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SPANDANA SPHOORTY FINANCIAL LIMITED

IPO Note

(SUBSCRIBE)

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5 August 2019

IPO details

Key Data	
Issue Opens	5-Aug-19
Issue Closes	7-Aug-19
Equity Shares Offered (in mn.)	14.05
QIB	Up to 50%
NIB	Min 35%
Retail	Min 15%
Face Value (₹)	10
Price Band (₹)	853-856
Max. Issue Size (₹ mn)	12,023
Lot Size (Eq. Shares)	17 and multiple thereof

	Pre Issue		Post Issue^	
	# mn Shares	% Holding	# mn Shares	% Holding
Promoters	48.4	81.2%	39.1	60.7%
Public	11.2	18.8%	11.2	17.4%
Offer for sale			9.4	14.5%
Fresh Issue			4.7	7.3%
Total	**59.6**	**100.0%**	**64.3**	**100.0%**

Object of the issue

- Augmenting the capital base
- General corporate purposes

Valuation	@₹ 853are	@ ₹856per share
Market Cap (₹ mn)	54,868	55,060
Net Debt (₹ mn)	25,956	25,956
Enterprise Value (₹ mn)	80,824	81,017
EV/ Sales	2.9	2.9
EV/ EBIDTA	9.7	9.7
P/E	17.6	17.6

Recommendation

SSFL is a leading MFI and 6th largest by AUM Rural Focused NBFC-MFI with a geographically diversified presence in India offering income generation loans under the joint liability group model, predominantly to women from low-income households in Rural Areas. SSFL is the most efficient micro-finance company with a cost to income ratio of 25% and the industry-leading opex ratio of 4.6% for FY19. Its AUM posted 85% CAGR and PBT posted 222% CAGR in last two years with just 0.01% NPAs as on 31.03.19. We are positive on the company and its business model. Therefore we recommend **SUBSCRIBE** over the issue for a long term perspective.

* Calculated on EPS of FY17

Source: Red Herring Prospectus, Dealmoney Research

Leading, rural focused NBFC-MFI

- Spandana Sphoorty is a leading, rural focused NBFC-MFI with a geographically diversified presence in India. The NBFC offer income generation loans under the joint liability group model, predominantly to women from low-income households in Rural Areas. As of March 31, 2019, it is the fourth largest NBFC-MFI and the sixth largest amongst NBFC-MFIs and SFBs in India, in terms of AUM (Source: ICRA Research). Further, according to ICRA Research, the operating expense to average managed assets ("AMA") ratio was better than the industry as a whole for Fiscal 2019.

- Through its extensive corporate history, it has developed an in-depth understanding of the borrowing requirements of the low-income client segment. The business model involves regular client meeting processes through the employees, who maintain contact with the clients across the districts that it cover.

- As of June 30, 2019, it had 7,062 employees (including 5,051 credit assistants) operating out of 929 branches in 269 districts across 16 states and 1 union territory in India. Through the company's loan products and client-centric approach, it endeavour to strengthen the socio-economic well-being of low-income households by providing financing on a sustainable basis in order to improve livelihoods, establish identity and enhance self-esteem.

- In October 2010, the MFI industry (including Spandana Sphoorty) was severely impacted due to external regulatory action, as the government of the formerly unified Andhra Pradesh promulgated the AP Microfinance Ordinance 2010, which enforced several restrictions on the operations of MFIs.

- This severely impacted the collections and the consequent cash-flow shortage impacted its ability to service the debt, which in turn impaired the growth and profitability. The lenders referred it to the corporate debt restructuring ("**CDR") mechanism of the RBI to develop a plan to restructure borrowings and revive** the business. It agreed on a CDR plan with the lenders, which allowed the company to get cash-flow relaxations to enable it to continue the efforts towards portfolio diversification, process improvement and cost rationalization. These measures helped them turn the operations profitable from the year ended March 31, 2014.

- Further during the time that it was under CDR, it deployed efforts to recover dues in AP, such as continuing to keep the branches open and continuing to engage with borrowers.

- The operations turned profitable in the year ended March 31, 2014 and it went on to make profits for four consecutive years while operating under the CDR mechanism. Our restated standalone profit after tax (under Previous Indian GAAP) was ₹1,050.99 million and ₹2,432.35 million for Fiscals 2015 and 2016.

Source: Red Herring Prospectus, Dealmoney research

Strengths

- ***Seasoned business model with resilient performance through business cycles:*** Through various business cycles, it has been able to leverage the inherent strength of client centric business model, focus on internal controls, the expertise of Individual Promoter and core management team to maintain status as a leading NBFC-MFI. The response to the 2010 AP crisis demonstrated the strength of its decision making, planning and execution. In the aftermath of the 2010 AP crisis, even while it was under CDR, it continued operations outside Andhra Pradesh in various states. In this period, it focused on rebuilding profitable operations through portfolio diversification, cost rationalization, customer retention, and recovery from its Andhra Pradesh portfolio. These measures helped the company to raise new debt from existing lenders and gain capital infusion from Kangchenjunga, its Corporate Promoter and Kedaara AIF 1, which allowed the company to exit from CDR in March 2017. According to ICRA Research, it is one of the only two major MFIs to successfully exit from CDR post AP crisis.
- ***High degree of client engagement and robust risk management, leading to superior asset quality and collections:*** it focuses on a high degree of client engagement through large employee base and operating procedures. The client engagement practices include village/block level centre meetings and client training. Prior to lending to a client, it impart training over three days on loan terms, utilization and repayment, insurance and client support services. It also conduct center meetings where clients interact with the staff at regular intervals (typically based on their installment payments frequency). The company believe that these practices helps it to stay in close contact with its clients, which enables to collect installments on the due dates and at specified times. It believes that it has been able to perform better than the peers on collection efficiency as a result of our practices, staff training, incentive structures designed to reward process adherence and asset quality and regular client engagement activities.
- ***Streamlined systems and processes and high employee productivity leading to low operating expense ratio:*** The business processes are designed for scale and efficiency and it constantly review and endeavor to strengthen them as the scale of operations increase. The operational efficiency is also driven by streamlined systems and procedures and scalable workforce deployment. At the branch level, it has implemented standardized systems and a front-end interface that gives real time information on demand and collections. The systems follow an accounting module with budget controls built and approval authorities clearly earmarked. These practices and systems help in reducing the time and cost of operations. As a result, according to ICRA Research, it had the lowest operating expenses/AMA ratio amongst certain major NBFC-MFIs and SFBs for Fiscal 2019.
- ***Focus on the high potential and under-served rural segment*:** Rural Areas in India are a highly under-served market for formal banking services in terms of access, availability and suitability of products and services. Therefore, it strategically focus on clients in the rural sector. According to ICRA Research, while rural India accounts for approximately 68% of India's population as of March 2018, it accounted for only 34% of total deposit accounts and 23% of the loan accounts in scheduled commercial banks. ICRA Research notes that the significant under penetration of credit in Rural Areas offers strong potential for improvement and that given the relatively deeper reach, existing client relationships and employee base, micro-finance institutions are well placed to address this demand, which is currently being met by informal sources such as local money lenders. Accordingly, with our focus on the rural segment as of December 31, 2018, 88% of its portfolio was located in Rural Areas, as compared with 61% for 33 NBFC-MFIs as a whole. (*Source: ICRA Research).*

Source: Red Herring Prospectus, Dealmoney research

Future road ahead

- ***Leverage our popular income generation loan products to derive organic business growth***: Through the company's client-centric business model, it focuses on providing financing to its clients on a speedy and continual basis (while always adhering to strict risk management policies), according to their life-cycle needs. It focuses on providing income generation loans and the popular 'Abhilasha' loans (which are income generation loans) amounted to 84.62% of Gross AUM, as of March 31, 2019. ICRA Research estimates the microfinance credit opportunity to amount to ₹5–6 trillion. The company expect to derive organic growth through popular income generation loan products that are offered through the JLG model. To this end, it intends to utilize existing branch infrastructure and employee base to increase its volume of income generation loans. It intend to offer income generation loans both to existing clients (as they complete their existing loan cycles) and to new clients through existing branches. It commences processing loans for existing clients at the time when two instalments of their existing loan are due, so as to disburse loans on the same day that the existing loan is fully repaid.
- ***Leverage existing branch network by increasing loan portfolio and enhancing employee productivity***: it has a large branch network which can be further leveraged since it has maintained low exposure levels per branch thus far. While it was under CDR, it focused on retaining branch franchise as much as possible and this required maintaining low ticket sizes (leading to low AUM/branch levels) to ensure that once funding levels improve post CDR exit, it can leverage on the branch franchise. Within the branches, during the time that it was in CDR, it focused on retaining clients even though it had to keep its ticket sizes lower than the client demand and credit approval levels
- ***Increase its presence in under-penetrated states and districts***: it has grown it geographical presence by expanding branches into different regions. With this strategy, it expanded operations into three new states, Bihar, West Bengal and Tamil Nadu and one union territory, Pondicherry, in the last two years besides restarting operations in Rajasthan where it had exited. The company's contiguous growth strategy is also relevant for expanding into newer districts within the states where it already have operations. It intend to continue to expand it geographical coverage into newer states and union territories as well where it sees business potential (for instance, Assam, Punjab and Haryana).
- ***Further diversify the borrowing profile and reduce the cost of borrowings:*** The funding sources are varied, as it believes that a diversified debt profile ensures that are not overly dependent on any one type or source for funding. Post exit from CDR, it has diversified lender base and accessed diverse sources of liquidity, such as term loans, cash credit and subordinated debt from banks, financial institutions and non-banking financial companies, proceeds from loan assets securitized, and proceeds from the issuance of NCDs to meet its funding requirements.

Source: Red Herring Prospectus, Dealmoney research

Peer Comparison

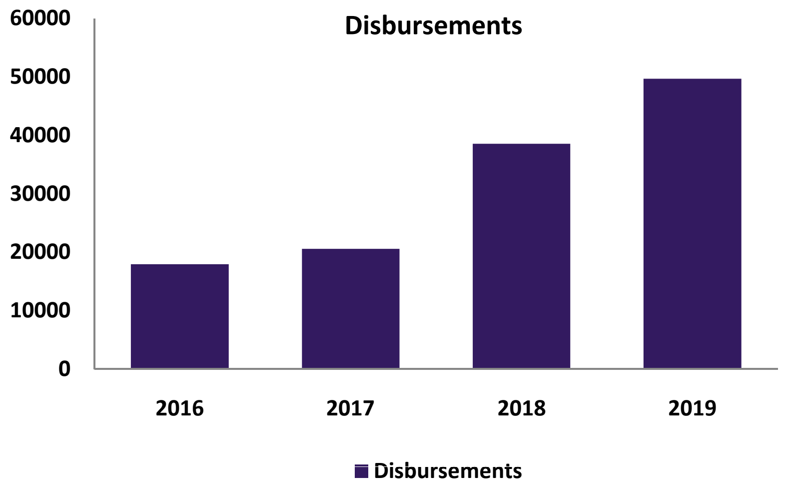
Company	M. Cap (₹ Cr)	Net Profit (₹ Cr)	Gross Loan Book (₹ Cr)	Net NPA (%)	RoE (%)	RoA (%)	Adj. BV (₹/sh)	P/Adj. BV (x)
Bandhan Bank	57,263	1,952	44,800	0.58	17.4	3.9	94	5.1
Bharat Financial Incl #	12,384	985	17,394	0.22	23.3	9.7	300	2.9
Spandana Sphoorty ^	5,505	312	4,437	0.01	16.5	6.3	294	2.9
Ujjivan Financial Serv.	3,487	150	11,049	0.3	8	1.7	157	1.8
Satin Creditcare*	1,392	202	7,068	1.6	17.5	3.1	237	1.1

* NPAs imply the Expected Credit Loss (ECL) as per FY19 PPT; # Bharat Financial Inclusion is suspended to be merged with IndusInd Bank, hence the M. Cap is calculated on the basis of the merger swap ratio;

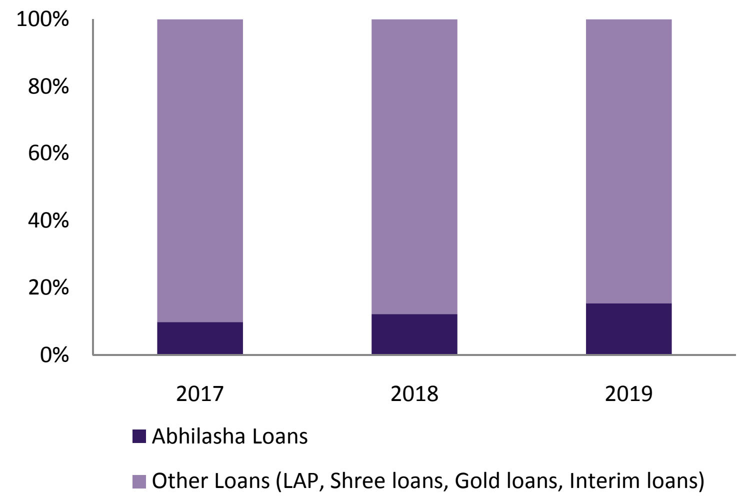
^ Higher end of price band of ₹856 has been considered;

Source: Red Herring Prospectus, Dealmoney research

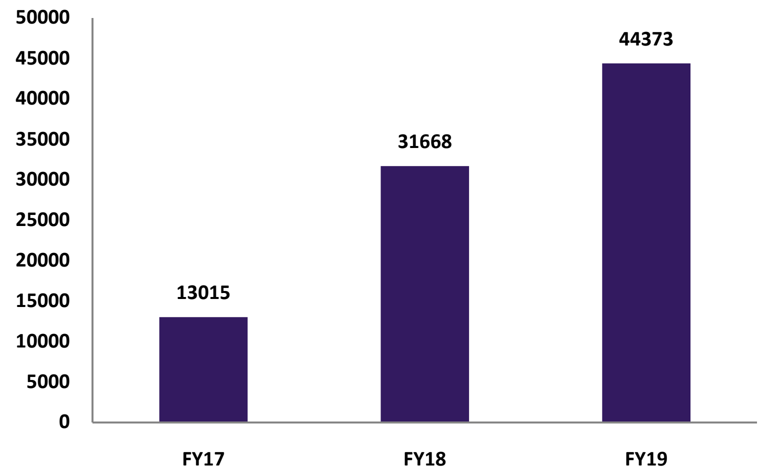
Financial Performance



Loan Book Split



Gross AUM Growth



Key Risks

- The operations are concentrated in the states of Karnataka, Madhya Pradesh, Orissa, Maharashtra and Chhattisgarh and any adverse developments in these states could have an adverse effect on our business, financial condition, results of operations and cash flows.
- There is outstanding litigation against the Company, its Directors, one of its Promoters and one of Subsidiaries which, if adversely determined, could affect the business and results of operations.
- It had negative cash flows in the past and may continue to have negative cash flows in the future.
- It has certain contingent liabilities that have not been provided for in financial statements, which, if they materialize, may adversely affect the results of operations, financial condition and cash flows.
- In order to support and grow the business, it must maintain a minimum capital to risk weighted assets ratio, and lack of access to the capital markets may prevent it from maintaining an adequate ratio

Source: Red Herring Prospectus, Dealmoney research

Summary Financials

Income Statement

` mn	FY17	FY18	FY19
Total Income	3,714.7	5,873.1	10,431.0
Operating Expense	1,348.6	1,021.3	2,085.4
EBIDTA	**2,366.0**	**4,851.8**	**8,345.6**
Depreciation	83.3	57.2	69.7
Other Income	561.4	356.3	54.3
Finance Costs	2,096.4	2,323.9	3,595.6
PBT	**747.8**	**2,827.0**	**4,734.7**
Exceptional items	-	-	-
Profit before tax	**747.8**	**2,827.0**	**4,734.7**
Provision for Tax	218.3	947.6	1,615.7
Profit for the year	**529.5**	**1,879.5**	**3,119.0**

₹ mn	FY17	FY18	FY19
EBIDTA Margin	78.8%	88.7%	80.5%
Net Margin	12.4%	30.2%	29.7%
ROE	-	13.5%	16.5%
ROA	-	5.0%	6.3%
NET NPA (%)	-	0.17	0.02

Balance Sheet

₹ mn	FY17	FY18	FY19
Liabilities			
Share capital	596	298	596
Share Warrants & Outstandings	41	1	41
Reserves and surplus	18,226	13,607	18,257
Minority Interest	-	-	9
Long-Term Borrowings	13,720	10,147	13,720
Deferred tax liabilities(Net)	(1,998)	(3,841)	(2,000)
Long term Liabilities	223	180	225
Long term Trade payables		-	-
Long Term Provisions	3	4	4
Trade Payables	637	-	-
Other current liabilities	15,530	347	648
Short term borrowings	3	12,965	15,755
Short Term Provisions		93	63
Total Liabilities	**46,982**	**33,802**	**47,317**
Assets			
Loans	41,654	30,896	42,678
Net Assets	92	85	268
Non Current Investments	646	1	1
Long Term Loans & Advances	83	14	128
Other Non Current Assets	127	2	2
Sundry Debtors	35	25	35
Cash and Bank	3,482	2,078	3,518
Other Current Assets	2	8	103
Short Term Loans and Advances	860	694	584
Total Assets	**46,982**	**33,802**	**47,317**

Source: Red Herring Prospectus, Dealmoney research

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