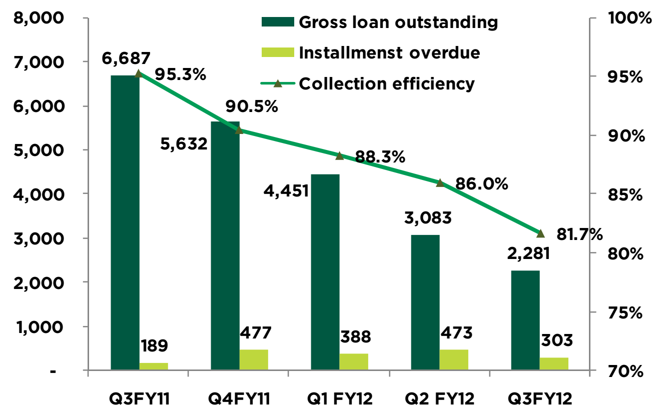
Figure 3 Collection efficiency of SKS in top states after Andhra crisis



Source: Company filings, Espirito Santo Investment Bank Research

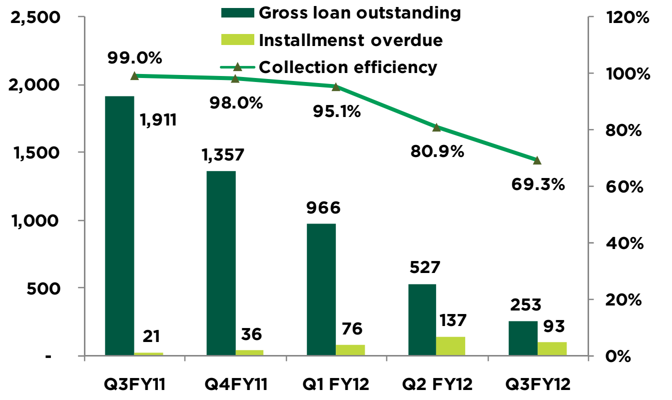
West Bengal and Gujarat: These were the two states where the collection ratio dipped over the last 16 months: in West Bengal it dropped from 95% to 82% and in Gujarat from 99% to 69.3%. In both these places the collection efficiency dipped quite sharply over the last few quarters making investors concerned that the contagion effect of Andhra is spreading to other states. Our conversations with the management and channel checks suggest that in Bengal the default happened in three districts and in a few districts of Gujarat, however a) it did not spread in the adjoining districts and b) the amount of defaulting portfolios did not increase substantially (see charts below). The main reason for the sharp reduction in collection efficiency was the sharp decline in the loan book leading to the good book being collected but the overdue book remaining on the book. We think that these types of isolated events are inherent within the microfinance model and hence we expect c.2% credit cost in normal circumstances.

Figure 2 West Bengal book



Source: Company filings , Bloomberg, Espirito Santo Investment Bank Research

Figure 3 Gujarat book



Source: Company filings , Bloomberg, Espirito Santo Investment Bank Research

Positive regulatory developments:

The biggest reason for the sector getting into problems was excessively lax and light regulation which brought in too many players who were moneylenders guised as microfinance companies. This light regulation led to the Andhra government to come out with its own regulations for the sector. However over the last six months many positive developments have happened on the regulatory front, with the RBI clearly recognizing this sector separately as NBFC MFI, also the Central government came out with its draft regulations which had positive implications for MFIs.

The Malegam Committee's recommendations: the RBI accepted most of the Malegam Committee's recommendations http://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/IEPR1035P0111.pdf and also relaxed some of the recommendations of the Malegam Committee towards the minimum income requirement etc. see table below.

Table 2 Changes from Malegam committee recommendations in RBI notification

Criteria	Malegam Committee recommendations	RBI notification
Income level	Ceiling of income at Rs.50,000 per family	Ceiling of income at Rs.60,000 per family in rural areas and Rs.120,000 per household in urban and semi urban areas
Interest rate and margin cap	Interest rate cap of 24% and margin cap of 12% excluding upfront processing charge of 1%	Interest rate cap of 26% and margin cap of 12% excluding upfront processing charge of 1%
Amount of loan	Capped at Rs.25000 per borrower	Loan amount of Rs35,000 in first cycle, Rs50,000 in subsequent cycle and total indebtness not to exceed Rs.50,000 for a single borrower

Source: Malegam Committee and Espirito Santo investment Bank Research

Priority sector kept for NBFC MFIs: The RBI specifically kept the priority sector status to loans given to NBFC MFIs whilst removing the priority sector status of all other loans to NBFC. This is clearly an indication of the fact that the RBI thinks that the sector's funding should be restored as it does not see any current alternative to the MFIs.

Draft MFI act from the central government: The draft MFI bill of the Central Government specifically recommends the RBI as the regulator and has specific provisions within the act which stipulates that the state governments cannot have a separate act for the MFIs. This act, once implemented, should remove the bulk of the regulatory uncertainty from the sector. Media articles suggest that the draft bill may have received finance ministry approval and can be presented in the Budget session of the parliament starting mid March

http://www.livemint.com/2012/01/22225124/Finance-ministry-clears-propos.html,

However, given the current pace of bills progressing through parliament one cannot be certain of the exact timing.

Eased out competitive environment:

There were more than 200 microfinance companies with the top 10 companies competing closely with a loan book of more than 20,000 crores in Sept 2010. However, since then 6-7 of these top MFIS have already undergone CDR, substantially reducing their ability to grow their loan book. Also, if these MFIs decide to write off/provide for their Andhra book, most of their net worth would become negative and hence they'd have no ability to give further loans. Also, the RBI's requirement of Rs 25 crore of minimum capital and a tier 1 capital requirement of 15% would mean that we are unlikely to see new MFIs mushrooming as we saw earlier. All this implies that the competitive environment for SKS has substantially eased and post QIP it could be one of the few MFIs to grow its loan book at a decent pace while also being selective. Also, in the near term we do not see any multiple lending happening, as MFIs other than SKS, Bandhan and Ujjivan have substantial capacity to lend.

Clarity on balance sheet

With SKS providing for more than 1,000 crores for the Andhra portfolio, we now believe that there is reasonable clarity on the book value of SKS and from hereon we do not expect a material reduction in book value, after taking into account the deferred tax assets being generated from the losses of Andhra (see table 3). If the company is able to restart its operations in Andhra, then we think there is a fair chance that the company may be able to recover part of its book.

Table 3 Book value analysis

Description	Amount (Rs'mn)	Possible loan (Rs'mn)
Closing net portfolio of Andhra	4,840	
Book value of SKS	7,620	
Net book value after considering write off of 80% of the residual net portfolio	3,748	22,488
Deferred tax available on total	4,800	
Present value of deferred tax	2,790	
Adjusted book value	6,538	39,228

Source: Espirito Santo Investment Bank Research

Dupont going forward

In our opinion, other activities beyond lending (i.e. distribution of insurance, services to kirana stores etc.) will play an important role in the earnings of SKS given it has already got the infrastructure in place. This is in line with the new group strategy to increase its service offerings and it was something we highlighted in our earlier thematic, suggesting that the earnings structure of MFIs will have a higher proportion coming from activities other than lending. Our calculations suggest that SKS would still be able to generate around 20% ROE in the stable state.

Table 4 Stable state RoEs

DuPont	Stable State Ratios
Assigned/Total Loans	10.0%
Net Interest Margin (balance Sheet)	13.8%
Interest Margin (Off-balance Sheet)	12.0%
NIM	13.6%
Other Income (including processing fees)	2.5%
Operating expenses	9.5%
Credit Cost	2.0%
Pre-Tax RoA	4.8%
Post Tax RoA	3.2%
Leverage	6x
RoE	20%

Source: Espirito Santo Investment Bank Research

Risks:

Given a 90% fall, a lot has clearly been priced in. however there remain issues to watch:

Delay in funding

One of the major repercussions of the Andhra regulations was that banks stopping funding the MFI sector given their concerns around the viability of the business model post Andhra uncertainty. The banks were concerned about similar regulations being implemented by other states, the contagion effect of loan losses spreading to other states and that were waiting for regulatory clarity to emerge on this sector. We do not see the bank funding regaining the earlier levels for the foreseeable future; however over the next couple of quarters we would expect significant improvements in the level of funding which is quite visible from the following quotes from banks. Nevertheless, any delay in bank funding would have negative implications for the company's operations.

Table 5 Recent comments by Bankers highlight rising optimism towards Microfinance sector

Bankers/description	Comments by the bankers/newsflow on financing	Source
Bhaskar Sen, CMD, UBI	*"We will extend loans to MFIs that follow Malegam committee recommendations diligently."*	*Economic Times, 29th July, 2011*
M Narendra, CMD, IOB	*"We will increase focus in microfinance sector. After the Malegam committee recommendation, a lot of doubts are cleared about the sector. Now, there is no harm in giving loans to rated micro finance companies,"*	*Rupee Times, 8th August, 2011*
S N Mishra, GM (Corporate Lending), IOB	*"Though we have not disbursed any fresh loans during the quarter but we will now increase MFI exposure. It seems, all the risk factors have eased. Good amount of loan recoveries also prompted us to expand the book,"*	*Rupee Times, 8th August, 2011*
Rana Kapoor, MD & CEO, Yes Bank	*"If the RBI regulates the sector, I will build an MFI portfolio of 1,000-1,500 crore by March 2012,"*	*Economic Times, 29th July, 2011*
RK Bansal, ED, IDBI Bank	*"We have exposure of about 800 crore, and we can take it to about 1,500 crore by the end of the fiscal,"*	*Business World, 9th August, 2011*
R Ramachandran, CMD, Andhra Bank	*"If some proposal comes to us seeking funding we will examine it on merit."*	*Economic Times, 29th July, 2011*
Sushil Munhot, CMD, SIDBI,	*"Lenders are willing to finance MFIs now that the Malegam committee report is made public and the draft bill on regulating MFIs is out"*	*Economic Times, 29th July, 2011*
NK Maini, Deputy Managing Director, SIDBI	*"We are not shying away from lending to MFI sector in the recent time. Rather, we do have a target of disbursing around Rs 1,000 crore of loan in the current fiscal against Rs 840 crore of advances last fiscal,"* *"We feel that Indian MFI sector is very responsible and continues to be economically viable,"*	*Economic Times, 8th August, 2011*
SIDBI	*SIDBI gives 100 crores loan to SKS*	*Mint, Feb 2nd 2012*
Equity funding	*Ujjivan Financial Services, one of India's leading urban poor-focused microfinance institutions, has raised Rupees 127.9 Crores (USD 25.5 Million) in its fifth round of equity funding. Two new Foreign Institutional Investors FMO (Netherlands Development Finance Company) and WCP Mauritius Holdings III (Wolfensohn Capital Partners) and existing investors participated in this round*	*Business Standard,1st Feb 2012*
Assignment Transaction	*SKS Microfinance Limited completes the largest MFI rated pool assignment transaction of Rs. 243 crore.*	*Company filings to exchange (NSE & BSE)*

Source: As listed in table and Espirito Santo Investment Bank Research

Delay in regulatory changes

The RBI's acceptance of the Malegam Committee's recommendations may have resolved the regulatory problems for the microfinance sector to a large extent, and we do not expect any other state to come out with a separate set of regulations for the microfinance industry. However, the constitutional authority of a state overriding executive power of the RBI will remain until the time the Central government comes out with the MFI bill, which as highlighted earlier is expected to be presented in the budget session of the parliament scheduled for mid March (but given the current state of government delays are possible).

Delay/failure to raise capital

When we look at the current capital position of the company, it does not appears to need capital till the time there is substantial improvement in the loan book, however, if it were to provide for the entire Andhra book by April, then its capital adequacy falls to 24% in the absence of a deferred tax asset (still above required levels) (see table 3). However the banks may not be comfortable with any material lending at these capital adequacy levels.

Table 6: Key assumptions & estimates

All figures in Rs.m	FY11	FY12E	FY13E	FY14E	Comments
Yield and Margins					
Gross Yield on Balance sheet	31.9%	24.6%	24.6%	24.6%	This is in line with the company policy and RBI standards
Yield on assignments	13%	12%	12%	12%	Being conservation we have used lower yield on assignments
Cost of funds	11%	13%	13%	13%	
Net Interest Margin	19%	14%	13%	14%	In line with RBI guidelines
Other Income/Average assets	2.6%	1.9%	2.3%	1.9%	Considering 1% upfront processing fees implying a gross yield of 2%
Opex/Average Assets	12%	23%	12%	10%	Opex ratio will reduce given that the company would not be required to increase its infrastructure for next 2-3 years
Credit cost	6%	76%	4%	3%	We have written off entire Andhra book and assumed 2% credit cost for outside Andhra book
Balance Sheet					
Disbursements YoY growth (%)	1%	-78%	110%	26%	We have assumed that 70% of the existing customers outside Andhra would borrow in FY13
Loan Book (on Balance Sheet)	34,790	15,571	24,338	36,258	Based on the above assumption
Assignments	6,320	2,361	3,719	4,685	We have assumed 15% assignments
Debt to Equity	1.3	4.1	2.1	2.9	
Outstanding AP loan Book	14,060	1,000	500	0	

Source: Company, Espirito Santo Investment Bank Research

Valuation

We use the excess return model to value SKS Microfinance using a cost of equity as 16%. This gave us a fair value of Rs. 120 (earlier valuation of Rs. 544) for SKS Microfinance implying a 1.1x FY13E P/B. The forecasts are not comparable since we had expected an early resolution of the Andhra crisis given the RBI's involvement leading to a write-off of just 40% of the Andhra portfolio. Also we expected the funding situation to improve by Q2 of FY12. Now we assume:

a) a write-off of the entire Andhra book and no resolution to the Andhra problem leading to the company shutting down its operations in Andhra,

b) the company is able to raise 500 crores from the current capital raising,

c) c.10% of the total income coming from other sources.

The stock is currently trading at 0.9x FY13E adjusted P/B and it cannot be compared with other NBFCs at the moment, given the special situation of the company where the operations are almost at a standstill.

Also, there is a lot of uncertainty as to the timing of the MFI bill, banks' funding and the eventual outcome of the Andhra crisis. Hence we have tried some scenario analysis and the current share price seems to us to be pricing in the worst case.

Table 7: Scenario analysis

Description	Bear case	Base case	High case
Outcome of Andhra crisis	Entire book written off no business in Andhra	Entire book written off no business in Andhra	30% recovery in Andhra due to the microfinance act and SKS's starting business in Andhra
QIP	Not able to raise money	Goes through and SKS raises 500 crores	Goes through and SKS raises 500 crores
MFI act	No MFI act	MFI act goes through but only by September	MFI bill goes through in March
Disbursements	Company able to disburse only Rs. 2,000 crores in FY13 given lower availability of funds	Company able to disburse 3500 crores in FY13	Company able to disburse 6,000 crores in FY13 given better environment in Andhra and rest of the world
Valuation	Rs81, 10% downside Implied P/B 1.3X	Rs.120, 33% upside implied P/B1.1x	Rs.271, 208% upside, implied P/B 1.4x

Source: Espirito Santo Investment Bank Research

Table 8: Excess Return Model Assumption

Key assumptions	
Cost of Equity	16%
Terminal Growth Rate	7%
Dividend Payout	0%
Fair Value	120
Implied P/B	1.1
Sustainable RoE	20%

Source: Espirito Santo Investment Bank Research

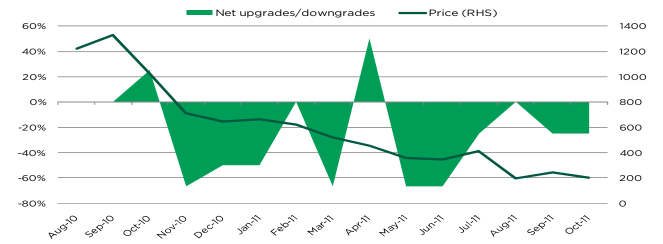
Traffic Lights

Table 8 Traffic Lights: criteria for judgement

Parameter	Traffic signal	Reasons
Accounting & governance	**AMBER**	We have not been able to find any specific weakness in the company's accounting practices and its disclosure practices have been very conservative, however the removal of the CEO just after the QIP has led us to retain the amber rating
Franchise strength	**AMBER**	SKS still retains the strongest MFI by some distance, however the strength of franchise has deteriorated over the last 18 months given the Andhra crisis
Earnings momentum	**AMBER**	Has deteriorated significantly after the Andhra crisis and

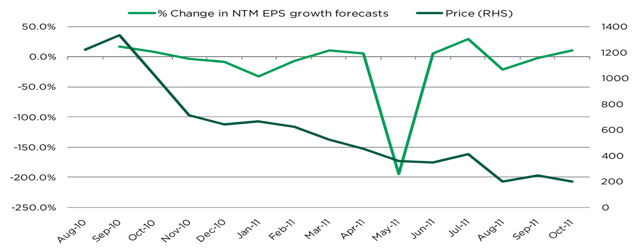
Source: Espirito Santo Investment Bank Research

Figure 4 Earnings Momentum charts



Source: Company filings , Bloomberg, Espirito Santo Investment Research

Figure 5 Earnings Momentum charts



Source: Company filings , Bloomberg, Espirito Santo Investment Research

Share price and rating chart

SKS Microfinance *SKSM IN*

Report Date	Recommendation	Fair Value (INR)
05-May-11	Buy	Rs544.0
24-Nov-10	Buy	Rs1011.0

Source: Bloomberg, Espirito Santo Investment Bank Research

Summary Financials *(All figures in Rs m unless stated. Year-end is March)*

SKS Microfinance

Recommendation:	**BUY**
Fair Value:	**INR 120**
Share Price:	INR 98
Upside / Downside	23%
3 Month ADV ($m)	2
Free Float	65%
52 Week High / Low	749-85
Bloomberg:	SKSM IN
Model Published On:	07 February 2012
Shares In Issue (mm)	74
Post QIP, shares In Issue (mm)	124
Market Cap ($bn / Rs bn)	**$0.14 bn/Rs. 7 bn**

Forthcoming Catalysts
QIP expectd to be completed by March
MFI Bill expected to be tabled in parliament

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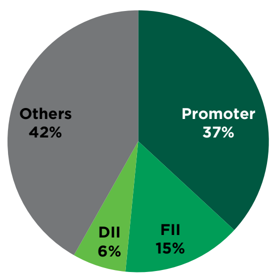
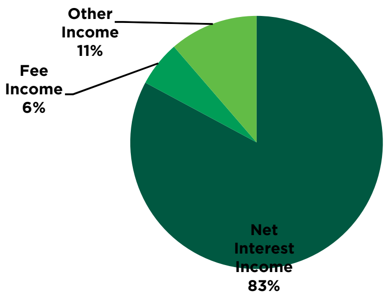
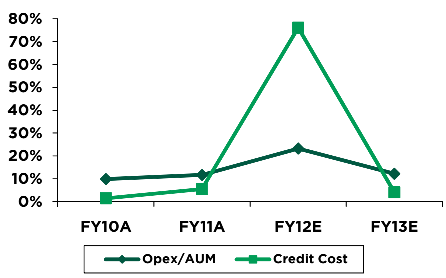
Shareholding Pattern



Revenue Breakdown



Margin Trends



Valuation Metrics	2010	2011	2012E	2013E	2014E
P/E	4.2	6.5	-	273	8.7
P/BV	0.8	0.4	2.2	1.5	1.2
P/Adjusted BV	0.8	0.4	0.9	0.9	0.9
ROA	5.4%	2.9%	-51.5%	0.2%	4.5%
ROE	21%	8%	-137%	1%	15%
Book value per share (BVPS)	129	241	45	68	79
Adjusted BVPS (incl. DTA)	**129**	**241**	**109**	**106**	**113**
Implied Valuation Ratios					
P/E	5	8	-	335	11
P/BV	0.9	0.5	2.7	1.8	1.5
P/Adjusted BV	0.9	0.5	1.1	1.1	1.1
P&L Summary					
Net Interest Income	**5,852**	**8,123**	**2,405**	**3,245**	**5,114**
Processing Fees	-	-	169	354	446
Other Income	854	1,093	329	542	675
Total Income	6,705	9,216	2,903	4,141	6,235
Operating expenses	3,385	4,968	3,893	2,945	3,435
Operating Costs	1,221	1,705	1,440	998	1,269
Employee Costs	2,164	3,263	2,453	1,948	2,166
Pre Provisioning Profit	3,320	4,248	(991)	1,195	2,800
Provisions	517	2,362	13,329	989	1,238
Operating Profit	**2,803**	**1,886**	**(14,319)**	**206**	**1,562**
Depreciation	126	161	161	161	161
PBT	**2,677**	**1,724**	**(14,481)**	**45**	**1,400**
Less:Tax	937	608	-	-	-
PAT	**1,740**	**1,116**	**(14,481)**	**45**	**1,400**
EPS	33	16	-204	0	11
Balance Sheet Summary					
Equity	687	817	817	817	817
Reserves and Surplus	8,893	16,991	2,510	7,555	8,955
Networth	**9,580**	**17,808**	**3,327**	**8,372**	**9,772**
Borrowings	26,947	22,361	13,509	17,511	28,616
Total Sources of funds	36,527	40,169	16,836	25,882	38,388
Loan Book	29,747	34,790	15,571	24,338	36,258
Investments	2	38	38	38	38
Fixed Assets	189	219	219	219	219
Intangible Assets	55	93	93	93	93
Deffered Tax Assets	95	357	-	-	-
Net working Capital	6,440	4,673	917	1,196	1,782
Total Application of funds	36,527	40,169	16,836	25,882	38,388
Key Ratios					
Yield on Loans	34.3%	31.9%	24.6%	24.6%	24.6%
Cost of funds	10.7%	10.7%	13.0%	13.0%	13.0%
Spread	23.6%	21.2%	11.6%	11.7%	11.6%
NIM	17.1%	19.2%	13.7%	13.5%	14.2%
Opex/AUM	9.9%	11.7%	23.3%	12.2%	9.5%
Credit Cost	1.5%	5.6%	76.1%	4.1%	3.4%
Capital Ratios					
CAR	**26%**	**47%**	**20%**	**32%**	**25%**
Asset/Equity (x)	4	2	7	3	4
Assigned loans/Total Loans	32%	15%	13%	13%	11%
Growth Ratios					
Loan Book (On Balance Sheet)	107%	17%	-55%	56%	49%
Total Loan Book	**76%**	**-6%**	**-56%**	**56%**	**46%**
NII	88%	39%	-70%	35%	58%
PBT	116%	-36%	-940%	-100%	3046%

Source: Company Filings, Espirito Santo Investment Bank Research estimates

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BUY	Analyst expects at least 10% upside potential to fair value, which should be realized in the next 12 months
NEUTRAL	Analyst expects upside/downside potential of between +10% and -10% to fair value, which should be realized in the next 12 months.
SELL	Analyst expects at least 10% downside potential to fair value, which should be realized in the next 12 months
SHORT TERM RATING	**DEFINITION**
ST POSITIVE	Analyst expects the stock price to appreciate in value within 3 months of the rating assignation because of a specifically identified catalyst(s) or event(s)
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SELL	63	13.6%	0	0.0%	0.0%
RESTRICTED	0	0.0%	0	0.0%	0.0%
UNDER REVIEW	6	1.3%	2	3.9%	0.4%
TOTAL	**463**	**100%**	**51**	**100%**	

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SHORT TERM NEGATIVE	0	0%	0	0%	0%
TOTAL	**0**	**0%**	**0**	**0%**	

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