INDIA

Financials

CENTRUM

Micro-banking

Initiating Coverage **14 July 2016**

From the last mile to a marathon win

We initiate coverage on 'micro-banking' with Satin Creditcare Network (Buy) and Ujjivan Financial Services (Hold). While the sizeable under-penetration of credit at the bottom of the pyramid has always been an attraction for lenders to this segment, more stringent regulation and greater diversity in business models have mitigated challenges in addressing this segment and heightened its appeal. We believe that new players – small finance banks (SFBs) in particular – will help expand the market, while keeping the lending activity profitable. In a phenomenon similar to NBFCs flourishing after banks' aggressive inroads into the former's businesses, microfinance companies (MFIs) with their unique positioning, presence and established historical precedents should continue to thrive in the new world.

- **Serving the un-served has had tactical, sustainable benefits:** Micro-banking business (MFI/SHG), which was historically an outcome of the country's large under-penetrated banking credit market, has been hugely successful, even though regulatory and legislative friction disrupted it temporarily in 2010. The unsecured nature of lending and the doorstep service have been the key distinguishing features of micro-banking, and possibly a reason for mainstream banks to have largely stayed away from lending to these customers. With a huge, deprived credit market, we believe the micro-banking space is well-poised for healthy growth in the longer run.
- **MFIs set for steady growth rate, SFBs could deepen the market further:** With 32mn customers, cumulative MFI industry size stood at ~Rs533bn (48% CAGR over FY12-16). Stringent regulations on lending, capital norms, capital requirement and exposure limits have led to discipline among players. Market opportunity remains healthy at ~Rs2.7-3tn, and after a blistering growth phase, we expect the industry to grow at a steady but high 30-35% in the coming years. Within the ambit of tighter regulation and access to deposits unlike MFIs, SFBs are entrusted with serving broadly similar markets.
- **MFI vs SFBs – complementarity rather than contest:** As SFBs have access to low-cost funds and potentially greater product diversification, the transition to maturity will be critical. Size and scale will play a crucial role, and we expect RoA/RoE to move from very low levels initially to our estimated sustainable 2.5% RoA/16.7% RoE in the longer run. While MFIs will continue to operate the doorstep lending model more efficiently, we believe SFBs will complement the existing JLG-based lending by offering additional avenues/products. Although banking licence is a distinct advantage, CRR/SLR requirement and having to offer higher rates on savings deposits to gain competitiveness can be substantive challenges.
- **Outlook and recommendation:** We initiate coverage on micro-banking with a positive tone. We do not foresee the SFB model to pose a major threat to the MFI industry and believe that these models will continue to operate successfully in their own business environment. We initiate with Buy on Satin Creditcare and Hold on Ujjivan Financial Services. Socio-political and concentration risk can impact growth and asset quality materially for MFIs. Cost overruns, inability to shore up deposits and higher delinquencies remain major risks for SFBs.

Stock Price Performance (%) *

Company Name	1 M	3M	6 M	1 Yr
Bharat Financial Inclusion	*13.4*	*35.6*	*45.8*	*49.8*
Satin Creditcare	*10.1*	*46.3*	*28.0*	*-*
Equitas	*0.4*	*-*	*-*	*-*
Ujjivan Financial Services	*11.1*	*-*	*-*	*-*
Nifty	*5.0*	*8.5*	*11.7*	*0.7*

*Source: Bloomberg; *as on 13 July 2016*

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Company Name	Rating	Target Price (Rs)	*Upside / Downside (%)*	P/E (x)			P/B (x)			*RoE (%)*			*RoA (%)*			*Dividend yield (%)*		
				FY16	FY17E	FY18E	FY16	FY17E	FY18E	*FY16*	*FY17E*	*FY18E*	*FY16*	*FY17E*	*FY18E*	*FY16*	*FY17E*	*FY18E*
Satin Creditcare	Buy	600	*25.7*	26.0	22.5	15.3	4.6	2.9	2.4	*22.4*	*16.8*	*17.4*	*2.2*	*2.1*	*2.5*	*0.0*	*0.0*	*0.0*
Ujjivan Financial	Hold	400	*(0.3)*	22.9	24.6	20.0	3.6	2.9	2.6	*18.3*	*13.1*	*12.8*	*3.7*	*2.9*	*2.4*	*0.1*	*0.1*	*0.2*

Source: Company, Centrum Research Estimates

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Micro-banking

Micro-banking, a formalised and regulated lending market is an outcome of the inability of the Indian banking space to penetrate deeper into the un-served population. Micro-banking, also termed as shadow banking, is broadly classified into Self Help Group (SHG) bank-based lending approach and microfinance institutions (MFI) and has been in existence for years (SHG model was first introduced in 1990s). High under-penetration in the credit market and cumulative credit under these forms of lending, which was upwards of Rs1.1tn till end-FY16, augur well for the industry, especially the MFI space. We estimate the MFI industry market opportunity at ~Rs2.7-3tn.

Exhibit 1: Microcredit market in India

Microfinance Credit Delivery Models in India

SHG-Bank linkage

- Involvement of bank
- Formation of SHG consisting mostly of poor women
- Development of credit behavior
- Eligible to avail credit from banks
- Group members shall not be eligible for future credit in case of a default
- Bank bears the loss

JLG -MFI model

- Involvement of MFIs
- Formation of JLG consisting mostly of poor women
- Eligible to avail credit
- Other members repay on behalf of the defaulter
- On continuing default, group is ineligible for credit
- MFI bears credit cost if joint liability fails

Individual lending

- Involvement of any lending institution and individual borrower
- No group lending or liability structure
- Individuals relatively
- more credit worthy than group-based models
- More suited for populations with good credit behaviors

Source: Industry, Centrum Research

While individual lending is also a part of microfinance credit in India, its market size has remained limited. Further, though at a nascent stage of implementation, and also drawing parallels from individual-based lending approach globally, the Indian MFI industry and especially some larger players are venturing into this segment.

The door-to-door based lending model is the key to success of the joint liability group (JLG)-based MFI model in India; further, with strong credit policies in place and stringent regulations including cap on lending norms have led to discipline among players. On the flipside, unsecured nature of the product, high operating costs, need for 'feet on street' sales and requisite collection mechanism could be the reasons for the banking industry to have remained shy of the opportunity.

The MFI industry has been through a roller-coaster ride in its initial and mere 10 years of existence in India. Stringent regulations on lending norms, capital requirement and exposure limits for the lender and borrower emerged post the AP crisis. The industry since then has witnessed 48% AuM CAGR (ie, during FY12-16) led by improved reach, increase in customer profile and surge in ticket size. However, post the high growth phase, we believe the industry is well-poised for steady but still at high 30-35% growth in the longer run. We base our belief of steady growth in the longer run on the premise of increasing incidences of over-leveraging, ghost borrowers and rise in rejection rates. Further, we expect the growth rate to be more calibrated and designed with a prudent approach towards penetration and focus on a well-balanced volume and value-driven growth.

Differentiated banking model – small finance bank: The need for a differentiated banking structure received greater emphasis following the discussion papers by RBI on 'Banking Structure in India – The Way Forward' in August 2013, which called for thrust on financial inclusion. Also, the need to ensure healthy competition led to the need for a separate banking structure.

The RBI discussion paper states the following:

Small banks vs large banks: There is an ongoing debate on whether we need small number of large banks or large number of small banks to promote financial inclusion. Small local banks with geographical limitations play an important role in the supply of credit to small enterprises and agriculture. While small banks have the potential for financial inclusion, their performance in India (LABs and UCBs) has not been satisfactory. If small banks are to be preferred, the issues related to their size, numbers, capital requirements, exposure norms, regulatory prescriptions and corporate governance need to be suitably addressed.

Small finance banks (SFB) have been carved out with the prime objective of ensuring financial inclusion through credit supply to small business units, small & marginal farmers, micro & small industries and other entities in the unorganised sector through high-technology and low-cost operations. Accordingly, RBI has given in-principle approval to 10 entities, of which eight are MFIs. The inclusion of MFIs in the SFB license shows the significance of the MFI industry in enabling financial inclusion. However, with relatively smaller balance sheet franchises, capital position and foreign shareholding pattern (in certain cases), we believe transition could be a challenge for these entities. Size and scale will play a crucial role in enabling MFIs to successfully transition into SFBs.

Also, while the creation of a differentiated vehicle for financial inclusion in the form of SFBs will aid in ensuring banking credit to the under-served and un-served population, the transition process and migration of technology, infrastructure, human resource, balance sheet profile is an uphill task.

The banking industry has witnessed failures/successes during the phase of balance sheet transformation, and we believe operational efficiency will play a crucial role in determining a similar situation for the SFB model in its initial phase of transformation. Centurion Bank of Punjab is a classic example of the inability to transition following huge cost over-runs and asset quality-related risks at a later stage. On the other hand, Indusind Bank and DCB Bank are classic examples of a successful transition. These stocks continue to attract considerable investor attention.

Our analysis suggests material impact on profitability ratios for MFI-turned SFBs in the initial phase of transition following the regulatory requirements of CRR/SLR maintenance, building up of deposit franchise, huge overhead costs and asset quality-related headwinds. The near-term RoA may dip to 0.9-1.0% and RoE to 5.2-6.1% levels. However, as these SFBs grow and mature, have a diversified borrowing pool including retail deposit base, channelize efforts towards cost rationalisation, ensure limited delinquencies and provisioning thereon, we expect RoAs to inch towards 2.5%. RoEs could well be at 16.7% levels in such scenarios, assuming leverage at <7x ie tier-I CAR at 15%.

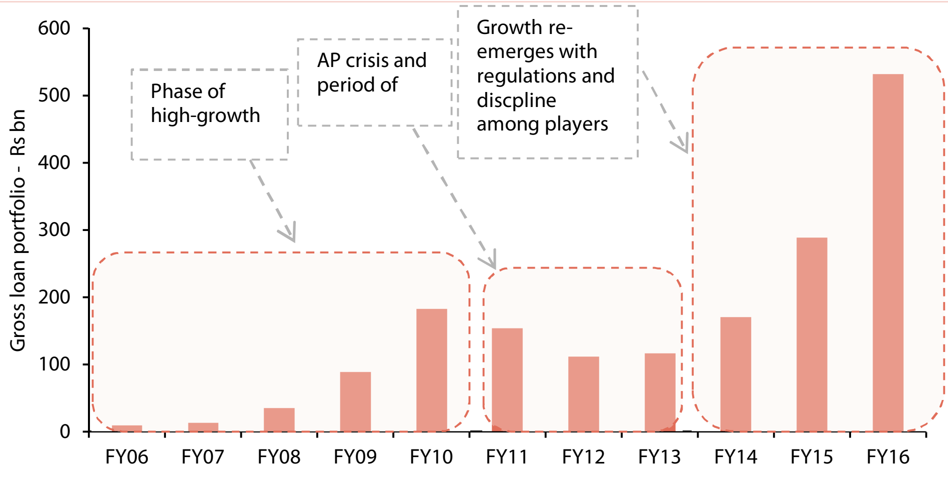
MFI industry: huge growth potential; inelastic demand – key feature

- **Emerged as a fast growing sector with 48% CAGR in AuM over FY12-16, led by 22% / 21% CAGR rise in volumes (no. of borrowers) and value (loan O/s per borrower).**
- **Self-regulatory associations (SRO), credit information bureaus (CIB), cap on lending spreads, provisioning requirement and capital requirement have resulted in discipline among players.**
- **Penetration in India still lower than MFI operations globally. Market opportunity pegged at Rs2.7-3tn, implying strong growth potential in the longer run.**
- **After a high growth phase, industry could witness steady 30-35% CAGR in the longer run. Well-balanced volume- and value-driven growth – a more prudent approach.**

The fall and rise of the sector

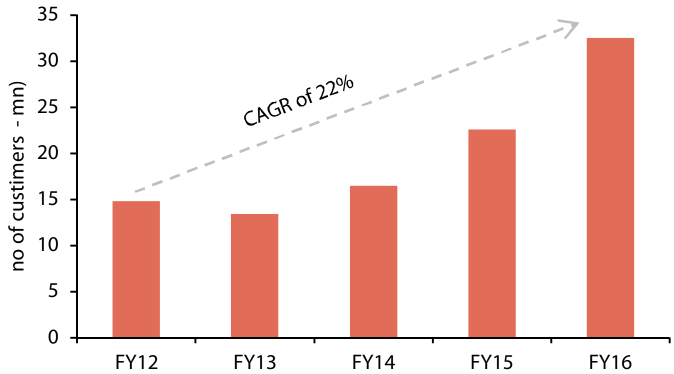
With mere 10 years of existence in India, the microfinance industry has already been through a roller-coaster ride: a) the FY06-10 period was characterised by robust growth and profitability; b) in the period thereafter, i.e. FY11-13, wherein NPAs rose, portfolio ran down and many MFIs went bankrupt following AP crisis; and finally c) the period post FY13 was characterised by high growth rates due to increased reach. The sector has emerged as the fastest growing one, with 48% CAGR in AuM, led by over 2x rise in volume (no. of borrowers at 32.5mn in FY16 vs 14.8mn in FY12) and 21% rise in value. Ticket size per borrower stood at Rs16,379 vs. ~Rs.7,550 in FY12. The penetration has extended to cover 32.5mn (vs 13.4mn in FY13) through branch reach of 9,669 and across 30 states/union territories.

Exhibit 2: MFI industry has seen both its fall and rise



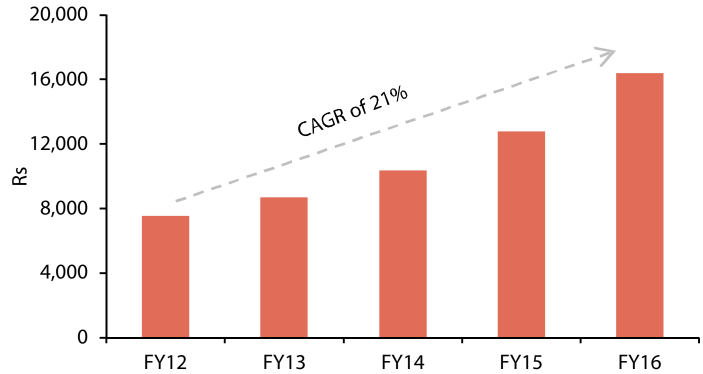
Source: MFIN, Centrum Research. Industry size for the period FY12-16 is ex-Bandhan.

Exhibit 3: Customer reach increased over 2x, at 32.5mn as at end-FY16



Source: MFIN, Centrum Research

Exhibit 4: … with commensurate increase in loan O/s. per borrower



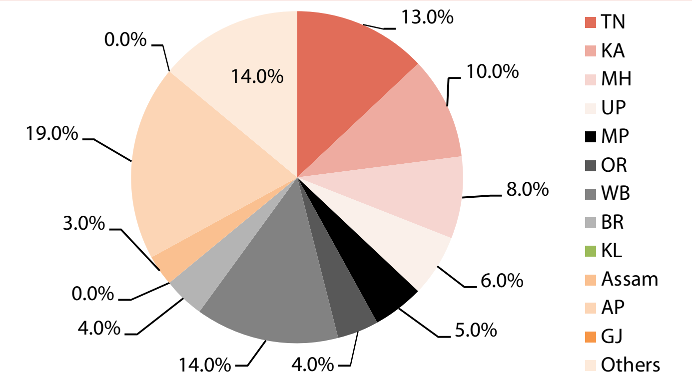
Source: MFIN, Centrum Research

While MFI operations were initially concentrated in south India, over a period of time, players expanded their reach, following a) the need to de-risk state concentration, especially in south India and more to avoid an AP-like crisis, and b) the ability to expand business into new regions given the highly under-penetrated and under-served markets, particularly in north and central India. Over FY13-16, the AuM mix across various states and regions has become sustainable, with new states of Uttar Pradesh and Madhya Pradesh comprising ~20% of total GLP.

One of the possible reasons for MFIs to diversify their loan portfolio is given their gearing i.e. state-wise loan concentration. According to rating agencies, one of the important rating requirements includes taking into consideration the state-wise exposure as % of net worth. Comfort can be drawn from an exposure of maximum 15-16% of net worth.

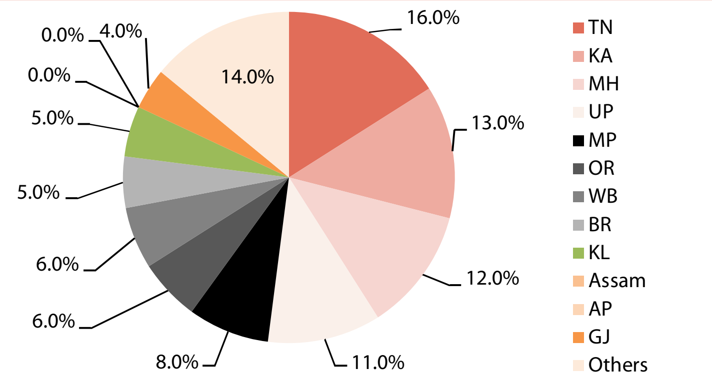
State-wise GLP

Exhibit 5: Top-5 states of TN, Karnataka, Maharashtra, West Bengal and AP comprised 64% of GLP in FY13



Source: MFIN, Centrum Research

Exhibit 6: … the mix has changed considerably, with UP and MP emerged as new states and accounting for 20% of market in FY16

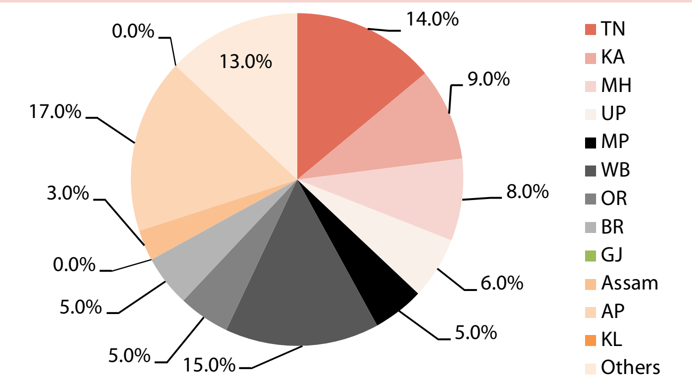


Source: MFIN, Centrum Research

In terms of client base, during FY13-16, client penetration increased in Maharashtra, Uttar Pradesh and Madhya Pradesh which compensated for gradual withdrawal from highly penetrated markets of West Bengal and Andhra Pradesh.

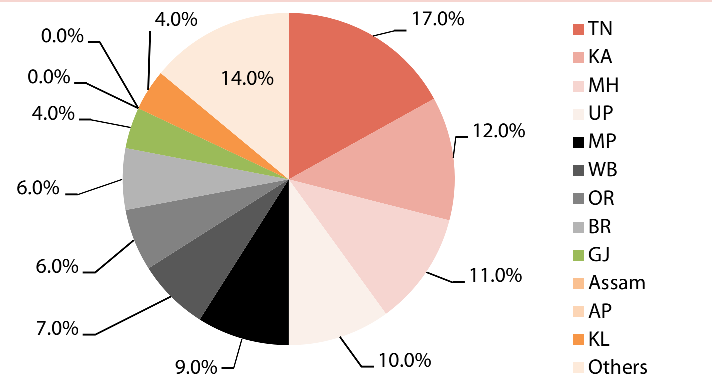
Client concentration

Exhibit 7: Top-5 states of TN, Karnataka, Maharashtra, West Bengal and AP comprise 64% of GLP (FY13)



Source: MFIN, Centrum Research

Exhibit 8: Client penetration increased in Maharashtra, UP and MP. The same is being offset by withdrawal from West Bengal and AP (FY16)

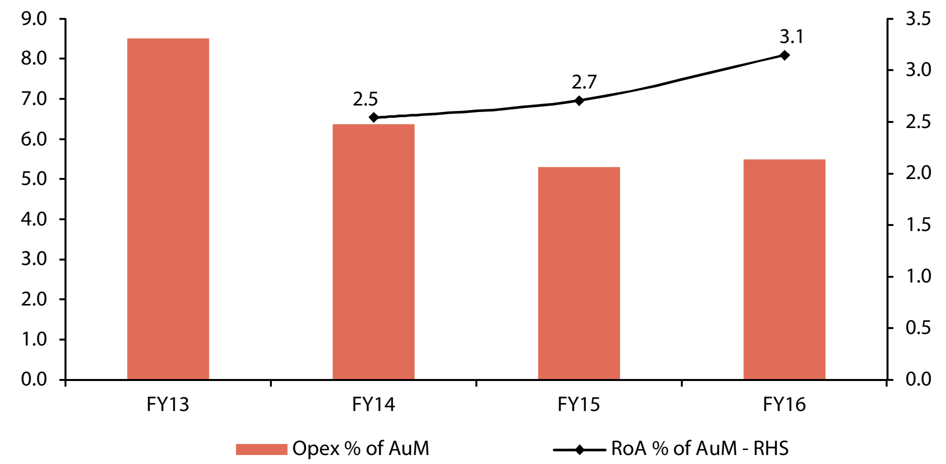


Source: MFIN, Centrum Research

The introduction of self-regulatory organisations like Microfinance Institutions Network (MFIN) and Sa-Dhan, and the establishment/prominence of credit information bureau, Equifax Credit Information Services Private Limited (Equifax) and CRIF High Mark Credit Information Services (Highmark) have played a vital role in bringing about integrity, transparency towards clients and protecting them from unethical practices and ensuring privacy.

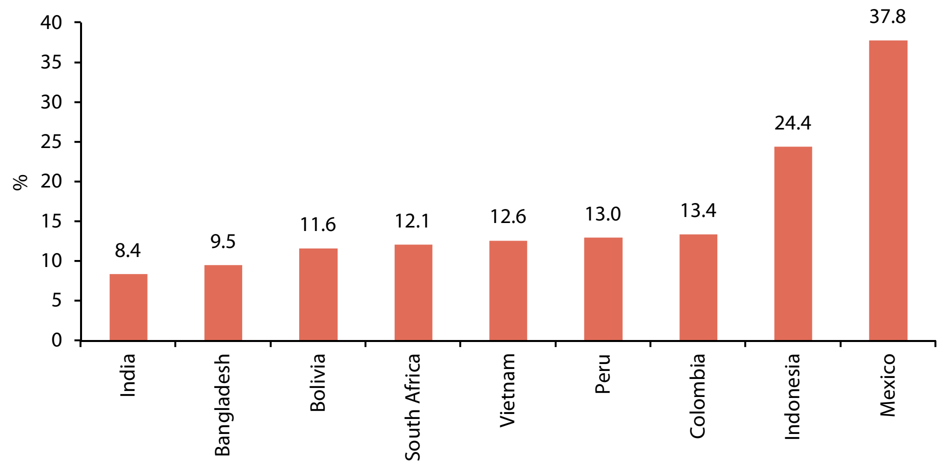
Caps on lending rates (10% lower for MFIs with total assets above Rs1bn/12% for assets below Rs1bn or 2.75x of the base rate for top-5 banks) have created lending discipline. Thus, with the spread cap at 10%/12% and a well-contained asset quality, the only way to ensure healthy profitability is to contain operating costs. Cost-rationalisation efforts in the form of process automation, increase in the ratio of borrower / loan per employee and ticket size per borrower, the industry has been in position to reduce overhead costs and in-turn improve RoA profile.

Exhibit 9: Led by operating efficiency, RoA profile has been steadily on a rise.



Source: Companies, Centrum Research. Note: We have considered Bharat Financial Inclusion, Satin Creditcare, Ujjivan and Equitas for the above calculation. FY13 RoA is not calculated as SKS was loss making

Exhibit 10: Operating costs in India is lower when seen in context of MFI operations globally



Source: Mix market, December, 2013.

Penetration still lower when compared globally

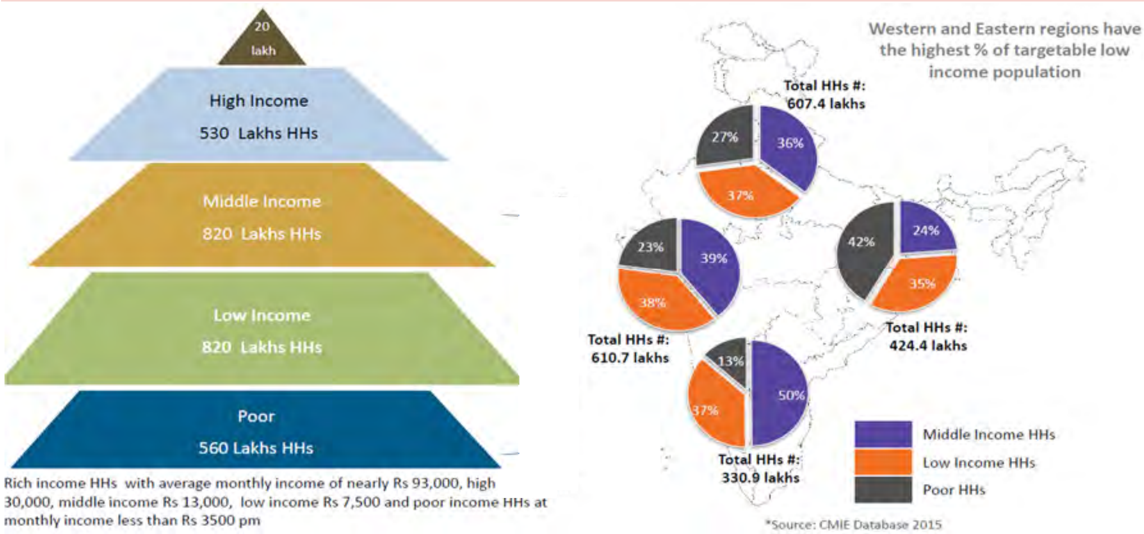
The combined lending by both MFI and SHG stood at Rs1.1tn for FY16 and has witnessed 24% CAGR over FY12-16. This compares with 11% CAGR in overall non-food credit growth over the same time. The increased credit flow clearly goes in favour of RBI's intention towards financial inclusion. MFIs have emerged as an important vehicle for catering to the capital requirement of un-served and under-served segments. However, even as the proportion of MFI credit (including SHG) has been on the rise, MFI penetration in India remains far too low compared to MFI operations globally.

Potential market size at ~Rs2.7-3tn

While it is difficult to calculate the potential market opportunity given the sheer under-penetration of credit market, prevalence of informal channels and existence of money-lenders, our rough assumptions based on certain parameters indicate India's potential MFI market size at ~Rs2.7-3tn. This is based on the following premise:

- With ~220mn households in the poor to middle income segment (Exhibit 11) and assuming that even 50% of the households can be financially supported, the potential market size assuming the basic lending at Rs25,000 per HH would mean an opportunity of around Rs2.75tn.
- Another way of assessing the market opportunity is to consider World Bank statistics. About 24% of India's population earns less than US$1.3 per day (defined as below the poverty line) and another 35% earns US$1.3-2.0 per day. Assuming a household comprises an average of five members (national consensus estimate), approximately 163mn households form the target customer base. Further, if we peg an average financing need of Rs20-25k per household, the overall demand for microfinance loans could be Rs2.7-3tn

Exhibit 11: About 220mn HH is the addressable market opportunity



Source: Industry, Centrum Research

The Government of India and the RBI have created a favourable policy and regulatory framework for MFIs to operate in the country. Initiatives like Micro Units Development Refinance Agency (MUDRA) Bank (for refinancing and regulating microfinance sector), Pradhan Mantri Jan Dhan Yojana (PMJDY) by the new government in 2014 and the creation of SRO by RBI have further strengthened the growth potential for the sector.

In its 2015 Union Budget, the government announced creation of MUDRA Bank, with a corpus of Rs200bn and credit guarantee corpus of Rs30bn. MUDRA Bank proposes refinancing all MFIs that are in the business of lending to micro/small business entities, who are commonly engaged in manufacturing, trading and service activities and regulating MFIs which are outside the RBI's regulatory umbrella.

The new government also announced the launch of PMJDY, the world's largest financial inclusion scheme. This scheme is aimed at enhancing financial inclusion by extending banking facilities to the 'last' person. The scheme made bank account opening easier for individuals and extended insurance benefits along with RuPay debit cards and overdraft facilities up to Rs5,000 for active account holders.

Source: Sa-Dhan

Growth to stabilise at steady but still high 30-35% rate after high growth phase

Stringent regulations by RBI, the central regulator, in terms of a) lending rate caps; b) limit on loan amounts, limit on the number of micro-loans that a borrower can avail and specification on loan tenure; c) adherence to capital norms for MFIs; d) need for greater transparency; and e) creation of SROs and CIBs have set the stage for the industry to evade any AP-like crisis situation. Also, with market opportunity at ~Rs2.7-3tn, we believe the industry is well-poised for strong growth in the longer run.

However, with increasing incidences of over-leveraging, ghost borrowers, rise in rejection rates in some states (especially WB, TN and Karnataka, where rejection rates are in upwards of 25%-30%), evolution of differentiated banking (SFBs), penetration through the BC model and growth initiatives such as Jan Dhan and MUDRA Bank, growth rates are likely to moderate.

According to global research, the global microfinance market would witness 10-15% growth. Asia-pacific is set to be the world's fastest-growing microfinance market with projected growth of 30%.

While the former risks (ie, over-leveraging, ghost borrowers and rise in rejection rates) are more player-specific and depend on individual MFI's stance towards growth, the latter (ie, evolution of differentiated banking models, BC channels, GoI initiatives for financial inclusion) are unlikely to act as a deterrent in the near term. This is also because MFI turned SFBs are currently going through a phase of structural transformation and merit the need for lower growth (see our section on SFBs). While MFIs will continue to operate the doorstep lending model more efficiently, we believe SFBs will complement the existing JLG-based lending by offering additional avenues/products. GoI initiatives towards financial inclusion (Jan Dhan, MUDRA) are yet to reflect positive outcomes (see exhibits below) but we believe it will be rather complementary to MFI operations.

Thus, while the near-term growth is unlikely to be a constraint, in the longer run, we expect the growth rate to be more calibrated and designed with a prudent approach towards penetration and focus on a well-balanced volume- and value-driven growth. We, thus, expect the industry to grow at steady but still at a high 30-35% CAGR in the longer run.

Jan-Dhan account: While Jan-Dhan has made a decent progress in terms of number of accounts opened and reduction in the overall proportion of zero balance accounts over a period, this model needs to be tested for its ability to shore up assets. With customer profile averse to banking business, the door-to-door based lending approach (ie, MFI business) will continue to hold relevance in the near term. This is even as rate differentials remain higher.

Exhibit 12: Jan-Dhan – Balance per account remains substantially lower

Period	No of accounts opened (mn)	No of RuPay cards issued (mn)	Balance in accounts (Rs mn)	*% zero balance accounts*
Sept'14	53.8	18.6	42,732	*76.8*
FY15	125.5	110.8	1,04,996	*67.3*
Till date	221.8	181.7	3,91,529	*25.2*

Source: PMJDY.

Also, while MUDRA Bank has been set up with the prime objective of ensuring credit to the unserved and under-served populations, through its refinancing window – Shishu, Tarun and Kishor – total disbursements done stood at Rs1.3tn for FY16. Of this, disbursement done by the banks was at Rs800bn and the rest being done by the MFI players.

Exhibit 13: The scheme has already seen disbursements of Rs1.3tn in its first year

MUDRA schemes	No of accounts (mn)	Disbursement (bn)	O/s. amount (bn)
Shishu	32.4	620.3	468.1
Kishore	2.1	410.7	366.1
Tarun	0.4	298.5	258.7
Total	**34.9**	**1,329.5**	**1,092.9**

Source: Mudra.org

Views of India Ratings: Ind-Ra believes that MFIs are set for a sustained, stable medium-term growth until FY19 based on sector performance in the aftermath of AP crisis and the emerging landscape of microfinance, with the government's thrust on financial inclusion and diversified banking licenses. We expect that other models of microfinance delivery (BC, small banks, SHG) could achieve traction by FY19; by then, the current RBI guidelines may have a larger impact on limiting the growth of existing MFIs in their current form. MFIs could evolve their operations over the next five years to provide a full range of financial services to the poor and withstand competition on a strong footing.

Could very well migrate to individual-based lending over traditional GLP model

While the JLG-based lending model is set for steady growth in the longer run, drawing parallels from some other countries, we believe that larger MFIs in India could very well migrate to individual-based lending approach. This could be also because as the borrower moves up the value chain, the capital requirement may increase, and with borrowing caps in place, the ability to fund such requirements may be limited under the existing regulatory framework. Also, from the lenders' perspective, as the customer enters the second or third cycle of credit, his behaviour and financial discipline is well-established, which in turn enables the MFI to take higher exposure.

While some larger MFI players in India have already adopted individual-based lending approach, a few are in the process of evaluating the business model and expected to follow suit. In some countries in South and Central America, MFIs have migrated from group lending to individual lending models. Some countries also allow MFIs to fund MSMEs. This, if permitted in India, could well be a major positive for the sector.

MFI model superior to traditional SHG bank-based lending approach

Even as we believe that the MFI industry is set for a steady growth at 30-35% in the longer run, we believe the model is far more superior to the traditionally perceived SHG bank-based lending approach. SHG is the largest state-sponsored microfinance programme with its origins in the early 1990s. Over a period of time, credit to the underserved segment has steadily increased under the scheme, with exposure of ~Rs600bn as at end-FY16. The client outreach too remained healthy at ~100mn accounts.

The model was initially created to provide sustainable financial services and involved a culture of encouraging group members to pool their savings regularly and use the pooled thrift to provide small, interest-bearing loans to other members. However, with increasing incidences of NPAs, the SHG model is now losing its appeal. Over FY12-16, SHG bank-based lending portfolio grew mere 13% CAGR vs 48% CAGR in MFI AuM.

Exhibit 14: Asset quality-related risk has been on the rise for the SHG programme

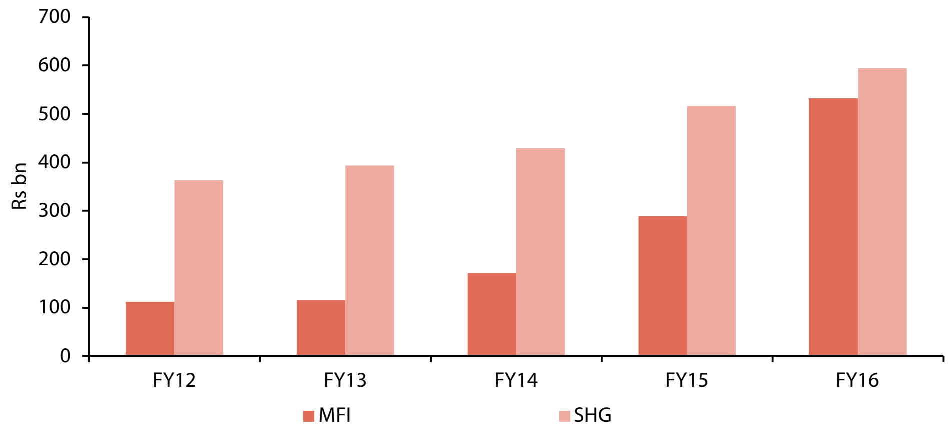
%	FY11	FY12	FY13	FY14
All India	*6.9*	*6.1*	*7.1*	*6.8*
South	*3.8*	*5.0*	*5.1*	*4.6*
North	*7.1*	*6.9*	*11.2*	*13.7*
East	*4.3*	*7.3*	*10.3*	*11.1*
West	*7.3*	*8.2*	*8.6*	*11.1*
Central	*10.7*	*13.2*	*17.3*	*18.9*
North east	*8.4*	*5.2*	*8.6*	*8.9*

Source: NABARD

Exhibit 15: … the same, though remains well under control for the MFI Industry

Source: MFIN

Exhibit 16: Credit under SHG grew mere 13% CAGR vis-a-vis 48% for MFI over FY12-16



Source: NABARD, MFIN, Centrum Research. Note: We have assumed 15% growth in SHG credit for FY16.

Interaction with stakeholders

In our endeavour to understand the sector in greater length, its positives, negatives, challenges and opportunities, we interacted with various stakeholders. Accordingly, we met up with rating agencies, and government officials. Listed below are some key takeaways from these interactions:

Interaction with rating agencies:

Q: What are the key elements behind determining a rating?

A: In addition to analysing some key ratios of profitability, spreads and asset quality, ratings also depend on a) balance sheet size and product diversification, b) geographical presence in terms of number of states covered, c) concentration risk and d) avenues for non-interest income. <u>A key element from the rating point of view also includes single-state concentration. Any exposure in upwards of 15-16% of net worth is considered to be a riskier proposition.</u> This is also because higher the state exposure, higher is the risk of default.

Q: How do you look at the MFI industry and the practises followed by various players?

A: The outlook for the sector remains stable. There are two ways to analyse GLP growth: volume based and value driven. Volume growth is preferable to value growth as value growth is a function of higher ticket sizes which in a sense will be a riskier strategy in the longer run. However, after a phase of high growth, the sector is set for growth stabilisation. This is also due to the following:

- Incidences of ghost borrowers in certain regions are on the rise.
- Information captured by credit bureaus is not adequate; hence, their credit appraisal policies are not fool-proof.
- Credit behaviour in non-south states is under developed; hence, there is a high probability of frauds materialising. However, despite matured behaviour of borrowers in southern states, the CIB rejection rates in these states are also high (50% in some districts) which indicates the high penetration levels in these states. Ticket size is much higher in south states and is thus an added risk for the industry.
- Practises of certain players are not uniform. The sector needs to be tested on the funding profile as the sector is currently flush with debt and equity funds which have supported GLP growth.

Q: Can MFI industry see some migration to individual-based lending approach?

A: The individual-based lending model is followed in some countries, and there is no harm in migrating to this approach. This is also given the ability of the MFI to retain its customers for their higher ticket requirement. Also, having served the client in earlier cycles, the risk and behaviours are well-known to the MFIs.

Q: **The industry is yet to see any material signs of asset quality deterioration? Are we sitting on an asset quality time bomb?**

A: With stringent regulations in place by RBI, AP-like crisis can be evaded to a certain extent. Also, with SROs, CIBs the system shows some discipline. Recent incidences in TN and UP were adequately addressed in a timely manner. However, despite this, incidences of over-leveraging and ghost borrowers have increased. It will be more prudent for a player to follow a much calibrated and well-defined strategy towards growth.

On the asset quality front, the numbers may be very drastic, ie, very low or high GNPA, since a group lending scenario is characterised by an event-related chain reaction. Also, there are socio-political risks which may trigger an event, leading to asset quality stress. Hence, geographic diversification is very important.

Q: How do rating agencies look at the new forms of lending entities like SFBs? Will they pose a threat to the system/MFIs?

A: Conversion to SFB will not disrupt the market for existing MFIs, and SFB will only change the liability profile. From a regulatory perspective, SFBs would be regulated under the direct purview of the RBI.

Interaction with MUDRA Bank Officials

Q: What are the key features of MUDRA Bank? Could you help us understand the schemes?

A: MUDRA Bank, incorporated in April 2015, is being created with a corpus of Rs200bn and credit guarantee corpus of Rs30bn and is primarily aimed at refinancing all MFIs that are in the business of lending to micro/small business entities, who are commonly engaged in manufacturing, trading and service activities and regulating MFIs which are outside the RBI's regulatory umbrella. **The refinancing schemes are provided under three different loan schemes and include:**

- **Shishu:** covers loans up to Rs50,000
- **Kishor:** covers loans above Rs50,000 and up to Rs5 lakh
- **Tarun:** covers loans above Rs5 lakh and up to Rs10 lakh

We also fund banks for loans which are eligible as per scheme mentioned above.

Q: How effective have the MFIs been in ensuring financial inclusion?

A: The MFI industry has seen a strong resurgence post the AP crisis. Regulations, lending caps and cap on borrower limits have all created an environment of discipline among players. Although the industry size at <Rs600bn is still a fraction of overall banking credit and MFI operations globally, it is well placed for a much stronger growth in the longer run. It is important for players to be more cognizant of growth which is more volume driven and not value based.

Q: What is the extent of cost benefit from borrowing under the MUDRA Bank for the MFIs?

A: MUDRA makes ~300bps spread on the lending business to MFI players. In other words, with average lending rate at ~9.75%, the cost saving to larger MFIs is at 150-200bps vis-à-vis borrowings from banks/other avenues.

We have already funded some larger MFIs in the recent past and are in talks with many more players.

Q: Do you believe the new banking models – SFBs – could pose a threat to MFI business in India?

A: Small finance banks, while being of MFI origin, have a different mandate for functioning. We do not expect these models to be a threat to MFIs in India.

Small finance bank (SFB): Step towards last mile connectivity

- **SFB – a step towards the last mile connectivity. The selection of eight MFIs among the 10 shortlisted entities shows the relevance of the sector and its aim of ensuring credit to the unserved segment.**
- **Phase-I of transformation – structural changes in balance sheet and profitability profile to impact near-term returns profile. Steady state RoA/RoE at 2.5%/16.7% in the longer run.**
- **Scale and size will play a crucial role in determining the ability towards transition.**

SFBs and the basis of their creation:

The need for a differentiated banking structure in India has been in discussion for a long time now. The same, however, received greater emphasis following the release of discussion papers by RBI on 'Banking Structure in India – The Way Forward' in August 2013, which called for thrust on financial inclusion. Also, the failure to ensure banking credit through alternate channels led to the need for a separate structure.

The discussion paper stated the following:

Small banks vs large banks: There is an on-going debate on whether we need small number of large banks or large number of small banks to promote financial inclusion. Small local banks with geographical limitations play an important role in the supply of credit to small enterprises and agriculture. While small banks have the potential for financial inclusion, their performance in India (LABs and UCBs) has not been satisfactory. If small banks are to be preferred, the issues relating to their size, number, capital requirements, exposure norms, regulatory prescriptions and corporate governance need to be suitably addressed.

Accordingly, in Nov 2014, RBI laid down the final guidelines for SFBs in the private sector and subsequently, in Sept 2015, issued in-principle license to 10 entities. The guidelines for the SFB license articulated the following objective: "The objectives of setting up of small finance banks will be to further financial inclusion by (i) provision of savings vehicles and (ii) credit supply to small business units, small and marginal farmers, micro & small industries, and other unorganised sector entities, through high-technology low-cost operations."

Exhibit 17: Key features of the RBI's guidelines for SFBs

	Key guidelines
Capital requirement	❍ Minimum paid-up equity capital of Rs1bn. ❍ Minimum scapital adequacy ratio of 15%.
Activities	❍ Primarily, basic banking activities of deposit-taking and lending for small-sized customers. ❍ Distribution of mutual funds, insurance and pension products, with prior approval of RBI. Forex dealing is allowed. ❍ At least 25% of branches need to be in unbanked rural centres (population <10k). ❍ The SFB cannot be a Business Correspondent (BC) for another bank, but it can have its own BC network. After first five years of operation and a review by the RBI, the requirement of prior approval for annual branch expansion plans and scope of activities can be liberalised.
Prudential norms	❍ Usual CRR and SLR apply (currently at 4% and 21.5%, respectively). ❍ Priority sector lending (PSL) requirement of 75% (of adjusted net credit) will apply. Adjusted credit of 40% under PSL will be subjected to similar sub-limit for sub-sectors as it is for existing banks. The remaining 35% of adjusted credit can be to any sub-sector. ❍ Loans of size up to Rs2.5mn will have to form at least 50% of the loan book. ❍ An NBFC/MFI converting to an SFB will cease to exist and all its business which a bank can undertake would be brought under the bank and the activities that a bank cannot statutorily undertake would be divested/disposed of.
Shareholding and listing requirement	❍ Minimum promoter shareholding of 40% for five years. ❍ Promoter shareholding to be brought down to 40% in the first five years, 30% in the next five years and 26% in further two years. ❍ Foreign shareholding as per FDI policy for private sector banks, ie, currently, total FDI limit at 74%, with FII sub-limit of 49%. ❍ Listing within three years after reaching a net worth of Rs5bn.

Source: RBI

Exhibit 18: Entities that have received in-principle approval for SFB license – 8 of the 10 applicants are MFIs

FY15	AUM (Rs bn)	Net worth (Rs bn)	*Promoter stake (%)*	*Foreign holding (%)*	Headquarters	Major Presence
Au Financiers (India)	55.7	8.1	*30.0*	*68.0*	Jaipur	Rajasthan, Madhya Pradesh, Maharashtra
Equitas Holdings	40.1	11.7		*93.0*	Chennai	Tamil Nadu, Maharashtra, Madhya Pradesh, Karnataka
Janalakshmi Financial Services	37.7	10.9	*17.8*	*76.3*	Bengaluru	Pan India – 17 states
Ujjivan Financial Services	32.7	7.4	*1.0*	*88.7*	Bengaluru	Karnataka, West Bengal, Maharashtra ~45%
ESAF Microfinance and Investments	10.6	1.5	*52.5*	*40.4*	Chennai	Kerala (~70%), Maharashtra, TN
Capital Local Area Bank	9.3	0.9	*37.6*	*NA*	Jalandhar	Punjab
Disha Microfin	2.1	0.4	*18.7*	*72.6*	Ahmedabad	Gujarat, Karnataka
Utkarsh Micro Finance	7.3	1.6	*6.0*	*85.0*	Varanasi	Uttar Pradesh, Bihar, Maharashtra
Suryoday Micro Finance	5.9	1.3	*12.0*	*68.0*	Navi Mumbai	Maharashtra, TN
RGVN (North East) Microfinance	2.3	0.9	-	*69.0*	Guwahati	North East

Source: Companies, RBI, Centrum Research.

While the creation of a differentiated vehicle for financial inclusion in the form of SFBs will help ensure banking credit to the under-served and un-served population, the transition process and migration of technology, infrastructure, human resource and balance sheet profile is an uphill task.

Also, while 8 of the 10 entities which have been awarded the SFB license are MFIs, and this shows the importance of the MFI industry in enabling financial inclusion with relatively smaller franchises, foreign shareholding and capital position (in certain cases), we believe transition could be a challenge. Size and scale will play a crucial role in enabling MFIs to successfully transition into SFBs. The industry could potentially see some players withdraw their licenses given the inability to comply with the regulatory norms and the challenge in terms of technology / infrastructure up-gradation.

Key challenge / opportunities under transition to SFB model include

Challenges

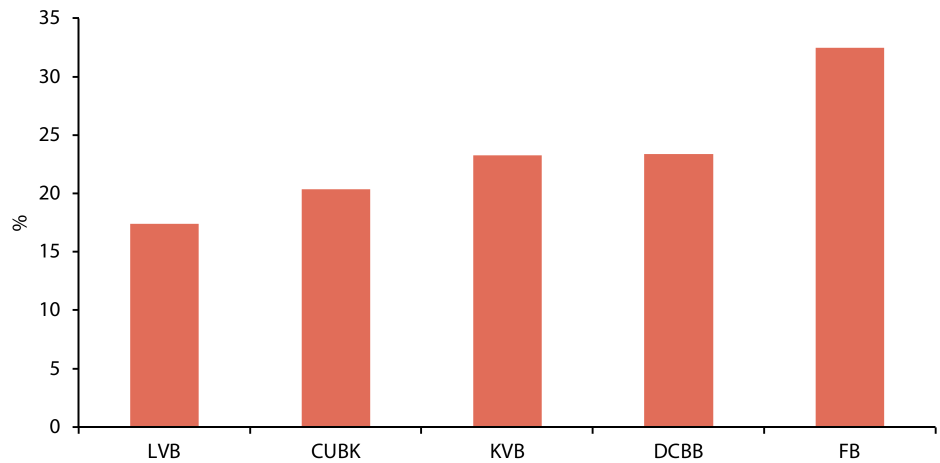
Creation of retail/CASA franchise: Currently, dependence of the MFI industry on bank avenues is very high at 70-75% (average). Post the conversion, this ratio will have to be reduced substantially and replaced with avenues of low-cost retail/CASA deposits or rely on high-cost fixed deposits (as seen in the case of universal banks which are awarded licenses). In our view, creation of CASA franchise would take time to become a meaningful portion of SFB's liability profile. Also, given the rural, semi-urban nature of presence, ability to garner deposits and also credit remains a challenge. According to RBI data, while SA accounts comprised 65% of accounts in rural-semi-urban area, SA balances as % of total deposits stood at mere 42%.

Exhibit 19: SA proportion (% of deposits) has remained lower in rural & semi-urban markets

Source: RBI, Centrum Research

Regional players ie old private sector banks, despite strong regional presence and existence, have faced challenge in shoring up their CASA franchises.

Exhibit 20: CASA proportion for old private sector banks have remained lower traditionally



Source: Companies, Centrum Research

The sticky nature of retail deposits, will limit the ability for SFBs to attract money at cheaper rates from other players including public sector and payment banks. The cost of CA/SA acquisition, expenses towards account maintenance including ATMs is an added burden. Thus, until a certain level of scaling up is done, we believe that maintaining a retail franchise will be a challenging task.

Branch expansion and IT infrastructure spend: The need for prior approval from RBI towards branch addition and regulatory requirement of at least 25% of branches to be unbanked rural centres (population <10,000) will slow down the pace of branch expansion for these SFBs. Additionally, the cost of IT and infrastructure spending to upgrade the current MFI-based branch to core banking system-related technology will lead to higher costs.

Ownership: SFB guidelines limit aggregate foreign investment at 49% through the automatic route. Few of the MFIs that are granted SFB license have foreign ownership at very high level. Thus, to meet RBI requirements, these companies will have to raise substantial domestic equity. Dilution at lower valuations may not favourable for the minority stakeholders.

Compliance with CRR/SLR requirement: SFBs need to comply with CRR/SLR norms from day 1 and no forbearance is provided for complying with statutory provisions. This, we believe, will lead to lower availability of funds for lending, resulting in lower loan growth and thus the returns profile.

We expect the MFI turned SFB players to go slow on growth in their initial phase of transformation. This would create room for existing NBFC-MFIs to capitalise on the market by increasing their presence. We continue to believe that volume-based growth is a more prudent approach towards scaling portfolio than value-based growth. As highlighted in our earlier part of the section, we also believe that after a high growth phase, the growth rate for the MFI industry should stabilise at 30-35% levels in the longer run.

Opportunities

Transition to SFB model will come with its own set of challenges. While there are internal challenges, the external environment could also pose an additional threat. However, we believe that with differentiated business model in terms of its clientele, business profile and reach, SFBs should transit into a niche entity that is somewhere between banks and NBFCs.

Diversified loan product: Unsecured microfinance would remain the core focus lending area of SFBs given the untapped opportunity, low delinquency and high profitability. In addition to MFI business, we believe, with close proximity to customers and the ability to lend for marginally higher ticket size, these entities could very well enter into the retail market of gold loans, MSME lending, cars/two-wheelers. Foray into corporate lending at an early stage of transition would not be the right approach towards balance sheet growth as it comes with its own challenges/capital requirement.

Access to low-cost retail deposits: SFBs will be permitted to collect deposits from their customers. Low-cost deposits would help generate better margins, aiding profitability. This is a key differentiator in the long-term vis-à-vis MFI business model in India.

No spread limitation: While MFIs currently are regulated with spread caps, the SFB regulation does not mention spread cap for the SFBs to follow on their loan portfolio. Although eventually, as the industry matures coupled with increased competition from regional players/other SFBs, we believe spreads could stabilise at near 7.5-9% levels for these players – similar to other rural/retail players.

Ability to cross sell: While processing fees remain the one of the drivers of other income for SFBs, the ability to cross-sell, especially for MFI turned SFB could be a major revenue driver. However, foray into other non-interest income avenues of treasury/forex as seen in case of commercial banks is unlikely to happen anytime soon.

Returns profile to undergo sea change

We believe that scale and size will play a crucial role in successful transition to the SFB model. The banking industry has seen classic examples of failures/successes during the phase of balance sheet transformation, and we believe operational efficiency will play a crucial role in determining a similar situation for the SFB model in its initial phase of transformation. Centurion Bank of Punjab is a classic example of the inability to transition following huge cost over-runs and asset-quality related risk that emerged at a later stage. On the other hand, Indusind Bank and DCB Bank are classic examples of successful transition. These stocks continue to attract considerable investor attention.

We have tried to analyse the possible impact on profitability for MFIs turned SFBs in its initial transition phase. CRR/SLR requirement, nascent pace of deposit mobilisation largely in the form of retail deposits, huge overhead cost and asset quality-related headwind could lead to a dip in near-term RoA to 0.9-1.0% and RoE to 5.2-6.1-% levels.

Exhibit 21: RoA / RoE profile in the initial phase of transition to undergo sea change

% of assets	MFI (present structure)	Phase of transition to SFB	Comments
Net interest margin	***9.95%***	***7.10%***	**Margins to decline given the need for setting aside funds for low-yielding SLR / CRR requirement.**
Non-interest income	*2.10%*	*2.00%*	
Total income	***12.05%***	***9.10%***	
Operating costs	*6.5%*	*7.00%*	IT, infrastructure spending, need for more rural-based branches will lead to rise in cost/income ratio
Provisions	*0.9%*	*0.75%*	
Profit before tax	***4.65%***	***1.35%***	
Tax	*1.54%*	*0.44%*	
Profit after tax	***3.1%***	***0.90%***	
Return on assets (RoA)	***3.1%***	***0.9%***	**Scale and size will play a crucial role in successful transition to SFB model**
Assets/equity (leverage) (x)	5.0	6.8	Expect SFBs to maintain tier-I CAR requirement at 12% vs overall CAR requirement of 15%
Return on equity (RoE)	***15.6%***	***6.1%***	

Source: Centrum Research Estimates

In the initial transition phase, if we assume a tier-1 ratio of 12% instead of 15%, the leverage increases to 8.4x which would bump up the ROE by 90bps to 7%, but depress the RoA by 10 bps to 0.8%. Reduction in RoA would be driven by a decline in NIM by 11bps.

Sustainable RoE could well be at 16.7% levels

With a well-diversified asset portfolio, slow yet steady improvement in liability franchise including gradual traction in the retail/CASA proportion, and adequate liquidity including adherence to capital requirement, we expect NIMs to stabilise in upwards of 7%. Avenues of non-interest income, on-going efforts towards cost rationalisation, limited delinquencies and provisioning thereon would translate into RoA of 2.5%. RoEs could well be at 16.7% levels in such a scenario.

Exhibit 22: Sustainable RoE to be at 16.7% levels

% of assets	SFB in its initial phase of transition	Steady state RoA profile
Net interest margin	***7.10%***	***7.32%***
Non-interest income	*2.00%*	*2.50%*
Total income	***9.10%***	***9.93%***
Operating costs	*7.00%*	*5.00%*
Provisions	*0.75%*	*1.13%*
Profit before tax	***1.35%***	***3.69%***
Tax	*0.44%*	*1.22%*
Profit after tax	***0.90%***	***2.47%***
Return on assets (RoA)	***0.9%***	***2.5%***
Assets/equity (leverage) (x)	6.8	6.8
Return on equity (RoE)	***6.1%***	***16.7%***

Source: Centrum Research Estimates

SFBs unlikely to be a major threat to NBFC-MFIs model

While one class of investors believes that the introduction of new banking models could potentially act as a deterrent to existing micro-credit-based lending models of MFI/SHG bank-based lending approach, we believe the same is unlikely to happen in the near term, especially for NBFC-MFIs. SHG-based lending approach is seeing signs of growth moderation following asset quality-related issues (explained earlier) and thus could witness potential impact in the longer run.

However, the MFI industry, with the advent of new lending entities, can see several positive impacts, including lower costs for borrowers and greater systemic stability. We believe that both SFB and MFI industry will continue to operate in their own space, given the following scenarios:

- While SFBs are structurally better placed than MFIs given their access to low-cost funds, diversified product offerings and regulatory environment, the business model is crafted to cater to the credit requirement of under-served affluent MSME, individual and secured retail class in addition to existing MFI clientele.
- On the flip side, MFI players will continue to focus on the un-served and under-served customer base. Large players could also potentially move from GLP-based lending to individual-based lending approach, largely in the form of unsecured loans.
- MFIs over a period of time have specialised in catering to their set of customer profile. The door-to-door lending model is the key differentiating factor, and we believe that MFI turned SFBs will find it incrementally difficult to run this model given the high operating cost.

SFB versus the existing set of regional / Old private sector banks:

- The success of SFB model will also depend on its transition. Also, while being pan-India, these players have established strong presence in their areas of origin, especially in south India. With a distinct lending model, these players are unlikely to be a major threat to existing regional/old private sector banks given the well-established presence, customer profile and product offering of the latter.
- The space, however, could see intense competition on the deposit front, especially for weaker players which have been losing out on their share as SFBs are set to price their deposit rates (including saving deposit rates) higher. On the asset side, we do not foresee SFBs as a major threat to existing old private sector banks.
- Our belief on limited threat to the MFI model is also based on the premise that both asset finance companies and housing finance companies have existed and are capable of scaling their business model successfully even as banks continue to operate in these segments. Over a period, housing finance companies gained market share over banks. Asset financing companies have also created a niche, with some players gaining market share over banks.

Exhibit 23: Distinct characteristics of each of the lending model.

% of assets	MFI	SFB's	Bank
Capital requirement	CAR at 15%; tier-I at 10% by end-FY18	Minimum CAR at 15%	CAR at 9%; tier-I at 6%
Business model	Door-to-door – niche and USP	Set- up with a) provision of savings vehicles and (ii) credit supply to small business units, small and marginal farmers, micro & small industries, and other unorganised sector entities, through high-technology low-cost operations	Diversified loan product offering.
Ability to raise deposit	Not permitted. Though in some of other countries, MFI are permitted to raise deposits.	Key elements to watch out for given a) new entrants b) sticky nature of deposits, especially term deposits	Cost of deposits is a function of dependence on various sources of deposit funding
Asset quality	Even as the nature of lending is unsecured , asset quality risk have remained low	Model will have to be tested for ability to contain delinquencies	Retail franchises have seen limited NPA's. Corporate lenders continue to grapple with NPA problem
Spreads / margins	Cap on lending spreads. Margins a function of liquidity	No cap on lending spreads. NIM's set to dip in initial years of transformation.	Competitive pricing environment limits the ability to earn high spreads
Return profile	RoA / RoE could well be at 3% / 18% levels in the steady state environment	Initial phase of transformation to see RoA profile dip. Steady state RoA at 2.5% / RoE at ~17%.	Banks with varied balance sheet profile and asset quality operate with different RoA / RoE profile.

Source: Centrum Research

Annexure

Exhibit 24: Summary of Major Changes in MFI Sector

RBI has emerged as the central regulator of NBFC-MFI

- This limits the scope of interference by individual state governments, which could have otherwise used the Money Lenders Act to control MFIs.
- It also provides huge legitimacy to the sector and improves MFI"s access to funds from the commercial banking sector.

RBI has clearly defined process, rates and code of conduct

- Margins have been capped at 10% for large MFIs, thus limiting the scope for charging excessive interest rates.
- Insurance expense and processing fees are the only charges that an MFI can levy.
- Recovery practices have been clearly defined.

LOW RISK

CIBs provide an efficient monitoring mechanism

- High indebtedness in AP was an outcome of absence of any customer-related credit information.
- CIBs generate an exception report when more than two MFIs lend to a single borrower, thus acting as a check on MFIs.

Geographic diversification has ensured lower exposure to a state

- Top five AP-based MFIs had over 35% of their portfolios in AP.
- Many MFIs have begun to diversify into multiple states, partly under the fear of AP-like event and partly in search of growth opportunities.

Source: Ind-Ra, RBI, Centrum Research

Exhibit 25: Key Differences in the SHG and JLG Models

	SHG-Bank linkage	**JLG model**
Participating institutions (features and form)	**Lending institutions:** Commercial banks, cooperative and regional rural banks Regulatory and implementation: RBI, NABARD, SIDBI, etc. Group fostering: NGOs and other SHPIs for up to six months	**Lending institutions:** NBFCs, Section 25 companies, Societies and trusts (other than NBFCs, all are non-profit) Regulatory and implementation: RBI (with regard to prudential and deposit-related norms) Group fostering: Two weeks to one month
Group size	10-20 members	5-10 members
Liability structure	Banks open the account in the name of the SHG. The lending is to the group; hence, the liability is on the group as well In case a group member and thereby the group defaults, the group is no longer eligible for credit	The liability is on the group. In case a member defaults, other members pay on his behalf to maintain their access to credit If the group defaults, the members are not eligible for credit
Set-up costs	High; the initial costs are borne by the SHPIs, part of which is reimbursed by NABARD	Medium; group fostering guidelines not as long and stringent as for SHG
Loan features and tenor	2-4 years interest rates between 3% and 12%	Maximum one-year interest rate up to 35-40%
Credit costs	All India: 6.8% in FY14, 18-25% in some large states	0.5%-1% of the portfolio on account of JLG structure
Sustainability	The programme sustains on government sponsorship and support, NABARD reimbursements and refinance facilities available to banks	For-profit entities can continue running their business till it is profitable

Source: Ind-Ra

Exhibit 26: Guidelines for the MFI Industry

Terms	
Borrower loans	
Borrower profile	Maximum of two NBFC-MFIs can lend to the same borrower
Income generating loan	Loans towards income generation activities more than 70% of overall book
Loan terms	85% of net assets to be assets complying with following: ❍ Borrower household annual income levels: rural below Rs100,000; urban and semi-urban below Rs1,60,000 ❍ Loan amount below Rs60,000 in the first cycle and up to Rs100,000 subsequently ❍ Total borrower indebtedness below Rs100,000
Loan tenor	❍ Not less than 24 months for loan amount above Rs30,000 ❍ Minimum moratorium equal to interest period
Interest rate caps (linked to bank rates)	❍ No interest rate cap ❍ Margin cap 12% for small MFIs and 10% for other MFIs (based on asset size) ❍ Interest to be calculated on diminishing outstanding basis
Interest periods and repayment	❍ Weekly, fortnightly or monthly
Penalty	❍ No penalty on delayed payments ❍ No prepayment penalty
Transparency on other charges	❍ Only three forms of charges – interest, processing fee 1% of disbursement and insurance premium (including admin charges) ❍ No collection of security deposits ❍ Loan card to every borrower with details in vernacular language
Recovery	Recoveries at residence only if a customer fails to appear at the designated place more than twice
Funding and capital	
Capital ratios	Min net owned funds: INR50m (North east MFIs – INR20m) after 31 March 2014 Min CAR (Tier 1 + Tier 2): 15% of risk weighted assets Tier 2 capital cannot exceed 100% of Tier 1 capital Exceptions for AP portfolio of MFIs
Priority sector	Status to continue
Governance	
Code of conduct, customer protection code	NBFC-MFIs to ensure that a code of conduct and systems are in place for recruitment, training and supervision of field staff
Provisioning	Loan provision to be maintained by NBFC-MFIs shall be the higher of a) 1% of the outstanding loan portfolio, or b) 50% of the aggregate loan instalments which are overdue above 90 days and below 180 days; 100% of the aggregate loan instalments which are overdue for 180 days or more
CIB	Mandated that all NBFC-MFIs be members of at least one CIB
SRO	Mandated that all NBFC-MFIs be members of at least one SRO

Source: RBI, Centrum Research

Exhibit 27: MFI Industry – Analysis of state-wise composition of client base and loan portfolio. Loan portfolio grew 76% CAGR driven by 40% CAGR in volumes (ie no of borrowers) and 26% CAGR in value (ie. loan O/s. per borrower)

	No of MFI's			Client base (in mn)			Loans portfolio O/s. (Rs bn)			Loan amount O/s. per client (Rs)			CAGR % (FY14-16)	
	2014	**2015**	**2016**	**2014**	**2015**	**2016**	**2014**	**2015**	**2016**	**2014**	**2015**	**2016**	**Volume based**	**Value based**
Tamil Nadu	20	17	19	3.8	4.4	5.7	38	51	87	10,000	11,591	15,263	*22*	*24*
Karnataka	18	18	24	2.5	2.7	3.8	26	41	72	10,400	15,185	18,947	*23*	*35*
Maharashtra	22	21	32	2.4	2.6	3.7	24	34	63	10,000	13,077	17,027	*24*	*30*
Uttar Pradesh	15	12	19	1.8	2.1	3.1	20	31	56	11,111	14,762	18,065	*31*	*28*
Madhya Pradesh	21	22	27	1.7	1.8	2.8	15	23	41	8,824	12,778	14,643	*28*	*29*
Orissa	11	7	13	1.5	1.4	2.1	11	16	31	7,333	11,429	14,762	*18*	*42*
West Bengal	12	8	14	3.9	1.7	2.2	39	17	31	10,000	10,000	14,091	*(25)*	*19*
Bihar	17	16	21	1.7	1.2	1.9	16	15	29	9,412	12,500	15,263	*6*	*27*
Kerala	7	7	10	0.9	0.7	1.2	10	12	24	11,111	17,143	20,000	*15*	*34*
Gujarat	18	15	19	0.7	0.9	1.2	8	10	21	11,429	11,111	17,500	*31*	*24*
Rajasthan	14	11	14	0.6	0.6	0.8	6	7	13	10,000	11,667	16,250	*15*	*27*
Haryana	9	11	14	0.2	0.3	0.5	2	4	12	10,000	13,333	24,000	*58*	*55*
Punjab	5	-	10	-	-	0.6	-	-	10	-	-	16,667	-	-
Jharkhand	10	9	17	0.4	0.3	0.6	3	4	9	7,500	13,333	15,000	*22*	*41*
Chhattisgarh	8	12	17	0.4	0.4	0.6	3	4	9	7,500	10,000	15,000	*22*	*41*
Assam	6	6	10	0.9	0.3	0.5	11	4	8	12,222	13,333	16,000	*(25)*	*14*
Uttarakhand	10	10	11	0.2	0.2	0.3	3	3	6	15,000	15,000	20,000	*22*	*15*
Delhi	9	8	8	0.2	0.2	0.6	3	4	6	15,000	18,250	9,700	*73*	*(20)*
Puducherry	6	9	10	0.1	0.1	0.1	1	1	2	10,000	10,000	20,000	*0*	*41*
Total industry				**16.5**	**22.6**	**32.5**	**171**	**289**	**532**	**10,364**	**12,805**	**16,379**	***40***	***26***

Source: MFIN, Centrum Research

On a satin-smooth track

We initiate coverage on Satin Creditcare Network Ltd (SCNL) with Buy and a TP of Rs600. We believe this under-researched stock that is in a space which is well-discovered, regulated and attracting a lot of investor attention, merits consideration for its track record of performance, geographical presence and market share. MFI industry is set for steady growth in the longer run; and this, with strong presence in north and Central India, bodes well for SCNL. Also, while near-term RoAs are a notch lower than peers, we believe the progressive move to our estimated "sustainable RoA" could see the stock trade at higher multiples.

- **Geographic reach + product diversification – strong growth drivers:** Led by sheer market opportunity given high levels of credit under-penetration in India, MFI industry has grown at a higher pace. The higher growth was also due to expansion into new regions and reduction in concentration risk. SCNL, with presence in 16 states, primarily in north and central India, grew at 79% AuM CAGR over FY12-16 (vs. industry CAGR of 48%). With continued focus on deeper penetration and new product offerings (more to leverage on existing customer base), we believe SCNL is well poised for a healthy 34% CAGR in AuM over FY16-18E.
- **Well-defined process in place, operating leverage to help cost reduction:** Intense training programmes, three layers of credit appraisal, regular inspections and audits are integral to the business model which has enabled SCNL to ensure credit control and contain risk of ghost borrowers that are endemic in this industry. Our field surveys indicated favourable feedback for SCNL in terms of its processes and track record. In a bid to de-risk the cash collection model, SCNL is in talks to move to the cashless collection process. This, in addition to the plan for cashless disbursements (in times to come), will augment operational efficiencies.
- **Estimated sustainable RoA/RoE at ~2.9%/19.0%:** Some larger MFI players operate at higher RoA/RoE, an outcome of their varied balance sheets and the ability to efficiently sweat their assets. Thus, while near-term RoA for SCNL appears lower than peers, we believe that adequate leverage, operating efficiencies and non-interest income will help address the concerns in the longer run. Also, we believe that as the company becomes more mature with stable growth and adequate leverage, it could potentially trade at a "steady state" RoA/RoE of 2.9%/19.0%.
- **Valuation, view and key risks:** We like SCNL for its business model, well-defined credit process, track record of modest delinquencies (even during Andhra crisis) high promoters' skin in the game. Being relatively low on tier-I capital (and thus, higher leverage), we have factored dilution into our estimates for FY17. We expect SCNL to grow at 34%/43%/40% CAGR in AuM/NII/PAT over FY16-18E. We Initiate with Buy and a TP of Rs600 (valued at 3x FY18E ABV). Gradual improvement to a more sustainable RoA could see multiples expand further. Concentration risk and its fallout effect on asset quality, growth and inability to contain costs remain key risks.

Target Price	Rs600
CMP*	Rs477
Upside	25.7%

Key Data	
Bloomberg Code	SATIN IN
Curr Shares O/S (mn)	32.0
Diluted Shares O/S(mn)	32.0
Mkt Cap (Rsbn/USDmn)	15.2/227.4
52 Wk H / L (Rs)	543.5/88.5
5 Year H / L (Rs)	543.5/88.5
Daily Vol. (3M NSE Avg.)	225799

Price Performance (%)*

	1M	6M	1Yr
SATIN IN	10.1	28.0	-
Nifty	5.0	12.7	0.7

*as on 13 July 2016; Source: Bloomberg, Centrum Research

Shareholding pattern *(%)*

	Q4FY16	Q3FY16	Q2FY16
Promoter	36.2	34.7	34.7
FIIs	48.9	51.3	48.9
DIIs	-	-	-
Others	14.9	15.0	16.4

Source: BSE, *as on 12 July 2016

Expect SCNL to scale towards steady-state RoA / RoE as it attains maturity

RoA breakdown	SCNL (FY16-18E)	Sustainable RoA / RoE
NIM	**9.62**	**9.61**
Other income	1.90	2.00
Total income	**10.75**	**11.61**
Operating Expenses	6.38	6.25
Pre-provision profit	**4.38**	**5.36**
Provisions	0.99	1.05
Profit before tax	**3.39**	**4.31**
Tax	1.14	1.42
PAT / RoA	**2.3**	**2.9**
Leverage (x)	8.43	6.67
RoE	**18.9**	**19.0**

Source: Centrum Research

Read the inside pages for:

- *Thrust at under-penetrated markets of north and central India*
- *Best-in-class operational efficiency; well-defined business processes have enabled mitigate NPA risk*
- *Dilution factored in; leverage, rating to get addressed*
- *Steady-state RoA / RoE at 2.9% / 19% levels*

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Gaurav Jani, gaurav.jani@centrum.co.in; 91 22 4215 9110

Y/E Mar (Rs mn)	Net Income#	PPOP	Rep. PAT	YoY (%)	EPS (Rs)	P/E (x)	Adj BV (Rs)	P/Adj BV (x)	RoA (%)	RoE (%)
FY14	856	325	156	302.3	6.9	69.6	61.0	7.8	1.7	11.9
FY15	1,467	562	317	103.8	12.5	38.2	76.2	6.3	2.0	19.1
FY16	2,686	1,083	579	82.7	18.4	26.0	102.4	4.7	2.2	22.4
FY17E	3,949	1,520	775	33.8	21.2	22.5	163.1	2.9	2.1	16.8
FY18E	5,257	2,266	1,136	46.6	31.1	15.3	194.0	2.5	2.5	17.4

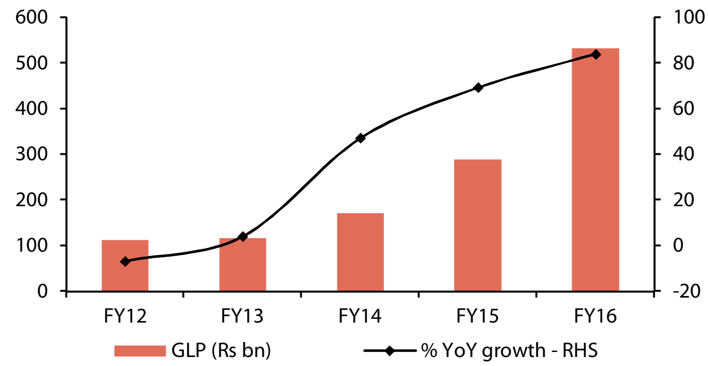
Source: Company, Centrum Research Estimates #denotes NII + other income

Strong business model; continued focus therein with new product offering to aid in strong growth

- **Presence in highly under-penetrated and relatively under-served markets of north and central India. Well-drawn out strategy for growth has led to 79% AuM CAGR over FY12-16.**
- **AuM growth led by near 6x increase in no of borrowers and <2x rise in ticket size.**
- **Continued focus on key areas of presence including newer geographies, new product offerings by leveraging on existing MFI clientele and foray into MSME opportunity to translate into stronger growth.**
- **We are factoring in 34% AuM CAGR over FY16-18E.**

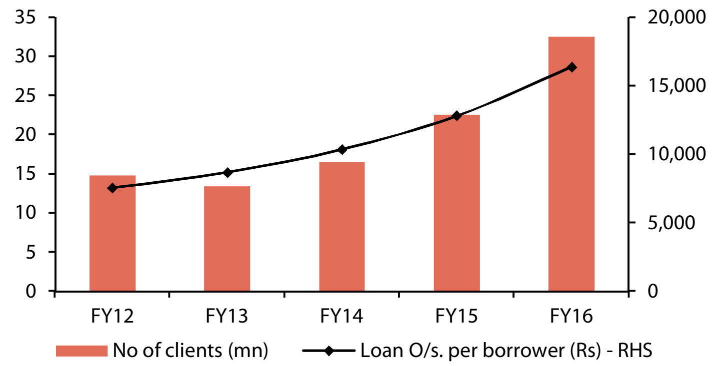
The sheer market opportunity given the lack of formalised credit market has seen the MFI industry witness healthy growth over the last few years. The increase in loan portfolio is primarily following increased branch reach and steady rise in their ticket sizes. On a system-wide basis, the gross loan portfolio (GLP) for the industry grew at 48% CAGR to Rs533bn led by 2.2x increase in customer base to 32.5mn and 21% rise in loan O/s. per borrower over FY12-16. As explained in our sector piece, we expect the growth rates to continue, though at a steady pace, across all players. Deeper penetration through a well-assessed strategy, avoidance of over-leveraging and ensuring discipline will aid in healthy growth for players.

Exhibit 28: Industry GLP grew 48% CAGR over FY12-16



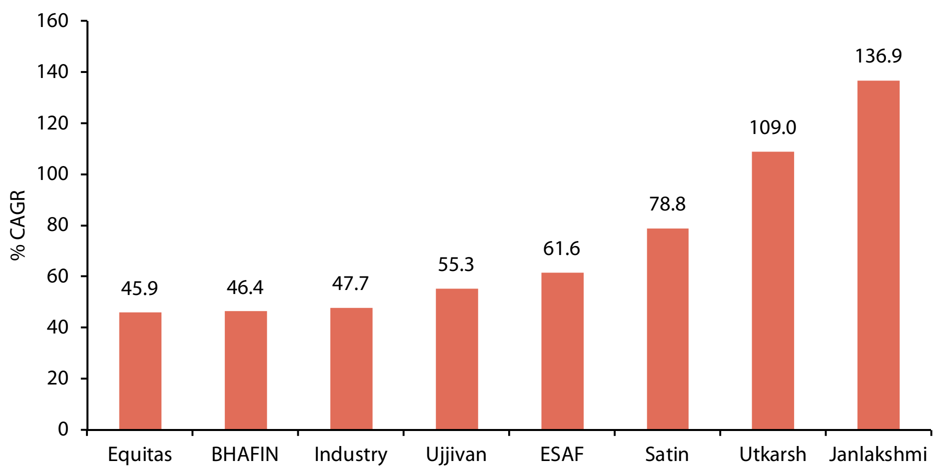
Source: MFIN, Centrum Research

Exhibit 29: … led by healthy increase in customer base and steady rise in loan outstanding per borrower



Source: MFIN, Centrum Research

Exhibit 30: Trend in loan CAGR (FY12-16) - select larger players have seen growth rates be in upwards of systemic run-rate



Source: MFIN, Centrum Research.

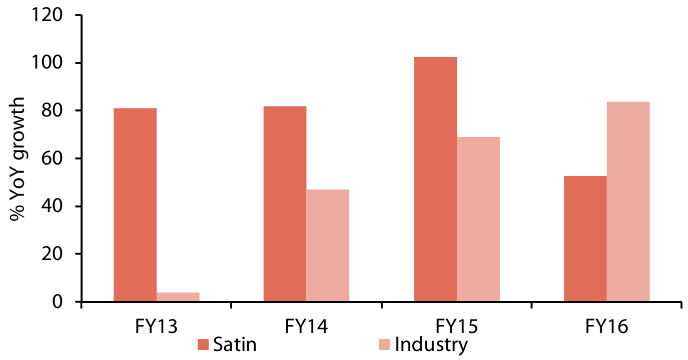
Satin Creditcare: Thrust on under-penetrated market of north and central India

While some larger MFIs, with their origins in south India, have preferred to penetrate deeper in existing regions in their initial growth phase and later move to areas in and around their home-state, SCNL has carved a niche by placing greater emphasis into highly under-served and relatively under-penetrated markets of north and central India. Despite SCNL's presence in the traditionally perceived socio-politically riskier regions of north India, its core understanding of the door-to-door business model, has helped the company grow stronger and ensure steady footing in its key areas of operations. The first-mover advantage in certain states also helped SCNL enjoy near market leadership position in certain regions.

Starting with MFI business in UP, SCNL currently operates in 16 states, with over 431 branches and employee strength of ~3,900. *Over FY12-16, the company witnessed 79% CAGR in loans led by 57% CAGR in number of borrowers and 14% CAGR in value per borrower. The higher dependency on volume-led (no. of borrowers) growth clearly signifies SCNL's ability to penetrate deeper into the under-served markets and also sweeten their assets efficiently*. The increased borrower base (vis-à-vis ticket size) is also a function of SCNL's dependence on customer base in rural area, outlining its focus on targeting the un-served/under-served segment.

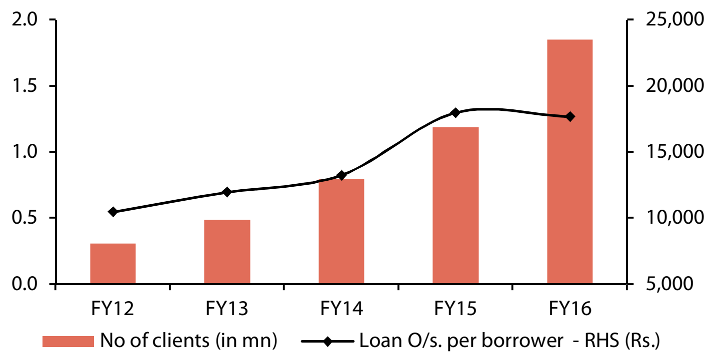
While 65% of loans are aimed at borrowers in rural area, the rest is towards customers on the outskirts of rural/tier-II regions. Portfolio mix continues to be in the nature of agri/allied activities (63%), production (7%), services/trade and rest (30%).

Exhibit 31: SCNL has witnessed 79% CAGR in GLP vs. 48% CAGR for the industry over FY12-16.



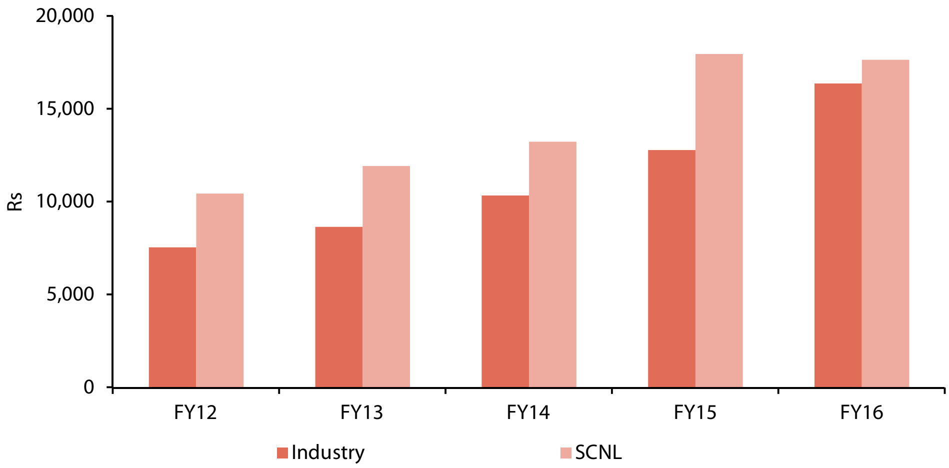
Source: MFIN, Centrum Research

Exhibit 32: Customer profile grew 6x increase vs. <2x increase in loan O/s. per borrower.



Source: Company, Centrum Research.

Exhibit 33: SCNL has seen 14% CAGR in its loan O/s. per borrower vs. 21% CAGR for the industry

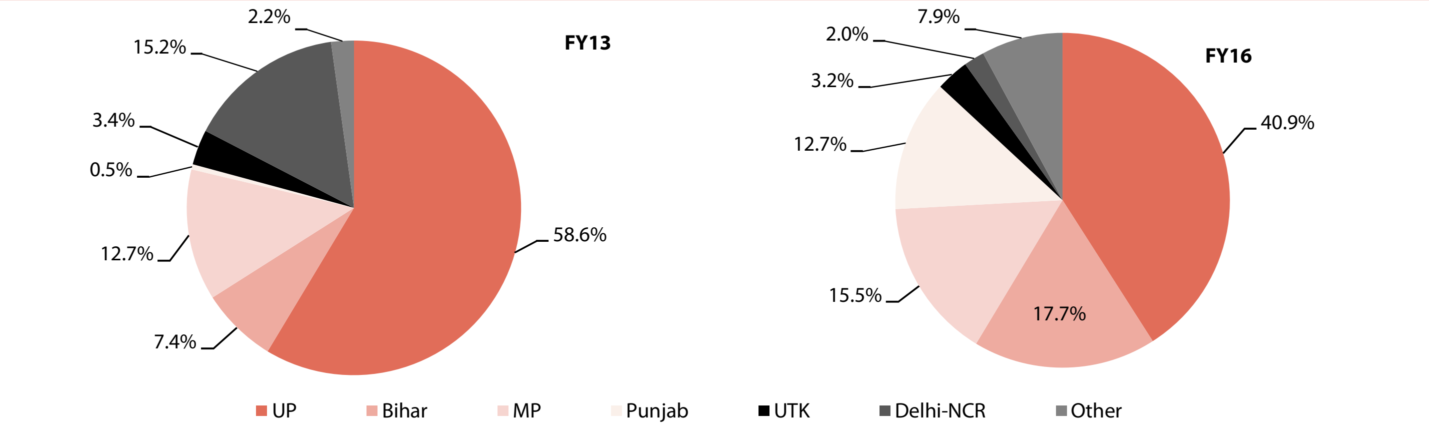


Source: MFIN, Company, Centrum Research

The increased reach over the past four years has enabled SCNL to reduce its over-dependency on certain states. With initial focus on UP in FY12, the company gradually entered into markets of Bihar, Delhi, Jammu and Kashmir, Rajasthan and Uttarakhand and over FY12-15. During FY16, it forayed into Chhattisgarh, Jharkhand, Himachal Pradesh, West Bengal and Gujarat.

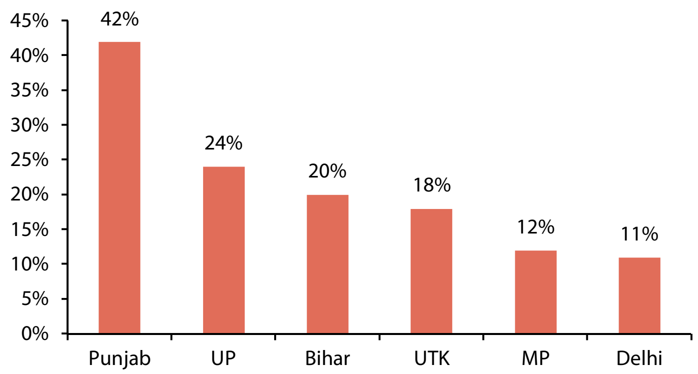
While state-wise exposure is higher for SCNL and especially in its state of origin ie UP, with deeper penetration into newer areas, it plans to reduce per-state concentration to below 20% levels. This, we believe is a step in the right direction as it also addresses one of the key criteria of rating agencies.

Exhibit 34: Over FY13-16, SCNL has been in a position to reduce its state-concentration.



Source: Company, Centrum Research

Exhibit 37: Earlier mover advantage has helped SCNL's enjoy strong market share in some of the key states of presence (FY16)



Source: Company, Centrum Research

Exhibit 38: Industry-wide GLP and no of MFI players. SCNL has rightly stayed away from highly-penetrated and overly serviced regions of south-India. On the flip-side foray into newer geographies will aid in increasing exposure

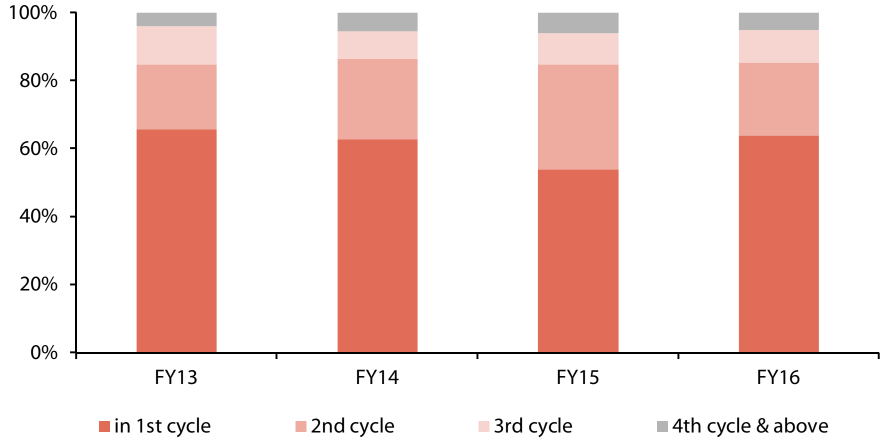
States	Industry			SCNL GLP (Rs bn)
	Players in that state	**GLP (Rs bn)**	***% YoY growth***	
TN	19	86.9	*71.0*	0
Karnataka	24	71.7	*74.4*	0
Maharashtra	32	63.3	*88.3*	0.5
UP	19	56.5	*83.8*	13.4
MP	27	40.8	*81.2*	5.1
West Bengal	14	30.8	*85.4*	0.0
Bihar	21	29.2	*90.4*	5.8
Gujarat	19	20.6	*100.8*	0.2
Haryana	14	11.7	*176.7*	0.6
Rajasthan	14	12.6	*78.6*	0.8
Punjab	10	9.9	-	4.2
UTK	11	5.9	*73.4*	1.1
Delhi	8	5.8	*59.5*	0.7

Source: MFIN, Centrum Research: Data for FY16

The company is in no hurry to move into regions of TN and Karnataka which bodes well in terms of mitigating over-lapping of customer and asset quality related headwinds in near future. On the flip-side, entry into newer geographies of high growth states of Gujarat, Chhattisgarh and Jharkhand bodes well for SCNL in diversifying its loan portfolio.

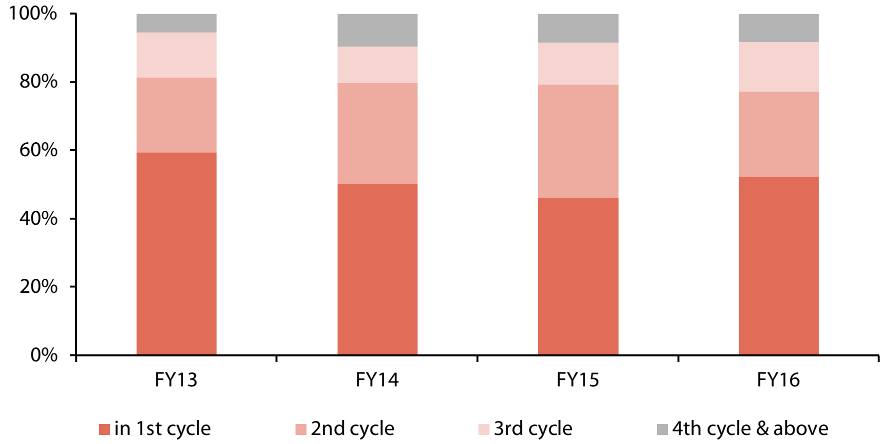
Near leadership position in certain geographies is also represented from the fact that average 50% of its loan exposure is towards customers in their second and subsequent cycle of credit requirements. When seen in context of borrowers in 2nd cycle and beyond, this ratio has remained in excess of 40% despite near 4x increase in borrower base over FY13-16.

Exhibit 39: 40% of clients remain in 2nd cycle and above…



Source: Company, Centrum Research

Exhibit 40: … in terms of loan exposure, this ratio has been around 50% (average)



Source: Company, Centrum Research

Continued focus on key areas of presence + product diversification = stronger growth

In our sector piece, we have mentioned growth opportunities in the sector given the huge untapped market. However, unlike the previous cycle of FY12-16 that saw exponentially higher growth rates, we expect the pace of acceleration to be more prudent and well-calibrated in the current phase. This is due to the extent of over-leveraging in certain pockets, rise in rejection status and the prevailing environment characterised by emergence of new lending institutions – small finance banks (SFB). The latter, however, in our view and based on our interaction with experts, do not pose a systemic risk to existing MFIs.

Given a well-defined strategy in place and relatively nascent nature of presence in some newer key geographies of Chhattisgarh, Jharkhand, Himachal Pradesh, West Bengal and Gujarat, we expect SCNL to grow at a steady pace. Over FY17-18E, we expect a steady loan growth of 30%, driven by deeper penetration into existing areas, tapping new geographies and an average ~8-10% increase in ticket size.

Product diversification more as a strategy towards leveraging on its customer franchise

Product financing: In addition to pure MFI loans and predominantly under the group lending approach (98% of loans), SCNL forayed into the business of product financing of solar lamps in FY16. The company has already disbursed loans to ~0.2mn customers. As at end-FY16, the loan portfolio stood at Rs113mn.

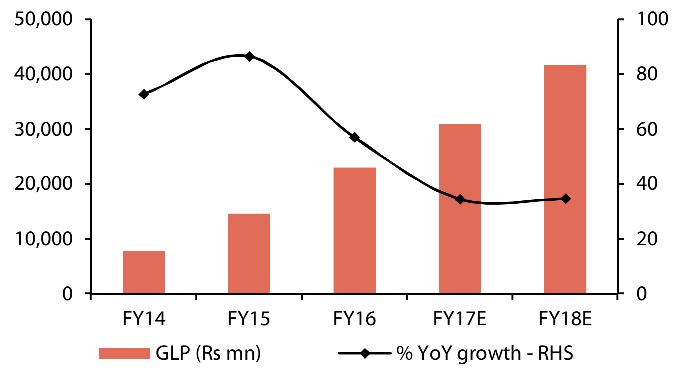
Individual micro-loan (IML): The current MFI regulations have set a cap on ticket size and the number of MFIs that one borrower can approach for his capital requirement. In a bid to address the un-bankable market opportunity and marginally higher ticket size loans, SCNL plans to foray into this venture. The need for differentiated lending vehicle is also given the higher proportion of client base in the second cycle and above.

With average ticket size at Rs70,000-Rs100,000, SCNL has indicated for strong growth potential from this avenue. Though on a pilot basis and at a nascent stage of introduction, drawing parallels from some existing business models run by other MFIs, we believe the product offering will augur well along with SCNL's strategy of deeper penetration. Also, with seasoned nature of customer profile, delinquency rates are expected to remain lower.

SME business: SCNL has also forayed into the business of SME financing beginning FY17. Under the leadership of a well-experienced senior person, the company is planning to cater to borrowers with a capital requirement in the range of Rs0.1-1mn of loans and tenure of 2-5 years. Given the nascent nature of business and larger focus on asset quality over growth, management has guided for minimal contribution in first year of incorporation. However, as the product gains importance, we expect it to contribute meaningfully to the overall loan portfolio.

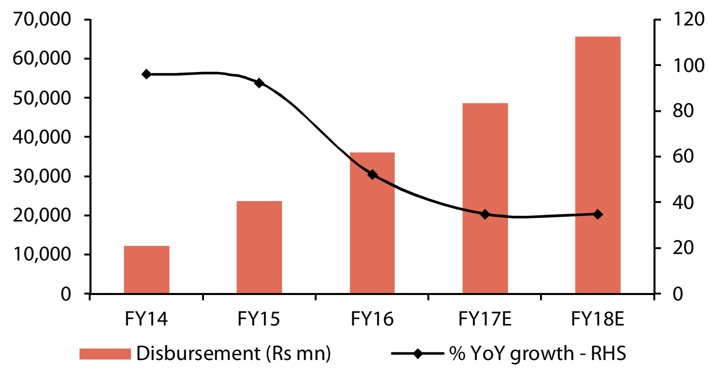
We believe a greater focus on the MFI business and a slow but steady pick-up in other financing avenues, will aid in steady growth over FY17-18E. The pace of growth, however, is slated to be far more prudent, and thus, we are factoring in loans/disbursement CAGR of 35% each over FY16-18E vs 86%/75% CAGR in loans/disbursement over FY12-16.

Exhibit 41: Factoring in 35% CAGR in gross loan portfolio



Source: Company, Centrum Research Estimates

Exhibit 42: …led by healthy disbursements over FY16-18E.

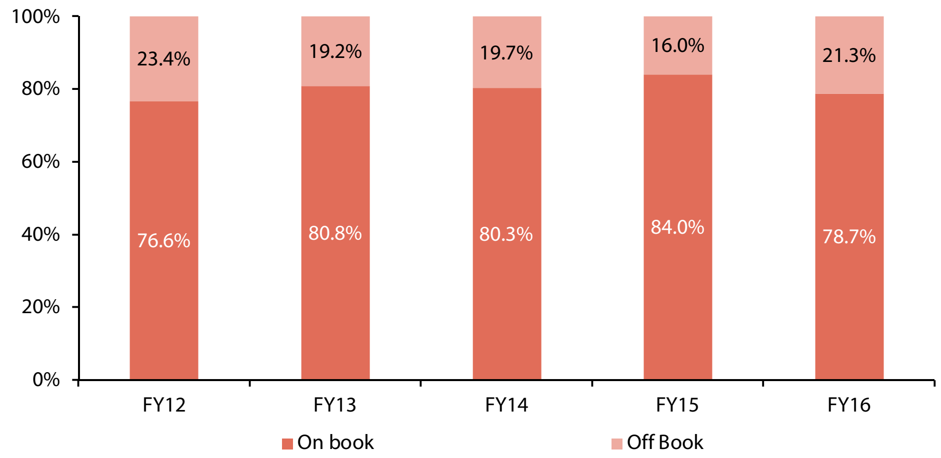


Source: Company, Centrum Research Estimates

While in the post-AP crisis period, banks immediately withdrew from lending to MFI segment, the stringent regulations in place and the PSL nature of lending by MFIs saw banks extend credit facilities towards the industry. On an industry-wide basis, securitisation comprises ~20% of overall AuM. The proportion of securitised loans for SCNL however has been higher given its a) relatively high cost of borrowing from other avenues and b) capital release under the credit enhancement route.

We expect SCNL to continue resorting to securitisation route and are thus factoring in 34% AuM CAGR, led by 35% CAGR in loan portfolio and 34% CAGR in securitisation.

Exhibit 43: Securitisation as % of AuM for the industry has remained at ~20% levels.



Source: MFIN, Centrum Research

Exhibit 44: … for SCNL, though has remained traditionally higher at 30% levels and we expect the same to continue over FY16-18E.

Source: Company, Centrum Research Estimates

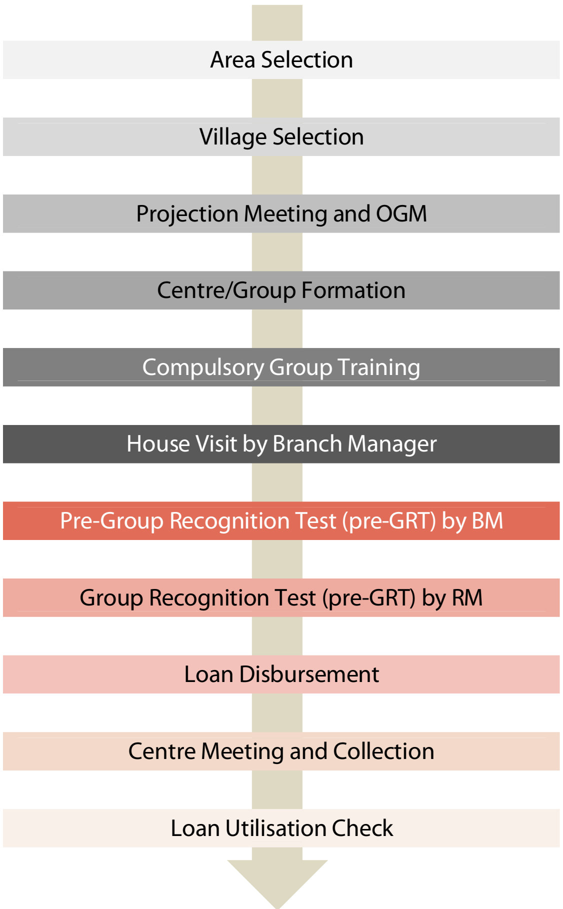
Well-defined credit process in place; operating leverage to aid in further cost reduction

- **Three layers of credit assessment, route checks to ensure leakages, credit quality and ghost borrowers. Our field survey validated the process in place.**
- **Best-in-class operating efficiency evident in loan / borrower per employee. Moving towards digitisation way of doing business.**
- **Socio-political risk well-contained, asset quality related risks have remained lower.**

Well-defined credit assessment strategy

The door-to-door nature of lending and involvement of cash warrants a well-defined strategy to avoid any leakages. With larger thrust on credit quality over growth, SCNL has set in place a well-defined strategy for credit assessment, disbursement and collection. Impetus is also given on training the borrower community, to ensure financial discipline.

Exhibit 45: SCNL: Credit policies and process



CSO –Community Service Officer (Loan Officer)
BM –Branch Manager
TM –Territory Manager
RM –Regional Manger
OGM –Open General Meeting
CDS –Collection & Demand Sheet

1. Field officers (ie, CSO) are required to undergo an intense training programme (both internal and external).
2. The selection of state/village is based on feedback from a) primary survey by field officers and territory manager, b) analytical team that validates data from CIB and c) involvement of deputy CEO/COO.
3. Post the selection of village, members form groups of 3-5 and centres are created. Each group member will appoint a group leader from among themselves. Each member of the centre is required to undertake three days of intense training programme.
4. **CSO and BM make house visit at each of the centre members to ensure genuineness of the borrower. Thorough credit-check is undertaken for fund requirement, repayment capacity, etc.**
5. **Once approved by the CSO and BM, the entire database from a particular centre including loan requirement by each group member is sent to TM for his approval.**
6. After TM's approval (post his own validation for a select set of borrowers), the proposals are validated against the CIB records.
7. Rejections, if any, are accordingly captured and intimated at TM, BM level/centres.
8. Clients, accordingly, are intimated about the amount sanctioned and the date of disbursement through a loan sanction letter.
9. **Disbursement always happens at the branch and in the presence of at least two officers of the same branch. Cards are issued with detailed information of loan amount, purpose, EMI schedule and dates.**
10. Collection is typically fortnightly. In certain cases it is even on a monthly basis.
11. Post two instalments from the date of disbursement, CSO/BM/TM undertake loan utilisation checks to ensure productive usage of borrowed funds.

Source: Company, Centrum Research

Unlike some other larger MFIs where the credit assessment, disbursement and collection processes are segregated across teams, SCNL follows a single-structure model for client relationship. Also, the three-layered process of credit appraisal at SCNL is unique and rarely followed by any of the larger MFI players. SCNL implements some distinct credit appraisal policies which include practices like a) regular inspections by the TM, b) quarterly branch audits, c) compulsory visits by BM to the centres once in six months and d) employee code of conduct.

Field survey validated the credit policies, collection process and customer preference for SCNL

In our endeavour to understand the credit policies and processes for collection, centre meetings, records maintenance at branches and other aspects of business, we undertook a field visit to some of SCNL's centres and branches in West UP. We chose to visit UP with an aim to understand the socio-political risk to the running businesses in these regions.

Our interaction with centre members indicated preference for SCNL given its long standing relationship, collection processes, transparency and due-diligence. Thus, even as the region we visited had four other MFIs, a larger proportion of women borrowers resorted to SCNL for their funding requirement. Verification of records and branch pointed for customers in their 2nd/3rd cycle of credit. The long-standing relationship and training programme at the beginning also helped SCNL mitigate any social/political risk.

Exhibit 46: Centre meetings

Source: Centrum Research

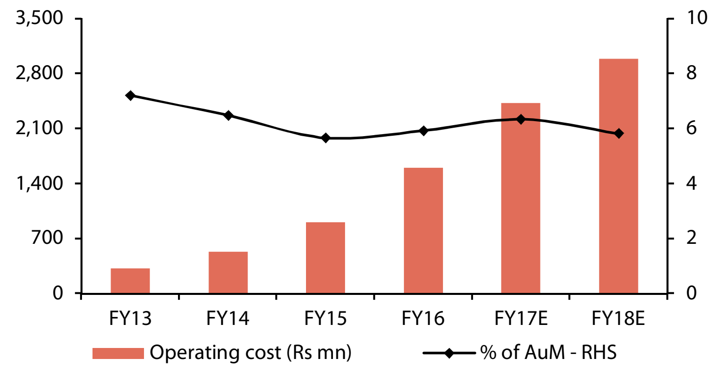
Exhibit 47: Centre meetings

Source: Centrum Research

Best-in-class operating efficiency, digitalisation process underway

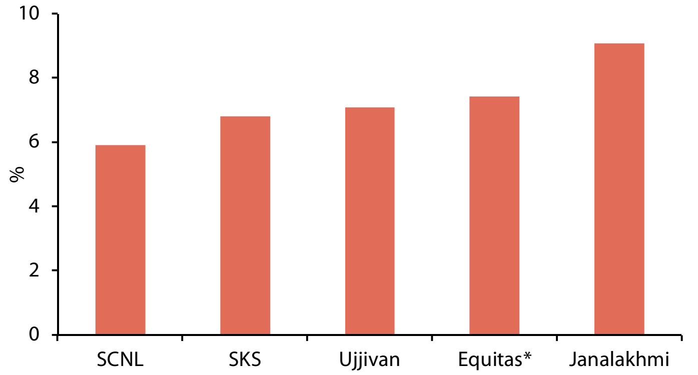
The rural-based MFI business model tends to be more challenging than urban models; hence, MFIs place greater emphasis on strategy towards credit assessment and process audits including regular internal audits to continue refining existing practises. SCNL has a well-defined strategy for cost rationalisation which has enabled the company to reduce its operating expenses over the longer run. Efforts towards cost rationalisation include a) fixed compensation to field officers on the hierarchical basis, b) splitting of branches once they attain a certain level of borrower count, c) defined process for branch selection and d) compensation structure to BM/TM. An average branch would require ~1,000 borrowers to achieve break-even and a larger proportion of existing branches have already achieved breakeven. Also, the ratio of borrower per employee / loan per employee goes to show the efficiency of the team and contain overall operating costs.

Exhibit 48: SCNL: Operating expenses % of avg. AuM* has been on a decline…



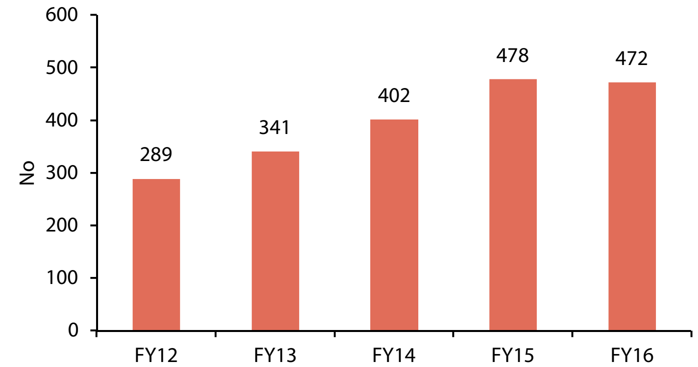
*Source: Company, Centrum Research Estimates. * We have not considered provisions in calc of operating expenses.*

Exhibit 49: ….and remains comparable to some of the other larger players.



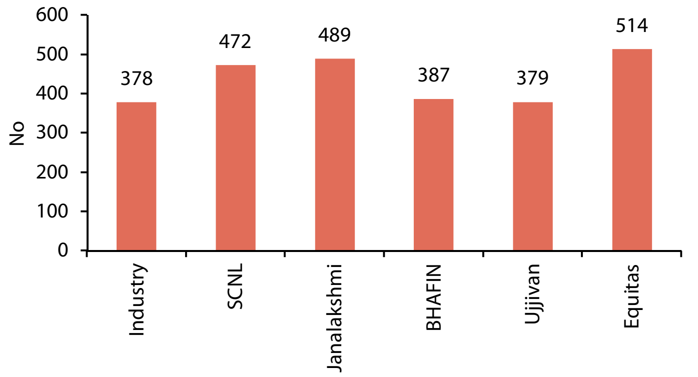
*Source: Companies, Centrum Research. * reported number*

Exhibit 50: Borrower per employee for SCNL has steadily been on a rise…



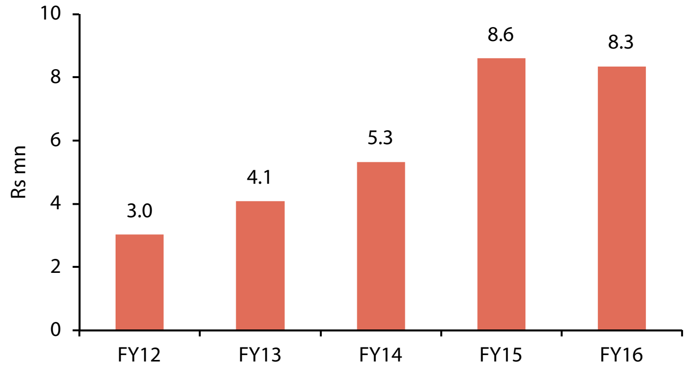
Source: Company, Centrum Research

Exhibit 51: … and is fairly placed to some of the leading players (FY16)



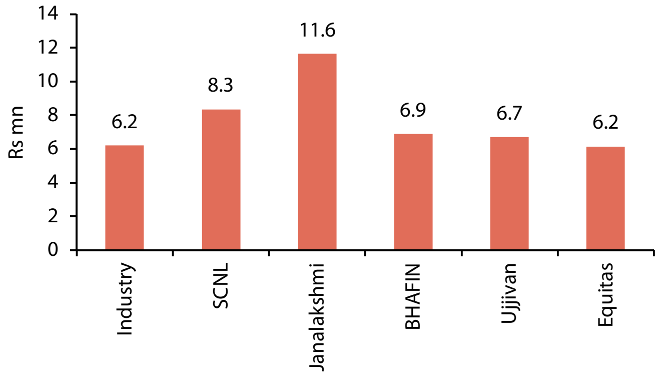
Source: Companies, Centrum Research.

Exhibit 52: Loan per employee for SCNL too remains healthy…



Source: Company, Centrum Research

Exhibit 53: … also when seen in context of peers reflecting operating efficiency (FY16)



Source: Companies, Centrum Research.

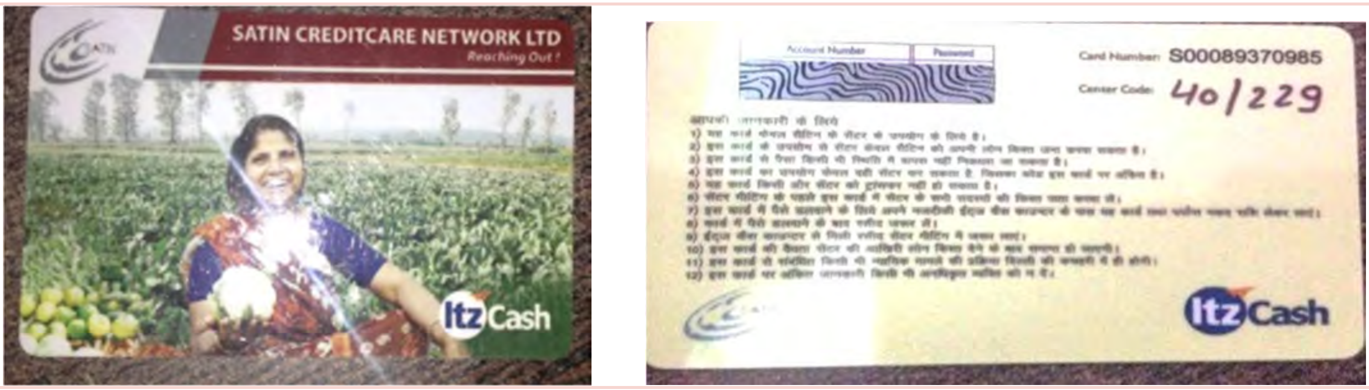
Migration to cashless-based business model underway

Currently, while disbursements happen at the branch level and at a pre-set date, collection is either fortnightly/monthly and in the form of cash. In a bid to reduce dependence on cash-based lending-collection model, SCNL has initiated a cashless programme. We believe, this process will help SCNL mitigate any socio-political risk and risk of theft, which could have a potential impact on the business process.

Currently, 83 of a total of 431 branches are undergoing pilot test for cashless collections. For this, the company has entered into a tie-up with CSE, and upon successful integration, it plans to implement the same on pan-India basis in FY17. Further, while collection today is more via pen-and-paper i.e. the traditional way of doing business, SCNL plans to introduce tablets to automate the collection process and efficiently transmit the data to branch manager/regional office and head office at the same time.

Disbursements today are generally through the cash route; however, as a large proportion of SCNL's borrowers hold Aadhar card/Jan Dhan accounts, it plans to eventually migrate to cashless-based disbursements. The migration of IT-based platform is cost intensive and hence likely to dent the operating profile. However, automation-led systems have led to further cost optimisation and efficiency improvement, which was also witnessed by some other MFI players. Thus, we are building in operating expenses/AuM at 6.4% over FY16-18E.

Exhibit 54: Tie-up with CSE, ie, ITZ cards



Source: Company

Optimising the client base to shore up non-interest income avenues

While cross-selling can aid in sustainable revenues for MFIs given their huge client base, not many have been in a position to leverage on the same, barring Bharat Financial Inclusion. SCNL too has made limited foray into non-interest income avenues, though it is in talks with various operators to capitalise on its existing client base.

Non-interest income for SCNL, however, includes fees from Taraashna, a group company of SCNL that operates as Business Correspondent Services. Taraashna has partnered with two private banks and two NBFCs. As at end-FY16, its loan portfolio stood at Rs3.4bn (vs Rs2.6bn in FY15), with presence in five states and 115 branches. Its client base stood at 0.27mn vs 0.19mn in FY15. Taraashna shares 10% of its gross receipts with SCNL for technical know-how.

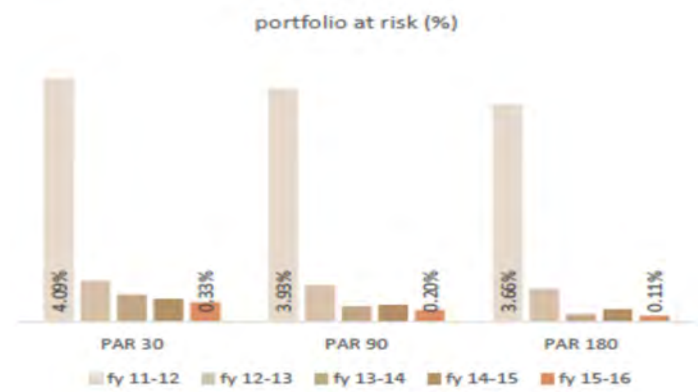
The board in its recent meeting has approved the acquisition of Taraashna Services Private Limited ("TSPL") as a wholly owned subsidiary of the Company by purchase of entire shareholding of TSPL from its existing shareholders through share swap deal. Valuations for the same are being worked out. We have not factored the dilution into our numbers.

Asset quality risk mitigated; with product diversification, factoring in marginal increase in delinquencies for SCNL over FY16-18E

The inherent nature of lending, i.e. without collateral comes with its own set of risks. Thus, in order to mitigate the asset quality risk, the groups are self-created by members among themselves, which are in-turn liable for dues in the event of default by any member. Further, as the customer profile majorly includes women, any socio-political event can act as a deterrent to the collection process, eventually leading to rise in delinquencies. Economic factors like floods and drought-like situation also act as a hindrance. However, as the nature of lending is more towards income generating assets, the extent of eventual write-off remains lower.

MFI sector, to a large extent, has been in a position to mitigate asset quality-related risk following a) a strong credit appraisal mechanism including visiting the borrower's house, b) training programmes aimed at bringing in financial discipline, c) stringent regulations, and importantly, d) social factor attached in the event of a default. System-wide NPAs have thus remained low, with collection efficiency at near 99% levels across various regions.

Exhibit 55: System-wide NPAs remain comfortable….



Source: MFIN

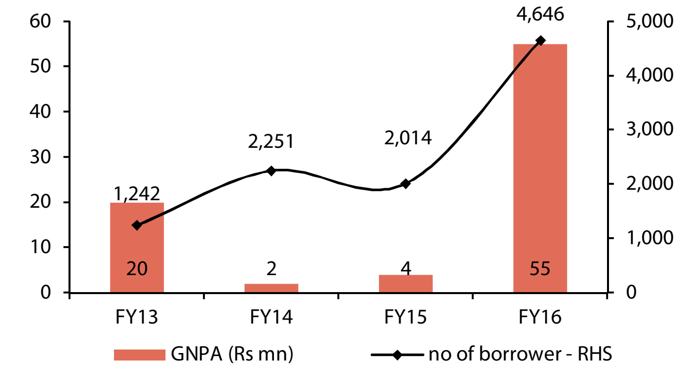
Exhibit 56: … led by strong collection efficiency

States	PAR 30	PAR 60	PAR 90
Tamil Nadu	0.21%	0.11%	0.05%
Karnataka	0.49%	0.33%	0.19%
Maharashtra	0.29%	0.19%	0.08%
Uttar Pradesh	0.39%	0.23%	0.16%
Madhya Pradesh	0.46%	0.30%	0.17%
West Bengal	0.18%	0.13%	0.08%
Bihar	0.22%	0.14%	0.08%
Gujarat	0.53%	0.33%	0.14%
Kerala	0.10%	0.06%	0.04%
Delhi	1.80%	0.71%	0.31%

Source: MFI

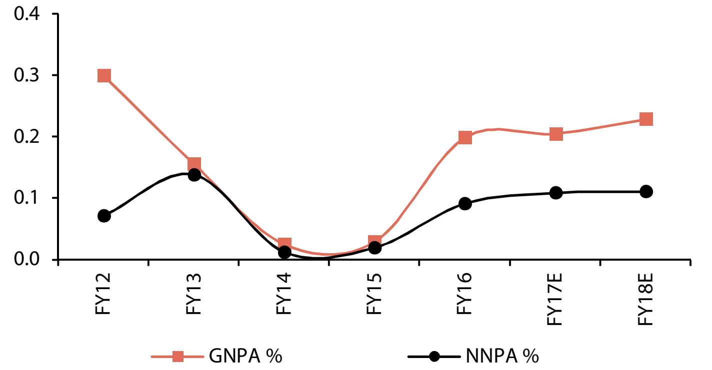
The core understanding of the business model, near leadership position in certain regions and well-designed credit policies have enabled SCNL to mitigate asset quality risk. This is even as it operates in traditionally perceived riskier regions of UP, Bihar and Punjab. Our interaction during our field survey indicated financial discipline among borrowers. For FY16, GNPA/NNPA remained at comfortable levels of 0.19%/0.09%. Collection efficiency in PAR 90 days too remains comfortable at mere 0.26%.

Exhibit 57: Asset quality has remained comfortable for SCNL…



Source: Company, Centrum Research

Exhibit 58: .. however with product diversification, we are factoring in marginally increase in delinquencies



Source: Company, Centrum Research Estimates

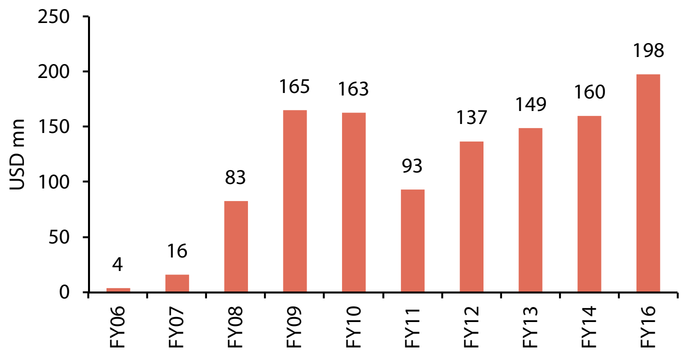
However, with incidences of over-leveraging by players pan-India, higher exposure in certain states and product diversification by SCNL, asset quality-related risk cannot be ruled out. While management has indicated for containing its overall GNPA levels at comfortable levels, drawing parallels from industry players, behaviour of the SME space and given that the MFI industry is at an inflection point, we believe asset quality-related headwinds cannot be ruled out. Also, given the concentration risk, particularly in case of SCNL, we are building in marginally higher delinquencies, and thus, elevated GNPA/NNPA over FY16-18E. Our estimates are aggressive on asset quality front, and we would watch, how the new business plans pan out and its impact on delinquency levels.

Diversified borrowing profile; factoring in capital dilution given the growth potential

- **Unusual to other players, SCNL's portfolio grew even during the crisis period. Diversified borrowing profile to aid in containing overall costs/mitigating interest rate risk**
- **Cost of funds has remained high vis-à-vis peers, an outcome of excess leverage**
- **Factoring in dilution given the growth potentials and regulatory requirements**

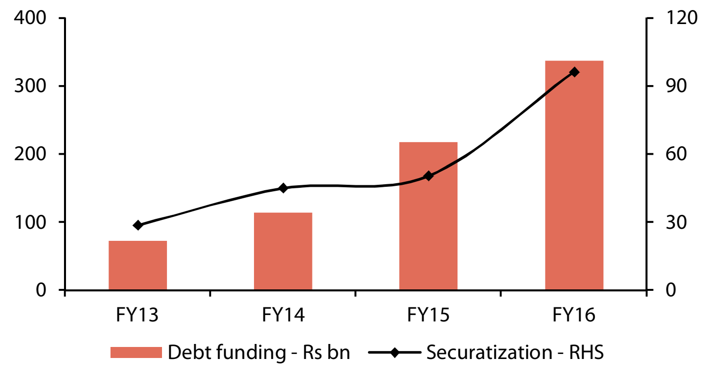
The capital-intensive nature of the business (RWA are 100% given the unsecured nature of lending) and high growth rates have seen entities resort to regular fund raising via either debt or equity. According to data, MFI sector has seen cumulative investment by PE investors to the tune of US$600mn+ over FY12-16. Also, while banks withdrew from lending during the AP crisis, with regulations in place, and PSL nature of loan portfolio by MFIs, bank channel was one of the important avenues for funding requirement for MFIs. Debt funding to the sector stood at Rs337bn for FY16 compared to Rs72.6bn in FY13. Securitisation has also been on the rise and stood at Rs96.3bn for FY16.

Exhibit 59: Sector has seen PE investments in excess of US$600mn since FY12.



Source: Industry, Centrum Research

Exhibit 60: … funding via debt route (including securitisation) too has been on a rise.



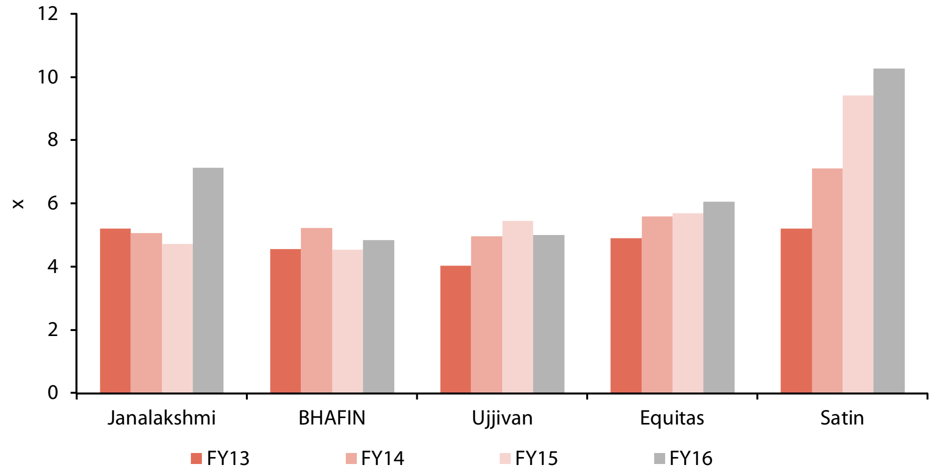
Source: MFIN, Centrum Research.

SCNL: Leverage on the rise in the recent past

Unlike other larger MFI players which have resorted to regular dilutions in the past to fund their growth, SCNL has raised funds, i.e. both equity and debt, to suffice its growth requirement while maintaining the required capital adequacy. Over FY11-16, the company raised equity to the tune of ~Rs1.3bn compared to over ~Rs21bn increase in its loan portfolio over the same duration. Consequently, its leverage inched up to 10.3x for end-FY16 from 3.9x in FY11. Capital adequacy as at end-FY16 stood at 16.8%, with tier-I CAR at 11.3% (vs regulatory requirement of tier-I CAR at 7.5%) and tier-II CAR at 5.5%.

SCNL has operated at higher leverage to its peers, particularly during the period of FY14-16.

Exhibit 61: Leverage across some of the larger players and across different time-frames



Source: Companies, Centrum Research.

Exhibit 62: Trend in leverage and capital position for SCNL

Rs mn	FY11	FY12	FY13	FY14	FY15	FY16
Networth	786	799	1,237	1,384	1,935	3,240
Total assets	2,951	3,171	7,461	11,217	20,107	33,034
Leverage (%) *		***3.9***	***5.2***	***7.1***	***9.4***	***10.3***
AuM		**3,200**	**5,800**	**10,561**	**21,407**	**32,708**
Capital adequacy (%)	**39.2**	**34.9**	**23.4**	**15.3**	**15.7**	**16.8**
- Tier I (%)	*38.9*	*34.5*	*23.2*	*14.3*	*9.6*	*11.3*
- Tier II (%)	*0.2*	*0.4*	*0.2*	*1.0*	*6.1*	*5.5*

Source: Company, Centrum Research. Leverage has been calculated as average of assets / average of equity.

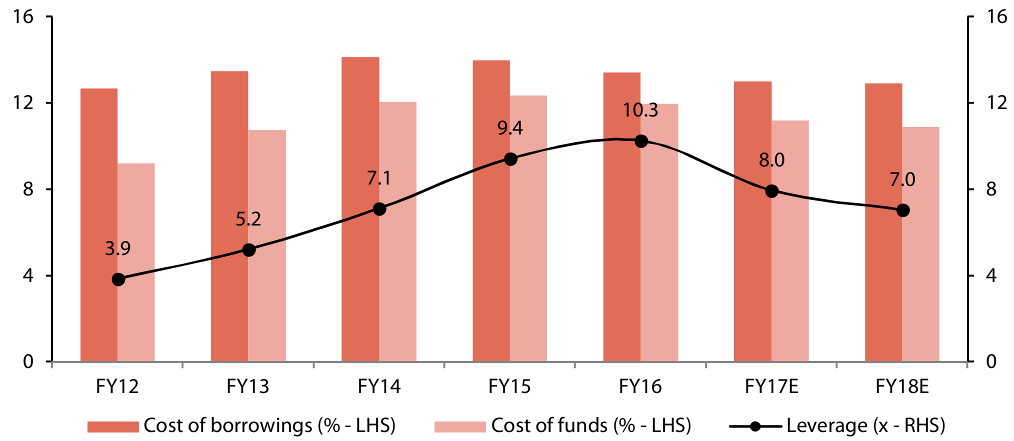
Dilution eminent; improved leverage to aid in reducing overall cost of funds; rating improvement to be an added benefit

Even as SCNL has a well-diversified borrowing profile, its overall cost of funds remains substantially higher given a) ~30% of borrowings in the form of NCD/term loan from institutions/sub-debt which are at a relatively higher rate and b) the leverage (as discussed above). Bank borrowing (42% of total borrowing) has seen reduction in overall cost of funds, though it remains higher compared to peers.

With tier-I capital at 11.3% (regulatory requirement of tier-I cap at 10% by end-FY18E) and continued balance sheet growth, we believe SCNL will raise tier-I equity to support growth. We thus are factoring in Rs2bn of equity infusion for FY17 (dilution of 13-15% post equity) which is in addition to ongoing programme to raise debt/tier-II capital for FY17E.

We believe, the capital raising in FY17E will not only help SCNL address its tier-I requirement but also enable the company to a) reduce its overall cost of borrowings b) address its leverage which in turn will aid in further improvement of its rating profile (currently rated BBB+ by CARE). We expect the equity infusion in addition to further diversification in borrowing profile to aid in overall reduction in cost of funds. The pace of reduction, however, would be gradual and also depend on the extent of equity infusion and rating profile.

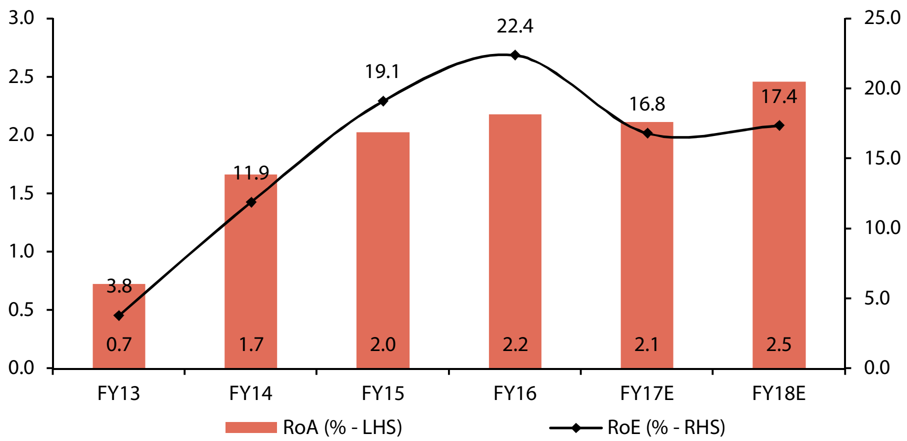
Exhibit 63: SCNL: Equity dilution to aid in reducing overall cost of borrowings



Source: Company, Centrum Research Estimates

The growth potential that the sector offers (as explained in our sector piece) and especially in the scenario of gradual withdrawal of MFI turned SFBs from the market over FY17-18E will see SCNL raise equity on an on-going basis. The need for capital raising is also due to the need for healthy capital adequacy (particularly tier-I) in the context of regulatory compliance and rating agencies requirement. We have not factored in any dilution for FY18E, though we foresee SCNL to raise funds again in FY19E, more to suffice for the growth requirement while maintaining healthy capital adequacy. However, with strong profitability and respectable RoAs, we do not expect RoEs to dilute materially from the current run-rate.

Exhibit 64: Expect RoA / RoE at 2.5% / 17.4% levels respectively by end-FY18E.



Source: Company, Centrum Research Estimates.

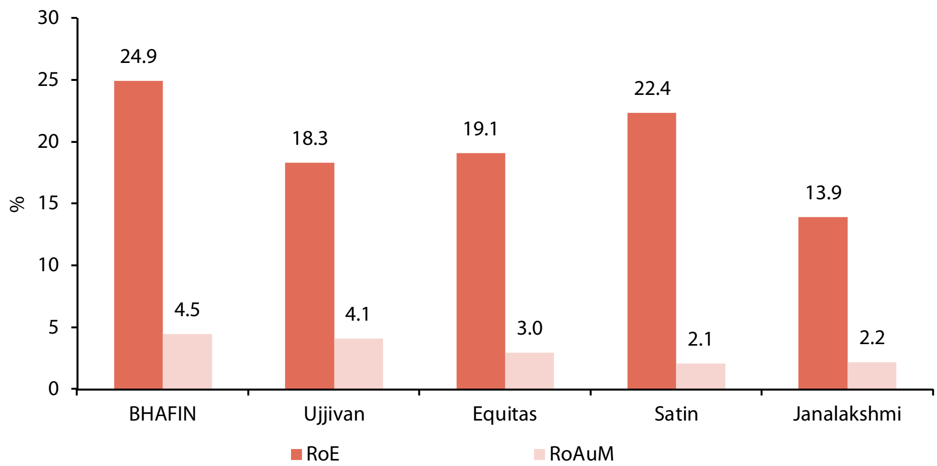
Sustainable RoA/RoE a more prudent way of analysing companies with varied balance sheet structure

- **Sheer growth potential has seen MFI players dilute in the past.**
- **While some of the players have operated at lower levels of leverage, SCNL has diluted to the extent of ensuring capital norms as per regulatory requirement**
- **Sustainable RoA / RoE for the sector to be more, at 2.9%/19% levels, respectively, in a "steady-state" manner**

Owing to the varied nature of balance sheet profile (especially in the context of leverage and thus credit rating), MFI players operate at different RoA profiles. Regular dilution and thus a lower leverage, multiple avenues of non-interest income and lower tax rate vis-à-vis peers have enabled BHAFIN report RoAuM/RoE of 4.5%/25% for FY16. In case of Ujjivan, RoAuM/RoE stood at 4.1%/18.3% for FY16. Equitas' RoAuM/RoE was at 3.0%/19.1% in FY16.

SCNL has seen dilution over FY14-16 which was led by balance sheet growth. However, unlike other players which have operated at very high levels of tier-I capital adequacy, SCNL tier-I/overall capital adequacy has remained at around 11-12%/16% levels over the same time frame.

Exhibit 65: Returns profile across various players (FY16)



Source: Companies, Centrum Research.

Sustainable RoA/RoE to be at 2.9%/19.0% levels in the longer run

We believe that for a sector characterised by players with varied balance sheet profile, it is important to look at a more sustainable RoA/RoE model from a longer-term perspective, especially also given that the sector has witnessed very higher growth rates.

Our calculations suggest that for a business model with a) well-diversified loan portfolio, b) adequate leverage and hence a far more prudent liability franchise and overall costs of funds, c) gradual pick-up in non-interest income avenues, d) continued cost rationalisation efforts and e) well-contained provisioning costs could very well translate into 2.9% RoA/19% RoE on a steady-state basis.

Exhibit 66: Sustainable RoE could well be at 19% levels in the longer run.

RoA breakdown	SCNL (FY16-18E)	Sustainable RoA / RoE	Comments
Yield on advances	*19.86*	*20.80*	Blend of MFI and non-qualifying assets and at yields calculated based on various business models
Cost of funds (including capital)	*11.36*	*9.59*	
Spreads	***6.04***	***7.92***	
NIM	***9.62***	***9.61***	
Other income	*1.90*	*2.00*	Fees from third-party product, cash and bank balances, etc
Total income	***10.75***	***11.61***	
Operating Expenses	*6.38*	*6.25*	Estimates based on recent trend
Pre-provision profit	***4.38***	***5.36***	
Provisions	*0.99*	*1.05*	Assuming provisioning as per regulatory requirement
Profit before tax	***3.39***	***4.31***	
Tax	*1.14*	*1.42*	Tax rate at 33%.
PAT / RoA	***2.3***	***2.9***	
Leverage (x)	*8.43*	*6.67*	Assuming tier-I CAR at 15% (50% above the regulatory requirement)
RoE	***18.9***	***19.0***	

Source: Centrum Research

Rating agencies, too expects RoA / RoE for the industry to hover at around 3% / 18% levels for the larger MFI's.

Exhibit 67: RoA Tree and Expected Returns

RoA Tree and expected returns	Gross loan portfolio (GLP) above INR1.0bn	GLP below INR 1.0bn	Comments
Spread (%)	10	12	RBI stipulation (based on asset size)
Margin (%)	**11.5**	**13.8**	Minimum Tier 1: 15%
Fees and other income (%)	2	2	1% can be charged - RBI stipulation, disbursement usually 30% higher than GLP
Total income (%)	**13.5**	**15.8**	
Operating costs (%)	8-10	10-13	Estimates based on experience of MFIs
Pre provisioning profit (%)	**3.5-5.5**	**2.8-5.8**	
Provisioning (%)	1	1	
Pre-tax profit (%)	**2.5-4.5**	**1.8-4.8**	
Tax (%)	0.8-1.5	0.6-1.6	33%
RoA (%)	**1.7-3**	**1.2-3.2**	
Leverage (x)	6	4-5	Lower leverage for MFIs with GLP below INR1.0bn because of lower bankability
RoE (%)	**10.2-18**	**4.8-12.8**	

Source: Ind-Ra

Financial analysis

Satin Credit with AuM of Rs32.7bn is the fifth largest MFI in India and the first in north India. As at end-FY16, the company operated through 431 branches spread across 16 states and a customer base of 1.8mn. In FY12-16, SCNL reported 65%/143% and 154% CAGR in NII/pre-provisioning profit and net profit led by 86% CAGR in its loan portfolio. We expect SCNL to report 35% loan/34% AuM CAGR over FY16-18E, led by capital infusion. This will translate into 43%/45% and 40% CAGR in NII/PPOP and net profit over the same time frame.

Even as the nature of lending remains unsecured, the joint liability group (JLG)-based lending model with stringent regulations have seen MFIs operate at lower delinquency levels. Asset quality for SCNL remains comfortable with GNPA/NNPA at 0.19%/0.09% for FY16. We, however, have built in higher delinquencies for FY16-18E, given the extent of over-leveraging in certain pockets, concentration risk and asset quality-related risk following product diversification.

Led by product diversification, equity infusion and thus enabling reduction of overall cost of funds, we expect spreads (calc) to improve over FY16-18E. Also, traditionally, while the extent of liquid assets, i.e. cash holding, remained substantially higher (given the need for setting aside certain funds as deposit with banks), we believe the proportion of liquid assets will moderate. This, in turn, will aid in efficient capital utilisation and thus margin improvement. Continued investment towards infrastructure and technology will keep operating costs higher. After adjusting for the same including credit costs, we expect RoA/RoE to inch towards 2.5%/17.4% levels by end-FY18E.

Exhibit 68: DuPont analysis

(% of avg assets)	FY13	FY14	FY15	FY16	FY17E	FY18E
Yield on AuM	*17.5*	*19.4*	*16.9*	*17.4*	*17.0*	*16.2*
Yield on assets	*15.8*	*18.2*	*18.7*	*19.0*	*19.0*	*19.5*
Cost of borrowings	*13.5*	*14.2*	*14.0*	*13.4*	*13.0*	*12.9*
Cost of funds	*10.8*	*12.1*	*12.4*	*12.0*	*11.2*	*10.9*
Spreads	***2.3***	***4.0***	***4.7***	***5.6***	***6.0***	***6.5***
NIM	***6.4***	***7.6***	***8.1***	***8.9***	***9.7***	***10.3***
Other income	*1.9*	*2.4*	*2.0*	*2.0*	*1.9*	*1.8*
Total income	***7.5***	***9.2***	***9.4***	***10.1***	***10.8***	***11.4***
Operating expenses	*6.1*	*5.7*	*5.8*	*6.0*	*6.6*	*6.5*
Provisions	*0.4*	*1.0*	*0.6*	*0.8*	*1.0*	*1.2*
PBT	***1.0***	***2.5***	***3.0***	***3.3***	***3.2***	***3.7***
Tax	*0.3*	*0.8*	*0.9*	*1.1*	*1.1*	*1.2*
RoA	***0.7***	***1.7***	***2.0***	***2.2***	***2.1***	***2.5***
Leverage	*5.2*	*7.1*	*9.4*	*10.3*	***8.0***	***7.0***
RoE	***3.8***	***11.9***	***19.1***	***22.4***	***16.8***	***17.4***
NIM (on AuM	***6.6***	***7.8***	***7.2***	***7.9***	***8.5***	***8.6***
RoA (including securitisation)	***0.6***	***1.4***	***1.6***	***1.7***	***1.6***	***1.9***

Source: Company, Centrum Research Estimates

In the recent past, SCNL has operated at a leverage of 8.9x (average for FY14-16). As a result, its cost of borrowings has remained substantially higher especially when compared to some larger peers that operate at a leverage of 4-5x (average). While we have assumed equity dilution to the extent of Rs2bn for FY17E which will enable reduction of the overall leverage, we have been conservative on reducing our overall cost of borrowings.

Reduction in leverage, gearing – i.e. state-wise exposure as % of net worth – and overall return on assets (including securitisation) are important factors in determining the rating profile. We believe equity dilution in FY17E for SCNL will address some of these aspects, and in turn, aid in improving the rating profile. This will also have a direct bearing on cost of borrowings. Any material reduction in leverage will have disproportionate impact on cost of funds and consequently the return profile. We have not factored the same into our numbers, though we will watch for development on this front.

Valuation and view

We like SCNL for its business model, credit policies and process, thus enabling contain costs – both operational and asset and the returns profile.FY16 RoA / RoE stood at 2.2% / 22.4% respectively. With well-defined strategy towards growth in its key areas of presence i.e. north and Central India including newer geographies and product diversification, strong credit model including a move towards technology driven way of doing business and lower delinquencies, SCNL is well poised for further improvement in its RoA profile in the longer run. We have factored dilution to the tune of Rs2bn in our FY17 estimates.

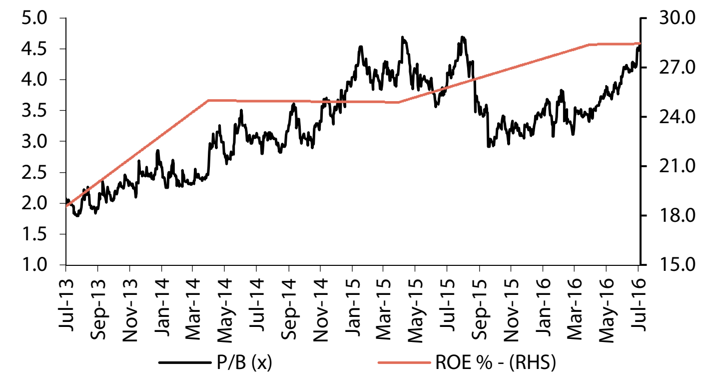
MFI industry is poised for steady growth and with respectable market share (including near leadership position in certain geographies), SCNL is well-placed for stronger growth in the longer-run. While management has pointed for 50% growth in loans for FY17E, we are building in lower growth estimates (factored in 35% disbursement / loan growth each for FY17). This will translate into 43% / 37% and 41% CAGR in NII /PPOP and PAT over the same time frame.

The reason for lower loan growth is also on back of the need for lowering the leverage. We expect leverage ratio to inch lower to 7x levels by end-FY18E vs 9x (average for FY14-16). The larger emphasis at containing leverage (over growth) in our estimates is more to address the cost of funds. Any material reduction in leverage will also have a direct bearing on rating profile, thus enabling to reduce overall costs of borrowings.

We initiate coverage on Satin Creditcare with Buy and TP at Rs600 (valued at 3x FY18E ABV of Rs195). The theoretical PB multiple for SCNL with RoE's at 19% (average) over FY16-18E is at 2.5x. We believe SCNL deserves premium to its theoretical PB multiple given a) the sector dynamics, b) changing business environment with some of players moving to the SFB's based lending model and c) its own business model characterised with inherent strength in its key area of presence, credit processes, improving leverage profile and performance record.

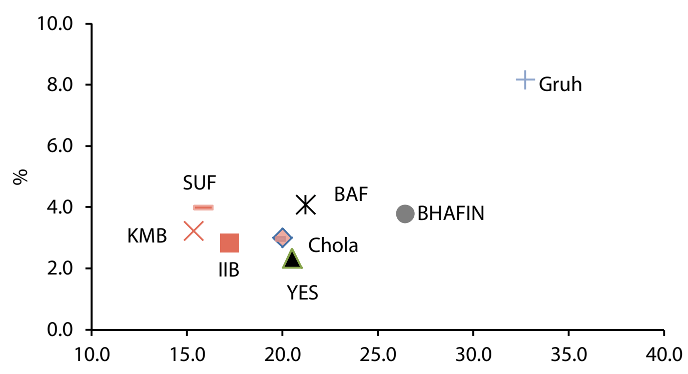
The reason for premium to the theoretical PB multiple is also based on the premise of 40% PAT growth and respectable RoA / RoE for SCNL over FY16-18E. On the flip side, Bharat Financial Inclusion (SKS Micro), with 44% PAT growth and RoE in of 25%+ over FY16-18E, trades at 4.5x rolling forward PB. We expect the discount gap of SCNL to narrow in coming periods.

Exhibit 69: Bharat Financial Inclusion – Improving RoE profile has seen P/B multiple inch upwards



Source: Bloomberg

Exhibit 70: RoE (%) – PB (x) profile for niche models (FY18E)



Source: Bloomberg, Centrum Research

Companies with niche business model / in the phase of higher growth rates tend to trade at premium as investors draw comfort. We believe a similar kind of re-rating is likely to happen in case of SCNL.

Corporate governance

Exhibit 71: Board of directors – participation by Independent directors

	FY12	FY13	FY14	FY15	FY16
Total Directors	9	9	10	12	14
Independent directors	4	4	4	6	7
% share of independent	*44*	*44*	*40*	*50*	*50*

Source: Company

Exhibit 72: Directors Compensation

(Rs. Mn)	FY12	FY13	FY14	FY15	FY16
MD & CEO	3	3	6	6	15.0
% share of PBT	*14.6*	*5.8*	*2.6*	*1.3*	*1.7*

Source: Company

Exhibit 73: Independent directors - Directorship in other companies

Directors Name	No of directorship in other companies
Mr Sundeep Kumar Mehta	1
Mr. Rakesh Sachdeva	-
Ms. Sangeeta Khorana	-
Mr. Richard Benjamin Butler	-
Goh Colin	-
Mr Sanjay Kumar Bhatia	-
Mr. Arthur Sletteberg	3 - NMI AS/Entra ASA/Ness Risan & Partners AS
Mr HP Singh	14 - Amusha Estates / Parinita Investment,etc.
Mr. Satvinder Singh	1
Mr Sujan Chawla	-
Ms. Deepa Hingorani	1

Source: Company

Exhibit 74: Auditor details

Auditor Name	Auditor since	Other Audited companies
A.K. Gangaher & Co.	More than a decade	DFM Foods Ltd. (FY05-13)

Source: Company

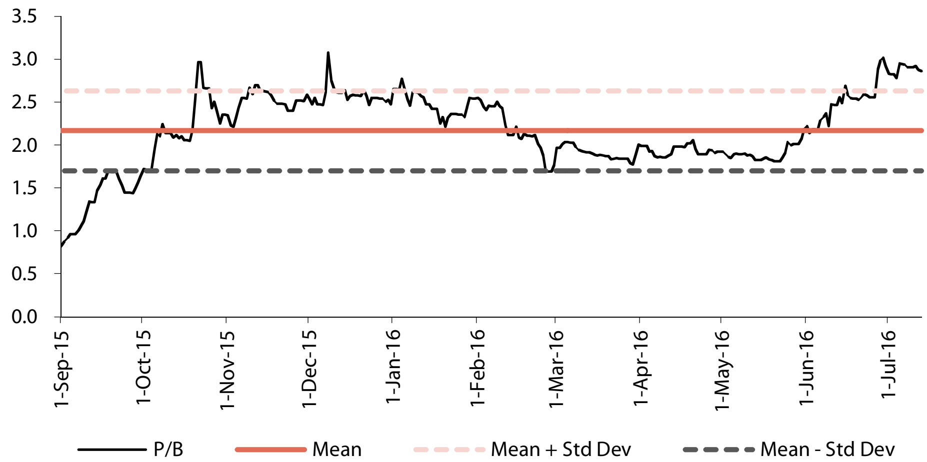
Sensitivity analysis and peer comparison

Exhibit 75: Sensitivity analysis – impact of change in NIM and AuM on FY17PBT

%		AuM				
		+ 10bps	+ 20bps	Current levels	- 10bps	- 20bps
NIM	- 5bps	*(3.0)*	*(3.6)*	*(2.5)*	*(1.9)*	*(1.3)*
	- 10bps	*(5.5)*	*(6.1)*	*(4.9)*	*(4.4)*	*(3.8)*
	Current levels	*(0.6)*	*(1.2)*	*-*	*0.6*	*1.2*
	+ 5bps	*1.9*	*1.3*	*2.5*	*3.0*	*3.6*
	+ 10bps	*4.4*	*3.8*	*4.9*	*5.5*	*5.5*

Source: Company, Centrum Research Estimates

Exhibit 76: Rolling forward PB



Source: Bloomberg, Centrum Research Estimates

Exhibit 77: Comparative Valuations

Company	Mkt Cap (Rs mn)	CAGR (FY16-FY18E) (%)			PE (x)			ROA (%)			RoE (%)			P/BVPS (x)			Div Yield (%)		
		Net income#	PPOP	PAT	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E
SCNL*	**15,247**	***39.9***	***44.6***	***40.1***	**26.0**	**22.5**	**15.3**	***2.2***	***2.1***	***2.5***	***22.4***	***16.8***	***17.4***	**4.6**	**2.9**	**2.4**	***0.0***	***0.0***	***0.0***
Ujjivan*	47,444	*32.4*	*20.0*	*15.8*	22.9	24.6	20.0	*3.7*	*2.9*	*2.4*	*18.3*	*13.1*	*12.8*	3.5	2.8	2.5	*0.1*	*0.1*	*0.2*
Equitas	58,506	*45.3*		*28.2*	29.6	31.2	22.4	*3.0*	*2.3*	*2.2*	*12.8*	*10.6*	*11.1*	3.6	2.6	2.4	*0.6*	*0.6*	*0.6*
BHAFIN	96,744	*41.3*	*60.9*	*43.7*	31.7	19.5	15.4	*5.2*	*4.8*	*4.4*	*24.5*	*27.4*	*26.5*	7.1	4.9	3.8	*0.4*	*0.4*	*0.4*

*Source: Bloomberg consensus, Company, * denotes Centrum Research Estimates #denotes net interest income + other income.*

Key risks

- **Concentration risk:** In terms of higher exposure to a particular region, this is a major concern as higher the exposure, greater is the probability of delinquencies, and consequently, the rise in NPAs. While self-regulatory organisations (MFIN and Sa-Dhan) have made considerable efforts to ensure asset quality, any external factors like flood, drought, earthquake or political factor can act as a deterrent for the business.
- **Socio-political risk:** The involvement of cash and socio-political risk is a challenge to the success/failure of the model. Also, as the business model involves engagement with women borrowers, it is important to ensure etiquettes. Any misbehaviour therein will have multi-fold impact in terms of collection/fresh disbursements.

Exhibit 78: Quarterly table

(Rs mn)	Q1FY15	Q2FY15	Q3FY15	Q4FY15	Q1FY16	Q2FY16	Q3FY15	Q4FY16
Income statement								
Interest earned	620	740	864	996	1136	1261	1424	1702
Interest expended	321	387	497	570	603	668	746	881
Net interest income	**298**	**353**	**367**	**426**	**532**	**593**	**677**	**821**
Non-interest income	6	2	5	9	9	10	15	29
Total income	**304**	**356**	**372**	**435**	**542**	**603**	**692**	**850**
Operating expenses	187	237	239	241	351	362	385	505
PPOP	**116**	**118**	**133**	**194**	**190**	**241**	**308**	**344**
Provisions	14	26	21	36	9	21	85	94
PBT	**102**	**92**	**112**	**158**	**181**	**220**	**223**	**250**
Tax	33	26	35	54	60	76	73	87
PAT	**69**	**66**	**77**	**105**	**121**	**144**	**150**	**163**
Ratios								
Growth YoY (%)								
Net- interest income					*78.6*	*68.0*	*84.6*	*92.7*
Operating expenses					*87.3*	*52.5*	*60.9*	*109.6*
PPOP					*63.7*	*103.9*	*131.2*	*77.5*
PAT					*74.5*	*118.2*	*93.9*	*56.4*

Source: Company, Centrum Research

Comments on quarterly results

SCNL Q4'16 NII grew 93% to Rs821mn led by 53% yoy growth in AuM to Rs32.7bn. The company continues to invest towards its assets i.e. employees and as a result saw operating expenses grow 110% YoY. Pre-provisioning profit came in at Rs344mn and after providing for NPA provisioning including taxes, net profit at Rs163mn grew 55% YoY.

Exhibit 79: Shareholding pattern (%)

	Q4FY16	Q3FY16	Q2FY16
Promoter	*36.2*	*34.7*	*34.7*
FIIs	*48.9*	*51.3*	*48.9*
DIIs	-	-	-
Others	*14.9*	*16.0*	*16.4*

Source: BSE

Company Background

SCNL is an NBFC-MFI with an asset base of Rs. 32.8bn (including managed assets), 3918 employees, 431 branches and 1.85mn customers as of Mar'16. It is in North India's largest and India's sixth largest MFI in terms of AUM with a presence across 16 states. The company is led by Mr. HP Singh who has more than 25 years retail financing experience

Incorporated in 1990, SCNL functions as a microfinance lending institution with a pan India presence. Currently the market share of SCNL is 4.8% as of Mar'16, in terms of AUM. It offers a comprehensive basket of financial products to the financially underserved population – MFI loans, individual micro loans, MSME loans, low ticket LAP, product financing (solar lamps) and business correspondent services (via Taraashna services Pvt. Ltd). The company was listed on the Delhi, Jaipur and Ludhiana stock exchanges in 1996 and it obtained listing on NSE, BSE and CSE in 2015. It started the JLG model in May 2008 and this portfolio currently accounts for 98% of the total loan portfolio.

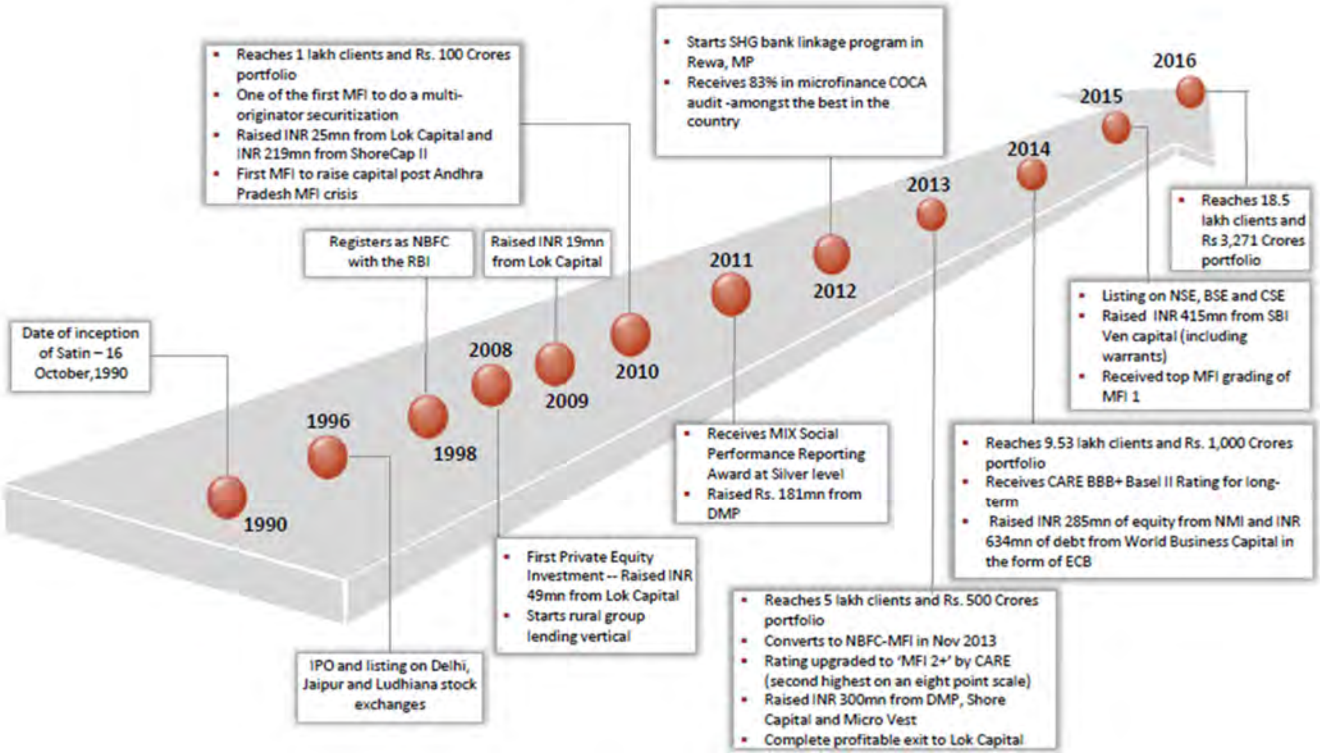
Investors may draw comfort from the fact that currently promoter stake in Satin is the highest in the MFI space in India. Also, SCNL in present in the relatively underpenetrated states in terms of MFI finance and is not present in the southern states where the penetration levels are quite high. Currently, UP, Bihar, MP and Punjab account for 88% of the portfolio mix. With regard to economic activity, agriculture and allied activities contribute, 62.8% to the portfolio, service and trade account for 29% and production accounts for 7.8%.

Exhibit 80: Key management personnel

Name	Position	Profile
Mr. H P Singh	Chairman & MD	Mr. H P Singh is a law graduate and a fellow of The Institute of Chartered Accountants of India since 1984. He has over two decades of microfinance experience and pioneered the unique concept of daily collection of repayments of loans. Besides an expert in lending (especially microfinance) he has experience in the field of auditing, accounts, project financing, advisory services and company law matters. His financial engineering experience of almost three decades has helped the Company in operational strategy and efficiency. He is actively involved in SCNL's day-to-day operations and has been a vital source of inspiration since the Company's inception in 1990. Under his leadership, SCNL has grown into one of the leading microfinance institutions in North India and continues to expand its operations.
Mr. Satvinder Singh	Executive Director	Mr. Singh has extensive consumer marketing and finance experience and has developed new methods of credit appraisal and marketing for SCNL. Mr. Singh is a management graduate and has been associated with the SCNL since its inception in 1990 and acted as Managing Director of SCNL from September 1995 to February 2011.
Mr. Jugal Kataria	Chief Financial Officer	Mr. Jugal is the CFO of Satin since 2000. He is a graduate from Shree Ram College of Commerce and is a Cost Accountant, Chartered Accountant and Company Secretary with approx. 22 years of relevant experience. He has participated in an 'Internal Auditors Training Course' for ISO 9000 and HBS Accion Program on Strategic Leadership for Microfinance. He attended leadership program organized by Women's World Banking at Wharton Business School, University of Pennsylvania in 2011. Mr. Jugal worked with Apollo Tyres Ltd. and Berger Paints (India) Ltd. before joining SCNL in 2000.

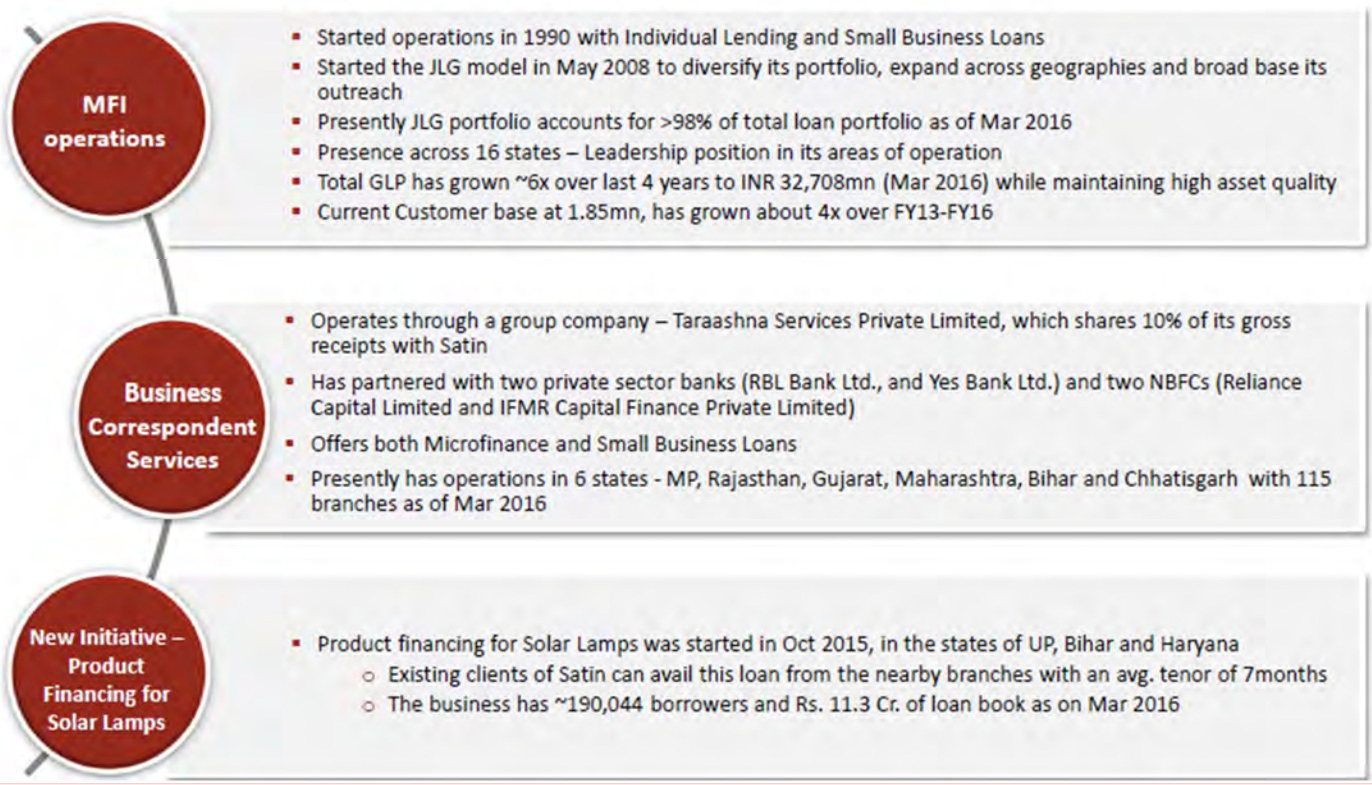
Source: Company

Exhibit 81: SCNL - Key milestone



Source:Company

Exhibit 82: Product portfolio – Diversification underway



Source: Company

Financials-Standalone (historical)

Exhibit 83: Income Statement

Y/E March (Rs mn)	FY11	FY12	FY13	FY14	FY15
Interest Income	586	562	841	1,696	2,929
Interest Expense	283	268	543	1,061	1,775
Net Interest Income	**303**	**294**	**298**	**635**	**1,154**
Non -Interest Income	-	1	102	221	313
Total Net Income	**303**	**294**	**400**	**856**	**1,467**
Total Operating Expenses	**257**	**263**	**324**	**531**	**905**
Employee expenses	149	154	159	236	392
Other Operating Expenses	108	110	166	295	513
Pre-provision Profit	**46**	**31**	**76**	**325**	**562**
Provisions & Contingencies	12	10	22	91	97
Profit Before Tax	**34**	**21**	**53**	**234**	**465**
Taxes	12	7	15	79	148
Profit after tax	**22**	**14**	**39**	**156**	**317**
Exceptional items	-	-	-	-	-
Adj Net Profit	**22**	**14**	**39**	**156**	**317**

Source: Company, Centrum Research

Exhibit 84: Balance sheet

Y/E March (Rs mn)	FY11	FY12	FY13	FY14	FY15
Current assets	885	926	2,165	2,446	4,033
Loans & Advances	1,829	1,916	4,547	7,905	14,774
Investments	7	7	7	1	1
Total Int Earning Assets	**2,721**	**2,849**	**6,719**	**10,352**	**18,808**
Fixed Assets	81	80	83	120	144
Other non-current assets	149	242	659	745	1155
Total Assets	**2,951**	**3,171**	**7,461**	**11,217**	**20,107**
Borrowings	**2,074**	**2,155**	**5,898**	**9,146**	**16,361**
- Long term	574	963	2,780	3,288	8,117
- Short term	1,500	1,192	3,118	5,858	8,244
Interest Bearing Liabilties	**2,074**	**2,155**	**5,898**	**9,146**	**16,361**
Non int bearing Liabilities	91	216	326	686	1,812
Total Liabilities	**2,164**	**2,372**	**6,224**	**9,832**	**18,172**
Equity	786	799	1,237	1,384	1,935
Total Liabilities	**2,951**	**3,171**	**7,461**	**11,217**	**20,107**

Source: Company, Centrum Research

Exhibit 85: DuPont analysis

(% of avg assets)	FY11	FY12	FY13	FY14	FY15
Yield on assets	*30.9*	*18.3*	*15.8*	*18.2*	*18.7*
Cost of funds	*15.4*	*9.2*	*10.8*	*12.1*	*12.4*
Spreads	*9.5*	*5.7*	*2.3*	*4.0*	*4.7*
NIM	***17.0***	***10.8***	***6.4***	***7.6***	***8.1***
Other income	*0.0*	*0.0*	*1.9*	*2.4*	*2.0*
Total income	***16.0***	***9.6***	***7.5***	***9.2***	***9.4***
Operating expenses	*13.5*	*8.6*	*6.1*	*5.7*	*5.8*
Provisions	*0.6*	*0.3*	*0.4*	*1.0*	*0.6*
PBT	***1.8***	***0.7***	***1.0***	***2.5***	***3.0***
Tax	*0.6*	*0.2*	*0.3*	*0.8*	*0.9*
RoA	***1.1***	***0.5***	***0.7***	***1.7***	***2.0***
Leverage	*3.7*	*3.9*	*5.2*	*7.1*	*9.4*
RoE	***4.3***	***1.8***	***3.8***	***11.9***	***19.1***

Source: Company, Centrum Research

Exhibit 86: Financial ratios

Y/E March	*FY12*	*FY13*	*FY14*	*FY15*
Growth Ratios (%)				
Loans	*4.8*	*137.3*	*73.8*	*86.9*
AuM	*-*	*81.3*	*82.1*	*102.7*
Assets	*7.5*	*135.3*	*50.3*	*79.3*
Borrowings	*3.9*	*173.7*	*55.1*	*78.9*
NII	*(3.1)*	*1.5*	*113.0*	*81.8*
Provisions	*(18.2)*	*123.6*	*304.3*	*6.7*
PAT	*(36.1)*	*177.5*	*302.3*	*103.8*
Operating Ratios (%)				
Yield on advances	*22.8*	*21.6*	*23.7*	*21.1*
Cost of borrowings	*12.7*	*13.5*	*14.2*	*14.0*
NIM (on AuM)	*18.1*	*6.6*	*7.8*	*7.2*
Fee to disbursement	*-*	*0.9*	*0.9*	*1.0*
Cost/Income	*89.4*	*81.1*	*62.0*	*61.7*
Opex / Avg AuM	*16.2*	*7.2*	*6.5*	*5.7*
Effective tax rate (%)	*33.7*	*27.3*	*33.6*	*31.8*
RoA	*0.5*	*0.7*	*1.7*	*2.0*
RoE	*1.8*	*3.8*	*11.9*	*19.1*
RoTA (incl Off B/S)	*0.5*	*0.6*	*1.4*	*1.6*
Credit Quality Ratios (%)				
Gross NPA	*0.30*	*0.16*	*0.03*	*0.03*
Net NPA	*0.07*	*0.14*	*0.01*	*0.02*
NPA coverage ratio	*76.2*	*11.7*	*50.0*	*51.2*
Capital Adequacy Ratios (%)				
Total CAR	*34.9*	*23.4*	*15.3*	*15.7*
Tier I	*34.5*	*23.2*	*14.3*	*9.6*
Tier II	*0.4*	*0.2*	*1.0*	*6.1*
Assets/equity (x)	3.9	5.2	7.1	9.4
Dividend details				
DPS (Rs)	-	-	-	-
Dividend Payout (%)	-	-	-	-
Per Share (Rs)				
BVPS	44.8	54.5	61.0	76.2
Adjusted BVPS	44.7	54.2	61.0	76.2
EPS - basic	0.8	1.7	6.9	12.5
Valuations Ratios				
Price/BV (x)	10.7	8.8	7.8	6.3
Price/Adj. BV (x)	10.7	8.8	7.8	6.3
P/E (x)	611.1	280.0	69.6	38.2
Dividend Yield (%)	*0.0*	*0.0*	*0.0*	*0.0*

Source: Company, Centrum Research

Financials-Standalone

Exhibit 87: Income Statement

Y/E March (Rs mn)	FY14	FY15	FY16	FY17E	FY18E
Interest Income	1,696	2,929	5,049	6,973	8,990
Interest Expense	1,061	1,775	2,899	3,722	4,573
Net Interest Income	**635**	**1,154**	**2,150**	**3,251**	**4,417**
Non -Interest Income	221	313	536	698	840
Total Net Income	**856**	**1,467**	**2,686**	**3,949**	**5,257**
Total Operating Expenses	**531**	**905**	**1,603**	**2,429**	**2,991**
Employee expenses	236	392	884	1,132	1,422
Other Operating Expenses	295	513	719	1,297	1,570
Pre-provision Profit	**325**	**562**	**1,083**	**1,520**	**2,266**
Provisions & Contingencies	91	97	208	355	557
Profit Before Tax	**234**	**465**	**875**	**1,166**	**1,709**
Taxes	79	148	296	391	572
Profit after tax	**156**	**317**	**579**	**775**	**1,136**
Exceptional items	-	-	-	-	-
Adj Net Profit	**156**	**317**	**579**	**775**	**1,136**

Source: Company, Centrum Research Estimates

Exhibit 88: Balance sheet

Y/E March (Rs mn)	FY14	FY15	FY16	FY17E	FY18E
Current assets	2,446	4,033	8,492	7,770	8,554
Loans & Advances	7,905	14,774	22,995	30,929	41,639
Investments	1	1	1	1	1
Total Int Earning Assets	**10,352**	**18,808**	**31,488**	**38,699**	**50,193**
Fixed Assets	120	144	213	227	243
Other non-current assets	745	1155	1334	1426	1532
Total Assets	**11,217**	**20,107**	**33,034**	**40,353**	**51,969**
Borrowings	**9,146**	**16,361**	**26,906**	**30,595**	**40,366**
- Long term	3,288	8,117	13,335	15,225	20,253
- Short term	5,858	8,244	13,572	15,369	20,112
Interest Bearing Liabilities	**9,146**	**16,361**	**26,906**	**30,595**	**40,366**
Non-int bearing Liabilities	686	1,812	2,888	3,778	4,486
Total Liabilities	**9,832**	**18,172**	**29,794**	**34,372**	**44,852**
Equity	1,384	1,935	3,240	5,980	7,117
Total Liabilities	**11,217**	**20,107**	**33,034**	**40,353**	**51,969**

Source: Company, Centrum Research Estimates

Exhibit 89: DuPont analysis

(% of avg assets)	FY14	FY15	FY16	FY17E	FY18E
Yield on assets	*18.2*	*18.7*	*19.0*	*19.0*	*19.5*
Cost of funds	*12.1*	*12.4*	*12.0*	*11.2*	*10.9*
Spreads	*4.0*	*4.7*	*5.6*	*6.0*	*6.5*
NIM	***7.6***	***8.1***	***8.9***	***9.7***	***10.3***
Other income	*2.4*	*2.0*	*2.0*	*1.9*	*1.8*
Total income	***9.2***	***9.4***	***10.1***	***10.8***	***11.4***
Operating expenses	*5.7*	*5.8*	*6.0*	*6.6*	*6.5*
Provisions	*1.0*	*0.6*	*0.8*	*1.0*	*1.2*
PBT	***2.5***	***3.0***	***3.3***	***3.2***	***3.7***
Tax	*0.8*	*0.9*	*1.1*	*1.1*	*1.2*
RoA	***1.7***	***2.0***	***2.2***	***2.1***	***2.5***
Leverage	*7.1*	*9.4*	*10.3*	*8.0*	*7.0*
RoE	***11.9***	***19.1***	***22.4***	***16.8***	***17.4***

Source: Company, Centrum Research Estimates

Exhibit 90: Financial ratios

Y/E March	*FY14*	*FY15*	*FY16*	*FY17E*	*FY18E*
Growth Ratios (%)					
Loans	*73.8*	*86.9*	*55.6*	*34.5*	*34.6*
AuM	*82.1*	*102.7*	*52.8*	*34.0*	*34.7*
Assets	*50.3*	*79.3*	*64.3*	*22.2*	*28.8*
Borrowings	*55.1*	*78.9*	*64.5*	*13.7*	*31.9*
NII	*113.0*	*81.8*	*86.3*	*51.2*	*35.9*
Provisions	*304.3*	*6.7*	*114.4*	*70.4*	*57.1*
PAT	*302.3*	*103.8*	*82.7*	*33.8*	*46.6*
Operating Ratios (%)					
Yield on advances	*23.7*	*21.1*	*20.2*	*20.1*	*19.3*
Cost of borrowings	*14.2*	*14.0*	*13.4*	*13.0*	*12.9*
NIM (on AuM)	*7.8*	*7.2*	*7.9*	*8.5*	*8.6*
Fee to disbursement	*0.9*	*1.0*	*1.0*	*1.0*	*1.0*
Cost/Income	*62.0*	*61.7*	*59.7*	*61.5*	*56.9*
Opex/ Avg AuM	*6.5*	*5.7*	*5.9*	*6.3*	*5.8*
Effective tax rate (%)	*33.6*	*31.8*	*33.8*	*33.5*	*33.5*
RoA	*1.7*	*2.0*	*2.2*	*2.1*	*2.5*
RoE	*11.9*	*19.1*	*22.4*	*16.8*	*17.4*
RoTA (incl. Off B/S)	*1.4*	*1.6*	*1.7*	*1.6*	*1.9*
Credit Quality Ratios (%)					
Gross NPA	*0.03*	*0.03*	*0.20*	*0.21*	*0.23*
Net NPA	*0.01*	*0.02*	*0.09*	*0.11*	*0.11*
NPA coverage ratio	*50.0*	*51.2*	*64.8*	*59.5*	*62.9*
Capital Adequacy Ratios (%)					
Total CAR	*15.3*	*15.7*	*16.8*	*22.1*	*19.6*
Tier I	*14.3*	*9.6*	*11.3*	*16.8*	*15.5*
Tier II	*1.0*	*6.1*	*5.5*	*5.3*	*4.1*
Assets/equity (x)	7.1	9.4	10.3	8.0	7.0
Dividend details					
DPS (Rs)	-	-	-	-	-
Dividend Payout (%)	-	-	-	-	-
Per Share (Rs)					
BVPS	61.0	76.2	102.9	163.9	195.0
Adjusted BVPS	61.0	76.2	102.4	163.1	194.0
EPS - fully diluted	6.9	12.5	18.4	21.2	31.1
Valuations Ratios					
Price/BV (x)	7.8	6.3	4.6	2.9	2.4
Price/Adj. BV (x)	7.8	6.3	4.7	2.9	2.5
P/E (x)	69.6	38.2	26.0	22.5	15.3
Dividend Yield (%)	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*

Source: Company, Centrum Research Estimates

INDIA

HOLD

CENTRUM

Ujjivan Financial Services

Financials

Initiating Coverage

14 July 2016

From doorstep to vault

We initiate coverage on Ujjivan Financial Services with Hold and a TP of Rs400. Strong geographical reach, product offering, management pedigree and customer base remain key strengths for Ujjivan which will aid in smooth transition to an SFB model on the asset side. Greater focus on IT and infrastructure up-gradation, and creation of liability franchise will determine success of the proposed small finance bank (SFB) model. We expect near-term RoA/RoE to enter a trough before stabilising at 2.5%/18.6% in the longer run. In light of the above and the stock's recent run up, near-term upside seems limited.

- **Expansive and well-diversified business model a key strength:** Ujjivan, an NBFC-MFI with presence in 24 states, through 469 branches, enjoys ~11% market share in overall industry-wide AuM. It has carved a niche by offering customised products to over 3mn customers under both the group loan and individual loan segment routes. This resulted in 66% CAGR in AuM over FY12-16, led by 39% rise in its volume (customer base) and 20% rise in value of loans. With tested grounds, and especially for individual loans (both secured and unsecured), we believe Ujjivan is well-positioned for a transition to SFB on in its asset side, i.e. loan offerings.
- **Transition to SFB – integration to determine the success of the model:** The success of MFI turned SFB model will depend entirely on a) ability to create liability i.e. deposit franchise and b) efficient IT & infrastructure. Ability to contain costs plays a vital role in profitability, as history has seen classic failures due to cost escalation. In case of Ujjivan, we believe costs are set to steadily rise in the initial phase of transition (factoring in cost/assets at 700bps+ for FY17-18E, as against 6.3% in FY16) before economies of scale kick in. Also, efficiency of the model will be tested in terms of garnering CASA/retail deposits (which will have to be priced higher) and scouting for new customers in addition to strengthening relationships with existing ones.
- **Near-term RoA to decline, sustainable RoA at 2.5% levels:** The transition to SFB model will see dip in margins following the need to earmark funds for CRR/SLR requirements in addition to IT and infrastructure costs which will dent the pre-provisioning front. Overall RoA/RoE should trend lower to 2.4%/12.8% levels by end-FY18E (vs 3.7% RoA / 18.3% in FY16). Post the successful transition to the SFB model and economies of scale playing out, including well-contained costs, we expect RoA/RoE to inch up to 2.5%/18.6% by end-FY20.
- **Valuation, view and key risk:** We like Ujjivan for its business model, management pedigree, credit process and well-laid out strategy in transition to the SFB model. Our estimates are conservative on the growth front, as we foresee the need for greater emphasis on transformation in the near term. We are thus building in 27%/22%/16% CAGR in loans/NII and PAT over FY16-18E. Stock has seen a run-up given the growth opportunity, leaving limited room for upside. We Initiate with Hold and a TP of Rs400. Inability to contain operational costs and its impact on profitability, or ability to shore deposit franchise remain key risks in the near term.

Target Price	Rs400
CMP*	Rs401
Downside	*0.3%*

Key Data	
Bloomberg Code	UJJIVAN IN
Curr Shares O/S (mn)	118.2
Diluted Shares O/S(mn)	118.2
Mkt Cap (Rsbn/USDmn)	47.4/707.5
52 Wk H / L (Rs)	431/216.7
5 Year H / L (Rs)	431/216.7
Daily Vol. (3M NSE Avg.)	-

Price Performance (%)*

	1M	6M	1Yr
UJJIVAN IN	11.1	-	-
Nifty	5.0	12.7	0.7

as on 13 July 2016; Source: Bloomberg, Centrum Research

Read the inside pages for:

- *Strong business model; pan-India presence may mitigate concentration and asset quality risk*
- *TAT improving; customer retention rate at 80%+*
- *Transition to small finance bank (SFB)*
- *RoA /RoE to dip in near term before stabilising at respectable levels in the longer run*

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Y/E Mar (Rs mn)	Net Income#	PPOP	Rep. PAT	YoY (%)	EPS (Rs)	P/E (x)	Adj BV (Rs)	P/Adj BV (x)	RoA (%)	RoE (%)
FY14	2,231	970	584	77.7	8.4	47.9	53.4	7.5	3.4	16.9
FY15	3,566	1,355	758	29.7	10.6	37.8	81.7	4.9	2.5	13.7
FY16	6,040	2,971	1,772	133.8	17.5	22.9	113.7	3.5	3.7	18.3
FY17E	8,723	3,354	1,930	9.0	16.3	24.6	142.5	2.8	2.9	13.1
FY18E	10,595	4,278	2,377	23.2	20.1	20.0	160.6	2.5	2.4	12.8

Source: Company, Centrum Research Estimates #denotes NII + other income

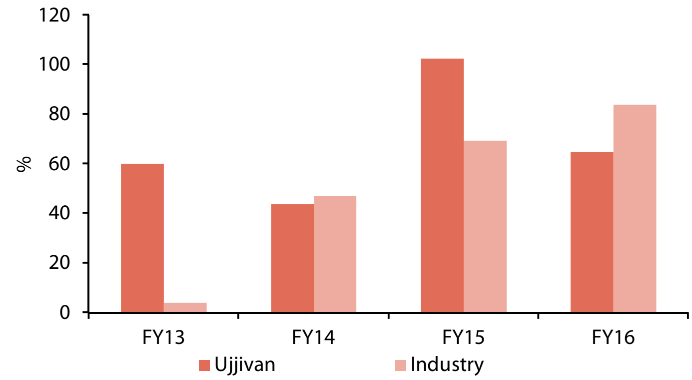
Geographical reach with diversified product offering – key strength; to aid in asset growth post conversion to SFB model

- **With pan-India presence and diversified product offering, Ujjivan reported 66% CAGR in AuM over FY12-16.**
- **Foray into individual loans segment in 2012 (both secured and unsecured) to cater to the increasing requirement of its existing customer base. Contribution to AuM stood at ~13% for FY16. Of the individual loan customers, 60% have been MFI customers earlier.**
- **Well-diversified business model to aid in health asset growth post the conversion to small finance bank (SFB) model. Factoring in 29% AuM CAGR over FY16-18E.**

Ujjivan Financial Services (Ujjivan), with gross loan portfolio of ~Rs54bn is the third largest MFI in terms of asset base and operates through 469 branches spread across 24 states in India. Having started its operations as an NBFC in 2005, with a mission to provide a full range of financial services to the economically active poor who are not adequately served by financial institutions, the company today caters to over 3mn customers and under both the JLG-based and individual lending models (both secured and unsecured).

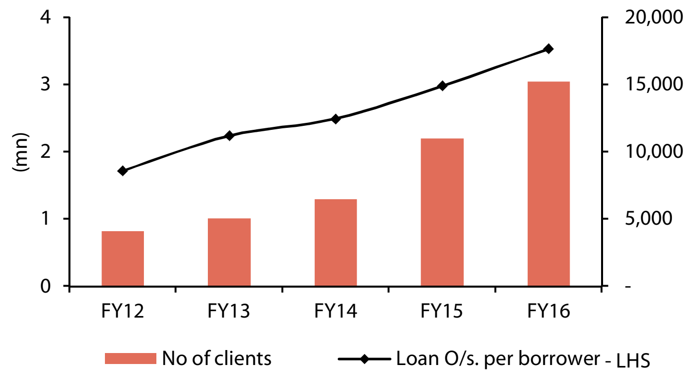
Ujjivan has adopted an integrated approach to lending, which combines a high customer touch point, typical of microfinance, with the technology infrastructure and related back-end support functions similar to that of a retail bank. Over FY12-16, Ujjivan has witnessed 66% CAGR in AuM (i.e. GLP) led by 39% rise in its volume (i.e. customer base) and 20% rise in value of loans. In other words, its customer base has increased from 0.8mn in FY12 to 3mn for FY16. Ticket size over the same time frame increased from Rs8,588 to Rs17,784.

Exhibit 91: Ujjivan witnessed 66% AuM CAGR vs 48% CAGR for the entire industry



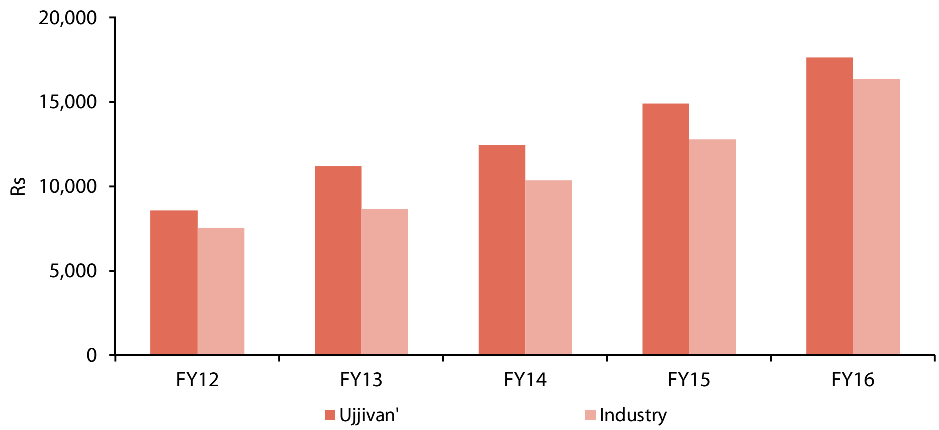
Source: MFIN, Centrum Research

Exhibit 92: Ujjivan has witnessed near 3.7x increase in its customer profile. Loan o/s. per customer has increased by ~2x over the same time



Source: Company, Centrum Research. Note

Exhibit 93: Ujjivan saw 20% CAGR in its loan O/s. per customer vis-à-vis 21% CAGR for the industry over FY12-16



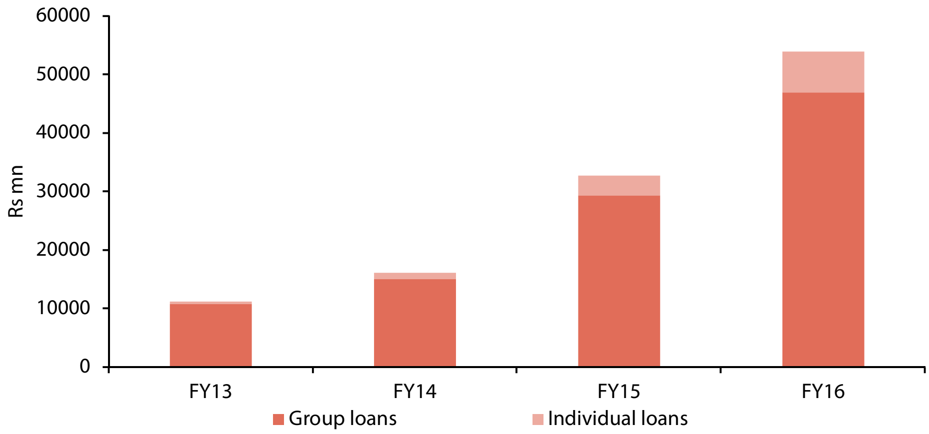
Source: MFIN, Company, Centrum Research

Foray into Individual loan (IL) segment:

While having forayed into GLP business since its inception, with increasing demand from its customer for higher ticket size loans, Ujjivan entered into the individual lending model in 2012. The individual lending model, at the outset was entirely unsecured in nature and more in form of funding to meet capital requirements towards MSE route or housing requirement. Over the years, with increasing credit demand, Ujjivan has also forayed into secured nature of lending. As at end-FY16, individual loan segment comprised 13% of total AuM. Further, 60% of individual loans are sourced from group loan customers.

Ujjivan plans to increase the share of IL in its portfolio as the drop-out rates post the second cycle (repeat customer) in GL are higher. As drop-out rates increase, the customer base starts to deplete. To retain this customer base, MFIs globally and to a certain extent in India have introduced the IL model.

Exhibit 94: AuM breakdown – Proportion of Individual loans have steadily been on a rise



Source: Company, Centrum Research

While average ticket size for JLG lending model stood at Rs22,000-23,000 for FY16 and has increased from Rs11,000-12,000 in FY12, the average ticket size in the individual loan segment was Rs65,000. The yield on group loans is 22.5% and the blended yield on individual loans is roughly 20% .

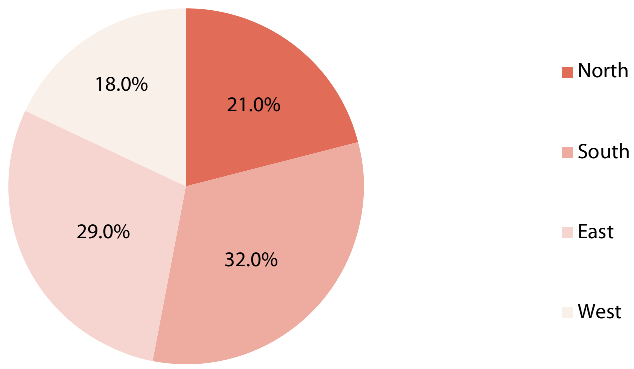
Exhibit 95: Loan offerings, blended yield and purpose of lending

Loan type	AuM (Rs bn)	Yield (%)	Purpose
Gourp Loans	46.9	23	Business, purpose, top-up, emergency, education
Individual loans - MSE	6.5	20	Business, bazaar, secured business, agriculture, livestock
Individual loans - Housing	0.2	16	improvement, self-construction, under-construction purchase, ready purchase

Source: Company

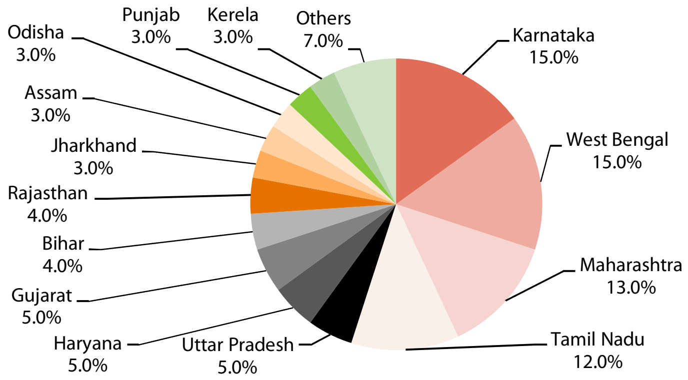
Since Ujjivan has its origins in south India, unlike other players which continue to have larger exposure in certain states, Ujjivan has been able to expand its reach pan India. State-wise exposure also remains low, enabling to mitigate concentration risk. Top-5 states of Karnataka, West Bengal, Maharashtra, TN and UP comprised 50% of total loan exposure.

Exhibit 96: AuM split – region-wise



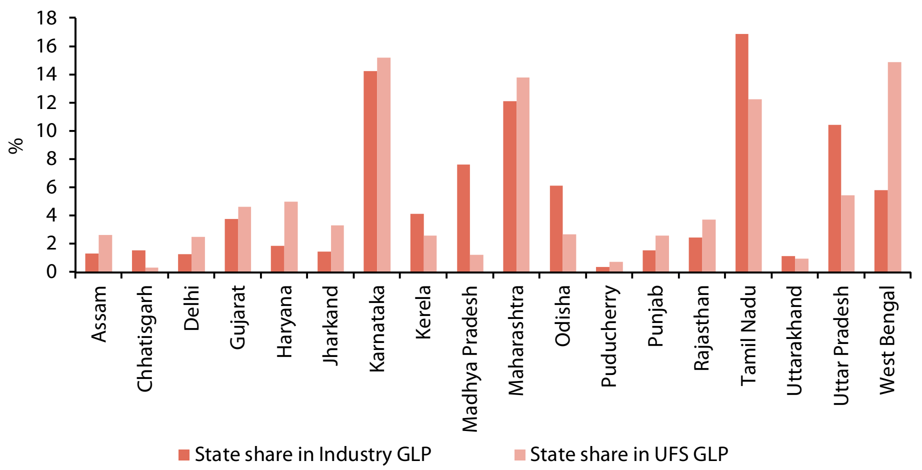
Source: Company, Centrum Research

Exhibit 97: State-wise concentration remains comfortable with no single state exposure in excess of 16%.



Source: Company, Centrum Research

Exhibit 98: Pan-India presence has enabled enjoy respectable market share



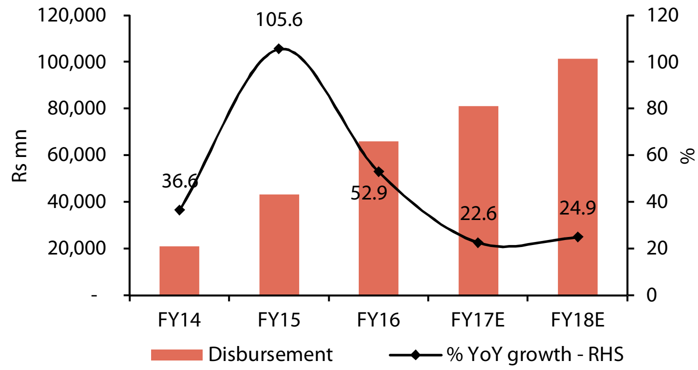
Source: Company

Diversified product offering to aid in healthy asset growth post conversion to SFB

While the phase of transition to SFB model merits slow pace of growth, we believe that Ujjivan with well-diversified product offering, pan-India presence, larger being in urban and semi-urban areas is well placed for strong growth, once it resumes operations under its new lending model. Individual loans comprised <13% of overall AuM, and the management expects the same to contribute meaningfully to the portfolio in the longer run (~50%). This may be possible given the wider access to customer pool with varied credit requirement.

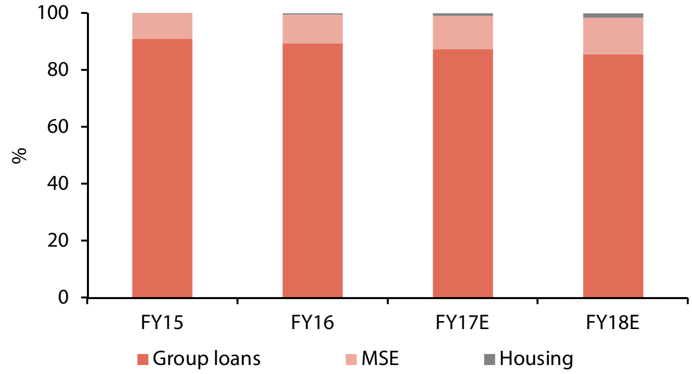
We expect Ujjivan to report 29% CAGR in AuM over FY16-18E. This compares with 83% AuM CAGR over FY14-16. We expect the proportion of group loans to moderate and be replaced by either unsecured SME/individual loans or through secured asset class segments of home loans/SME or even foray into new product offerings of vehicle financing, personal loan or gold loan. These avenues, though new, will take some time to become fully operational and contribute meaningfully to the overall growth rate.

Exhibit 99: Factoring in 24% CAGR in disbursements



Source: Company, Centrum Research Estimates

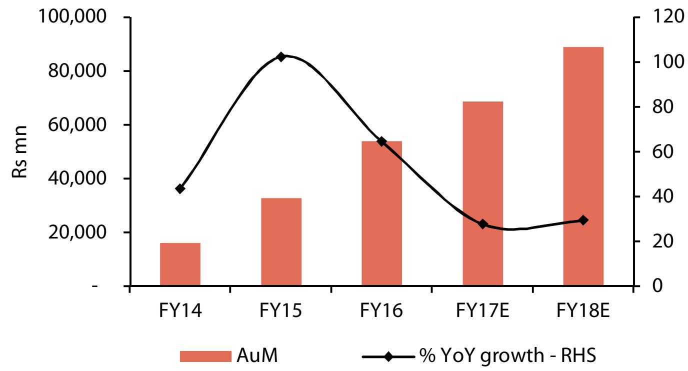
Exhibit 100: …led by increasing share of non-GLP segment



Source: Company, Centrum Research Estimates

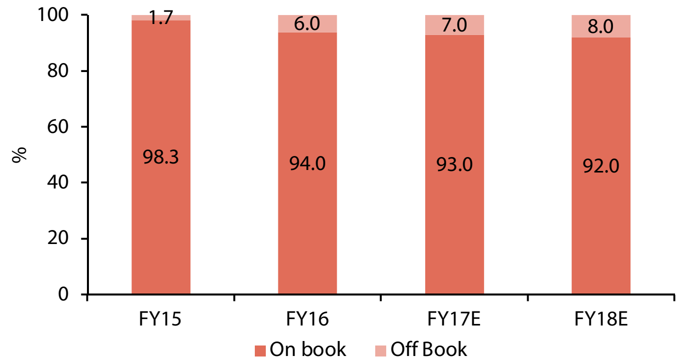
While dependence on securitisation route has remained low for Ujjivan in the past on account of access to relatively cheaper cost of funds, we expect Ujjivan to increasingly resort to securitisation as it transitions to the SFB model given the need for liquidity towards compliance with CRR / SLR.

Exhibit 101: Factoring in 29% AuM CAGR



Source: Company, Centrum Research Estimates

Exhibit 102: … with increasing proportion of securitized portfolio



Source: Company, Centrum Research Estimates

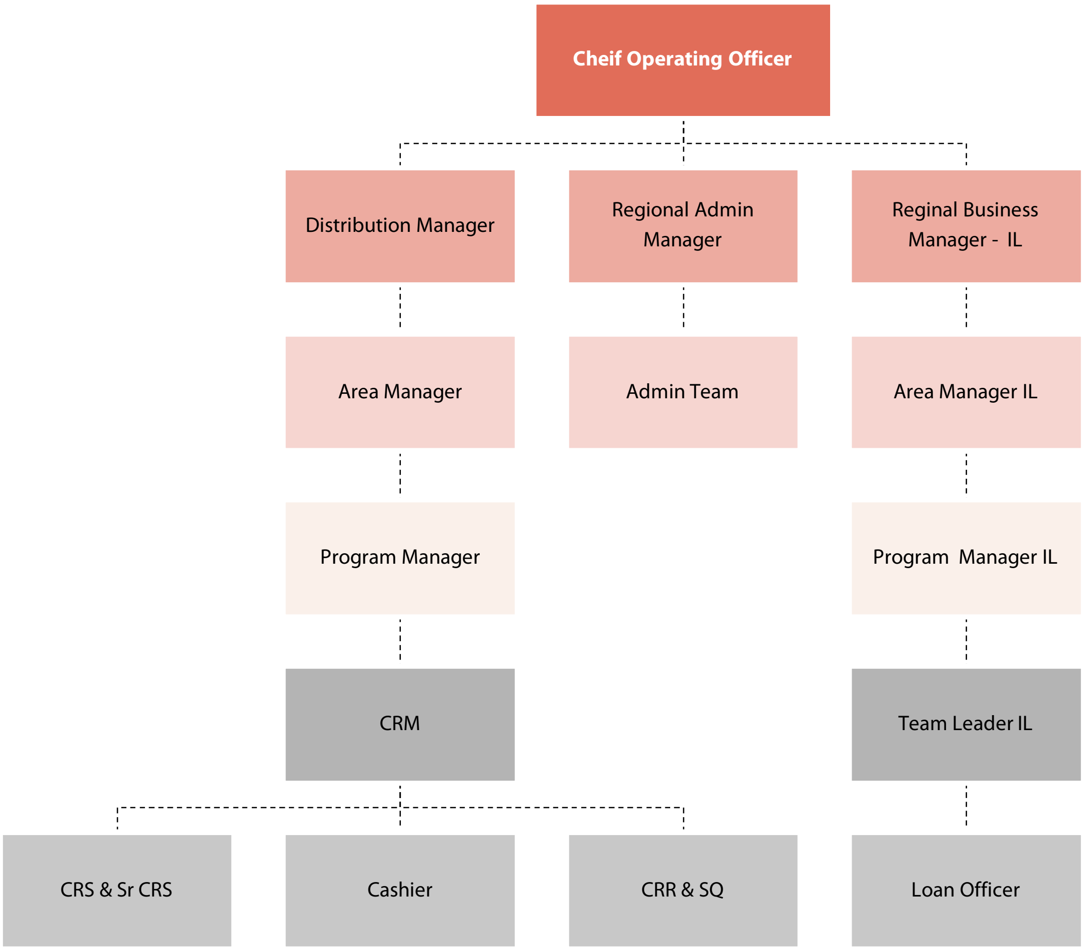
Business processes in place; customer retention rate, turn-around time has considerably improved

- **Well-designed credit process for each business model – GLP and individual loans. Focus on digitalisation as a way of doing business. Field surveys validate credit process and practises.**
- **Branch expansion strategy and approach towards customer acquisition has enabled significant improvement in overall turn-around time. Customer retention rate stood at 86.3% for FY16. TAT has reduced considerably across business.**

Well-designed credit process

Owing to the inherent nature of the business model, the MFI industry has tightened its credit process norms to avoid leakages. Ujjivan with diversified product offerings (though more of mono-line nature of business) has made considerable efforts to improve the overall efficiency. Credit processes are separate for each business model. Also, the decentralisation of offices into four regions has enabled quick decision making and evade an AP like crisis. The credit processes, though, are centralised, with teams involved in regular audits, inspections, improvement, etc.

Exhibit 103: Organisation structure- hierarchy well-strategized



Source: Company

Exhibit 104: Well-designed credit process

Branch set - up

Street - survey -Door to door promotion of Ujjivan by the requisite personnel

Projection meeting - Meeting of 35-40 people from the vicinity where a further detailed explanantion is given to the entire group

Group formation- Groups of typically 5-8 members approach Ujjivan for loans. Each group is given a loan application form (LAP) and each customer is given a customer profile (CP) form. The CRS completes the non-financial parts of the CP (7 mandatory fields)

House Visit - Done by CRM and CRS while the CRM posts the necessary observations and verifications, and the CRM fills-up the financial part of the CP relating to income and expenditure. Also collection of primary ID proof (only Aadhar card or voter ID) and secondary ID for address proof (photo pass, electricity bill

Cumpulsory group training (CGT) - Means to educate the customers regarding the policies and processes at Ujjivan

Group recognition test (GRT) - The GL members have to give a compulsory test. The person conducting the test is a PM, DM, AM or FCO not from the same branch who has given a one day test and passed with a score of 85.

Scanning of CP and LAP documents which are then sent to the regional office where data entry is done. This information is then checked by the independent credit department which is then sent to the Credit Inforamtion Bureau (CIB).

Disbursement - The CIB then verifies this information and if appropriate sends it back to the operations team post which dibursement of the loan happens.

Defined as the turn-around-time (TAT) which is currently 4.3 days for GL and 6.3 days for IL

Source: Company

Field survey and key observations

We visited a few branches of Ujjivan as part of our research process to understand the process of customer selection, credit and other business-related aspects.

At the branch level, functions are bifurcated on the basis of the type of borrowing – group lending (GL) and individual lending (IL). The functions of the various personnel at the branch level including the CRM (branch manager) and the persons junior to him/her are discussed below.

CRM (branch manager) – Oversees profitability of the branch, controlling risk by ensuring requisite audits are carried out, people management and field supervision. Responsible for quantifying the responsibilities of a CRM, roughly, 40% would involve business development, 35% repayment and risk management, 10% community development programs and 5% people management. (For mature branches there is also an assistant CRM).

Customer care representative (CCR) – As the face of the customer; responsible for promoting products to active and non-active customers, targeting non-active customers, converting drop-out clients to active clients, conducting exit interviews, etc.

Customer relationship staff (CRS) – Acquires new customers from allocated working area, serving repeat customers, form filling, collecting EMIs and involves 90% field work, etc.

Loan officers (LO) – Promotes individual loans to existing group loan customers by visiting existing branches (reports to the CRM – GL or the PM – IL).

Key observations and risks to the above processes

- In a GL scenario, income proof is not provided by the customer, and the income and expenditure evaluation is done by the CRM at the time of the house visit which brings in an element of subjectivity during verification. This risk is addressed by the fact that in a GL scenario, the members would know each other's credit history and the CRM verifies and evaluates this as he visits each member's house. Moreover, the CRM checks whether the house is actually owned by the individual.
- CRS is responsible for completion of the CP, coupled with the collection of the EMIs at the centre meetings, which may create a bias in the mind of the CRS. This risk is addressed by the fact that the CRS only fills up the non-financial part of the CP, while the CRM completes the financial part of the CP
- There is a risk that the CRS may siphon away the cash collected as repayment at centre meetings. To address this risk, the CCR, ACRM, CRM and PM each is required to randomly visit 20 centre meetings per month other than the ones conducted in relation to their branch.
- As an effective risk management practice, a branch audit is conducted every quarter while records of 250 random borrowers are checked by an internal audit team. The Field Credit Officer (FCO) is required to visit four random branches per month, while the vigilance executive is required to randomly visit customers.

Exhibit 105: Centre meetings

Source: Company, Centrum Research

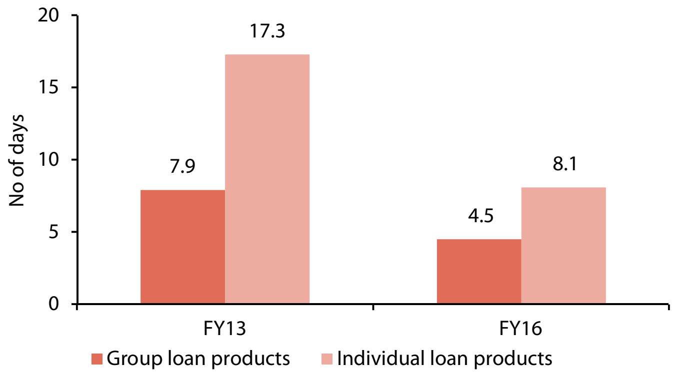
Exhibit 106: Borrowers are issued cards once loans are disbursed. The same is being updated post payment of each instalment dues.

Source: Company, Centrum Research

TAT has considerably improved; customer retention rate at 86%

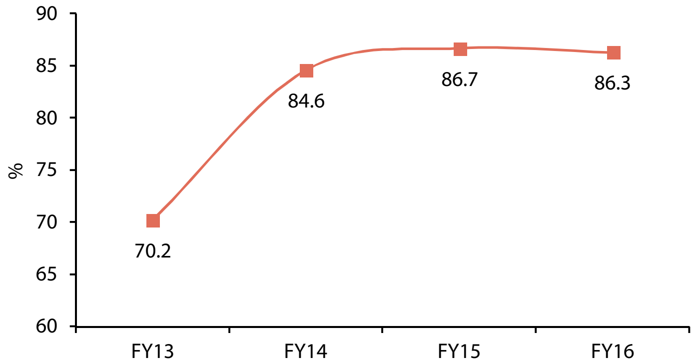
Branch expansion, customer acquisition and turn-around time are all linked as only a higher branch base enables more customers on account of deeper penetration. A faster TAT attracts a larger number of customers. The use of the Android-based application (60% of business is done through systems) for back office processing of loans, which is unique to Ujjivan, has helped reduce TAT. Thus, paperless processing of applications and documents at the branches has enabled efficient and secure document management with low TAT. Further, an automated backend, supported by a robust core banking system and a document management system, has improved efficiency and minimised TAT.

Exhibit 107: TAT has improved over time led by process automation…



Source: Company, Centrum Research

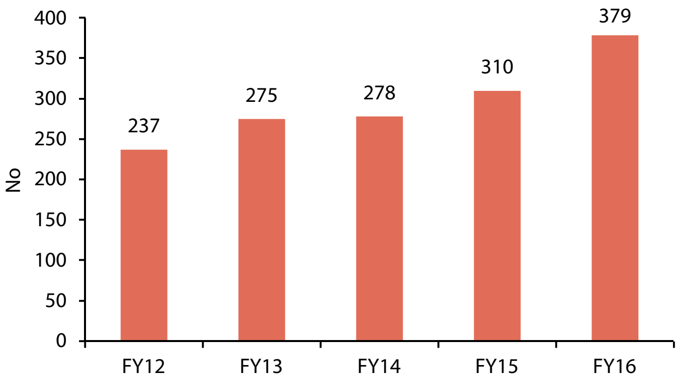
Exhibit 108: … also led to better customer retention rates.



Source: Company, Centrum Research.

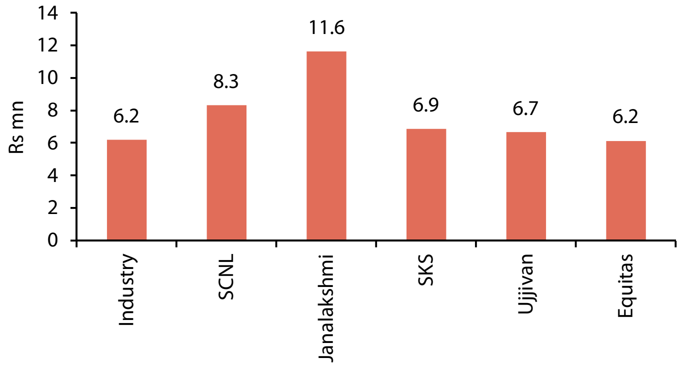
On account of these operational efficiencies due to the use of technology leading to a faster TAT, the customer retention ratio has also improved over FY13-16. MFI business growth also depends on word-of-mouth which aids in higher customer retention. A robustly growing customer base has been a result of a higher customer retention ratio which was possible due to assessing customer's requirements, taking their feedback for introduction of new products and a dedicated service quality department to focus on customer protection and grievance redressal.

Exhibit 109: Borrower per employee has been on a rise for Ujjivan



Source: Company, Centrum Research

Exhibit 110: Loan per employee remains comfortable when compared to peers.

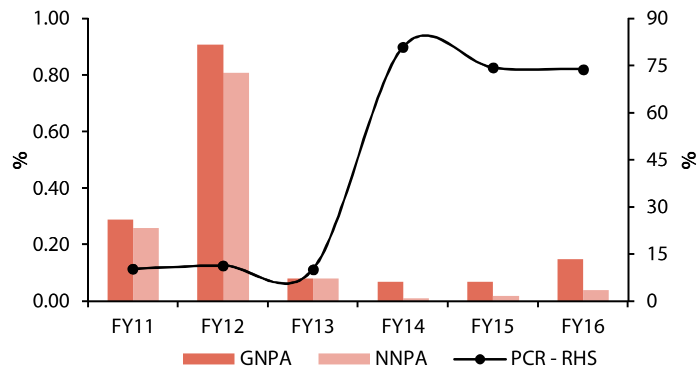


Source: Companies, Centrum Research. (FY16)

Robust asset quality; NPA recognition policy stringent to regulatory requirement

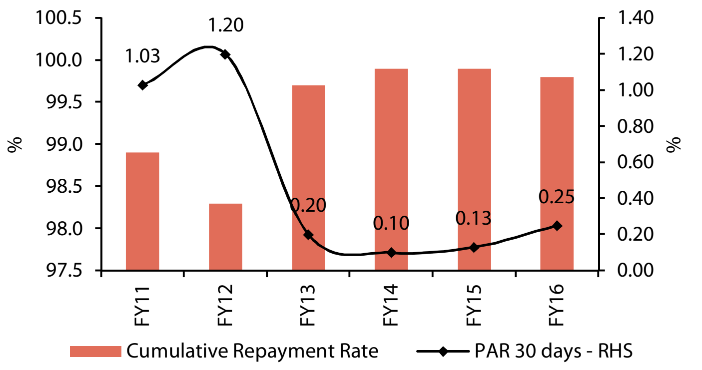
The inherent strength of the business model has seen MFI industry operate at very low GNPAs. Similar to the industry-wide phenomenon, headwinds related to asset quality have remained low for Ujjivan, given their stringent credit policies, regular inspections and audits. Further, with decentralised offices and limited state-wise concentration, it has been in a position to mitigate any AP-like situation.

Exhibit 111: Asset quality remains comfortable



Source: Company, Centrum Research

Exhibit 112: Led by higher repayment rate

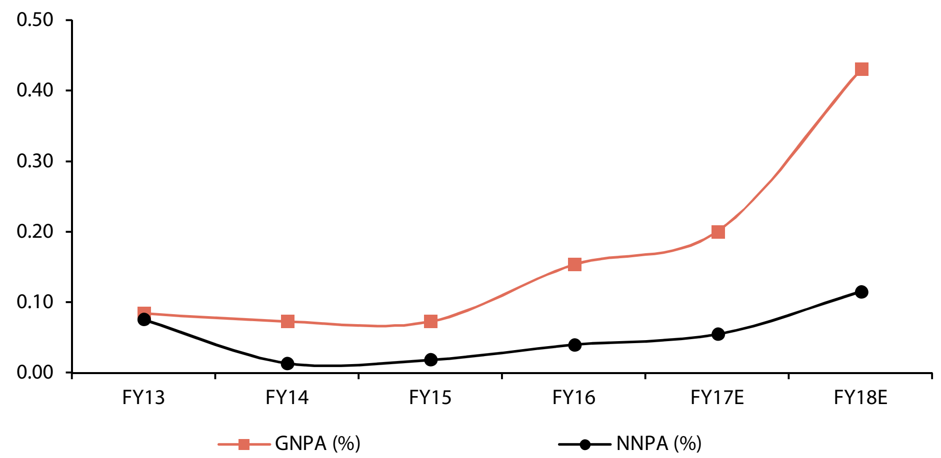


Source: Company, Centrum Research.

While we expect the trend in asset quality to remain benign for the JLG portfolio, delinquencies in the individual loan segment cannot be ruled out. This is also given the a) core underlying behaviour of the asset, b) relatively higher ticket size vis-à-vis JLG business, c) absence of group liability (and thus limited social obligation) unlike the JLG-based lending approach and d) Ujjivan increasing reliance on this segment to shore up loan portfolio.

We thus build in higher delinquencies and proportionately higher credit cost. We however draw comfort from the fact that the company also plans to increase the proportion of secured lending which is currently negligible. This may preserve asset quality to some extent.

Exhibit 113: Expect asset quality to see an uptrend following product diversification



Source: Company, Centrum Research Estimates

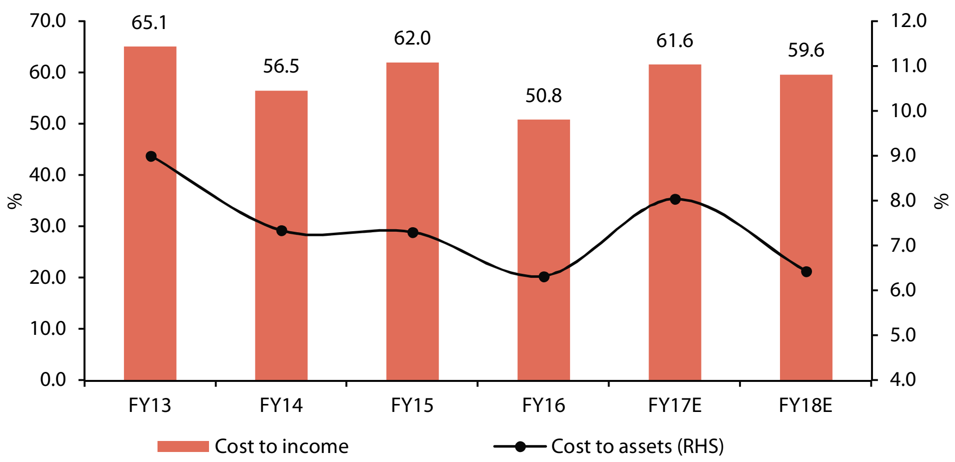
Transition to SFB model – An uphill task

- **Degree of success entirely dependent on the ability to contain costs – both operational and credit costs. Banking industry has seen examples of failed/successful transformation.**
- **Structural changes in balance sheet profile to impact near-term RoE. Growth with higher profitability post transition to aid in considerable improvement in returns profile.**
- **We expect RoA/RoE for Ujjivan to inch towards 2.5%/18.6% by end-FY20.**

As discussed in our sector piece, the success/failure of a business model hinges largely on the ability to contain costs – both operational and asset quality. Driven by operational efficiency, faster turn-around time and automated processes in business; Ujjivan has considerably improved its cost/income ratio. FY16 cost/asset ratio stood at 6.3% (vs 7.3% for FY15).

Transition to SFB model will lead to a surge in overall costs. As per management, the costs associated with systems and infrastructure up-gradation include a) Rs3bn to be incurred on IT up-gradation, b) Rs1.2-1.5mn for upgrading existing branches, c) new branch addition (at an average of Rs1mn per branch), d) new recruitments (both at junior level and senior staff) and e) wage increases. We thus expect costs/assets for Ujjivan to hover at 7.5% over FY17-18E. However, with improved earnings and operating leverage, we expect the ratio to average at 6% levels for FY18-20E. Ujjivan has pointed for conversion to SFB model in Q1CY17, with 200 of the existing 469 branches to migrate to bank models (vs existing MFI structure) from day one. With the need for rural branches, it has also indicated for addition of 80 new branches in year one of operation.

Exhibit 114: While costs are slated to move higher in the initial phase of transition, we expect the same to stabilise at 600bps post successful transition to SFB.



Source: Company, Centrum Research Estimates

The banking industry has seen classic instances of failed/successful transformation. Centurion Bank of Punjab saw a prolonged period of higher operating costs and material impact on profitability due to asset quality-related headwinds. Instances of successful transformation include Indusind Bank and DCB Bank. These stocks, over a period of time, have seen trade premium valuations following increased investor interest.

We are building escalation in GNPA during the phase of transformation. The ability to contain the same will also play an important role in determining the profitability.

In addition to changing the way of doing business, and thus operational costs, Ujjivan post the conversion is slated for structural changes in its balance sheet profile.

On the deposit side: The need to replace bank loans (both term and working capital) with CASA/retail deposits would be challenging. This is given the sticky nature of the deposits and also the inability to attract them even at higher interest rate. We thus believe the asset growth will need to be funded by diversifying the borrowing profile, including resorting to short-term money market instruments/certificate of deposits.

On the asset side: While asset growth is unlikely to be a major deterrent, we expect the growth rate to be far more prudent and lower in the initial years of transformation. The major challenge would be in the form of compliance with CRR/SLR requirement from day one which has a negative carry on the balance sheet. The need for adherence to these norms will also see Ujjivan resort to securitisation.

Exhibit 115: Balance sheet profile to undergo major changes….

% of assets	FY14	FY15	FY16	FY17E	FY18E	FY19E	FY20E
Equity	*17.9*	*18.5*	*20.9*	*22.9*	*16.4*	*14.5*	*12.8*
Deposits	*0.0*	*0.0*	*0.0*	*49.3*	*50.2*	*47.6*	*40.6*
Borrowings	*79.4*	*78.5*	*75.7*	*26.2*	*32.4*	*37.5*	*46.5*
Other Liabilities	*2.7*	*3.0*	*3.3*	*1.6*	*1.0*	*0.4*	*0.1*
Total liabilities	***100.0***	***100.0***	***100.0***	***100.0***	***100.0***	***100.0***	***100.0***
Cash	*19.0*	*16.2*	*8.6*	*8.8*	*9.9*	*10.2*	*9.9*
Customer loans	*77.8*	*80.9*	*88.4*	*83.9*	*68.3*	*67.8*	*68.0*
Investments	*0.0*	*0.0*	*0.0*	*3.8*	*19.0*	*19.1*	*19.2*
Fixed & intangible assets	*0.6*	*0.5*	*0.4*	*0.9*	*0.8*	*0.8*	*0.8*
Other assets	*19.0*	*16.2*	*8.6*	*8.8*	*9.9*	*10.2*	*9.9*
Total assets	***100.0***	***100.0***	***100.0***	***100.0***	***100.0***	***100.0***	***100.0***

Source: Company, Centrum Research Estimates

Exhibit 116: … and led to dip in RoE over FY17-18E before stabilising at 18.6% levels by FY20E

(% of avg assets)	FY14	FY15	FY16	FY17E	FY18E	FY19E	FY20E
Yield on assets	*20.3*	*19.8*	*20.8*	*19.5*	*17.4*	*16.8*	*16.6*
Cost of funds	*8.1*	*8.7*	*9.0*	*8.6*	*8.7*	*8.8*	*8.7*
Spreads	*10.1*	*9.1*	*9.4*	*8.3*	*6.5*	*6.2*	*6.3*
NIM	***12.9***	***11.6***	***11.9***	***10.8***	***8.8***	***8.0***	***7.8***
Other income	*0.6*	*0.4*	*0.4*	*2.0*	*1.9*	*1.9*	*2.0*
Total income	***13.0***	***11.8***	***12.4***	***13.1***	***10.8***	***10.0***	***9.9***
Operating expenses	*7.3*	*7.3*	*6.3*	*8.0*	*6.4*	*5.4*	*5.1*
Provisions	*0.5*	*0.7*	*0.5*	*0.7*	*0.7*	*0.9*	*1.0*
PBT	***5.2***	***3.8***	***5.6***	***4.4***	***3.7***	***3.6***	***3.8***
Tax	*1.8*	*1.3*	*2.0*	*1.5*	*1.2*	*1.2*	*1.3*
RoA	***3.4***	***2.5***	***3.7***	***2.9***	***2.4***	***2.4***	***2.5***
Leverage	*5.0*	*5.5*	*5.0*	*4.5*	*5.3*	*6.5*	*7.4*
RoE	***16.9***	***13.7***	***18.3***	***13.1***	***12.8***	***15.6***	***18.6***

Source: Company, Centrum Research Estimates

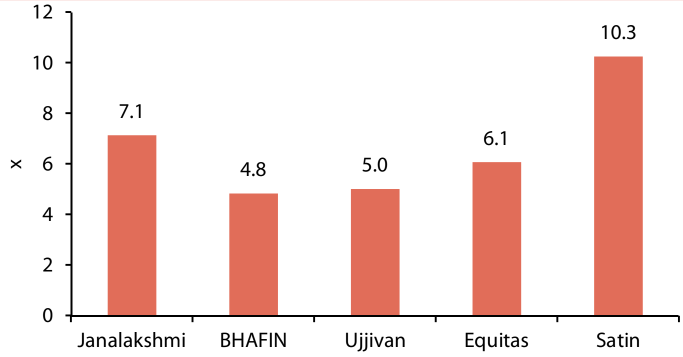
Capital position remains comfortable and will aid in funding growth

Historically, Ujjivan has always maintained a robust capital adequacy given its capital raise every 12-14 months (average) and strong profitability. Consequently, it has enjoyed a lower cost of borrowing as compared to the industry. We expect tier-1 to improve in FY17 on the back of capital raise in the same financial year.

The need to raise further capital for Ujjivan would depend on its AUM growth, given its transition to SFB and the AUM mix going forward. Given its capital raise in FY17 and our expectation of low growth due to its transition to SFB, we believe Ujjivan will not need further capital in the near term.

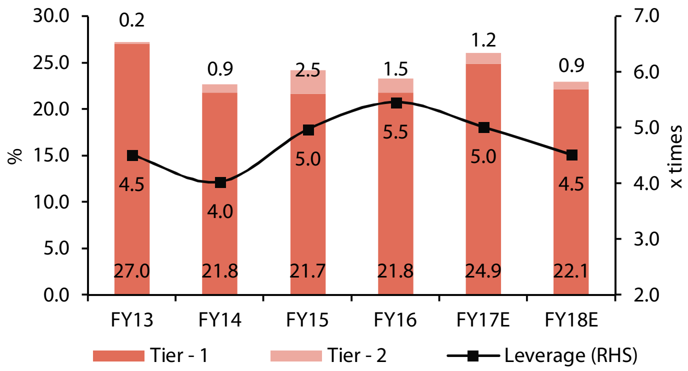
Moreover, as the company intends to increase the share of secured loans, housing loans and securitisation (which have a lower risk weight), its capital consumption will be slower than in the past. Hence, we believe that Ujjivan will be able to maintain strong tier-1 owing to robust profitability coupled with a lower requirement of funds owing to a more favourable loan mix and lower growth.

Exhibit 117: Leverage remains comfortable vis-a-vis peers (FY16)



Source: Company, Centrum Research Estimates

Exhibit 118: Expect strong capital position



Source: Company, Centrum Research Estimates

Financial analysis

Ujjivan with AuM of Rs53.9bn is the third largest MFI in terms of AuM with a pan India presence. As at end-FY16, the company operated through 469 branches spread across 24 states and a customer base of 3.05mn. Over FY13-16, Ujjivan reported 59%/76% and 75% CAGR in NII/pre-provisioning profit and net profit led by 65% CAGR in its loan portfolio. We expect the company to report 27% loan/29% AuM CAGR over FY16-18E, mainly led by growth in each of the segments of MFI, MSE and housing. This will translate into 22%/20% and 16% CAGR in NII/PPOP and net profit over the same time frame.

Even as the nature of lending remains unsecured, the joint liability group (JLG)-based lending model with stringent regulations have seen MFIs operate at lower delinquency levels. Asset quality for Ujjivan remains comfortable with GNPA/NNPA at 0.15%/0.04% for FY16. However, we have built in higher delinquencies for FY16-18E, given the asset quality-related risk following further in-roads into the MSE and housing loans, which have a higher ticket size. However, comfort can be drawn from the fact that the company also plans to increase the proportion of secured loans.

The future financial performance for Ujjivan can be further bifurcated into two stages, the transition phase (FY16-18E) and the full-fledged SFB phase (post FY18E). We believe, over FY16-18E, loan/AuM growth will be relatively subdued on account of a greater focus on transition. On the margin front we expect moderation in NIMs on account of the fact that post conversion, the company will have to adhere to CRR/SLR guidelines which will drive down margins to some extent, due to yield contraction on account of lower yield on investments and negative carry on cash. However as per our estimates, the cost of funds will not witness a major change, since on the liability side, term loans from banks will be substituted by deposits in the nature of wholesale, retail and CASA and borrowings in the nature of certificate of deposits and commercial papers.

Also, there would be challenges related to transition in the form of a spurt in operating expenses on account of branch expansion, technological spends and personnel expenses. All these factors will lead to a lower CAGR in NII/ PPOP and PAT as compared to the high CAGR in profitability witnessed in the past. We expect RoA to moderate to 2.4% in FY18E from the current level of 3.7%. RoE is slated to decline towards 12.8% levels. However, post transition we do expect a pick-up in the loan/AuM growth which will lead to an improvement in RoE. Over FY18-20E we expect a loan/AuM CAGR of 33%/35%. We expect steady-state RoA / RoE at 2.5% / 18.6% in the longer-run.

Exhibit 102: DuPont analysis

(% of avg assets)	FY13	FY14	FY15	FY16	FY17E	FY18E
Yield on AuM	*22.6*	*23.7*	*22.5*	*21.5*	*20.8*	*20.0*
Yield on assets	*19.8*	*20.3*	*19.8*	*20.8*	*19.5*	*17.4*
Cost of borrowings	*9.7*	*10.2*	*10.7*	*11.4*	*11.1*	*10.9*
Cost of funds	*7.2*	*8.1*	*8.7*	*9.0*	*8.6*	*8.7*
Spreads	***10.1***	***10.1***	***9.1***	***9.4***	***8.3***	***6.5***
NIM	***13.3***	***12.9***	***11.6***	***11.9***	***10.8***	***8.8***
Other income	*1.0*	*0.6*	*0.4*	*0.4*	*2.0*	*1.9*
Total income	***13.9***	***13.0***	***11.8***	***12.4***	***13.1***	***10.8***
Operating expenses	*9.0*	*7.3*	*7.3*	*6.3*	*8.0*	*6.4*
Provisions	*0.6*	*0.5*	*0.7*	*0.5*	*0.7*	*0.7*
PBT	***4.2***	***5.2***	***3.8***	***5.6***	***4.4***	***3.7***
Tax	*1.3*	*1.8*	*1.3*	*2.0*	*1.5*	*1.2*
RoA	***2.9***	***3.4***	***2.5***	***3.7***	***2.9***	***2.4***
Leverage (x)	*4.0*	*5.0*	*5.5*	*5.0*	*4.5*	*5.3*
RoE	***11.8***	***16.9***	***13.7***	***18.3***	***13.1***	***12.8***
NIM (on AuM	***15.8***	***15.6***	***14.1***	***13.5***	***12.1***	***11.0***
RoA (including securitisation)	***2.9***	***3.4***	***2.5***	***3.5***	***2.7***	***2.3***

Source: Company, Centrum Research Estimates

Valuation and view

We like Ujjivan for its pan-India presence, customer base, well-diversified loan offerings despite it being mono-line in nature and a senior management team with strong banking background. Ujjivan has received in-principle approval to migrate to SFB model and management has indicated the transition would begin in Q1CY17. Post the conversion to SFB, it will operate as a wholly owned subsidiary of Ujjivan Financial Services.

Success/failure of the business model entirely depends on the ability to contain costs without material impact on profitability. Also, with structural changes in balance sheet profile (compliance with CRR/SLR requirement, need to shore up deposit franchise), Ujjivan is set to witness significant change in its returns profile in the near term.

With FY16 RoA/RoE at 3.7%/18.3% respectively, we expect near-term RoA/RoE to dip to 2.4%/12.8% levels by end-FY18E. However, with improving cost of borrowing profile, diversified product offering, economies of scale, cost efficiencies and well-contained asset quality risk, we expect RoA/RoE to inch towards 2.5%/18.6% levels by end-FY20E. We remain positive on Ujjivan given its performance track record, product understanding and, importantly, the management.

We initiate coverage on Ujjivan Financial Services with Hold and a TP of Rs400 (valued at 2.5x FY18E ABV). With limited listing history, we have valued the entity on theoretical PB multiple basis and assigned a premium thereon. Our theoretical PB of 2x, is derived by taking an average of a) PB based on near-term RoEs – which are set to trend lower in initial areas of transition and b) RoEs in a steady state manner which we believe could well be at 18-19% levels. We have assigned a premium to these multiples given a) strong management bandwidth with banking background, b) business model characterised by inherent strength in credit processes, pan-Indian presence and diversified loan offering, and c) ability to efficiently sweeten the assets.

Our valuation multiples factor in lower growth (in initial phase of transformation), well-contained costs and ability for smooth transition on the liability end post conversion to SFB. Degree of success of either of these parameters is thus crucial from an RoA stand point and in determining the valuation multiples.

Corporate governance

Exhibit 119: Board of directors – participation by Independent directors

Particulars	FY13	FY14	FY15
Total Directors	11	12	13
Independent directors	3	3	3
% share of independent	*27*	*25*	*23*

Source: Company

Exhibit 120: Directors' Compensation

Particulars	FY12	FY13	FY14	FY15
Chairman & MD (Promoter) (Rs. Mn)	4	4	5	7
- % share of PBT	*17.2*	*0.9*	*0.6*	*0.6*

Source: Company

Exhibit 121: Independent directors

Directors Name	No of directorship in other companies
Mr. K R Ramamoorthy	0
Mr. Samit Ghosh	0
Mr. Sunil Patel	0
Ms Vandana Viswanathan	0
Ms. Bhama Krishnamurthy	0
Mr. Sandeep Farias	1 – Elevar Equity
Mr Venkatesh Natarajan	1 – Lok Capital LLC
Mr. Sarvesh Suri	1 – IFC Indonesia
Mr. Jayanta Basu	1 – Alena Pvt. Ltd.
Mr. Amit Gupta	1 – New Quest Asia Investments Ltd.

Source: Company

Exhibit 122: Auditor details

Auditor Name	Auditor since	Other Audited companies
Deloitte Haskins & Sells	Over 5 years	Janalakshmi and Equitas

Source: Company

Sensitivity analysis and peer comparison

Exhibit 123: Sensitivity analysis – impact of change in NIM and AuM on FY17PBT

%		Credit cost				
		+ 10bps	+ 20bps	Current levels	- 10bps	- 20bps
NIM	- 5bps	(2.2)	(2.8)	(1.6)	(1.0)	(0.3)
	- 10bps	(3.8)	(4.4)	(3.2)	(2.6)	(1.9)
	Current levels	(0.6)	(1.3)	-	0.6	1.3
	+ 5bps	1.0	0.3	1.6	2.2	2.8
	+ 10bps	2.6	1.9	3.2	3.8	3.8

Source: Company, Centrum Research Estimates

Exhibit 124: Comparative Valuations

Company	Mkt Cap (Rs mn)	CAGR (FY16-FY18E) (%)			PE (x)			ROA (%)			RoE (%)			P/BVPS (x)			Div Yield (%)		
		Net income#	PPOP	PAT	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E
Ujjivan*	**47,444**	**32.4**	**20.0**	**15.8**	**22.9**	**24.6**	**20.0**	**3.7**	**2.9**	**2.4**	**18.3**	**13.1**	**12.8**	**3.5**	**2.8**	**2.5**	**0.1**	**0.1**	**0.2**
SCNL*	15,247	39.9	44.6	40.1	26.0	22.5	15.3	2.2	2.1	2.5	22.4	16.8	17.4	4.6	2.9	2.4	0.0	0.0	0.0
Equitas	58,506	45.3		28.2	29.6	31.2	22.4	3.0	2.3	2.2	12.8	10.6	11.1	3.6	2.6	2.4	0.6	0.6	0.6
BHAFIN	96,744	41.3	60.9	43.7	31.7	19.5	15.4	5.2	4.8	4.4	24.5	27.4	26.5	7.1	4.9	3.8	0.4	0.4	0.4

*Source: Bloomberg consensus, Company, * denotes Centrum Research Estimates #denotes net interest income + other income*

Key risks

- **Transition risk**: Inability to successfully transition from existing MFI/individual loan-based lending model to SFB model remains a key risk. Expenditure towards IT/infrastructure can have material impact on profitability; hence, inability to contain the same can impact return ratios, and thus, the valuation multiple.
- **Inability to shore up deposit franchise**: Banking industry continues to grapple with relatively lower levels of CASA/retail franchise. Thus, raising deposits (even as it was to be priced relatively higher) would be a challenge.
- **Asset quality risk**: Scope for product diversification has its own asset quality-related risks. Retail NPAs for the sector have remained low, though the ability to assess customer profile plays a crucial role. While having catered to individual sector and more in the form of unsecured loans, foray into highly competitive secured piece will not only reduce the lending rates but also increase the risk of asset quality related headwinds.

Exhibit 125: Shareholding pattern (%)

Foreign investors	*48.7*
Mutual Funds	*9.6*
Bodies corporate	*26.8*
Residents / Individuals / HUF	*11.6*
Employees & Directors	*1.4*
Banks / Fis / NBFCs / Trusts	*0.4*
Others	*1.5*

Source: Company

Company Background

Ujjivan Financial Services Ltd. is an NBFC-MFI with AuM of Rs53.9bn, employee strength of 8,049, 469 branches and 3.05mn customers. The branches are spread across 24 states and union territories and 209 districts in India. Of the 469 branches, 185 are located in under-banked districts. After registration as an NBFC in 2005, Ujjivan began operations in southern India. The company mainly focuses on lending in the microfinance space and caters to MFI, MSE and housing segments. The MFI lending happens via the JLG structure, while the MSE and housing loans are individual loans.

Ujjivan was founded in 2005 by Mr. Samit Ghosh as a firm for the urban poor. Granted MFI status by the RBI in 2013, it functions as a microfinance lending institution with a pan-India presence. Currently, it commands a market share of 11.1% as of Mar'16 in terms of AuM. It offers a comprehensive basket of financial products to the financially underserved population – MFI loans, MSE loans and individual loans. Its target segment is families that have a monthly income of Rs10,000 and above. It is a predominantly urban focused MFI and roughly 70% of Ujjivan's branches are in urban and semi-urban areas.

Investors may draw comfort from the fact that compared to other MFIs, Ujjivan is present in the maximum number of states (24). Moreover, its single state concentration in terms of AuM does not exceed 16% which diversifies the risk. Also, Ujjivan is present in relatively underpenetrated states of the north-east in terms of MFI finance. In terms of GLP and branch presence, the eastern region contributes 29% and 28%, respectively (including West Bengal).

Exhibit 126: Key management personnel

Name	Position	Profile
Mr. Samit Ghosh	MD & CEO	Mr. Samit Ghosh is the Managing Director and Chief Executive Officer of Ujjivan. He founded the company in 2005 as a microfinance firm for the urban poor. With a master of business administration from the Wharton School of Business, University of Pennsylvania, Mr Ghosh was a career banker for 30 years and worked both in South Asia and the Middle East. He began his career with Citibank in 1975 and later worked with Standard Chartered Bank, HDFC Bank and the Bank Muscat. He was past President of Microfinance Institutions Network and chairman of Association of Karnataka Microfinance Institutions (AKMI), and is currently a board member of Stichting to Promote Women's World Banking.
Ms. Sudha Suresh	CFO	A chartered accountant and also a qualified cost accountant, Ms. Sudha Suresh has a corporate career spanning over 18 years. In 2013, she was awarded the 'CFO 100 – Recognition of Excellence'. At Ujjivan, she is manages strategic business planning and budgetary controls, treasury management, accounts & taxation and board & regulatory compliance.

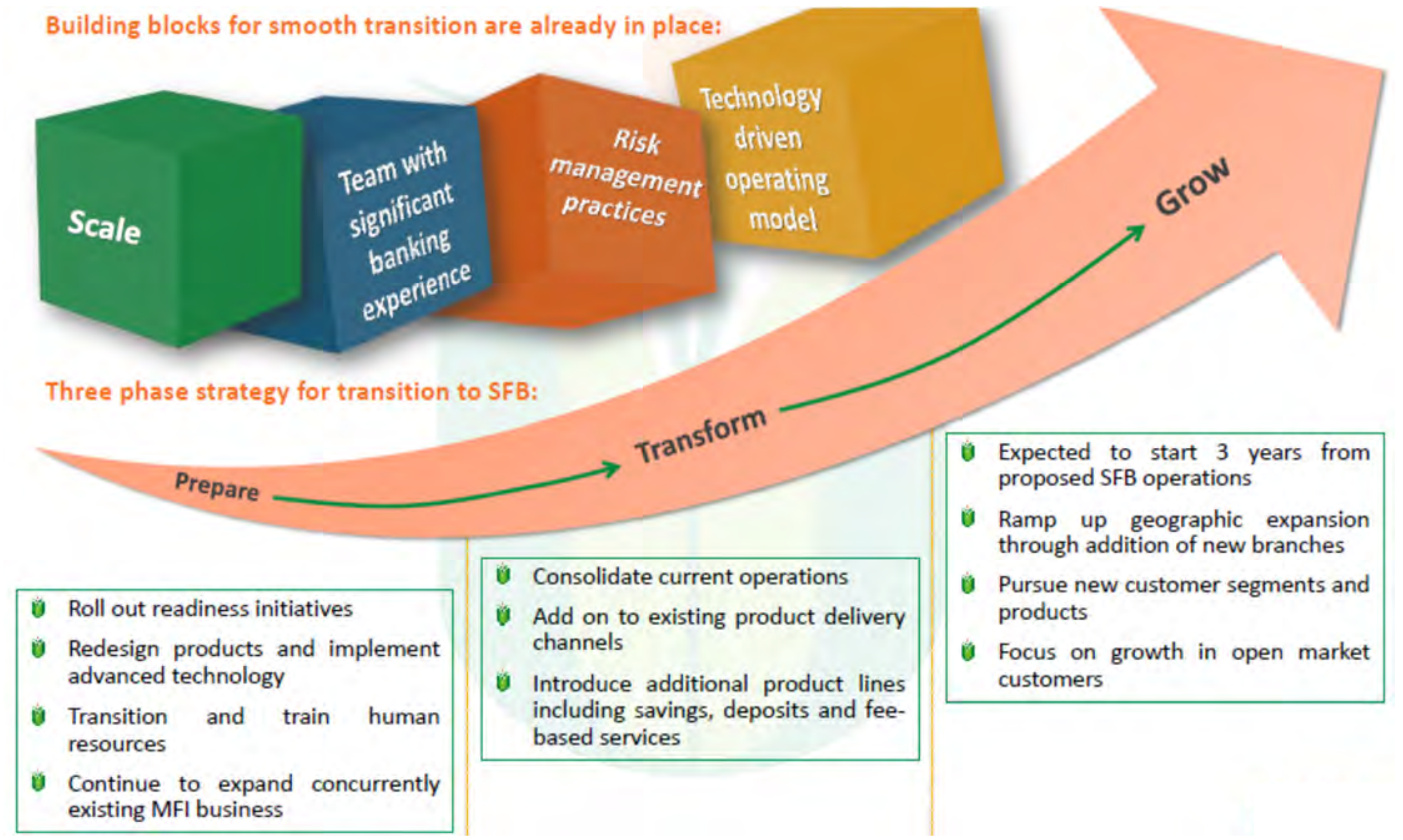
Source: Company

Annexure

Exhibit 127: History of Ujjivan

Source: Company

Exhibit 128: Transition to SFB model



Source: Company

Financials-Standalone (historical)

Exhibit 129: Income Statement

Y/E March (Rs mn)	FY11	FY12	FY13	FY14	FY15
Interest Income	1,553	1,482	2,225	3,479	5,993
Interest Expense	459	555	780	1,345	2,553
Net Interest Income	**1,094**	**927**	**1,445**	**2,134**	**3,440**
Non-Interest Income	12	81	114	98	126
Total Net Income	**12**	**81**	**114**	**2,231**	**3,566**
Total Operating Expenses	**888**	**953**	**1,015**	**1,261**	**2,211**
Employee expenses	556	603	659	815	1,330
Other Operating Expenses	333	350	355	446	882
Pre-provision Profit	**218**	**55**	**545**	**970**	**1,355**
Provisions & Contingencies	45	57	68	82	209
Profit Before Tax	**172**	**(1)**	**477**	**888**	**1,145**
Taxes	56	(3)	148	304	387
Profit after tax	**116**	**1**	**329**	**584**	**758**

Source: Company, Centrum Research

Exhibit 130: Balance sheet

Y/E March (Rs mn)	FY11	FY12	FY13	FY14	FY15
Other assets	512	1,615	1,786	3,945	6,448
Loans & Advances	6,251	6,912	11,260	16,173	32,187
Investments	1	1	1	1	1
Total Int Earning Assets	**6,764**	**8,527**	**13,047**	**20,118**	**38,636**
Fixed Assets	98	112	111	127	179
Other non-current assets	247	313	410	542	947
Total Assets	**7,109**	**8,951**	**13,569**	**20,787**	**39,762**
Borrowings	4,721	6,172	9,975	16,500	31,218
Deposits	-	-	-	-	-
Interest Bearing Liabilities	4,721	6,172	9,975	16,500	31,218
Other non int bearing Liab.	1,233	375	414	562	1,180
Total Liabilities	5,954	6,548	10,389	17,062	32,398
Equity	1,154	2,403	3,180	3,725	7,365
Total Liabilities	**7,109**	**8,951**	**13,569**	**20,787**	**39,763**

Source: Company, Centrum Research

Exhibit 131: DuPont analysis

(% of avg assets)	FY11	FY12	FY13	FY14	FY15
Yield on assets	*27.7*	*18.5*	*19.8*	*20.3*	*19.8*
Cost of funds	*9.9*	*7.7*	*7.2*	*8.1*	*8.7*
Spreads	*14.8*	*8.3*	*10.1*	*10.1*	*9.1*
NIM	***20.4***	***12.0***	***13.3***	***12.9***	***11.6***
Other income	*0.2*	*1.0*	*1.0*	*0.6*	*0.4*
Total income	***19.8***	***12.6***	***13.9***	***13.0***	***11.8***
Operating expenses	*15.9*	*11.9*	*9.0*	*7.3*	*7.3*
Provisions	*0.8*	*0.7*	*0.6*	*0.5*	*0.7*
PBT	***3.1***	***0.0***	***4.2***	***5.2***	***3.8***
Tax	*1.0*	*0.0*	*1.3*	*1.8*	*1.3*
RoA	***2.1***	***0.0***	***2.9***	***3.4***	***2.5***
Leverage	*5.1*	*4.5*	*4.0*	*5.0*	*5.5*
RoE	***10.5***	***0.1***	***11.8***	***16.9***	***13.7***

Source: Company, Centrum Research

Exhibit 132: Financial ratios

Y/E March	FY12	FY13	FY14	FY15
Growth Ratios (%)				
Loans	*10.6*	*62.9*	*43.6*	*99.0*
AuM	*12.5*	*60.1*	*43.6*	*102.4*
Assets	*25.9*	*51.6*	*53.2*	*91.3*
Borrowings	*30.7*	*61.6*	*65.4*	*89.2*
NII	*(15.3)*	*55.9*	*47.6*	*61.2*
Provisions	*(74.6)*	*887.4*	*78.0*	*39.6*
PAT	*(98.8)*	*-*	*77.7*	*29.7*
Operating Ratios (%)				
Yield on advances	*20.3*	*22.7*	*23.7*	*22.8*
Cost of borrowings	*10.2*	*9.7*	*10.2*	*10.7*
NIIM (on AUM)	*14.0*	*15.8*	*15.6*	*14.1*
Fee to disbursement	*1.1*	*0.8*	*0.9*	*1.0*
Cost/Income	*94.5*	*65.1*	*56.5*	*62.0*
Opex/ Avg AuM	*14.3*	*11.1*	*9.2*	*9.0*
Effective tax rate	*197.7*	*31.1*	*34.2*	*33.8*
RoA	*0.0*	*2.9*	*3.4*	*2.5*
RoE	*0.1*	*11.8*	*16.9*	*13.7*
RoTA (including off-balance sheet)	*0.0*	*2.9*	*3.4*	*2.5*
Credit Quality Ratios (%)				
Gross NPA	*0.91*	*0.08*	*0.07*	*0.07*
Net NPA	*0.81*	*0.08*	*0.01*	*0.02*
NPA coverage ratio	*11.4*	*10.3*	*81.1*	*74.4*
Capital Adequacy Ratios (%)				
Total CAR	*32.4*	*27.3*	*22.7*	*24.2*
Tier I	*32.4*	*27.0*	*21.8*	*21.7*
Tier II	*0.0*	*0.2*	*0.9*	*2.5*
Assets/equity (x)	4.5	4.0	5.0	5.5
Dividend details				
DPS (Rs)	-	0.3	0.5	0.5
Dividend Payout (%)	-	5.8	6.6	6.8
Per Share (Rs)				
BVPS	39.8	45.4	53.4	81.8
Adjusted BVPS	38.9	45.3	53.4	81.7
EPS - basic	0.0	4.7	8.4	10.6
Valuations Ratios				
Price/BV (x)	10.3	9.1	7.7	5.0
Price/Adj. BV (x)	10.6	9.1	7.7	5.0
P/E (x)	-	87.7	49.2	38.8
Dividend Yield (%)	*0.0*	*0.1*	*0.1*	*0.1*

Source: Company, Centrum Research

Financials-Standalone

Exhibit 133: Income Statement

Y/E March (Rs mn)	FY14	FY15	FY16	FY17E	FY18E
Interest Income	3,479	5,993	10,073	12,996	17,112
Interest Expense	1,345	2,553	4,236	5,592	8,394
Net Interest Income	**2,134**	**3,440**	**5,836**	**7,403**	**8,718**
Non-Interest Income	98	126	204	1,320	1,878
Total Net Income	**2,231**	**3,566**	**6,040**	**8,723**	**10,595**
Total Operating Expenses	**1,261**	**2,211**	**3,068**	**5,370**	**6,318**
Employee expenses	815	1,330	1,967	3,222	3,949
Other Operating Expenses	446	882	1,102	2,148	2,369
Pre-provision Profit	**970**	**1,355**	**2,971**	**3,354**	**4,278**
Provisions & Contingencies	82	209	252	438	686
Profit Before Tax	**888**	**1,145**	**2,720**	**2,916**	**3,591**
Taxes	304	387	948	986	1,214
Profit after tax	**584**	**758**	**1,772**	**1,930**	**2,377**

Source: Company, Centrum Research Estimates

Exhibit 132: Balance sheet

Y/E March (Rs mn)	FY14	FY15	FY16	FY17E	FY18E
Other assets	3,945	6,448	4,913	6,682	11,862
Loans & Advances	16,173	32,187	50,644	64,031	81,964
Investments	1	1	1	2,879	22,817
Total Int Earning Assets	**20,118**	**38,636**	**55,558**	**73,591**	**1,16,642**
Fixed Assets	127	179	242	717	918
Other non-current assets	542	947	1,473	1,965	2,516
Total Assets	**20,787**	**39,763**	**57,273**	**76,273**	**1,20,076**
Borrowings	16,500	31,218	43,380	19,975	38,882
Deposits	-	-	-	37,596	60,323
Interest Bearing Liabilities	16,500	31,218	43,380	57,571	99,205
Other non int bearing Liab	562	1,180	1,915	1,251	1,153
Total Liabilities	17,062	32,398	45,295	58,822	1,00,358
Equity	3,725	7,365	11,978	17,452	19,718
Total Liabilities	**20,787**	**39,763**	**57,273**	**76,273**	**1,20,076**

Source: Company, Centrum Research Estimates

Exhibit 133: DuPont analysis

(% of avg assets)	FY14	FY15	FY16	FY17E	FY18E
Yield on assets	*20.3*	*19.8*	*20.8*	*19.5*	*17.4*
Cost of funds	*8.1*	*8.7*	*9.0*	*8.6*	*8.7*
Spreads	*10.1*	*9.1*	*9.4*	*8.3*	*6.5*
NIM	***12.9***	***11.6***	***11.9***	***10.8***	***8.8***
Other income	*0.6*	*0.4*	*0.4*	*2.0*	*1.9*
Total income	***13.0***	***11.8***	***12.4***	***13.1***	***10.8***
Operating expenses	*7.3*	*7.3*	*6.3*	*8.0*	*6.4*
Provisions	*0.5*	*0.7*	*0.5*	*0.7*	*0.7*
PBT	***5.2***	***3.8***	***5.6***	***4.4***	***3.7***
Tax	*1.8*	*1.3*	*2.0*	*1.5*	*1.2*
RoA	***3.4***	***2.5***	***3.7***	***2.9***	***2.4***
Leverage	*5.0*	*5.5*	*5.0*	*4.5*	*5.3*
RoE	***16.9***	***13.7***	***18.3***	***13.1***	***12.8***

Source: Company, Centrum Research Estimates

Exhibit 134: Financial ratios

Y/E March	FY14	FY15	FY16	FY17E	FY18E
Growth Ratios (%)					
Loans	*43.6*	*99.0*	*57.3*	*26.4*	*28.0*
AuM	*43.6*	*102.4*	*64.6*	*27.8*	*29.4*
Assets	*53.2*	*91.3*	*44.0*	*33.2*	*57.4*
Borrowings	*65.4*	*89.2*	*39.0*	*31.6*	*70.3*
NII	*47.6*	*61.2*	*69.7*	*26.9*	*17.7*
Provisions	*78.0*	*39.6*	*119.3*	*12.9*	*27.5*
PAT	*77.7*	*29.7*	*133.8*	*9.0*	*23.2*
Operating Ratios (%)					
Yield on advances	*23.7*	*22.8*	*22.5*	*21.6*	*20.8*
Cost of borrowings	*10.2*	*10.7*	*11.4*	*11.1*	*10.9*
NIM (on AuM)	*15.6*	*14.1*	*13.5*	*12.1*	*11.0*
Fee to disbursement	*0.9*	*1.0*	*1.1*	*1.3*	*1.4*
Cost/Income	*56.5*	*62.0*	*50.8*	*61.6*	*59.6*
Opex/ Avg AuM	*9.2*	*9.0*	*7.1*	*8.8*	*8.0*
Effective tax rate (%)	*34.2*	*33.8*	*34.8*	*33.8*	*33.8*
RoA	*3.4*	*2.5*	*3.7*	*2.9*	*2.4*
RoE	*16.9*	*13.7*	*18.3*	*13.1*	*12.8*
RoTA (including securitisation)	*3.4*	*2.5*	*3.5*	*2.7*	*2.3*
Credit Quality Ratios (%)					
Gross NPA	*0.07*	*0.07*	*0.15*	*0.20*	*0.43*
Net NPA	*0.01*	*0.02*	*0.04*	*0.05*	*0.12*
NPA coverage ratio	*81.1*	*74.4*	*73.9*	*72.7*	*73.2*
Capital Adequacy Ratios (x)					
Total CAR	22.7	24.2	24.1	26.0	22.8
Tier I	21.8	21.7	22.4	24.9	21.9
Tier II	0.9	2.5	1.7	1.2	0.9
Assets/equity (x)	5.0	5.5	5.0	4.5	5.3
Dividend details					
DPS (Rs)	0.5	0.5	0.5	0.6	0.8
Dividend Payout (%)	*6.6*	*6.8*	*3.4*	*4.3*	*4.7*
Per Share (Rs)					
BVPS	53.4	81.8	113.9	142.8	161.4
Adjusted BVPS	53.4	81.7	113.7	142.5	160.6
EPS - basic	8.4	10.6	17.5	16.3	20.1
Valuations Ratios					
Price/BV (x)	7.7	5.0	3.6	2.9	2.6
Price/Adj. BV (x)	7.7	5.0	3.6	2.9	2.6
P/E (x)	49.3	38.8	23.5	25.2	20.5
Dividend Yield (%)	*0.1*	*0.1*	*0.1*	*0.1*	*0.2*

Source: Company, Centrum Research Estimates

Appendix

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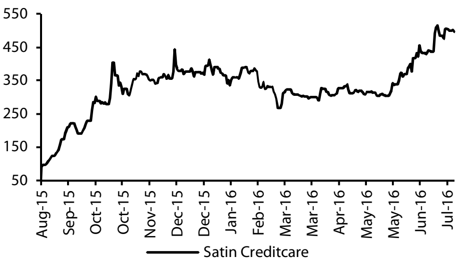
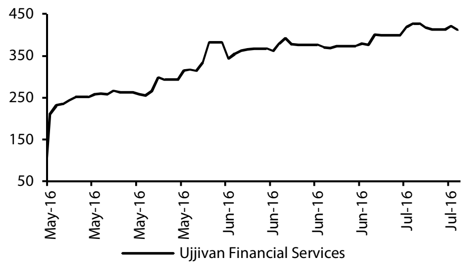


Ujjivan Financial Services price chart



Source: Bloomberg, Centrum Research

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