

ADD

SKS Microfinance

Target Price(INR)

374

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

Rating



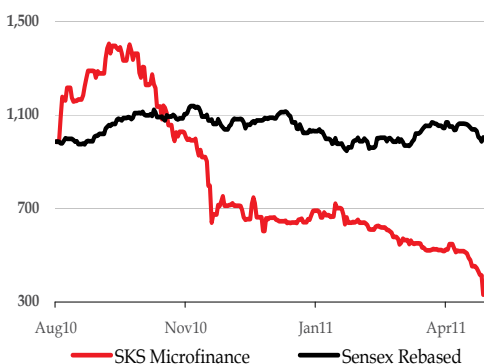
Last Price (INR)

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
FIs	20.6	21.3
Public	29.0	28.9
Others	8.6	8.0

Stock Chart (Relative to Sensex)



Stock Perf. (%)	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
Aventus net income	1.1	-6.0	3.1	4.9
Shares outstanding (mn)	72	72	72	72
Aventus dil. shares (mn)	72	72	72	72
Aventus 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
Aventus net income	-35.9	-633.5	0.0	60.8
Aventus 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
Extramordianaries	-	-	-	-	-
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 Aventus 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

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