Company Focus

SMALL & MID CAP

6 November 2007 | 36 pages

# Motilal Oswal Financial Services (MOFS.BO)

Initiation of coverage

## Initiating at Buy: Good Business in Good Times

- **Initiating at Buy (1M), Rs1,500 target** — MOFS is one of India's larger independent domestic brokers; it has a strong, growing presence in both retail and institutional segments and offers one of the few standalone, diversified low-risk opportunities to invest in the Indian capital market space. We value MOFS near market multiples, at 22x FY09E earnings.
- **Equity markets: strong but has risks** — India's equity markets have grown rapidly in both retail and institutional activity. Economic growth, increasing equity participation and consolidation should drive further expansion. However, high current activity levels, strong recent volume growth, and increasing regulatory oversight (recent limit on P-Notes) suggest some near-term caution.
- **MOFS: Amongst larger players, growing market share, well balanced business** — MOFS has over 5% share of total market volumes; is amongst top 5 domestic retail and institutional brokers, and is building out a well rounded product suite including investment banking, wealth and asset management. We believe it is well positioned to benefit from the expansion in India's financial services sector
- **Strong earnings growth** — We estimate 41% 3-year recurring EPS growth, relatively weighted towards broking, backed by investment banking revenues. The business has high operating leverage, is market-volume dependent (+/-10% volumes = +/-12% earnings), and we factor in some market share gains.
- **Risks** — Equity market volatility, competitive pricing pressures and execution.

| **Buy/Medium Risk** | **1M** |
|---|---|
| Price (05 Nov 07) | Rs1,205.00 |
| Target price | Rs1,500.00 |
| Expected share price return | 24.5% |
| Expected dividend yield | 0.0% |
| **Expected total return** | **24.5%** |
| Market Cap | Rs34,227M |
| | US$873M |

**Price Performance (RIC: MOFS.BO, BB: MOFS IN)**

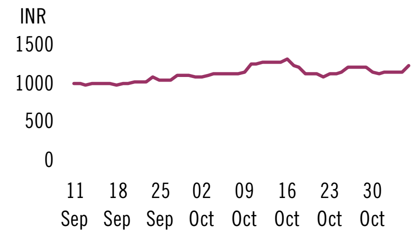


**Figure 1. Statistical Abstract**

| Year to March | Net Profit (Rs Mils.) | FD EPS (Rs) | EPS Growth (%) | P/E (X) | P/BV (X) | RoAE (%) | ROAA (%) | Div Yld (%) |
|---|---|---|---|---|---|---|---|---|
| 2006A | 602 | 21.4 | NA | 56.2 | 30.7 | 54.7 | 13.6 | 0.0 |
| 2007A | 684 | 30.7 | 43.2 | 39.2 | 9.2 | 30.9 | 10.2 | 0.0 |
| 2008E | 1,468 | 46.6 | 51.7 | 25.9 | 4.7 | 27.7 | 12.8 | 0.0 |
| 2009E | 1,945 | 68.5 | 47.0 | 17.6 | 3.7 | 23.7 | 12.8 | 0.1 |
| 2010E | 2,462 | 86.7 | 26.6 | 13.9 | 2.9 | 23.7 | 13.6 | 0.1 |

Source: Company Reports and Citi Investment Research estimates

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| Fiscal year end 31-Mar | 2006 | 2007 | 2008E | 2009E | 2010E |
|---|---|---|---|---|---|
| **Valuation Ratios** | | | | | |
| P/E adjusted (x) | 56.2 | 39.2 | 25.9 | 17.6 | 13.9 |
| P/E reported (x) | 56.2 | 44.8 | 23.3 | 17.6 | 13.9 |
| P/BV (x) | 30.7 | 9.2 | 4.7 | 3.7 | 2.9 |
| P/Adjusted BV diluted (x) | 30.7 | 9.2 | 4.7 | 3.7 | 2.9 |
| Dividend yield (%) | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 |
| **Per Share Data (Rs)** | | | | | |
| EPS adjusted | 21.43 | 30.70 | 46.59 | 68.48 | 86.67 |
| EPS reported | 21.43 | 26.93 | 51.69 | 68.48 | 86.67 |
| BVPS | 39.21 | 131.06 | 255.62 | 323.10 | 408.76 |
| Tangible BVPS | 39.21 | 131.06 | 255.62 | 323.10 | 408.76 |
| Adjusted BVPS diluted | 39.21 | 131.06 | 255.62 | 323.10 | 408.76 |
| DPS | 0.00 | 0.00 | 0.50 | 1.00 | 1.00 |
| **Profit & Loss (RsM)** | | | | | |
| Net interest income | 48 | 224 | 398 | 637 | 814 |
| Fees and commissions | 2,591 | 3,500 | 5,296 | 7,060 | 8,814 |
| Other operating Income | 55 | 29 | 106 | 123 | 145 |
| **Total operating income** | **2,693** | **3,752** | **5,800** | **7,821** | **9,773** |
| Total operating expenses | -1,793 | -2,534 | -3,748 | -4,816 | -5,986 |
| **Oper. profit bef. provisions** | **901** | **1,218** | **2,052** | **3,005** | **3,787** |
| Bad debt provisions | 0 | 0 | 0 | 0 | 0 |
| Non-operating/exceptionals | 0 | 0 | 0 | 0 | 0 |
| **Pre-tax profit** | **901** | **1,218** | **2,052** | **3,005** | **3,787** |
| Tax | -298 | -410 | -681 | -997 | -1,257 |
| Extraord./Min. Int./Pref. Div. | -1 | -123 | 97 | -62 | -69 |
| **Attributable profit** | **602** | **684** | **1,468** | **1,945** | **2,462** |
| Adjusted earnings | 602 | 780 | 1,323 | 1,945 | 2,462 |
| **Growth Rates (%)** | | | | | |
| EPS adjusted | na | 43.2 | 51.7 | 47.0 | 26.6 |
| Oper. profit bef. prov. | na | 35.2 | 68.5 | 46.4 | 26.0 |
| **Balance Sheet (RsM)** | | | | | |
| **Total assets** | **4,421** | **9,004** | **13,911** | **16,547** | **19,771** |
| Avg interest earning assets | 5,093 | 3,989 | 7,493 | 10,632 | 13,055 |
| Customer loans | 1,209 | 2,410 | 4,392 | 5,731 | 7,504 |
| Gross NPLs | 0 | 0 | 0 | 0 | 0 |
| **Liab. & shar. funds** | **4,421** | **9,004** | **13,911** | **16,547** | **19,771** |
| Total customer deposits | 0 | 0 | 0 | 0 | 0 |
| Reserve for loan losses | 0 | 0 | 0 | 0 | 0 |
| Shareholders' equity | **1,101** | **3,332** | **7,261** | **9,177** | **11,610** |
| **Profitability/Solvency Ratios (%)** | | | | | |
| ROE adjusted | 54.7 | 35.2 | 25.0 | 23.7 | 23.7 |
| Net interest margin | 0.94 | 5.60 | 5.32 | 5.99 | 6.23 |
| Cost/income ratio | 66.6 | 67.5 | 64.6 | 61.6 | 61.2 |
| Cash cost/average assets | 40.5 | 37.7 | 32.7 | 31.6 | 33.0 |
| NPLs/customer loans | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Reserve for loan losses/NPLs | na | na | na | na | na |
| Bad debt prov./avg. cust. loans | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Loans/deposit ratio | na | na | na | na | na |
| Tier 1 capital ratio | na | na | na | na | na |
| Total capital ratio | na | na | na | na | na |

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# Contents

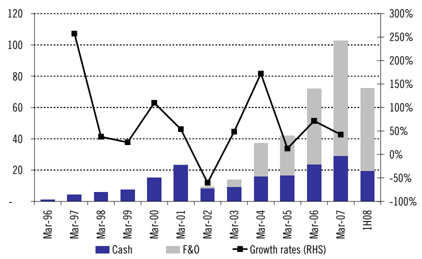
# Investment Thesis

## Initiating at Buy (1M) –Stronger business and markets

We initiate coverage on Motilal Oswal Financial Services (MOFS) with a Buy / Medium Risk (1M) rating and Rs1,500 target price. The stock is currently trading at 17.6x FY09E EPS and offers 25% expected total return to our target price. MOFS is one of larger domestic brokers in India; it has been gaining market share and currently enjoys over 5% market share. MOFS is one of few direct and diversified plays on the Indian capital markets opportunity, with a strong management and a relatively low-risk approach.

## Capital Markets – Growing, institutionalizing, consolidating

**Figure 2. Total Equity Volumes and Growth, FY96 – 1H08, Rs Trillion, Percent**



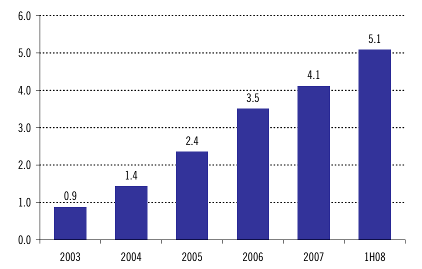

Source: NSE, BSE

India's capital markets have expanded substantially in scale and depth, in products and participants, and stronger operating platforms that can support substantially larger expansion. The capital markets are increasingly institutional and scale driven, leading to a rapid consolidation in market share amongst brokers. We expect these trends to continue, and they should drive revenues, customer acquisition and opportunity for well positioned brokers.

However, current high market activity levels, rapid volume growth in a relatively short time (volumes are up 40%+ in July-Sep'07 over the previous quarter), and increasing regulatory discomfort and oversight (recent limit on P-Note issuances being a case in point) suggest near-term caution. While the recent limitations on P-Notes could be a near-term volume dampener for the institutional segment, it should also drive direct market participation by a larger base of foreign investors, and offer wider opportunities for stronger domestic brokerages to increase market share among foreign institutional investors.

## MOFS - Retail and Institutional broker, with a research focus

**Figure 3. MOFS: Market Share (%, FY03-1H08)**




Source: Company Reports

MOFS offers a healthy mix of retail and institutional business, backed by a strong research focus. MOFS is among the top 5 domestic retail and institutional brokers, has consistently and significantly gained market share over the past five years, and currently has over 5% share of overall market volumes (from less than 1% market share in FY03). It is one of the few domestic brokers with strong retail as well as an institutional franchise; is well balanced between both these segments; and is expanding rapidly in distribution capability and network (currently has 1,288 outlets in 385 cities).

MOFS' broking business is also backed by its strong research focus, especially fro the institutional segments. It has large coverage and has been ranked consistently amongst leading domestic brokerages.

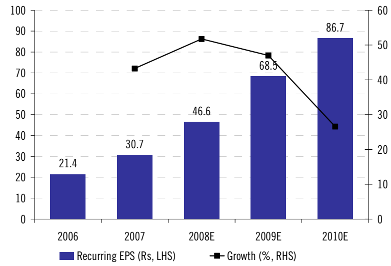
## Broad, diversified platform – Positioned to grow

MOFS also distinguishes itself through its broader platform – in addition to the broking business (equities and commodities), it offers a broad product suite in both retail and institutional business segments. In the institutional segment, the focus is on investment banking. In the retail segment, it offers margin finance third-party product distribution and is moving up the value chain to wealth management (through its recently launched initiative, Purple) and asset management (another recent initiative).

## Strong management, relatively low-risk model

MOFS's has a strong and fairly broad senior management team that is experienced and should be able to support planned business expansions. The business model is relatively low risk with little financial leverage historically and a relatively smaller margin lending portfolio compared to similarly scaled peers.

**Figure 4. MOFS: Recurring EPS and Growth (Rs, Percent, FY06-10E)**




Source: Company Reports and CIR estimates

## Strong 41%pa earnings growth outlook, but cyclical

We estimate a 41% FY07-10E recurring EPS CAGR, driven primarily by retail and institutional broking, higher market volumes and some market share gains from consolidation. We also see earnings support from investment banking, more margin finance, and wealth management initiatives. Earnings are relatively broad-based across retail and institutional businesses, but remain inherently linked to the cyclical capital market environment. There is a high correlation with market volume growth however, a +/-10% change in FY09E volumes could result in +/-12% change in earnings for MOFS (assuming constant market shares).

## Valuation benchmarks ... few pure capital markets plays

We believe MOFS is one of few concentrated capital market exposures in the Indian market – its larger brokerage peers also offer substantially large other businesses. We would expect its primary valuation benchmark to be the broader market (Sensex) PE multiple (currently 21x FY09E).

We value MOFS near current market multiples (at 22x FY09E earnings), in part supported by lack of scale, diversified, standalone domestic brokers. We are basing our target multiple on MOFS' diversified, low-risk business model, strong management, a growing market share and underlying structural growth in the industry. This implies a target price of Rs1,500 and a 25% expected total return from current price levels. It could be argued, however, that in a strong capital market environment (as is the case currently), valuations should be at a discount to market multiples to factor in the business cyclicality. Our target multiple though slightly aggressive, is justified on strong industry growth and outlook, in our view.

**Figure 5. India Brokerages – Comparative Valuation Summary**

| Domestic Peers | Ric code | Price | EPS FY08E | EPS FY09E | P/E 08 | P/E 09 |
|---|---|---|---|---|---|---|
| Indiabulls | IBUL.BO | 693 | 31.5 | 38.7 | 22.0 | 17.9 |
| Kotak Mahindra | KTKM.BO | 981 | 24.4 | 29.8 | 40.3 | 32.9 |
| IL&FS Investsmart | ILFI.BO | 174 | 11.9 | 12.2 | 14.6 | 14.3 |
| Motilal Oswal | MOFS.BO | 1,205 | 46.6 | 68.5 | 25.9 | 17.6 |
| India Infoline ** | IIFL.BO | 1,072 | 21.6 | 41.1 | 49.7 | 26.1 |
| Reliance Capital ** | RLCP.BO | 1,902 | 34.7 | 43.9 | 54.9 | 43.4 |

Source: Citi Investment Research ** Based on Consensus Estimates from Bloomberg

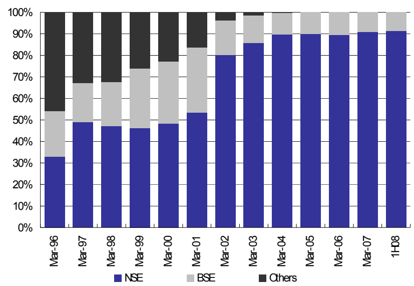
## Risks

Key risks include: a) Earnings strongly correlated to volatile capital markets; b); b) Execution of aggressive expansion; c) Margin finance risks ) Regulatory changes.

# Industry Outlook

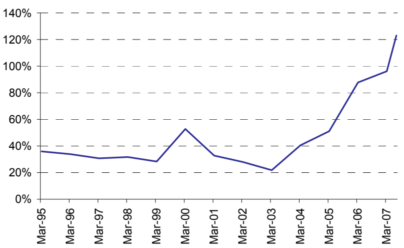
- Equity markets are expanding aggressively on strong economic growth, and household savings are likely get directed to equity, from a currently low level
- Growth momentum is across retail and institutional segments
- Brokerage business is consolidating; large players are gaining in market share, and this trend is likely to continue
- Commission compression should be limited, as brokerage rates in India are already among the lowest in the world, and there has already been an aggressive shift to low yield derivative businesses
- Capital markets activity can be volatile, however

Figure 6. Concentration of Market Volumes in Exchanges (FY96 – 1H08, Percent)




Source: ISMR, NSE, BSE

Figure 7. Market Capitalization/GDP (FY95 – Oct07, Percent)




Source: NSE, RBI.

## Historically, a vast but disorganized market

Indi a's stock exchanges were established in the 19th century, and, while the country has historically enjoyed an active stock market, in the past it suffered from a lack of institutionalization, with limited retail participation. Key characteristics of the market included:

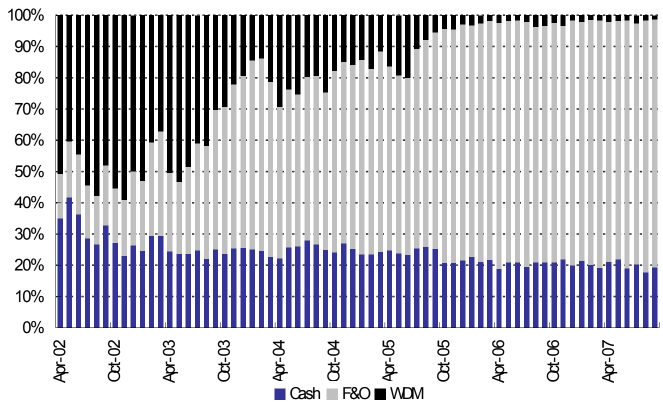
1. Fragmentation – more than 20 stock exchanges with limited trading volumes
2. Severe restrictions on primary markets limiting the number of issuers in the market
3. Shallow markets, high trading costs and low transparency
4. Long settlement cycles with difficult and expensive settlement procedures

### Fundamental changes over the past 10-15 years; easier, more transparent and cheaper access

Over the past 10-15 years, fundamental changes have taken place in the Indian securities markets, including:

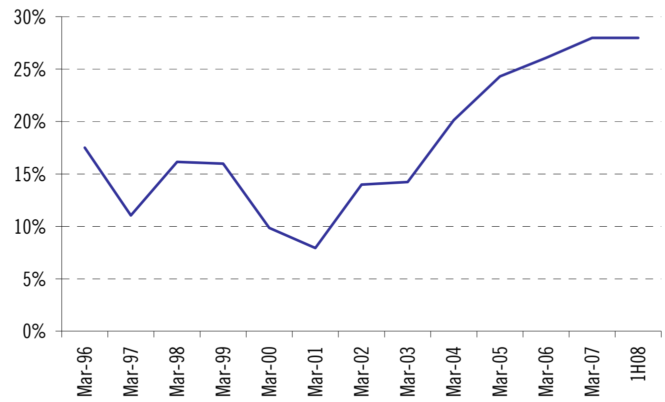
1. Freeing up of primary markets, with improved regulation and the establishment of a market regulator;
2. Screen-based trading with automated electronic matching of trades – introduced by the National Stock Exchange (which was established in 1994);
3. Sharply reduced costs with high levels of transparency – an outcome of screen-based trading and automated matching;
4. Sharply reduced settlement cycles and costs enabled by dematerialized securities, with better regulation and the establishment of a depository;
5. Establishment of specialist and technology-based broking houses with reach and transparent operations.

**Figure 8. Changing Structure of the Secondary Markets (April'03- Sep'07, %)**




Source: NSE, BSE

**Figure 9. Delivery Trades/Value of Total CM Trades (FY96 – 1H08, Percent)**



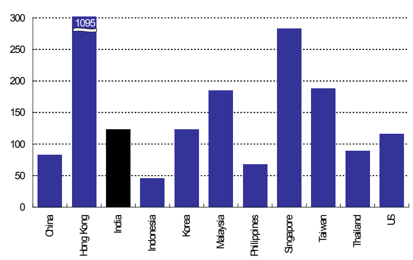

Source: ISMR, NSE

The derivatives market has also grown rapidly. Within a few years of its introduction, derivatives volumes are larger than cash volumes – and we believe there is significant non-institutional participation in the derivatives segment.

The Indian market, however, continues to have a large speculative element, with over 70% of trades on a non-delivery basis – this holds true for the non-institutional segment as well. We think the rising proportion of delivered trades would, however, suggest an increase in the non-speculative element of the market.

### Structurally growing market – market cap/GDP has grown substantially

**Figure 10. Comparative Market Capitalization to GDP (Percent)**




Source: Citi Investment Research

The freeing up of the economy and the primary markets in the early 1990s has resulted in structural growth in the market, both in terms of the breadth of companies and sectors available for investment, as well as the size of the companies. Measured as a percentage of nominal GDP, the market capitalization of listed companies has increased from 30% in FY95 to more than 120% – an indicator of the increasing breadth of the market.

We believe a significant part of India's economy is not yet represented on the markets, and that markets will continue to increase in size and breadth as the economy develops. Market capitalization (as a percentage of GDP) in developed markets tends to range between 120% and 230%.

## Retail Businesses

### Equities – A very small part of household savings

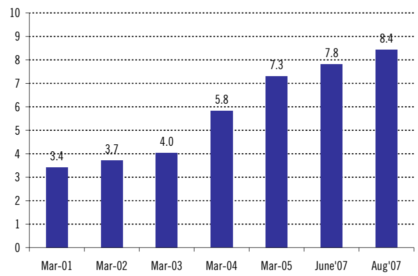
Households over the last few years have directed a large share of their high level of savings towards bank deposits, primarily due to historically high interest rates, combined with volatility and lack of transparency in capital markets.

**Figure 11. India — Breakdown of Annual Household Savings, FY00-06 (Percent)**

| YE Mar 31 | Currency | Bank deposits | Life insurance fund | Provident & Pension Fund | Claims on Government | Shares & Debentures | Others | Total |
|---|---|---|---|---|---|---|---|---|
| FY00 | 10.5 | 42.7 | 9.9 | 19.1 | 10.1 | 5.7 | 1.9 | 100.0 |
| FY01 | 10.0 | 42.5 | 10.4 | 19.1 | 10.9 | 5.6 | 1.6 | 100.0 |
| FY02 | 9.9 | 42.4 | 10.9 | 18.7 | 11.8 | 5.3 | 1.0 | 100.0 |
| FY03 | 9.8 | 42.2 | 11.6 | 18.3 | 12.5 | 4.9 | 0.8 | 100.0 |
| FY04 | 9.9 | 42.1 | 11.8 | 17.7 | 13.5 | 4.5 | 0.4 | 100.0 |
| FY05 | 9.8 | 41.8 | 12.0 | 17.1 | 14.8 | 4.2 | 0.3 | 100.0 |
| FY06 | 9.6 | 42.0 | 12.6 | 16.0 | 15.1 | 4.3 | 0.2 | 100.0 |

Source: RBI—Currency & Finance—FY2000-06.

**Figure 12. Retail Accounts (FY01 – Aug07, Million): Rising Participation in Direct Equities**




Source: NSDL, CDSL

We believe many of these conditions have evolved recently, which should eventually result in marked changes in the household savings profile. We expect deposit growth rates to experience downward pressure due to:

1. A slight shift away from deposits into other savings instruments – the share has risen over the last five years;

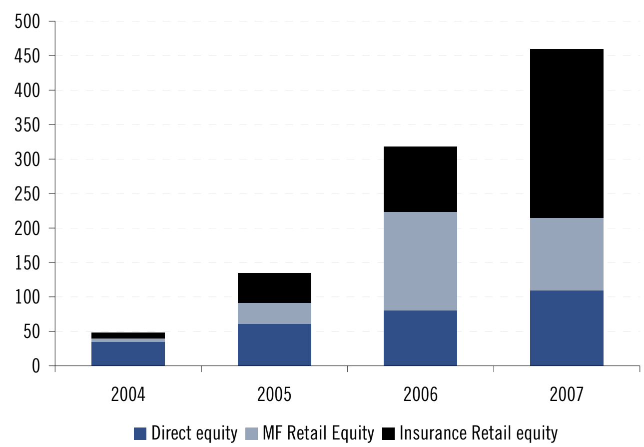
2. Disintermediation by mutual funds;

3. Attractive returns on equities over the last few years; and

4. Increasing consumerism (which should pressure the savings rate).

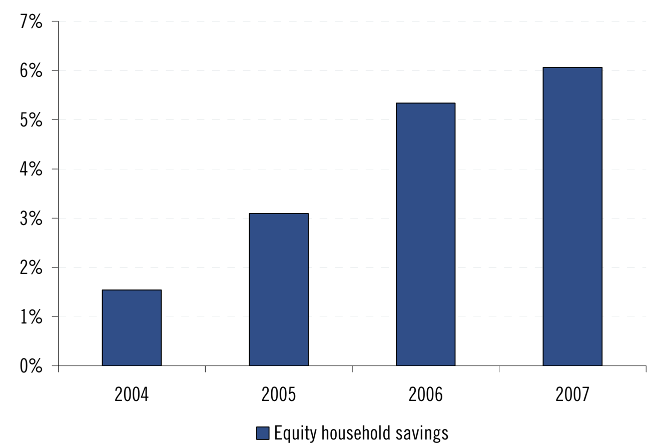
The changing savings profile is spurring growth in non-bank savings and investments products, including mutual funds, insurance, and other linked products. We believe this is resulting in significant opportunities opening up in savings and financial services.

**Figure 13. Incremental Household Savings in Equity (Including Retail share in Mutual Fund and Insurance equity)**




Source: RBI and Citi Investment Research estimates

**Figure 14. Household Equity Savings as % of Total Savings**




Source: Citi Investment Research estimates

### The brokerage industry is consolidating – opportunity for technology-backed professional services

The broking industry remained fragmented until the mid-1990s, with business spread over 5,000 brokers operating across the locations where the 22 exchanges were based. With low retail participation and a client base limited largely to high-net-worth individuals, the services offered then were also more personalized and relationship driven.

**Industry has been consolidating steadily over the past 10 years**

However, the industry has been consolidating steadily over the past 10 years, with the share of the top 25 brokers having risen to almost 40% currently from less than 20%. The key enablers of this consolidation have been:

1. **Technology** – screen-based trading, electronic matching, and paperless securities;
2. **Telecom connectivity and costs** – ability to have large interconnected operations across multiple locations for centralized operations and effective risk management and control;
3. **Capital requirements –** Also, with the rapid growth in the number of small retail investors over the past few years, the business has tended to become more process-oriented and professional; and
4. **Distribution** – A multi-channel nationwide distribution network enables benefits of scale and improved operating efficiency, and is a source of competitive advantage.

**Figure 15. Market Share of Top 'N' Brokers ( FY01-Sep'07, Percent)**

| Top 'N' Brokers | Top 5 | Top 10 | Top 25 | Top 50 | Top 100 |
|---|---|---|---|---|---|
| Sep' 07 | 16 | 26 | 45 | 61 | 78 |
| 2006-07 | 15 | 24 | 43 | 57 | 71 |
| 2005-06 | 15 | 23 | 38 | 53 | 68 |
| 2004-05 | 14 | 20 | 35 | 49 | 65 |
| 2003-04 | 12 | 17 | 30 | 44 | 61 |
| 2002-03 | 10 | 16 | 29 | 42 | 59 |
| 2001-02 | 7 | 12 | 24 | 36 | 53 |
| 2000-01 | 8 | 13 | 23 | 34 | 49 |

Source: Citi Investment Research

**We believe the retail broking industry is likely to consolidate further; large opportunity for technology-based professional services**

We believe the retail broking industry is likely to consolidate further, with the smaller brokers increasingly marginalized and many becoming sub-brokers/franchisees for the larger brokers or closing operations. We see a large opportunity for technology-based professional services companies to grab significant market share in the retail broking industry.

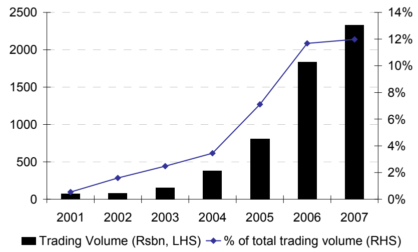
### Competitive market – brokerage commission rates among the lowest globally

**Brokerage commission are among the lowest globally**

Brokerage commission rates in India (across the entire product range) are among the lowest globally, due to the market's fragmentation and stiff competition. Rates have also declined substantially over the years as use of technology has lowered costs of trading and settlement, especially for the larger firms. Brokerage rates in India range from 2-100bps, with the bulk of the volumes concentrated in the 2-10bps range for non-delivery-based and derivatives trades.

### E-broking growing steadily – better services at lower cost

**Figure 16. Internet Trading Volume (FY01 – FY07, Rupees Billion, Percent)**




Source: NSE

The share of Internet-based trading, or e-broking, has grown to over 9% since its introduction in 2000. However, its share of the addressable market (excluding institutional business and the brokers' proprietary turnover) would be close to 15-18%.

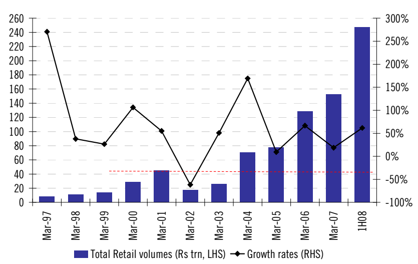
The e-broking business is much more consolidated than the overall retail broking business. We believe the top five firms offering e-broking services comprise a significant portion of the industry. Most e-brokers in India offer an integrated broking, banking and 'demat' (electronic stock) account service. This integrated service offers the dual benefit of better service and convenience levels for retail investors and lower cost of operations and lower risk for brokers.

We believe the share of e-broking will rise steadily in India given: 1) widening retail investor participation; 2) growing Internet usage; 3) faster telecom connectivity; and 4) increasing comfort levels with transacting on the Internet.

The rapid rise in retail participation, and the acceptance of electronic trading platforms, is reflected in the sharp rise in Internet-based trading.

### Revenues dependent on cyclical capital markets activity

**Figure 17. Volatility in Retail Market Volumes – Cash and F&O, FY97-1H08 (Rs Trillion, Percent)**




Source: NSE

Revenues and earnings in the retail broking business depend on capital market activity and can be quite volatile. Overall broking volumes can decline by more than 50% during bear phases, with the turnover of the retail segment even more volatile. The impact on profitability can be more severe, given the operating leverage in the business.

## Margin Finance

### Margin finance risks appear relatively low, given good technology support

Margin finance can broadly be divided into two businesses – for settlement and for holding. We believe margin finance during the settlement period accounts for the bulk of the outstanding asset book. Currently, the equity markets operate on a T+2 settlement basis, while the derivative markets operate on a monthly contract basis, with daily mark-to-market settlement (on T+1).

Most large retail brokers operate centrally controlled risk management systems, with programmed margin call and stop-loss levels. In most cases, the stop-loss orders are program generated and executed, without human intervention and offering no flexibility.

We believe conservative risk-management practices with robust technology support limit the risks on margin finance to a great extent, although the possibility of significant losses during times of extreme market volatility cannot be ruled out. No brokers reported significant market losses following the 15% single-day decline (on 17 May 2004) in the BSE Sensex.

### Competition in margin finance limited – banks exposure to margin financing is capped

**Margin finance interest yields are high, though volume of activity can be very volatile**

Margin finance faces limited competition because commercial banks are capped in their exposure to capital markets (5% of their loans) and Rs2mn per customer (in case of loans against securities). As a result, market interest rates for margin finance (12-18%) are relatively high, especially considering the relatively low risk made possible by good technology support and conservative margin levels.

However, the volume of margin finance activity can be extremely volatile, as investors can be averse to leveraging 2-3x and paying 12-18% interest during bear market phases – a trend that compounds the effect of low market activity during bear markets.

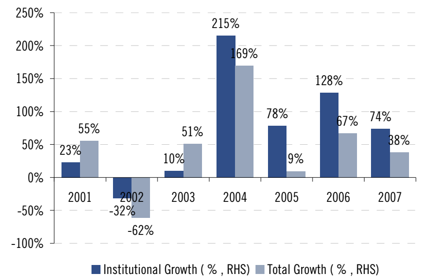
## Institutional Businesses

### Institutional Equities – rapid growth and momentum

**FII inflows have been robust over the past 24 months, and equity funds under management have grown substantially**

The structural growth and broadening of the equity markets have been supported by a sharp increase in the number of institutional investors, and the India assets under management of institutional funds, both domestic and foreign.

**Figure 18. Broking Industry - Institutional and Total Volume Growth (%)**




Source: NSE, BSE

FII inflows have been robust over the past 24-36 months, and equity funds under management by the domestic mutual funds industry have also grown substantially. The life insurance industry has also emerged as a large investor and is set to grow rapidly in the medium term given significant growth in unit-linked plans and a long-term investing horizon.

Growth in institutional trading volumes have been significantly higher than those in the retail equity segment over the last four years. This has also driven the share of traded volumes of FIIs and domestic mutual funds to increase from 20% to 30% over this period. In addition, life insurance companies have also built a significant equity asset base (rivaling that of the domestic mutual funds) and also contribute significantly to overall market volumes.

### Investment Banking – large pipeline, though cyclical

**The pipeline appears robust, and bodes well for the merchant banking and debt syndication businesses**

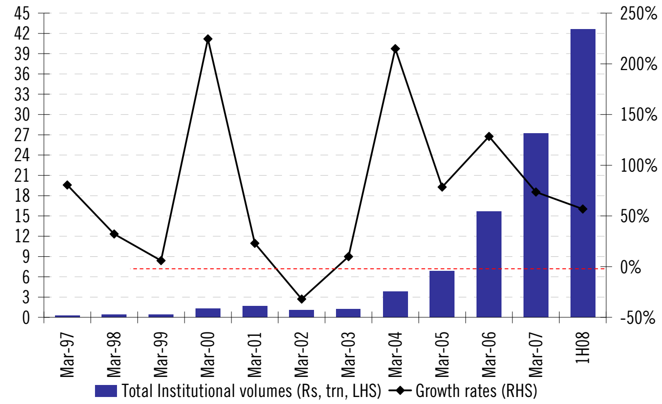
The broadening base of issuers, along with large capital raising by existing listed companies, has resulted in significant capital issuance, both on the domestic markets and overseas, over the past two years. With significant capital expenditure planned by the corporate sector, the pipeline also appears robust, and bodes well for the merchant banking and debt syndication businesses.

## Competitive nature of business – margins low, but under pressure

**However, businesses are intensely competitive and revenues and earnings tend to be cyclical**

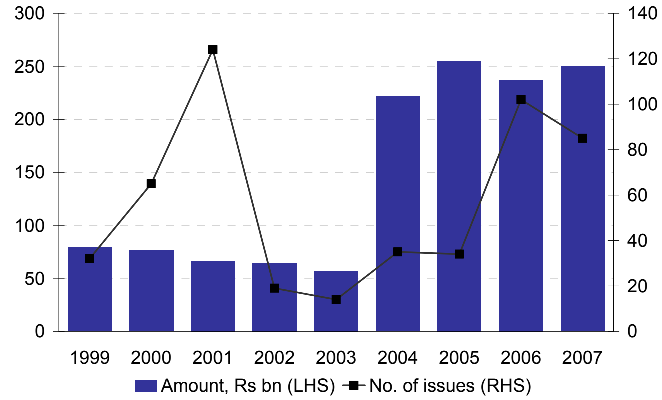
However, all these businesses are intensely competitive, with most of the global investment banks seeking to increase to their presence in India, either through JVs or independently. Commission rates on broking, investment banking and debt syndication are all low as a result of the competition – though we not seen significant price pressure so far, the increase in competition for global as well as domestic players suggest that there is could be pressures on margins over the medium term, albeit gradual. Revenues and earnings remain dependent on capital market volumes, which tend to be cyclical.

**Figure 19. Trend in Institutional Volumes in NSE, FY97-Dec'06 (Both sides – Cash and F&O, Rupees Billion, Percent)**




Source: NSE *1H08 figs are annualised

**Figure 20. Primary Equity Issues (Domestic), FY99-07, (Rupees Billion)**

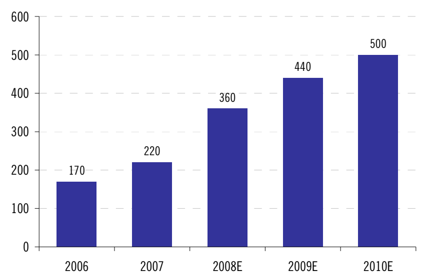



Source: Prime Database

# Competitive Positioning

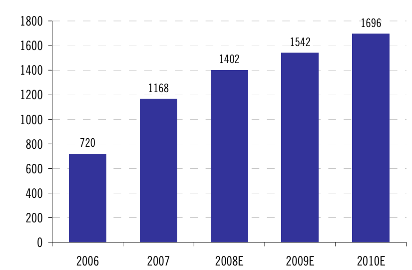
- MOFS is one of the larger Indian brokers with a rapidly growing client base and wide distribution
- Retail business has been growing strongly, with a growing customer base and expanding distribution
- Strong institutional equity business, with a well respected research presence and track record
- Modest margin finance capability so far; competitive disadvantage relative to market leaders
- Early gains in investment banking and fund management – one of few domestic players with a keen focus in this space
- A more broad-based offering than most domestic peers, though inherently linked to capital market volatility

**Figure 21. MOFS: Retail Broking Customers (No in Thousands, FY06-10E)**




Source: Company Reports, Citi Investment Research

**Figure 22. MOFS: Total Outlets (FY06-10E)**




Source: Company Reports and Citi Investment Research

## Retail broking – Strong and expanding

### Rapidly growing customer base

MOFS has been growing its retail customer base rapidly over the past five years. The pace of customer acquisition has picked up noticeably over the past two years, aided by the strong equity markets and its distribution build-out (including acquisition of other brokerages). It is among the larger retail brokers in the country (with Kotak Securities and Indiabulls as the market leaders).

### Wide distribution – expanding rapidly

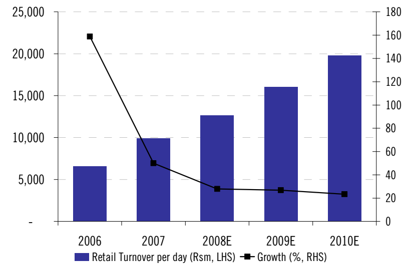
The company has built out a wide distribution network: 1,288 branches/franchisee outlets in 385 cities, with some concentration in Western India. MOFS uses a mix of company-owned branches and business associates for distribution, which is in line with conventional distribution adopted by most large brokers, except Indiabulls. We believe MOFS's distribution network is a source of competitive advantage as the broking business consolidates and local brokers become marginalized, due to the professional services that large nationwide brokers are able to provide and sustain at low broking commissions.

### Internet-based trading...adds to distribution strength

**MOFS has recently entered into a strategic alliance with SBI for online brokerage**

MOFS started offering Internet-based trading to its customers in FY2005. Internet trading gives customers the flexibility to choose their preferred mode of transacting, either online or offline, and in our view should help the company access a wider client base. The company has recently entered into a strategic alliance with State Bank of India, for online brokerage offering. We believe Internet trading offers potential for significant growth – it accounts for 9% of market volumes and 10-50% of revenues for peers. Going forward, we expect migrating customers from offline channels to the Internet for transacting should also help the company reduce costs and gain more significant economies of scale.

Figure 23. MOFS: Average Daily Retail Turnover, Rsm (FY06-10E)




Source: Citi Investment Research

### Strong competitive position – among the larger retail brokers

We believe MOFS has built a strong competitive position in the retail broking business over a short time frame, in particular over the last two years. We identify the company's key strengths as:

- Its nationwide network
- Large and multiple distribution channels
- Professional service.

The company now has a large client base of 328,000 with a national footprint, which gives it a relatively stable revenue base, albeit with the inherent volatility of the capital markets. It is one of the larger retail brokerages in India, with a market share of about 5% of volumes in the equity markets across the NSE/BSE.

MOFS has made aggressive strides in this space over the last two years; it does however lag the market leader, Kotak Securities. We do see MOFS currently tied for a few spaces behind the market leader; MOFS is however running a broader equity product offering, that could see it gain ground on the leader. The gap between the MOFS and the market leader is however vast; we do not see MOFS competing for the top slot in the near term.

Figure 24. Comparative Market Shares – Retail + Institutional Volumes (Percent)

| Market Share - Overall | Q207 | Q108 | Q208 |
|---|---|---|---|
| Indiabulls | 6.1 | 5.2 | 4.7 |
| Kotak Securities | 8.2 | 8.3 | 8.0 |
| Motilal Oswal | 4.0 | 5.2 | 5.0 |
| India Infoline | 2.1 | 2.9 | 3.2 |

Source: Company Reports and Citi Investment Research

## Margin finance – Small book size

**Small size of the margin finance book is potentially a competitive disadvantage**

We believe the ability to provide customers margin finance; in size and at relatively competitive rates, is a meaningful competitive advantage. MOFS, on account of a relatively small capital base has lagged the market leaders, Kotak Securities and Indiabulls, in this space. We do see this as a competitive disadvantage in attracting clients and retaining them. We expect MOFS to try and bridge this gap, but it is likely to lag the market leaders. MOFS's management appears relatively risk averse and has not built up leverage on the margin finance book, limiting its size. Also MOFS does not have a proprietary trading book.

**MOFS has however, built strong risk-management systems**

MOFS has however, built strong risk-management systems, which enable the company to monitor positions and set limits across all offices and clients from a centralized location. The risk-management system also enables margin calls and stop-loss orders at pre-determined levels, as the margin cover (investor's equity) in a position is eroded. MOFS has not yet taken any significant losses on the margin finance business, and the system has been tested in volatile markets – the most significant being the 15% decline in the Sensex on 17 May 2004.

## Institutional businesses – Growth opportunities, strong position amongst domestic brokers

### Institutional broking – large, research-based franchise

**MOFS has a strong track record and research focus for the institutional business**

In institutional broking, MOFS has scale, client franchise and enjoys a strong position among the domestic brokers in India. MOFS has a strong track record in the business and has a strong research focus for the institutional business. It has had strong research rankings in the external polls, with consistent top 3 rankings amongst the domestic brokers with one of the largest research teams with 28 analysts (including equity and technical analysts) and over 200 stocks under coverage. It has strong and established relationships with over 240 institutional clients.

**… we see reasonable growth opportunities in this business**

With the majority of the overall business coming from foreign institutions, the lack of global distribution and franchise somewhat limits the scale and MOFS's competitive position. However, with increasing institutional interest and participation in the secondary markets, on both the cash and F&O side, we see reasonable growth opportunities in this business.

The recent regulatory changes limiting the issuance of P-Notes to foreign institutional investors, in our view, is a medium-term positive for scale domestic brokers including MOFS. While near-term volumes could be dampened, we believe a wider direct participation from these investors will likely results in broader opportunities for MOFS, including possible market share gains.

### Investment banking – Aggressive start, strong potential

**Has recently established an investment banking business**

MOFS has recently established an investment banking business, lead by a team of professionals. This team is an incentivized one and has a 25% stake in the investment banking business. This business also has relatively strong synergies with the institutional distribution business; and has got off to a strong start. The group has seen its first set of revenues, closed 10 deals aggregating US$500mn; has a further 12 mandates of a similar aggregate value in the pipeline; and has the potential to develop into a larger business.

## Venture fund management

**This foray seeks to widen the earnings pool; from a transaction based one, to a more annuity driven one**

The group has also launched a US$100m venture fund; about US$77m has been raised till now. This is another area of focus, and the management has more aggressive plans. This foray seeks to widen the earnings pool; from a transaction based one, to a more annuity driven one. There are few domestic brokers in this space; and MOFS's relatively strong corporate relationships in the mid-corporate space could tie in well with this venture. This business also better rounds off the institutional business.

## Broader platform, distinct from most peers

**MOFS has a broader platform – should lend diversity and resilience to earnings**

MOFS distinguishes itself from most peers through its broader platform – in addition to the retail businesses – broking, margin finance, IPO distribution, wealth management and third-party mutual fund distribution – it has investment banking, institutional broking and private equity. It also has commodities broking, which offers significant growth opportunities in India as the commodity markets are still in the development stage. We see these businesses as synergistic, feeding on each other, and they should lend diversity and resilience to earnings.

# Strategy

- Build distribution network rapidly, in the retail space
- Expand market share in retail broking and distribution, with increased support from margin finance
- Focus on wealth management, to leverage relationships, and expand fee pie
- Broaden the institutional business; sustained research thrust, wider investment banking capabilities

## Expanding distribution network

**Continued focus on expanding network aggressively, both organically and inorganically**

MOFS has grown its distribution network rapidly over the past two years. The bulk of the growth has come from expanding its associates and franchisee network. The company's total network has expanded to 1,288 by Sep07. The company continues to focus on expanding its network aggressively, both organically and inorganically and also through alliances.

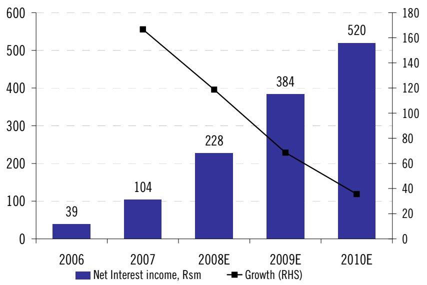
A significant proportion of MOFS's growth in distribution is coming from smaller brokers closing standalone operations and joining the MOFS network. MOFS is able to build up a customer base quickly, and at very low cost, using the franchisee route because the brokers have existing clients. While we are surprised by the pace of consolidation given the buoyant markets, we believe consolidation will likely gather momentum when the market cycle turns.

## Expanding through the Internet platform

**We believe Internet trading offers potential for significant growth**

MOFS started offering Internet-based trading to its customers in FY2005. Internet trading gives customers the flexibility to choose their preferred mode of transacting, either online or offline, and in our view should help the company access a wider client base. We believe Internet trading offers potential for significant growth – it accounts for 9% of market volumes and 10-50% of revenues for peers. Going forward, we expect migrating customers from offline channels to the Internet for transacting should also help the company reduce costs and gain more significant economies of scale. We believe this channel has the potential to add significantly to MOFS's customer base because of: 1) the nature of the market and 2) industry volumes have shown strong growth.

**Figure 25. Margin Finance - Net Interest Income and Growth (Rupees Million, %, FY06-10E)**




Source: Citi Investment Research

## Expand the margin finance business

MOFS' margin finance business is relatively smaller in size as compared to peers like Kotak Securities and Indiabulls and a represents a meaningful competitive disadvantage. MOFS' smaller book size is largely due to management's relatively risk averse nature and its modest capitalization levels. MOFS is now looking to expand the margin finance business meaningfully with additional capital, to support its rapidly growing broking business. We believe increasing margin funding would boost MOFS' ability to strengthen its competitive position and reach in the retail broking business. The ability to provide margin finance is fundamentally a competitive advantage, which could be leveraged further with capital. However, we believe the company would not look to use debt for financing its margin finance book in the next 1-2 years given the availability of capital and relatively risk-averse nature of the management.

## Increase market share in Institutional broking with continued research focus

MOFS has a strong research franchise built over the years and currently has 28 analysts covering over 200 stocks. Among the domestic brokers, they also have one of stronger client relationships in the institutional segment. The India growth story remains intact and an increasing number of institutional clients are getting more interested in the domestic markets or setting up base in India. This is in the midst of a structural growth with industry volumes rising almost 200% over the last two years. We expect growth rates to moderate, though still remaining strong, and with cyclical downsides.

**MOFS has a strong research franchise built over the years...**

MOFS has been expanding its institutional business and we see the business growing at 43% CAGR over FY07-10E, due to — a) further penetration of key large accounts, b) synergies from the investment banking business and c) availability of capital increasing capacity and opportunities with additional accounts.

**...the competition is however, tough**

The competition in the segment is however, tough with MOFS lacking a global franchise or global distribution partner and intensifying with large international brokerages setting up new offices in India recently.

## Focus on wealth management and advisory

**Credibility gained from its institutional backing would be a key advantage in developing wealth management**

MOFS has a discretionary portfolio management business, and about Rs7.8bn in its investment advisory product. The company is seeking to build these businesses rapidly. The target customer segment for the wealth management business would largely be the HNW segment. The growing client base of its broking and distribution businesses would be a captive source for cross-selling these products. MOFS has recently launched a separate branded product (Purple) for catering to the needs of this segment.

We believe the credibility gained from its institutional backing would be a key advantage in developing this business, though there is intense competition from banks, which have much larger client bases and deeper relationships.

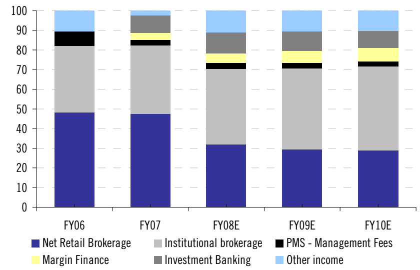
## Build on mutual fund distribution

The company is also focusing on the mutual fund and IPO distribution business, as a part of its broader thrust in the wealth management business. Currently small the business has potential to gain scale as MOFS leverages its strong business associate distribution network. It can also add more products to its portfolio and build on its brand and positioning.

## Asset management – recent initiative

MOFS is also seeking to establish a separate asset management subsidiary; though this is in early stages yet and is pending regulatory approvals. The company is looking to offer domestic mutual funds, asset management and advisory products as well as offshore investment products. We are currently not factoring in upside from this business as we believe it is too early to ascribe any value to this.

**Figure 26. MOFS: Revenue Mix (FY06-10E)**

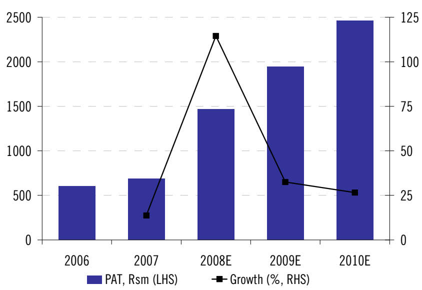



Source: Company Reports, Citi Investment Research

## Multiple product lines offer synergies; to maintain diversified business profile

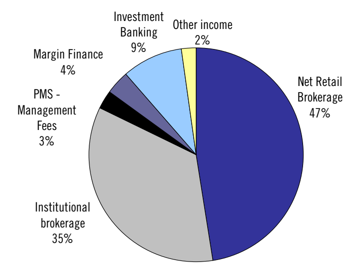
MOFS's various businesses offer some synergies to each other, potentially leading to a better competitive position and higher profitability. Its investment banking business is largely a domestic business, which is well supported by a large IPO distribution business for retail and high net worth clients. The investment banking business also supports the institutional broking business, and offers opportunities for cross-selling the debt syndication business to corporates. The venture fund management business builds on the strong client franchise and research focus of the company and earns a stable management fee in addition to any performance upsides. We believe the company is looking to maintain a mix of businesses which provide synergies with each other, diversify the revenue and earnings base, and improve the company's competitive position.

**Figure 27. Net Profit Growth (Rupees Million, Percent, FY06-10E)**



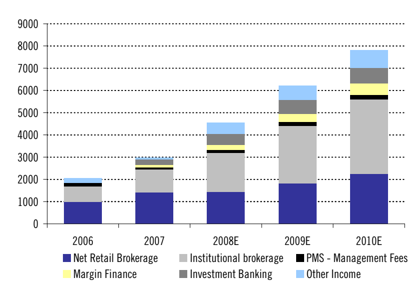

Source: Company Reports, Citi Investment Research

**Figure 28. MOFS: Revenue Mix (FY07)**




Source: Citi Investment Research

**Figure 29. MOFS: Overall Revenues (FY06-10E)**




Source: Company Reports and Citi Investment Research estimates

# Financials

- We forecast revenue CAGR of 37% over FY07-10E, earnings growth of 41% over the same period, earnings cyclicality from capital markets dependence
- We expect healthy growth in broking revenues; volume growth with stable commission rates
- Broking and margin finance should remain dominant, even as revenues diversify
- Business remains linked to the equity markets, and could be volatile

## Revenues – strong growth across businesses

We estimate 37% revenue CAGR over FY07-10E, and recurring earnings growth of 41% over the same period. We think earnings will be driven by strong growth across all businesses, particularly by retail broking and margin finance due to infusion of additional capital. Profit growth should also be driven by the operating leverage and some synergies across businesses. However, the risk of earnings cyclicality is high due to the company's dependence on the capital markets

## Relative diverse revenues and earnings; retail heavy

MOFS has reasonable diversity in revenues and earnings, though its entire pie is dependent on capital market activity. Retail business is well diversified with revenues from secondary markets (broking and margin finance), primary markets (IPO distribution and financing) and distribution of mutual funds.

The wholesale business is also well diversified, with significant contributions from debt syndication, and equity primary (merchant banking) and secondary (institutional broking) markets. Key risks to earnings include a decline in primary and secondary market activity and a turn in market sentiment.

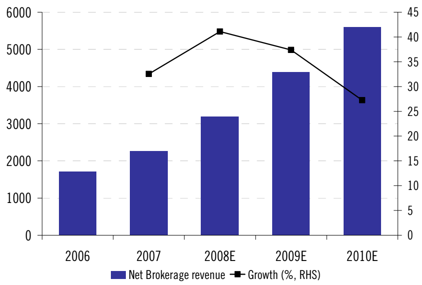
## Healthy growth in broking revenues; from currently high market volumes

We estimate a 35% CAGR in net broking revenues over FY07-10E, driven by healthy customer acquisitions and building up distribution network. MOFS' earnings are highly leveraged to industry volume growth – a +/-10% change in secondary market volumes could result in +/-12% change in earnings for the company assuming constant market share. We estimate the customer base to reach 360,000 by end-FY08E, and 500,000 by end-FY10E. We think customer acquisition is likely to be largely franchisee driven as increases in own branch network would significantly lag the growth in franchisee additions.

We believe retail growth will outpace growth in institutional broking over the longer term as MOFS builds out its reach. Currently however, the institutional volumes have significantly outpaced retail growth and expect the trend to continue over the near to medium term. We believe this should increase the operating leverage in the business, and also reduce the risk to earnings if the market turns.

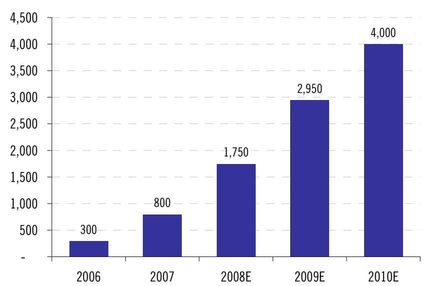
A significant shift in transactions to the Internet can result in improved operating efficiencies and leverage. Customer acquisition costs are likely to decline, in our view, as the bulk of the customer acquisition is franchisee driven rather than using owned distribution.

**Figure 30. Total Net Brokerage Revenues (Rupees Million, FY06-10E)**




Source: Company Reports, Citi Investment Research estimates

**Figure 31. Margin Finance Average Book size (Rupees Million, %)**




Source: Citi Investment Research estimates

## Broking margins – relatively low, in line with industry

Broking commissions are low, but in line with the industry average – we estimate blended margins are about 6bps. This is a mix of a 16-18bps average commission on the cash market, which contributed about 30% of volumes, and a 2-3bps commission on the derivatives market, which is almost 70% of volumes. We believe there is limited downside to gross broking margins from current levels, though competitive intensity in the retail broking industry is increasing.

## Margin finance – upping the ante

We estimate 119% growth in the average margin finance asset base in FY08E and 69% in FY09E, driven largely by additional capital infusion and the rapid growth in the client base and buoyant market volumes. The revenues from margin finance should increase four-fold in FY09E from FY07. The increase in margin finance ability should be relatively positive for MOFS from a competitive standpoint and will help drive increasing customer revenues from its retail client segment.

## Strong growth in wealth management – diversifies revenue and earnings

We expect strong growth in revenues from wealth management products including its discretionary portfolio management and distribution of mutual funds, driven by robust customer growth and strong equity markets. Fee income from wealth management diversifies the revenues and earnings base, and reduces volatility, as it is less linked to market activity than the other businesses of MOFS. MOFS earns about 2-2.5% pa from equity AUMs on the managed portfolios as annual fees, in line with industry norms.

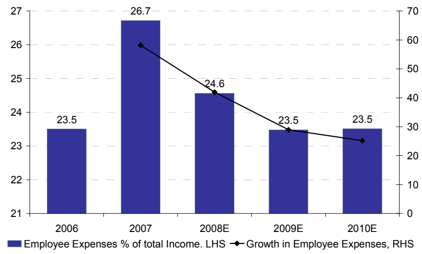
### Private equity and investment banking – additional kickers

**Recently started business - expected to contribute significantly to revenues from FY08E**

The recently started venture capital management and investment banking businesses are also expect to contribute significantly to revenues from FY08E. The venture capital arm of MOFS has been appointed manager to a US$100mn, India-dedicated small- and medium-size enterprises focused fund. MOFS has closed about US$77mn of funding for the fund and is expected to earn a fixed management fee and a variable fee (carry) on the fund. There are also possible upsides in revenues from the venture capital based on performance (domestic markets have shown strong growth in the last three years).

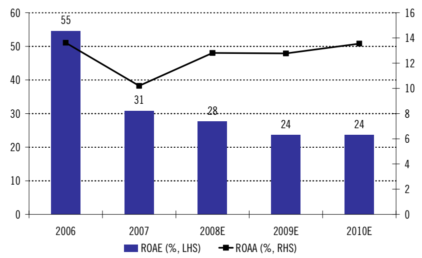
The investment banking business is expected to benefit from the strong capital market activity levels; we expect revenues to grow at 37%pa over FY07-10E though coming off a relatively low base in FY07.

**Figure 32. Employee Expenses —Growth, Percent of Total Income (Percent, FY06-10E)**




Source: Company Reports, Citi Investment Research estimates

**Figure 33. ROE and ROA (Percent, FY06-10E)**




Source: Company Reports, Citi Investment Research estimates

## Robust growth in institutional businesses – function of market

MOFS has seen robust growth across its institutional businesses, reflecting the strong operating environment and its strong research based client relationships. We expect growth to continue in the equity-related businesses, as markets remain strong. The key risk to earnings is a decline in market activity – both primary and secondary.

## Costs increases likely to be muted as franchisee network is cost efficient

We expect operating expenses to increase 41% in FY08E, primarily driven by increase in employee costs, launch of new business (investment banking and venture capital) and branch rollouts. We forecast the increase in operating expenses should slow down gradually as MOFS is not seeking to invest significantly in new branches, with bulk of the growth driven by franchisees and associates.

## RoEs should decline

MOFS earned a high RoE of 31% in FY07, a combination of strong business growth, high operating leverage and strong markets. We expect RoEs to decline going forward to around 28% in FY08E and 24% in FY09-10E on increased capital base and higher margin finance portfolio, which has higher capital utilization than the broking businesses.

**Figure 34. MOFS — Profit and Loss Account (Rupees Million, FY06-10E)**

| Profit and Loss, Rsm | 2006 | 2007 | 2008E | 2009E | 2010E |
|---|---|---|---|---|---|
| Brokerage Income | 2,382 | 3,079 | 4,516 | 6,067 | 7,655 |
| Retail | 1,661 | 2,225 | 2,759 | 3,501 | 4,319 |
| Institutional | 696 | 1,040 | 1,758 | 2,566 | 3,336 |
| *Growth (%)* | | *29* | *47* | *34* | *26* |
| PMS - Management Fees | 150 | 83 | 132 | 174 | 208 |
| Private Equity - Management Fees | | | 90 | 110 | 170 |
| Interest Income - Margin Finance | | 107 | 228 | 384 | 520 |
| Advisory | | 267 | 480 | 624 | 686 |
| Research Fees | 22 | 34 | 37 | 41 | 45 |
| Depository Income | 37 | 37 | 41 | 45 | 50 |
| Other Operating Income | (14) | (20) | 53 | 65 | 81 |
| **Income from Operations** | **2,576** | **3,587** | **5,576** | **7,508** | **9,415** |
| *Growth (%)* | | *39* | *55* | *35* | *25* |
| Interest Income | 80 | 155 | 226 | 330 | 391 |
| Other Income | 69 | 48 | 53 | 59 | 64 |
| Total Other Income | 149 | 204 | 280 | 389 | 455 |
| **Total Income** | **2,725** | **3,791** | **5,856** | **7,897** | **9,870** |
| *Growth (%)* | | *39* | *54* | *35* | *25* |
| Employee Costs | 640 | 1,013 | 1,438 | 1,854 | 2,320 |
| *Growth (%)* | | *58* | *42* | *29* | *25* |
| Brokerage Sharing Expenses | 671 | 811 | 1,316 | 1,670 | 2,061 |
| Depreciation | 55 | 110 | 154 | 200 | 240 |
| Other Operating Costs | 425 | 600 | 840 | 1,092 | 1,365 |
| Interest Expenses | 32 | 39 | 56 | 76 | 97 |
| **Total Expenses** | **1,824** | **2,573** | **3,804** | **4,892** | **6,083** |
| **Profit Before Tax** | **901** | **1,218** | **2,052** | **3,005** | **3,787** |
| *Growth (%)* | | *35* | *68* | *46* | *26* |
| Tax | 298 | 410 | 681 | 997 | 1,257 |
| **Profit After Tax** | **603** | **808** | **1,371** | **2,007** | **2,530** |
| *Growth (%)* | | *34* | *70* | *46* | *26* |
| Extraordinary Items | | (96) | 145 | | |
| Minority Interest | (1) | (27) | (48) | (62) | (69) |
| **Attributable Profits** | **602** | **684** | **1,468** | **1,945** | **2,462** |
| *Growth (%)* | | *14* | *114* | *32* | *27* |
| EPS | 21.4 | 26.9 | 51.7 | 68.5 | 86.7 |
| **Recurring EPS** | **21.4** | **30.7** | **46.6** | **68.5** | **86.7** |
| *Growth (%)* | | *43* | *52* | *47* | *27* |
| Dividends | | - | 14 | 28 | 28 |
| DPS | - | - | 0.5 | 1.0 | 1.0 |

Source: Company Reports and Citi Investment Research estimates

**Figure 35. MOFS — Balance Sheet (Rupees Million, FY06-10E)**

| Balance Sheet, Rsm | 2006 | 2007 | 2008E | 2009E | 2010E |
|---|---|---|---|---|---|
| Fixed Assets | 519 | 685 | 890 | 1,024 | 1,178 |
| Investments | 79 | 856 | 856 | 856 | 856 |
| Cash | 1,240 | 2,165 | 4,306 | 5,123 | 6,039 |
| Debtors | 1,344 | 2,808 | 3,369 | 3,706 | 4,077 |
| Loans | 1,209 | 2,410 | 4,392 | 5,731 | 7,504 |
| Stock in Trade | 18 | 0 | 0 | 0 | 0 |
| Others | 12 | 81 | 97 | 107 | 117 |
| **Total Assets** | **4,421** | **9,004** | **13,911** | **16,547** | **19,771** |
| Secured Loans | 22 | 0 | - | - | - |
| Minority Interest | 0 | 30 | 78 | 141 | 209 |
| Creditors | 2,064 | 3,657 | 4,388 | 4,827 | 5,309 |
| Provisions | 677 | 1,130 | 1,243 | 1,367 | 1,504 |
| Others | 556 | 856 | 941 | 1,035 | 1,139 |
| **Liabilities** | **3,320** | **5,673** | **6,650** | **7,370** | **8,161** |
| Paid up Capital | 56 | 127 | 142 | 142 | 142 |
| Reserves and Surplus | 1,045 | 3,205 | 7,119 | 9,035 | 11,468 |
| **Networth** | **1,101** | **3,332** | **7,261** | **9,177** | **11,610** |
| **Total Liabilities** | **4,421** | **9,004** | **13,911** | **16,547** | **19,771** |

Source: Company Reports and Citi Investment Research estimates

**Figure 36. MOFS —Key Ratios (Percent, FY06-10E)**

| Ratios (%) | 2006 | 2007 | 2008E | 2009E | 2010E |
|---|---|---|---|---|---|
| RoAA | 13.6 | 10.2 | 12.8 | 12.8 | 13.6 |
| RoAE | 54.7 | 30.9 | 27.7 | 23.7 | 23.7 |
| Net Profit Margin | 22.1 | 18.1 | 25.1 | 24.6 | 24.9 |
| Employee Expenses % Total Income | 23.5 | 26.7 | 24.6 | 23.5 | 23.5 |
| Profit Before Tax % Total Income | 33.1 | 32.1 | 35.0 | 38.0 | 38.4 |
| **Growth Rates** | | | | | |
| Gross Brokerage Income | | 29.2 | 46.7 | 34.3 | 26.2 |
| Net Brokerage Income | | 32.6 | 41.1 | 37.4 | 27.2 |
| Gross Retail Brokerage Income | | 34.0 | 24.0 | 26.9 | 23.4 |
| Net Retail Brokerage Income | | 43.0 | 2.0 | 26.9 | 23.4 |
| Institutional Brokerage Income | | 49.4 | 69.0 | 46.0 | 30.0 |
| Total Income | | 39.1 | 54.5 | 34.9 | 25.0 |
| Employee Expenses | | 58.2 | 42.0 | 28.9 | 25.2 |
| Total Expenses | | 41.0 | 47.8 | 28.6 | 24.3 |
| Profit Before Tax | | 35.2 | 68.5 | 46.4 | 26.0 |
| Attributable Profits | | 13.7 | 114.5 | 32.5 | 26.6 |
| **Revenue Mix** | | | | | |
| Net Retail Brokerage | 48.2 | 47.4 | 31.8 | 29.4 | 28.9 |
| Institutional brokerage | 33.9 | 34.9 | 38.7 | 41.2 | 42.7 |
| PMS - Management Fees | 7.3 | 2.8 | 2.9 | 2.8 | 2.7 |
| Margin Finance | - | 3.6 | 5.0 | 6.2 | 6.7 |
| Investment Banking | - | 8.9 | 10.6 | 10.0 | 8.8 |
| Other income | 10.7 | 2.3 | 11.0 | 10.4 | 10.3 |

Source: Company Reports and Citi Investment Research estimates

# Valuation

- We value MOFS at 22xFY09E earnings, implying a target price of Rs1,500 per share.
- Brokerages are usually benchmarked off P/E multiples in aggressively growing markets
- US brokerages are often valued on DCF; possibly reflecting more predictable and stable earnings, and stronger customer traction. Also trade at discounts to the market
- Expect Indian brokerages to be valued on PE's – strong markets should probably support valuations at discounts or par with market multiples, while weak markets could support premia's
- Relatively few benchmarks in Indian space; larger players valuation meaningfully influenced by other dominant businesses
- Broader retail and institutional mix should support a premium over standalone retail brokerages

## Similar businesses – all capital-markets related

**MOFS generates all its earnings from capital-markets-related businesses**

MOFS generates all its earnings from capital-markets-related businesses, though the pie is diversified among primary and secondary markets, and between equity and debt businesses. Most of the businesses are fee-based transaction businesses, and do not require much capital. While margin finance does require capital, the business is linked intrinsically to the underlying broking and distribution businesses.

## P/E multiple most appropriate benchmark

**P/E multiple is the most appropriate benchmark to value the company**

The nature of all these businesses is similar, and we believe a P/E multiple is the most appropriate benchmark to value the company, rather than a P/B multiple which would be appropriate for book-based businesses. While differing business models would suggest a range of multiples, we believe a brokerage/capital markets business should trade near or slightly below the market benchmark's multiple.

Most comparable US brokerages trade at discounts to the market. There are exceptions, although we believe they have a much broader earnings mix, and are not wholly dependent on secondary market broking and the margin finance that supports it.

## Multiples could compress in strong markets

**Cyclical nature of the brokerage business suggests that valuations should compress in strong markets and vice-versa**

The cyclical nature of the brokerage/capital markets business would also suggest that valuations should compress in strong markets – given that earnings are usually at highs during strong markets, and market multiples also tends to be on the higher side. This is the case with most domestic peers in the Indian market. We believe current year multiples are most appropriate – this makes earnings more predictable, and factors in earnings growth, in the event the market is strong.

## Integrated business model and lower operating leverage suggests positive thrust to valuations

MOFS's relatively integrated business model, with various businesses drawing synergies off each other and offering some revenue diversification, in our view could be an influence in boosting valuations relative to pure retail brokerages. We think its thrust on a primarily third-party sourcing model for the broking business (franchisees, sub-brokers and bank tie-ups), with a revenue-sharing arrangement and lower fixed costs, will likely reduce operating leverage and cyclicality of earnings – a likely positive for valuations.

## Limited direct peer comparison…likely benchmark will be market multiples

**We expect MOFS to trade at market multiple, valuing it at Rs1,500 per share**

We believe P/E multiples are the fair benchmark valuations for brokerages. Further, valuations are also benchmarked off domestic market multiples. Current domestic market multiples are at a high (21x FY09E PE); we believe MOFS should trade near market multiples, in part supported by lack of diversified, standalone, scale investment opportunities in the Indian capital market space. We value MOFS at 22xFY09E earnings, implying a target price of Rs1,500 per share.

It could be however, argued that in a strong capital market environment (as is the case currently); valuations should be at a discount to market multiples to factor in the business cyclicality. In this context, our target multiple, though slightly aggressive, appears justified on strong industry growth and outlook.

**Figure 37. India Brokerages – Comparative Valuation Summary**

| Domestic Peers | Rating | Ric code | Price | EPS FY08E | EPS FY09E | P/E 08 | P/E 09 |
|---|---|---|---|---|---|---|---|
| Indiabulls | 3M | IBUL.BO | 693 | 31.5 | 38.7 | 22.0 | 17.9 |
| Kotak Mahindra | 2M | KTKM.BO | 981 | 24.4 | 29.8 | 40.3 | 32.9 |
| IL&FS Investsmart | 3M | ILFI.BO | 174 | 11.9 | 12.2 | 14.6 | 14.3 |
| Motilal Oswal | 1M | MOFS.BO | 1,205 | 46.6 | 68.5 | 25.9 | 17.6 |
| India Infoline ** | | IIFL.BO | 1,072 | 21.6 | 41.1 | 49.7 | 26.1 |
| Reliance Capital ** | | RLCP.BO | 1,902 | 34.7 | 43.9 | 54.9 | 43.4 |

Source: Citi Investment Research estimates ** Based on Consensus Estimates from Bloomberg

**Figure 38. Valuation Comparison —Global**

| Company | RIC Code | Rating | Country | Price (LC) | PE-06 | PE-07 | PE- 08 |
|---|---|---|---|---|---|---|---|
| Charles Schwab Corp | SCHW.O | 1M | USA | 23 | 30.5 | 26.1 | 14.7 |
| Lazard Ltd | LAZ.N | 2H | USA | 48 | 24.0 | 18.8 | 15.8 |
| Merrill Lynch & Co Inc | MER.N | 1M | USA | 57 | 9.9 | 12.2 | 11.8 |
| Morgan Stanley | MS.N | 1M | USA | 59 | 9.5 | 7.6 | 7.4 |
| Nuveen Investments Inc | JNC.N | 2M | USA | 65 | 30.6 | 26.7 | 22.7 |
| TD Ameritrade Holding Corp | AMTD.O | 1M | USA | 19 | 21.9 | 18.3 | 15.8 |
| Federated Investors, Inc | FII.N | 2M | USA | 41 | 22.3 | 20.1 | 16.9 |
| Legg Mason Inc | LM.N | 1M | USA | 78 | 10.1 | 16.5 | 14.2 |
| T Rowe Price Group Inc | TROW.O | 2M | USA | 63 | 36.1 | 29.6 | 24.4 |
| Calamos Asset Management Inc | CLMS.O | 2H | USA | 33 | 24.3 | 24.9 | 24.5 |
| E Trade Financial Corp | ETFC.O | 2S | USA | 9 | 7.4 | 8.1 | 9.1 |
| Lehman Brothers Holdings Inc | LEH.N | 2H | USA | 60 | 9.7 | 8.3 | 8.0 |
| The Goldman Sachs Group Inc | GS.N | 2H | USA | 230 | 14.4 | 9.9 | 9.7 |
| New Star Asset Management Group Plc | NSAM.L | 1M | UK | 3 | 16.0 | 12.9 | 10.4 |
| Schroders PLC | SDRt.L | 2M | UK | 13 | 19.1 | 15.1 | 13.3 |
| Cash Life AG | SGSG.DE | 1H | Germany | 9 | 11.0 | 11.4 | 8.5 |
| HCI Capital AG | HXCIGn.DE | 1M | Germany | 15 | 9.3 | 9.7 | 10.0 |
| Lloyd Fonds AG | L1OG.DE | 1M | Germany | 15 | 11.1 | 9.6 | 8.7 |
| MPC Muenchmeyer Petersen Capital AG | MPCG.DE | 1M | Germany | 55 | 14.3 | 14.2 | 12.1 |
| AWD Holding AG | AWDG.DE | 2M | Germany | 22 | 20.2 | 14.3 | 12.5 |
| Perpetual Ltd | PPT.AX | 2L | Australia | 72 | 24.1 | 20.5 | 18.7 |
| Samsung Securities | 016360.KS | 2L | Korea | 105000 | 32.5 | 28.3 | 17.8 |
| Korea Investment Holdings | 071050.KS | 1L | Korea | 81300 | 9.9 | 17.2 | 12.6 |
| Woori Investment & Securities | 005940.KS | 1L | Korea | 25300 | 14.2 | 14.7 | 10.5 |
| Daishin Securities | 003540.KS | 2M | Korea | 25200 | 10.0 | 13.3 | 8.2 |
| Hyundai Securities | 003450.KS | 3M | Korea | 19950 | 11.5 | 18.1 | 10.9 |
| Tong Yang Investment Bank | 003470.KS | 2M | Korea | 18300 | 11.0 | 13.7 | 10.8 |

Source: Citi Investment Research estimates

# Risks

- Broking/margin finance highly cyclical; current market activity at a high
- Large losses possible in margin finance during extreme market events
- Highly incentivized compensation structure for retail sales force, could lead to meaningful customer erosion or slowdown, if activity levels fall
- Regulatory overhang: margin finance is being looked at closely by the regulator

We rate MOFS shares as Medium Risk, though our quantitative risk rating system which tracks 260-day historical share price volatility suggests a High Risk rating. MOFS has a broad and diversified business revenue mix, is well balanced between the retail and institutional segments and has a strong and relatively risk averse management, which we believe, reduces the operating risk of the business.

Key risks that could prevent the stock reaching our target price include:

### Business revenues and profitability dependent on capital market activity

This tends to be highly cyclical, especially with retail business volumes in the secondary market falling more than 50% during bear markets from bull-market levels. The impact on MOFS's revenues could be pronounced due to its margin finance portfolio, even tough it has a relatively smaller book size. Current market activity is at a high.

### Risks of losses in margin finance

Large losses are possible in the margin financing business during extreme market events, especially with growing market share and size. We note that risk systems held the last time the market fell sharply (though the scale of the business then was lower).

### Pricing / yield pressure

Though yields are relatively low, aggressive competition and a continued shift towards lower yield revenue mix, could dampen profitability

### Highly incentivized sales force accentuate risk of business slowdown in times of lower market activity

MOFS is heavily dependent on its franchisee and associates network for its retail distribution and broking business. These franchisees as well as its own sales force have a highly incentivized compensation structure. This increases the risk of a significant slowdown in customer acquisition or business volumes during periods of lower capital market activity.

### Regulatory risk

Margin finance and capital markets activity is being looked at closely by the regulators, and there could be changes in the guidelines of either the Reserve Bank of India or the Securities and Exchange Board of India. This could necessitate a change in the business structure, or dampen the growth of the margin finance business, impacting earnings. This is in context of publicly voiced concerns that excessive margin financing and speculation could be fueling the currently strong equity markets.

There are also certain ongoing investigations by SEBI, the stock market regulator, on MOSL, along with other business related regulatory issues. These have not been resolved yet, and could carry risks in terms of financial damages, and possible restrictions to some or all of its business.

### Execution risk

MOFS has an aggressive expansion plan, on customer acquisition, distribution and newer business initiatives. The rapid pace of targeted expansion could carry execution and management risks.

# Company Background

**Started business as a retail broker … has widened its business mix**

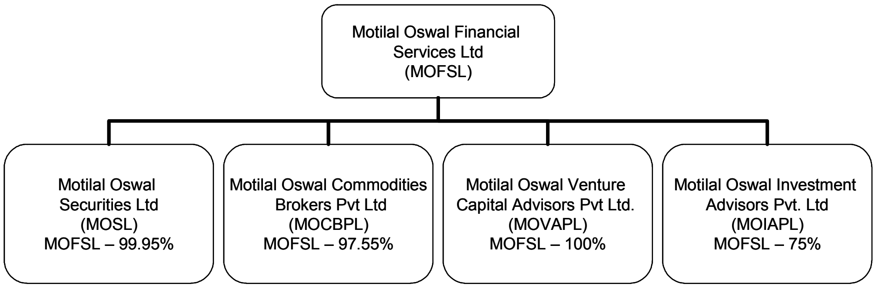
Motilal Oswal Securities Ltd (MOSL), incorporated in 1994, was started by two entrepreneurs, Raamdeo Agrawal and Motilal Oswal. The company started business as a retail broker, and has widened its business mix to include institutional equity broking and commodity broking, investment banking, discretionary portfolio management, venture capital management, and third party product distribution. The businesses are housed under four different entities, under the umbrella of the holding company Motilal Oswal Financial Services Limited (MOFS).

**Has invested in a large pool of professional managers…**

MOFS is a promoter owned and controlled company. The company is headed by Mr Motilal Oswal, Chairman and Managing Director and Mr Raamdeo Agrawal, Non-executive Director, who are also the founding promoters of the company, and active managers. There is also a large pool of professional managers at the operational level, with the core team of senior managers responsible for different operations. MOFS has over 2,000 employees currently.

The company's predominant business lines are institutional and retail broking; it has expanded into the areas of investment banking and venture capital management, recently. In addition, the company is seeking to build on its equity and retail market businesses, and establishing a wealth management platform.

**Figure 39. Organization Structure and Parent Shareholding**

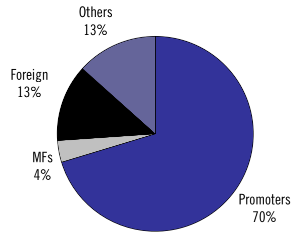



Source: Company Reports

# Ownership and Management

- Promoter held and controlled – MOFS is dominantly promoter held and controlled; at the operational level there is a pool of senior management professionals
- Pre-IPO placements with private equity players (New Vernon Private Equity and Bessemer Venture Partners); currently hold 8.5% stake
- Senior management fairly experienced, and incentivized with stock options

**Figure 40. Shareholding Pattern as at September 30, 2007**




Source: Company Reports

## Ownership

MOFS is a dominantly promoter (i.e., founding shareholders) held and controlled company. The promoters, Mr Motilal Oswal, Chairman and Managing Director and Mr Raamdeo Agrawal, Non-executive Director, take key strategic decisions in the company. At the operational level, the company has a fairly large pool of senior management. Key managerial personnel are fairly experienced professionals and are also incentivized with stock options. It has also placed about 8.5% of its capital with two private equity players, New Vernon Private Equity and Bessemer Venture Partners.

## Management

MOFS's senior management is fairly experienced, with a mix of MNC and domestic private sector backgrounds. A number of them have been with the company over the past few years, and have built the businesses over the last few years. The management is also incentivized with stock options. We believe the management is experienced and relatively broad, and should be able to support the planned expansion.

Each of the separate businesses is headed by a professional and report to the top management individually. The retail business is headed by Mr Hitungshu Debnath, The institutional broking business is headed by Mr Navin Agarwal, the Investment Banking division is managed by Mr Ashutosh Maheshwari and the Venture Capital Management business by Mr Vishal Tulsyan

# Appendix A-1

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|---|---|---|---|
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