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Morning Buzz
INDIA

6 April 2016

Top Research Picks

- Equitas Holdings IPO: Don't underestimate risks
- Mphasis: Key investor call takeaways – Near-term earnings upgrade capped

Other Research

- India Economics: RBI Monetary Policy Review - Focus on liquidity and transmission
- India Financials: Monetary policy – Few notable changes for banks

5 April 2016

Equitas Holdings IPO

Don't underestimate risks

Equitas Holdings (Equitas), one of the 10 entities to receive a small finance bank (SFB) license, intends to raise Rs 7.2bn via a fresh issue (IPO: 5-7 Apr) of 65.5mn shares priced at Rs 110 (upper band). We remain negative on the microfinance sector and believe Equitas' microfinance business (50% of total) is very risky due to high concentration (80% AUM from top 2 states) in well-penetrated states. Also, ex-microfinance, its loan book is still budding, making it difficult to forecast high, sustainable growth with superior margins. In our view, conversion into a SFB is unlikely to alleviate these concerns.

- **Microfinance business remains very risky:** We remain negative on the microfinance sector (*India Microfinance: Crises brewing – SELL SKSM*) as our in-depth study reveals that penetration levels are alarmingly high in the sector's traditional southern and eastern markets (Fig 1, 2). Market saturation is fuelling aggressive growth in new regions, which could lead to unhealthy competition and hurt MFIs.

- **Equitas – At a higher risk versus peers:** Political risks, natural calamities and economic and regional shocks can lead to massive loan write-offs for MFIs and erode a substantial part (or all) of their net worth. Conversion into a SFB does not erase these concerns. In an unsecured lending business, slippages are concentrated in any given year over a cycle and the loss given default (LGD) is ~100%. Even Grameen Bank – the world's most successful company model – has passed through cycles and has a portfolio at risk (PAR) of 2.7%. Importantly, Equitas is not well-diversified and operates in overcrowded states (Fig 6), with the top two states contributing 80% of its AUM (fig 5). This increases the risk versus peers.

- **Ex-microfinance book – still at nascent stage:** Ex-microfinance, Equitas' loan book (~50% of total) comprises CV, MSME and home loans. Since this business is at a nascent stage, it would be too soon to project sustainable, industry-leading growth with superior profits in the long term. We note that (1) for used CV loans, organised players are enjoying >60-70% market share while large MFIs are struggling, and (2) even for housing loans, high growth and superior profits are not a given. For instance, Mahindra Rural Housing Finance's loan book is way below its guided levels, with GNPAs deteriorating to 10% as of 9MFY16.

- **Conversion into SFB may drag medium-term ROEs:** While we see a clear ~300bps advantage in cost of funds (post negative carry on SLR/CRR) once Equitas converts to a SFB, these savings are likely be passed on to microfinance customers. Also, upon conversion, Equitas will have to invest in branches/technology while benefits would accrue over the long term – thus dragging ROEs over the medium term.

- **Issue priced attractively versus peers:** The IPO looks attractive as the company's growth potential looks promising at this stage. However, a re-rating over the next few years would hinge upon sustainable profitability/growth outlook post conversion into a SFB. The IPO is priced at Rs 110 (upper band) which is 1.8x PBV post dilution – at a ~50% discount to SKS Microfinance (SKSM) which prices in the hit to profitability over the near term due to SFB conversion.

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Key financials

Particulars	FY14	FY15	9M FY16
AUM (Rs bn)	24.9	40.1	55.1
Net profit (Rs bn)	0.7	1.1	1.2
Avg. Net worth (Rs bn)	6.1	9.6	12.3
ROA (%)	3.2	3.0	3.1
ROE (%)	12.3	11.2	13.0
Gross NPA (%)	0.7	1.1	1.3
Net NPA (%)	0.6	0.8	1.0

IPO details

Opening Date	5-Apr-16
Closing Date	7-Apr-16
Price Band (Rs)	109-110
Fresh Issue (m shares)	65.5
Offer for sale (m shares)	130.8

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5 April 2016

HOLD
TP: INR 475.00
▲ 4.5%

Mphasis

MPHL IN

Near-term earnings upgrade capped

Key takeaways from MPHL's investor call are: (1) management expects the direct core business (50% of total revenues) to grow at 14% YoY, (2) the recently signed five-year US$ 990mn Master Services Agreement (MSA) with HP lends a floor to revenues but offers limited colour on near-term run-rate, (3) new opportunities to provide technological support to Blackstone (BX) portfolio companies have opened up, and (4) the margin band remains at 13-15%. We view the ownership change and MSA as positive developments but greater confidence in growth is key to a re-rating. Maintain HOLD.

- **HP MSA lends a floor:** HP Enterprises (HPE) has signed an MSA (preferred vendor status) with MPHL for a ***minimum*** US$ 990mn revenue spread over five years with an automatic renewal clause for another six years after the initial term. The MSA lends a floor to HP revenues which have been declining at 20% p.a. for the last three years; however, management gave limited colour on the trajectory of the HP revenue run-rate. HP's current run-rate is US$ 55mn/qtr vs. US$ 50mn/qtr implied in the MSA.
- **BX opportunity:** The change in MPHL ownership from HP to BX opens up avenues to drive future growth by providing technological solutions to BX-owned portfolio companies. BX currently owns more than 80 portfolio companies across sectors.
- **Earnings expectations not too low:** We think earnings expectations are already factoring in 14% growth in the direct core channel (50% of revenue) and a US$ 50mn/qtr run-rate for HP. Thus, we see limited room for upgrades in the near term. Overall, we estimate a 3%/8% US$ revenue/EPS CAGR over FY15-FY18.
- **View:** Earnings expectations aren't conservative and clarity on the HP run-rate along with a pick-up in direct channel business will be key to a re-rating. We expect the stock to remain range-bound in the near-term and would like to see more consistent execution before turning constructive on the stock. Maintain HOLD.

Financial Highlights

Y/E 31 Mar	5MFY14A	FY15A	FY16E	FY17E	FY18E
Revenue (INR mln)	25,939	57,948	61,181	65,310	71,183
EBITDA (INR mln)	4,397	8,676	9,040	9,954	10,869
Adjusted net profit (INR mln)	3,026	6,746	7,185	8,118	8,603
Adjusted EPS (INR)	14.7	32.3	34.2	38.7	41.0
Adjusted EPS growth (%)	(58.0)	119.3	6.0	13.0	6.0
DPS (INR)	14.0	16.0	49.0	17.0	68.0
ROIC (%)	8.5	16.6	17.1	18.5	20.7
Adjusted ROAE (%)	6.2	12.8	12.7	13.4	14.7
Adjusted P/E (x)	30.9	14.1	13.3	11.8	11.1
EV/EBITDA (x)	18.0	9.0	8.1	7.4	6.2
P/BV (x)	1.9	1.7	1.6	1.5	1.7

Source: Company, Bloomberg, RCML Research

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PRICE CLOSE (04 Apr 16)
INR 454.70

MARKET CAP
INR 95.6 bln
USD 1.4 bln

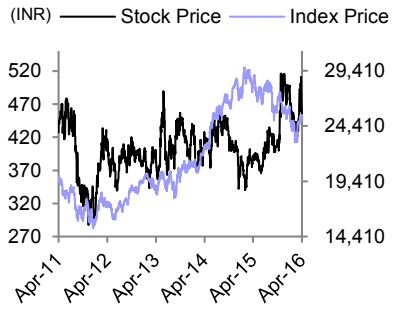
SHARES O/S
210.0 mln

FREE FLOAT
35.2%

3M AVG DAILY VOLUME/VALUE
0.2 mln / USD 1.6 mln

52 WK HIGH
INR 534.35

52 WK LOW
INR 361.05



Per Share Data

Y/E 31 Mar (INR)	5MFY14A	FY15A	FY16E	FY17E	FY18E
Reported EPS	14.7	32.3	34.2	38.7	41.0
Adjusted EPS	14.7	32.3	34.2	38.7	41.0
DPS	14.0	16.0	49.0	17.0	68.0
BVPS	243.6	260.9	279.8	298.6	260.0

Valuation Ratios

Y/E 31 Mar (x)	5MFY14A	FY15A	FY16E	FY17E	FY18E
EV/Sales	3.0	1.3	1.2	1.1	0.9
EV/EBITDA	18.0	9.0	8.1	7.4	6.2
Adjusted P/E	30.9	14.1	13.3	11.8	11.1
P/BV	1.9	1.7	1.6	1.5	1.7

Financial Ratios

Y/E 31 Mar	5MFY14A	FY15A	FY16E	FY17E	FY18E
Profitability & Return Ratios (%)					
EBITDA margin	17.0	15.0	14.8	15.2	15.3
EBIT margin	15.0	13.3	13.6	14.0	14.0
Adjusted profit margin	11.7	11.6	11.7	12.4	12.1
Adjusted ROAE	6.2	12.8	12.7	13.4	14.7
ROCE	5.1	9.5	9.8	10.3	11.5
YoY Growth (%)					
Revenue	(55.2)	123.4	5.6	6.7	9.0
EBITDA	(56.7)	97.3	4.2	10.1	9.2
Adjusted EPS	(58.0)	119.3	6.0	13.0	6.0
Invested capital	4.2	(0.9)	11.7	(8.1)	2.6
Working Capital & Liquidity Ratios					
Receivables (days)	190	77	58	48	48
Inventory (days)	0	0	0	0	0
Payables (days)	0	0	0	0	0
Current ratio (x)	3.4	3.8	6.1	4.2	3.3
Quick ratio (x)	1.7	2.1	3.5	2.6	1.7
Turnover & Leverage Ratios (x)					
Gross asset turnover	2.2	5.5	6.2	6.1	5.6
Total asset turnover	0.4	0.8	0.9	0.9	0.9
Net interest coverage ratio	0.0	0.0	0.0	0.0	0.0
Adjusted debt/equity	(0.3)	(0.4)	(0.4)	(0.5)	(0.4)

DuPont Analysis

Y/E 31 Mar (%)	5MFY14A	FY15A	FY16E	FY17E	FY18E
Tax burden (Net income/PBT)	70.7	71.7	72.6	72.3	72.3
Interest burden (PBT/EBIT)	110.0	121.8	119.1	122.7	119.7
EBIT margin (EBIT/Revenue)	15.0	13.3	13.6	14.0	14.0
Asset turnover (Revenue/Avg TA)	37.7	80.8	85.2	88.1	94.8
Leverage (Avg TA/Avg equities)	137.9	135.5	126.4	122.1	128.1
Adjusted ROAE	6.2	12.8	12.7	13.4	14.7

Income Statement

Y/E 31 Mar (INR mln)	5MFY14A	FY15A	FY16E	FY17E	FY18E
Total revenue	**25,939**	**57,948**	**61,181**	**65,310**	**71,183**
EBITDA	4,397	8,676	9,040	9,954	10,869
EBIT	3,893	7,721	8,312	9,147	9,941
Net interest income/(expenses)	414	1,401	1,449	2,080	1,958
Other income/(expenses)	0	0	(53)	0	0
Exceptional items	0	0	0	0	0
EBT	4,282	9,408	9,898	11,227	11,898
Income taxes	(1,191)	(2,630)	(2,713)	(3,109)	(3,295)
Extraordinary items	(64)	(32)	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
Reported net profit	**3,026**	**6,746**	**7,185**	**8,118**	**8,603**
Adjustments	0	0	0	0	0
Adjusted net profit	**3,026**	**6,746**	**7,185**	**8,118**	**8,603**

Balance Sheet

Y/E 31 Mar (INR mln)	5MFY14A	FY15A	FY16E	FY17E	FY18E
Accounts payables	0	0	0	0	0
Other current liabilities	13,044	12,875	7,246	12,302	13,315
Provisions	0	0	0	0	0
Debt funds	5,396	5,753	3,650	3,650	3,650
Other liabilities	0	0	0	0	0
Equity capital	2,101	2,101	2,102	2,102	2,102
Reserves & surplus	49,049	52,697	56,655	60,596	52,492
Shareholders' fund	51,150	54,798	58,757	62,698	54,594
Total liabilities and equities	**69,590**	**73,426**	**69,652**	**78,650**	**71,559**
Cash and cash eq.	22,824	27,640	25,085	32,044	23,061
Accounts receivables	12,967	11,371	8,229	8,995	9,736
Inventories	0	0	0	0	0
Other current assets	8,885	10,434	10,627	10,707	10,787
Investments	0	0	0	0	0
Net fixed assets	2,178	1,562	1,172	2,365	3,437
CWIP	62	318	849	849	849
Intangible assets	21,865	21,781	22,933	22,933	22,933
Deferred tax assets, net	0	0	0	0	0
Other assets	809	826	757	757	757
Total assets	**69,590**	**73,932**	**69,652**	**78,650**	**71,559**

Cash Flow Statement

Y/E 31 Mar (INR mln)	5MFY14A	FY15A	FY16E	FY17E	FY18E
Net income + Depreciation	3,530	7,701	7,913	8,925	9,532
Interest expenses	(414)	(1,401)	(1,449)	(2,080)	(1,958)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(1,167)	(122)	(2,681)	4,211	192
Other operating cash flows	0	0	0	0	0
Cash flow from operations	**1,949**	**6,178**	**3,783**	**11,055**	**7,767**
Capital expenditures	(1,050)	(595)	(869)	(2,000)	(2,000)
Change in investments	350	67	(1,083)	0	0
Other investing cash flows	525	1,681	1,697	2,292	2,170
Cash flow from investing	**(175)**	**1,153**	**(255)**	**292**	**170**
Equities issued	2,769	833	8,813	0	0
Debt raised/repaid	(175)	357	(2,103)	0	0
Interest expenses	(111)	(280)	(248)	(212)	(212)
Dividends paid	(3,440)	(3,931)	(12,039)	(4,177)	(16,708)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	**(957)**	**(2,521)**	**(6,077)**	**(4,389)**	**(16,920)**
Changes in cash and cash eq	**817**	**4,810**	**(2,549)**	**6,958**	**(8,983)**
Closing cash and cash eq	**22,824**	**27,634**	**25,091**	**32,044**	**23,061**

5 April 2016

RBI Monetary Policy Review

Focus on liquidity and transmission

In its first bimonthly monetary policy review for FY17, the RBI cut the repo rate by 25bps while narrowing the policy rate corridor to 50bps. The central bank's focus has increasingly shifted to better liquidity management and improved transmission from mere policy rate cuts – this should yield better outcomes in terms of bringing down the cost of capital (recent measures should result in a 50+bps lending rate cut). Although we believe another rate cut is in the offing, the RBI is likely to wait till August for more clarity on monsoon, monetary transmission and 7th CPC.

- **RBI narrows policy rate corridor:** The RBI has cut the repo rate by 25bps to 6.5% (the lowest in five years) in its first bimonthly monetary policy review for FY17 held today. The move was along expected lines – a favourable inflation number for Feb'16, the Govt.'s commitment to stick to fiscal deficit targets, ongoing weakness in the domestic economy and the Fed's dovish guidance had warranted a rate cut. However, the central bank surprised the market by narrowing the policy rate corridor to 50bps from 100bps, by hiking the reverse repo rate by 25bps and reducing the marginal standing facility (MSF) rate by 75bps. This step is aimed at minimising volatility in the weighted average call money rate and aligning it more closely with the repo rate.

- **Focus on liquidity:** The RBI, in its review, has focused on adopting measures to better manage liquidity and improve transmission of monetary policy changes through the system. It (1) reduced the minimum daily cash reserve ratio (CRR) requirements to 90% from 95%, (2) narrowed the policy rate corridor to 50bps and (3) stated that it would lower the average liquidity deficit from 1% of NDTL to a neutral stance over time.

  Introduction of the marginal cost of funds-based lending rate (MCLR) and the recent cut in small savings rate along with a likely improvement in liquidity (as well as more OMOs) should improve monetary transmission. The MCLR has already led to an effective decline in fresh lending rates by ~25bps, even before today's rate cut. Thus recent measures are likely to lead to an effective decline of over 50bps in lending rates.

- **Inflation targets challenging:** The RBI expects inflation to remain at ~5% during FY17 (with slight inter-quarter variations) before moderating to 4.2% by Q4FY18. However, the upside risks to this forecast are quite significant: (1) as per the central bank's own estimates, implementation of the 7th Pay Commission is expected to push up inflation by 100-150bps during FY17 and FY18, (2) the RBI's inflation forecast assumes average crude oil prices of US$ 40/barrel during FY17 – a run-up in crude could raise inflation above the RBI's baseline projection, and (3) a deficient monsoon could lead to a spike in food inflation. Besides, core inflation, which has remained sticky at ~5% during the last 12 months, would have to moderate from current levels, in order to cushion the sharp monthly variations usually seen in food inflation.

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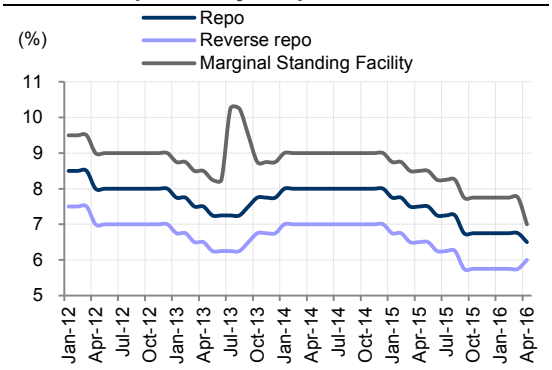
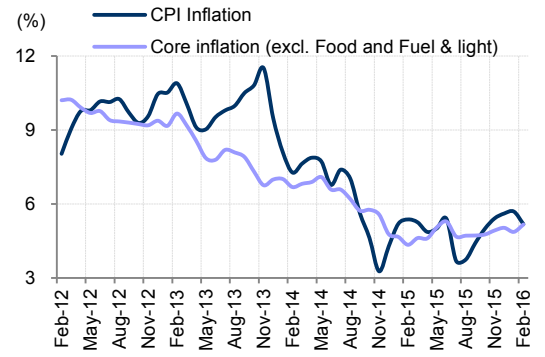
RBI cuts repo rate by 25bps



Source: RBI, RCML Research

CPI inflation declined to 5.2% in Feb'16



Source: MOSPI, RCML Research

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RBI Monetary Policy Review

Focus on liquidity and transmission

Economics
INDIA

- **RBI likely to pause till August:** The average real interest rate (CPI minus 1-year T-bill) stood at 2.4% in FY16, above the RBI's indicative range of 1.5-2%. Thus, we continue to believe there is room for another 25bps rate cut. However, the RBI is likely to wait at least till August for further developments on (1) the progress of the monsoon, (2) announcements regarding 7th CPC implementation, (3) movements in core inflation and (4) evidence of transmission of prior policy rate cuts, before going in for further monetary easing.

  The central bank's focus has increasingly shifted from policy rate cuts to better liquidity management and improved transmission of the 150bps repo rate cuts already undertaken since the beginning of the easing cycle. The measures adopted today should yield better outcomes than plain-vanilla policy rate cuts (of say 25bps) in terms of bringing down cost of capital. It would be interesting to see the long-term efficacy of this policy tool mix being deployed by the monetary policy authority in India.

5 April 2016

India Financials

Monetary policy – Few notable changes for banks

- **Focus on better liquidity management:** The RBI has cut the repo rate by 25bps and announced three steps to improve liquidity: (1) Reduction in the minimum daily maintenance of CRR from 95% of the requirement to 90%. (2) Narrowing of the policy rate corridor from +/-100bps to +/- 50bps by cutting the MSF rate by 75bps and increasing the reverse repo rate by 25bps. (3) Lowering the average liquidity deficit from 1% of NDTL to a position closer to neutrality.
- **Large borrowers to tap markets instead of banks:** The RBI will issue a fresh discussion paper by Apr'16 (final implementation: Jan'19) on large borrowers meeting a part of their funding requirements from markets. While this will hurt loan growth, it will ease the burden of banks to lend to large corporates/groups, and aid liquidity and asset quality management.
- **Rationalisation of branch authorisation policy – a positive:** The RBI aims to redefine the branch authorisation policy to promote financial inclusion and provide flexibility on the choice of delivery channel. To this end, it proposes to include other permissible methods of outreach (extension counters, satellite offices, mobile branches, ultra small branches) and as against only branches currently. The move would enable banks to meet their financial inclusion targets at lower investments.
- **Differentiated licensing/on-tap universal licensing guidelines – a positive:** The RBI will put out a discussion paper for on-tap licensing and licensing differentiated banks, such as custodian banks and banks concentrating on wholesale/long-term financing. This is positive for NBFCs looking to convert into a bank (such as L&T Finance Holdings; not rated). Also, long-term financing banks can ease infrastructure funding pressures of the banking system.
- **Countercyclical capital buffers (CCCB):** Implementation of CCCB (0-2.5% of RWAs) has been deferred since the RBI believes its activation is not necessary at present. This has come as a relief for PSU banks, especially mid-size PSU banks which are struggling to maintain adequate core equity capital as per Basel III norms.
- **Other notable proposals:**
  1. **P2P lending:** The RBI will put out a concept note on P2P lending (which has shown robust growth in last one year) and will issue final guidelines/ framework on regulating P2P lending in consultation with SEBI.
  2. **Business Correspondent (BC) services:** To keep a tab on BCs and strengthen their infrastructure, the RBI has requested the Indian Banks Association (IBA) to initiate a certification/training programme. This would enable BCs to go beyond deposit and remittance and execute tasks like delivery of financial products.
  3. **MSME promotion:** The RBI will issue a framework for credit counsellors who can act as facilitators between entrepreneurs and the formal financial system. These counselors will not only assist MSMEs in preparing project reports but will also aid banks in making informed decisions.
- **Expect banks to cut lending rates:** There is headroom for banks to cut deposit rates post the recent cut in small savings rates. We expect banks to cut both deposits and lending rates by ~25bps in Q1FY17. The cut in lending rates would hurt NIMs due to the lead/lag impact.

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