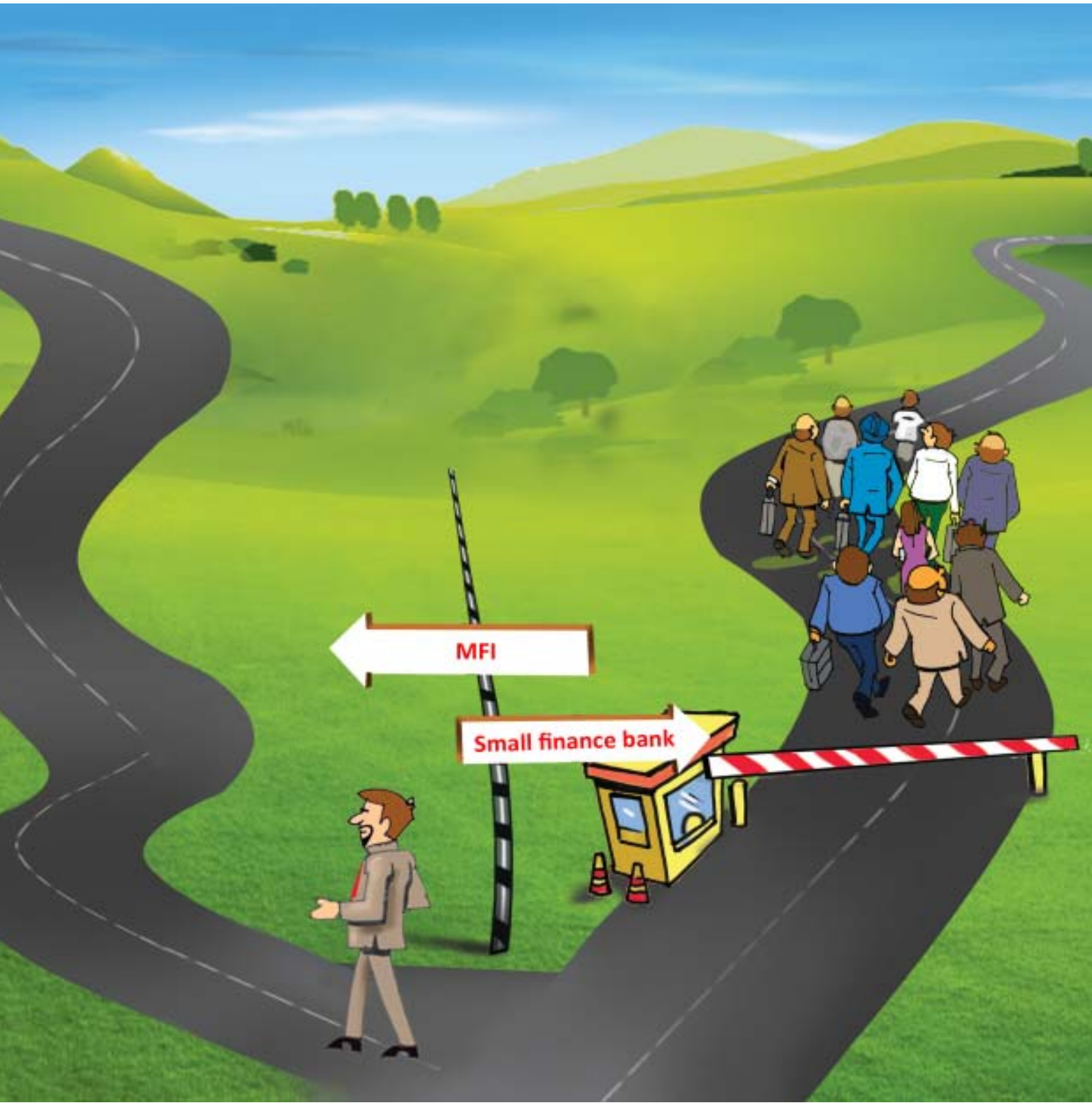
MOTILAL OSWAL

Initiating Coverage |28 December 2015
Sector: FInancial | NBFC

# SKS Microfinance




## Not the end of road

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# SKS Microfinance

| BSE Sensex | S&P CNX |
|---|---|
| 26,034 | 7,925 |

**CMP: INR485** **TP: INR589 (+21%)** **Buy**

**Stock Info**

| | |
|---|---|
| Bloomberg | SKSM IN |
| Equity Shares (m) | 126.3 |
| 52-Week Range (INR) | 590/369 |
| 1, 6, 12 Rel. Per (%) | 7/10/24 |
| M.Cap. (INR b)/(USD b) | 61.1/0.9 |
| Avg Val, (INR m) | 951 |
| Free float (%) | 93.7 |

**Financial Snapshot (INR Million)**

| Y/E MARCH | FY16E | FY17E | FY18E |
|---|---|---|---|
| NII | 5,401 | 7,613 | 10,322 |
| PPP | 3,767 | 5,386 | 7,482 |
| PAT | 2,780 | 3,920 | 5,334 |
| EPS (INR) | 22.0 | 31.0 | 42.2 |
| BV/Sh. (INR) | 104.9 | 135.9 | 168.3 |
| RoA on AUM (%) | 5.0 | 5.2 | 5.3 |
| RoE (%) | 23.4 | 25.8 | 27.8 |
| **Valuations** | | | |
| P/E (x) | 22.0 | 15.6 | 11.5 |
| P/BV (x) | 4.6 | 3.6 | 2.9 |

**Shareholding pattern (%)**

| As on | Sep-15 | Jun-15 | Sep-14 |
|---|---|---|---|
| Promoter | 6.3 | 9.2 | 9.3 |
| DII | 16.7 | 18.4 | 15.3 |
| FII | 47.8 | 42.7 | 44.7 |
| Others | 29.2 | 29.6 | 30.8 |

FII Includes depository receipts

SKS Microfinance
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## Not the end of road

### Strong growth and profit visibility for the next three years

- **Recent regulatory development bodes well for largest incumbent SKS Microfinance (SKSM). RBI doubled ticket size of one year loan to INR30,000; SKSM a clear beneficiary as 70% of its loans fall in this category. This will help boost AUM growth without incurring additional cost thereby by driving operating efficiencies. Opex to AUM to improve to 6.3% in FY18 from 8.9% in FY15.**
- **SKSM to gain market as competitive intensity to come down- ~54% of the industry is now small finance bank (SFB), management bandwidth of these entities will be channelized towards setting up bank. Moreover not obtaining a license is positive for medium term earnings, as it removes overhang of dilution, regulatory costs and large opex in initial years, which would have resulted in low single digit RoEs.**
- **Competitive positioning to improve on back of lowest lending rates in the industry due to optimized borrowing profile, superior credit rating and business correspondent opportunities in tie-up with large banks.**
- **Stable and supportive regulatory environment with RBI as the sole regulator abates possibility of any AP-like backlash.**
- **Presence in a highly underpenetrated industry (est. size at INR4.5t in FY16 with just 15% penetration) high growth potential, strong management expertise and low competitive intensity provides +40% AUM/ profit growth for next 3 years.**
- **Current valuation of 3.6x/2.9x FY17E/18E P/BV is attractive. Initiate coverage on SKSM with a Buy rating and target price of INR589 (21% upside).**

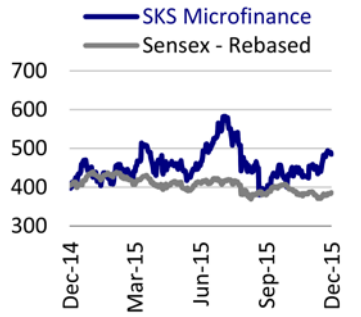
### Multiple near-medium term triggers

SKS Microfinance (SKSM) failed to obtain small finance bank license (SFB). While this creates uncertainty over long term (+5 years), however the recent RBI's announcement for MFI sector bodes well for SKSM viz. a) RBI doubled the limit of 1 year loan from INR15,000 to INR30,000 will enable higher growth b) Assessment of PSL requirement for banks will shift from annual basis to quarterly basis from FY17- This would have twin benefit 1) would help further bring down funding cost for SKS and 2) most large MFIs now SFBs won't participate in securitization, hence SKS would be preferred entity for banks and c) SKS has witnessed sharp decline in cost of funds, and it has passed on the benefits to borrowers, SKS now charge 19.75% which is the lowest charged by any private sector MFI globally. In our view these incremental developments bodes well for SKS to maintain a strong growth momentum.

### Migration to SFB an uphill task for competition; SKSM to gain

Not obtaining SFB license is positive for near-medium term earnings for SKSM as a) it removes massive overhang of dilution b) no regulatory costs such as CRR/SLR requirement C) will not have to incur massive opex to set up bank and d) competitive intensity to come down as ~54% of the industry is now SFB, management bandwidth of these entities will be channelized towards converting to bank- this should help SKSM to further gain market share.

**Stock Performance (1-year)**




## Competitive positioning to improve

a) SKSM has 400bp funding cost benefit over other MFIs (including SFB licensees); while bank license would help raise CASA deposits but it will be negated by regulatory costs and high opex. Any material benefit would take at least 5 years. b) NBFC-MFI can tie-up with a universal bank or a payment bank and become a business correspondent to offer same level of services. c) Management bandwidth and high level of customer engagement will remain a cornerstone of success

## Political risk has reduced significantly

Immunity from any AP-like political backlash was one of the strongest arguments for conversion to an SFB. However, in our view, post introduction of the NBFC-MFI category in 2011 (RBI as regulator for NBFC-MFI) with various safeguards, the uncertainty on regulations had ended and political risk was no longer a major issue for the sector. Moreover post the AP crisis SKSM's business strategy has been to reduce the political risk by spreading operations to various geographies.

## Regulatory environment supportive for the sector

Regulatory framework, credit infrastructure, technology and supportive regulations have put microfinance industry back on track. Regulations post AP crisis have strengthened the industry and have made the business model stable and sustainable. Moreover RBI has given most SFB licenses to MFIs reiterates the regulators positive stance on the MFI sector.

## Expect +42% PAT CAGR; Premium valuation to sustain; Initiate with BUY

Presence in an underpenetrated industry (just 15% penetration with estimated size at INR4.5t), high growth potential, profit visibility and strong performance across operating parameters, had aided a stock re-rating in the last two years. In our view near-to medium term growth and profitability will remain highest in the sector with AUM/profit growth of over 40% for next 3 years remain the best in the sector. We initiate coverage with a buy rating with a target price of INR589 (21% upside) valuing the stock at 3.5x FY18E P/B. **BUY**.

# Missed on SFB license; multiple medium term triggers

## Multiple positive developments bodes well for strong growth momentum

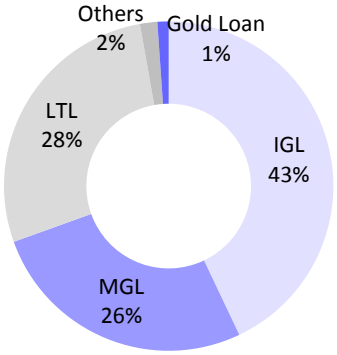
- **RBI doubled ticket size of one year loan to INR30,000; SKSM is a clear beneficiary as 70% of loan book consists of loans under one year and average ticket size is already very close to regulatory ceiling.**
- **Under revised PSL norms, banks could find it difficult to meet the sub-targets for small/marginal farmers. With SFBs undergoing transformation, SKSM would be the preferred source for PSL loans.**
- **SKSM already has lowest lending rate in the industry, even lower than Bandhan Bank, due to lower borrowing costs on back of superior credit ratings and efficient borrowing practices.**

### Limit of one year loan doubled to INR30,000- to drive operating efficiency

After the AP-MFI crisis, RBI came up with several regulations in order to regulate the MFIs sector. One of the regulations capped the limit of one year loans to INR15,000. However, recently, RBI has doubled the limit of one year loans to INR30,000 from INR15,000 earlier.

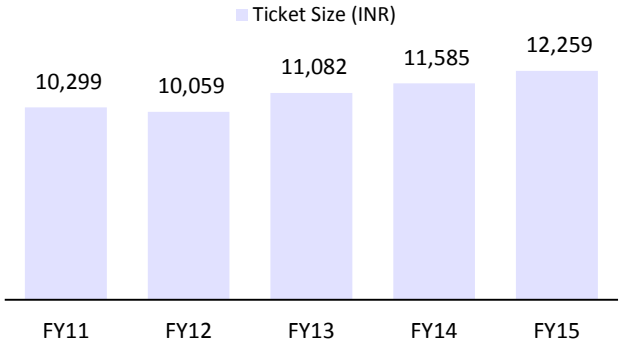
Currently, 70% of SKSM's loan book consists of loans of less than one year, with average ticket size of ~INR13,400/borrower (already very close to the regulatory ceiling). Further, following conservative lending practices, SKSM does not give two-year loan to new customers. A borrower needs to complete two 1-year loan with the company to be eligible for higher tenure loans. As a result, the average ticket size growth for SKSM has remained low and has grown at just 4.5% CAGR since FY11.

**Exhibit 1: 70% of loan book consists of <1 year loan**



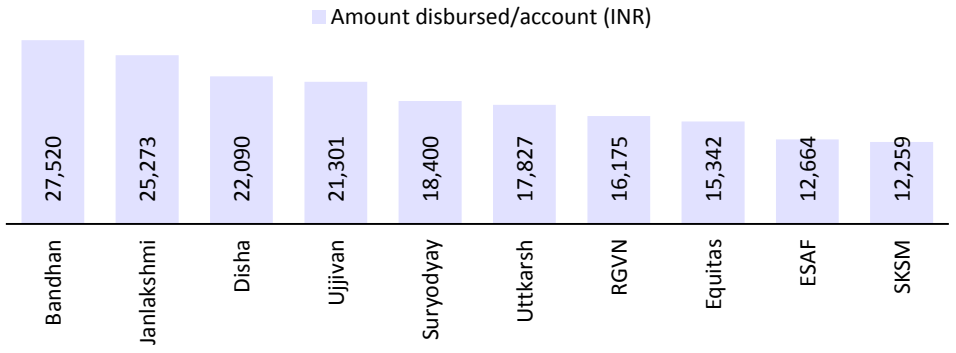

*IGL and MGL loans are of <1 year tenure Source: Company, MOSL

**Exhibit 2: Average ticket size grew at 4.5% CAGR since FY11**




Source: Company, MOSL

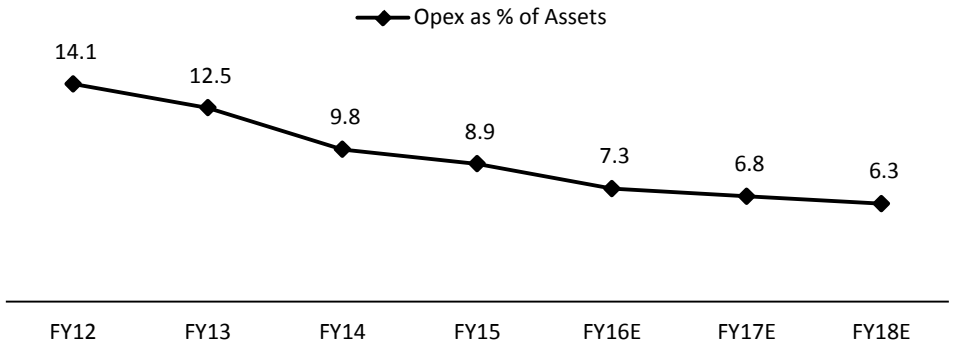
**Exhibit 3: Average ticket size of SKSM is lowest in the industry**




Source: MOSL, MFIN

In our view, SKSM is a big beneficiary of this move because in order to grow its AUM the company had to incur additional expenditure for adding new branches, hiring loan officers and enrolling new customers. However, now the company can lend higher amount (up to INR30,000) to existing credit-tested customers and can also finance new customers who have higher financing needs. SKSM need not incur additional expenditure to increase its branch presence or hire more loan officers, thus improving its operating leverage. We estimate that the company's operating expenses to total assets would decline sharply from 8.9% in FY15 to 6.3% in FY18E.

**Exhibit 4: Opex as % of assets to improve sharply**




Source: Company, MOSL

**Exhibit 5: SKS would be able to increase average ticket size in its IGL and MGL loan segments**

| | IGL | MTL | LTL | Other product offerings |
|---|---|---|---|---|
| Loan portfolio (INR m) | 23,460 | 14,510 | 15,130 | 930 |
| % share | 43 | 27 | 28 | 2 |
| | | | | |
| Ticket size (INR) | 9,060-14,940 | | 20,840-31,470 | 1,785-4,995 |
| Average ticket size (INR) | 14,518 | 14,404 | 29,667 | 2,159 |
| | | | | |
| Eligibility | - Completion of CGT<br>- Age limit 18 years to 55 years | - With IGL -Between 20th to 46th week<br>- With LTL –Between20th to 96th week | - Minimum Two IGL Loan cycle completed | - With IGL –Between 4th to 46th week<br>- With LTL –Between4th to 100th week |
| Tenure (weeks) | 50 | 50 | 104 | 25 |
| Annual effective interest rate (%) | 19.75 | | | 19.8-20.45 |
| Processing fee (incl S Tax)(%) | 1.14 | 1.14 | 1.14 | 0.94-1.14 |

*IGL- Income Generation Loan; MTL- Medium Term Loan; LTL- Long Term Loan; CGT- Compulsory Group Training Source: Company, MOSL

## Revised PSL norms, to help reduce borrowing costs

RBI, in March 2015, revised the priority sector lending (PSL) norms applicable for banks. While the overall PSL target for agriculture is maintained at 18%; a sub-target of 8% of adjusted net bank credit (ANBC) has been recommended for small and marginal farmers. In our view, banks would find it difficult to meet the sub-target of 8% credit disbursal to small and marginal farmers and would have to meet this target via securitization route.

**Exhibit 6: Key change in priority sector lending norms**

| % of ANBC or CEOBE | Revised Guidelines | Old guidelines |
|---|---|---|
| Overall PSL | 40 | 40 |
| Agriculture | 18 | 18 |
| **Direct Agriculture** | **-** | **13.5** |
| **Small/Marginal farmers** | **8** | **-** |
| Weaker sections | 10 | 10 |
| **Export credit** | **2 (limit)** | **-** |
| Micro Enterprises | 7.5 | - |

Source: RBI, MOSL

Revised PSL norms for small and marginal farmers are expected to generate additional securitization opportunity to the tune of INR460b

Assuming banking credit growth of 14% CAGR by FY18 and a 3% PSL shortfall towards small and marginal farmers, it is expected to lead to a cumulative INR460b of securitization requirement. Moreover while transforming, SFBs are likely to undergo a phase of contraction, and banks may be under pressure to reposition their PSL portfolio from institutions transforming from SFBs to non-SFB MFIs. This could lead, at least in the short to medium run, to a liquidity surplus that could translate into lower interest rates. With SKSM being the largest MFI in the country with superior asset quality and most of the loan book falling under PSL in the new norms it would be the most sought after player.

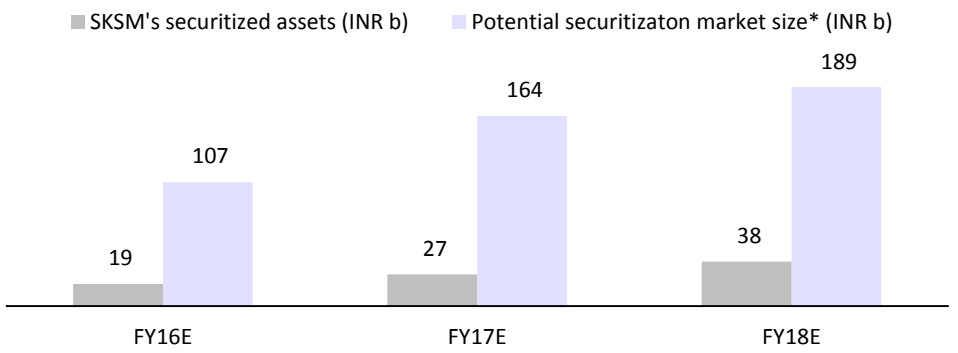
Further, new guidelines envisage banks to monitor their PSL compliance every quarter (with effect from FY17) instead of annually, which will lead to a flow of PSL funds throughout the year rather than being skewed towards financial year-end.

**Exhibit 7: Expected securitization business from banks to be lucrative**

| | FY15 | FY16E | FY17E | FY18E |
|---|---|---|---|---|
| **Total Banking Credit (INR b)** | **61,023** | **68,346** | **78,598** | **90,387** |
| YoY Growth | | 12% | 15% | 15% |
| | | | | |
| **PSL requirement (% of ANBC)** | | | | |
| Small/Marginal Farmers | | 7% | 8% | 8% |
| | | | | |
| **Credit to Small/Marginal Farmers (INR b)** | | **4,272** | **5,468** | **6,288** |
| Estimated Shortfall in PSL(%) | | 2.5% | 3.0% | 3.0% |
| **Potential securitization market size (INR b)** | | **107** | **164** | **189** |

Source: MOSL

**Exhibit 8: Potential securitization market estimated at cumulative INR460b**




*Potential securitization market size for small/marginal farmer loans Source: MOSL, Company

## At 19.75%, SKSM's lending rates are lowest in the industry

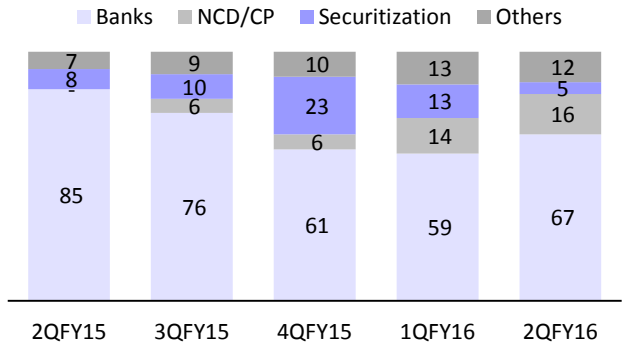
SKSM has seen sharp decline in cost of funds over last 2 years led by reducing risk premium. With regulatory and credit infrastructure in place has reduced inherent business risks, and improved the industry's perception among lenders and other stakeholders. This coupled with 125bps cumulative reduction in repo rate by the central bank leading to reduction in base rates by banks, has resulted in decline in borrowing rates for the MFI industry.

SKSM has lowest lending rates on the back of superior credit rating resulting in higher NCD and CP issuance and reducing dependence on costly bank borrowing.

SKSM on back of its superior credit rating (A+), at par with Bandhan Bank, has reduced its exposure to relatively higher cost bank borrowings and increased exposure to NCDs and commercial papers, where at present borrowing costs are lower than that of banks. Thus SKSM is able to reduce its borrowing rate more effectively than players.

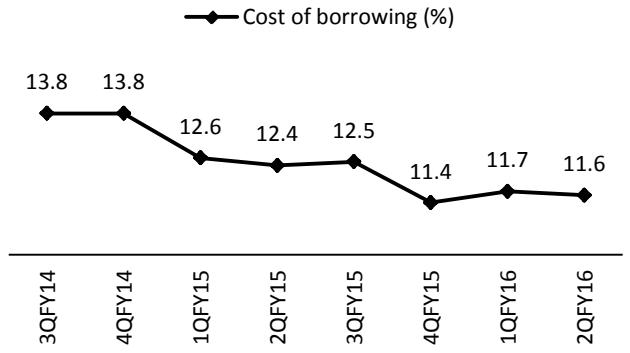
During last 16 months SKSM has reduced the lending rates by 480bps for its customers and now charges interest rate of 19.75%, which is the lowest charged by a private sector MFI globally.

**Exhibit 9: Reducing exposure to bank borrowing (%)**




Source: MOSL, Company

**Exhibit 10: Steady decline in cost of funds**




Source: MOSL, Company

# Migration to SFB an uphill task for peers

**Transition is expected to be a drag on short-term earnings for SFBs**

- **Nearly all upcoming SFBs have high foreign shareholding; raising domestic equity at rich valuation would be difficult.**
- **SFBs would need to maintain CRR/SLR ratios from day one, thus they would need to increase their borrowing by ~25% just to maintain their current book size.**
- **Raising CASA for SFBs would be difficult as they need to compete with government sponsored programs and also payment banks. Further, SFBs would lack credibility of public sector banks when it comes to safety of deposits.**
- **SFBs RoE in the first year of operation is expected to be in low single digits, due to additional capital needed to meet regulatory requirements.**

## Massive dilution overhang

Most SFB licensees have foreign shareholding above regulatory limit. This would lead to substantial dilution for these entities

SFB guidelines limit aggregate foreign investment at 49% through the automatic route. All MFIs who are granted SFB license (except ESAF) have foreign ownership at very high level. Thus in order to meet RBI requirements these companies will have to raise substantial domestic equity. Dilution at lower prices may not be acceptable to the existing foreign investors, many of whom are currently the majority shareholders and enjoy management control. According to media reports, SFB licensees would need to raise INR40b-50b over the next one year to meet shareholding requirements.

**Exhibit 11: Major MFIs have high percentage of foreign shareholding**

| MFI | Foreign Shareholding | Potential Dilution |
|---|---|---|
| Equitas | 92.8% | 47.2% |
| Ujjivan | 88.7% | 44.8% |
| Utkarsh | 85.0% | 42.4% |
| Janalakshmi | 76.3% | 35.8% |
| Disha | 72.6% | 32.5% |
| RGVN | 69.0% | 29.0% |
| Suryoday | 68.0% | 27.9% |
| SKS* | 68.0% | 27.9% |
| ESAF | 40.4% | - |

*Potential dilution if SKSM would have got SFB license

Source: Company, MOSL

Compounding the challenge will be low interest of PE players, who have come to expect exponential growth in MFIs' lending. Faced with the probability of low growth, due to transition into a banking entity, their interest in investing will decrease – and thus they are less likely to contribute positively. This could potentially delay the transformation process; we expect that these challenges will consume the management bandwidth of SFBs over the period of next 9—12 months.

Had SKSM got SFB license, it would have led to equity dilution of 28%, as the company has foreign shareholding of 68%, resulting in lower RoEs and thus lower returns to existing investors.

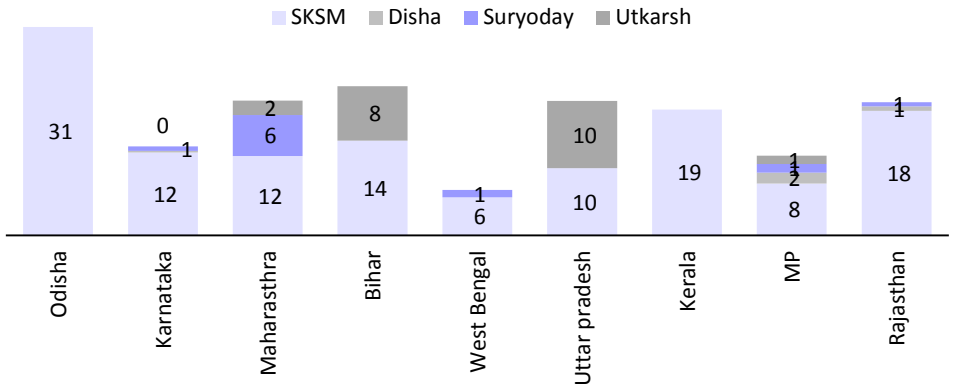
## SFBs need to maintain CRR/SLR; have restrictions on branch expansion

SFB need to comply with CRR/SLR norms from day-1 and no forbearance is provided for complying with statutory provisions. This would result in lower funds available for lending, resulting in lower loan growth and lower return ratios. Industry experts estimate that overall funding requirement for SFBs to go up by 20-25% just to maintain their current book size, primarily due to regulatory cost of capital. In its current form, SKSM does not need to maintain CRR/SLR. Thus freeing capital and supporting return ratios.

Restrictions on branch expansion to impact SFBs expansion plans

SFBs expansion into new region/territory would be slow because they would need prior RBI permission for opening new branches and at least 25% of branches should be in unbanked rural centers (population <10,000). Thus SFBs would focus on areas where they already are present and would rather go slow on expansion in newer areas. SKSM would benefit as there is minimal presence of SFBs in regions where SKSM has strong presence and it faces no restriction on geographic expansion.

**Exhibit 12: Market share of major SFB licensees in key states of SKSM**




Source: Company, MOSL

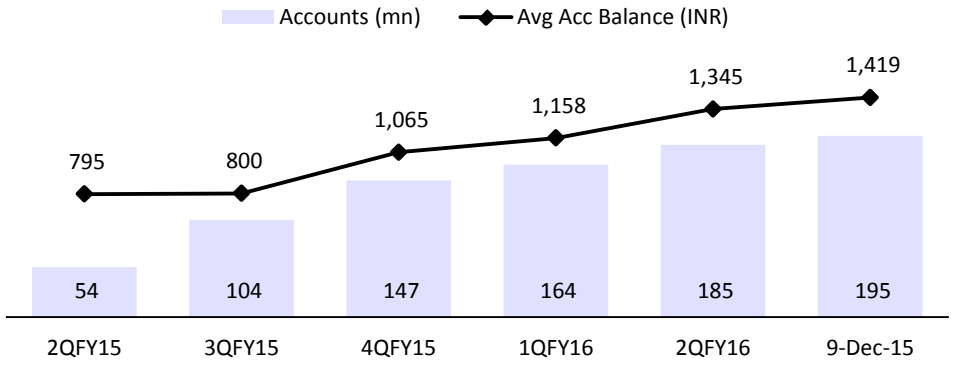
Other major SFB licensees, Ujjivan and Janalakshmi have strong presence in states where SKSM has large operations (namely Odisha, Karnataka and Maharashtra); but they primarily cater to urban population; thus do not directly compete with SKSM. Equitas, other major SFB aspirant has majority of its operation in Tamil Nadu, a state where SKSM has no operations.

## CASA franchise would take time to develop

SFBs are likely to face tough competition from government's Jan-Dhan scheme and payment banks in mobilizing CASA

In our view for CASA deposits would take time to become a meaningful portion of SFB's liability profile. Given that a vast portion of the unbanked and under-served population is being brought into the banking ambit under the government's 'Jan Dhan' scheme. Under Jan Dhan, 195m basic savings bank deposit accounts have been opened in the 15 months till December 2015. The total balance in such bank accounts is estimated at INR277b, translating into an average balance of INR1,419. These accounts are likely to become the primary accounts for the holders, as they are linked to their AADHAR card and subsidies from various government schemes are transferred directly into these bank accounts.

**Exhibit 13: Jan Dhan scheme has given a fillip to basic savings bank deposit accounts**



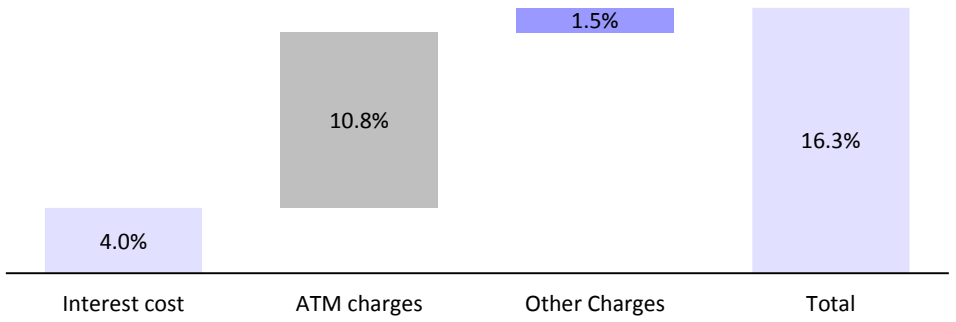

Source: MOSL

Having said that convincing people to move away from public sector bank to a SFB is would be daunting task, as without doubt, public sector banks enjoy better credibility when it comes to safety of deposits. Additionally, SFBs will also face competition from payments banks to mobilize deposits as their target segments will overlap.

Cost of maintaining a SA account is likely to be very high for SFBs, at least in the initial years

It is widely expected that SFBs would target their existing customer base to develop their liability franchise. Based on our assumptions, of 4% interest on savings account, an average of three transactions per month at an ATM costing around INR15/transaction and around INR75/annum other charges for the account, total cost for maintain saving account balance of INR5000 would be 16.3% p.a. Thus in our view, unless SFBs develop scale the cost of maintaining a retail franchise is expected to remain high.

**Exhibit 14: Average SA balance of INR5,000 would typically cost 16.3% for an SFB**




Source: MOSL

## Near term RoEs of SFBs to be muted

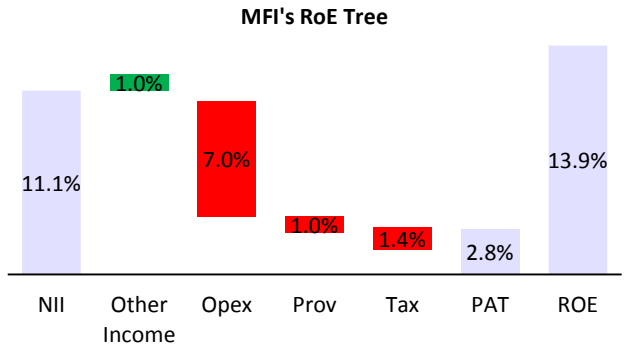
As per our estimates, the short term profitability of SFBs would be severely affected as they would continue to rely heavily on institutional financing as low cost deposit would take time to ramp up. On the other hand, SFBs will have to maintain CRR and SLR ratios from day one. This would lead to lower yields on assets without a significant saving in cost of funds, thus dragging down NIMs. As per our calculations, RoEs for SFB in the first year of operation is likely to be 1.6% as compared to 14% RoE for MFIs.

**Exhibit 15: SFBs profitability will be impacted in the short-term**

| | MFI | SFB |
|---|---|---|
| Interest income on portfolio loans | 19.8% | 17.5% |
| Interest Expenses | 10.4% | 11.0% |
| **Net Interest Income** | **11.1%** | **7.0%** |
| Other income | 1.0% | 1.0% |
| **Net Income** | **12.1%** | **8.0%** |
| **Operating Expenses** | **7.0%** | **6.5%** |
| Cost to income (%) | 57.6% | 81.5% |
| **Operating Profits** | **5.1%** | **1.5%** |
| Provisions/write offs | 1.0% | 1.0% |
| **PBT** | **4.1%** | **0.5%** |
| Tax | 1.4% | 0.2% |
| Tax Rate (%) | 33.0% | 33.0% |
| **PAT** | **2.8%** | **0.3%** |
| Leverage (x) | 5.0 | 5.0 |
| **RoE** | **13.9%** | **1.6%** |

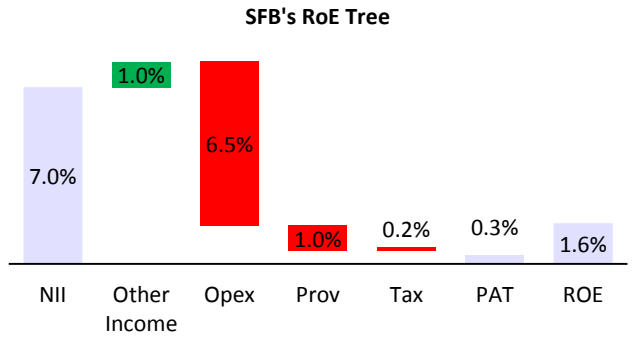
Source: MOSL, Company

**Exhibit 16: MFI's RoE Tree**




Source: Company, MOSL

**Exhibit 17: SFB's expected RoE tree**




Source: MOSL

## SKSM's strong competitve position to sustain

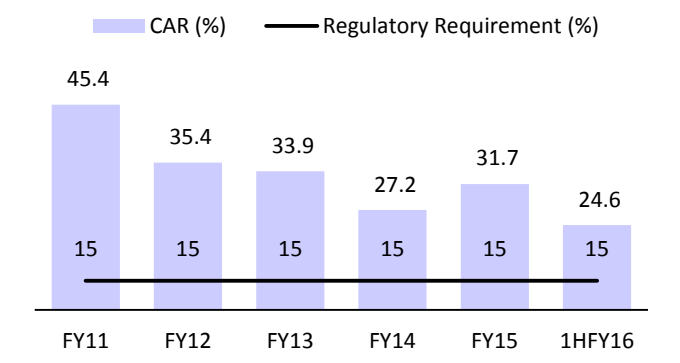
**Benefits of being a bank would be realized only over the medium term**

- **Strong balance sheet, positive ALM structure has enabled SKSM to achieve best credit rating in the industry. This in turn has helped it achieve the lowest cost of funds.**
- **High vintage of branches, deep local knowhow and high collection efficiency have resulted in an efficient operating structure, with the lowest CI ratio in the industry.**

### Strong balance sheet leading to best-in-class interest rates

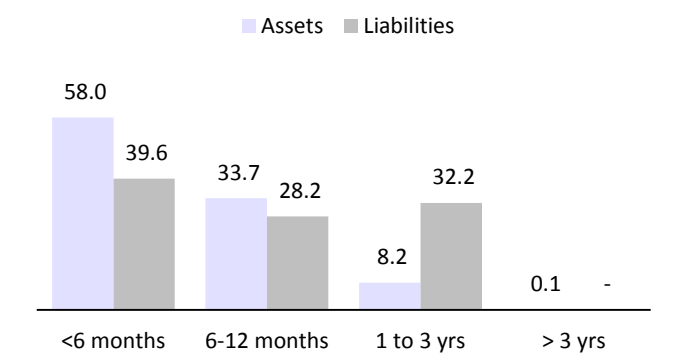
SKSM has a strong balance sheet, with capital adequacy ratio of 24.6% as against the regulatory requirement of 15%. The company also has a favorable ALM profile, with nearly 92% of the assets getting due in less than a year against 68% of the liabilities. Even during the AP crisis, SKSM was the only major MFI that did not opt for corporate debt restructuring (CDR) and repaid its bank debt completely.

**Exhibit 18: CAR well above regulatory requirement**




Source: Company, MOSL

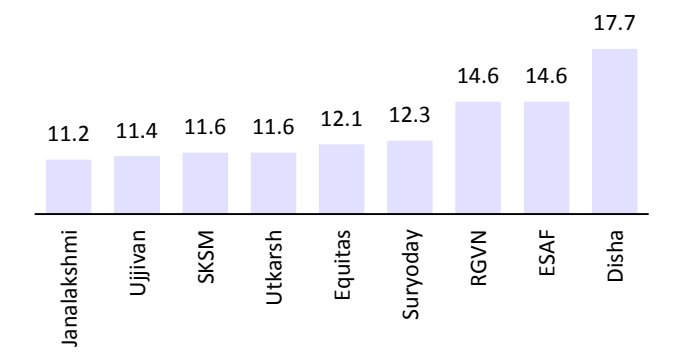
**Exhibit 19: Long-term liabilities financing short-term assets**




Source: Company, MOSL

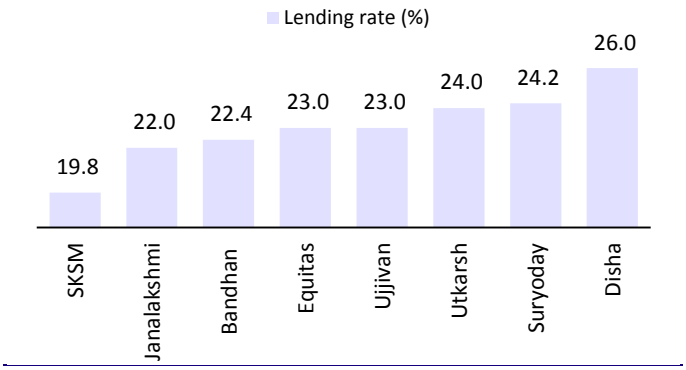
These factors have led to rating upgrades from various rating agencies, resulting in lowest borrowing cost structure and thus lower lending rates. SKSM's cost of borrowing of 11.6% (incremental cost of borrowing ~10%) is currently among the lowest in the industry and its lending rate of 19.75% is even below Bandhan Bank's lending rate.

**Exhibit 20: SKSs borrowing cost is among the lowest**




Source: MOSL

**Exhibit 21: Lending rate is lowest among MFIs**

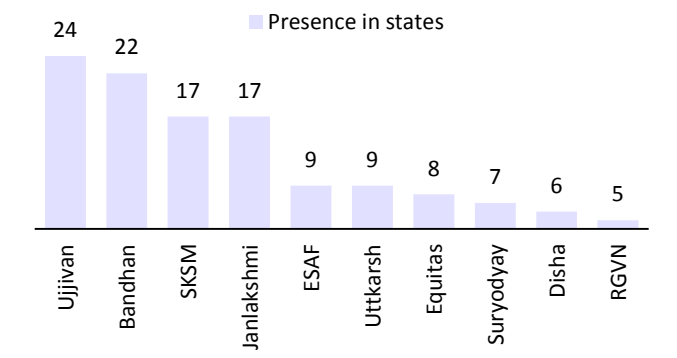



Source: MOSL, MFIN

## Efficient operating structure with lowest CI ratio in the industry

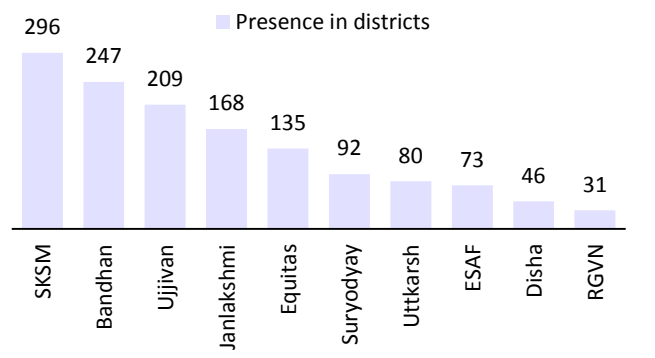
SKSM's weighted average vintage of branches is at 7 years, indicating that it enjoys deep local knowledge and understanding of repayment habits of the local populace. This has resulted in repayment rate of 99.9%. The company's average ticket size is low at INR13.4k/borrower and it has set limits on disbursements at branch, district and state level. This results in a granular portfolio with limited concentration.

**Exhibit 22: SKS is present in 17 states…**




*Data for Bandhan is for 1QFY16 Source: MOSL,MFIN

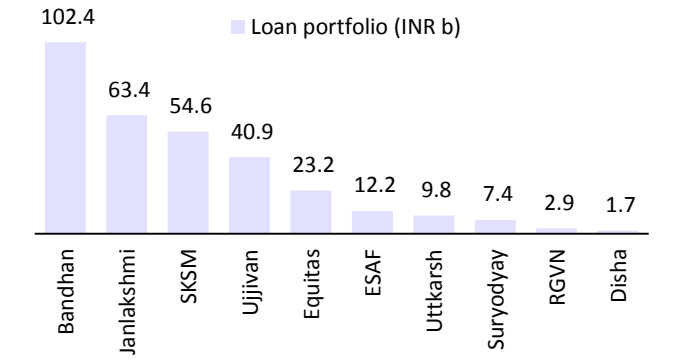
**Exhibit 23: …and has penetrated deep into each state**




*Data for Bandhan is for 1QFY16 Source: MOSL,MFIN

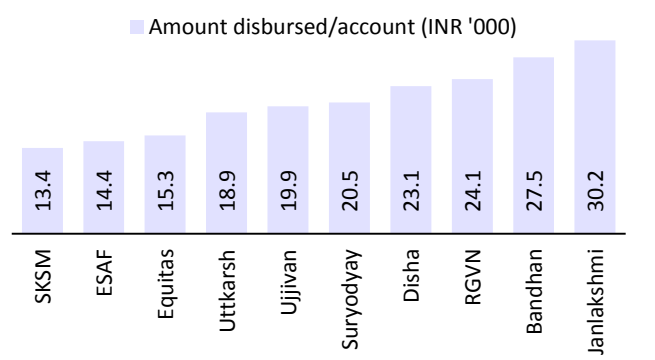
Due to low average ticket size per borrower, AUM growth for the company is driven by volume growth, that is, number of loans disbursed and number of clients enrolled. On account of lower lending rates, SKSM enjoys high client retention and high repayment track record.

**Exhibit 24: SKS has the one of the largest loan portfolio**



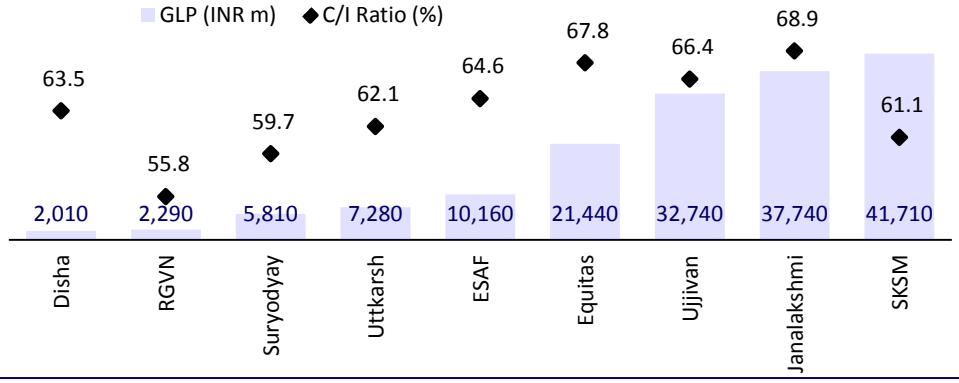

*Data for Bandhan is for 1QFY16 Source: MOSL,MFIN

**Exhibit 25: Amount disbursed/account is low**




*Data for Bandhan is for 1QFY16 Source: MOSL,MFIN

**Exhibit 26: SKS' C/I ratio is one of the lowest**

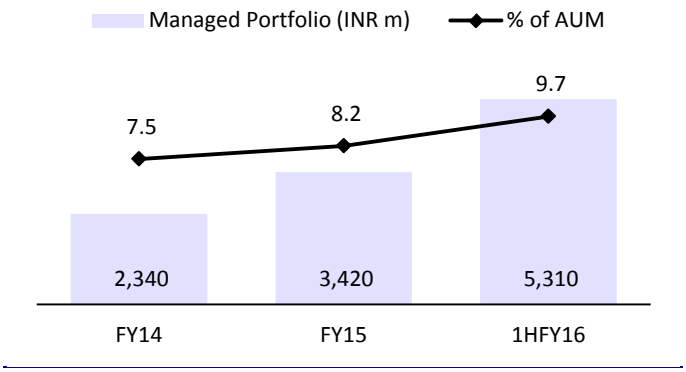



Source MOSL:

## BC tie-ups with banks would help SKSM provide similar services

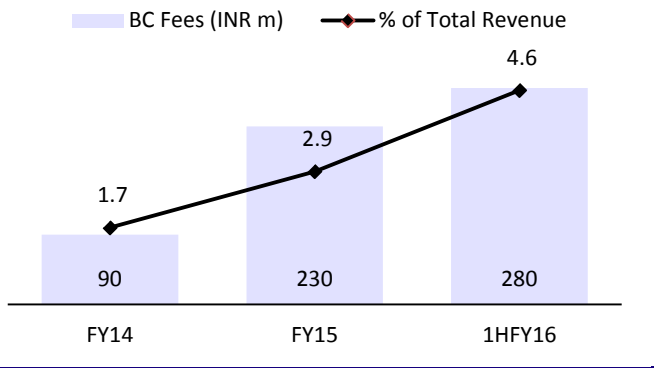
RBI allowed NBFCs to act as business correspondents (BC) for banks in 2014. BCs are allowed to offer banking services such savings products, money transfer facilities and loan products in areas not served by the banks. Thus acting as BC SKSM can offer nearly the same services that a SFB would offer, but at the same time it need not invest management's bandwidth and incur additional capex of setting up a full-fledged bank. SKSM has tied up with a leading private sector bank to act as BC and manages a portfolio of over INR5b as at 1HFY16.

**Exhibit 27: Managed portfolio more than doubled**




Source: Company, MOSL

**Exhibit 28: Share of BC Fees in total revenue at 4.6%**




Source: Company, MOSL

BC model is a win-win for bank and MFI both as it allows banks to provide banking services, especially MFI loans, in areas where they don't have a physical presence. MFIs earn fee income for services rendered on behalf of banks utilizing the existing network of branches and workforce; MFIs need not incur any additional expenditure for providing BC services. MFIs don't bear any credit risk in the BC model as the loan sits on bank's balance sheet and MFIs acts as an originator.

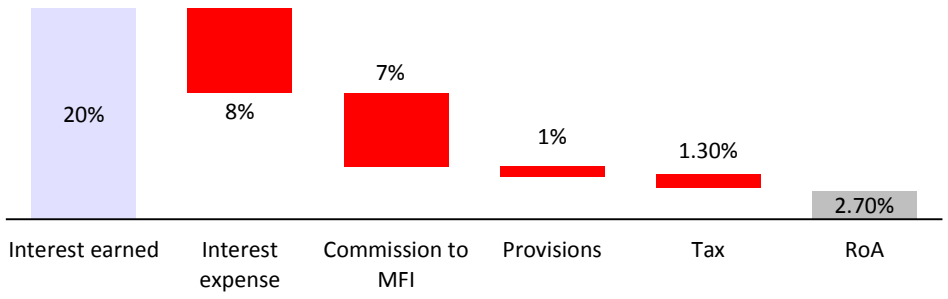
As per our estimates banks can make RoAs of 2.5-3% on the MFI loans disbursed via this channel. Even MFIs earns fee income in the range of 6-7% of the loan amount disbursed and does not incur any major expense on servicing the loan on behalf of the bank.

**Exhibit 29: Banks can make RoA of ~3% using the BC model**

| **Bank** | |
|---|---|
| Interest income on portfolio loans | 20.0% |
| Interest Expenses | 8.0% |
| **Net Income** | **12.0%** |
| **Commission to MFI** | **7.0%** |
| Cost to income (%) | 58.3% |
| **Operating Profits** | **5.0%** |
| Provisions/write offs | 1.0% |
| **PBT** | **4.0%** |
| Tax | 1.3% |
| Tax Rate (%) | 33.0% |
| **PAT** | **2.7%** |

Source: Company, MOSL

**Exhibit 30: RoA tree for bank using BC model**




Source: Company, MOSL

RBI guidelines for SFBs do not permit them to act as BCs for other banks. Thus large established MFIs such as SKSM would be the preferred players for banks who wish to appoint BCs. For SKSM, fees from BC services already contribute nearly 5% of total revenue for the company, up from <2% in FY14.

# Regulations turn supportive

## Regulations favor incumbent players such as SKSM

- **Post AP-crisis, RBI introduced regulations that among other things caped the borrowing per person and the number of MFIs a person can borrow from, thus increasing entry barrier for new players and benefitting the existing MFIs.**
- **MFIs have to submit data to credit information bureaus and have to mandatorily perform a credit check before disbursal; thus reducing overleveraging in the system and improving asset quality**

### RBI the sole regulator; risk of political backlash abates

Immunity from any AP-like political backlash was one of the strongest arguments for conversion to an SFB. However, in our view, post introduction of the NBFC-MFI category in 2011 (RBI as regulator for NBFC-MFI) with various safeguards, the uncertainty on regulations has ended and political risk are no longer a major issue for the sector.

RBI governor, in a recent interview mentioned that the central bank would continue to regulate the MFIs under the NBFC-MFI category and that MUDRA Bank would not regulate the sector, as commonly perceived. With this, the uncertainty arising out of multiple regulators is quelled.

RBI in its MFI regulations has introduced various checks and balances such as maximum of two MFIs can lend to the same borrower and credit checks need to be carried out before loan disbursement. Additionally, it capped the total indebtedness of a borrower at INR100,000, while maintaining the priority sector status of microfinance loans.

The central bank also introduced a margin cap for MFIs thereby ensuring no entity overcharges its customers, but at the same time ensured that MFIs are able to maintain profitable operations.

### Introduction of credit bureaus to minimize cases of overleveraging

Prior to AP- crisis, MFIs were not in a position to know a borrower's total indebtedness and the number of MFIs he has borrowed from. A borrower could default on his loan from one MFI and still avail loans from other MFIs. Over-indebtedness due to multiple borrowings was one of the key reasons that led to the AP crisis.

Thus in order to avoid multiple borrowing, RBI has made it compulsory for MFIs to conduct credit checks on borrowers through credit information bureaus (CIB) before disbursement. Currently, two CIBs – High Mark and Equifax – provide services to MFIs.

Development of the CIBs has introduced more information symmetry, enabling MFIs to avoid lending to borrowers who have reached their maximum indebtedness limit or have borrowed from more than two MFIs. Thus, MFIs are able to maintain high recovery rates and healthy asset quality.

# Robust AUM growth to drive 42% PAT growth

**5% RoA / 28% RoE by FY18E**

- **Underpenetrated MFI industry offers enormous growth potential; we estimate industry demand at INR 4.5t.**
- **Strong industry demand, low competitive intensity and strong capitalization levels to enable 43% AUM CAGR**
- **Improving operating leverage on back of technology rollouts, increasing share of higher ticket loans to drive CI ratio to 46% by FY18E.**

## Potential demand for micro-credit pegged at INR4.5t

We attempt to estimate rural demand for microfinance. The 2011 census puts the rural Indian population at ~833m. Also, the United Nations' "World Population Prospects" published by its Department of Economic & Social Affairs sees India's annual population growth rate at 1.65%. Assuming an average household of five members, the number of households in FY16 would be ~181m. Assuming yearly credit requirement of INR25,000 per household, we estimate microcredit requirement of INR4.5t for rural households alone by FY16.

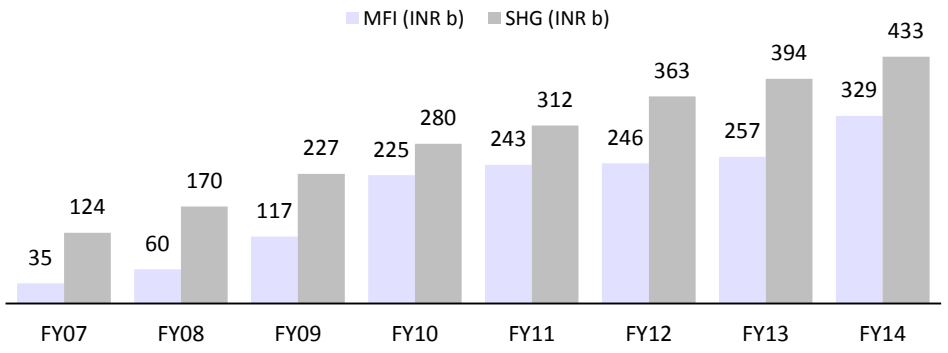
**Exhibit 31: Microfinance has potential demand of INR4.5t**

| | FY11 | FY12E | FY13E | FY14E | FY15E | FY16E |
|---|---|---|---|---|---|---|
| Rural population (m) | 833 | 847 | 861 | 875 | 889 | 904 |
| No. of rural households (avg. five a household) | 167 | 169 | 172 | 175 | 178 | 181 |
| Annual rural household credit demand (INR) | 17,015 | 18,376 | 19,846 | 21,433 | 23,148 | 25,000 |
| Total microfinance credit demand (INR b) | 2,835 | 3,112 | 3,416 | 3,751 | 4,117 | 4,520 |

Source: MOSL, Company

Supply of microfinance credit is far below demand; institutional lenders in this segment – bank-linked self-help groups (SHGs) and non-banking microfinance companies (NBFC-MFIs) such as SKSM – address only 15% of the demand for microfinance. In FY13, the microfinance sector, including SHGs and MFIs, was estimated at ~INR60b and reached out to ~73m individuals, the average loan size being INR8,500. The Indian microfinance sector is significantly underpenetrated and latent demand for microcredit is significant.

**Exhibit 32: MFIs and SHGs combined constitute only 15% of potential demand**

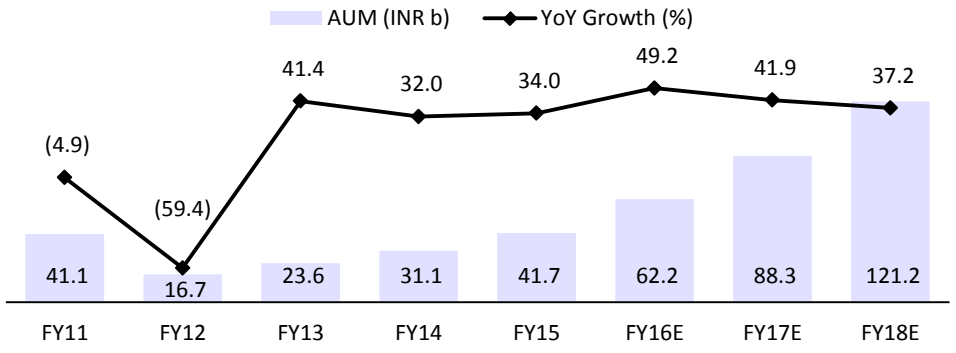



Source: MOSL

## Strong demand, low competitive intensity to drive AUM growth

Currently, the microfinance industry is in a high growth phase, given huge under-penetration. Competitive intensity is also low, as most players are in the midst of converting into banks. This provides SKSM an open field to grow its operations on the back of a strong balance sheet (CAR at 24.6% in 2QFY16), increasing ticket size and supportive regulations. We expect SKSM's AUM to grow at a CAGR of 43% to INR121b by FY18.

**Exhibit 33: AUM expected to grow at healthy 43% YoY**




Source: Company, MOSL

SKSM has consistently maintained capitalization ratio comfortably above the RBI's prudential norms, with current CAR at 24.6%. Such high capital ratio provides a cushion against unforeseen shocks and ample headroom to expand its loan book. With strong capitalization and diversified presence across 17 states, where the average vintages of branches has been seven years, SKSM is well-placed to deliver robust AUM growth and gain market share.

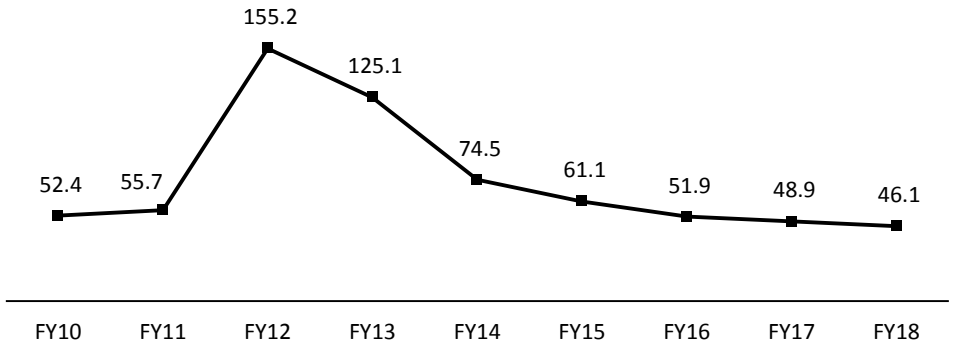
## Technology initiatives and higher ticket size to improve operating leverage

SKSM is working to improve operating efficiency with the help of technology by connecting every branch with head office, providing tablets to every loan officer, acting as business correspondent for banks and offering non-MFI loans (loan for solar lamps, mobile phone etc). Various technology implementations have resulted in significant time saving for the loan officers, which is expected to result in higher number of center meetings which in turn would increase the number of borrowers per loan officers.

The technology initiatives have also resulted in data availability within 24 hours with the head office instead of a month earlier. With rapid data availability, the company is able to deploy its cash more effectively and thus lower cash requirement at every branch leading to savings in interest costs.

Further, with RBI doubling the limit for one year loan, SKSM would be able increase its loan ticket size without incurring additional expenses on branch expansion and increased manpower. This would further improve its operating efficiency and we estimate SKSM's cost-to-income ratio to improve from 61.1 in FY15 to 46.0 by FY18E.

**Exhibit 34: Cost to income ratio expected to decline (%)**



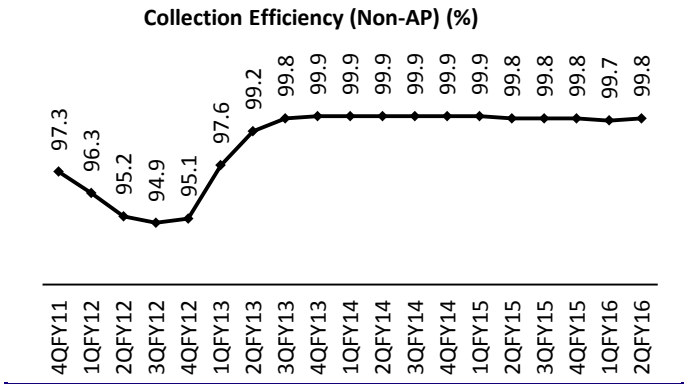

Source: Company, MOSL

## High collection efficiency and stable asset quality

SKSM has maintained high collection efficiency (99.8% for FY15, excluding AP). It provides credit to customers in their villages, rather than requiring customers to travel to obtain loans. Further, the company holds weekly meetings, which begin early in the morning so as not to interfere with customers' daily activities, to collect repayments and disburse new loans. It has developed customized and comprehensive software, which simplifies data entry, and targets to improve accuracy and efficiency of collections and fraud detection.

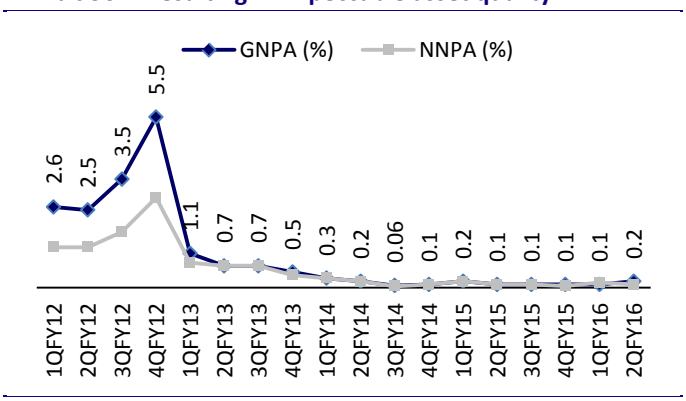
Post the AP crisis, SKSM has maintained stable asset quality in its non-AP loan portfolio (GNPA: 0.2%; NNPA: 0.1%). It has provided for the entire GNPA (INR1.8b) in its AP loan portfolio.

**Exhibit 35: Maintained high collection efficiency…**



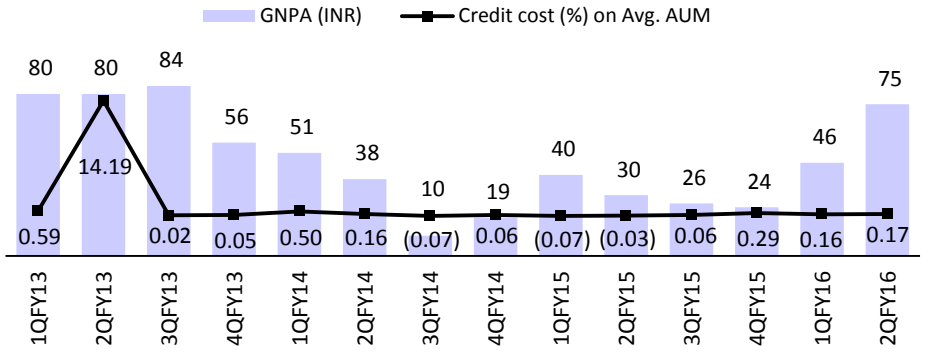

Source: Company, MOSL

**Exhibit 36: …resulting in impeccable asset quality**




Source: Company, MOSL

**Exhibit 37: Credit costs reduced with improvement in asset quality**




Source: Company, MOSL

SKSM's NPA classification norms are more stringent than those prescribed by the RBI. It classifies loans that remain overdue for more than 60 days as NPAs as against the requirement of 90 days mandated by the RBI. We expect asset quality to remain benign over the forecast period on the back of effective collection policy and prudent lending practices followed by the company.

**Exhibit 38: SKS' provisioning norms are more stringent than required by RBI**

| | | RBI Norms (NBFC-MFI) | SKS compliance |
|---|---|---|---|
| Asset Classification | Standard Assets | 0-90 days | 0-60 days |
| | Sub-standard Assets | 91-180 days | 61-180 days |
| | Loss Assets | >180 days | >180 days |
| Provisioning norms | Standard Assets | 1% of overall Portfolio reduced by Provision for NPA (If provision for NPA < 1% of overall Portfolio) | 0.30-1% depending on NPA or as stipulated by RBI, whichever is higher |
| | Sub-standard Assets | 50% of installments overdue* | 50% of outstanding principal* |
| | Loss Assets | 100% of installments overdue* | 100%of outstanding principal/ write-off* |

* The aggregate loan provision will be maintained at higher of 1% of overall portfolio or sum of provisioning for sub-standard and loss assets.

Source: Company, MOSL

## Accumulated losses to provide tax benefits for 8-10 years

SKSM will continue to be taxed at a lower rate for the next 8-10 years

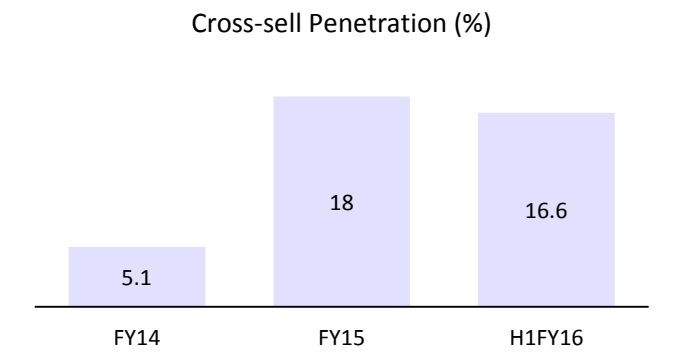
Due to the AP crisis, SKSM suffered substantial losses in FY12/13. It is now a profit-making entity but will be offsetting its accumulated losses against the profits. From FY16, it will be paying minimum alternate tax (MAT) of 21% instead of the usual corporate tax of 34%. We believe SKSM will be paying MAT for the next 8-10 years. Further, the MAT payment will be used as credit to offset its written-off AP portfolio once it is required to pay tax at the normal rate. Thus, SKSM's effective tax rate will be 'zero' till the entire AP portfolio is written-off. As this portfolio is already completely provided for, there will be no further hit on reported P&L. Using WACC of 13%, the NPV of future benefits on tax works out to INR38/share. In our view, this should be added to the current book value for comparable valuations.

The company intends to gradually convert its non-MFI businesses into separate business verticals or operate them through subsidiaries

## Non-MFI business could contribute 15% of revenue and 25% of profits

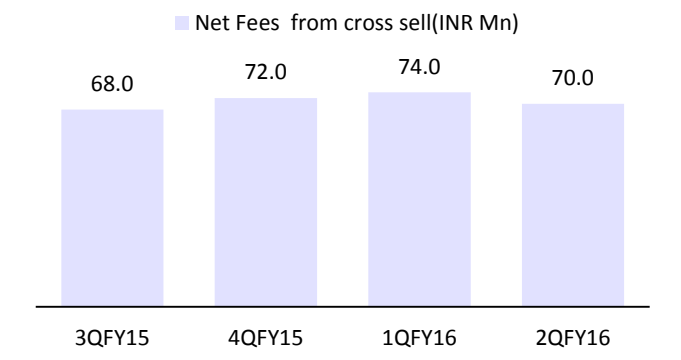
To diversify its revenue stream, SKSM has introduced non-MFI products in its portfolio. These include gold loans and loans to purchase mobile phones and solar lamps. The company also earns referral fees from Nokia (for mobile phone loans) and DLight (for solar lamp loans). SKSM plans to scale up its non-MFI business so that it constitutes ~10% of its assets, but contributes 15% to revenue and 25% to profit over the medium term. It intends to gradually convert its non-MFI businesses into separate business verticals or operate them through subsidiaries.

**Exhibit 39: Cross-sell penetration increasing…**




Source: Company, MOSL

**Exhibit 40: …with steady contribution to fee income**




Source: Company, MOSL

**Exhibit 41: Non-MFI products**

| Product | Feature | Purpose |
|---|---|---|
| **Mobile Phone Loan** | Loans range from INR1,800-INR2,000. Interest rate ~20% per annum. Processing fee – 0.90%. Tenure 25 weeks with principal and interest payments due on a weekly basis | Financing to purchase Nokia mobile phone handsets, currently offer this product in 10 states in India. |
| **Solar Lamp Loan** | Loan of INR1,772. Interest rate ~20% per annum. Processing fee – 0.90%. Tenure 25 weeks with principal and interest payments due on a weekly basis | Provide financing for purchase of solar lamps. |
| **Referral fee for Mobile Phone Loan /Solar Lamps loan** | The company is paid a processing or referral fee by Nokia and their distributors for the mobile phones sold. Similarly, the company is paid referral fee by D.Light for the lamps sold. | . |

Source: Company, MOSL

# Premium valuations to sustain

## Initiate coverage with Buy

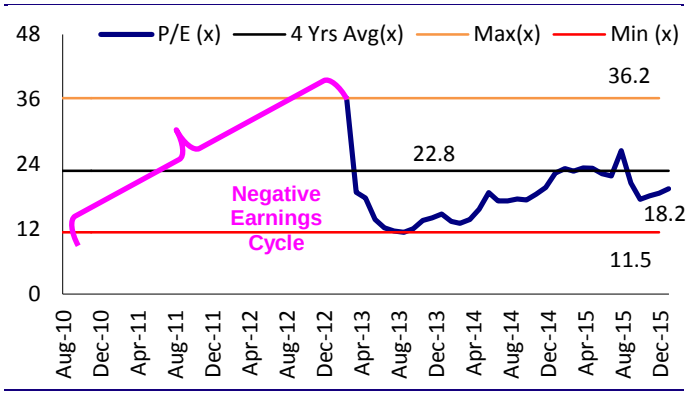
- **SKSM quotes at 3.6x FY17E and 2.9x FY18E BV. We believe valuations are justified, given high medium-term growth visibility, strong profitability, low competitive intensity and superior asset quality.**
- **Current valuations should sustain and could improve, given strong profitability (42% PAT CAGR over FY15-18), and healthy asset quality and capitalization.**
- **We initiate coverage with a Buy rating. Our target price is INR589 (3.5 FY18E BV).**

The AP-crisis had resulted in a sharp decline in AUM and concurrent increase in GNPA for the MFI industry, leading to huge losses for the participants. However, timely RBI intervention led to stable and uniform regulations across the country. This de-risked the sector and provided a new lease of life to MFI companies, especially SKSM (SKSM had the largest AP portfolio at the time of crisis). SKSM has since witnessed an impressive turnaround, led by strong performance across operating parameters. The stock has also been re-rated in the last two years. We expect SKSM to continue to grow at a healthy pace, driven by vast geographic presence, experienced management and efficient operating metrics. We believe SKSM will be a prime beneficiary of underlying growth in the industry.

With most of its peers busy turning themselves into SFBs, we expect 43% CAGR in SKSM's AUM over the next 2-3 years. SKSM would be the fastest growing company in our Financials coverage – our 3-year PAT CAGR estimate for SKSM is 42%.

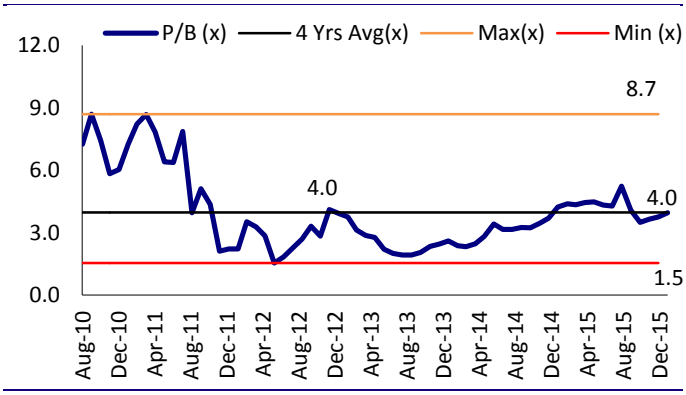
Low competitive intensity, supportive regulations, strong balance sheet, and best-in class operating metrics have put SKSM on a high growth path. Currently, SKSM quotes at 3.6x FY17E and 2.9x FY18E BV. While these valuations appear high, we note that SKSM has traded at much higher multiples before the Andhra Pradesh crisis. We believe current valuations are justified, given high medium-term growth visibility, strong profitability, and superior asset quality. Current valuations should sustain and could improve, given strong profitability (42% PAT CAGR over FY15-18), and healthy asset quality and capitalization. We initiate coverage with a Buy rating. Our target price is INR589 (3.5x FY18E BV).

**Exhibit 42: P/E ratio**




Source: Company, MOSL

**Exhibit 43: P/B ratio**




Source: Company, MOSL

# Risks

### Competition from small finance banks and universal banks

Microfinance credit demand is being met by various entities – MFIs, SHGs, cooperative societies, local area banks, NGOs, etc. Though we expect NBFC-MFIs to gain market share over SHGs and other entities, given wide presence and increased customer reach, competition from SHGs cannot be ruled out completely. Further, emergence of small finance banks (SFBs), which will essentially serve the same segment as MFIs, and increased focus of universal banks on this underserved segment is a risk. SFBs and universal banks will be in a position to provide a complete suite of basic banking services, heightening competition for MFIs.

### Regulatory risks

Post the AP crisis, the RBI has been regulating the MFI sector. However, in the last union budget, the government proposed Mudra Bank as the regulator for the sector. We believe it is in the best interest of the sector that RBI remains the regulator. Any other regulator without adequate powers is a key risk for the sector.

### Political risk: Repeat of an AP-like backlash

SKSM caters to customers at the lower end of the income spectrum (poor households) and is vulnerable to political risk. An AP-like crisis remains a key risk.

### Over-leveraging

Microfinance has emerged as one of the fastest growing segments, clocking 32% CAGR in AUM over FY13-15 to INR401bn (albeit on a lower base). With rising presence of MFIs, customers are now being approached by several MFIs, leading to over-leveraging of customers. However, there are regulatory checks imposed by the RBI in terms of overall indebtedness limit and number of lenders a borrower can get loans from. Moreover, establishment of credit bureaus provides lenders with adequate information on overall indebtedness of customers and repayment history.

### Concentrated borrowing profile

Large part of SKSM's borrowing is from banks. Its access to other sources was hampered in the wake of the AP crises. However, with recent rating upgrade, it will be able to borrow money from the debt market at competitive rates.

## Company description

SKS Microfinance (SKSM) is the second largest microfinance company in India in terms of gross loan portfolio. Its core business is providing small value loans and other basic financial services to its customers, who are predominantly located in rural areas. The company extends loans to them mainly for use in small businesses or for other income generating activities and not for personal consumption.

SKSM's business was initially organized as part of SKS Society in Andhra Pradesh, which until 2003 extended micro-credit as a non-government organization. In 2003, SKS Society decided to transfer its business and operations to SKSM and the transfer was completed in 2005. Since 2005, SKSM is registered with and regulated by the RBI as an NBFC-ND. In November 2013, the RBI granted SKSM a certificate of registration permitting it to carry on the business of an "NBFC-MFI", a separate category of non-deposit taking non-banking finance companies engaged in microfinance activities. As of 2QFY15, SKSM had an overall AUM of INR54.6b, with a customer base of 6.4m spread across 1,268 branches.

### Strong and capable management team

SKSM has a strong and capable management team. Its current management team (CEO, President, CFO and COO) has been with the company since pre-IPO days. The team is led by Mr M Ramachandra Rao, who has 27 years of experience in retail financial services and is associated with the company since 2006. He has vast experience in managing operations in a large business environment, formulating business strategies and identifying new markets. He has been driving company's rural distribution reach and scale-up operations. Mr Rao has been instrumental in combating the AP MFI crisis for the company and insulating its non- AP operations from the contagion risk. President, Mr S Dilli Raj has ~24 years of experience in corporate finance, treasury, policy advocacy and corporate tax planning. He has been associated with the company since 2008 and has introduced mainstream financial products into microfinance. Mr Raj played a lead role in preparing the company for its IPO by strengthening the financial system. He played a strategic role in SKSM's turnaround and managing the AP crisis by focusing on cash flow management, cost structure optimization and gaining confidence of credit grantors.

**Exhibit 44: Key managerial personnel**

| Name | Designation | Age | Education | Prior assignments |
|---|---|---|---|---|
| Mr M Ramachandra Rao | Managing Director and Chief Executive Officer | 50 | Post-Graduation in Management Studies from BITS Pilani | 42 years of experience in Financial Services<br>Was earlier associated with ING Vysya Life Insurance, Standard Chartered Bank, American Express and Esanda Finza & Leasing Limited |
| Mr S Dilli Raj | President | 45 | Bachelors in Commerce - Vivekananda College<br>MBA - Central University Pondicherry | Has about 24 years of experience in corporate finance, treasury, policy advocacy and corporate tax planning<br>Also a member of the financial inclusion committee of FICCI |
| Mr Ashish Damani | Chief Financial Officer | 35 | Accelerated General Management Program - IIM Ahmedabad | Has a total work experience of ~14 years<br>Was formerly Manager CMM with Fullerton India Credit Company Limited |
| Mr KV Rao | Chief Operating Officer | 51 | Bachelors of Science<br>MBA - Institute for Social Sciences and Research | Has overall experience of over 28 years and has worked with organizations such as Blue Dart, Esanda Finanz (subsidiary of Grindlays Bank plc), Standard Chartered Bank and Sundaram Home Finance Limited (TVS group) |
| Mr PH Ravi Kumar | Non-Executive Chairman & Independent Director | 62 | Bachelors of Commerce - Osmania University | 42 years of experience in the financial services sector<br>Was earlier associated with Bank of India and ICICI Bank among others |
| Mr Geoffrey Tanner Woolley | Independent Director | 54 | Bachelors of Science - Brigham Young University<br>MBA from Utah University | Mr Woolley co-founded Dominion Ventures, Kreos Partners and also holds the position of Chief Executive Officer of Unitus Impact |
| Mr Tarun Khanna | Independent Director | 48 | Bachelors of Science- Princeton University<br>Ph.D - Harvard University | Has 22 years of experience as an author, educator, consultant and investor in emerging markets worldwide |
| Mr P Krishnamurthy | Nominee Director | 62 | Masters of Science - Bangalore University<br>MBA -University of Birmingham | Has 35 years of experience in banking and central banking<br>Retired as Chief General Manager at RBI |
| Mr Sumir Chadha | Non-executive Director | 43 | Bachelors of Science - Princeton University<br>MBA from Harvard University | Has 17 years of experience<br>Co-founded WestBridge Capital and Sequoia Capital India<br>Also worked at Goldman Sachs and McKinsey |
| Mr Paresh D Patel | Non-executive Director | 43 | Bachelors in Arts - Boston College<br>MBA - Harvard Business School | Is the Managing Director of Sandstone Capital Advisors Private Limited<br>Previously, he was the Managing Director of Sparta Group, a private investment company |
| Dr. Punita Kumar Sinha | Independent Director | 52 | Ph.D. and a Masters in Finance- Wharton School, University of Pennsylvania | She is the Founder and Managing Partner, Pacific Paradigm Advisors, an independent investment advisory and management firm.<br>Previously she was Head of Blackstone Asia Advisors. and its Chief Investment Officer, |

Source: Company, MOSL

## Annexure I: Andhra Pradesh Microfinance Crisis

Andhra Pradesh had leadership within the Indian microfinance industry up until 2010. The state accounted for more than 30% of all borrower accounts and outstanding loan portfolios of MFIs.

In October 2010, Government of Andhra Pradesh issued an ordinance - A.P.-MFI Ordinance- that regulated money lending transactions by MFIs. The ordinance was issued on back on news reports that several low income borrowers had committed suicide due to coercive recovery practices adopted by some MFIs. The A.P.-MFI Ordinance among other things, applied severe restrictions on processing new loans applications, stopped weekly collections, required that all repayments must be made only by monthly installments at the designated offices of the Andhra Pradesh Government, required that every loan issued to a client and each purpose of the loan to be individually approved by the AP Government. The ordinance was followed by the A.P.-MFI Act in January 2011.

This had an immediate impact on the recoveries by MFIs. The stringent regulations set by the act, particularly the inability to hold center meetings for repayment of loans, led to a significant fall in repayment levels. Recovery rates that were as high as 99.0% plummeted to as low as 10.0% in Andhra Pradesh.

The sharp fall in repayment levels coupled with high exposure to Andhra Pradesh led to sharp erosion of net worth of many large MFIs. Further, due to high NPAs, MFIs faced issues raising funds in order to expand operations outside AP. This resulted in many MFIs going for restructuring under the CDR route, which applied additional restriction on expanding the loan book.

Post the AP-crisis, the RBI accepted the recommendations of the Malegam Committee and instituted a separate regulatory framework for NBFC-MFIs. Under the NBFC-MFI Directions, NBFC-MFIs are required to comply with certain requirements and restrictions in connection with: qualifying as NBFC-MFIs, provision of loans, average loan size, capital adequacy ratio, minimum average loan provision, asset classification, and security deposits, multiple lending and pricing of credit, as discussed in the earlier part of the report.

# Annexure II: RBI norms for MFIs

**Exhibit 45: RBI norms for MFIs**

| Borrower loans | |
|---|---|
| Borrower profile | Maximum of two NBFC-MFIs can lend to the same borrower |
| Income generating loan | Loans towards income generation activities more than 70% of overall book |
| Loan terms | 85% of net assets to be assets complying with following:<br>- Borrower household annual income levels: rural below INR100,000 (enhanced from INR60,000); urban and semi-urban below INR160,000( enhanced from 120,000);<br>- Loan amount below INR60,000 (enhanced from INR35,000) in the first cycle and up to INR100,000 ((enhanced from INR50,000) subsequently<br>- Total borrower indebtedness below INR100,000 (increased from INR50,000) |
| Loan size limits | - MFIs can lend under SHG/JLG/individual level<br>- Max loan amount = INR100,000<br>- Max overall indebtedness = INR100,000 |
| Loan tenor | - Not less than 24 months for loan amount above INR30,000<br>- Minimum moratorium equal to interest period |
| Interest rate caps (linked to bank rates) | - No interest rate cap<br>- Margin cap 12% for small MFIs and 10% for other MFIs (based on asset size)<br>- Interest to be calculated on diminishing outstanding basis |
| Interest periods and repayment | - Weekly, fortnightly or monthly |
| Penalty | - No penalty on delayed payments<br>- No prepayment penalty |
| Transparency on other charges | - Only three forms of charges - interest, processing fee 1% of disbursement and insurance premium (including admin charges)<br>- No collection of security deposits<br>- Loan card to every borrower with details in vernacular language |
| Recovery | - Recoveries at residence only if a customer fails to appear at the designated place more than twice |
| **Funding and capital** | |
| Capital ratios | Min net owned funds: INR50m<br>(North east MFIs – INR20m) after 31 March 2014<br>Min CAR (Tier 1 + Tier 2): 15% of risk weighted assets.<br>Tier II capital cannot exceed 100% of Tier I capital<br>Exceptions for AP portfolio of MFIs |
| Priority sector | Status to continue |
| **Governance** | |
| Code of conduct, customer protection code | NBFC-MFIs to ensure that a code of conduct and systems are in place for recruitment, training and supervision of field staff |
| Provisioning | Loan provision to be maintained by NBFC-MFIs shall be the higher of<br>a) 1% of the outstanding loan portfolio, or<br>b) 50% of the aggregate loan installments which are overdue above 90 days and below 180 days; 100% of t aggregate loan installments which are overdue for 180 days or more |
| CIB | Mandated that all NBFC-MFIs be members of at least one credit information bureau |
| SRO | Mandated that all NBFC-MFIs be members of at least one SRO |

Source: RBI, India Ratings, MOSL

# Financials & Valuations

| INCOME STATEMENT | | | | | | | (INR Million) |
|---|---|---|---|---|---|---|---|
| **Y/E MARCH** | **2012** | **2013** | **2014** | **2015** | **2016E** | **2017E** | **2018E** |
| Interest Income on books Port. | 3,589 | 2,200 | 3,930 | 5,665 | 8,934 | 12,259 | 16,557 |
| Interest Expense | 2,001 | 1,427 | 2,142 | 2,790 | 4,345 | 5,802 | 7,874 |
| **Net Financing income** | **1,587** | **773** | **1,788** | **2,874** | **4,589** | **6,458** | **8,684** |
| *Change (%)* | *-76.7* | *-51.3* | *131.4* | *60.7* | *59.7* | *40.7* | *34.5* |
| Income from assignment of loans | 346 | 580 | 557 | 668 | 812 | 1,155 | 1,638 |
| **Net Income (Incl Secur)** | **1,933** | **1,353** | **2,345** | **3,542** | **5,401** | **7,613** | **10,322** |
| *Change (%)* | *-75.9* | *-30.0* | *73.4* | *51.0* | *52.5* | *40.9* | *35.6* |
| Other operating income | 422 | 542 | 702 | 907 | 1,560 | 2,038 | 2,635 |
| Other Income | 366 | 204 | 258 | 791 | 866 | 891 | 916 |
| **Net Income** | **2,722** | **2,098** | **3,306** | **5,240** | **7,827** | **10,542** | **13,873** |
| *Change (%)* | *-70.4* | *-22.9* | *57.6* | *58.5* | *49.4* | *34.7* | *31.6* |
| **Operating Expenses** | **4,224** | **2,626** | **2,462** | **3,204** | **4,060** | **5,156** | **6,391** |
| *Change (%)* | *-17.6* | *-37.8* | *-6.2* | *30.1* | *26.7* | *27.0* | *24.0* |
| **Operating Profits** | **-1,503** | **-527** | **844** | **2,036** | **3,767** | **5,386** | **7,482** |
| *Change (%)* | *-136.9* | *-64.9* | *-260.1* | *141.2* | *85.0* | *43.0* | *38.9* |
| **Total Provisions** | **11,735** | **2,444** | **146** | **100** | **248** | **424** | **731** |
| *% to operating income* | *-781.0* | *-463.7* | *17.3* | *4.9* | *6.6* | *7.9* | *9.8* |
| **PBT** | **-13,237** | **-2,971** | **699** | **1,936** | **3,519** | **4,962** | **6,752** |
| Tax | 369 | 0 | 0 | 59 | 739 | 1,042 | 1,418 |
| *Tax Rate (%)* | *-2.8* | *0.0* | *0.0* | *3.0* | *21.0* | *21.0* | *21.0* |
| **PAT** | **-13,606** | **-2,971** | **699** | **1,877** | **2,780** | **3,920** | **5,334** |
| *Change (%)* | *-1,318.9* | *-78.2* | *-123.5* | *168.7* | *48.1* | *41.0* | *36.1* |
| Proposed Dividend | 0 | 0 | 0 | 0 | 0 | 0 | 1,067 |

| BALANCE SHEET | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Y/E MARCH** | **2012** | **2013** | **2014** | **2015** | **2016E** | **2017E** | **2018E** |
| Equity Share Capital | 724 | 1,082 | 1,082 | 1,263 | 1,263 | 1,263 | 1,263 |
| Reserves & Surplus | 3,623 | 2,822 | 3,510 | 9,202 | 11,981 | 15,902 | 19,987 |
| **Networth** | **4,347** | **3,904** | **4,592** | **10,465** | **13,244** | **17,165** | **21,250** |
| **Borrowings** | **10,213** | **16,186** | **15,313** | **32,800** | **46,925** | **65,732** | **88,651** |
| *Change (%)* | *-54.3* | *58.5* | *-5.4* | *114.2* | *43.1* | *40.1* | *34.9* |
| **Other liabilities** | **2,245** | **5,024** | **5,067** | **3,722** | **4,094** | **4,504** | **4,954** |
| *Change (%)* | *-27.5* | *123.8* | *0.9* | *-26.5* | *10.0* | *10.0* | *10.0* |
| **Total Liabilities** | **16,805** | **25,115** | **24,972** | **46,987** | **64,263** | **87,400** | **114,856** |
| **Loans** | **9,496** | **15,654** | **17,528** | **29,584** | **44,578** | **62,445** | **84,219** |
| *Change (%)* | *-74.0* | *64.8* | *12.0* | *68.8* | *50.7* | *40.1* | *34.9* |
| **Investments** | **2** | **2** | **2** | **2** | **0** | **0** | **0** |
| Net Fixed Assets | 206 | 113 | 112 | 102 | 93 | 85 | 77 |
| Other assets | 7,101 | 9,346 | 7,330 | 17,299 | 19,592 | 24,870 | 30,560 |
| **Total Assets** | **16,805** | **25,115** | **24,972** | **46,987** | **64,263** | **87,400** | **114,856** |

| Assumptions | 2012 | 2013 | 2014 | 2015 | 2016E | 2017E | 2018E |
|---|---|---|---|---|---|---|---|
| AUM (INR b) | **16,689** | **23,590** | **31,128** | **41,710** | **62,230** | **88,305** | **121,194** |
| AUM Growth | -59.4 | 41.4 | 32.0 | 34.0 | 49.2 | 41.9 | 37.2 |
| Borrowings Growth | -54.3 | 58.5 | -5.4 | 114.2 | 43.1 | 40.1 | 34.9 |
| Dividend per share | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 8.4 |

*E: MOSL Estimates*

# Financials & Valuations

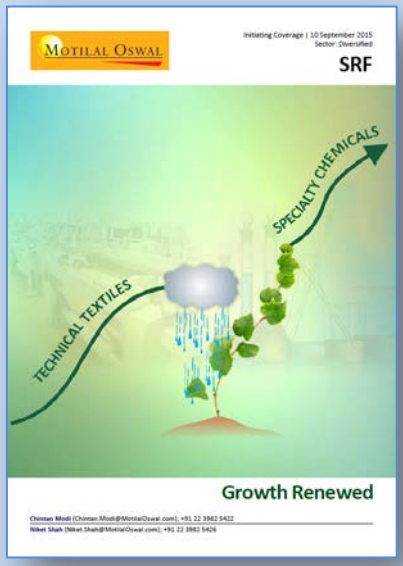
| RATIOS<br>Y/E MARCH | 2012 | 2013 | 2014 | 2015 | 2016E | 2017E | 2018E |
|---|---|---|---|---|---|---|---|
| **Spreads Analysis (%)** | | | | | | | |
| Avg. Yield - on Financing portfolio | 16.9 | 22.0 | 29.2 | 26.4 | 25.0 | 23.5 | 23.0 |
| Avg. Cost of funds | 12.3 | 10.8 | 13.6 | 12.8 | 10.9 | 10.3 | 10.2 |
| Interest Spread on Financing portfolio | 4.6 | 11.2 | 15.6 | 13.6 | 14.1 | 13.2 | 12.8 |
| Net Interest Margin (incl Securitization) | 6.7 | 6.7 | 8.6 | 9.7 | 10.4 | 10.1 | 9.9 |
| Net Interest Margin (Excl Securitization) | 7.5 | 7.7 | 13.3 | 13.4 | 12.8 | 12.4 | 12.1 |
| **Profitability Ratios (%)** | | | | | | | |
| RoE | -122.8 | -72.0 | 16.4 | 24.9 | 23.4 | 25.8 | 27.8 |
| RoA* | -45.3 | -14.2 | 2.8 | 5.2 | 5.0 | 5.2 | 5.3 |
| Op. Exps./Net Income | 155.2 | 125.1 | 74.5 | 61.1 | 51.9 | 48.9 | 46.1 |
| Empl. Cost/Op. Exps. | 61.8 | 65.8 | 67.2 | 72.4 | 74.2 | 76.0 | 76.6 |
| **Asset-Liability Profile (%)** | | | | | | | |
| Net NPAs to Adv. | 32.1 | 0.4 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 |
| Debt/Equity (x) | 2.3 | 4.1 | 3.3 | 3.1 | 3.5 | 3.8 | 4.2 |
| Average leverage | 1.5 | 3.2 | 3.7 | 3.2 | 3.4 | 3.7 | 4.0 |
| CAR | 35.4 | 33.9 | 27.2 | 31.7 | 29.7 | 25.0 | 22.9 |

| Valuations | 2012 | 2013 | 2014 | 2015 | 2016E | 2017E | 2018E |
|---|---|---|---|---|---|---|---|
| Book Value (INR) | 60.1 | 36.1 | 42.4 | 82.9 | 104.9 | 135.9 | 168.3 |
| Price-BV (x) | 8.1 | 13.4 | 11.4 | 5.9 | 4.6 | 3.6 | 2.9 |
| EPS (INR) | -188.0 | -27.5 | 6.5 | 14.9 | 22.0 | 31.0 | 42.2 |
| EPS Growth (%) | -1,318.3 | -85.4 | -123.5 | 130.2 | 48.1 | 41.0 | 36.1 |
| Price-Earnings (x) | -2.6 | -17.7 | 75.1 | 32.6 | 22.0 | 15.6 | 11.5 |

*E: MOSL Estimates *Borrowers generally repay the loans in 6-7 months thus completing 2 cycles in a year, resulting in RoAs of ~5%*

# REPORT GALLERY

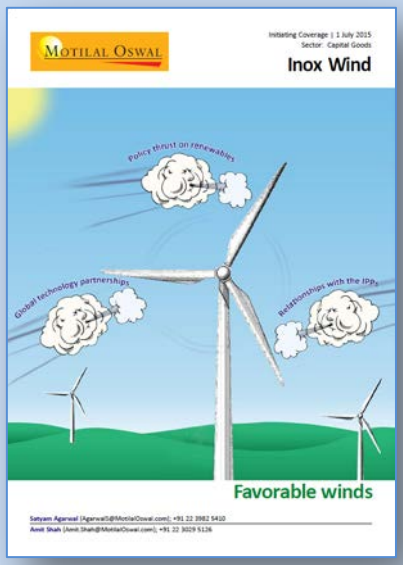
## RECENT INITIATING COVERAGE REPORTS

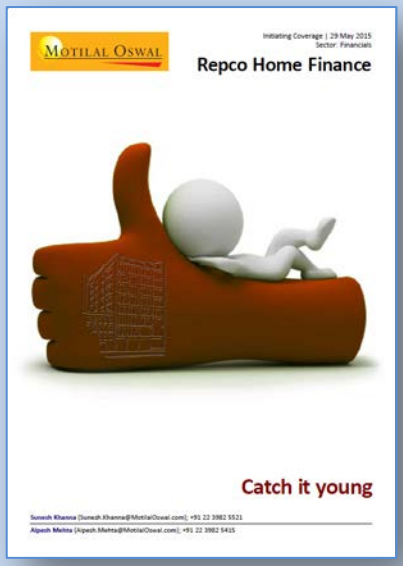











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| Disclosure of Interest Statement | SKS Microfinance |
|---|---|
| ▪ Analyst ownership of the stock | No |
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