Swadhaar FinServe Pvt Limited

MFI Grading Report

December 2008

Swadhaar FinServe Pvt Limited (SFPL)

Year of incorporation : May 2008 Legal Status: Non Banking Finance Company Type of Institution: MFI Lending Model: Group Lending and Individual Lending	Ms. Veena Mankar, Managing Director Swadhaar FinServe Pvt. Ltd. 5/39, Shree OM Co-operative Housing Society Anand Nagar, Guru Narayen Road Off LIG Nehru Road, Santacruz (E) Mumbai - 400 055 Phone : +91-22-26138700 Fax: +91-22-26138797/8 Email: vmankar@swadhaar.com Website : www.swadhaar.com

MFI Grading mfR1 mfR2 mfR3 mfR4 **mfR5** mfR6 mfR7 mfR8 mfR1:highest mfR8: lowest	CRISIL's microfinance institution (MFI) grading is a current opinion on the ability of an MFI to conduct its operations in a scalable and sustainable manner. The grading is assigned on an eight-point scale, with 'mfR1' being the highest, and 'mfR8' the lowest. The MFI grading is a measure of the overall performance of an MFI on a broad range of parameters under CRISIL's MICROS framework. It includes a traditional creditworthiness analysis using the CRAMEL approach, modified to be applicable to the microfinance sector. The acronym MICROS stands for Management, Institutional arrangement, Capital adequacy and asset quality, Resources and asset-liability management, Operational effectiveness, and Scalability and sustainability.

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1 Rationale

CRISIL's microfinance institution (MFI) grading of **'mfR 5'** reflects the following strengths of Swadhaar FinServe Pvt Ltd (SFPL):

- Strong governing board
- Adequate capitalisation levels and shareholder support
- Strong technical and managerial support from ACCION International[1] (ACCION)

The abovementioned grading strengths are partially offset by SFPL's:

- Short operating track record
- Asset quality and credit risks untested over a period of time
- Low efficiency, leading to weak earnings profile

Profile

SFPL is a non-banking financial company (NBFC), targeting the urban poor in Mumbai. It was registered with the Reserve Bank of India (RBI) in May 2008 and started its operations in July 2008. The promoters of SFPL commenced micro credit activity in March 2006 with the inception of a Section 25 company, Swadhaar FinAccess (SFA), which was incorporated in March 2005. In September 2008, SFPL took over the entire microcredit portfolio of SFA. SFPL aims to make the urban poor self reliant, and help them engage in activities leading to income generation. Starting with a group loan product for economically active women, SFA subsequently introduced individual loans to meet the requirements of micro-enterprises of both women and men, in November 2007. The target segment for the individual loans are small entrepreneurs, who do not have bank accounts, or those with inactive banking relationships.

SFA focuses now on development activities by imparting financial education to existing and prospective clients of SFPL, playing the role of business correspondent for ICICI Bank Ltd and Citibank NA (savings accounts promotion under financial inclusion schemes of these banks), and undertaking other initiatives for improving its members' livelihood. As on September 30, 2008, SFPL had loan outstanding of Rs.18.40 million spread across 3,621 borrowers in four branches in Mumbai.

Management

The MFI grading is constrained by SFPL's short operating track record in microfinance. CRISIL believes that the processes, controls and systems need to be refined and strengthened further to minimise credit and operational risks in an unexplored Mumbai market. The company currently enjoys strong technical and managerial support from ACCION, which has rich experience in individual lending in Latin America. However, the cases of intentional defaults by borrowers in the individual loan category (which include repeat borrowers) highlight the lack of strong client screening process that is required for offering credit to the not so-poor segment in a metropolis.

Given the easier access to credit and higher financial literacy levels in Mumbai, the moral hazard risks are also very high. Therefore, CRISIL believes that a mere replication of practices followed by other NBFCs in client selection, loan screening processes and internal controls may not suit SFPL or necessarily minimise its credit risks. These processes may require modification to meet local market conditions. Likewise, the products offered and the approach strategy chosen by the MFI should also have a local flavour. The current loan recovery process includes offering multiple options to the clients for repayments and does not offer operating efficiencies. One such option is collection of loan instalments from each borrower's doorstep, even in case of group loans. SFPL is already aware of these issues and therefore, instead of pursuing an aggressive growth strategy, it is refining its loan screening and repayment collection processes before it scales-up its operations.

The company has a loan monitoring software supplied by a reputed vendor and this helps SFPL track arrears on a daily basis. ACCION, the technical partner of the MFI, is analysing the internal data to refine credit screening process, which enables more sophisticated detection of high risk clients.

[1] ACCION, established in 1961, has more than 45 years of experience in microfinance. Headquartered in Boston, USA, ACCION has more than 35 MFIs as partners in 25 countries worldwide to which it provides technical assistance. In India, it has a regional office in Bangalore.

Institutional Arrangement

The MFI has a relatively strong governing board and experienced management. The board comprises well experienced and recognised leaders in the financial sector and shareholder representatives of two international microfinance investment funds and a well known business family in India (refer Table 1). In CRISIL's opinion, the shareholding structure and composition of the board should provide the company with sound corporate governance and transparency. Similarly, the MFI has a competent management, which has experience in banking, finance, and microfinance.

The company is promoted by Ms. Veena Mankar, who has more than three decades of experience in factoring business. Ms. Mankar aims to look at urban microfinance differently from the way it is practiced in other parts of the country. She has been quite successful in raising not only the capital required to fund a non-conventional project, but also in obtaining the shareholders support for a business plan, which assumes break-even only in the long term. ACCION, one of the pioneers of microfinance in Latin America, is not only an investor but also provides technical and managerial support to SFPL. It has deputed two of its employees, which includes SFPL's chief operating officer.

Table 1: Board of Directors as on November 30, 2008

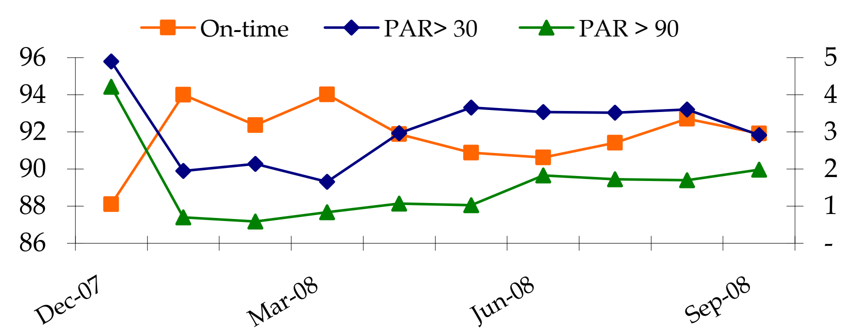
Director	Profile
Ms. Lalita D. Gupte, Chairperson	Formerly Joint Managing Director of ICICI Bank Ltd., Ms. Gupte has more than 3 decades of experience in the financial sector. She is a member of board of directors of several organisations including Nokia Corporation
Ms. Veena Mankar, Managing Director	Has over 30 years of experience in development and commercial banking. Ms. Mankar was the founding Managing Director of Global Trade Finance and an expert in factoring
Ms. Anita Ramchandran	Ms. Ramachandran, is the founding Managing Director of Cerebrus Consultants. She specialises in HR consultancy
Mr. Siddhartha H Chowdri	He is the Country Manager – India for ACCION International
Ms. Geeta Dutta Goel	She manages the Michael & Susan Dell Foundation's microfinance initiative in India. Has more than 12 years of experience in corporate finance
Mr. Srinivas Bhaskar Rao	He has more than 2 decades of development banking experience and currently represents the largest shareholder
Ms. Pearl Tiwari	Currently heads the corporate social responsibility (CSR) department at Ambuja Cements Ltd and is also the Chief Executive Officer of Ambuja Cements Foundation

Capital Adequacy and Asset Quality

CRISIL has factored in the adequate capitalisation levels to support potential credit risks and shareholders support to an untested business model as key grading strengths. SFPL had raised Rs.94 million in the second quarter of 2008-09 (refers to financial year, April 1 to March 31) from various institutional investors. As on September 30, 2008, SFPL had paid-up capital of Rs.120 million, which would be adequate to support its growth plans for the next two to three years. Given its unconventional business model, the MFI does not intend to expand its business rapidly in the next one to two years. Hence, SFPL does not expect to register surplus in the next three years. The business plan shared with its investors does not project the company leveraging beyond 0.5 times for the year ending March 2009 and March 2010.

The company's risk profile is marked by exposure to high risk segments. Even SFPL's group loans predominantly have individual loan characteristics in comparison with joint liability group (JLG) loans of other MFIs operating in cities. The asset quality is vulnerable given the unsecured nature of the loans provided to individuals. Moreover, in a city like Mumbai, the company faces relatively high moral hazard risks as its individual loan are to the not-so-poor category that has access to credit in the form of credit cards and personal loans. The MFI's ability to minimise such moral hazard risks through refinement and strengthening its credit screening process need to be demonstrated over a period of time. SFPL has indicated its plans to expand its operations outside Mumbai, and CRISIL is of the view that this could mitigate the credit risks.

Chart 1: Asset quality trend



On a monthly basis, the portfolio at risk (PAR) greater than 90 days has increased to 1.98 per cent as on September 30, 2008, from 0.69 per cent levels as on January 31, 2008. This is on account of increased delinquencies in the individual loan product category. On the other hand, the on-time repayment rates have moved in the 90 to 94 per cent range during this period. As can be seen in the graph, the trend in the on-time repayment rates have not necessarily moved in tandem with PAR greater than 90 days and PAR greater than 30 days as the on-time repayment rate of SFPL is influenced by the multiple collection options that are made available to the borrower during the course of a month.

In comparison, several of the new NBFC-MFIs with professional managements operating in other cities and evaluated by CRISIL in 2008 had lower delinquency levels on a largely unseasoned portfolio. In CRISIL's opinion the difference between SFPL and its above indicated peers is that while SFPL adopted an unconventional approach to try new product, its peers adopted group lending methodologies that were tested.

Resources and Asset Liability Management

SFPL has not yet resorted to any borrowing till December 26, 2008. The small loan portfolio is entirely funded by capital. As per SFPL's business plan, the company's borrowing requirements to fund its business growth in the next one to two years are small; CRISIL therefore believes that the MFI would not find it difficult to raise the necessary borrowings when the need arises. In the past, SFA's loan portfolio was funded by Friends of Women's World Banking (FWWB), HDFC Bank Ltd and ICICI Bank Ltd, which were repaid when SFPL acquired SFA's loan book.

Operational Effectiveness

SFPL's operations are small and do not fully cover the high operating costs in a metropolis like Mumbai. Given the difference in the clients targeted and distinct characteristics of the urban poor, the management has been conservative enough not to undertake any aggressive expansion; however, it is undertaking the lending activity on a pilot basis. Consequently, the MFI has a small base of 3,621 borrowers with a low productivity of only 905 borrowers per branch as on September 30, 2008 (refer Table 2).

Table 2: Outreach and Productivity Indicators

For the period ended	Unit	Sept-08	Mar-08*	Mar-07*	Mar-06*
Members	No.	5,162	3,524	1,387	58
Borrowers	No.	3,621	2,410	1,123	58
Borrowers/branch	No.	905	1,205	562	58
Loan accounts/ branch	No.	905	1,205	562	58
Loan outstanding/branch	Rs. Million	4.60	5.49	2.12	0.37

* These figures are for SFA

In CRISIL's opinion, the MFI's attempt to modify the JLG model in its lending activity leads to lower efficiency levels. The modifications include sub-optimal level of borrowers per group (three as against minimum of five in case of other MFIs adopting the JLG model) and collection of loan instalments individually from each borrower of the group by the loan officer. CRISIL expects the low efficiency and productivity levels to result in SFPL's earnings profile remaining weak in the next one to two years. Apart from high operating expenses, any increase in delinquency levels could lead to higher provisioning and write-offs, further impacting the profitability.

Scalability and Sustainability

SFPL, which has taken over the two-year old operations of SFA, intends to continue in pilot phase mode for the next one to two years by reaching out to towns in Maharashtra and Gujarat. Among the new NBFC-MFIs with professional managements graded by CRISIL, SFPL is one of the few MFIs, which does not expect to register surplus in the first five years of operations (factoring in SFA's past performance too). Thus, while shareholder support and adequate capitalisation could ensure sustainability of the microfinance programme during the next two years, the long term sustainability would depend on the company's ability to improve efficiency levels, while continuing to minimise credit losses.

2 Annexures

2.1 Financial Statements of Swadhaar FinAccess

2.1.1 Income and Expenditure Statement

Rs. million

For the year ended March 31,	2008	2007	2006
Fund based income			
Interest income from loans	1.98	0.84	-
Interest on bank deposits	0.10	0.14	0.06
Other income	0.05	0.01	-
Total fund based income	**2.13**	**0.99**	**0.06**
Interest and finance charges			
On borrowings	0.92	0.40	0.01
Bank charges	0.05	-	-
Total interest and finance charges paid	**0.97**	**0.40**	**0.01**
Gross spread	**1.15**	**0.59**	**0.06**
Total fee based income	**0.58**	**0.21**	**0.01**
Total income	**2.70**	**1.20**	**0.07**
Gross surplus	**1.73**	**0.80**	**0.06**
Expenses			
Personnel expenses	8.95	4.22	0.97
Administrative expenses	4.38	2.23	0.71
Operating expenses	**13.33**	**6.44**	**1.69**
Write-offs and provisions			
Write-off of bad debts	0.28	0.07	-
Provision for loan loss	-0.07	0.30	-
Total write-offs and provisions	**0.20**	**0.37**	**-**
Depreciation	0.84	0.49	0.03
Profit before revenue grants	**-12.65**	**-6.51**	**-1.65**
Add: Grants received	10.81	9.11	0.51
Less: Donations made	-	-	0.08
Net Profit	**-1.84**	**2.60**	**-1.22**

2.1.2 Balance Sheet

Rs. million

As at March 31,	2008	2007	2006
Liabilities			
Share Capital	0.60	0.60	0.14
Accumulated surplus	-0.45	1.38	-1.22
Net worth	**0.15**	**1.98**	**-1.08**
Borrowings	14.73	6.00	3.70
Total long term borrowings	**14.73**	**6.00**	**3.70**
Provision for loan loss	0.20	0.30	-
Other liabilities	2.15	1.24	0.26
Total current liabilities	**2.36**	**1.54**	**0.26**
Total liabilities	**17.24**	**9.52**	**2.88**
Assets			
Loans and advances	10.98	4.24	0.37
Cash & bank balances	1.05	1.03	1.20
Other assets & advances	1.68	0.72	0.25
Total current assets	**2.74**	**1.75**	**1.45**
Total funds deployed	**13.72**	**5.99**	**1.82**
Net fixed assets	3.51	3.52	1.06
Total assets	**17.24**	**9.52**	**2.88**

2.1.3 Key Financial Ratios

Year ended March 31,	2008	2007
Yield		
Fund based yield (A)	21.58%	25.31%
Portfolio yield*	25.94%	36.40%
Fee based income /Avg. funds deployed	5.86%	5.37%
Total income / Avg. funds deployed	27.43%	30.67%
Cost of funds		
Interest paid/Avg. funds deployed (B)	9.87%	10.21%
Interest paid/Avg. borrowings (C)	9.39%	8.23%
Interest spread		
Gross spread/Avg. funds deployed (A) - (B)	11.70%	15.09%
Spreads on lending (A) - (C)	12.19%	17.07%
Overheads		
Operating expenses / disbursements	59.89%	62.57%
Operating expense ratio	143.79%	177.44%
Personnel expense ratio	90.80%	107.83%
Administrative expense ratio	44.44%	57.03%
Profitability		
Return on net worth	-172.52%	576.76%
Return on funds deployed	-18.62%	66.57%
Operational self sufficiency	17.61%	15.55%
Asset quality		
Net write-offs / Avg. loan outstanding	3.66%	3.16%
Total loan loss rate	2.68%	16.20%
Provisioning / Avg. loan outstanding	2.67%	13.05%
Capitalisation		
Total debt/net worth (times)	100.75	3.03
Capital adequacy	0.90%	23.35%

* The actual interest rates charged are 18% flat on group loans and 36% declining basis on individual loans

2.2 Projected Financial Statements as provided by SFPL

2.2.1 Income and Expenditure Statement

Rs. million

For the year ended March 31,	2009	2010	2011	2012	2013	2014
Fund based income	**7.36**	**29.51**	**94.53**	**243.96**	**521.53**	**942.66**
Interest paid	-	1.19	21.15	53.99	138.24	263.48
Gross spread	**7.36**	**28.32**	**73.38**	**189.96**	**383.28**	**679.17**
Operating expenses	22.54	45.96	83.92	149.33	263.76	374.54
Write-offs and provisions						
Provision for loan loss	1.85	5.72	17.11	31.35	61.17	91.94
Total write-offs & provisions	1.85	5.72	17.11	31.35	61.17	91.94
Profit/ Loss before tax	-17.03	-23.36	-27.65	9.28	58.35	212.69
Less : Tax	-	-	-	-	7.08	69.12
Net Profit/ Loss	**-17.03**	**-23.36**	**-27.65**	**9.28**	**51.27**	**143.57**

2.2.2 Balance Sheet

Rs. million

As at March 31	2009	2010	2011	2012	2013	2014
Liabilities						
Share capital	120.00	120.00	180.00	300.00	300.00	300.00
Accumulated surplus	-18.03	-41.39	-69.04	-59.75	-8.48	135.08
Net worth	**101.97**	**78.61**	**110.96**	**240.25**	**291.52**	**435.08**
Borrowings	-	42.83	357.36	739.74	1660.61	2765.70
Total long term borrowings	**-**	**42.83**	**357.36**	**739.74**	**1660.61**	**2765.70**
Total liabilities	**101.97**	**121.44**	**468.32**	**979.99**	**1952.13**	**3200.79**
Assets						
Loans and advances	**38.70**	**114.54**	**415.25**	**926.62**	**1883.74**	**3128.70**
Cash & bank balances	56.87	1.34	5.42	10.21	19.75	29.32
Total current assets	**56.87**	**1.34**	**5.42**	**10.21**	**19.75**	**29.32**
Total funds deployed	**95.57**	**115.87**	**420.68**	**936.82**	**1903.49**	**3158.02**
Net fixed assets	6.40	5.57	47.64	43.16	48.64	42.77
Total assets	**101.97**	**121.44**	**468.32**	**979.99**	**1952.13**	**3200.79**

2.2.3 Projected key financial ratios

Year ended March 31,	2009	2010	2011	2012	2013
Yield					
Fund based yield	13.47%	27.91%	35.24%	35.94%	36.72%
Cost of funds					
Interest paid/Avg. borrowings	-	5.55%	10.57%	9.84%	11.52%
Interest spread	13.47%	22.36%	24.66%	26.10%	25.20%
Operating expense ratio	41.24%	43.47%	31.28%	22.00%	18.57%
Profitability					
Return on net worth	-33.3%	-25.9%	-29.2%	5.3%	19.3%
Return on funds deployed	-31.16%	-22.10%	-10.31%	1.37%	3.61%
Operational self sufficiency	30.18%	55.81%	77.37%	103.96%	112.60%
Capitalisation					
Total debt/net worth (times)	-	0.54	3.22	3.08	5.70
Capital adequacy	226.10%	65.45%	23.97%	24.77%	15.09%