Equities

10 November 2011 | 10 pages

SKS Microfinance (SKSM.BO)

Sell: Asset Quality Concerns Not Alleviated

- Company Update
- Target Price Change
- Estimate Change

- **Higher credit costs lead to larger than expected losses in 2Q FY12** — SKS' losses expanded to Rs3.8bn in 2Q, driven by higher credit costs on its Andhra Pradesh (AP) loan portfolio. While its non-AP portfolio remained largely stable (on loan yields and asset quality), the AP regulatory environment is a key business constraint.

- **Lowering earnings, reducing TP to Rs155** — We are revising our earnings estimates down to factor in higher credit losses in 1H FY12 and reducing our target price to Rs155 (from Rs200), benchmarked now at 1.2x Adjusted BV (after incorporating losses from the AP book, net of tax benefits). Persistent regulatory overhang continues to meaningfully impact SKS' business prospects; the longer the impasse in AP continues, the lesser is the likelihood of recoveries from this portfolio. Maintain Sell (3H).

- **AP and WB recoveries still low, could hurt more** — SKS' AP loans are Rs8.2bn (32.8% of loans), down from its peak of Rs15bn a year ago (post ~Rs5.5bn of write-offs, provisions and marginal recoveries). Incremental recoveries continue to be low for AP (~10%) and WB (~85%). We expect low eventual recoveries in AP (~15%), given the unsecured nature and long repayment gaps (over 1 year for most loans).

- **Likely capital raising near term** — SKS has sought shareholder approval for incremental capital issuance of Rs9bn. At current stock prices, this would lead to 42% dilution for existing shareholders. While this would support capital adequacy and liquidity management, the current weak capital markets could lead to delays.

- **Expected MFI Bill a positive, but delays a key risk** — We believe the proposed MFI Bill, if enacted, would be a positive for the MFI sector (removes the AP Ordinance and its inherent constraints). The Bill is expected to be presented in the coming months; however, given the uncertain political environment, risks of delays cannot be ruled out. Moreover, we believe the road to profitability for SKS will still be long and gradual, and it is too early to turn positive on the stock.

Sell/High Risk	**3H**
Price (09 Nov 11)	Rs175.55
Target price	Rs155.00
from Rs200.00	
Expected share price return	-11.7%
Expected dividend yield	0.0%
Expected total return	**-11.7%**
Market Cap	Rs12,867M
	US$257M

Price Performance
(RIC: SKSM.BO, BB: SKSM IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2010A	1,740	30.94	77.9	5.7	1.2	21.6	0.0
2011A	1,116	16.31	-47.3	10.8	0.7	8.2	0.0
2012E	-6,940	-95.96	na	-1.8	1.2	-48.4	0.0
2013E	-612	-8.46	91.2	nm	1.2	-5.8	0.0
2014E	-874	-12.09	-42.9	-14.5	1.4	-8.9	0.0

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Fiscal year end 31-Mar	2010	2011	2012E	2013E	2014E
Valuation Ratios					
P/E adjusted (x)	5.7	10.8	-1.8	nm	-14.5
P/E reported (x)	5.7	10.8	-1.8	nm	-14.5
P/BV (x)	1.2	0.7	1.2	1.2	1.4
P/Adjusted BV diluted (x)	1.2	0.7	2.1	2.5	2.4
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Per Share Data (Rs)					
EPS adjusted	30.94	16.31	-95.96	-8.46	-12.09
EPS reported	30.94	16.31	-95.96	-8.46	-12.09
BVPS	148.47	246.23	150.26	141.81	129.72
Tangible BVPS	148.47	246.23	150.26	141.81	129.72
Adjusted BVPS diluted	148.85	248.33	84.47	71.02	72.29
DPS	0.00	0.00	0.00	0.00	0.00
Profit & Loss (RsM)					
Net interest income	5,960	8,186	2,889	4,667	6,603
Fees and commissions	726	1,008	747	988	1,285
Other operating Income	15	22	44	88	175
Total operating income	**6,701**	**9,217**	**3,681**	**5,743**	**8,063**
Total operating expenses	-3,511	-5,130	-4,071	-3,975	-4,636
Oper. profit bef. provisions	**3,190**	**4,087**	**-390**	**1,768**	**3,427**
Bad debt provisions	-513	-2,362	-6,220	-2,694	-4,752
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	**2,677**	**1,724**	**-6,610**	**-927**	**-1,325**
Tax	-937	-608	-330	315	450
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	**1,740**	**1,116**	**-6,940**	**-612**	**-874**
Adjusted earnings	1,740	1,116	-6,940	-612	-874
Growth Rates (%)					
EPS adjusted	77.9	-47.3	-688.2	91.2	-42.9
Oper. profit bef. prov.	131.9	28.1	-109.5	553.1	93.9
Balance Sheet (RsM)					
Total assets	**40,552**	**42,997**	**31,824**	**39,022**	**47,012**
Avg interest earning assets	34,716	40,808	37,376	36,289	44,361
Customer loans	29,778	36,029	29,333	36,293	45,281
Gross NPLs	97	182	7,208	7,574	7,915
Liab. & shar. funds	**40,552**	**42,997**	**31,824**	**39,022**	**47,012**
Total customer deposits	0	0	0	0	0
Reserve for loan losses	122	334	2,449	2,455	3,761
Shareholders' equity	**9,580**	**17,808**	**10,868**	**10,256**	**9,382**
Profitability/Solvency Ratios (%)					
ROE adjusted	21.6	8.2	-48.4	-5.8	-8.9
Net interest margin	17.17	20.06	7.73	12.86	14.88
Cost/income ratio	52.4	55.7	110.6	69.2	57.5
Cash cost/average assets	9.9	12.3	10.9	11.2	10.8
NPLs/customer loans	0.3	0.5	24.6	20.9	17.5
Reserve for loan losses/NPLs	125.6	183.4	34.0	32.4	47.5
Bad debt prov./avg. cust. loans	2.3	7.2	19.0	8.2	11.7
Loans/deposit ratio	na	na	na	na	na
Tier 1 capital ratio	28.5	44.6	32.5	25.1	18.2
Total capital ratio	28.5	44.6	32.5	25.1	18.2

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Figure 1. SKS Microfinance — 2Q FY12 Results: Key Financial Highlights (Rupees Million, Percent)

	2Q FY12	2Q FY11	YoY %	1Q12	QoQ%	CIRA Comments
Interest Income	1,141	3,367	-66.1	1,499	-23.8	Interest yields on non-AP portfolio remains unchanged at 25% levels. Interest on AP book recognized only on actual receipt
Interest Expense	(527)	(908)	-41.9	(629)	-16.2	Cost of funding continues to increase - now ~13.5% levels
Net Interest Income	614	2,459	-75.0	869	-29.4	Low AP collections force NIMs down sharply
Fee-Based Income	170	360	-52.7	269	-36.6	
Other Non-Interest Income	-	50	NM	-	NM	
Non Interest Income	170	360	-52.7	269	-36.6	Remains low as incremental disbursements have fallen sharply
Operating Income	784	2,818	-72.2	1,138	-31.1	
Operating Expenses	(1,078)	(1,407)	-23.4	(1,131)	-4.7	Declining, though much slower than the decline in assets, should continue to reduce going ahead
Pre-Provision Profit	**(294)**	**1,412**	**NM**	**6**	**NM**	**Below estimates as revenues disappoint significantly**
Charges for Bad Debts	(3,533)	(173)	1941.4	(1,837)	92.4	Driven by write-offs in the AP portfolio (also some part in WB), ahead of regulatory requirements, management says no need for more provisions near to medium term
Other Operating Items	-	-	NM	-	NM	
Operating Profit	(3,827)	1,238	NM	(1,830)	109.1	
Pre-Tax Profit	(3,827)	1,238	NM	(1,830)	109.1	
Tax	(18)	(433)	-95.8	(357)	-94.9	
Net Profit	**(3,845)**	**805**	**NM**	**(2,187)**	**75.8**	**Well below estimates on higher than expected credit costs, should mark an earnings trough**
EPS	(53.24)	11.19	NM	(30)	75.8	
DPS	-	-	NM	-	NM	
Gross Loan Portfolio	26,350	54,340	-51.5	34,500	-23.6	Includes securitized loans of 2.1bn, AP exposures now down to Rs8.2bn (33% of total loans)
Borrowings	13,918	35,004	-60.2	17,240	-19.3	80% of funding comes from banks (50% public sector, 21% private and 9% foreign banks)
AIEA	30,436	50,081	-39.2	37,825	-19.5	
AIBL	15,579	31,310	-50.2	19,800	-21.3	
Total Assets	28,663	57,430	-50.1	36,250	-20.9	
Avg Assets	32,457	48,826	-33.5	39,625	-18.1	
Non-Performing Loans (NPL)	9,250	100	9150.0	11,780	-21.5	Large write-offs in the AP portfolio has reduced NPLs, though asset quality stress remains on the remaining AP book
Loan Loss Reserves (LLR)	(1,080)	337	NM	(1,360)	-20.6	
Shareholders' Funds	11,810	18,040	-34.5	15,630	-24.4	Management has sought shareholder approval for Rs9bn of fresh capital raising
Book Value Per Share	163	250	-34.6	216	-24.4	
					NM	
Members (mn)	6.396	7.772	-18%	6.879	-7.0	Steady reduction in members as incremental lending in AP has not resumed
Branches	2032	2407	-16%	2093	-2.9	Consolidation of the branch network, especially in AP
Employees	19,315	27,054	-29%	20,859	-7.4	Steady employee attrition - not being replaced for now
Key Ratios (%)	**2Q FY12**	**2Q FY11**	**Bps Δ YoY**	**1Q12**	**Bps Δ QoQ**	
ROAA (annualized)	(47.4)	6.6	-5399	(22.1)	-2531	
ROAE (annualized)	(130.2)	17.9	-14810	(56.0)	-7426	
Net Interest Margin (bps)	807	1,964	-115687	919	-11218	NIMs continue to decline as AP portfolio is a key drag
Fee Inc/Operating Income	21.7	12.8	895	23.6	-190	
Other Non-Interest Inc/Op Inc	21.7	12.8	895	23.6	-190	
Op. Cost/ Operating Income	137.4	49.9	8751	99.4	3798	Costs remain high and will be a challenge going ahead even as growth resumes gradually
Asset-to-Equity Ratio	223	301	-7810	221	239	
NPL/Loan Ratio	35.1	0.2	3492	34.1	96	
LLR/NPL Ratio	11.7	(337.0)	34868	11.5	13	Coverage levels remain low - higher write-offs and low regulatory requirements on loan losses currently

Source: Company and CIRA

Figure 2. SKS Microfinance — Earnings Revision (Summary)

	Net Profit (Rs mn)			EPS (Rs)			DPS (Rs)	
	Old	New	% change	Old	New	% change	Old	New
FY12E	-3,331	-6,940	NM	-46.1	-96.0	NM	0.0	0.0
FY13E	-952	-612	NM	-13.2	-8.5	NM	0.0	0.0
FY14E	551	-874	NM	7.6	-12.1	NM	0.0	0.0

Source: Citi Investment Research and Analysis estimates

Figure 3. SKS Microfinance — Valuation Summary

	Rs million
Networth (Sep-11)	11,810
Unprovided AP loan book	8,220
Less: Recoveries @ 15%	1,233
Less: Future Tax Break Available	4,486
Residual Impact from AP portfolio	2,501
Adjusted Networth	9,309
Book Value per share, Rs	129
Fair Value (1.2x Adjusted BV), Rs	**155**

Source: Citi Investment Research and Analysis estimates

SKS Microfinance

Company description

SKS Microfinance (SKS) was started by Dr. Vikram Akula, a social entrepreneur in 1998, as a non-government organization (NGO) engaged in lending to people below the poverty line. It was converted into a non-banking finance company (NBFC) in 2005 and also inducted a professional management team around the same time. Since then, SKS has grown rapidly and is now the largest MicroFinance Institution (MFI) in India. SKS has adopted a modified version of the Grameen Bank model and operates its lending primarily under Joint Liability Group (JLG) Model, inducting only women as members. Its typical loans run for 50 weeks with equal monthly repayments.

Investment strategy

We rate SKS shares as Sell/High Risk with a target price of Rs155. We believe the business is facing significant pressures on its loan book growth and quality, especially in the state of Andhra Pradesh. This is primarily due to a change in regulations in October 2010, restricting incremental lending as well as collections in the state. We believe this is likely to result in meaningful losses on this portfolio for SKS, and the longer the regulations stay in force, the greater could be the eventual write-offs.

SKS is the largest microfinance player in India and is well positioned to benefit from the expanding reach of the microfinance segment. Key strengths of the company are: a) Large balance sheet size and wide distribution network, b) Professional management team, and c) Robust asset quality track record. However, these are largely offset by the likely moderation in loan growth and asset quality in the medium term, which are likely to impact its business performance, returns and valuations.

Valuation

We now believe adjusted book value rather than EVA is more appropriate for valuing SKS given the significant likelihood of asset quality impairments in the medium term. We adjust the book value for likely losses in SKS' AP loan portfolio, net of tax benefits. We believe the balance non-AP portfolio is profitable on a steady state basis, and can have a mid-teens ROE in the current environment. We therefore value the business at 1.2x adjusted book value, giving a target price of Rs155 per share.

We also benchmark our fair value for SKS based on CIRA's EVA model, which captures the long-term value of the business. Our EVA model assumes: a) risk-free rate of 8.5% in-line with the current 10-year G-Sec interest rates; b) longer-term loan loss provisions of 225bps given its inherently higher asset risk segment, though higher near- to medium-term losses, especially in the AP portfolio; c) longer-term loan spreads of 900bps which is significantly higher than the banking sector given its high-yielding asset profile; and d) long-term fee income growth of 10%. This values the business at Rs160 per share.

Risks

We assign a default High Risk rating to SKS given that the stock is deemed to be relatively volatile by our quantitative risk-rating model (based on stock price movements in the past year) or that it has a trading history of less than 3 months. Key upside risks that would keep the stock above our target price include: a) Stronger-than-expected loan growth, b) Reversal to a low interest rate/ easy liquidity environment, and c) Continued robust asset quality over the medium term.

Appendix A-1

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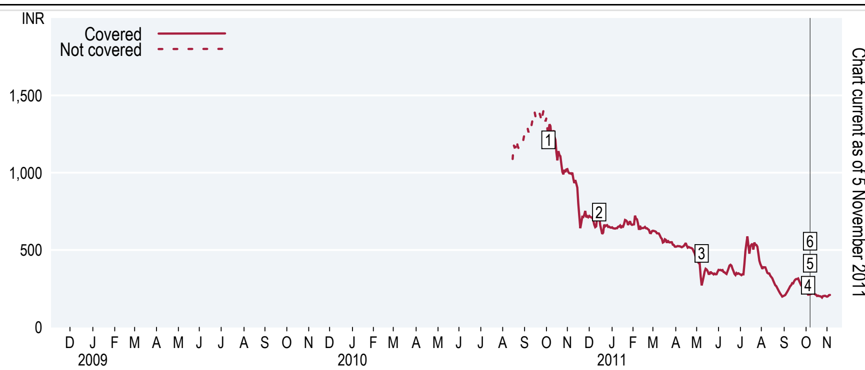
IMPORTANT DISCLOSURES

SKS Microfinance (SKSM.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Manish Chowdhary, CFA
Covered since October 5 2010



	Date	Rating	Target Price	Closing Price
1	5-Oct-10	*2M	*1,435.00	1,259.20
2	15-Dec-10	*3M	*605.00	721.35
3	9-May-11	3M	*250.00	270.80
4	5-Oct-11	3M	*200.00	211.00
5	7-Oct-11	Stock rating system changed		
6	7-Oct-11	*3H	200.00	212.25

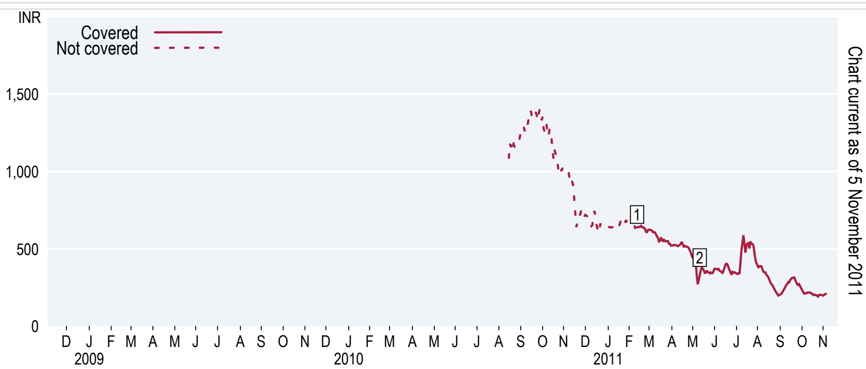
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

SKS Microfinance (SKSM.BO)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Manish Chowdhary, CFA
Covered since October 5 2010



	Date	Rating	Target Price	Closing Price
1	11-Feb-11	*ADD LP	-	638.40
2	11-May-11	*REM LP	-	327.60

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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	12 Month Rating			*Relative Rating*		
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% of companies in each rating category that are investment banking clients	45%	42%	37%	50%	43%	46%

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