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India Microfinance

Crisis brewing – SELL SKSM

19 August 2015

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Precursors to the last nine microfinance failures point to a crisis brewing in India. Most past crises, both domestic and global, were preceded by a mix of (1) headlong growth (50% AUM CAGR for Indian MFIs over FY13-FY15, plans for 50-60% growth by FY19), and (2) heady return expectations (post massive PE/VC capital injections). We have an anti-consensus Negative stance on the sector and rate the only listed player, SKSM, a SELL.

- **Precursors to a crisis:** Our analysis of six international and three domestic microfinance crises in the last 15 years suggests that rapid growth and high return expectations were precursors to almost every crisis. Indian microfinance institutions (MFI) have clocked a 50% AUM CAGR over FY13-FY15 and our interactions with a cross-section of MFIs operating across the country suggest they have ambitious expansion plans in newer, unknown markets. At the same time, massive PE/VC investments in the sector have led to unduly high return expectations from investors.
- **Structural risks to growth:** Our in-depth study suggests that penetration levels are alarmingly high in the sector's traditional southern and eastern markets. Market saturation is fuelling aggressive growth in newer regions (north, central, western), which could lead to unhealthy competition and backfire on MFIs unless accompanied by an adequate understanding and pricing of risks. This is especially true given the weaker market traits in these regions, in that the group loan culture is still nascent and empowerment of women – a key client base for MFIs – is low.
- **Popular misconceptions mask deeper concerns:** We look at 7 common arguments that bat in favour of the microfinance sector (credit bureau data is foolproof, political risk is the only risk, group lending and market diversification offer safety nets, among others) and provide counter-arguments, backed by detailed analysis and channel checks, that root out these misconceptions and reveal multiple weak spots in the sector.
- **Small bank licences – not a game-changer:** While conversion to a bank would offer several key advantages to MFIs, we see risks to growth in the near term, with ROE likely to halve due to CRR/SLR obligations and high operating costs. After assuming normalised credit cost, ROE will be marginally lower than well-run private sector banks in India in the long term, belying the street's upbeat growth expectations.
- **Adequate pricing of risks essential; SELL SKSM:** Political risks, natural calamities and economic, regional & local shocks can lead to massive loan write-offs for MFIs and erode a substantial part (or all) of their net worth. Conversion into a bank does not erase these concerns. Base-case credit cost forecasts should be much higher than the regulatory minimum to account for the inherent lending risks. We assume credit costs of 1.5% vs. the current rate of 0.3% to arrive at our target FY17 P/BV multiple of 2.8x for SKS Microfinance (SKSM, TP: Rs 400, 26% downside) – initiate coverage on the stock and sector with an anti-consensus SELL rating.

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Recommendation snapshot

Company	TICKER	CMP (Rs)	TP (Rs)	REC
SKS Microfinance	SKSM	543	400	SELL

Companies covered in our report

Large MFIs	Small/fast growing
SKS Microfinance	Utkarsh Microfinance
Janalakshmi Microfinance	Suryoday Microfinance
Ujjivan Financial Services	SV Creditline
Satin Creditcare Network	Arohan Microfinance
Grameen Koota Fin. Service	Fusion Microfinance
ESAF Microfinance and Investments	Belstar Microfinance

Aggressive growth plans

Particulars	FY12-FY15 CAGR (%)	FY15-FY19 CAGR (%)
Large MFIs (AUM>Rs 10bn)	59.4	45.9
Small & Midsize MFIs	93.9	60.8
Total	64.2	49.2

Source: Company projections

High MFI penetration in top 5 states

States	MFI clients as % of total households	MFI clients as % of poor households
Tamil Nadu	24.4	142.5
Karnataka	20.4	86.5
West Bengal	20.8	78.0
Assam	19.2	50.8
Odisha	16.1	43.4
Madhya Pradesh	12.7	34.7
Maharashtra	11.5	46.9

Source: Census 2011, MFIN, RCML Research

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India Microfinance

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Sector Report
INDIA
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Our approach

- **Comprehensive channel checks:** In order to better gauge sector trends, we interacted with 12 microfinance institutions across India, lenders (banks) active under the Business Correspondence (BC) route for microfinance, private equity players and venture capitalists – key sources of seed capital for the sector – and a credit bureau for MFIs (Equifax Credit Information Services) that holds 70% market share in India. Key findings from our channel checks inform this report.

  We also profile all 12 MFIs, chosen for their healthy mix of regional coverage (north, south, east and west), AUM size (small, mid and large) and business focus (urban/semi-urban and rural). Of the 12 companies and we initiate coverage on the only listed player, SKSM, with a SELL rating.

For our channel checks, we spoke to 12 MFIs, banks active under BC route, PE & VC funds and credit bureau Equifax

- **Crises analysis:** The crux of our report is a deep dive into nine microfinance crises that took place in the last 15 years, including six international (Bolivia, Nigeria, Pakistan, Bosnia & Herzegovina, Nicaragua and Morocco) and three domestic failures (Krishna – FY06, Karnataka – FY09 and Andhra Pradesh – FY10). We present the causes, consequences and lessons learnt from each event and, more importantly, discuss findings that support our anti-consensus SELL call on the Indian microfinance sector.

- **News & views:** Lastly, we discuss structural challenges to growth, debunk several microfinance misconceptions, examine why the small bank licence is unlikely to be much of a game-changer, and cap it all off with an interesting journey through microfinance in India starting from the year 2000.

Fig 1 - Channel checks with 12 MFIs across India

Company	Regional coverage	Size	Focus
SKS Microfinance	South, West	Large	Rural
Janalakshmi Microfinance	Pan India	Large	Urban
Ujjivan Financial Services	Pan India	Large	Urban & semi urban
Satin Creditcare Network	North	Large	Mainly Rural
Grameen Koota Financial Services	South	Large	Rural
ESAF Microfinance and Investments	South	Large	Rural
Utkarsh Microfinance	East	Small/fast growing	Largely Rural
Suryoday Microfinance	West	Small/fast growing	Urban
SV Creditline	North	Small/fast growing	Rural
Arohan Microfinance	East	Small /fast growing	Rural
Fusion Microfinance	North	Small/fast growing	Rural cum urban
Belstar Microfinance	South	Small /fast growing	Rural

Source: RCML Research

India Microfinance

Crisis brewing – SELL SKSM

Fig 2 - Regional coverage of MFIs included in our report

Jammu and Kashmir
Himachal Pradesh
Chandigarh
Punjab
Uttarakhand
Haryana
Delhi
Rajasthan
Uttar Pradesh
Sikkim
Arunachal Pradesh
Assam
Nagaland
Meghalaya
Bihar
Manipur
Jharkhand
Tripura
West Bengal
Mizoram
Gujarat
Madhya Pradesh
Chhattisgarh
Orissa
Maharashtra
Telangana
Goa
Andhra Pradesh
Karnataka
Pondicherry
Tamil Nadu
Kerala

Company	Symbol
Arohan Microfinance	◆
Satin Creditcare Network	●
Suryoday Microfinance	■
Utkarsh Microfinance	✥
Fusion Microfinance	✹
SV Creditline	⬟
Janalakshmi Microfinance	✱
ESAF Microfinance and Investments	✖
SKS Microfinance	▲
Ujjivan Financial Services	◎
Grameen Koota Financial Services	◈
Belstar Microfinance	✶

Source: RCML Research

Crises analysis: Key findings

Precursors to a crisis: Headlong growth, heady expectations

Our analysis of nine microfinance crises in developing economies, including India, over the last 15 years suggests that they were triggered by a variety of events, including political interference, natural calamities, economic or sector-specific slowdowns, and the global financial crisis (GFC). More importantly, however, the precursors to these crises remained very much the same – ambitious loan growth and aggressive return expectations. We found that:

Striking similarities between present situation and earlier crises, viz.:

1) Rapid growth

2) High return expectations given massive investments by PEs/VCs

- In most past international MFI crises, players rapidly scaled up their client base by 3-4x and portfolio size by 5-10x in the five years preceding the crash. Competition was intense and borrowers were overleveraged due to the easy availability of credit.
- We observed similar trends in the three Indian failures as well, viz. AUM growing at 40-50% for two to three years pre-crisis and cutthroat competition among players.
- Secondly, mounting investor pressure led to unbridled growth and higher risk-taking by MFIs – seed capital investors (PEs/VCs) who are the primary source of funding for MFIs in India typically had board representation with rights to oversee growth and returns, which put higher pressure on MFIs to perform.

Fig 3 - Unbridled growth often precedes a microfinance crisis

Year	Country / Regions	Pre-crisis
FY01	Bolivia	• Microfinance companies began giving out loans for consumption purposes vs. income generation • Competition among players intensified • Borrowers were overleveraged due to the easy availability of credit • New entrants had high return expectations
FY05	Nigeria	• Regulator gave 800+ licences for microfinance lending • Players grew aggressively in order to compete and show higher profits
FY06	Krishna (Andhra Pradesh – India)	• Loan growth burgeoned over FY00-FY05 • Outreach (branch presence) grew by 46% YoY in FY04 and 63% YoY in FY05 • MFIs began chasing the same set of customers (multiple lending), charged high interest rates and followed coercive collection methods
FY08	Bosnia & Herzegovina	• Conversion of no-profit MFIs to for-profit led to aggressive growth and high return expectations • Lending portfolio grew 11x over FY03-FY08 • Average loan outstanding per borrower grew 3x during the same period
FY08	Nicaragua	• Lending portfolio grew ~6x over FY03-FY07 and formed ~15% of total credit • MFI leverage doubled from 2.8x to 5x
FY08	Morocco	• Lending portfolio grew 11x over FY04-FY08, covering ~40% of the population • Average loan ticket size increased by 4x during the same period
FY09	Karnataka (India)	• Aggressive and multiple lending • Mysore and Kolar districts had 10-12 MFIs operating whereas these regions could support only 5-6 players
FY10	Andhra Pradesh (India)	• Aggressive and multiple lending in the state • Some districts overcrowded with MFIs • Lack of self-discipline, competition with government-run schemes • High return expectations due to heavy PE/VC investments

Source: Media reports, RCML Research

India Microfinance

Crisis brewing – SELL SKSM

Indian MFIs could be in for a hard landing

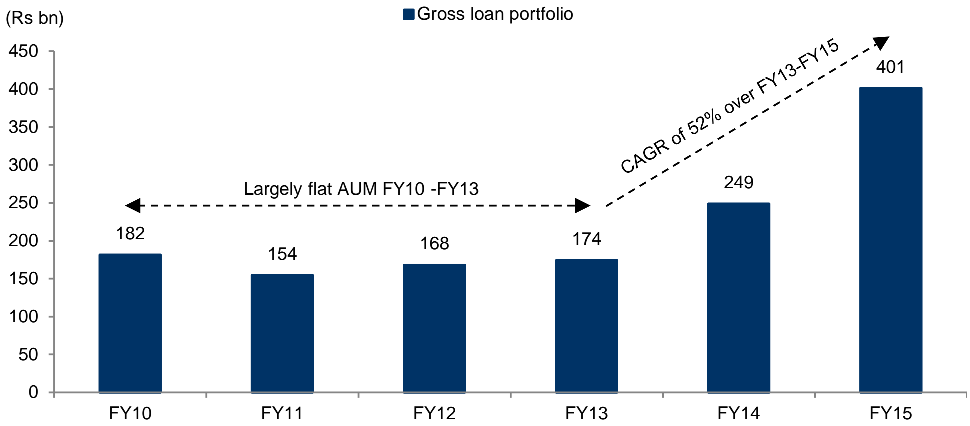
We observe striking similarities between the present situation in India and the run-up to past crises both within the country and abroad, viz. a rapid growth cycle for Indian MFIs – 50% AUM CAGR over FY13-FY15 and ambitious expansion plans – coupled with massive PE/VC investments in the sector and the ensuing high return expectations.

50% CAGR in AUM over FY13-FY15

Growth revived for the sector after four years of flat AUM

Following the Andhra Pradesh crisis that hit the microfinance sector in FY10, AUM growth remained flat for four years through to FY13. During this period, the RBI introduced a series of positive regulatory changes, including the creation of self-regulatory organisations (SRO) and credit information bureaus, that helped put the industry back on track. MFIs recovered to post an impressive 50%+ CAGR over FY13-FY15 that raised total AUM from Rs 174bn to Rs 400bn in FY15. Branch network has grown at a brisk clip of 20% in the last two years and aggregate MFI employee count has risen by 13% YoY in FY14 and 20% YoY in FY15.

Fig 4 - Surge in AUM growth of Indian MFIs post-FY13



Source: MFIN

Ambitious growth plans

MFI growth plans look very ambitious and can lead to unhealthy competition

We expect the rapid ramp-up in network and AUM to continue over the next 3-4 years given the conducive regulatory environment and stated growth plans of many of the MFIs we interacted with – in all, 10 of the 12 companies we spoke to are eyeing rapid expansion in outreach (branch network) and AUM.

Small to mid-size MFIs tell us they plan to grow at a 50-60% CAGR over the next four years and large players are targeting 30-40% growth through to FY19. While we agree that the sector has tremendous potential for growth given India's large population of low-income under-banked households, burgeoning growth in any industry is never without attendant risks. The four-year AUM growth target of 5-6x for small to mid-size players and 3-4x for large players looks highly ambitious, particularly when these plans appear to be focused on newer geographies with a limited track record and inherently weak market characteristics.

Headlong growth will also create more competitive market conditions, which in turn ratchets up credit risk as the bid to grab market share could weaken the underlying credit appraisal standard across players in the industry.

Fig 5 - MFIs have aggressive growth plans for the next few years

(Rs bn)	FY12 AUM	FY15 AUM	FY12 - FY15 CAGR (%)	FY19E AUM	FY15 - FY19E CAGR (%)
Arohan	0.5	3.8	92.4	24.6	59.1
Satin	3.2	21.4	88.4	133.0	57.9
SV Creditline	0.6	4.2	92.6	24.3	54.9
Utkarsh	0.3	7.3	183.8	41.6	54.6
Ujjivan	7.0	32.7	67.0	125.8	40.0
ESAF	2.9	10.2	51.7	39.0	40.0
Suryoday	0.9	5.8	84.7	FY16 AUM target of Rs 10bn, up 60% YoY	
Janalakshmi	3.5	37.7	120.3	NA	
Fusion	0.2	2.4	121.2	FY16 AUM target of ~Rs 5bn, up 100% YoY	
SKS Microfinance	9.5	28.3	43.9	FY15-FY17 CAGR of 50%+	
Grameen Koota	3.8	14.5	56.0	FY15-FY17 CAGR of 49%	
Belstar	0.9	2.0	31.8	FY18 AUM target of Rs 10bn, CAGR of 70%	

Source: Companies

Massive PE/VC investments in the sector…

Investors have shown greater interest in the sector post regulatory changes by the RBI in FY12 that have helped strengthen asset quality and oversight. Apart from SROs and credit bureaus, the RBI has stipulated tier-1 and total CAR requirements of 10% and 15% respectively under NBFC-MFI guidelines. However, MFIs are stockpiling much higher capital than the regulatory minimum to fund their AUM growth plans and also to earn better credit ratings.

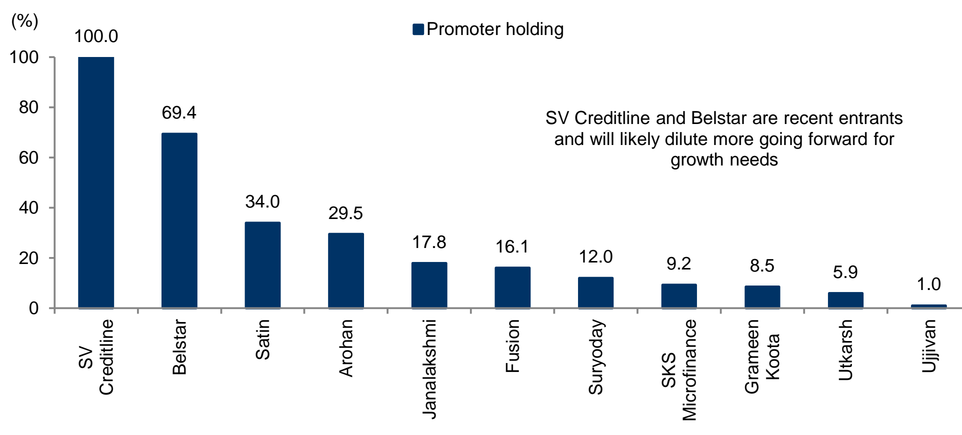
PE/VC injections of US$ 300mn-350mn in microfinance companies over FY13-FY15

Seed capital providers are best suited to fund fast-growing microfinance companies given the sector's high risk, high return profile. PE firms and VCs have cumulatively invested US$ 150mn-175mn every year in microfinance companies from FY13-FY15, aiding their remarkable growth but at the same time potentially raising performance pressure.

…shrinking promoter holding to record lows

With MFIs across the board heavily diluting equity in the last 2-3 years to fund AUM growth, promoter holdings have dropped to record lows. Three of the MFIs we met had sub-10% promoter stakes (Ujjivan, Utkarsh and SKSM), even as the shareholding of the largest PE/VC investor was higher than that of the promoter. This occurs primarily because most MFI promoters come from social welfare backgrounds and hence do not have the capital necessary to maintain their stakes.

Fig 6 - Promoter holdings are sub-50% for most MFIs



Source: Companies

Fig 7 - PE and VC investments in MFIs in the last 2-3 years

MFIs	Investors	MFIs	Investors
Janalakshmi – We will make the difference	citi; Morgan Stanley; nmi Norwegian Microfinance Initiative; GAWA Capital – Life changing investments; TATA CAPITAL LIMITED; Tree Line	Ujjivan	IFC; FMO Finance for Development; elevar equity; Lok Capital; SEQUOIA CAPITAL; unitus seed fund; WOLFENSOHN & COMPANY; OMIDYAR NETWORK; Saama Capital
IFMR Rural Channels	TATA CAPITAL LIMITED	Suryoday – Enabling Dreams. Empowering Lives.	IFC
MAS Financial Services Ltd. – The Power of Distribution	IFC; DEG KFW Bankengruppe	SAIJA – Empowering through Microfinance	ACCION – Helping Millions Help Themselves; PRAGATI INDIA FUND
Bandhan	IFC; GIC; SIDBI	equitas – micro finance macro vision	FMO Finance for Development; CDC; CLSA; MicroVentures finance for development; IFC; SIDBI
financing livelihood	incofin investment management; bio Development through Investment	arohan	Aavishkaar
Utkarsh Micro Finance Pvt Ltd	Aavishkaar; Lok Capital; CDC; IFC; nmi Norwegian Microfinance Initiative	Grameen Koota Financial Services Pvt. Ltd.	Creation Investments; MicroVentures finance for development
SATIN	SBI Ven Capital Pte. Ltd.; nmi Norwegian Microfinance Initiative; MAJ Invest Managing Danish Microfinance Partners	Fusion Microfinance	rural impulse II by Incofin IM; nmi Norwegian Microfinance Initiative

Source: Companies, Various media reports, RCML Research

Misconceptions mask deeper structural concerns

Several arguments used in favour of the sector are actually its weakest points

In the course of our analysis, we observed a host of popular misconceptions (listed below) that have added sheen to the microfinance sector for investors, but in fact mask deeper structural concerns. These are:

1. Credit bureau data is failsafe and foolproof
2. Political risk constitutes the biggest and only risk
3. Diversification considerably lowers risk
4. Group lending mechanism ensures recovery in the event of default
5. Consumption loans carry the same risks as income-generating loans
6. Individual loans are as profitable as group loans
7. Income from other sources can support earnings and aid profitability

Our crises analysis and channel checks have served to thoroughly debunk these misconceptions and uncover the potential hidden challenges facing the sector.

Adequate pricing of risks is essential

Credit cost assumptions for MFIs must be higher than the regulatory minimum to account for high inherent risks

Based on our study of the sector, we believe it would be a serious misstep to align credit cost assumptions for MFIs to the regulatory minimum given (1) the sector is highly vulnerable to political risk and cyclical pressures (economic or sectoral slowdowns, global slowdown, natural calamities), (2) looming challenges to growth, especially growth in newer, unknown regions where the cost of operations and credit cost will be higher, and (3) risks from a rising share of consumption loans as compared to income-generating loans.

We set our base-case credit cost assumption at 1.5% for the sector – much higher than the regulatory minimum of 0.3%. Adjusted for higher credit cost, we estimate that microfinance companies should earn an ROE of 17-18% over a cycle versus expected ROE of 22-24% in FY16-18, which forms the basis of our Negative stance on the sector. We set a target P/BV valuation multiple of 2.8x FY17 BV for SKSM (the only listed player). This yields a TP of Rs 400 for the stock (26% downside) and we initiate coverage with SELL.

Anatomy of past microfinance crises

In this section, we undertake a detailed study of six international and three domestic microfinance failures that have occurred since the year 2000 to understand the potential precursors and contributing factors, the impact on industry and the post-crisis milieu.

Bolivia – FY00-01

Bolivia, with one of the highest penetration levels of microfinance in the world, has been a pioneer in microcredit. Microfinance grew rapidly here from the early 90s and many non-profit organisations (NGOs) were allowed to convert into regulated commercial banks. High growth and return prospects attracted many new entrants.

New players concentrated heavily on growth by giving multiple loans to the same set of borrowers, even for consumption purposes. In 2001, the country suffered a recession and many borrowers expressed their inability to pay or even took one loan to repay another due to intense competition among lenders. Defaults shot up among consumer lenders and the contagion spread across microfinance lenders.

New players grew by giving multiple loans to the same set of borrowers

Impact on the industry

Due to the political fallout, the country's banking regulator issued a new rule limiting debt servicing of consumer loans to 25% of a person's salary or income. Massive write-offs shattered the business model and many companies closed operations.

Post-crisis

Microfinance players (mostly banks) came back on track in a few years and doubled their lending book between FY07 and FY11. Currently, microfinance credit accounts for ~10% of total GDP.

Nigeria – FY05

The Nigerian government launched a Microfinance Policy Framework in 2005, following which the regulator, Central Bank of Nigeria (CBN), gave hundreds of banking licences to MFIs in an attempt to serve the country's poor and increase the sector's depth. Many MFIs were new and didn't understand the sector, its method of functioning and its core competency well. And since they were given banking licences, many lost focus and started competing with banks for deposits.

Regulator gave 800+ licences for microfinance lending; players grew aggressively in order to compete

Impact on the industry

The regulator found that out of 820 microfinance banks in the country, 224 or over 25% were terminally distressed and insolvent. Many of these banks closed operations within six months, primarily due to undercapitalisation and rising non-performing loans. The Nigeria Deposit Insurance Corporation (NDIC) had to pay NGN 0.1mn per depositor in line with its statutory obligations.

Post-crisis

Recovery took around 3-4 years as companies took massive write-offs. CBN revised its Microfinance Policy Framework in 2011. Access to formal financial credit improved to nearly 50% of the population in FY14 as compared to just ~24% in FY08.

Pakistan – FY08 and FY10

Microfinance players in the central part of Punjab province were hit when borrower groups refused to repay their loans in late-2008. The crisis soon spread to semi-urban areas adjacent to Lahore district and three MFIs reported a sharp increase in portfolio at risk (PAR).

Pakistan was hit by heavy floods that destroyed crops and businesses

Thereafter, in FY10-FY11, Pakistan was hit by heavy floods that destroyed 21% of its crop area. Approximately one-fifth of Pakistan's total land area was submerged. Borrowers lost all their means of earning and many were unable to repay loans taken from microfinance banks and institutions.

Impact on the industry

As per the initial assessment by the Pakistan Microfinance Network (PMN), companies had a portfolio worth PKR 4bn in the affected regions, out of which ~PKR 3bn worth of loans were declared non-performing (75% of the total). The number of rural borrowers declined from 1.2mn in FY10 to 0.9mn in FY11.

Post-crisis

Gross loan portfolio (GLP) has grown steadily since the flood and stood at PKR 61bn in FY14 as compared to PKR 25bn in FY11. PAR declined from 4.1% in FY10 to 1.1% in FY14.

Bosnia and Herzegovina (BiH) – FY08

Lending portfolio grew 11x over FY03-FY08 and average loans outstanding per borrower grew 3x

The microfinance sector in BiH experienced robust growth from FY06 to FY08 financed by relatively cheap cross-border funding, as banks benefited from the support of their foreign parents. MFIs and banks grew AUM at 85% YoY and 28% YoY respectively in FY07 alone. Excess liquidity led to immense competition between MFIs and banks, which manifested in multiple lending to the same set of borrowers. When the global financial crisis hit in FY08, over-indebtedness among borrowers sent the microfinance industry into a downward spin.

Impact on the industry

Thirteen large members of the Association of Microfinance Institutions (AMFI) reported a decline in loan book to EUR500mn in Q3FY09 vs. EUR600mn in Q4FY08 as funding became expensive and scarce due to the GFC. AMFI members reported PAR (>30 days) of 6% as compared to their historical rate of 1%. In FY09, AMFI declared 28% of all MFI clients seriously indebted or over-indebted. Of these, monthly repayment for 17% of clients was higher than their total household disposable income.

Post-crisis

MFIs took heavy write-downs and became extremely conservative post the crisis. Many companies scaled back their loan books by 25% YoY in FY09. Loan growth in FY10 was merely 5%. Recovery set in over FY11 and FY12 which attracted large equity funds, thereby supporting business growth.

Nicaragua – FY08

Lending portfolio grew ~6x over FY03-FY07 and formed ~15% of total credit; MFI leverage doubled from 2.8x to 5x

The microfinance sector in Nicaragua was booming when in 2008 the GFC hit. This led to an abrupt decline in remittances and repayments as clients were over-indebted. The crisis escalated further due to political interference, when delinquent borrowers initiated a "No Pago" (no payment) movement backed by the government. These events took a toll on Nicaraguan MFIs and left them illiquid. International funders grew nervous about the country risk and retrieved their investments abruptly, leading to a further deepening of the crisis.

Impact on the industry

The crisis took a severe toll with the number of microfinance borrowers dropping from more than 0.5mn in 2008 to ~0.3mn in 2011 and the microcredit portfolio of MFIs and banks plunging from US$ 563mn to US$ 266mn during the same period. Moreover, PAR (>30 days) increased from 3.6% in Dec'07 to 14.2% in Dec'10.

Post-crisis

Support for the 'No Pago' movement reduced and the sector gained some ground after passage of the MFI Law in 2011. After declining for three consecutive years, the sector grew by ~5% in 2012 and has continued to grow since. In FY14, the loan portfolio of MFIs grew 11% to US$ 210mn backed by a base of 0.25mn customers.

Morocco – FY08

Lending portfolio grew 11x over FY04-FY08, covering ~40% of the population; average loan ticket size increased by 4x

The Moroccan microcredit sector was the largest in the Middle East and North Africa – the cumulative loan portfolio of MFIs had grown 11x to US$ 733mn over FY04-FY08 and the number of clients reached 1.35mn as on Dec'07. This rapid growth, which was fuelled by lax underwriting standards and a lack of regulation, soon proved unsustainable. MFIs had outgrown their capacity and many had begun distributing ever larger loans with longer maturities that borrowers then couldn't afford to repay. Signs of stress surfaced in 2007 when more and more micro-entrepreneurs began turning delinquent.

Impact on the industry

Portfolio risk began to grow considerably from an average of less than 1% at the sector level during 2003-07 to over 5% in 2008 and over 10% in 2009 and 2010. The number of clients served by 13 Moroccan MFIs declined to 0.8mn in 2011 and the cumulative loan portfolio dropped to US$ 552mn.

Post-crisis

The crisis in Morocco was both less severe and shorter than that in Bosnia, Nicaragua, and Andhra Pradesh, lasting for just one year at its worst phase. The market started to stabilise in 2011 with the formation of credit bureaus. The decrease in loan portfolio size was accompanied by an improvement in quality of the portfolio, with PAR (>30 days) reducing to 6% in 2011 from ~10% in 2010.

Andhra Pradesh (Krishna district) – FY05/06

Unease among politicians/bureaucrats and complaints by borrowers fueled the crisis

In early 2005, Dr. YSP Thorat, the then Managing Director of NABARD, presented a paper at a high-level policy conference in New Delhi which highlighted striking similarities between the NBFC failure of the 90s and the FY05 microfinance market. This paper proved to be a harbinger of the Krishna crisis in Andhra Pradesh (AP). In Mar'05, a few people in the Krishna district, including a sitting member of the legislative assembly, alleged that MFIs were chasing high profits and hence charging inflated interest rates, following coercive recovery tactics, offering no clarity on fees and other charges, and forcefully confiscating land documents of borrowers.

Impact on the industry

Following an agitation, district authorities closed down 50 MFI branches operating in the region. The RBI expressed concern to the state government that the actions it had taken could have wider repercussions, jeopardizing ~Rs 7bn of loans given by banks to MFIs. Banks subsequently curtailed lending to the sector. MFI employees were reluctant to visit borrowers' homes due to the hostile atmosphere and hence repayments dropped to 10-20% for a few months after the crisis.

Post-crisis

The crisis was short-lived as MFIs capitulated and promised to adopt a code of conduct for operations and committed to apply for SRO membership. Many MFIs proffered assurances to the state government that they would not engage in multiple lending to the same customers, avoid coercive recovery techniques and charge reasonable interest rates. A favourable policy environment and increased PE/VC funding helped the sector and its loan book to near-double every year over FY07-FY09.

Karnataka – FY09

Pre-event, growth rates, loans per borrower and average ticket size were higher in Karnataka than the industry

Microfinance in Karnataka grew at a rapid pace over FY07-FY09, registering a CAGR of 64% as compared to ~40% for the industry. From FY05-FY09, loan size per borrower grew at 85% per year as compared to 76% for the industry, indicating over-indebtedness. This situation was unsustainable and sparked a rash of market failures across the state of Karnataka (southern regions), starting from the town of Kolar and spreading to Sidlaghatta, Ramnagaram and Mysore.

As per a study conducted by the Association of Karnataka Microfinance Institutions (AKMi), borrowers in the town of Kolar – the epicentre of the crisis – had an average of three loans each. Debt was ~US$ 1,000 per client which was clearly unsustainable. Still, competition among players remained fierce until Dec'08 with many new MFIs entering the region.

Impact on the industry

MFIs suffered from higher default rates in the four affected districts of southern Karnataka

Repayment rates dropped to 20-30% a few months after the crisis. As per the AKMi study, delinquencies increased for all MFIs operating in southern Karnataka. MFIs operating in Kolar district were the most affected, with defaults ranging from 10-70% (35% on average). SKSM registered 8-10% delinquencies in these districts.

Fig 8 - Default rates for MFIs operating in southern Karnataka

Districts	Default range (%)
Kolar	10-70
Sidlaghatta	8-28
Ramnagaram	10-30
Mysore	5-61

Source: AKMi

Post-crisis

Like the Krishna crisis, the one in Karnataka was short-lived and players were able to absorb losses due to rapid growth in other states (mainly AP) in FY08 and FY09. But clearly, no lessons had been learnt, as this was followed by a mega failure in FY10 that affected MFI growth rates across India.

Andhra Pradesh – FY10-FY12

AP crisis of FY10-FY12 sent shockwaves across the industry and led to mass default in the state

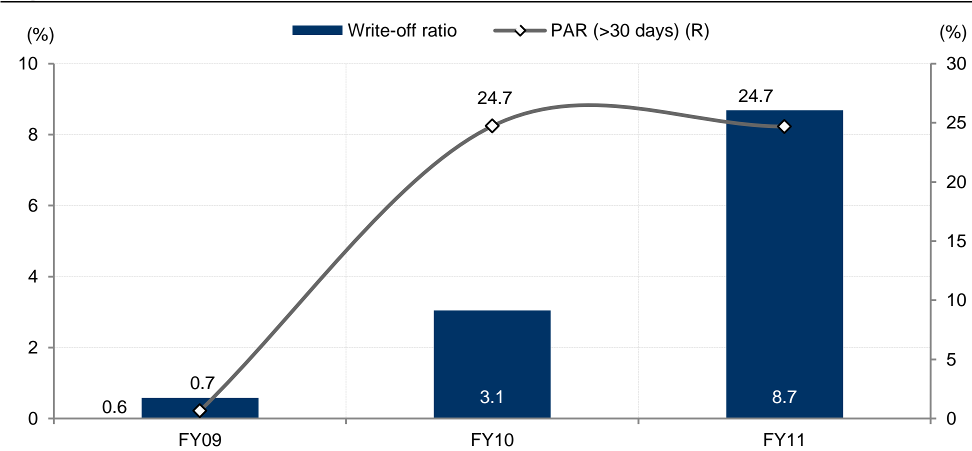
Backed by funding from private investors and banks, MFIs built their loan books at a swift pace – both SHG and MFI loan portfolios in AP grew at a robust CAGR of 48% and 64% respectively over FY08-FY10. However, MFIs failed to learn a lesson from the Krishna and Karnataka crises and did very little to follow the code of conduct laid down by SROs.

In Oct'10, with no warning whatsoever, the AP government issued the Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Ordinance, 2010, with immediate effect, which virtually crippled the operations of MFI players in the state. The ordinance was followed by the draconian MFI Bill 2011.

Impact on the industry

Loan growth and recovery came to a grinding halt as the new bill prevented recovery from borrowers at their workplace and imposed hurdles to fresh lending. Politicians also encouraged non-repayment, which led to massive defaults of ~Rs 72bn by over 9mn borrowers in FY09/10. As a consequence, the asset quality of MFI players worsened and write-offs increased from 0.6% in FY09 to ~9% in FY11. The situation turned so dire that in Sep'11, corporate debt restructuring (CDR) bailout packages had to be rolled out to major MFI players operating out of AP. In all, five of the top six MFIs in India had their debt restructured.

Fig 9 - Massive defaults and write-offs post MFI Bill



Source: Sa-dhan, MFIN

Post-crisis

The main upshot of the AP crisis was that it brought about important regulatory reforms and operational improvements in the microfinance industry. The RBI came out with NBFC-MFI guidelines which required a cap on spreads and restricted multiple lending and over-indebtedness. Capital requirements were tightened and credit bureaus were created to check multiple lending, raising the industry's operational efficiency.

For more details on the three domestic market failures as well as the evolution of India's microfinance industry, refer to the *Appendix on Page 37.*

India MFIs: Structural challenges to growth

The Indian microfinance sector has moved into a high growth phase after recovering from the Andhra Pradesh event. Overall AUM has increased at a 50% CAGR over FY13-FY15, largely on account of higher average ticket size and robust client accretion. And it doesn't stop there. Our meetings with 12 MFIs operating across the country suggest that small to mid-size companies plan to grow at a 50-60% CAGR over the next four years and large players are targeting 30-40% growth through to FY19. These AUM growth targets look highly ambitious, particularly when expansion plans appear focused on newer, unknown geographies.

Overcrowded, saturated market

Traditional markets are saturated pushing players to explore new regions with potentially higher risk

The MFI customer base in most southern and eastern states of India is at disturbingly high levels – we note that the top 5/top 7 states constitute half/two-thirds of total microfinance credit in India. Borrowing per poor household is also very high, implying limited upside potential from higher penetration.

India's microfinance industry is 1.15x MFIN credit

We have collated data on the total microfinance credit disbursed by all players, namely (1) MFIs registered with supervisory body Microfinance Institutions Network (MFIN), (2) MFIs registered with supervisory body Sa-Dhan but not with MFIN, (3) Trusts, (4) Section 25 Companies, (5) Cooperatives, (6) Local Area Banks, (7) Self-Help Groups (SHG) and (8) Non-Profit Organisations (NGO).

Contrary to market perception, microfinance credit outstanding with non-MFIN players (ex-Andhra Pradesh) is substantial at over 50% of total microcredit as of FY14. Therefore, all calculations regarding penetration levels and indebtedness of borrowers (loans outstanding) should take into account non-MFIN credit in our view.

Total market size of microfinance credit is ~115% more than MFIN credit

Fig 10 - Total microfinance credit available in India

	FY14		
(Rs mn)	**No.**	**Rs bn**	**Rs bn (ex-BC loans for banks)**
Cooperative	18	3	2
Local area bank	1	1	1
Sec 25 Company	26	8	6
Society	111	10	7
Trust	21	34	24
NBFCs (ex. MFIN and ex. CDR MFIs in AP)	46	26	26
SHG credit (ex AP)		218	218
Total non-MFIN credit	223	300	283
MFIN credit		249	249
Total microfinance credit		**548**	**532**
Total credit as % of MFIN credit		**121%**	**114%**

Source: MFIN, Sa-Dhan, RCML Research | Note: We provide FY14 data as ex-MFIN lender details are available only till FY14

Per feedback from our channel checks, to avoid double counting we have excluded 30% of credit generated by non-bank/NBFC players (trusts, Sec25 companies, cooperatives and local area banks) as these players act as business correspondence or BC agents and generate considerable SHG business for banks. For example, the largest microfinance trust in India, Sri Kshetra Dharmasthala Rural Development Project (SKDRDP), has a total AUM of Rs 32bn of which ~Rs 23bn is direct lending to borrowers and ~Rs 9bn is BC loans generated for banks.

India Microfinance

Crisis brewing – SELL SKSM

Traditional markets saturated

Southern and eastern states such as Andhra Pradesh, Tamil Nadu, Karnataka, Kerala, West Bengal and Odisha are traditionally the most attractive regions for microfinance in India. These markets have inherent traits that form the backbone of the microcredit industry including relatively high levels of woman empowerment, a mature group culture and small-scale business units. Many MFIs who have expanded to become pan-India players have earned their spurs in South India.

Southern market is highly penetrated; Maharashtra, UP, MP and Bihar are growing rapidly

Fig 11 - Penetration levels for microfinance in India

Jammu and Kashmir
Himachal Pradesh
Chandigarh
Punjab
Uttarakhand
Haryana
Delhi
Arunachal Pradesh
Sikkim
Rajasthan
Uttar Pradesh
Assam
Nagaland
Bihar
Meghalaya
Manipur
Tripura
Jharkhand
West Bengal
Mizoram
Gujarat
Madhya Pradesh
Chhattisgarh
Orissa
Maharashtra
Telangana
Goa
Karnataka
Andhra Pradesh
Pondicherry
Tamil Nadu
Kerala

Microfinance Penetration

- High Penetration
- Medium Penetration
- Low Penetration
- No Penetration

Source: RCML Research

Client base at alarming levels

The MFI customer base as a percentage of total households in most southern and eastern states is alarmingly high. Our analysis suggests that in the five large states of Tamil Nadu, Karnataka, West Bengal, Assam and Odisha, which account for 50% of India's total outstanding microfinance credit, one of every five households has borrowed from MFIs as of FY15. In the top 7 states which account for two-third of total microfinance credit, one of every ten households has borrowed from MFIs.

Top 5/top 7 states constitute half/two-thirds of microfinance credit in India

It will thus be an uphill task to increase the client base in these states. Our channel checks suggest that competition is intense and some districts have 10-12 MFIs battling it out for market share.

Fig 12 - Penetration among households very high in top 5 states

States	Total households (mn)		MFI client base- FY15 (mn)	MFI clients as % of total households	Poor households (%)	Poor households (mn)	MFI client base as % of poor households	GLP (Rs bn)	GLP (% of total)
	FY11	FY15							
Tamil Nadu	18.5	20.0	4.9	24.4	17	3.4	143	57	14
Karnataka	13.3	14.4	2.9	20.4	24	3.4	87	44	11
West Bengal	20.3	22.0	4.6	20.8	27	5.9	78	60	15
Assam	6.4	6.9	1.3	19.2	38	2.6	51	21	5
Odisha	9.6	10.4	1.7	16.1	37	3.8	43	19	5
Madhya Pradesh	15.0	16.3	2.1	12.7	37	6.0	35	24	6
Maharashtra	24.3	26.3	3.0	11.5	25	6.4	47	39	10
Bihar	18.9	20.4	2.1	10.4	54	10.9	19	27	7
Gujarat	12.2	13.2	1.1	8.2	23	3.0	36	NA	NA
UP	33.2	36.0	2.4	6.6	38	13.6	18	33	8

Source: MFIN, Consensus of India 2011, RCML Research

For our calculations above, we have used Census 2011 household data and assumed a 2% CAGR thereafter till Mar'15. To arrive at a figure for unique microfinance clients, we have taken MFIN's latest numbers (Mar'15) as a base and then adjusted for overlaps or duplicate members and also add in clients not covered by the regulatory body.

- **Adjustment for overlapping clients of member MFIs:** As per MFIN's disclosure in its May'15 Micrometer issue, *"The no. of clients stated is the aggregate of clients of member MFIs. Given some degree of overlaps, it does not reflect the number of 'unique' clients*." Note the May'15 issue puts out data pertaining to Mar'15.

  While it is very difficult to determine the number of clients that have borrowed from two MFIs, our interaction with 12 companies and Equifax (credit bureau with 70% market share) suggests that overlapping could be in the range of 25-40%. In the following section, we cross-check this figure via a rough calculation based on the number of active clients with Equifax.

Very difficult to arrive at exact number of unique clients

Fig 13 - Rough estimate of overlapping clients in MFIN database

MFI customers	
No. of active customers with Equifax (in mn)	22.0
- Out of these customers of non-MFIN members (20%)	4.4
No. of active customers for MFIN players per our estimate	17.6
Total active customers reported by MFIN	30.0
Unique clients (%)	59
Overlapping clients (%)	**41**

Source: RCML Research

No. of overlapping clients in MFIN database could be ~40% of the total customer base

Equifax has an extensive database of ~22mn active clients (as of Mar'15). About 140-150 MFIs contribute to the Equifax database and 70-80 of these use the credit bureau's data to run checks on customers. For new loan disbursements, Equifax has a 90-95% hit rate – hit rate captures the probability that a borrower being looked up by an MFI appears in the database. A high hit rate suggests that Equifax data is extensive and fully updated.

The top 50 MFI clients who are also MFIN members account for a majority ~80% of Equifax's customer base. The balance ~100 clients would be sub-20% of the bureau's customer base as they are very small (AUM of Rs 100mn-600mn). For example, 46 NBFCs not registered with MFIN but registered with Sa-Dhan have a cumulative AUM of Rs 26bn, which is less than Rs 600mn on average. Besides this, there are 111 societies giving out microfinance credit but their total exposure is just Rs 10bn. Excluding the client base of these non-MFIN members (20% share), we arrive at a figure of ~18mn which represents the total number of active clients for MFIN credit in Equifax's database.

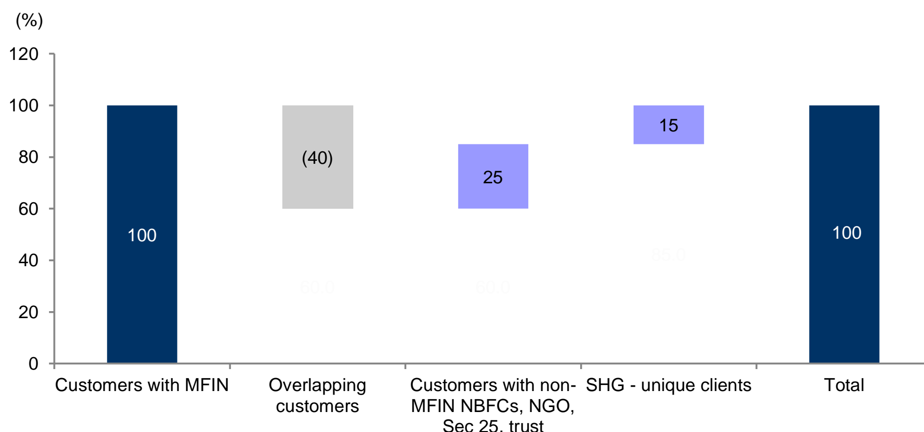
MFIN has reported a total client base of 30mn (as of Mar'15). Our calculation above indicates that unique clients are ~18mn or ~40% less than MFIN's total client base. Accordingly, MFI clients as a percentage of total households should be lower to that extent.

- **Accounting for clients not covered by MFIN:** MFIN data includes customers for the 50 MFIs registered with it. Besides this, there are 250-270 institutions in various legal forms (trusts, NGOs, section 25 companies) operating in India that provide microfinance, but aren't registered with MFIN – they may be either unregistered altogether or affiliated to other self-regulatory organisations such as Sa-Dhan (which has a database of 91 NBFCs).

Customer base of institutions not registered with MFIN more than offsets overlapping customers

In addition, we have the base of SHG clients, who account for an estimated 1.3x of total MFI credit (~1x if we exclude the Andhra Pradesh portfolio). We agree that a majority of households borrow from both sources – MFI as well as SHG. However, even if we assume that ~15% of SHG customers have borrowed from only one source, then unique customers who have availed of microfinance increase further. Overall, we believe the customer base of institutions not registered with MFIN will offset the above overlapping customers.

Fig 14 - Overlapping MFIN customers are offset by non-MFIN and SHG customers



Source: RCML Research

Loan outstanding = No. of households x Ticket size

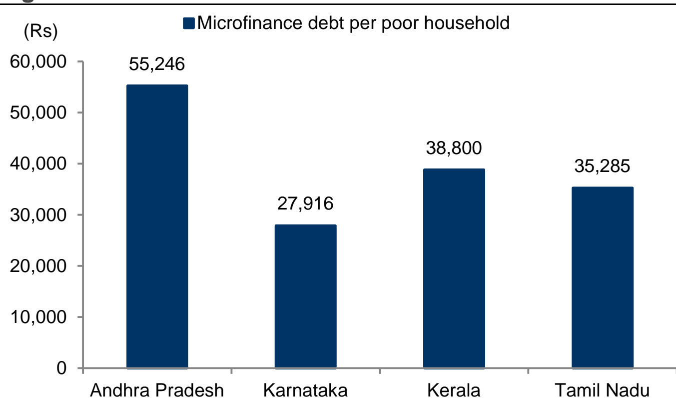
A few of the MFIs we interacted with argued that the number of overlapping households could be more than our estimated 40% figure, implying lower penetration. We highlight that if the number of households penetrated is lower, this in turn implies that the ticket size is higher than that reported by MFIN, thereby limiting growth potential through higher sums of lending.

Borrowing per poor household also high

As of FY14, microfinance debt (MFI + SHG) outstanding per poor household in southern India is currently in the range of Rs 25k-45k. This is very high and limits upside potential from higher penetration. In comparison, central, northern and western India have far lower borrowings per household – Rajasthan, Uttar Pradesh and Bihar have outstanding microfinance credit per poor household in the range of just Rs 3.5k-5k (one-sixth of Karnataka). Even Madhya Pradesh and Maharashtra have lower outstanding microfinance credit per poor household in the range of Rs 5k-9k.

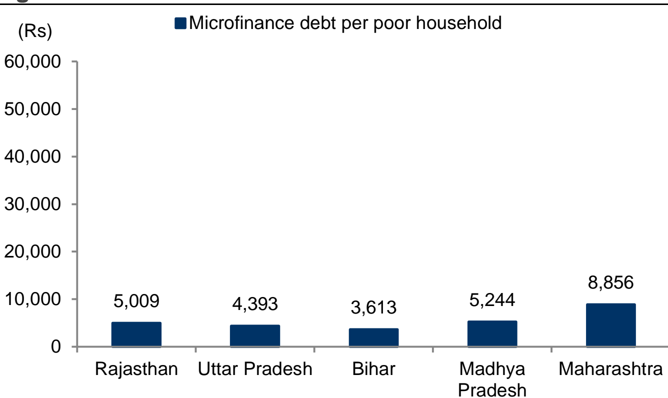
Borrowings per poor household 5-8x higher in South India as compared to North and Central India

Fig 15 - Southern market crowded



Source: Census 2011, NABARD, RCML Research

Fig 16 - Penetration levels low in other states



Source: Census 2011, NABARD, RCML Research

Growth in new regions entails high risk, high opex

Players entering northern and central India in a big way, raising competition levels

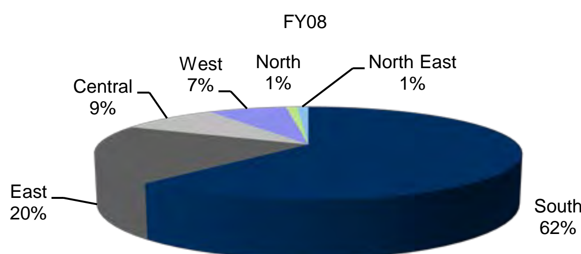
With southern markets saturated and the recent Andhra Pradesh crisis highlighting the concentration risk in South India, MFIs have begun expanding their footprint into newer regions. But differing market characteristics and limited expertise with the new demographic could spell trouble, unless accompanied by appropriately tailored products and investments. Already a few districts in Madhya Pradesh and western Uttar Pradesh have reported asset quality issues in the last one year. NPAs under government-sponsored SHG programmes in these states are 2-3x that of southern states, reflecting the challenging market conditions.

Entry into newer markets

High penetration in traditional markets has led MFIs to expand into newer regions in West (Maharashtra, Rajasthan), North (Uttar Pradesh, NCR) and Central India (Madhya Pradesh). As per MFIN data, 10 new players have entered Madhya Pradesh and Maharashtra in the last three years. At the same time, the number of players operating in the southern states of Andhra Pradesh and Tamil Nadu has declined due to the exit of companies under the CDR (corporate debt restructuring) mechanism.

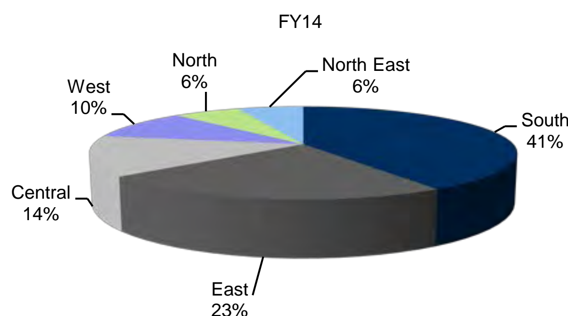
In FY08, southern states accounted for ~60% of total loans outstanding, which has reduced to 40% as of FY14. We expect the trend to continue as MFIs expand rapidly into untapped markets.

Fig 17 - Southern India accounted for 60% of the portfolio…



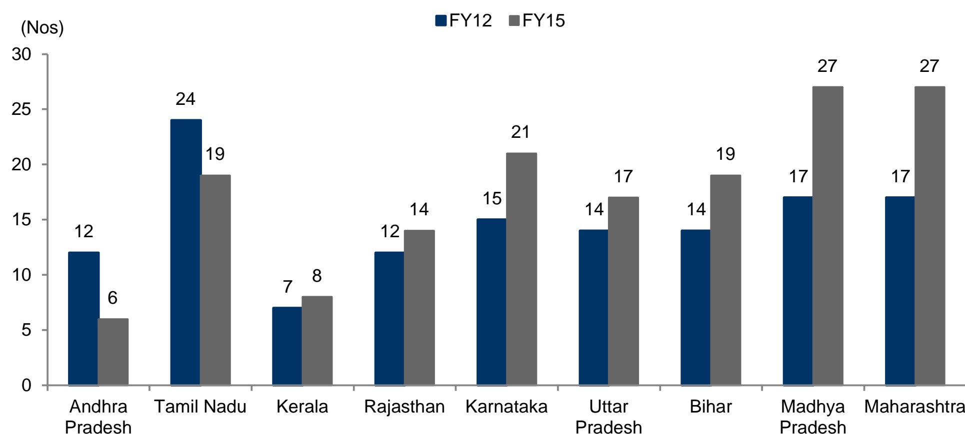
Source: Sa-Dhan

Fig 18 - …but this share is on the decline



Source: Sa-Dhan

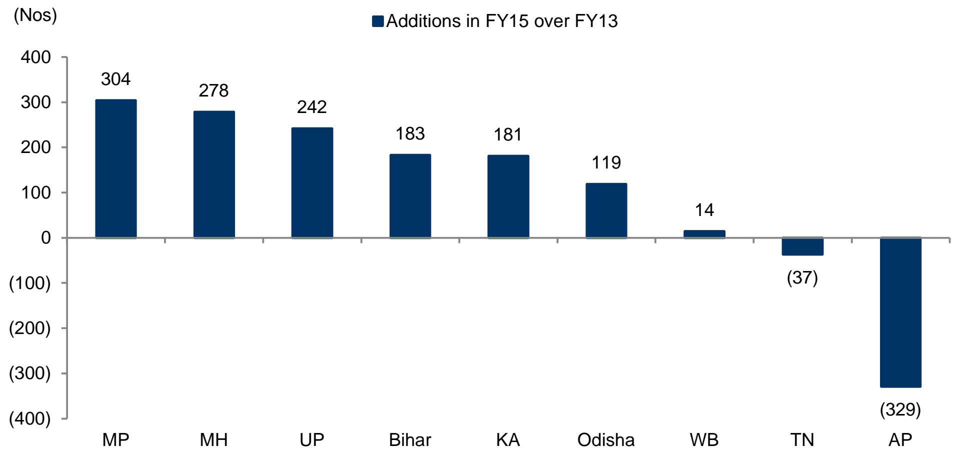
Fig 19 - No. of players operating in northern states has increased substantially



Source: MFIN, RCML Research

The trend in incremental branch additions in the last two years suggests a similar pattern of growth – except for Karnataka, other southern states and eastern states like West Bengal and Odisha have had very few branch additions, whereas newer markets are witnessing rapid network expansion.

Fig 20 - Rapid branch additions in underpenetrated states



Source: MFIN, RCML Research

Fewer branch additions in traditional markets

Immature markets

The newer markets have very different characteristics from southern states. Whereas MFIs prefer joint liability group (JLG) lending to dilute risk and primarily focus on loans to women (whom studies have shown consistently repay better), in newer markets, the group credit culture is still developing and women are less empowered as compared to southern states. MFIs therefore must have a differentiated product offering and will need to penetrate much deeper into these regions to achieve the same level of growth. Future growth would thus come at much higher operating and credit costs, and hence lower ROE, over a cycle.

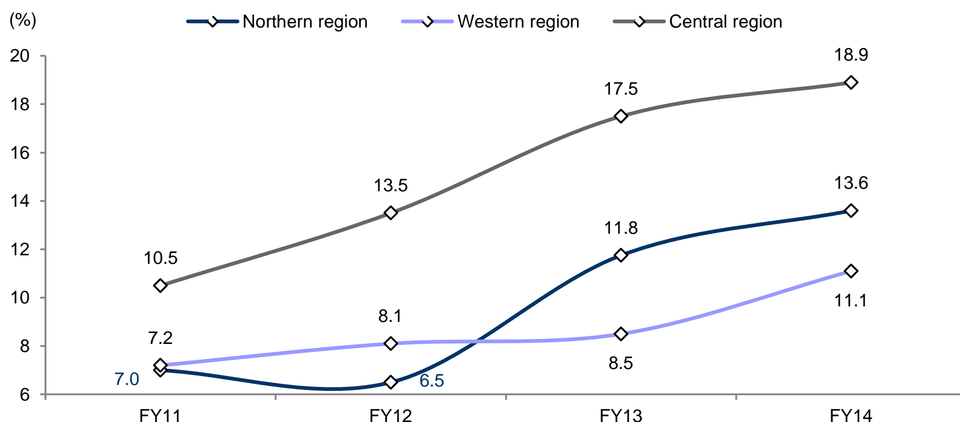
We strongly believe that aggressive growth in new markets without product differentiation, higher investment in manpower and branches, and an understanding and adequate pricing of risks – all of which we aren't seeing enough of – can severely backfire on MFIs.

Asset quality trends in new states discouraging

NPA levels in northern and central states 2-3x higher than southern India, implying a poor credit culture

If we look at the asset quality performance of a comparable subset, viz. SHGs, then southern states have low NPA ratios as compared to non-southern faster growing states. Some industry experts believe that geographical risks too are lower in South India as rains are more or less adequate whereas many regions of Maharashtra, Rajasthan, Madhya Pradesh and Uttar Pradesh suffer from drought and flood-like situations at least once in 3-4 years, raising the scope for defaults.

Fig 21 - SHG – NPAs in northern, western and central regions have gone up

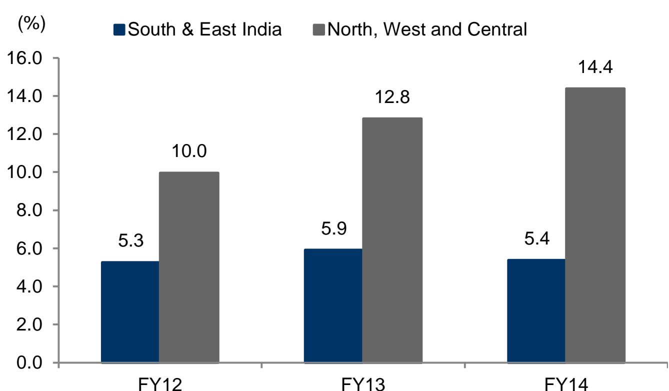


Source: Sa-dhan, NABARD, RCML Research

Matured states (South and East): Karnataka, Kerala, Tamil Nadu, Andhra Pradesh, Odisha and West Bengal

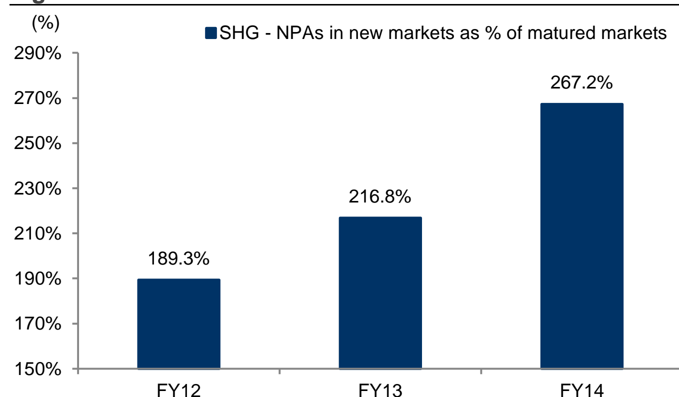
Fast growing states (North, west and central): Gujarat, Rajasthan, Maharashtra, Madhya Pradesh, Uttar Pradesh, Bihar, Jharkhand and Chhattisgarh

Fig 22 - SHG – NPAs much higher in new markets



Source: NABARD, RCML Research

Fig 23 - SHG – NPAs in new markets as % of matured mkts



Source: NABARD, RCML Research

7 microfinance misconceptions debunked

In this section, we discuss seven popular misconceptions that have added sheen to the sector for investors but in fact mask deeper structural concerns. Our crises analysis and channel checks have served to thoroughly debunk these misconceptions and uncover the potential hidden challenges facing the sector.

#1 Credit bureau data is failsafe and foolproof

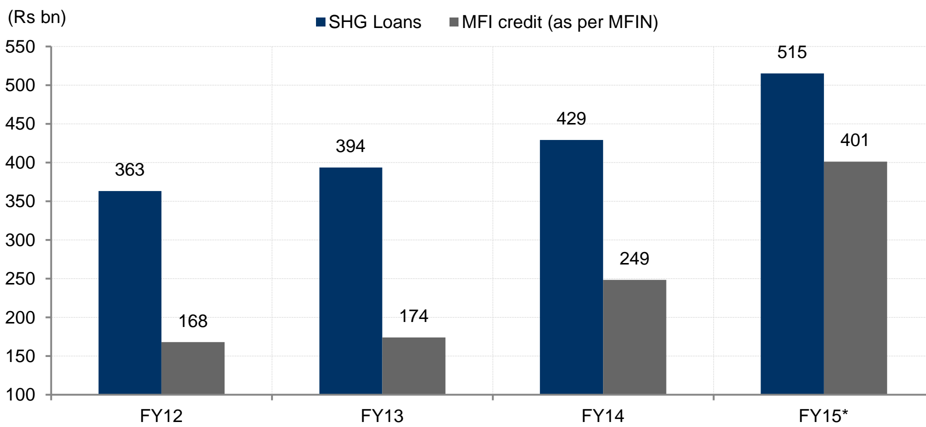
Per our estimates, credit bureaus do not capture as much as 60% of total microfinance credit

We estimate that microfinance credit bureaus, which are the primary source of formal information on the sector in India, do not capture as much as 40% of total microfinance credit data (ex AP). Falling outside their purview are SHG credit (including BC loans), and lending by small MFIs & NGO. In addition, NBFC-MFIs limits are not applicable for individual loans – this renders meaningless any formal analysis of the indebtedness of borrowers and the number of sources through which they have borrowed.

SHG loans are not captured by credit bureaus

As of FY15, total credit under the Indian government's SHG-Bank linkage programme is ~1.3x MFI credit (1x excluding Andhra Pradesh). Banks do not collect member-wise SHG data and are not required to share it with microfinance credit bureaus, leading to a spotty database of microfinance customers. Our checks with MFIs and credit bureaus suggest that there is significant overlapping between MFI and SHG customers, especially in southern India. This could signal repayment difficulties as well as a potential shakeout of duplicate customers if the RBI mandates data sharing by banks, due to (1) the cap of Rs 100k on microcredit that can be availed per person and (2) the cap on number of institutions permitted to lend to an individual (maximum of two).

Fig 24 - SHG loans are 1.3 times MFIN credit



Source: NABARD, MFIN, RCML Research | *FY15 SHG data not available. We have assumed 20% YoY growth as compared to 60% reported by MFIs under MFIN.

BC and individual loans technically do not fall under NBFC-MFI limits

Technically, NBFC-MFI limit does not apply to BC and individual loans, which are likely to constitute ~20% share in 2-3 years

MFIs have started a business correspondence (BC) service for several major private banks including Yes Bank, Development Credit Bank, Ratnakar Bank and IndusInd Bank. Here, loans are originated directly in the banks' books and MFIs receive fees (9-10%) for undertaking the risk. Technically, the limit of borrowing from only two MFIs and the overall limit of Rs 100k does not apply to banks. The BC route accounts for 8-12% of total microfinance disbursements.

This apart, MFIs have started giving individual loans to group customers with higher credit needs. These loans do not come under the JLG scheme and therefore are not required to follow NBFC-MFI norms. Though the proportion of individual loans is small, current trends suggest this can increase to ~10% of total credit by FY17. Many large, seasoned MFIs have suggested that individual loans could form 30-40% of their total AUM by FY19 as growth opportunities under JLG schemes are limited.

Lastly, since membership with credit bureaus is voluntary, there are many small NGOs and MFIs operating in pockets throughout India that neither use the services of credit bureaus nor contribute to any database.

MFIs do not check indebtedness with retail database

Possible overlap between individual or group loans given by MFIs and small-ticket loans given by NBFCs

There are three types of databases in India:

1. Corporate credit database (for companies),
2. Retail credit database (for individual loans such as home/auto loans, personal loans, credit card), and
3. Microfinance database (for group loans given by NBFC-MFIs).

Equifax (credit bureau) and the MFIN data analytics team highlighted to us that MFIs currently check borrower indebtedness only against the microfinance database maintained by credit bureaus. It is possible that borrowers either forming a part of JLGs or availing of higher-ticket individual loans from MFIs have taken loans from other NBFCs as well, for purposes such as used vehicles or housing. At the same time, NBFCs do not check borrower details against the microfinance database before lending. This implies a high possibility of overlap as MFIs increasingly chase larger loans in both the individual/group categories and NBFCs move into low-ticket segments.

New banks may not be required to participate in credit bureaus

Bandhan holds 25% of MFIN credit market share; adherence to NBFC-MFI limits crucial post conversion to a bank

Bandhan Microfinance (~25% market share) is the first MFI to win a banking licence and will be converted into a universal bank in Aug'15. The RBI is likely to issue small bank licences by the end of August – we expect 3-4 licences to be awarded to seasoned players. Technically, banks are outside the preview of MFIN and hence are neither required to disclose their lending to microfinance credit bureaus nor are they governed by lending limits as is the case with MFIs. If microcredit customer data isn't shared and new banks are not required to adhere to borrower limits, we could see a further deterioration in data and asset quality for the sector.

All this implies a gaping hole in credit bureau data

If we aggregate SHG credit, individual loan data and lending by small MFIs & NGOs who don't contribute to the credit bureau database, we find that these bureaus do not capture and/or NBFC-MFI limit does not apply to as much as 61% of total microfinance (45% excluding AP) credit data. This makes an analysis of borrower indebtedness and the sources of their borrowings a futile exercise.

Fig 25 - Credit data not captured / loans which NBFC-MFI limits don't apply

Source of credit	as % of MFI credit
MFI credit (a)	100
Not covered by credit bureaus	
SHG credit (BC loans are included here) (b)	130
Loans on which NBFC-MFI limits don't apply	
Individual loans (part of total credit reported by MFIs) (c)	10
Total loans (a + b)	230
Loans not covered / loans on which NBFC-MFI limit don't apply (b+c)	140
Loans not covered / loans on which NBFC-MFI limit don't apply as % of total	**61%**

Source: MFIN, RBI, RCML Research

Ex-AP, credit bureaus fail to capture 46% of microfinance credit data

Andhra Pradesh accounted for ~50% of total microfinance credit under the SHG category in FY14, whereas MFIs have reduced their exposure considerably to the state after the crisis in FY10. If we exclude SHG credit in the state, credit bureaus still fail to capture 46% of the microfinance credit data.

Fig 26 - Credit data not captured / loans which NBFC-MFI limits don't apply (ex-Andhra Pradesh)

Source of credit	as % of MFI credit
MFI credit (a)	100
Not covered by credit bureaus	
SHG credit* (BC loans are included here) (b)	65
Loans on which NBFC-MFI limits don't apply	
Individual loans (part of total credit reported by MFIs) (c)	10
Total loans (a + b)	165
Loans not covered / loans on which NBFC-MFI limit don't apply (b+c)	75
Loans not covered / loans on which NBFC-MFI limit don't apply as % of total	**45.5%**

Source: MFIN, RBI, RCML Research | *AP accounted for ~50% of total portfolio in FY14. We have assumed the same proportion in FY15

SHG data will strengthen the database but impact near-term growth

Capturing SHG data could lead to breaching of Rs 100k borrowing cap, affecting loan growth

Self-regulatory organisation MFIN and other major MFIs have requested the RBI to direct commercial and regional banks to share member-wise data for SHGs with credit bureaus. This will strengthen the microfinance database and reduce overleveraging by a few customers. Conversely, if data sharing materialises, the resultant shakeout of customers who have breached either the overall borrowing limit of Rs 100k or the number of MFI borrowing sources (capped at two) can affect loan growth in the near/medium term.

#2 Political risk constitutes the biggest and only risk

A common misconception is that the microfinance sector is most vulnerable to political risk and that this risk has subsided considerably after the RBI introduced regulations for MFIs (called NBFC-MFIs), such as the creation of credit bureaus and self-regulatory bodies (MFIN, Sa-dhan). This lower risk perception has attracted a flood of investments and debt funding into the sector from banks and financial institutions.

But domestic as well as international experiences suggest that the sector is equally vulnerable to geographical risks such as flood and drought, macro shocks including economic or sectoral slowdown, and debt traps arising out of liquidity troubles.

Microfinance sector not immune to risks faced by other lending segments

Economic slowdown – Bolivia, FY01: In 2001, Bolivia suffered recession and many borrowers who took multiple loans due to easy availability of finance were unable to repay. Due to the political fallout, the regulator issued a limit on repayment to 25% of the borrower's salary or income, leading to massive losses for MFIs.

Political interference and global slowdown – Nicaragua, FY08: Nicaragua's booming microfinance industry was hit not only by the global slowdown but by political inference, with the government starting a "No Pago" (no payment) movement. PAR increased to 14.2% in Dec'10.

Slowdown in silk industry – Karnataka, FY09: Borrowers in the Sidlaghatta district of Karnataka who were engaged in the silk reeling industry had each borrowed from 3-6 MFIs in order to expand their businesses. However, the purchase cost of raw materials (mulberry silk cocoons) rose sharply during FY09, while the selling price of silk yarn did not move in tandem on account of the global economic crisis – sending MFIs into a tailspin.

Communal riots and religious reasons – Karnataka, FY09: Communal riots broke out in the Mysore district of Karnataka in FY09, resulting in repayment difficulties as the businesses of many small borrowers were completely destroyed. Clerics issued *fatwas* or bans directing women from the minority community not to attend group meetings, stating that these were contrary to the community's cultural and religious norms.

Global slowdown – Bosnia and Herzegovina (BiH), FY09: MFIs in these regions were supported by cheap funding from global parent companies which led to exponential growth during FY06-FY08, accompanied by intense competition and multiple lending where customers were able to borrow from several competing institutions. With the global financial meltdown, the overheated microfinance industry slipped into turmoil – PAR increased to 6% vs. 1% in FY08 and 28% of MFIs were declared seriously indebted.

Poor underwriting standards and lack of regulation – Morocco, FY09: MFIs clocked unbridled growth due to poor underwriting standards and a lack of regulation. When the GFC hit, many borrowers turned delinquent. Unsustainable, unregulated growth led to PAR (>30 days) increasing from 0.4% in FY04 to 5% in FY09.

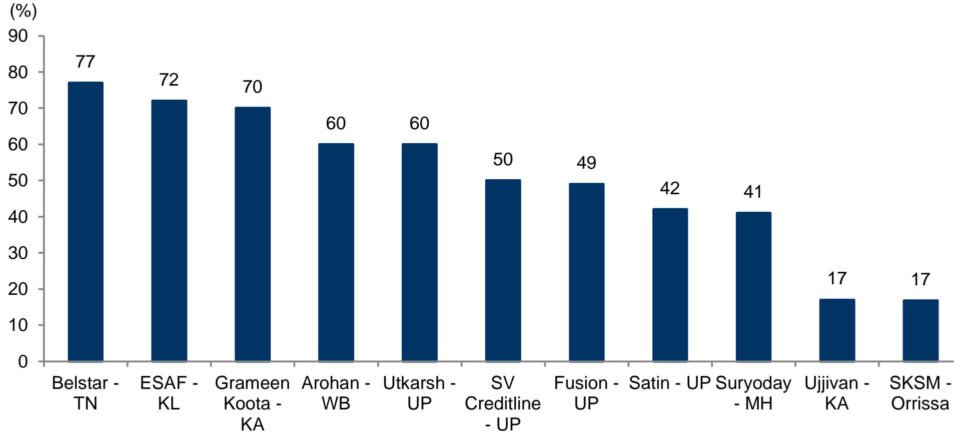
Natural calamities or geographical risks – Pakistan, FY10: Pakistan was hit by heavy floods in FY10 and FY11 which destroyed 21% of its crop area. Approximately one-fifth of Pakistan's total land area was submerged under water. MFI companies had a portfolio worth PKR 4bn in the affected regions, of which ~PKR 3bn worth of loans were declared non-performing (75% of the total).

#3 Diversification considerably lowers risk

Following the Andhra Pradesh microfinance crisis of FY10, five out of the six affected MFIs are still under the corporate debt restructuring (CDR) programme – primarily because their portfolios were state-centric. Heavy concentration in one particular state (+50%) should be avoided at any cost and big MFIs in India have realised this and begun to expand their loan books in other states. But the top 5/top 7 states still constitute half/two-thirds of total microfinance credit in India. Furthermore, all states do not have the characteristics of a successful microfinance market and hence diversification could inject added risk.

- **Top 5/top 7 states still constitute half/two-third of microfinance credit:** Many MFIs still have more than 40% of their loans concentrated in a single state (Fig 27). Thus, any geographic or political disturbance can have a significant impact on financials.

Fig 27 - MFIs with highest single state exposure



Source: Companies

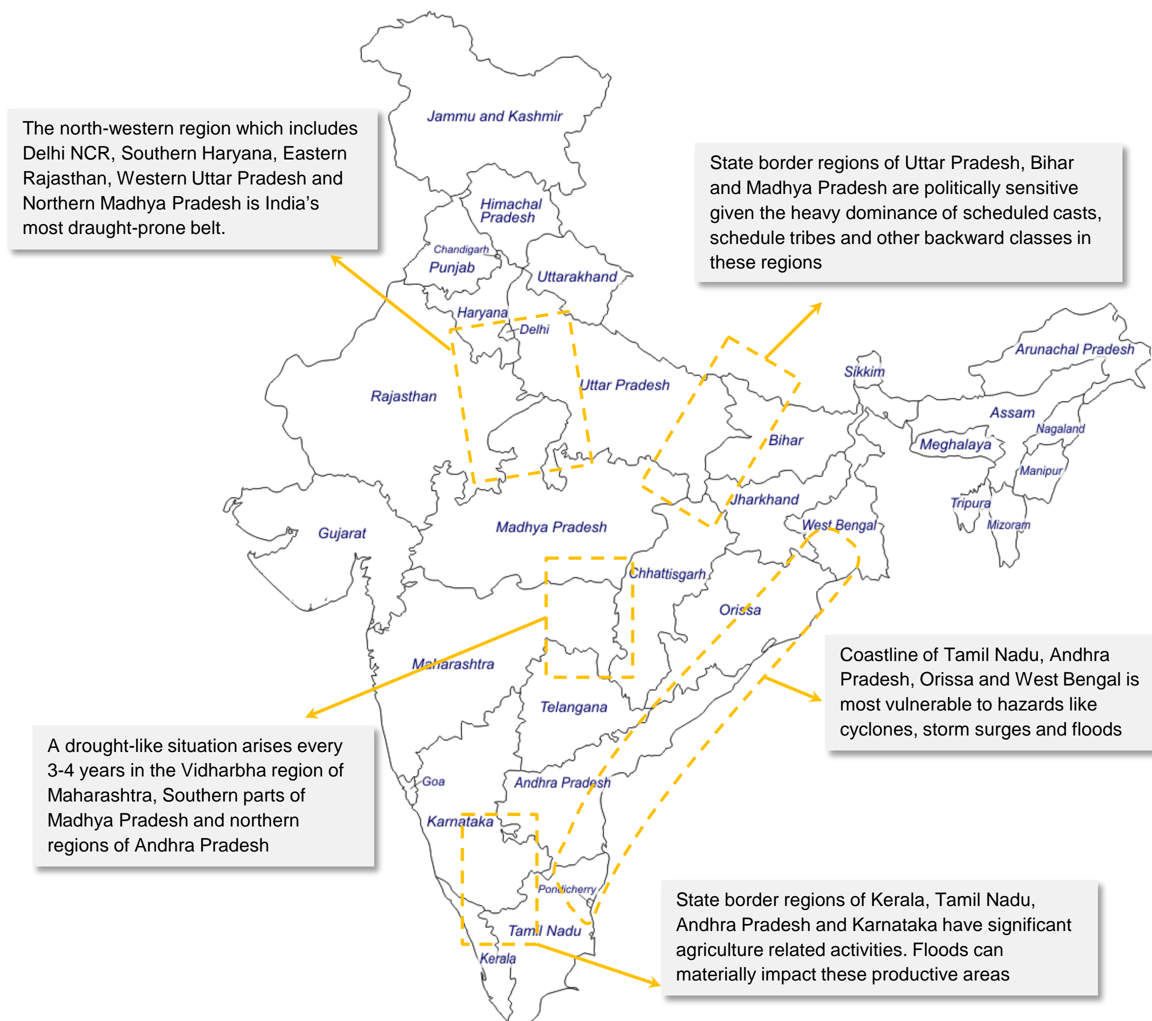
Barring seasoned and large MFIs, small/midsize MFIs have considerable concentration in one single state

- **Diversification may in fact add risk:** Unlike traditional microfinance markets in South India, northern, central and western states have less attractive market traits, in that the group loan culture is still evolving and empowerment of woman (a key client base for MFIs) is low. We believe absorption capacity comes with experience. Aggressive growth in newer regions without adequate understanding or pricing of risks can spell trouble for MFIs.

Crisis can infect states with similar market characteristics

- **Contagion can spread to multiple states:** Many regions in India have similar characteristics in terms of economic activity, political environment and climatic conditions (drought/flood prone). In such cases, a sector-wide crisis can erupt in these states simultaneously or spread across 2-3 states, particularly when accompanied by political backing.

Fig 28 - Crisis can hit multiple states simultaneously



Source: RCML Research

#4 Group lending mechanism ensures recovery in event of default

Group members do not pay up if more than two borrowers in the group default

MFIs are entering into unknown geographies on the premise that the group loan mechanism will act as a cushion. This is only partly true. Historical evidence and our channel checks suggest that the group lending mechanism ensures that people with the same risk appetite and who are familiar with each other come together. As per JLG terms and conditions, every borrower in the group is liable to pay in case of default by any of its member/s.

Past trends indicate that group members have paid for other member/s in case of a delay for 1-2 cycles; however the same is not true in case of a default. This is mainly because every member is leveraged to her utmost capacity and has limited free money at her disposal to pay for the defaulters. This is true particularly when more than two members default. The ability to pay for defaulters decreases as the number of people defaulting in a group increases.

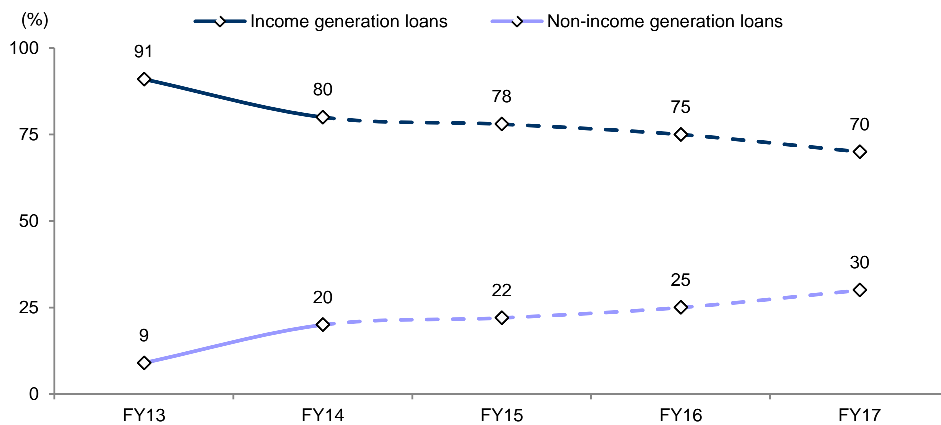
Failure of group mechanism – Karnataka, FY09: This crisis saw a breakdown of the group guarantee mechanism for loan repayment. In many groups, 40-50% of the members defaulted due to communal riots in the state, a slowdown in the silk industry and religious groups' intervention. In a cycle of sorts, some borrowers stopped paying as they felt that MFIs would in any event refuse to lend further to villages that had multiple defaulters.

#5 Consumption loans carry the same risks as income-generating loans

Microfinance players are increasingly giving out loans for consumption purposes as opposed to income generation – we estimate that the proportion of consumption loans will increase to 25% of total loans by FY16 and ~30% by FY17 as compared to 20% in FY14 and just 9% in FY13. In the case of income-generating loans, the underlying cash flow acts as a security for repayment. Further, default risks on consumption loans are high as the proportion of overleveraged customers in this segment is higher as compared to income-generating loans.

Consumption loans more risky than income-generating loans, in our view

Fig 29 - Proportion of income-generating loans to decline



Source: Sa-dhan, RCML Research

#6 Individual loans are as profitable as group loans

Individual loans good for growth but ROE dilutive

Individual loans have high monitoring costs in terms of appraisal and collections, plus there is no pressure from group members to repay the loan. Credit cost assumptions over a cycle should therefore be higher than group loans. Group loans have opex/average assets of 7-8% depending upon scale and size, and credit costs of 0.5-1%.

We believe the operating costs for individual loans will be at least a 100bps higher, while credit cost of 1% would be a best-case scenario. We note that NBFCs lending for income-generating assets such as automobiles incur credit costs of 1.5-1.7% over a cycle.

#7 Income from other sources can support earnings

Selling financial service products and commodities is revenue neutral

The business of selling financial services such as insurance, pension schemes (mainly national pension scheme – NPS), mutual funds or medical policies is revenue neutral. Indeed, the cost of maintaining separate books of accounts, regularly collecting premiums and liaising with insurance & mutual fund companies is almost equivalent to the revenue earned from selling these financial products. Further, several MFIs told us that sales of market-linked insurance or mutual fund schemes have backfired as their customers (typically low income and poorly educated) do not understand the underlying risks. This creates conflicts that tend to tarnish the image of MFIs and affect their main lending business.

Similarly, MFIs can't earn much by selling commodities such as solar lamps, bicycles or low-cost mobile handsets. The cost of storage, pilferage, handling charges and maintenance of books of accounts needs to be taken into account.

The only advantage of selling financial products is that it increases customer loyalty towards MFIs and ensure checks against potential defaults. And the main reason for selling commodities is that MFIs can secure lending opportunities against the same.

Small bank licence – not a game-changer

A big-ticket event for the microfinance sector is the upcoming release of small banking licences by the RBI at the end of Aug'15. Several NBFCs and MFIs have applied for conversion into small finance banks. While this conversion would offer several advantages in the form of reduction in political risk and loan portfolio extensions, we see risks to growth in the near term with ROE likely to halve due to CRR/SLR obligations and high operating costs. Further, only a few large promoters with a strong track record in the financial services industry and reasonable balance sheet size are likely to qualify.

RBI to announce small bank licences by the end of Aug'15

Banking licence norms in a nutshell

- Existing NBFCs and MFIs can opt for conversion into small finance banks after complying with legal and regulatory requirements from various authorities.
- These banks shall primarily undertake basic banking activities of acceptance of deposits and lending to unserved and underserved sections, including small business units, small and marginal farmers, micro and small industries and unorganised sector entities.

Main purpose is to ensure financial inclusion

- Local focus and the ability to serve smaller customers will be a key criterion for licencing.
- Small finance banks will be subject to all prudential norms and regulations of RBI as applicable to existing commercial banks, including the requirement of CRR and SLR.
- The minimum paid-up equity capital shall be Rs 1bn. These banks will be required to maintain 15% capital adequacy (CRAR), of which 7.5% should be tier-1 capital.
- Small banks must extend 75% of their Adjusted Net Bank Credit (ANBC) to priority sector lending (PSL).
- The maximum exposure to single and group loans will be restricted to 10% and 15% of capital funds respectively. At least 50% of the loan portfolio should constitute loans and advances of up to Rs 2.5mn.
- The promoter's minimum initial contribution to paid-up equity capital shall be at least 40%. If higher, it should be brought down to 40% within a period of five years (thereafter 30% within 10 years and 26% within 12 years).
- If the existing NBFCs or MFIs have promoter shareholding below 40%, but above 26%, due to regulatory requirements or otherwise, the RBI may not insist on the promoters' minimum initial contribution.
- Foreign shareholding would be as per the FDI policy for private sector banks. As per the current FDI policy, the aggregate foreign investment from all sources is allowed up to a maximum of 74% of the paid-up capital of the bank (automatic up to 49% and approval route beyond 49% to 74%).
- Individuals (including relatives) and entities other than promoters will not be permitted to have shareholding in excess of 10%.
- Shareholder's voting rights will be capped at 10% but can be raised to 26% in a phased manner by the RBI.
- Listing of small banks on the exchanges will be mandatory within three years from reaching the net worth of Rs 5bn.

The advantages

Reduction in political risk the biggest advantage

Small finance banks will be regulated by the RBI and hence state governments cannot exercise control over them. This will substantially reduce the risk of political interference. We note that the Andhra crisis that resulted in massive losses for MFIs was fueled by political intervention.

Biggest advantage is reduction in political risks and diversification in loan book

However, international experiences suggest that conversion into a bank does not erase this risk entirely. For instance, the microfinance crises in Bolivia (2001) and Nigeria (2005) happened at a time when the sector was well regulated by a single authority. However, public outrage forced the political parties to favour heavily indebted borrowers at the cost of microfinance companies and banks. Thus, it is crucial that political risk is adequately priced into the business model.

Wider loan portfolio

MFI lending is governed by ticket size and is subject to caps on how much an individual can borrow. After conversion into a bank, it will be possible to extend services into higher duration loans such as small-ticket housing, gold loans, and working capital or term loans to the MSME sector. Housing and MSME term lending has a long gestation period which will help small banks expand their loan books rapidly.

Reduced borrowing cost to offset CRR/SLR impact in long term

Since there is no cap on spreads for small finance banks, they can continue to charge steady interest rates despite a reduction in cost of funds, if any. This is likely to offset loss of revenue due to the maintenance of CRR and SLR balances.

Better cross-selling ability

A bank can cross-sell products such as life/non-life insurance and mutual fund products much more easily than a microfinance company, as it has a captive base of savings deposit customers. Banks can also earn additional revenue including retail loan fees and charges on utility bill payments and government fund transfers.

The pitfalls

Near-term pressure on profitability…

ROE likely to halve due to CRR/SLR obligations and high operating cost

Small finance banks will have to comply with all prudential norms and regulations that apply to existing scheduled commercial banks. Therefore, MFIs will have to maintain cash reserve (CRR) and statutory liquidity (SLR) requirements from day one of conversion into a bank.

Banks do not earn any interest on the CRR balance kept with RBI, while SLR can earn interest of 7.0-8.0% as compared to the current loan yield of 22-24% for MFIs. This is likely to weigh on profitability in the near term. Operating cost is expected to go up as small finance banks will have to invest in technology for branch operations and in hiring staff dedicated to building the deposit franchise.

- We expect net interest margins to decline as the new bank will have to borrow from the market and invest in CRR and SLR. This will be a negative carry as borrowing costs (currently at 12-15%) are unlikely to fall immediately while CRR and SLR will earn 0% and 7.0-8.0% interest income respectively.
- Operating cost as a percentage of total assets is likely to go up by 1% due to investment in branch operations for building up the deposit franchise base.

- We expect ROA to decline to ~2% from 3.7% currently for a majority of MFIs and ROE to halve to ~10% for the first one to two years.
- We have not assumed any improvement in leverage immediately.

Fig 30 - Pressure on profitability in the near term

DuPont (%)	Pre-conversion	Immediately post-conversion
Interest Income	22.0	23.7
Interest expenses	9.6	12.8
Net interest income	12.4	10.9
Fee income	1.5	1.5
Total Income	13.9	12.4
Operating cost	8.0	9.0
Operating profits	5.9	3.4
Credit cost	0.3	0.4
Profit before tax	5.6	3.0
Tax	1.9	1.0
RoA (Profit)	3.7	2.0
Leverage	5.0	5.0
RoE	18.5	9.9

Source: RCML Research

…but the impact will be short lived

Relatively small size, short tenure of deposits and scope for improvement in cost of funds will limit negative impact

IDFC Ltd, a large infrastructure lending institution, is likely to be converted into a universal bank from Oct'15. There are concerns over the potential impact on IDFC's profitability with respect to prudential norms such as CRR and SLR and the 40% priority sector requirement for all universal banks in India. As such, we believe the impact on MFI profitability upon conversion to a bank will be lower and short-lived as compared to IDFC. This is mainly because MFIs are growing rapidly and will likely absorb the negative impact much faster. Whereas MFIs are likely to continue growing much above the industry, IDFC has little scope to ramp up growth due to its size and limited market opportunity. For MFIs, improvement in credit rating profile offers another avenue for reducing the cost of funds.

Fig 31 - Comparison between MFIs and IDFC

Parameters	Majority of MFIs	IDFC Ltd
Credit Ratings	BBB+ (just above investment grade)	AAA - highest possible rating
Cost of funds	12-15%	9-10%
Asset size (Rs bn)	Rs 15bn-20bn	Rs 525bn
Growth prospects	40-50% YoY growth	Less than 10%
Branches	Existing branch network can be used for deposits	Needs to build new branches

Source: RCML Research

Hard to build a strong deposit franchise

Priority sector requirement of 75% will limit overall growth

MFIs have succeeded in providing credit to unfunded sectors and regions in India. However, garnering deposits from this category of customers will be a tough task in our view. Therefore, the CASA franchise may remain weak. Further, as per RBI norms, small finance banks will have to maintain the PSL proportion at 75% of the total book as compared to 40% for scheduled commercial banks. This means that the opportunity to grow in other areas, especially high ticket loans, will be limited.

Number of licences to be limited

Base case: Total 5 licenses and around 3-4 to MFIs

The RBI has always exercised tremendous caution when granting banking licences as the funds of small depositors are at stake and missteps could lead to systemic risk. We believe a maximum of five licences will be granted in the first round that is likely to take place by the end of August. Of the five, we expect MFIs to bag three to four licences and the rest could be given to other sectors. We, however, wouldn't be surprised if the RBI hands out only three or four licences including two to existing microfinance companies.

Fig 32 - Private bank licences granted by RBI since 1994

Year	No. of licences	Players who bagged licences
1994	8	HDFC Bank, ICICI Bank, Axis Bank, IndusInd Bank, DCB, Global Trust Bank (merged with OBC), Centurion Bank and Times Bank (later merged with HDFC Bank)
2004	2	Yes Bank and Kotak Bank
2014	2	IDFC and Bandhan Microfinance

Source: RBI, RCML Research

Top contenders for a banking licence

Good corporate governance and clean promoter background essential

We believe promoters with a strong track record of at least 7-10 years in the financial services industry and reasonable balance sheet size (+Rs 10bn) will qualify. Further, since small banks are likely to operate in semi-urban and rural areas with a main objective of improving financial inclusion, key determinants will be transparency and corporate governance. Lastly, the RBI may prefer companies with a simple shareholding structure rather than the NOFHC route.

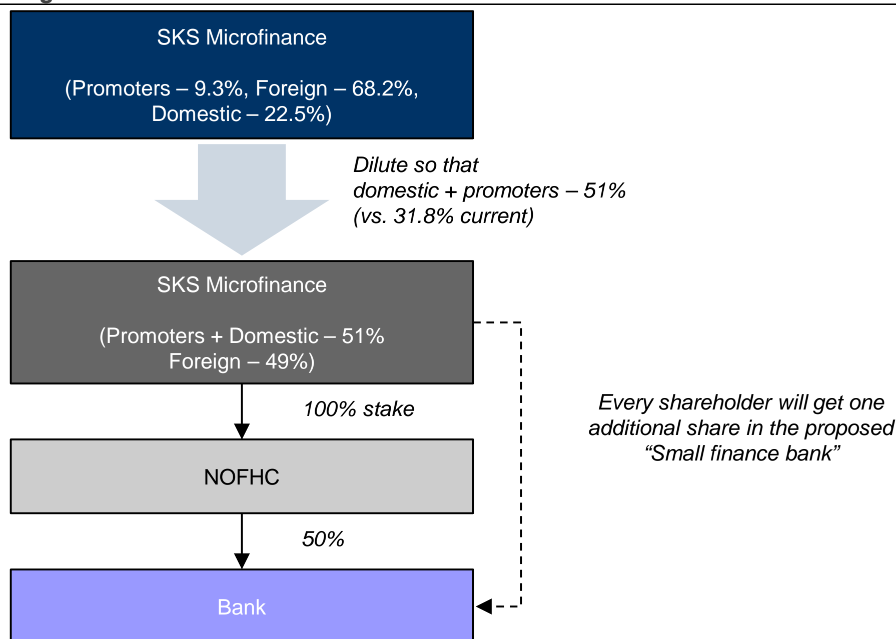
Fig 33 - Top MFI contenders for a banking licence

No.	Companies	Place	Year of commencement	AUM (Rs mn)	States
1	Equitas Holding	Chennai	2007	21,440	7
2	ESAF Microfinance and Investments	Chennai	2008	10,161	9
3	Grama Vidiyal Micro Finance	Tiruchirapalli	2008	10,145	4
4	IntelleCash Microfinance Network Company (Arohan)	New Delhi (Arohan – West Bengal)	2008	38,000	5
5	Janalakshmi Financial Services	Bengaluru	2008	37,736	16
6	RGVN (North East) Microfinance	Guwahati	2010	2,290	5
7	Satin Creditcare Network	New Delhi	2008	21,407	11
8	SKS Microfinance	Mumbai	2005	41,710	19
9	Ujjivan Financial Services	Bengaluru	2005	32,741	24

Source: RBI, RCML Research

We note that a key clause that takes several MFIs out of the running is the 40% initial promoter stake. Most MFIs have raised massive amounts of money from foreign investors in the last 2-3 years to fulfill their growth needs, leading to high FII and low promoter holding. Though MFIs with promoter holding below 40% can float an NOFHC which in turn will own the bank, we believe the RBI could prefer companies with a more straightforward shareholding structure.

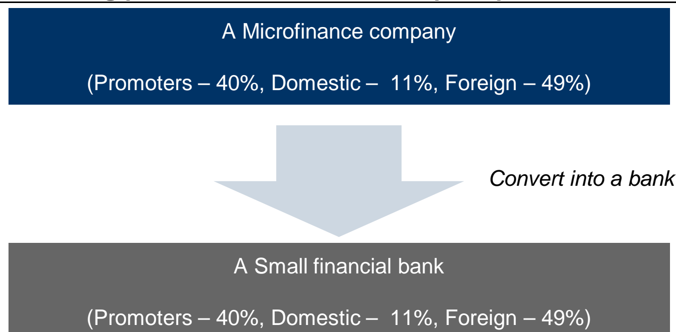
Fig 34 - Microfinance companies will have to float an NOFHC to comply with small bank guidelines



Source: RCML Research

MFIs with promoters' holding below 40% will have to float an NOFHC which in turn will own the bank

Fig 35 - Direct holding possible for MFIs with adequate promoter holdings



Source: RCML Research

MFIs with > 40% promoter holdings and low foreign equity (<49%) can directly convert into a bank

Adequate pricing of risks is essential

Political risk still significant

MFIs across India emphasised to us that political risk was their biggest worry. Any state government can restrict lending and collection activities of MFIs even though the sector is now more organised, with an SRO, centralised database of borrowers and RBI regulations. In our view, the outcome of any adverse political situation can potentially lead to bankruptcy in the event of a heavy write-down of loans. Note that even five years after the Andhra Pradesh crisis, five out of the six affected MFIs are still under CDR. PE investors who had put money into these companies have suffered huge losses. International experiences suggest that conversion into a bank does not erase the political risk entirely.

Higher base-case NPA and credit cost assumptions

MFI lending faces the same risks as other types of lending and this should be priced in

Based on our study of the sector, we believe it would be inadvisable to align credit cost assumptions for MFIs to the regulatory minimum, given (1) the sector is highly vulnerable not only to political risk but also to cyclical pressures (economic or sectoral slowdowns, global slowdowns, natural calamities), (2) looming challenges to growth, especially growth in newer, unknown regions where the cost of operations and credit cost will be higher, and (3) risks from a rising share of consumption loans as compared to income-generating loans.

Our P/B multiple reflects credit cost of 1.5% vs. current credit cost of 0.3-0.4% across MFIs

We believe that the inherent risks for a sector that gives unsecured credit should be reflected in the P/B multiples ascribed to its participants. We set our base-case credit cost assumptions at 1.5% – much higher than the regulatory minimum, and accordingly fix our P/BV valuation multiple for FY17 at 2.8x. Adjusted for higher credit costs, we estimate that microfinance companies should earn an ROE of 17-18% over a cycle vs. 22-24% estimated by the street for FY16 and FY17. We have assumed higher spreads for small MFIs and consequently higher operating costs for them.

We have assumed credit cost of 1.5% as compared to 0.3-0.4% currently

Fig 36 - Du-Pont analysis for MFIs

(%)	Large/mid MFIs	Small-size MFIs
Interest Income	22.0	24.0
Interest expenses	10.0	9.3
Net interest income	**12.0**	**14.7**
Fee income	1.5	1.5
Total Income	**13.5**	**16.2**
Operating cost	7.5	9.0
Operating profits	**6.0**	**7.2**
Credit cost (our assumption is higher than the regulatory minimum)	1.5	1.5
Profit before tax	**4.5**	**5.7**
Tax	1.5	1.9
RoA (Profit)	**3.0**	**3.7**
Leverage	6.0	4.5
RoE	**17.8**	**16.8**

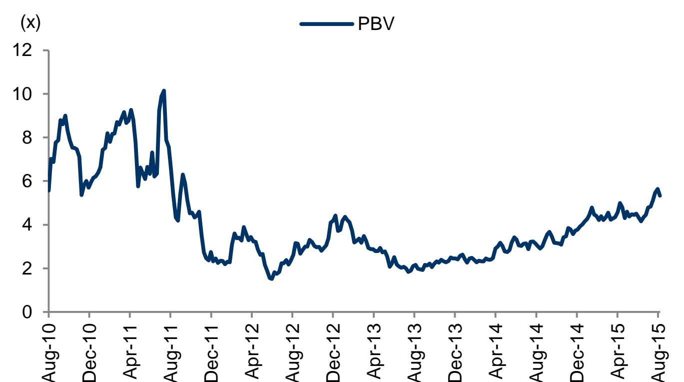
Source: RCML Research, Company

PE/VC investments in unlisted MFIs at steep discount to only listed player SKSM

As per our channel checks, a majority of PE/VC investments in small to mid-size MFIs is at 1.8-2x current BV – a sharp discount to SKSM (listed player) which is trading at ~5x BV. We find SKSM's valuation premium unjustified even after accounting for its superior liquidity and size. In fact, growth potential and the possibility of an increase in sustainable earnings through economies of scale are higher for unlisted companies. We thus expect the valuation gap to be bridged going forward and initiate coverage on SKSM with a SELL rating and a FY17 TP of Rs 400 set at 2.8x P/B (26% downside).

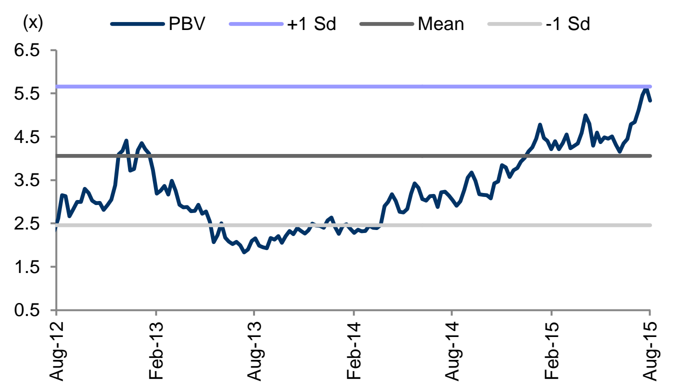
SKSM trading at 6x current BV (Jun'15) looks fairly priced; investment in unlisted MFIs at 1.8-2x current BV

Fig 37 - One-year forward P/B: Pre-AP crisis



Source: Bloomberg, Company, RCML Research

Fig 38 - One-year forward P/B: Post-AP crisis



Source: Bloomberg, Company, RCML Research

Appendix

Looking back: India's microfinance journey

We take you on an interesting ride through India's microfinance industry, starting from the year 2000 when the industry first reported an exponential growth phase and culminating at the current cycle of heady growth and ambitious expansion plans. As we progress on this journey, we stop over at three domestic microfinance failures and make a detailed study of their causes, repercussions and the lessons learnt from each one.

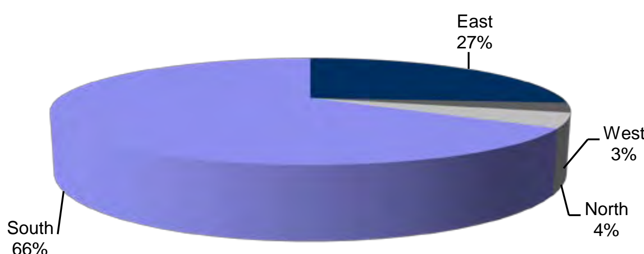
FY00-FY05 – low base, high growth

Microfinance started gaining traction in India in the late 1990s and the first phase of exponential growth was seen between FY00 and FY05. It is estimated that ~800 NGO-MFIs were undertaking financial intermediation by FY04. Annual growth in outreach was strong at 46% and 63% respectively for FY04 and FY05 due to the low base effect.

Southern India accounted for 2/3rd of total customer base followed by Eastern India (~1/4th)

Only a few commercial MFIs accounted for a bulk of the outreach (branch presence) in India, with an outstanding portfolio of ~Rs 16bn at the end of FY05. The industry was highly fragmented but South India was always the primary focus, with the states of Andhra Pradesh (undivided) and Tamil Nadu seeing maximum coverage in FY05.

Fig 39 - MFI outreach in FY05



Source: Sa-Dhan

Growth in MFI outreach over FY04-FY05

Regions (%)	FY04	FY05
East	32.7	61.1
West	42.2	31.4
North	19.5	11.3
South	51.7	67.5
Total	**45.9**	**62.9**

Source: Sa-Dhan

NABARD policy meet forewarns a crisis

In 2005, Dr. YSP Thorat, the then Managing Director of the National Bank for Agriculture and Rural Development (NABARD), presented a paper entitled *Regulation and Areas of Potential Market Failure in Microfinance* at a high-level policy conference in New Delhi, chaired by a Senior Joint Secretary of the finance ministry. As outlined below, the paper highlighted striking similarities between the microfinance market in 2005 and the NBFC failure of the 90s and illustrated several potential areas where market failure could indeed occur, especially post the rapid growth seen over FY00-FY05. The paper called for a single regulatory body, while pointing out that political interference in the sector appeared to be increasing at the local level.

Striking similarities between 90s NBFC failure & 2005 microfinance market (Dr. Thorat)

Paper presented by NABARD brought out several issues facing the microfinance industry

- **Burgeoning growth:** Rapid growth of institutions and portfolios – be it clients, groups or loans – enhances several risks such as political risk, fraud risk, operational risks and the like, which need to be immediately addressed.

- **Lack of regulation:** Microfinance lending in India is undertaken through a variety of entities such as trusts, societies, mutual benefit trusts, NBFCs and traditional cooperatives. Each of these cannot be regulated and supervised by different authorities. This calls for a single regulatory authority for all models and forms of microfinance.

- **Profit orientation fuelling growth amid inadequate administrative capacity:** The increasing profit orientation of the microfinance industry versus not-for-profit goals earlier is attracting private investors, and suppliers of finance to the industry have grown significantly. There is a serious risk of rapid growth fuelled by the supply (wholesaler) side but unsupported by appropriate growth in MFI systems and administrative capacity.

- **Corporate governance, transparency in infancy:** Governance and transparency are at a nascent stage in the industry and require considerable strengthening. Institutions must address these constraints through the induction of professionals at various levels including at board, senior management and operational levels.

- **Lack of KYC norms:** With the high growth in clients and use of outsourcing agents, it is imperative that the sector begins to implement KYC (Know Your Customer) norms. This is the only way to reduce institutional failure due to ghost clients, ghost branches and ghost fieldworkers and also prevent diversion of funds from microfinance.

Fig 40 - MFI situation in 2005 was similar to NBFCs in 1990s

No	Parameters	NBFC situation of the 1990s	Microfinance situation in 2005
1	Growth	Explosive growth	Burgeoning growth
2	Promoter group companies	Group companies present	Several entities under a promoter group
3	Diversion of funds	Funds diverted to group companies	Possibility of non-transparent transactions between group entities – a serious risk
4	Regulations	No serious regulator and lack of coordination among regulators	No single regulator – multiple regulators with different levels of supervision and no proper coordination
5	Ghost transactions	Ghost plantations were a primary cause of the failure as the same plantations were sold to many investors	Possibility of ghost clients, ghost branches and ghost fieldworkers. Same clients shown as borrowers for loans from multiple lenders
7	Poor systems, MIS	Weak governance, poor MIS and controls, and very little risk management	Weak governance, MIS and controls and perhaps, very weak risk management functions
8	No control on lending / deposits	'Cheap' and unlimited public deposits	By and large, collateral-free, soft interest, condition-less (no personnel guarantee) loans
9	Outcome	NBFCs failed leading to a loss of money for depositors, and loss of faith in the NBFC system among bankers and the public	??

Source: Regulation and Areas of Potential Market Failure in Micro-Finance by YSP Thorat, RCML Research

The microfinance industry dismissed the issues raised by the paper, saying it had good systems in place which could adequately protect against systemic risks. However, many industry experts argued that the paper planted unease about the microfinance industry among bureaucrats, government officials and politicians.

FY05/06 – Andhra Pradesh (Krishna) crisis

50 branches closed following complaints of high interest rate and coercive collection techniques

Microfinance institutions operating in the Krishna district of Andhra Pradesh (AP) faced a crisis in Mar'05 when a few people, including a sitting member of the legislative assembly, alleged that MFIs were charging inflated interest rates, following coercive recovery tactics, offering no clarity on fees and other charges, and forcefully confiscating land documents of borrowers. The late Dr. Rajasekhar Reddy, then Chief Minister of AP, visited Guntur and Krishna districts and asked the collector to enquire into these allegations.

MFIs stated that local politicians were unnecessarily accusing them of charging high interest rates. They argued that since SHG members were increasingly joining their JLGs, MFIs were directly competing with the SHG-Bank linkage programme sponsored by the state government, creating vested political interests.

Repayments dropped to 10-20% from 99% for a few months after the crisis

Following an agitation, district authorities closed down 50 MFI branches operating in the region. This was short-lived, however, as MFIs capitulated and promised to adopt a code of conduct for operations and committed to apply for SRO membership. Many MFIs proffered assurances to the state government that they would not engage in multiple lending to the same customers, avoid coercive recovery techniques, charge reasonable interest rates, refrain from approaching SHG customers and reduce consumption lending. Branches were permitted to open soon after these assurances. However, employees were reluctant to visit borrowers' homes due to the hostile atmosphere and hence repayments dropped to 10-20% for a few months after the crisis.

The RBI expressed concern to the state government that the actions it had taken could have wider repercussions by vitiating the MFI repayment culture in other parts of the state, jeopardizing ~Rs 7bn of loans given by banks to MFIs in AP. The state government then set up a Coordination Forum to discuss the matter. At a meeting of the forum held on Apr'06, the AP government claimed that the MFI movement was "eating into the SHG movement", MFI practices were "barbaric" and posed a serious law and order problem, and that even the lower interest rates of ~24% suggested in the Mar'05 code of conduct were usurious and illegal.

The state government further argued that loans given under the SHG model were far more transparent with respect to various terms like rate of interest, penalty in the event of failure, loan recovery and tenure.

Impact on the industry

Banks' lending curtailed but equity investments helped

The Krishna crisis had a short-term impact on the sector as banks stopped lending to MFIs for six months to a year. Commercial banks, especially in the private sector, were reluctant to lend to MFIs as a few banks had lost a significant amount of money during the turmoil. Banks were also worried about the political risk and some of them increased lending rates. MFIs thus ran short of resources to finance their growth plans.

Post-crisis

Equity investors helped MFIs overcome the temporary liquidity problem. The sector began to grow once again post-2006. In FY07 and FY08, the microfinance industry received equity infusions of ~US$ 130mn from PEs/VCs. MFI network "Sa-Dhan", set up by the MFIs framed a code of conduct for its members in Mar'06 and assured the AP government that it would ensure strict implementation of its code. The code was pro-client and contained several features to alleviate client troubles apparently caused by MFIs.

Sa-Dhan's Voluntary Mutual Code of Conduct for MFIs, Mar'06

Self-regulatory body Sa-Dhan framed a code of conduct post-crisis

- MFIs will ensure that they complement the credit provided to poor households under the SHG-Bank linkage programme, and especially extend services to those not served adequately by banks.
- MFIs will avoid over-financing of the same household by different institutions, by informal information sharing on operations among themselves and with banks engaged in SHG lending.
- MFIs will charge reasonable interest rates and MFIs will indicate interest rates, including loan processing and other charges, on an annual percentage rate basis (effective rate on declining balance).
- MFIs will not take original land titles, house *pattas* (home registration documents), ration cards and other documents as collateral security for loans but can take copies of these for fulfilling the RBI's KYC norms.
- MFIs will strictly instruct staff members not to use abusive language or intimidation tactics while collecting repayment and will dismiss those staff members who do so.
- MFIs will adopt a high standard of corporate governance, with eminent independent board members, fully involving them in policy-related decisions.

FY06-FY10 – Rapid growth fuelled by favourable policy environment

Priority sector tag and government focus on financial inclusion helped the sector to grow rapidly

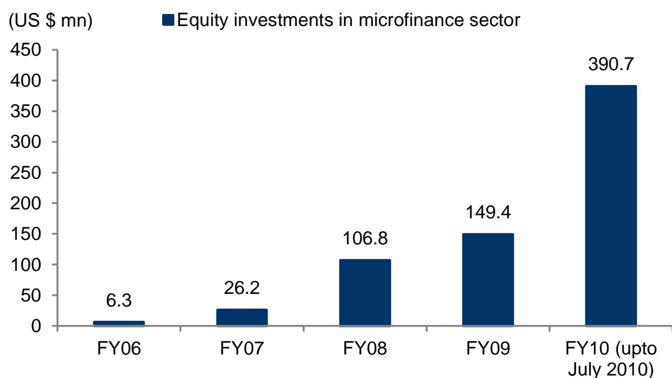
Two committees created by the government on (1) financial inclusion – chaired by C Rangarajan and (2) financial sector reforms – chaired by Raghuram Rajan, made a strong pitch for reforms in the financial sector to enable greater financial inclusion in the country.

Banks in India are required to have 40% of their total lending directed to the priority sector. Many banks fell short of this target due to a lack of branch network in rural areas and limited expertise in lending to the priority sector, but they had the option to make up this shortfall by buying loans from NBFCs that catered to priority sectors. Loans given to MFIs were classified as priority sector lending (PSL) for banks, who could even buy the securitised portfolio of MFIs in order to fulfill their targets. This led to rapid growth in bank lending to MFIs at a lower rate, enabling the microfinance industry to grow its loan book at a rapid pace over FY06-FY10.

Return of debt and equity funding

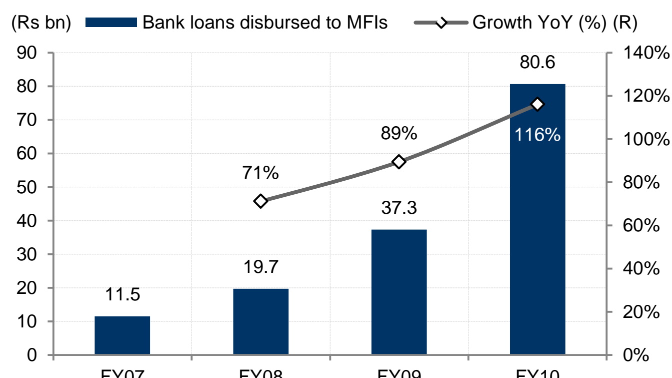
During this phase, the microfinance industry attracted a lot of attention as a poverty alleviation tool, given its success in Bangladesh. This resulted in a large flow of debt and equity funds from banks and PE investors respectively. Equity investment in the sector surged from a mere US$ 6mn in FY06 to US$ 150mn in FY09 and US$ 390mn in FY10. Similarly, bank lending to the sector grew at an exponential rate – disbursements to MFIs were at Rs 11bn in FY07 which increased to Rs 81bn by FY10.

Fig 41 - Equity investments gather momentum



Source: Sa-Dhan

Fig 42 - Rapid growth in bank credit to MFIs

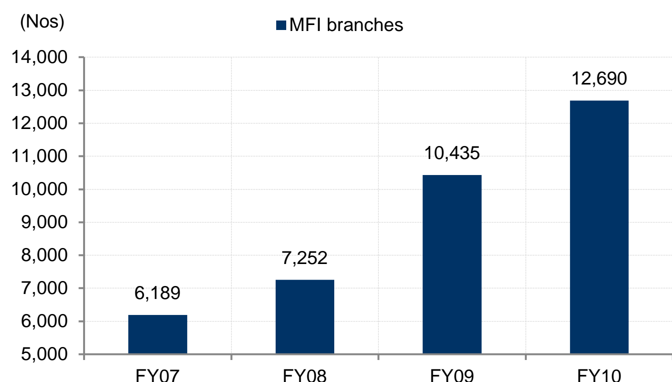


Source: RBI

Large-scale expansion in branches and employees

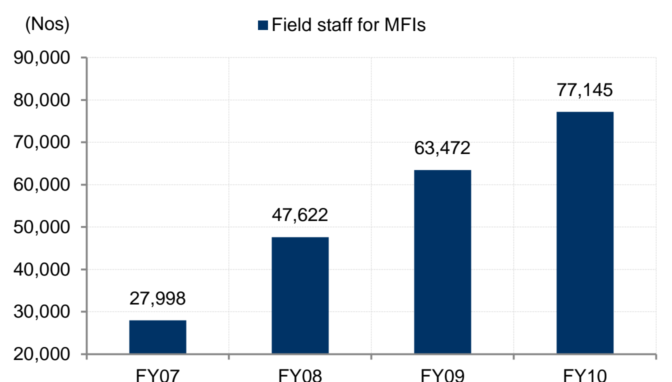
With ample funding support, MFIs undertook large-scale expansion from FY07 onwards, soon after the Krishna crisis. The industry's loan book doubled almost every year due to expansion in branches and employee base.

Fig 43 - Branches doubled in three years



Source: Sa-Dhan

Fig 44 - Field staff increased by 2.8 times



Source: Sa-Dhan

Loan book doubled every year over FY07-FY09

MFIs experienced burgeoning growth from Apr'07 to Mar'09 – adding the largest number of active borrowers and disbursing the largest amount of loans in their history. Players in South India recorded the highest growth and their client addition during FY07-FY09 was 3-5 times that seen over FY05-FY07. The overall loan book grew ~12x during this period.

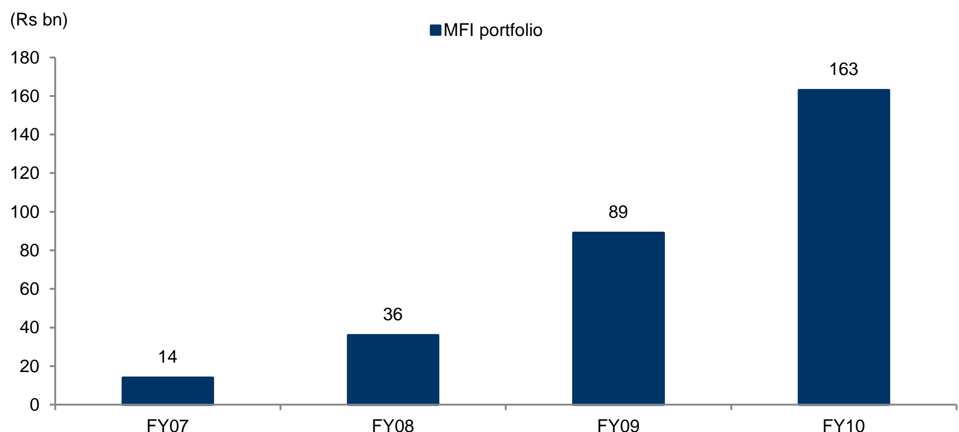
Southern India-based MFIs added 3x clients in FY07-FY09 as compared to FY05-FY07

Fig 45 - Rapid expansion in client base

	No. of clients added ('000)		
	FY05-07	FY07-09	Growth (%)
SKS Micro	1,457	4,166	186.0
Spandana	467	2,474	429.5
Share Microfin	175	1,368	679.4
Basix	162	809	399.1
Asmitha Microfin	172	774	349.6
Trident Microfinance	8	167	1,919.7

Source: Sa-Dhan

Fig 46 - Loan portfolio grew by ~12x over FY07-FY10



Source: Sa-Dhan

FY09 – Karnataka crisis

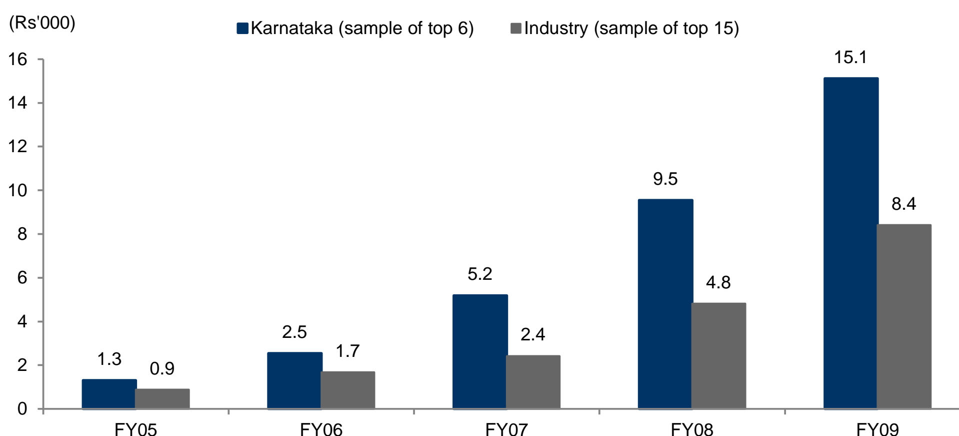
Average loan size grew at a much faster rate in Karnataka as compared to the rest of the industry

Microfinance in Karnataka grew at a blistering pace over FY07-FY09, registering a CAGR of 64% as compared to ~40% for the industry. Karnataka was the second fastest growing microfinance state in India during FY08-FY09. Over FY04-FY09, the number of clients in the state grew at 74% per year, slightly slower than the top 15 MFIs in the country (80%), but the increase in loan size was at 85% per year compared to 76% for the top 15 MFIs.

In FY09, this growth proved unsustainable and MFI failures began to spread like a contagion across the state's southern regions, starting from the town of Kolar and spreading to Sidlaghatta, Ramnagaram and Mysore. The attempted suicide of a prominent member of the minority community in Kolar in Jan'09 sparked the crisis. The resulting delinquency amongst minority clients spread to other towns as a variety of vested interests came into play.

As per a study conducted by the Association of Karnataka Microfinance Institutions (AKMi), borrowers in the town of Kolar – the epicentre of the crisis – had an average of three loans each. Debt was ~US$ 1,000 per client which was clearly unsustainable. Nevertheless, competition among players remained fierce until Dec'08 with many new MFIs entering the region.

Fig 47 - Average loan size over FY04-FY09



Source: AKMi

Karnataka MFI statistics before crisis

Particulars	
No of MFIs in the State	27
Client base (mn)	3.2
Loans (Rs mn)	214.8
No. of district served	**29 (all)**
- No. of poor districts	10

Source: AKMi

AKMi data confirmed over-indebtedness and multiple lending

AKMi's study team visited the affected districts and confirmed that 25-50% of clients had more than one loan from the seven MFIs covered in the study. Adding the clients of MFIs that did not cooperate with the study, the team believed the figure would rise to 40-70%. The addition of loans provided by SHGs would raise the levels of over-indebtedness further. Since it is highly unlikely that the entire financially excluded population would have borrowed – as not everyone feels the need for credit – AKMi's calculation confirms the impression that clients in Kolar had an average of three MFI loans each.

Fig 48 - Rough indication of multiple memberships

Particulars	Assumptions	Kolar	Sidlaghatta	Ramanagaram	Mysore
Population, 2001		1,13,299	41,105	79,365	7,99,228
Estimated population 2009		1,33,000	52,000	1,00,000	10,00,000
No. of families	5.1 persons/family	26,100	10,200	19,200	1,92,000
Financially excluded families (%)		70%	80%	80%	60%
Financially excluded families		18,200	8,000	15,000	1,15,000
Borrowers, March 2009		36,200	8,000	22,500	55,000
Extent of coverage	Less 10% of financially excluded	2.2	1.1	1.6	0.5

Source: AKMi

Kolar – Over-indebtedness, multiple lending and the religious divide

Reasons for the Kolar debacle were largely similar to the Krishna crisis – as per a post-crisis study released by the Association of Karnataka Microfinance Institutions, key reasons included aggressive loan book growth, lending by many institutions to the same set of borrowers, coercive collection methods and non-cooperation with a local organization.

Members committing suicides and religious reasons trigged the crisis

Further, since MFIs prefer women as clients (as they typically have a better repayment profile than men), there were concerns amongst the town's minority (Muslim) community that MFI requirements such as group meetings at central places, contact with unrelated men and filing of personal photographs, were flouting the basic socio-cultural norms of the community. In addition, some members attempted suicide due to over-indebtedness which led the local community body to issue a fatwa for non-repayment of loans.

Sidlaghatta – Taking a leaf out of Kolar's book

Borrowers engaged in the silk reeling industry took multiple loans from as many as 3-6 MFIs to expand their businesses and began to default in Mar'09 when the purchase cost of raw materials (mulberry silk cocoons) rose sharply, but the selling price of silk yarn did not move in tandem due to the GFC. According to media reports, Sidlaghatta's default was largely willful and directly related to the Kolar incident, with the Masjid Committee in Sidlaghatta, aided and abetted by the local councilor, declaring that none of the clients should repay their loans to MFIs.

Ramnagaram – Business rivalry and trouble in the silk industry

Silk industry went through a tough time due to the global financial crisis

Silk factory owners in Ramnagaram were also the local moneylenders. They would give loans to workers who were made to work at substantially low daily wages in return. Some borrowers highlighted that they had been working in these factories all their lives and would still never be able to repay the loan.

Businessmen and cleric nexus resulted in non-payment

Because of the fair practices of MFIs and relatively cheaper loans offered, many of the Muslim women who worked as casual labour in the silk reeling industry managed to free themselves from the factories. However, this had a direct impact on the workforce in

these factories. Some media articles pointed to a strong nexus between silk reeling factory owners and religious clerics who issued a fatwa for non-payment of loans for religious reasons.

Mysore – Communal riots

In Apr'09, communal riots broke out, affecting the minority community engaged in the silk industry and leading to repayment difficulties. Local political groups accused MFIs of charging high interest rates and exploiting customers. Many borrowers stopped payment as their businesses were completely destroyed in the riots.

Impact of the crisis

MFIs suffered from higher default rates in the four affected districts of southern Karnataka

Repayment rates dropped to 20-30% a few months after the crisis. As per the AKMi study, delinquencies increased for all MFIs operating in southern Karnataka. MFIs operating in Kolar district were the most affected, with defaults ranging from 10-70% (35% on average). SKSM registered 8-10% delinquencies in these districts.

Fig 49 - Default rates for MFIs operating in the southern Karnataka

Districts	Default range (%)
Kolar	10-70
Sidlaghatta	8-28
Ramnagaram	10-30
Mysore	5-61

Source: AKMi

Lessons learnt

Group mechanism not failsafe

- In all of the above failures, MFIs faced a breakdown of the group guarantee mechanism for loan repayment. Group members can stand in for 1-2 defaulting members (out of say 10), but in the event that more members default, it becomes impossible for the rest to pay.
- Religion can play a key role as seen from communally charged Ramanagaram, where tensions built when clients from one community approached the others to repay, which worked against the group guarantee mechanism.
- The non-repayment cycle was exacerbated as borrowers felt that MFIs would no longer cater to villages with multiple defaults, leaving them with no reason to repay their loans.
- Defaults are not restricted to borrowers who cannot pay. Borrowers who paid back in full were denied incremental loans if group members defaulted. Considering this, many borrowers who had the capacity to repay defaulted willingly.

Microfinance industry not ring-faced from inherent risks faced by all segments of lending in India

Avoid excessive competition, multiple lending

- Kolar and Ramnagaram had ~10 MFIs along with unorganised moneylenders, leading to unhealthy competition in a market that couldn't sustain the same.
- Some MFIs adopted harmful practices such as non-payment of salaries if their staff failed to get 100% repayment. This resulted in undue repayment pressure by employees on clients.
- MFIs failed to share client details which enabled borrowers to take loans from multiple sources, creating a debt-trap when crisis hit.

FY10-FY12 – Andhra Pradesh statewide crisis

The AP crisis was no different from that in the Krishna district in terms of triggers, but the scale was much larger, spreading across the state and taking a toll on some of the then largest MFIs in India. In this section, we look at the contributing factors and outcome of the worst microfinance failure in the industry's history, including the RBI's intervention to put the crippled industry back on track.

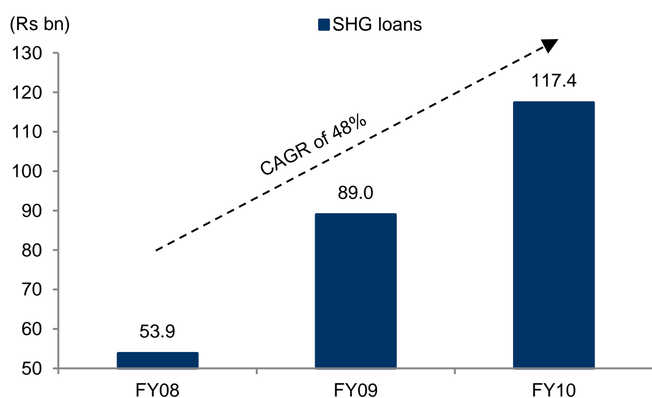
What caused the failure

MFIs failed to adhere to voluntary code of conduct accepted by them in FY06

- **No lessons learnt from Krishna and Kolar:** MFIs failed to learn a lesson from the Krishna crisis and did very little to follow the code of conduct laid down by SROs. Given lax regulatory oversight, they continued with multiple lending, high interest rates and coercive practices to recover loans. The sector grew at a heady pace over FY06-FY10 until the AP government brought in a stringent ordinance to regulate its activities.

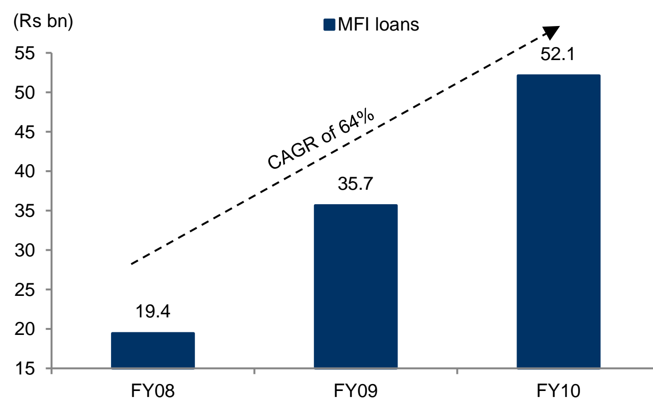
- **Intense competition led to undue risk-taking:** Backed by funding from private investors and banks, MFIs built their loan books at a swift pace – both SHG and MFI loan portfolios in AP grew at a robust CAGR of 48% and 64% respectively over FY08-FY10. Competition between SHGs and MFIs and also among MFIs themselves intensified in FY09 and FY10, with MFIs often chasing the same set of customers.

Fig 50 - Sharp growth in loan book for SHG loans in AP



Source: State of the Sector Report 2011

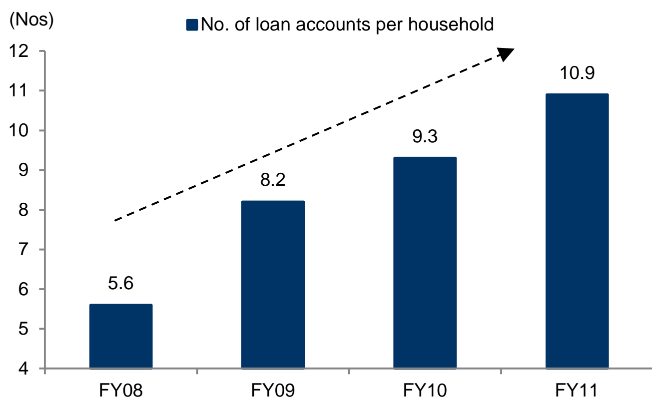
Fig 51 - MFI loans in AP grew at a CAGR of 64%



Source: State of the Sector Report2011

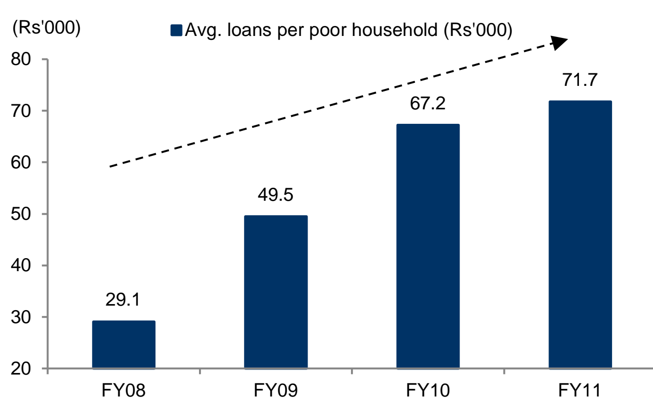
As per the RBI's State of the Sector Report 2011, the number of loan accounts per poor household in AP nearly doubled from 5.6 in FY08 to ~11 in FY11. Average loans per poor household increased to an alarming level of Rs 72k in FY11 from Rs 29k in FY08, which proved very difficult for customers to service. Fig 52 and 53 suggest that households were heavily burdened by the mounting debt. In order to show better asset quality, some MFIs increasingly adopted coercive collection methods.

Fig 52 - No. of loan accounts per household doubled between FY08 and FY11



Source: State of the sector report FY11

Fig 53 - Avg. loan per poor household increased 2.5x



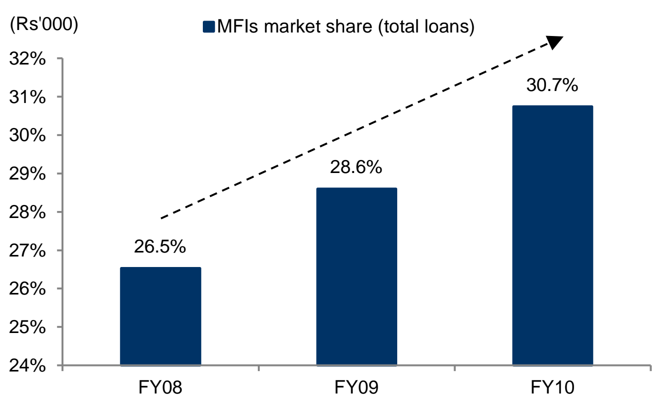
Source: State of the sector report FY11

- **Market share losses for government-run SHG schemes:** MFIs were fast gaining ground over the state-sponsored SHG programme, potentially replacing the latter as a popular model for microfinance. The AP government's SHG scheme was bleeding market share, even as that of MFIs in the state increased by 2% each in FY09 and FY10. This was viewed askance by the political class as it meant losing hold over an important vote bank.

AP govt. intervened due to loss in SHG market share and coercive tactics adopted by MFIs

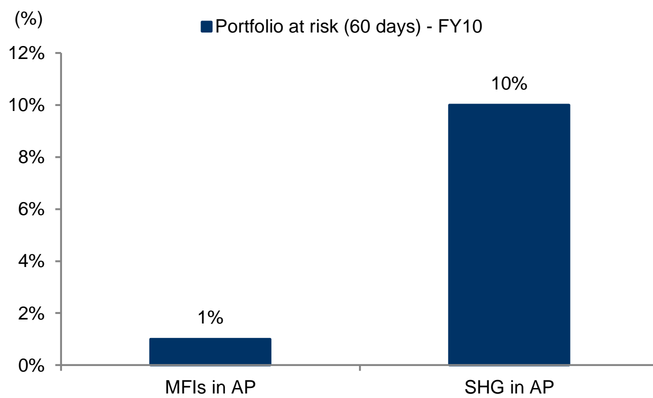
High growth for MFIs was further supported by low default rates, with PAR (<60days) of just ~1% for most players vs. ~10% for SHG loans. The state government attributed this to coercive tactics used by MFIs to recover loans. They believed that if MFIs were allowed to continue in their current form, it would lead to further market share losses and deterioration in the SHG repayment rate, as borrowers would first repay aggressive collectors. At this time, some suicides were reported in the state, which were ascribed to mounting debt levels and aggressive recovery techniques adopted by MFIs. All of this paved the way for government action against MFIs in the form of stringent regulation, which played a key role in precipitating the crisis.

Fig 54 - MFIs gained market share in FY09/10



Source: Sa-Dhan, RBI

Fig 55 - PAR was far better managed by MFIs than SHGs



Source: Sa-Dhan, RBI

- **Intervention by AP government and draconian MFI Bill 2011:** In Oct'10, with no warning whatsoever, the AP government issued the Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Ordinance, 2010, with immediate effect, which virtually crippled the operations of MFI players in the state. The Andhra Pradesh MFI Act followed in Jan'11. According to the AP government, the decision to regulate MFIs was constructed on four premises:

1. MFIs charged usurious interest rates,
2. Adopted coercive recovery practices,
3. Profiteered from poverty and lacked a social mission to aid financial inclusion, and
4. Borrower interest needed to be protected

But MFIs saw the law as a thinly veiled attempt to protect the uncompetitive government-backed SHG programme rather than to protect the poor. It was estimated that by 2010 there were ~6.3mn MFI borrowers in AP and 17.3mn SHG-Bank linkage members.

MFIs argued that MFI bill was mainly to protect uncompetitive SHG programme

Fig 56 - Salient features of the MFI Act

Feature	Terms
Registration	Register within 30 days from the date of the ordinance with every registering authority in every district of operations of the MFI with the following details: - Villages or towns in which they operate or propose to operate - Rate of interest being charged or proposed to be charged - System of conducting due diligence - List of persons authorised to conduct the activity of lending or recovery of money being lent Restriction on operations without registration
Cancellation of registration	Registration can be cancelled at any time at the discretion of the registering authority or upon complaints by SHGs, after assigning sufficient reasons and notice for cancellation
Sourcing for borrowers	No member of an SHG can be a member of more than one SHG MFIs willing to lend to an SHG borrower have to take prior approval of the district authority
Collateral	MFIs cannot seek any security from a borrower for the loan
Lending rates	Interest charged cannot exceed the principal over the loan tenor MFIs cannot charge anything beyond interest rates agreed before disbursement
Submitting monthly statements	Every MFI shall submit on a monthly basis to the registering authority details regarding the list of borrowers, the loan given and the interest rate charged
Recovery actions	Any employee responsible for day-to-day control of the business can be punished with three years of imprisonment or fine up to Rs 100,000 or both if he uses coercive recovery practices MFIs cannot outsource their recovery operations to external agents Recovery to be done only at a central location, MFIs cannot obstruct a borrower's daily routine
Undertaking by CEO	CEO to be held directly responsible for any lapse in following the terms of the act

Source: AP Act 2010, RCML Research

Impact on the microfinance industry

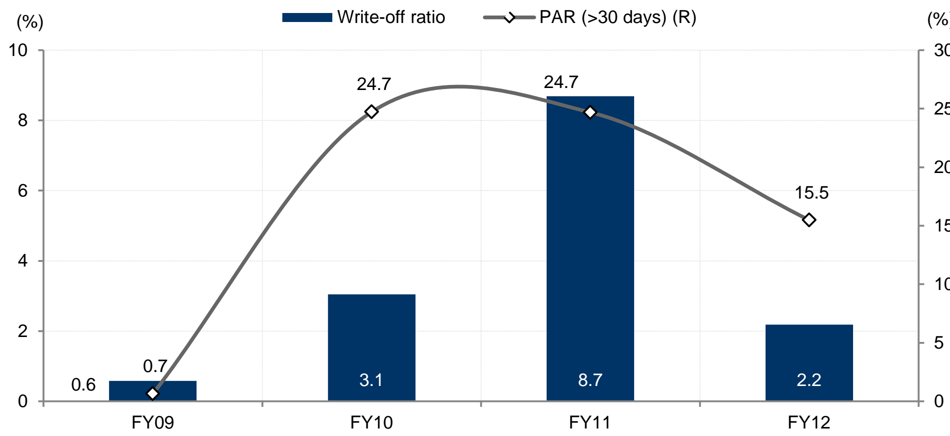
- **Administrative hurdles:** The law required MFIs to (1) register in each district of operation and renew the registration annually, (2) submit details regarding the list of borrowers, loans given and interest rates charged to the registering authorities on a monthly basis, and (3) obtain prior approval of district authorities even before sanctioning loans. All of this severely hit business as a key feature of MFI loans was speed and timely availability of finance to borrowers.

- **Loan recovery hurdles:** Recovery came to a grinding halt as MFI staff were restrained from visiting the borrower's residence or workplace to recover the loan and instead had to wait at a 'central public place' in the hope that the borrower would come there and repay. Clients interpreted the law differently and stopped repaying entirely. Collection rates in the state fell from 99% right before issuance of the ordinance to less than 20% within the span of a few months. Politicians also

Lending and recovery came to a complete halt and collection rate dropped to just 20% from 99%

encouraged people to avoid repayment, which led to massive defaults of ~Rs 72bn by over 9mn borrowers in FY09/10. As a consequence, the asset quality of MFI players worsened and write-offs increased from 0.6% in FY09 to ~9% in FY11.

Fig 57 - Asset quality of MFIs worsened

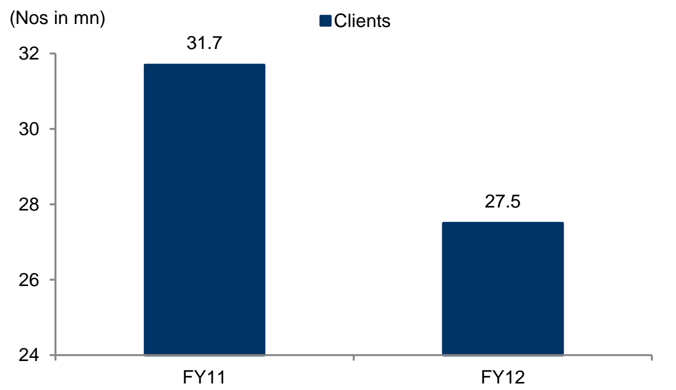


Source: Sa-dhan

Draconian MFI Bill by AP government resulted in mass default. PAR rose to 9% and ROE stood at -35% in FY12

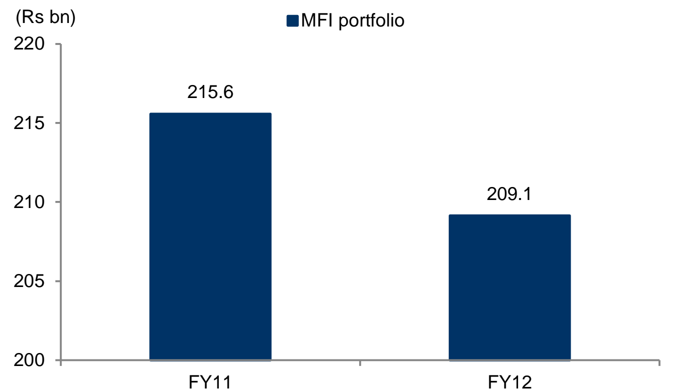
- **Portfolio rundown, client losses and branch closure:** The full impact of the AP crisis was felt when the sector was starved of funds. Banks cut off funding to MFI players on expectations of possible losses, despite stable repayments elsewhere in the country. Consequently, MFIs were compelled to scale back operations, leading to a decline in the number of clients and portfolio value for the first time in a decade.

Fig 58 - Number of clients declined by ~13% in FY12…



Source: Sa-Dhan

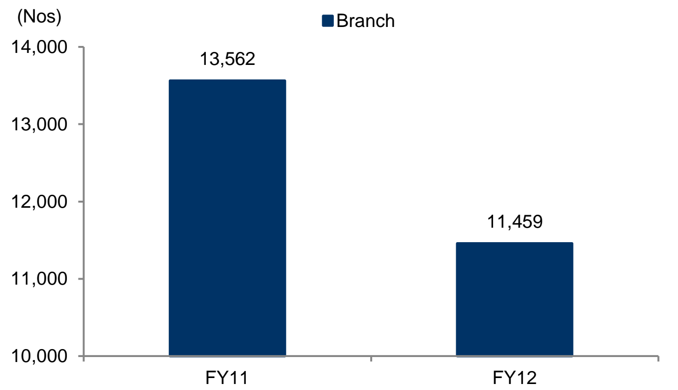
Fig 59 - …while the portfolio declined by ~3%



Source: Sa-Dhan

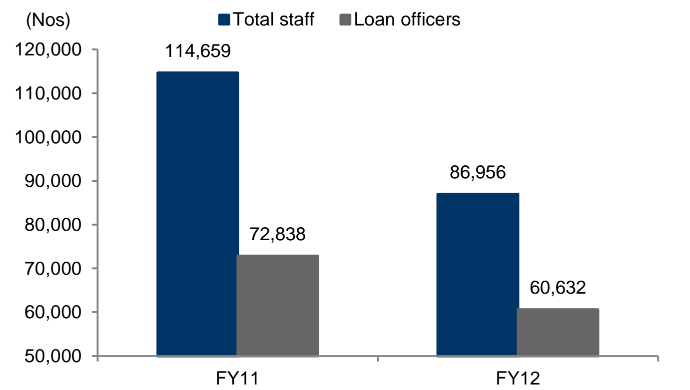
Infrastructure in terms of branch network and workforce was significantly downsized as a part of the austerity measures. Around 25% of MFIs reported a dip in branches as over 2,000 branches were either merged or closed down, leading to mass attrition in the employee base: as many as ~28,000 people were left redundant including ~12,000 loan officers.

Fig 60 - Over 2,000 branches were either merged or closed



Source: Sa-Dhan

Fig 61 - Staff strength was reduced by ~25%



Source: Sa-Dhan

Fig 62 - Operational AP MFIs and their financial performance during the turmoil

AP-based MFIs	2011	2012	YoY growth (%)
No. of branches	6,426	5,227	(18.7)
No. of staff	55,512	39,067	(29.6)
Active clients (mn)	16	12	(25.0)
Loan portfolio (Rs mn)	1,39,430	79,120	(43.3)
Disbursements (Rs mn)	1,91,800	62,900	(67.2)
PAR 60 (%)	30	31	
Total assets (%)	1,35,210	91,730	(32.2)
Net Owned Fund (Rs mn)	31,490	25,380	(19.4)
Yield (%)	22	10	
Operating expenses (%)	10	6	
Operational sufficiency (%)	111	55	
RoA (%)	2	(8)	
RoE (%)	2	(35)	

Source: Sa-Dhan report 2012

- **CDR package necessitated for the ailing microfinance sector:** The situation turned so dire that in Sep'11, corporate debt restructuring (CDR) bailout packages had to be rolled out to major MFI players operating out of AP. Five of the top six MFIs in India had their debt restructured as they could not service their obligations due to a fall in recovery rates and huge write-offs. SKSM was the only large player that survived without a restructuring of its bank borrowings via CDR, as it had an adequate capital buffer raised through an IPO just months before the crisis broke out.

  The basic terms of the CDR package which was largely applicable to all MFIs were as follows:

  - Loans were restructured at an interest rate of 12% and a repayment period of 7-8 years, including a moratorium of 1-2 years.
  - A part of the debt was converted into optionally convertible redeemable preference shares, allowing banks to convert debt into equity if an MFI defaulted.
  - Promoters were asked to pledge their shares to the consortium of banks and provide personal guarantees to maintain their stake in the business if banks converted debt to equity.
  - Two or three bank-nominated directors were brought on the Boards of each MFI.

Five of India's top six MFIs required debt restructuring through CDR mechanism

Despite the bailout package, most MFIs failed to turn around, as recovery of loans from the AP market did not transpire as expected. In FY13, MFIs demanded a second round of restructuring without classifying the loans as bad, but their appeal was rejected by the RBI. Later, in Apr'14, the central bank permitted forbearance on certain capitalisation requirements (net owned funds of Rs 50mn and capital to risk asset ratio or CRAR of 15%) till FY16. While Future Financial Services is the only MFI that successfully managed to opt out of CDR in Mar'14, other players are still facing challenges even today.

- **Five large companies bore the brunt:** Spandana Sphoorty Financial, Bhartiya Samruddhi Finance, Trident Microfinance, Share Microfinance and Asmitha Microfinance bore the brunt of the industry failure in AP, as seen from the brief profiles below. Trident Microfinance was forced to shut down operations in FY15.

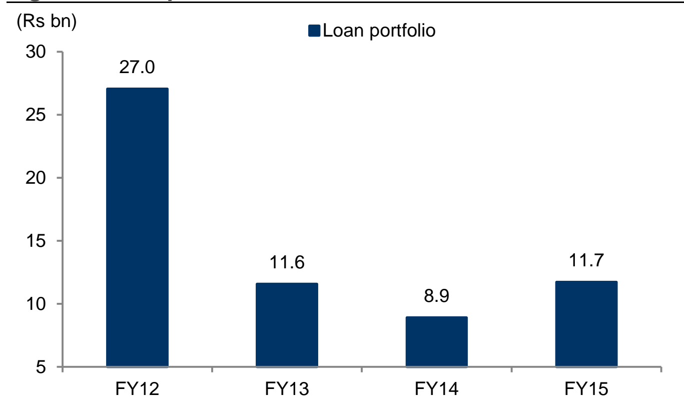
#1 Spandana Sphoorty Financial Ltd

Rapid portfolio build-up: Spandana began operations in FY05 and registered tremendous growth in AUM till FY10. In Sep'10, it had an AUM of Rs 44bn (~5mn borrowers) with an employee base of 13,500. Net worth stood at ~Rs 6bn in FY10 and it was the second largest MFI in India after SKSM, with plans to start overseas operations in Nepal and China. Before the crisis, promoters owned 50% and PE investors such as Lok Capital, JM Financial and Valiant owned the remaining 50%.

CDR package: In the aftermath of the AP market failure, AUM had dropped to Rs 27bn and the client base to 3.4mn as of FY12. Spandana was forced to restructure debt (CDR) in Sep'11 where the interest rate was capped at 12% and loan repayment tenure was extended to seven years. However, its financials remained under pressure. While the RBI rejected appeals for a second round of restructuring, it did permit forbearance of net owned funds and CRAR requirements till FY16. The company expects to get additional debt funding of Rs 15bn from banks in FY14-16.

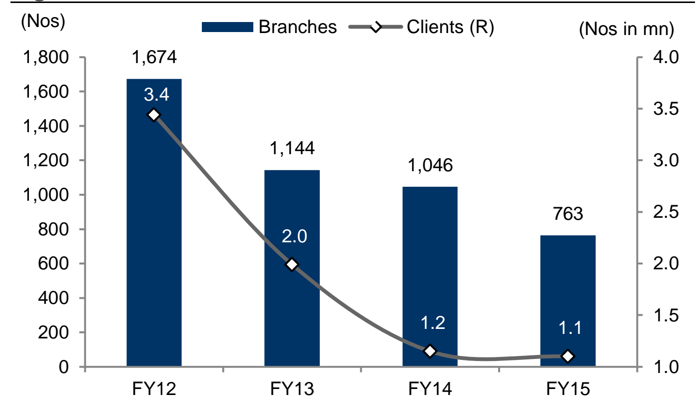
Portfolio size down to half: Spandana's AUM has shrunk to ~Rs 12bn currently as compared to Rs 44bn in Sep'10, and its client base is down by a fifth to just 1.1mn. Promoters and bankers are jointly trying to revive the company by moving the portfolio to other states and using those earnings to repay debt.

Fig 63 - Loan portfolio has more than halved since FY12…



Source: MFIN, RCML Research

Fig 64 - …so have branches and client base



Source: MFIN, RCML Research

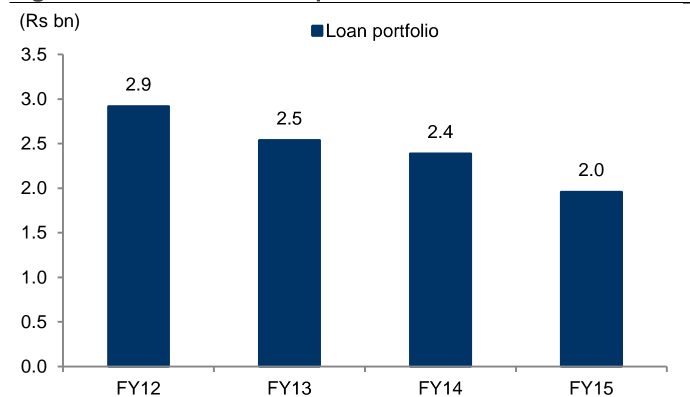
#2 Bhartiya Samruddhi Finance (Basix)

One of the largest players in AP till Sep'10: Set up in 1996, Basix is one of the oldest MFIs in India. It was also one of the largest players in AP with a loan portfolio of Rs 18bn and net worth of Rs 2bn as on Sep'10, spread across 1.74mn customers and employing ~9,000 people. Before the crash, promoters owned ~35% and PE investors including Matrix Partners, Lok Capital, International Finance Corporation and SIDBI owned ~60%.

CDR package: BSFL had an outstanding portfolio of Rs 5.7bn in AP in Sep'10 which reduced to Rs 4bn in Mar'11 following recoveries and write-offs. It was initially given an option to restructure debt under CDR in Jun'11, but management did not opt for this, as it believed the company would survive by servicing bank loans from recoveries in non-AP states, ensuring steady funds from banks. However, it eventually had to restructure debt in Sep'12 when Rs 516mn of its NPAs had to be written off following new RBI guidelines for NBFC-MFIs. Under the restructuring package, banks converted Rs 5bn of debt into compulsorily convertible preference shares and stretched the balance of Rs 1.7bn over a seven-year tenor.

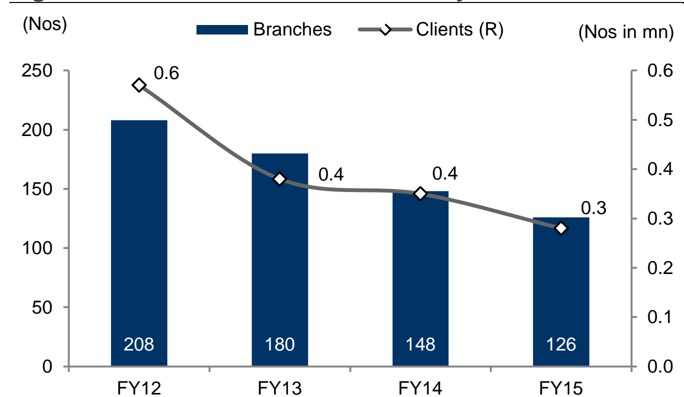
Portfolio size down to 5%: Basix's loan portfolio has shrunk to ~Rs 2bn currently as compared to Rs 18bn in Sep'10. The company continues to report losses but started repaying bank loans in FY14.

Fig 65 - Slowdown in loan portfolio



Source: MFIN, RCML Research

Fig 66 - Branches/no. of clients virtually halved



Source: MFIN, RCML Research

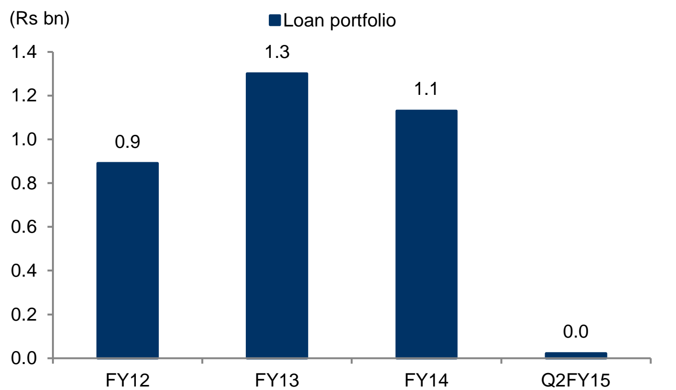
#3 Trident Microfinance

Achieved rapid growth: Trident Microfinance was established in 2007 and managed to scale up quickly despite being a late entrant in the MFI space. As on Jun'10, it had ~0.2mn borrowers and AUM of Rs 1.4bn. It employed over 500 people and had a network of 70 branches including 46 in AP. Pre-crisis, 67% of the company was owned by two microfinance investment vehicles managed by Caspian Advisors, with the balance owned by the promoters (19%) and Trident Employees Benefit Trust (14%).

CDR package: Trident had ~75% exposure to AP and an outstanding debt obligation of Rs 1.4bn. It opted for CDR in Sep'11 and as per the terms of the restructuring agreement, 25% debt was converted to equity and 25% into optionally convertible cumulatively redeemable preference shares in case of default. The remaining 50% debt would have to be repaid over eight years, including a two-year moratorium at an interest rate of 12%. Post-restructuring, the promoter's stake dropped to 4.2% when the lender consortium acquired 60% stake by converting debt to equity.

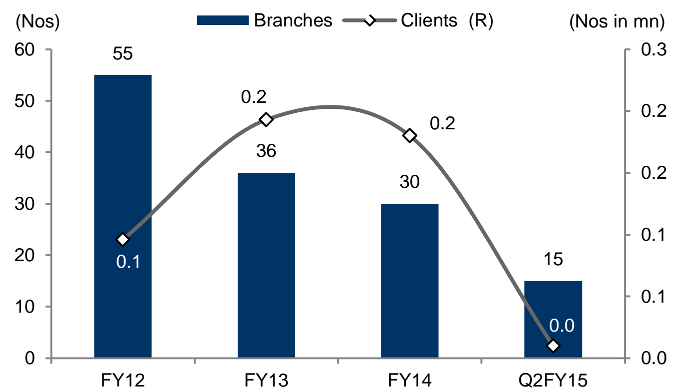
Only MFI that was forced to shut down: When repeated efforts to revive the company failed, CDR demanded a one-time settlement and directed Trident to pay 18% (Rs 250mn) of the outstanding debt. The MFI managed to repay Rs 230mn by selling down assets worth Rs 180mn and consequently was forced to shut down in Q2FY15.

Fig 67 - Loan portfolio was sold off to pay CDR dues…



Source: MFIN, RCML Research

Fig 68 - …which led to closure of the business



Source: MFIN, RCML Research

#4 Share Microfinance

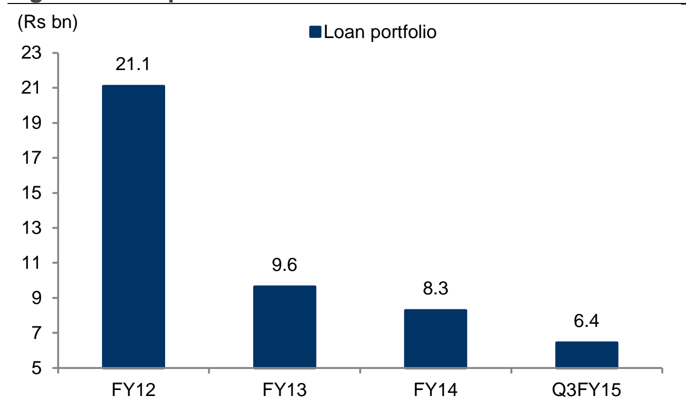
Once was the third largest MFI in India: Share Microfinance began operations in 1989 and is one of the oldest MFIs in India. Before the AP crash, Share was also the third largest MFI in the country with an AUM of ~Rs 20bn in FY10, operations spread across 19 states and ~3.3mn clients. Legatum and Aavishkaar Goodwell India held a controlling stake in the company at the time.

CDR package: Share's total debt was ~Rs 19bn at the time of the crisis and lenders agreed to restructure Rs 12bn. Under CDR, the interest rate was capped at 12% and loan repayment tenure was extended to seven years, including a moratorium period of one year. The remaining Rs 7bn was taken over by banks in the form of preferential shares with a convertibility clause in case of default. Investors Legatum Ventures and Aavishkaar Goodwell infused Rs 480mn of fresh equity in the MFI post CDR.

Like Spandana, Share sought approval for a second round of debt restructuring, which the RBI rejected. But the RBI permitted forbearance on capitalisation requirements of net owned funds and CRAR till FY16. The company expects additional debt funding of Rs 3.6bn from banks over FY14-16.

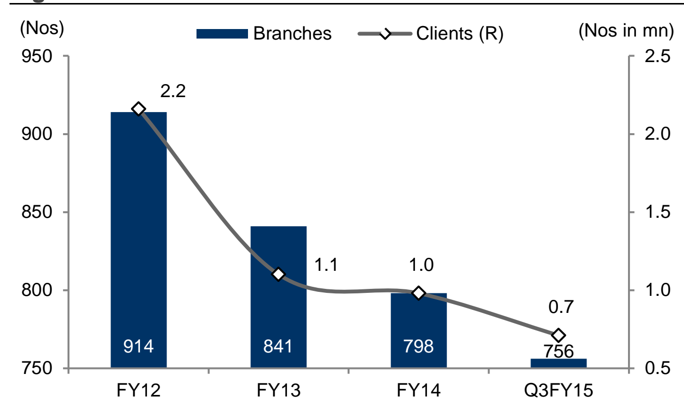
Portfolio down to a third: Share's current AUM is just a tad over Rs 6.4bn as compared to Rs 20bn pre-crisis. It is still under CDR and has chalked out a reorganisation plan for its businesses. Share and sister company Asmitha together plan to demerge their non-AP portfolio and consolidated the same. Their AP portfolios would be retained for recovery of dues in the state, but lending activity would be halted. Both MFIs have submitted these plans to bankers and are currently awaiting approval.

Fig 69 - Loan portfolio down to a third…



Source: MFIN, RCML Research

Fig 70 - …so is the client base



Source: MFIN, RCML Research

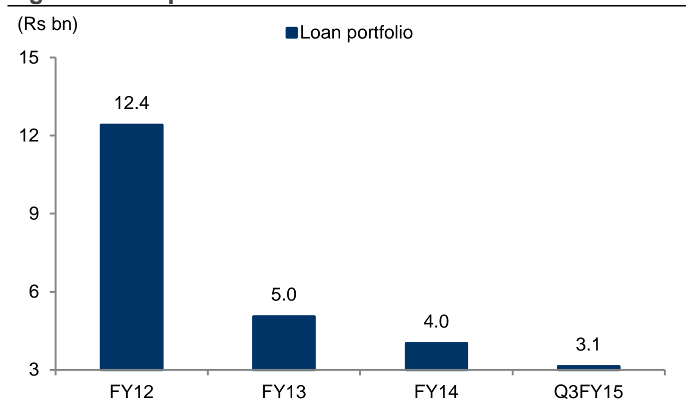
#5 Asmitha Microfinance

Among the larger players in AP: Asmitha was set up in 2002 by the promoters of Share Microfinance as a for-profit organisation. As of FY10, Asmitha had an AUM of ~Rs 14bn, of which ~50% was concentrated in AP.

CDR package: Asmitha's total debt was ~Rs 13.8bn at the time of the crisis and lenders agreed to restructure Rs 7.5bn. Under CDR, the interest rate was capped at 12% and loan repayment tenure extended to seven years, including a one-year moratorium. As with some of the other players, a second round of restructuring was disallowed but the company has got the RBI's nod for forbearance on capitalisation requirements (net owned funds and CRAR) till FY16. It expects to get additional debt funding of Rs 2.7bn from banks.

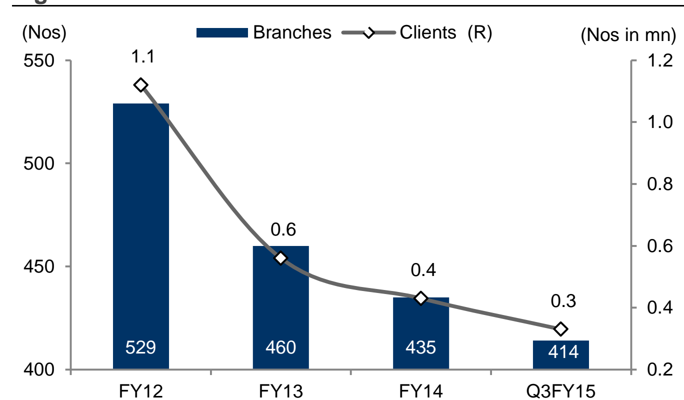
Portfolio size down by 75%: Asmitha's AUM has reduced from ~Rs 14bn in FY10 to ~Rs 3bn at present as most of the funds have been directed toward repaying its bank loans. Asmitha along with sister company Share has submitted a revamp plan to CDR. Under the plan, both companies will consolidate their non-AP portfolios and retain the AP portfolio for recovery. The MFI is currently awaiting approval from bankers.

Fig 71 - Loan portfolio has reduced to Rs 3.1bn…



Source: MFIN, RCML Research

Fig 72 - …while the client base has fallen to 0.3mn



Source: MFIN, RCML Research

Upshot of the crisis: Better regulations, more discipline

The main upshot of the AP crisis was that it brought about important regulatory reforms and operational improvements in the microfinance industry. Due to the burgeoning troubles in AP, the RBI was forced to intervene and appointed a committee chaired by Y H Malegam (Malegam Committee) to study the issues facing the microfinance industry and recommend suitable regulatory structures. Based on the committee's recommendations, the RBI issued a detailed set of guidelines in Dec'11. The central bank recognised MFIs as a separate NBFC category known as NBFC-MFIs and regulations were placed to steer various operational facets of MFIs (Fig 73).

RBI issued NBFC-MFI guidelines in Dec'11

A stronger regulatory environment coupled with government initiatives to improve financial inclusion in the country helped the crippled industry get back on track and led to renewed growth and a return of funding from PE investors post-FY12. In the state of AP, however, the draconian MFI bill continues to hold back growth.

Fig 73 - RBI guidelines for NBFC-MFIs

Particulars	Terms
Multiple lending	Not more than two MFIs can lend to the same borrower
Annual income of households qualifying for MFI loans	<= Rs 100,000 in rural areas <= Rs 160,000 in non-rural areas
Disbursement	<= Rs 60,000 in the first cycle <= Rs 100,000 in subsequent cycle
Borrower indebtedness	Capped at Rs 100,000
Loan tenure	>= 24 months for loan amount in excess of Rs 15,000 The moratorium shall not be less than the frequency of repayment
Loan repayment	Repayable on weekly, fortnightly or monthly instalments at the choice of the borrower
Loan purpose	>= 50% of the total loans given by the MFIs should be for income generation activity
Interest rate	Lower of the following 1) cost of funds plus margin (capped at 10% for large MFIs and 12% for others) 2) Average base rate of the five largest commercial banks by assets multiplied by 2.75%
Penalty	No penalty on delayed payments No penalty on prepayments
Capital requirement	Minimum net owned funds of Rs 50mn (Rs 20mn for northeast MFIs) after 31 March 2014 Minimum CAR of 15%
Provisions	Shall not be less than 1) 1% of the outstanding loan portfolio 2) 50% of the loan installments which are overdue for >=90 days and <=180 days 3) 100% of the loan installments which are overdue for >=180 days
Recovery practice	1) Shall adopt non-coercive methods of recovery 2) Recoveries to be made only at a central designated place 3) Recoveries at residence only if a customer fails to appear at the designated place more than twice
Priority Sector	PSL status to continue
Credit Information Bureaus (CIB)	Mandated MFI to be a member of at least one CIB
Self-Regulatory Organization (SRO)	Mandated MFI to be a member of at least one SRO

Source: RBI

The RBI guidelines had the following key positive implications for the sector:

- **Cap on spreads:** The high interest rates charged by MFIs were cited as a primary reason behind non-repayment of loans during the crisis period. To address this issue, the RBI placed a spread cap on the sector. By limiting the scope for excessive charging, the central bank made sure that MFIs actually served the purpose of

Spreads capped at 10% for large MFIs and 12% for small MFIs

financial inclusion and did not profiteer from poverty. One of the key positives of placing a cap on spreads was that it led to an improvement in productivity and efficiency levels of MFIs.

- **Restrictions on multiple lending and over-indebtedness:** Earlier, a borrower could be a member of multiple JLGs, which meant he could borrow from one MFI to repay his existing debt with another MFI. To avoid excessive leveraging by a borrower, the RBI placed a cap on their indebtedness at Rs 100k. Secondly, borrowing from multiple MFIs put pressure on the customer to service loans from time to time, often leading to defaults. To avoid such a situation, the RBI set a cap on the maximum number of MFIs that could lend to a single borrower (two) under the JLG mechanism. This has helped MFIs keep asset quality in check as borrowers can service loans in a timely manner.

- **Cap on non-income generating loans:** According to a report titled "Access to Finance in Andhra Pradesh, 2010" by IFMR Research, only 25% of the loans disbursed before the AP crisis were given for income-generating activities. In order to safeguard the interest of borrowers by ensuring that loans were utilised for livelihood enhancement rather than consumption, the RBI stated that ~50% of the loans given by MFIs should be for income-generating activities. This also helps lower the NPA risk as loans used for consumption purposes do not offer visibility on loan repayment.

At least 50% of loans given by MFIs to be for income-generating activities

Fig 74 - Usage of loans in Andhra Pradesh, 2010

SN	Particulars	JLG%	SHG%
1	Income generation	25.6	25.4
2	Repayment of old debt	25.4	20.4
3	Health	10.9	18.6
4	Home improvement	22.1	13
5	Education	4.4	5.7
6	Others	11.6	7.9

Source: IFMR Research

- **PSL tag reinstated:** Bank funding to the microfinance sector had dried up after the RBI revoked its priority sector lending (PSL) status post the AP crisis. However, considering their role in the financial inclusion agenda, the RBI reinstated PSL status to MFIs after extending them policy support. This once again ensured a steady flow of bank funding into the sector.

- **Capital requirement norms to limit leverage:** Owing to the volatile and high-risk environment that MFIs operate in, the RBI set a minimum net owned funds requirement of Rs 50mn and CRAR requirement of 15% for these institutions in order to limit their leverage and increase their ability to withstand asset quality shocks.

- **Set up of a supervisory structure:** RBI guidelines made it mandatory for NBFC-MFIs to become a member of at least one self-regulatory organisation (SRO). Microfinance Institutions Network (MFIN) and Sa-Dhan were two industry bodies that existed even before the AP crisis in a voluntary supervisory role and aimed to address the sector's data quality, credit and concentration risks. However, adherence to guidelines put out by these bodies was not mandatory until the RBI accorded formal recognition to MFIN as the SRO for NBFC-MFIs in Jun'14.

  The key action areas for SROs as spelt out by the RBI include surveillance, grievance redressal, dispute resolution, investigation, data collection, training and knowledge development. The central bank also directed MFIN to formulate a code of conduct for NBFC-MFIs which was then made mandatory for MFIN members to adhere to.

Mandatory for NBFC-MFIs to become a member of at least one SRO

Fig 75 - MFIN code of conduct: A snapshot

Code	Overview
Part I: The Core Values of Microfinance	Provide timely access of financial services to low-income clients that is ethical, dignified, transparent, equitable and cost effective
	Ensure that clients are protected against fraud and misrepresentation, deception or unethical practices and ensure that all practices related to lending and recovery of loans are fair
Part II: Code of Conduct	Promote and strengthen the microfinance movement by bringing low-income clients to the mainstream financial sector
	Build progressive, sustainable, and client-centric systems and practices to provide a range of financial services to clients
	Promote cooperation and coordination among MFIs and other agencies in order to achieve higher operating standards and avoid unethical competition in order to serve clients better
Part III: Client Protection Guidelines	Ensure complete disclosure and transparency in all dealings with clients. Shall disclose all terms and conditions to the client for all products/services offered, prior to disbursement
	Ensure fair practices, avoid over-indebtedness and maintain appropriate interaction and collection practices
	MFIs will share complete client data with all RBI-approved Credit Bureaus, as per the frequency of data submission prescribed by the Credit Bureaus
Part IV: Institutional Conduct Guidelines	Ensure complete compliance with the Code of Conduct
	Maintain formal records of all transactions in accordance with all regulatory and statutory norms
	Adhere to employment and anti-poaching measures as per SRO guidelines

Source: MFIN

In its supervisory role, MFIN has managed to bring stability to the sector and discipline among players. It has played a vital role in ensuring transparency in client dealings and fair practices related to lending and recovery of loans. It does this through an enforcement committee which exercises oversight and ensures that its code of conduct is complied with. MFIs also report data on loans, asset quality, geographical concentration of portfolio and interest rates periodically to MFIN, which the latter publishes on a quarterly basis. In our view, better disclosures by MFI players have created the ability to detect fraud and inefficiency in a timely manner.

MFIN as an SRO brought stability to the sector and discipline among players

- **Establishment of credit information bureaus (CIB):** In order to prevent multiple lending and over-borrowing, the RBI insisted that NBFC-MFIs be registered with at least one CIB. CIBs provide, maintain and update borrower records on loans availed along with their payment history. They also provide an efficient monitoring mechanism which enables MFIs to perform credit checks on borrowers before disbursing loans. Four CIBs, viz. Credit Information Bureau, Equifax, Experian and CRIF High Mark have been granted a certificate of registration by the RBI. But most MFIs have registered with, and are contributing credit information to, Equifax and CRIF High Mark.

NBFC-MFIs must be registered with at least one CIB

In our view, CIBs have proved crucial to the healthy development of the microfinance industry. Before RBI made CIB registration mandatory, MFIs did not share client data among themselves. Thus, an MFI's knowledge of a client's credit history or existing debt obligation was limited to the extent of information proffered by the client himself. This eroded credit discipline as loan defaulters could always avail of credit from another MFI in the absence of a centralised database.

CIBs have built a database of 50-60mn accounts and update new clients periodically. The probability of finding a new customer in the database has increased to 92%, enabling MFIs to make more informed lending decisions. According to SKSM, its rejection rate for a loan application by a new customer has gone up from 12% to 22%. MFIs have managed to reduce the pressure on asset quality as credit referencing has lowered the probability of disbursing loans to a fraud borrower.

Probability of finding a new customer in the database has increased to 92%

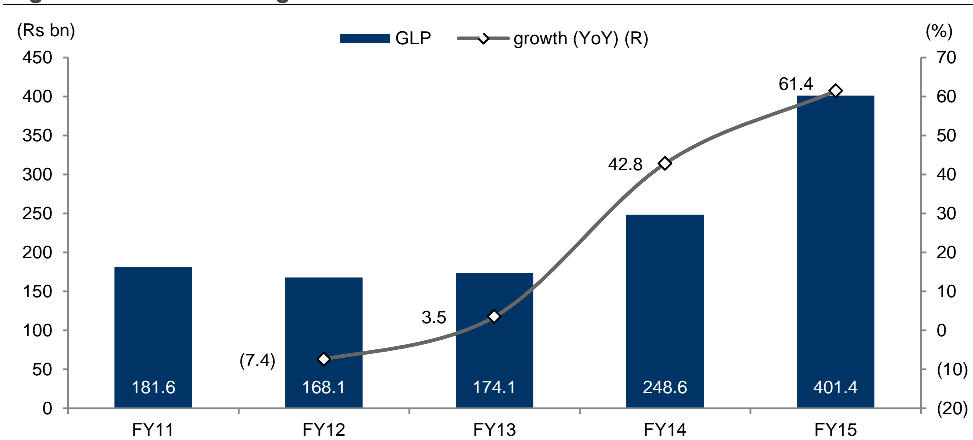
FY12-FY15 – MFIs back on an aggressive growth path

32% CAGR in AUM

Today, India's regulated microfinance market is served by close to 50 NBFC-MFIs, which are governed by MFIN. The sector has moved into a high growth phase after recovering from the AP microfinance crisis. Overall AUM has increased at a 32% CAGR over FY12-FY15, largely on account of strong growth in GLP – 22% CAGR over FY12-FY15 and 50% in the last two years – due to higher average ticket size and robust client accretion.

GLP CAGR of 22% over FY12-FY15, largely on account of rise in average ticket size and robust client accretion

Fig 76 - MFIs' GLP has grown at 61% YoY in FY15



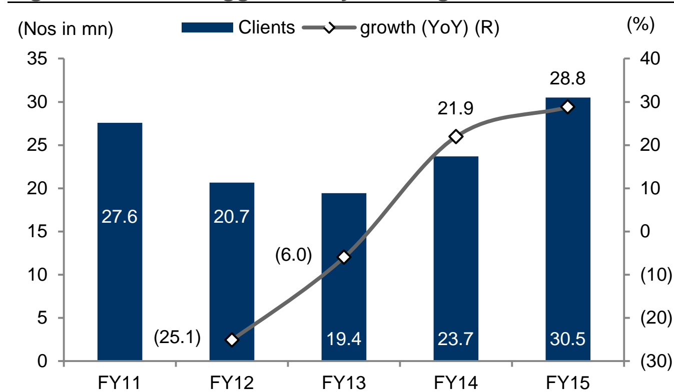
Source: MFIN

Record client base

MFIs (registered with MFIN) now serve a record 30.5mn clients with loan outstanding per customer at Rs 13,160, after clocking a CAGR of 14% and 17% in these metrics respectively over FY12-FY15. Inflation aside, we believe the increase in the loan outstanding is due to the rising needs of an unbanked population.

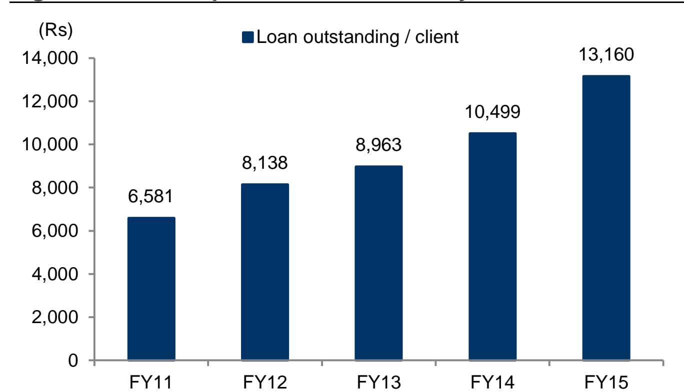
As of FY15, MFIs served over 30.5mn clients with loan outstanding per customer at Rs 13,160

Fig 77 - MFIs are aggressively chasing new clients



Source: MFIN, RCML Research

Fig 78 - Loan o/s per client increased by 25% in FY15



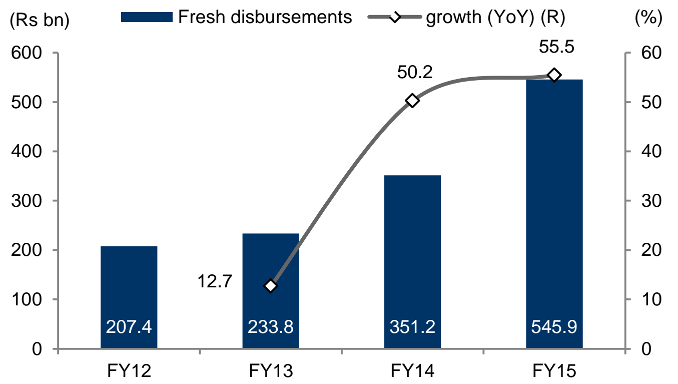
Source: MFIN, RCML Research

Disbursements scaling new heights

Disbursements by MFIs are scaling new heights given the huge demand for microcredit. As on FY15, fresh disbursements grew by 55% YoY to Rs 545.9bn while the number of loans disbursed grew by 37% YoY to 33.4mn. Fresh disbursements by the top 10 MFIs accounted for ~80% of the total. On average, the amount of loan disbursed per account grew by 14% YoY to Rs 16,327 as on FY15.

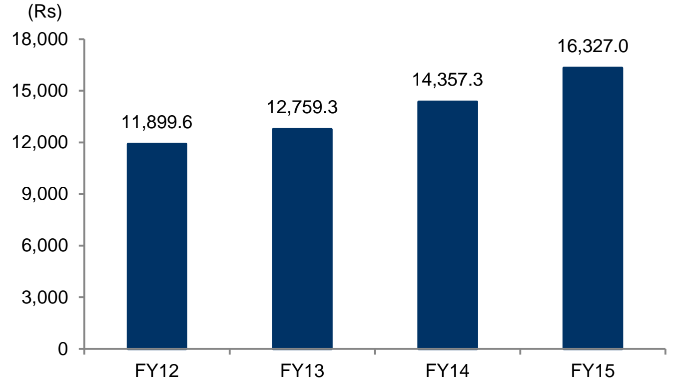
Disbursements at peak levels given the huge demand for microcredit

Fig 79 - Disbursements have increased at a CAGR of 38%



Source: MFIN, RCML Research

Fig 80 - Avg. ticket size of loans disbursed



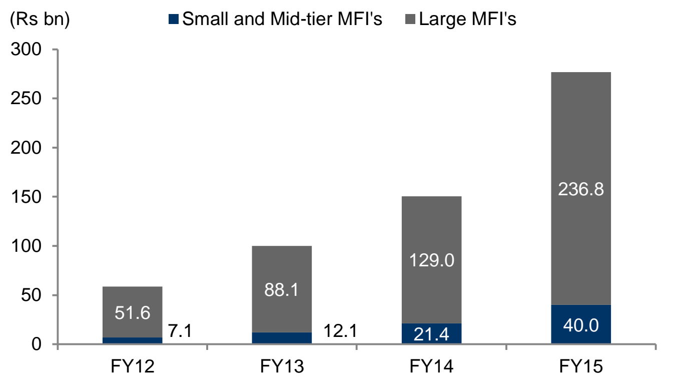
Source: MFIN, RCML Research

Heavy debt funding

Three-fourths of the funding required by Indian MFIs is currently met in the form of debt. In FY15, total debt raised by MFIs grew by 84% YoY to Rs 276.8bn. Banks still act as a major source of debt funding, and other financial institutions meet only 22% of the funding requirement.

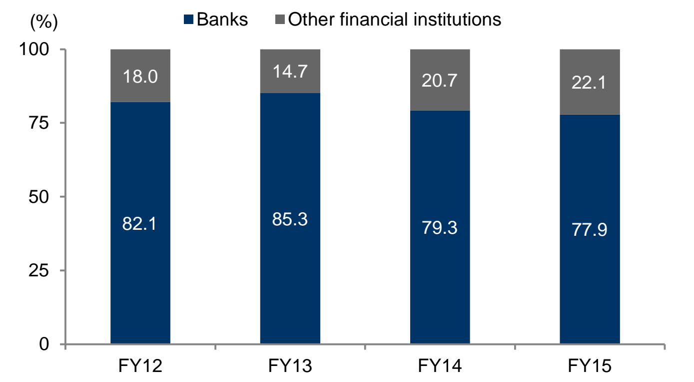
Three-fourths of funding requirement of MFIs met in the form of debt

Fig 81 - Quantum of debt raised by MFI players



Source: MFIN, RCML Research

Fig 82 - Sources of debt funding

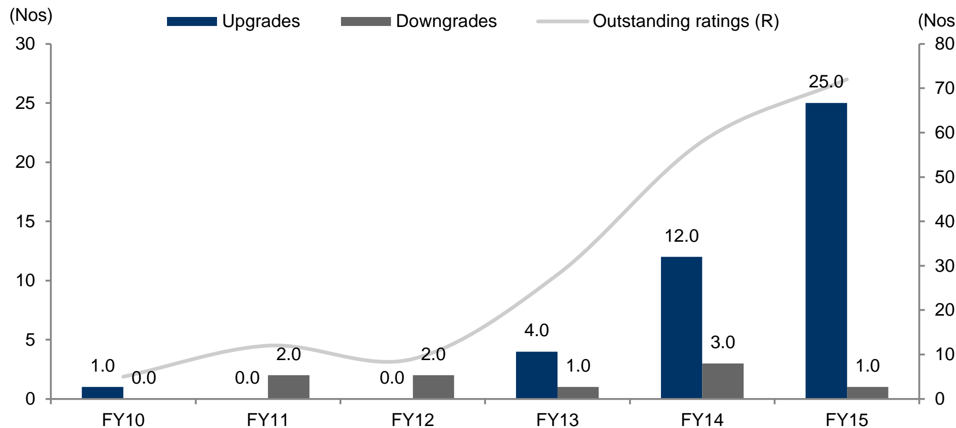


Source: MFIN, RCML Research

The effective cost of funding has also come down given the improvement in MFI credit rating. Several MFIs have been upgraded in recent months and more companies (small and local MFIs) are applying for ratings with a view to lowering their borrowing costs.

Number of rating upgrades has increased post-crisis

Fig 83 - Rating transitions in MFIs

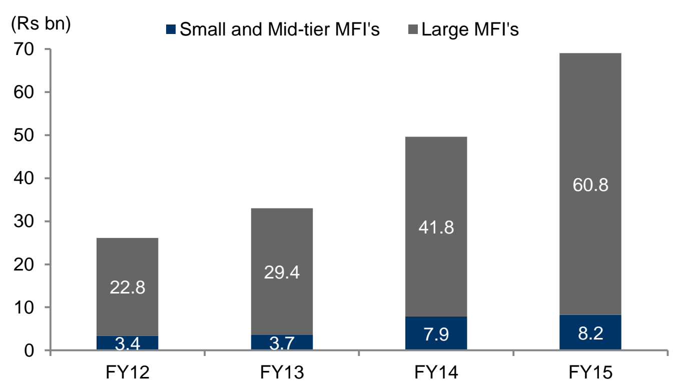


Source: IFMR, RCML Research | Note: Outstanding ratings, upgrades & downgrades include multiple ratings for the same entity by different rating agencies

Large MFIs securitised ~90% of loans in the sector

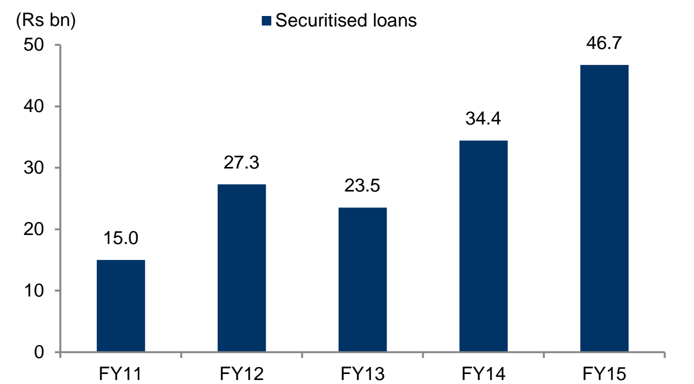
As MFIs cater to the weaker sections of society and lead the financial inclusion footprint, most of their loans qualify as PSL. Consequently, their securitised loans have witnessed steady demand post the AP imbroglio and have evolved as a vital funding source for the industry. The securitised portfolio for the industry as a whole forms ~10% of AUM as on FY15. According to MFIN, securitised loans increased by 39% YoY to Rs 69bn in FY15, primarily on account of sell-down by large MFIs (constitute ~90% of securitised portfolio).

Fig 84 - Securitised portfolio of industry players



Source: MFIN, RCML Research

Fig 85 - Loans securitised (fresh sell-down) has gone up since FY13



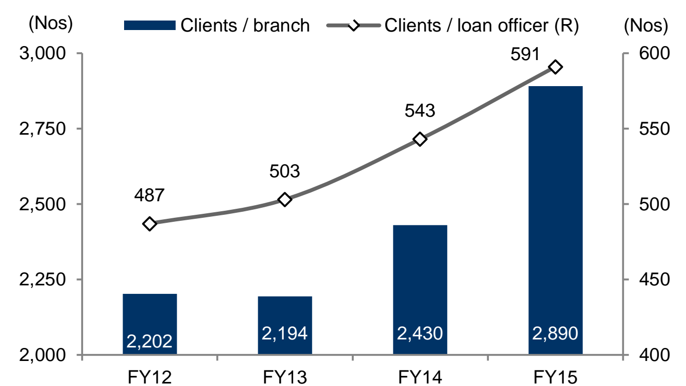
Source: MFIN, RCML Research

Rising efficiency

Operating efficiency has improved considerably in the last three years

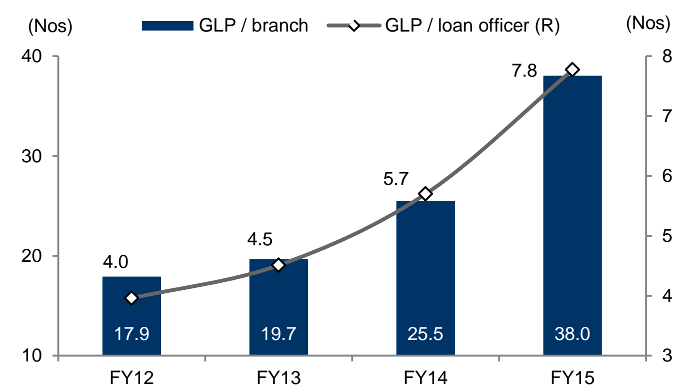
The microfinance industry in India has gradually turned more efficient even as it is clocking high growth in terms of both the number of borrowers as well as portfolio volumes. In our view, MFI productivity is improving due to increasing outreach and better utilisation of manpower (which happens to be the biggest operating expense). Large players lead the efficiency metric rather than smaller companies which lack economies of scale.

Fig 86 - Clients per branch and loan officer



Source: MFIN, RCML Research

Fig 87 - GLP per branch and loan officer



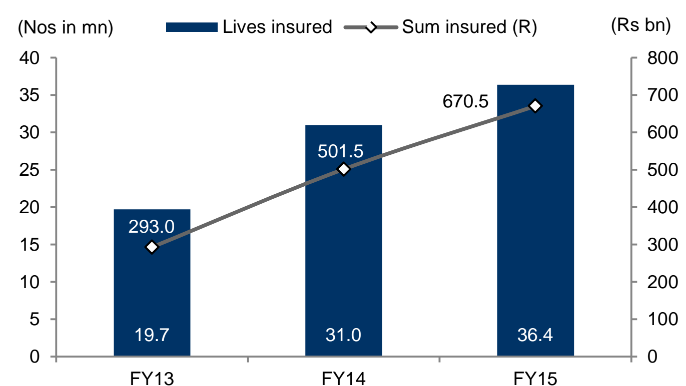
Source: MFIN, RCML Research

Portfolio diversification

Apart from providing microcredit, MFIs are also increasingly distributing insurance and pension to their clients by partnering with insurance companies and the national pension scheme. As on FY15, MFIs provided insurance to over 36.4mn clients with a sum insured of Rs 670.5bn and extended pension accounts to over 1.87mn clients through their network.

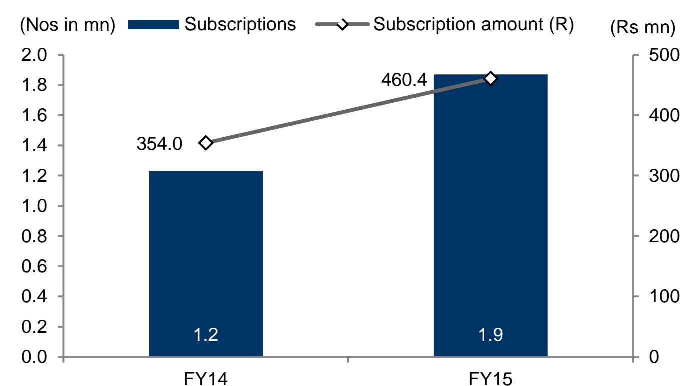
Apart from providing microcredit, MFIs are also increasingly distributing insurance and pension to clients

Fig 88 - Insurance services



Source: MFIN, RCML Research

Fig 89 - Pension scheme



Source: MFIN, RCML Research

Companies & channel checks

19 August 2015

Equifax (Credit Bureau): Meeting takeaways

Higher loan ticket size to fuel growth

We met the management of Equifax, a leading credit bureau with 70% market share in MFI data analytics. Equifax has an active base of 22mn clients and receives 3.5mn enquiries per month. But management believes growth in active customers has peaked and much of the upside hereon would come from higher loan ticket-sizes in well-penetrated states, as opposed to new regions which require heavy investment. Management also highlighted that creation of a foolproof database was possible only upon data sharing by banks.

- **Market leader in microfinance data analytics:** Equifax is 51% owned by US-based Equifax Inc (operates in 15 countries) and 49% owned by Indian banks and financial institutions. The company has 70% market share in India and is one of only two MFI credit bureaus in the country. About 140 MFIs contribute to the company's database which currently comprises 50-60mn customers (22mn active) with 150-160mn accounts (35mn active). Notably, the company gets 3.5mn client enquiries per month.

- **Extensive, well-integrated database to detect fraud:** Equifax has a comprehensive database and has developed algorithms and programmes to detect tampering of any data such as names, surnames or identity card numbers. Many MFIs have integrated their systems fully with Equifax. As a security measure, customer data entered at MFI branches is first routed through Equifax's regional office before results of the loan request query are relayed to the branch – this keeps a check on branch and employee-related fraud.

- **Higher ticket size to lead future growth:** The company's active customer base of 22mn has grown at a far slower pace than the growth in gross loan portfolio (GLP). Currently, 60% of the customer base has taken loans from only one MFI and the average loan per customer is well below regulatory limits (of Rs 100k). This suggests that they can borrow from more MFIs, which will drive growth.

- **Growth from newer geographies difficult:** States like Maharashtra, Tamil Nadu, Karnataka, West Bengal and Kerala have a traditionally strong microfinance base and are among the top contributors to MFI growth in India. Others such as Bihar, Uttar Pradesh and Madhya Pradesh are larger but don't have the inherent characteristics of microfinance markets, in that women are not empowered to do business and the northern region is highly male dominated. Companies will therefore have to innovate in terms of product offering and grow into remote unbanked areas. This will require substantial investments in both time as well as infrastructure – management therefore expects growth from these states to be slow over the next 2-4 years.

- **Database incomplete without SHG data:** Total credit to self-help groups (SHG) is ~1.3x MFI credit and management believes a vast majority of customers, particularly in southern states, are borrowing from both sources. If banks are required to share their SHG databases with MFIs, the resulting shakeout of customers that have breached the RBI's borrowing cap of Rs 100k could hit growth. On the flip side, data sharing will help improve credit discipline in the long term.

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Equifax: Business snapshot

Year of starting of operations	June 2011
No. of players in MFI credit bureau	2
Market share in microfinance	70%
Total no. customer base (mn)	50-60
Total no. of accounts (mn)	150-160
No. of active customers (mn)	22
No. of active accounts (mn)	35
Inquires per day (mn)	3.5
Customer hit rate	90%

Source: Equifax (enquries per month)

Equifax (Credit Bureau): Meeting takeaways

Higher loan ticket size to fuel growth

Q&A with the Equifax management

Can you give us a snapshot of your company and its operations?

- Credit information Bureaus (CIB) maintain and update borrower records on loans availed, along with their payment history. They also provide an efficient monitoring mechanism which enables MFIs to perform credit checks on borrowers before disbursing loans.

Only two players in the microfinance credit bureau space and Equifax has 70% market share

- Equifax Credit Information Services Private Limited (Equifax) is 51% owned by the Equifax Inc (headquartered in the US and operates in 15 countries through North America, Latin America, Europe and Asia). The balance 49% is owned by Indian banks and financial institutions, including State Bank of India, Kotak Bank, Bank of Baroda, Bank of India, Union Bank, Religare Finvest and Sundaram Finance. As per Indian regulations, a foreign company cannot hold more than 51% stake in credit bureaus.
- Equifax has a proven track record of building and managing Microfinance Data Exchanges in developing countries around the world. The company built Peru's first microfinance exchange in 1998 and Ecuador's exchange in 2004. Equifax launched its India operations in Jun'11. The company has the advantage of leveraging well-tested technology platforms provided by Equifax Inc (parent company).
- Equifax is one of only two credit bureaus operating in India and commands ~70% market share. There are ~140 MFIs registered with the company and currently contributing to its database.

What is your database strength currently?

22mn active customers and 3.5mn enquiries per month

- The company started operations in 2011 and has seen the fastest growth in database among CIBs operating throughout the world – to 50-60mn customers and 150-160mn accounts.
- Of this, 22mn customers and 35mn accounts are currently active, while a large part of the Andhra Pradesh customer database is inactive.
- Equifax is currently receiving 3.5mn enquiries per month which is encouraging.

What are the charges for MFIs to use this database? Are there any fixed plus variable fees akin to that charged by CIBIL?

- Equifax does not charge any fixed fees. Anyone who uses the database is charged on a per-transaction (enquiry) basis.
- The company charges anywhere between Rs 2.5 to Rs 5 per transaction depending on the volume of transactions.

How do credit bureaus detect fraud?

Proprietary algorithms and fully integrated systems with clients help detect fraud

- Equifax has developed algorithms and computer programmes that can detect any tampering with names, surnames or identity card numbers. This is possible because the database includes each member's name, surname, spouse's name, residential address, occupation, amount borrowed, history of repayment, locality and joint lending group (JLG) details, among others.
- Many MFIs have now fully integrated their systems with the Equifax database. As a security measure, customer data entered at MFI branches is first routed through Equifax's regional office before results are relayed back to the branch – this ensures

that branch officers or staff cannot tamper with names or identity numbers once rejected by the system.

- Equifax provides a consumer credit report to MFIs on every enquiry. This is backed by advanced search-and-match algorithms which help assess risk and give MFI members a complete view of the borrower. The report includes identification, i.e. confirmed application information with access to the consumer's name, date of birth, address and ID information; Credit Summary; Recent Activity (including accounts which have gone delinquent and new accounts that have been opened); Account Details (consumer's repayment record) and Enquiries (details of enquiries made on a consumer).

Your company has a 90% hit rate on your database. How is this possible when the sector is still highly underpenetrated?

Loan portfolio should grow at much faster rate than active customer base

- Loans are generally given for less than a year, so there are many repeat customers where the hit rate is close to 100%. For new customers, the hit rate may be in the range of 70-80%, so that averages to ~90%.
- Hit rate captures the probability that a borrower being looked up by an MFI appears in the database.

If this is true, then it means that incremental loan growth will come from higher ticket size and that growth from new geographies is lower?

Not easy to grow portfolios in newer geographies due to different market characteristics

- That's right. The top states contributing to growth are Maharashtra, Tamil Nadu, Karnataka, West Bengal and Kerala. These states have a strong base of microfinance.
- Newer markets like Bihar, Uttar Pradesh and Madhya Pradesh are larger but don't have the inherent characteristics of microfinance markets, in that the northern region is highly male dominated and women are not empowered to do business.
- The company's active customer base of 22mn has grown at a far slower pace than the growth in gross loan portfolio (GLP). Going forward as well, this trend is likely to continue.
- In addition, currently 60% of the customer base has taken loans from only one MFI. This suggests they can borrow from more MFIs, which will drive growth.
- In new geographies, companies will have to innovate in terms of product offering and grow into more remote, unbanked areas. This will require substantial investment in time as well as infrastructure and hence growth from these areas is likely to be slow over the next 2-4 years.

In the last two years, companies have grown their loan books by ~30% and many MFIs are planning to grow aggressively in the future as well. Where do you think growth will come from?

Heavy investment, product differentiation and innovation will be required to increase penetration

- It will have to come from higher ticket sizes of loans. Growth from newer regions will be very limited.
- Companies are also giving more individual loans to group customers with sound track records in terms of payment.

Equifax (Credit Bureau): Meeting takeaways

Higher loan ticket size to fuel growth

Does your company capture self-help group (SHG) data? If not, then isn't it difficult to conclude that borrowing per customer is at manageable levels?

- A substantial part of credit goes to SHGs, mainly in southern states such as Andhra Pradesh, Karnataka and Tamil Nadu. West Bengal has fewer such groups. The total credit under SHGs is ~1.3x of MFI credit. Since SHGs have a large presence in Andhra Pradesh, other southern states have SHG credit which may be equivalent or marginally higher than the total MFI credit.
- Without SHG data, it is difficult to determine borrower-wise data. MFIN and other large companies have requested the RBI to direct banks to submit SHG data to credit bureaus. The problem is banks only track data based on groups; they don't have individual names and outstanding loans against individual borrowers.

If SHGs start submitting borrower-wise data, will loan growth be challenging given that there could be several overlapping borrowers?

SHG data sharing critical to build a foolproof microfinance credit database

- Yes, it will. A vast majority of customers, particularly in southern states, are likely to have borrowed from both sources. Whenever the SHG database is shared, growth will take a hit as there is a cap on the amount that a single individual can borrow. In addition, an individual cannot borrow from two MFIs.
- However, this will be positive in the long term as credit discipline will improve.

Are you planning to introduce new products like that which CIBIL offers stakeholders in India?

Equifax has already launched or is planning to introduce a number of new and innovative products:

- **Microfinance Portfolio Review:** This will provide an overall portfolio review that can be used by MFIs to benchmark their performance with competition and to gauge where they stand in their chosen domain.

  Microfinance portfolio review can also give early warning indicators, such as whether competition has begun to see declining sourcing trends in a particular market, thereby enabling the MFI member to cut its losses early.

  Further, it can help MFIs to devise an entry strategy – for instance, it determines if there is a lucrative market that the MFI needs to focus on, how the market has been performing and what is its potential size.

Plans to launch a product that will allow MFIs to benchmark their performance with competition

- **Microfinance Score:** Equifax has launched the country's first Microfinance Score. The new market-level risk score is designed to predict the likelihood that a customer will default in the next six months. The score aims to facilitate automated decision-making and has been developed specifically for the Indian market, using Indian data and incorporating local market knowledge.

19 August 2015

Private Banks: Meeting takeaways

BC model lucrative for banks to meet PSL targets

We met private sector banks active under the business correspondence (BC) model for microfinance. We noted that banks find it very lucrative to lend under the BC model as yields adjusted for the potential risk are probably the highest under priority sector segments. The current market size of BC lending is ~10% (Rs 40bn-50bn) of the total MFIN portfolio and is expected to increase in the coming years.

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- **BC model very lucrative for banks:** The weaker sections' sub-target under RBI's priority sector norms is the most difficult for banks to meet. To this end, the high-margin business correspondence (BC) product offers a lucrative option, and has led to private sector banks such as Yes Bank, IndusInd Bank, Kotak Bank, HDFC Bank and Ratnakar Bank offering microfinance loans under the model. Yields are in the range of 13-15% and MFIs give credit enhancement up to 5%. In case of low/no default, BC loans are the highest ROE-accretive priority sector loans. Current market size is ~10% of total MFIN portfolio.

- **Return ratios not materially different from direct lending to MFIs:** Yields on BC loans are 100bps-200bps higher than traditional on-lending to MFIs. However, banks highlighted that operating costs are high under the BC model as separate software and infrastructure for capturing data of small borrowers needs to be created. Also, banks need to carry out the KYC procedure for all customers, with verification in some cases even done at the respective branches besides auditor visits to rural branches where transactions have been initiated. Therefore, adjusted for operating costs, BC and direct lending generates the same ROE for banks.

- **Caps enforced to curtail risk on loans:** Banks highlighted that there are inherent default risks which can lead to high credit costs on the portfolio. Although risks can't be brought down to zero, banks reduce risks by maintaining a cap on total BC lending, besides enforcing caps on regions/geographies and on MFIs.

- **NBFC-MFI borrowing limits do not apply to BC loans:** As per RBI guidelines, borrowers can't borrow from more than two MFIs and the total borrowing is capped at Rs 100,000. However, technically these limits do not apply to BC loans as they are originated directly in the books of banks. Nevertheless, private banks with greater risk aversion do checks with credit bureaus (Equifax) and do not participate in portfolios which don't comply with NBFC-MFI norms.

- **Aggressive lending, undercutting by NBFCs a concern:** Banks highlighted that many NBFCs are competing to lend to MFIs directly or under the BC route. For NBFCs, it may not be as lucrative because banks attempt to meet their priority sector requirements through BC lending. Though BC loans carry high risk, yields too are significantly higher at 13-15% than 6% generated by alternate investments in RIDF bonds. Therefore, even after accounting for the potentially high risk, returns are attractive for banks rather than NBFCs.

BC loan penetration data

BC loans through MFIs currently	Rs40-50bn
As % of MFIN credit	~10%
Yields on BC loans	13-15%
Opex for maintenance / due diligence of the portfolio	1-2%
Yields on direct lending to MFIs	12-14%

Source: Banks, RCML Research

Fig 1 - MFIs as Business Correspondents (as on Mar'14)

Banks	MFIs	No. of MFIs
Yes Bank	Mahashakti Foundation, Disha India Micro Credit, Samhita Community Development Services, Bhartiya Micro Credit	4
Axis Bank	Janalakshmi Financial Services	1
Union Bank of India	SKDRDP, Satin Creditcare	2
State Bank of India	SKDRDP, Swayamshree Micro Credit Services, Initiative for Development Foundation (IDF), Drishtee Foundation	4
Corporation Bank	SKDRDP	1
Canara Bank	SKDRDP, BWDA Finance	2
Punjab National Bank	CDoT	1
Allahabad Bank	CDoT	1
UCO Bank	CDoT	1
ICICI Bank	Cashpor Micro Credit, Shikhar Microfinance, Prayas Juvenile Aid Centre	3
IDBI Bank	SKDRDP, People's Action for Transformation	2
Ratnakar Bank	SKDRDP	1
Pragati Krishna Gramin Bank	SKDRDP	1

Source: Sa-Dhan; Note: Data as on Mar'14. In the last one and half years many MFIs have tied-up with banks for BC loans. Therefore to that extent business correspondence relationship is higher than reported in the table above.

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19 August 2015

Seed Investors: Meeting takeaways

Valuation gap between listed & unlisted MFIs unduly high

We met several private equity (PE) and venture capital (VC) funds, who have invested in various MFIs, in order to understand their views on the sector. Key takeaways: (1) AUM growth is likely to remain strong but competition is intensifying in some regions. (2) The valuation gap between listed and unlisted MFIs is unduly high and likely to be bridged going forward. (3) Diversification and/or conversion into a bank can mitigate risks, but the change in structure and operations would prove challenging for MFIs.

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- **AUM growth to remain strong but competition intensifying:** PE/VC players expect microfinance AUM growth to remain strong over FY15-FY17. Small players are likely to double their loan book every year for the next two years, whereas large and mid-size players are eyeing a 50% CAGR. Investors believe this high growth is not worrying as much of it is coming from branch and geographic expansion, suggesting ample opportunities in unbanked and credit-starved regions. The VC/PE funds we met highlighted that competition is intensifying in the states of Gujarat, Tamil Nadu and Maharashtra. However, they don't see any risk to margins or asset quality currently and feel that larger players have taken note of the increased competition and turned more cautious.

- **Diversification a must to mitigate risks:** MFIs have become more disciplined after RBI regulations were introduced for NBFC-MFIs. Self-governing bodies (MFIN) and credit bureaus (Equifax) have helped improve their performance. But political risks remain. Local and regional disturbances or natural calamities can also lead to large losses. Political risks can be mitigated by converting the business into a bank, while MFIs need to diversify in order to avoid sudden losses from local disruptions and natural calamities. Investors highlighted that they too have diversified by investing small sums across 5-7 MFIs in order to mitigate the political risk.

- **Gap between unlisted and listed MFIs unduly high; set to narrow:** SKSM, the only listed player, is trading at 5.5x FY15 P/B whereas PE/VC deals in the unlisted space have taken place in the range of 1.7-2.2x. Investors believe that the valuation differential is not justified even after accounting for the liquidity premium for the only listed MFI and also considering that medium-term growth prospects are higher for small unlisted MFIs. Valuations are expected to improve for small/unlisted MFIs as they grow, improve their credit ratings and diversify their investor base.

- **Conversion into small bank brings both opportunities as well as challenges:** Conversion into a bank will mitigate political risk and diversify the income and funding mix. However, small MFIs may face challenges in terms of new processes, handling of branch operations on the liability side and HR issues. Small MFIs that bag a bank licence may have to consolidate operations, which could result in a flat loan book for the next one to two years. PE/VC investors feel that, at best, 2-3 MFIs will be given banking licences in the first round.

Seed Investors: Meeting takeaways

Valuation gap between listed & unlisted MFIs unduly high

Q&A with investors

What is your assessment of AUM growth going forward?

- AUM growth is likely to remain very strong over FY15-FY17.
- Small players are expected to double their loan book every year for the next two years whereas mid-to-large players are looking at a 50-60% CAGR.

Many MFIs are eyeing 50-100% growth over the next few years. Don't you think this is worrying?

Ample opportunities for growth in unbanked and credit-starved regions

- High growth is worrying if borrowing per customer (indebtedness) is increasing. However, current growth is supported by branch and geographic expansion and so it is fair to conclude that there are opportunities in many unbanked and credit-starved regions.
- A typical branch in a rural or semi-urban region can generate Rs 50mn-70mn of total AUM after 2-3 years of operations. For an urban branch, this figure is Rs 60mn-80mn. These statistics have remained more or less constant. However, if AUM per mature branch increases substantially (adjusted for inflation) over the next two years, that will be worrying as it could lead to margin compression or asset quality concerns.
- Competition is intensifying in a few regions of Gujarat, Tamil Nadu and Maharashtra. Some regions have 10-12 MFIs which is worrisome. However, these players aren't seeing any risk to margins or asset quality currently. Sound, large players have taken note of the increased competition and turned more cautious.

What do you think were the lessons learnt from the AP crisis?

- Any industry or its sub-segment operating without regulation is bound to face political risks. Some MFIs were charging as much as 30% interest pre-AP crisis with no control over operating expenses – operating cost as a percentage of total assets was as high as 10-15%. MFIs weren't transparent in terms of disclosures and corporate governance.
- Post-RBI regulations on NBFC-MFIs, the sector has become more disciplined. Self-governing bodies (MFIN) and credit bureaus (Equifax) have helped improve their performance. With the cap placed on spreads (10%), MFIs have become efficient and reduced their operating cost in order to maintain profitability. Credit bureau checks and limits on borrowers will help maintain asset quality.
- Seed/angel investors had to write-off some of their investment in companies like Bhartiya Samruddhi Finance (Basix), Share Microfinance and Spandana Sphoorty Financial as they went under CDR. Banks may have to take a hit as well. The possibility of recovering equity contributions looks very thin at this stage.

Seed Investors: Meeting takeaways

Valuation gap between listed & unlisted MFIs unduly high

Do you agree that political and other risks remain high?

- Political risks still remain even after the positive changes wrought by the RBI, as state governments can exercise control over MFIs. Political risks can be mitigated by converting into a bank. Also, passage of the MFI bill is crucial.
- Local and regional disturbances or natural calamities could lead to large losses. MFIs need to diversify in order to avoid these risks.
- Investors too have diversified by investing small sums across 5-7 MFIs in order to mitigate the political risk.

At what multiples are deals taking place in the unlisted space? What is your assessment on valuations?

- SKS Microfinance, the only listed player, is trading at 5.5x FY15 P/B whereas PE/VC deals in the unlisted space have taken place in the 1.7-2.2x range. This valuation gap is unduly high.
- This is despite the fact that growth prospects are higher for small unlisted MFIs in the medium term. The valuation differential is not justified even after accounting for the liquidity premium for the only listed MFI.
- Valuations are expected to improve for small MFIs as they grow, improve their credit ratings and diversify their investor base.

How do you view conversion into a small bank?

- Key benefits of conversion into a bank will be the mitigation of political risk and diversification of the income and funding mix. Reduction of the political overhang is crucial as this can even lead to bankruptcy.
- Many MFIs lack experience as they currently have a small loan book of Rs 20bn-30bn. Thus, they may face challenges in terms of changes in processes, handling of branch operations on the liability side and HR issues. MFIs that bag a small bank licence may have to consolidate operations, which could result in a flat loan book for the next one to two years.
- At best, 2-3 MFIs will get banking licences in the first round. The RBI is unlikely to give licences to all aspirants at one go (15-18 MFIs have applied).

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19 August 2015

SELL
TP: INR 400.00
▼ 26.3%

SKS Microfinance

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Valuation pricing in best case; initiate with SELL

We initiate coverage on SKSM with an anti-consensus SELL rating and a Mar'17 TP of Rs 400, as we believe the stock is pricing in a best-case scenario in terms of growth, asset quality, award of a bank licence and successful execution thereafter. SKSM is a top contender for a small bank licence – assuming this materialises, we expect return ratios to remain lower than private banks and loan growth to be capped due to the mandated 75% PSL target. Incremental growth is likely to come at much higher risks as many markets are saturated.

- **Small bank licence – little to be gained:** If SKSM were to win a small banking licence, high dilution (to bring foreign holdings down to 49%) and prudential norms (CRR/SLR) will be a drag on profitability for the first 2-3 years. Also, the priority sector target of 75% will restrict loan growth in the long run. Building a strong liability franchise would prove challenging and costly given low volumes per branch/customer. The resultant reliance on bulk deposits coupled with limited room for a credit rating upgrade due to an unsecured loan book will keep the cost of funds high. After assuming normalised credit cost, ROE will be marginally lower than well-run private sector banks in India in the long term – belying the street's upbeat growth expectations.

- **Southern market crowded; growth in new geographies at higher risk:** Southern states and many regions of fast-growing states like Uttar Pradesh, Madhya Pradesh and Maharashtra are overcrowded. Around 50% of SKSM's book is concentrated in states where microfinance penetration is alarmingly high. Incremental growth from larger ticket size and new geographies will entail high risk and high costs, in our view.

- **Valuation pricing in best case; SELL:** SKSM is currently trading at 3.9x FY17E P/B, a premium to private sector banks which is unjustified given its 100% unsecured loan portfolio and poor liability franchise. Credit cost assumptions cannot be kept at the regulatory minimum for an unsecured portfolio. We initiate coverage on the stock with a SELL rating and a Mar'17 TP of Rs 400 set at 2.8x forward P/B.

Financial Highlights

Y/E 31 Mar	FY14A	FY15A	FY16E	FY17E	FY18E
Net interest income (INR mln)	2,345	3,542	5,209	7,141	9,837
Net revenues (INR mln)	3,306	5,241	7,587	10,471	14,665
Pre-provision profits (INR mln)	844	2,037	3,207	4,460	6,365
Adj. PAT (INR mln)	699	1,877	2,316	2,968	4,209
Adj. EPS (INR)	6.5	14.9	18.3	23.5	33.3
ROE (%)	16.4	24.9	19.9	20.8	23.6
ROA (%)	2.8	5.2	4.3	4.0	4.1
Gross NPA (%)	0.1	0.1	0.1	0.8	1.3
CAR (%)	27.2	31.7	27.5	24.2	22.3
P/BV (x) – (ex-DTA)	12.8	6.6	5.4	4.4	3.4
P/E (x)	84.1	36.5	29.6	23.1	16.3

Source: Company, Bloomberg, RCML Research

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PRICE CLOSE (19 Aug 15)
INR 543.10

MARKET CAP
INR 68.7 bln
USD 1.1 bln

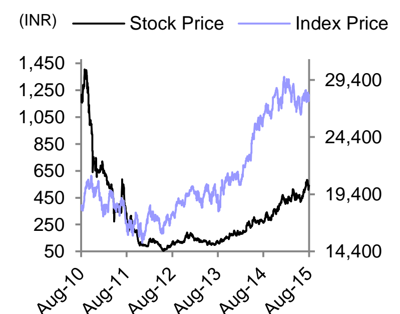
SHARES O/S
126.3 mln

FREE FLOAT
90.8%

3M AVG DAILY VOLUME/VALUE
1.3 mln / USD 10.3 mln

52 WK HIGH
INR 589.60

52 WK LOW
INR 260.50



Small banking licence – little to be gained

SKSM is widely acknowledged as the top contender for a small finance bank licence, due for release by the RBI later this month. We believe conversion to a bank will weigh heavy on profitability in the initial 2-3 years of operations due to the negative carry on CRR/SLR provisioning and high dilution to meet shareholding norms. As per our calculation, dilution alone could have a 740bps hit on ROE in FY17.

In the long term, we forecast a material 300bps decline in spreads to 7% given (1) lower spreads on non-microfinance loans, (2) high costs not only to maintain regulatory prerequisites but also due to a likely run-down of the high-margin managed portfolio for growth needs, and (3) challenges to building a strong deposit franchise. Our analysis of the long-term return matrix suggests that after assuming normalised credit cost, SKSM's ROE will be marginally lower than that of well-run private sector banks in India – belying the street's upbeat expectations.

Top contender for a small bank licence

Compliant with most RBI requirements

SKSM's current AUM mix is fully compliant with the RBI's priority sector lending (PSL) norms for a small finance bank. The RBI has mandated that 75% of loans should be directed to the priority sector and 40% of this should be allocated as per the existing PSL requirements for the banking sector (the balance 35% can be allocated as per the small bank's competitive advantage).

Current AUM mix fully compliant with the PSL requirement for a small finance bank

According to management, barring gold loans which form 1% of the total loan book, ~99% of the portfolio qualifies as PSL. Further, agriculture and livestock lending constitutes 30% of the total loan book, which will help SKSM meet the 18% agriculture loan requirement. Also, the largest ticket size in SKSM's loan portfolio is not more than Rs 30,000, well within the RBI's stipulation that 50% of the portfolio should not exceed a ticket size of Rs 2.5mn.

Fig 1 - SKSM's portfolio qualifies for PSL target of 40% under new norms

RBI				SKS compliance	
S.no.	Sector	Category	Target for Banks (%)	Qualifying Portfolio of SKS (%)	Comments
1	Agriculture	Target	18	30	Livestock, Agri & Allied
2	Small & Marginal farmers	Sub-target	7 (Mar'16) 8 (Mar'17)	30	
3	Weaker	Target	10	100	100% loans are to women beneficiaries (with ticket size of less than Rs 100,000) Further, minority communities constitute 16% and economically weaker sections 71% of the loan portfolio
4	Micro- enterprises	Target	7 (Mar'16) 7.5 (Mar'17)	100	Loans to MFIs for on-lending to microenterprises

Source: Company, RCML Research

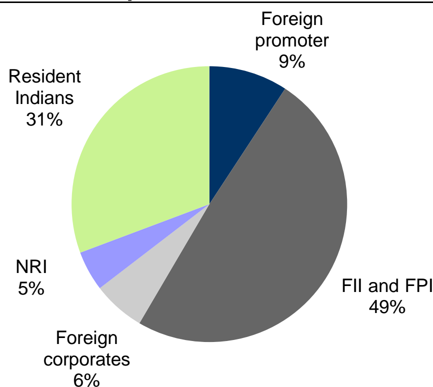
Major ownership hurdle to be crossed

A major hurdle for SKSM would be a restructuring of its shareholding pattern to comply with the licencing guidelines. The RBI requires promoters to hold at least 40% and resident Indians to hold ~51% in the proposed bank. As of Mar'15, SKSM had foreign promoter holding of 9.3% and foreign investor holding of ~68%. Thus, it will need to raise capital from domestic entities to bring the foreign shareholding down to 49%. To comply

Needs to raise capital from domestic entities to bring the foreign shareholding to 49% from 68% now

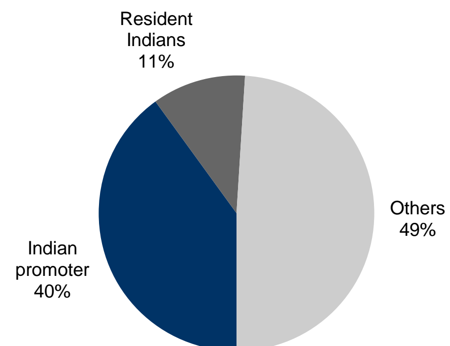
with the ownership requirements, SKSM may float the small finance bank under a fully owned non-operative subsidiary (NOFHC) and transfer its lending business into it.

Fig 2 - Present ownership structure



Source: Company, RCML Research

Fig 3 - RBI requirement (Indian promoters must own 40%)



Source: RBI, Company, RCML Research

Our back-of-the-envelope calculations suggest that in order to draw the foreign shareholding down to 49%, SKSM will need to raise ~Rs 27bn of capital from domestic investors, necessitating equity dilution of ~39%. Dilution would have a negative impact on EPS in the short term and cause ROE to fall dramatically by 740bps in FY17 (ROA to remain strong), based on our estimates.

SKSM will need ~Rs 27bn of capital support from domestic investors, necessitating ~39% dilution

Fig 4 - Calculation for expected dilution

Parameters	
CMP (Rs)	543
Shares (mn)	126.3
Market capitalization (Rs bn)	67.8
Current foreign shareholding (%)	68.2
New domestic capital required to be issued (Rs bn)	**26.6**
Issue price (Rs)	537
Number of shares to be issued (mn)	49.5
Foreign holding post money (%)	49.0
Market cap post money (Rs bn)	94.4
Likely dilution (%)	**39.2**

Source: RCML Research

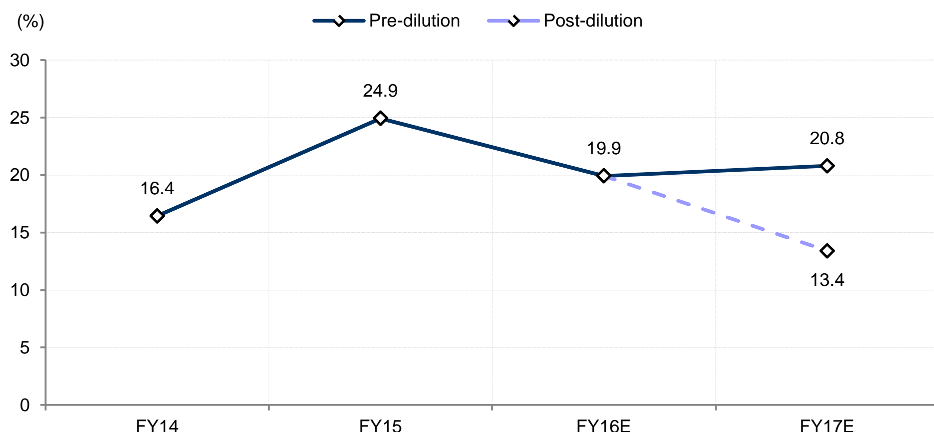
Given the heavy dilution, we expect ROE to fall dramatically

Fig 5 - Impact of dilution

Particulars	Pre-dilution		Post-dilution	
	FY16E	FY17E	FY16E	FY17E
No. of shares (mn)	126.3	126.3	126.3	175.8
ROE (%)	**19.9**	**20.8**	**19.9**	**13.4**
ROA (%)	4.3	4.0	4.3	4.8
PBR (excluding DTA) (x)	5.3	4.3	5.3	2.2
BVPS (Rs)	101.2	124.7	101.2	245.2
EPS (Rs)	18.3	23.5	18.3	21.3

Source: RCML Research

Fig 6 - Dilution to hit ROAE



Source: Company, RCML Research

Challenges to building a strong deposit franchise

Current customer base has limited surplus savings

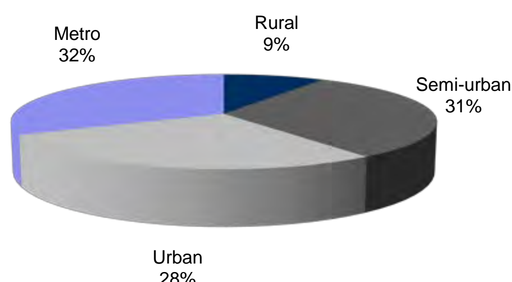
MFIs provide credit to unfunded sectors and regions of the country, catering purely to the lower-income strata. Garnering deposits will be a real challenge as MFIs serve those sections of the population that are unable to meet their own needs and hence have limited surplus savings, if any.

High competition from private sector banks

HDFC Bank has opened 70% of its incremental branches in rural and semi-urban areas

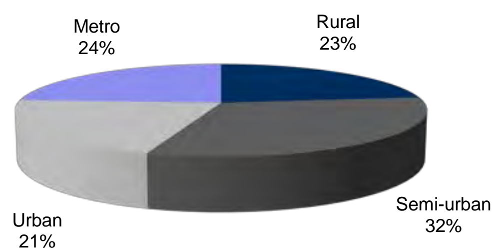
Under the revised RBI norms, banks are allowed to open branches in rural or semi-urban areas without seeking prior permission of the central bank. To aid financial inclusion, new branch licencing in urban areas is also dependent on branches opened in unbanked regions. In the last 3-4 years, banks – especially private sector banks – have increased their presence in unserved areas in order to meet priority sector targets and improve their liability franchise. HDFC Bank, for instance, has opened ~70% of its new branches in rural and semi-urban areas in the last four years. Rural branches as a percentage of its network have gone up from 9% in FY11 to 23% in FY15. In other words, SKSM faces stiff competition to building a strong deposit franchise.

Fig 7 - HDFC Bank – breakup of branches (FY11)



Source: HDFC Bank

Fig 8 - HDFC Bank – breakup of branches (FY15)



Source: HDFC Bank

Direct competition from Jan Dhan bank accounts

Banks, especially PSUs, have opened more than 125mn accounts under the government's Pradhan Mantri Jan Dhan Yojana (PMJDY). Launched in Aug'14, PMJDY aims to provide universal access to banking facilities and focuses on people who are not covered under normal bank channels. We believe that virtually the entire addressable customer base that was outside the formal banking channel has now been covered under PMJDY.

Government's PMJDY bank account scheme already covers most of the addressable market

Under this scheme, account holders are provided with zero-balance bank accounts and other benefits including medical and accident insurance. The government is also looking at direct transfers of various subsidies through these accounts. Thus, unbanked customers and those with low deposit balances would likely prefer the convenience of Jan Dhan accounts for their surplus savings. New banks, especially those operating in under-banked areas, will therefore find it difficult to garner retail deposits.

Long-term spreads likely to decline materially

Prudential norms will have a negative carry

As per RBI stipulations, small finance banks need to maintain the same CRR and SLR as universal banks. Upon conversion to a bank, SKSM will thus need to maintain a low-yielding SLR portfolio and also park CRR balances with the RBI at zero interest. Thus, ~26% of borrowings (SLR at 22% and CRR at 4%) will earn less than the cost of funds in the short term, hitting margins.

CRR/SLR requirements will have negative carry in the short to medium term

Unsecured loan book and bulk deposits to keep cost of funds high

Post-conversion into a bank, SKSM will cease to be an NBFC-MFI. Thus, loans provided by it will no longer enjoy PSL status, which would invariably raise the cost of funds. Moreover, SKSM will need to rely more on bulk deposits as its ability to garner retail deposits would be restricted by limited scalability of its liability franchise and direct competition with banks who are also expanding into rural and semi-urban markets.

Cost of funds to remain high – no PSL status for borrowings, little scope for credit rating upgrade, poor deposit mix

Scope for a credit rating upgrade and resulting reduction in cost of funds is limited, as a large portion of SKSM's loan book will comprise unsecured microfinance credit (at least in the initial years). Further, the priority sector will constitute 75% of the loan book where risks are higher, keeping costs elevated.

Non-microfinance loans will come at much lower spreads

As a bank, SKSM will likely move towards secured products such as business loans, SME, MSME, auto & home loans and loans against property. NBFCs and commercial banks are already well established in these segments, implying intense competition for small finance banks. Incremental spreads on these products will be in the range of 4-5% as compared to 10% on microfinance loans currently.

Priority sector loans not as scalable as non-PSL

Post conversion into a bank, SKSM will have a 75% PSL target (vs. 40% for universal banks). We note that growth opportunities are very limited in microfinance and other related assets classified as priority sector, whereas non-priority sector loans are easily scalable given that they are not highly dependent on the liability franchise.

To illustrate:

- Bandhan Financial Services, the largest and among the oldest microfinance institutions in India, today has a loan book of ~Rs 100bn after 15 years of operations.

Yes Bank which started operations effectively in FY04 or 12 years ago has customer assets of Rs 900bn.

- Mahindra & Mahindra Financial Services (MMFS, CMP: Rs 261, TP: Rs 270, HOLD) started a rural housing subsidiary to provide small-ticket housing loans in rural areas in Apr'07. The company had a target of Rs 50bn in AUM after five years of operations by FY12. Today, after eight years of operations, AUM is at Rs 23bn, less than half the initial target.

At the same time, a few PSL segments where risks are low and credit costs are predictable, such as small-ticket home loans and auto loans, have become highly competitive and are dominated by NBFCs and banks. Competition is also intense in the MSME and SME segments.

Priority sector sell-down to decline over medium-to-long term

SKSM will have to run down managed portfolio for its growth needs

SKSM securitised loans stood at Rs 6.2bn and managed loans created in the books of the other banks stood at Rs 4.8bn as of Mar'15. These together constitute 23% of its gross loan portfolio (GLP). The managed loan pool is margin and ROE accretive as these loans are outside the balance sheet and earn almost the same spread as on-book loans.

SKSM is able to securitised loans and create managed portfolio in the books of banks as there is no requirement to maintain priority sector loans on balance sheet for NBFC-MFIs. However post conversion into a small finance bank, it will be mandatory to maintain 75% priority sector loans target. At the same time, the company will like to grow its non-priority sector portfolio. Therefore, SKSM will have to reduce its priority sector sell-down in order to maintain a 75% PSL share and manage growth needs.

Refinancing from Mudra Bank could help

The small bank structure could open up refinance lines from Mudra Bank for lending to the microfinance segment. MFIs currently borrow from banks at 11-14%. However, Mudra aims to avail of funds at rates lower than that provided by banks, which will inevitably lead to a lower cost of funds for SKSM.

Spreads to come off materially in the long term

We expect spreads to decline 300bps in the long term

We do acknowledge that capital raising and refinance from Mudra Bank will be positive for SKSM's NIM. But, in our view, these benefits will be more than offset by costs incurred on maintaining the regulatory CRR/SLR prerequisites, run-down of managed portfolio for growth needs, and lower spreads on non-microfinance loans post conversion to a small bank. Thus, we expect spreads to decline in the long term. In the long term, we forecast a material 300bps decline in spreads to 7%

Growth and profitability to mirror private sector banks

75% priority sector requirement to limit growth upsides

The market appears to be pricing in substantial upsides to growth and profitability for SKSM due to the low loan base and reduction in cost of funds. But unless the company compromises materially on margins, we estimate that loan growth would merely track that of private sector banks in its initial years of operations, given the large PSL mandate. As mentioned earlier, the relatively small portfolio of Bandhan Financial Services vs. Yes Bank reflects the limited growth opportunities in the priority sector space (Bandhan will be converted into a full-fledged bank from Aug'15).

Expect ROA of 1.5-1.7% and ROE of 17-18% in the long term

We have made a detailed calculation of SKSM's potential profit matrix post conversion into a bank. As seen in Fig 5 & 6, profitability would be under pressure in the short term (initial 2-3 years) due to CRR/SLR requirements and high dilution to bring the foreign shareholding below 49%. Post conversion into a bank, SKSM would look to grow its non-PSL portfolio to up to 25% of total loans. These loans will come at significantly lower spreads (4-5%) as compared to current microfinance loans (~10%). Within the priority sector, the company may grow in areas such as MSME, auto loans and low-ticket housing loans where competition is stiff, putting pressure on priority sector yields.

Blended loan yields to decline due to lower yield on non-priority sector loans and build-up of secured assets (low-ticket home loans, auto loans)

We expect cost of funds to remain in the range of 8.25-8.5% as a large portion of deposits will come from the wholesale market. We note that the average cost of funds for Yes Bank, which has a CASA ratio of 23%, has been ~8.4% for the last four years. We model for a cost-to-income ratio of 60% in the long term (opex/average assets at 5.5%) and assume higher credit costs at 1.3% of total assets. ROA should remain in the range of 1.5-1.7% while ROE would drop to 17-18% in the long term from 20-22% at present.

Fig 9 - Long-term return matrix for SKSM after converting into a small finance bank

No.	Particulars	Long term return profile
1	**Loan yields**	
	- Priority sector	20.5%
	- Non-priority sector	13.0%
2	**Loan mix**	
	- Priority sector	75.0%
	- Non-priority sector	25.0%
3	**Blended loan yields (1X2)**	**18.6%**
	- SLR book yield	7.6%
	- CRR book yield	0.0%
4	**Asset mix**	
	- Loans	76.2%
	- Investments	20.3%
	- Cash with RBI	3.6%
5	**Liability mix**	
	- Borrowings	15.0%
	- Deposits	75.0%
	- Net worth	10.0%
6	**Blended yield on asset book (3x4)**	**15.7%**
7	Cost of deposits / borrowings	8.4%
8	Spread	7.3%
	Du-Pont Analysis	
	NII to total assets {6- (5*7)}	8.2%
	Fees	1.0%
	Total income	9.2%
	Cost to income (60%)	5.5%
	Operating profits	3.7%
	Provisions	1.3%
	Profit before tax	2.4%
	Tax (34%)	0.8%
	Profit after tax (ROA)	1.6%
	Leverage	11x
	ROE	17.5%

Source: RCML Research

Cost of funds to remain in the range of 8.3-8.5% as building low-cost deposit franchise will be a challenge

We assume C/I ratio of 60% due to high investment in technology and processes to manage liabilities

We assume credit cost of 1.3% over a cycle as a large portion of the book is unsecured

Headwinds to core business growth

Our thesis of a crisis brewing in India's microfinance sector suggests multiple risks to SKSM's core business from saturated markets, high competition and rapid growth in untested geographies. In our view, incremental growth in newer states would come at higher operating and credit costs over a cycle as compared to traditional markets. Thus, base-case credit cost (on advances) forecasts need to be much higher than the regulatory minimum (we model for 1.5% vs. 0.3-0.4% currently), and the P/B multiple for the sector must be adjusted accordingly. SKSM is trading at 4.4x FY17E BV (3.9x after taking deferred tax assets), which we believe is unjustified for the microfinance business (100% unsecured loan book). Thus, banking licence or not, we are negative on the company.

Southern market saturated

Top 5/top 7 states constitute half/two-third of microfinance credit

As highlighted in our sector report, India's southern and eastern states (including Andhra Pradesh, Tamil Nadu, Karnataka, Kerala, West Bengal and Odisha) have high microfinance penetration levels in the range of 16-25%. Our estimates suggest that in the top 5 states which account for 50% of total outstanding microfinance credit in the country, one out of every five households has borrowed from microfinance institutions. In the top 7 states which account for two-third of total microfinance credit, one of every ten households has borrowed from MFIs.

Proportion of MFI customers to total households is alarmingly high in southern and eastern states

MFIs will find it challenging to penetrate further in these states as the addressable market is limited because (1) the working class as well as high & middle income groups typically do not avail of microfinance and (2) more than 60-70% penetration in the low-income segment is unlikely as not everyone will borrow or require credit facilities.

Fig 10 - Penetration among households very high in top five states

States	Total households (mn)		MFI client base- FY15 (mn)	MFI clients as % of total households	Poor household (%)	Poor households (mn)	MFI client base as % of poor household	GLP (Rs bn)	GLP (% of total)
	FY11	FY15							
Tamil Nadu	18.5	20.0	4.9	24.4%	17%	3.4	143%	57	14%
Karnataka	13.3	14.4	2.9	20.4%	24%	3.4	87%	44	11%
West Bengal	20.3	22.0	4.6	20.8%	27%	5.9	78%	60	15%
Assam	6.4	6.9	1.3	19.2%	38%	2.6	51%	21	5%
Odisha	9.6	10.4	1.7	16.1%	37%	3.8	43%	19	5%
Madhya Pradesh	15.0	16.3	2.1	12.7%	37%	6.0	35%	24	6%
Maharashtra	24.3	26.3	3.0	11.5%	25%	6.4	47%	39	10%
Bihar	18.9	20.4	2.1	10.4%	54%	10.9	19%	27	7%
Gujarat	12.2	13.2	1.1	8.2%	23%	3.0	36%	NA	NA
UP	33.2	36.0	2.4	6.6%	38%	13.6	18%	33	8%

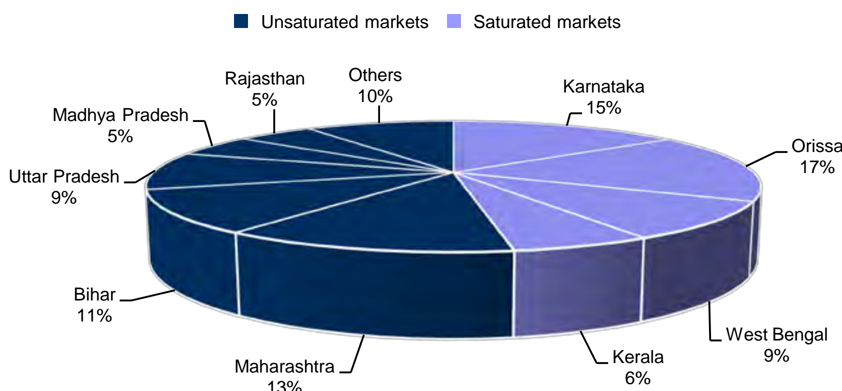
Source: Consensus 2011, MFIN, RCML Research

~50% of SKSM's portfolio concentrated in saturated states

High competition in traditional markets has made it increasingly difficult for MFIs to grow their client base. Our channel checks suggest that some districts have more than 10-12 MFIs competing for market share. Saturated states account for 48% of SKSM's AUM, implying that growth in these regions will come only from higher ticket sizes.

Saturated states accounts for ~48% of AUM

Fig 11 - Close to half of SKSM's AUM concentrated in saturated regions



Source: Company, RCML Research

Growth in new regions entails high risk, high cost

Rapid scale-up in northern and central states

SKSM, like most industry players, is now expanding its footprint in northern and central states (like Uttar Pradesh, Bihar, Madhya Pradesh, National Capital Region and Rajasthan) in search of growth.

Based on the data released by MFIN, 10 new players have entered Madhya Pradesh and Maharashtra over the last three years. Incremental branch addition in Madhya Pradesh has been higher than Karnataka and Odisha put together. Our channel checks suggest that penetration levels are equal to or even higher than southern and eastern states in certain pockets of these newer markets, viz. –

1. Maharashtra – Vidarbha region, Pune and Nashik belt
2. Uttar Pradesh – Western and eastern UP (limited growth opportunities in central UP)
3. Bihar – Regions near eastern UP and West Bengal
4. Madhya Pradesh – Regions near western UP, Haryana (northern MP) and Maharashtra (southern MP)

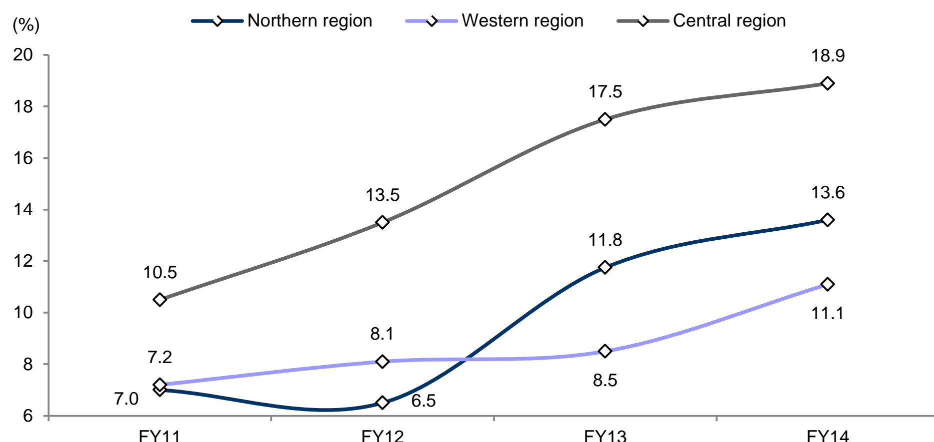
Rising costs

NPA levels in northern and central states is 2-3x higher than South India

Incremental growth in these states, mainly from regions yet to be explored by MFIs, may not come at the same operating and credit costs over a cycle as compared to southern states, as they share different market characteristics. The group credit culture is still developing and women, a key MFI client base, are less empowered here. MFIs will have to offer differentiated products and penetrate much deeper into these regions, which will likely increase their operating costs.

A look into the asset quality performance of self-help groups (SHG) suggests that NPA levels in northern and central states is 2-3x higher than southern India, reflecting the challenging market conditions.

Fig 12 - SHG – NPAs in northern, western and central regions have gone up



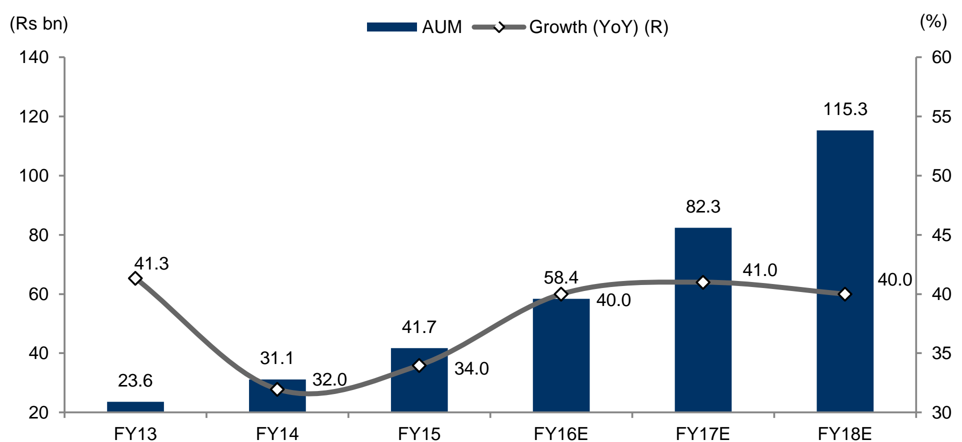
Source: Sa-dhan

We model for higher credit cost

We have factored in an AUM CAGR of 40% over FY15-FY17. Since a majority of the growth is likely to be contributed by new geographies and higher ticket-size loans, NPAs and credit cost would increase going forward. Spreads are likely to remain in the current range of 9.5-10%. We expect GNPA to increase from 0.1% currently to 1.3% by FY18 and model for 1% credit cost in FY17 and FY18.

We expect SKSM's GNPA to increase to 1.3% by FY18 and model for 1% credit cost in FY17/FY18

Fig 13 - Momentum in AUM growth likely to be sustained



Source: Company, RCML Research

AP crisis – Impact analysis

SKSM suffered heavy losses during the Andhra Pradesh microfinance failure of FY10, with AUM more than halving from Rs 43.2bn in FY10 to Rs 16.7bn in FY12. However, it was the only large player that survived without restructuring its bank borrowings through the corporate debt restructuring (CDR) mechanism. Further, proactive steps to strengthen the business and a strategy to avoid concentration risks aided a swift return to growth for the company. We look at the impact of the event on SKSM and key lessons learnt.

Pre-crisis

AUM increased at CAGR of ~150% over FY07-FY10

SKSM, like other players, expanded at a blazing pace of ~150% (CAGR) between FY07 and FY10. Its AUM increased from just over Rs 2.8bn in FY07 to Rs 43.2bn in FY10, on the back of rapid expansion in distribution network and employees. Andhra Pradesh (AP) – a role model state for MFI players – was a key driver for this growth and accounted for ~30% of SKSM's AUM.

In FY12, the AP government brought in an ordinance to regulate MFIs that was apparently aimed at protecting the MFI borrower from coercion and over-indebtedness, but in reality served to virtually cripple the industry. The two crucial provisions that hit MFIs were: (1) staff was not permitted from visiting the borrower's residence or workplace for loan recovery and instead had to wait at a 'central public place' in the hope that the borrower would come and repay, and (2) MFIs were prohibited from disbursing fresh loans without the government's prior approval. People took a convenient interpretation of the law and stopped repayments which led to a mass default in AP.

Impact on business

As bank funding dried up, AUM more than halved from Rs 43.2bn in FY10 to Rs 16.7bn in FY12

SKSM had an exposure of ~Rs 14.9bn to AP in FY10 but was able to recover a mere ~Rs 1.3bn – the balance had to be provided towards credit costs. In the end, the company had to write off its entire balance exposure in AP as the collection efficiency dropped from 99% to 5% post crisis, forcing SKSM to stop lending activity in the state.

SKSM was also forced to shrink its non-AP loan book as bank funding dried up following fears of default and a large part of the collections were channeled into repaying existing bank loans. AUM more than halved from Rs 43.2bn in FY10 to Rs 16.7bn in FY12. The dwindling portfolio size and high credit cost on AP loans led to net losses for seven consecutive quarters.

Post-crisis

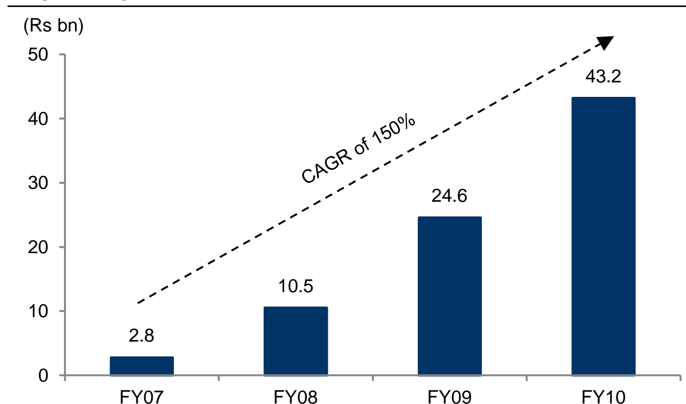
Despite losses, SKSM was the only large player that survived without restructuring its bank borrowings through the corporate debt restructuring (CDR) mechanism, given it had an adequate capital buffer from funds raised through an IPO just months before the crisis broke out. Post-crisis, the company went into damage control mode and took proactive steps to strengthen the business:

- SKSM consolidated its existing borrower base and abstained from acquiring new clients in order to avoid further risk to asset quality. Consequently, its active borrower base declined from 6.7mn in Q3FY11 to 4.1mn in Q3FY13.
- The company also structurally readjusted its branches and rationalised the head count to rein in operating costs. It cut down ~1,100 branches and ~14,500 employees between Q3FY11 and Q3FY13.

- Moreover, it diversified into gold loans, financing *kirana* stores and the purchase of mobile phones (less risky than traditional microfinance loans) in non-AP states.

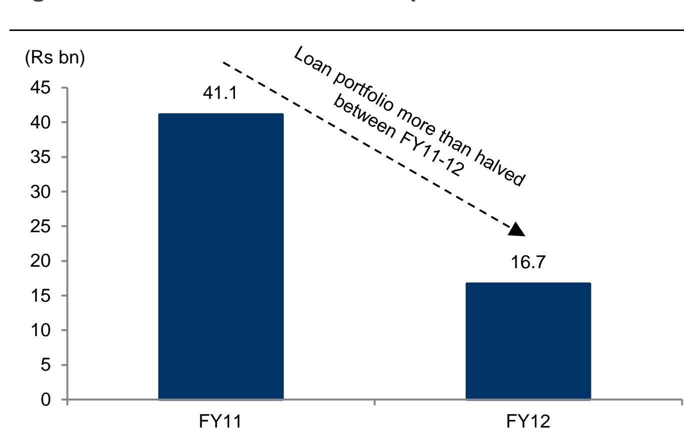
SKSM managed to recover quickly as the crisis was limited only to the state of AP. A strategy to avoid concentration risks and ensure diversification into other states further aided the company's return to growth.

Fig 14 - SKSM reported strong AUM growth over FY07-FY10…



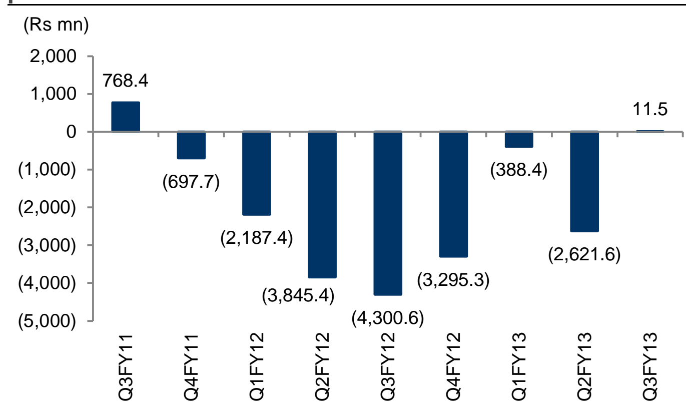
Source: Company

Fig 15 - …which more than halved post-AP crisis



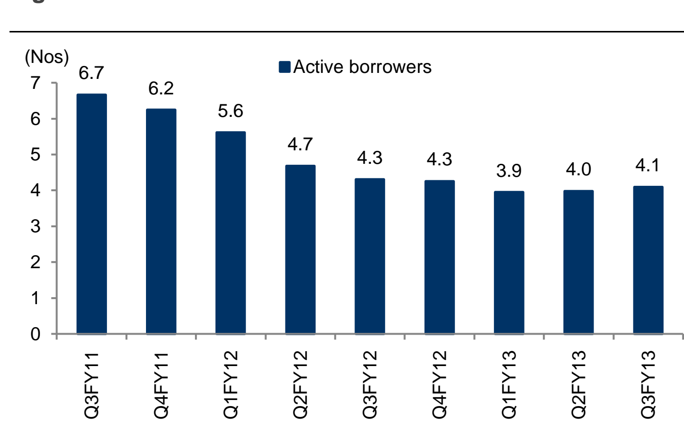
Source: Company

Fig 16 - Losses reported for seven consecutive quarters post-crisis



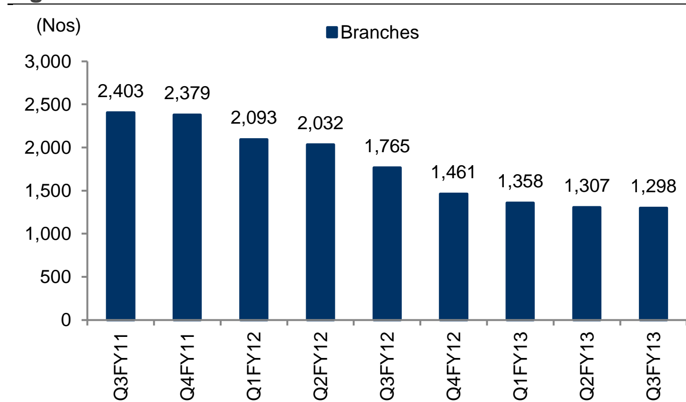
Source: Company

Fig 17 - Reduction in borrower base



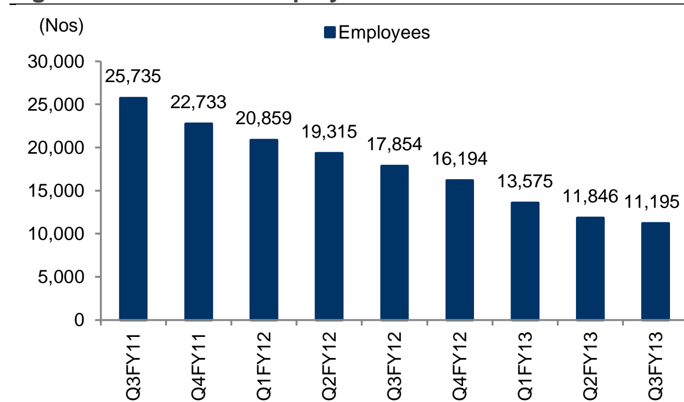
Source: Company

Fig 18 - Reduction in branches



Source: Company

Fig 19 - Reduction in employee count



Source: Company

Fig 20 - SKSM's product offerings are more diversified than before

Type of product		MTL	LTL	Other product offerings	Gold loans
Loan portfolio (Rs bn)	22.6	11.4	6.8	0.7	0.5
Ticket size range (Rs)	7,591 to 14,959		21,943 to 29,809	Solar lamp: 1,772 Mobile phone: 2,495	2,000 to 200,000
Avg. Ticket Size (Rs)	13,565	12,751	28,739	2,048	13,705
Eligibility*	Completion of CGT / GRT	With IGL – Between 20th to 46th week	Minimum two IGL loan cycles completed	With IGL – Between 4th to 46th week	Maximum LTV as % of gold value on disbursement
	Age limit 18 years to 55 years	With LTL –Between 20th to 96th week	No current IGL outstanding	With LTL – Between 4th to 100th week	SP3: 68% SP4: 75%
Tenure	50 weeks		104 weeks	25 weeks	SP3: 0 -365 days SP4: 0 -270 days
Annual effective interest rate	23.55%			Solar: 22.85% Mobile: 20.5%	SP3: 15% -24% SP4: 19.2% -26%
Processing fee	1%			Solar: 0.7% Mobile: 0.9%-1.0%	SP3 & SP4: 0.5%

Source: Company, * Eligibility criteria over and above the criteria prescribed by the RBI

Note: IGL - Income generating loans, MTL - Mid-term Loans, LTL - Long term loans CGT - Compulsory group training, GRT – Group recognition test

Lessons learnt

Strong internal concentration norms

Post-crisis, SKSM decided that the best way to manage political risk was to avoid the concentration risk. The company put in place a well-defined matrix to keep its geographic concentration under check. The strategy involved capping the exposure to any single state to 15% of disbursements and 50% of net worth. Similarly, caps were defined at district and branch levels. More importantly, SKSM stops disbursing fresh loans to branches where NPAs rise in excess of 1% or where collection efficiencies drop below 95%. This, in our view, should keep a check on asset quality going forward.

Exposure to a single state capped at 15% of disbursements and 50% of net worth

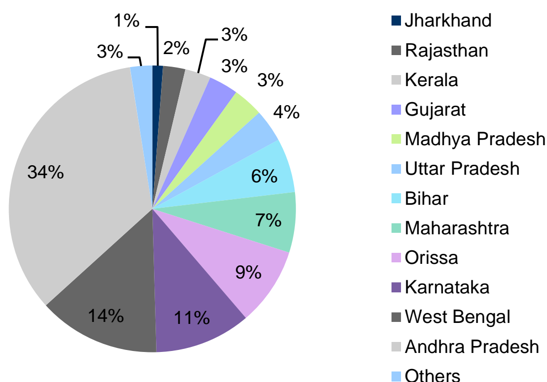
Fig 21 - Concentration norms

Metric	% Cap on Disbursement*	Exposure cap as a % of Net worth
State	▪ <15% ▪ (20% for Karnataka & Orissa)	▪ 50%
District	▪ <3 % ▪ (4% for Karnataka & Orissa)	▪ 5% ▪ (Only 5% of the total operating districts can go up to 10% of Net worth)
Branch	▪ <1 % ▪ (1.25 % for Karnataka & Orissa)	▪ 1% ▪ (Only 5% of the total operating branches can go up to 2% of Net worth)
NPA	▪ No disbursement to a branch with NPA > 1 %	
Collection efficiency	▪ No disbursement to a branch with on-time collection efficiency of < 95%	

Source: Company, * Subject to tolerance of 10%

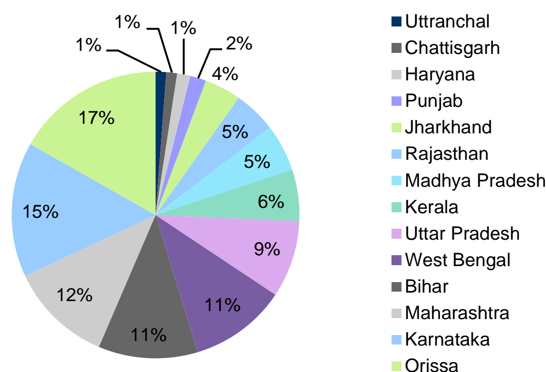
SKSM brought down its GLP concentration in the top three states to 44% in FY15 from 59% in FY11.

Fig 22 - Top three states formed 59% of GLP in FY11…



Source: Company

Fig 23 - …which has dropped to 44% in FY15



Source: Company

Prudent provisioning policies

SKSM's internal practices for provisioning and NPA recognition are more stringent than RBI requirements, which gives us comfort on asset quality. SKSM classifies loans as NPAs if these remain unpaid for 60DPD as against RBI norms of 90DPD. Moreover, in the event of an NPA, SKSM makes provisions based on the outstanding principal due as against RBI requirements of providing only for installments due.

Classifies loan as NPA if it remains unpaid for 60DPD as against RBI norms of 90DPD

Fig 24 - SKSM's provisioning policy

		RBI NBFC-MFI norms	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)	0.25-1% depending on NPA or as stipulated by RBI, whichever is higher
	Sub-Standard Assets	50% of instalments overdue*	50% of outstanding principal*
	Loss Assets	100% of instalments overdue*	100% of outstanding principal/ write-off*

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

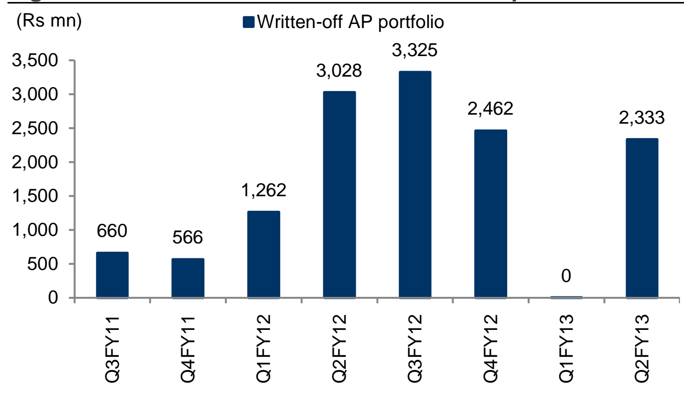
Potential upsides to earnings

Recoveries on AP portfolio can add to earnings

SKSM had loan exposure of ~Rs 14.9bn to AP but was able to recover a mere ~Rs 1.3bn – the balance had to be completely written off. The company received an interim order from the Supreme Court in Mar'13 to resume operations in the state and is making every effort to recover the residual portfolio. According to management, incremental disbursements are being made only to customers who are repaying past dues. At present, incremental disbursements are capped at 70% of recoveries. SKSM recovered ~Rs 260mn from the written-off portfolio in FY15 and expects the same level of collections going forward.

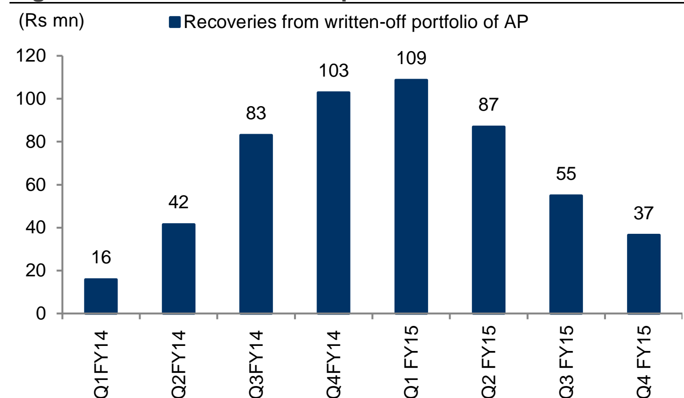
~Rs 260mn recovered from the written-off portfolio in FY15

Fig 25 - SKSM wrote off Rs 13.6bn of its AP portfolio



Source: Company

Fig 26 - Recoveries from AP portfolio should continue



Source: Company

Tax benefits to continue over next few years

SKSM was exempted from paying tax in FY13-FY14 as it had suffered substantial losses in FY12-FY13 due to the AP crisis. After turning profitable again, the company was entitled to pay tax only at the MAT (Minimum Alternative Tax) rate as the accumulated profits were used to offset the profits generated. However, the tax rate was nil in FY13-FY14 as SKSM began writing off its AP portfolio (MAT allows for deduction of write-offs from profits). The AP portfolio was fully written off in Q3FY15 and SKSM began paying MAT in Q4FY15. In our view, the company will continue to be taxed at a lower rate and pay at MAT rate (currently 21%) until its entire accumulated losses and MAT credits are offset against profits.

Tax to remain at MAT rate till entire accumulated losses and MAT credit are offset against profits

Valuation

Best-case priced in

We believe the SKSM stock is pricing in a best-case scenario in terms of growth, asset quality, award of a bank licence and successful execution thereafter. Indeed, failure to win a licence could see the stock correcting by 10-15%. We do not share the street's enthusiasm as we expect return ratios to remain lower than that of private sector banks (upon potential conversion into a bank) and loan growth to be capped due to the mandated 75% priority sector target. Further, incremental growth is likely to come at much higher risks as many regions are saturated. We are ~20% lower than consensus earnings estimates mainly because we have assumed higher credit costs.

We are ~20% lower than consensus on earnings due to higher credit cost forecasts

Fig 27 - RCML vs. Consensus estimates

Particulars	RCMLe			Consensus		
	FY16E	FY17E	FY18E	FY16E	FY17E	FY18E
Net Profit (Rs mn)	2,316	2,968	4,209	2,502	3,674	5,298
EPS (Rs)	18	23	33	20	29	42
BVPS (Rs)	101	125	158	102	131	176
ROE (%)	19.9	20.8	23.6	21.0	24.6	27.2

Source: Bloomberg, RCML Research

Initiate with SELL

We assume credit cost of 1.5% to arrive at sustainable long-term ROE for the company. Our credit cost assumption for sustainable ROE is much higher than both the regulatory minimum of 0.3% and our 1% assumption for FY17/FY18.

SKSM is currently trading at 3.9x FY17E P/B, a premium to private sector banks which is unjustified given its 100% unsecured loan portfolio and poor liability franchise. We initiate coverage on the stock with an anti-consensus SELL rating and a Mar'17 of Rs 400 set at 2.8x forward P/B.

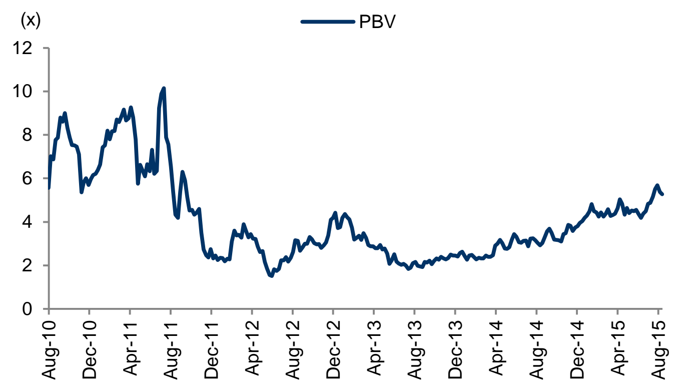
We value SKSM at 2.8x FY17 P/B; SELL

Fig 28 - Valuation snapshot

Components of two-stage DDM	Assumptions
Beta (x)	1.2x
Risk free rate	7.5%
Risk premium	5.0%
Cost of equity	13%
RoE	**20%**
g	16%
r	13%
gn	4%
n	10
P/BV	**2.8x**
FY17 BV (Rs) – including DTA	141
Target Price (Rs)	**400**

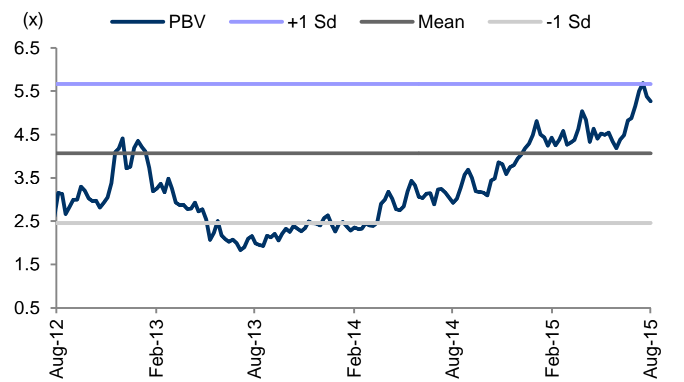
Source: Bloomberg, RCML Research

Fig 29 - One-year forward P/B: Pre-AP crisis



Source: Bloomberg, Company, RCML Research

Fig 30 - One-year forward P/B: Post-AP crisis



Source: Bloomberg, Company, RCML Research

Management profile

Fig 31 - Key management

Name	Designation	Profile
M R Rao	Managing Director & CEO	Mr. Rao has over 25 years of experience in Profit Centre Management, setting up distribution in Insurance, Retail Banking and Consumer Finance. Prior to SKSM, he was associated with ING Vysya Life Insurance, American Express, Standard Chartered Bank and Esanda Finanz & Leasing Limited. Mr. Rao joined SKSM in Oct'06 and has been at the forefront, driving its rural distribution reach and scale-up.
Dilli Raj	President	Mr. Raj has 23 years of experience in corporate finance, treasury, policy advocacy and corporate tax planning. He joined SKSM in Jan'08 and introduced mainstream financial products into microfinance. Mr. Raj had a strategic role in SKS' turnaround and managing the AP MFI crisis by focusing on cash flow management, cost structure optimisation and gaining the confidence of credit grantors. He is a member of the financial inclusion committee of FICCI and has done his MBA from the Central University of Pondicherry.

Source: Company

Fig 32 - Investors holding more than 1% in SKSM

Name of the holder	Holding (%)
IDFC Mutual Fund	5.7
Route One Investment Company Lp	4.7
Sandstone Invstmnt Prtns I	4.6
Amansa Capital Pvt Ltd	4.5
Kismet Microfinance	4.5
Khosla Vinod	3.4
CLSA Mauritius Ltd	3.3
Credit Agricole Sa	3.3
Morgan Stanley Asia/Singapore	3.3
Tree Line Asia Master Fund	3.0
DSP Blackrock Investment Manager	2.9
Norges Bank Investment Managemen	2.8
Westbridge Vent Inv Hldgs	2.8
Kismet Sks Ii	2.4
Kumaon Investment Holdings	2.0
Government Pension Fund - Global	1.6
Birla Sun Life Asset Management	1.5
Max New York Life Ins Co	1.5
TVF Fund Ltd	1.4
Driehaus Capital Management LLC	1.4
Grantham Mayo Van Otterloo & Co	1.3
Small Industries Dev Bank	1.3
Berhad Cimb Bank	1.2
Alliancebernstein LP	1.2
Mankekar Shivanand Shankar	1.0
MV SCIF Mauritius	1.0

Source: Bloomberg, RCML Research

Disbursements

Y/E 31 Mar (INR mln)	FY14A	FY15A	FY16E	FY17E	FY18E
Disbursements	47,870	68,910	96,350	1,35,854	1,90,195
Growth (%)	44.2	44.0	39.8	41.0	40.0
AUM/Sanctions	31,130	41,710	58,394	82,336	1,15,270
Growth (%)	32.0	34.0	40.0	41.0	40.0

Per Share Data

Y/E 31 Mar (INR)	FY14A	FY15A	FY16E	FY17E	FY18E
Reported EPS	6.5	14.9	18.3	23.5	33.3
Adjusted EPS	6.5	14.9	18.3	23.5	33.3
DPS	0.0	0.0	0.0	0.0	0.0
Book value	42.4	82.9	101.2	124.7	158.0
Adjusted book value	42.3	82.8	101.0	122.8	153.9

Valuation Ratios

Y/E 31 Mar (x)	FY14A	FY15A	FY16E	FY17E	FY18E
P/E	84.1	36.5	29.6	23.1	16.3
P/BV - (ex-DTA)	12.8	6.6	5.4	4.4	3.4
P/ABV - (ex-DTA)	12.8	6.6	5.4	4.4	3.5

Financial Ratios

Y/E 31 Mar (%)	FY14A	FY15A	FY16E	FY17E	FY18E
Spread Analysis					
Interest spreads	2.8	5.8	8.2	8.2	8.1
Yield on advances	30.4	25.9	25.7	25.5	25.3
Yield on assets	16.4	17.4	19.6	19.4	19.2
Cost of funds	13.6	11.6	11.4	11.2	11.1
NIMs	14.1	15.0	14.7	14.3	14.0
Operating Ratios					
Operating cost to income	74.5	61.1	57.7	57.4	56.6
Operating expenses / Avg assets	9.8	8.9	8.1	8.2	8.1
Asset Quality and Capital					
Gross NPA	0.1	0.1	0.1	0.8	1.3
Net NPA	0.1	0.0	0.1	0.4	0.6
CAR	15.8	45.8	50.0	50.0	50.0
Growth Ratios					
Net interest income	73.0	51.0	47.0	37.1	37.8
Non-interest income	29.3	76.8	40.0	40.0	45.0
Pre-provisioning profit	(260.1)	141.2	57.5	39.1	42.7
Net profit	(123.5)	168.7	23.4	28.1	41.8
Assets	(0.6)	88.2	30.4	40.2	37.6
Advances	12.0	68.8	40.0	41.5	40.3
Book value	17.6	95.3	22.1	23.2	26.7
EPS	(123.5)	130.3	23.4	28.1	41.8

DuPont Analysis

Y/E 31 Mar (%)	FY14A	FY15A	FY16E	FY17E	FY18E
Net interest income / Assets	9.4	9.8	9.6	9.7	9.6
Non-interest income / Assets	3.8	4.7	4.4	4.5	4.7
Operating expenses / Assets	9.8	8.9	8.1	8.2	8.1
Provisions / Assets	0.6	0.3	0.5	1.0	1.0
Taxes / Assets	0.0	0.2	1.1	1.1	1.1
ROA	2.8	5.2	4.3	4.0	4.1
Equity / Assets	18.3	29.1	23.6	21.4	19.6
ROAE	**16.4**	**24.9**	**19.9**	**20.8**	**23.6**

Income Statement

Y/E 31 Mar (INR mln)	FY14A	FY15A	FY16E	FY17E	FY18E
Interest income	4,488	6,332	9,793	13,668	19,016
Interest expense	(2,142)	(2,790)	(4,585)	(6,526)	(9,179)
Net interest income	2,345	3,542	5,209	7,141	9,837
Non-interest income	961	1,699	2,378	3,329	4,827
Net revenue	3,306	5,241	7,587	10,471	14,665
Operating expenses	(2,462)	(3,204)	(4,380)	(6,010)	(8,299)
Pre-provisioning profits	844	2,037	3,207	4,460	6,365
Provisions & contingencies	(146)	(100)	(275)	(704)	(1,037)
PBT	699	1,936	2,932	3,756	5,328
Extraordinaries	0	0	0	0	0
Income tax	0	(59)	(616)	(789)	(1,119)
Reported PAT	699	1,877	2,316	2,968	4,209
Adj. net profit	**699**	**1,877**	**2,316**	**2,968**	**4,209**

Balance Sheet

Y/E 31 Mar (INR mln)	FY14A	FY15A	FY16E	FY17E	FY18E
Advances	17,528	29,584	41,418	58,399	81,758
Investments	2	2	2	2	2
Current assets	7,330	17,299	19,750	27,358	36,245
Net block (inc CWIP)	112	102	117	135	155
Goodwill	0	0	0	0	0
Other assets	0	0	0	0	0
Total Assets	**24,972**	**46,987**	**61,287**	**85,894**	**1,18,161**
Share capital	1,082	1,263	1,263	1,263	1,263
Options/warrants/others	0	0	0	0	0
Reserves & surplus	3,510	9,202	11,518	14,485	18,694
Net worth	4,592	10,465	12,781	15,748	19,957
Total borrowings	6,326	16,668	24,205	35,019	49,027
Current liabilities	11,807	19,272	23,425	33,891	47,448
Provisions	2,248	582	876	1,235	1,729
Deferred tax liabilities	0	0	0	0	0
Other liabilities	0	0	0	0	0
Total Equity & Liabilities	**24,972**	**46,987**	**61,287**	**85,894**	**1,18,161**

19 August 2015

Janalakshmi Microfinance

Largest urban MFI with robust technology platform

Janalakshmi Microfinance (JFS, unlisted) is India's largest urban MFI with an AUM of ~Rs 38bn, 233 branches and a customer base of 2.3mn. The company's best-in-class technology platform has helped it improve productivity and scale up rapidly over last few years. JFS' urban focus, particularly tier 1-3 cities, is driven by the lower credit and political risk and higher economies of scale in these areas, which along with a larger ticket size of loans offers strong potential for growth ahead.

- **India's first urban microfinance company:** JFS is India's third largest MFI and largest urban player, with an AUM of ~Rs 38bn (FY15) and a presence across 17 states in 151 Indian cities. The company gave its first microfinance loan to urban underserved customers near Bengaluru under the initiative 'Sanghamitra Urban Programme' in 2000. Promoters acquired an NBFC licence for JFS in 2008 and the company got PE funding to escalate AUM growth almost every year since FY08 to FY14.

- **Extensive use of technology, well-centralised operations:** JFS has already adopted a core banking solution and partnered with well-established global players such as IBM (for technology) and Accenture (for operations). The company uses biometric devices which avoid duplication and capture data at source on real-time basis. The entire workflow system is automated which improves branch/employee productivity. Also, JFS has a balance scorecard system which facilitates monitoring and controls. The company has also lunched pre-paid cards and mobile POS. A robust technology platform provides a solid foundation for cross-selling.

- **Strong growth potential in urban microfinance – a low risk, low opex market:** JFS is targeting the financially excluded urban segment in tier 1-3 cities (+100k population) as the repayment risk is lower in urban lending due to higher income generation. The political interference is also low in urban areas, with the company consciously avoiding politically-sensitive states such as Andhra Pradesh and Orissa. While costs of operation are higher, this is largely offset by better sale. Customers/ loans/branch are also higher and the loan ticket sizes twice as much as rural areas.

- **Strong management profile, good corporate governance:** The promoter, Mr. Ramanathan, is a pioneer in urban microfinance with more than 12 years of experience in this field, and also a part of various government committees on urban policy formulation. With his holding stake in JFS through Jana Foundation, a Sec 8 non-profit organisation, any returns from the company do not flow back to the promoter but are used for charity. Vertical heads have 20+ years of experience with MNC banks and the Board has representation from reputed PE investors.

- **Broadening its product offering:** JFS has introduced 'Nano' loans which focus on a specific subset of existing customers to meet their financial needs, as they do not fit into the traditional group-lending model. Under this category, the company gives MSME, auto, housing loans and education/gold loans. JFS has also tied up with other companies to offer micro pension and micro insurance to its customers.

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Key financials

Particulars	FY13	FY14	FY15
AUM (Rs mn)	9,608	20,529	37,736
Net profit (Rs mn)	181	506	754
Net worth (Rs mn)	1,907	5,140	10,893
ROA (%)	2.4	2.8	2.0
ROE (%)	12.6	14.4	9.4
PAR >=180 days (%)	0.1	0.2	0.4

Source: Company

Janalakshmi Microfinance

Largest urban MFI with robust technology platform

JFS is a new-age microfinance institution that seeks to service the financial needs of the urban underserved in India, in a market-oriented fashion. It is a for-profit NBFC while promoter stakes are held in Jana Foundation, a not-for-profit company. Funds in Jana Foundation can only be used to address social issues.

Services financial needs of the urban underserved as against the rural focus of most other microfinance companies

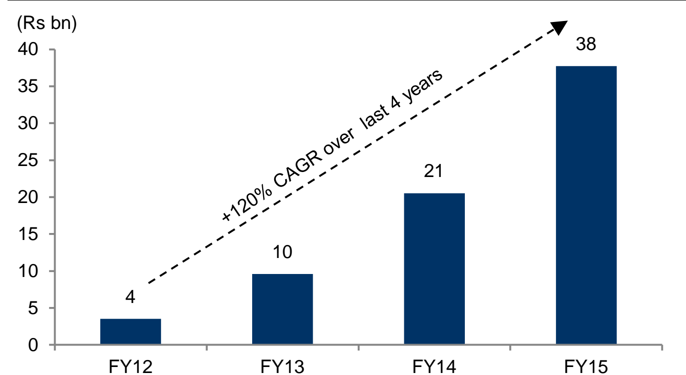
JFS' market-based approach to financial inclusion is defined by three distinct characteristics: (1) An exclusive focus on servicing the needs of the urban underserved populace. This is in sharp contrast to majority of other microfinance companies primarily focused on rural areas. (2) A strong customer-value driven approach in designing financial products. (3) The centrality of technology and processes as the foundation of a scalable enterprise. Since it is a new-aged player with focus on urban areas, use of technology helps reduce cost and improve efficiencies.

Well-diversified geographical presence

JFS is the third largest MFI in India and its AUM of ~Rs 38bn has increased at a CAGR of +120% over FY12-FY15, making it the fastest growing MFI among top players. JFS has achieved a large scale of operations by rapidly expanding into new geographies. Its network has increased from a mere 17 branches in FY10 to 233 branches in FY15, leading to ~130% CAGR in customers over this period.

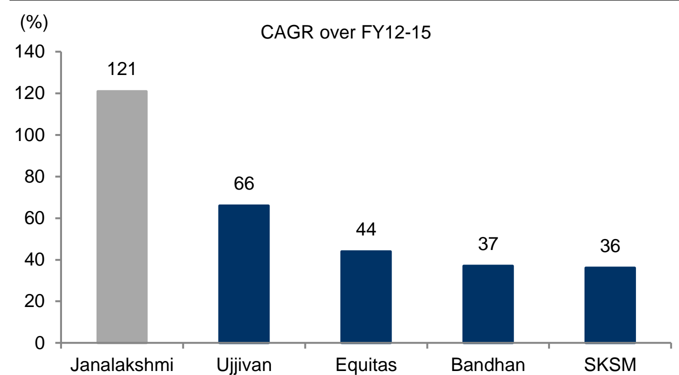
AUM of Rs 38bn and 233 branches as of FY15

Fig 1 - Strong AUM growth over last few years



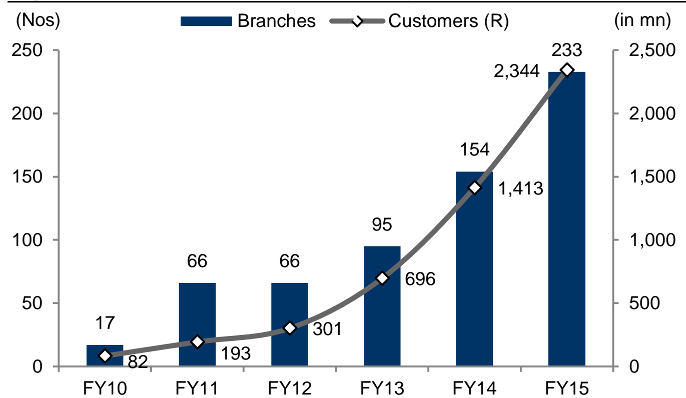
Source: Company

Fig 2 - Fastest growing MFI among large players



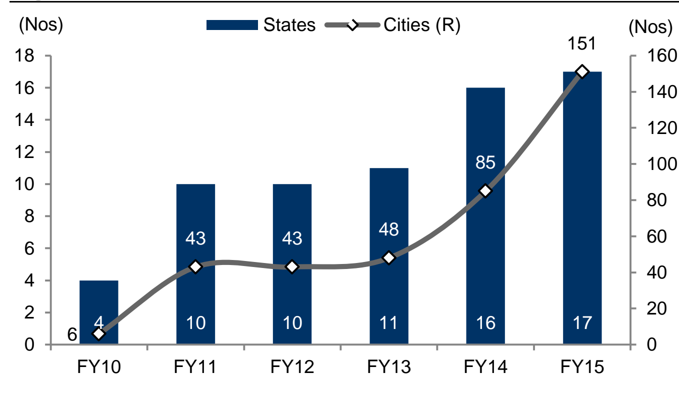
Source: Company

Fig 3 - Customer mop-up backed by branch expansion



Source: Company

Fig 4 - JFS has a presence in 151 cities



Source: Company

Janalakshmi Microfinance

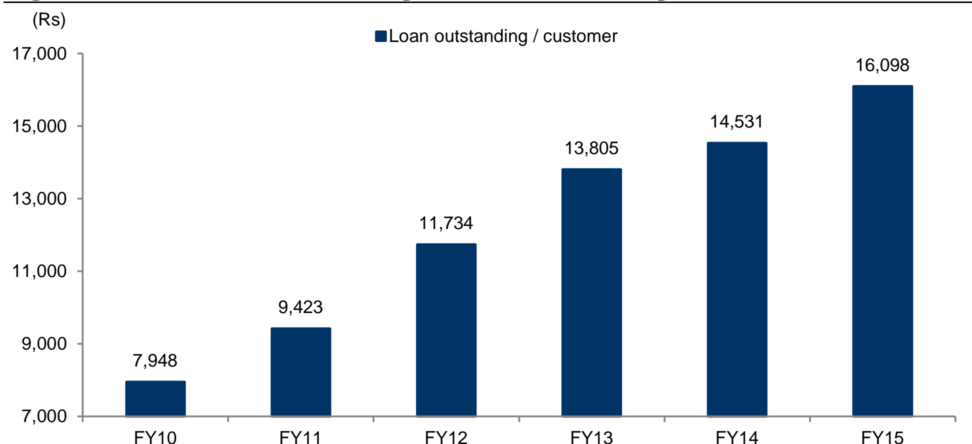
Largest urban MFI with robust technology platform

A well-planned strategy of having a diversified presence has mitigated geographical risk. As on FY15, it had a presence in over 150 cities across 17 Indian states. Moreover, its 233 branches are well distributed across South (27%), North (29%), West (27%) and East (17%) India.

Loan ticket size in urban areas is twice as much as rural areas given the higher income levels. Apart from a surge in the customer base, an increase in the loan outstanding per customer from ~Rs 8,000 in FY10 to ~Rs 16,000 in FY15 has contributed to AUM growth. That said, JFS has conservatively ensured that the increase in loan outstanding is in tandem with the customer's ability to repay.

Loan outstanding per customer has doubled to ~Rs 16,000 over FY10-FY15

Fig 5 - Increase in loan outstanding has also aided AUM growth



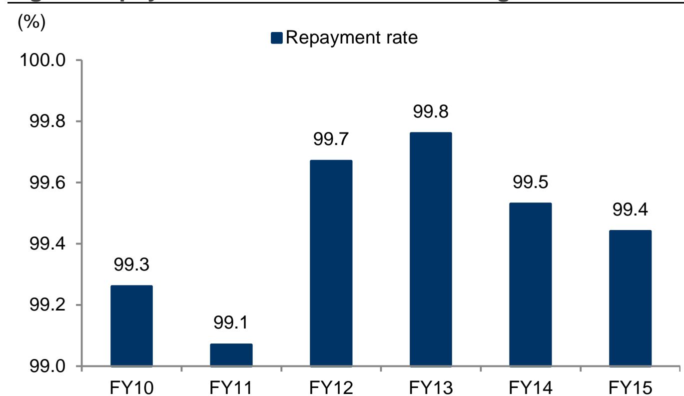
Source: Company

Asset risk well managed

JFS was the one of the first MFIs to subscribe to credit bureaus. Today, checks are done with all three credit bureaus in India – CIBIL, Equifax and High Mark. The strength of the company's credit monitoring system can be gauged from its healthy repayment rate of group loans which remained above 99% even during the industry-wide crisis in FY12. Moreover, portfolio at risk (>= 180 days) of 0.4% as on FY15 indicates that asset quality risks are well managed.

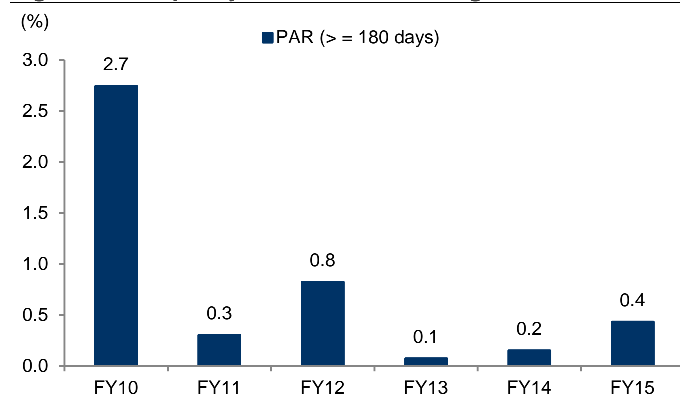
PAR (>= 180 days) low at 0.4% as on FY15

Fig 6 - Repayment rate has remained strong



Source: Company

Fig 7 - Asset quality risks are well managed



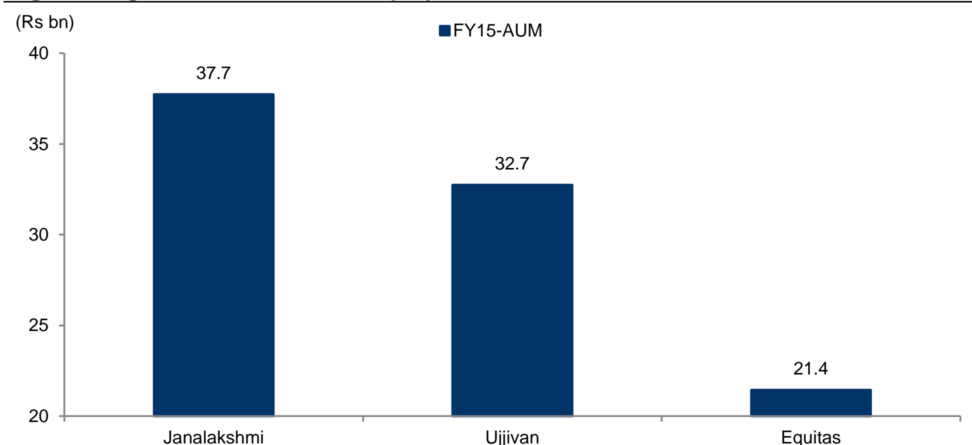
Source: Company

Urban focused player

Apart from being the first MFI to begin operations in urban India, JFS is also the largest urban-centric player. Its AUM of Rs 38bn is nearly 15% more than the second largest player, Ujjivan, also operating in the urban market. JFS typically targets the financially excluded urban population in tier 1-3 cities (+100k population). Management believes one of the key benefits of urban lending is a check on asset quality as income generation potential is higher than rural areas and political risk lower.

Management believes a key benefit of urban lending is a check on asset quality

Fig 8 - Largest urban-centric MFI player



Source: Company

Management follows three primary criteria while selecting a new city to expand into, which drive the company's urban-centric operations:

Follows a three-pronged approach to select target cities

- **High concentration of industries:** This leads to a higher income generation potential and thus reduces repayment risk.
- **Low competitive intensity**: Only a handful of MFIs have urban focus.
- **Low risk of political uncertainty:** This has helped JFS to stay away from politically uncertain states such as Andhra Pradesh and Orissa.

The company has also initiated efforts to target the rural/agri customer base by opening select centres. On the product front, JFS has a comprehensive suite specifically designed to address the needs of individuals and enterprises. Its main focus in retail lending is microfinance, but it has recently has expanded this offering to include five different types of retail loans (Fig 9).

Fig 9 - Loans for individuals

Particulars	Small Batch Loans	Nano Loans	Home Improvement Loans	Jana Kisan Loan	Education Loan
Description	This is JFS' core product. Small batch loans are given under JLG of 5-25 women. This structure has five loan cycles	This business loan allows budding entrepreneurs to finance working capital and to invest in equipment. It is offered to customers with a proven credit history after they have completed two years in a small batch loan structure	Home improvement loan is given to customers for minor improvements, extensions, repairs and renovations of their homes. The product is offered to customers with a proven credit history after they have completed two years in a small batch loan structure	Offered to small and marginal famers for capital formation and enhancement of farm productivity. It is offered through our rural and semi-urban branches	Offered to all existing small batch loan members to support their school-going child's education
Loan size (Rs)	15,000 - 50,000	60,000 - 2,00,000	60,000 - 1,00,000	50,000 - 1,00,000	<= 50,000
Tenure	12 - 24 months	<= 36 months	<= 24 months	<= 24 months	<= 24 months
Purpose	Income generating or others	Working capital and equipment investment	House improvement, extension and renovation	Agriculture and allied activities	Educational purposes
Interest rates	23.72	26% for new to Nano customers; 25% for repeat Nano customers	26	22	24

Source: Company

Moreover, it offers the following four products to enterprises that are too big for microfinance but not big enough to conveniently access funds from the banking system.

Fig 10 - Loans for enterprises

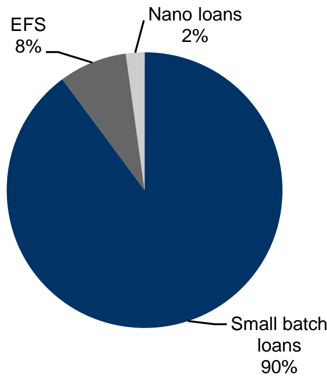
Particulars	Super Nano Loan	MSME Loan	Long-term business loans	Equipment and Machinery Financing
Description	Offers to support the growing credit requirements of MSEs belonging to existing Nano loan customers and also to customers in the open market, who have a favourable credit history with other financial institutions	The loan is for MSMEs in the unorganised sector seeking working capital and term loans. To assess eligibility and serve this segment, JFS employs sophisticated assessment tools and underwriting techniques	This product addresses the liquidity needs of MSMEs and provides financing against self-owned and occupied property. It offers customers funding for long-term growth while keeping EMIs affordable.	A quick loan facility for MSMEs to purchase new or used machines to upgrade their technology.
Loan size (Rs)	2,00,000 - 6,00,000	2,00,000 - 5,00,000	5,00,000 - 50,00,000	2,00,000 - 50,00,000
Tenure	<= 60 months	Flexible repayment option of 12-48 months, with part payment facility and top-up loans	<= 60 months	<= 60 months
Purpose	Working capital and equipment investment	Working capital and term loan lending	Loan against property	Equipment financing loans
Interest rates	23-24%	18-26%	18-26%	18-26%

Source: Company

Small batch loan is JFS' core product which forms ~90% of its AUM and 99% of its customer base. Under this product, loans in the range of Rs 15,000-50,000 are provided to individuals in a group of 5-25 women in five loan cycles. After completion of each cycle, a customer can either borrow the same amount or move on to the next level.

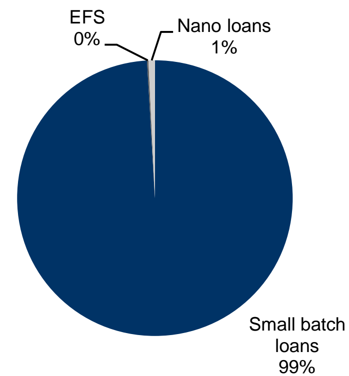
Largest urban MFI with robust technology platform

Fig 11 - Small batch loans form 90% of AUM



Source: Company

Fig 12 - …and 99% of its customer base



Source: Company

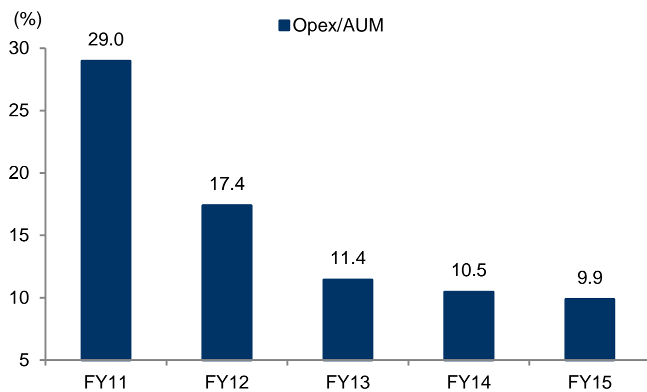
Apart from credit, JFS meets end-to-end customer requirements by offering financial products like micro pension and micro insurance among others, in partnership with other companies. It also offers goal-based savings plans by offering doorstep collection services. JFS has tied up with India Invest Micro Pension Services, a fund managed by Unit Trust of India, to offer a flexible micro pension scheme. Moreover, it has partnered with Bajaj Allianz Life, HDFC Life and Kotak Life to provide life insurance against loans. JFS also offers livestock insurance for livestock loans and has tied up with Royal Sundaram Alliance Insurance for the same.

Has partnered with other NBFCs to offer micro pension and micro insurance to customers

Operational efficiency beginning to kick in

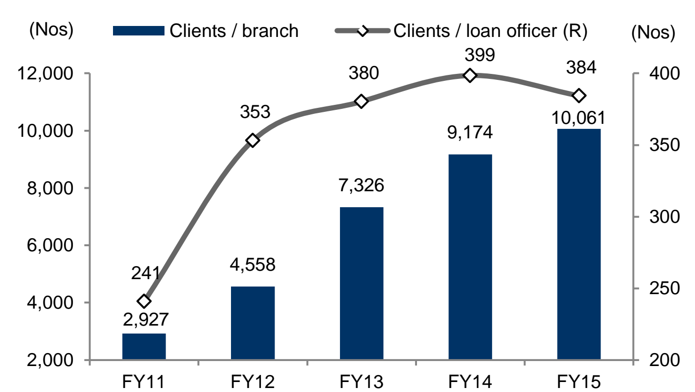
Operating costs have been high for JFS given that it is still expanding and has invested in technology upfront. However, with improved economies of scale, the operating expense ratio for the company has been gradually moderating.

Fig 13 - Operating cost ratio gradually coming down…



Source: Company

Fig 14 - …with improved economies of scale



Source: Company

We think JFS' operational efficiency has been aided by the fact that customers/loans per branch are higher in urban areas. While the company has steadily managed to improve this ratio, the proportion of clients/loan officer has dipped marginally in FY15 as the increase in loan officers was largely back-ended.

Largest urban MFI with robust technology platform

Robust technology platform

Use of sophisticated technology at all levels of operations has ensured higher productivity per loan officer and enhanced the ability to scale up with a limited number of branches. JFS has partnered with global players such as IBM (for technology) and Accenture (for operations). It is the only financial services company that uses a front-end biometric device that captures real time data and reduces risk by avoiding duplication of clients. To enable better branch and employee efficiency, JFS uses the 'Sales Force' software to capture and automate customer data. Moreover, Oracle's core banking solution software 'Flexcube' and adequate back-office and management information service systems aids JFS in tracking key operational parameters.

Cutting-edge technology usage at all levels ensures higher productivity and transparency

The company uses co-branded VISA prepaid cards to disburse loans, which enable its customers to withdraw the loan amount from any ATM in installments. It also assigns a unique identification number and a personalised co-branded visa card to each of its borrowers, which enhances transparency in the collection process and ensures timely flow of information for carrying out effective follow-up.

Fig 15 - Cutting-edge technology platform

Particulars	Benefits
Biometric Device	Real time data capture Avoids duplication Enables digitisation at source
Customer Relationship Management	CRM system captures customer data Workflow automation enables better branch and sales force efficiency
Core Banking System	System of records for each customer Enables data access from any location
Mobile based POS	Dongle gets attached to an affordable android phone Secure Card swipe can be done using dongle by user Payments at door step
Prepaid Cards	Customer Account Management Pin request, dispute management Card inventory/pin code tracking
MIS – Scorecard	Balanced scorecard system used by 60% of fortune 500 companies. Instantly generates the latest status reports Real time monitoring leading to strong internal controls

Source: Company

Strong management profile

JFS is managed by a mix of highly motivated individuals who have a deep understanding of the business gained over an average 30+ years of relevant experience. Lending verticals are headed by former corporate credit bankers who have 20+ years of experience in MNC banks. Mr. Ramesh Ramanathan, promoter of JFS, is a pioneer in urban microfinance with more than 12 years of experience and is a part of various government committees on urban policy formulation. The board also comprises five key committees chaired by independent directors.

Fig 16 - Key management team

Name	Designation	Profile
Ramesh Ramanathan	Chairman	Mr. Ramanathan is the founder and Chairman of JFS and has a proven track record in addressing several issues faced by urban India. He has to his credit strong international banking experience, creating innovative institutional products, working with cutting edge technology and risk management systems. He possesses an Honors degree in Physics from BITS Pilani, and an MBA from Yale University's School of Management.
R Srinivasan	Executive Vice Chairman	Mr. Srinivasan has over four decades of experience and has worked closely with Mr. Ramanathan in drawing the blueprint of JFS. Prior to joining JFS as CEO, he served as Deputy CEO, ANZ Grindlays Bank, India, and later as a senior advisor to both Fitch Ratings and JP Morgan. Mr. Srinivasan has an M A in Economics from Delhi University and has more than four decades of experience in both the public and corporate sectors.
V S Radhakrishnan	MD & CEO	Mr. Radhakrishnan, at JFS since Aug'07, is a veteran banker with an illustrious career in the banking sector. He was associated with HSBC for over 25 years where he held various senior positions. He has an MBA from IIM, Ahmedabad, and also holds a CAIIB qualification from the Indian Institute of Banking & Finance.

Source: Company

Jana Foundation – a purpose-driven social enterprise

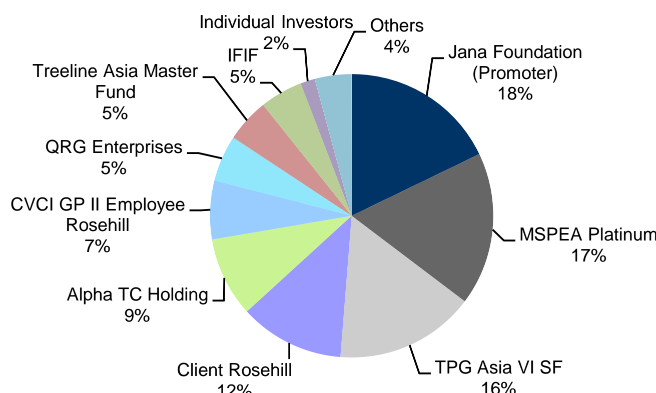
JFS operates with a unique two-tier structure. Mr. Ramanathan's stake in JFS is held through Jana Foundation, a Section-8 not-for-profit company based in Bangalore. All returns from JFS are ploughed back into Jana Foundation to be used for implementing its charter with no returns flowing to the promoter. This acts as a major de-risking factor for JFS, given the criticism about MFIs being vehicles for promoters to amass wealth.

Per management, the foundation has a vision of a transformed urban India where financial inclusion and an enhanced quality of life are assured to all those who aspire to help themselves. Also, it aims at ensuring holistic urban change by developing actionable customer insights, incubating viable and scalable social business models, undertaking cutting-edge research and championing policy initiatives – with the help of state-of-the-art technology and spatial planning tools.

Shareholding pattern with marquee investors

JFS has a set of marquee shareholders who have invested in five rounds of equity capital financing. Moreover, its board comprises representatives from some of the most reputed international PE firms such as Morgan Stanley, Citi, and TPG as international investors. Mr. Ramanathan has donated his stake in JFS to Jana Foundation. This unique structure has been formed to retain the social focus of the company.

Fig 17 - Promoter holds stake in JFS through a not-for-profit Jana Foundation



Source: Company

Moreover, JFS has suitably diversified its debt capital with an adequate mix of bank loans, NCDs, ECB, securitisation and other funding sources.

Fig 18 - Key shareholders, directors

Name	Investor Director	Profile
S. Viswanatha Prasad	Caspian Advisors	Mr. Prasad has over 10 years of operating and senior management experience in microfinance, preceded by a decade of experience in mainstream finance. He is the co-founder of Bellwether Microfinance Fund and promoter of its fund manager, Caspian Advisors.
Zaheer Abbas Sitabkhan	Treeline Investment Management	Mr. Sitabkhan is the CEO of Treeline Investment Management, and was earlier Director of Lloyd George Management. He has a BA from Case Western Reserve University and an MBA from Indiana University.
Anil Rai Gupta	Havells India	Mr. Gupta is CMD of Havells India, which he joined in 1992, and helped transform the brand *Havells* over the years. He graduated in Economics from Sri Ram College of Commerce, Delhi University, and has an MBA from Wake Forest University, North Carolina, USA.
Ling Wei Ong	Morgan Stanley	Mr. Ong is an Executive Director of Morgan Stanley. He joined Morgan Stanley in 2005 and monitors the group's investments, including structuring and valuation, finance and compliance. Mr. Ong is a native of Singapore and is based in Hong Kong.
Akhil Shriprakash Awasthi	Tata Capital	Mr. Awasthi joined Tata Capital in 2009 and has experience across the financial services sector. He sits on the Investment Committee of Tata Capital Growth Fund.
Puneet Bhatia	TPG Capital India	Mr. Bhatia, an MBA from IIM, Calcutta, is the MD and Country Head of TPG Capital India. He serves on the boards of several companies.

Source: Company

Financials

Fig 19 - Income Statement

Particulars (Rs mn)	FY11A	FY12A	FY13A	FY14A	FY15A
Interest income	385	587	1,464	3,565	6,424
Interest expense	106	192	651	1,604	3,195
Net interest income	**279**	**395**	**813**	**1,961**	**3,229**
Non-interest income	92	124	231	525	1,160
Net total income	**371**	**519**	**1,044**	**2,486**	**4,389**
Operating Expense	358	465	751	1,575	2,871
Pre-provisioning profit	**13**	**54**	**293**	**911**	**1,518**
Provisions	34	42	56	171	285
Profit before tax	-21	12	237	740	1,233
Tax	-21	-	56	234	479
Profit after tax	**-**	**12**	**181**	**506**	**754**

Source: Company

Fig 20 - Balance Sheet

Particulars (Rs mn)	FY11A	FY12A	FY13A	FY14A	FY15A
Shareholders' funds	432	56	1,907	5,140	10,893
Borrowed Funds	712	1,835	3,961	7,163	37,809
Non-Current Liabilities	80	15	18	76	140
Current Liabilities	728	1,417	4,794	12,728	1,167
Total Liabilities	**1,951**	**4,223**	**10,679**	**25,107**	**50,009**
Non-current assets	373	909	2,404	5,875	12,345
Current assets	1,578	3,314	8,275	19,231	37,664
Total Assets	**1,951**	**4,223**	**10,679**	**25,107**	**50,009**

Source: Company

19 August 2015

Ujjivan Financial Services

Pan-India player with presence across 24 states

Ujjivan Financial Services (Ujjivan, unlisted) is the fourth largest MFI in India with an AUM of Rs 32.7bn as of FY15. It is incrementally focusing on individual loans and aims to increase its proportion from 10% now to 40% of AUM by FY19. Also, management is targeting an AUM of Rs 48bn in FY16 and expects a 40% CAGR till FY19. A high credit rating of 'A' by CARE makes Ujjivan one of the most efficient borrowers in the MFI industry. The company's opex ratio at 8.4% is among the best in the industry, and further improvement should drive ROA to 3-3.5% and ROE to 18-20% by FY19.

- **Diversified player with AUM target of 40% CAGR till FY19:** Ujjivan is the fourth largest MFI in India, geographically diversified across 24 states and union territories. It began operations in 2005 and serves over 2mn clients through a network of 423 branches. Its AUM, of Rs 32.7bn as on FY15, is fairly distributed in terms of geographies, with top three states accounting for ~45% and exposure to no single state at more than 17%. Management is aiming for an AUM of Rs 48bn in FY16 and expects a 40% CAGR till FY19.

- **Group lending attaining saturation in South:** Ujjivan follows both the JLG (joint group lending) and individual lending models, with the former constituting 90% of its portfolio but set to attain saturation in southern states. Management is thus sharpening its focus on individual loans and targets to increase their share from 10% currently to 40% of AUM by FY19. Once this vertical forms 15% of AUM, it will be hived off as a subsidiary if Ujjivan does not secure a banking licence.

- **Expects strong improvement in profitability ratios:** Ujjivan's PAT increased at a 61% CAGR over FY11-FY15 to Rs 758mn, driven by strong core performance, improving operating ratios and credit rating. Given that its long-term bank borrowings and NCDs have been rated as 'A' by CARE, it is one of the most efficient borrowers with average cost of borrowings at 12.7%. Also, its opex ratio has declined from 17.6% in FY11 to 8.4% in FY15, and further improvement to 7% should drive ROA to 3-3.5% and ROE to 18-20% by FY19.

- **Applied for a small banking licence:** Ujjivan has applied for conversion into a small bank, but faces a major hurdle as its promoter holding is fully diluted and foreign shareholding is high. Management is aware that the company needs capital restructuring and will float a subsidiary which would act as a small bank.

- **Limited upside from other financials products:** Ujjivan offers non-financial products like micro insurance and micro pension, as well as loans for solar lamps, mobile phones and building sanitation facilities. However, these products are revenue-neutral and do not add much to the company's bottomline.

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Key financials

Particulars	FY13	FY14	FY15
AUM (Rs mn)	11,260	16,170	32,741
Net profit (Rs mn)	339	550	758
Net worth (Rs mn)	3,213	3,725	7,364
ROA (%)	3.0	3.2	2.5
ROE (%)	12.0	15.9	13.7
Net NPA (%)	0.0	0.0	0.0

Source: Company

Ujjivan Financial Services

Pan-India player with presence across 24 states

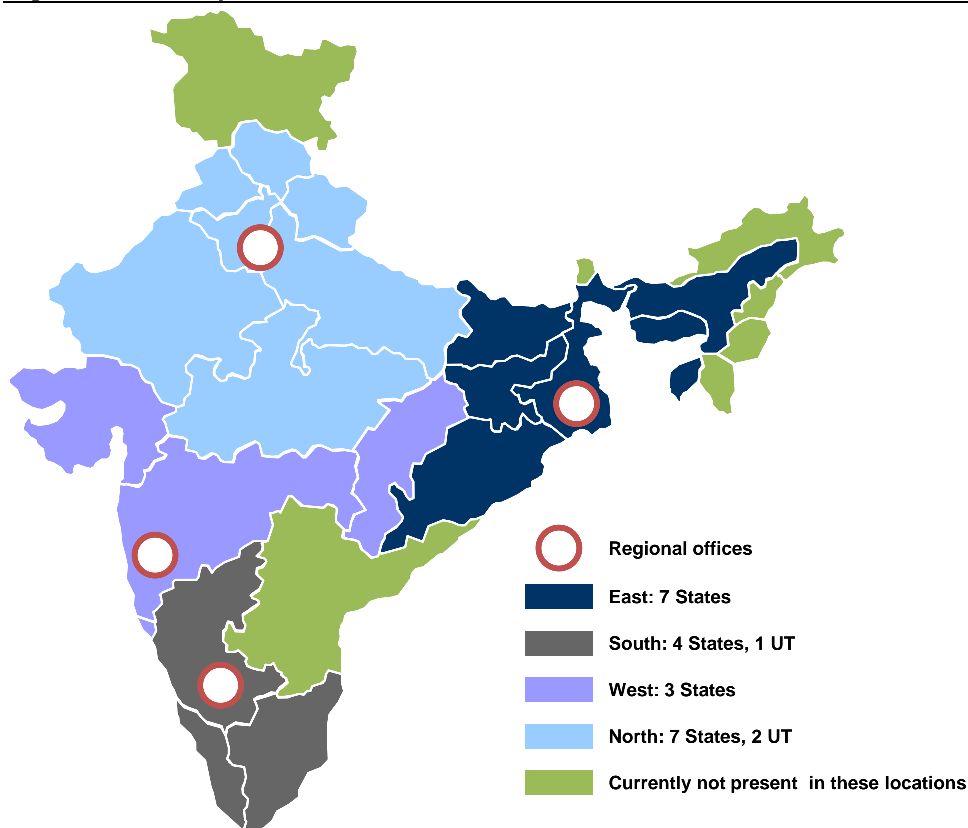
Company Update
INDIA
MICROFINANCE

Ujjivan is a large-sized MFI promoted by Mr. Samit Ghosh. Headquartered in Bengaluru and having commenced its operations in Nov'05, Ujjivan has a pan-India presence with 423 branches in 21 states and 3 union territories. As on FY15, it had an AUM of Rs 32.7bn and a customer base of over 2mn. Top three states, viz. Karnataka, West Bengal and Maharashtra, form ~45% of its portfolio, with exposure to Karnataka the highest at 17%. While it largely serves the urban and semi-urban poor, it also caters to the unbanked and under-banked customers living in all tiers of India.

Fourth largest MFI with near pan-India presence

Ujjivan has the most diversified customer base and a loan portfolio across the geographical expanse of India, covering 21 states and 3 union territories, thus lowering its concentration risk. Its branch network is one of the most geographically diversified among MFIs. Its Bengaluru-based head office also serves as the regional office for the South. Also, it has three other regional offices – Delhi for the northern region, Kolkata for the eastern region and Pune for the western region.

Fig 1 - Diversified presence across 21 states and 3 union territories

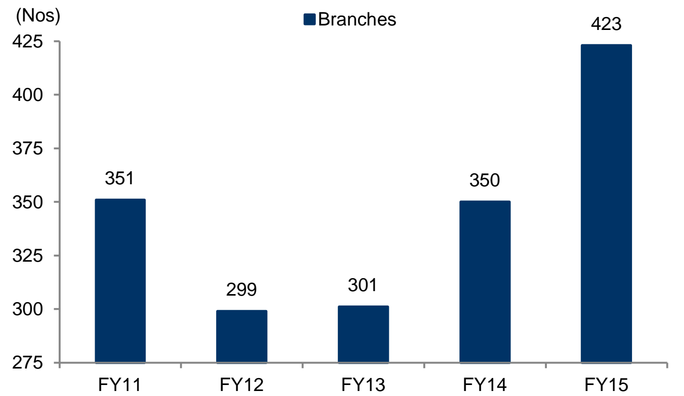


Source: Company

Over 120 branches added in last three years with a network of 423 branches as of FY15

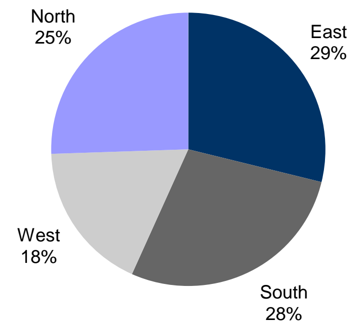
Ujjivan had 351 branches as on FY11 but industry-wide crisis forced consolidation in FY12. Consequently, the company merged/closed some of its branches, which reduced the branch count to 301 in FY13. However, post the consolidation phase, the company has added 120 branches in last three years, taking its network to 423 branches as of FY15. These branches are fairly distributed in the North, East, South and West India.

Fig 2 - Ujjivan has scaled up its branches rapidly…



Source: Company

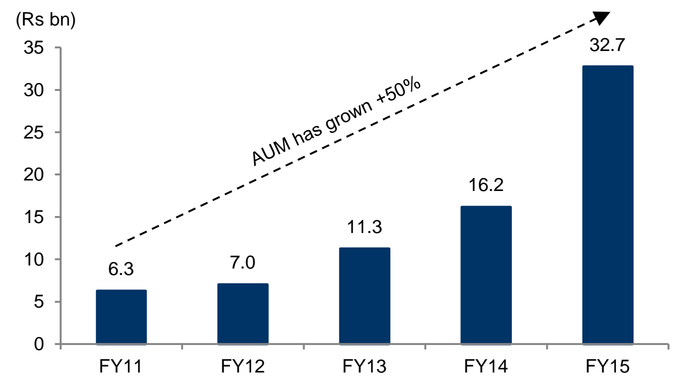
Fig 3 - … which are fairly distributed across regions



Source: Company

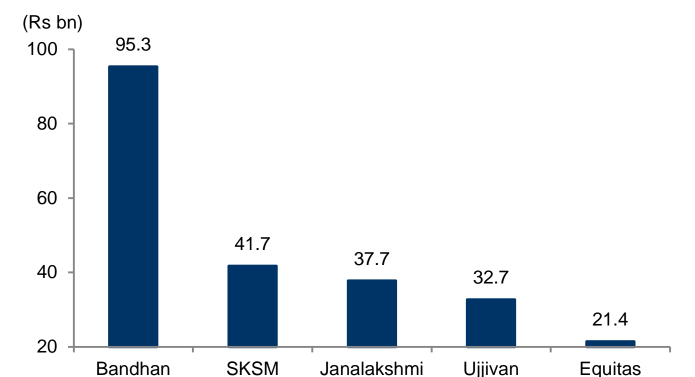
Given the rapid scale-up of branches, Ujjivan has managed to build a huge customer base. Its AUM of Rs 32.7bn has reported a CAGR of +50% in last four years. In our view, the robust growth in AUM is largely on account of a sharp uptick in the client base and a rise in the loans outstanding per customer. Ujjivan has gradually emerged as the largest MFI player after Bandhan, SKSM and Janalakshmi.

Fig 4 - AUM has seen a CAGR of +50% over FY11-FY15



Source: Company

Fig 5 - Ujjivan is the fourth largest MFI by AUM

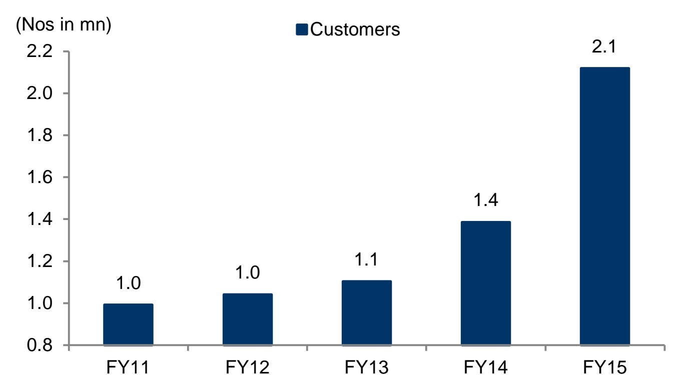


Source: Company

Ujjivan has an active base of over 2mn customers as on FY15, which has increased at a CAGR of +21% over last four years. Moreover, the loan outstanding per customer has increased from a mere Rs 6,300 in FY11 to Rs 15,500 in FY15. Despite the robust client accretion and rise in outstanding loans per customer, the company's asset quality has remained strong which in our view reflects its conservative lending approach.

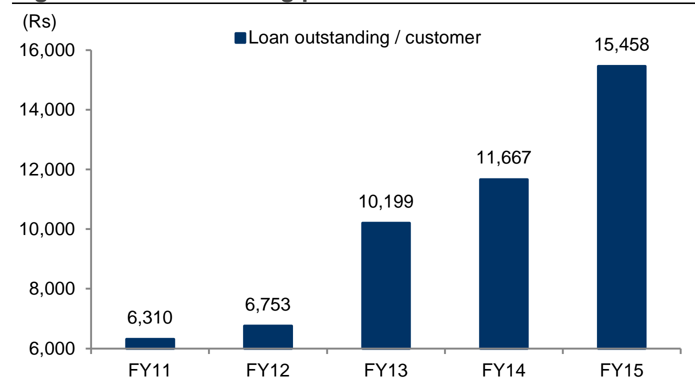
Active customers have increased at a +21% CAGR in last 4 years to over 2mn

Fig 6 - Robust accretion in client base



Source: Company

Fig 7 - Loan outstanding per customer has also increased



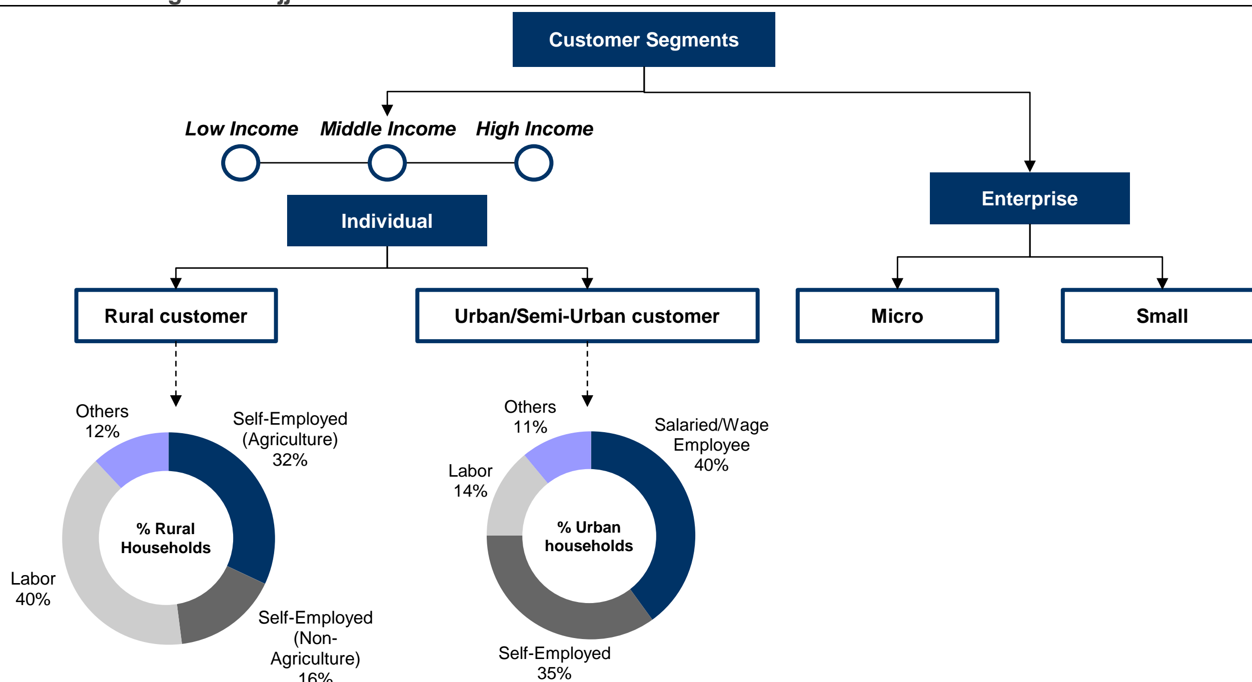
Source: Company

Ujjivan Financial Services

Pan-India player with presence across 24 states

Ujjivan has segmented its customers by geographic location, occupation and income levels. It has a fair knowledge of their needs and has developed suitable products to provide better services for the financially excluded. The company mainly focuses on the urban and semi-urban poor but also serves rural customers living in towns and villages. This gives it an access to customers in all three areas: urban, semi-urban and rural.

Fig 8 - Customer segments Ujjivan caters to



Source: Company

Ujjivan follows both Grameen Bank's and individual lending models. Its group lending business is however more popular among clients and forms ~90% of its portfolio. The company offers a wide range of products under group loans, which can be availed for business, family, agriculture, education and emergency purposes.

Group lending business forms ~90% of portfolio

Fig 9 - Group lending product profile

Type of group loan	Particulars	Loan purpose	Loan size (Rs)	Tenure	Interest rates (%)	Processing fees (%)
Core Group Loan Products	Business Loan	Provided to self-employed women for financing diverse business needs such as capital equipment expenditure, working capital and repayment of high-cost debt	6,000 - 50,000	12 - 24 months	23.6	1
	Family Loan	Family loan is provided to women with low income to finance a range of family needs	6,000 - 35,000			
	Agriculture and Allied loan	These loans are provided to women to meet the cost of cultivation and working capital activities for farming and allied activities	6,000 - 50,000			
Value- Added Group Loan products	Business Top-up Loan	This loan allows customers access to additional money over and above their initial business loan and is given based on a satisfactory credit history	3,000 - 6,000	9 months		1
	Emergency Loan	The loan is designed to meet the unforeseen medical emergency requirements of customers. The loan is disbursed within 24 hours of request	2,000 - 5,000	6 months		0
	Education Loan	This loan has been designed to help finance education expenses (admissions fees, text books, uniforms) of children studying between KG and class12	5,000 - 25,000	12 - 24 months		1

Source: Company

However, as per management, the group lending model is attaining saturation as it covers limited customer needs. Moreover, only 20% of the financially excluded customers in urban/semi-urban areas prefer group credit. Over the years, although the microfinance boom has improved financial access to customers, increased competition has also exerted downward pressure on the market potential of group lending, indirectly limiting Ujjivan's growth. Consequently, management has been exploring avenues to move beyond the group lending model, and has tailored a suite of individual lending products that it offers to existing clients with a good repayment track record under the group lending business.

Fig 10 - Individual loan products offered by Ujjivan

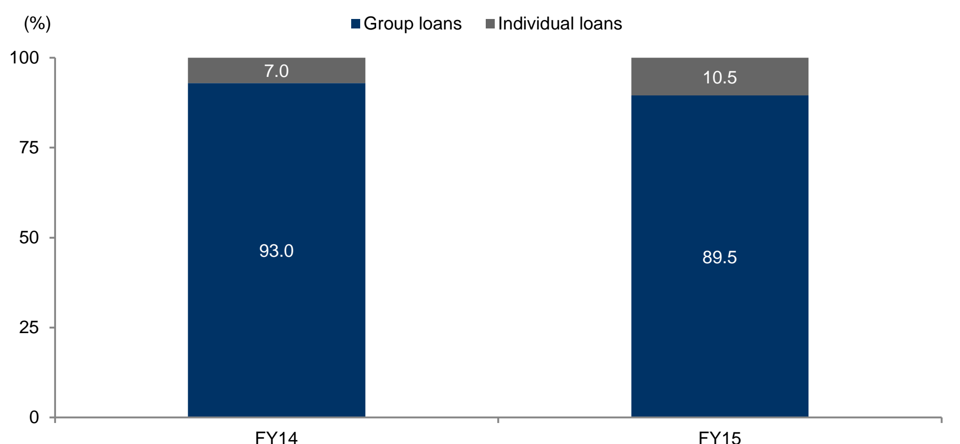
Particulars	Loan purpose	Loan size (Rs)	Tenure	Interest rates (%)	Processing fees (%)	Collateral
Pragati Individual Loan	This is an unsecured individual loan product given to both Ujjivan's existing as well as new customers. This loan can be utilised for business expansion, purchasing milch animals and dairying, home improvement, higher education of children, farming activities and medical emergencies	51,000 - 1,00,000	24 - 36 months	23.6	1.0	-
Individual Business Loan	These loans are given to Ujjivan's existing customers who have a running business and require funds for working capital needs or financing of fixed assets	41,000 - 1,50,000	6 - 24 months	28.0	2.2	-
Individual Livestock Loan	These loans are offered to dairy farmers living in villages in the working areas of Ujjivan's branches. The loan helps customers to meet the finance needs of livestock business, including purchase of cows/buffaloes, cattle shed renovation, purchase of feed/fodder and purchase of machinery.	41,000 - 1,00,000	9 - 24 months	26.0	1.0	-
Home Improvement Loan	The purpose of this loan is to provide customers who are renovating or expanding their houses with timely credit facilities	41,000 - 1,50,000	12 - 36 months	24.0	2.2	-
Higher Education Loan	These loans cater to the needs of the customers for the higher education of their children	41,000 - 3,00,000	6 - 60 months	26.0	1.0	-
Individual Agriculture Loan	This is a tailor-made product offered to marginal and tenant farmers to meet their differential needs	21,000 - 80,000	4 - 12 months	24.0	1.0	-
Secured Business Loan	Secured business loan caters to the investment needs of micro and small entrepreneurs, to expand and boost their business. The loan is secured by land & building, taken as collateral.	2,00,000 - 10,00,000	24 - 84 months	23.0	2.2	Minimum 150% of loan amount
Secured Home Loan	This is an affordable housing loan product designed for low- income households, and offered for home improvement/ renovation/extension, home construction and home purchase	2,00,000 - 10,00,000	24 - 120 months	18.0	2.5	-

Source: Company

Share of individual loans has increased to >10% in FY15 from 7% in FY14

Though focus on individual loans is a recent step, their share in the portfolio has increased to more than 10% in FY15 from 7% in FY14. Management is confident on the growth in this segment and its objective over the next five years is to increase the penetration level to 50% from a mere 5-7% achieved through group loans.

Fig 11 - Ujjivan largely focuses on group loans



Source: Company

Ujjivan also provides life insurance to customers and their spouses. It has partnered with Bajaj Allianz Life Insurance to offer a group term life insurance policy, with different insurance schemes based on loan type and repayment mode. In FY14, it started offering micro pension schemes to customers to address their financial insecurity during old age. The programme was initiated in partnership with Invest India Micro Pension Services under which each customer contributes a minimum amount of Rs 200/month jointly towards UTI-RBPF (Retirement Benefit Pension Fund) and NPS-LITE schemes.

Robust technology platform

Ujjivan has one of the best information technology systems among MFI players. Its IT foundation is robust which continues to innovate and build requisite change drivers.

Fig 12 - Best-in-class technology platform

Technology	Benefits
State-of-the-art Data Centre at IBM	Ujjivan has selected IBM's private cloud resilience services to ensure continuous business operations for the financial transactions of clients. It offers dedicated infrastructure for Ujjivan's primary setup with high-speed SAN data storage, top-end IBM Blade Center Servers, IBM P6 and P7 Series servers with AIX OS and high-end databases including DB2, Oracle and SQL Server
Deployment of Handheld Devices	Customer acquisition, loan underwriting and loan processing are made easier through the use of tablets and the Artoo System. Field transaction data is captured using mobile phones and the Trucell System
DMS and Workflow System for Loan Processing	Ujjivan's momentum in growth has resulted in the need to capture more data and establish new processes to meet regulatory requirements. To meet these requirements, it uses IBM Filenet, the most robust software for DMS, content management, workflow and process management. It digitalises customer documents and eliminates the movement of physical documents between departments for loan processing
Core Banking Solution for Micro Finance Business	The company uses BR.Net as its Core Banking Solution (CBS). It is a platform in which communication and IT are merged to suit core requirements in providing financial services. It is also well-integrated with mobile transactions in the field
Use of Linux and Open Source Software	To balance IT requirements with cost efficiency, Ujjivan's IT Department has deployed open source software where possible. This includes Linux operating systems in branches, which offer smooth operations and cost savings. An open source email solution has been deployed as the communication system. And open source software is also used for the Help Desk System and Complaint Management.

Source: Company

Sharp improvement in operating ratios

The biggest threat that Ujjivan faced during the Andhra Pradesh crisis was not the quality of its portfolio but a highly expensive and inefficient operating base. Its opex ratio was as high as 18% during FY11 and in order to rein in operating costs, it introduced new technology through an extensive re-engineering programme which covered all aspects of its business. To minimise operating costs and improve services, it brought branches online and initiated processing paperless transactions. Consequently, its opex ratio declined to 8.4% in FY15, which is at par with the best in the industry.

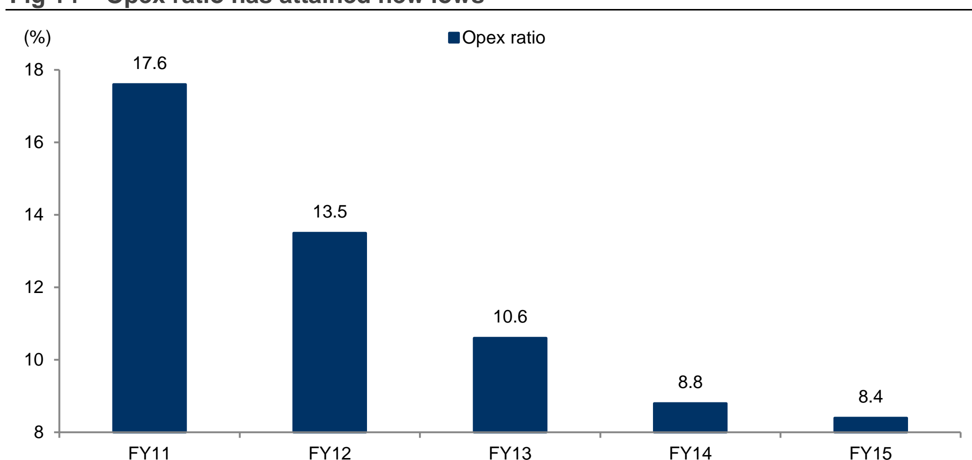
Ujjivan has also moved to handheld devices and introduced tablets and mobile phones to its field officers for reducing the loan turnaround time and automating repayments. As on date, 266 field officers use tablets for customer acquisition and 88 branches mobile phones for loan repayments.

Fig 13 - Improvement in key operating parameters

Particulars	Jul'12	Mar'13	Mar'14	Jan'15
Loan turnaround time (in days)	17.8	7.9	5.3	6.5
Loans processed in a month (No.)	82,739	1,03,773	1,18,491	2,08,187
Pre-approved loans (No.)	-	38,697	51,903	60,713
Cash netting-off (%)	56.0	53.0	59.0	64.4
Customer retention rate (%)	-	70.2	84.6	86.6
Cashless loans (Rs mn)	8	10,416	10,374	17,320

Source: Company

Fig 14 - Opex ratio has attained new lows



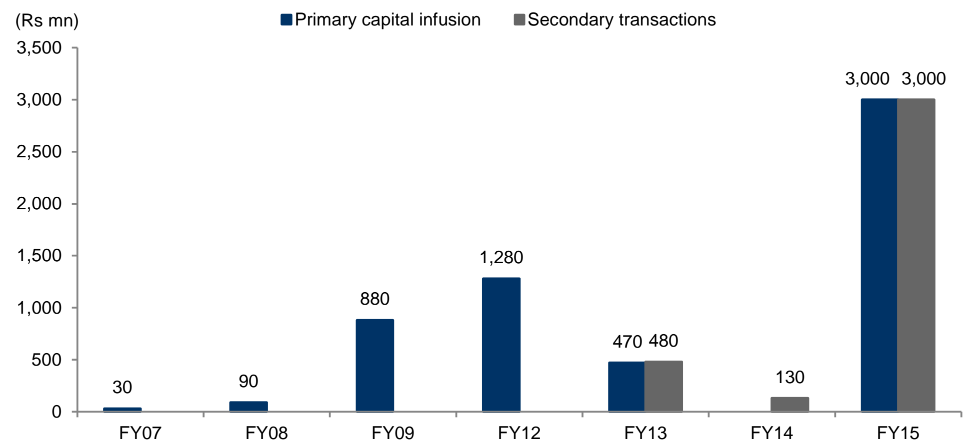
Source: Company

Opex ratio has declined to 8.4%, at par with the best in industry

Strong investor confidence

Ujjivan's growth success story is largely linked to its ability to raise capital at timely intervals. It has raised capital six times up to FY15, which includes Rs 5.7bn of primary capital infusion. Also, secondary transactions of Rs 3.6bn have taken place to provide an exit to early-stage investors such as Bellwether and Michael & Susan Dell Foundation.

Fig 15 - Ujjivan has raised capital in a timely manner

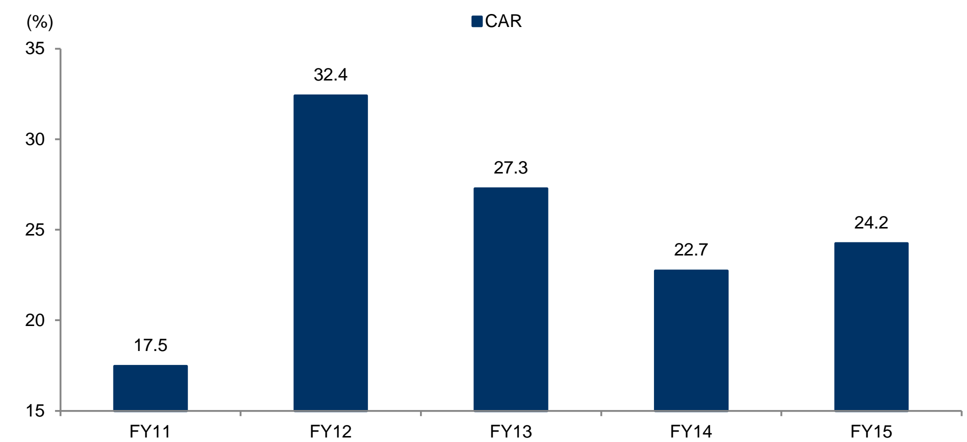


Source: Company

Capital raised six times till FY15 – primary capital infusion/secondary transactions of Rs 5.7bn/Rs 3.6bn

Recently, in its sixth round of capital infusion, Ujjivan raised Rs 3bn from six new investors, viz. CDC Group, NewQuest Asia Investments II, Alena, CX Partners Fund I, Bajaj Holdings & Investment and AAJV Investment Trust, and two existing investors, IFC and Elevar Equity Mauritius. Moreover, secondary transactions worth Rs 3bn provided an exit to both individual and institutional investors with returns ranging from 14.6x-2.5x since inception, depending on the timing of their investments. We believe that apart from fueling growth, these capital infusions have kept Ujjivan adequately capitalised.

Fig 16 - CAR is above the regulatory requirement of 15%



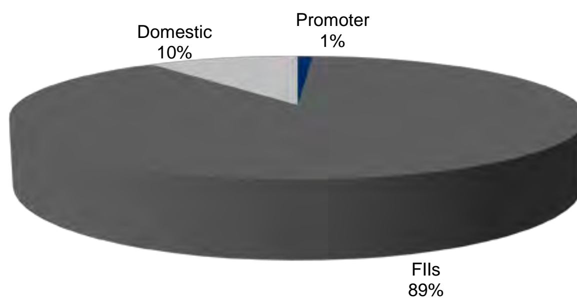
Source: Company

Low promoter holding a hurdle for securing small bank licence

Given Ujjivan's frequent equity dilution, promoter holding has dropped to 1% with FIIs holding a dominating ~89% stake in the company. This acts as a major hurdle for Ujjivan in securing a small bank licence. However, management is aware that the company needs capital restructuring and will float a subsidiary which will act as a small bank.

Frequent equity dilution has dropped promoter holding to 1%

Fig 17 - Promoter holding low



Source: Company

Consistent upgrades by rating agencies

Many rating agencies have consistently upgraded Ujjivan's credit rating based on its growth and performance across various parameters. Its long-term bank borrowings and NCDs were rated as 'BBB' by CARE in 2010, which got upgraded to BBB+ in 2012, to 'A-' in 2014 and to 'A' in Mar'15. In our view, these upgrades are driven by multiple factors like consistent and robust improvement in earnings, increase in scale of operations, higher efficiency, a geographically well-diversified client portfolio, good asset quality, a well-developed portfolio management system and experienced management. Its NCDs are also rated 'A-' by ICRA. Also, in 2013, CRISIL graded it as Mfr1 – the highest grade allotted by the rating agency to a MFI.

High credit rating by several agencies has made Ujjivan one of the most efficient borrowers with an average borrowing cost at 12.7%.

High credit rating has made Ujjivan one of the most efficient borrowers with an avg. borrowing cost of 12.7%

Fig 18 - Credit rating by agencies

Year	Agency	Rating / Grading	Instrument
2010	CARE	BBB	Long term bank borrowings and NCDs
2012	CARE	BBB+	Long term bank borrowings and NCDs
2013	CRISIL	Mfr1	MFI grading, the highest grade that a microfinance institution can achieve
2014	CARE	A-	Long term bank borrowings and NCDs
2015	CARE	A	Long term bank borrowings and NCDs
2015	ICRA	A-	NCDs

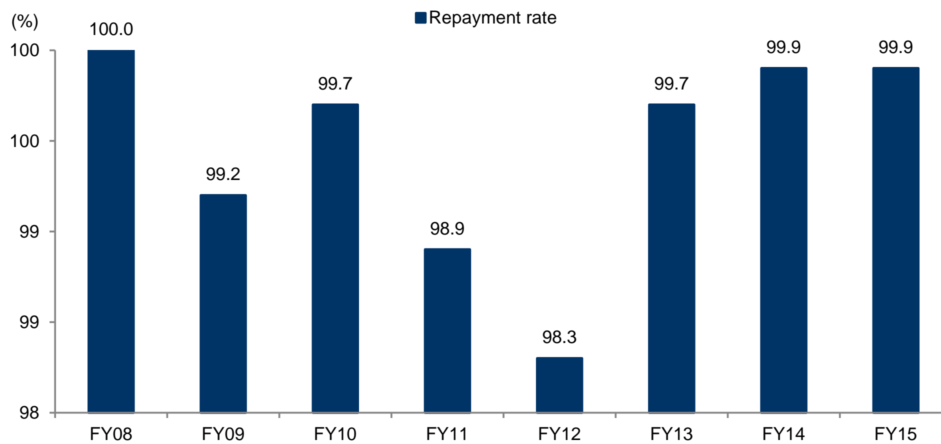
Source: Company

Well-managed asset quality

Ujjivan has an independent credit function to manage overall credit process and quality

Ujjivan's credit monitoring system is unique as its branch-wise credit policies are aligned to the occupation, income levels and demographic profile of customers. Also, it is one of the few in the industry to have an independent credit function to manage overall credit process and quality. The strength of its credit monitoring system can be gauged from its healthy repayment rate which remained above 98% even during the industry-wide crisis in FY12 – vindicating our stance that its asset quality is well managed.

Fig 19 - Repayment rate has remained strong

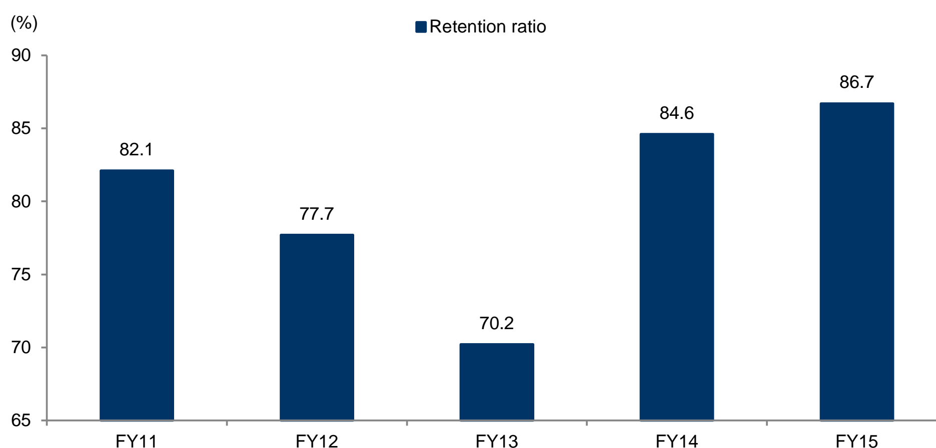


Source: Company

High repayment rate and customer retention implies well-managed asset quality

In addition, we believe a high customer retention ratio has been a key factor aiding Ujjivan in maintaining healthy asset quality. A high customer retention ratio indicates that the credit history of borrowers is well known to the MFI player, which reduces the probability of default by enabling them to make informed lending decisions.

Fig 20 - Customer retention ratio has improved



Source: Company

Management profile

Fig 21 - Key management team

Name	Designation	Profile
Samit Ghosh	CEO & MD	Mr. Ghosh founded Ujjivan in 2005 as a pioneering microfinance firm for the urban poor. He has over three decades of international banking experience and has worked in various capacities in banks such as Citibank, Standard Chartered, Bank Muscat and HDFC Bank.
Sudha Suresh	CFO	Ms. Sudha is a CA with a rich corporate career spanning over two decades. Her expertise and contributions include areas of fiscal management, strategic planning, capital and debt syndication, MIS and compliances in private and public limited companies.
Carol Furtado	COO – South & North	Ms. Carol has been with Ujjivan since inception. She is a Finance professional with over 15 years of experience, having worked at ANZ Grindlays and Bank Muscat, where she specialised in modern retail banking operations. Carol is an MBA from Mount Carmel Institute of Management, Bengaluru.
Abhiroop Chatterjee	COO – East	Mr. Chatterjee joined Ujjivan in April'08 as a management trainee. His first assignment was to establish operations at Jharkhand as Area Manager. In Jan'14, he was appointed Chief of Staff for the Eastern Region and was soon promoted as COO-East in Apr'14. Abhiroop has a PGDM-Rural Management from Xavier Institute of Management, Bhubaneswar.
Jolly Zachariah	COO – West	Mr. Zachariah has over 22 years of International Banking experience with Citibank. He led and managed consumer banking and credit card businesses in India and overseas. He is responsible for establishing Ujjivan as the leading MFI service provider in urban Maharashtra and Gujarat.

Source: Company

Fig 22 - Key investor directors

Name	Designation	Profile
Bhama Krishnamurthy	Nominee Director – SIDBI	Ms. Bhama currently serves as a Director in SIDBI Venture Capital, IDBI Capital Market Services, Reliance Industrial Infrastructure and a few other companies. She has over three decades of experience in development banking both in IDBI and SIDBI. She holds a Masters' Degree in Science.
Sandeep Farias	Nominee Director – Elevar Equity Mauritius	Mr. Farias currently serves as a Director of Elevar Advisors, Vistaar Financial Services, Madura Micro Finance and a few other companies. He has varied experience with NBFCs, MFIs and other financial and investment companies. He holds Law & Arts Honors Degree from the National Law School of India, University in Bengaluru.
Venkatesh Natarajan	Nominee Director – Lok Capital	Mr. Natarajan serves as a director in Lok Advisory Services, Equitas Finance, and Suryoday Micro Finance among others. He has almost 15 years of work experience in engineering and investment. He holds an MBA from Cornell University, a Master's degree in Electrical Engineering from Arizona State University and a Bachelor's in Electronics & Instrumentation Engineering from Annamalai University.
Sarvesh Suri	Nominee Director – IFC	Mr. Suri joined IFC Indonesia as the Country Manager in Jan'12. He holds a PG diploma in Business Management from IIM, Ahmedabad, and Bachelor's in Mechanical Engineering from Delhi University.
Amit Gupta	Nominee Director – NewQuest Asia Investments II	Mr. Gupta has more than 14 years of industry experience. He is the Chief Operating Officer of NewQuest and oversees India & SE Asia business. He has an MBA from IIM, Bengaluru, and an undergraduate degree holder in electrical engineering from REC Kurukshetra.
Jayanta Basu	Nominee Director – Alena	Mr. Basu serves as a director in Security and Intelligence Services (India) and Matrix Cellular (International) Services among others. Prior to co-founding Alena, Mr. Basu was a Director with CVCI. He is a MBA from IIM, Ahmedabad, and a B.A. in Economics from St. Stephen's College, Delhi University.

Source: Company

Financials

Fig 23 - Income statement

Particulars (Rs mn)	FY11A	FY12A	FY13A	FY14A	FY15A
Interest income	1,327	1,338	2,066	3,254	5,508
Interest expense	477	586	806	1,449	2,714
Net interest income	**850**	**752**	**1,260**	**1,806**	**2,795**
Non-interest income	238	225	273	322	610
Net total income	1,088	977	1,533	2,128	3,405
Operating Expense	865	898	972	1,207	2,049
Pre-provisioning profit	**223**	**80**	**561**	**921**	**1,356**
Provisions	45	58	69	83	210
Profit before tax	177	22	492	838	1,145
Tax	63	5	153	288	387
Profit after tax	**114**	**17**	**339**	**550**	**758**

Source: Company

Fig 24 - Balance sheet

Particulars (Rs mn)	FY11A	FY12A	FY13A	FY14A	FY15A
Shareholders' funds	**1,162**	**2,427**	**3,213**	**3,725**	**7,364**
Share capital	348	573	656	656	861
Reserves and surplus	814	1,854	2,558	3,069	6,503
Non-Current Liabilities					
Long term borrowings	1,671	2,550	3,835	5,651	12,831
Long term provisions	15	19	12	23	59
Current Liabilities					
Short term borrowings	9	-	40	19	45
Trade Payables	43	41	48	51	118
Other current liabilities	4,140	3,834	6,310	11,083	18,920
Short term provisions	77	103	144	234	425
Total	**7,117**	**8,975**	**13,602**	**20,787**	**39,763**
ASSETS					
Non-Current Assets					
Fixed assets	98	112	111	127	179
Tangible assets	88	87	83	98	142
Intangible assets	10	24	29	29	37
Non-current investment	1	1	1	1	1
Deferred tax assets (net)	21	32	40	68	153
Long term loans and advances	36	30	33	51	68
Other non-current assets	176	479	1,904	2,383	6,055
Current Assets					
Receivables under financing activity	6,180	6,531	9,474	13,876	26,299
Cash and bank balances	512	1,615	1,786	3,945	6,378
Short term loans and advances	20	22	62	106	207
Other current assets	73	154	191	229	422
Total	**7,117**	**8,975**	**13,602**	**20,787**	**39,763**

Source: Company

19 August 2015

Satin Creditcare Network

Largest player in North India

Satin Creditcare Network (SCNL) is the sixth largest MFI in the country with an AUM of ~Rs 21bn and a primary focus on North India where it has a presence across 11 states. It also provides business correspondent services to Yes Bank and Ratnakar Bank through a group company for a 10% royalty fee, besides originating LAP for Reliance Capital. Management sees immense potential for growth in the underserved states of Uttar Pradesh, Bihar and Madhya Pradesh, and is targeting 60-70% AUM CAGR along with steady 18-20% ROEs over FY15-FY17. We do not have a rating on the stock.

- **Business profile:** SCNL was formed in 1990 to give individual loans to urban shopkeepers for tiny businesses. It forayed into microfinance in 2008 and scaled up quickly to emerge as the largest player in Northern India. The company has a presence in 11 states and is a market leader in Uttar Pradesh and Madhya Pradesh. SCNL currently has ~2,500 employees, 267 branches and 1.2mn clients. AUM has grown rapidly over FY11-15, which has aided +180% CAGR in net profit, even as lower delinquencies have helped keep GNPAs at 0.02%. Notably, SCNL enjoys the confidence of PE investors who have infused money at regular intervals.

- **Targeting 65-70% CAGR in AUM over next two years:** SCNL is the sixth largest MFI in India with an AUM of ~Rs 21bn as of Mar'15 and strong potential for growth given its presence in states where the per capita income level is below the national average. Management sees substantial business opportunities as the sector is highly underpenetrated and believes it can scale AUM up 60-70% over FY15-FY17 to ~Rs 56bn.

- **BC services and low-ticket LAP growing rapidly:** SCNL provides business correspondent (BC) services to Ratnakar Bank and Yes Bank through group company Taraashna Services (~0.2mn customers), for which it earns 10% of revenue as royalty. SCNL has also partnered with Reliance Capital to cross-sell low-ticket LAP to existing clients (ticket size Rs 0.1mn-0.3mn, tenure 1-3 years, LTV of 70%). Loans are originated in the Reliance Capital book and SCNL provides collections and maintenance. It retains loan yields over 15% for undertaking risks.

- **Strong profit profile:** Spreads are likely to remain protected at 9-9.5%. Opex to average assets has come off from ~10% in FY12 to ~6% currently and management expects to maintain this in a range of 5.5-6.5% going forward. ROE has improved substantially from sub-5% in FY12/FY13 (Andhra Pradesh crisis) to ~19% in FY15 and management expects a range of 18-20% going forward.

- **Applied for banking licence:** SCNL has applied for conversion into a small bank. The biggest advantage is that conversion into a bank will substantially reduce political risk for the business. In addition, this will give the company access to cheaper funds which will offset the CRR/SLR impact in the near term.

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Key financials

Particulars	FY13	FY14	FY15
AUM (Rs mn)	5,800	10,561	21,407
Net profit (Rs mn)	39	156	317
Net worth (Rs mn)	1,248	1,396	1,946
ROA (%)	0.6	1.4	1.6
ROE (%)	3.8	11.8	19.0
Net NPA (%)	0.1	0.0	0.0

Source: Company

Satin Creditcare Network

Largest player in North India

Company Update
INDIA
MICROFINANCE

SCNL was formed by Mr. HP Singh in 1990. The company was initially set up as an NBFC with the simple concept of providing individual loans to urban shopkeepers for tiny businesses, but forayed into microfinance in 2008. The business quickly scaled up and today SCNL has emerged as the largest microfinance player in North India and the sixth largest MFI in the country. Delinquency levels are low despite robust AUM growth over the last five years. The company's network of 267 branches is spread across 11 states and it enjoys a leading position in Uttar Pradesh and Madhya Pradesh.

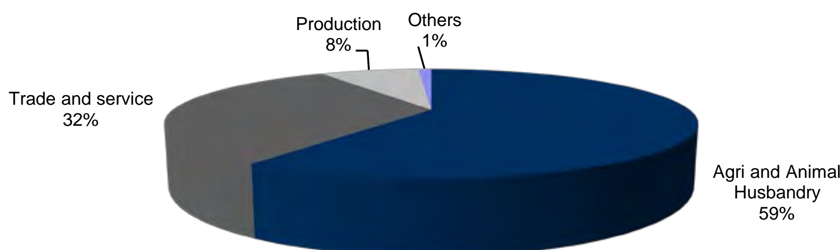
Largest (and oldest) microfinance player in Northern India and the 6th largest in India, with an AUM of ~Rs 21.4bn

Dominant player in North India

SCNL has developed strong expertise for lending in the North Indian market. It primarily caters to bottom-of-the-pyramid customers by providing loans to unserved and underserved sections of the population for requirements such as starting new businesses and/or growing existing ones. About 90% of its AUM comprises microcredit for agricultural activity, animal husbandry and for trade & services.

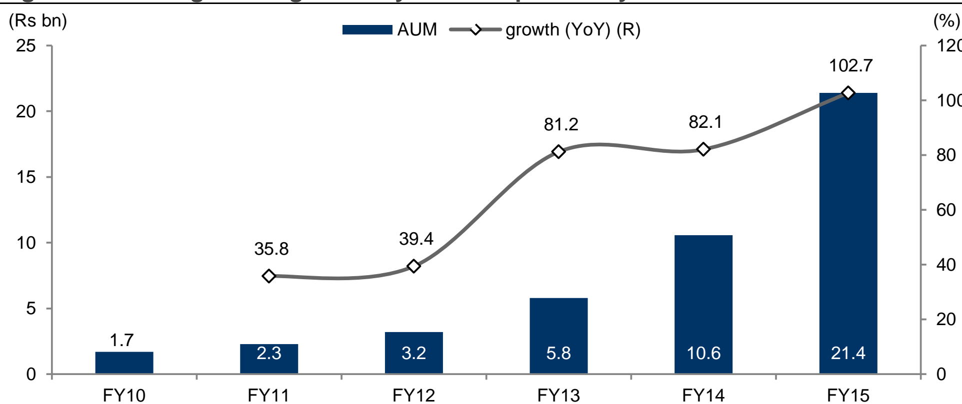
Primarily offers microcredit for agricultural activity, animal husbandry and for trade & services (90% of AUM)

Fig 1 - Agri and animal husbandry forms 59% of AUM



Source: Company

Fig 2 - AUM has grown significantly over the past few years



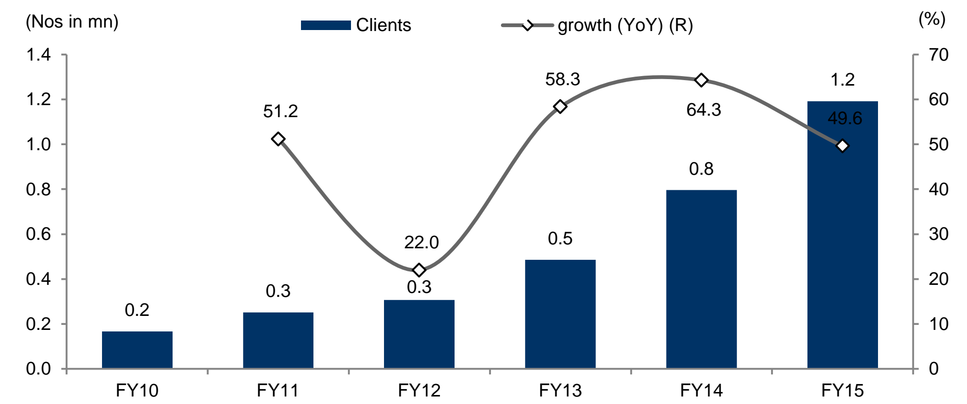
Source: Company

AUM CAGR of 75% over FY11-15

SCNL has clocked a robust 75% CAGR in AUM over FY11-15, largely on account of strong growth in its client base and an increase in average ticket size of loans. The company has an active client base of ~1.2mn customers (FY15), which has increased at a 48% CAGR over FY11-15.

Active client base of ~1.2mn customers – 48% CAGR over FY11-15

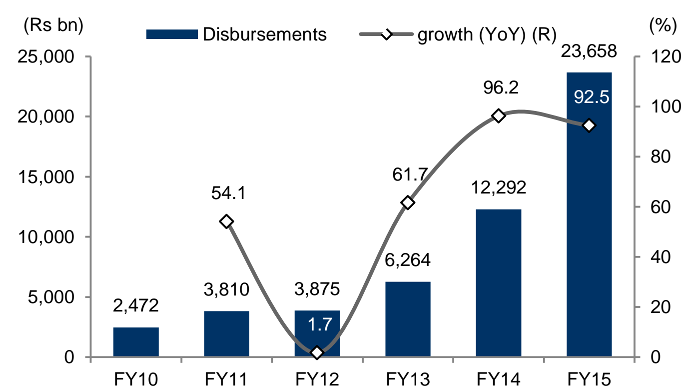
Fig 3 - Robust client accretion



Source: Company

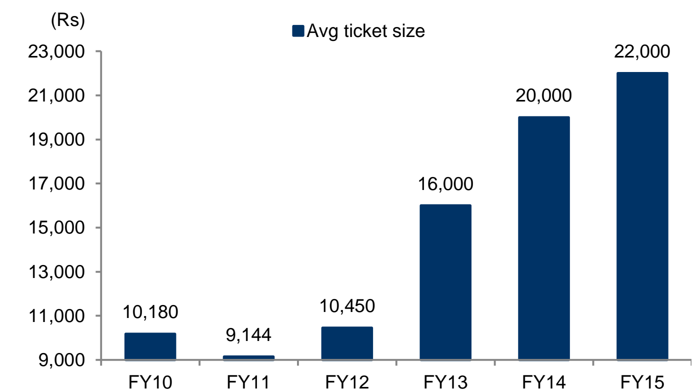
Disbursements have grown at a 58% CAGR – especially post the Andhra Pradesh crisis which hit performance in FY11-FY13. While, the average ticket size of loans has risen from a mere Rs 10,500 in FY12 to Rs 22,000 in FY15. Despite the robust client accretion and higher ticket size, SCNL's asset quality has remained strong, which we believe reflects the company's prudent lending approach.

Fig 4 - Disbursements have picked up pace…



Source: Company

Fig 5 - …due to higher loans disbursed per client

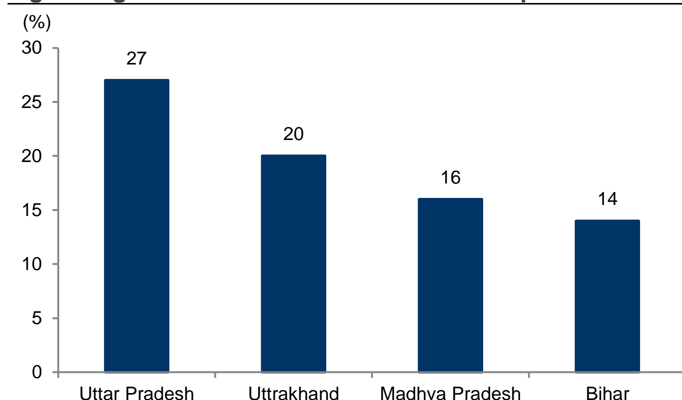


Source: Company

SCNL has uniquely positioned itself amongst the leading microfinance players in 11 states in North India. It is the largest player in Uttar Pradesh (27% share) and Madhya Pradesh (16%) besides commanding a high market share in the states of Uttarakhand (20%) and Bihar (14%).

Largest player in Uttar Pradesh and Madhya Pradesh

Fig 6 - High market share in states where it operates



Source: Company

Fig 7 - Market leader in three major states

Source: Company, *Considering only non-CDR MFIs

Satin Creditcare Network

Largest player in North India

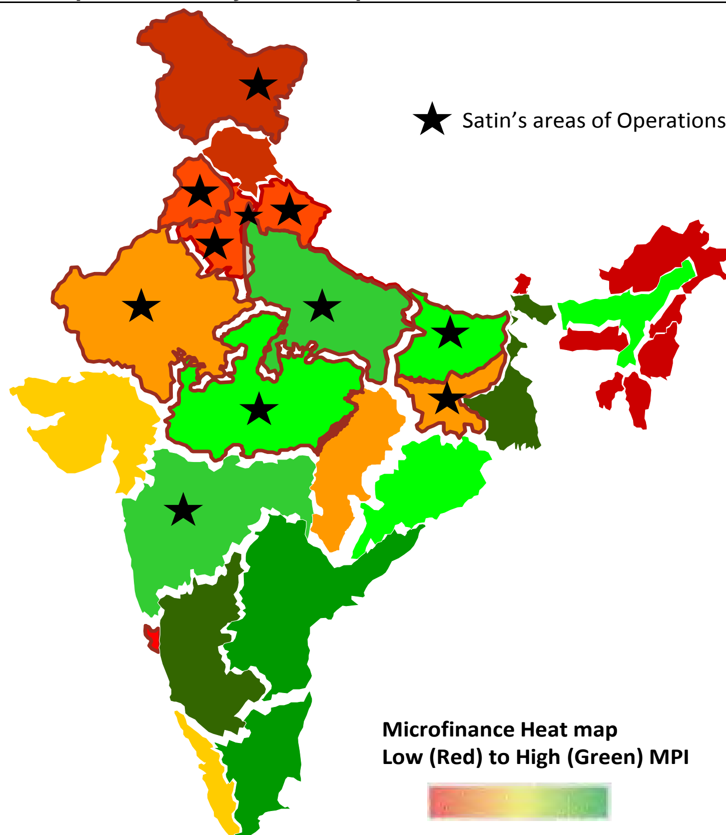
Company Update
INDIA
MICROFINANCE

Strategy of targeting under-penetrated markets

In our view, the key to SCNL's success has been its positioning as an early entrant in states where other MFIs have a low presence. The company has maintained its competitive positioning through a presence in urban and rural areas along with offerings in both individual and group lending products.

Largely operates in states where other MFIs have a low presence

Fig 8 - SCNL is present mostly in under-penetrated states

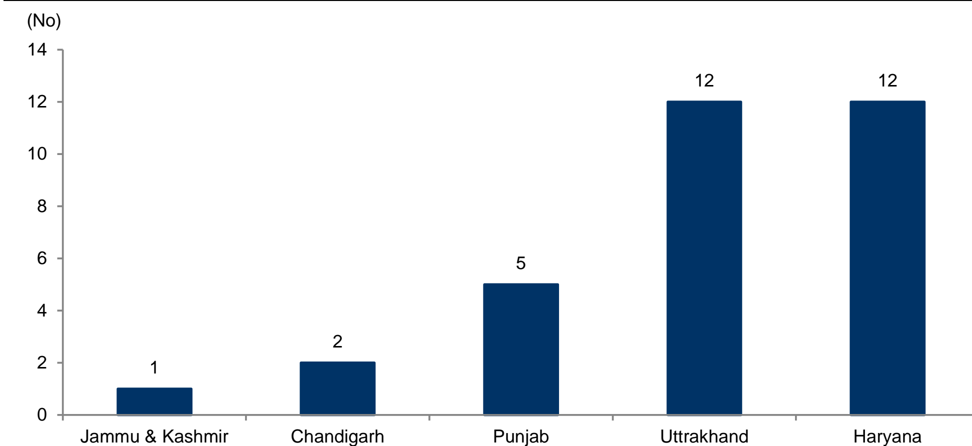


Source: Company, Sa-Dhan | Note: MPI is Microfinance Penetration Index

According to management, SCNL is the only institution serving the financial needs of as many as ~50% of its customers. In FY13, SCNL started operations in Jammu & Kashmir where it is the only player and in Punjab where it is one of only five players.

SCNL is the only institution serving financial needs for ~50% of its customers

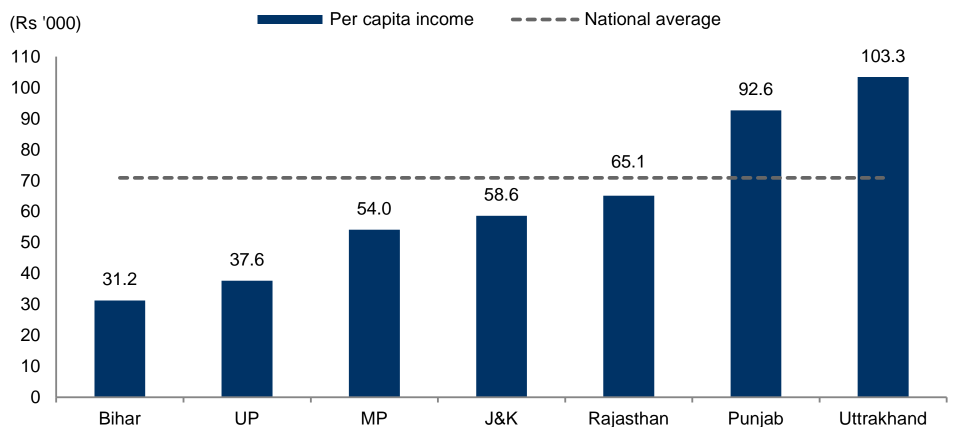
Fig 9 - Number of players in states where SCNL is present (includes SCNL)



Source: Company

SCNL's second strategy is to build a presence in states where the per capita income is lower than the national average – this implies access to a larger addressable market of bottom-of-the-pyramid customers.

Fig 10 - SCNL targets lending to low per-capita income states

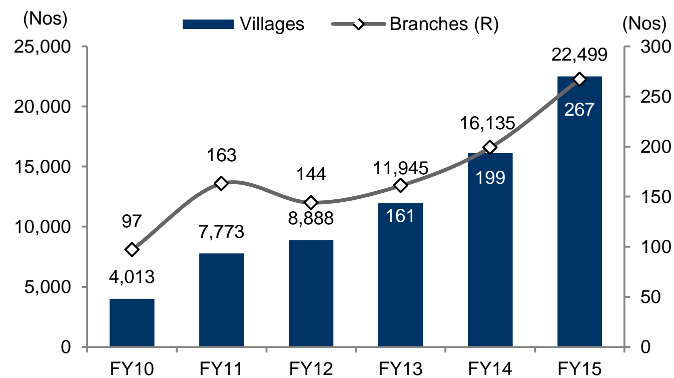


Source: Company

The company is aggressively pursuing new villages in order to access more clients. As of FY15, it operates in ~22,500 villages through a network of 267 branches. We believe SCNL has optimally utilised its branches, as each branch now caters to ~84 villages on average as compared to 41 villages in FY10.

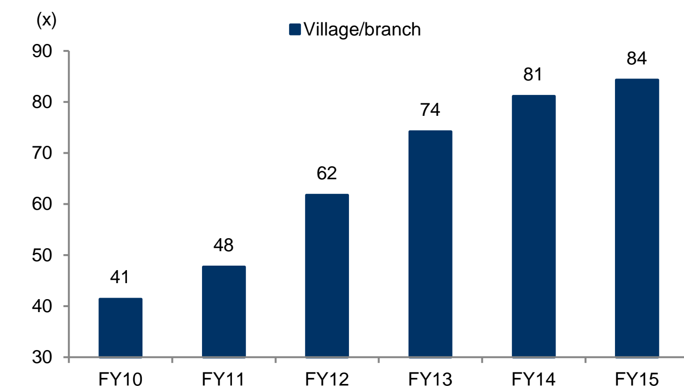
Present in ~22,500 villages through a network of 267 branches

Fig 11 - SCNL has a wide rural network



Source: Company

Fig 12 - Branches have been optimally utilised



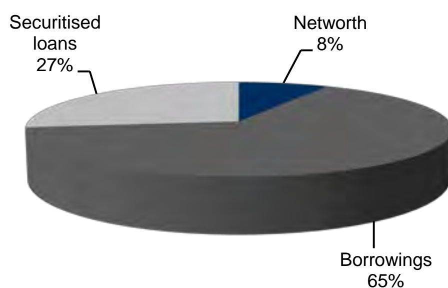
Source: Company

Diversified resource base

Term loans from banks and financial institutions are a major source of external funding for SCNL. It has lending relationships with 57 lenders, which is the highest in the MFI space. In our view, SCNL's access to a large pool of lenders has been instrumental in aiding its rapid scale of expansion. The company's credit profile is currently rated as BBB+ by CARE and has been upgraded for two consecutive years, which reflects the strength of its business model.

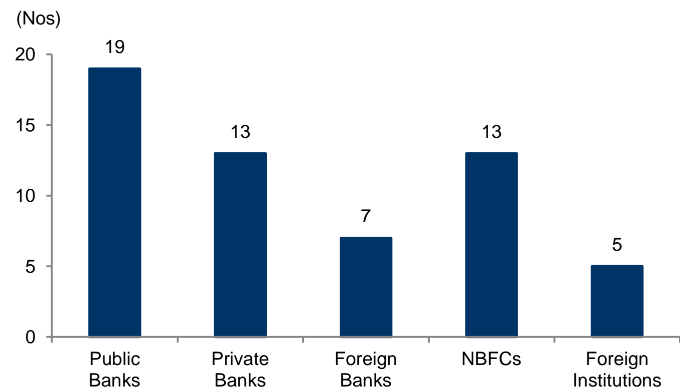
SCNL's credit profile currently rated as BBB+ by CARE and has been upgraded for two consecutive years

Fig 13 - Diversified resource base



Source: Company

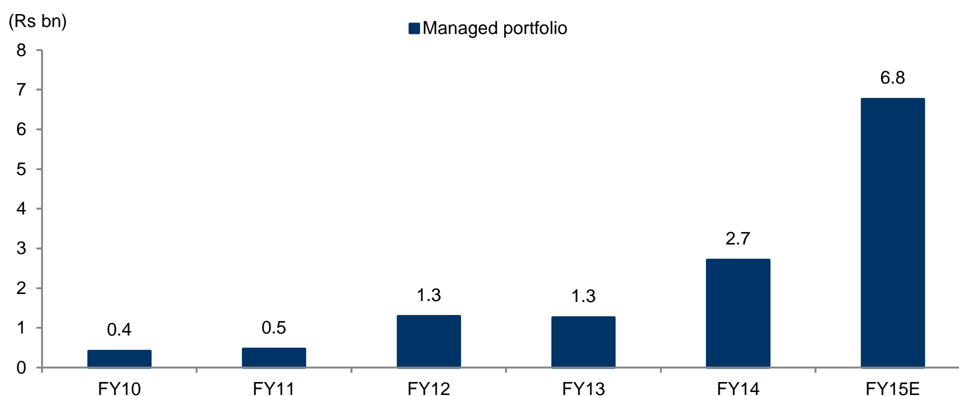
Fig 14 - Strong lending relationships



Source: Company

SCNL also accesses the securitisation/assignment route for tapping funds. The company's managed portfolio as on FY15 stood at Rs 6.8bn and has increased at a CAGR of ~95% over FY11-FY15. In our view, an increase in managed portfolio is beneficial for NIMs as borrowing via this route is ~200bps cheaper than on-balance-sheet borrowing.

Fig 15 - Rapid scale-up in managed portfolio



Source: Company

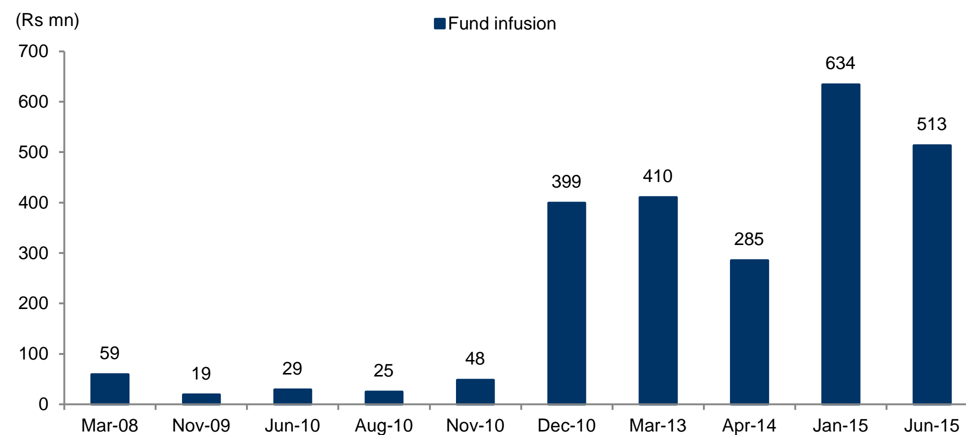
Enjoys strong investor confidence

SCNL has benefited from a series of fund infusions by PE investors at regular intervals, including follow-on investments from Lok Capital LLC, ShoreCap II and Danish Microfinance Partners. Notably, the company offered a profitable exit to its first investor despite adverse industry conditions.

Regular capital infusion has ensured timely funds for sustaining strong business growth

Recently, SBI-FMO Emerging Asia Financial Services Fund and the company's promoters infused Rs 513mn into the business via a combination of equity shares and warrants. Capital infusion at regular intervals has not only kept SCNL adequately capitalised, but has also ensured timely availability of funds for sustaining strong business growth.

Fig 16 - Fund infusion at regular intervals by investors and promoters

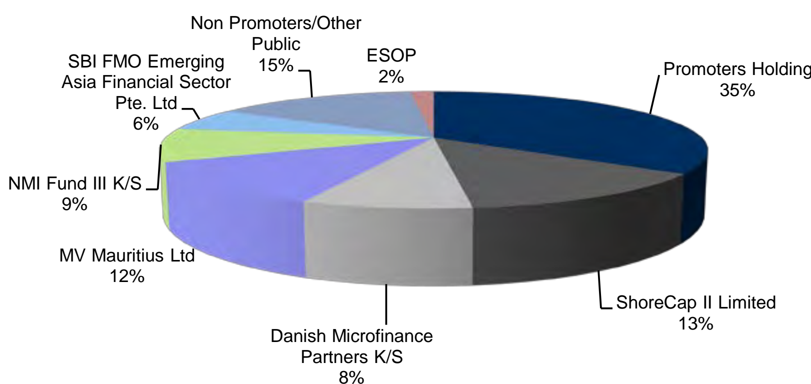


Source: Company

The company's shareholding pattern is fairly distributed with PE and other investors holding ~48% stake. The promoters have managed to keep their stake at 35% by infusing capital in a timely manner, even post the Andhra Pradesh crisis. This implies promoter confidence in the company's earnings potential.

The promoters have managed to keep their stake at 35% by infusing capital in a timely manner

Fig 17 - Promoter holding in SCNL is at 35% as on Jun'15



Source: Company

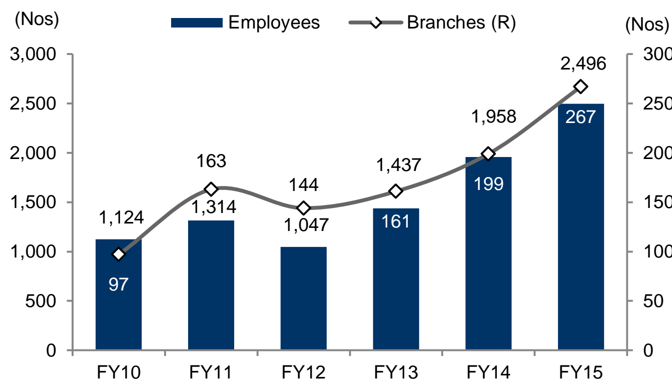
High operational efficiency

SCNL is one of the most efficient players in the microfinance industry – despite a 22% and 18% CAGR in branch network and employee base respectively, its operating expense as a percentage of average AUM declined from 12.8% in FY10 to 6.2% in FY15. Strong NII growth coupled with operational efficiency saw earnings more than double in FY15.

Despite rapid expansion, opex as a percentage of avg. AUM has dropped to 6.2% in FY15

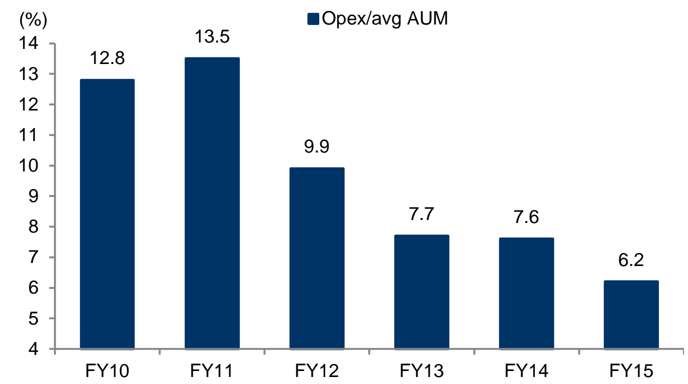
The company has frontloaded its investments in setting up systems and processes to support large-scale operations at a later stage. Moreover, it has improved operational efficiency by pushing up disbursements at the branch and employee level.

Fig 18 - Trend in branch network and headcount



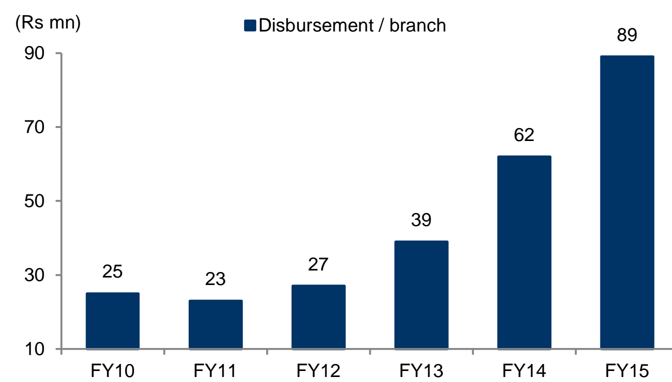
Source: Company

Fig 19 - Opex/ Avg. AUM has declined



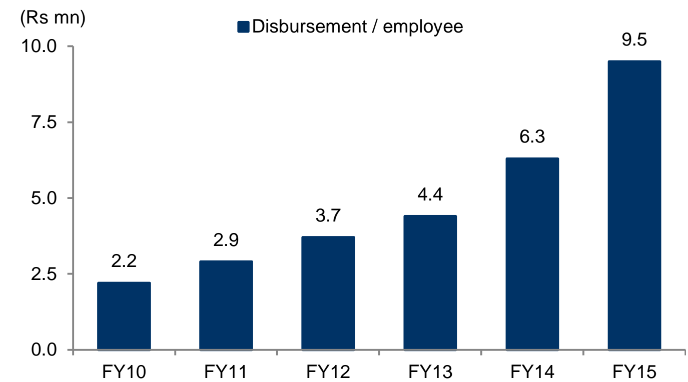
Source: Company

Fig 20 - Trend in disbursement per branch



Source: Company

Fig 21 - Trend in disbursement per employee



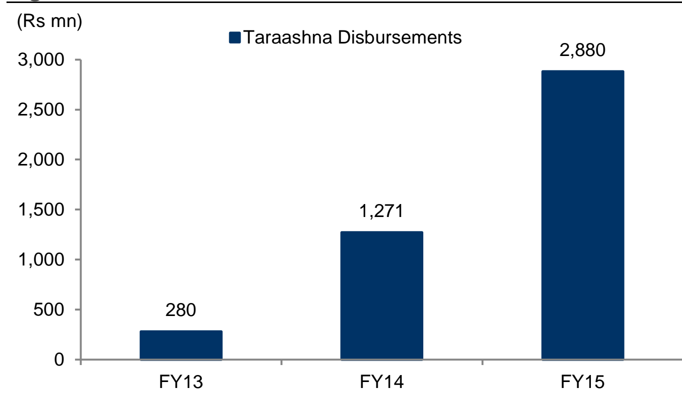
Source: Company

New business initiatives – BC services and low-ticket LAP

Beyond microfinance, SCNL offers business correspondent (BC) services through its group company Taraashna Services. Taraashna sources high-yield MFI loans that qualify as priority sector lending for banks and has partnered with Ratnakar Bank and Yes Bank to offer BC services. Other banks are also approaching the company for tie-ups. The management team is headed by CEO Pinaki Ranjan Mitra who has vast experience in the MFI industry.

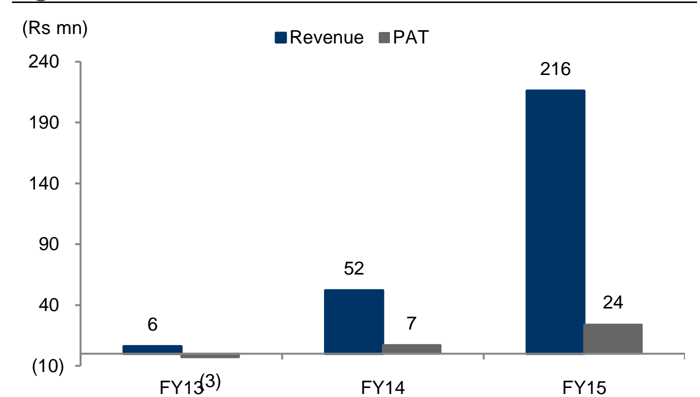
Although FY14 was only the first full year of Taraashna's operations, it already caters to a large base of ~0.2mn customers through a network of 73 branches. Disbursements have grown to Rs 2.9bn while net profit stood at Rs 24mn in FY15. SCNL gets 10% of Taraashnas' revenue as royalty which acts as a tailwind to profitability.

Fig 22 - Trend in Taraashna's disbursements



Source: Company

Fig 23 - Taraashna's revenue and PAT



Source: Company

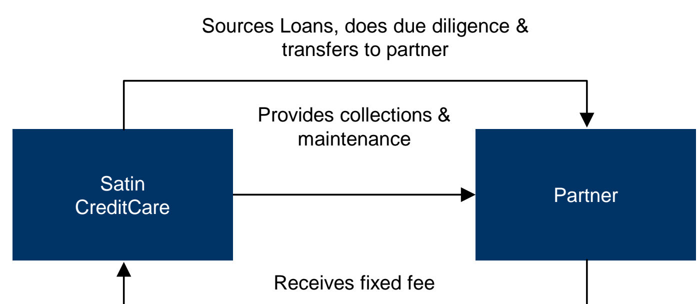
SCNL has partnered with Reliance Capital to cross-sell low-ticket LAP to its existing clients. These clients are generally small entrepreneurs who need to fund working capital and other business requirements. Under this arrangement, loans originate in Reliance Capital's book and SCNL provides collection and maintenance services, against which it retains yields over 15% for the risk it undertakes.

Fig 24 - Product features

Ticket Size	Rs 0.1mn – 0.25mn
Tenor	1 – 3 years
Security	Self-occupied shop / residence
LTV	Up to 70%
Interest rate	18 – 24%

Source: Company

Fig 25 - Mechanism – how it actually works



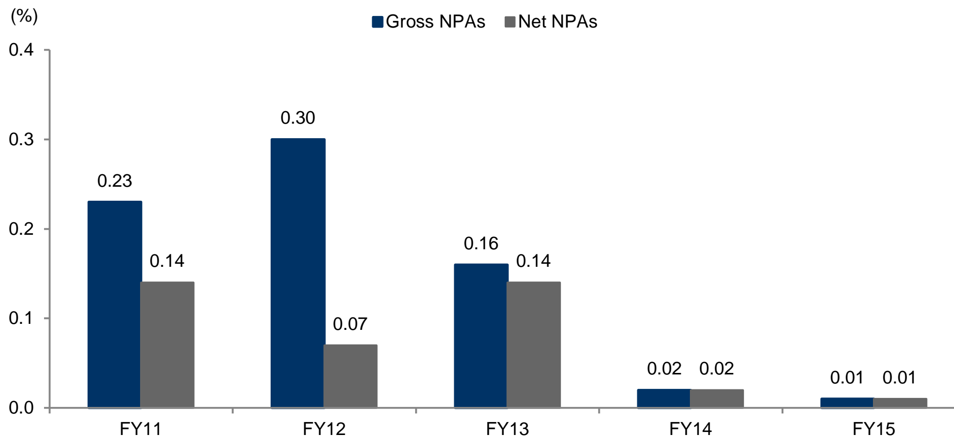
Source: Company

Delinquency levels well managed

SCNL's delinquencies have remained low despite ~9x growth in AUM over the last five years. Headline NPA spiked once in FY12 to 0.3% due to the Andhra crisis, post which it has steadily declined and stabilised at 0.01% in FY15. In our view, SCNL's low delinquency level validates its operational model.

Headline NPA spiked once in FY12 to 0.3% due to the AP crisis, post which it has steadily declined

Fig 26 - Manageable stress on asset quality



Source: Company

SCNL uses an integrated system that handles accounting, reporting and monitoring. The system has the ability to track a variety of data on a daily basis to help management monitor operational aspects such as portfolio at risk (PAR), portfolio outstanding, disbursement and collections.

Technology platform supports asset quality and scalability

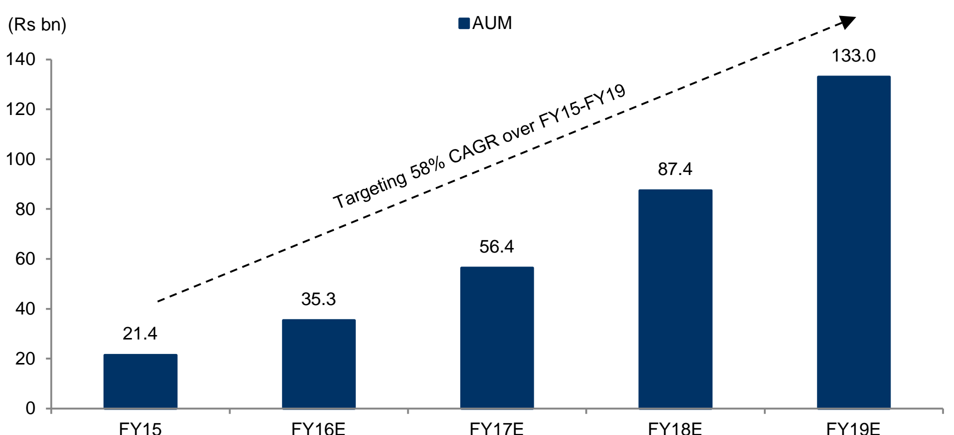
Ambitious growth plans

Given that the sector is highly underpenetrated, management is targeting a 60-70% CAGR in AUM and expects to reach ~Rs 56bn in FY17. Further, the company has ambitious plans to reach Rs 133bn by FY19-end, implying a 58% CAGR in AUM over FY15-FY19.

Profitability is expected to remain strong going forward and management is hopeful of maintaining ROE in the range of 18-20%. Spreads are likely to remain protected at 9-9.5% while opex to average assets should remain in the range of 5.5-6.5% as compared with ~6% currently. SCNL has applied for a small bank licence – if this materialises, it will substantially reduce the political risk on the company.

Targeting a 60-70% CAGR in AUM to reach ~Rs 56bn in FY17

Fig 27 - Ambitious growth plans



Source: Company projections

Management profile

Fig 28 - Key management team

Name	Designation	Profile
H P Singh	CMD and Promoter	Mr. Singh is a Chartered Accountant and has over 25 years of experience in the microfinance sector. He is actively involved in SCNL's day-to-day operations.
Jugal Kataria	Chief Financial Officer	Mr. Kataria is a graduate from Shree Ram College of Commerce and is a Cost Accountant, Chartered Accountant and Company Secretary with 24 years of relevant experience. Prior to joining SCNL in 2000, he worked with Apollo Tyres and Berger Paints (India).
Vivek Tiwari	Chief Operating Officer	Mr. Tiwari has 12 years of experience in the microfinance and development sector and holds a postgraduate degree in Rural Development and Management. He has played a vital role in accelerating the JLG movement in several parts of Uttar Pradesh.
Sandeep Lohani	Chief Strategy Officer	Mr. Lohani joined SCNL in Dec'14 and has over 14 years of relevant experience. He holds an MBA degree from JBIMS and has pursued an Executive Leadership Program in microfinance from Harvard Business School.

Source: Company

Fig 29 - Key investor directors

Name	Designation	Profile
Davis Golding	Investor Director, ShoreCap II Limited	Mr. Golding has over 30 years' of experience in international finance, banking, and mergers and acquisitions. He holds a B.A. degree in Business Administration from Duke University, Durham, North Carolina.
Deepa A Hingorani	Investor Director, Danish Microfinance Partners K/S	Ms. Hingorani has been associated with IFU, an investment fund owned by the Danish government, for over 16 years and has been working out of Chennai, Copenhagen, Singapore and New Delhi. She is also on the Board of Directors for a number of organisations and holds an Executive MBA degree from Scandinavian International Management Institute, Copenhagen.
Richard B. Butler	Investor Director, MV Mauritius Limited	Mr. Butler has served for 30 years at various international financial service companies. He is a graduate in Development Economics & Middle Eastern History from Georgetown University and has done postgraduate studies in Agriculture Economics at the University of Minnesota.

Source: Company

Satin Creditcare Network

Largest player in North India

Company Update

INDIA

MICROFINANCE

Financials

Fig 30 - Income statement

Particulars (Rs mn)	FY10A	FY11A	FY12A	FY13A	FY14A	FY15A
Interest income	246	416	368	698	1,467	2,374
Non-interest income	114	170	194	246	450	868
Total income	**360**	**586**	**562**	**943**	**1,917**	**3,242**
Interest expense	158	283	268	543	1,061	1,775
Personnel expense	95	187	178	201	296	452
Administration and other expenses	57	75	89	140	319	530
Depreciation	5	7	7	6	7	20
Profit before tax	45	34	21	54	234	465
Tax	15	12	7	15	79	147
Profit after tax	**29**	**22**	**14**	**39**	**156**	**317**

Source: Company

Fig 31 - Balance sheet

Particulars (Rs mn)	FY10A	FY11A	FY12A	FY13A	FY14A	FY15A
Net worth	286	796	812	1,248	1,396	1,946
Preference shares	-	-	-	-	60	60
Sub debt	-	-	-	-	-	809
Borrowings	1,842	2,074	2,155	5,898	9,086	15,492
Managed Portfolio	413	469	1,291	1,259	2,712	6762
Total Liabilities	**2,541**	**3,340**	**4,258**	**8,405**	**13,255**	**25,068**
					-	
Fixed Assets	58	81	80	83	120	144
Investments	7	7	7	7	1	1
Cash & Bank Balance	473	158	337	516	944	1,664
Fixed Deposits	356	840	734	2,188	1,928	2,924
Portfolio (incl. managed portfolio)	1,691	2,296	3,201	5,800	10,561	21,406
Other Current Assets	44	56	115	152	463	899
Less: Current Liabilities & Provisions	88	99	217	341	762	1,970
Total Assets	**2,541**	**3,340**	**4,258**	**8,405**	**13,255**	**25,068**

Source: Company

Fig 32 - Du-Pont analysis

Particulars (%)	FY10A	FY11A	FY12A	FY13A	FY14A	FY15A
Total Income	29.4	29.4	20.5	21.0	23.4	20.3
Interest expense	12.9	14.2	9.8	12.1	13.0	11.1
Net Interest Income	16.5	15.2	10.7	8.9	10.5	9.2
Opex	12.8	13.5	9.9	7.7	7.6	6.3
Provision for Tax	1.3	0.6	0.3	0.3	1.0	0.9
RoA	**1.6**	**0.7**	**0.4**	**0.6**	**1.4**	**1.7**
Avg Assets/ Avg Net worth	8.1	5.6	4.9	6.4	8.6	11.5
RoE	**12.8**	**4.0**	**1.7**	**3.8**	**11.8**	**19.0**

Source: Company

19 August 2015

Grameen Koota Financial Services

Serving India's rural poor – a large addressable market

Grameen Koota Financial Services (GKFS, unlisted) started operations in 1999 with seed capital funding from the well-known Grameen Trust in Bangladesh. The company's AUM has increased at a 55% CAGR over FY11-FY15 and currently stands at ~Rs 15bn. GKFS caters to the financial needs of poor women in rural areas. Backward classes and minorities constitute 95% of its customer base and the state of Karnataka accounts for ~70% of AUM. GKFS plans to grow its AUM at a 50% CAGR over the next two years with a focus on profitability as well.

- **Concentrating on the poorest rural segments:** GKFS has a deep presence in rural areas and serves the most vulnerable segments of society. Of its total customer base, ~70% earn below US$ 2 per day and 70% come from rural areas. In comparison, other MFIs have 55-60% of their customers from rural areas and the rest from semi-urban and urban centres. Backward category customers (such as OBC, ST, SC) account for 70% of GKFS' customer base, while minority and general category customers constitute 25% and 5% respectively.

- **Southern market well penetrated but rural regions still under-served:** Southern India, especially Karnataka and Tamil Nadu, is well penetrated by MFIs and the urban market appears saturated to some extent. GKFS' management feels there is ample scope for growth in rural areas instead – in fact, the company is the only MFI providing loans in several districts. Average ticket size in these states is Rs 17-20k, which drops to Rs 10-12k in rural areas vs. Rs 30-40k in urban areas, implying scope to improve ticket size as well.

- **Robust growth target:** As of FY15, GKFS' AUM stood at Rs 14.5bn (up 80% YoY). Management is targeting growth to Rs 24bn by FY16 and Rs 32bn by FY17, translating into a CAGR of ~50% over the next two years. The company has adequate capital to fund growth and CAR as of FY15 stood at 28%. GKFS is targeting ROA of 3.7-4% by FY17 with ROE sustained at current levels of 17-18%.

- **Prefers group loans over individual loans:** GKFS focuses on joint liability group (JLG) loans and does not give out individual loans. It believes that individual loans have high monitoring costs in terms of appraisal & collections and also high credit costs given the absence of group bargaining power and large ticket size. In other words, while such loans are good for growth, they can be ROE dilutive.

- **Not applied for a small bank license:** The company has foreign shareholding of 90% and a low promoter stake of 9% which are the main constraints for a small bank licence. In addition, management thinks that small banks cannot do much that is materially different from MFIs. Further, building a deposit franchise would be very challenging as the company serves people who are unable to meet their own needs and hence have no substantial surplus savings.

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Key financials

Particulars	FY13	FY14	FY15
AUM (Rs mn)	5,239	8,101	14,471
Net profit (Rs mn)	85	185	495
Net worth (Rs mn)	1,125	2,111	3,809
ROA (%)	2.0	2.3	3.5
ROE (%)	10.4	11.4	16.7
Net NPA (%)	0.0	0.0	0.0

Source: Company

Grameen Koota Financial Services

Serving India's rural poor – a large addressable market

As on FY15, GK had an AUM of Rs 14.5bn, 0.9mn clients and ~240 branches

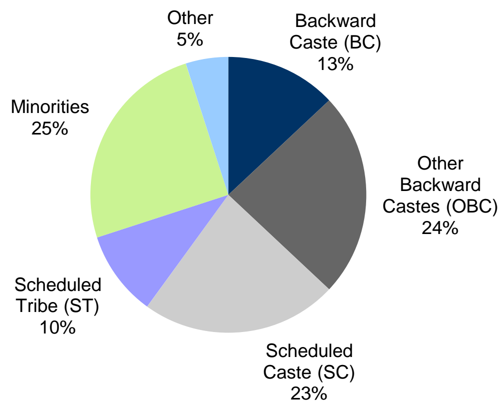
GKFS, popularly known as Grameen Koota, is a Bangalore-based MFI which caters to the financial needs of poor women. It began operations in 1999 under the leadership of Mrs. Vinatha M Reddy with seed capital funding of US$ 35,000 from Grameen Trust Bank, Bangladesh. It was transformed from an NGO-MFI to an NBFC-MFI in 2007 by the acquisition of Sanni Collection Pvt Ltd, a Kolkata-based NBFC which was later rechristened Grameen Koota Financial Services. GKFS has most of its operations concentrated in Karnataka, Maharashtra and Tamil Nadu. As on FY15, it had an AUM of Rs 14.5bn and 0.9mn clients serviced through a network of 238 branches.

Addresses bottom-of-the-pyramid customers

70% of customer base earns less than $2 per day

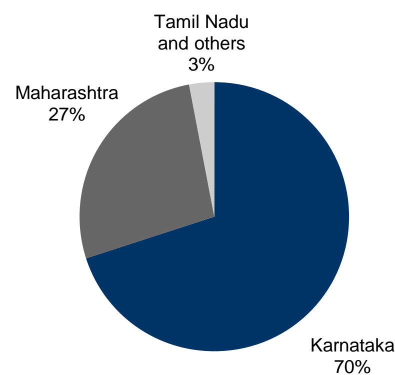
GKFS has a strong presence in rural areas where it caters to the poorest segments of society. Of its total customer base of ~0.9mn customers, 70% are based in rural areas and ~70% earn below US$ 2 per day. In comparison, other MFIs have 55-60% of their customers coming from rural areas and the rest from semi-urban and urban centres. Backward category persons (such as OBC, ST, SC) account for 70% of GKFS' customer base while minorities constitute 25%.

Fig 1 - Customer profile based on ethnicity



Source: Company

Fig 2 - State-wise distribution of portfolio



Source: Company

GKFS has an operational presence in Karnataka, Maharashtra and Tamil Nadu. While Karnataka continues to account for ~70% of its portfolio, the company has recently ventured into two new states, namely Madhya Pradesh and Chhattisgarh, in order to reduce the geographical concentration risk.

Scope to improve ticket size of loans

Management sees ample scope for growth in rural areas and in those districts where it is the only player. The company offers a wide range of products to meet the financial needs of clients. However, it focuses only on group loans as the monitoring costs and credit costs are high for individual loans. More than 85% of loans are disbursed for income generation purposes. Apart from acquiring new customers, growth should come from an improvement in ticket size of loans – the average ticket size in the southern states where GKFS operates is Rs 17-20k, which drops to Rs 10-12k in rural areas vs. Rs 30-40k in urban areas.

Fig 3 - Product offering

Particulars	Loan purpose	Loan size (Rs)	Tenure	Interest rates (%)
Income Generation Loan	For income enhancement activities of business enterprises and individuals. Also caters to the working capital requirements of their businesses.	5,000 - 30,000	52 - 104 weeks	25-26
Home Improvement Loan	Helps clients to avail of water connections, construct toilets and improve & extend existing houses.	5,000 - 25,000	52 - 104 weeks	22
Emergency Loan	Typically short-term emergency loans offered to clients to help address emergencies and short-term cash flow constraints	upto Rs 1,000	up to 3 months	24
Family Welfare Loan	Supports all activities that help clients to improve their quality of life which includes loans for fulfilling genuine consumption needs	1,000 - 5,000	12 - 52 weeks	22-24
Home Construction Loan	Offered to clients who have been associated with GKFS for more than three years for any major home construction.	25,000 - 2,00,000	104 - 260 weeks	22

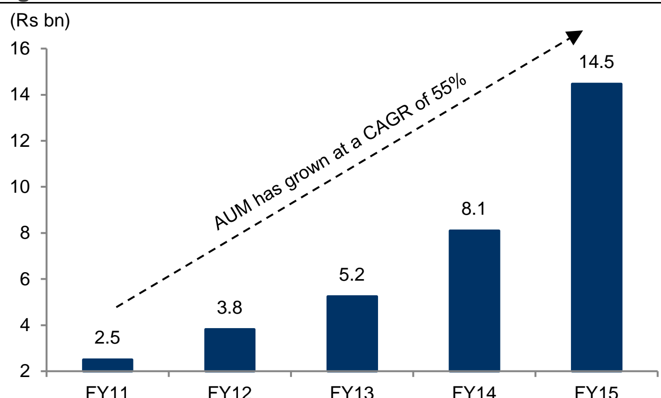
Source: Company

Branch expansion aiding AUM growth

GKFS has built an AUM of Rs 14.5bn as on FY15, clocking a robust 55% CAGR over the past four years, largely on account of strong growth in its client base. Its active client base of 0.9mn customers (FY15) has increased at a 30% CAGR over the last four years.

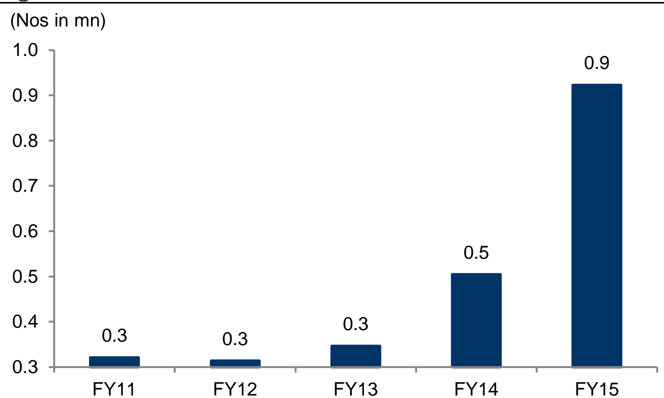
55% CAGR in AUM with 30% growth in customer base over past four years

Fig 4 - AUM CAGR of 55% over FY11-FY15…



Source: Company

Fig 5 - …on the back of robust increase in client base

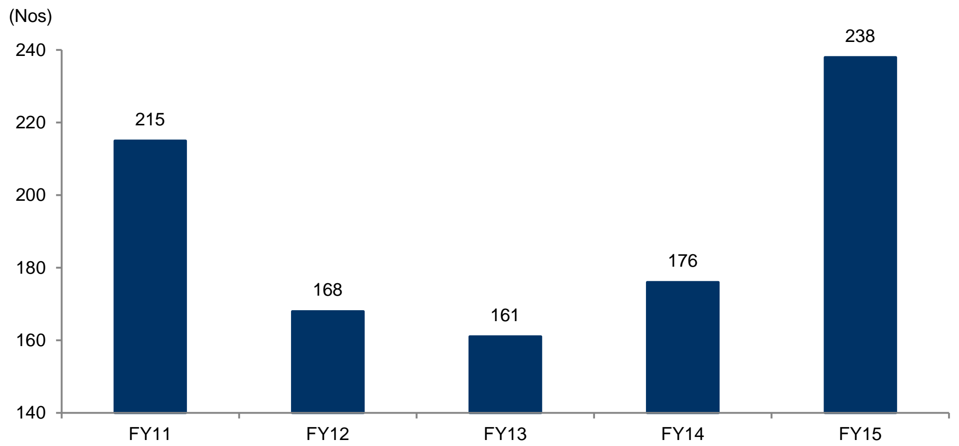


Source: Company

The strong growth in client base has been backed by an increase in branch count. GKFS had 215 branches as on FY11 but an industry-wide crisis forced consolidation in FY12. The company merged or closed some of its branches which reduced the count to 161 in FY13. However, post the consolidation phase, it added +75 outlets in the last three years and has built a network of 238 branches as of FY15.

Over 75 branches added in the last three years, aiding client growth

Fig 6 - GKFS is gradually scaling up its branch network

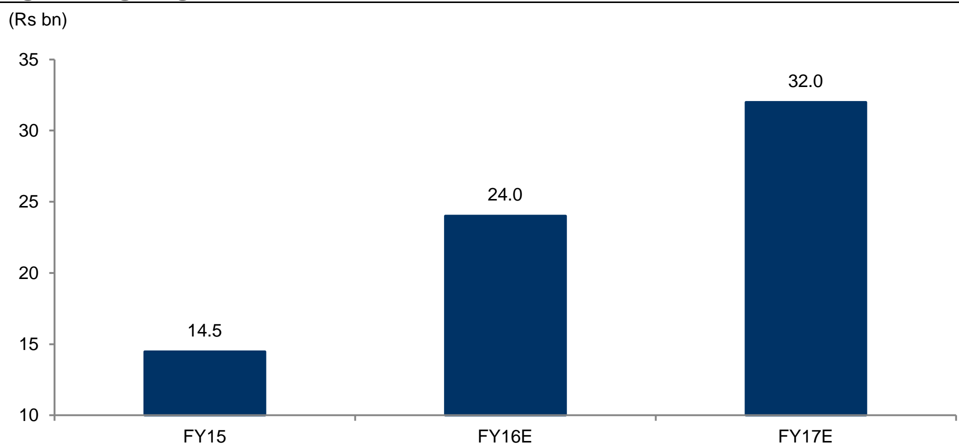


Source: Company

The company has a strong CAR of 28% as on FY15. Since it has enough capital to fund growth needs, management is targeting an AUM of Rs 24bn in FY16 and Rs 32bn in FY17, implying a CAGR of ~50% over the next two years. Moreover, it is targeting ROA of 3.7-4% with ROE sustained at current levels of 17-18%.

Management targeting AUM of Rs 24bn in FY16 and Rs 32bn in FY17

Fig 7 - Targeting ~50% CAGR in AUM over FY15-FY17

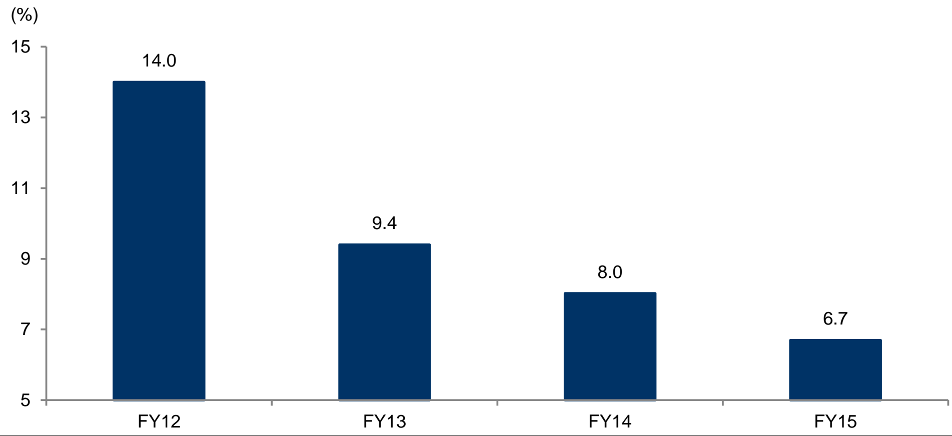


Source: Company

Considerable improvement in operating ratios

Despite the robust branch expansion spree, the company has managed to contain cost ratios. Notably, its operating expense ratio has declined from 14% in FY12 to ~7% in FY15.

Fig 8 - Lower operating expense ratio reflects efficiency

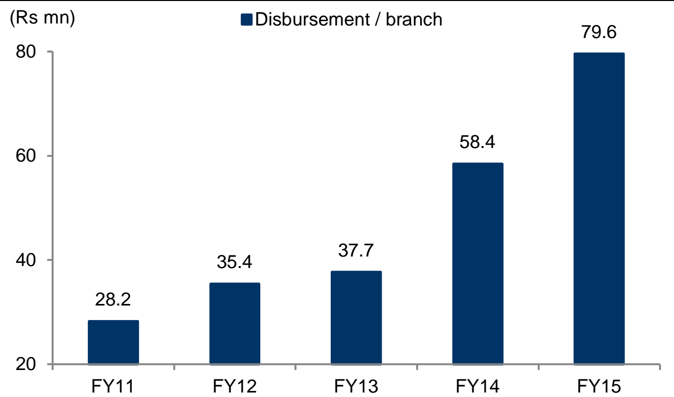


Source: Company

Opex ratio has halved from 14% in FY12 to 7% in FY15

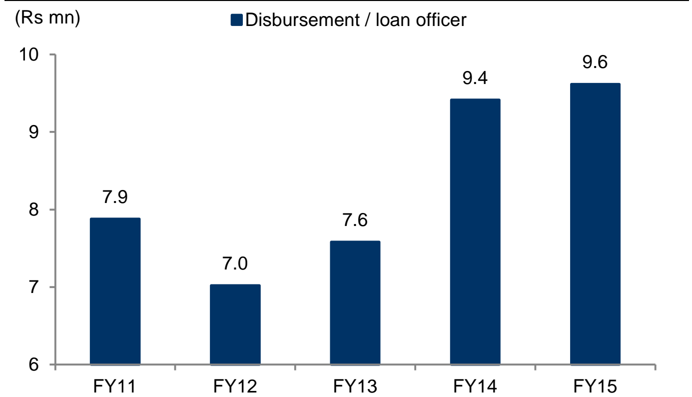
In our view, GKFS has managed to bring in operating efficiency by improving the productivity of its branches and employees. Disbursements have grown at a 33% CAGR over FY11-FY13 and the average amount disbursed per loan account has increased to ~Rs 20,500 in FY15. Disbursement per loan officer does not appear to have grown much over FY14-FY15 as most of the loan officer hiring was back-ended.

Fig 9 - Disbursement per branch has improved…



Source: Company

Fig 10 - …so has disbursement per loan officer



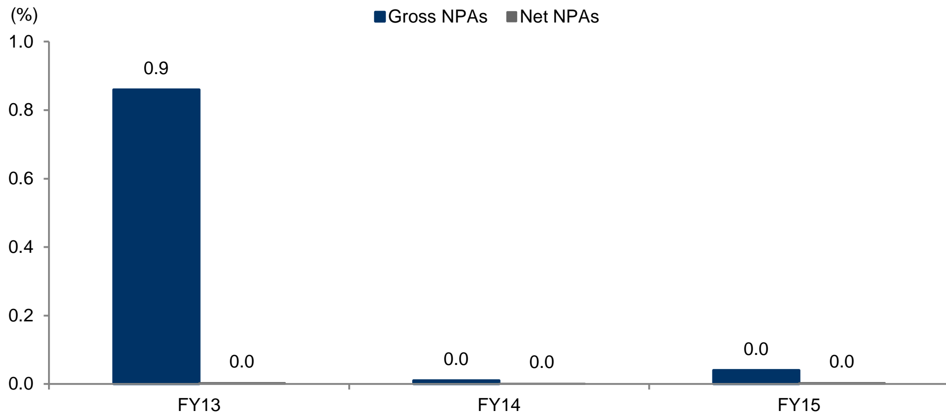
Source: Company

Strong showing on asset quality

GKFS has managed to control its delinquencies despite strong AUM growth and hence GNPA has remained low over the past three years. Moreover, a strong provisioning policy has contained NNPA at near-zero levels. We believe low delinquencies validate the company's strong operational model.

Low delinquencies validate the company's strong operational model

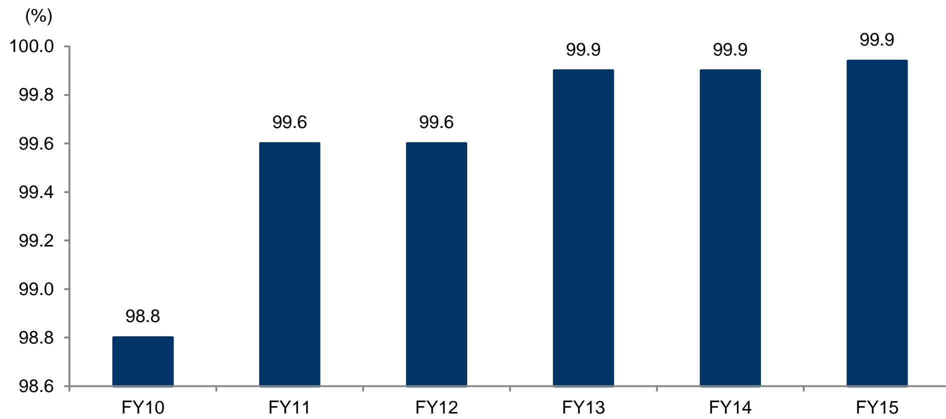
Fig 11 - GNPA and NNPA ratios are well contained



Source: Company

Moreover, the company has achieved a high repayment rate historically despite higher disbursements per client, which suggests prudence while lending.

Fig 12 - Strong repayment rate



Source: Company

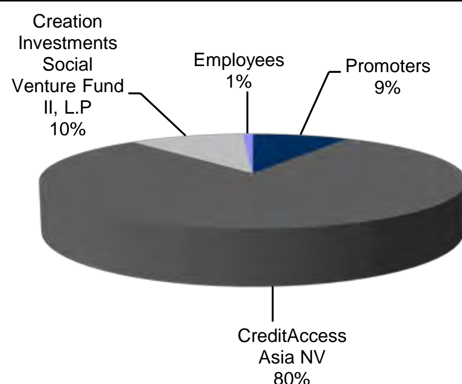
Not applied for a small bank licence

Ownership pattern does not meet RBI's small bank licence norms

GKFS is backed by foreign investors such as CreditAccess Asia NV and Creation Investments which hold a 90% stake in the company. Promoters and employees hold the remaining 10%. The company has raised close to Rs 2.5bn in equity over FY13-FY15 from well-known investors including Creation Investments, MicroVentures and Credit Access Asia and also provided an exit to some of them.

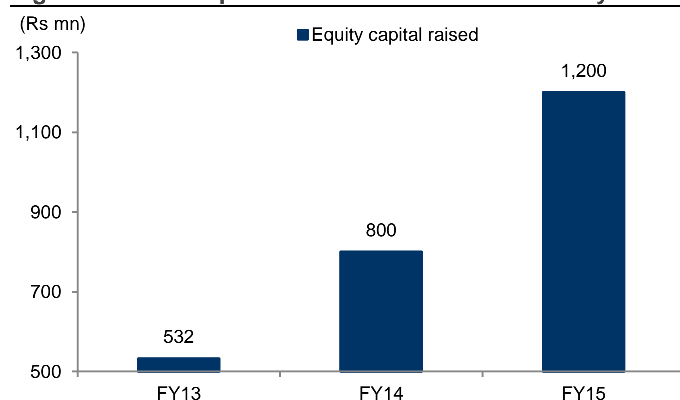
GKFS has not applied for a banking licence citing large foreign and low promoter holding as a major hurdle. According to RBI guidelines, promoters are required to hold at least 26% in the bank while resident Indians are required to hold ~51%. In any case, management believes that small banks cannot do much materially different from MFIs. Further, building a deposit franchise would be very challenging as the company serves people who are unable to meet their own needs.

Fig 13 - Foreign investors hold 90% in GKFS



Source: Company

Fig 14 - Raised capital of ~Rs 2.5bn over last three years



Source: Company

Management profile

Fig 15 - Key management team

Name	Designation	Profile
Vinatha M. Reddy	Founder, Promoter & Chairperson	Ms. Reddy founded Grameen Koota in 1999 and has nurtured it from a project under a not-for-profit entity into an NBFC-MFI. She currently serves as the Chairperson of GKFS, Navya Disha – an NGO, and GK Development Trust. She is an Arts graduate.
Suresh K Krishna	Co-Promoter & Managing Director	Mr. Krishna has been at the helm of activities at GKFS since its inception in 1999. He has over a decade of experience in microfinance and has guided the company from its start-up with a strong focus on bottomline, ensuring high social impact and financial sustainability. He has a Master's degree in Sociology and also holds a degree in MPEFB from IIMB.
Udaya Kumar	Chief Executive Officer	Mr. Kumar has been associated with GKFS since Sep'10 and overlooks the activities of GKFS and its business divisions. He is a veteran with three decades of experience in the banking sector. He has previously worked with Corporation Bank for 10 years, ICICI Bank for over 12 years and Barclays Bank for 3 years. Mr. Kumar holds a Master's degree in Commerce, CAIIB from the Indian Institute of Bankers, and is a graduate in Bank Operations and Technology from BAI, USA.
B. R. Diwakar	Chief Finance Officer	Mr. Diwakar joined GKFS in Oct'11 and has over 22 years of experience in the finance field. He has worked with an array of organisations including LIC of India, SIDBI, ICICI Bank, ACCION, IFMR Trust and IFMR Capital. He holds a post-graduate degree in Commerce from Osmania University and has completed the JAIIB programme from the Indian Institute of Bankers.
Gururaj K S Rao	Senior VP – Internal Audit & Risk Management	Mr. Rao has been associated with GKFS since Jul'09 and has over two decades of experience in finance, internal audit and management in growth-oriented organisations that offered challenging and diverse responsibilities. He is a Certified Internal Auditor (CIA) from the Institute of Internal Auditors, (Illinois, USA), AMFI Advisor and Certified Financial Analyst – Level 1(CFA Institute, USA).

Source: Company

Fig 16 - Key investor directors

Name	Designation	Profile
Paolo Brichetti	Investor director - MicroVentures Network	Mr. Brichetti, the Founder and Promoter of MicroVentures Network, is the current CMD of MicroVentures Finance Group SA. He has a professional background in finance and has spent several years heading innovative business initiatives with partners in emerging countries. He has been serving on the Boards of MV Microfin, GK and Equitas Holding.
Kenneth Dan Vander Weele	Investor director - Creation Investments	Mr. Vander Weele is the Co-founder of Creation Investments and serves as the Chief Investment Officer. He has a Bachelor of Business Administration degree from the University of Wisconsin–Madison and a PhD from the Open University of the UK under the sponsorship of the Oxford Center for Mission Studies and Oxford University. He is also a Certified Public Accountant.

Source: Company

Financials

Fig 17 - Income Statement

Particulars (Rs mn)	FY11A	FY12A	FY13A	FY14A	FY15A
Interest income	631	498	769	1,256	2,395
Interest expense	343	303	403	694	1,279
Net interest income	**288**	**195**	**366**	**562**	**1,116**
Non-interest income	188	124	123	222	419
Net total income	476	319	490	784	1,535
Operating Expense	397	351	356	451	706
Pre-provisioning profit	**79**	**(32)**	**134**	**334**	**829**
Provisions	41	(14)	44	57	68
Profit before tax	38	(17)	90	277	761
Tax	3	12	6	91	266
Profit after tax	**35**	**(29)**	**85**	**185**	**495**

Source: Company

Fig 18 - Balance Sheet

Particulars (Rs mn)	FY11A	FY12A	FY13A	FY14A	FY15A
Shareholders' funds	**537**	**508**	**1,125**	**2,111**	**3,809**
Share capital	248	248	396	530	730
Reserves and surplus	289	260	729	1,581	3,080
Non-Current Liabilities					
Long term borrowings	789	750	1,470	3,700	5,850
Long term provisions	2	6	51	29	30
Current Liabilities					
Short term borrowings	55	318	-	-	-
Trade Payables	2	3	-	-	-
Other current liabilities	1,500	1,596	2,794	4,717	7,504
Short term provisions	28	10	14	62	120
Total Liabilities	**2,914**	**3,191**	**5,454**	**10,619**	**17,313**
ASSETS					
Non-Current Assets					
Fixed assets	45	33	29	29	62
Tangible assets	34	31	26	25	26
Intangible assets	10	1	1	2	12
Capital work-in-progress	0	1	1	2	25
Non-current investment	2	2	2	2	2
Deferred tax assets (net)	10	-	17	13	36
Long term loans and advances	38	850	956	1,587	2,703
Other non-current assets	34	190	358	471	761
Current Assets					
Current investments	314	-	3	-	-
Trade Receivables		-	0	-	-
Cash and bank balances	581	169	912	3,250	2,798
Short term loans and advances	1,868	1,926	3,011	5,180	10,831
Other current assets	22	22	165	87	120
Total Assets	**2,914**	**3,191**	**5,454**	**10,619**	**17,313**

Source: Company

19 August 2015

ESAF Microfinance and Investments

Largest MFI in Kerala with 30% market share

ESAF Microfinance and Investments (ESAF, unlisted) is the largest microfinance institution in the state of Kerala with an AUM of Rs 10bn as of FY15. The company is set to embark on an aggressive expansion plan, with a target 40% AUM CAGR over next four years (~Rs 38bn-40bn by FY19), robust profitability (RoE: +20%) and superior asset quality (recovery rate: 99%). ESAF is also the front runner for a small bank license as it meets all requirements, particularly in terms of foreign and promoter shareholding with a co-operative society holding a 52.5% stake in the company.

- **Largest MFI in Kerala:** ESAF has a decade-long track record in the microfinance industry, and has emerged as India's tenth largest and Kerala's largest MFI with over 30% market share in the state. As of FY15, its AUM stood at Rs 10.2bn, which has grown at a CAGR of ~48% over past four years. ESAF is well-capitalised as strong investor backing has resulted in regular capital infusions. The quality of its loan portfolio however is a tad below peers with gross NPAs of 0.64% as of FY15.

- **Aggressive growth plan outlined:** ESAF is targeting an AUM of ~Rs 38bn-40bn by FY19, implying a CAGR of 40% over next four years. While more than 70% of AUM is concentrated in the state of Kerala, this proportion should decline to 40-45% by FY19 as incremental growth likely comes from underpenetrated states of Madhya Pradesh, Maharashtra and Chhattisgarh.

- **Return ratios, profitability to remain superior:** Management believes that recovery rates are likely to remain in excess of 99% despite aggressive loan growth outlined by ESAF over next four years. The company has recently undertaken several technology-led initiatives which will help in better management of its portfolios. ROA/ROE are likely to remain strong at 3.5-4%/18-22% over FY15-FY19E.

- **Separate subsidiary for non-qualifying loans:** As per RBI norms, a MFI's qualifying assets should constitute 85% of its total loans. For non-qualifying loans, ESAF stated that it has floated a separate subsidiary, ESAF Enterprise Finance, to tap the robust demand for higher ticket size loans. Loans higher than Rs 100k would be given to individuals having more than 2-3 cycles of track record with the company.

- **Fulfills most criteria for a small bank license:** ESAF has applied for a small bank license, and would merge the subsidiary floated for offering higher ticket size loans into the company once the license is secured. ESAF is also among the few MFIs to meet most of the requirements for a small bank license, particularly in terms of promoter and foreign shareholdings limits without making any changes in the existing shareholding structure. ESAF Multi State Swasraya Credit Co-operative Society, a co-operative society promoted by Mr. Paul Thomas – the founder of ESAF NGO and the promoter of ESAF Microfinance – holds 52.5% in ESAF, and Dia Vikas Capital 37%.

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Key financials

Particulars	FY13	FY14	FY15
AUM (Rs mn)	5,392	7,401	10,160
Net profit (Rs mn)	55	103	225
Net worth (Rs mn)	626	1,300	NA
ROA (%)	1.4	1.7	6.7
ROE (%)	9.1	10.7	NA
Gross NPA (%)	0.7	1.0	0.6

Source: Company

ESAF Microfinance and Investments

Largest MFI in Kerala with 30% market share

Established in 1992 by Mr. K. Paul Thomas in Thrissur, Kerala, Evangelical Social Action Forum society commenced its microfinance operations in 1995. The society then acquired Pinnai Finance and Investments in 2006 and renamed it as ESAF Microfinance and Investments (ESAF). The society's entire microfinance business was then taken over by ESAF later in Apr'08.

Tenth largest MFI in India with an AUM of Rs 10bn as of FY15

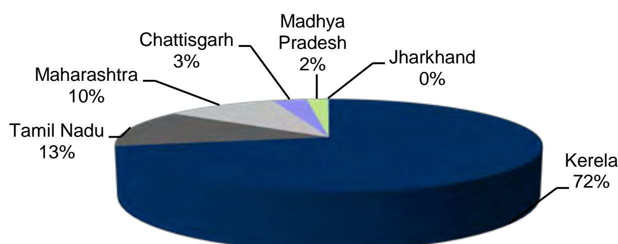
ESAF predominantly offers loans to women under the joint liability group model of lending. With an AUM of Rs 10bn as of FY15, it is the largest MFI in Kerala and the tenth largest in India. It serves ~0.5mn customers through a network of 175 branches.

Market leader in Kerala

ESAF has a decade-long track record in microfinance and over the years has emerged as the tenth largest MFI in India. It extensively offers loans, mostly to deprived women residing in rural and most remote areas, for income generating activities. At present, ~80% of borrowers hail from rural areas and over 95% of them are women. Overall, ESAF serves ~0.5mn customers in six states through a network of 175 branches, but 68% of its customers and 57% of its branches are based out of Kerala. It has an AUM of Rs 5.7bn in Kerala, which makes it the largest player in the state with a market share of over 30%.

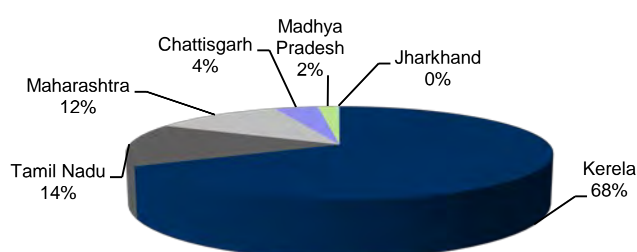
Largest MFI in Kerala with an AUM of Rs 5.7bn and a market share of over 30% in the state

Fig 1 - Geographic spread of AUM



Source: Company

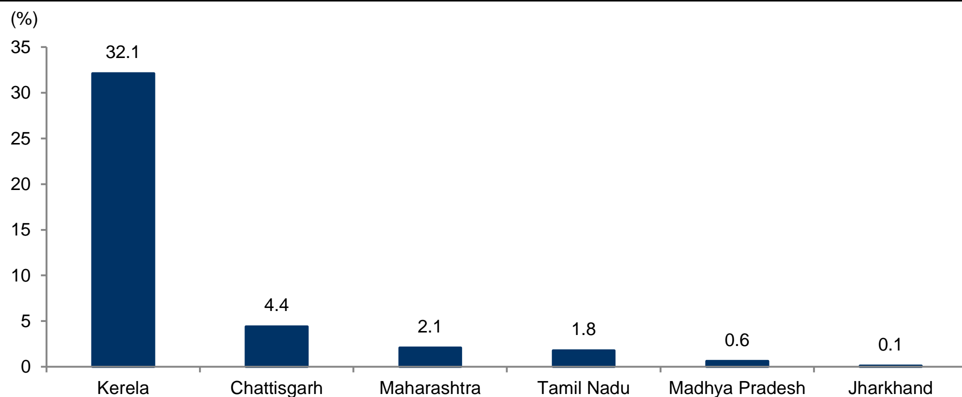
Fig 2 - Geographic spread of borrowers



Source: Company

Apart from Kerala, ESAF operates in Tamil Nadu, Maharashtra and Chhattisgarh, states where its market share ranges between 2-4%. It also has a small market share in Madhya Pradesh and has recently entered into Jharkhand. It is one of the few financial institutions successfully operating in the Naxalite-affected districts of Maharashtra, Chhattisgarh and Jharkhand – regions which often lack access to proper financial services and act as a huge source of opportunity for the company.

Fig 3 - ESAF has over 30% market share in Kerala



Source: Company, MFIN

ESAF Microfinance and Investments

Largest MFI in Kerala with 30% market share

While ESAF offers several products to cater to the multiple needs of customers, its income generation loan product is widely popular and constitutes ~88% of its AUM.

Income generation loan product forms a large chunk of its AUM

Fig 4 - Products offered

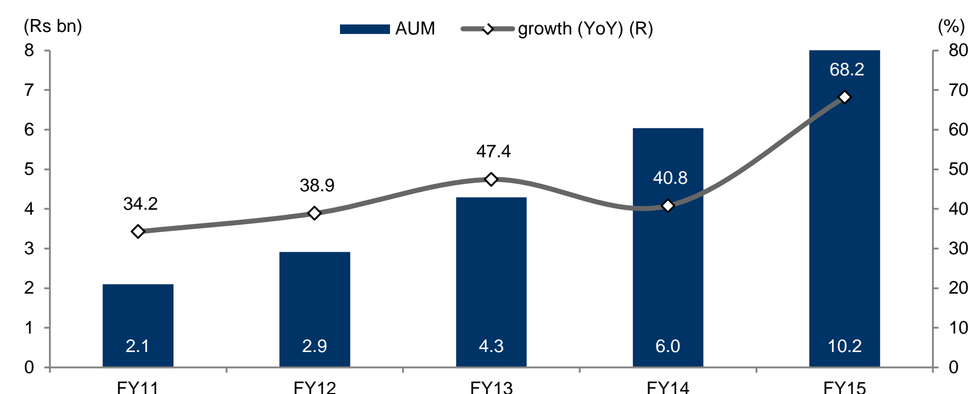
Products	Loan purpose	Ticket size (Rs)	Tenure	AUM (Rs mn)	AUM (%)
Income Generation Loan	Offered to small-scale entrepreneurs for income generating activities	8,000-40,000	50-75 weeks	6,918	87.8
General Loan	Offered for consumption purposes	<= 10,000	50 weeks	772	9.8
Mobile Phone Loan	Offered to enable clients to buy mobile phones	2,599 - 3,828	6 months	87	1.1
Surya Jyothi Loan	Offered to purchase clean energy products such as solar lamps	1,000-10,000	6-12 months	34	0.4
Micro Enterprise Loan-Dairy	Offered to milk vendors who play a critical role in the milk supply chain	30,000-50,000	24 months	26	0.3
Jeeva Dhara Loan	Offered for building water connection infrastructure	2,000-12,000	2 years	16	0.2
Housing Loan	Offered for house repair /construction purposes	50,000	4-7 years	13	0.2
Vidya Jyothi Loan	Offered to aid customers in providing quality education to their children	5,000-10,000	NA	9	0.1
Nirmal Loan	Offered for building sanitary facilities	7,000-12,000	2 years	7	0.1
Griha Jyothi Loan	Offered for purchasing energy-efficient cooking stoves	1,315	NA	2	0.0

Source: Company | Note: AUM break-up is as on Q3FY15

48% CAGR in AUM over last four years

ESAF reported a strong 48% growth in AUM over FY11-FY15 supported by new geographies and increased presence in underpenetrated states such as Maharashtra and Chhattisgarh.

Fig 5 - AUM growth stays robust



Source: Company

Most of the incremental growth has come from higher branch and employee productivity. Over last five years, ESAF has opened only 25 new branches, with ~50% of these in Kerala.

ESAF has opened only 25 new branches over last five years, with ~50% of these in Kerala

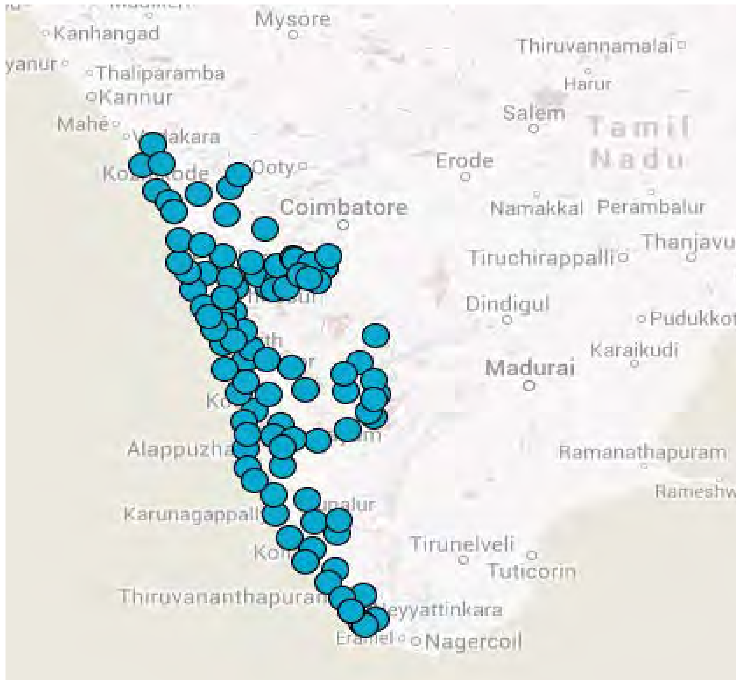
Fig 6 - Branch network

	FY11	FY12	FY13	FY14	FY15	Net additions
Total branches	**150**	**147**	**148**	**160**	**175**	**25**
- Kerala	87	86	90	97	99	12
- Non-Kerala	63	61	58	63	76	13

Source: Company

Moreover, it already has a wide presence in Kerala and operates in 11 out of the 14 districts in the state.

Fig 7 - ESAF's presence in Kerala



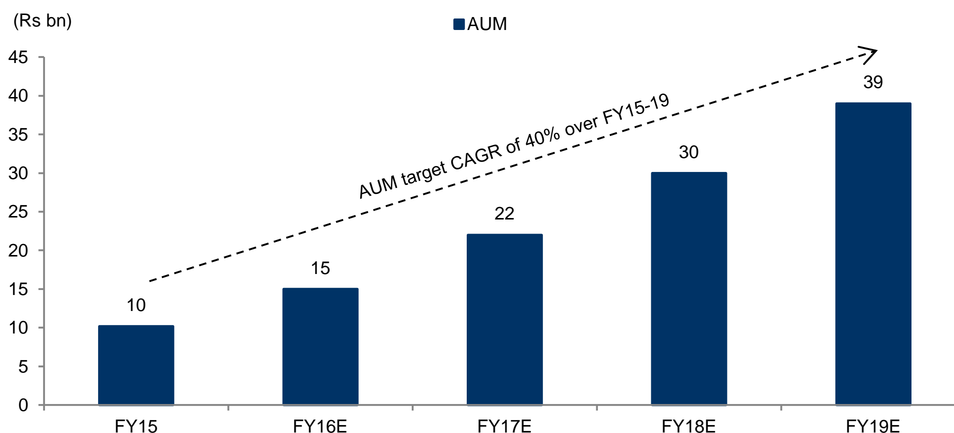
Source: Company

Covers 11 out of Kerala's 14 districts

AUM target of Rs 38bn-40bn by FY19

Management has articulated an aggressive growth plan with a 40% AUM CAGR over the next four years (FY15-FY19) to ~Rs 38bn-40bn. Incremental loan growth is expected to remain highly skewed towards new, underpenetrated states such as Madhya Pradesh, Maharashtra and Chhattisgarh.

Fig 8 - Aggressive growth plan outlined over next four years

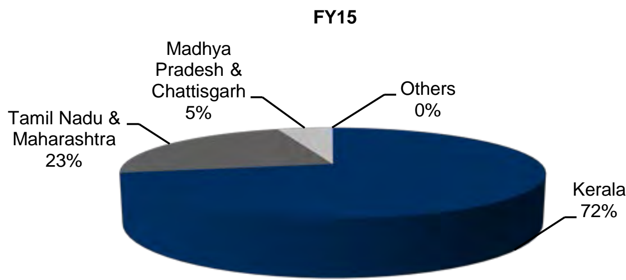


Source: Company

Incremental AUM growth to come from underpenetrated states of Madhya Pradesh, Maharashtra and Chhattisgarh

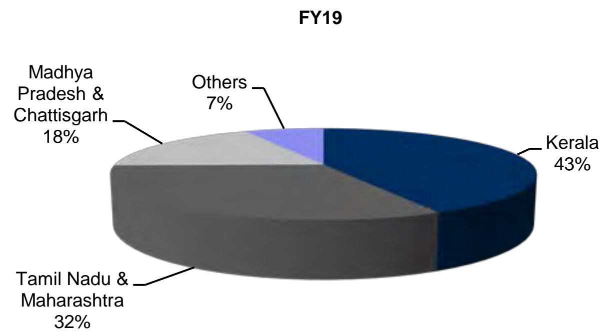
Currently, more than 70% of AUM is concentrated in Kerala, which management expects to drop gradually to 40-45% by FY19.

Fig 9 - AUM break-up by states



Source: Company

Fig 10 - Likely AUM break-up by states



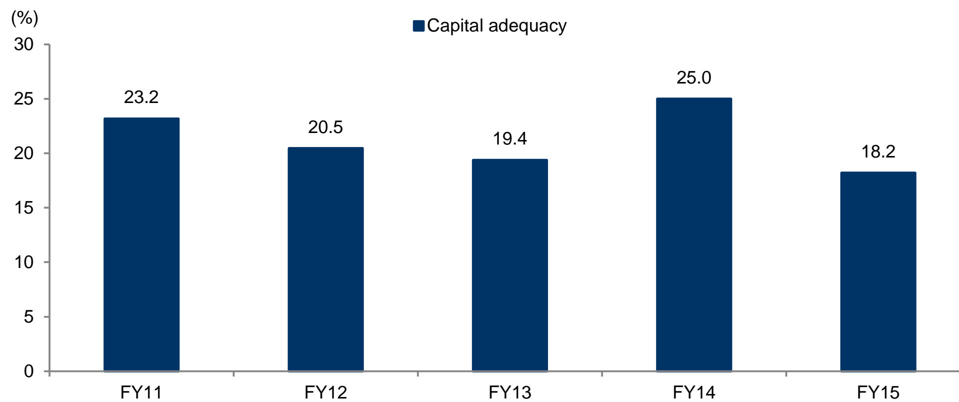
Source: Company

Comfortable capital position

ESAF enjoys strong capital adequacy, with its FY15 CAR at 18% against the regulatory norm of 15%. It also has strong investor backing with Dia Vikas Capital and Manaveeya Development and Finance together holding about 40% stake in the company.

Well-capitalised as strong investor backing has resulted in regular capital infusions

Fig 11 - ESAF is adequately capitalised

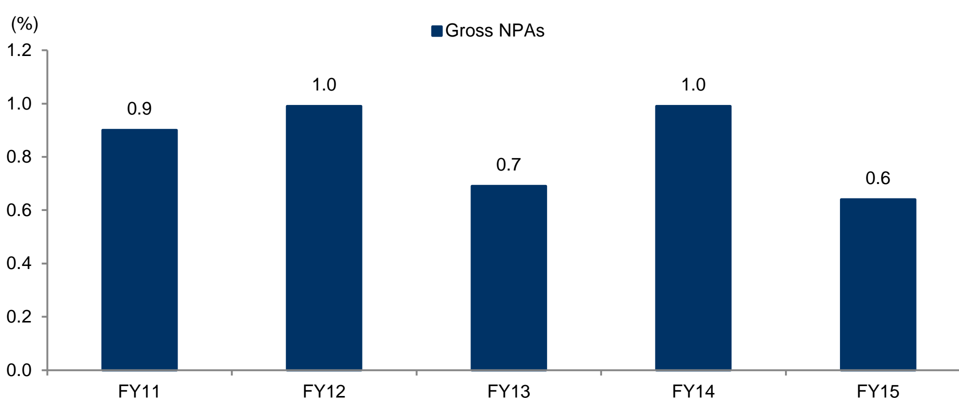


Source: Company

Moderate asset quality

Historically, ESAF's asset quality has been a tad below the industry average. Its headline NPAs have ranged between 0.5-1% over FY11-FY15 despite adequate monitoring systems and credit approval mechanisms. Gross NPAs for FY15 stood at 0.64%.

Fig 12 - Gross NPA level a tad higher than peers



Source: Company

Access to technology that supports growth

ESAF relies on BR.Net, its core banking solution which was implemented across branches in Dec'13. BR.Net is a new-age platform that offers customised solutions which can be adapted to changing business requirements; it also integrates the financial accounting system to allow timely updates of operational transactions, real time monitoring of receivables and review of borrower credit history at the branch level. ESAF is currently in the process of rolling out tablets to its field employees, which would facilitate real-time updates to the head office on collections and disbursements.

Management profile

Fig 13 - Key management team

Name	Designation	Profile
Paul Thomas	Founder and CMD	Mr. Paul Thomas is the founder of ESAF Microfinance and has over two decades of experience in the microfinance sector. He is on the Board of MFIN (apex microfinance body) and the Chairman of Kerala Association of Microfinance Institution
Sabu Thomas	Chief Financial Officer	Mr. Sabu Thomas is a CA with over a decade of experience in finance/retail banking. He has worked with KFC Kerala Financial Corporation, a Kerala government venture, HDFC Bank and ING Bank
Padmakumar K	Head – Compliance and Internal Audit	Mr. Padmakumar K is a Company Secretary with over six years of experience. He joined ESAF in 2008, prior to which he was associated with HLL
Paul Joy	Head – Resource Mobilization	Mr. Joy holds an MBA Finance degree and has experience in banking and fund raising. He has worked with South Indian Bank, Suzlon and Muthoot Fincorp at the middle and senior management levels

Source: Company

ESAF Microfinance and Investments

Largest MFI in Kerala with 30% market share

Financials

Fig 14 - Income statement

Particulars (Rs mn)	FY11A	FY12A	FY13A	FY14A	FY15A
Interest income	507	599	698	1,010	1,598
Interest expense	243	255	362	581	919
Net interest income	**264**	**344**	**336**	**428**	**679**
Non-interest income	31	54	109	198	414
Net total income	295	398	445	626	1,093
Operating Expense	264	317	357	448	704
Pre-provisioning profit	**30**	**81**	**88**	**178**	**389**
Provisions	11	19	6	8	53
Profit before tax	19	62	82	169	336
Tax	7	21	27	67	111
Profit after tax	**13**	**41**	**54**	**103**	**225**

Source: Company

Fig 15 - Balance sheet

Particulars (Rs mn)	FY11A	FY12A	FY13A	FY14A
Shareholders' funds	**513**	**571**	**626**	**1,300**
Share capital	483	500	500	1,072
Reserves and surplus	30	71	126	228
Non-Current Liabilities				
Long-term borrowings	740	935	2,045	2,044
Deferred tax liabilities	3	2	-	5
Other long term liabilities			-	2
Long-term provisions	-	6	14	4
Current Liabilities				
Short-term borrowings	50	149	135	96
Trade payables			18	27
Other current liabilities	965	1,057	2,179	3,160
Short-term provisions	45	78	57	73
Total	**2,315**	**2,797**	**5,075**	**6,712**
ASSETS				
Non-Current Assets				
Fixed assets	107	123	106	156
Tangible assets	67	103	106	145
Intangible assets	40	20	-	11
Non-current investments	1	1	47	1
Long-term loans and advances	83	647	1,459	1,645
Other non-current assets			274	492
Current Assets				
Current investments	-	0	-	-
Loans under financing activity	1,934	1,663	1,697	3,064
Cash and cash equivalents	121	184	1,328	1,186
Short-term loans and	52	155	16	12
Other current assets	18	24	147	156
Total	**2,315**	**2,797**	**5,075**	**6,712**

Source: Company; *Note: We do not have access to the FY15 balance sheet as annual report for the year has not yet been published*

19 August 2015

Utkarsh Microfinance

Fastest growing large-tier MFI

Utkarsh Microfinance (Utkarsh, unlisted) has posted a strong 120% CAGR in AUM to Rs 7.3bn over the last four years and management is targeting six-fold growth to Rs 42bn by FY19. The company primarily operates in India's underpenetrated north and west regions. Micro loans form 95% of its portfolio which management intends to bring down to 50-60% over five years via new product launches. Utkarsh operates at spreads of 8.5% vs. 10% for other MFIs, given a low operating expense ratio of 7.7%.

- **Loan portfolio more than doubled last year:** Utkarsh was formed in 2009 by the former business head for micro banking at ICICI Bank. The company's loan portfolio has more than doubled in the last year, making it the fastest growing large-tier MFI in India, according to Microfinance Institutions Network (MFIN). It has a base of ~0.6mn customers serviced out of 271 branches. Delinquency levels are low with NNPA contained at 0.01% despite strong growth in the portfolio over the last five years.

- **Targeting 80% CAGR in portfolio over FY15-FY19:** Utkarsh primarily operates out of eight states located in India's north and west regions. Management has a clear strategy of avoiding the south and east as it believes these regions are already well penetrated. The company plans to expand operations in two more eastern states (Jharkhand and Chhattisgarh) and is targeting AUM of Rs 42bn by FY19, implying ~80% CAGR.

- **Evolving into a multi-product company:** At present, Utkarsh has two products which are operating at full scale – microfinance loans and MSME loans. It recently introduced affordable housing loans as a pilot project and intends to foray into commercial vehicle finance in the near term. Microfinance lending is the company's prime focus and constitutes ~95% of AUM. Management intends to bring this share down to 50-60% over the next five years by raising the proportion of affordable housing and MSME loans.

- **Strong profit profile:** Utkarsh's profitability has improved significantly over the last four years, with a net profit CAGR of +100% owing to a reduction in operating expenses, increased scale of operations and lower credit costs. A lower operating expense ratio of 7.7% gives Utkarsh the flexibility to operate at spreads of 8.5% as compared to 10% for other MFIs. Management is hopeful of achieving 18-20% ROE over the next 4-5 years.

- **Robust investor support:** Utkarsh is backed by a reputed set of institutional investors who have injected capital at regular intervals, supporting a strong CAR of 35%. The company has applied for a small bank licence – though promoter holding is low at ~6% and FII holding is above 49%, management indicated that it has lined up domestic investors and does not foresee difficulties in raising capital to meet the RBI's ownership requirements for small banks. To further comply with these requirements, management will form an NOFHC and float the small finance bank as a 100% subsidiary.

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Key financials

Particulars	FY13	FY14	FY15
AUM (Rs mn)	1,783	3,556	7,281
Net profit (Rs mn)	39	82	160
Net worth (Rs mn)	643	743	1,617
ROA (%)	2.2	2.3	2.3
ROE (%)	8.0	11.9	13.6
Net NPA (%)	0.0	0.0	0.0

Source: Company

Utkarsh Microfinance

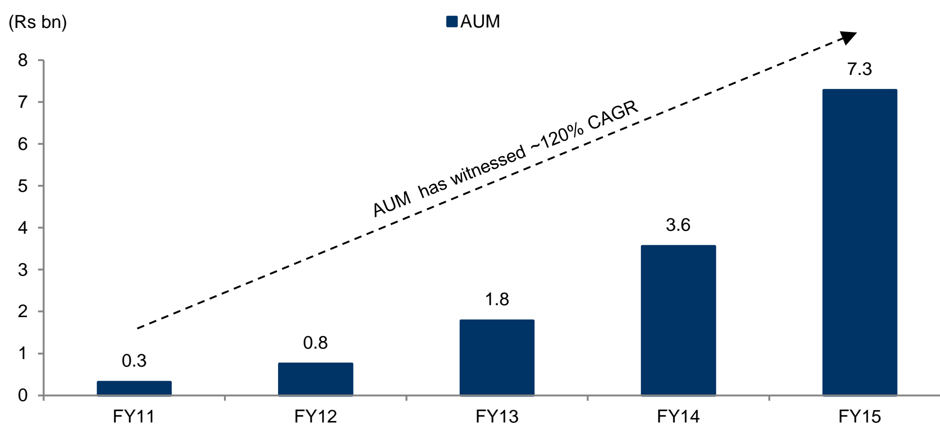
Fastest growing large-tier MFI

Company Update
INDIA
MICROFINANCE

One of the fastest growing MFIs in India with an AUM of Rs 7.3bn, spread across ~0.6mn clients

Utkarsh is an Uttar Pradesh–based MFI promoted in 2009 by Mr. Govind Singh, the former business head for micro banking at ICICI Bank. Despite being a late entrant into the sector, Utkarsh has emerged as one of the fastest growing large MFIs in India. Its AUM of Rs 7.3bn as on FY15 is spread across ~0.6mn clients serviced via 271 branches in 8 states. The AUM has grown 23x over FY11-15, which has aided a +100% CAGR in net profit. Despite the robust growth, NNPA was contained at 0.01% as on FY15.

Fig 1 - AUM has grown ~23x over FY11-FY15



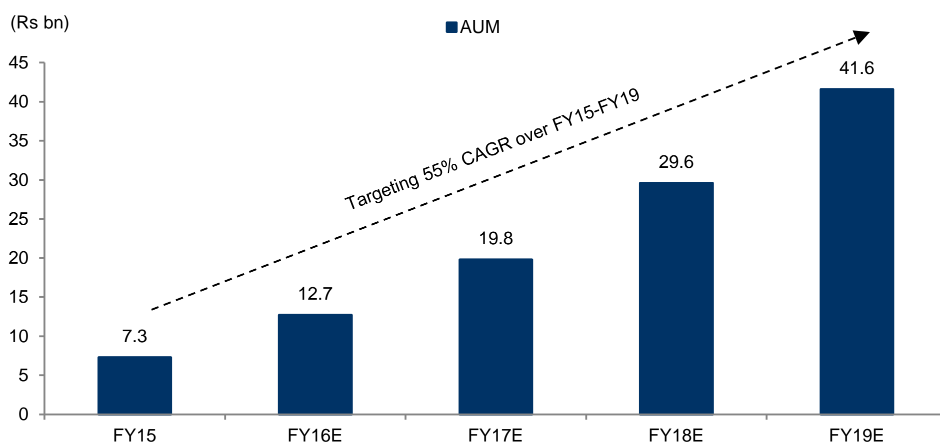
Source: Company

Fastest growing large-tier MFI

Management targeting portfolio of Rs 42bn by FY19, implying 55% CAGR

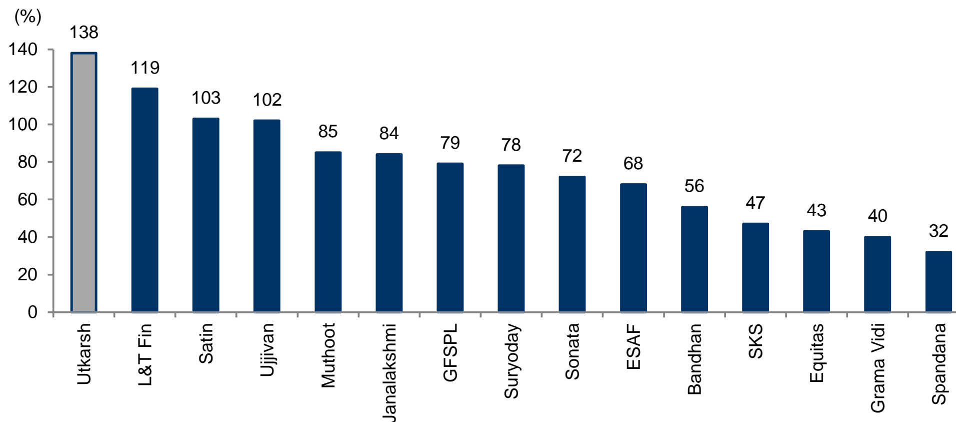
Utkarsh's loan portfolio has more than doubled in the last one year, which makes it the fastest growing large-tier MFI (AUM > Rs 5bn), according to MFIN. Management expects the traction in its portfolio to continue and has guided for a CAGR of ~55% over FY15-FY19, taking the total AUM to Rs 41.6bn.

Fig 2 - Aggressive AUM growth planned by the company over FY15-FY19



Source: Company projections

Fig 3 - YoY growth in AUM of large-sized MFIs in FY15



Source: MFIN

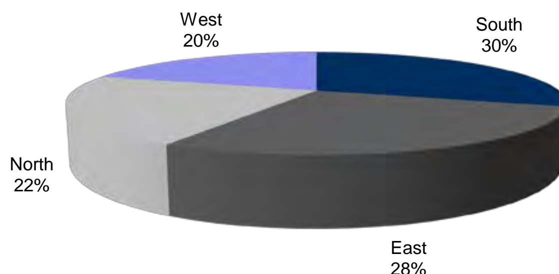
Utkarsh's operations are consolidated in eight states, namely Uttar Pradesh, Bihar, Uttarakhand, Madhya Pradesh, Haryana, Himachal Pradesh, Delhi and Maharashtra. The company is especially focused on the rural regions of states like Uttar Pradesh, Bihar, Uttarakhand and Madhya Pradesh where penetration levels are less than 5%.

As on FY15, these states cumulatively formed over 90% of its AUM with Uttar Pradesh alone accounting for 48% share. In order to diversify political and business concentration risks, management is looking to expand into the states of Jharkhand and Chhattisgarh and also focus more on Bihar, Maharashtra and Madhya Pradesh.

Management avoids southern and eastern markets as it believes these regions are overcrowded

Management has a strategy of eschewing operations in southern and eastern India as it believes these markets are crowded out and have high penetration levels. MFIN data indicates that the two regions cumulatively form 58% of MFI AUM, which in a way vindicates management's stance of avoiding these markets due to high competition.

Fig 4 - India's north and west regions form only 42% of Indian MFI's AUM



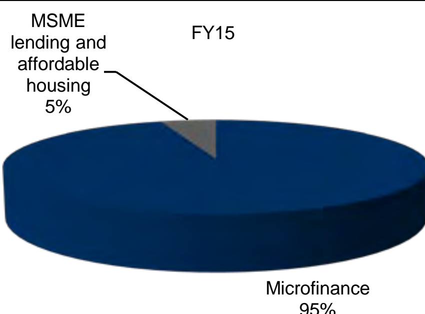
Source: MFIN

Multi-product strategy

Long term goal is to be recognised as a multi-product company

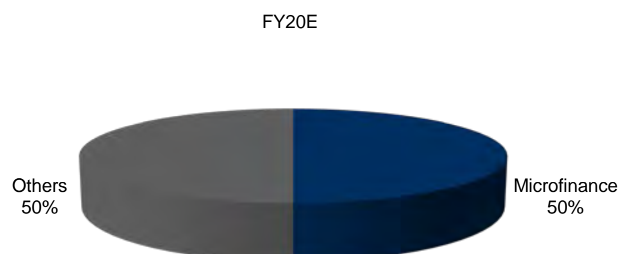
As on FY15, ~95% of Utkarsh's portfolio comprised microfinance loans to women for income-generating activities. Borrowers of these loans are typically involved in animal husbandry projects, small trade and services, cottage industries and agricultural-based projects. Utkarsh has a long-term goal of being recognised as a multi-product company and has accordingly devised a strategy to lower the share of microfinance loans in its portfolio from 95% currently to 50-60% over the next five years via additions to its product basket.

Fig 5 - Microfinance forms a chunk of the portfolio…



Source: Company

Fig 6 - …which management intends to bring down to 50%



Source: Company

New affordable housing product in a pilot stage

Utkarsh currently has two products which are operating at full scale, viz. microfinance loans and MSME loans, and has introduced a third product for affordable housing which is currently in a pilot stage. Joint liability group (JLG) lending remains its prime product as micro enterprise loans are still at a nascent stage. The new affordable housing product has been launched at two branches in Varanasi and Nagpur. Management intends to expand the offering in H2FY16 based on the outcome of the pilot.

Fig 7 - Product offering

Product features	JLG loans		Micro enterprise loans			Affordable housing loans	
	Pragati	Kiran	Samridhi	Sulabh	GrihSudhar	Grih Vistar	Grih Uthan
Loan purpose	Income generating activities		Working capital, business structure renovation, asset acquisition, business expansion		House improvement, extension, renovation	Construction of new house or for extension	Renovation or repair of house
Loan amount (Rs)	6,000 - 15,000	18,000 - 40,000	50,000 - 3,00,000	50,000	50,000 - 3,00,000	100,000- 500,000	100,000- 150,000
Loan tenure (Months)	14	24	6 - 36	6 - 24	6 - 36	12 - 60	12 - 36
Ann. interest rate (%)	24		29			22	24
Repayment frequency	Weekly, fortnightly, monthly		Monthly			Monthly	
Processing fee	1.14% of loan amount		1% of loan amount			2% of loan amount	
Insurance fee	1% of loan amount	1.5% of loan amount	1% of loan amount			As per insurance company	

Source: Company

Utkarsh also offers savings products under the National Pension Scheme (NPS) through 53 branches and has opened over 34,000 accounts to date. This is a profit-neutral product as it is widely targeted towards financial inclusion and does not earn much income for the company. Utkarsh has received IRDA approval to distribute insurance but has postponed product delivery given regulatory changes in the past year.

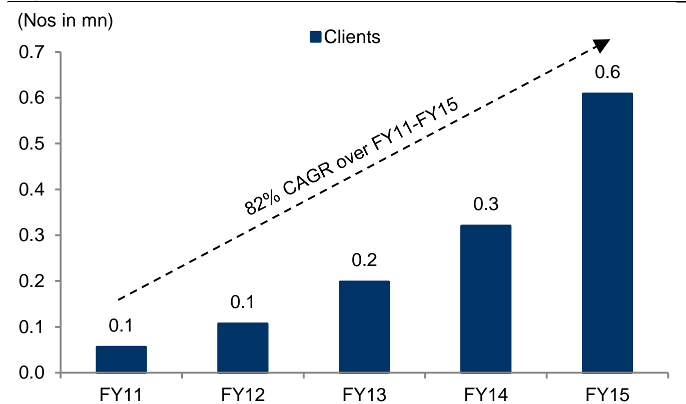
Going ahead, management intends to foray into the financing of commercial vehicles. Moreover, if its application for a small bank licence is accepted, it can launch a whole suite of products ranging from agri loans and gold loans to warehouse receipt funding. Management plans to adopt a holding company structure and form separate companies for different lending activates, since RBI guidelines require an MFI to have 85% of its assets in microfinance loans.

High operational efficiency

Over the last five years, Utkarsh's client base has ramped up 11-fold on the back of a 5-fold expansion in branches, reflecting high operating efficiency.

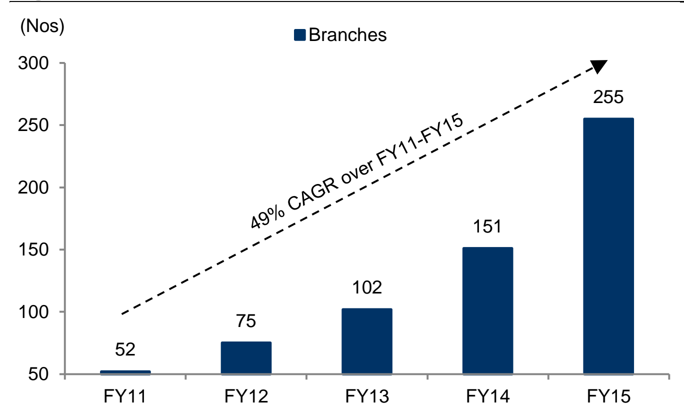
Client base has ramped up much faster than branch expansion

Fig 8 - Clients have increased 11x…



Source: Company

Fig 9 - …with 5x expansion in branches



Source: Company

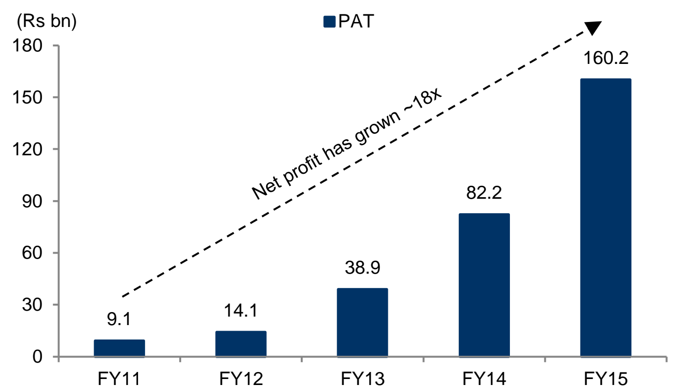
The company follows a well-devised strategy in order to contain costs:

- All decision-making processes regarding expenses are centralised, which plugs the loophole of undue expense claims.
- Travelling expenses of field officers are capped at 25% of overall administration expenses.
- Personnel, rent, printing and stationery expenses are capped at ~9% of total operating expenses.
- A tight cash management system is maintained, wherein a branch cannot keep cash balances of more than Rs 0.1mn on a daily basis.
- Most of the outstanding portfolio is in the fortnightly repayment model which offers opportunities to enhance productivity further.

Earnings CAGR of +100% on account of improved economies of scale and cost ratios

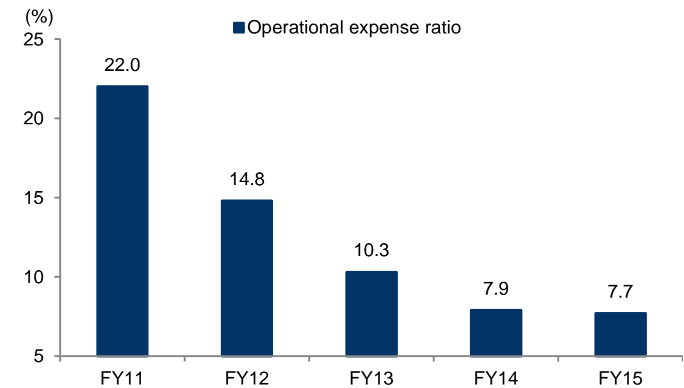
In our view, adherence to prudent management practices gives Utkarsh the leeway to operate at spreads of 8.5% as compared to 10% for other MFIs. Notably, despite a 50% CAGR in branch network, the operational expense ratio has actually declined from 22% in FY11 to 7.7% in FY15. This likely stems from increased productivity at the field officer level and also from the scale-up of operations and efficiency levels. Improved economies of scale and healthy cost ratios have supported a strong net profit CAGR of +100% for the company over FY11-15. Management is hopeful of achieving ~20% ROE over the next 4-5 years.

Fig 10 - Earnings have grown multifold over FY11-FY15…



Source: Company

Fig 11 - …due to a tight leash on operating expenses



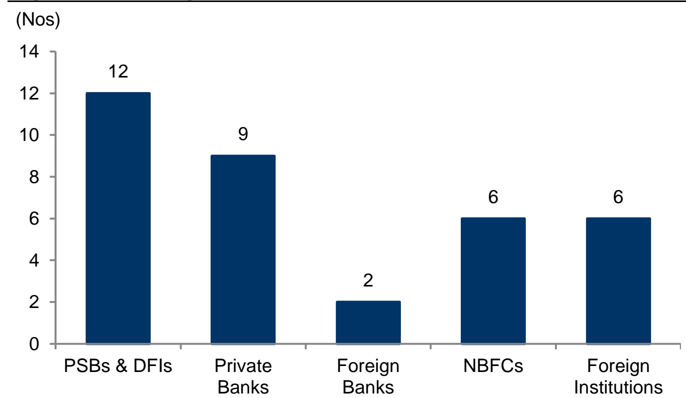
Source: Company

Diversified funding base

Like most MFI players, banks and financial institutions are the major sources of external funding for Utkarsh. The company has lending relationships with 35 funders. Its securitisation transactions and bank loan rating have been upgraded to A- and BBB respectively by ICRA and the company is currently graded as M2+. According to management, the company's grading and rating have improved steadily during the last three years. Utkarsh received total funding support of over Rs 5.3bn from debt providers during FY15 (including off-balance sheet transactions).

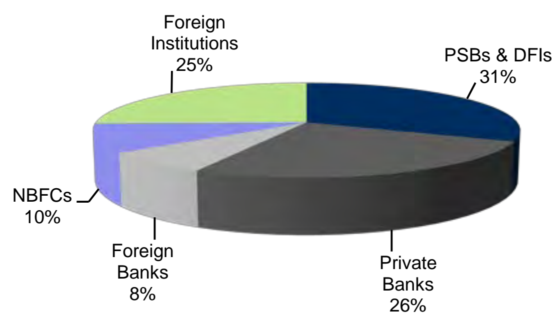
Steady improvement in grading and rating during the last three years

Fig 12 - Lending relationships



Source: Company

Fig 13 - Utkarsh's debt mix grouped by lenders

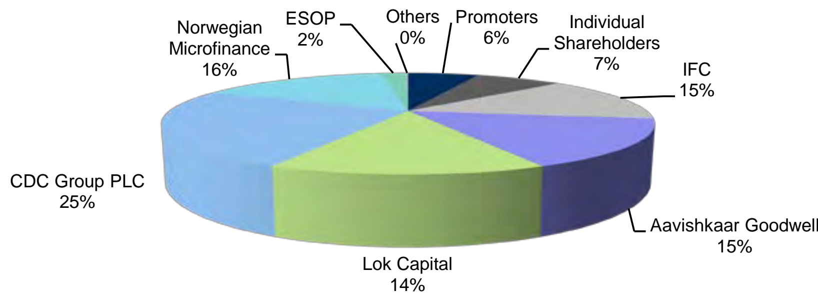


Source: Company

Strong investor backing

Utkarsh is supported by a reputed set of institutional investors who have infused money at regular intervals, including Aavishkaar Goodwell, Norwegian Microfinance and IFC. Despite adverse industry conditions, the company managed to raise Rs 250mn within a year of the Andhra Pradesh crisis.

Fig 14 - Shareholding pattern fairly distributed among investors



Source: Company

In FY15, Utkarsh received Rs 1.3bn (Rs 0.7bn by way of common equity and Rs 0.6mn by way of compulsorily convertible debentures) from two new investors – Commonwealth Development Corporation and Lok Capital, and three existing investors – Aavishkaar Goodwell, IFC and Norwegian Microfinance Initiative. Timely funding has ensured comfortable CAR levels and strong business growth. Utkarsh has a strong CAR of 35% (including tier-I of 22%) as against the regulatory requirement of 15%.

Strong CAR of 35% including tier-I of 22% as against the regulatory requirement of 15%

As mentioned earlier, Utkarsh has applied for a small bank licence. According to RBI guidelines, promoters are required to hold at least 26% while resident Indians are required to hold ~51% in the bank. Since promoter holding in the company is ~6% and FII holding is above 49%, Utkarsh will need to raise capital from domestic entities to bring the foreign shareholding down. According to management, the company has domestic investors lined up and does not expect to face difficulties in raising capital. Moreover, to comply with the ownership requirements, management will form a NOFHC and float the small finance bank as its 100% subsidiary.

Management profile

Fig 15 - Key management team

Name	Designation	Profile
Govind Singh	Founder, MD & CEO	As MD & CEO, Mr. Singh is involved in the day-to-day management of the company and responsible for all management activities, formation of new policies and procedures. He has been a banker for over 22 years and was responsible for building ICICI Bank's microfinance funding portfolio (wholesale funding to MFIs).
Abhisheka Kumar	CFO	Mr. Kumar has over 14 years of experience and is in charge of the Finance and Account function. He is also responsible for the Shareholder / Investor Relations department. Prior to his stint in Utkarsh, he was the Regional Head – Microfinance Division for the north region in ICICI Bank.
Trilok Nath Shukla	COO	Mr. Shukla is the Chief Operating Officer of Utkarsh and is in charge of all day-to-day operations in the states of Uttar Pradesh and Bihar. His responsibilities also include in-depth analysis of these micro-markets and developing growth-based plans, identifying new markets and driving initiatives in these locations. He was one of the founding members of Cashpor Micro Credit, Varanasi.
Rahul Dey	Head – MEL and IT	Mr. Dey has over a decade of experience in banking and microfinance. He currently heads the Micro Enterprise Loan & Information Technology department in Utkarsh. His key responsibilities involve augmenting the Micro Enterprise business and enhancing the use of information technology. Prior to Utkarsh, he served as Regional Business Manager at Ujjivan Financial Services and was responsible for their individual lending business in the east.
Vivek Kashyap	VP – Operations	Mr. Kashyap has over 8 years of experience in microfinance. At Utkarsh, he is in charge of day-to-day operations in the states of Maharashtra, Delhi, Uttarakhand, Madhya Pradesh, Haryana and Himachal Pradesh. He holds an MBA degree from IRMA and has worked in various capacities in SKS Microfinance and Swarna Pragati Housing Micro Finance.

Source: Company

Fig 16 - Key investor directors

Name	Designation	Profile
Knut Frigaard	Nominee Director – Norwegian Microfinance Institution	Mr. Frigaard has gained extensive experience in financial planning and strategy while in his stints at Verdane Capital Advisors, McKinsey & Company, Medecins Sans Frontieres (MSF), Mamut ASA, and numerous boards in the Nordic region as well as in Europe and the US. He has done his MBA from INSEAD, France, MSc in Economics and Business from Norwegian School and has undergone microfinance training from The Boulder Institute of Microfinance.
Nagarajan Srinivasan	Nominee Director – CDC Group Plc.	Mr. Srinivasan has gained extensive experience in private equity deals while working with PE fund Actis in South Asia and in Sub-Saharan Africa with both CDC and Standard Chartered Bank. He has a Master's degree in Economics and is a Post Graduate in Business Administration from Warwick School of Business.
Sushma Kaushik	Nominee Director – Aavishkaar Goodwell	Ms. Kaushik has extensive experience in financial services, real estate, hospitality and education. Prior to working with Aavishkaar, she was associated with Starwood Capital India Advisors and Ashoka – Innovators for the Public (especially worked with social entrepreneurs in the "Housing for ALL" initiative).
Vishal Mehta	Nominee Director – Lok Capital	Mr. Mehta is the co-founder of Lok Advisory Services. He has gained extensive experience in financial services while working with Capital One, Siemens, PRTM and also as a consultant to social projects in India and Kenya. He has an engineering degree from Delhi University and an MBA degree from the University of Michigan, Ann Arbor.

Source: Company

Financials

Fig 17 - Income Statement

Particulars (Rs mn)	FY11A	FY12A	FY13A	FY14A	FY15A
Interest income	72	106	264	605	1,200
Interest expense	28	35	129	350	651
Net interest income	**44**	**71**	**135**	**256**	**549**
Non-interest income	18	23	49	98	150
Net total income	**62**	**94**	**184**	**353**	**699**
Operating Expense	51	70	119	217	434
Pre-provisioning profit	**12**	**24**	**65**	**136**	**265**
Provisions	1	2	6		
Profit before tax	10	22	60	136	265
Tax	1	7	21	54	105
Profit after tax	**9**	**14**	**39**	**82**	**160**

Source: Company

Fig 18 - Balance Sheet

Particulars (Rs mn)	FY11A	FY12A	FY13A	FY14A	FY15A
Shareholders' funds	**126**	**326**	**643**	**743**	**1,617**
Non-Current Liabilities					
Long term borrowings	12	136	678	1,838	4,213
Long term liabilities			1	5	10
Long term provisions			1	7	17
Deferred tax liabilities (net)	-	0			
Current Liabilities					
Short term borrowings	-	140	50	0	180
Other current liabilities	184	363	1,235	2,042	3,330
Short term provisions	3	6	9	24	63
Total	**325**	**972**	**2,618**	**4,659**	**9,429**
ASSETS					
Non-Current Assets					
Fixed assets	3	5	7	16	32
Deferred tax assets (net)	-	-	0	0	0
Long term loans and advances	4	5	205	0	0
Long term Trade Receivables	236	383	1,201	2,846	6,234
Other non-current assets	-	109	166	305	571
Current Assets					
Current investments	1	1	1	0	1
Trade Receivables	-	-	-	10	41
Cash and bank balances	67	445	987	1,320	2,368
Short term loans and advances	13	14	19	70	95
Other current assets	2	10	32	91	86
Total	**325**	**972**	**2,618**	**4,659**	**9,429**

Source: Company

19 August 2015

Suryoday Microfinance

New entrant with urban focus

Suryoday Microfinance (SMF, unlisted) is an urban/semi-urban centric player that operates in the vicinities of towns and metros in seven states, including Maharashtra and Tamil Nadu (together 65% of the portfolio). AUM has expanded at 90% CAGR to Rs 5.8bn over FY11-FY15 and management is targeting a loan book of Rs 10bn in FY16. With GNPA of 0.13%, asset quality is well within manageable levels. SMF has also applied for a small bank licence.

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- **Rapid growth in AUM:** SMF's AUM base has risen to Rs 5.8bn after a 90% CAGR over FY11-15, backed by a growing client base and an expanded branch network. The company had ~0.5mn customers through a network of 145 branches as of FY15. Profitability has improved meaningfully during the last couple of years due to better operational efficiency. Management is now targeting a 70% YoY increase in AUM to Rs 10bn in FY16 along with a 200+ branch network.

- **Urban/semi-urban centric player:** SMF operates in towns and metros of seven states, focusing on areas which are not yet fully developed. At present, Maharashtra accounts for 40% of its AUM, followed by Tamil Nadu at 26%. SMF follows the Joint Liability Group (JLG) model of lending and focuses only on women borrowers from economically weaker sections that lack access to traditional banking services. The company has also started a pilot project for providing individual loans with an average ticket size of Rs 40,000-50,000 to existing customers.

- **Asset quality well within the comfort zone:** SMF's asset quality has remained fairly stable. GNPA spiked up to 2.4% in FY11 due to the Andhra Pradesh crisis, but thereafter it declined to 0.03% in FY14. In FY15, GNPA increased marginally to 0.13% but remains well within manageable levels.

- **Operating efficiency to drive improvement in ROE:** Management is aiming to improve ROE in the long term by driving improvement in operating efficiency. SMF's average cost of operations stood 8% of assets as on FY15 which the management would like to bring it down to 7.25% going forward. SMF aims to operate at low leverage which can ensure a better credit rating and better loss absorption capacity.

- **Strong management profile:** SMF has applied for a small bank licence. It has a diversified board of directors with Dr. Sheela Bhide (a retired IAS officer with over 36 years' experience in various capacities) as Independent Director & Chairperson and Mr Ramachandran (who retired CMD of Andhra Bank) as Independent Director. Domestic investors hold 32% in the company. Mr R Baskar Babu is the promoter of SMF. The other investors are Social Initiative Funds and Institutions including Aavishkar Goodwell, HDFC Life, HDFC Holdings, Lok Capital, International Finance Corporation (IFC) and Developing World Markets (DWM).

Key financials

Particulars	FY13	FY14	FY15
AUM (Rs mn)	1,524	3,266	5,818
Net profit (Rs mn)	20	88	169
Net worth (Rs mn)	641	875	1,319
ROA (%)	1.4	2.9	2.9
ROE (%)	4.2	11.6	15.4
Net NPA (%)	0.0	0.0	0.0

Source: Company

Suryoday Microfinance

New entrant with urban focus

SMF serves ~0.5mn customers through a network of 145 branches spread across seven states. Its AUM currently stands at Rs 5.8bn (FY15), having increased at a swift CAGR of ~90% in the last four years. Growth has been led by a ramp up in client base and branch network expansion in urban and semi-urban areas. The company follows the Joint Liability Group (JLG) model of lending and focuses only on women borrowers from economically weaker sections that lack access to traditional banking services. Incorporated in 2008, SMF received seed funding even before it commenced operations in May'09.

First MFI in India to receive seed funding even before it commenced operations

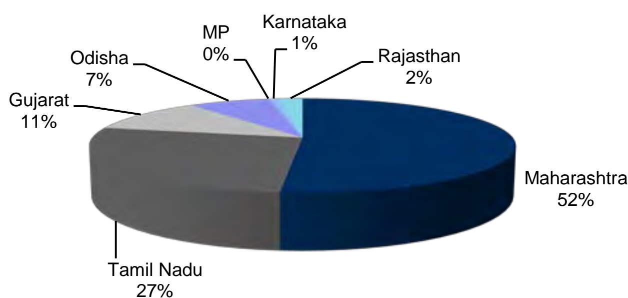
Urban and semi-urban player

SMF currently operates in the urban and semi-urban pockets of seven states, namely Maharashtra, Tamil Nadu, Orissa, Gujarat, Rajasthan, Karnataka and Madhya Pradesh. As on FY15 Maharashtra accounts for ~40% of its AUM, followed by Tamil Nadu at 26%. Despite high competition in the southern state of Tamil Nadu, management says the company is still witnessing high demand in certain regions.

Exposure to Maharashtra accounts for 41% of portfolio

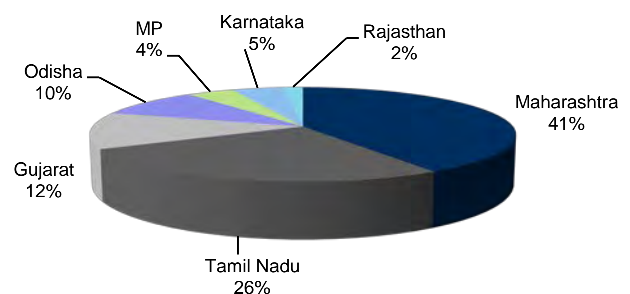
SMF has a wide reach in Maharashtra, where it operates in developing towns and metros such as Pune, Kolhapur, Solapur, Nagpur, Nasik, Aurangabad, etc. Management believes Maharashtra is a fairly stable state in terms of political risks – but as a matter of prudence, it is following a strategy of growing faster in non-Maharashtra states so as to reduce its geographic concentration. In FY15, SMF focused on growing its portfolio in Karnataka, Madhya Pradesh, Odisha and Gujarat – consequently, Maharashtra's share in AUM reduced from 52% in FY14 to 41% in FY15.

Fig 1 - Maharashtra formed ~52% of AUM in FY14…



Source: Company

Fig 2 - …its share has now come down to 41% in FY15



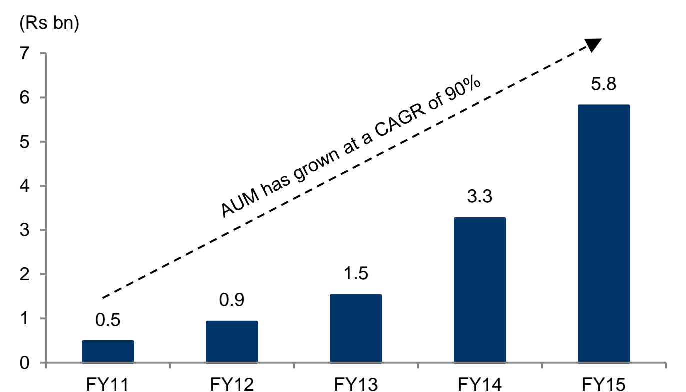
Source: Company

Traction in AUM to continue

Though SMF operates in states occupied by various large as well as mid-size NBFCs, its AUM has grown at ~90% CAGR to Rs 5.8bn over FY11-FY15. We believe this rapid growth has stemmed from branch expansion into newer geographies as opposed to peers' strategy of deeper penetration in existing area of operations. Over FY11-FY15, SMF's customer base has increased six-fold to ~0.5mn on account of a 5x increase in network count to 145 branches from 31 in FY11.

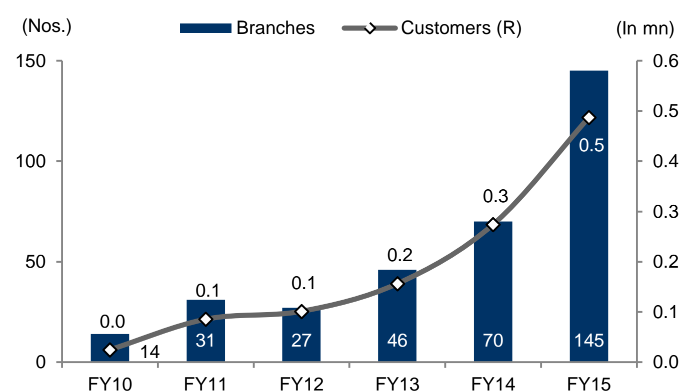
AUM clocked 90% CAGR over FY11-FY15 despite stiff competition

Fig 3 - 90% CAGR recorded in AUM over FY11-FY15



Source: Company

Fig 4 - Higher customer mop-up backed by expansion



Source: Company

SMF commenced its operations with five branches in Pune with a weekly repayment schedule. In early 2011, based on customer preference, it introduced products with fortnightly and monthly repayment which enabled the company to focus on better customer servicing and portfolio expansion.

Fig 5 - Microfinance Loans for Income Generation Activities (Changed)

Loan Amount (Rs)	Tenor	Processing Fees Incl. Service Tax (Rs)	Rate of Interest (%)	Insurance Premium Incl Service Tax (Rs)	Joint Life Insurance Cover for Member & Guarantor (Rs)	Repayment
7,000	1 Year	79	25.4	122	10,000	
10,000	1 Year	114	25.3	122	10,000	12 Monthly or 24 Fortnightly or 48 Weekly Installments
15,000	1 Year	171	25.0	183	15,000	
18,000	2 Years	205	24.9	380	22,000	
22,000	2 Years	250	25.0	380	22,000	24 Monthly or 53 Fortnightly or 105 Weekly Installments
26,000	2 Years	296	25.4	518	30,000	
30,000	2 Years	342	25.7	518	30,000	
30,000	3 Years	342	25.1	765	30,000	
40,000	3 Years	456	25.0	1020	40,000	36 Monthly or 80 Fortnightly or 158 Weekly Installments
50,000	3 Years	570	25.0	1275	50,000	

Source: Company

Apart from its traditional portfolio, SMF has recently introduced a pilot project for providing individual loans with average ticket sizes of Rs 40,000-50,000 to existing customers. Management is optimistic on continued traction in demand and is targeting an AUM of Rs 10bn in FY16, along with a network of over 200 branches and two-fold growth in client base during the year.

Management aims for an AUM base of Rs 10bn and doubling of client base in FY16

Fig 6 - Individual Loans for Business Activities (Changed)

Loan Amount (Rs)	Tenor	Processing Fees Incl. Service Tax (Rs)	Rate of Interest (%)	Insurance Premium Incl Service Tax (Rs)	Joint Life Insurance Cover (Rs)	Repayment (in monthly installments)
35,000	1 Year	1,197	28.0	610	50,000	12
50,000	1 Year	1,710	28.0	610	50,000	12
75,000	1 Year	2,565	25.2	914	75,000	12
75,000	1.5 Years	2,565	25.2	1,294	75,000	18
1,00,000	1 Year	3,420	25.2	1,218	100,000	12
1,00,000	1.5 Years	3,420	25.3	1,725	100,000	18
1,00,000	2 Years	3,420	25.2	1,725	100,000	24

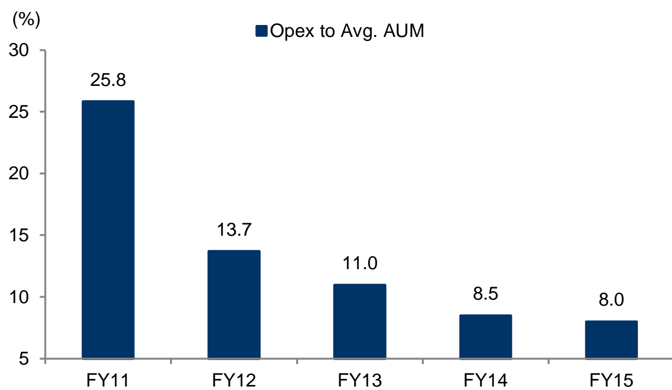
Source: Company

Considerable improvement in operating ratios

Despite the robust branch expansion spree, SMF has managed to contain its cost ratios. Opex as a percentage of average AUM has declined from 26% in FY11 to 8% in FY15. SMF's operational efficiency compares favourably with other MFIs as it largely operates in urban and semi-urban regions vs. a rural focus for peers. Apart from economies of scale, we believe an increase in loan outstanding per customers has also helped to improve efficiency.

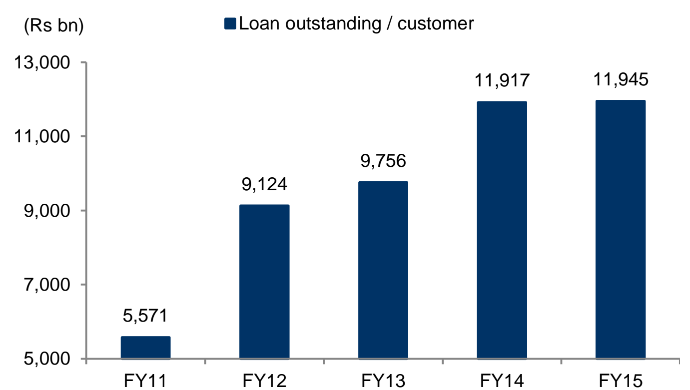
Opex as a percentage of avg. AUM down from 26% in FY11 to 8% in FY15

Fig 7 - Opex/Avg. AUM has declined…



Source: Company

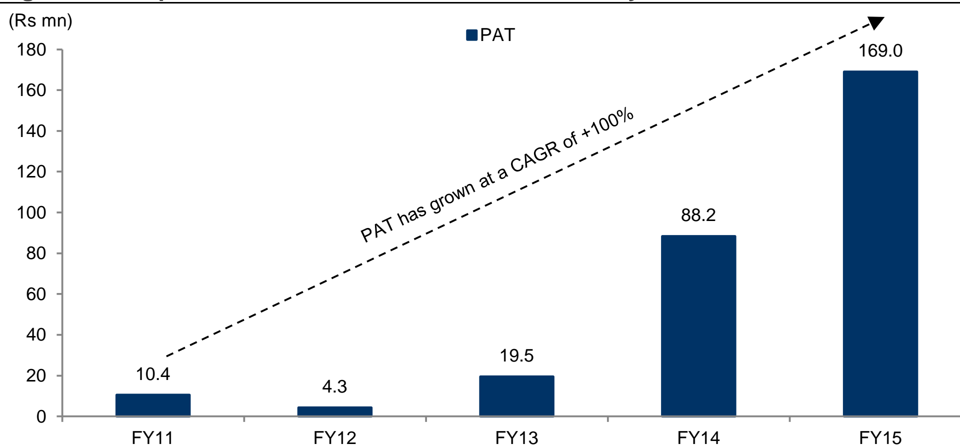
Fig 8 - …on account of higher productivity



Source: Company

In addition to an increased scale of operations and low credit costs, a tight leash on operating expenses has enabled SMF to post strong profitability. Net profit has clocked +100% CAGR over the last four years to Rs 169mn.

Fig 9 - SMF's profits have increased multifold over the years



Source: Company

Management is aiming to improve ROE in the long term by driving improvement in operating efficiency. SMF's average cost of operations stood 8% of assets as on FY15 which the management would like to bring it down to 7.25% going forward. SMF aims to operate at low leverage which can ensure a better credit rating and better loss absorption capacity.

Operating efficiency to drive improvement in ROE

Better technology platform to aid efficiency

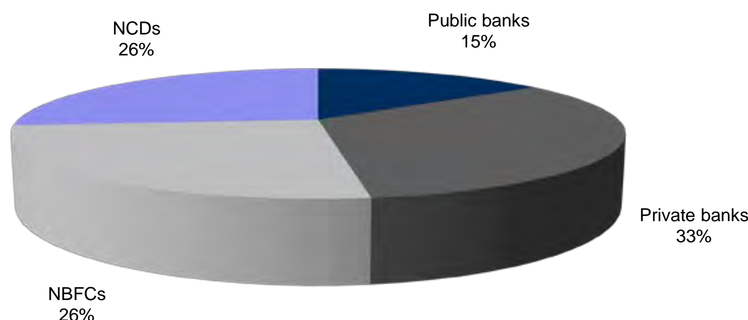
Implemented BR.Net in April 2014

Suryoday migrated to Craft Silicon's BR.Net – a proven industry benchmarked solution, in April 2014. The company further implemented a pioneering initiative - a Loan Origination System, Branch Audit and Surprise Center Visits as customized modules within the BR.Net System to track the entire loan lifecycle and also integrated this system with the Credit Bureau such that credit decisions are fully automated based on prescribed parameters. SMF has also implemented a Business Intelligence & Analytics Solution to better understand customer and market patterns. At SMF, different platforms are fully integrated for efficient reporting and real time monitoring. It also plans to implement various workflow solutions to further enhance efficiency as it moves towards a paperless environment. SMF is currently piloting a mobile solution for Collections.

Diversified sources of funding

SMF's financial flexibility has improved over the years as it has been able to tap funds from multiple sources, including banks, institutional lenders and through non-convertible debentures (NCD). The company has lending relationships with 30 lenders, including 18 banks. It closed five NCD issuances in FY15 worth Rs 1.5bn and has another two worth Rs 410mn in the pipeline for FY16. Borrowings as on FY15 stood at Rs 5.9bn.

Fig 10 - SMF has managed to raise debt from a variety of sources

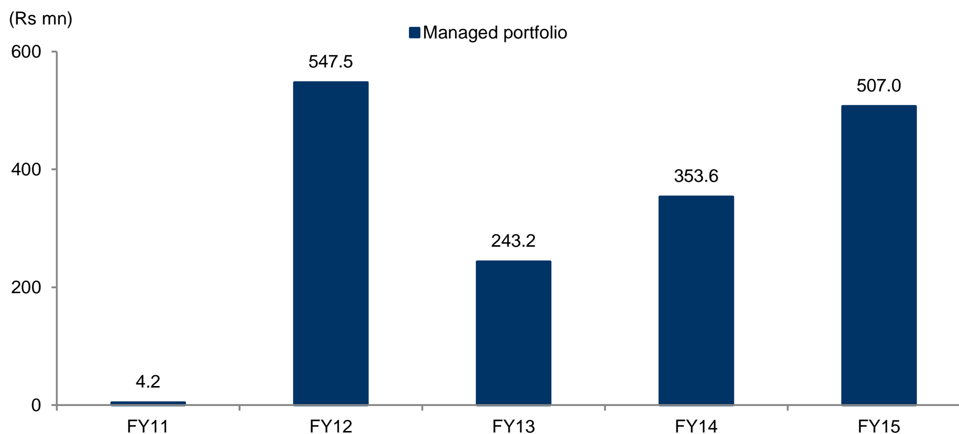


Source: Company

Managed portfolio as on FY15 stood at Rs 0.5bn and has increased at a CAGR of 44% over FY13-FY15

The company also accesses the securitisation or assignment route for tapping funds. SMF's managed portfolio as on FY15 stood at Rs 0.5bn. In our view, an increase in the managed portfolio is beneficial for margins as borrowing via this route is ~200bps cheaper than on-balance-sheet borrowing.

Fig 11 - Trend in SMF's securitised portfolio



Source: Company

SMF's current credit rating is BBB and there is a potential for upgrade with equity infusion in pipeline. Moreover, its grading as M2+ by ICRA reflects a robust business model.

Fig 12 - Grading upgrade by rating agencies

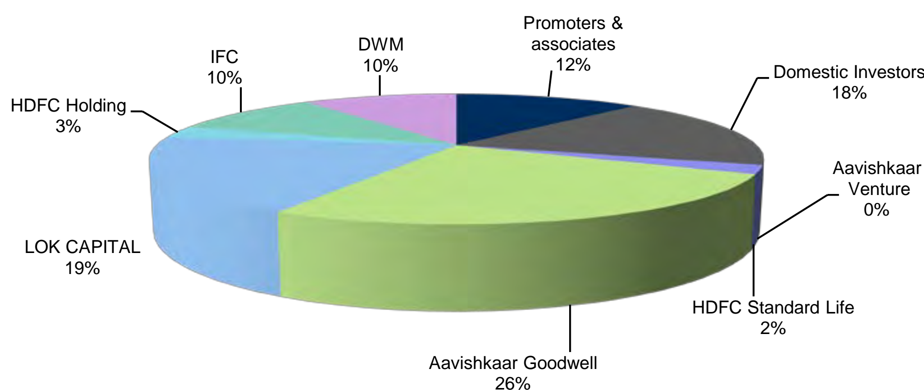
	2009	2010	2011	2012	2013	2014	2015
Grading	Crisil-mfR5	Crisil-mfR4	Crisil-mfR4	Crisil-mfR3	Crisil-mfR3	Crisil-mfR3	ICRA-M2+

Source: Company

Strong investor backing

SMF is supported by a strong set of investors like Social Initiative Funds and Institutions like Aavishkar Goodwell, HDFC Life, HDFC Holdings, Lok Capital, International Finance Corporation (IFC) and Developing World Markets (DWM). It has a well distributed shareholding pattern – promoters and associates hold 12% in the company, while the share of domestic and foreign investors is 20% and 68% respectively.

Fig 13 - Fairly distributed shareholding pattern

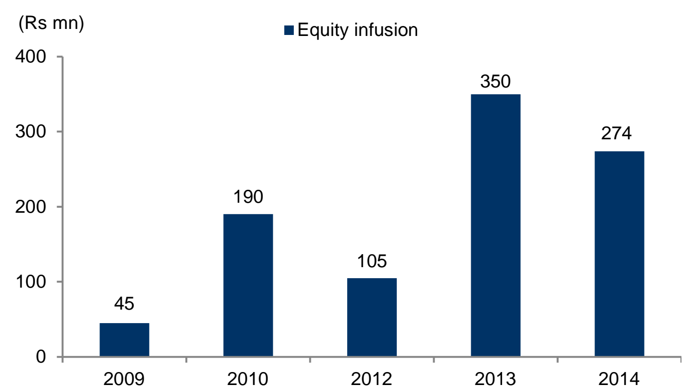


Source: Company

SMF has received multiple rounds of equity infusion from Aavishkar Goodwell and Lok Capital. It received an equity infusion of Rs 274mn in 2014 (Rs 150mn from a new investor IFC and Rs 120mn from existing investors). Timely rounds of funding from various investors and promoters has not only aided strong growth in AUM over the last five years but also kept SMF adequately capitalised. CAR as on FY15 stood at 26%, well above the regulatory requirement of 15%.

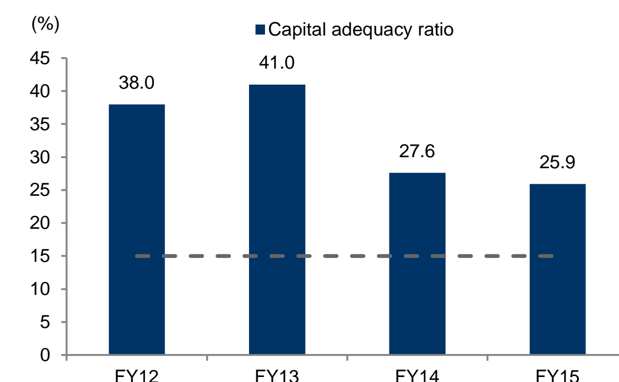
Timely funding from various investors and promoters has aided AUM growth

Fig 14 - Investors infused funds at regular intervals…



Source: Company

Fig 15 - … which has kept SMF adequately capitalised

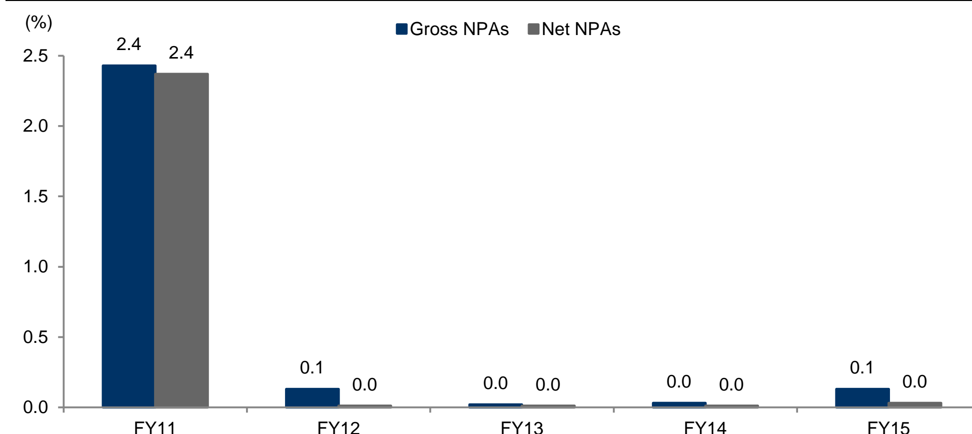


Source: Company

Asset quality within the comfort zone

SMF's portfolio has matured after the Andhra Pradesh crisis, with manageable stress on asset quality. Headline NPAs spiked up to 2.4% in FY11 due to the Andhra Pradesh crisis, but thereafter it declined to 0.03% in FY14. In FY15, GNPA increased marginally to 0.13% but remains well within manageable levels.

Fig 16 - GNPA and NNPA are in line with the industry



Source: Company

Stress on asset quality is in line with the industry

Fig 17 - Key management team

Name	Designation	Profile
R. Baskar Babu	Chief Executive Officer	Mr. Baskar is an Engineering and Management graduate with over 20 years of experience in financial services. Prior to SMF, he was associated with Cholamandalam, HDFC Bank and GE Commercial Finance in various leadership positions.
Narayan Rao	Head – Support Services	Mr. Rao holds an MBA degree from Symbiosis and has over 25 years of work experience spanning sales, operations and IT, including over 6 years in the US. He has worked in organisations such as Motorola-Pagepoint, Intelligroup and PINC.
Vikrant Bhagwat	Head – Business	An Executive MBA with over 17 years of work experience in banking and financial services, Mr. Bhagwat has worked in organisations including Cholamandalam, HDFC Bank, DCB Bank and Lok Capital.

Source: Company

Financials

Fig 18 - Income Statement

Particulars (Rs mn)	FY11A	FY12A	FY13A	FY14A	FY15A
Interest income	123	140	214	534	1,040
Interest expense	46	51	94	284	551
Net interest income	**77**	**88**	**120**	**250**	**490**
Non-interest income	28	25	43	82	143
Net total income	**105**	**113**	**163**	**332**	**632**
Operating Expense	78	97	124	187	353
Pre-provisioning profit	**27**	**17**	**39**	**145**	**279**
Provisions	14	10	10	16	24
Profit before tax	12	7	29	129	255
Tax	2	2	9	41	86
Profit after tax	**10**	**4**	**20**	**88**	**169**

Source: Company

Fig 19 - Balance Sheet

Particulars (Rs mn)	FY11A	FY12A	FY13A	FY14A	FY15A
Shareholders' funds	**278**	**287**	**641**	**875**	**1,320**
Non-Current Liabilities					
Long term borrowings	66	107	471	1,091	2,972
Long term liabilities	-	0	1	1	4
Long term provisions	0	1	4	9	6
Deferred gains (non-current)	-	1	1	3	-
Current Liabilities					
Short term borrowings	75	25	0	21	4
Trade Payables	2	4	2	4	9
Other current liabilities	168	285	889	1,944	3,202
Short term provisions	6	4	9	21	51
Deferred gains - (current)	0	34	16	28	
Total	**596**	**749**	**2,033**	**3,997**	**7,568**
ASSETS					
Non-Current Assets					
Fixed assets	5	4	7	10	17
Non-current investment	-	-	21	-	-
Deferred tax assets (net)	3	3	6	12	24
Long term loans and advances	9	40	25	31	-
Long term Trade Receivables	35	96	369	801	762
Other non-current assets	0	72	30	144	300
Current Assets					
Current investments	-	-	0	9	9
Trade Receivables	448	280	912	2,113	-
Cash and bank balances	78	220	567	754	1,676
Short term loans and advances	14	20	65	74	4,674
Other current assets	4	15	30	50	107
Total	**596**	**749**	**2,033**	**3,997**	**7,568**

Source: Company

19 August 2015

SV Creditline

Leading north-India based MFI

SV Creditline (SVCL, unlisted) is a North-India based MFI with an AUM of ~Rs 4bn and 120 branches as of FY15. The company has a strong regional focus and presence in the northern and central belt of India, particularly in states with low per-capita income – a strategy which enables it to cater to the high-growth addressable market of bottom-of-the-pyramid customers. SVCL also provides business correspondence (BC) services to IndusInd Bank and Kotak Bank, with its current portfolio at ~Rs 540mn. The company has outlined an aggressive growth plan and targets an AUM of Rs 30bn by FY19.

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- **Company profile:** SVCL commenced its microfinance operations only in Jan'10 but quickly emerged as the fastest-growing North-India based mid-tier MFI with an AUM of Rs 4.2bn. It has a network of 120 branches spread primarily over Uttar Pradesh, Madhya Pradesh and Rajasthan. Asset quality is well managed despite a ~86% CAGR in its AUM over last four years. SVCL is adequately capitalised with a CAR of 17.1% (tier 1 of 12.76%) which is above the regulatory norm. However, the company will require capital infusion due to rapid expansion.

- **Aggressive growth outlined till FY19:** SVCL indicated that Uttar Pradesh, its key market, is highly underpenetrated with demand likely to stay robust going forward. The company targets to grow at an annualised rate of 60-65% over FY16 and FY17 followed by 50% in FY18 and FY19, leading to an AUM of Rs 27-30bn by FY19-end. Management expects concentration in Uttar Pradesh to reduce going forward as it scales up in other states of Madhya Pradesh, Rajasthan and Chhattisgarh. Asset quality remained well under control with Gross NPA at 0.2%, and the trend is expected to continue ahead.

- **Business correspondence service to IndusInd Bank, Kotak Bank:** SVCL has tied up with IndusInd Bank and Kotak Bank for BC services. Of the total AUM of Rs 4.2bn, SVCL's BC portfolio is ~Rs 540mn, wherein loans are originated in the books of lenders (IndusInd and Kotak) and SVCL earns fees (~9.5%) for undertaking maintenance and credit risk. SVCL expects its BC portfolio to remain in the range of 8-12% of total AUM going forward.

- **Managing manpower the biggest challenge:** Apart from political risks and uncertainty, the biggest challenge for the sector and companies operating in the northern region is to recruit and retain workforce. SVCL stated that there is a shortage of employees with 2-4 years of relevant work experience due to massive expansion undertaken by several players in northern India. The average employee cost for experienced staff has gone up by 15-20% over last 1-2 years, and attrition too has increased due to high competition.

- **Fully owned by promoters; no interest in banking licence at present:** Promoters own 100% in the company through holding companies SV Corporation and Vans, domestic and foreign partners respectively and both holding a 50% stake each in SVCL. Despite this, it has not applied for a banking licence as management feels it is difficult to build a deposit franchise and the NBFC model is more suitable for servicing the addressable segment.

Key financials

Particulars	FY13	FY14	FY15
AUM (Rs mn)	1,033	2,155	4,212
Net profit (Rs mn)	7	80	94
Net worth (Rs mn)	209	382	520
ROA (%)	0.8	4.2	2.6
ROE (%)	3.6	27.1	20.8
Gross NPA (%)	0.6	0.4	0.2

Source: Company

SV Creditline

Leading north-India based MFI

Company Update
INDIA
MICROFINANCE

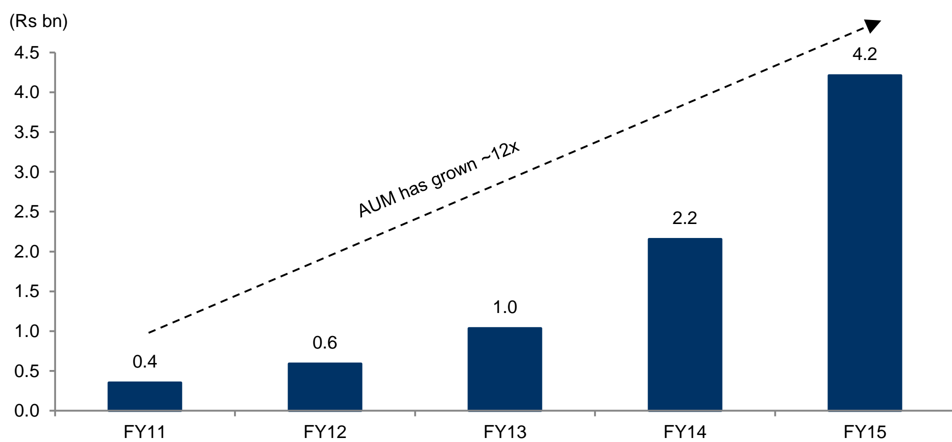
SVCL was incorporated in 1996 as Mantrana Finlease and renamed SVCL in 2008. It is equally owned by SV Corporation, a domestic promoter, and Vans, a foreign entity. SVCL commenced its microfinance operations only in Jan'10 but quickly emerged as a leading mid-tier MFI with an AUM of Rs 4.2bn. It currently operates in seven states through a network of 120 branches. Delinquency levels are low despite a ~86% CAGR in AUM over last four years.

One of the fastest growing mid-sized MFIs

SVCL's AUM has clocked an 86% CAGR over FY11-FY15, driven by (1) a larger client base, (2) rise in the loan outstanding per customer, (3) branch network expansion and (4) expansion into newer geographies.

AUM growth of 86% CAGR over FY11-FY15 largely driven by expansion and higher ticket sizes of loans

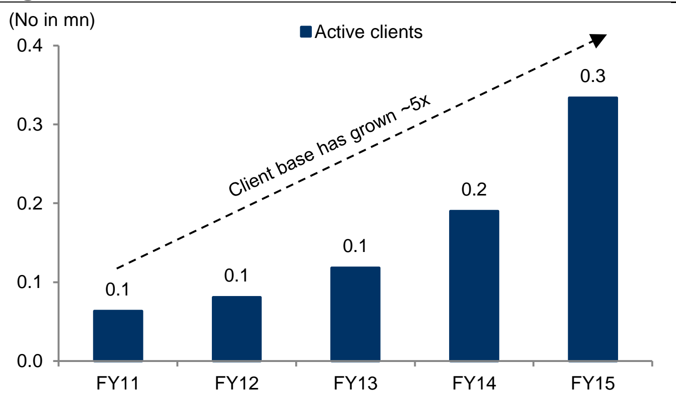
Fig 1 - Robust growth in AUM over FY11-15



Source: Company

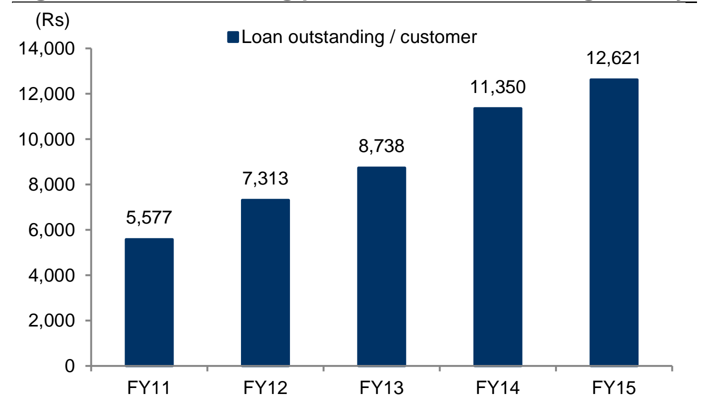
SVCL has an active client base of ~0.3mn customers as on FY15, which has increased at a CAGR of +50% over last four years. Loan outstanding per customer has also increased from ~Rs 5,600 in FY11 to ~Rs 12,600 in FY15, even with SVCL conservatively ensuring that the increase remains in tandem with the customer's ability to repay.

Fig 2 - Client accretion robust



Source: Company

Fig 3 - Loan outstanding per client has increased gradually



Source: Company

SVCL offers small credit facility for income generation activities to its target customers who are unable to avail credit facilities from the existing banking structure owing to lack of collateral. It broadly has three loan products in its kitty: (1) *Unnati* and *Pragati* where ticket sizes range from Rs 10,000-Rs 25,000 and (2) *Samriddhi* with ticket sizes are in the Rs 25,000-Rs 1,00,000 range.

Fig 4 - Products offered

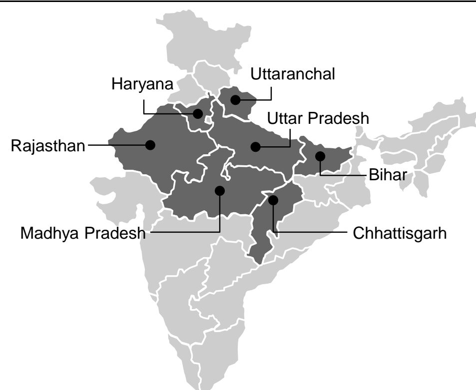
Product Name	Unnati	Pragati	Samriddhi
Loan Amount	Rs.10,000/- To Rs.15,000/-	Rs.18,000/- To Rs.25,000/-	Rs.25,000/- To Rs.100,000/-
Loan Tenure	46 Weeks	2 Years	1-3 Years
Repayment Option	Weekly / Fortnightly /Monthly		Fortnightly / Monthly
Rate of Interest	26%		
Loan Processing Fee	1% of Loan Amount + Service Tax as applicable		
Grace Period	2 Weeks		
Security Deposit	Nil		
Foreclosure Charges	Nil		
Penalty for delay in Repayment	Nil		
Insurance Premium	As per Insurance Provider		
Insurance Tenure	1 - 3 Years		
Insurance Coverage	Client and Spouse		

Source: Company

Doubled branch network in last one year to reduce concentration risk in UP

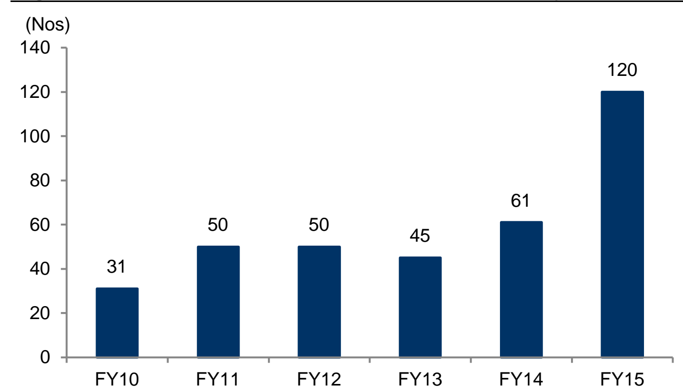
Up to FY14, SVCL restricted its operations to only three states, viz. Uttar Pradesh, Madhya Pradesh and Rajasthan, and expanded only in these areas to increase penetration. This led to concentration risk as Uttar Pradesh constituted ~50% of its portfolio. In order to diversify, SVCL quickly ramped up its operations to four more states by opening ~60 new branches in FY15.

Fig 5 - SVCL now has a presence in seven states



Source: Company

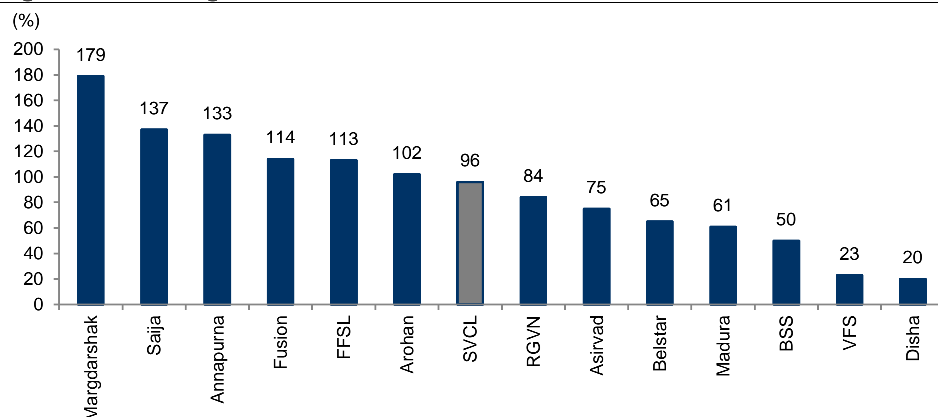
Fig 6 - Branch network has doubled in last one year



Source: Company

Robust branch expansion led to strong AUM growth in FY15, which placed SVCL amongst the top-10 fastest growing mid-tier (gross loan portfolio or GLP>Rs 1bn-5bn) MFIs.

Fig 7 - FY15: YoY growth in GLP of mid-sized MFIs

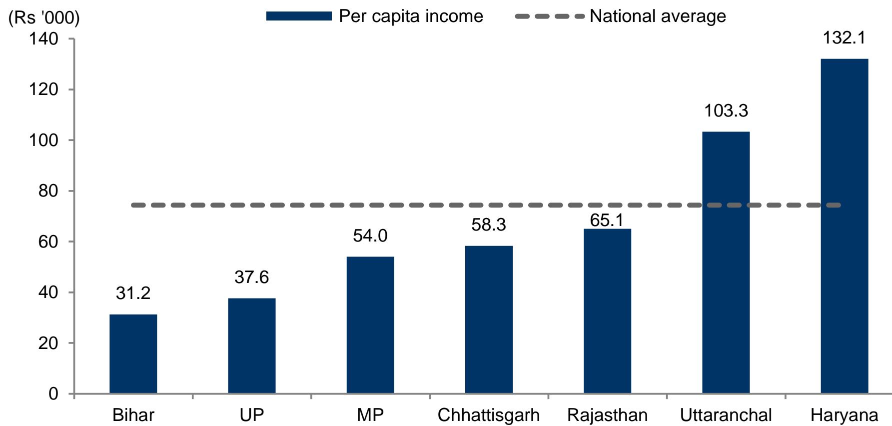


Source: Company, MFIN

Presence in states with low per capita income

SVCL follows a strategy of operating in states where per capita income is lower than the national average, offering it strong growth potential as the addressable market of bottom-of-the-pyramid customers is high in such states.

Fig 8 - Per capita income of states where SVCL has a presence



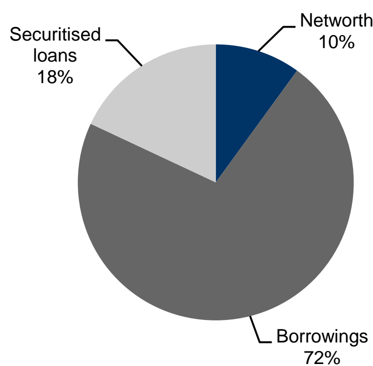
Source: Company

Diversified resource base

SVCL's major funding source has been term loans from banks and financial institutions, while also accessing the securitisation/assignment route for tapping funds. The company's managed portfolio as on FY15 stood at Rs 0.9bn and has increased at a CAGR of 48% over FY11-FY15. In our view, an increase in the managed portfolio should boost NIMs as borrowing via this route is ~200bps cheaper than on-balance-sheet borrowing.

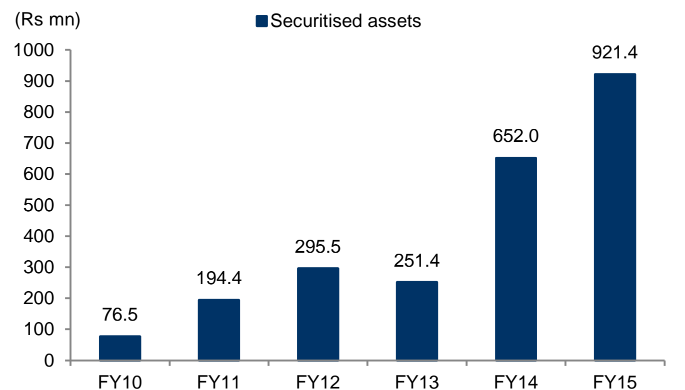
SVCL's managed portfolio as on FY15 stood at Rs 0.9bn and has increased at a CAGR of 48% over FY11-FY15

Fig 9 - SCNL has a diversified resource base



Source: Company

Fig 10 - Securitised portfolio



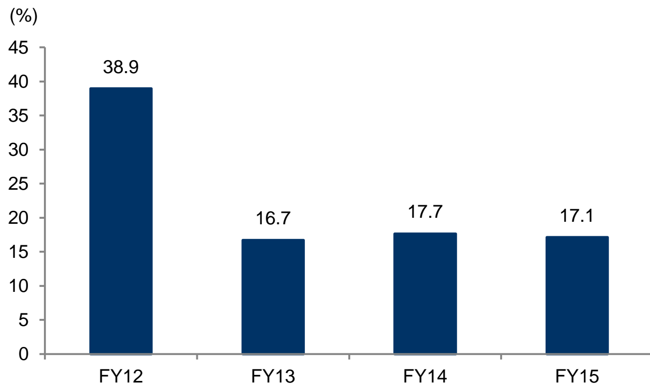
Source: Company

Adequately capitalised

SVCL has remained adequately capitalised due to regular capital infusion by promoters, SV Corporation and Vans, who together own 100% stake in the company. Though SVCL's CAR ratio has declined to 17.1% in FY15 from 17.7% in FY14 due to an increase in AUM, it remains well above the regulatory requirement of 15%. In our view, the company will soon require capital infusion due to rapid expansion.

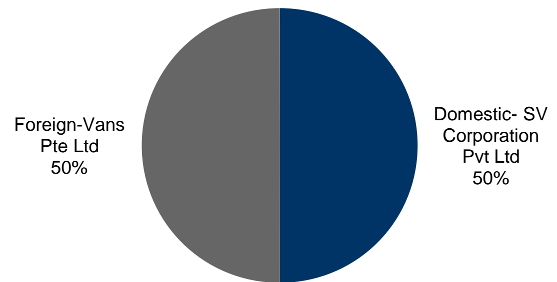
Regular capital infusion has ensured adequate capital adequacy levels

Fig 11 - CAR well above the regulatory requirement of 15%



Source: Company

Fig 12 - SVCL 100% owned by promoters

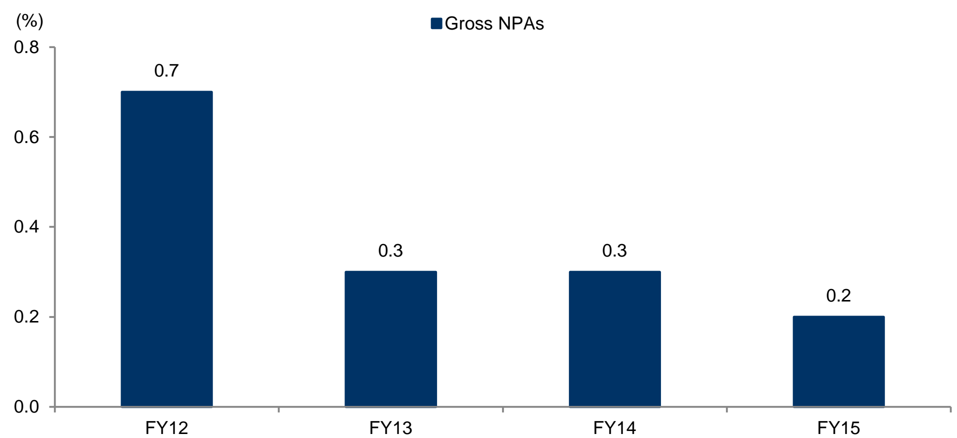


Source: Company

Well-managed asset quality

SVCL has adopted a well-balanced approach between sustained growth and maintaining the quality of its asset portfolio. Its gross NPAs have ranged from 0.7-0.2% between FY12-FY15 and are at the lower end of the band at 0.2% as of FY15.

Fig 13 - Asset quality fairly stable



Source: Company

Well-tested in-house technology platform

SVCL has an accounting and MIS system that has been developed over a period of time, with all branches IT-enabled from day one. The company uses in-house software which has two integrated modules for managing its portfolio and accounting requirements. The loan management module keeps a record of all transactions for each client and generates weekly reports, while the accounting module registers daily accounting entries in computerised ledgers, and generates financial statements and reports.

The software also generates collection and demand sheet which provides information on collections to be made on a weekly basis. The data is maintained with separate user accounts at the branch level and the rights to access are defined for different users at the head office. Thus, clear authority is defined by the MIS which ensures data security. The data is backed up on a daily basis both at the branch and head office level. In our view, SVCL's current technology platform is adequate for the current level of operations and helps reduce duplication, increase accuracy of information & data security, and gives faster access to reports for day-to-day monitoring.

Management profile

Fig 14 - Key management team

Name	Designation	Profile
Rakesh Dubey	Chief Executive Officer	Mr. Dubey has more than 18 years of experience in the MFI industry. Prior to joining SVCL, he co-founded SONATA Finance and was a founding member of CASHPOR Micro Credit
Durgeshwar Mishra	Chief Financial Officer	Mr. Mishra carries over 17 years of experience in microfinance. He too was a part of the initial management team that built CASHPOR Micro Credit from scratch to one of the largest MFIs in North India. At SVCL, Mr. Mishra heads fund mobilisation, finance & accounts and administration departments
K K. Singh	National Business Head	Mr. Singh has over 18 years of experience in the microfinance sector. He was a part of the senior management team at CASHPOR Micro Credit, and handled HR, operations & training. He heads business operations at SVCL

Source: Company

SV Creditline

Leading north-India based MFI

Financials

Fig 15 - Income statement

Particulars (Rs mn)	FY12A	FY13A	FY14A	FY15A
Interest income	104	138	322	606
Interest expense	51	76	161	343
Net interest income	**54**	**62**	**161**	**263**
Non-interest income	35	28	55	106
Net total income	**89**	**90**	**216**	**369**
Operating Expense	84	80	127	237
Pre-provisioning profit	**4**	**10**	**90**	**132**
Provisions	1	3	8	13
Profit before tax	4	7	82	119
Tax	-	-	2	25
Profit after tax	**4**	**7**	**80**	**94**

Source: Company

Fig 16 - Balance Sheet

Particulars (Rs mn)	FY12A	FY13A	FY14A	FY15A
Shareholders' funds	**175**	**209**	**382**	**520**
Non-Current Liabilities				
Long term borrowings	34	175	631	1,632
Long term liabilities	-		9	12
Long term provisions	1	1	3	4
Current Liabilities				
Short term borrowings			258	194
Other current liabilities	342	848	1,259	2,143
Short term provisions	4	8	16	24
Total	**556**	**1,242**	**2,558**	**4,530**
ASSETS				
Non-Current Assets				
Fixed assets	8	9	10	15
Deferred tax assets (net)	-	-	-	5
Loan portfolio	**10**	**33**	**139**	**443**
Long-term loans and advances	3	7	53	59
Other non-current assets	23	69	88	242
Current Assets				
Trade receivables	-	-	1	5
Cash and bank balance	85	346	805	1,308
Loan portfolio	**384**	**705**	**1,354**	**2,312**
Short-term loans and advances	13	20	15	39
Other current assets	31	54	93	102
Total	**556**	**1,242**	**2,558**	**4,530**

Source: Company

19 August 2015

Arohan Microfinance

Rising profitability, growing footprint

Arohan Microfinance (Arohan, unlisted) is the largest MFI in East and Northeast India. It currently operates in five low-income states and has an AUM of Rs 3.8bn. Management is targeting AUM of ~Rs 25bn by FY19, implying a 60% CAGR over the next four years. The company's capital adequacy ratio (CAR) is strong at 36% as on FY15 and profitability has improved significantly over the last couple of years, with further upside potential. ROE is targeted to reach 18-19% over the next four years.

- **Dominant player in East and Northeast India:** Arohan is the largest MFI in the country's eastern and northeast regions, with an AUM of Rs 3.8bn as on FY15, implying a 90% CAGR over the last three years. The company's success lies in its strategy of operating in financially deprived, low income states. It has a client base of over 0.3mn and currently operates in the five states of West Bengal, Bihar, Assam, Jharkhand and Orissa, where per capita income is typically lower than the national average. Profitability has improved significantly over the last couple of years due to a reduction in operating costs and loan loss ratio.

- **Targeting 60% CAGR in AUM through FY19:** Arohan has recently expanded its operations into Jharkhand and Orissa and is planning to enter new geographies such as Uttar Pradesh, Madhya Pradesh, Chhattisgarh, Meghalaya and Tripura over the medium term. Management sees immense business opportunities in these states, especially in the underpenetrated economically backward areas, and is hence targeting a 60% CAGR in AUM to ~Rs 25bn by FY19.

- **Profitability to remain strong:** Arohan's profitability has increased significantly over the last couple of years. Its loan loss ratio in terms of disbursement has improved from 1.2% in FY11 to 0.15% in FY15 and the operating expense ratio has come off from 13% in FY13 to 8% currently. Management expects the opex ratio to improve further to 6.8% in FY16. ROE has risen from sub-1% in FY13 (due to the Andhra crisis) to 11% in FY15 and management is targeting a range of 18-19% by FY19.

- **Applied for small bank licence through group company:** Arohan has applied for a small bank licence through its group company – IntelleCash Microfinance Network – which holds ~30% in Arohan. If this application is accepted, management intends to merge all group companies and create one frontline entity – IntelleCash – which will act as a small bank with interests in microfinance and small business loans, among others. The merged entity will have a shareholding structure that meets the RBI's requirement. In our view, the biggest advantage of converting the business into a small bank is that it will drastically reduce the political risk.

REPORT AUTHORS

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Key financials

Particulars	FY13	FY14	FY15
AUM (Rs mn)	904	1,903	3,839
Net profit (Rs mn)	1	31	109
Net worth (Rs mn)	420	673	1,380
ROA (%)	-	1.8	2.9
ROE (%)	0.2	5.6	10.6
Loan loss ratio (%)	0.3	0.3	0.2

Source: Company

Arohan Microfinance

Rising profitability, growing footprint

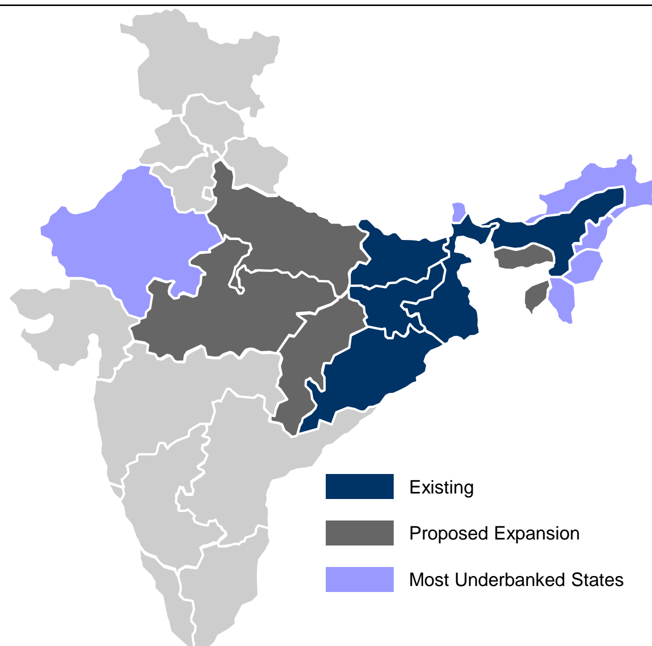
Arohan is a Kolkata-based MFI which began operations in 2006. In Sep'12, the company was taken over by IntelleCap when the latter acquired a majority stake from investors such as Bellwether Microfinance Trust and India Financial Inclusion Fund. Post-acquisition, Arohan has emerged as the largest MFI in eastern and northeastern India with an AUM of ~Rs 3.8bn as on FY15. It has a client base of over 0.3mn and currently operates in five states – Assam, Bihar, West Bengal, Jharkhand and Orissa.

One of the largest players in the east and northeast regions

Focus on operating in financially deprived states

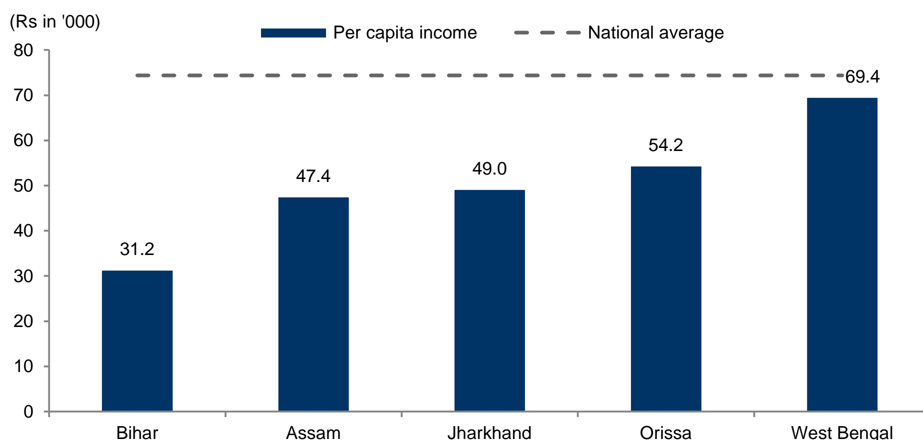
Up to FY14, Arohan had operations concentrated in three states, namely West Bengal, Bihar and Assam. In H1FY15, it expanded into Jharkhand and recently entered Orissa. According to management, over 80% of low income groups in India's low income states remain unbanked. Low penetration of competing financial institutions translates to strong demand for Arohan's services. Management aims to limit operations to such states as they offer a large addressable customer base.

Fig 1 - Arohan focuses on low income markets…



Source: Company

Fig 2 - …with operations in states that have below-average per capita income



Source: Company

Jharkhand and Orissa are new additions to the company's focus list

Arohan Microfinance

Rising profitability, growing footprint

Diversifying the product basket

Partnered with Future-Generali and SBI Life for general and life insurance respectively

Arohan extends income-generating loans to individuals and has five products in its basket. Management is looking to diversify its income profile by introducing new products such micro-pension (tied up with IFMR) and micro-insurance (tied up with SBI Life). Arohan has also partnered with Future Generali to offer general insurance services to low income groups. However, these products are profit-neutral as they are widely targeted towards financial inclusion and do not earn much income for the company.

Fig 3 - Current product offering

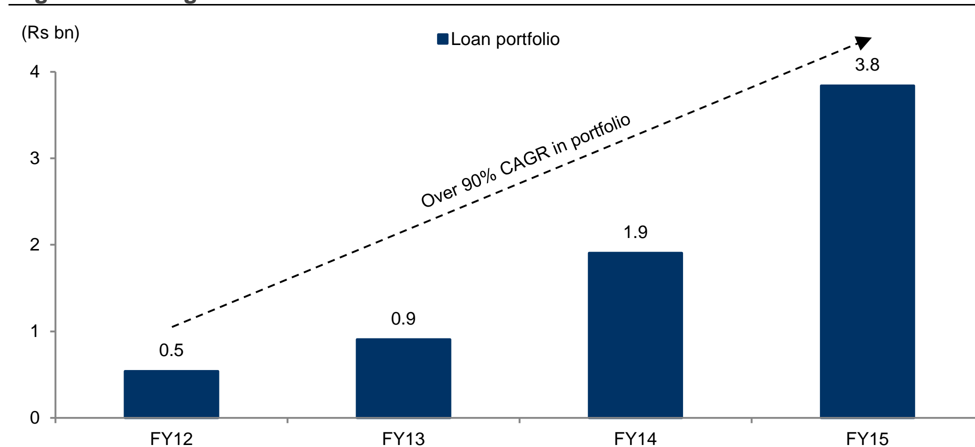
Description	Saral Loan	Saral Plus Loan	Bazaar Loan	Bazaar Plus Loan	Pragati Loan
Launch Date	Apr-06	Aug-13	Apr-08	Aug-13	Apr-10
Customer Profile	Economically active women residing in slums and low income areas, generally involved in trade & services		Vendors in authorised markets selling household commodities, generally perishables. Typically male.		Entrepreneurs involved in nonfarm enterprises (manufacturing, service units, agri-allied enterprises – e.g. furniture makers or retail traders)
Loan Conditions	3-5 member joint liability groups (JLG) who undergo 3 days of training prior to loan sanction	Individual loans for people who have a prior credit history with Arohan	3-5 member JLGs who undergo 2 days of meeting prior to loan sanction	Individual loans for people who have a prior credit history with Arohan	Individuals involved in manufacturing, services and trading, and employing at least 2 wage labourers
Loan Size	Rs 10,000 to Rs 15,000	Rs 20,000 to Rs 30,000	Rs 10,000 to Rs 15,000	Rs 20,000 to Rs 30,000	Rs 50,000 to Rs 500,000
Repayment Frequency			Monthly		
Loan Tenure	12 months	24 months	12 months	24 months	12-36 months
Interest Rate (declining rate)	26.25%	26%	27%	26.50%	30%

Source: Company

Traction in AUM to continue

Arohan has an AUM of ~Rs 3.8bn as on FY15, which has increased at a CAGR of +90% over FY12-15. In the medium term, the company plans to gradually enter new geographies such as Uttar Pradesh, Madhya Pradesh, Chattisgarh, Meghalaya and Tripura.

Fig 4 - Robust growth in AUM recorded over FY12-FY15



Source: Company

Arohan Microfinance

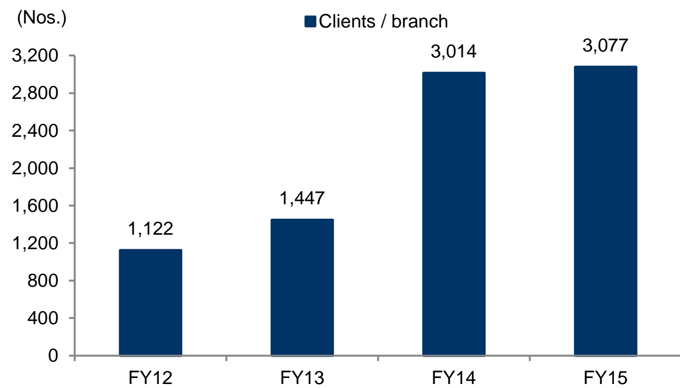
Rising profitability, growing footprint

Company Update
INDIA
MICROFINANCE

In our view, Arohan has managed to rapidly achieve scale by optimally utilising its branches and by expanding into new geographies. The company had 98 branches in FY12 but due to an increase in loan losses and the need to rein in operating costs, it pared the branch count to 73 in FY14. Consequently, the number of clients handled per branch rose from ~1,100 in FY12 to ~3,000 in FY14. This figure continues to improve despite an increase in number of branches to 104 in FY15. Management plans to open 76 new branches in H1FY16, including 20 in Orissa where operations were recently launched.

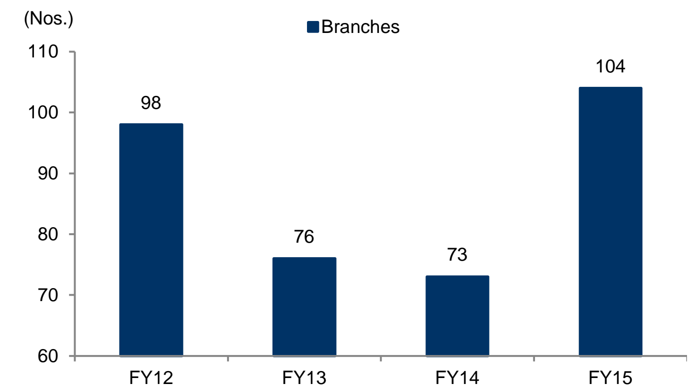
Management plans to open 20 new branches in Orissa where it recently began operations

Fig 5 - Clients handled per branch



Source: Company

Fig 6 - Branch count crossed 100 in FY15

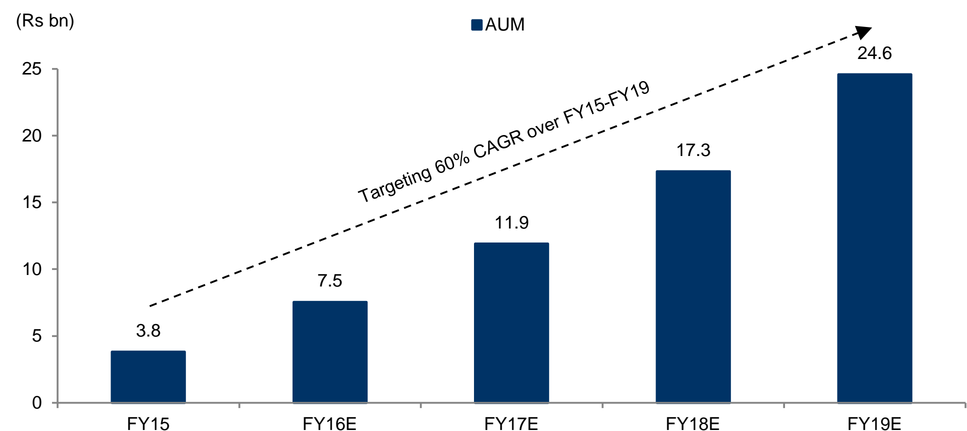


Source: Company

Management is targeting a 60% CAGR in AUM to Rs 24.6bn by FY19. Growth will be aided by a doubling of market coverage to a total of 10 low income states and an increase in branch strength from ~100 currently to 370 by FY19.

Management targeting AUM of Rs 24.6bn in FY19

Fig 7 - Management expects an AUM CAGR of 60%



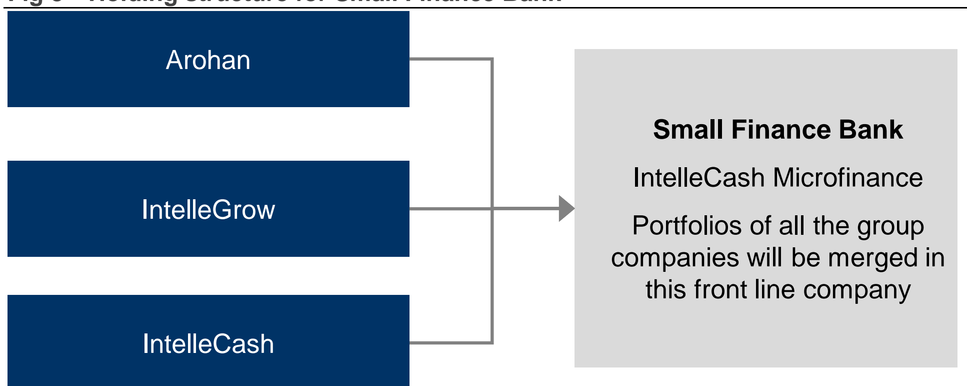
Source: Company projections

Applied for a small bank licence

Arohan has applied for a small bank licence through its group company and institutional promoter, IntelleCash Microfinance Network. If the application is accepted, the strategy will be to merge all group companies – Arohan, Intellegrow and Intellecap – and create one frontline company called IntelleCash. According to management, this will create a structure where the institutional promoter and domestic investor holding will meet the RBI requirement of 26% and 51% respectively for becoming a small bank. In our view, the biggest advantage of conversion into a small bank is that it will substantially reduce the political risk.

Small bank licence application made through group company IntelleCash Microfinance Network

Fig 8 - Holding structure for Small Finance Bank



Source: Company

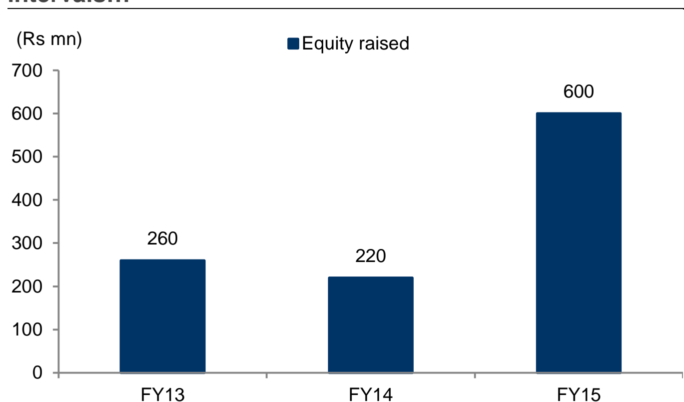
Adequately capitalised for growth

Received fresh funding of Rs 600mn from PE player Tano Capital in FY15

Arohan has the strong backing of institutional investors such as Aavishkaar Goodwell, Michael & Susan Dell Foundation, and India Financial Inclusion Fund, who have infused capital in a timely manner to fuel its growth.

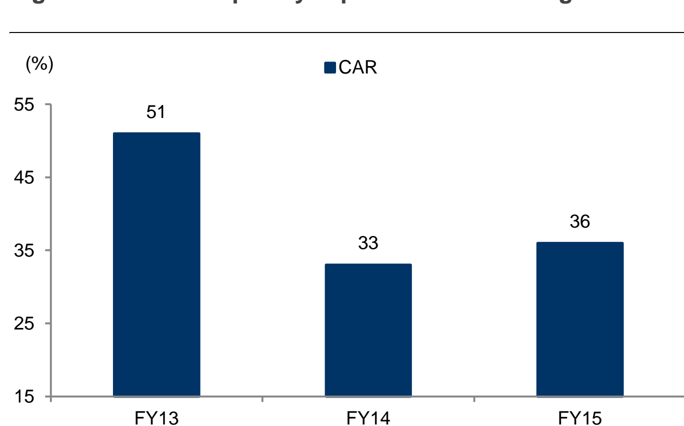
In FY14, the company raised Rs 220mn from existing stakeholders (Aavishkaar Goodwell, Michael & Susan Dell Foundation) and a new private investor, Swaminathan Anklesaria Aiyar. In FY15 too, it received fresh funding of Rs 600mn from private equity player, Tano Capital. Capital infusion at regular intervals has not only kept Arohan adequately capitalised, but has also ensured timely availability of funds for sustaining strong business growth.

Fig 9 - Arohan has managed to raise equity at regular intervals…



Source: Company

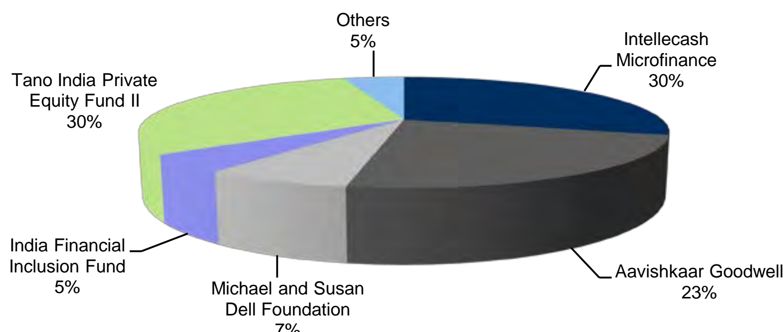
Fig 10 - and is adequately capitalised for future growth



Source: Company

Arohan's shareholding pattern is fairly distributed among institutional investors and private equity funds. IntelleCash Microfinance is the institutional promoter, holding ~30% stake, while Aavishkar Goodwell and Tano Capital cumulatively hold 53% stake.

Fig 11 - Shareholding pattern



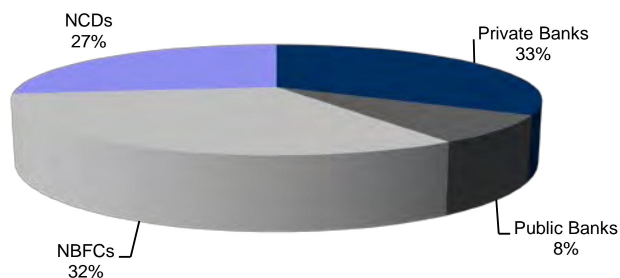
Source: Company

Fairly diversified resource base

Term loans are a major source of external funding for Arohan and the company has relationships with 26 lenders including banks and financial institutions. It has outstanding sanctions of Rs 540mn for FY16 received from different lenders, including Axis Bank, Yes Bank, SBI, IDFC HDFC and SIDBI. In our view, access to a large pool of lenders has aided the rapid scale of expansion. In FY15, Arohan raised Rs 3.8bn of debt which included seven NCD issues amounting Rs 1.1bn raised from well-known institutions, including IFMR Capital, AAV, Sarl and MIFA.

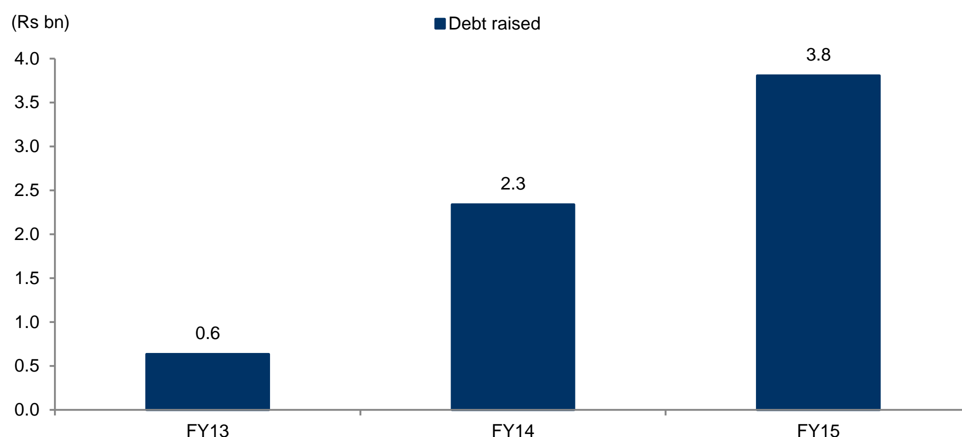
Outstanding sanctions of Rs 540mn from different lenders

Fig 12 - Composition of outstanding borrowings



Source: Company

Fig 13 - Debt raised by Arohan



Source: Company

Arohan Microfinance

Rising profitability, growing footprint

CARE has upgraded Arohan's MFI grading and bank loan rating to MFI 2+ and BBB+ respectively in FY15

CARE has upgraded Arohan's MFI grading and bank loan rating to MFI 2+ and BBB+ respectively in FY15, which reflects the strength of its business model.

Fig 14 - Rating assessment by agencies

Year	Agency	Rating
2015	CARE MFI Grading	Upgraded from MFI 2 to MFI 2+
2015	CARE Bank Loan Rating	Upgraded from BBB to BBB+
2013	MF Transparency	91/100 – Rank 4
2014	ACCESS-ASSIST Code of Conduct Assessment	3.18/4 – A category
2015	Smart Campaign – Client Protection Certification	7th Institution in India and 32 in World

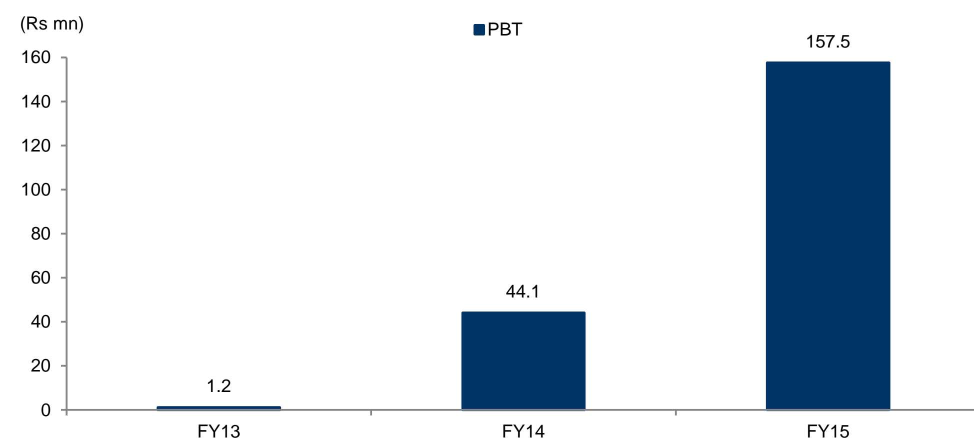
Source: Company

Profitability expected to remain strong

Loan loss ratio has significantly improved from 1.2% to 0.2% over FY11-FY15

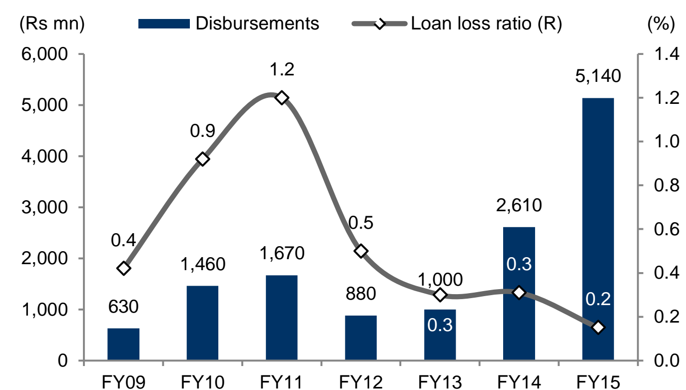
Arohan's profitability was severely affected during the Andhra Pradesh crisis and its loan loss ratio on disbursements increased to 1.2% in FY11. But with judicious corrective measures, the company's PBT has risen from just Rs 1.2mn in FY13 to Rs 157.5mn in FY15. Its loan loss ratio has significantly improved from 1.2% to 0.2% over FY11-FY15 (aided by the Credit Bureau establishment) and the operating expense ratio is down from 13% in FY13 to 8% in FY15 on account of operational efficiency.

Fig 15 - PBT has improved dramatically over the last three years



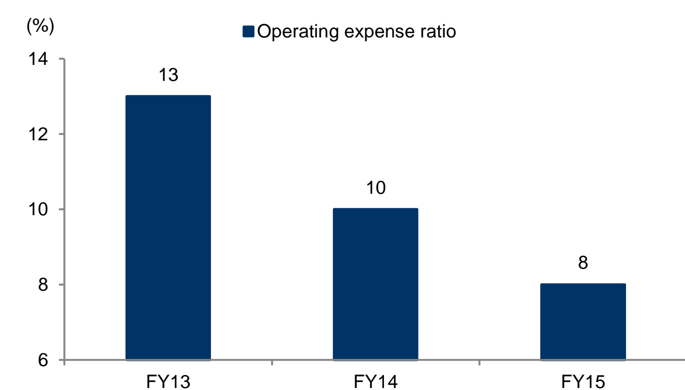
Source: Company

Fig 16 - Loan losses have reduced significantly



Source: Company

Fig 17 - Operational efficiency has contained costs



Source: Company

Going forward, management expects profitability to remain strong on the back of increased disbursements and AUM growth, with ROE targeted to improve to 18-19% by FY19 from 11% in FY15.

Management targeting ROE of 18-19% by FY19 from 11% in FY15

Fig 18 - Management guidance

Particulars	FY16	FY17	FY18	FY19
States	5	7	10	10
Total Branches	180	264	309	371
Disbursements (Rs mn)	9,770	14,482	20,444	27,692
AUM (Rs mn)	7,538	11,905	17,328	24,579
PBT (Rs mn)	401	753	1,240	1,719

Source: Company

Management profile

Fig 19 - Key management team

Name	Designation	Profile
Manoj Kumar Nambiar	MD & Board Member	Mr. Nambiar has over 27 years of experience in consumer finance & retail banking. He is a mechanical engineer from VJTI, Mumbai, and a management post graduate from JBIMS, Mumbai. He is a director on the boards of IntelleCash Microfinance Network and Intellecap Software Technologies, and has also been a member of the governing board at Microfinance Institutions Network (MFIN) since Jan'13 and was elected its President in Jul'15.
Shubhankar Sengupta	CEO & Board Member	Mr. Sengupta is the founder of Arohan and has +17 years of experience. He worked previously at BASIX and is a founding board member of MFIN. Mr. Sengupta holds a post graduate degree from Institute of Rural Management and has completed a program on Strategic Leadership in Microfinance from Harvard Business School.
Madhu Murthy	Senior Vice President – Business Head	Mr. Murthy leads Arohan's distribution across all its states of operation. He brings over 23 years of accomplishments in sales and P&L responsibility across MNC and Indian corporations. Prior to joining Arohan, he was heading the eastern region for SKS Microfinance. He is a Commerce Graduate and has completed the Management Development program on managerial success at IIM Lucknow.
Amit Dutta	Vice President – Finance	Mr. Dutta joined Arohan in 2008 and currently heads the Finance department. He is a Chartered Accountant and has completed his Executive MBA from the Xavier Institute of Management, Bhubaneswar.

Source: Company

Fig 20 - Key investor directors

Name	Designation	Profile
Vineet Rai	Investor Director	Mr. Rai is the founder and MD of Aavishkaar and co-founder and Chairman of the Intellecap Group of companies. He has over 18 years of experience in early stage investing, small business incubation and microfinance. He holds a post graduate diploma in Forestry Management from the Indian Institute of Forest Management, Bhopal.
Sanjib Jha	Investor Director	Mr. Jha is the CEO & Director of group company, IntelleGrow, and has over 14 years of experience in varied fields. He was among the initial founding team members at ATS Services, a domestic BPO, and later joined Actis. After Actis, Sanjib played a role in setting up Lok Capital in India. Sanjib is a qualified Company Secretary.
Sushma Kaushik	Investor Director	Ms. Kaushik brings with her over 9 years of diverse experience in the field of consulting and investing. She is an engineering graduate from RVCE, Bangalore, and has an MBA degree from the Indian School of Business, Hyderabad.
Anurag Agrawal	Investor Director	Mr. Agrawal is presently the CEO of Intellecap, and has over a decade of experience in investment banking with a focus on assisting early and growth stage enterprises to raise capital. He has a Bachelor of Business Administration and a Master of Commerce Degree from Madras University, and an MBA degree in Finance from TA Pai Management Institute.
Piyush Goenka	Investor Director	Mr. Goenka has over 15 years of experience in the financial services industry. He is a postgraduate in Business Administration from Management Development Institute, India, and a Commerce graduate from St. Xavier's College. He is also a CFA Charterholder.

Source: Company

Financials

Fig 21 - Income statement

Particulars (Rs mn)	FY13A	FY14A	FY15A
Interest income	123	304	666
Interest expense	42	149	356
Net interest income	**81**	**156**	**311**
Non-interest income	21	43	79
Net total income	103	199	390
Operating Expense	99	142	211
Pre-provisioning profit	**4**	**57**	**179**
Provisions	2	13	21
Profit before tax	1	44	158
Tax	1	13	49
Profit after tax	**1**	**31**	**109**

Source: Company

Fig 22 - Balance sheet

Particulars (Rs mn)	FY13A	FY14A	FY15A
Shareholders' funds	**420**	**673**	**1,380**
Share capital	298	407	692
Reserves and surplus	123	267	689
Non-Current Liabilities			
Long term borrowings	443	339	1,194
Long term provisions			4
Current Liabilities			
Short term borrowings	36	112	19
Trade Payables	0	1	5
Other current liabilities	158	1,151	2,536
Short term provisions	3	18	37
Total	**1,060**	**2,293**	**5,175**
ASSETS			
Non-Current Assets			
Fixed assets	15	13	17
Tangible assets	7	7	10
Intangible assets	3	5	5
Capital work-in-progress	4	1	2
Non-current investment	1	1	1
Deferred tax assets (net)	-	5	13
Loan to customers	115	150	491
Long term loans and advances	29	17	16
Other non-current assets	59	80	131
Current Assets			
Current investments	28	-	11
Cash and bank balances	121	521	1,205
Loan to customers	571	1,396	3,154
Short term loans and advances	113	90	86
Other current assets	9	21	50
Total	**1,060**	**2,293**	**5,175**

Source: Company

19 August 2015

Fusion Microfinance

New generation microfinance company

Fusion Microfinance (FMPL, unlisted) is a new generation and one of the fastest-growing North/Central India-focused MFIs with 61 branches and an AUM of Rs 2.8bn as of FY15. It is one of the very few MFIs in northern India which uses extensive technology for end-to-end processes across branches and central offices. The company is present in five states as well as the Delhi-NCR region, and is likely to double its loan book to ~Rs 5bn by FY16-end. Profitability is likely to improve ahead with management targeting a ROE of 17-18% over the medium term.

- **Company profile:** FMPL is one of the fastest-growing mid-sized MFIs with an active client base of ~0.2mn. It largely operates in the Delhi-NCR region and five states located in North-Central India. AUM stood at Rs 2.8bn as of FY15, 50% of which is concentrated in Uttar Pradesh. FMPL has a strong capital adequacy ratio with its FY15 CAR at 19%, well above the regulatory norm of 15%. Its PAR (>30) of 0.39% is one of the best among peers.

- **Robust technology platform, strong asset quality:** FMPL has implemented 'Shakti', a core microfinance solution with real time and web-based cloud computing. All branches are computerised and extensively use technology for administrative work, besides implementing high-performance HR systems to ensure better work culture. Enhanced technology usage has improved efficiency across credit, banking and collection processes, with FY15 operating cost down to 8.5% from 18% in FY12.

  In terms of asset quality, FMPL ranks among the best in industry with delinquencies remaining low despite a ~120% AUM CAGR over last four years. Headline NPAs were high at 2.3% in FY11 when it began operations, post which they have steadily declined and stabilised at 0.4% in FY15.

- **Aggressive growth plans:** FMPL has a presence across Uttar Pradesh, Madhya Pradesh, Uttarakhand, Haryana, Bihar as well as the Delhi-NCR region. Uttar Pradesh currently accounts for 49% of total AUM, with the proportion set to gradually decline over the years. The company had 61 branches as of Mar'15; management intends to scale this up to 125 branches and double the portfolio to ~Rs 5bn by FY16-end. While profitability is low currently with ROE of 14.5%, management expects to take this to 17-18% over the medium term with further improvement in operating ratios and an increase in leverage.

- **Promoter holding at 16%; no interest in banking license:** Due to robust expansion and in turn high capital requirement, promoter holdings have diluted to 16%, with RIF North Fund II owning 43% and NMI Frontier Fund 31%. Management highlighted that raising money from the domestic market is a challenge. It also stated that it is not interested in a banking license at present as NBFC-MFIs can cater to microfinance in a more effective manner, while a banking structure would offer limited differentiation to its customers.

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Key financials

Particulars	FY13	FY14	FY15
AUM (Rs mn)	570	1,380	2,790
Net profit (Rs mn)	3	30	53
Net worth (Rs mn)	211	241	491
ROA (%)	0.5	2.7	2.3
ROE (%)	1.7	13.3	14.5
PAR > 30 days (%)	0.0	0.0	0.4

Source: Company

Fusion Microfinance

New generation microfinance company

Company Update
INDIA
MICROFINANCE

FMPL is one of the fastest growing mid-sized MFIs with an AUM of Rs 2.8bn and ~0.2mn active customers. It initiated greenfield operations in Jan'10 when the current promoters acquired Ambience Fincap and rechristened it as FMPL. In Mar'10, FMPL ramped up operations by acquiring the Rs 6.3mn microfinance portfolio of Aajeevika, a not-for-profit body operating in Delhi. FMPL operates in Delhi-NCR and five states through a network of over 60 branches and has low delinquency levels despite robust AUM growth in last five years.

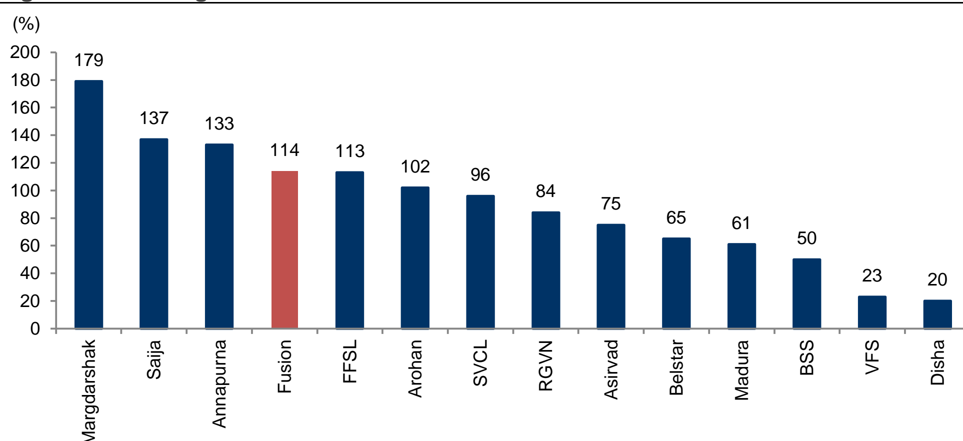
One of the fastest-growing mid-sized MFIs with an AUM of Rs 2.8bn and ~0.2mn active customers as of FY15

Amongst the fastest growing mid-sized MFIs

According to data released by MFIN, FMPL is one of the fastest-growing companies in the mid-tier MFI space (GLP> Rs 1bn-5bn). As on FY15, it had an AUM of Rs 2.8bn, which has increased at a CAGR of ~120% over last four years.

~120% AUM CAGR clocked over last four years

Fig 1 - YoY AUM growth for mid-sized MFIs

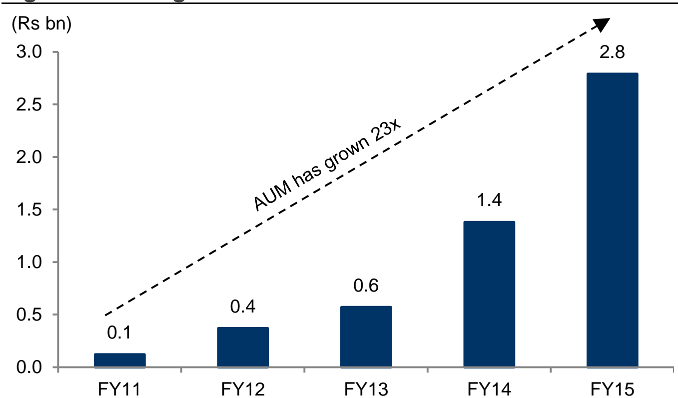


Source: Company, MFIN

AUM growth was driven by increased employee productivity, addition of nearly 50 branches during FY11-FY15 (~50% CAGR) and entry into newer geographies. Going forward, management intends to expand its reach with increased penetration in existing states like Uttar Pradesh, Madhya Pradesh, and Uttarakhand, as well as enter new markets by increasing the branch count to 160.

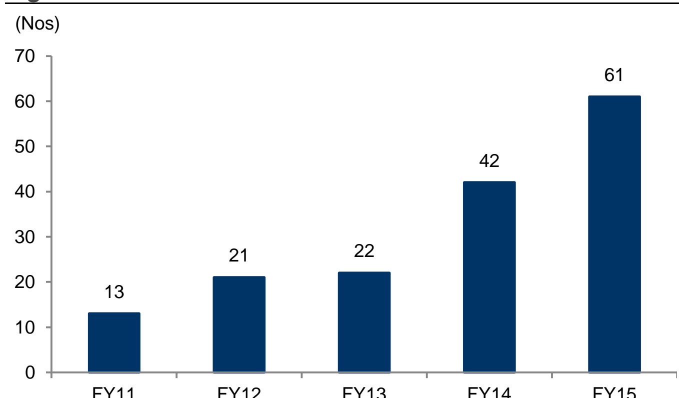
Added nearly 50 branches between FY11-FY15, implying a CAGR of ~50%

Fig 2 - Robust growth in AUM over FY11-15



Source: Company

Fig 3 - Branches have increased at a CAGR of ~50%



Source: Company

FMPL provides loans of Rs 15,000-30,000 to urban and rural poor women under the JLG lending model for agriculture, animal husbandry, fishery, poultry and other income generating activities. It also provides small-ticket vehicle loans up to Rs 0.6mn.

Provides loans ranging from Rs 15,000-30,000 to urban and rural poor women under the JLG lending model

Fig 4 - Products offered

Products	IGLM26-15000	IGLM26-20000	IGLM26-25000	IGLM26-30000	STVL
Loan Amount (Rs)	15,000	20,000	25,000	30,000	0.1-0.6mn
Loan Cycle	1st / 2nd Cycle	1st / 2nd Cycle	2nd / 3rd Cycle	3rd / 4th Cycle	NA
Loan Tenure	1 year 5 months	2 Years	2 Years	2 Years	1-3 Years
Repayment Frequency	28 days	28 days	28 days	28 days	Monthly
No of Installments	19	26	26	26	12-36
Insurance Fees (Amount)	334	445	556	667	Depends on Age
Processing Fees (1%) + Service tax (12.36%)	169	225	281	337	1% exclusive of service tax
Insurance Tenure	2 years	2 years	2 years	2 years	As per Loan Tenure
Installment Amount	1,000	1,000	1,250	1,500	Variable
Security	NIL	NIL	NIL	NIL	Vehicle is hypothecated
Interest Rate (Reducing)	26%	26%	26%	26%	24-26%

Source: Company

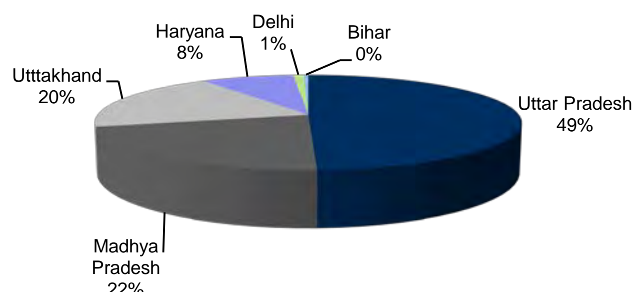
Up to FY14, FMPL was operational only in Uttar Pradesh, Madhya Pradesh, Uttarakhand and Delhi-NCR, but has recently expanded into Haryana and Bihar. Uttar Pradesh contributes ~50% of its AUM, Madhya Pradesh and Uttarakhand ~42%. To further diversify its portfolio and client base, FMPL aims to enter the states of Punjab and Rajasthan.

To diversify its portfolio and client base, FMPL intends to enter Punjab and Rajasthan

Fig 5 - FMPL has a presence in Delhi as well as five states

Source: Company

Fig 6 - Region-wise loan portfolio

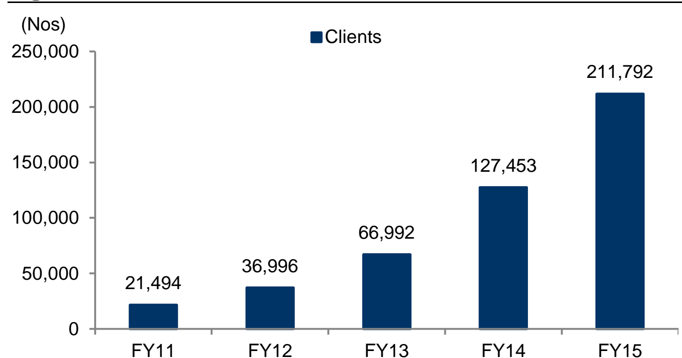


Source: Company

FMPL has an active client base of 0.2mn, which has increased at a 77% CAGR over FY11-FY15. Clients are moderately diversified across states, with concentration in Uttar Pradesh at 50% in FY15.

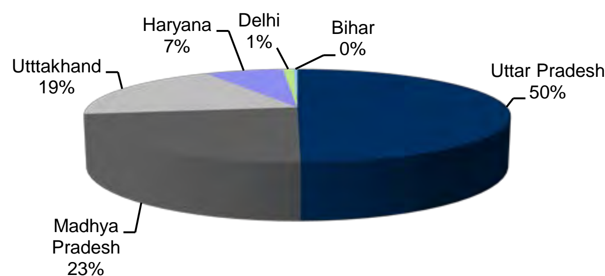
FMPL has an active client base of 0.2mn which has increased at a CAGR of 77% over FY11-FY15

Fig 7 - Client base has increased at CAGR of 77%



Source: Company

Fig 8 - Uttar Pradesh accounts for 50% of client base



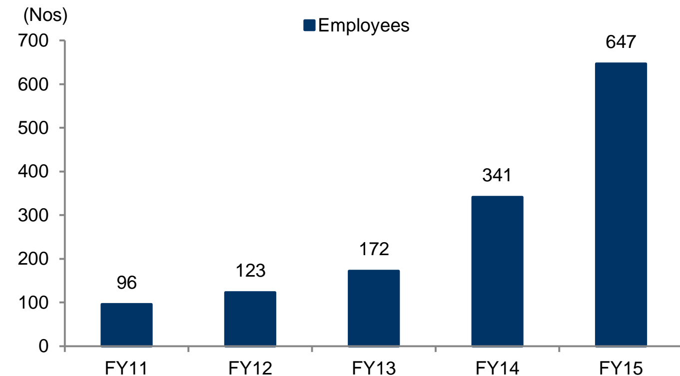
Source: Company

High operational efficiency

FMPL's profitability has improved significantly over the last 2-3 years, with earnings growing by ~76% in FY15 on account of strong net interest income growth and operational efficiency. Despite a ~50%/60% CAGR in its branch network/employee base, its opex as a percentage of average AUM has declined from 18% in FY12 to 8.5% in FY15. FMPL has improved its operational efficiency by increasing disbursements at both branch and employee level.

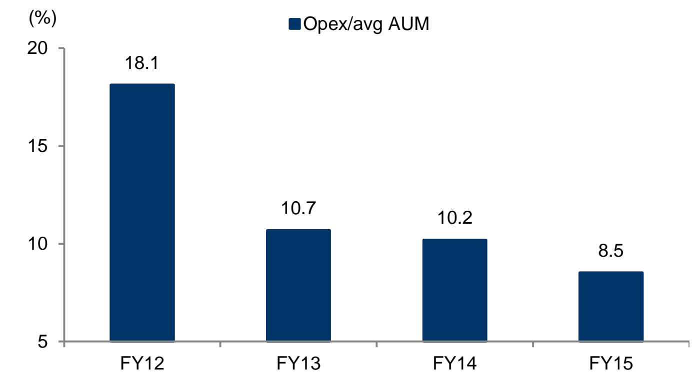
Despite a ~50%/60% CAGR in branch network/employee base, opex/avg. AUM ratio has declined from 18% in FY12 to 8.5% in FY15

Fig 9 - Employee count has increased at a ~60% CAGR



Source: Company

Fig 10 - Opex/avg. AUM has declined over last four years



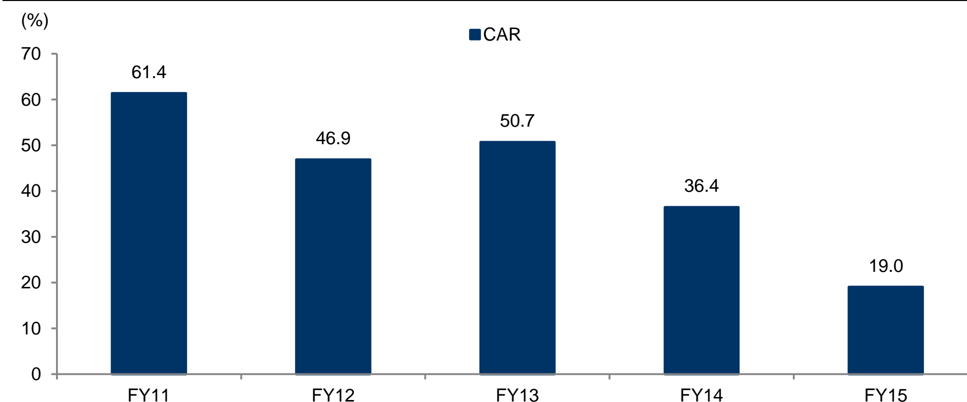
Source: Company

Strong capital adequacy

FMPL is well-funded from different sources and its capitalisation levels are adequate for the current level of operations. Its CAR as of FY15 stood at 19%, which is above the regulatory norm of 15%.

FY15 CAR at 19%, which is above the regulatory norm of 15%

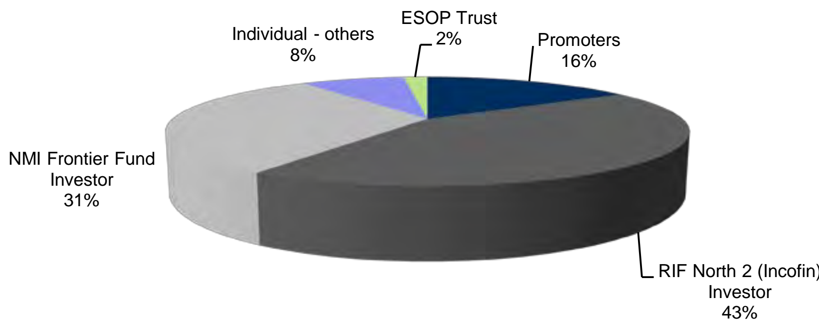
Fig 11 - FMPL is adequately capitalised



Source: Company

Promoters hold ~16% stake in the company while well-known investors such as Incofin and NMI Frontier ~74%.

Fig 12 - Promoters hold ~16% in FMPL



Source: Company

Well-managed asset quality

The trend in FMPL's asset quality is commendable; delinquencies have remained low despite the fact that its AUM has increased at a CAGR of ~120% over last five years. Headline NPAs were high at 2.3% in FY11, when it began operations, post which they have steadily declined and stabilised at 0.4% in FY15. In our view, FMPL's asset quality is amongst the best in industry, which in a way validates its business model.

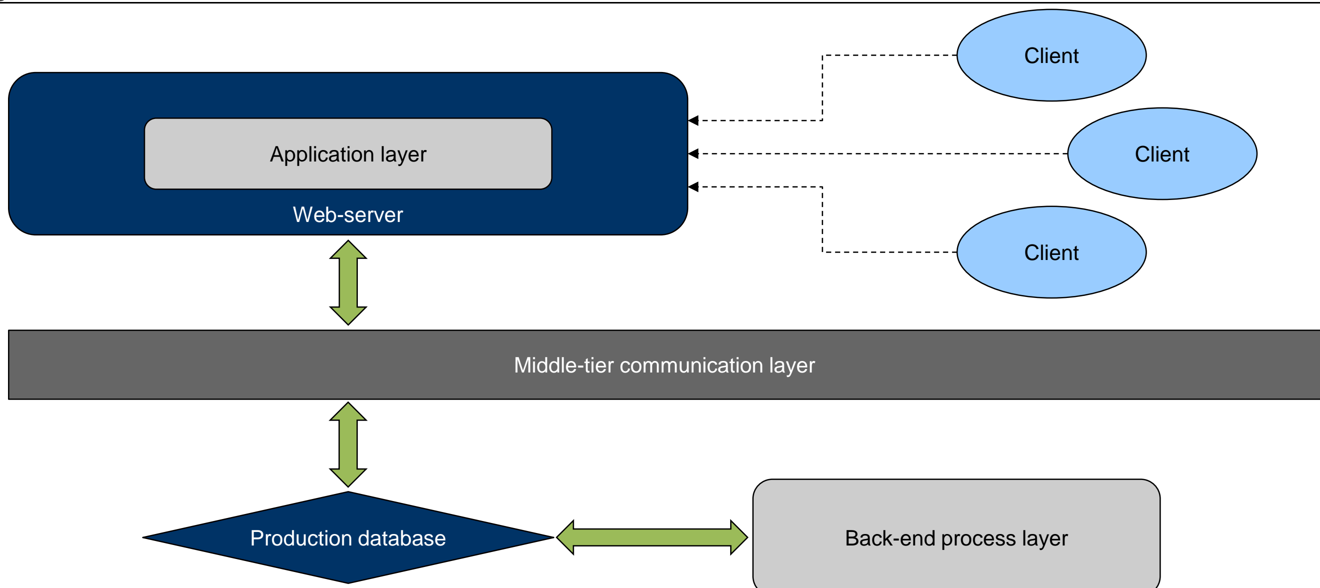
Delinquencies low despite robust growth in AUM over last five years

Strong technology platform

Fusion has implemented 'Shakti' – a core microfinance solution with real time and web-based cloud computing. It involves all aspects of gathering, storing, tracking, retrieving and using information within a business or organisation. The information system helps loan officers track client repayment schedules and balances, and management to assess the quality of loan portfolios, which in turn can improve transparency and efficiency, lower costs, improve reporting, and facilitate informed decision making.

MIS 'Shakti' involves all aspects of gathering, storing, tracking, retrieving and using information in a business

Fig 13 - Technical architecture of MIS



Source: Company

Management profile

Fig 14 - Key management team

Name	Designation	Profile
Devesh Sachdev	Chief Executive Officer	Mr. Sachdev is an XLRI Post Graduate with around 20 years of experience in the service industry, mainly at Citigroup and BSA. He served as the director of BSA and was in charge of strategy and finance.
Ashish Tewari	Chief Operating Officer	Mr. Tewari is an Economics, Law and Management graduate with over a decade of experience in financial services. He has earlier worked with the Development Credit Bank, GE and ICICI in various leadership positions.
Ankur Singhal	VP – Risk and Audit	Mr. Singhal has been working in the development sector for nearly a decade now. His first job was at PRADAN, a national level NGO, post which he joined Intellecap as zonal head, North India.
Praveen Choudhary	VP – Operations	Mr. Choudhary has over 13 years of experience in business operations and the financial Industry. He has worked in GE and Development Credit Bank in his past assignments and has expertise in identifying potential clients, developing new territories and executing sales plan with analysis.

Source: Company

Financials

Fig 15 - Income Statement

Particulars (Rs mn)	FY12A	FY13A	FY14A	FY15A
Interest income	60	90	214	492
Interest expense	19	55	98	277
Net interest income	**41**	**36**	**116**	**215**
Non-interest income	9	18	35	57
Net total income	**49**	**54**	**151**	**272**
Operating Expense	44	50	99	178
Pre-provisioning profit	**5**	**4**	**52**	**94**
Provisions	4	1	8	15
Profit before tax	1	3	44	80
Tax	(0)	(0)	14	27
Profit after tax	**2**	**3**	**30**	**53**

Source: Company

Fig 16 - Balance Sheet

Particulars (Rs mn)	FY12A	FY13A	FY14A	FY15A
Shareholders' funds	**124**	**211**	**241**	**491**
Non-Current Liabilities				
Long term borrowings	60	259	334	1,148
Long term liabilities	1	1	9	14
Long term provisions	1	2	5	15
Current Liabilities				
Short term borrowings	1	0	0	0
Other current liabilities	140	326	851	1,502
Short term provisions	2	5	8	23
Total	**328**	**804**	**1,448**	**3,192**
ASSETS				
Non-Current Assets				
Fixed assets	4	3	13	12
Deferred tax assets (net)	1	1	5	12
Loan portfolio	67	72	249	900
Long-term loans and advances	1	3	2	2
Other non-current assets	47	41	69	168
Current Assets				
Current investments	25	208	23	2
Cash and bank balance	22	88	253	525
Loan portfolio	151	342	779	1,479
Short-term loans and advances	4	6	11	6
Other current assets	8	39	45	87
Total	**328**	**804**	**1,448**	**3,192**

Source: Company

19 August 2015

Belstar Microfinance

Rapidly growing mid-sized player

Belstar Microfinance (Belstar, unlisted) started operations in 2009 after being acquired by the Hand-in-Hand group to scale up its microfinance business. Besides offering microfinance to the socially backward, Belstar focusses on their social mobilisation/capacity building – a key factor differentiating it from other MFIs. The company currently has an AUM of Rs 2bn and is one of the fastest growing mid-sized MFIs in South India. Going forward, it plans to expand into western states and is eyeing a 70% AUM CAGR over next three years.

- **Company profile:** Belstar was acquired by the Hand-In-Hand group (HIH) in FY08 to scale up its microfinance programme. The company secured NBFC-MFI registration in Dec'13 and currently has ~70 branches spread across five states with an AUM of ~Rs 2bn. Along with offering microfinance credit to the socially backward, Belstar focuses on their social mobilisation/capacity building, which makes it unique among MFIs. The Sarvam Mutual Benefit Trust owns ~61% in the company while foreign PE investors such as IFC, Norweigan Microfinance and Aavishkaar own 31%.

- **Portfolio concentrated in southern India:** Tamil Nadu (TN) accounts for 77% of Belstar's total portfolio, followed by Pondicherry and Karnataka at 9-10% each.

- **Set to expand into West/Central India, with focus on North ahead:** Management believes that western states such as Maharashtra, Gujarat and Madhya Pradesh offer good growth opportunity. Thus to reduce its concentration risk, strong growth is targeted in non-southern states, including expansion into North India over the next four years.

- **Aggressive growth plans with ROE target of 16-18%:** Belstar targets to grow its AUM to Rs 10bn over next three years (FY16: Rs 3.5bn, FY17: Rs 6bn, FY18: Rs 10bn), translating into a CAGR of 70%. Current profitability is low (FY15 ROE at sub-10%) but should improve going forward; also, the already-low operating costs should decline further as the investment phase gets over in the next 2-3 years. The company is eyeing a post-tax ROA of 3%, with ROE in the 16-18% range over the medium term as leverage will be kept at 5-5.5x over this period.

- **Other financial products, commodity selling a revenue-neutral exercise:** Management stated that selling financial products like pension, insurance and mediclaim policies do not generate high commission, which rather is largely offset by the cost incurred for running such products/schemes. The scenario is similar for other commodities such as solar lamps, bicycle and mobile phones. The only advantage is that it brings in customer loyalty and reduces asset quality risk to some extent.

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Key financials

Particulars	FY13	FY14	FY15
AUM (Rs mn)	962	1,234	2,038
Net profit (Rs mn)	14	26	30
Net worth (Rs mn)	198	308	338
ROA (%)	1.3	2.1	1.5
ROE (%)	7.2	10.3	9.3
PAR > 30 days (%)	0.1	0.1	0.0

Source: Company

Belstar Microfinance

Rapidly growing mid-sized player

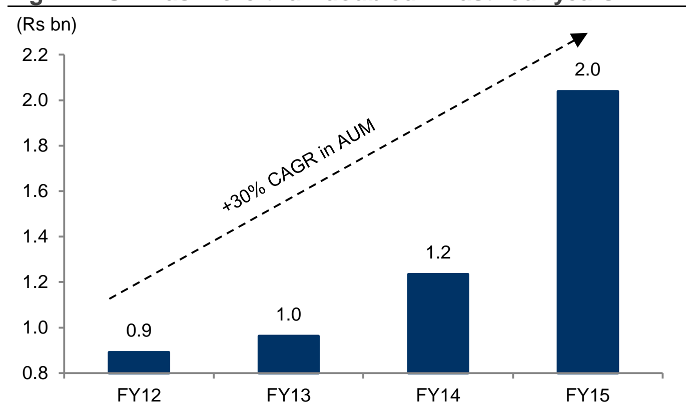
Operates in five states with an AUM of Rs 2bn as of FY15

Belstar was acquired in Sep'08 to provide scalable microfinance services to entrepreneurs nurtured by Hand-in-Hand (HIH) India's Self-Help Group (SHG) programme. It began operations in Mar'09 by using the capital raised from Dr. Kalpana Sankar and her family along with employees of the HIH group. During FY10, the Sarvam Mutual Benefit Trust (SMBT) pooled resources from all MBTs and invested ~61% as equity in Belstar. Apart from providing micro credit to socially backward people, it also focuses on social mobilisation/capacity building, which makes it unique in the space.

One of the fastest growing mid-sized MFIs

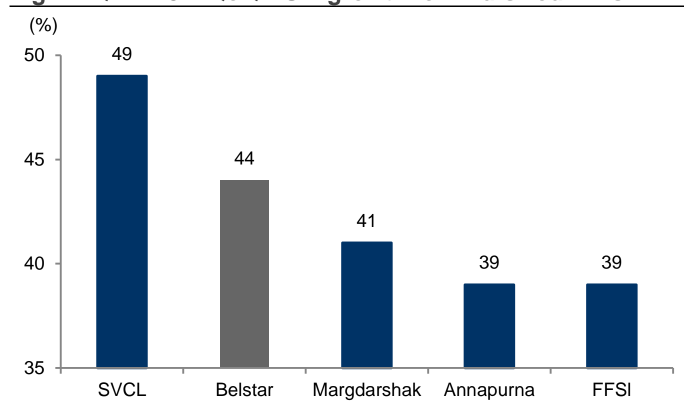
Belstar is a mid-sized MFI which operates in five states, namely Tamil Nadu, Pondicherry, Karnataka, Madhya Pradesh and Maharashtra. It is one of the fastest growing MFIs with an AUM of ~Rs 2bn as of FY15.

Fig 1 - AUM has more-than-doubled in last four years



Source: Company

Fig 2 - Q4FY15 – QoQ AUM growth for mid-sized MFIs

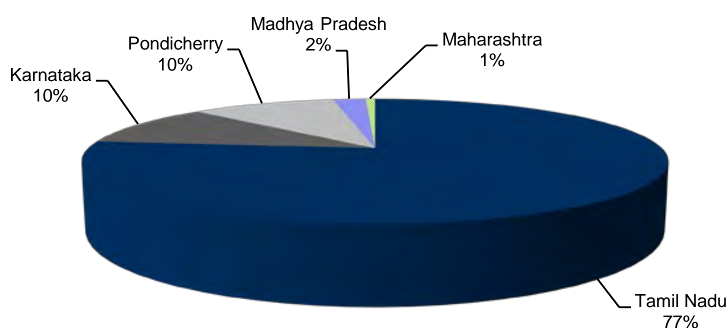


Source: MFIN, Company

A large part of its AUM is concentrated in southern India with Tamil Nadu accounting for 77% of the share followed by Karnataka and Pondicherry contributing ~10% each. To reduce its geographical concentration risk, Belstar plans to expand into northern states over the next four years, and also target higher growth in states such as Madhya Pradesh and Maharashtra.

Plans to expand presence in northern and central India to reduce concentration risk in the south

Fig 3 - Southern India accounts for 97% of AUM



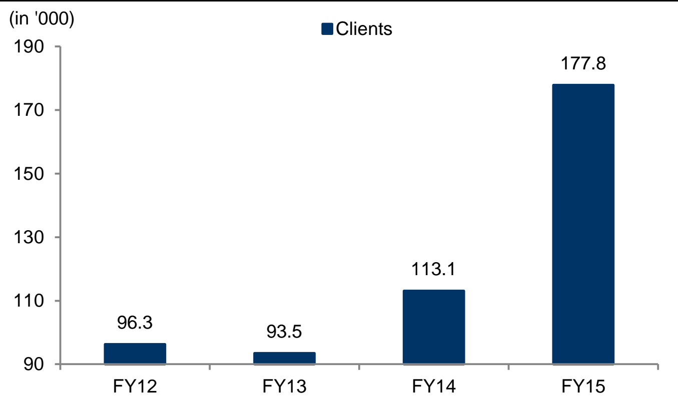
Source: Company

Belstar's AUM has more-than-doubled over FY12-FY15 led by an increase in client base as well as higher loan ticket sizes. The company's base of ~0.2mn clients as on FY15 grew at a 23% CAGR over last three years, with the average loan per borrower increasing from ~Rs 9,200 in FY12 to Rs 11,500 in FY15. Belstar plans to grow its AUM to Rs 10bn over the next three years (FY16 Rs 3.5bn, FY17 Rs 6bn, FY18 Rs 10bn), translating into a 70% CAGR.

Belstar Microfinance

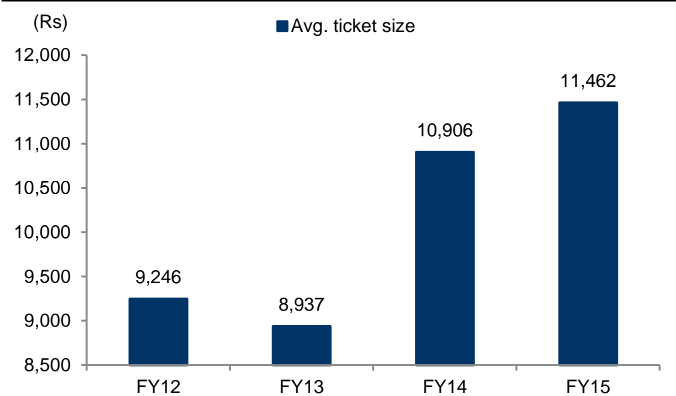
Rapidly growing mid-sized player

Fig 4 - Client base has grown at a 23% CAGR…



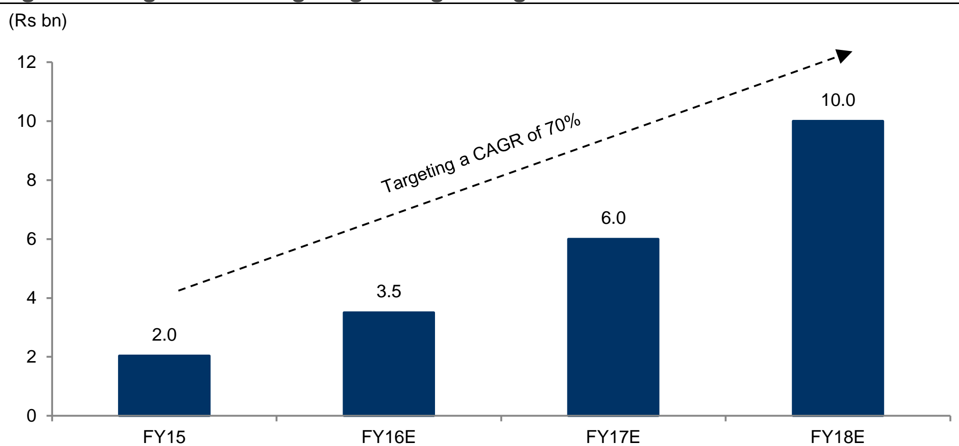
Source: Company

Fig 5 - …while ticket size of loans has also increased



Source: Company

Fig 6 - Management is targeting strong AUM growth of 70% over FY15-FY18E

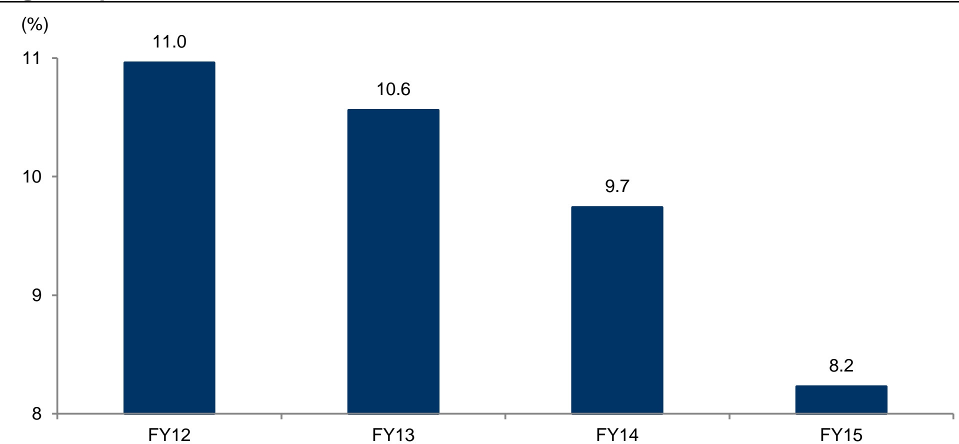


Source: Company

High operational efficiency

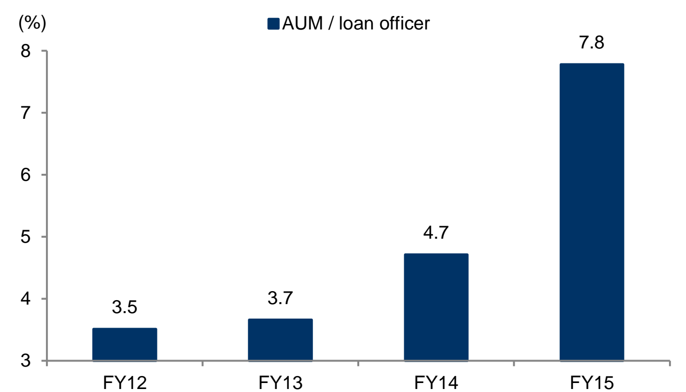
Despite the increased scale of operations, Belstar has controlled its operating cost ratio which declined from 11% in FY12 to 8.2% in FY15. The company has enhanced its operational efficiency by improving the productivity at both branch and employee level.

Fig 7 - Opex ratio has declined to 8.2%



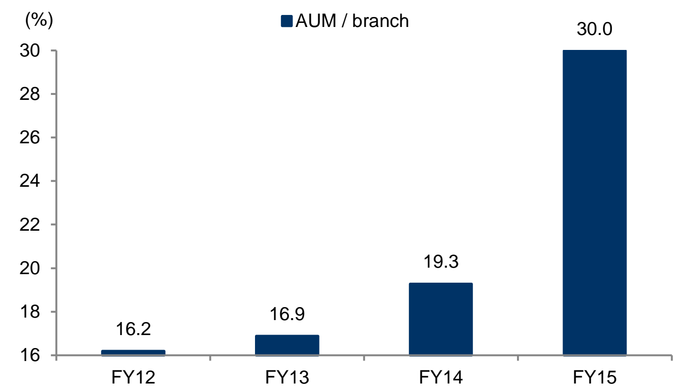
Source: Company

Fig 8 - AUM per loan officer has improved…



Source: Company

Fig 9 - …so has the AUM per branch



Source: Company

Management profile

Fig 10 - Key management team

Name	Designation	Profile
V. Venkatakrishnan	CEO	Mr. Venkatakrishnan has 30 years of experience in the banking and MFI domain. He previously worked in two MFIs at senior level, viz. Janalakshmi and Jagdhan Finance
P S Vijayalakshmi	CFO	Ms. Vijayalakshmi a Chartered Accountant and Company Secretary. She previously worked for Tata Consultancy Services and Ford Group
D. S. Chakravarthy	Head – Internal Audit	Mr. Chakravarthy is a CA and has 32 years of experience in Canara Bank
Ramesh Rajaraman	CTO	Mr. Rajaraman is an engineering graduate and has about 30 years of experience in the IT industry

Source: Company

Financials

Fig 11 - Income Statement

Particulars (Rs mn)	FY12A	FY13A	FY14A	FY15A
Interest income	141	213	236	329
Interest expense	74	109	108	181
Net interest income	**67**	**104**	**128**	**148**
Non-interest income	15	15	18	36
Net total income	82	118	145	184
Operating Expense	79	94	104	130
Pre-provisioning profit	**3**	**25**	**41**	**53**
Provisions	3	4	3	8
Profit before tax	0	21	38	45
Tax	-0	7	12	15
Profit after tax	**0**	**14**	**26**	**30**

Source: Company

Fig 12 - Balance Sheet

Particulars (Rs mn)	FY12A	FY13A	FY14A	FY15A
Shareholders' funds	**184**	**198**	**308**	**338**
Share capital	110	110	144	144
Reserves and surplus	74	88	164	194
Non-Current Liabilities				
Long term borrowings	394	280	388	794
Long term provisions	7	9	12	20
Current Liabilities				
Short term borrowings	193	96	95	96
Other current liabilities	313	489	642	1,206
Short term provisions	4	2	5	23
Total	**1,094**	**1,075**	**1,449**	**2,477**
ASSETS				
Non-Current Assets				
Fixed assets	5	3	4	7
Tangible assets	2	2	2	2
Intangible assets	4	1	2	5
Capital work in progress	-	-	-	3
Deferred tax assets (net)	2	3	5	7
Receivables under financing activity	104	189	221	406
Long term loans and advances	0	0	4	17
Other non-current assets	13	25	62	121
Current Assets				
Receivables under financing activity	786	774	1,013	1,632
Cash and bank balances	168	68	121	250
Short term loans and advances	8	3	6	8
Other current assets	7	10	14	25
Total	**1,094**	**1,075**	**1,449**	**2,477**

Source: Company

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