Microfinance

NEGATIVE

SECTOR UPDATE **March 17, 2016**

Will the dream run continue?

Given a large addressable market, growth will not be a constraint for Indian MFIs. However, maintaining current ROAs and ROE would be challenging as current low credit costs look unsustainable and opex/asset ratios are already lower than those of global peers. Banking licenses would give stability to MFIs given a stable deposit base, access to the entire gamut of services, and freedom from the purview of State Money Lending Acts. However, these MFIs would have to quickly ramp-up their low-cost deposit bases to maintain profitability/ growth in the face of regulatory costs of becoming a bank and lower availability of bank funding. Given lack of a long track record, want of a credible liability franchise, and risky nature of lending, there is no compelling reason for the valuation premium for the sector vs other NBFCs and small regional banks.

Huge growth potential: Given a large market size of ~₹3tn and low financing penetration of MFIs (~10% of total potential demand), we believe MFIs are likely to sustain robust growth in the foreseeable future.

Current robust asset quality unsustainable: Given the sub-prime nature of lending, MFIs' current credit costs of <1% seem unsustainable as credit costs of even secured products have been 3-4% across cycles. Moreover, historical credit costs of 3-30% for MFIs in other countries and India's own history of higher credit costs in the sector support our concerns. Investors need to watch out for two key risks: i) inability of MFIs to disburse new loans, and ii) adverse events in Tamil Nadu, Karnataka, Uttar Pradesh, Maharashtra and Madhya Pradesh – states that have cornered ~60% of MFIs' AUM.

Improving operational efficiencies; but could pose asset quality risks: Operating efficiencies of MFIs have significantly improved with opex/AUM ratio coming down ~13% in FY12 to 7-8% in YTDFY16, driven by bigger ticket sizes and higher number of loans per employee. RBI relief on borrower lending cap could boost operating leverage to ~6%. However, increasing ticket sizes and higher number of loans per employee could inflate credit costs, offsetting operational efficiency gains.

Bank MFIs better placed in the long term: MFIs-turned-banks are structurally better placed than NBFC MFIs due to access to low cost of funds, ability to provide entire gamut of financial services and being out of the purview of State Money Lending Acts. However, loan growth would be constrained in the short term as bank MFIs change liability mix to meet RBI guidelines. This could help NBFC MFIs' loan growth as MFIs that banks can lend to meet PSL requirements are now fewer; resulting in improvement in both availability and cost of funding for NBFC MFIs.

What about profitability after conversion to banks? Conversion to banks could reduce RoA of MFIs by ~170bps (current RoA at ~3.5%). To offset this, MFIs would have to decrease funding costs by ~370bps. Assuming a deposit mix with 25% CASA ratio, deposits would have to replace ~75% of total existing liabilities for such a decline in funding cost.

What should be the reasonable valuations for the sector? Given lack of a long track record, low or negligible cross-cycle profitability, absence of a credible liability franchise, and risky nature of lending, there is no compelling reason to pay a higher multiple to MFIs over other NBFCs and small regional banks. Loan growth, we believe, should be the last reason to pay a premium for a lender in a credit-starved country where lenders struggle to collect even secured credit.

BFSI

Stocks discussed

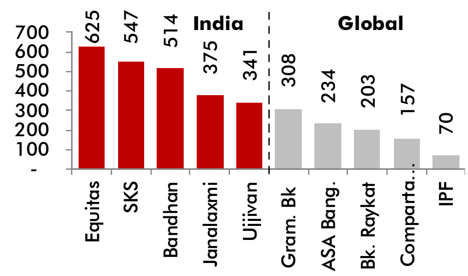
SKS Microfinance	**NOT RATED**
Ujjivan Fin. Services	**NOT RATED**
Equitas	**NOT RATED**

Credit costs for MFIs across the world are high

Lender	Geography	Avg. credit costs	Time period
International Personal Fin.	Europe/Latin America	28.40%	2007-15
Compartamos	Mexico	4.80%	2006-15
Grameen Bk.	Bangladesh	4.50%	1998-13
Equity Bk.	Kenya	2.20%	2004-14
Bank Raykat	Indonesia	2.20%	2001-15
ASA Bangladesh	Bangladesh	0.90%	2002-15

Source: Company, Ambit Capital Research

Indian MFIs have higher borrower count per employee



Source: Company, Ambit Capital Research

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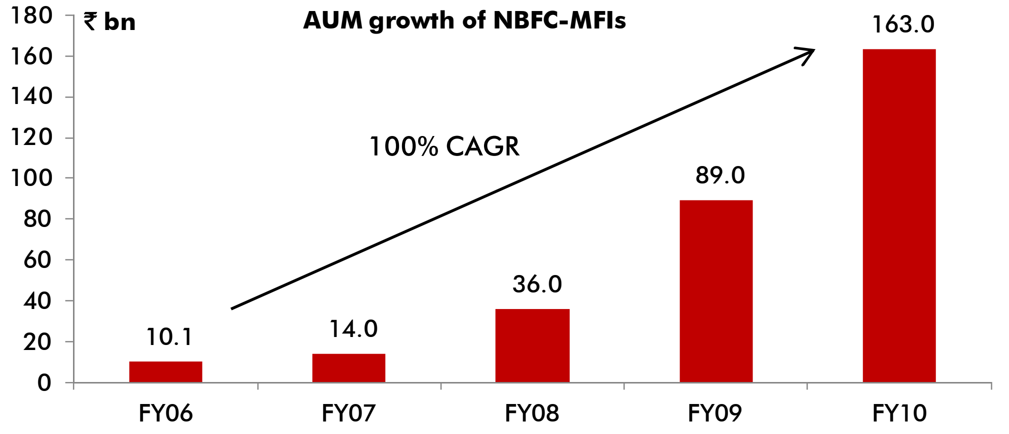
Microfinance: A roller-coaster ride

The Indian microfinance industry has been on a roller-coaster ride in the first decade of its existence. FY06-10 was characterised by robust growth and profitability. However, a mass default in the state of Andhra Pradesh (AP) in 2010 led to bankruptcy of many MFIs with high exposure to the state and resulted in a funding crunch for the sector. The crisis drove the RBI to frame a new set of regulations for the sector. Funding for the sector has picked up over the past three years and the sector is back on the growth and profitability path. The sector has found favour with the RBI as reflected in the fact that it received 8 of 10 small finance bank licenses issued last year.

FY06-10: The ascent

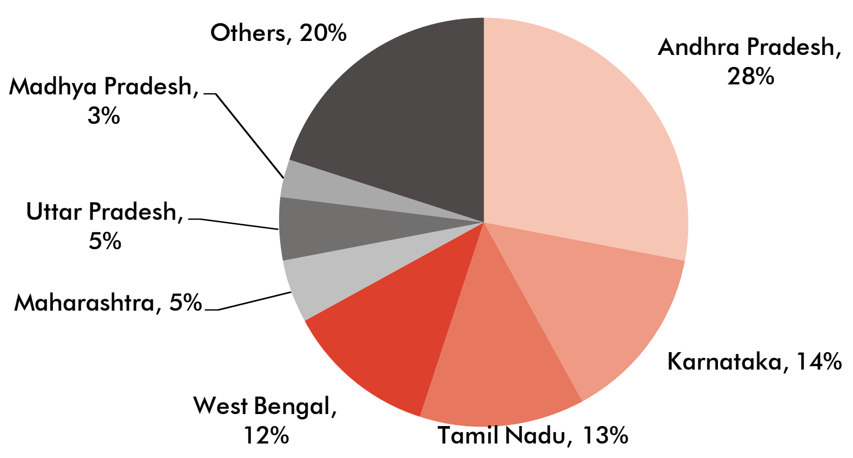
The microfinance industry started gathering pace in India in 2005 and grew at a scorching pace of 100% CAGR over FY06-FY10. Andhra Pradesh was the centre of microfinance in India during the period, contributing ~30% of the industry' loan book as of Mar'10.

Exhibit 1: Spectacular growth of Indian MFI industry over FY06-10



Source: Sa-Dhan, MFIN, Ambit Capital research

Exhibit 2: Andhra Pradesh dominated the exposure of MFIs in 2010



Source: Sa-Dhan, MFIN , Ambit Capital research

SKS Microfinance was the poster boy of the sector during this period. It expanded its loan book at a 160% CAGR over FY06-10 and raised ₹17bn from a blockbuster IPO in **Aug'10 that valued the company at ₹120bn**.

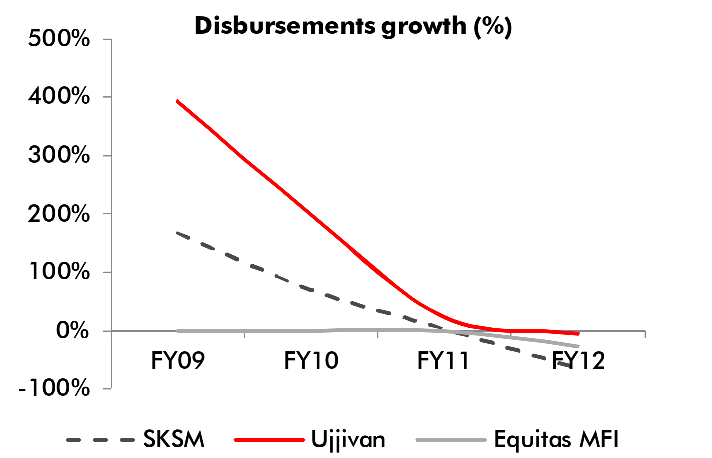
FY10-12: The descent

However, the party did not last long. Following reports of suicides by some women borrowers, the AP government passed an ordinance in **Oct'10** restricting the activities of MFIs in terms of new disbursements and collections. The cause of the borrowers was supported by some political parties, which led to a mass default in AP. Microfinance companies lost 30-40% of their outstanding portfolio in the sector due to this mass default.

Most microfinance companies which had significant exposure to AP went bankrupt after the mass default. SKS Microfinance suffered losses to the tune of ₹17.4bn over 4QFY11-2QFY13, which wiped out ~95% of its net worth and ~96% of its market cap during the period. However, SKS was able to survive as it had raised a large sum of equity just before the event, which kept it afloat.

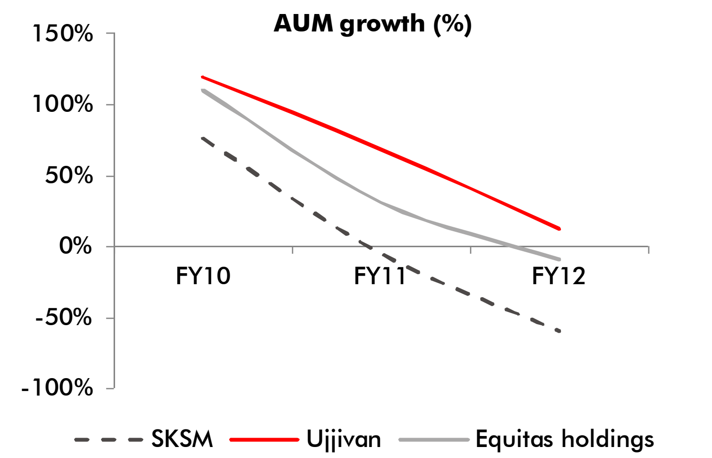
Banks and equity investors stopped funding the sector due to the default, leading to de-growth in the sector. Even MFIs operating in other states faced liquidity crunch, which resulted in de-growth in the sector over FY11-13.

Exhibit 3: Disbursements for leading MFIs declined over FY10-12…



Source: Company, Ambit Capital research

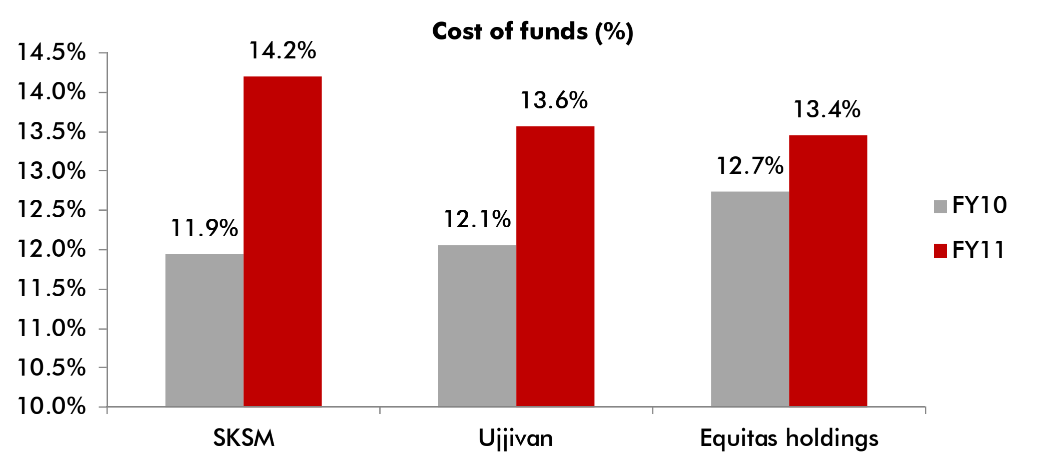
Exhibit 4: …leading to decline in AUM growth



Source: Company, Ambit Capital research

The reduced appetite of banks to fund MFIs was also visible in a sharp increase in funding cost of MFIs post the AP crisis.

Exhibit 5: Increase in funding costs for MFIs over FY10-11



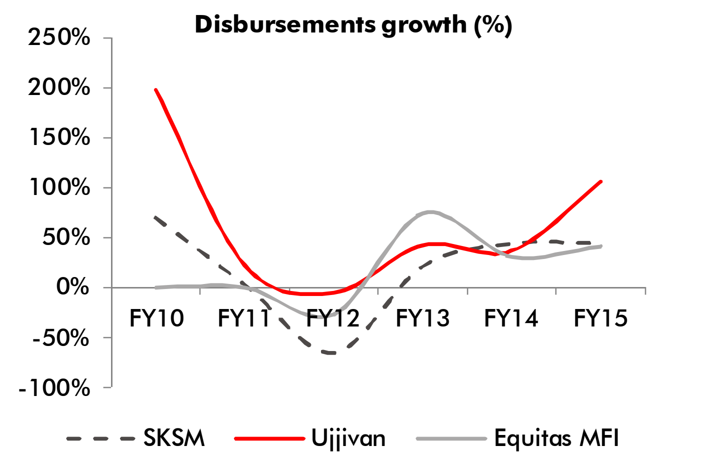
Source: Company, Ambit Capital research

The mass defaults in AP led the RBI to introduce a new set of regulations for MFIs in Dec'11. Some of the key regulatory changes for the sector were: capping the net interest spread at 10%, restricting per borrower lending limit at ₹50,000 across MFIs, and minimum tenure of 2 years for loans above ticket size of ₹15,000.

FY12 onwards: Revival after regulatory intervention

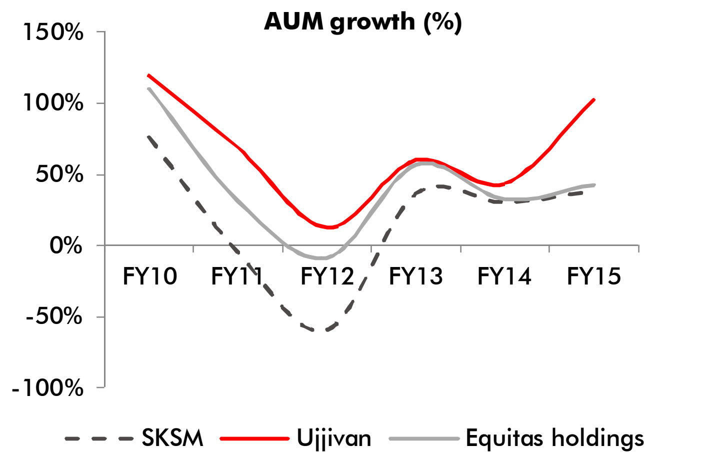
The industry resumed the growth path from 2012. It registered a CAGR of over 50% over FY12-YTDFY16 as funding from banks to MFIs increased.

Exhibit 6: Disbursements of MFIs picked up post FY12...



Source: Company, Ambit Capital research

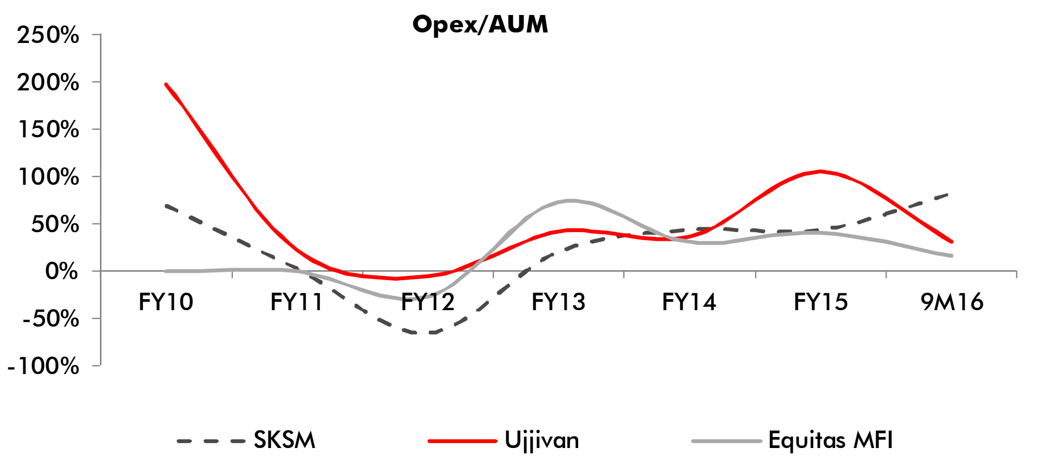
Exhibit 7: ...driving improved AUM growth after FY12 slowdown



Source: Company, Ambit Capital research

With growth coming back, operational efficiencies of MFIs started improving with cost-to-asset ratios increasing by over 10 percentage points to 6-7% for most MFIs.

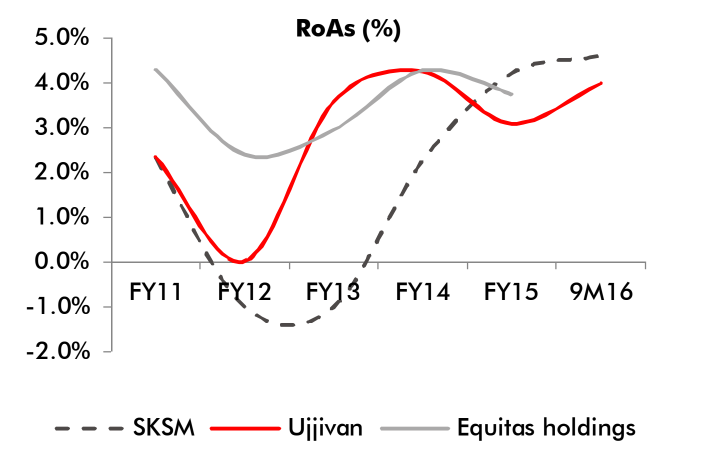
Exhibit 8: Opex/AUM ratios have improved for MFIs



Source: Company, Ambit Capital research

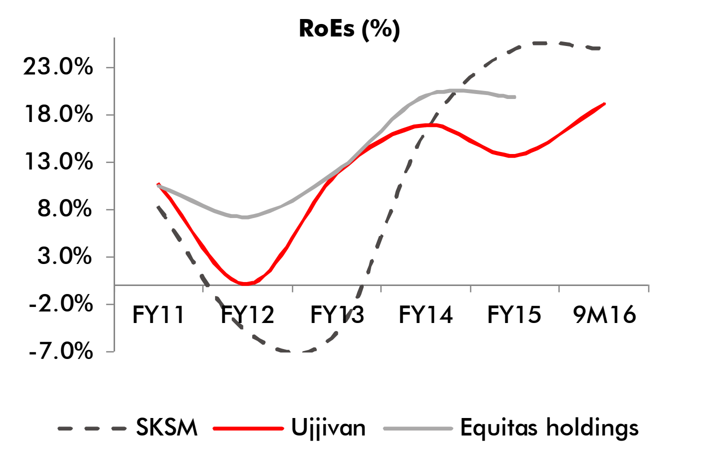
Moreover, the asset quality performance of the sector has been impeccable over the past three years which, coupled with growing loan book and falling cost-to-asset ratios, resulted in significant ROA and ROE improvement for the sector.

Exhibit 9: RoA of MFIs improved significantly after FY12…



Source: Company, Ambit Capital research

Exhibit 10: … driving improvement in RoE too



Source: Company, Ambit Capital research

Evolving into banks – answering key investor questions

The RBI announced setting up of small finance banks last year. MFIs were the favourites with the RBI, grabbing 8 of 10 small finance licenses. Two of these MFIs that got SFB licenses, Ujjivan and Equitas, have filed their draft IPO prospectuses and are expected to hit the markets soon. In this context, we answer some key questions investors have asked us in our recent interaction with them on the sector:

1) What is the growth potential in the MFI space?
2) Is the currently robust asset quality of MFIs sustainable?
3) When will the asset quality of MFIs deteriorate?
4) What has driven recent improvements in operating efficiency of MFIs?
5) How much can operating efficiency improve further from here on?
6) How will small finance banks impact the competitive landscape for NBFC-MFIs?
7) What will be the profitability of MFIs post their conversion into a bank?
8) What is the future regulatory framework for NBFC-MFIs?

Q#1: What is the growth potential in the MFI space?

With a large market size of ~₹3tn and low financing penetration (~10% of the total potential demand), MFIs could sustain robust growth in the foreseeable future. Moreover, with more than 50% of MFI loans concentrated in only four states, growth for MFIs can increase as the remaining states are tapped.

Various sources peg the size of the microfinance opportunity between ₹1.5tn-₹3.3tn. Our analysis backs the view that the potential market size is ~₹3tn. With low financing penetration in this segment (current outstanding loans of MFIs being just ₹367bn, ~10% of the total potential demand in the sector) and slower offtake of the rival SHG programme (11% CAGR over FY11-14), we believe MFIs could sustain robust growth in the foreseeable future.

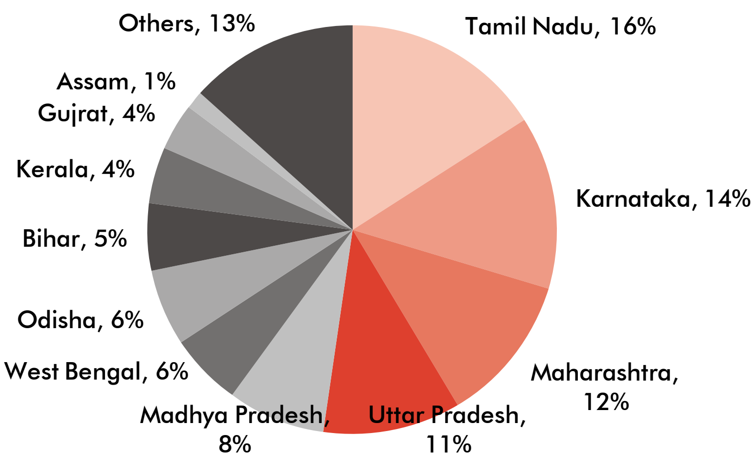
Exhibit 11: MFI is a large market with very low levels of penetration

Particulars	Units
Households in India (mn)	247
Households without access to credit (mn)	99
Per ticket loan (₹)	30,000
Potential opportunity (₹ bn)	**2,960**
Current market size (₹ bn)	**796**
MFI	367
SHG	429
Financing penetration – overall	**27%**
MFI	10%
SHG	17%

Source: Census 2011, GOI, RBI, NABARD, Ambit Capital research

Moreover, more than 50% of MFI loans are still concentrated in four states (Tamil Nadu, Karnataka, UP and Maharashtra). This indicates huge growth potential.

Exhibit 12: More than 50% of MFI loans are concentrated in just four states



Source: MFIN, Ambit Capital research

From a funding availability perspective, the microfinance industry is still less than 1% of the Indian banks' total outstanding credit. Therefore, funding should not be a challenge for the sector as long as it is able to maintain asset quality.

Q#2: Is the current robust asset quality sustainable?

Credit costs of MFIs have meaningfully improved from 4-40% in FY11-13 to sub-1% levels currently. Such low credit costs look unsustainable due to the unsecured and sub-prime nature of MFI lending. Credit costs even in secured products like tractors/used CVs/two-wheelers have been in the range of 2-4% across cycles in India. Moreover, historical credit costs of 3-30% for MFIs operating in other countries and India's own history of higher credit in the sector indicate the unsustainability of current low credit costs of MFIs.

MFIs hit a rough patch in FY11-FY13 when those exposed to AP saw a sharp spike in credit costs. Even some not exposed to AP saw an increase in delinquencies during the period. However, credit costs started coming down from FY14 and have averaged ~50bps over the past three years.

Exhibit 13: Credit costs of MFIs have hit a purple patch recently

Credit costs	FY10	FY11	FY12	FY13	FY14	FY15	YTDFY16*
SKSM	NA	5.0%	42.9%	13.3%	0.6%	0.3%	0.6%
Ujjivan	1.1%	0.9%	0.9%	0.8%	0.6%	0.9%	0.6%
Equitas MFI	1.1%	4.0%	0.6%	0.6%	0.4%	0.5%	0.5%
MFI Industry (PAR** –180dpd)	0.5%	31.2%	2.0%	0.4%	0.1%	0.1%	0.1%

*Source: Company, Ambit Capital research, MFIN; *Note: 9MFY16 for SKSM, 1HFY16 for Ujjivan and 1QFY16 for Equitas MFI; **PAR stands for portfolio at risk; Source: MFIN.*

However, the key question is whether these levels are sustainable given low credit costs have been the key drivers of improvement in profitability of MFIs over the past three years.

Based on various data points, we believe the current sub-1% credit costs of MFIs are not sustainable. We say so based on following observations:

High credit costs in other risky lending segments: Credit costs in other risky loans (like tractors/used CVs/two-wheelers) have been in the range of 2-4% in India despite these products being secured. Given MFI loans are unsecured and are given to people at the bottom of the pyramid, it seems unlikely that microfinance loans can have lower credit costs than other secured products.

Exhibit 14: Credit costs of secured lending products are much higher

Product	Average credit costs
Tractor Financing	~3-4%
2-wheelr financing	~3-5%
Subprime SME loans	~2-3%
Used CV loans	~2-3%

Source: Ambit Capital research

Global experience in microfinance indicates much higher credit costs: The Indian MFI model is not strictly comparable with the MFI business in other countries. However, the long-term credit costs in microfinance business in other countries are high. Data from some prominent MFIs in other countries shows average credit costs in the range of 1%-30%. We have not come across any substantial argument from Indian MFIs to believe that credit costs of Indian MFIs could be structurally lower than those of their global counterparts.

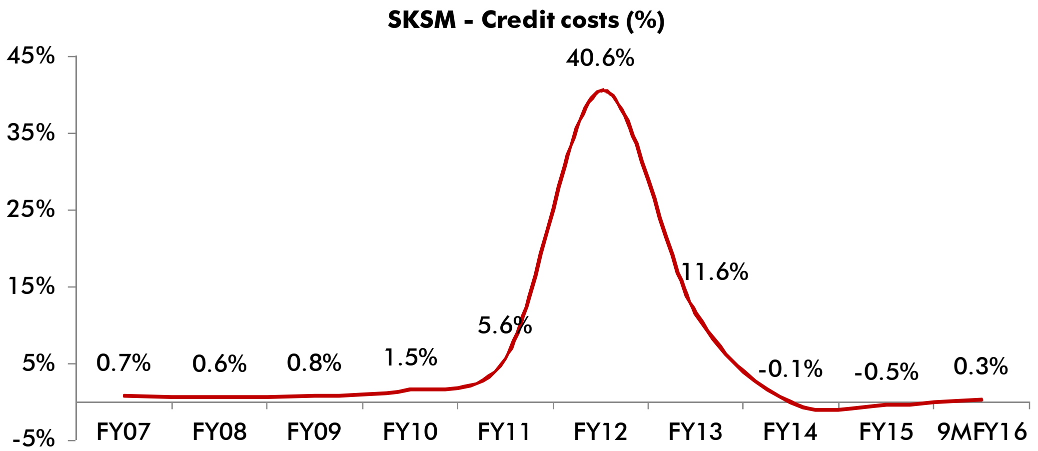
Exhibit 15: Credit costs for MFIs across the world are higher

Lender	Geography	Average credit costs	Time period
International Personal Finance	Europe/Latin America	28.4%	2007-15
Compartamos	Mexico	4.8%	2006-15
Grameen Bank	Bangladesh	4.5%	1998-13
Equity Bank	Kenya	2.2%	2004-14
Bank Raykat	Indonesia	2.2%	2001-15
ASA Bangladesh	Bangladesh	0.9%	2002-15

Source: Company, Ambit Capital research

Credit costs in India have averaged at >5% in the past decade: There is no comprehensive data available for historical credit cost of Indian MFIs. However, if we take SKS as a representative of Indian microfinance, credit costs for even Indian MFIs should have averaged at >5% in the last decade.

Exhibit 16: Credit costs have averaged at >5% for SKS



Source: Company, Ambit Capital research

Busting some myths ...

Myth #1: Andhra Pradesh event was a one-off

Many investors have argued that the AP mass default was a rare event and, hence, the losses should not be counted in arriving at average credit costs for Indian MFIs. However, looking at the history of microfinance across the world, AP-like events have been a common phenomenon and several microfinance institutions have gone bankrupt because of such mass defaults. Hence, another mass default in the sector cannot be ruled out, especially in a country like India where votebank politics is rampant (even at the local level).

Exhibit 17: Mass defaults are frequent in the MFI industry

Country	Events which triggered the mass default	Impact
Nicargua (Mid-2008)	In mid-2008, a movement began in Nicaragua called "Movimiento No Pago" (a movement for non-payment of loans). This movement is supported mostly by farmers of the north of Nicaragua with ties to the left-wing party in Nicaragua.	PAR increased to ~15% in the northern region and forced many MFIs to close their shops.
Morocco(Late-2008)	MFIs have started experiencing rising delinquencies but problem escalated when the merger and acquisition of a large distressed MFI became public.	PAR increased to ~10%.
Bosnia and Herzegovina (Late-2008)	Recession in Europe	PAR increased to ~7% despite aggressive write-offs by MFIs.
Pakistan (Late-2008)	A loan waiver proclamation by a local politician, and the spread of false loan waiver news stories, gave momentum to the mass defaults.	PAR increased to ~12%.
Kolar, India (Mid-2009)	A decree issued by some religious leaders to not pay back the loans taken from micro-finance institutions.	This led to defaults in the range of 25%-80% of the outstanding loans as per industry sources.
Andhra Pradesh, India (Late-2010)	Farmer suicides in 2010 caught the attention of media and local politicians. Eventually, due to public and political pressure the state government has to pass an ordinance which severely disrupted the collection process of MFIs.	Credit costs increased ~40% of SKS's entire loan book. Many MFI's based in Andhra Pradesh went under liquidation.

Source: Consultative Group to Assist the Poor (CGAP), Various media sources, Ambit Capital research

Myth #2: Credit costs have been lower in non-AP states

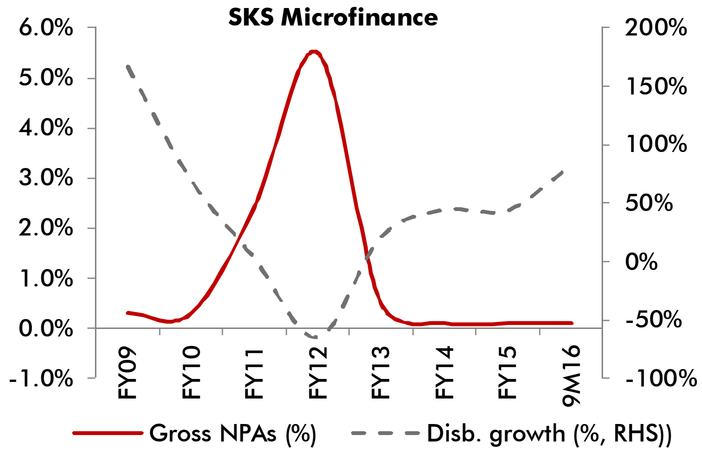
It can be argued that credit costs of select lenders (e.g., SKS) are not a true representation and they were inflated by the mass defaults in AP. However, we would like to highlight that credit costs of even SKS averaged at 6.3% in other states during FY11-FY13 despite no mass defaults and SKS was not able to make fresh disbursals in other states due to the liquidity crunch.

Exhibit 18: SKS' credit costs in states other than AP have been significantly high

Time period	Non AP provisions & write-offs (₹ mn)	Non AP AUM (₹ mn)	Credit costs (%)
3QFY11	340	35,260	3.9%
4QFY11	496	27,060	7.3%
1QFY12	574	21,010	10.9%
2QFY12	510	16,350	12.5%
3QFY12	260	11,850	8.8%
4QFY12	320	13,200	9.7%
1QFY13	100	12,290	3.3%
2QFY13	10	13,720	0.3%
3QFY13	3	14,960	0.1%
4QFY13	10	20,160	0.2%
1QFY14	120	20,030	2.4%
Total write-offs as a % of beginning non AP book during the crisis period (3QFY11 to 1QFY14)			**7.4%**
Quarterly average credit cost			**5.4%**

Source: Company, Ambit Capital research

Exhibit 19: SKS' asset quality worsened significantly as disbursements declined in states other than AP



Source: Company, Ambit Capital research

The above data points give a reasonable indication that current credit costs of MFIs are not sustainable.

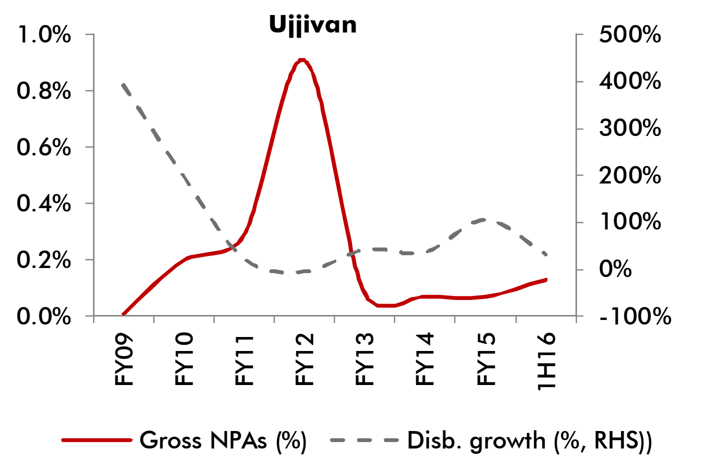
Q#3: What could lead to deterioration in the asset quality of MFIs?

The history of mass defaults and credit costs of Indian MFIs indicate that investors should watch out for these two key risks: i) inability of MFIs to disburse new loans; and ii) any adverse events in the 5 key states of Tamil Nadu, Karnataka, Uttar Pradesh, Maharashtra and Madhya Pradesh.

Inability of MFIs to disburse new loans

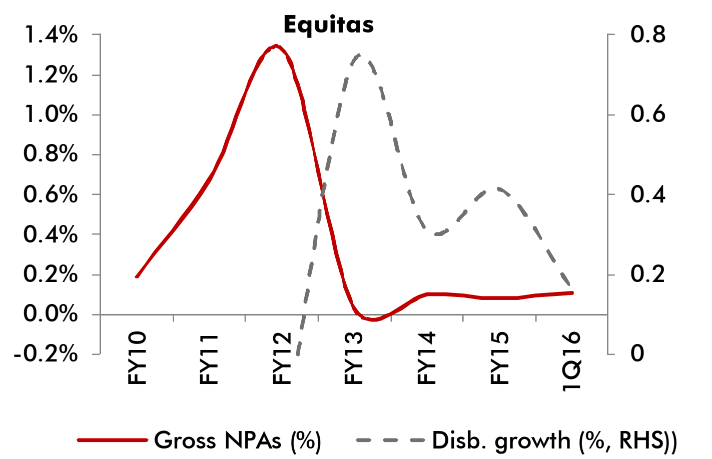
SKS' credit costs increased in states other than AP when it was not able to disburse new loans. Asset quality of non-AP MFIs deteriorated as well when they faced a funding crunch. These events indicate that continuity of business and disbursements is key for MFIs to maintain their asset quality.

Exhibit 20: Ujjivan's asset quality worsened despite minimal exposure to AP due to decline in disbursements



Source: Company, Ambit Capital research

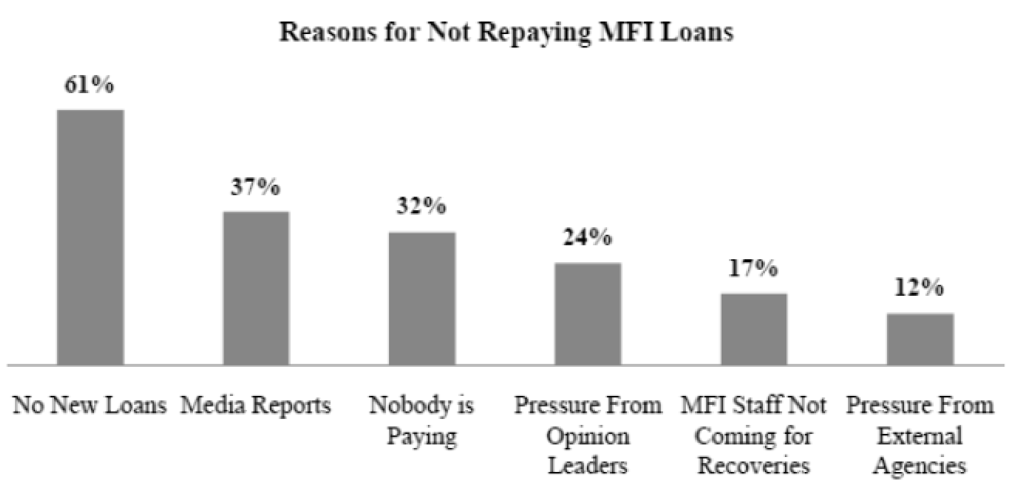
Exhibit 21: Equitas' asset quality worsened despite having minimal exposure to AP as its disbursements declined



Source: Company, Ambit Capital research

Even a survey done by microfinance self-regulatory body MFIN indicates how critical it is for MFIs to keep disbursing new loans to maintain their asset quality.

Exhibit 22: MFIN study highlights fresh disbursals are a key driver for repaying MFI loans



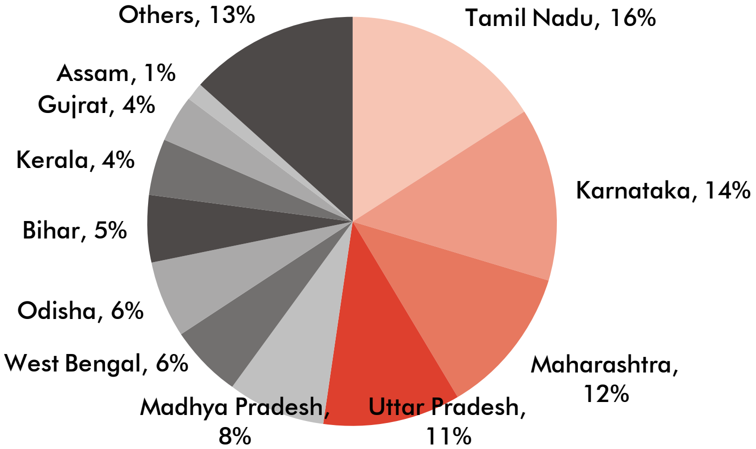
Source: MFIN, Ambit Capital research

Hence, we urge investors to keep a close eye on the liquidity situation of the lender and political and climatic changes in the states the lender operates in to monitor the ability to disburse new loans.

Watch out for political, religious, social and climatic adversities in 5 key states

Mass defaults have been the major reason for MFI failures. Hence, investors should closely monitor political, religious, social and environmental developments in the states the lender is most exposed to. Currently, Tamil Nadu, Karnataka, Uttar Pradesh, Maharashtra and Madhya Pradesh are the states in which MFI loan portfolios are concentrated.

Exhibit 23: More than 50% of MFI loans are concentrated in four states



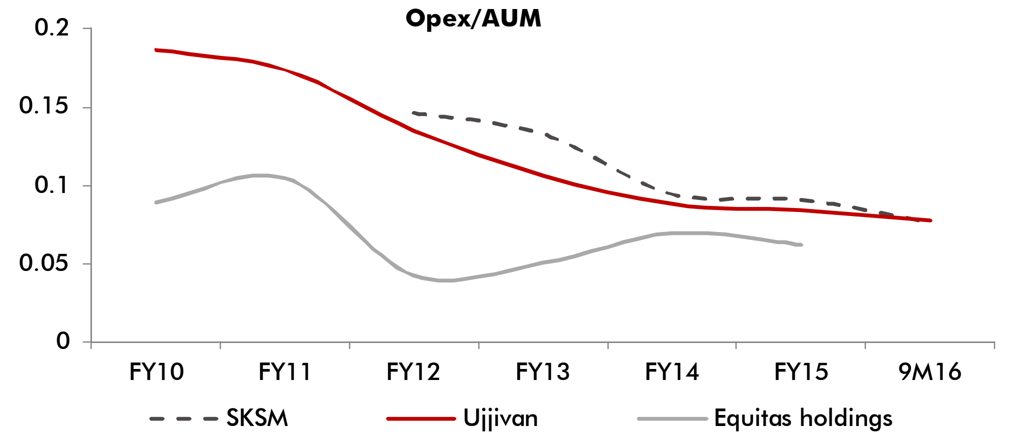
Source: MFIN, Ambit Capital research

Q#4: What has driven recent improvements in operating efficiency?

Operating efficiencies of MFIs have significantly improved from ~13% in FY12 to 7-8% in YTDFY16. This has been driven by increase in ticket sizes of loans and a higher number of loans per employee.

Operating efficiency of MFIs has improved meaningfully after FY12, with the opex/AUM ratio declining from ~13% in FY12 to 7.5% in YTDFY15.

Exhibit 24: Operating efficiencies of MFIs have improved after FY12

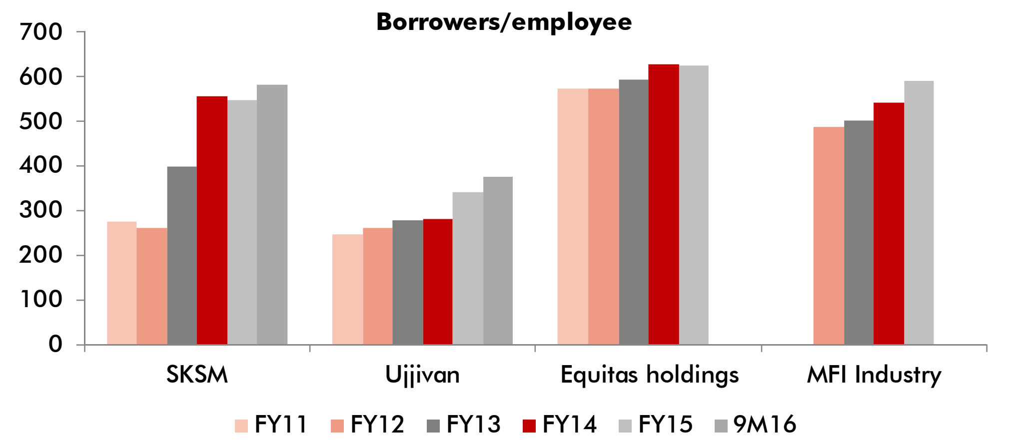


Source: Company, Ambit Capital research

Given that many MFIs were at a nascent stage of operations in FY12 (e.g., Ujjivan and Equitas) and were operating at a much smaller scale, loan growth over the last three years has helped these companies to sweat their fixed overheads over a larger loan book. However, the improvement in the operational efficiency has been a result of primarily two changes:

Increased employee productivity: With growth picking up for the sector, the number of loan accounts an employee handles has gone up during this period. On average, the number of loan accounts per employee for three MFIs we analysed increased from ~365 borrowers in FY12 to ~505 in 9MFY16.

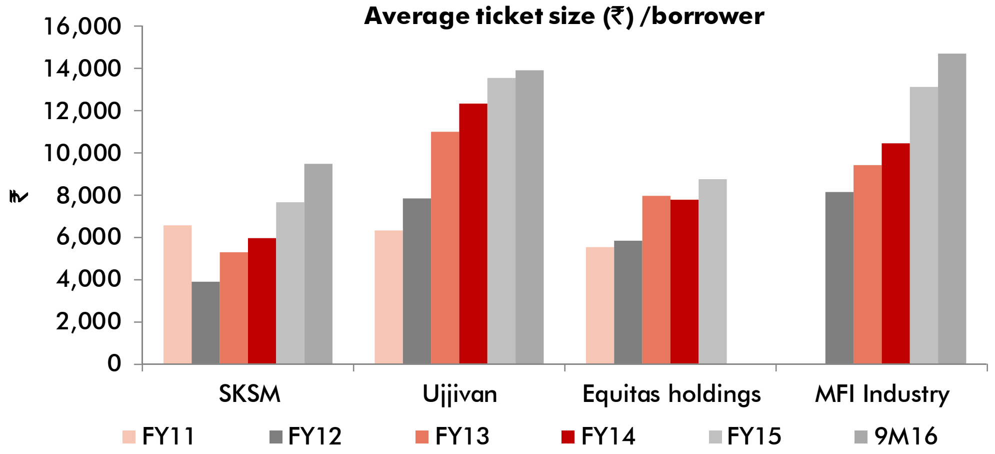
Exhibit 25: Borrowers per employee have increased meaningfully for MFIs



Source: Company, Ambit Capital research; Note: The data is based on number of employees for the MFIs and on number of loan officers for the entire industry.

Increased ticket size per borrower: The average ticket size per borrower has also increased over FY12–9MFY16 from ~₹8k to ~₹15k.

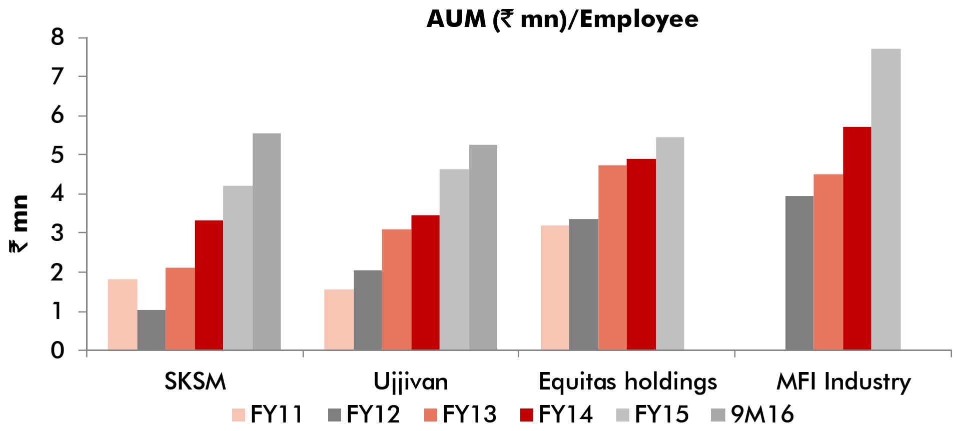
Exhibit 26: Average ticket size per borrower has increased for MFIs



Source: Company, Ambit Capital research

The increase in the number of borrowers per employee and bigger ticket size per borrower have resulted in loan book/employee for MFIs increasing by 3x over the last 6 years.

Exhibit 27: Average AUM per employee has increased for MFIs



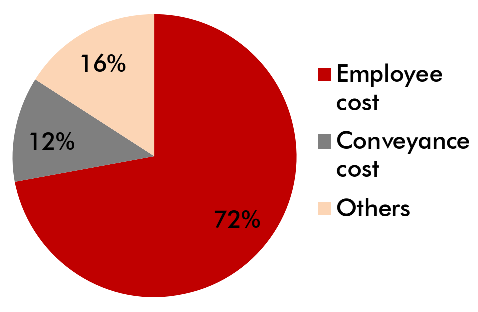
Source: Company, Ambit Capital research

Q#5: How much can operating efficiency improve hereon?

With the cap on borrower lending limits recently relaxed by the RBI, operating leverage can improve from current levels to ~6% due to increase in ticket sizes. However, higher ticket sizes and higher number of loan employees could also result in higher credit costs for MFIs, offsetting gains from operational efficiency.

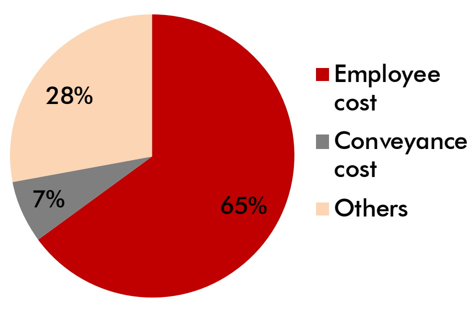
Given that employee expenses form 60-70% of the total expenses of MFIs and travel expenses these employees incur to cater to borrowers forming another 7-12% of expenses, there is a huge operating leverage in the business model if each employee is able to serve more borrowers and give more money to each of these borrowers.

Exhibit 28: Opex breakup of SKS



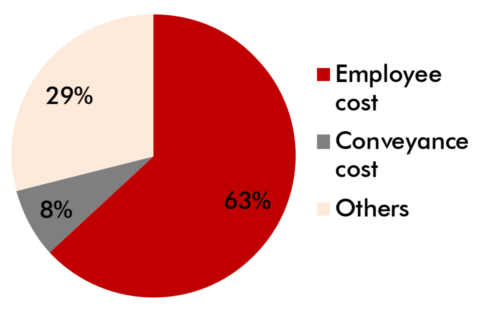
Source: Company, Ambit Capital research

Exhibit 29: Opex breakup of Ujjivan



Source: Company, Ambit Capital research

Exhibit 30: Opex breakup of Equitas



Source: Company, Ambit Capital research

So the key question is whether there is further scope for improvement in operational efficiency for MFIs. Looking at borrowers per employee for SKS indicates there is ample room for improvement for Equitas and Ujjivan. Moreover, the RBI recently relaxed some rules on per borrower lending limits, which gives significant scope to MFIs to increase their ticket sizes.

Exhibit 31: Regulator has relaxed borrower limits for MFIs

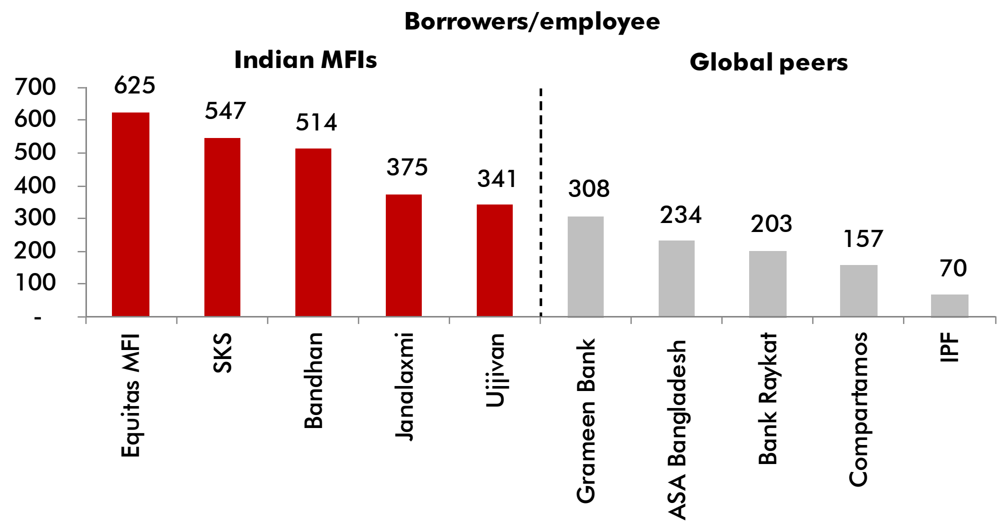
Before…
Per borrower lending limit at ₹50,000 across MFIs – Dec'2011.
Minimum tenure of 2 years for loans above ticket size of ₹15,000 – Dec'2011.
…After
Borrower lending limit across MFIs has increased from ₹50,000 to ₹100,000 – April'15.
Maximum lending limit for loan of tenures up to 2 years has increased from ₹15,000 to ₹30,000 – Nov'15.

Source: The RBI, Ambit Capital research

However, increasing number of borrowers per employee and higher ticket size per employee have pitfalls. Given that microfinance loans are unsecured loans given to people with unstable income and those who are susceptible to manipulations by political and religious leaders (as explained in an earlier section), it is imperative that MFI loan officers meet their borrowers more frequently to maintain asset quality. An increase in the number of borrowers serviced limits that ability of loan officers. Hence, an increase in the number of borrowers per loan officer beyond a certain level would elevate asset quality risks for the lenders.

While it is difficult to estimate the right number of borrowers per employee, a comparison with global peers shows that this ratio is high for the Indian MFIs (though business models are not strictly comparable).

Exhibit 32: Indian MFIs have higher borrower count per employee than their global counterparts



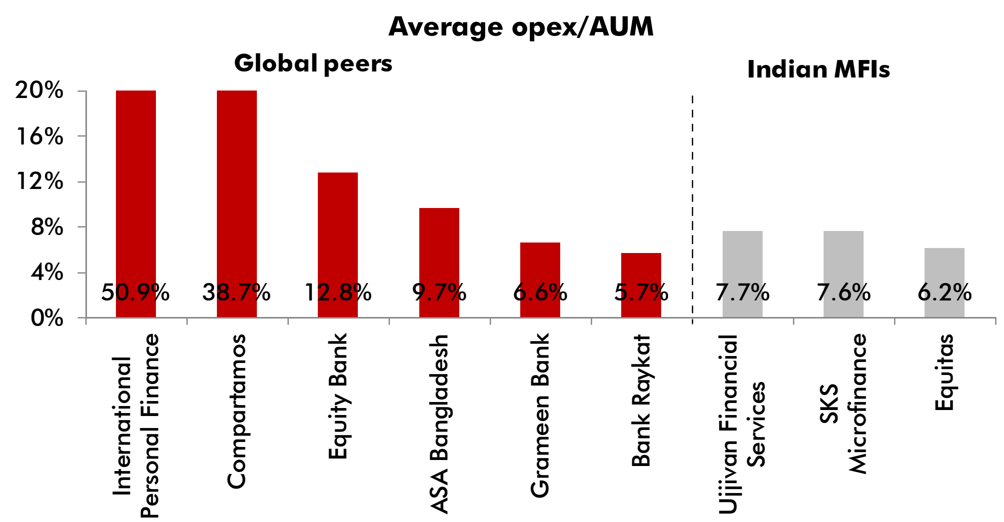
Source: Company, Ambit Capital research

Increased ticket sizes could elevate asset quality risks: Increased ticket sizes per borrower without a commensurate increase in the paying capacity of the borrowers could increase default risks for the borrowers. While RBI rules prevent excessive leveraging at the borrower level from MFIs, these borrowers could always over-leverage themselves by borrowing from informal sources.

Hence, higher borrowers per employee and higher ticket sizes per borrower might not necessarily be the best way to increase operational efficiency unless backed by proper checks and balances.

Overall, the opex/ AUM ratio of Indian MFIs is already lower than that of their global peers.

Exhibit 33: Indian MFIs have lower opex/AUM than their global counterparts



Source: Company, Ambit Capital research

Q#6: How will small finance banks impact the competitive landscape for NBFC-MFIs?

Given access to low cost funds, ability to provide the entire gamut of services and being out of the purview of State Money Lending Acts of various states, the MFIs that have become banks are structurally better placed than NBFC MFIs. That said, bank MFIs changing their liability mix to meet RBI guidelines could help NBFC MFIs in terms of loan growth and availability/cost of funds. However, spread cap for NBFC MFIs imply that their NIMs will not improve. For a listed player like SKS, most of the new-licensees pose neither threat nor any opportunity in the near term, as they were not in direct competition.

Given that some prominent MFIs have become banks, the question arises as to how it would change the competitive dynamics of the sector. Given access to low cost of funds, ability to provide the entire gamut of services, and being out of the purview of State Money Lending Acts of various states, MFIs which have become banks are structurally better placed than NBFC MFIs. However, this would not impact NBFC MFIs in the near term as it would take at least 2-3 years before bank MFIs build low-cost liabilities and product suites before they get an advantage over NBFC MFIs.

In fact, NBFC MFIs could benefit in the short term. Given that bank MFIs would have to change their liability mix away from bank borrowings to meet RBI guidelines, it would constrain their loan growth in the short term. This could help NBFC MFIs in terms of loan growth as there would fewer MFIs whom banks can lend to meet their priority sector requirement. Hence, the availability and cost of funding for NBFC MFIs should improve because of a decrease in the number of NBFC MFIs. However, given that spreads are capped for NBFC MFIs, lower competitive intensity and lower cost of funds would not help their NIMs.

More specifically, for listed player SKS, most of the MFIs which have been granted license were not in direct competition. So, neither do they pose much threat nor any opportunity to SKS in the near term.

Exhibit 34: Threats from different MFIs – SKS faces moderate threat only from 3 MFIs of 13 bank licensees

Company	Key area of operation (branch count)	Portfolio size	Competitive threat to SKSM?
Au Financiers (NBFC-CV, SME, LAP)	Rajasthan (248)	AUM: ~₹65bn	No, different target customers
Capital Local Area Bank (Local Area Bank)	Punjab (39)	Loans & deposits: ₹26bn	No, Too small with 39 branches, Punjab is <2% of SKS's book.
Disha Microfin (MFI)	Gujarat (71)	Loans: ~₹2bn	No, Gujrat is less than 1% of SKSM's AUM
Equitas Holdings (MFI)	Tamil Nadu (367)	Loans: ₹40bn	No, Tamil Nadu is less than 1% of SKSM's AUM
ESAF Microfinance and Investments (MFI)	Tamil Nadu (~500)	Loans: ~₹10bn	No, Tamil Nadu is less than 1% of SKSM's AUM
Janalakshmi Financial Services (MFI)	Bengaluru (234)	Loans: ₹38bn	No, Janalakshmi is a MFI focusing on urban poor in contrast to SKSM which focuses in the rural (68% of branches in under-banked districts).
RGVN (North East) Microfinance (MFI)	North East (104)	Loans: ₹2.3bn	No, North East is less than 1% of SKSM's AUM
Suryoday Micro Finance (MFI)	Maharashtra/Tamil Nadu (164)	Loans: ₹6.9bn	Low threat as its present mainly only in Maharashtra and Tamil Nadu (not more than 13% of SKS's AUM)
Ujjivan Financial Services (MFI)	Diversified across India (461)	Loans: ₹26bn	Moderate threat as it is present in most of the geographies where SKS is.
Utkarsh Micro Finance (MFI)	Bihar (269)	Loans: ₹8.6bn	Moderate threat, due to its presence in Bihar and UP (not more than 22% of SKS's AUM)

Source: Company, Press reports, Ambit Capital research

Q#7: What will be the profitability of MFIs after conversion to banks?

We expect ~170bps impact on RoA of MFIs (versus current RoA of ~3.5%) due to conversion to a bank. To compensate for such decrease in RoA, MFIs would have to decrease their funding costs by ~370bps. Assuming a deposit mix with 25% CASA ratio, the deposits would have to replace ~75% of their total existing liabilities for the funding cost to decrease by ~370bps while keeping the cost of bank borrowings and wholesale liabilities unchanged.

In the long term, we believe that a banking license would give more stability to MFIs' businesses given a stable liability base, a broader set of products, and better regulatory oversight. However, in the near term, MFIs' profitability could decrease due to costs associated with regulatory requirements like CRR and SLR and additional expenses to open new branches and hire employees for banking services. However, in the long term, lower cost of funds should offset the regulatory costs.

Moreover, high opex/asset ratio for the MFI business and current low credit costs would be major drivers of sustainable profitability for these MFIs.

Based on our back-of-the-envelope calculations, we expect ~220bps impact on RoA of MFIs (versus current RoA of ~3.1%) due to conversion into a bank.

Exhibit 35: Impact of conversion of a MFI into a bank

Particulars (as a % of average assets)	MFI
Current RoA - A]	3.5%
Pre-tax cost of conversion into a bank	**2.6%**
Regulatory cost	1.7%
Loss due to SLR	1.5%
Loss due to CRR	0.1%
Increase in operating cost	1.0%
Post-tax cost of conversion into a bank - B]	**1.7%**
Post-conversion RoA - C]=A]-B]	**1.8%**

Source: Ambit Capital research

To compensate for this decrease in RoA, MFIs would have to decrease their funding costs by 370bps to maintain current RoA. Assuming a deposit mix with 25% CASA ratio, the deposits would have to replace ~74% of their total existing liabilities (assuming that cost of bank borrowings and wholesale liabilities remain unchanged).

Exhibit 36: MFIs would have to entirely replace liabilities with deposits to sustain current RoE

Particulars	
Target benefit from conversion into a bank - A]	**2.6%**
Target funding cost decline - B] = A]/72%	3.7%
Existing funding cost - C]	12.1%
Target funding cost - D] = C] - B]	**8.4%**
Cost of CASA (Assuming 50% SA @ 6% and 50% CA @ 0%)	3.0%
Cost of non-CASA deposits (Closest to a small bank)	8.5%
Cost of CASA + non-CASA liabilities (assuming 25% CASA)	7.1%
Target deposit ratio (Total deposit to total liabilities)	**~75%**

Source: Ambit Capital research

Q#8: What is the future regulatory framework for NBFC-MFIs?

We believe the RBI is in favour of regulating large MFIs as it does not want the industry to be at mercy of the state governments given the links of the sector with the banking system. The RBI is also not in favour of excessive profit making by MFIs. That said, the legislators intend to have a separate regulatory body for MFIs – the newly floated MUDRA Bank has not yet been transferred regulatory powers on MFIs. We expect MUDRA to be a more pro-borrower regulator than the RBI given its explicit mandate to help the poor (and not MFIs). Therefore, regulatory risk is still not behind for the MFI industry.

Rather than regulating the entire microfinance sector, the RBI is more interested in regulating large MFIs. The RBI's principles in regulating MFIs are two-fold:

- The RBI does not want large MFIs to be at the mercy of the state governments given the linkages of these institutions with rest of the financial system (banks and other financial institutions).
- The RBI is not in favour of excessive profit making and wants a balance of social impact and profits. This is substantiated through one of the many speeches the RBI governor made on this topic – *"My sense is that you cannot, in good conscience, make a fortune at the bottom of the pyramid. Make reasonable profits, but if you start making a fortune, it does start raising social anxiety about how the fortune is being made."*

A joint committee of Parliament had earlier shot down a microfinance bill on the grounds that it was pro-MFI and not pro-borrower and vesting all the regulatory powers to the RBI. The committee had asked the bill to be re-drafted after consulting the stakeholders (especially state governments) and was not in favour of the RBI overriding existing state government legislation on MFIs, which the earlier version proposed. Nothing has been heard about this bill since. The parliamentary committee had also suggested that, instead of vesting the RBI with the responsibility for overseeing MFIs, it might be better to create an independent regulator – tentatively called the Microfinance and Development Regulatory Authority (MUDRA). In line with the suggestion of the committee, the prime minister has floated MUDRA Bank, but regulatory powers on MFIs have not yet been transferred to it.

The objective of MUDRA is to help the poor and not MFIs. Hence, MUDRA might not necessarily be a pro-MFI regulator. So, overall we believe regulatory risk is still not behind for the NBFC MFI industry.

Q#9: What should be the reasonable valuations for the sector?

Given lack of a long track record of the sector, low or negligible cross cycle profitability, lack of a credible liability franchise and risky nature of lending, there is no compelling reason to pay a higher multiple to MFIs compared to other NBFCs and small regional banks. Loan growth, we believe, should be the last reason to pay a premium for a lender in a credit starved country where lenders struggle to collect even secured credit.

Exhibit 37: Relative valuation snapshot

	Mcap (US$bn)	Mkt Price (₹)	P/B (x)			P/E (x)			RoA (%)			RoE (%)			5 years avg. RoE (%)
			FY15	FY16E	FY17E	FY15	FY16E	FY17E	FY15	FY16E	FY17E	FY15	FY16E	FY17E	
NBFCs															
Shriram Transport	3.1	911	2.28	2.01	1.76	19.76	15.52	12.17	2.0%	2.0%	2.1%	14.1%	14.3%	15.4%	20.3%
M&M Finance	1.9	230	2.20	2.01	1.83	14.35	17.43	15.65	2.5%	1.8%	1.8%	15.5%	11.2%	11.2%	20.5%
Magma Fincorp	0.3	77	0.96	0.83	0.74	8.76	9.85	5.74	0.9%	1.0%	1.6%	11.1%	10.0%	13.7%	12.2%
Sundaram Finance	2.0	1,226	4.86	4.08	3.63	28.12	27.91	24.55	2.9%	2.7%	2.7%	18.7%	15.4%	15.6%	20.0%
Cholamandalam	1.5	653	3.55	2.74	2.44	21.79	20.08	15.12	1.7%	1.8%	2.1%	17.5%	15.7%	17.4%	14.9%
Bajaj Finance	5.2	6,482	7.09	4.77	4.07	36.03	29.69	24.51	3.0%	3.1%	3.0%	20.4%	19.8%	17.9%	21.1%
Shriram City Union Finance	1.5	1,502	2.22	2.00	1.77	16.78	15.93	12.56	3.2%	3.2%	3.3%	14.9%	13.4%	14.9%	20.4%
Manappuram	0.4	35	NA	0.98	0.92	NA	9.48	8.12	NA	2.6%	2.7%	NA	11.5%	12.7%	15.6%
Muthoot Finance	1.0	177	1.39	1.24	1.12	10.15	8.98	7.42	3.0%	2.9%	3.1%	14.7%	14.6%	15.9%	31.5%
Average			**3.07**	**2.30**	**2.03**	**19.47**	**17.21**	**13.98**	**2.4%**	**2.3%**	**2.5%**	**15.8%**	**14.0%**	**15.0%**	**19.6%**
Regional Banks															
Federal Bank	1.2	48	1.07	1.00	0.93	8.23	12.74	9.59	1.3%	0.7%	0.9%	13.7%	8.1%	10.1%	13.3%
Karur Vysya bank	0.8	428	1.23	1.14	1.06	11.22	10.10	8.89	0.9%	0.9%	1.0%	12.3%	11.7%	12.4%	17.5%
South Indian Bank	0.3	17	0.67	0.63	0.59	7.56	7.39	5.89	0.5%	0.5%	0.6%	9.2%	8.8%	10.3%	17.3%
City Union Bank	0.8	87	1.93	1.71	1.50	13.14	11.94	9.84	1.5%	1.5%	1.5%	16.7%	15.1%	16.2%	21.3%
DCB Bank	0.3	78	1.44	1.28	1.15	12.37	12.92	12.04	1.2%	0.9%	0.8%	13.0%	10.2%	10.1%	10.6%
Average			**1.27**	**1.15**	**1.04**	**10.50**	**11.02**	**9.25**	**1.1%**	**0.9%**	**0.9%**	**13.0%**	**10.8%**	**11.8%**	**16.0%**
Micro Finance															
SKS Microfinance	1.0	523	6.29	4.92	3.74	32.65	23.14	16.37	6.6%	5.2%	5.0%	25.9%	23.9%	25.8%	-29.5%
Equitas Finance	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3.3%	n.a.	n.a.	11.2%	n.a.	n.a.	8.1%
Ujjivan Financial Services	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3.1%	n.a.	n.a.	13.7%	n.a.	n.a.	10.6%
Average			**6.29**	**4.92**	**3.74**	**32.65**	**23.14**	**16.37**	**4.3%**	**5.2%**	**5.0%**	**16.9%**	**23.9%**	**25.8%**	**-3.6%**

Source: Bloomberg, Ambit Capital research; Estimates for SUF,MGFL, MUTH, DCBB and SKSM are consensus estimates.

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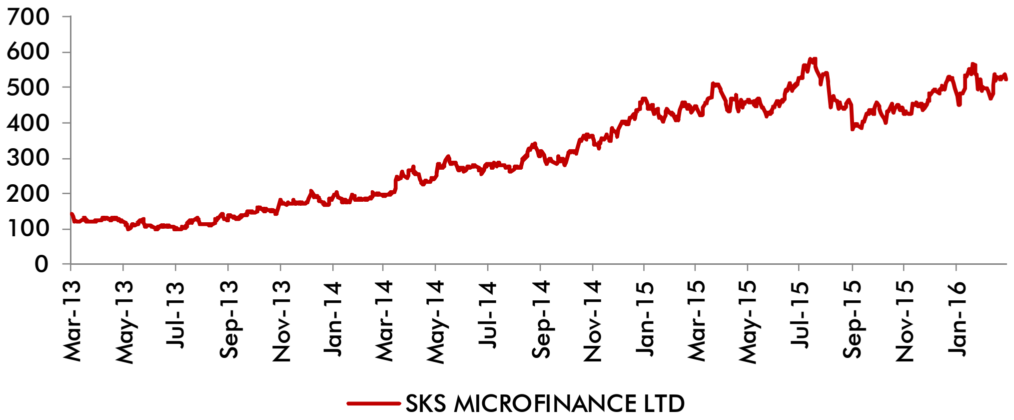
E&C = Engineering & Construction

SKS Microfinance Ltd (SKSM IN, NOT RATED)



Source: Bloomberg, Ambit Capital research

Explanation of Investment Rating

Investment Rating	Expected return (over 12-month)
BUY	>10%
SELL	<u><</u>10%
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