

MAY 09, 2011
RESULT

Coverage view: **Attractive**

Price (Rs): **332**

Target price (Rs): **350**

BSE-30: **18,519**
Protracted delay in normalization of business in AP worrying. Retain REDUCE.

SKS reported a net loss of Rs700 mn on the back of high provisions and interest write-back on its stressed loan book in AP. Recent regulatory developments are encouraging, but the delay in normalization of business in AP is raising concerns regarding SKS's ability to recover loans. We are cutting our estimates to model large credit losses in AP over the next two years. We cut our price target to Rs350, retain REDUCE.

Company data and valuation summary

SKS Microfinance

Stock data

52-week range (Rs) (high,low)	1,492-331
Market Cap. (Rs bn)	25.0

Shareholding pattern (%)

Promoters	37.0
FIs	20.6
MFs	0.0

Price performance (%)	1M	3M	12M
Absolute	(36.8)	(52.7)	0.0
Rel. to BSE-30	(33.1)	(54.0)	0.0

Forecasts/Valuations

	2011	2012E	2013E
EPS (Rs)	15.7	(39.1)	3.9
EPS growth (%)	-	(349.4)	(109.9)
P/E (X)	21.1	(8.5)	85.6
NII (Rs bn)	8.2	6.8	11.2
Net profits (Rs bn)	1.1	(2.9)	0.3
BVPS	237.8	203.9	212.0
P/B (X)	1.4	1.6	1.6
ROE (%)	8.3	(17.4)	1.9
Div. Yield (%)	0.0	0.0	0.0

SKS reported loss in 4QFY11

SKS reported loss of Rs700 mn in 4QFY11 on the back of provisions of Rs1 bn and interest write back of Rs810 mn.

- ▶ **SKS follow's RBI's NBFC guidelines on NPL provisions.** SKS follows RBI's NPL guidelines for NBFC on its AP loan book (since loans cannot be recovered on weekly basis) and its internal (more conservative) guidelines for other loans. Accordingly, the company will make provisions of 10% on loans which are 180-720 days overdue and 100% on loan overdue over 720 days. The policy for delinquencies on loans sold down is more conservative - the company has already written back all loan overdues from its loans sold down/ securitized. All its securitized pools are performing without any external support.
- ▶ **Malegam committee recommendation awaited.** As o March 2011, gross NPLs stood at 2.4% and net NPLs at 1.3%. Final recommendations of the Malegam committee (that SKS will need to eventually comply with) link provisions to overdue installments (and not outstanding loans); these are expected shortly.
- ▶ **Income reversal policy more conservative.** SKS has, however, reversed income on loan sell-down on loans overdue for over 90 days. As such, the company reversed Rs810 mn of interest income on its AP loan portfolio in 4QFY11. The management has highlighted that the entire income booked on overdue loans in AP has now been reversed.

Loan book shrinks further, incremental signals positive

SKS reported loan book of Rs41 bn down from Rs54 bn and Rs52 bn in December and September 2010, respectively. SKS went slow on incremental lending due to limited access to funding from banks.

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- ▶ **SKS better placed than other MFIs.** In the past few months, banks have been working on a restructuring package for MFIs. In light of SKS's low leverage and limited exposure to AP (25% as compared to 40% for other large players), the company has opted out of the restructuring package. The company sold down loans of Rs7 bn to banks during the quarter.
- ▶ **Regulatory developments encouraging.** The RBI has retained priority sector status on MFIs (that fulfill the criteria decided by the Malegam Committee) although this has been withdrawn for all direct lending (refinance) to NBFCs. We believe that the positive regulatory developments and priority sector status will help SKS and MFIs grow business in other geographies. On this low base, we are modeling 30% and 22% loan growth CAGR over next two years.
- ▶ **Pain in some other pockets.** Collection efficiency in select pockets of West Bengal (90% for SKS in 4QFY11 and 95% in 3QFY11) and Tamil Nadu has declined due to localized opposition. Given that the constraints are localized and not State-wide, the management expects to overcome the challenges as in the past.
- ▶ **Spread of 12%.** SKS's marginal borrowings cost is close to 12% and lending yield is now capped at 24%. We are modeling spread of about 12% in our model (and upfront fees of 1%). The recent credit policy has proposed a cap of 12% on spreads for MFIs even as the lending rate has been increased to 26%.

Pain in AP loan book imminent for MFIs

We believe delay in resolution of the MFI dispute in the state of AP and restoration of normal business conditions will drive significant NPLs for MFI. The AP Ordinance was passed about six and half months back but MFIs have not resumed disbursements; collections remain low at 10% as compared to 99% in the past. RBI's Malegam committee report raises the hope of resolution in the near future. Nevertheless, credit losses in the loan book appear imminent due to unsecured nature of the loan book.

In light of the delay, we are raising our estimates of credit losses. We are now modeling credit losses of Rs10 bn staggered over FY2010-12E. We are consequently modeling credit losses of Rs5bn and Rs4.4 bn in FY2011E and FY2012E. The extent and timing of credit losses has high sensitivity to restoration of normal business conditions in AP and the provisioning policy followed by SKS (post the final recommendations of Malegam Committee).

Reducing target price, retain REDUCE

We believe that SKS can deliver 20%+ steady state RoEs. However, credit losses in AP will pull down net earnings over next two years. We are revising our estimates to factor lower growth, high credit losses as discussed above. Lower competition and better operating leverage are upsides to our estimates. Resolution in AP and clarity on the losses in the state remain key sensitivities. We are cutting our price target to Rs350 from Rs700 and retain our REDUCE rating. At our price target, SKS will trade at 1.7X PBR FY2013E for 20% steady state RoE.

SKS- Quarterly sheet
4QFY 10-4QFY11 (Rs mn)

	4Q10	1Q11	2Q11	3Q11	4Q11	YoY(%)	4Q11E	Actual vs KS (%)
Interest income	2,390	2,250	3,020	3,375	1,620	(32)		
Income on loans sold down	380	550	350	200	90	(76)		
Other interest income	30	45	50	40	—	(100)		
Interest expenses	820	733	910	970	868	6		
Net interest income	1,980	2,112	2,510	2,644	842	(57)	1,972	(57)
Credit cost	150	120	170	1,008	1,062	608	960	11
NII (post credit cost)	1,830	1,993	2,340	1,637	(220)	(112)	1,012	(122)
Other income	240	290	310	280	230	(4)	250	(8)
Membership fees	50	40	40	20	—	(100)		
Insurance commission	30	40	190	20	10	(67)		
Group insurance charges	130	170	40	190	160	23		
Others	30	40	40	50	60	100		
Operating expenses	1,090	1,269	1,410	1,399	1,055	(3)	1,200	(12)
Administration expenses	400	412	480	474	339	(15)		
Employee expenses	650	815	880	887	683	5		
Depreciation	40	42	50	38	34	(16)		
PBT	980	1,014	1,240	518	(1,046)	(207)	62	(1,784)
Tax	350	348	430	176	(350)	(200)	(19)	1,722
PAT	630	666	810	341	(696)	(210)	81	(956)
Other operational highlights								
Members (mn)	6.8	7.3	7.8	7.7	7.3			
Active borrowers (mn)		6.2	6.6	6.4	6.2			
MFI Loans (Rs mn)	43,210	45,780	54,340	50,280	41,110			
Disbursements (Rs mn)	23,010	22,830	31,710	—	7,860			
Branches (#)	2,093	2,266	2,407	2,403	2,379			
Gross yields (%)	28.3	29.8	29.8	29.8	17			
Portfolio yield (%)	25.3	25.2	26.9	27.7	15			
Borrowings cost (%)		10.2	10.2	—	7.6			
Marginal borrowing cost (%)		9.7	9.8	—	12			
Operating costs/ income (%)	49.1	52.8	50.0	47.8	98.5			
NIM (KS- %)	19.6	19.0	20.1	20.2	14.5			
RoA (%)	6.2	6.0	6.5	2.6	(6.1)			
Gross NPL (%)	—	0.2	0.2	0.4	2.4			
Net NPLs (%)	0.16	0.11	0.1	0.23	1.28			
Capital adequacy ratio (%)	28.2	24.9	33.2	35.6	45			
Balance Sheet (Rs mn)								
Networth		10,270	18,040	18,450	17,808			
Equity share capital		650	720	720	723			
Reserves		9,620	17,320	17,730	17,085			
Loan funds		27,620	35,000	32,040	22,361			
Current liabilities and provisions		4,330	4,390	3,700	2,828			
Total liabilities		42,220	57,430	54,190	42,997			
Fixed Assets		220	230	240	219			
Intangible assets		80	90	80	93			
Investments		2	40	40	38			
Deferred tax assets		110	260	370	357			
Security deposit		1,720	1,330	1,150	—			
Cash		2,960	4,540	2,830	5,579			
Sundry debtors		30	30	20	19			
Other current assets		738	780	950	156			
Loan and advances		36,340	50,130	48,510	36,535			
Total assets		42,200	57,430	54,190	42,995			

Source: Company

SKS: Key financial highlights
March fiscal year-ends, 2009-2013E

	2009	2010	2011E	2012E	2013E
Operating highlights					
Branches (#)	1,354	2,093	2,379	2,879	3,479
Clients (# mn)	3.9	6.8	7.3	6.4	7.1
Loan book/ branch (Rs mn)	18.1	20.6	17.3	18.5	18.7
Average loan size (Rs '000)	6,298	6,354	5,632	8,344	9,178
Average clients/employee (#)	299	321	321	258	225
Spreads (%)	14.0	13.0	13.2	12.5	12.5
NII / loans under management (%)	17.8	17.6	19.4	14.5	19.0
Operating costs/ net income (post provisions- %)	61.8	52.4	74.6	219.8	94.2
Debt/ equity (X)	3.0	2.8	1.3	1.4	1.7
Growth in key parameters (%)					
Net interest income	228	91	37	(16)	64
PAT	381	117	(35)	(355)	(110)
EPS	345	61	(42)	(349)	(110)
Du Pont analysis					
(% of average loans under management)					
Net interest income	17.8	17.6	19.4	14.5	19.0
Other income	2.7	2.2	2.5	1.2	1.2
Credit costs	0.7	1.5	5.7	11.5	8.9
Operating expenses	12.7	10.4	12.1	11.2	12.0
PBT post extraordinaries	7.1	7.9	4.1	(6.1)	0.7
1-tax rate	0.6	0.6	0.6	1.0	0.7
RoA	4.6	5.1	2.7	(6.1)	0.5
Average assets / average equity (X)	4.0	4.2	3.1	2.9	3.8
RoE	18.5	21.7	8.3	(17.4)	1.9

Source: Company, Kotak Institutional Equities

SKS: Highlights of P&L and Balance Sheet
March fiscal year-ends, 2009-2013E (Rs mn)

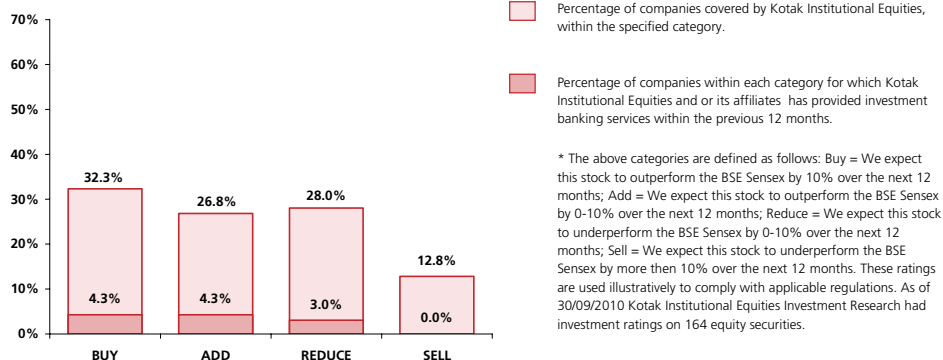
	2009	2010	2011E	2012E	2013E
Income statement (Rs mn)					
Net interest income	3,125	5,965	8,180	6,843	11,224
Fee income	456	673	920	539	698
Net total income	3,595	6,704	9,220	7,406	11,947
Provisioning expenses	135	517	2,360	5,000	4,421
Operating expenses	2,220	3,511	5,120	5,289	7,094
PBT before extraordinaries	1,240	2,676	1,740	(2,883)	433
Tax	438	937	610	0	143
PAT	801	1,739	1,130	(2,883)	290
No. of shares (mn)	48	65	72	74	75
EPS (Rs)	17	27	16	(39)	4
BVPS (Rs)	137	147	247	207	212
Balance sheet (Rs mn)					
Assets					
Loans (1)	14,127	29,271	34,790	21,768	27,127
Total assets	30,389	40,475	43,010	44,279	55,002
Loans outside books (2)	10,389	13,843	6,320	31,580	37,895
Loans under management (1) + (2)	24,564	43,210	41,110	53,348	65,022
Liabilities					
Borrowings	19,960	26,946	22,360	21,081	26,579
Total liabilities	23,832	30,970	25,190	29,018	39,130
Share capital	479	645	720	737	749
Shareholders funds	6,557	9,503	17,800	15,261	15,872

Source: Company, Kotak Institutional Equities estimates

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Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of March 31, 2011

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ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

REDUCE. We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

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Our target price are also on 12-month horizon basis.

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