India Equity Research
Financials

**May 9, 2011**

# SKS Microfinance

## AP fully priced in; revival in other states to drive value

**ADD**

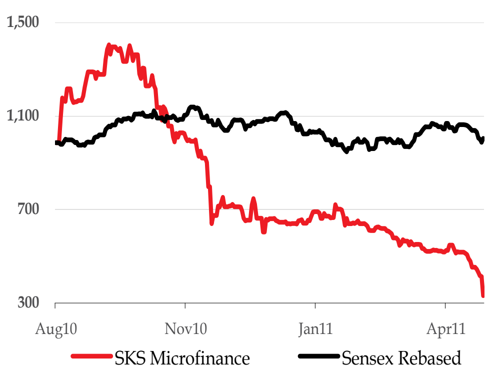
**Target Price(INR) 374**

**Rating** ⇔

| Last Price (INR) | 332 |
|---|---|
| Bloomberg code | SKSM IN |
| Reuters code | SKSM.BO |
| Avg. Vol. (3m) | 0.3 |
| Avg. Val.(3m)(INRmn) | 146 |
| 52-wk H/L (INR) | 1,492 / 284 |
| Sensex | 18,519 |
| MCAP (INRbn/USDmn) | 24.0 / 536 |

| Shareholding (%) | 12/10 | 03/11 |
|---|---|---|
| Promoters | 37.0 | 36.9 |
| MFs, FIs, Banks | 5.0 | 4.9 |
| FIIs | 20.6 | 21.3 |
| Public | 29.0 | 28.9 |
| Others | 8.6 | 8.0 |

Stock Chart (Relative to Sensex)




| Stock Perfm. (%) | 1m | 3m | 6m |
|---|---|---|---|
| Absolute | (40.7) | (51.0) | (67.6) |
| Rel. to Sensex | (35.5) | (55.9) | (55.7) |

| Financials (INRbn) | 03/10 | 03/11f | 03/12f |
|---|---|---|---|
| NII | 5,871 | 8,123 | 7,613 |
| YoY (%) | 88 | 38 | (6) |
| Operating profit | 3,194 | 4,086 | 3,734 |
| A.PAT | 1,740 | 1,116 | (5,953) |
| Sh o/s (diluted) | 687 | 720 | 720 |
| A.EPS (INR) | 27.0 | 15.5 | (82.7) |
| YoY (%) | 61 | (42) | (633) |
| Equity/Assets (%) | 4.0 | 2.7 | 3.5 |
| P/E (x) | 12.3 | 21.3 | (4.0) |
| P/B (Adj) (x) | 2.2 | 1.3 | 2.1 |
| RoA (%) | 5.4 | 3.0 | (11.8) |
| RoE (%) | 21.6 | 8.1 | (41.1) |

| Quarterly Trends | 06/10 | 09/10 | 12/10 | 03/11 |
|---|---|---|---|---|
| Op. income (INRbn) | 1.5 | 1.4 | 1.5 | 0.0 |
| PAT (INRbn) | 0.7 | 0.8 | 0.3 | (0.7) |

**Impact of credit losses in Andhra Pradesh (AP) is now fully reflected in the stock. Acceptance of the Malegam Committee proposals brightens the outlook for microfinance institutions (MFIs) in states outside AP. Our forecasts assume revival in loan growth in other states during FY12; recent weeks provide evidence that funding has eased. Even after adjusting for the losses in AP, we find significant value in the stock arising from the growth and profitability of the rest of the loan book. A potential trigger could be the possible withdrawal of the AP MFI Act and/or recoveries from the state. We revise our forecasts and target price. Maintain Add with a Mar12 price target of INR374.**

### Credit losses in AP are fully priced in

The quarter ending Mar11 saw collections in AP dropping to 10.5% for SKSM, which resulted in higher credit losses and consequently a loss of INR0.7bn for the quarter. While higher losses in AP now appear a reality, sensitivity to defaults in the book indicates current levels factor in c100% write-offs without any recoveries, a low probability in our view. We assume write-offs upto 80% of the AP book. The loss after factoring in operating expenses and write-offs, when adjusted with the weighted average fair value of the Non-AP book, results in a fair value of INR374, an upside of 13%.

### Non-AP book likely to be the driver of growth

The non-AP book declined c10% y-o-y during FY11, as the company deliberately slowed down disbursements driven by lack of bank funding. We believe that growth outside AP is likely to pick up as funding constrains ease with the new regulatory framework under the RBI. In recent weeks SKSM able to securitize loans amounting to INR6.6bn (out of the non-AP portfolio). We factor in a CAGR of 40% in the loan book during the three-year period ending Mar14f.

### Malegam Committee norms could create a silver lining

The revised norms for the Malegam Committee recommendations give MFIs the much-needed flexibility in pricing and collection of loans. We believe the priority-sector status and acceptance of the Malegam Committee proposals by the RBI will ease concerns on availability of funds and the spillover of the AP MFI Act, to other states. With the RBI still in talks with officials from the Andhra Pradesh government, a probable withdrawal of the AP MFI Act, after acceptance of the Malegam Committee recommendations by the RBI, is likely to pose an upside risk to our estimates.

### Maintain Add with a Mar12 price target of INR374

We believe the street is not factoring in the profitability and the growth potential of the non-AP book. The excessive price correction on back of increased write-offs in the AP business is overdone in our view. We arrive at a Mar12 target price of INR374 by valuing the Non-AP book independently and deducting the cumulative losses in the AP book over the two-year period ending Mar13f, an upside of 13%. Maintain Add.


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Exhibit 1: Result snapshot for the quarter ending Mar11.

| (INR mn) | Mar10 | Dec10 | q-o-q (%) | Mar11 | y-o-y (%) |
|---|---|---|---|---|---|
| Interest income | 2,820 | 3,640 | -53.0 | 1,710 | -39.4 |
| Interest expense | 820 | 970 | -10.3 | 870 | 6.1 |
| Net interest income | 2,000 | 2,670 | -68.5 | 840 | -58.0 |
| Other income | 230 | 260 | -11.5 | 230 | 0.0 |
| Operating income | 2,230 | 2,930 | -63.5 | 1,070 | -52.0 |
| Operating expense | 1,090 | 1,400 | -25.0 | 1,050 | -3.7 |
| Operating profit | 1,140 | 1,530 | -98.7 | 20 | -98.2 |
| Provisions & contingencies | 150 | 1,010 | 5.0 | 1,060 | 606.7 |
| Provision for tax | 350 | 180 | -294.4 | -350 | -200.0 |
| Net profit | 640 | 340 | -302.9 | -690 | -207.8 |
| **Key ratios (%)** | | | | | |
| Loan growth | NA | -7% | | -18% | |
| Spreads | 11% | 11% | | 9% | |
| GrossNPL | 0.3% | 0.4% | | 2.4% | |
| NetNPL | 0.2% | 0.2% | | 1.3% | |

Source: Company, Avendus Research

Exhibit 2: Earnings revision summary

| (INR bn) | ----------- FY12f----------- | | | ----------- FY13f----------- | | |
|---|---|---|---|---|---|---|
| | Old | New | Var (%) | Old | New | Var (%) |
| Net interest income | 10,752 | 7,613 | -29.2 | 14,252 | 10,252 | -28.1 |
| Operating income | 11,830 | 8,664 | -26.8 | 15,457 | 11,416 | -26.1 |
| Operating profit | 6,047 | 3,836 | -36.6 | 8,200 | 5,238 | -36.1 |
| Net profit | 2,470 | -5,953 | -341.1 | 3,312 | 3,063 | -7.5 |
| EPS(INR) | 34 | -83 | -341.0 | 46 | 43 | -7.5 |
| Adjusted Book value(INR) | 293 | 155 | -47.1 | 340 | 198 | -42.0 |

Source: Company, Avendus Research

## Erosion in market price exceeds worst-case impact in AP loans

We value both the AP and the non-AP businesses independently. We assume no incremental disbursements in the AP book and factor in write-offs at 80% of total loans in the state, resulting in higher provisioning. Note that we have assumed credit losses based on the provisioning guidelines as per the Malegam Committee report, which is more stringent than current provisioning norms applicable for other NBFCs. The resultant loss, after factoring in operating expenses, amount to INR14bn. The loss per share, when adjusted with the weighted average fair value of the non-AP book based on the P/E, P/B and discounting excess returns, results in a total target price value of INR374.

## Growth outside AP likely to pick up

We assume the non-AP business to be growing under normal business conditions, which is likely under the new framework and regulatory oversight of the RBI. After acceptance of the Malegam Committee recommendations, availability of funding from banks is likely to increase, aiding our base-case assumption of a CAGR of 40% in the non-AP portfolio in the three-year period ending Mar14f. Additionally, the concern on spillover of the AP MFI Act to other states is likely to be addressed with the new framework under the RBI.

## Maintain Add rating with a Mar12 price target of INR374

We believe the street is not factoring in the profitability and the growth potential of the non-AP portfolio. The excessive price correction on back of increased write-offs in the AP business is overdone in our view. We arrive at a Mar12 target price of INR374 by valuing the non-AP book independently and deducting the cumulative losses in the AP book over the two-year period ending Mar13f, an upside of 13%. We maintain the Add rating on the stock.

### Exhibit 3: Sensitivity of fair value to write-offs in the AP book

| Sensitivity of fair value to write-offs in AP | Scenario 1 | Scenario 2 | Scenario 3 | Scenario 4 |
|---|---|---|---|---|
| Write-offs in Andhra Pradesh (of the total AP book) | 60% | 70% | 80% | 90% |
| Net profit/loss in the AP business (INRbn) | -10 | -12 | -13 | -15 |
| Profit/Loss per share | -139 | -161 | -183 | -204 |
| Fair value of the non-AP business (INR/share) | 563 | 558 | 557 | 556 |
| Total fair value (INR/share) | 424 | 397 | 374 | 352 |

Source: Company, Avendus Research

### Exhibit 4: Sensitivity of fair value to growth in non-AP book

| INR/share | Growth in the loan book (CAGR for the three year period ending Mar14) | | | |
|---|---|---|---|---|
| | **30%** | **40%** | **50%** | **60%** |
| Non-AP fair value | 513 | 557 | 602 | 658 |
| Loss in AP at base case (80%) | -183 | -183 | -183 | -183 |
| Fair value | 330 | 374 | 420 | 475 |

Source: Company, Avendus Research

# Financials and valuations

## Income statement (INRbn)

| Fiscal year ending | 03/11f | 03/12f | 03/13f | 03/14f |
|---|---|---|---|---|
| **Net interest income** | **8.1** | **7.6** | **10.3** | **15.0** |
| Fee income | 0.7 | 0.4 | 0.5 | 0.7 |
| Trading profit | 0.0 | 0.0 | 0.0 | 0.0 |
| Other income | 0.4 | 0.7 | 0.7 | 0.7 |
| **Total operating income** | **9.2** | **8.7** | **11.4** | **16.5** |
| Total operating expense | 5.1 | 4.9 | 6.3 | 8.1 |
| **Operating profit** | **4.1** | **3.7** | **5.1** | **8.4** |
| Provision for bad debt | 2.4 | 9.5 | 1.3 | 1.1 |
| Other provision | 0.0 | 0.0 | 0.0 | 0.0 |
| PBT (reported) | 1.7 | -5.8 | 3.8 | 7.4 |
| Total taxes | 0.6 | 0.2 | 0.8 | 2.4 |
| PAT (reported) | 1.1 | -6.0 | 3.1 | 4.9 |
| (+) Share in assoc. earnings | 0.0 | 0.0 | 0.0 | 0.0 |
| Less: Minority interest | 0.0 | 0.0 | 0.0 | 0.0 |
| Prior period items | 0.0 | 0.0 | 0.0 | 0.0 |
| Net income (reported) | 1.1 | -6.0 | 3.1 | 4.9 |
| **Avendus net income** | **1.1** | **-6.0** | **3.1** | **4.9** |
| Shares outstanding (mn) | 72 | 72 | 72 | 72 |
| Avendus dil. shares (mn) | 72 | 72 | 72 | 72 |
| **Avendus EPS (INR)** | **15.5** | **-82.7** | **42.6** | **68.4** |

## Growth ratios (%)

| | | | | |
|---|---|---|---|---|
| Loans | 24.4 | 58.0 | 9.8 | 42.0 |
| Net interest income | 38.4 | -6.3 | 34.7 | 46.7 |
| Fee income | 102.7 | -48.3 | 36.1 | 40.0 |
| Provision for bad debt | 356.8 | 302.1 | -86.5 | -16.0 |
| Avendus net income | -35.9 | -633.5 | 0.0 | 60.8 |
| Avendus EPS | -42.5 | -633.5 | 0.0 | 60.8 |

## Operating ratios (%)

| | | | | |
|---|---|---|---|---|
| NII/operating income | 88.1 | 87.9 | 89.8 | 91.2 |
| Fee income/operating income | 7.7 | 4.2 | 4.4 | 4.2 |
| Operating profit margin | 44.3 | 43.1 | 44.9 | 51.1 |
| Net profit margin | 12.1 | -68.7 | 26.8 | 29.9 |
| Effective Tax rate | 35.3 | -3.3 | 20.1 | 33.0 |

## Balance sheet (INRmn)

| Fiscal year ending | 03/11f | 03/12f | 03/13f | 03/14f |
|---|---|---|---|---|
| Equity capital | 0.7 | 0.7 | 0.7 | 0.7 |
| Preference capital | - | - | - | - |
| Reserves and surplus | 17.1 | 10.4 | 13.5 | 18.6 |
| Net worth | 17.8 | 11.2 | 14.2 | 19.3 |
| Total borrowings | 22.4 | 49.4 | 53.6 | 74.1 |
| **Total liabilities** | **40.2** | **60.6** | **67.8** | **93.4** |
| Current Assets | 5.8 | 4.7 | 7.9 | 11.2 |
| Less: Current Liabilities | 2.8 | 2.1 | 3.9 | 8.2 |
| Investments | 0.0 | 0.0 | 0.0 | 0.0 |
| Advances | 36.5 | 57.7 | 63.4 | 90.0 |
| Fixed assets | 0.3 | 0.3 | 0.4 | 0.4 |
| Other assets | - | - | - | - |
| **Total assets** | **39.8** | **60.6** | **67.8** | **93.4** |

**Business Ratios (%)**

| | | | | |
|---|---|---|---|---|
| Loan / Borrowings | 163.4 | 116.7 | 118.3 | 121.5 |
| Shares to investments | 5.3 | 100.0 | 100.0 | 100.0 |

## Decomposition of RoA (%)

| Fiscal year ending | 03/10 | 03/11f | 03/12f | 03/13f | 03/14f |
|---|---|---|---|---|---|
| Net interest income | 18.2 | 21.7 | 15.1 | 16.0 | 18.7 |
| Fee income | 1.1 | 1.9 | 0.7 | 0.8 | 0.9 |
| Other income | 2.0 | 1.0 | 1.4 | 1.0 | 0.9 |
| Operating income | 21.3 | 24.7 | 17.2 | 17.8 | 20.5 |
| Operating expenses | 11.0 | 13.3 | 9.6 | 9.6 | 9.9 |
| **Operating profit** | 10.3 | 11.4 | 7.6 | 8.2 | 10.6 |
| Loan loss provisions | 1.6 | 6.3 | 18.9 | 2.0 | 1.3 |
| Depreciation | 0.4 | 0.4 | 0.2 | 0.2 | 0.1 |
| Extramordinaries | - | - | - | - | - |
| Tax | 2.9 | 1.6 | 0.4 | 1.2 | 3.0 |
| Net profit | 5.4 | 3.0 | (11.8) | 4.8 | 6.1 |
| RoA | 5.4 | 3.0 | (11.8) | 4.8 | 6.1 |
| Assets / Equity | 4.0 | 2.7 | 3.5 | 5.1 | 4.8 |
| RoE | 21.6 | 8.1 | (41.1) | 24.2 | 29.4 |

## Key Ratios

| Fiscal year ending | 03/10 | 03/11f | 03/12f | 03/13f | 03/14f |
|---|---|---|---|---|---|
| **Valuation ratios (x)** | | | | | |
| P/E (on Avendus EPS) | 12.3 | 21.3 | -4.0 | 7.8 | 4.8 |
| P/BV | 2.2 | 1.3 | 2.1 | 1.7 | 1.2 |
| P/Adjusted BV | 2.2 | 1.4 | 2.3 | 1.8 | 1.3 |
| Dividend yield (%) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Per share ratios (INR)** | | | | | |
| Basic Reported EPS (INR) | 34.0 | 16.4 | -82.7 | 42.6 | 68.4 |
| Diluted Reported EPS (INR) | 14.4 | 12.5 | -82.7 | 42.6 | 68.4 |
| Reported Book Value (BV) | 148.5 | 247.4 | 154.9 | 197.5 | 268.5 |
| Adjusted Book Value (ABV) | 147.7 | 241.4 | 145.5 | 185.3 | 252.6 |
| Dividend per share (INR) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Return / Profitability Ratios (%)** | | | | | |
| Yield on advances | 25.3 | 28.2 | 20.1 | 24.0 | 24.0 |
| Cost of funds | 10.0 | 14.7 | 13.3 | 11.9 | 13.1 |
| Spreads | 15.3 | 13.5 | 6.8 | 12.1 | 10.9 |
| Net interest margin | 20.0 | 22.2 | 13.2 | 16.2 | 16.7 |
| Fee income/ Op revenue | 3.7 | 2.4 | 2.7 | 2.6 | 2.6 |
| Op expense/ Op revenue | 37.1 | 36.3 | 35.9 | 34.6 | 33.2 |
| **Capitalization Ratios (%)** | | | | | |
| Equity / Assets | 23.5 | 38.3 | 32.1 | 32.1 | 26.8 |
| Loans / Assets | 72.4 | 91.3 | 95.6 | 95.4 | 96.6 |
| Investments / Assets | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Dividend payout | - | - | - | - | 14.0 |
| Internal capital growth | 26.6 | 19.3 | 13.2 | 15.6 | 15.4 |
| Capital adequacy | 29.8 | 44.1 | 35.9 | 35.5 | 29.6 |
| **Asset Quality** | | | | | |
| Gross NPL ratio | 0.3 | 1.9 | 2.0 | 2.6 | 2.7 |
| Net NPL ratio | 0.2 | 1.0 | 1.3 | 1.7 | 1.7 |
| Net NPL / networth | 0.4 | 0.5 | 2.3 | 3.8 | 4.9 |
| Loan-loss reserve / Gross NPL | 14.5 | 62.1 | 224.1 | 166.7 | 151.1 |
| Loan provisions / NII | 0.2 | 1.0 | 29.1 | 124.8 | 12.5 |
| Loan provisions / Total loans | 0.0 | 0.2 | 4.4 | 14.0 | 1.6 |
| **Productivity / Efficiency ratios** | | | | | |
| Net profit per employee (INRmn) | 0.1 | 0.0 | (0.2) | 0.1 | 0.2 |

## Analyst Certification

I, Jaynee Shah, MBA, research analyst and author of this report, hereby certify that all of the views expressed in this document accurately reflect our personal views about the subject company/companies and its or their securities. We further certify that no part of our compensation was, is or will be, directly or indirectly related to specific recommendations or views expressed in this document.

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| | Analyst ownership of the stock | Avendus or its associate company's ownership of the stock | Investment Banking mandate with associate companies of Avendus |
|---|---|---|---|
| SKS Microfinance Ltd. | No | No | No |

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