"SKS Microfinance Limited Q3 FY11 Results Conference Call"

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Note:

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Moderator: Ladies and Gentlemen, good day and welcome to the Q3FY11 results conference call of SKS Microfinance Limited. We have with us today Dr. Vikram Akula, founder and chairman; Mr. M. R. Rao, MD and CEO; and Mr. Dilli Raj, CFO. I would now like to hand the conference over to Dr. Vikram Akula. Thank you and over to you, Sir.

Dr. Vikram Akula: Thank you and good afternoon everybody. Thank you for participating in our earnings call. Apart from apprising you of the quarterly financial performance we also wish to give you an account of the social value added and I am going to actually start with that dimension. At SKS Microfinance, in parallel to creating shareholder value we also strive to create social value for our rural borrowers by providing timely access to capital. Let me explain. Despite calling economics a social science many of us fail to understand the power of credit in the hands of individual poor women. One easily understands the positive impact of say Rs. 1,000 crore loan to a power generation unit or a cement company. What we want to do is spend a few minutes explaining the impact of small loans of Rs. 2,000-Rs. 26,000 to 77 lakh borrowers across the country and what the impact is on the rural economy. Let me start with the number of people. Assuming five members per household, we have made a positive change in the lives of 38.5 million rural poor i.e., about 3% of the Indian population. If that is not palpable enough, let us look at a list of productive assets that have been added to the rural economy through SKS's micro-loan assistance, which aggregates to a cumulative disbursement of Rs. 21,431 crores over the six years that we have been in operation. I will take a few examples, which are among our most significant areas of lending. In the areas of large livestock, in Q3 we added 2.7 lakh buffaloes and cows to bring the cumulative number to 41.29 lakh. In the realm of kirana shops or small grocery stores, this quarter we have added 1.1 lakh general and kirana stores to bring our cumulative lending to 18.2 lakh kirana stores. In the area of small livestock, goats for example, this quarter we have added 44,511 goats i.e., a cumulative total of 6.25 lakh goats since we have started operations. In terms of dhabas or small hotels or micro-diners, we have added this quarter 28,568 dhabas, which brings our cumulative figure to 5.89 lakh dhabas and then in terms of weaving and tailoring units we have added 73,000 weaving and tailoring units, this would bring our cumulative total to 19.23 lakh weaving and tailoring units and finally cell phones or productivity enhancing product we have added 4,698 cell phones that we lent leading to a cumulative total to 3.68 lakh cell phones. Now, each one of these has their own significant economic impact.

Buffalo Economics:

I want to give you one example, let us take a milk producing animal like a buffalo - each buffalo yields about 7 liters of milk per day, which is sold at Rs. 20 per liter with a yield period of nine months, sometimes ten months a year i.e., somewhere in the range of gross revenue of Rs. 38,000- Rs. 40,000 on each buffalo. Typically a buffalo gives birth to a calf whose economic value ranges anywhere from Rs. 5,000- Rs. 10,000. So depending upon the assumptions it could be a gross yield on a buffalo of Rs. 50,000. Now the upfront investment needed to buy a single buffalo is anywhere between Rs. 15,000- Rs. 20,000, so based on the case study that we have given, we estimate that a micro enterprise typically generates something in the range of Rs. 50,000 per annum. Accordingly, the 7.7 million micro-enterprises funded by SKS alone add somewhere in the range of Rs. 37,000 crore to the rural GDP, which works out to 0.8% of India's GDP and this is without including the indirect impact. I think we have made our point that the social impact that we are creating is SKS Microfinance’s parallel to kind of shareholder value that we are also trying to create.

SKS Trusts:

A second social area that I wanted to highlight is the SKS Trust. As many of you may know SKS borrowers are members of a trust and those trusts own a significant part of SKS Microfinance. For them there is a direct impact from the shareholder value that is created, for example, the trust sold 20 lakh shares in the IPO and generated Rs. 194 crore and today the trust owns 11.27% of SKS Microfinance on a fully diluted basis, which translates into a holding value of more than Rs. 500 crore. Upon monetization from time to time of their holding, the corpus is utilized to create durable social assets in the areas of education and health, so this is a direct way that a number of communities participate in the shareholder value that is created.

Malegam Committee Report (MCR):

The third and final area that I want to talk about before handing it over to my colleagues is the Malegam report. As all of you know the Malegam Committee has come out with a set of recommendations for microfinance and we generally welcome the recommendations that have been put forth. The recommendations have provided a tremendous boost to the sector and reaffirmed the critical role microfinance plays in financial inclusion. We feel that the committee’s recommendation will lead to an orderly and healthy growth of the sector, enabling microfinance institutions to continue to provide access to finance for millions of unbanked households across the country.

Specifically I want to highlight three dimensions that we are particularly happy to see in the report. The first is that there is now regulatory clarity. Up until now there was some confusion on- "do the states regulate MFIs or does the RBI?" The committee report makes clear that the RBI will be sole regulator specifically for NBFC-MFIs and therefore there is no regulatory void for any state government to step in. This brings a kind of regulatory clarity that we need as a sector to look forward, specifically the creation of the NBFC as NBFC-MFI category is something that is in line with our long pending request to the RBI and we are delighted that the committee has made this a part of their recommendation. The second dimension that we are very excited about is that there will now be no contagion of what has happened in Andhra Pradesh to other parts of the country, specifically the committee's recommendation that the A.P. MFI Act be withdrawn and for the committee to give seven independent merit based reasons and arguments why the A.P. MFI Act is no longer necessary provides tremendous relief to us. Our hope is that the State Government officials will examine closely the recommendations and eventually will rescind the A.P. Microfinance Act but at the very least even if that takes some time what the specific recommendations does with regards to the A.P. MFI Act is it ensures that other States do not create similar legislation in those specific States. This is especially true because the recommendations are very clear about addressing concerns such as pricing and recovery practices that the A.P. Act was supposed to take up and now that the recommendations have done that our expectation is that other States will not create a similar type of Act and that hopefully even the A.P. Act will get rescinded. We are also delighted to see that the recommendations gets into specific operational details such as allowing borrowers to choose the repayment period, the repayment frequency whether that be weekly or monthly and these are the types of recommendations that will again ensure that a State Governments does not feel obliged to create an Act similar to the A.P. Act. The third and final dimension that we are excited about the recommendations is the affirmation of the priority sector lending status for NBFC-MFIs. Clearly, the priority sector status has helped bring credit to the sector and the fact that the committee has reaffirmed this reiterating that microfinance is a national priority, we think is a very important boost to the sector. On the dimensions that perhaps we are less excited about - clearly we are opposed to the idea of margin caps. Ideologically we think that margin caps will restrict the free market play and ultimately not necessarily be the best thing for borrowers, so that is something that we are not as keen on; however, it turns out that in effect this will actually help SKS Microfinance and it will do so because as an institution we can handle those margin caps. We have the efficiency and the economies of scale where those margin caps are easily achievable by us and in fact what will happen in the sector more broadly is there will be a consolidation in the industry. In fact, the MCR, the

Malegam Committee Recommendations, are very explicit about wanting to achieve that - wanting to change the sector such that you have a few number of large players instead of the hundreds of small and medium size players that exist today. So as a result of these margin caps you will have fewer MFIs as some MFIs would not be able to handle those margin caps and because of this consolidation what you will also have is individual MFIs that continue to exist like SKS Microfinance will invariably have the opportunity to provide larger ticket sizes. This will enable MFIs like SKS to become more efficient and benefit from those efficiency gains and therefore whatever affect there might be from margin caps will be more than offset by the fact that ticket sizes will increase. In fact, if you look at SKS Microfinance today, we have already dropped our interest rates across the country to 24.6% which is well within the Malegam Committee's recommendations. Those recommendations are that a large MFI can charge 10% over the cost plus a 1% fee, so effectively adding 12% to your cost of funds, so at 24.6% we are already well within the limit and depending upon what the cost of funds are, we may have to make some slight additions, but largely the margin cap is something that is quite feasible for us. A final thing I will mention before turning it over to my colleagues is when thinking about the cost of borrowing from the perspective of a borrower, let me introduce the idea of the true cost of microfinance and the true cost of microfinance is not simply the interest rate. From the perspective of the poor, there are other costs that they consider when they look at different options to borrow and I am going to give an analogy from the automobile industry. In the automobile industry, it is not just the sticker price of the car that matters but also fuel efficiency, maintenance cost, and other associated costs. That is why auto manufacturers use the concept of total cost of ownership when they sell cars. The same is true in microfinance. The borrower may compare a 24% loan from SKS to a 12% bank loan or even a subsidized 7% loan or for that matter in the state of Andhra Pradesh a highly subsidized 3% loan, but when a borrower does that they look at not just those interest rates but also the transaction cost, they look at the travel cost, how many trips it takes to go to a Bank branch where they might need to get one of these subsidized loans, what are the bus fares, what are the opportunity costs such as a day's lost wage of having to make this trip, what are the other transaction costs, every things from broker fees to filling out an application to the cost of collateral, and finally let us be honest, they also look at the cost of bribes. The World Bank, in a study called Access To Finance, estimates that bribes on government scheme lending are as high as 42% for the value of the loan, so when they look at a subsidized loan of let us say 7% or 3%, they are also adding these other costs and what they are finding is that a microfinance loan tends to be very attractive when you look at that true cost of borrowing. With a margin cap, it may bring us down from 24.6% to let us say 24%,

SKS Microfinance therefore becomes even more attractive and this will help us consolidate not just loans from some other MFIs but really loans from the broader universe of lenders. With that let me turn over to M. R. Rao.

M. R. Rao: Good afternoon, this is M. R. Rao here, thank you all for joining in this call. I will give you an update on the operations in Q3 from October 1st to December 31st. Q3 began actually on a good note till October 15th and on October 15th, the A.P. Government introduced the Microfinance Ordinance with no transition period and some parts of the ordinance and the rules were with retrospective effect, for example, collection of installments on monthly basis and so on and so forth. This effectively derailed our operations for some time. So our first and foremost priority after the introduction of the ordinance was to get ourselves registered and comply with the ordinance and we did that pretty soon and we were registered in all the 23 districts under the ordinance. There were considerable disruptions in the field due to extralegal measures adopted by different stake holders at the village level. Despite this, our field force continued their efforts and we are happy to report that there has been a significant improvement in the attendance at the various center meetings and we are able to now go to the villages without any hindrance. One of the main features of the ordinance with retrospective effect was the change of collection frequency from weekly to monthly mode. This resulted in us having to change our IT systems, the reporting structure, re-training the staff to move to a monthly mode. We did this by December and our staff started going back to the field to collect the installments from the members. However, while the law mandated us to collect on a monthly basis the borrowers are facing a huge hardship as most of their businesses are on a daily cash flow basis and they are more comfortable repaying on a weekly basis rather than a monthly basis. So there was huge demand from the borrowers that repayments should be on the weekly basis and we have taken up this with the Government of Andhra Pradesh. Another major concern on the ordinance which subsequently turned into an Act in the middle of December was that we had to take prior approval from the Government of Andhra Pradesh for every fresh loan that we disburse. This entails humongous collection of data from the borrower level- just to give you an illustration, if a borrower applies for a loan we have to fill up 21 columns of data to be submitted to the Government. This includes borrowings from other MFIs, from informal sources, from the SHG bank linkage program, most of which is not available with the borrowers. In spite of this, we have been able to submit 13,000 loan applications to the Government after collecting the data from the borrowers and there are another 76,000 loan applications in the pipeline where our field staff are actually painstakingly collecting information from the individual borrowers to fill up the forms before submitting it to the Government. Out of the13,000 loan applications

that we have submitted ever since the ordinance came into effect, we have got about 29 loan approvals and we have disbursed these loans. However, given the disruption in field operations we have been trying different methods to improve the attendance and improve our relationship with the borrowers - we have piloted different strategies and one of the strategies that is paying off well is our Group Leader meetings. Typically, each borrower has to be a member of group of five and this group of five women has a leader called a Group Leader. At different branches we have been calling the Group Leaders to a common area and explaining them the impact of the ordinance and what are the rules of the ordinance and the fact that we need to take prior approval from the Government and so on and we are also communicating to the borrowers that if meet the rules laid down as per the ordinance, we are willing to disburse and the fact that we have disbursed 29 loans based on approvals and some more loans where we had a prior approval from the Government. We conveyed to the borrowers our intent to continue to be present in Andhra Pradesh in the MFI space. This had the positive rub off in the branches that we have conducted Group Leader meetings and both attendance and repayments have improved. While interacting with the borrowers what has come out startlingly is the fact that over the last three months they have not been getting any loans from anybody else, so all the MFIs have been stopped from lending due to the MFI Act, and the Government is not bridging the gap. There is a huge demand-supply gap and so the borrowers are being forced to go to the moneylenders and borrow at usurious interest rates, which is exactly what the ordinance was supposed to prevent. What we are confident is that once this approval process gets streamlined by the Government and we start lending, there is a huge demand at the ground level for us to be able to get back our operations back on stream. In the last three months, we as management, with support from our board, have been engaging the Government of A.P. as well as the Central Government and other stake holders in trying to get this MFI ordinance to be more MFI friendly. Effectively, we started the Group Leader meeting about one-and-a-half months back. In the last one-and-a-half months, we have managed to meet 62,000 Group Leaders who represent 300,000 customers and one-to-one interactions with them has given us the confidence that the situation will improve drastically once we start disbursals in Andhra Pradesh. As I stated earlier, there are another 76,000 loan applications for which we are collecting the data and the field is also collecting more loan applications from the customers who have met our criteria and the data for those customers is also being collated to be submitted to the Government of Andhra Pradesh. While this was going on in Andhra Pradesh, our non-Andhra Pradesh portfolio continues to do business as usual. While we had to reduce disbursals on account of lower bank lending, we are happy to report that the repayments have not been affected at all. We did disburse about Rs.1400 crores in non-

A.P. States in the last three months and our operations continue to be smooth in all 18 non-AP states. So, essentially Q3 was a quarter for consolidation. While this was going on, we also tried to de-risk our business by piloting gold loan business in five branches in Karnataka and Gujarat- three branches in Gujarat and two in Karnataka and while that pilot is still very new, it is just less than a month old, we are happy with the results so far and if things go according to plan, we intend to scale up this pilot and expand to cover more branches and more States. Essentially we disbursed about Rs. 1,590 crores in Q3. Due to the A.P. ordinance, we have not opened any new branches. We have also frozen recruitment. Basically, we always have a pipeline of loan officer trainees' (the Sangam Manager trainee) to take care of attrition and because of the fact that we are not opening any new branches we did not recruit any new loan officer trainees. The natural attrition in this business led to the staff count coming down by about 1300 numbers. Because of no disbursals in A.P. and low disbursals in the rest of the country, our gross loan portfolio reduced by 7% quarter-on-quarter but there was a year-on-year growth of 33% with the gross loan portfolio book at Rs. 5,028 crores. With this I will hand it over to Dilli Raj.

Dilli Raj: Thanks M. R. and I thank all the participants for taking time-out. I just want to start with the perspective that this A.P. crisis raised serious concerns on five fundamental aspects of microfinance as a business activity-

1. First and foremost, I think the very business model validity was challenged.
2. Second, there was a regulatory haze,
3. third I think the future of A.P. portfolio came under question, and
4. fourth, many concerns were expressed on the proposed contagion risk on non-A.P. portfolio, and
5. Finally, there were lots of uncertainties on the funding side.

Now if we treat Malegam Committee Report (MCR) as the approach document and read in conjunction with the Q3 results, which are in front of you, I think one would easily note that we have absolute clarity on four out of these five issues and some amount of clarity on the fifth issue also. Let me quickly articulate.

Regulatory clarity:

RBI will be the sole regulator and not just that, RBI will also start regulating us on the functional aspects like pricing, transparency, governance, customer grievance handling, etc. One is happy about it because there is no regulatory void or gap left for

anybody else to step in, leave alone the State Governments. So we have absolute clarity on the regulatory side.

Contagion risk is mitigated:

As Vikram said, since the proposition is that the State Governments stay away from getting into this legislative piece, the contagion risk is mitigated but most importantly if we were to look at the collection ratio we have given in the deck it is 99% for Q3 also. You would readily agree that the propensity for others to just rush in with something like A.P. legislation would be more pronounced in the first 90 days rather than the next 90 days. Of course, the Malegam Committee makes a clear-cut recommendation that State Governments should not get involved in it, so we have certainty on the contagion risk too.

Funding certainty:

There was so much speculation on whether the priority sector status would continue, now it's here to stay. The second important aspect of that is moving beyond Malegam Committee's report, Reserve Bank of India has also issued a circular giving the dispensation to the participating banks that even if they were to restructure or reschedule some of their MFI exposure they could continue to treat that as standard assets. The argument is not that SKS is going to immensely benefit out of it because I do not think we would make use of that dispensation but the argument is that it significantly enhances the confidence of the bankers in taking credit decisions on the sector. It strengthens the psychological foundation considerably.

Business model validity:

Going back to the point M. R. said, in this crisis period if A.P. Government or for that matter any Government were to step in and put out Rs. 5,000 crores, one could have accepted that the validity is challenged or for that matter if mainstream banks or any other credit guarantor had quickly reinvented a model to reach across to the rural poor on a collateral free manner, we could have said that business model is challenged. Now that is not the case, that is not going to be the case, so that is the clarity one has on the business model aspects, and Malegam Committee also reiterates that we are an important plank in the whole grand scheme of financial inclusion.

A.P. scenario:

Finally, that leaves us with the A.P. scenario, I said we do not have complete clarity, but we have some clarity. Treating MCR, Malegam Committee Recommendation, as the approach document there is a specific request to withdraw the MFI Act of A.P. on seven merit based arguments and that process is continuing.

With that, I will just quickly move on to the Q3 numbers.

Q3FY11 Results:

As set out earlier, the priority for Q3 has been the following-

1. To combat the A.P. crisis,
2. Insulate the non-A.P. portfolio from A.P. portfolio or this risk casting its shadow over them,
3. To continue to deliver on all our promises, meaning, meet the corporate obligations, and
4. Finally protect our investment in the franchise building intact.

Now, if you take a quick account of what happened, I think we seemed to have achieved all those obligations. Number one, we repaid every single rupee of interest or loan repayable to every single banker and met all our corporate obligations. Second, we did not lose a single field officer but for the natural attrition. Third, we maintained 99% collection efficiency in non-A.P. portfolio, and finally we ended the quarter with a strong net worth of Rs. 1,845 crores and cash and bank balance of Rs. 398 crores leaving no room for any concern whatsoever on solvency or liquidity.

Now, let me get into the financials quickly. Looking at the highlights, gross revenues are up by 5% QoQ, muted for SKS's standards primarily because there was a deceleration in the incremental disbursement from Rs. 3,171 crores in the previous quarter to Rs. 1,590 crores. Second, in terms of moving on to the expenses side, financial expenses in absolute amount went up by 7% (QoQ), but if you look at it as a percentage, which you should, cost of borrowings were contained at 11.6% for both Q3 and Q2 despite base rates moving up by 150 basis points. Then we move on to another important cost item that is the personnel cost, which is probably the largest cost component of our model that was again controlled in absolute amount at Rs. 88 to Rs. 89 crores (QoQ) but as M. R. pointed out, head count reduced by 5% between the two

quarters for the reason of natural attrition. The total operating cost was contained at Rs. 140 crores but cost to income reduced to 48% from 50%.

Provisions and Write-offs:

Now I would take probably a minute to explain this very important aspect of the P&L configuration - that is "provisions and write-offs". As you could notice, we have made a provision and write-offs of Rs. 100.75 crores, a 7.5 fold increase YoY, 4.8 fold increase QoQ. There are three important items. For the A.P. portfolio, the provision and write-offs is Rs. 58.74 crores, non-A.P. Rs. 15 crores, and also there is another item of voluntary provisioning of Rs. 27 crores adding up to Rs. 100.75 crores. First and foremost, I want to confirm that we have not made any accounting policy change to abate the pain on the A.P. crisis so the complete hit has been taken on that account for incurred loss. As you know, we have a provisioning policy for a weekly product and a monthly product; both are much more stringent than the extant RBI provisions so we have followed with that. Now, let me take a minute to explain the voluntary provisioning of Rs. 27 crores. What we did was we have accepted MCR as the approach document. If you look at MCR, i.e. Malegam Committee Recommendation, the stipulation is that you should either have 1% of all your assets as cumulative provisioning or 50% of the overdue installments beyond 90 days and 100% of overdue installments beyond six months and you need to have whichever is higher, either the former 1% or the latter stipulated provisioning. We looked at it and wanted to embrace it voluntarily ahead of schedule and that self-imposed financial discipline resulted in hit of Rs. 27 crores and but for it, if we had not self-imposed that financial discipline on us ahead of schedule, our PAT could have been higher by another Rs. 18 crores.

Balance Sheet:

Then we move on to Balance Sheet. As I said, net worth was an impressive Rs. 1,845 crores and we ended with a cash and bank balance of Rs. 398 crores. The ratios are available with you in the deck, just to make one point on the RoRA, Return on Risk Asset, it reduces to 2.6% but primarily on account of this voluntary provisioning and of course the credit loss we have taken on the A.P. portfolio. If we were to readjust the numbers without this voluntary provisioning, the RoRA would be 4% almost close to 5% last year number. Capital adequacy is an impressive 35.7%. Here I would stop for a minute and go back to Malegam Committee Recommendation. It stipulates high restriction on securitisation and assignment of loans where for the credit enhancement part of it, it wants a dollar to dollar adjustment out of the capital rather than treating the

credit enhancement as an off balance sheet or a contingent liability into 50% risk weight and taking capital requirement as just 15% of that. If we just quickly do a back of the envelope calculation, even if we were to assume that we maintain 30% of our book as off balance sheet, we normally have given maximum of 8% FLDG so that would convert into a credit enhancement of Rs. 2.4 for a balance sheet size of Rs. 100, so even if you were to deduct the Rs. 2.4 or let us say 2.4% out of this 35% capital adequacy, the reconstructed capital adequacy of 32.6% is significantly higher than the mandated 15%.

Funding:

On the funding side, as you could notice despite all that has been written about banks slowing down their lending we had managed a sanction of Rs. 1,500 crores of which about Rs. 400 crores was disbursed by a set of nine banks and as we speak today, we are sitting on a sanctioned pipeline of somewhere around Rs. 2,700 crores and post RBI dispensation on standard asset treatment and Malegam Committee's forward looking encouragement to the banks, in specific the recommendation that flow of credit from that banking system to the sector be augmented, we have been holding discussions with our bankers and we are reasonably confident that bulk of this huge sanction pipeline will be translated into cash in the time to come. Now we can go back to question and answers.

Moderator: Sure sir. Thank you very much. We will now begin the question and answer session. Anyone who wishes to ask a question at this time may press "*" and then "1". Participants are requested to use only handsets while asking a question. Anyone who has a question at this time may press "*" and then "1". The first question is from Ashish Sharma from Enam Asset Management, please go ahead.

Ashish Sharma: Good evening Sir and good set of numbers considering the operating environment we were in. This clarification now with this Malegam Committee Recommendation coming in now, what is the process for this Malegam Committee Recommendation superseding the A.P. MFI Act Sir?

Dilli Raj: See, first of all we need to understand that this is a subset of RBI board. Just for want of vocabulary, it is not headed by an external academician where one has to closely deliberate on. So the point I am making is it is really an executive body of Reserve Bank of India but in terms of process, RBI needs to dwell over it, look at it and then translate them into circulars, notifications, etc. That is one part of it and we guess once that is done, that would bind the A.P. Government like any other citizen of this country

because, again not to get into the legal aspects but just as a matter of information, Reserve Bank of India Act is the only Act of the parliament which starts with the wording saying that "notwithstanding any other provisions of any other act". Having said that, I think we are in the hands of a very matured regulator, a regulator who adds balance to the financial system all the time including global balance and I am sure that would be coordinated among the Ministry of Finance, Reserve Bank of India, and the honorable A.P. Government.

Ashish Sharma: The point that I just wanted to make or get an understanding on was that now no regulatory or the self-regulatory body of MFI needs to take any legal process to ensure that this act when it is entirely under the purview of RBI they need to ensure that this become superseded the A.P. MFI Act?

Dr. Vikram Akula: This is Vikram. I will just add to what Dilli said and also answer your question. The committee is very explicit in giving a date, what they have given is 1st April, 2011 and I will read from the report- "1st April, 2011 may be considered as a cut-off date by which time our recommendations if accepted, must be implemented, and in particular the recommendation as to the rate of interest and so on and so forth", so basically they are giving a final date by which this must be accepted. Now there will obviously have to be some coordination between the RBI and the State Government. As you know, this committee's recommendation uses the word- "we request the A.P. Government to revoke the act" but after April 1st our reading is that is no longer a request but it becomes a mandate. RBI has its own channels for making their position clear to the A.P. State Government. We as MFIN network or as an individual institution would not need to take any legal steps, that is something that the RBI and the State Government would coordinate.

Ashish Sharma: Okay Sir. Now just a clarification on the asset quality. You have mentioned that the gross NPA is 0.38%, Rs. 18.2 crores, we have write-off around Rs. 50 crores in the A.P. portfolio. Now this whole Rs. 50 crores is off the books, I mean we have already provided for the losses?

Dilli Raj: That is correct since it is a write-off it has gone off the book.

Ashish Sharma: And we had provided that voluntary provisioning of Rs. 27 crores, I actually missed that point, you had mentioned that, so this is as per which option, is it 1% of the outstanding loan portfolio? Going forward incrementally, do we need to provide anything or is it the other two options, which is mentioned in the Malegam Committee Recommendation Sir?

Dilli Raj: Under the 1% option because actually it is whichever is higher, if we were to go with the set B option that is 50% of overdues on three months, 100% of overdues on six months, the cumulative provisioning we need to do will be much lower than the 1% so we bridge the gap with 1% .

Ashish Sharma: Okay, so 1% of outstanding loan portfolio?

Dilli Raj: Yes.

Ashish Sharma: And incrementally it would be very marginal because it would be on the incremental loan portfolio?

Dilli Raj: Absolutely.

Ashish Sharma: Fine sir, thanks a lot and all the best for the next quarter.

Vikram Akula: Thank you very much.

Moderator: Thank you. The next question is from Anand Vasudevan from Franklin Templeton, please go ahead.

Anand Vasudevan: I would like to get clarification on the statement that Mr. Dilli Raj had made. I think you had said that you have not made any changes to provisioning norms to accommodate the situation in Andhra Pradesh. However, my understanding is that you have made changes to your earlier practice of starting providing loans that become non-performing, within eight weeks of becoming non-performing and that seems to have been changed for the A.P. portfolio, so I would just like to understand what is happening there and also putting it in the context of the collection efficiency that you mentioned by State A.P. is running at 43.6% on a approximately Rs. 1,500 crore portfolio. I would like to understand what your view is on the collectability and therefore on the future provisioning incidence on the A.P. portfolio?

Dilli Raj: Thanks Mr. Anand Vasudevan. If you look at our FY'08 to FY'10 balance sheet we had two products, a weekly product called IGL loans (JLG model) and also a monthly product called ILP. Now we had two different sets of provisioning policies. For a weekly product, yes you are right the ageing norm was eight weeks and for 8 to 25 weeks we would provide 50% and beyond 25 weeks would write them off. On the monthly product, three months is the ageing period and for three to six months 10% provision, six to twelve months 50% provision and beyond twelve months 100% we

would write them off. Just to quickly clarify, both of them are much more stringent than the extant RBI provisioning, which gives you a time up until 180 days for ageing and thereafter 10% up to one year and thereafter write-off, so we did have two sets of policies for weekly and monthly. Now, in the case of A.P. portfolio, a weekly product has been converted into a monthly product by the force of law and we had very little say in the matter, so therefore because it has become a monthly product the applicable policy was followed.

On the question of collectability and future provisioning- now as we have said in our clause 41 filing with the stock exchange, at this stage we plead inability to predict the collectability or for that matter future provisioning on this portfolio primarily because of four or five reasons, number one there is absolutely no precedence for this for us to get the help of the learning curve here to make any predictions. Number two, as RBI has chosen to describe this, this is not on account of weakening of the credit profile of the underlying borrowers, so this is not a typical asset quality slippage, this is on account of external intervention, which RBI calls as environmental factors. What is the difference between October 14th or October 15th, it is just A.P. ordinance, so if something were to be done in that regard the whole thing will change, it is not that the underlying businesses of the consumers have changed or adversely impacted, so that is the second reason. The third is, truly speaking we really have too little data, yes between October 15th and December 31st it could be two-and-a-half months. We have put the collection efficiency saying that yes of course it is abnormal at 44%, but within that three months also there are three different months, October is different from November, November is different from December because in October it is just something like A.P. legislation hitting us like a bolt from the blue. And November, there were field disruptions and December is training and retraining our field staff, changing MIS, and things like that. Those are the reasons, which preclude us from really predicting the collectability. Having said that, I want to reassure you that no incurred loss has been ignored and under this, all incurred losses have been provided and in addition we have made that voluntary provisioning also.

Anand Vasudevan: Okay, thanks for that. Also in West Bengal your collection ratio is 95%, I am wondering whether that is unusual, what was it for all of FY'10 and is 95% running below normal or is that in line with your expectations?

Dilli Raj: You raised a valid question on this. Now what happens is, if you have our deck for Q1-Q2 and last year also, the ratios between 90 to 99% for a particular State is very nominal, for instance if you look at the early part of FY10, Chhattisgarh would have

had an NPA of about 5% and if you see in some other period, if you go back to the credit loss ratios we have given in Karnataka it would have gone to you know, 5% or 10% and then it comes back so that is the background. It is quite usual for a particular state to slip out on particular reason and revert to normalcy.

Anand Vasudevan: Okay, and is there any specific reason that we could understand what was happening in West Bengal?

M. R. Rao: The slippage is primarily on account of external factors and pockets where the local politicians tried to influence the members not to pay stating that the similar ordinance or act like the Andhra Pradesh Government would be passed in West Bengal also. But we have gone back to the members and communicated to them the actual facts and so we will see a significant improvement in the collections going forward there.

Moderator: Thank you. The next question is from Shaba Rizivi from Darashaw & Company, please go ahead.

Shaba Rizivi: My question is with regards to the calculation of the cost of funds. Now I am looking at your presentation, your cost of fund includes the cost of debt and the cost of equity, which comes up to around 14.4%. Now if you look at the Malegam calculation point number seven, point seven in the report while mentioning the cost of funds they have actually mentioned just a cost of debt and from thereon they have calculated the cost of funds and on top of it the return on equity part comes under internal cost, which forms the part of the margin cap and if you take that calculation into picture only 9.1% would qualify for the cost of funds as per the calculation done by the committee, so would request your comments on that.

Dilli Raj: Okay, If you go back to the normative example used by the Malegam Committee in their report, in principle, they are saying that equity has a cost, so they are not stopping at the fact that there is no accounting cost on equity and they admit that there is an economic cost and I would say a reasonable number of 22% pre tax and 15% post tax is allowed. Now our interpretation is that cost of funds of course would include debt and equity and you need to provide for both. Now we have sought clarification from Reserve Bank of India parking that for a moment going back to our illustration in page 14 of our deck, the point is our cost of borrowing is 12% if you were to say that cost of equity is not allowed it would not be 9.1%, then it would be 12% because we have assumed here equity and debt mix based on our FY'10 balance sheet. Now, if you re-look at Malegam Committee Recommendations, what they are saying is that what comes into immediate effect is this 24% from 1st April so the rest of the margin cap is

for us to wait for your balance sheet and look at what has been the margin, it is more of a lag factor than a lead factor. We did a quick calculation saying that if you go with that 24%, there is 1% processing fee in addition to that, therefore you could talk about a portfolio yield of 26.1%. Then we tabulated the numbers based on our FY'10 template without assuming anything, just a quick extrapolation of that, would indicate that we are left with a net portfolio yield of 2.9% and we have also removed the earnings on products, which we may not be able to do, for instance you cannot charge membership fee or for that matter group admin charges, so we have assumed nil earning on that, but retained those which are allowed under the framework of Malegam Committee Recommendations, like retail insurance commission of 0.6% and other income of 1%, then we are left with RoRA of 4.5%, and ROA of 4.3% and even if you were to include off balance sheet into it something like 3.3%, so in terms of compression, FY'10 was 5% that comes down to 4.3% on ROA and ROA including off balance sheet was 3.7% for FY'10 that could come down to 3.3%, so we are talking about a 40 basis points compression in ROA including off balance sheet and 70 basis points compression on ROA without the off balance sheet.

Shaba Rizivi: Right, we completely understand that ROA template that you have made, the only issue is with the calculation of the cost of funds because they have taken 85% constitutes the loan portfolio, average portfolio, and thereby they have calculated at 85 considering the 12% is the borrowing cost they have calculated 10.2 as 85% or 12% as the cost of funds. Now if you take that calculation into mind, and you calculate the entire thing, the total interest that you could probably charge comes around to 19%, 20%?

Dilli Raj: No, two explanations here. Let me first talk about this 9%. If you got that our cost of borrowing is 12%. So, for a moment if you were to say that no cost of equity is provided here then it could be 12% plus 10%, 22%. Now what we have done here is this 15% capital they have assumed in the normative example is the best case scenario. That template assumes that one goes out and leverages 6.6 times, which is not practical. So, the point I am making is what is more relevant for maybe FY'11 is the 24% because if you read the fine print in Malegam Committee Report it is the 24%, which comes into immediate effect. Analysis will be a post-facto, postmortem analysis as and when you have your balance sheet ready. So what would come into immediate effect is the 24% that is what we have worked with and in the meantime we are engaging Reserve Bank of India on this cost of equity and cost of debt being treated as cost of funds because funds would include both your equity and debt, and whilst there is no accounting cost, some reasonable economic cost has to be approved on that based on whatever is our debt and equity mix, the 15:85 is an ideal situation; if, you know, from

a regulatory perspective if 15% is the capital adequacy then the assumption is that one is leveraging 6.6 times, which is not practically possible or advisable.

Shaba Rizivi: Okay. As per the new provisioning guidelines that we have after 180 days, you will have to write off the entire portfolio that is bad loans, so given the crisis in A.P. and the collection pressures in the next one or two quarters, how do you see the profitability being affected because of the new provisioning guidelines?

Dilli Raj: Okay, I will give you some numbers. As we said we are not predicting it but in the interest of transparency I will give you the numbers. Now with Malegam Committee Report as the approach document for the reason that our provisioning is much more stringent than extant RBI provisions, so if you treat that Malegam Committee Report says that all those overdues, beyond three months, we need to provide 50% and beyond six months 100%. If you look at our Q3 numbers the total overdues are Rs. 292 crores of principal and Rs.32 crs. of interest; and Rs. 274 crores are in the bucket of beyond 30 days but less than 60 days, so if you look at Q4 let us say the entire Rs. 324 crores slips beyond the 90 days and gets into the first bucket of 90 to 180 days, so by that token you need to provide 50% of this, which will work out to let us say somewhere around Rs. 162 crores. Then we already have cumulative provisioning of about Rs. 51 crores so the additional debit could be about Rs. 110 crores. But this is absolutely ultra conservative and unrealistic assumption that we do not collect even a pie. So now you look at the next case scenario. The collection efficiency for Q3 is let us say 44%, if you were to merely apply that then what would happen is this Rs. 162 crores would be reduced by another 50%, so the provisioning you do at the lower end will be Rs. 40 crores, so you are talking about Rs. 40 crores to Rs. 110 crores, with the unrealistic assumption that we do not collect a pie out of the overdue. Have I answered your question?

Shaba Rizivi: Yes, thank you.

Moderator: Thank you. Ladies and Gentlemen, if you wish to ask a question at this time you may press "*" and then "1". As there are no further questions from the participants I would now like to hand over the conference to Mr. Dilli Raj for closing comments.

Dilli Raj: Again we thank each one of you, the participants for taking out their time and if there are queries which you have, take time to reach out to our IR section, we would respond to you. Thank you.

Moderator: Thank you very much. On behalf of SKS Microfinance Limited that concludes this conference call. Thank you for joining us and you may now disconnect your lines. Thank you.