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IPO Note | Banking

July 28, 2010

# SKS Microfinance

## Prosperity to masses

SKS Microfinance (SKSMF) offers a high quality play on India's vast Rs2.7lakh cr microfinance opportunity. SKSMF's core strength lies in effective risk management and governance, advanced technology, wide product portfolio, diversified sources of capital and strong pan-India distribution network, all of which have brought down the cost of credit to the poorest to amongst the lowest in the world, unlocking tremendous latent demand. **We recommend a Subscribe to the issue.**

**Huge Business Opportunity:** India's estimated demand for micro-credit was Rs2,40,000cr in 2008 (Intellecap). By FY2010, Self Help Groups and MFIs had outstanding portfolio of just Rs45,200cr, indicating more than 80% unmet demand. SKSMF is India's largest MFI, having increased marketshare from 2% to 10% over FY2007-10. In an industry growing at 30%+, we expect larger MFIs like SKSMF to further gain marketshare on the back of scalable best practices and cheap capital(at 70% CAGR over FY2011-12E, SKSMF's marketshare would stand at 14.3%).

**Low lending rates for bottom of the pyramid:** SKSMF lends exclusively to Joint Liability Groups of women from low-income households for income generating assets. This capitalizes on social collateral (pioneered by Grameen Bank), restricting provisioning to just 1.5% of average assets (FY2010). Further, the extensive use of technology has restricted opex to 9.9% of average assets (FY2010) in spite of low ticket size, enabling SKSMF bring down lending rates to just about 25% (much lower than domestic moneylenders and even organized MFIs globally).

**High Valuations underpinned by huge growth potential and profitability:** Global peers are trading at 3.7x trailing P/BV and 19.1x P/E (Closest peer Compartamos is trading at 8.0x and 21.7x respectively). At the upper end of the price band, SKSMF will be valued at P/BV multiples of 6.6x FY2010 and 3.1x FY2012E. Although valuations are on the higher side, looking at the strong and sustainable growth and RoE prospects for the company, **we recommend a Subscribe to the issue.**

### Key Financials

| Y/E March (Rs cr) | FY2009 | FY2010 | FY2011E | FY2012E |
|---|---|---|---|---|
| **NII** | **264** | **495** | **868** | **1,246** |
| *% chg* | *214.3* | *87.3* | *75.2* | *43.6* |
| **Net Profit** | **80** | **174** | **298** | **426** |
| *% chg* | *381.8* | *116.9* | *71.4* | *42.7* |
| NIM (%) | 12.3 | 13.6 | 16.6 | 15.5 |
| **EPS (Rs)** | **14.1** | **27.0** | **41.4** | **59.1** |
| P/E (x)* | 70.1 | 36.5 | 23.8 | 16.7 |
| P/ABV (x)* | 8.5 | 6.6 | 3.7 | 3.1 |
| RoA (%) | 3.9 | 4.9 | 5.5 | 5.1 |
| RoE (%) | 18.5 | 21.6 | 20.7 | 20.4 |

*Source: Company, Angel Research; Note: * at the Upper end of the price band*

## SUBSCRIBE

Issue Open: July 28, 2010
Issue Close: August 2, 2010

### Issue Details

Face Value: Rs10

Present Eq. Paid up Capital : Rs64.5cr

Offer Size: 1.68cr Shares (Fresh Issue 0.74cr shares & Offer for sale 0.94cr shares)

Post Eq. Paid up Capital : Rs72.0cr

Issue size (amount): Rs1,427cr - Rs1,654cr*

Price Band: Rs850-985#

Promoters holding Pre-Issue: 55.8%

Promoters holding Post-Issue: 37.1%

Note: *at Lower and Upper price band respectively; # Rs50 discount for retail investors

### Book Building

| | |
|---|---|
| QIBs | At least 60% |
| Non-Institutional | At least 10% |
| Retail | At most 30% |

### Post Issue Shareholding Pattern

| | |
|---|---|
| Promoters Group | 37.1% |
| MF/Banks/Indian FIs/FIIs/Public & Others | 62.9% |


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## Investment Rationale

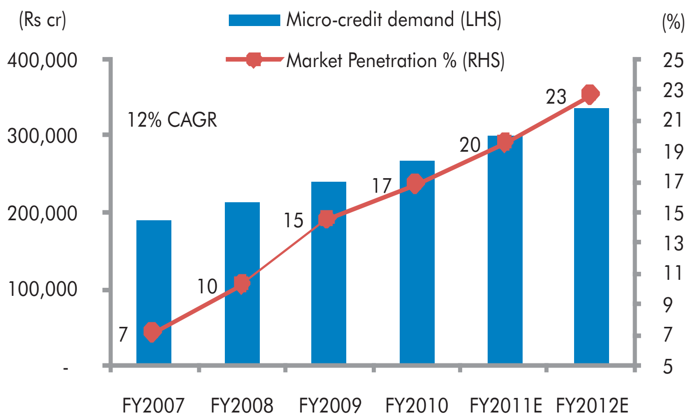
### Market leadership in India's fast-growing Microfinance industry

India's total estimated demand for micro-credit in India was Rs2,40,000cr in 2008 (Source: Intellecap). By FY2010, SHGs and MFIs had combined outstanding portfolio of just Rs45,200cr, indicating more than 80% unmet demand.

According to a CRISIL Report on Top 50 Indian MFIs, SKSMF is the largest MFI in India in terms of number of borrowers, number of branches and total loans as of September 30, 2008. The company continues to maintain its leadership position, with approximately 6.8mn customers, 2,029 branches, presence in 19 states and loans of Rs4,321cr as of FY2010. During the period of FY2006-10 its branches have grown at a CAGR of 124.0%, customer base at CAGR of 141.3%, loans outstanding at CAGR of 161.8% and the Net profit has increased by a whopping 345.9% CAGR.

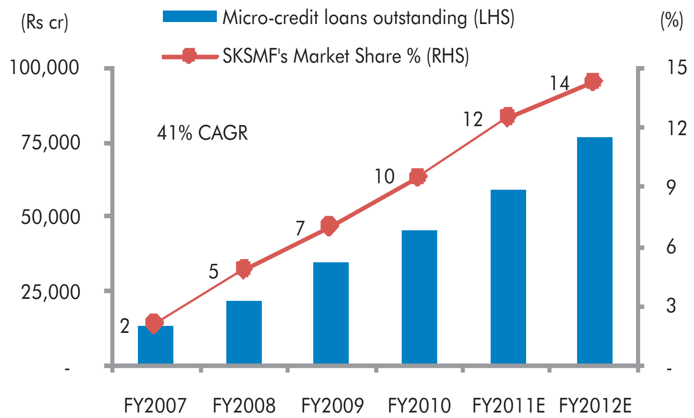
Using total microcredit in India as a base, SKSMF has increased its marketshare from 2% in FY2007 to 10% by FY2010. In an industry growing at 30%+, we expect larger MFIs like SKSMF to further gain marketshare on the back of scalable best practices and cheap capital (at 70% CAGR over FY2011-12E, SKSMF's marketshare would stand at 14.3% of total microcredit).

**Exhibit 1: Micro credit demand and penetration rates**




*Source: CRISIL, Intellecap, Angel Research*

**Exhibit 2: Micro credit loans and SKSMF's Market Share**




*Source: CRISIL, Intellecap, Angel Research*

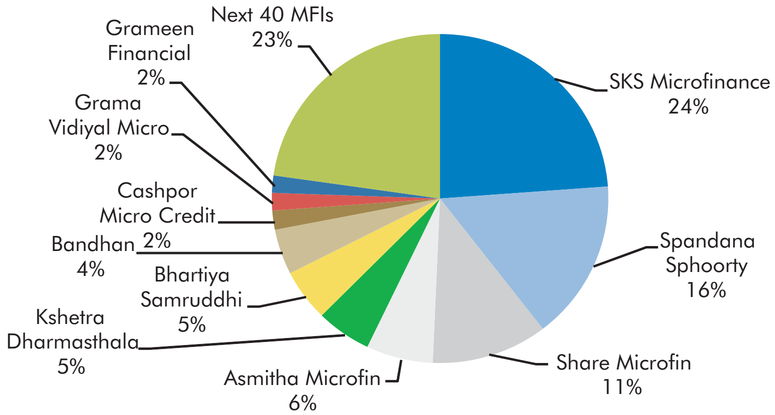
The company's market leadership position in the microfinance sector enhances its reputation and credibility with its customers and its lenders. Enhanced reputation and credibility have numerous benefits for the company, including the ability to secure capital at lower costs, recruit and retain employees, retain its existing members and expand into new regions and product areas.

**Exhibit 3: Operational & Financial Highlights**

| Particulars | FY06 | FY07 | FY08 | FY09 | FY10 | CAGR FY06-10 (%) |
|---|---|---|---|---|---|---|
| **Operational Highlights** | | | | | | |
| No. of branches | 80 | 276 | 770 | 1,353 | 2,029 | 124.4 |
| No. of districts | 19 | 103 | 219 | 307 | 354 | 107.8 |
| No. of employees | 574 | 2,381 | 6,818 | 12,814 | 21,154 | 146.4 |
| No. of Customers (in lakhs) | 2 | 6 | 19 | 40 | 68 | 141.3 |
| Disbursements (Rs cr) | 153 | 452 | 1,680 | 4,485 | 7,618 | 165.6 |
| Gross loan portfolio (Rs cr) | 92 | 276 | 1,051 | 2,456 | 4,321 | 161.8 |
| **Financial Highlights** | | | | | | |
| Incremental borrowings (Rs cr) | 88 | 277 | 1,063 | 3,762 | 5,132 | 176.3 |
| Total revenue (Rs cr) | 11 | 46 | 170 | 554 | 959 | 205.6 |
| Profit after tax (Rs cr) | 0 | 4 | 17 | 80 | 174 | 345.9 |
| Total assets (Rs cr) | 100 | 335 | 1,089 | 3,039 | 4,047 | 152.2 |
| Return on average asset (%) | 0.9 | 0.8 | 2.3 | 3.9 | 4.9 | |
| Return on average equity (%) | 5.0 | 4.1 | 11.7 | 18.5 | 21.6 | |

*Source: Annual Report, RHP*

**Exhibit 4: Market Share of MFIs in India**

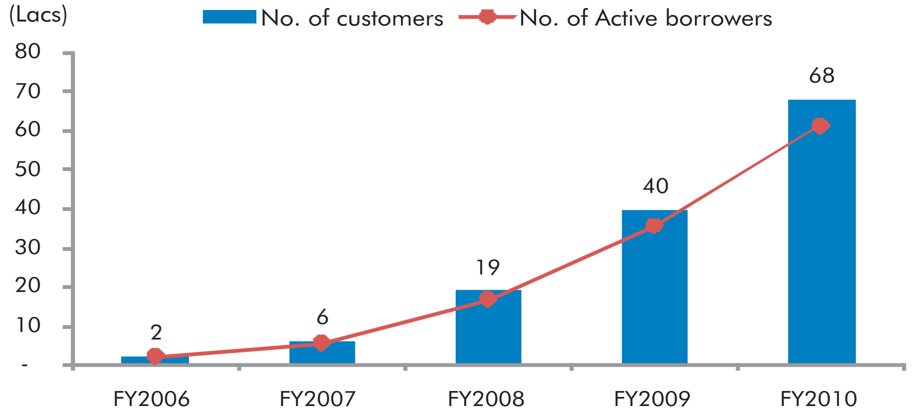



*Source: Crisil Report - India Top 50 Microfinance Institutions, October 2009*

## Expertise in microfinance

SKSMF has been focusing on lending to poor women in India since its inception in 1997. Thus, over the years, the company has developed a specialised understanding for the needs and behaviour of individuals in this segment across India, the complexities of lending to these individuals and issues specific to the microfinance industry in India and its processes. This gives the company a competitive edge over commercial banks in terms of knowing the customer better. Further, SSKMF has developed skills to train its customers and design specialised financial products.

**Exhibit 5: Strong customer base**




*Source: DRHP, Annual Report, Angel Research*

### Grameen Bank model ensures enviable asset quality

SKSMF lends exclusively Joint Liability Groups (JLGs) of women belonging to low-income households for income generating assets. This capitalizes on the social collateral pioneered by Grameen Bank, Bangladesh, restricting provisioning to just 1.5% of average assets (FY2010). SKSMF's superior asset quality is underpinned by the following key attributes of the Grameeb Bank model:

- **Ensure credit discipline through mutual support and peer pressure:** SKSMF structures its loans around a village-centred, group-lending model to provide unsecured loans to its members. This model ensures credit discipline through mutual support and peer pressure within the group to ensure individual members are prudent in conducting their financial affairs and are prompt in repaying their loans. Failure by an individual member to make timely loan payments will prevent other group members from being able to borrow from SKSMF in the future; therefore, the group will typically make the payment on behalf of a defaulting member or, in case of willful default, will use peer pressure to encourage the delinquent member to make timely payments, effectively providing an informal joint guarantee on the member's loan.

- **Focus on income-generating loans for low-income households:** The company offers short-term loans primarily for income-generating activities or to fund increases in productivity. Such loans demonstrate the highest potential of generating additional income and, therefore, increase the likelihood of loan repayment.

- **Lending exclusively to women - Ensures low probability of default:** SKSMF lends exclusively to women of low-income households, even if loan proceeds are used in their family-run household business.

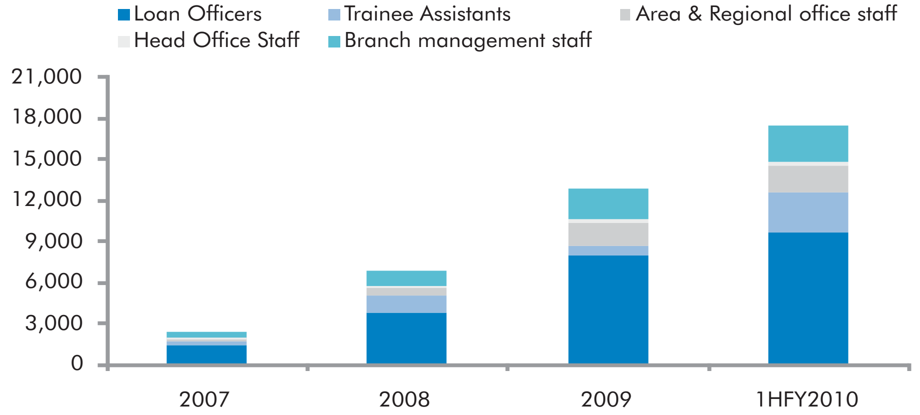
### Low operating costs the other pillar of SKSMF's successful microfinance model

Establishing and growing a successful rural microfinance business in India involves the significant challenge of addressing the rural poor that live in India's remote locations. Hence, SKSMF's cost-to-income ratio (52%) and the opex to average assets ratio (9.9%), which appear much higher than that of the banking industry, should be seen in the context of distributing and servicing extremely small ticket-size loans to far-flung rural areas.

Apart from the low credit costs, the extensive use of technology has restricted opex to 9.9% of average assets (FY2010) in spite of low ticket size, enabling SKSMF bring down lending rates to just about 25% (much lower than domestic moneylenders and even organized MFIs globally), thereby unlocking the demand at the bottom of the pyramid.

The company has standardised recruitment and training programs and material so that they can easily be replicated across the entire organisation. This standardised approach also enables employees to efficiently move from region to region based on demand and growth requirements. The company's business processes, from member acquisition to cash collections, have also been standardised and appropriately documented. Its branch offices are similarly structured, allowing for the quick rollout of new branches. In addition, the terms and conditions of its loan products are generally uniform throughout India, although interest rates may vary from region to region.

**Exhibit 6: Exponential growth in staff**

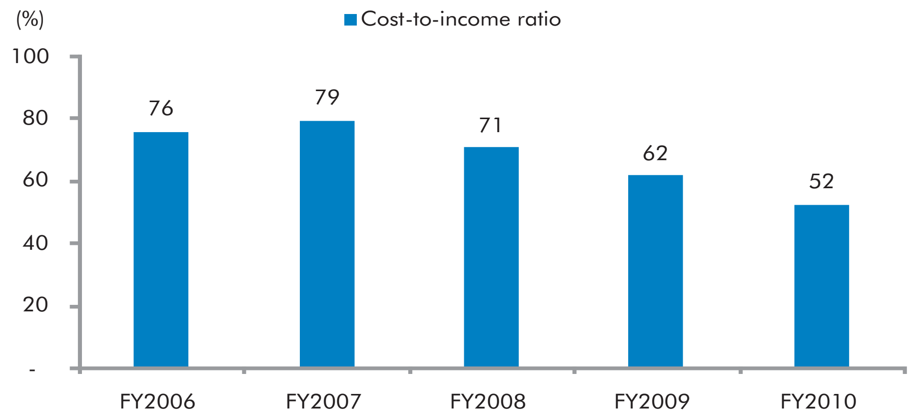



*Source: DRHP, Annual Report, Angel Research*

SKSMF has deployed a sophisticated technology platform to enable it to improve field-level productivity by simplifying data entry, enhancing the accuracy and efficiency of collections and improving fraud detection. At the same time, the technology enables data collection related to its members and loan portfolio, which can be used for management's decision making. HDFC has licensed SKSMF a portion of its proprietary technology systems to track and support loan disbursement.

SKSMF intends to further develop this system to enable real-time, internet-based reporting from all its branches as well as integration with its accounting systems. In addition, the company plans to purchase and implement an integrated risk management system that will further enhance its risk management ability.

**Exhibit 7: Cost-to-income ratio coming down**



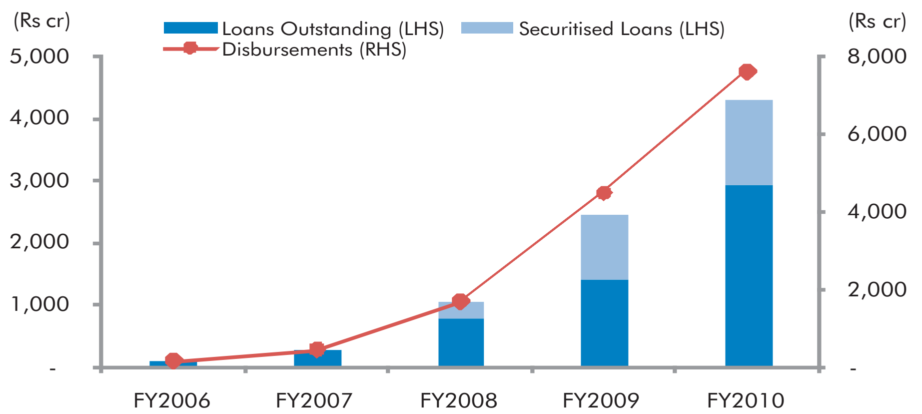

*Source: Annual Report, RHP*

### Diverse sources of funds; savior for banks' low on priority sector targets

The company has two major sources of funds in the form of term loans from banks, which account for 85.5% of total sources, and debentures which constitute 6.5% of total sources. Banks lending to MFIs qualify for mandatory priority sector lending. Thus, term loans to MFIs can be used to meet sub-targets for agriculture, microcredit and lending to weaker sections. The company also securitises assets and sells its loans to banks. As of March 31, 2010, the company had outstanding loans of Rs26,946.72 million from more than 45 banks and other financial institutions and a debt to equity ratio of 2.84.

The company has well-diversified lenders among public sector domestic banks, private sector domestic banks, private sector foreign banks and institutional investors. As of September 30, 2009, no single creditor represented more than 22.5% of the company's total indebtedness.

**Exhibit 8: Rising Proportion of Securitization**



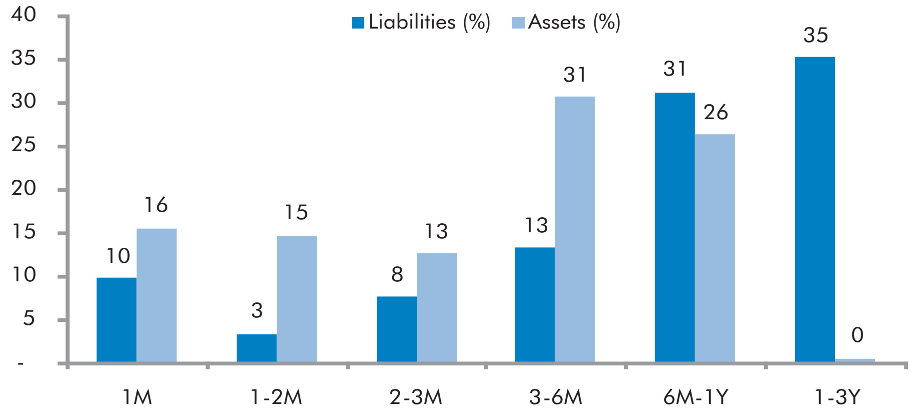

*Source: Angel Research, Annual Report, RHP*

The company is one of the first MFIs in India to complete a rated bond issuance, issue commercial paper, assign a rated pool, sell a weaker section portfolio, list debt instruments on the BSE and complete an assignment of receivables with a public sector bank.

**Favourable ALM profile for the current environment of rising rates**

About 35% of SKSMF's liabilities have a maturity period of one to three years; whereas almost all of the company's assets have maturity of less than one year. While ALM mismatches of any kind carry inherent interest rate risks, at this point in the cycle, with interest rates clearly headed upwards, the company's positive ALM gap, will be an added benefit.

**Exhibit 9: Long-term maturity borrowings to fund short-term loans**




*Source: Annual Report, RHP*

## Expanding Income avenues

While the company's core business involves providing its customers with its traditional loan products, the company also offers other loans known as Productivity Loans, which are designed for purchase of goods that enhance the productivity of its customers. In addition to the loan given to the customers, the company also requires them purchase insurance to cover the principal amount of loan obtained and it charges them the administrative charges for the same.

The company's national presence and large customer base can be leveraged to negotiate favourable terms with enterprises that want to distribute their products through the company's network, resulting in lower pricing for products that are distributed to its customers. This gives a competitive edge to the company over other regional lenders as well as other products distributors.

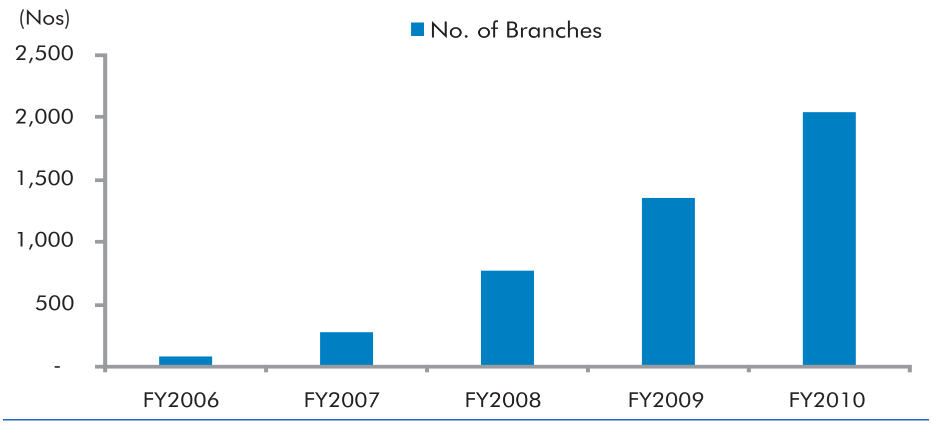
Currently, the company has a strong distributor relationship with Bajaj Allianz Life Insurance for the sale of their insurance products. SKSMF has distributed over 2.9 million policies as of March 31, 2010.

Further, the company has recently obtained the RBI's approval to market and distribute mutual funds as an agent for an initial period of two years.

SKSMF has entered into a strategic relationship with Nokia and Airtel, where the company can issue loan to a customer for the purchase of a Nokia mobile phone and Airtel service.

Under a pilot program with METRO Cash & Carry India Private Limited, the company provides working capital financing to its customers operating local retail shops (called kirana stores) that purchase supplies from METRO on a wholesale basis. In addition, the company has recently commenced a pilot program to provide home improvement loans to its customers.

**Exhibit 10: Aggressive Branch Network Expansion**




*Source: DRHP, Annual Report, Angel Research*

### Experienced top management

SKSMF's management team has significant experience in the microfinance and financial services industry and has developed the knowledge to identify and offer products and services that meet the needs of its members, while maintaining effective risk management and competitive margins.

Substantially, all of the company's senior managers have over 17 years of experience with well-reputed national and multinational companies, particularly in the retail and commercial banking industries.

## Company Background

The company is registered with the RBI as a non-deposit taking NBFC. During FY2006-10, the number of members in the company increased from 0.2mn in five states to 6.78mn in 19 states. Further, the company expanded its branch network from 80 to 2,029 branches across India. Gross loan portfolio increased at a 162% CAGR, from Rs92cr in FY2006 to Rs4,321cr as of March 31, 2010. From FY2006 to FY2010, SKSMF's profit after tax increased at a 345.9% CAGR, from Rs4.4 million to Rs1739.5 million. The company is currently required by the RBI to maintain a minimum capital to risk asset ratio of 12.0% and to 15.0% as of April 1, 2011.

## Investment Concerns

### Credit Risks

All of the company's loans are unsecured, which makes it more vulnerable to credit risks as it will not able to realise anything out of such loans. As of March 31, 2010, net NPAs were 0.16% of the company's net loans. Also the company's customers are relatively poor, as a result, are more vulnerable if economic conditions worsen or growth rates decelerate in India, or if there are natural disasters such as floods and droughts in areas where its customers live. The company's business model requires it to carry out both the advances and repayments in the form of cash only. This has inherent risks of fraudulent nature of transactions being carried out by the employees.

### Inherent risks in scaling up business & dynamically managing it

The company's network of branches and customers has expanded rapidly and current valuations are factoring in substantial growth over the next several years. This kind of exponential growth comes with the inherent risk in scaling up the business & executing the transactions effectively. It will be a challenge for the company to maintain the personalized approach and the customer service, while keeping asset quality and opex in check. Also the company will have to substantially scale up its internet based software platform for integrated cash management system which covers about 65.9% of the branch network as of FY2010.

## Outlook and Valuation

We have compared SKSMF with a cross-section of Microfinance companies across the world, out of which Compartamos of Mexico and Bank Rakyat Indonesia (BRI) are amongst the closest comparables. Globally, MFIs are trading at 3.7x trailing P/BV and 19.1x P/E ratios.

Closest peer, Compartamos is trading at rich valuations of 8.0x trailing P/BV, which reflects the companies high-growth, high-RoE model (35% CAGR in assets over the last 4 years, 43% RoEs). RoE and yield on assets in Compartamos' Latin American markets are usually far above levels at which organized players function in India.

In our view, SKSMF offers a combination of robust and sustainable RoEs of about 20%, which is very healthy in the Indian context, and at the same time offers far higher growth potential, considering the relatively untapped market and scope for marketshare gains by SKSMF. At the upper end of the price band of Rs985, SKSMF will be valued at P/BV multiples of 6.6x FY2010 and 3.1x FY2012E. Although valuations are on the higher side, looking at the strong and sustainable growth and RoE prospects for the company, **we recommend a Subscribe to the issue.**

**Exhibit 11: Peer comparison**

| | | Growth | | | Profitability | Size | | Valuations | |
|---|---|---|---|---|---|---|---|---|---|
| Company | Country of Listing | Asset Growth (5 Yr CAGR) | Revenue Growth (5 Yr CAGR) | EPS Growth (5 Yr CAGR) | RoE (Latest) | Total Assets (Latest) (Rs cr) | Latest Mcap (Rs cr) | Latest P/E | Latest P/B |
| SKS Microfinance $ | India | 151.3 | 244.5 | 43.8 | 21.6 | 4,055 | 7,089 | 36.5 | 6.6 |
| African bank | South Africa | 33.3 | 23.6 | 2.9 | 15.0 | 21,947 | 17,238 | 17.3 | 2.2 |
| Banco Panamericano | Brazil | 46.5 | 38.2 | 26.0* | 13.9 | 30,958 | 5,752 | 13.5 | 2.0 |
| BRI | Indonesia | 25.4 | 14.8 | 12.9 | 29.5 | 155,557 | 63,696 | 18.1 | 4.1 |
| Compartamos # | Mexico | 34.5 | 35.8 | (25.9) | 43.1 | 3,289 | 11,623 | 21.7 | 8.0 |
| Danamon | Indonesia | 11.9 | 16.9 | (14.3) | 11.6 | 48,392 | 24,631 | 33.7 | 3.2 |
| First Cash Financial | USA / Mexico | 11.3 | 16.8 | 18.3 | 27.1 | 1,192 | 3,470 | 16.8 | 3.5 |
| Fin. Independecia * | Mexico | 75.8 | 87.8 | 2.0 | 31.6 | 2,116 | 3,386 | 15.5 | 4.5 |
| IPF * | UK | 1.1 | 4.1 | (3.7) | 12.7 | 5,038 | 4,123 | 16.5 | 2.1 |

*Source: Bloomberg, Angel Research; Note: * 2 Yr CAGR, # 4 Yr CAGR, $ Asset, Revenue & EPS CAGR for 4 years and Mkt Cap, P/E & P/B at the upper end of the price band*

## Income Statement

| Y/E Mar (Rs cr) | FY2007 | FY2008 | FY2009 | FY2010 | FY2011E | FY2012E |
|---|---|---|---|---|---|---|
| **Net Interest Income** | **27** | **84** | **264** | **495** | **868** | **1,246** |
| - YoY Growth (%) | 499.2 | 212.2 | 214.3 | 87.3 | 75.2 | 43.6 |
| **Other Income** | **5** | **29** | **95** | **175** | **277** | **401** |
| - YoY Growth (%) | 82.2 | 504.8 | 223.5 | 84.3 | 58.3 | 44.7 |
| **Operating Income** | **32** | **114** | **360** | **671** | **1,145** | **1,648** |
| - YoY Growth (%) | 344.0 | 256.9 | 216.7 | 86.5 | 70.8 | 43.9 |
| **Operating Expenses** | **25** | **80** | **222** | **351** | **614** | **891** |
| - YoY Growth (%) | 364.8 | 218.5 | 176.2 | 58.1 | 75.0 | 45.0 |
| **Pre - Provision Profit** | **7** | **33** | **138** | **319** | **531** | **757** |
| - YoY Growth (%) | 279.0 | 404.5 | 314.9 | 132.3 | 66.1 | 42.6 |
| **Provision and Contingencies** | **2** | **4** | **14** | **52** | **81** | **115** |
| - YoY Growth (%) | 170.6 | 107.1 | 220.8 | 283.1 | 56.4 | 41.9 |
| **Profit Before Tax** | **5** | **29** | **124** | **268** | **450** | **642** |
| - YoY Growth (%) | 361.7 | 537.7 | 328.5 | 115.8 | 68.0 | 42.7 |
| **Provision for Taxation** | **3** | **12** | **44** | **94** | **152** | **216** |
| - as a % of PBT | 60.3 | 42.5 | 35.3 | 35.0 | 33.7 | 33.7 |
| **PAT** | **2** | **17** | **80** | **174** | **298** | **426** |
| - YoY Growth (%) | 307.2 | 822.7 | 381.8 | 116.9 | 71.4 | 42.7 |

## Balance Sheet

| Y/E Mar (Rs cr) | FY2007 | FY2008 | FY2009 | FY2010 | FY2011E | FY2012E |
|---|---|---|---|---|---|---|
| Share Capital | 27 | 44 | 57 | 65 | 72 | 72 |
| Reserve & Surplus | 45 | 168 | 607 | 894 | 1,848 | 2,191 |
| Borrowings | 249 | 790 | 2,137 | 2,695 | 4,177 | 6,683 |
| Other Liabilities & Provisions | 15 | 87 | 238 | 403 | 694 | 961 |
| **Total Liabilities** | **335** | **1,089** | **3,039** | **4,055** | **6,791** | **9,907** |
| Cash and Bank Balance | 56 | 275 | 1,547 | 974 | 1,117 | 1,135 |
| Advances | 264 | 781 | 1,418 | 2,937 | 5,433 | 8,421 |
| - Growth (%) | 238.5 | 195.6 | 81.5 | 107.2 | 85.0 | 55.0 |
| Fixed Assets | 5 | 14 | 19 | 24 | 40 | 57 |
| Other Assets | 9 | 18 | 55 | 120 | 202 | 294 |
| **Total Assets** | **335** | **1,089** | **3,039** | **4,055** | **6,791** | **9,907** |
| - Growth (%) | 229.3 | 225.0 | 179.1 | 33.5 | 67.5 | 45.9 |

## Ratio Analysis

| Y/E Mar (Rs cr) | FY2007 | FY2008 | FY2009 | FY2010 | FY2011E | FY2012E |
|---|---|---|---|---|---|---|
| **Per Share Data (Rs.)** | | | | | | |
| EPS | 0.7 | 3.8 | 14.1 | 27.0 | 41.4 | 59.1 |
| BVPS | 26.8 | 47.9 | 116.5 | 148.5 | 266.8 | 314.4 |
| **Profitability ratios (%)** | | | | | | |
| NIMs | 12.4 | 11.1 | 12.3 | 13.6 | 16.6 | 15.5 |
| Other Inc/Avg. assets | 0.5 | 2.8 | 4.2 | 4.9 | 5.1 | 4.8 |
| Cost to Income ratio | 90.0 | 77.0 | 63.3 | 52.4 | 53.7 | 54.1 |
| ROA | 0.8 | 2.3 | 3.9 | 4.9 | 5.5 | 5.1 |
| ROE | 4.1 | 11.7 | 18.5 | 21.6 | 20.7 | 20.4 |
| **Capital Adequacy Ratio** | | | | | | |
| CAR | 24.7 | 24.7 | 39.0 | 28.6 | 42.8 | 32.8 |
| - Tier I | 24.7 | 24.7 | 38.5 | 28.6 | 42.8 | 32.8 |
| **Valuation Ratios** | | | | | | |
| PER (x) | 1,454.7 | 262.3 | 70.1 | 36.5 | 23.8 | 16.7 |
| P/BVPS (x) | 36.8 | 20.6 | 8.5 | 6.6 | 3.7 | 3.1 |
| **Dupont Analysis** | | | | | | |
| NII | 12.3 | 11.8 | 12.8 | 14.0 | 16.0 | 14.9 |
| (-) Prov. Exp. | 0.9 | 0.6 | 0.7 | 1.5 | 1.5 | 1.4 |
| Adj NII | 11.4 | 11.2 | 12.2 | 12.5 | 14.5 | 13.6 |
| Other Inc. | 2.2 | 4.1 | 4.6 | 4.9 | 5.1 | 4.8 |
| Op. Inc. | 13.6 | 15.4 | 16.8 | 17.4 | 19.6 | 18.4 |
| Opex | 11.6 | 11.3 | 10.8 | 9.9 | 11.3 | 10.7 |
| PBT | 2.1 | 4.1 | 6.0 | 7.5 | 8.3 | 7.7 |
| Taxes | 1.3 | 1.7 | 2.1 | 2.6 | 2.8 | 2.6 |
| **ROA** | **0.8** | **2.3** | **3.9** | **4.9** | **5.5** | **5.1** |
| Leverage | 5.0 | 5.0 | 4.8 | 4.4 | 3.8 | 4.0 |
| **ROE** | **4.1** | **11.7** | **18.5** | **21.6** | **20.7** | **20.4** |

## Annexure - 1

### Microfinance models in India

Microfinance has attempted to fill the void between mainstream commercial banks and private money lenders and has emerged as a fast-growing enabler for access to financial services for the poor.

Interest rates charged by microfinance organisations vary widely. Often they reflect inherently high operational and funding costs associated with rural lending activities and small loan sizes. For example, EDA-Rural Systems, in its 2004 Maturing of Indian Microfinance report, found that SHGs charged an effective interest rate of 24.0%-28.0%, while MFIs charged 32.0%-38.0%. As MFIs have grown, there has been evidence of some reduction in effective interest rates. According to the Microfinance MCRIL Analytics 2009 Report, the portfolio yield of MFIs surveyed was 31.4% in March 2009.

Microfinance has also focused on women as the recipients of loan. The focus on women follows the experiences of MFIs in South Asia, which indicate women tend have a better credit risk profile, thereby enabling a group-lending model. According to the 2009 State of the Microcredit Summit Campaign report, 83.2% of approximately 106.6 million microfinance borrowers worldwide in 2007 were women.

Currently, there are two microfinance models in India, the SHG model and the MFI model.

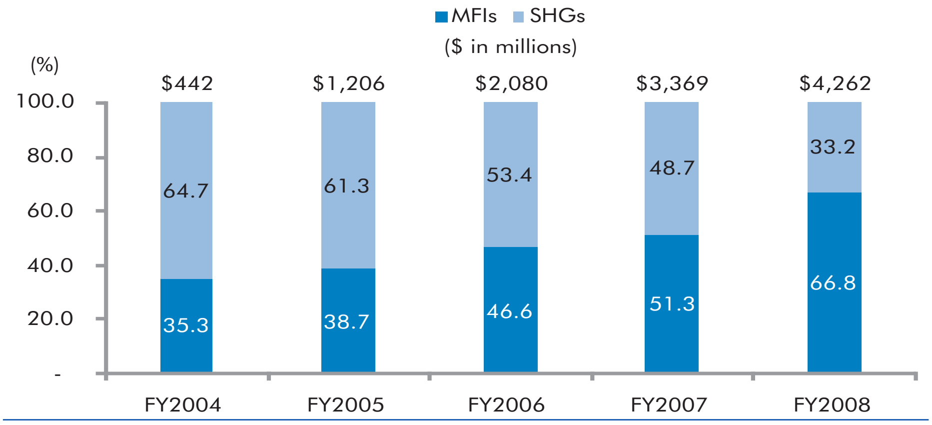
### The SHG Model

SHG is a group of 10 to 20 poor women in a village who come together to contribute regular savings to a common fund to deposit with a bank as collateral for future loans (usually in the savings to loan ratio of 1:1 to 1:4). The group has collective decision-making power and obtains loans from partner banks and other sources of capital, including MFIs in some instances. The SHG then loans these funds to its members at terms decided by the group.

Members of the group meet on a monthly basis to conduct transactions. Group leaders are responsible for maintaining their own records, often with the help of NGOs or government agency staff. In India, the microfinance movement started with the introduction of the SHG-Bank Linkage Programme in the 1980s by NGOs, which was formalised by the Government of India in the early 1990s. Pursuant to the programme, financial institutions, primarily public sector regional rural banks are encouraged to partner with SHGs to provide them with funding support, which is often subsidised by the government.

The SHG model is currently the dominant model in India in terms of number of borrowers and loans disbursed. The MFI model, however, is gaining market share from the SHG model. In its 2008 Inverting the Pyramid Report, Intellecap reported that market share for the SHG model has declined steadily from 2004 to 2008, as indicated in the chart below.

**MFIs gaining market share**




*Source: Angel Research, Intellecap, RHP*

SHGs are also showing signs of weak loan performance. According to the RBI's 2009 Report on Trends and Progress in India, bank recovery rates are relatively low. About 29.6% of the banks reported recovery rates of about 95.0% under the programme, 38.2% of the banks reported recovery rates in the range of 80.0% to 94.0%, another 22.1% of the banks reported recovery rates in the range of 50.0% to 79.0%, and 10.1% of the banks reported recovery rates of less than 50.0%.

**Emergence of the MFI model**

The MFI model has gained significant momentum in India in the recent years and continues to grow as a viable alternative to SHGs. In contrast to an SHG, an MFI is a separate legal organisation that provides financial services directly to borrowers. MFIs have their own employees and record-keeping and accounting systems and are often subject to regulatory compliance.

MFIs require borrowers from a village to organise themselves in small groups, typically a group of five women, that have joint decision-making responsibility for the approval of member loans. The groups meet weekly to conduct transactions. MFI staff travel to villages to attend weekly group meetings where they disburse loans and collect repayments. Unlike SHGs, loans are issued by MFIs without collateral or prior savings.

MFIs now exist in a variety of legal forms, classified under for-profit and not-for-profit. Both for-profit and not-for-profit, which includes trusts, societies, cooperatives, non-profit NBFCs, are registered under Section 25 of the Companies Act, and for-profit MFIs are registered with the RBI as NBFCs.

Trusts, cooperatives and section-25 companies are regulated by a specific legislation under which they are registered, and are not registered with the RBI.

Since there is no capital adequacy requirement for societies and trusts, they are not subjected to net owned funds requirements or prudential norms. MFIs seeking to obtain an NBFC license are required to have a minimum capitalisation of only Rs2cr. Recent legislation requires NBFCs to maintain a capital adequacy ratio of at least 12.0% by March 31, 2010, and 15.0% by March 31, 2011.

Favourable regulatory policies for MFIs, combined with weaknesses of the SHG model, continue to support MFI growth. According to the Bharat Microfinance Report, total MFI channel outreach grew from 10.0 million clients in 2007 to 22.6 million clients in 2009, representing a CAGR of 50.3%. The same report found that the total outstanding loan portfolio grew from Rs3,456cr in 2007 to Rs11,734cr in 2009, representing a CAGR of 84.3%.

For-profit MFIs have obtained a majority of the market share both in terms of clients and in terms of total outstanding loan portfolio. According to the same report, for-profit MFIs had 62.0% of all clients and 75.0% of outstanding loans as of March 2009.

The average loan outstanding per client has also increased in the recent years. According to the 2009 Microfinance India State of the Sector Report, average loan outstanding per client increased from Rs4,200 in 2008 to Rs5,200 in 2009, representing an increase of 23.8%. This increase is driven by increases in the percentage of borrowers that had loans exceeding Rs10,000 which grew from 20.0% in 2008 to 38.0% in 2009.

In addition to sustained growth in terms of borrowers and outstanding loan portfolio, the MFI model is demonstrating strong loan repayment rates as well. The RBI's November-December 2007 survey of MFIs reported a recovery rate of greater than 90.0%.

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