

Recommendation	Subscribe	
Price Band	Rs. 850-985	
Bidding Date	28 th July - 2 nd Aug	
Book Running Lead Manager	Kotak, Citi, Credit Suisse	
Sector	NBFC	
Retail Application- Detail At Cut off Price		
Number of Shares	98	
Application Money	96,530	
Amount Payable	96,530	
Discount to retail	Rs.50	
Financials (Rs in Crs)	FY09	FY10
Total Income	360	371
Operating Profit	138	319
PAT	80	174
Valuations	Lower Band	Upper Band
EPS*	24.2	24.2
Book Value*	220	234
P/E ratio*	35.1x	40.7x
P/BV*	39.x	4.2x
*calculated on diluted equity		
Post Issue Shareholding Pattern		
Promoters and Promoters Group	37.1%	
Institutions	37.0%	
Public	23.0%	
Others	3.0%	
Offer structure for different categories		
QIB (Including Mutual Fund)	60.00%	
HNI	10.00%	
Retail	30.00%	
Post issue Equity (Rs. in crore)	71.94	
Issue Size (Rs. in crore)	1427-1654	
Face Value (Rs.)	10	
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Background

SKS Micro Finance Ltd (SKS) is the largest Micro Finance company in India in terms of total value of loans outstanding, number of borrowers, and number of branches. It is a non-banking finance company, or NBFC, registered with and regulated by the Reserve Bank of India. Core business of SKS is to provide small loans exclusively to poor women predominantly located in rural areas in India. These loans are provided to such members essentially for use in their small businesses or other income generating activities and not for personal consumption. As of March 31, 2010, it has approximately 6.8 million members, 2,029 branches, a presence in 19 states and loans outstanding of Rs. 2936.72 crore.

During the four year period from fiscal 2006 to fiscal 2010, membership of the company has increased from 2 million in five states to 6.8 million members in 19 states, and branches expanded from 80 to 2029. Total loans outstanding increased at a CAGR of 147.7% from Rs. 78.05 crore as of March 31, 2006 to Rs. 2936.72 crores as of March 31, 2010. Over the four year period from fiscal 2006 to fiscal 2010, profit after tax has increased at a CAGR of 221%, from Rs. 1.65 crore to Rs. 175 crore.

Objects of the Issue

The Issue comprises of a Fresh Issue and an Offer for Sale. Out of total issue proceeds of Rs.1654cr at higher band Rs.732 cr will be raised as fresh issue. Company intends to utilise the Net Proceeds to augment capital base & to meet future capital requirements arising out of growth.

Post issue the promoter holding in the company would fall from 55.8% to 37.1%. Issue has been offered at a discount of Rs.50 to retail investors.

History

In 1997, Swayam Krishi Sangam, or SKS Society, was founded as a public society in the state of Andhra Pradesh, and it functioned as a non-governmental organization, or NGO, that provided microfinance in Andhra Pradesh. In 2003, SKS issued an aggregate of 99.5% of fully diluted share capital to five newly created mutual benefit trusts, or SKS MBTs. Since 2003, company has completed several dilutive issuances with investments by investors to fund its growth. In addition, to assist the SKS MBTs in maintaining a significant percentage holding of share capital as company issued additional share capital to fund growth, it has provided the SKS MBTs with an extension of the time to pay the required purchase price of the dilutive issuances. As of the date of, the SKS MBTs held an aggregate of 14.7% of fully diluted share capital.

Business Model and Methodology

Lending business is based on a group lending model. This model has been refined for over 30 years by MFIs internationally and in Bangladesh, and is based on the idea that the poor have skills that are underutilized.

Lending model is comprised of five key elements which are as follows –

Village Selection

Company designates field level employees, called Sangam Managers, to be responsible for a specified village or set of villages. Sangam Managers conduct a comprehensive survey to evaluate the local conditions and potential for operations based on several key factors that include total population, poverty level, road access, political stability and safety. After a village has been selected, employees conduct public meetings in the village to introduce themselves and the Company. In these meetings, employees explain the concepts of group lending, lending procedures and the requirements for group formation.

Focus on Women.

SKS lends exclusively to women of the low income households, even if loan proceeds are used in the household business that is run by the family, including the husband. Company believes that women can positively influence loan repayment in their household because they are generally more risk averse, cooperate better in groups, and are generally more accessible than their working husbands.

Member Training

For creating awareness of its product and credit discipline from the early stages of group formation, company provides training and education. Once a group is

formed, training sessions called Compulsory Group Training, or CGTs, consisting of a series of hour long sessions are conducted. During the training period, employees also collect quantitative data on each potential member to ensure she qualifies for the program and to record baseline information for future analysis.

Group Lending

SKS ensures credit discipline through mutual support and peer pressure within the group to ensure individual members are prudent in conducting their financial affairs and are prompt in repaying their loans. Failure by an individual member to make timely loan payments will prevent other group members from being able to borrow from it in the future; therefore the group will typically make the payment on behalf of a defaulting member or, in the case of willful default, will use peer pressure to encourage the delinquent member to make timely payments, effectively providing an informal joint guarantee on the member's loan. Optimal group size is exactly five women. This size is small enough for members to effectively exert peer pressure and large enough for them to have ability to repay for other members in the group in the event of a default. As other members are added and new five members groups are formed, company consolidate a series of such groups within a village to form a center, which is called a Sangam. A Sangam consists of three to 10 groups, has to approve the addition of any new group and also takes on responsibility for any member of any of the groups in that Sangam.

Village Level Lending and Collection.

Approach to rural lending involves providing credit to members in their village, rather than requiring members to travel in order to obtain loans. Company has developed a network that reaches each of the Sangams on a weekly basis which allows company to regularly collect payments on outstanding loans and disburse new loans, reinforce group stability and eliminate the travel and time constraints.

Credit application and approval process

SKS requires each member seeking a loan to submit an application in her weekly Sangam meeting that is managed by Sangam Managers. Company uses a standardized loan application form that must be signed by both the member and the center leader, who serves as a witness. Once complete, a new loan application is only accepted at a Sangam meeting in which all five members of the group to which the applicant belongs are present and a minimum of 70% of the center members are present. Once the loan application is accepted, employees review the information provided by the member on items such as the purpose of the loan, the amount and the relevant expertise of the member in the business.

Approval process for the new loans follows the following steps -

a) Unanimous consent of all members present at the Sangam meeting to the issuance of the loan to the member.

This serves to put the entire Sangam group on notice of the loan and the awareness that a default on the loan will prevent any other member from obtaining a new loan.

b) Approval of loan application by the branch manager - On a weekly basis, the branch manager leads a deliberation on each applicant's family, occupational background and previous loan history, if any. If the branch staff unanimously agrees to grant the applicant a loan, the branch manager approves the loan and the funds are disbursed to the member in the next weekly Sangam meeting.

Portfolio and Risk Management

The initial focus of loan portfolio management efforts is on Sangam Managers, who are given primary responsibility for both the issuance of loans and the collection of loan payments from members. As these employees are personally involved with forming of groups, leading weekly Sangam meetings in the villages and maintaining relationships with individual members, they serve as an important factor in enabling company to attain a repayment rate in excess of 99.0%. Sangam Managers input data regarding loan disbursements and collection into management information system on a daily basis. In the event of a late or missed loan payment, the officer responsible for managing the loan and branch managers commences a standardized collection process that includes direct in person visits with the member to determine the cause of the missed payment and the solutions to remedy it.

Cash management

All the disbursements and collections from members are done in cash, making cash management an important element of company's business. To reduce the potential risks of theft, fraud and mismanagement, company has recently implemented an integrated cash management system that was operational in approximately 636 branches. The system utilizes an internet banking software platform that interfaces with various banks to provide it with up to date real time cash information for these branches and the loan activity in them.

Information Technology

An integral part of the ability to scale for any organization is its ability to understand what the status of its product sales, revenues, costs and risks in operating the business.

a) Electronic Delivery Channels and Branch Infrastructure

Each of branches has branch terminals which provide facilities for branch data entry, loan processing, and collections along with detailed management information systems, or MIS, for branch officials.

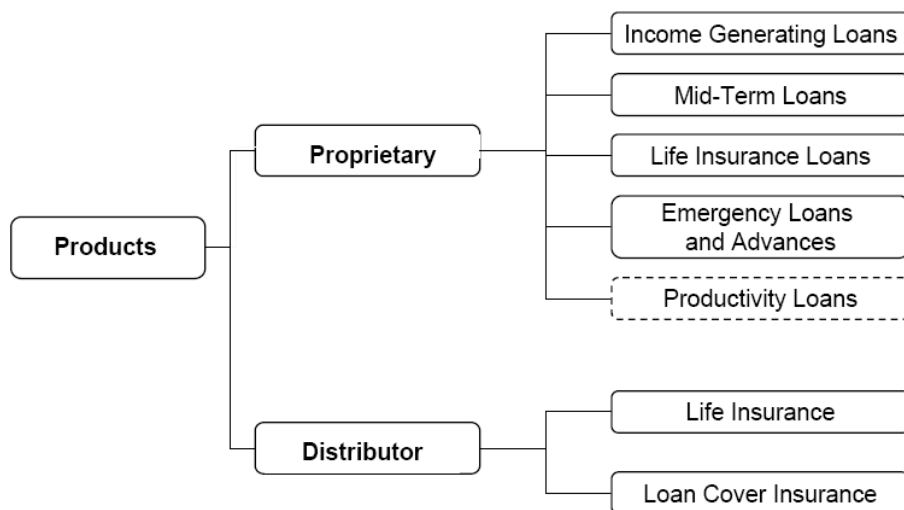
b) Networking

Networking in rural India is a challenge and company has made extensive use of the cellular telephony network and other technologies to establish connectivity with remote branches.

c) Internal Systems

In addition to the systems which provide core business functionality, company has deployed an enterprise resource planning system for internal finance and accounting processes and other internal systems for functions such as human resource management. Messaging and collaboration systems have been deployed at a third party managed data center facility in order to ensure consistent information exchange across organization.

Product profile



Source: DRHP

Income Generating Loans

This is core loan product for use by women in rural areas and is intended to provide capital for their small businesses. The loans are made to members for businesses such as running local retail shops called kirana stores, providing tailoring and other assorted trades and services, raising livestock, cottage production such as pottery, basket weaving. Loans granted under the Income

Generating Loan program range from Rs. 2,000.00 to Rs. 12,000.00 for the first loan. Subsequent loan amounts are determined by past credit history and increased each year in set increments up to a maximum of Rs. 30,000. The term of an Income Generating Loan is 50 weeks. Principal and interest payments are due on a weekly basis during the loan term.

Mid-Term Loans

Mid-Term Loans are for the same end use as an Income Generating Loan, but become available any time after the completion of 20 weeks of an Income Generating Loan cycle. The loan amount is smaller than an Income Generating Loan and is designed to provide members, who have obtained an Income Generating Loan, with additional capital while their Income Generating Loan is still being paid off. Loan amounts range from Rs. 2,000.00 to Rs. 15,000.00 in each annual cycle. The annual effective interest rate of the loan ranges from 26.7% to 31.4%. The term of the loan is 50 weeks.

Life Insurance Loans

Life Insurance Loans are issued to members to assist them in the purchase of whole life insurance policies it distributes. The loans are interest free and have a fixed principal amount of Rs. 500.00. The term of the loan is 25 weeks and payments are due on a weekly basis during the term of the loan.

Emergency Loans and Advances

The Emergency Loans and Advances are offered to members for use in the case of emergencies such as pregnancies, funerals and hospitalizations. Loans range from Rs. 500.00 to Rs. 2,000.00. It does not charge interest or fees on these loans.

Productivity Loans

SKS is currently piloting loan products that members can use to purchase consumer products that it believes will increase the productivity of members and their businesses. To ensure loan is used for the purchase of the specified product, company first enters in to a strategic relationship with the supplier of the product and specifies that the loan disbursement will be made directly to the supplier of the product rather than to the member. For example, SKS is piloting a program with Nokia and Airtel for the financing of mobile phones and mobile telephone services, respectively, for members. The annual effective interest rate of the mobile phone program loans range from 30.6% to 36.2%. The term of this loan is 25 weeks.

Company is also piloting a business to business loan program with METRO to fund the working capital needs of members who own and operate kirana stores. The program allows members to purchase their inventory of consumer goods and groceries from METRO at wholesale prices. Loan amounts range from Rs. 5,000.00 to Rs. 25,000.00 and are interest free. The term of the loan is 14 days.

Company receives a fixed commission from METRO (around 2%) for the total purchases a kirana store makes from METRO while utilizing productivity loan.

Investment Rationale

1) Market Leadership position

According to the CRISIL Report, SKS is the largest MFI in India in terms of total value of loans outstanding, number of borrowers, and number of branches as of March 31st, 2010. As of March 31, 2010, it has approximately 6.8 million members, 2,029 branches, a presence in 19 states and loans outstanding of Rs. 2936.7 crore. Market leadership position in the microfinance sector enhances reputation and credibility with members and lenders. This enhanced reputation and credibility has numerous benefits, including the ability to secure capital at lower costs, recruit and retain employees, retain existing members and expand into new regions and product areas.

Operational highlights

	2007	2008	2009	2010
No of Branches	276	770	1,353	2,029
No of District	103	219	307	354
No of Employees	2,381	6,818	12,814	21,154
No. of Memembers (in millions)	0.6	1.9	4.0	6.8
Disbursements (Rs. in Crores)	452	1,680	4,485	7,618
Gross Loan Portfolio (Rs. in Crores)	276	1,051	2,456	4,321

Source: Company (portfolio includes assigned portolio)

2) Scalable Operating Model

Establishing and growing a successful rural microfinance business in India involves the significant challenge of addressing the rural poor that live in remote locations across India. To address this problem company has designed a scalable model and have developed systems and solutions for the following three components that are required to effectively scaleup business:

- a) Capital** -The ability to access large and diverse groups of capital funds required for this market.
- b) Capacity** - The capacity to provide products and services to millions of members.
- c) Cost Reduction** -The implementation of technology and process based systems to reduce the cost of conducting numerous complex transactions.

The benefits realized from scale and capacities have also been achieved through proven business models in other sectors such as food, consumer durables and retail. It has adapted some of these models to the MFI sector. It has standardized recruitment and training programs and materials so that they can easily be

replicated across the entire organization.

3) Access to Multiple Sources of Capital

Historically, the MFI sector has relied on priority sector funding from commercial banks. In addition to such funding, company is also able to fund the growth of operations and loan portfolio through issuances of equity and private and publicly traded debt securities, loans with various maturities raised from domestic and international banks, and the securitization of components of its loan portfolio. In 2009, several of debt securities were rated by CRISIL and CARE at P1+(SO) and PR1+, respectively, which is the highest rating they give for such securities. Company is among the first MFIs in India to complete a rated bond issuance, issue commercial paper, assign a rated pool, sell a “weaker section” portfolio.

4) Diversified Sources of Revenue

a) Diversified Geographies.

As of March 30, 2010, SKS has 2029 branches in 19 states across India with no state accounting for more than 22.5% of outstanding loan portfolio. Broad footprint across India allows it to lend in almost all geographies in India which mitigates exposure to local economic slowdowns and disruptions resulting from political circumstances or natural disasters.

b) Diversified Product Offerings.

While core business is providing members with traditional loan products, company also offers other loans called productivity loans that are designed for purchase of goods that enhance the productivity of members. It also offers access to insurance products and loans to finance them. Such products have different pricing structures and payment terms which allows it to diversify and increase its revenue streams and revenue base.

5) Experienced Management Team and Board of Directors

Management team has significant experience in the microfinance and financial services industry. Substantially all senior managers have over 17 years of experience with well reputed national and multinational companies, particularly in the retail and commercial banking industries. Board is comprised of experienced investor, industry and management professionals.

6) Superior Asset Quality

SKS has developed a unique model to ensure that loans are repaid on time and with a low rate of default, given high rates of portfolio growth. As of March 31st, 2010 net non performing assets, or NPAs, were 0.16% of loans outstanding. In addition to traditional tools such as disciplined credit processes, and credit verification, product structure, sales and collection process and segment specific approach are designed to result in a higher repayment rate for loan portfolio.

7) Leverage Distribution Channels

Network of the company allows distributors to access a segment of the market to which many do not otherwise have access. Currently, it has a distributor relationship with Bajaj Allianz Life Insurance Company Limited, or BALICL, for the sale of their life insurance products, while meeting the protection or savings needs of members. It receives a fee based commission on these sales and going forward it sees that increases in this type of revenue would lower revenue risk exposure to longer term interest income based products.

Weakness

Governmental and statutory regulations

As a NBFC company is subject to regulation by Indian governmental authorities, including the Reserve Bank of India, or RBI. These laws and regulations impose numerous requirements on it, including asset classifications and prescribed levels of capital adequacy, cash reserves and liquid assets. For instance, a number of states in India have enacted laws to regulate money lending transactions. A significant change in the central government's policies, in particular, those relating to the microfinance industry in India, could adversely affect the business.

Operational risk

Because company handles cash in a high volume of transactions occurring through a dispersed network of branches and Sangam Managers, it is exposed to operational risks, including fraud, petty theft and embezzlement, which could harm its results of operations and financial position.

Inability to control NPA's

If company is unable to control the level of non-performing loans in the future, or if loan loss reserves are insufficient to cover future loan losses, financial condition and results of operations may be materially and adversely affected.

Natural disasters or other catastrophic events could adversely impact business.

As the borrower are very poor and do not have any collateral assets, any natural calamities like drought, flood in a region can impact the collection and increase NPA in that region.

Political risk

As the lending rate is quite high at around 25-30%, though it is substantially lower than the money lenders in rural areas, it gives opportunity to politicians to oppose the microfinance business.

Valuation & Peer Comparison

Though we do not have exact comparable peer for SKS we tried to compare it with Shriram Transport Finance (NBFC financing truck) and HDFC Bank which are best performing companies in their respective segments.

Based on FY10

All figures in INR cr, unless specified

	SKS	STFC	HDFC Bank
PAT	174	873	3,004
CAR (capital adequacy ratio)	25%	21%	17%
Cost to income ratio	52%	24%	47%
EPS	27	41	68
ROA	4.9%	3.3%	1.5%
RONW	21.5%	29.6%	14%
Net NPA	0.31%	0.7%	0.3%
Book Value (Post Issue for SKS)	235	170	470
P/E (at upper price band & diluted equity)	41	16	30
P/BV	4.2	3.7	4.5

Source: Company & Nirmal Bang Research

*P/E and P/BV at upper price band and diluted equity for SKS

Company	Lower Price Band	Upper Price Band
EPS (Post Issue)	24.2	24.2
Networth	1,586.0	1,686
Book Value (Post Issue)	220.5	235
Equity Capital (Post Issue)	71.9	71.9
P/BV	3.9	4.2
P/E Ratio	35.1	40.7

As compared to its peer SKS looks costly but SKS has substantial room to grow advances owing to huge financing requirement in rural areas due to lack of access to banks. Opportunity is quite huge in the microfinance industry with an estimated demand of \$51.4 billion as against total disbursements of \$4.3 billion (as per intellcaps report). Looking at the huge opportunity in microfinance industry and SKS being the leader, we believe that SKS is well capitalized to take advantage of the same.

SKS can also leverage its network (more than 2000 branches in FY10) to distribute financial products of other institutions to its members at a cost lower than other institutions. Network also allows distributors to access a segment of the market to which many do not otherwise have access. In order increase its revenue company is also continuously introducing newer and more innovative loan products including loans for the purchase of products

IPO Note

SKS Micro Finance Ltd

such as mobile phones, lights, water purifier etc. that will increase the productivity of a member. SKS have entered into strategic alliances with Nokia, Airtel, BALICL, HDFC and METRO. Monetizing of customers by introducing new products can be a key revenue driver in future.

Recommendation

Though SKS looks costly compared to its peer on historical data, but looking at the possibility of much higher growth, advantage of leadership and early mover in micro finance business, system driven standardized business and scalable business model, **we recommend subscribe to the issue.**

Income Statement
Condensed Income Statement

All figures in INR cr, unless specified	FY 2007A	FY 2008A	FY 2009A	FY2010A
Interest income	44	162	506	874
Interest expense	14	56	194	288
Net interest income	31	106	312	585
Other income	1	8	48	85
Total income	32	114	360	671
Operating expense	25	80	222	351
Staff costs	13	48	138	216
Other operating expense	12	33	84	135
Operating profit	7	33	138	319
Provisions	2	4	14	52
Profit before tax	5	29	124	268
Taxes	2	12	44	94
Net profit	2	17	80	174

Source: Company & Nirmal Bang Research

Balance Sheet

All figures in INR cr, unless specified	FY 2007A	FY 2008A	FY 2009A	FY2010A
Total cash and bank balances	56	275	1,547	974
Investments	0	0	0	0.2
Intangible assets	3	7	7	6
Advances	271	793	1,435	2,975
Fixed assets	2	8	12	19
Other assets	2	6	38	82
Total assets	335	1,089	3,038	4,055
Unsecured Loan	0	0	39	115
Secured loans	249	790	2,097	2,580
Current liabilities and provisions	15	87	238	402
Total liabilities	264	876	2,374	3,105
Equity capital	71	212	665	950
Total liabilities and equity	335	1,089	3,038	4,055

Source: Company & Nirmal Bang Research

Ratio Analysis

Financial Highlights

	2007	2008	2009	2010
Total Revenue	46	170	554	959
Profit after Tax (Rs. In Crore)	2	17	80	174
Total Assets	335	1,089	3,039	4,047
Return on average assets	1.7%	2.3%	3.9%	4.9%
Return on average equity	8.5%	11.7%	18.3%	21.5%
CAR	24.7%	24.7%	39.1%	28.3%
Cost to income ratio	79.3%	70.8%	61.7%	52.4%
Net NPA	0.05%	0.16%	0.18%	0.16%

Yield ratios

	2007	2008	2009	2010
Portfolio Yield	23.4%	23.8%	28.4%	25.3%
Financial cost ratio	7.5%	8.5%	11.1%	9.0%
Operating cost ratio	13.6%	12.0%	12.6%	10.4%
Loan loss ratio	1.1%	0.6%	0.8%	1.5%

NOTE

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