

SKS Microfinance

Event Update

4 November 2010

BUY

Target Price: Rs1,225

CMP: Rs998*

Upside: 23%

*as on 3 November 2010

In the Perfect Storm: Reiterate BUY

The current upheaval in the microfinance industry due to regulatory overhaul in AP, strong political pressure against MFIs and governance related issues have created the Perfect Storm for SKS. We lower our earnings estimates for FY11/12E by 11/13% reflecting the current business environment. We however remain positive on the stock as we expect the company to extricate itself from the current problems over the next couple of quarters. We believe the current sharp correction presents a good opportunity for long term investors to enter the stock. We reiterate a BUY on the stock with a lower target price of Rs 1225.

- **Political pressure to spike credit costs:** The current state-wide political backlash in AP against MFIs especially SKS will increase credit costs. We expect a potential spike in credit costs due to disruption in the repayment cycle as well as moral hazard concerns. We factor in 20 bps higher credit losses at 2% of gross loan portfolio for FY11/12E compared to 1.8% estimated earlier.
- **Business disruption to result in lower disbursement growth:** We lower our disbursement targets by 5/6% for FY11/12E to include the impact of current disruption in the business of SKS as well as implementation of the new ordinance by AP government which can impact growth.
- **Factoring in higher drop in loan yields:** The aggressive rate cut of 212 bps by SKS in AP to 24.55% is earlier and higher than anticipated by us. We factor in 20 bps further drop in loan portfolio yield than initially estimated at 25.4/25% for FY11/12E vis-à-vis 25.8% in FY10.
- **Possibility of lesser Competition:** We believe that current regulatory environment and business disruption will act as a deterrent for newer players to enter this business. This can act as a significant advantage to the incumbent players who have gained economies of scale.
- **Reiterate BUY:** We believe that the current issues will have a bearing on the short to medium term performance of the company with lower growth, portfolio yields combined with higher credit and operating costs. In the longer run however, business prospects continue to remain strong. We reiterate BUY on the stock with a TP of Rs 1225 valuing the business at 3.6X FY12E BV.

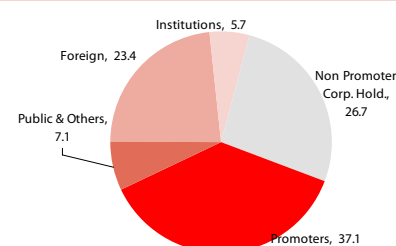
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Key Data

Bloomberg Code	SKSM IN
Reuters Code	SKSM.BO
Current Shares O/S (mn)	72.0
Diluted Shares O/S(mn)	72.0
Mkt Cap (Rsbn/USDbn)	71.5/1.6
52 Wk H / L (Rs)	1,492/890
Daily Vol. (3M NSE Avg.)	1,032,807
Face Value (Rs)	10

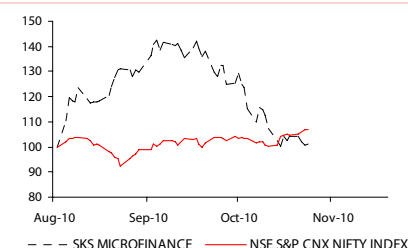
USD = Rs44.3

Shareholding Pattern (%)



As on 30 September 2010

One Year Indexed Stock Performance



Price Performance (%)

	1M	6M	1Yr
SKS Microfinance	(22.4)	-	-
NIFTY	1.5	21.4	32.7

Source: Bloomberg, Centrum Research
*as on 3 November 2010

Y/E Mar (Rsmn)	NII	Non Int. Inc.	PAT	YoY Gr (%)	EPS (Rs)	P/E (x)	Adj BV (Rs)	P/Adj BV (x)	RoA (%)	RoE (%)
FY09	3,125	470	797	380.8	11.1	90.2	136.7	7.3	3.9	18.4
FY10	5,966	739	1,748	119.4	24.3	41.1	147.3	6.8	4.9	21.8
FY11E	9,794	1,072	3,164	81.0	43.9	22.7	267.0	3.7	6.5	22.0
FY12E	15,424	1,374	5,068	60.2	70.4	14.2	337.4	3.0	7.3	23.3
FY13E	20,308	2,123	6,659	31.4	92.5	10.8	429.9	2.3	7.0	24.1

Source: Company, Centrum Research Estimates

KEY PARAMETERS CHANGE

We have changed some of our assumptions to factor in the current turmoil in AP.

- Lower disbursement growth for FY11/12E as disbursement slows down in AP
- Lower portfolio loan yields by 20 bps each for FY11/12E than initially estimated
- Hike initial credit cost estimate by 20 bps to 2% of the gross loan portfolio.
- Lower quantum of securitization portfolio to factor in possible risk averseness of banks.

Exhibit 1: Changes in our Assumptions

	Earlier Estimate		Current Estimate	
	FY11E	FY12E	FY11E	FY12E
Portfolio Yield (%)	25.6	25.2	25.4	25.0
Securitization as % of Disbursements	34.0	32.0	25.0	30.0
Lower Fee Income(Rsmn)	727	1,178	721	985
Disbursements(Rsmn)	134,413	207,588	127,118	191,894
Credit costs (%)	1.80	1.80	2	2

Source: Company, Centrum Research Estimates

AP CREDIT COST ESTIMATES

We have done a sensitivity analysis of the possible impact of the business disruption in AP which is 28% of the gross loan portfolio as of September 2010. We have factored in default rate of 5% for AP loan portfolio and 1.5% default rate scenario for the rest of country portfolio with no recovery expected from these defaults in our credit cost assumptions.

Exhibit 2: Scenario Analysis of various default rates and loss norms

	Portfolio Size	Default Rate Assumption			Loss Norm (Rsmn)		
		Worst Case	Base Case	Bull Case	Worst Case	Base Case	Bull Case
AP loan Portfolio	14,600	10%	4%	2.0%	1,460	584	292
Avg GLP ex AP	40,696	3%	1.50%	1.2%	1,221	610	488
Credit Costs					2,681	1,194	780
Impact on FY11E PAT					-31%	0%	9%

Source: Company, Centrum Research Estimates

VALUATION

At the current market price SKS is trading at 3x FY12E BV. We believe that the current business environment will not persist for long and business will return to normalcy over the next couple of quarters. We believe that the current correction in the stock price gives an excellent opportunity for the long term investors. We have a target price of Rs 1,225 valuing SKS at 3.6X FY12E BV.

Exhibit 3: Valuation based on single stage Gordon growth model

RoE	28.0%
g	8.0%
Cost of Capital (K)	13.5%
Justified P/BV	3.6
FY12E BV	337
Target Price	1,225

Source: Company, Centrum Research Estimates

Financials

Exhibit 4: Income Statement

Y/E March (Rsmn)	FY09	FY10	FY11E	FY12E	FY13E
Net Interest Income	3,125	5,966	9,794	15,424	20,308
YoY Growth (%)	228.3	90.9	64.2	57.5	31.7
Non Interest Income	470	739	1,072	1,374	2,123
YoY Growth (%)	156.3	57.1	45.1	28.2	54.5
Total Income	3,596	6,705	10,866	16,798	22,431
Total Operating Expenses	2,221	3,511	4,893	7,254	10,009
YoY Growth (%)	176.3	58.1	39.3	48.3	38.0
Pre-provision Profit	1,375	3,194	5,974	9,544	12,422
Provisions	134	517	1,106	1,748	2,178
Profit Before Tax	1,241	2,677	4,868	7,796	10,244
Taxes	444	929	1,704	2,729	3,585
Net Profit	797	1,748	3,164	5,068	6,659

Source: Company, Centrum Research Estimates

Exhibit 5: Balance Sheet

Y/E March (Rsmn)	FY09	FY10	FY11E	FY12E	FY13E
Share capital	479	645	720	720	720
Preference capital	92	-	-	-	-
Reserves & Surplus	6,069	8,858	18,497	23,564	30,223
Shareholders' fund	6,640	9,503	19,217	24,284	30,943
Loans	21,366	26,947	33,473	51,558	72,116
Current liabilities	2,384	4,025	4,697	5,284	5,661
Total Liabilities	30,389	40,475	57,387	81,127	108,720
Loans & Advances	14,349	29,747	50,717	69,673	96,155
Cash & Cash Equivalents	15,470	9,735	5,533	10,169	11,139
Fixed Assets	124	189	172	174	205
Other Assets	445	804	965	1,110	1,221
Total Assets	30,389	40,475	57,387	81,127	108,720

Source: Company, Centrum Research Estimates

Exhibit 6: Dupont Analysis

Y/E Mar	FY09	FY10	FY11E	FY12E	FY13E
% of Average Assets					
Net-Interest Income	15.1	16.8	20.0	22.3	21.4
Non-Interest Income	2.3	2.1	2.2	2.0	2.2
Net Income	17.4	18.9	22.2	24.3	23.6
Operating Expenses	10.8	9.9	10.0	10.5	10.5
Operating Profit	6.7	9.0	12.2	13.8	13.1
Provisions & Contingencies	0.7	1.5	2.3	2.5	2.3
RoAA (%)	3.9	4.9	6.5	7.3	7.0
Avg.assets/avg equity (x)	4.8	4.4	3.4	3.2	3.4
RoAE (%)	18.4	21.8	22.0	23.3	24.1

Source: Company, Centrum Research Estimates

Exhibit 7: Key Ratios

Y/E March	FY09	FY10	FY11E	FY12E	FY13E
Balance Sheet Structure Ratios (%)					
Loan Growth	133.8	75.9	56.0	59.3	25.3
Balance sheet Growth	179.1	33.2	41.8	41.4	34.0
Disbursements Growth	166.9	69.8	66.9	52.8	40.0
Operating Ratios (%)					
NIM	11.7	12.8	15.6	16.2	15.4
Non-interest income/Net income	13.1	11.0	9.9	8.2	9.5
Cost/Income (%)	61.8	52.4	45.0	43.2	44.6
Operating cost growth	176.3	58.1	39.3	48.3	38.0
Total prov as % of avg. loans	0.77	1.53	2.00	2.00	1.80
Tax Rate (%)	42.7	35.8	34.7	35.0	35.0
Capital Adequacy Ratios (%)					
Total CAR	38.4	28.3	30.0	23.4	23.5
Tier 1 CAR	38.4	28.3	30.0	23.4	23.5
Profitability Ratios (%)					
RoAE	18.4	21.8	22.0	23.3	24.1
RoAA	3.9	4.9	6.5	7.3	7.0
Valuations Ratios					
BVPS (Rs)	136.7	147.3	267.0	337.4	429.9
Price/BV (x)	7.3	6.8	3.7	3.0	2.3
EPS (Rs)	11.1	24.3	43.9	70.4	92.5
P/E (x)	90.2	41.1	22.7	14.2	10.8

Source: Company, Centrum Research Estimates

Exhibit 8: Dupont Analysis

Y/E Mar	FY09	FY10	FY11E	FY12E	FY13E
% of Average GLP					
Net-Interest Income	17.8	17.6	17.7	17.7	16.8
Non-Interest Income	2.7	2.2	1.9	1.6	1.8
Net Income	20.5	19.8	19.7	19.2	18.5
Operating Expenses	12.7	10.4	8.8	8.3	8.3
Operating Profit	7.8	9.4	10.8	10.9	10.3
Provisions & Contingencies	0.8	1.5	2.0	2.0	1.8
Taxes	2.5	2.7	3.1	3.1	3.0
PAT/Avg GLP (%)	4.5	5.2	5.7	5.8	5.5
Avg.GLP/avg equity (x)	4.0	4.2	3.9	4.0	4.4
RoAE (%)	18.4	21.8	22.0	23.3	24.1

Source: Company, Centrum Research Estimates

Appendix A

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