Rating Rationale for Mahindra and Mahindra Financial Services Limited's Unsecured Redeemable Subordinated Debt Instruments Issue of INR 200 crore or 2 billion

Issue Rating: BWR AA+	Outlook : Positive

Brickwork Ratings has assigned BWR AA+ (Pronounced BWR Double A plus) for Mahindra and Mahindra Financial Services Limited's ("MMFSL") proposed Unsecured Redeemable Subordinated Debt Instruments issue of INR 200 crore. 'BWR AA+' stands for an instrument that is considered to offer HIGH credit quality / safety in terms of timely servicing of principal and interest obligations. The rating takes into account MMFSL's business model which has clear focus on untapped rural/semi-urban markets, proven track record in asset financing, wide network of field staff across 25 states, well diversified portfolio, high capital adequacy and backing of the parent company Mahindra & Mahindra Ltd. (M&M). The rating is however constrained by high NPA of the company.

BWR has essentially relied upon the audited financial results, the projected financial figures, information and clarification provided by MMFSL.

MMFSL has a good track record of increasing profitability. Profit Before Tax has increased from Rs. 133 crore in FY2005 to Rs. 326 crore in FY2009. Profit After Tax has increased from Rs. 82 crore in FY2005 to Rs. 215 crore in FY2009. Its Profit After Tax (PAT) increased by 21% in FY 2009, mainly on back of increased spreads and margins. Profit After Tax (PAT) during the first half of FY2010 improved to Rs. 109 crore an increase of 76% from Rs. 62 crore in the corresponding period last year. The Company's Income has increased from Rs. 403 crores in FY2005 to Rs. 1385 crore in FY2009. It has however posted a slower growth in income at 13 % in FY09, essentially due to the economic slowdown across the world and consequent slowdown in sales of passenger cars, CVs and utility vehicles.

In first half of FY2010 MMFSL's disbursement improved and registered a growth of 9% at Rs. 3804 crores as compared to Rs.3475 crores during the same period previous year.

Gross NPAs increased steeply from 5.5% in FY 2007 to 8.7% in FY 2009. It had touched a high of 9.4% in Q2 of FY 09. As of Q2 FY 2010 the gross NPAs have slightly comedown to 9.0%.

Background

Mahindra Finance was promoted by M&M (US$ 6.3 billion Mahindra Group) and Kotak Mahindra Bank Ltd (formerly Kotak Mahindra Finance Ltd [KMFL]), with M&M as the major shareholder. In 1998, Mahindra Finance became a subsidiary of M&M after the latter bought out KMFL's stake. Currently, M&M holds 61% stake in the company. They offer the following products:

- Tractor Finance
- Car and Utility Vehicle Finance
- Commercial Vehicle Finance
- Construction Equipment Loan
- Insurance Broking
- Mutual Fund Distribution
- Housing Loans

The company principally finances UVs used both for commercial and personal purposes, tractors and cars. MMFSL's client base predominantly are small entrepreneurs or self-employed individuals such as transport operators, taxi operators and farmers. It's business model is positioned to tap the demand for financing in rural and semi-urban areas. While initially MMFSL started as a captive finance unit for M&M and would finance only M&M vehicles, it has over the years diversified to finance vehicles of other manufactures as well.

Network

MMFSL has a network of 439 branches in rural and semi-urban areas spread over 25 states and 2 union territories in India covering almost 90% of the districts in India. M&M vehicles account for about 60% of the loan book as it provide finance to over 1350 dealers of which 70% are M&M and PTL (Punjab Tractors Ltd.) dealers. MMFSL is also the preferred financier for Maruti vehicles and has tie up with several Maruti dealers.

Disbursement Mix

Majority of MMFSL's disbursements are made towards utility vehicles and tractors. Initially, the company started with financing UV and tractor manufactured by M&M and thereafter entered into CV and car financing. The share of CV and car financing in the disbursements has increased over the years. Thus the loan portfolio has become more diversified.

Segments	Sep - 09	Mar – 09	Mar – 08	Mar – 07
Auto/ Utility vehicles	35%	40%	34%	36%
Tractors	19%	22%	24%	23%
Cars	29%	25%	23%	22%
Commercial Vehicles	9%	6%	7%	4%
Refinance & Others	8%	7%	12%	15%

Funding Mix

MMFSL has a well diversified funding mix. Majority of its funding comes from term loans from banks and debentures. They also carry out Securitization/ Assignment transactions and also have a small share of fixed deposits.

Instrument	Amount(Rs. Crores) (as on 30th September 2009)	% share
Bank Term Loan	2849	39%
Bonds/ NCD's	2670	37%
Securitization/Assignment	1426	20%
Commercial Paper	145	2%
Fixed Deposit	153	2%

Management

MMFSL's Board of Directors comprises of eminent people from the industry and corporate world. Currently, the Board consists of 10 directors of whom 4 are board members or senior executives of M&M and 5 are independent directors from banking, financial services, advertising and marketing background and together provide valuable and extensive guidance. Operations of the company are managed by professionals with relevant industry and management experience.

Shareholding pattern

As at Q2 FY10, Promoters and promoters group have aggregate holdings of 60% in MMFSL, FIIs and ESOP Trust hold of 32% and 1% respectively and the public holds 7%.

Financial Performance

MMFSL has increased its total income in FY09 by 13% from Rs. 1226.80 crore in FY08 to Rs. 1384.66 crore in FY09 and their PAT increased by 21% from Rs. 177.02 crores in FY08 to Rs. 214.52 crores in FY09 on back of improved spreads and margins. It has also achieved an excellent return on assets figure of 2.97%.

Growth in disbursement has slightly gone down to 7.4% in FY09 as compared to 8% in FY08. However, the actual overall disbursement has increased from Rs. 5849.7 crore in FY08 to Rs. 6281.2 crore in FY09.

However, MMFSL reported Gross NPA ratio of 8.7% and net NPA ratio of 2.6% as on March 31, 2009 as compared to 7.6% and 2.9% as on March 31, 2008 respectively which is a cause of concern. Gross NPA ratio has risen due to slippages seen during the year due to overall slowdown in the auto industry. However, the company has increased its NPA provision by 14.7% from Rs. 246 crore in FY2008 to Rs. 282.4 crore in FY2009, coverage resulting in decline in Net NPA ratio. The company has been increasingly diversifying its portfolio in order to mitigate the risk of increasing NPAs.

The capital adequacy ratio remains comfortable. Balance sheet and P&L for the past three years have been shown in Annexure I and II.

	2009	**2008**	**2007**
Capital Adequacy			
CRAR	**19.40%**	**20.70%**	**14.70%**
Leverage	**5.07**	**5.34**	**8.08**
Net-worth (in Rs Crore)	**1467.90**	**1312.90**	**776.90**
Spread Analysis			
Total Income/Average Assets	19.10%	18.40%	14.90%

Interest / Average Assets	6.90%	6.70%	5.60%
Gross Spread	12.20%	11.70%	9.30%
Overheads/Average Assets	3.70%	3.80%	3.40%
Write offs & NPA provisions / Average Assets	3.90%	3.70%	2.20%
Net Spread	**4.60%**	**4.20%**	**3.70%**
Yield on Average Interest bearing assets	18.76%	17.18%	14.56%
Yield on Average Interest bearing liabilities	9.94%	9.14%	7.35%
Net Interest Margin	**8.81%**	**8.04%**	**7.21%**
Profitability			
PAT/Total Assets	2.90%	2.50%	2.10%
PAT/Total Income	15.50%	14.40%	15.70%
PBT/Total Assets	4.40%	3.90%	3.20%
PBT/Total Income	23.50%	22.20%	24.00%
Return on Average Assets	**2.97%**	**2.66%**	**2.35%**
Return on Equity	15.40%	16.90%	18.10%
Asset Quality			
Gross NPA to Total Assets (%)	8.70%	7.60%	5.50%
Net NPA to Total Assets (%)	2.60%	2.90%	2.50%

Contingent liability

As of FY09, amongst the others, the company has a contingent liability of Rs. 44.78 crore towards income tax dues against which Rs. 20.70 crores have been met and refunds are also being adjusted towards the same. Legal suits filed by the customers against company amount to Rs. 14.83 crores.

Q2 FY 2010 Performance

MMFSL increased its total income by 10% to Rs. 363 crores during Q2 FY 2010 as compared to Rs. 331 crores during the same period previous year. For the Q2 FY2010 MMFSL has made a PAT of Rs 69 crores, an increase of 96% from Rs. 35 crores for the same period last year.

During the first half of FY 2010, the total income increased by 10% at Rs. 692 crores as against Rs. 630 crores in the same period of the previous year. The PAT for the first half of FY 2010 was at Rs.109 crores registering a growth of 76% as compared to Rs. 62 crores during the first half of the previous year.

In first half of FY 2010 MMFSL's disbursement improved and registered a growth of 9% at Rs. 3804 crores as compared to Rs. 3475 crores during the same period previous year. The gross NPAs stand at 9.0% which has slightly decreased from 9.4% during the same period.

Peer Comparison

BWR has made a study of the performance **(FY2009)** of MMFSL vis-à-vis other asset financing companies in certain key parameters.

FY 2009 (Amount In Rs. Crores)	MMFSL	Peer Average
Leverage	5.07	8.73
Net-worth	1467.90	1274.86
Debt/Equity	3.54	6.78
Yield on Average Interest bearing assets	18.76%	17.00%
Yield on Average Interest bearing liabilities	9.94%	11.46%
Net Interest Margin	8.81%	5.94%
Total Income/Average Assets	19.10%	17.50%
Interest / Average Assets	6.90%	9.06%
Gross Spread	12.20%	8.44%
Overheads/Average Assets	3.70%	2.73%
Write offs & NPA provisions / Average Assets	3.90%	1.54%
Net Spread	4.60%	4.17%
PAT/Total Assets	2.9%	1.91%
PAT/Total Income	15.5%	12.48%
PBT/Total Assets	4.40%	2.82%
PBT/Total Income	23.50%	18.00%
Gross NPA to Total Assets (%)	8.70%	1.73%
Net NPA to Total Assets (%)	2.60%	0.53%
Return on Average Assets	2.97%	2.05%
Return on Equity	15.40%	18.15%
Capital Adequacy Ratio	19.40%	16.10%

The above table reveals that MMFSL has performed much better as compared to its peer group in almost all parameters except with regard to the NPA which is very high compared to the peers.

Subsidiaries

In 2005, MMFSL commenced insurance broking business in MIBL (Mahindra Insurance Brokerage Ltd.) which is into direct insurance broking for life and non-life products. MIBL posted a PAT of INR 650 lacs in FY09. PAT as of Q2 FY 2010 improved to Rs. 520 lacs.

MMFSL also started MRHFL (Mahindra Rural Housing finance Ltd.), a rural and semi-urban housing finance company in 2007. NHB has a 12.5% stake in this new venture while MMFSL holds the rest 87.5%. MRHFL currently has presence in six states. It had posted a profit of Rs. 0.43 crore during the first half of FY2010 as compared to loss of Rs. 0.71 crore for same period of the previous year.

Both the subsidiaries have strong synergy with company's existing business and have promising prospects ahead.

On a consolidated basis, during the first half of FY 2010 the total income increased by 10% to Rs. 704 crores as against Rs. 638 crores in the same period of the previous year. PAT rose to Rs.115 crores registering a growth of 79% as compared to Rs. 64 crores during the same period of the previous year.

Management of Risk:

MMFSL has a duly Board approved risk management system in place. The Risk management team which is a eight member team identifies, assesses and monitors the principal risks of the Company, in accordance with the defined policies and procedures. Also The Asset Liability Management Committee reviews risk management policies in relation to various risks including liquidity, interest rate, investment policies and strategy and the Audit Committee overseas the risk management policies and procedures and also reviews the credit risk of the Company.

Industry Analysis

After the Global economic turbulence during the period 2008-09 there has been a healthy pick-up in the demand the housing and auto sectors. Activities in the infrastructure sector are looking up too. After declining for the last 11 months, CV sales grew in July and August 2009. These factors taken together are likely to increase credit disbursement by asset financing companies and consequently the income of the sector is expected to grow. The rural market is also expected to continue to grow, though the delayed monsoon could have some adverse impact. Liquidity pressure on NBF companies has eased. This is reflected in the successful fund raising exercise carried out by leading financing services companies in the recent months.

Rating Outlook

MMFSL has, since inception, concentrated on semi-urban and rural areas, where competition is relatively low. The vast distribution network has enabled MMFSL to post strong and consistent growth in business as reflected in MMFSL's asset book which has grown at a robust 28% CAGR over FY05-FY09 led by aggressive expansion and strong growth in the auto sector. MMFSL has in recent years made attempts to diversify its loan portfolio and also reduce dependence on its parent company. The rating has, interalia factored the management quality, measures being taken to increase provisions against NPA as well as to reduce the high level of NPAs, comfortable capital adequacy ratio which is currently at 19.40% and the support of the promoter group. Demand in the auto sector seems to be picking up which will be beneficial to the company. However, reducing the NPAs quickly and improving the assets quality will be crucial to the company's performance.

Brickwork Ratings (BWR) has adopted SEBI's standardized Rating Symbols and their definition advised vide SEBI circular CIR/MIRSD/4/2011 dated June 15,2011, with effect from June 21, 2011. While there is no change in the Rating symbol as a consequence to the above, for the amended definition of the Rating, please refer to http://www.brickworkratings.com/scale.html. It is clarified that the said change in the definition should not be construed as a change in the Rating.

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Annexure I

Mahindra and Mahindra Financial Services Limited			
Balance sheet (Standalone)			
(Rs. In Crores)	**2009**	**2008**	**2007**
Sources of Funds			
Capital	95.71	95.29	84.02
Employee Stock Option Outstanding	1.29	1.35	1.28
Reserves and Surplus	1372.16	1217.62	692.93
Shareholders' Funds	**1469.16**	**1314.26**	**778.23**
Secured Loans	4466.83	4613.53	4580.27
Unsecured Loans	746.18	428.97	359.66
Loan Funds	**5213.01**	**5042.50**	**4939.93**
TOTAL	**6682.17**	**6356.76**	**5718.16**
Application of Funds			
Fixed Assets	**35.69**	**30.74**	**27.26**
Investments	**109.71**	**3.08**	**26.91**
Intangible Assets	**1.75**	**1.34**	**0.73**
Deferred Tax Asset	**178.75**	**125.44**	**74.46**
Sundry Debtors	0.78	0.95	1.10
Other Current Assets	2.54	1.46	1.94
Cash & Bank Balance	276.31	215.28	283.09
Loans & Advances	6838.33	6643.52	5865.48
Current Assets	**7117.96**	**6861.21**	**6151.61**
Less: Current Liabilities & Provs.	761.69	665.05	562.81
Net Current Assets	**6356.27**	**6196.16**	**5588.80**
TOTAL	**6682.17**	**6356.76**	**5718.16**

Annexure II

Mahindra and Mahindra Financial Services Limited			
Profit and Loss Account (Standalone)			
(Rs. In Crores)	**2009**	**2008**	**2007**
Income			
Income from Operations	1364.82	1205.75	829.11
Other Income	19.84	21.05	12.73
Total Income	**1384.66**	**1226.80**	**841.84**
Expenditure			
Financial Expenses	509.86	455.99	324.13
Administration & Other Expenses	258.05	243.80	188.05
Provisions & Write Off's	282.39	246.29	119.49
Depreciation	8.73	8.73	7.43
Total Expenditure	**1059.03**	**954.81**	**639.10**
Profit before tax	**325.63**	**271.99**	**202.74**
Profit after tax	**214.52**	**177.02**	**132.88**