October 1, 2009

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CMP : INR 223
Rating : Buy
Target : 275

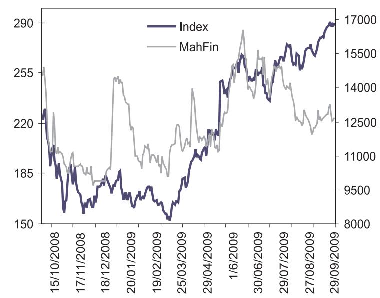
M&M Financial Services (MMFSL)

KEY DATA	
Market Cap (INR bn)	21.6
Market Cap (USD mn)	450.2
52 WK High / Low	294/161
Avg Daily Volume (BSE)	49547
Face Value (INR)	10

BSE Sensex	17127
Nifty	5084
BSE Code	532720
NSE Code	M&MFIN
Reuters Code	MMFS.BO
Bloomberg Code	MMFS IN

Shareholding %	3Q	4Q	1Q
Promoters	62.0	61.0	61.0
MF/Banks/Indian FIs	0.0	0.0	3.0
FII/ NRIs/ OCBs	35.0	35.0	32.0
Indian Public	3.0	4.0	4.0

Performance Chart



PRICE PERFORMANCE (%)

	3 M	6 M	12 M
Absolute	14.0	76.1	33.8
Relative	27.0	68.7	45.3

Financials (INR bn.)	F09	F10E	F11E
NII	8,550	9,298	10,839
PAT	2,145	2,413	2,904
EPS per sh	22.1	24.8	29.9
ABV per sh	131.4	145.5	161.3

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We interacted with the management of Mahindra & Mahindra Financial Services Limited. The key takeaways of the meeting are as under.

Disbursement growth

The disbursements are expected to grow at a CAGR of 20% over FY09-FY11E. This would be driven by revival in the auto segment (MoM growth in auto numbers) and relatively stable interest rates. Additionally, the several schemes launched by the government for rural India and the higher budgetary allocations towards the farm segment are likely to fuel demand in rural areas.

Spreads/ Margins

MMFSL is suitably placed between the money lenders and organized players like banks which has contributed to lesser competition and better yields (compared to urban areas). Presently, the tractor segment has the highest average yields of 20-24% followed by CV (avg yield 20%) and UV segments (avg yield ~18%). Going forward management expects to maintain spreads of ~11%.

Funding Mix

NCD's/ Debentures will continue to be the major source of funding for the company whereas the dependence on securitization will come down. According to the management, the company would restrict securitization to 15% of the funding mix in-order to improve balance sheet growth.

Asset Quality

NPA's have increased significantly (GNPA at 9.8% in Q1FY10) in the last 2-3 years led by the defaults from the tractor and CV segments. MMFSL follows aggressive provisioning policy (provision coverage of ~70%) thereby capping net NPA's at ~2.5% levels despite increase in slippages. However, considering the very nature of business, the gross NPAs are expected to remain high.

Capital adequacy

MMFSL maintains high capital adequacy ratio of 18.8% (tier I CAR of 17.2%) against the minimum requirement of 12% by RBI. Management plans to maintain CAR above 14% which leaves significant room for expansion of business.

Valuation

The company's asset quality risk is already priced due to aggressive provisioning policy. Currently the stock is trading at 1.6x FY10 ABV, a significant discount to Shriram Transport finance. We believe that MMFSL will make ~17% RoE's by FY11 (15.4% in FY09) led by strong earnings growth and should trade at 1.7x FY11 ABV. We initiate coverage with a target price of INR 275.

Concerns

MMFSL growth is dependent upon the growth of the parent company (M&M) as 60% of the vehicles financed are M&M vehicles.

About the company

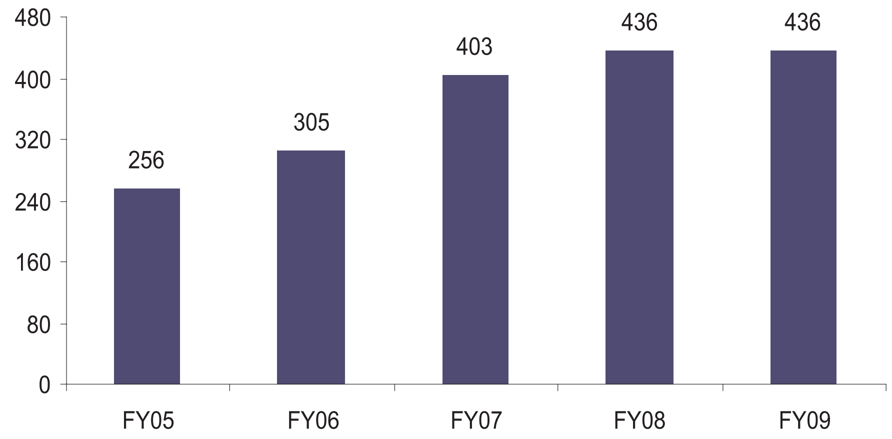
Mahindra & Mahindra Financial Services Ltd (MMFSL) is India's leading NBFC focused on the rural and semi-urban sector providing finance for utility vehicles, tractors and cars. MMFSL has a network of 436 branches in rural areas and has a total asset under management of INR 85.9 billion. The company is a subsidiary of M&M, a leading tractor and UV manufacturer with over 60 years experience in the Indian market.

Business Model

M&M vehicles account for 60% of the AUM

MMFSL is uniquely positioned between the organized banking sector and the local moneylenders providing vehicle finance to rural customers. The company principally finances UVs used both for commercial and personal purposes, tractors and cars. MMFSL's client base predominantly are small entrepreneurs or self-employed individuals such as transport operators, taxi operators and farmers. M&M vehicles account for about 60% of the loan book as it provide finance to over 1350 dealers of which 70% are M&M and PTL (Punjab Tractors Ltd.) dealers. MMFSL is also preferred financier for Maruti vehicles and has tie up with several Maruti dealers.

Chart : Branch Network



Source : Company, FQ Research

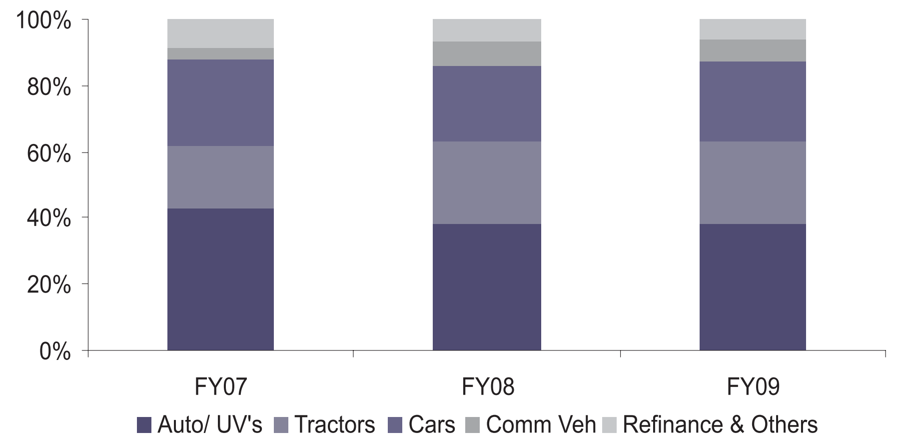
MMFSL has tie up with 1350 auto dealers, out of which ~900 are M&M & PTL dealers

MMFSL sources business mainly through its own branches and dealer networks of auto manufacturers. As on Q1FY10, the company had a network of 436 branches, spread over rural and semi-urban areas in India and covering almost 90% of the districts in India. MMFSL has tie ups with over 1350 automobile dealers (M&M and non M&M) in India, present mainly in the rural and semi-urban areas. The vast distribution network has enabled MMFSL to post strong and consistent growth in business. Further, the company's strong presence in rural areas has helped in cross-selling its other financial products, like insurance and mutual funds, to its customers, thereby contributing to improved profitability.

Asset composition

MMFSL asset book has grown at a robust 28% CAGR over FY05-FY09 led by aggressive expansion and strong growth in the auto sector. Currently, the company has over INR 85 billion of assets under management. Initially, the company started with financing UV and tractor manufactured by M&M and thereafter entered into CV and car financing. Presently, UV's occupy the highest portion of assets followed by tractors and cars.

Chart : Break up of Loan book



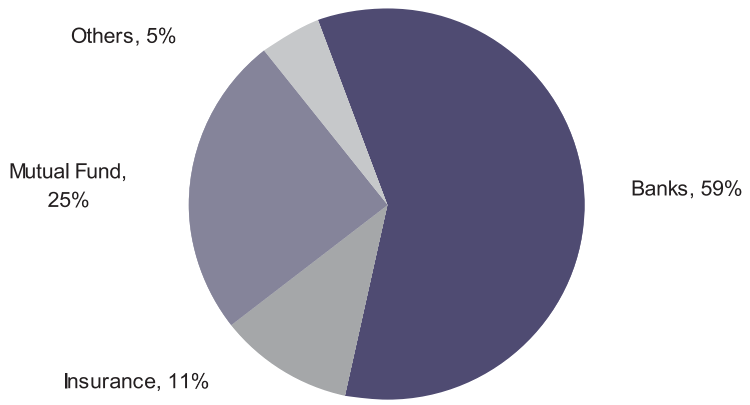
Source : Company, FQ Research

NCD's & Bank loans form major source of funding

Funding Profile

The company raises funds from diversified sources and through a wide range of instruments including non-convertible debentures, commercial paper, index-linked debentures, foreign currency loans, variable rate securities and securitization. It also undertakes non-recourse securitization transactions to increase capital adequacy ratio and increase the efficiency of the loan portfolio. FITCH has assigned AA (ind) rating and CRISIL has assigned a AA- rating to the Company's long term debt, which is also linked to credit rating of M&M. Presently, NCD's and bank loans form major source of funding for the company.

Chart : Funding Mix



Source : Company, FQ Research

Recovery and Collection

The recovery and collections activities are carried out by the company's own executives who are recruited locally. Once the default is identified by the local field executive; appropriate action is initiated such as requiring partial repayment and/or seeking additional guarantees or collateral. A few years back, the company was using external collection agencies for collection, which has been abandoned due to high recovery expenses. In the event of serious defaults the company repossess the vehicles and written intimation is given to the local police and notice is served on the customer/ guarantor. If the outstanding amount is not paid within the specified period, the vehicle is disposed through auction.

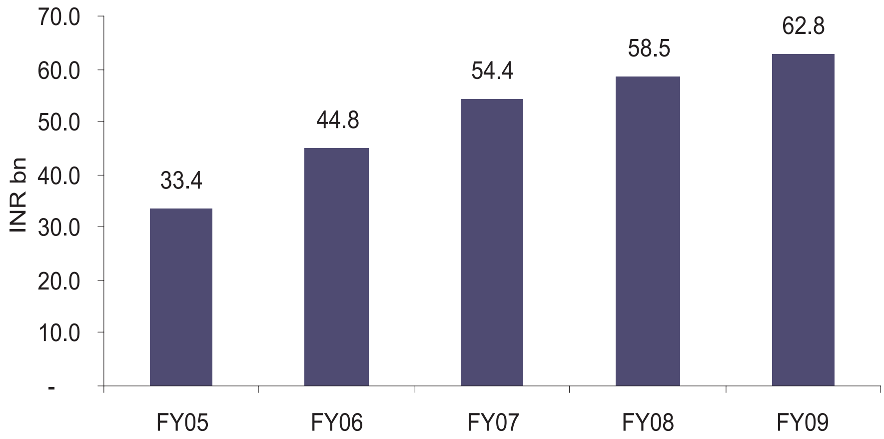
Key Points

Disbursement to grow by 20% over FY09-FY11E

Revival in auto sales coupled with governments thrust on rural economy will drive business growth

The disbursements are expected to grow at a CAGR of 20% over the FY09-FY11. This would be driven by revival in the auto segment (MoM growth in auto numbers) and relatively stable interest rates. In addition to that, the several schemes launched by the government and the higher budgetary allocations are likely to increase demand in rural areas. The company will focus on financing UV and car segments which are expected to grow at 15-20% YoY in FY10. However financing in the tractor segment is expected to grow at ~5% primarily due to slowdown in tractor industry and higher defaults in the tractor portfolio.

Chart : Disbursement



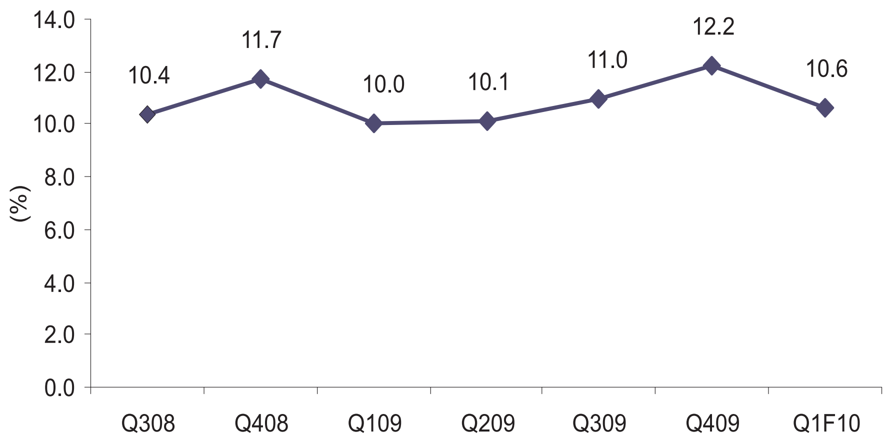
Source : Company, FQ Research

Spreads / Margins expected to improve in subsequent quarters

Traditionally spreads have remained low in first quarter and improves in subsequent quarters

MMFSL is suitably placed between the money lenders and organized players like banks. The moneylenders charge excessive rates whereas banks have limited presence in the rural areas with poor service levels. This has contributed to low competition and better yields (compared to urban areas) resulting in higher spreads for MMFSL. Presently, the tractor segment has the highest average yields of 20-24% followed by CV (avg yield 20%) and UV segments (avg yield ~18%). Historically, the spreads have remained subdued in first and the second quarters and pick up in the last two quarters. The company expects to maintain spread of 10-11% over the next two years.

Chart: Spreads



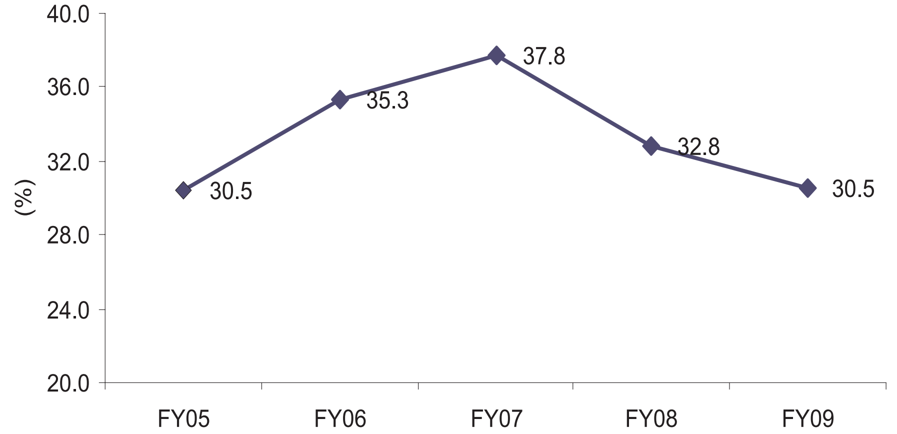
Source : Company, FQ Research

Over the next three years company plans to increase branch tally to 600 from 436 currently

Cost to income ratio to be maintained at ~30%

Led by strong traction in the core business and reduction in expenses (for eg dealers commission etc), the company reduced its cost to income ratio to 30.5% in FY09 from 35% in FY05. Historically, the company's operational expenses have remained high due to aggressive branch expansion and higher collection & recovery costs. MMFSL plans to ramp up its branch network to ~600 (currently 436 branches) over the next three years. However, with tight cost controls and increased collection efficiency, the management expects to maintain cost to income ratio in the range of 30-32%.

Chart: Trend for cost to income ratios



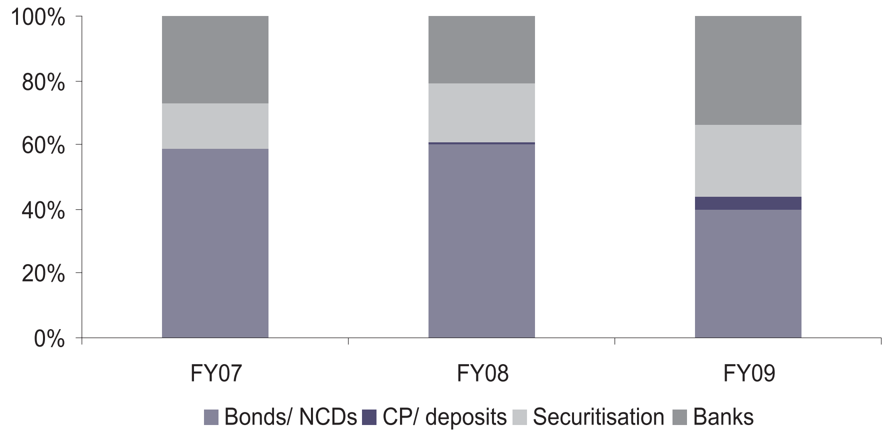
Source : Company, FQ Research

Relatively lower securitisation in future will aid balancesheet growth

Securitization would be restricted to 15% of the funds

NCD's/ Debentures will continue to be the major source of funding for the company whereas the dependence on securitization will come down. Since liquidity crisis in Oct-Dec the reliance on bank loans for funding has increased and constitutes 45% of the funding mix (21% in FY08). The company has done 38 securitization / assignment transactions till date aggregating INR 41.6 billion. In Q1FY10, securitization increased to 22.4% of the total funds as attractive rates were offered. Going forward, the company would restrict securitization to 15% of the funding mix in-order to improve balance sheet growth.

Chart : Funding Mix



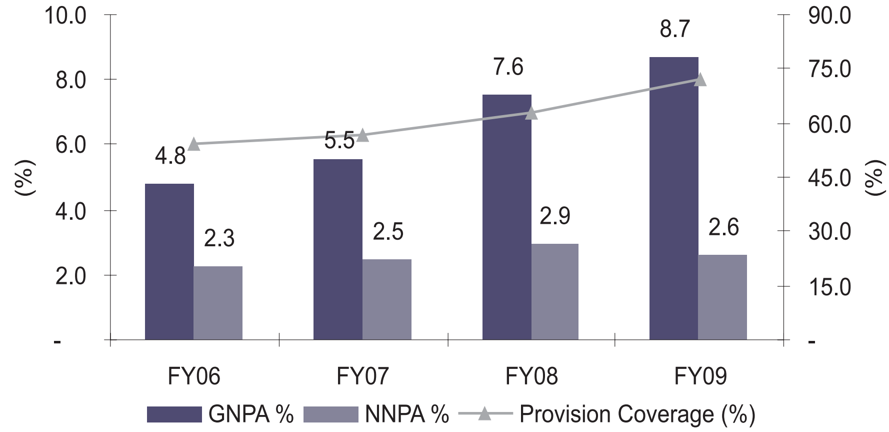
Source : Company, FQ Research

Gross NPA to remain high, provisioning to continue

Asset quality has deteriorated significantly in the last 2-3 years led by the defaults from the tractor and CV segments. Gross NPA's have increased to 9.8% (Q1FY10) from 5.5% in FY07. Tractor segment alone contributes to ~30% for the gross NPAs. However, considering the very nature of business where the lending is primarily to retail customers with irregular cash flows; the gross NPAs are expected to remain high.

Provision coverage ratio has increased to 72% in FY09 from 54% in FY06

Chart : NPA and provisioning trends



Source : Company, FQ Research

MMFSL follows aggressive provisioning and write off policy leading to low net NPAs despite increase in slippages. The net NPA's have consistently remained at ~2.5% whereas provision coverage ratio has increased to 72% (in FY09) from 54% in FY07. Management expects gross NPA to remain at the higher levels (6-7% of loans) due to the nature of business but will continue to pursue its aggressive provision policy.

Rural experience acts a strong entry barrier

Rich knowledge base of operating in rural/ semi-urban areas with over a decade of experience distinguishes MMFSL from other players. Further, the association with M&M which is the market leader in UVs and tractors and strong dealer presence across the country adds strength to the company's business. MMFSL's operations and recovery mechanisms are well tuned according to the local requirements and acts as a deterrent for the new player's to enter into the business.

CAR to be maintained at 14% levels

MMFSL maintains high capital adequacy ratio of 18.8 %(tier I CAR of 17.2%) against the minimum requirement of 12% by RBI. The company had raised capital in the FY08 leading to a high CAR. Management plans to maintain CAR above 14% which leaves significant room for expansion of loan book. At the given growth rate (~20%), the company is unlikely to raise capital at least for the next 2 years.

Strong growth potential from subsidiaries

The subsidiaries MRHFL & MIBL have strong growth potential in the long term

The company has ventured into rural housing and insurance broking space through its subsidiaries Mahindra Rural Housing Finance Ltd (MRHFL) and Mahindra Insurance Broking Ltd (MIBL). Both the subsidiaries have strong synergy with company's existing business and have promising prospects ahead. MRHFL currently has built up a loan book of INR 780 million and expects to ramp it up to INR 1.5 billion by the end of FY10. MIBL insures about 75% of the vehicles financed by its parent company (MMFSL) and had posted a PAT of INR 65 million in FY09 and INR 30 million in Q1FY10. Currently, the subsidiaries are in the start up phase and are expected to add significant value to the company (MMFSL) in the long term.

Q1FY10 Results Analysis

Net profit during Q1FY10 grew by 50% YoY to INR 400 million. The net interest income growth was subdued posting a growth of 8% YoY mainly due to slower growth in loans. Led by decline in the funding costs, the NIMs increased by 26 bps YoY to 10.6%, although it declined by 200 bps sequentially. The Company's disbursement registered a growth of 8% at INR 16.2 billion as compared to INR 15 billion during Q1FY09. Gross NPA's inched up to 9.8% whereas net NPA increased to 3.1% as the collection efficiency is usually lower in the first quarter.

Valuation & Outlook

MMFSL is expected to benefit from the government's thrust to the rural economy and revival in the auto segment. We expect business growth to pick up in the coming quarters resulting in disbursement growth of ~18% for FY10. The company would continue to make aggressive provisions to manage the asset quality risks. Currently the stock is trading at 1.6x FY10E ABV, a significant discount to Shriram Transport finance. We believe that MMFSL will make ~17% RoE's by FY11E (15.4% in FY09) led by strong earnings growth and should trade at 1.7x FY11E ABV. Historically, the stock has traded in the range of 1.5x - 2.5x, 1 year forward ABV. We initiate coverage with a target price of INR 275.

Concerns

- MMFSL growth is dependent upon the growth of the parent company (M&M) as 60% of the vehicles financed are M&M vehicles. Slowdown in the parent company's business may negatively impact MMFSLs business growth.

- Increase in NPA's especially from the farm segment would increase the provisioning requirements leading to decline in profitability.

Chart: P/ABV Band

Source : Company, FQ Research

STANDALONE FINANCIALS

Profit and Loss statement

FYE March, INR mn	FY08	FY09	FY10E	FY11E
Interest earned	12,057.5	13,648.2	14,837.6	17,544.2
Interest expended	4,560.0	5,098.6	5,539.9	6,705.1
Net interest income	7,497.6	8,549.6	9,297.6	10,839.1
Non-interest income	210.5	198.4	203.3	212.1
Operating expenses	2,525.3	2,667.8	2,844.8	3,033.5
Pre-provisioning profits	5,182.7	6,080.2	6,656.0	8,017.7
Provisions & contingencies	2,462.9	2,823.9	3,000.3	3,618.0
PBT	2,719.9	3,256.3	3,655.7	4,399.8
Income tax, Interest tax	949.6	1,111.1	1,242.9	1,495.9
Net profit	1,770.2	2,145.2	2,412.8	2,903.8

Balance Sheet

FYE March, INR mn	FY08	FY09	FY10E	FY11E
Cash and Bank balances	2,152.8	2,763.1	2,507.1	2,503.4
Other current assets	24.0	33.2	39.0	44.5
Current Liabilities & provisions	6,650.5	7,616.9	8,505.9	9,559.8
Net Current Assets	(4,473.6)	(4,820.6)	(5,959.7)	(7,011.9)
Loans and advances	66,435.2	68,383.4	80,008.5	95,210.2
Investments	30.8	1,097.1	582.7	743.7
Net Block (inc CWIP)	307.5	356.9	375.7	397.3
Intangibles	13.4	17.5	15.0	14.0
Deferred Tax asset	1,254.4	1,787.5	1,966.3	2,162.9
Total assets	63,567.6	66,821.8	76,988.5	91,516.1
Share Capital	952.9	957.1	959.0	959.0
Options/warrants/others	13.5	12.9	12.3	11.3
Reserves & surplus	12,176.2	13,721.6	15,434.3	17,495.5
Net Worth	13,142.6	14,691.6	16,405.6	18,465.9
Secured Loans	46,135.3	44,668.3	51,815.3	62,178.3
Unsecured Loans	4,289.7	7,461.8	8,767.6	10,871.9
Total liabilities	63,567.6	66,821.8	76,988.5	91,516.1

Ratios

FYE March, INR mn	FY08	FY09	FY10E	FY11E
Shares outstanding (mn)	96.6	97.0	97.1	97.0
FDEPS (Rs)	18.3	22.1	24.8	29.9
DPS (Rs)	4.5	5.5	6.2	7.4
Book value (Rs)	136.0	151.5	168.9	190.3
Adjusted book value INR/ sh	114.7	131.4	145.5	161.3
Valuation ratios				
P/E (x)	12.6	10.4	9.3	7.7
P/BV (x)	1.7	1.5	1.4	1.2
P/ABV (x)	2.0	1.8	1.6	1.4
Return Ratios (%)				
Interest spread	10.4	10.6	10.5	10.5
Net interest margin (incl securitisation)	11.4	12.1	11.9	11.9
Yield on assets	18.5	19.4	19.1	19.3
Cost of funds	8.1	8.7	8.6	8.8
Opex cost/ Total income	32.8	30.5	29.9	27.4
Return on average net worth	16.9	15.4	15.5	16.7
Return on average assets	2.9	3.3	3.4	3.4
Growth ratios (%)				
Net interest income	48.5	14.0	8.7	16.6
Total income	48.9	13.5	8.6	16.3
Pre-provisioning profit	60.8	17.3	9.5	20.5
PAT	33.2	21.2	12.5	20.4
Asset quality (%)				
Gross NPA	7.6	8.7	9.0	8.8
Net NPA ratio	2.9	2.6	2.7	2.8
CAR	20.7	19.4	17.6	16.5
Tier-I ratio	16.8	17.3	15.4	14.3

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Outperformer	Marketperformer	Underperformer
More than 10% to Index	Within 0-10% to Index	Less than 0-10% to Index