



MFI Grading Report

SKS Microfinance Pvt. Ltd. (SMPL)

October 2008

SKS Microfinance Pvt. Ltd.

<i>Year of Incorporation:</i> 1998	Mr. Dilli Raj S
<i>Legal Status:</i> Private Limited Company, Registered as NBFC (NBFC-ND-SI)	Chief Financial Officer 2-3-578/1, Maruti Mansion
<i>Type of Institution:</i> MFI	Kachi Colony, Nallagutta,
<i>Lending Model:</i> Group based and individual lending	Minister Road, Secunderabad - 500 003 Tel: 040-4452 6000
<i>Statutory Auditors:</i> S.R. Batliboi & Co.	Fax: 040-4452 6001 Email: dilliraj@sksindia.com

MFI Grading

mfR1
mfR2
mfR3
mfR4
mfR5
mfR6
mfR7
mfR8

mfR1: highest
mfR8: lowest

CRISIL's microfinance institution (MFI) grading is a current opinion on the ability of an MFI to conduct its operations in a scalable and sustainable manner. The grading is assigned on an eight-point scale, with 'mfR1' being the highest, and 'mfR8' the lowest. The MFI grading is a measure of the overall performance of an MFI on a broad range of parameters under CRISIL's MICROS framework. It includes a traditional creditworthiness analysis using the CRAMEL approach, modified to be applicable to the microfinance sector. The acronym MICROS stands for Management, Institutional arrangement, Capital adequacy and asset quality, Resources and asset-liability management, Operational effectiveness, and Scalability and sustainability.

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1 Rationale

CRISIL’s microfinance institution (MFI) grading to SKS Microfinance Private Ltd (SMPL) factors in the following:

Strengths

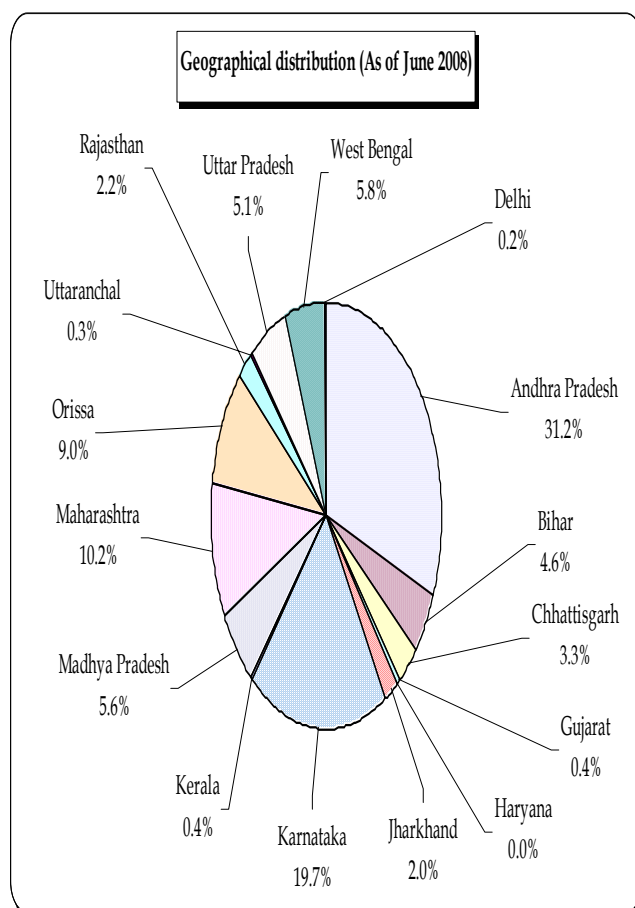
- ❖ Well experienced board and senior management
- ❖ Well-diversified funding profile
- ❖ Good asset quality and adequate capitalisation and capability to recapitalise

Weaknesses

- ❖ Internal controls which do not commensurate with planned business growth
- ❖ Moderate management information systems, given the size of operations

Profile

SMPL, based in Andhra Pradesh, is India’s largest MFI with disbursements of Rs.16.15 billion during 2007-08 (refers to financial year, April 1 to March 31), and loan outstanding of Rs.10.50 billion as on March 31, 2008. It was incorporated as a private limited company in 2003 for taking over the microfinance activities of Swayam Krishi Sangam (SKS), a society which was registered in 1997 and started operations in 1998. After obtaining the non-banking financial company (NBFC) licence from the Reserve Bank of India in January 2006, SMPL took over the operations of SKS. As on June 30, 2008, SMPL had 1,062 branches across 259 districts in 15 states and one union territory. The MFI forayed into Delhi, Gujarat, Kerala, and Uttranchal during 2007-08.



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During the first quarter of 2008-09, the MFI ventured into Haryana. It plans to expand its operations to Tamil Nadu and Punjab during the year. As of June 2008, the MFI caters to around 43 per cent of the total districts and more than 54 per cent of the states in the country.

Loan products	Income generation	Mid term	Emergency	Individual
Loan tenor	50 weeks	50 weeks	20 weeks	12-24 months
Interest rate (flat)	12.5 in AP and Karnataka, 15 % other states	12.5 in AP and Karnataka, 15 % other states		15%
Loan amount	Rs. 1000 to Rs.12,000	Cycle max less IGL amount	Rs. 500 – Rs. 1000	Rs. 20,000 – Rs. 50,000
Processing fee*	1%	1%	-	2%
Insurance fee*	1%	1%	-	1%

* on the loan amount

The company follows the group lending model, which closely resembles the Bangladesh-based Grameen bank model. As per this model, the NBFC provides loans to the individual members of a five women member group. Members having credit history with SMPL and requires loans of Rs.20,000 and above are offered individual loans. The group loans have a tenor of 50 weeks (weekly repayment of loan) while the individual loans are for 12 to 24 months (to be repaid in monthly instalments). The company charges an interest rate of 23.6 per cent on declining basis in Andhra Pradesh and Karnataka and 28 per cent in other states.

Apart from microcredit, SMPL has tied-up with Life Insurance Corporation of India (LIC), to offer group based life insurance products, ICICI Lombard for health insurance and with Bajaj Alliance for endowment policies.

Management

SMPL's operations derive significant benefits from the six years of microfinance experience of its predecessor SKS. In early 2007, SMPL adopted a factory style approach to recruit and train field staff and a decentralised operational model with the area offices providing the administrative and back-office support. This has helped the MFI expand its operations to new areas. The MFI had further decentralised its operations and created appropriate infrastructure in each state, to achieve the envisaged growth plans.

Given the significant growth in all operational parameters, SMPL has strengthened its internal control mechanisms. The MFI has started grading of each branch from April 2008, and this is linked to the performance of branch employees. However, in CRISIL's opinion the internal

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controls and audit need to be strengthened even further to address the issues arising from decentralisation and expansion across the country. The branch grading reports indicate that a comprehensive risk management policy and processes are still required to minimise the operational and credit risks of the company. The MFI is currently addressing these issues by creating various core teams and is focused on implementing robust risk management mechanisms to check various frauds and misappropriations at the branch level.

SMPL has a loan tracking software that is used for reporting and performance tracking by the branches. CRISIL is of the opinion that the company needs to implement robust management information system quickly, as this will dramatically reduce the time lag in providing branch-wise asset quality data. To overcome this, the MFI intends to upgrade the software, change the branch infrastructure with high-end technology backbone, which will assist the MFI to enhance branch connectivity, therefore enable the MFI to transfer the branch-wise data to regional office faster, and also lowers transaction costs. Further, this will also enable it to support the new financial and non-financial services.

The MFI, over a period of time, has streamlined and strengthened its human resource polices, which attributed the attrition rate to improve substantially to 17 per cent in 2007-08 from 26 per cent in 2005-06. However, this is still high in comparison to its peers.

Institutional Arrangement

Among CRISIL-evaluated MFIs, SMPL has one of the strongest governing board structures; the board comprises professional members, and experienced corporate leaders from the investment banking & finance, and business sectors, and from well-known venture capital companies. The institution also has some well qualified independent directors on its board.

Given its aggressive growth plans and a decentralised approach to manage its operations, the company had in 2007-08, strengthened its senior management by recruiting professionals with prior corporate experience. The MFI always had experienced professionals at the helm for the past several years. This was important given the non resident Indian (NRI) status of the founder cum managing director, who has regular engagements outside the country.

The MFI needs to re-strategise its overall lending policies and procedures and various process and control mechanisms to enable it to maintain the momentum in growth. This attains importance in the selection of borrowers; as per the management, around 83 per cent of the

overdue loans pertain to death of the borrower/spouse. CRISIL is of the opinion that the branch staffs needs to adhere the formulated policies and procedures, which may impact the asset quality.

In the past, the MFI was able to achieve its budgeted target set for them. CRISIL believes that, given the highly competitive market and changing business dynamics, achieving the budgeted targets in future would be a key challenge for the MFI.

Capital Adequacy and Asset Quality

Capital Adequacy

The company's current capitalisation levels are modest in relation to its aggressive short and medium term growth plans. As on March 31, 2008, SMPL had a Tier I capital of Rs.2.04 billion and a Tier I capital adequacy ratio of 24.77 per cent. CRISIL for its assessments considers the appropriateness of on- and off-balance sheet asset mix and therefore has adjusted SMPL's Tier I ratio for managed assets/assignment route of Rs.2.69 billion as on March 31, 2008. The adjusted Tier I capital adequacy ratio as of the above date was 18.68 per cent.

Given the envisaged business plan, the MFI intends to grow its portfolio by 172 per cent in 2008-09. To attain this growth, SMPL has indicated that there are plans to infuse additional capital in the range of Rs.3.8 billion to Rs.4.4 billion by the end of March 2009 from existing and new institutional investors. The MFI intends to raise 75 per cent of the additional capital by the end of October 2008 and the remaining by March 2009. Given the strength of the strong governing board, CRISIL believes that the MFI would be able to raise additional capital. However, this is not factored in to the business plan.

Post infusion of fresh capital by the company, the capitalisation levels (after factoring in the assigned portfolio) is likely to improve to 22.65 per cent as on March 31, 2009. CRISIL believes that maintaining of healthy capitalisation levels would be a key grading sensitivity factor in the short to medium term.

Asset Quality

SMPL has good asset quality as reflected in its on-time repayment rate of 99.15 per cent as on June 2008 which marginally improved from 99.03 per cent as on March 31, 2007. This improvement is mainly because of significant increase in business volumes. In absolute terms, the overdue portfolio greater than one day increased to Rs.118.28 million during the first

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quarter ended June 30, 2008 from Rs.109.93 million as on March 31, 2008. Out of Rs.109.9 million overdue amounts, around 17 per cent accounts to delinquent loans and the remaining are overdue due to death of the borrower/spouse.

For the period ended / As on	Jun-08		Mar-08		Mar-07	
	PAR Rs. mn	%	PAR Rs. mn	%	PAR Rs. mn	%
On time	13,814.64	99.15	10,411.40	98.96	2,741.60	99.03
Late (at least one payment)						
1-30 days	36.57	0.26	29.03	0.28	2.23	0.08
31-60 days	15.77	0.11	10.38	0.10	1.12	0.04
61-90 days	14.63	0.11	8.61	0.08	0.40	0.01
91-180 days	22.73	0.16	21.01	0.20	0.31	0.01
180 days -365 days	12.81	0.09	6.36	0.06	1.83	0.07
365 days and above	15.77	0.13	34.54	0.33	21.08	0.76
Total portfolio	13,932.93	100.00	10,521.33	100.00	2,768.56	100.00
Bad debt written off			18.96		11.60	
Net Loan portfolio	13,932.93		10,502.37		2,756.96	
Portfolio at risk (> 30 days delinquent)		0.61%		0.77%		0.89%
Portfolio at risk (> 90 days delinquent)		0.39%		0.59%		0.84%

Significant increase in individual loan portfolio, poses threat to the MFI's asset quality. CRISIL believes that the due diligence process for an individual / higher ticket size loans needs to be further strengthened. This contributes to around 7 per cent of the total loan outstanding as on June 30, 2008, a substantial increase from 1 per cent as on March 31, 2007.

SMPL has mitigated its operational risks by geographical diversification across various states. As on June 30, 2008, Andhra Pradesh and Karnataka accounts for 50 per cent of loan outstanding and the remaining is distributed among other 14 states. Similarly, the portfolio was evenly diversified across various activities. As on June 30, 2008, 81 per cent of the loan outstanding was spread across livestock, trading and services activities. Agriculture accounted for only 3 per cent of the overall portfolio.

The company's loan loss provisioning policies are less aggressive than those practised by some of the other CRISIL-evaluated MFIs. The MFI has restructured its loan loss provision policy from April 2008. It has reduced its provisioning on its standard assets from 0.75 per cent to 0.25 per cent. However, the company's loan loss provisioning policies are conservative than the

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provisions as per RBI prudential norms. It is providing a 100 per cent loan loss provision for group and individual loans which are overdue beyond 12 months. Given the unsecured nature of the microfinance loans and their short tenor, CRISIL believes large MFIs like SMPL need to adopt much more conservative provisioning norms.

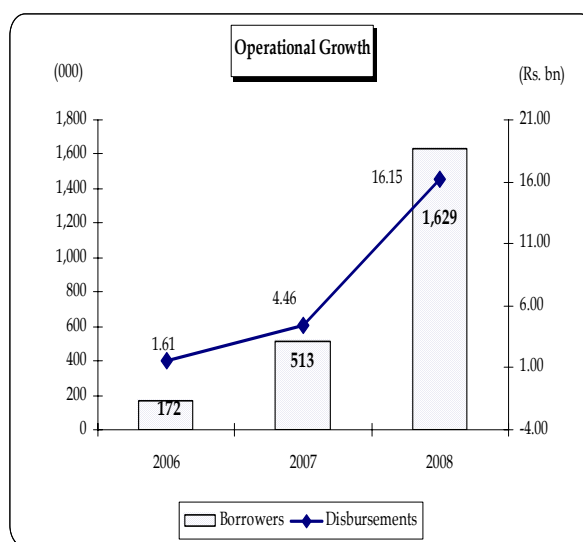
Resources and Asset Liability Management

SMPL has a diversified borrowing profile with access to funding from banks and apex MFIs like Small Industries Development Bank of India (SIDBI) and Friends of Women's World Banking (FWWB). The majority of lenders are private and foreign banks. The MFI was not able to raise sufficient resources from public sector banks in the past, as they are actively disbursing funds to other MFIs in the country.

SMPL's average cost of borrowings deteriorated marginally to 9.81 per cent during 2007-08 from 9.36 per cent during 2005-06, as lending institutions have increased their lending rates. The weighted cost of borrowing from all sources stood at 10.79 per cent as on March 31, 2008. CRISIL expects the company's borrowing cost to deteriorate further, given the inflationary pressure in the country. The asset liability maturity profile is comfortable as most of the loans of the MFI are for a period of 50 weeks whereas the borrowings were for 12-48 months.

Operational Effectiveness

SMPL registered significant growth during 2007-08 on most of the operational indicators. The MFI has registered a compounded annual growth rate (CAGR) of 217 per cent in disbursements and 237 per cent in loan outstanding between March 31, 2006 and March 31, 2008. As on June 30, 2008, 61 per cent of the loan outstanding is concentrated in states such as Andhra Pradesh, Karnataka and Maharashtra.



Outreach indicators					
For the period ended / As on	Units	Jun-08	Mar-08	Mar-07	Mar-06
Members outstanding	No.	2,420,672	1,879,258	603,933	201,943
Loans disbursed during the year	No.	947,124	2,050,596	652,110	220,342
Borrowers	No.	2,098,619	1,629,474	513,108	172,970
Branches	No.	1062	771	275	80
Districts covered	No.	259	222	102	19
Members/branch	No.	2,279	2,437	2,196	2,524
States	No.	16	15	11	11
Total disbursements*	Rs. million	8,242.16	16,153.20	4,463.75	1,612.00
Loan portfolio	Rs. million	13932.93	10,502.37	2,756.96	925.33
Loan outstanding/branch	Rs. million	13.12	13.62	10.03	11.57

The MFI was able to increase its share in Bihar, Uttar Pradesh and West Bengal during this period. During 2007-08, the MFI had started its operation in five new states, which also assisted the microfinance operations to expand. This growth in disbursements and loans outstanding was primarily supported by a substantial increase in number of branches to 771 during 2007-08 from 275 during 2006-07 with the addition of around 1.2 million members. The operating expense ratio deteriorated marginally to 9.16 per cent during 2007-08 from 8.47 per cent during 2005-06. This decline in operating expense ratio is largely due to less number of operating branches; as of March 31, 2008, 11 per cent of its total branches are yet to start its lending activities.

Net Profitability Margin			
For the period ended March 31,	2008	2007	2006
Interest Income/ Avg. funds deployed	18.76	19.29	16.71
Cost of Funds	9.81	9.79	9.36
Gross Spread	8.95	9.50	7.36
Operating Expenses/ Avg. funds deployed	9.16	10.66	8.47
Fee Income/ Avg. funds deployed	2.03	1.65	4.28
NPM (gross of credit loss)	1.81	0.49	3.17
Credit Loss (BD+Provn)/ Avg. gross adv	0.76	1.20	2.60
NPM (net of credit loss)	1.05	-0.70	0.56

SMPL's earning profile is satisfactorily with a net profitability margin (NPM) of 1.05 per cent for 2007-08. While expansion outside Andhra Pradesh and Karnataka is expected to result in

increase in fund-based yields, the increased borrowing costs, coupled with high operating expense ratios are expected to result in marginal decline in NPM. However, NPM is expected to remain around 2 per cent levels in the medium term.

Scalability and Sustainability

The MFI intends to mobilise resources to the tune of Rs.32 billion during 2008-09, to achieve the envisaged growth plan and is likely to approach 15 new banks. CRISIL believes that mobilising resources at regular intervals would be a key challenge for the MFI in 2008-09, given the inflationary pressure. Therefore, the MFI intend to raise resources through various structured products like securitisation, bond issuance and assignment.

CRISIL expects hardening of borrowing cost to impact the profitability of SMPL in the short to medium term. Moreover, this is expected to neutralise the impact of higher yields on account of growth in business volume. The operating expenses are also expected to remain high given the plans to add new branches and employees. Therefore, the company is exploring new financial and non-financial services which could be offered through the existing channels to create more fee-based income.

The strong management and governance are the key differentiators between SMPL and its peers in India; in CRISIL's opinion these are the key drivers which would enable the company to scale and sustain operations. The company does face some challenges on the operational front such as competition from other players, attrition of clients, employee retention and minimising operational and systematic risks. Therefore, CRISIL believes that the MFI needs to re-look its strategies to achieve the envisaged growth plan.

CRISIL believes that SMPL is susceptible to operational risks owing to high concentration of business in few states like Andhra Pradesh, Karnataka, Maharashtra, Orissa and West Bengal. Also, opportunities in few of these state have saturated given the presence of other large and mid-size players. Therefore, the MFI has plans to disburse higher ticket size loans (individual loans) in these states; this in turn may result in deterioration in SMPL's collection efficiency and impact its asset quality.

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2.1 Financial Statements

2.1.1 Income and expenditure statement

Rs million

For the year ended March 31,	2008	2007	2006
Fund based income			
Interest income from loans	1330.78	397.08	99.23
Income on managed loans	276.93	46.36	27.72
Income from investments	20.31	2.43	1.82
Other income	0.00	0.00	0.48
Total fund based income	1628.02	445.87	129.26
Interest and finance charges			
On borrowings	521.79	131.46	38.50
On managed loans	107.70	27.46	11.48
Finance charges	42.86	11.28	3.40
Total interest and finance charges paid	672.34	170.20	53.38
Gross spread	955.67	275.67	75.87
Fee based income			
Documentation charges	150.48	34.60	19.04
Other fee based income	29.27*	3.65	13.49
Total fee based income	179.76	38.25	32.53
Total income	1807.77	484.12	161.79
Gross surplus	1135.43	313.92	108.40
Expenses			
Personnel expenses	477.55	129.67	39.34
Administrative expenses	266.58	92.97	24.31
Total expenses	744.13	222.65	63.65
Write-offs and provisions			
Write-off of bad debts	18.61	11.60	6.24
Provision for loan loss	32.15	10.53	9.00
Total	50.76	22.12	15.24
Depreciation	51.11	23.79	1.64
Surplus/deficit before tax	289.43	45.36	27.86
Tax	122.96	27.34	5.40
Surplus/deficit before revenue grants	166.46	18.02	22.46
Prior period and extraordinary items	0.00	18.65	-0.94
Surplus/Deficit	0.00	18.65	-0.94
Net surplus	166.46	36.67	21.52

* Income from health insurance services Rs. 19.97 mn, Insurance commission Rs. 2.15 million and other misc. income

2.1.2 Balance Sheet

Rs. million

For the period ended March 31,	2008	2007	2006
Liabilities	Audited	Audited	Audited
Capital	443.32	266.43	139.07
Share premium	1471.32	408.90	0.00
Reserves	210.72	41.41	23.58
Less: Miscellaneous expenditure not written off	0.00	0.00	1.01
Less: Intangibles assets	19.19	27.13	0.00
Net worth	2106.16	689.62	161.65
Borrowings - own portfolio	7898.45	2490.19	703.15
Borrowings - managed portfolio	3201.19	115.04	169.48
Total long term borrowings	11099.64	2605.23	872.63
Sundry creditors	628.69	35.55	0.00
Interest accrued but not due	26.15	10.70	0.00
Provision for loan loss	61.49	29.34	19.92
Other liabilities	114.60	35.37	160.58
Other provisions	32.71	31.19	6.19
Total current liabilities	863.64	142.15	186.68
Total liabilities	14069.45	3437.00	1220.96
Assets			
Loans and advances from borrowings	7808.90	2641.92	755.85
Managed portfolio	2693.48	115.04	169.48
Total loan outstanding	10502.37	2756.96	925.33
Total investments	0.00		0.00
Cash & bank balances	2098.45	464.43	206.32
Deposits with banks	1164.54	100.11	14.50
Staff advances	9.25	0.00	0.00
Other assets & advances	172.07	90.50	65.16
Total current assets	3441.31	655.04	285.98
Total funds deployed	13943.68	3412.00	1211.31
Net fixed assets	125.76	25.00	9.65
Total assets	14069.45	3437.00	1220.96

2.1.3 Key Financial Ratios

For the period ended March 31,	2008	2007	2006
Yield			
Fund based yield	18.76%	19.29%	16.77%
Portfolio yield	20.07%	23.37%	20.20%
Fee based income / Avg. funds deployed	2.07%	1.65%	4.22%
Cost of funds			
Interest paid/ Average borrowings	9.81%	9.79%	9.36%
Interest spread			
Spreads on lending	8.95%	9.50%	7.42%
Overheads			
Operating expenses / disbursements	4.92	5.52	4.05
Operating expense ratio	9.16%	10.66%	8.47%
Personnel expense ratio	5.50%	5.61%	5.11%
Administrative expense ratio	3.66%	5.05%	3.37%
Profitability			
Net surplus/(deficit) on net worth	11.91%	8.62%	23.17%
Net surplus / (deficit) on funds deployed	1.92%	1.59%	2.79%
Operational self sufficiency	119.06%	110.34%	120.81%
Capitalisation			
Total debt/net worth (times)- reported	3.75	3.61	4.35
Total debt/net worth (times)- adjusted	5.27	3.78	5.40
Capital adequacy - Reported	24.77%	25.18%	19.46%
Capital adequacy- adjusted	18.68%	25.19%	16.16%

Note: The ratios for 2006-07 have been arrived at using the average of liabilities or assets of SKSM for 2006-07 and consolidated figures of SKSM and SKS for 2005-06. Similarly the 2005-06 and 2004-05 ratios are based on averages of consolidated figures.

2.2 Projected financial statements as provided by the MFI

2.2.1 Projected Income and expenditure statement

Rs. million

For the year ended March 31,	2011	2010	2009
Fund based income			
Interest income from loans	22,336.813	11,783.74	5,208.35
Other income	155.68	120.18	80.35
Total fund based income	22,492.49	11,903.92	5,288.70
Interest paid			
On borrowings	9,835.08	5,166.72	1,863.51
Total interest paid	9,835.08	5,166.72	1,863.51
Gross spread	12,657.42	6,737.20	3,425.18
Fee based income			
Total fee based income	518.26	301.21	167.37
Total income	23,010.75	12,205.13	5,456.07
Gross surplus	13,175.67	7,038.41	3,592.56
Expenses			
Personnel expenses	5,006.23	2,942.91	1,470.02
Operating expenses	2,109.51	1,349.03	814.66
Total expenses	7,115.74	4,291.94	2,284.68
Write-offs and provisions			
Provision for loan loss	1,729.46	957.16	447.43
Total	1,729.46	957.16	447.43
Depreciation	156.10	106.37	63.55
Surplus/deficit before tax	4,174.38	1,682.94	796.90
Tax	1,225.88	487.23	224.92
Net surplus	2,948.50	1,195.71	571.97

2.2.2 Projected Balance Sheet

Rs. million

For the year ended March 31,	2011	2010	2009
Liabilities	Projected	Projected	Projected
Share capital	8,574.43	5,611.98	2,508.49
Reserves	4,924.05	1,975.56	779.85
Net worth	13,498.48	7,587.53	3,288.34
Borrowings	81,599.43	45,351.74	20,638.58
Borrowings - managed	30,981.53	16,875.04	8,002.88
Total long term borrowings	112,580.97	62,226.78	28,641.45
Provision for loan loss	3,195.54	1,466.08	508.92
Other liabilities	3,415.97	1,867.53	813.04
Total current liabilities	6,611.51	3,333.61	1,321.95
Total liabilities	132,690.96	73,147.92	33,251.75
Assets			
Loan portfolio	91,776.58	50,014.24	21,676.50
Loan portfolio- managed	30,981.53	16,875.04	8,002.88
Total portfolio	122,758.11	66,889.28	29,679.37
Cash & bank balances	5,331.59	3,390.46	1,940.79
Other assets & advances	3,666.52	2,004.50	872.67
Total current assets	8,998.10	5,394.96	2,813.46
Total funds deployed	131,756.21	72,284.24	32,492.83
Net fixed assets	934.75	863.67	758.92
Total assets	132,690.96	73,147.92	33,251.75

2.2.3 Key financial ratios

For the year ended March 31,	2011	2010	2009
Yield			
Fund based yield	22.05%	22.72%	24.26%
Portfolio yield	23.56%	24.40%	27.79%
Cost of funds			
Interest paid/ Average borrowings	11.25%	11.37%	10.20%
Interest spread			
Spreads on lending	10.79%	11.35%	14.06%
Overheads			
Operating expense ratio	6.97%	8.19%	10.48%
Profitability			
Return on equity (reported)	27.97%	21.99%	21.13%
Return on funds deployed (reported)	2.89%	2.28%	2.62%
Operational self sufficiency	122.16%	115.99%	117.10%
Capitalization			
Total debt/net worth (times)-adjusted	8.34	8.20	8.71
Capital adequacy-adjusted	10.60%	10.88%	10.50%