

SKS Microfinance Private Limited

MFI Grading Report

October 2007

CRISIL Limited

SKS Microfinance Private Limited

Year of Incorporation: 1998	Kanchan Pandhre
Legal Status: Private Limited Company	Vice President - Finance & Accounts
Type of Institution: MFI	8-2-6084/1/1, Karama Enclave
Lending Model: Individual and Group-based	Road No. 10 Banjara Hills
(Grameen Model) Lending	Hyderabad - 500 034
	Tel: 040-23305101/2
	Fax: 040-23305106
	Email: kanchan.pandhre@sksindia.com

MFI Grading

mfR1
mfR2
mfR3
mfR4
mfR5
mfR6
mfR7
mfR8

mfR1: highest

mfR8: lowest

Grading on each of MICROS parameters

Grading	mfR							
	1	2	3	4	5	6	7	8
Parameter								
Management								
Institutional arrangement								
Capital adequacy and asset quality								
Resources and asset-liability management								
Operational effectiveness								
Scalability and sustainability								

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.

1 Rationale

The recommended grading of “**mfR2**” to SKS Microfinance Pvt Ltd (SKSM) factors in the following:

Strengths

- Competent board of directors and senior management
- Successful track record in microfinance
- Comfortable earnings profile
- Diversified wholesale funding profile
- Good asset quality
- Adequate capitalisation and capability to recapitalise

Weakness

- Internal controls not commensurate with the planned business growth

Analytical Approach

For arriving at its grading, CRISIL has used the financial and outreach information of SKSM and Swayam Krishi Sangam (SKS), a society. SKSM started operations in August 2005 by gradually taking over the portfolio of SKS, which was into microfinance operations since 1998. As on March 31, 2006, both the organisations had loan portfolios in their books; as on March 31, 2007, only SKSM undertook microfinance activity, while SKS has discontinued the same. To present an appropriate picture of the past performance, CRISIL has combined financials of SKSM and SKS for 2005-06 (refers to financial year, April 1 to March 31). The consolidated financial details for 2005-06, provided by SKSM, are after adjustment for inter-transactions between SKSM and SKS.

Company Profile

SKSM is India’s third-largest microfinance institution (MFI), with disbursements of Rs.4.46 billion during 2006-07 and loan outstanding of Rs.2.68 billion as on March 31, 2007. This private limited company was incorporated in 2003 with the objective of taking over the microfinance programme from SKS, a society that was registered in 1997. SKSM received the non-banking financial company (NBFC) licence from the Reserve Bank of India (RBI) in January 2005, and the operations were gradually transferred to SKSM from SKS from August 2005 onwards.

As on September 30, 2007, SKSM had 507 branches across 15 states – Andhra Pradesh, Bihar, Chattisgarh, Delhi, Gujarat, Jharkhand, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Orissa, Rajasthan, Uttar Pradesh, Uttaranchal, and West Bengal. As on the above date, the company had a loan outstanding of Rs.5.14 billion, and 1.06 million clients.

The company follows the group lending model, which closely resembles the Grameen Bank model. Loans are disbursed to individual members of women’s groups; five women make one group. Borrowers with credit history with SKSM

SKSM is India’s third-largest MFI, and among the fastest growing in the country

SKSM lends only to women; its group approach of lending is similar to that of Grameen Bank

and requiring 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 individual loans are for 12 to 24 months (to be repaid in monthly instalments). The company charges an interest rate of 12.5 per cent flat (23.6 per cent on diminishing basis) in Andhra Pradesh and 15 per cent flat (28 per cent) in other states.

SKSM also has a tie-up with Life Insurance Corporation of India to offer group-insurance products to its borrowers. Recently, the MFI tied up with a non-life insurance company on a pilot basis to offer health insurance to its clients in Karnataka.

Management

SKSM derives significant benefits from the nine years of microfinance experience of its predecessor, SKS. Since its inception the MFI has disbursed an aggregate loan of Rs.10 billion. Given its ambitious plans to add more than a million clients each year from 2008 onwards, the company has decided to adopt the policies followed by large service companies to expand their franchisees. Since early 2007, SKSM follows a factory-style approach to recruit and train field staff. It has decentralised its operational model, with the area offices providing the administrative and back office support. With experienced top management recently in place (for details, see Institutional Arrangement section), CRISIL believes that the company will quickly adopt the abovementioned scale-up strategies.

SKSM had a 53-member internal audit team in place as of August 2007. In CRISIL's opinion the internal controls and audit need to be strengthened substantially, to address the issues arising from decentralisation and expansion across the country. A review of the few of the internal audit reports indicate that comprehensive risk management policy and processes are required to minimise the operational and credit risks faced by the company.

SKSM has a decent loan tracking software that is used for reporting and performance tracking by the branches. The company now intends to upgrade the software, change the technology backbone and invest in connectivity as it sees technology as a key driver to automate and lower transaction costs. Another reason for the technology upgradation is to enable it to support the new financial and non-financial services which the company intends to offer.

Absence of a good administrative mechanism at the head office, commensurate with the growing needs of the company, is another serious issue faced by the organisation. There have been administrative delays in payments of statutory dues, including employee state insurance and income tax. There was also an instance of delayed loan repayment to one of the lenders by five days due to oversight by a staff member.

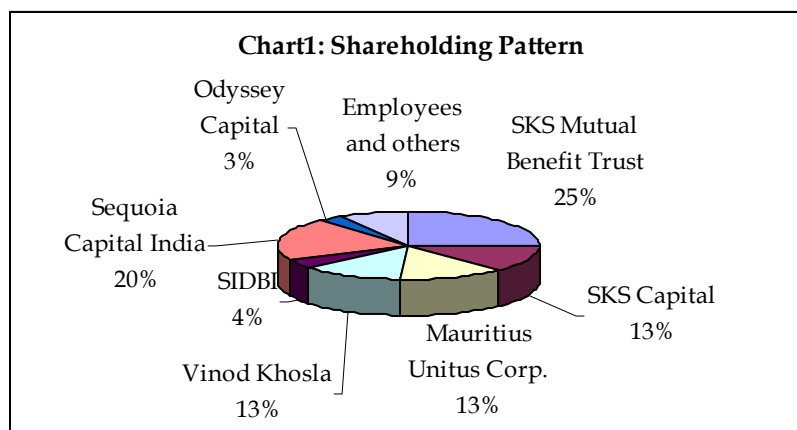
The recent scale-up strategies would allow it to expand its franchisee and service more clients

Internal controls need to be strengthened in the wake of ambitious expansion plans

SKSM has one of the most high profile board and investors among Indian MFIs

Institutional Arrangement

The presence of an experienced governing board and management is one of the key drivers of the grading assigned to the company. SKSM has one the most high profile board among Indian MFIs, with well-recognized corporate leaders and venture capitalists on board. The company's shareholders include Mr. Vinod Khosla (a, well known venture capitalist) and Sequoia Capital, a well known international venture capital company. Incidentally, SKSM is the first MFI in which Small Industries Development Bank of India (SIDBI), India's leading lender to MFIs, has an equity investment (see Chart 1).



Given its aggressive growth plan, and intention to emerge as a pan-India organisation, the company recently strengthened its senior management by recruiting professionals with corporate experience. To strengthen its decentralised operations, and also to develop future managers, the company has started recruiting management graduates from campuses for the positions of area managers.

During 2006-07, SKSM has adopted some transparency and investor confidence building measures. Some of the measures include appointment of a leading audit firm as its auditor, adoption of prudential accounting practices besides highlighting the interest rates charged to the clients in the annual report.

Capital Adequacy

Given the aggressive growth plans, SKSM will soon require capital infusion; it has indicated plans to raise Rs.1.2 billion incremental capital in 2007-08

SKSM's capitalisation levels are modest in relation to its aggressive medium- and long-term growth plans. As on March 31, 2007, SKSM had a Tier I capital of Rs.685 million and a Tier I capital adequacy ratio (CAR) of 24.16 per cent (adjusted for managed loan portfolio). The company intends to grow its portfolio by 262 per cent in 2007-08 and by a compounded annual growth rate (CAGR) of 105 per cent over the next five years. The company has indicated plans to raise additional capital of Rs.1.2 billion during 2007-08 from existing and new investors to fund this growth plan.

Infusion of capital by the company and maintenance of capital adequacy well above the regulatory minimum of 10 per cent are among the key grading sensitivity factors for the company in the medium term. CRISIL believes that, given the risks inherent to microfinance business (explained in detail later),

and restricted ability to recapitalise in a short time, MFIs would need to maintain higher capital adequacy levels, well above the regulatory minimum.

CRISIL, for its assessments, considers the appropriateness of on- and off-balance sheet asset mix and therefore has adjusted SKSM's Tier I ratio for managed assets of Rs.115 million as on March 31, 2007. Tier I ratio as reported by the company (not factoring managed assets) as on the above date, was 25 per cent.

Asset Quality

SKSM has good asset quality, as portfolio at risk greater than 8 weeks (PAR> 8 weeks) of 0.56 per cent as on March 31, 2007, and 1.56 per cent as on March 31, 2006 (on consolidated portfolio of SKS and SKSM). Given this, the company's gross non-performing asset (GNPA) levels were low at 0.12 per cent as on March 31, 2007.

As on March 31	2007		2006 (SKS+SKSM)	
	Rs. million	%	Rs. million	%
< 8 weeks *	2639	99.44	909	98.24
8-25 weeks	1	0.03	-	-
25-50 weeks	1	0.05	-	-
>50 weeks	13	0.48	16	1.76
Gross loan portfolio**	2654	100.00	925	100.00

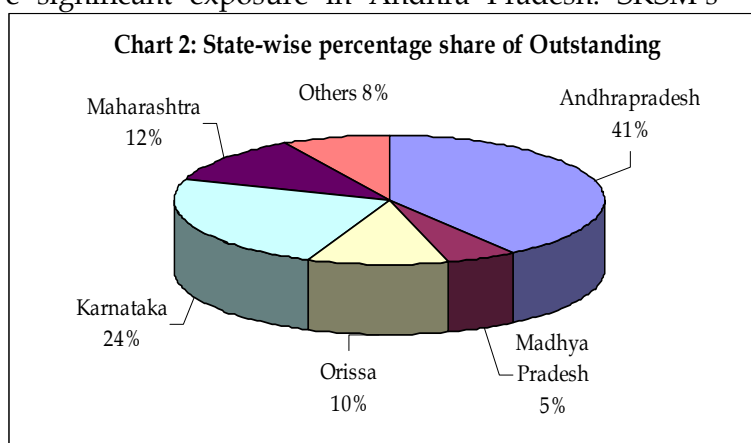
* The company shifted its method of lending rates calculation to declining basis from flat basis during early 2007. As a result the company had to track its loan portfolio manually during first few months of 2007. This as per SKSM had resulted in it temporarily stopping the tracking of on time repayments.

** including write-offs

Apart from high on-time collections, SKSM also has achieved greater geographic diversification than other large MFIs

SKSM's operations are more diversified than that of its peers, which incidentally, also have significant exposure in Andhra Pradesh. SKSM's

exposure to Andhra Pradesh, a market witnessing saturation, was 41 per cent as on March 31, 2007, lower than other leading MFIs. The other large state where the company has sizeable exposure is Karnataka, which accounted for 24 per cent of the loan outstanding as on the above date (See Chart 2).



Similarly, the portfolio was evenly diversified across various activities, though livestock rearing is the single-largest activity undertaken by most of the company's borrowers. As on March 31, 2007, 84 per cent of the loan

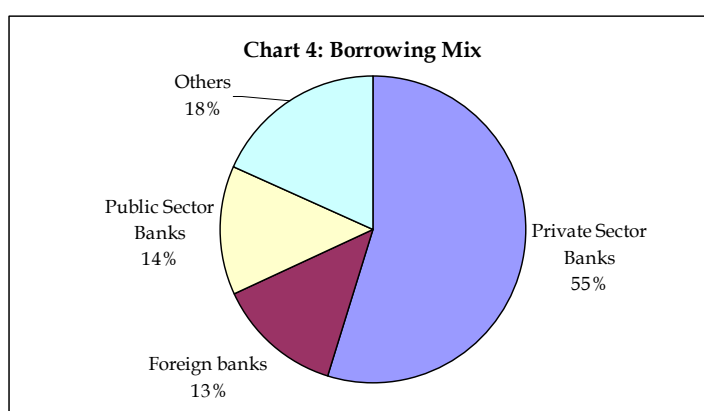
outstanding was spread across livestock, trading, and services activities. Agriculture accounted for only 4.15 per cent of the overall portfolio.

The company's loan loss provisioning policies are less aggressive than those practised by some of the other CRISIL-evaluated MFIs in India and in other countries. These MFIs adopt higher provisioning norms than SKS for loans that are overdue for 4 to below 50 weeks. However, the company's loan loss provisioning policies are more conservative than those recommended under 'RBI prudential norms'. It makes a 100 per cent loan loss provision for group and individual loans that are overdue for more than 12 months. Given the unsecured nature of the microfinance loans and their short tenor, CRISIL believes that MFIs such as SKSM need to adopt much more conservative provisioning norms.

Resources and Asset Liability Management

SKSM to maintain its diversified resource profile. Borrowing costs likely to increase by at least 200 bps in 2007-08; asset-liability mismatch will continue to be positive

SKSM has a diversified borrowing profile with access to funding from banks and apex MFIs like SIDBI and Friends of Women's World Banking (FWWB). A majority of lenders are private and foreign banks. The company is a non-deposit taking NBFC.



SKSM's average cost of borrowing (does not include SKS's borrowings) during 2006-07 was 8.97 per cent. However, CRISIL expects the company's borrowing cost to increase significantly, by at least 200 basis points (bps; 100 bps equals one percentage point), during 2007-08, since fresh borrowings have been raised at 11 per cent and above on a variable rate basis. During 2007-08, the company has managed to obtain Rs.1.85 billion loan from Citibank.

As on March 31, 2007, loans and advances, and liquid assets - cash and bank balances, and bank deposits - constituted 79 per cent and 17 per cent, respectively, of the assets. Group loans with a tenor of up to 50 weeks accounted for 99 per cent of the overall advances as on the above date; the borrowings were for 12 to 48 months, and hence, the asset-liability gap is positive.

Operational Effectiveness

Net profit margins are likely to drop marginally in the medium term due to rise in borrowing costs

SKSM's earnings profile is good, with a healthy net profitability margin (NPM) of 3.07 per cent in 2006-07. CRISIL expects the NPM to decline marginally in the medium term on account of increase in borrowing costs. The borrowing costs are expected to increase by at least 150 basis points during the medium term, and hence, are expected to more than neutralise the impact of higher yields on account of growth in business outside Andhra

Pradesh (interest rates in other states are 4.4 per cent higher). Similarly, operating expenses are also expected to remain high, given the plans to add new branches and employees.

Table2: Net Profitability Margin during 2006-07	
Particulars	%
Income / Avg. funds deployed	27.18
Cost of borrowings	9.03
Gross spread	18.15
Operating exp. / Avg. funds deployed	13.84
NPM(Pre-credit losses)	4.31
Credit losses	1.24
NPM (Post credit losses)	3.07

High operating expenses are also on account of lower employee productivity. Employee productivity, measured in terms of loan accounts per credit officer, was 477 accounts as on March 31, 2007, which is not the best among large MFIs adopting group-based approaches. One reason for the lower figure is the substantial number of new recruits during 2006-07.

Scalability and Sustainability

The strong management and governance are the key differentiators between SKSM and its peers in India. In CRISIL's opinion, these are the key drivers that would enable the company to substantially improve and sustain its operations. The company does face some challenges on the operational front, such as employee retention, minimising operational risks, and establishing banking relationships for easier fund transfer (given the fact that majority of the branches would be in rural regions). However, CRISIL believes that strengthening of senior management function, decentralisation of operations, and proposed investment in technology would address most of the operational challenges. Although the business plans chalked out by the company are ambitious, these are achievable if the MFI is able to raise the funds on time.

The company plans to raise sizeable capital of Rs.1.2 billion during the current year, which would allow it to fund its next two-three year business plan. Given the rising interest of social and commercial investors in microfinance, and the equity stake by reputed names like Sequoia Capital and Vinod Khosla, the company's ability to raise equity may not be difficult.

CRISIL expects SKSM's NPM to remain healthy, though in the medium term, it could witness a marginal decline. The company is in the processes of identifying new financial and non-financial services, which it could offer using its existing loan channels, and this, in the long run, could result in creation of sizeable fee-based income.

2 Financial Statements

2.1 Profit and Loss Statement

For the year ended March 31,	Rs. million	
	2007 SKSM	2006 SKSM+SKS
Fund based income		
Interest income from loans	397.08	99.23
Interest income on managed loans	46.36	27.72
Income from investments /bank deposits	2.43	1.82
Other income	-	0.48
Total fund based income	445.87	129.26
Interest and finance charges		
On borrowings	131.46	38.50
On managed portfolio	27.46	11.48
Finance charges	11.28	3.40
Total interest and finance charges paid	170.20	53.38
Gross spread	275.67	75.87
Fee based income		
Documentation and processing fees	34.60	19.04
Other fee based income	3.65	13.49
Total fee based income	38.25	32.53
Total income	484.12	161.79
Gross surplus	313.92	108.40
Expenses		
Personnel expenses	129.67	39.34
Administrative expenses	92.97	24.31
Total expenses	222.65	63.65
Write-offs and provisions		
Write-off of bad debts	11.60	6.24
Provision for loan loss	10.53	9.00
Total write-offs and provisions	22.12	15.24
Depreciation and amortization	23.79	1.64
Profit before tax	45.36	27.86
Add: Prior period Income/(expenses)	18.65	-0.94
Tax	27.34	5.40
Profit after tax	36.67	21.52

2.2 Balance Sheet

As on March 31	Rs. million	
	2007	2006
	SKSM	SKSM+SKS
Liabilities		
Share capital	266.43	139.07
Share Premium	408.90	-
Miscellaneous expenses (to the extent not written off)	-	1.74
Reserve and surplus	41.42	24.32
Net worth (reported) **	716.75	161.65
Borrowings	2490.19	703.15
Borrowings to fund managed loans	115.04	169.48
Total borrowings	2605.23	872.63
Interest accrued but not due	10.70	-
Provision for loan losses	29.34	19.92
Other liabilities	70.92	160.57
Other provisions	31.19	6.19
Total current liabilities	142.14	186.67
Total liabilities	3464.13	1220.96
Assets		
Loans and advances *	2641.92	755.85
Managed loan portfolio	115.04	169.48
Total loans and advances	2756.96	925.33
Cash & bank balances	464.43	206.32
Deposits with banks	100.11	14.50
Payment for members grant	-	45.50
Other assets & advances	90.50	19.66
Total current assets	655.04	285.98
Total funds deployed	3412.00	1211.31
Net fixed assets **	52.13	9.65
Total assets	3464.13	1220.96

* This also includes advances to employees, directors, employees benefit trust and other advances

** Net intangibles of Rs.30.93 million (previous year Rs.41.41 million) towards goodwill and computer software have not been knocked off from the net worth. The adjusted net worth would have been Rs.685.82 million. For the capital adequacy calculation, the intangibles have been knocked off.

2.3 Key Ratios

As on/for the year ended December 31	2007	2006
Yield (%)		
Fund based yield (A)	19.29	16.77
Portfolio yield	23.37	20.20
Fee based income / Avg. funds deployed	1.65	4.22
Total income / avg. funds deployed	20.94	21.00
Cost of funds (%)		
Interest paid/ Average funds deployed (B)	7.36	6.93
Interest paid/ Average borrowings (C)	9.79	9.36
Interest spread (%)		
Gross spread/ Average funds deployed (A) - (B)	11.93	9.85
Interest spread	9.50	7.42
Spreads on lending (A) - (C)	9.50	7.42
Overheads (%)		
Operating expense ratio	9.63	8.26
Operating expense ratio (including depreciation)	10.66	8.47
Personnel expense ratio	5.61	5.11
Administrative expense ratio	4.02	3.16
Profitability (%)		
Net profit / (deficit) on net worth	8.35	23.17
Net profit / (deficit) on funds deployed	1.59	2.79
Operational self sufficiency (OSS)	110.34	120.81
Capitalisation		
Total debt/net worth (times)	3.63	5.40

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.

3 Projections

For the year	2007-08	2008-09	2009-10	2010-11	2011-12
Members end of period	1,534,090	2,732,765	4,259,035	6,140,306	8,017,301
Borrowers end of period	1,351,264	2,372,444	3,545,658	4,875,030	6,232,702
Net Loan Portfolio (Rs. million)	9,577	18,306	28,367	39,079	47,157
Loan Disbursements (Rs. million)	15,413	30,309	49,853	73,022	95,323
Branches (no.)	478	988	1288	1588	1888
Borrowers / Field Assistant (no.)	462	417	431	432	430
Avg. Borrowers / branch (no.)	2215	2478	2625	2949	3252
Avg. Outstanding / borrower (Rs.)	7088	7716	8001	8016	7566

Disclaimer

CRISIL's MFI grading is a current opinion on the ability of an MFI/NGO-MFI to conduct its operations in a scalable and sustainable manner. The MFI grading does not involve an audit of the graded MFI by CRISIL. In the case of NGO-MFIs, CRISIL's MFI gradings apply only to their microfinance programmes. CRISIL MFI gradings are based on information provided by the graded MFI, or obtained by CRISIL from sources it considers reliable. CRISIL does not guarantee the completeness or accuracy of the information on which the grading is based.

This grading does not opine on the MFI's ability for timely payment of interest and principal. Nor is it a recommendation to purchase, sell, or hold any financial instrument issued by the graded MFI, or to make loans / donations/ grants to the graded MFI. The MFI grading assigned by CRISIL cannot be used by the MFI/NGO-MFI in any form for mobilizing deposits/savings/thrift from its members or general public.

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