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Mahindra & Mahindra Financial Services Ltd

PRICE : RS.262 | **RECOMMENDATION : BUY**

TARGET PRICE : RS.320 | **FY11E P/EX: 9.1X, P/ABVX: 1.5**

Stock details

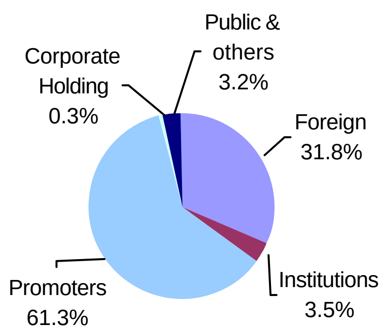
BSE Code	:	532720
NSE Code	:	M&MFIN
Market cap (Rs mn)	:	25803
Free float (%)	:	39
52- wk Hi/Lo	:	295/162
Avg. Daily Volume	:	102370
Shares (o/s) (mn)	:	97

Summary table

(Rs mn)	FY09	FY10E	FY11E
Interest Income	13,648	14,313	15,936
Interest expenses	5,099	5,326	5,839
NII	8,550	8,988	10,097
Other Income	198	223	234
Total Income	8,748	9,211	10,331
Optg Profit	6,080	6,351	7,160
PAT	2,145	2,509	2,824
Gross NPA (%)	8.7	9.7	9.6
Net NPA (%)	2.6	2.5	2.4
NIMs (%)	12.7	12.4	12.3
RoA (%)	3.3	3.5	3.5
RoE (%)	15.4	16.0	16.0
Divi. Payout Ratio (%)	24.5	25.0	25.0
EPS (Rs)	22.4	25.9	29.1
BV (Rs)	153.5	170.9	192.7
Adj. BV (Rs)	133.2	151.3	171.5
P/E (x)	11.8	10.2	9.1
P/ABV (x)	2.0	1.8	1.5

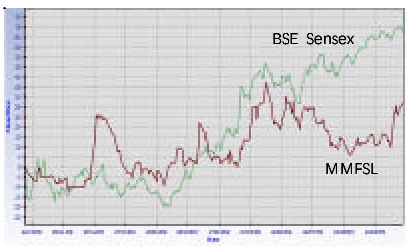
Source: Company,
Kotak Securities - Private Client Research

Shareholding pattern as on 30 Dec 08



Source: Capitaline

One-year performance (Rel to sensex)



Source: Capitaline

A steady increase in rural income and improving infrastructure is expected to increase demand for durable goods including vehicles, in rural India. MMFSL has a strong presence in rural India with about 436 offices and AUM of about Rs.86 bn in FY09. A 61% subsidiary of Mahindra & Mahindra, MMFSL has diversified across vehicles including Tractors, Farm equipment, CVs, cars, 2-wheelers and pre-owned vehicles, thus reducing portfolio concentration risks. M&M accounts for 65% of disbursements (FY09), while MMFSL has capped its exposure to M&M at 40% of M&M's sales. With priority sector status being accorded to rural and agricultural financing, MMFSL's assets are in demand from banks. The consequent asset securitization reduces financing costs and also provides a prominent source of financing. MMFSL's NIM is at a respectable 12.3%. An efficient cash collection system has insured the company from leakages. At 1.5x FY11 ABV, we believe valuations are attractive. We initiate coverage with a BUY and a price target of Rs.320.

INVESTMENT RATIONALE

- **Reducing dependence on monsoon and improving irrigation facility will led to better crop harvest.** Agriculture sector contributes close to 17% to India's GDP. Majority of the India's population which resides in the rural areas is largely dependent on agriculture. With governments thrust on strengthening irrigation system in India, the Indian agriculture sector has witnessed a reduction in dependency on monsoon Although Indian has witnessed a relatively scanty rainfall in the 2009 monsoon season, the delayed rainfall in the southern states has improved the moisture levels in the soil and therefore we expect a bumper Rabi crop. A robust crop harvest will improve growth for the agriculture sector - boosting rural disposable income and thus will recuperate demand for durable goods. We expect a 12.5% yoy growth in MMFSL's loan book to Rs.76.9 bn for FY10 and a 13% yoy growth in FY11 to Rs.86.9 bn.

- **Strong parentage of Mahindra and Mahindra group.** MMFSL was promoted in 1991 by Mahindra & Mahindra which currently holds ~60% in the company. M&M being the leading automobile manufacturer founded MMFSL to finance its UVs, tractors and farm equipment. MMFSL had capitalised on M&M's strong distributors and dealer network for financing its UVs and tractors.

- **Priority sector advantage.** Financing to rural and agriculture sector are categorised as priority sector lending and thus MMFSL's assets, which are largely concentrated in these segments, find huge demand from the Banks. Following the priority sector status accorded to the rural and farm lending, MMFSL is able to obtain close to 100-150bps discount on its borrowing cost on securitisation of such assets. Asset securitisation is also one of the prominent sources of funding for MMFSL.

- **Diversified business mix, with higher thrust on rural and semi-urban sector.** MMFSL offers a host of financial products to rural and semi-urban customers through its pan-India network of branches. It also provides financial assistance to M&M dealers. MMFSL has a well diversified lending portfolio; it finances tractors and farm equipment, cars, UVs, CVs, two-wheelers and pre-owned vehicles. This is with a view to de-risk MMFSL's business and will also improve growth rate. MMFSL finances M&M's tractors, farm equipments, SUVs and UVs. Tractors comprise of close to 24% of the MMFSLs total AUM. MMFSL has capped its exposure to 40% of M&M sales; M&M vehicles comprised close to 65% of total vehicles financed by MMFSL in FY09. Further, MMFSL has also diversified its business by financing vehicles manufactured by other OEMs, MMFSL has entered into tie-up with Maruti, GM, Hyndai etc. to finance their passenger vehicles.

- **Diversified borrowing mix.** MMFSL has a well diversified funding mix. Courtesy its prudent asset liability management, MMFSL has customized its borrowing mix, which helped the NBFC in containing its cost of funds. Good credit rating has also helped MMFSL raise funds at competitive rates. Rural and agri-loans are classified as priority sector loans and thus MMFSL securitises close to 15% of its incremental loans to banks. Assets are securitised at a discount to cost of funds, which also helps improve cash flow and reduce borrowings.

- **Efficient cash collection system in place; well insured for cash leakages.** As the company has a large rural customer base, which lacks banking habits, all MMFSL's transactions are carried out in cash. MMFSL has a strong cash collection system in place. To reduce the risk of frauds and leakages in its unique cash collection system, MMFSL largely relies on its own employees rather than being dependent on DSAs and collection agents. By having a smooth cash collection system, MMFSL has also insured itself against any losses likely to happen due to frauds and cash leakages.

- **Asset quality less likely to deteriorate any further.** MMFSL follows a relatively stringent provisioning policy. Over the period, MMFSL has improved its provision coverage from 57% in FY07 to 72% in FY09. It also maintains a lower loan to value ratio (LTV) of 73% to contain defaults. MMFSL operates in a segment where its customer's have lumpy cash flows and secondly since its recovery system is cash based which leads to certain delays. Moreover, higher NPAs (15% qoq) ratio of 3.1% in the Q1FY10 are seasonal in nature, and the delinquencies pertaining to increase in NPA is expected to be recovered in the H2FY10. Healthy monsoon season and improved macroeconomic condition are expected to support asset quality.

VALUATION AND RECOMMENDATION

We opine that the improvement in overall macroeconomic scenario and improved irrigation facility and a healthy Rabi crop season will stimulate MMFSL's business growth and therefore will also help fetch better valuation multiple for the stock.

We have valued MMFSL on dividend discount model to arrive at a fair price target of Rs. 320. At our target price the stock is valued at P/ABVx of 1.9x of if FY11E earnings estimate and offers a 23% upside from current levels.

At the current market price of Rs.262, the stock is quoting at 1.8x FY10 P/ABV of Rs.151 and 1.5x its FY11 P/ABV of Rs.171. We are initiating coverage on the stock with **BUY** recommendation and a price target of Rs.320.

Risk and concerns

- **Increasing competition with banks.** The NBFC faces higher competition with banks who, akin to MMFSL, have strong presence in rural India. To compete with banks MMFSL has expanded its branch network and is also offering personalized service to the rural customers through its well trained and experienced work force. This provides MMFSL a competitive edge over its banking counter parts.

- **Risk of inappropriate cash handling.** To prevent any loss of cash in MMFSL has an insurance against loss of cash in handling in place to protect the company against any losses which may impact MMFSL's bottomline.

Company Background

Mahindra & Mahindra Financial Services Ltd (MMFSL) a subsidiary of Mahindra & Mahindra (M&M) is one of India's leading non-banking finance companies focused on providing finance for utility vehicles, tractors and cars in the rural and semi-urban sector. Mahindra & Mahindra is a leading tractor and utility vehicle manufacturer. The company has positioned itself between the organized banking sector and local moneylenders, offering customers competitive, flexible and speedy lending services. MMFSL has a network of 436 branches spread across India and has entered into a total of 1,013,000 customer contracts since inception.

Business segments

Tractor financing

At the outset, MMFSL was predominantly engaged in providing financial assistance farmers for buying tractors and farm equipments. However, 2005 onwards MMFSL has diversified its lending portfolio and started financing UVs SUs cars CVs and two-wheelers as well.

Auto/Utility vehicles

MMFSL finances utility vehicles, SUVs and to some extent two-wheelers manufactured by M&M. Post acquisition of two wheeler division of Firodia group which manufactured Kinetic, the two Mahindra businesses drew more synergies and further expanded its product offered. This comprises of close to 38% of the total AUM. It also provides trade advance facilities for dealers.

Car Financing

While MMFSL has been a preferred financier for M&M, it has also entered into tie-ups with leading passenger car manufactures including Maruti, Hyndai, GM, HM etc. Leading automobile manufactures leverage on MMFSL's strong presence in the rural areas for providing financial assistance to retail customers. Car financing comprises 25% of the NBFC's disbursements.

Commercial vehicle financing

MMFSL offers loans to commercial vehicles and construction equipment, which includes trucks, buses, trippers, excavators, and light commercial vehicles. Such loans comprise of close to 8% of the total AUM of the NBFC.

Refinance assets

MMFSL refinances pre-owned automobiles such as CVs, cars, tractors etc. Since the valuation of the pre-owned vehicle is subjective, MMFSL lends in this segment at premium yields of 22%. The segment is relatively unorganized, however, it has enormous potential. Its LTV in this segment stands at 60%.

Investment Rationale

Declining dependence on monsoon following improving irrigation system; a bumper rabi crop likely to buoy up growth

GDP composition (Rs bn)

Sectors	FY08-09	% of GDP
Agriculture	8,617.53	17
Industry	9,852.97	20
Services	30,855.92	63
GDP	49,326.42	

Source: RBI, Kotak Securities - Private Client Research

With governments thrust on strengthening irrigation system in India, the Indian agriculture sector has witnessed a reduction in dependency on monsoon. The major contributor to improved yield is high yield seeds, good quality fertilizers and pesticides, better technology and not the least irrigation. The cultivable land dependent on monsoon has reduced with the improved irrigation system in India.

The total irrigation potential in the country has increased from 81.1 million hectares in 1991- 92 to 102.08 million hectares up to the end of the Tenth Five Year Plan (2006-07). Nonetheless, Of the total potential created, only 87.2 million hectares is actually utilized.

Government's focus on improving irrigation system and reducing dependance on monsoon will support India's agricultural growth

Under the Eleventh Five Year Plan (2007-12) the government has proposed creation of irrigation potential of 16 million hectares (9 million hectares from MMI sector and 7 million hectares from MI sector) .

Although Indian has witnessed a relatively scanty rainfall in the 2009 monsoon season, the delayed rainfall in the southern states has improved the moisture levels in the soil and therefore we expect a bumper Rabi crop.

A robust crop harvest will brace growth for the agriculture sector - boosting rural disposable income and thus will recuperate demand for consumable and durable goods.

Robust rabi crop harvest will brace growth for the agriculture sector

Agriculture sector contributes close to 17% to India's GDP. Majority of the India's population which resides in the rural areas is largely dependent on agriculture. Improving macroeconomic condition will support earning growth for MMFSL. Better monsoon will also boost rural income and thus demand for tractors and farm equipments.

Improving road infrastructure to boost demand for utility and commercial vehicles

Presently, rural roads comprise of close to 80% of the total road network of India and facilitate transportation of cereals, fruits and vegetable and other cash crops from hinterlands.

Better road infrastructure will improve mobility of goods and commodities and thus, will boost demand for UVs & CVs

Significant improvement in the rural road infrastructure in India would lead to a better movement of agri-products from rural to urban area. This would also facilitate faster movement of perishable items like milk and milk products to consumers and will open up new business avenues for people in rural areas.

Rural road development programme under the Prime Minister's Gram Sadak Yojana in select states has facilitated vehicle mobility in the rural areas, which in turn will boost demand for UVs, CV, and tractors in the rural and semi-urban areas.

Road network in India (kms)

	2008	% share
Expressways	200	0.01
National Highways	66,590	2.01
State Highways	131,899	3.98
Major district Roads	467,763	14.10
Rural and other roads	2,650,000	79.90
Total road network length	**3,316,452**	

Source: NHAI, Kotak Securities - Private Client Research

Strong parentage of Mahindra and Mahindra group further diversifying to de-risk

MMFSL draws synergies from parent M&M, which holds 60% in the company

MMFSL was promoted in 1991 by Mahindra & Mahindra and currently holds close to 60% in the company. M&M being the leading manufacturer of UVs and tractors founded MMFSL to finance its UVs, tractors and farm equipment. Diversification in M&M's automobile portfolio from UVs and tractors to cars and CV offers immense opportunity to MMFSL. Being an M&M subsidiary MMFSL initially financed parent company's automobiles only. MMFSL capitalises on M&M's strong distributors and dealer network for financing its UVs and tractors.

Maintains a policy to finance only 40% of M&M sales and thus diversified over the period to dilute its dependence on M&M

M&M vehicles comprise of ~65% of MMFSL's disbursement in FY09, which is lower than 70% of the loan book in FY2006. Besides this MMFSL is also maintaining a policy of financing only 40% of the M&M sales. This has also helped MMFSL in capping its risk of a slow down in M&M sales.

Over the period, MMFSL has diversified its lending portfolio, and started financing other vehicles as well. The strategy to dilute dependence on M&M was to reduce the impact of any slow down in M&M's sales on MMFSL profitability.

MMFSL has diversified its business by financing vehicles manufactured by other OEMs, MMFSL has entered into tie-up with Maruti, Hyndai to finance their passenger vehicles.

Diversified business mix, with higher thrust on rural and semi-urban sector

MMFSL diversified its business mix from tractors and farm equipment to Cars, UVs, CVs and refinanced vehicles manufactured by other OEMs

MMFSL offers a host of financial products to rural and semi-urban customers through its pan-India network of branches. It also provides financial assistance to M&M dealers.

MMFSL largely finances M&M's tractors, farm equipments, SUVs and UVs. **Tractors** comprise of close to 24% of the MMFSLs total AUM. Since the asset class is categorized as priority sector lending by RBI, Banks buy these assets. Although MMFSL has capped its exposure to 40% of M&M sales; M&M vehicles comprise close to 65% of total vehicles financed by MMFSL in FY09 as compared to over 70% in FY06.

MMFSL has a well diversified lending portfolio; it finances tractors and farm equipment, cars, UVs, CVs, two-wheelers and pre-owned vehicles. This is with a view to de-risk MMFSL's business and will also improve growth rate.

Car financing comprises of 24% of MMFSL lending portfolio. It has tied-up with both Maruti, Hyundai, GM etc. for car financing in the rural and semi-urban areas.

MMFSL has also initiated **financing CVs** which comprise close to 8% of the total AUM. The significant thrust on improving road infrastructure in India will drive the demand for commercial vehicles in India. Easing fuel cost and better freight rates also favour the CV demand.

Refinancing (financing for pre-owned vehicles) is one segment where the management sees huge potential. Pre-owned vehicle financing attracts higher yield and refinancing is one segment where the management sees huge potential. The pre-owned vehicle financing segment attracts higher yield, but also has high risk attached to it.

Early entrant advantage - Pan India presence

MMFSL has strong presence in Indian hinterlands with network of 436 branches spread across 25 states

MMFSL with its well equipped network infrastructure of 436 branches spread across 25 states has a strong presence in the rural and semi-urban areas. MMFSL has been able to establish itself in the Indian hinterlands and also enjoys first mover advantage and has a customer base of over 9 lakh and total asset under management of Rs.85.86 bn.

Having strong niche presence; MMFSL offers customized services to retail customers in rural and semi-urban areas. This has helped MMFSL withstand competition with both public and private sector banks and has turned it into a recognized brand in the rural and semi-urban markets of India.

Significant employee strength; helps avoid leakages and delinquencies

MMFSL has employee strength of 6000, this helps smoother cash collection and reduces risk of leakages and delinquencies

MMFSL source its executives locally and train them to understand the credit requirement of the customers and evolve a financial product based on the credibility of the borrowers. Its total employee strength stands close to 6000 employees (including ~1000 employee on contract basis).

To avoid any risk of leakage in its cash collection system, MMFSL does not hire any DSA and DMA for cash collections and new business acquisition. Higher reliance on its own employees helps avoid risk of cash leakages and higher delinquencies associated with asset originating from this distribution channel.

Strong traction in loan book likely

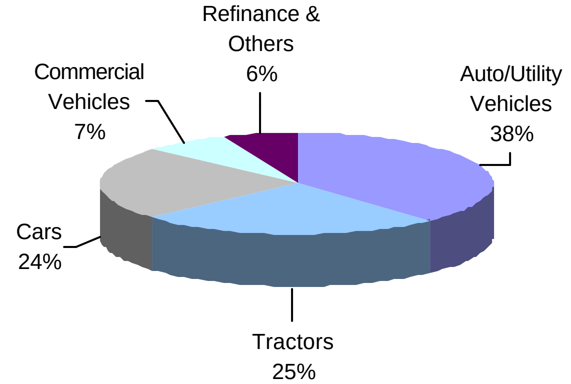
Better irrigation system will help reduce dependence on monsoon while robust rabi crop is expected to aid advances growth

In the wake of supportive government policies and better economic growth; MMFSLs advances witnessed a CAGR of 24% over FY05-09. However, during FY09, in the backdrop of unfavorable macroeconomic scenario and high risk of delinquencies, MMFSLs loan book moderated and grew by a meager 3% to Rs.68.38 bn. The slow down in the overall loan book was also due to securitsation of assets to the tune of Rs.10360 mn. Including this, the total asset would have actually grown by 9% to Rs.85.43 mn.

The enhanced irrigation facility in India and declining dependence on monsoon is expected to support agricultural income. Although we have witnessed a relatively scantly rainfall this monsoon season. However, a delayed rainfall in the southern state of India is has improved the moisture level in the soil, which will lead to a bumper Rabi crop.

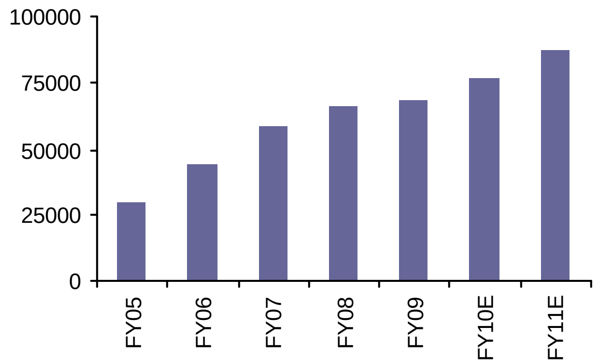
Going forward, we expect business growth to improve on lower asset base coupled with healthy macroeconomic conditions and improving monsoon in India. We expect a 12.5% yoy growth in MMFSL's loan book to Rs.76.9 bn for FY10 and a 13% yoy growth in FY11 to Rs.86.9 bn.

AUM (Rs mn)



Source: Company; Kotak Securities - Private Client Research

Loans (Rs mn)



Source: Company; Kotak Securities - Private Client Research

Diversified borrowing mix

MMFSL has a well diversified funding mix. Courtesy its prudent asset liability management, MMFSL has customized its borrowing mix, which helped the NBFC in containing its cost of funds.

Prudent and flexible borrowing mix coupled with assets securitisations helps contain cost of funds. Margin likely to remain stable

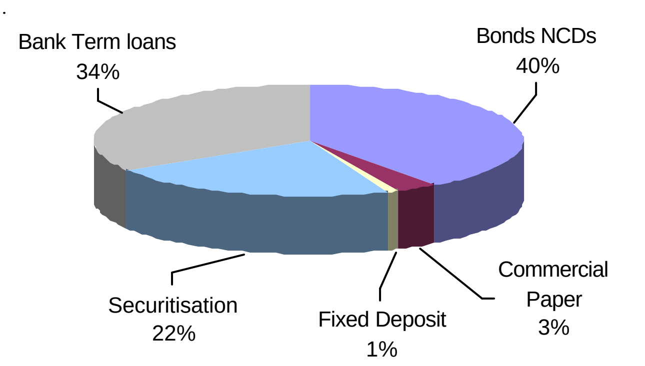
Strong parentage and good credit rating have also helped MMFSL raise funds at competitive rates. With its long term fund requirement tie-up with borrowers in place, we believe that the NBFC would able to maintain healthy spreads.

MMFSL enjoys an AA credit rating from FITCH and AA- from CRISIL. Good credit rating has also enabled MMFSL to borrow funds at a competitive rate. We opine that, following this MMFSLs paper would find a good demand from financial institutions, which is quite indicative in the change in its borrowers mix as borrowing from Insurance company has increased from 5% in FY08 to 11% in FY09.

With its Fixed Deposit license in place, MMFSL would borrow more from this window being more stable source of funds. Presently public deposits comprise of ~1% of the total borrowings.

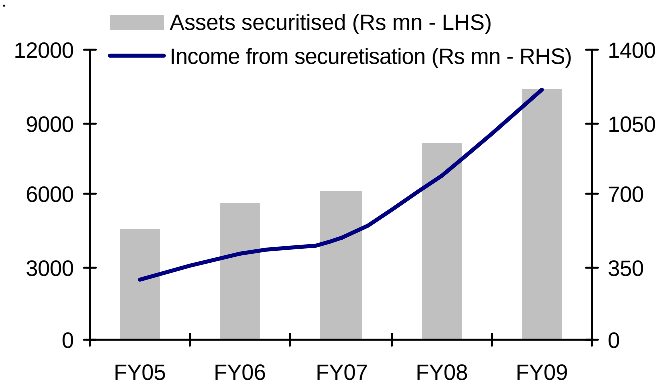
Besides borrowings from banks and mutual funds and insurance companies, securitisation had been one of the key sources of funding for MMFSL. Its borrowings from banks, inclusive of assets securitised, comprise of ~59% of its total borrowings. Assets are securitised at a discount to cost of funds, which also helps improve cash flow and reduce borrowings.

Borrowing mix (%)



Source: Company; Kotak Securities - Private Client Research

Loans



Source: Company; Kotak Securities - Private Client Research

Priority sector advantage

Rural and agriculture sector is categorised as priority sector lending thus securitised with banks at 100-150bps discount to borrowing cost

Financing to rural and agriculture sector is categorised as priority sector lending and thus MMFSL's assets, which are largely concentrated in these segments, find huge demand from the Banks. Banks have to mandatorily maintain 40% of their lending in priority sector lending. And therefore Banks buy these securitised assets to meet there annual priority sector lending requirements.

Following the priority sector status accorded to the rural and farm lending, MMFSL is able to obtain close to 100-150bps discount of its borrowing cost from Banks on securitisation of such assets. Asset securitisation is also one of the prominent sources of funding for MMFSL. It comprises of 22% of its total borrowings. With better cash flows and reduced borrowings, securitisation of assets also helps contain cost of funds. We opine that this contains MMFSL's borrowing cost, which is at 9.95% in FY09, we expect the similar trend to continue going forward.

Efficient cash collection system in place; well insured for cash leakages

Efficient cash collection system with high reliance on its own employees than DSAs. Insurance in place to cover against cash leakage

Having large rural customer base, which lacks banking habits; all MMFSL's transactions are carried out in cash only. MMFSL has a strong cash collection system in place. Its cash collection officers collect cash from the customer on a periodic basis, which is later deposited at respective branches located in these rural areas.

To reduce the risk of frauds and leakages in its unique cash collection system MMFSL, MMFSL largely relies on its own employee rather than being dependent on DSA and collection agents. MMFSL sources its executives locally and train them periodically to understand the credit requirement of the customers and evolve a financial product based on the credibility of the borrowers.

With all the measures in place to have a smooth cash collection system; MMFSL has also insured itself against any losses likely to happen due to frauds and cash leakages.

Asset quality less likely to deteriorate any further

MMFSL follows a relatively stringent provisioning policy. Over the period, MMFSL has improved its provision coverage from 57% in FY07 to 72% in FY09. It also maintains a lower loan to value (LTV) of 73% to contain defaults.

Stringent provisioning policy, lower LTV, customised payment schedule helps contain slippages

MMFSL operates in the rural and semi-urban areas where the demography has a large dependency on income from agriculture. Due to the seasonal nature of agriculture in India the cash flows are lumpy. Lumpy cash flows leads to delayed and irregular payments. Therefore MMFSL has structured its payments system in monthly (35%), Quarterly (20%), and Half-yearly (40%) installments.

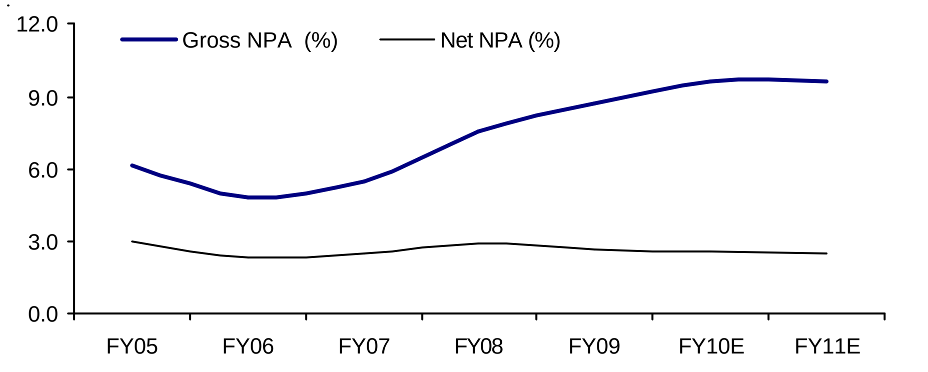
Due to seasonal nature of the business, delinquencies are higher in the tractor and farm equipment segment (24% of the total AUM) being directly linked to agriculture. It maintains a lower LTV of ~65% and higher provision coverage to contain defaults.

Moreover, higher NPAs (15% qoq) ratio of 3.1% in the Q1FY10 are seasonal in nature, and the delinquencies pertaining to increase in NPA shall be recovered in the H2FY10.

Besides tractors, refinance (for per-owned vehicles) is also a risky segment. However we have factored in the same in our workings to arrive at our price target.

Healthy monsoon season and improved macroeconomic condition are expected to support asset quality. Going forward, we opine that MMFSL will be able to maintain higher provision coverage (74%), with Net NPA of 2.5% for FY10E and 2.4% in FY11E.

Gross NPA & Net NPA (%)



Source: Company; Kotak Securities - Private Client Research

NEW BUSINESS VENTURES

Insurance brokerage business - Mahindra Insurance Brokers (MIBL)

MIBL is the wholly owned insurance broking arm of MMFSL for both life and non-life products. MMFSL is leveraging on its broad network of branches to become a one stop shop for all financial products in the Indian hinterlands. MIBL sales customized life insurance policy for its customers in the rural and semi-urban areas.

The non-life product segment largely comprises of motor insurance primarily in the rural markets. The business reported a commission income of Rs.231 mn and a net profit of Rs.65 mn for FY10.

Considering that the contribution from the insurance brokerage business is insignificant, we have not factored the same in our future earnings estimates to arrive at our fair price target for the stock.

Rural housing loan business- Mahindra Rural Housing Finance (MRHFL)

MRHFL is capitalizing on MMFSL's reach for creating a niche in the rural and semi-urban markets for housing finance. The MMFSL wholly owned subsidiary is in the second year of operation in the states of Maharashtra, Gujarat and all the southern states of India.

Disbursements in this segment had been quite low during FY09 following the unfavorable macroeconomic factors, notwithstanding, the company disbursed close to Rs.434 mn during FY09. Going forward, the management is targeting to disburse close to Rs.1500 mn in FY10E. We have not factored in any contribution from MRHFL in our future earnings estimates

Improving Financials to Support Valuation

Advances growth to improve; following beter government policies and robust rabi crop

Better Government policies in places coupled with a robust rabi crop will drive advance growth

During FY09, MMFSL's loan book growth trend remained flattish, recording a growth of 3% yoy to Rs.68.38 bn as compared to a 13% growth during FY08 to Rs.66.45 bn. The slow in the advances growth had been on account of unfavorable macroeconomic conditions which prevailed during FY09, the tight liquidity conditions and high interest rates.

However, with RBI's measures to improve liquidity situation and ease interest rates, the overall operating scenario in the economy improved significantly.

Advances growth in FY09 was also lower due to securitisation of assets worth Rs.10.3 bn. Factoring in the securitised assets; MMFSL's AUM grew by 9% to Rs.85.4 bn, as compared to 13% (to Rs.78.5 bn) during FY08.

Improved macroeconomic scenario, better Government policies which are focusing more on development of rural areas and expected good Rabi crop will provide significant opportunity to a financial institution like MMFSL. MMFSL appears to be in a sweet spot having a presence in the under penetrated rural area.

Going forwards we opine that the better irrigation facilities will support agriculture sector growth and thus will be materially positive for rural financiers like MMFSL. We expect a 13% yoy growth in MMFSL's loan book during FY10 to Rs.76.9 bn and a 13% yoy growth in FY11 to Rs.86.9 bn.

Attractive asset pricing, lower borrowing cost supported net margins; likely to remain stable

MMFSL caters to a segment with limited competition. This has provided immense opportunity to the organised player like MMFSL. Also it has a strong presence in under penetrated rural and semi urban area. Moreover, due to relatively higher risk associated with the rural and farm loans; MMFSL has been able to price the assets at attractive rates.

Assets priced at attactive rates, factors in high risk and operating cost. NIM at 11.9%, likely to remain stable

Secondly, due to higher operating cost on account personalized cash collection system, higher employee base and aberration in the cash flows with the customers, MMFSL lends at a higher rate of interest for these rural and farm loans.

On the cost front, MMFSL has been able to contain its cost of funds, courtesy its flexibility to swap its borrowing mix in line with market liquidity. Moreover, asset securitisation, which comprise of close to 22% of the total borrowings also helps hold cost of funds. Given the priority sector status accorded to the rural and farm lending, MMFSL is able to obtain close to 100-150bps discount of its borrowing cost from Banks. MMFSL maintained a higher net margin at 12.2% during FY09.

Going forward, in the backdrop of governments borrowing progmme to beginning the H2FY10, we expect the interest rates to harden. Following this we expect MMFSL to witness some pressure on its borrowing cost, following which there might be some pressure on net margins as well. We expect a net interest margin of 11.9% during FY10E.

Bottomline growth expected at around 17%

Stable NIM and healthy advance growth will lead to a 17% YoY bottomline growth in FY10

On the back of stable NIMs, which is supported by higher yield on loans and securitisation income, MMFSL will continue to maintain healthy growth in its core income. However, MMFSL will continue to provide higher provisions towards loan loss, coupled with higher operating expenses, will restrict higher bottomline growth.

Going forward, we expect a 17% yoy growth in net profit for FY10E to Rs.2.5 bn and 11% yoy growth in FY11E to Rs.2.8 bn, with an EPS of Rs.25.9 and Rs.28.6 respectively.

Well capitalized to grow, rebound in return ratios to drive valuation

MMFSL appears to be well capitalized and going forward we do not expect its business growth to be impacted by liquidity constrains. MMFSL's capital adequacy ratio (CAR) stood at 19.5%, with the Tier I CAR of 17.4%.

Lower equity leverage at 4.7x, is expected to increase with improving business growth. However, we expect MMFSL's return ratios to rebound, with RoA of 3.5% and RoE of 16%+ levels in FY10, which will help the stock fetch better valuations. Considering a 13%-15% loan growth, MMFSL will require to raise equity only post FY12.

Valuation and recommendation

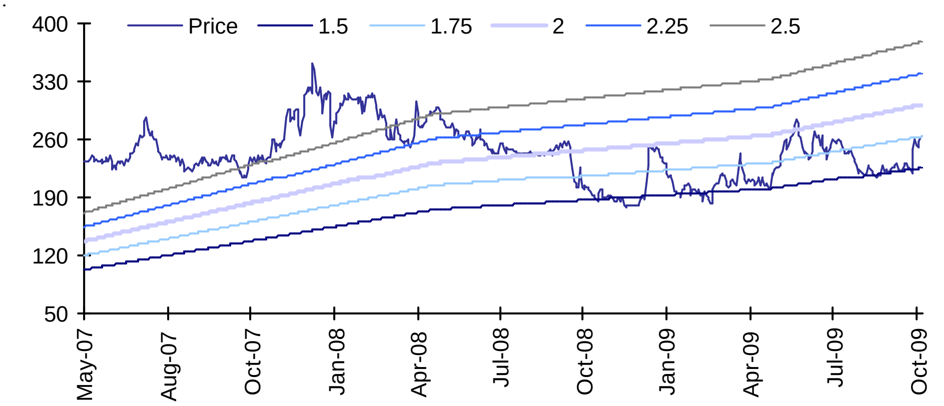
We opine that the improvement in overall macroeconomic scenario improved irrigation facility and a healthy Rabi crop season will stimulate MMFSL's business growth and therefore will also help fetch better valuation multiple for the stock. Looking at the one-year rolling P/BV chart, the stock is currently trading at the lower end of the P/BV band.

We initiate coverage on M&M Financial Services with BUY recommendatiion and a price target of Rs.320

We have valued MMFSL on dividend discount model to arrive at a fair price target of Rs.320. At our target price the stock is valued at P/ABVx of 1.9x of if FY11E earnings estimate. At our target price, the stock offers an upside of 23%.

At the current market price of Rs.262, the stock is quoting at 1.8x FY10 P/ABV of Rs.151 and 1.5x its FY11 P/ABV of Rs.171. We are initiating coverage on the stock with **BUY** recommendation and a price target of Rs.320.

PBV (x)



Source: Capitaline, Kotak Securities - Private Client Research

Financials

Profit and Loss Statement

(Rs mn)	FY08	FY09	FY10E	FY11E
Income from operations	12,058	13,648	14,313	15,936
Interest Expenses	4,560	5,099	5,326	5,839
Net Interest Income	7,498	8,550	8,988	10,097
Other income	210	198	223	234
Total Income	7,708	8,748	9,211	10,331
Operating Expenses	2,525	2,668	2,860	3,171
Operating profit	5,183	6,080	6,351	7,160
Provisions and write offs	2,463	2,824	2,543	2,874
PBT	2,720	3,256	3,808	4,287
Provi. For taxes	950	1,111	1,299	1,463
PAT	1,770	2,145	2,509	2,824
% chg	33	21	17	13

Source: Company, Kotak Securities - Private Client Research

Balance sheet

(Rs mn)	FY08	FY09	FY10E	FY11E
Equity capital	966	970	970	970
Reserves and Surplus	12,176	13,722	15,603	17,721
Shareholders fund	13,143	14,692	16,573	18,691
Loans	50,425	52,130	58,245	65,987
Total Liabilities	**63,568**	**66,822**	**74,818**	**84,678**
Intangible assets	13	18	18	18
Fixed Assets	307	357	357	357
Laons and avances	66,435	68,383	76,931	86,932
Investments	31	1,097	1,152	1,210
Current Assets	3,431	2,796	2,660	2,662
Current Liabilities	6,651	7,617	7,998	8,198
Net current assets	(3,219)	(4,821)	(5,338)	(5,536)
Deferred Tax Assets	-	1,788	1,698	1,698
Total Assets	**63,568**	**66,822**	**74,818**	**84,678**

Source: Company, Kotak Securities - Private Client Research

Key Data

	FY08	FY09	FY10E	FY11E
EPS (Rs)	18.6	22.4	25.9	29.1
BV (Rs)	137.9	153.5	170.9	192.7
ABV (Rs)	116.4	133.2	151.3	171.5
P/E (x)	14.3	11.8	10.2	9.1
P/BV (x)	1.9	1.7	1.6	1.4
P/ABV(x)	2.3	2.0	1.8	1.5
Asset Quality				
Gross NPA (Rs)	5,572	6,909	7,427	8,356
Gross NPA (%)	7.6	8.7	9.7	9.6
Net NPA (Rs)	2,053	1,943	1,901	2,055
Net NPA (%)	2.9	2.6	2.5	2.4

Source: Company, Kotak Securities - Private Client Research

Key ratios

	FY08	FY09	FY10E	FY11E
Yield on Advances (%)	19.3	20.2	19.7	19.5
Cost of funds (%)	9.1	9.9	9.7	9.4
NIM (%)	12.0	12.7	12.4	12.3
RoE (%)	16.9	15.4	16.0	16.0
RoA (%)	2.9	3.3	3.5	3.5
Leverage(x)	5.8	4.7	4.5	4.5
Profitability Ratios (%)				
Cost/Income	31.6	29.5	30.1	29.7
DPS	4.5	5.5	6.5	7.3
Dividend Yield	1.7	2.1	2.4	2.7
Dividend Payout ratio	24.2	24.5	25.0	25.0

Source: Company, Kotak Securities - Private Client Research

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Disclaimer

Analyst holding in stock: Nil

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