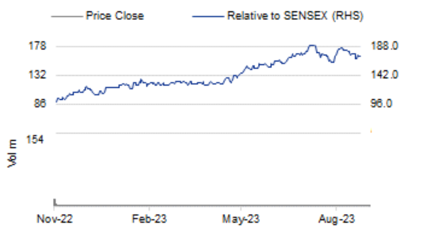
India

ADD *(Initiating coverage)*

Consensus ratings*:	Buy 8	Hold 0	Sell 0

Current price:	Rs616
Target price:	Rs800
Previous target:	NA
Up/downside:	29.9%
EIP Research / Consensus:	4.5%
Reuters:	
Bloomberg:	FUSION IN
Market cap:	US$745m
	Rs62,004m
Average daily turnover:	US$1.9m
	Rs157.7m
Current shares o/s:	100.3m
Free float:	32.0%

Source: Bloomberg



Source: Bloomberg

Price performance	1M	3M	12M
Absolute (%)	3.9	18.5	0.0
Relative (%)	(0.6)	10.7	0.0

Major shareholders	% held
Honeyrose	39.4
Creation investment	13.8
Devesh Sachdev	4.9

Fusion Micro Finance Ltd

Growth quality to ensure superior returns

- With market penetration deepening in the existing states for FMFL as well as a calibrated rise in new states, we build in ~29.6% AUM CAGR over FY23-26F.
- With elevated margins compensating for higher provisioning and with leverage improving, we are factoring in FY24F-26F RoE in the band of ~21-22%.
- We have valued the stock on an excess return on equity (ERoE) basis and arrived at a target price of Rs800, or ~2.2x P/BV and ~12x P/E on Mar 2025F.

Robust growth led by deepening penetration & diversified presence

Fusion Micro Finance (FMFL) has been the fastest-growing listed NBFC-MFI, growing its AUM CAGR at ~42% over FY18-23. We remain confident of FMFL managing its robust growth momentum in the coming quarters backed by consistency in new customer addition whereby we assume annualized addition of ~0.8m new customers, driving the overall customer franchise to ~5.8m by FY26F against ~3.5m in FY23. With deepening penetration in high-growth potential states like Uttar Pradesh & Bihar (~40% of AUM) as well as a calibrated rise in new geographies like Tamil Nadu, we are building ~29.6% CAGR in AUM over FY23-26F backed by ~27.5% CAGR in disbursements. The recent rise in loan ticket size for first-cycle customers in existing geographies, we feel, will further aid growth.

Superior margins to stay amid fixed-rate loans & improving liability

Building on a strong customer base, FMFL managed to pass on the recent rate hikes to its end-customers, the full impact of which will be visible in 1HFY24F. FMFL has also witnessed effective moderation in its overall cost of funds led by a diversified borrowing mix and balanced asset-liability management or ALM. Going ahead, FMFL, like most NBFC MFIs, will benefit from the softening monetary cycle amid a fixed-rate portfolio and variable borrowing mix. We are building margins in the range of ~12.5% for FY24F-26F.

Surge in near-term slippage likely; collection efficiency peaks

We expect the trend in fresh slippage to remain volatile in the near term due to floods in North India, including the state of Bihar, which remains the key market for FMFL. We are also keeping a close eye on the trend in collection efficiency, where further improvement is a challenge due to rising leverage in core states as well as new states still under the evolving stage. Accordingly, we are assuming a higher credit cost in FY24F-26F, in the range of ~250bp, as we prefer to remain conservative.

Initiate coverage on FMFL with ADD rating and target price of Rs800

We initiate coverage on FMFL with an ADD rating, valuing the stock on an excess return on equity basis. We have arrived at a target price of Rs800, or ~2.2x P/BV and ~12x P/E on Mar 2025F. We have assigned a premium valuation to FMFL over Spandana Sphoorty amid the overhang of Spandana ex-promoter's likely exit. However, we still believe Spandana is attractively priced due to its improving returns ratio, rising diversity and conservative management. Downside risks: Slower growth and a surge in fresh slippage.

Financial Summary	Mar-22A	Mar-23A	Mar-24F	Mar-25F	Mar-26F
Net Interest Income (Rsm)	5,684	9,573	13,609	17,791	22,519
Total Non-Interest Income (Rsm)	1,370	1,999	2,589	2,538	2,892
Operating Revenue (Rsm)	7,054	11,572	16,198	20,329	25,412
Total Provision Charges (Rsm)	(3,687)	(2,004)	(3,021)	(3,384)	(3,977)
Net Profit (Rsm)	219	3,871	5,471	7,214	9,220
Core EPS (Rs)	2.66	38.58	54.52	71.89	91.88
Core EPS Growth	(52%)	1,353%	41%	32%	28%
FD Core P/E (x)	232.06	15.97	11.30	8.57	6.71
DPS (Rs)	0.00	0.00	0.00	0.00	0.00
Dividend Yield	0.00%	0.00%	0.00%	0.00%	0.00%
BVPS (Rs)	162.3	231.4	285.9	357.8	449.7
P/BV (x)	3.80	2.66	2.16	1.72	1.37
ROE	1.7%	21.2%	21.1%	22.3%	22.8%

SOURCE: INCRED RESEARCH, COMPANY REPORTS

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Listed NBFC MFIs: A comparable study

Figure 1: Comparable matrices for all three listed NBFC-MFIs

	Fusion	Spandana	CreditAccess
Key Information			
AUM (Rs m)	92,960	85,110	2,10,313
Branch network	1,086	1,227	1,786
Employee base	10,000	10,016	16,759
Districts present	385	314	351
Customer base (m)	3.5	2.9	4.3
Meetings occurrence	Monthly/Weekly	Monthly/Weekly	Weekly
Employee attrition	31%	51%	40%
AUM for other business (if any)	NA	NA	1%
Promoter holding	68.20%	62.40%	66.80%
Comparable efficiency			
AUM per branch (Rs m)	85.6	69.4	117.8
AUM per employee (Rs m)	9.3	8.5	12.5
Customers per branch	3,250	2,331	2,385
Customers per employee	353	286	254
Employees per branch	9.2	8.2	9.4
Scope for expansion			
O/S per customer (Rs)	26,334	29,759	49,369
	2.8	3.9	5.1
Comparable opex			
Salary per employee (Rs m)	0.35	0.33	0.32
Opex per branch (Rs m)	1.2	1.3	1.8
Geographic concentration			
Share of top 5 states in AUM	69%	64%	82%
	Uttar Pradesh-21%	Karnataka-16%	Karnataka-33%
	Bihar-21%	Andhra Pradesh-15%	Maharasthra-21%
	Odisha-12%	Odisha-14%	Tamil Nadu-20%
	Madhya Pradesh-9%	Karnataka-10%	Madhya Pradesh-7%
	Tamil Nadu-7%	Maharashtra-9%	Odisha-3%
Return ratios comparison			
RoA-1QFY24	4.60%	4.20%	4.20%
RoE-1QFY24	20.70%	11.80%	18.00%
Margin profile			
Yield for FY23	19.90%	19.00%	18.90%
Cost of funds for FY23	10.20%	9.30%	9.40%
Spread	9.70%	9.70%	9.50%
Margin	11.90%	12.20%	11.60%
Comparable asset quality			
Stage-3 gross	3.50%	2.10%	0.90%
Stage-3 net	0.90%	0.60%	0.30%
Credit cost for FY23	2.70%	8.20%	2.10%
Coverage ratio	74.00%	69.10%	69.70%
Stage 1&2	96.50%	97.90%	99.10%

Figure 2:

SOURCE: INCRED RESEARCH, COMPANY REPORTS

Spandana Sphoorty, Fusion provide attractive risk-reward

We initiated coverage on Spandana Sphoorty after the change in its management, whereby we remain confident of the new management's strategy of adopting a process-driven approach to grow in new geographies. We have an ADD rating on Spandana Sphoorty, valuing the stock on an excess return on equity basis. We arrived at a target price of Rs1,000, or ~1.6x P/BV and ~12x P/E on Mar 2025F.

We also like Fusion Micro Finance (FMFL) due to its robust growth aided by superior return ratios. Elevated margin to compensate for higher provision while improving leverage to drive RoE in the range of ~21-22% in FY24F-26F.

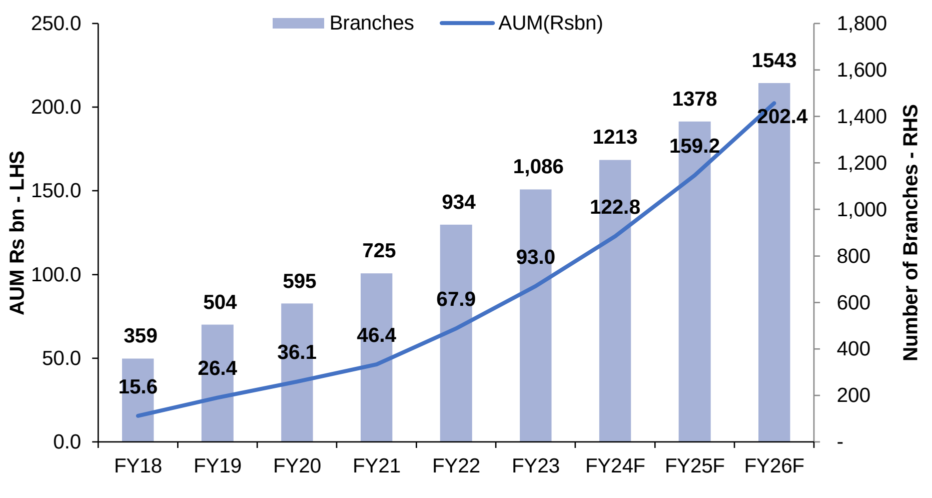
We have assigned a premium valuation to Fusion Micro Finance over Spandana Sphoorty amid the probable exit of the ex-promoter of Spandana, which is a near-term overhang on the stock. However, we continue to believe Spandana is attractively priced due to improving returns ratio, rising diversity and conservative management practices.

We remain neutral on CreditAccess Grameen amid its premium valuation and limited free float.

Fusion MFI: Focus on quality with diversity

Fusion Micro Finance (FMFL) has been one of the fastest-growing listed NBFC-MFI, with its AUM CAGR at 42% over FY18-23, touching Rs92.9bn as of Mar 2023-end, despite being hit by the Covid-19 pandemic, amid the focus on core geographies (top 5 states) as well as diversifying into new geographies. The company has expanded its branch network from 318 in FY18 to 1,103 in Jun 2023.

Figure 3: FMFL witnesses a surge in AUM driven by branch expansion

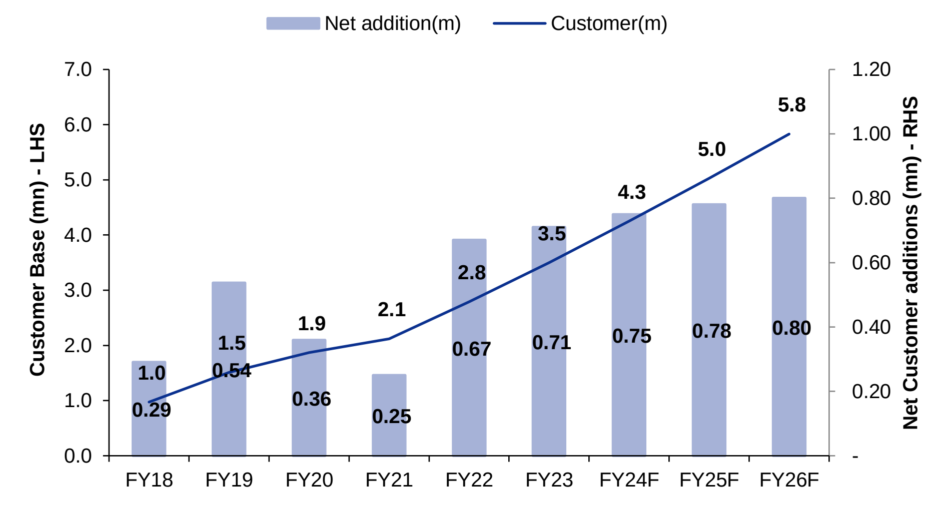


SOURCE: INCRED RESEARCH, COMPANY REPORTS

New customer addition to remain the key growth driver...

FMFL has a customer base of ~3.5m borrowers as of Mar 2023-end, as it added ~0.71m customers in FY23 vs. ~0.67m in FY22. The company has ~3.64m borrowers as of 1QFY24-end, registering a year-on-year or yoy growth of 25.7% and a quarter-on-quarter or qoq increase of 3%. FMFL also manages a healthy mix of new and existing customers in its portfolio to balance customer leverage.

Figure 4: Customer base expansion to continue, with a rising presence across states



SOURCE: INCRED RESEARCH, COMPANY REPORTS

We remain confident of FMFL managing its robust growth momentum in the coming quarters backed by consistency in new customer addition, whereby we assume an annualized addition of ~0.8m new customers, thereby driving the overall customer franchise to ~5.8m by FY26F vs. ~3.5m in FY23.

…but customer sanity remains equally important

Our discussions with various industry experts and visits to the company's branches gave us a clear indication that though the first-cycle customers get a preference by FMFL, customer addition is a complete process-driven approach and all related procedures like credit bureau verification, household income check, etc. is thoroughly undertaken. FMFL also checks any deviation of actual income vs. reported at the cluster level to identify unfair practices.

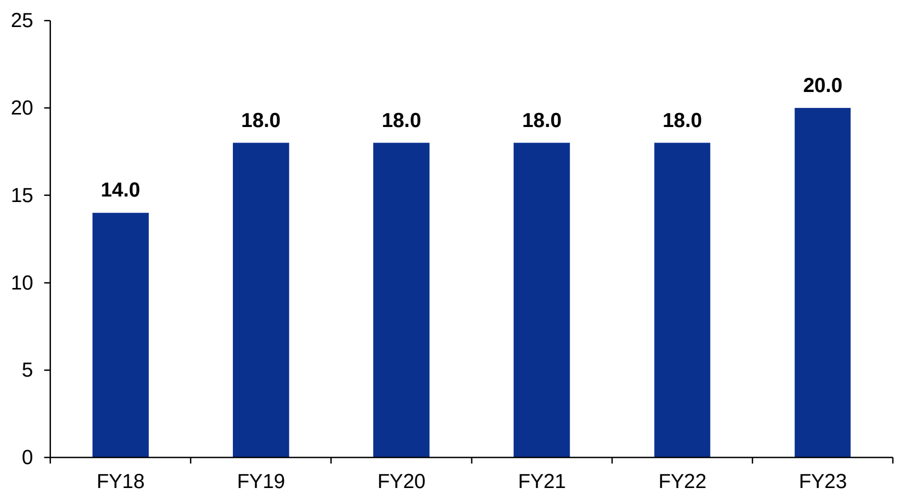
Though the aim of FMFL is to manage superior growth, its management is equally determined to maintain the fundamentals of prudence and conservatism while adding new clients. The sourcing team of the company is well trained and aligned with FMFL's overarching strategy of diversification, organic growth, execution capabilities and leveraging the diverse network by adding new customers.

Focus on growth diversity and improving its presence

Th rapid branch expansion by FMFL in the past few years has also brought in a decent diversity in its AUM as the company managed to spread its presence from 12 states in 2017 to 20 states in 2023. Though the large five states of the company contribute ~69% to AUM, as the new branches in new states start maturing the overall concentration risk is likely to ease.

However, while entering new states, the company is not very aggressive on opening a lot of branches. The branch expansion is calibrated based on the customer behaviour, comfort of the staff, response to the products launched and understanding of the markets and risks involved. Once confident of these aspects, further branch expansion is undertaken.

Figure 5: Expansion into new states led to granularity in customer addition

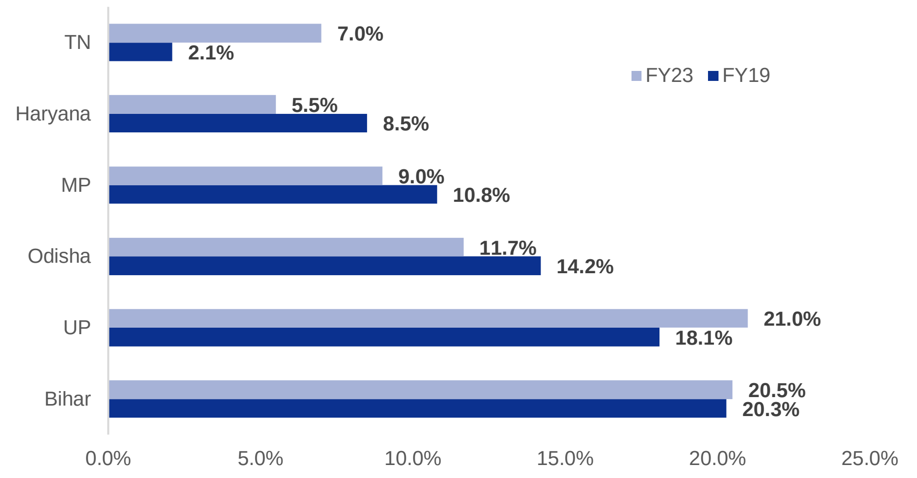


SOURCE: INCRED RESEARCH, COMPANY REPORTS

We remain equally optimistic on legacy states

Though FMFL is focused on diversification, we believe the contribution from legacy states should remain elevated considering its management's selective growth approach, which will allow these states to grow at a decent pace in the coming quarters as well. We continue to believe that considering the headroom available for growth in states like Uttar Pradesh and Bihar, FMFL will be able to maintain a prudent composition of all large states in its portfolio.

Figure 6: Contribution from top six states continue to remain healthy

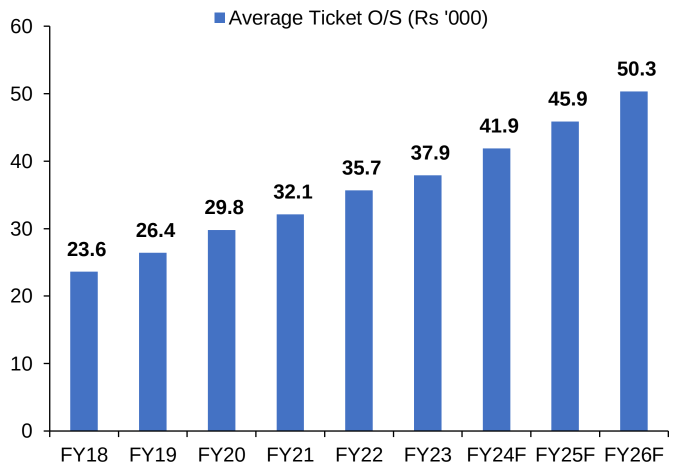


SOURCE: INCRED RESEARCH, COMPANY REPORTS

Increase in loan ticket size to aid AUM growth further

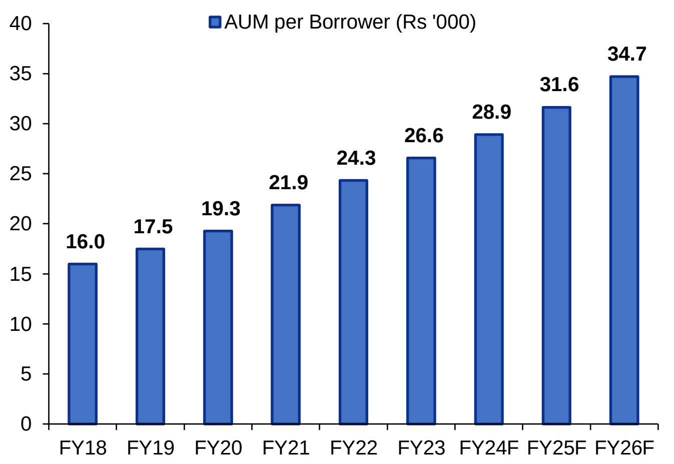
FMFL's management has maintained the average loan ticket size in a tight range during the pandemic years but post-pandemic, there was a need for increasing the average ticket size. Also, considering the competition, inflation and borrower needs, FMFL increased the average ticket size in FY23 by ~10%. However, the trend for the second-, third- or fourth-cycle customers remained stable over the years.

Figure 7: We expect the rise in average loan ticket size to aid growth



SOURCE: INCRED RESEARCH, COMPANY DATA

Figure 8: Rise in loan ticket size will lead to a rise in the outstanding per borrower

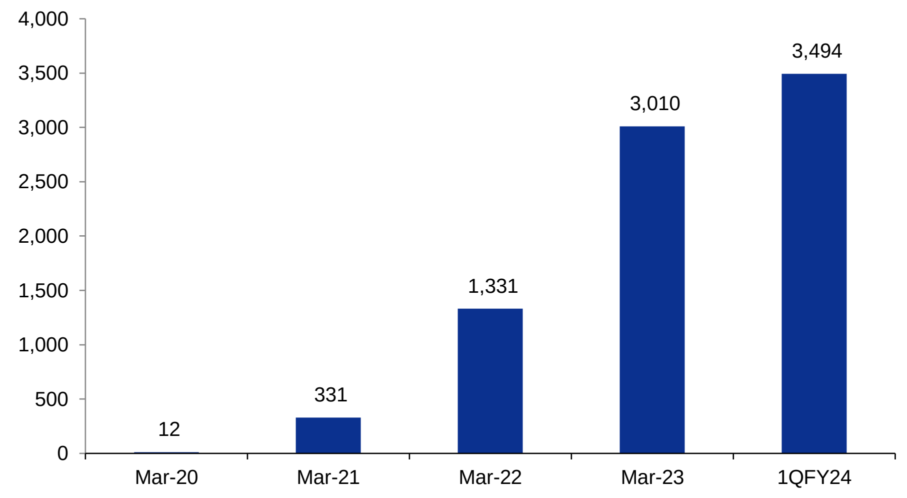


SOURCE: INCRED RESEARCH, COMPANY DATA

MSME book-building to be gradual as quality remains priority

FMFL's management has been building its MSME vertical in a different manner through separate branches. There are customers who are graduating in microfinance and need larger loans, and FMFL's management is targeting such customers and intends to service them through MSME branches. Being processed through MFI cycles, the quality of such customers is already tested, which makes the MSME book relatively better placed. Management is in no hurry to grow this book and prefers granularity along with diversity with a best-in-class process-driven approach.

Figure 9: FMFL is growing MSME AUM in a gradual & categorical manner

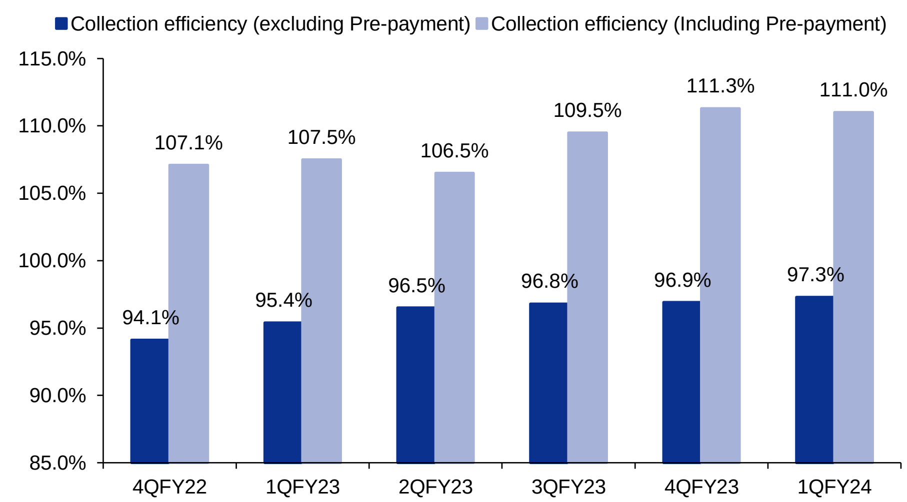


SOURCE: INCRED RESEARCH, COMPANY REPORTS

Higher repayment due to the shift towards second-cycle customers

Interestingly, there had been elevated prepayments witnessed by FMFL during the past couple of quarters, and the same is a function of customers moving towards the next new cycle, which is generally of a higher quantum. The company has a fair share of customers who take the next-cycle loan, and typically do not wait till the end of the tenor. They come a few months before where some amount of the loan is remaining. Thus, the overall trend in repayment and prepayment remains elevated for the company.

Figure 10: Collections, including prepayments, witnessed a spurt in the past quarters

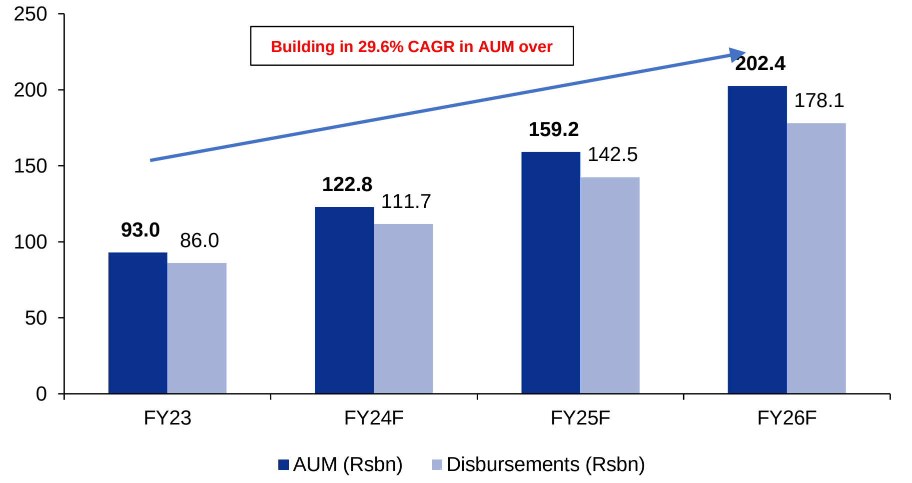


SOURCE: INCRED RESEARCH, COMPANY REPORTS

Building in ~29.6% CAGR in AUM over FY23-26F

We remain confident of the long-term sustainable growth of the company amid its management's vision of being an organically diversified company, expanding the network, investing in human capital, and strengthening overall processes and digitization. We are building in ~29.6% CAGR in AUM over FY23-26F, backed by ~27.5% CAGR in disbursement and the repayment ratio at ~40%.

Figure 11: We are building in ~29.6% CAGR in AUM over FY23-26F



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Healthy margin trajectory is manageable

The Reserve Bank of India (RBI) had earlier placed a cap of ~10% on the spreads earned by NBFC MFIs, which was reflected in the margins of FMFL as its margin profile remained in a specific range. However, post lifting of the restriction last year, we are witnessing an improvement since the past few quarters, mainly led by the rise in yields and moderation in the cost of funds.

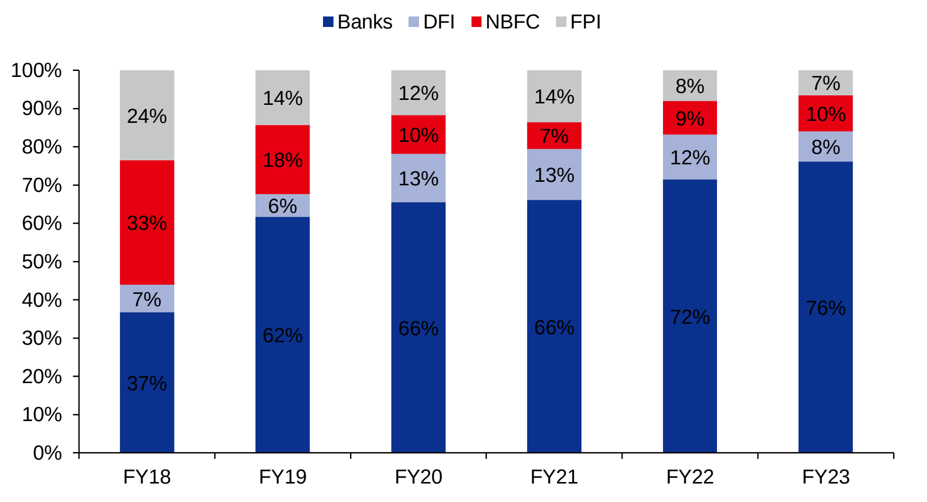
FMFL witnesses a gradual improvement in yields

Post removal of the restriction on the spreads by the RBI, FMFL witnessed a gradual rise in yields as its management could pass on the overall cost tightening to end-customers due to the strong demand undercurrent. Overall yields have improved significantly from ~19.5% in 1QFY23 to ~21.5% in 1QFY24. As per our discussions with FMFL's management, the impact of the new RBI regulation will be reflected from 1QFY24, and the full impact will be visible by 1HFY24F.

Diversified borrowing mix; robust capital adequacy ratio

FMFL has witnessed effective moderation in its overall cost of funds over a period led by its diversified borrowing mix and a balanced ALM profile. The company has successfully tackled the rising interest rate cycle as its marginal cost of funds continues to decline. With improving performance and credit rating profile, FMFL kept switching from expensive NBFC borrowing to reasonably priced borrowing from most reputed private, public and foreign banks added to the profile.

Figure 12: Diversity in borrowings through a shift from NBFCs to banks is visible

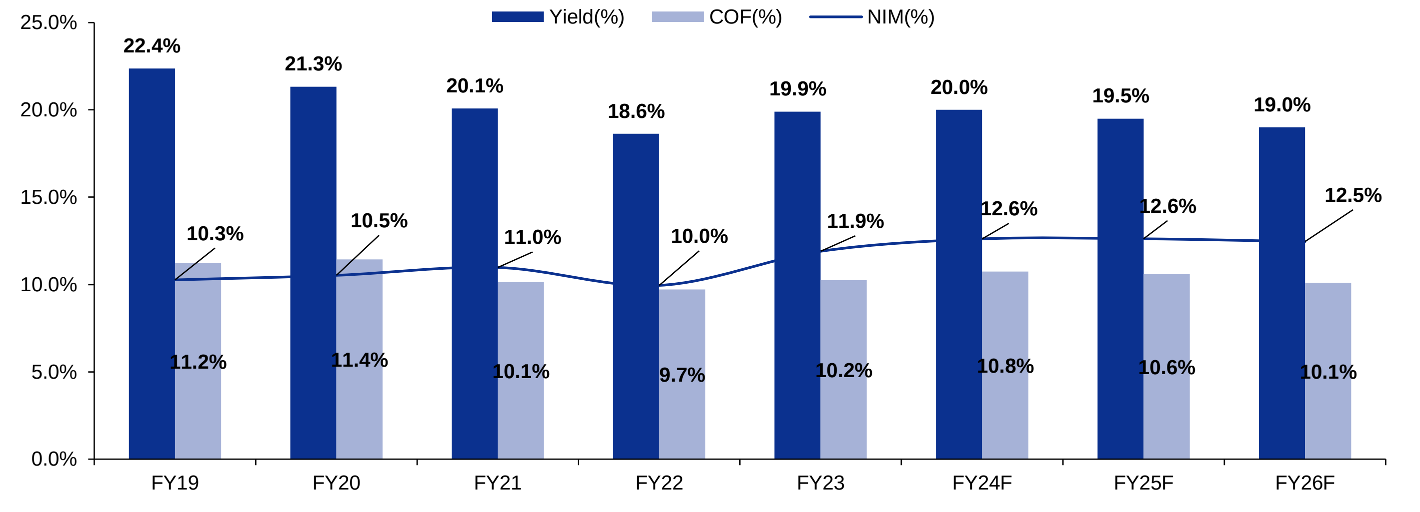


SOURCE: INCRED RESEARCH, COMPANY REPORTS

FMFL's superior margin profile to stay intact

FMFL has managed its funding cost well which, coupled with rate hikes, has helped it to post a higher net interest margin or NIM. We believe the steady debt rerating (CRISIL Stable/A) due to strong capital position and financial performance should further improve the company's funding cost and thus help sustain margins.

Figure 13: We expect the elevated margin trajectory at around ~12.5% to stay amid improved yields & declining cost of funds



SOURCE: INCRED RESEARCH, COMPANY REPORTS

FMFL, like most NBFC MFIs, will benefit from the softening monetary cycle amid its fixed-rate loan portfolio and a variable borrowing mix. We are building in margins in the range of ~12.6% for FY24F-26F.

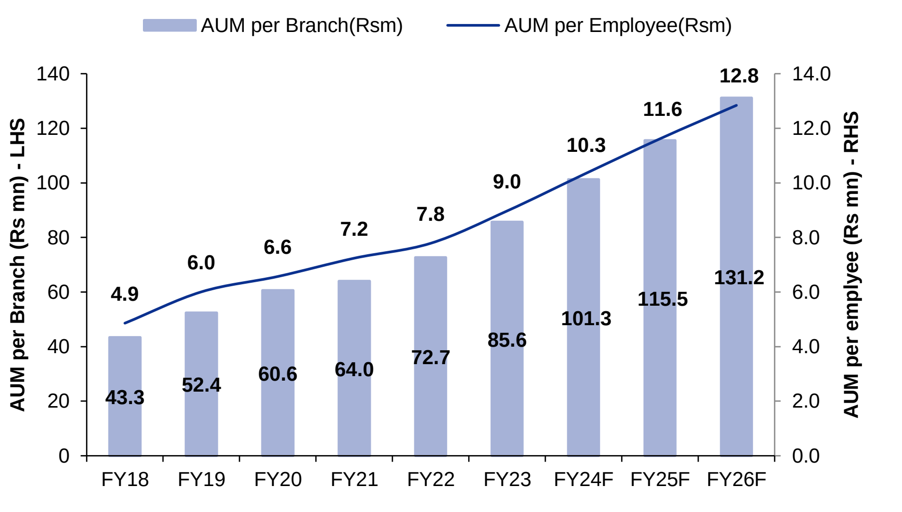
Efficiencies drive operational outperformance

FMFL has witnessed an improvement in the operating leverage last year amid its focus on optimization of resources, whereby the AUM per branch and AUM per employee witnessed an improvement.

Resource optimization led to improvement in operating matrix

The cost-to-income ratio improved by ~583bp from 44.3% in FY22 to 38.4% in FY 23. The company reported an improvement in operating matrices on per branch as well as per employee basis, which indicates the improving efficiency across areas, the trend, we feel, will continue in the coming years as well.

Figure 14: Improvement in AUM per employee/per branch to continue

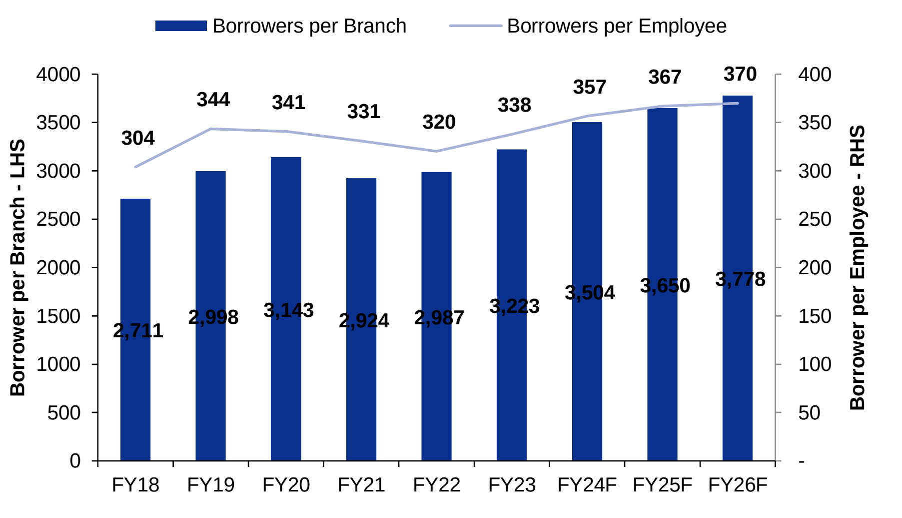


SOURCE: INCRED RESEARCH, COMPANY REPORTS

Robust client addition has also been efficiently managed

FMFL has witnessed branch expansion in new states during the past few years, which also led to a sharp surge in the borrower base of the company. Typically, a new customer with the first credit cycle has a lower ticket size, but despite this the company continued to improve on borrower per branch and borrower per employee matrices, which further reiterates the improving operating efficiency of FMFL.

Figure 15: Efficiency is visible despite robust borrower addition in the past few years



SOURCE: INCRED RESEARCH, COMPANY REPORTS

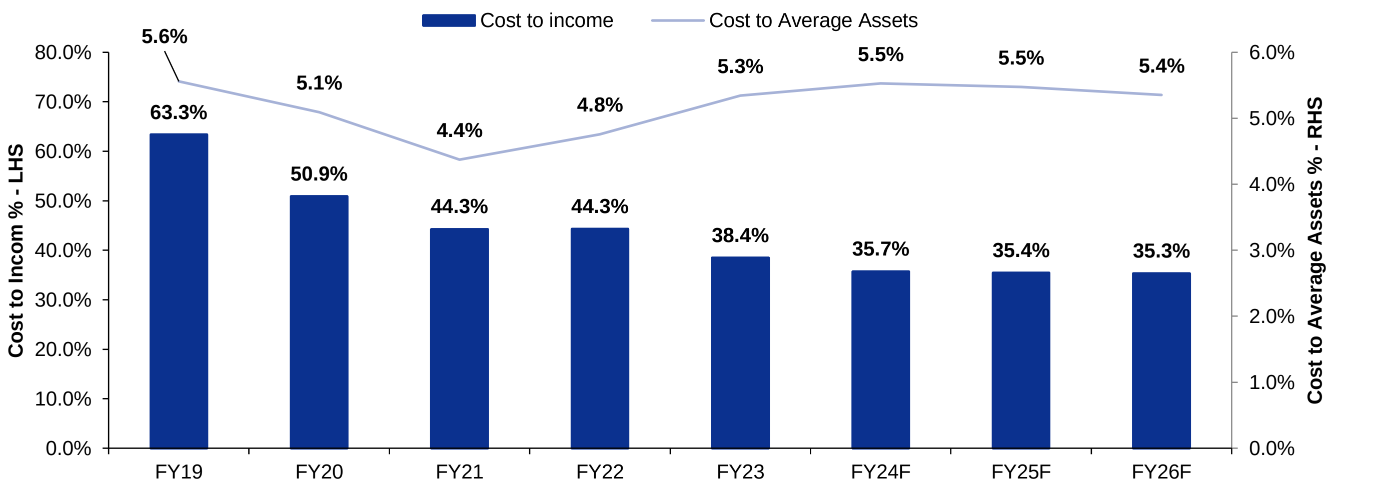
Rising focus on digitalization to handle business volume

FMFL's management is focusing on digitalization to manage the superior optimization of available resources. The company has already formulated a strategic roadmap for the next three years that closely aligns with its business growth plans. It is focused on technology investments to be ahead of the curve and seamlessly manage growing business volume without increasing the costs proportionately. Repetitive tasks such as data entry and quality check are being automated using robotic process automation to handle a growing business volume without increasing human capital.

We are building stability in cost matrices from FY24F-26F

We are building a flat cost-to-income matrix in the coming years amid expansion plan of FMFL being adjusted against optimization of available resources. The company has expanded into new states during the past few years, but the average loan ticket size for new customers is expected to remain low during the initial years due to conservative management practices whereas operating costs are likely to remain elevated in the initial years. This will keep the overall cost-to-income ratio steady in the coming years but with a gradual maturity of the markets, it will allow the operating leverage to play accordingly.

Figure 16: Cost matrices likely to stay higher as the company remains in an expansion mode



SOURCE: INCRED RESEARCH, COMPANY REPORTS

FMFL is expanding into new states where the average loan ticket size for new customers to remain low amid conservative management practices. Thus, with a relatively stretched branch break-even, we are building in the cost-to-average assets ratio to be ~5.4% in FY24F-26F against ~5.4% in FY23.

Asset quality is volatile but still comfortable

FMFL MFI, like most industry players, has witnessed a volatile trend in asset quality, especially during the pandemic. However, the situation improved over a period with normalization of economic activities. The company's management has been focusing on improving the overall collection mechanism and has also built buffer provision against probable adversities in future. This provides us the necessary comfort, although we expect the overall trend to stay volatile due to the nature of the business.

Elevated near-term slippage amid floods in North India

Though the company demonstrated a consistent improvement in its asset quality post-pandemic, we are building a relatively higher slippage as our channel check indicates the pressure rising in Northern India states including Bihar, Uttar Pradesh, and Haryana due to the recent floods. Considering the normalized trend in write-offs, we are projecting steady headline non-performing assets or NPAs for now.

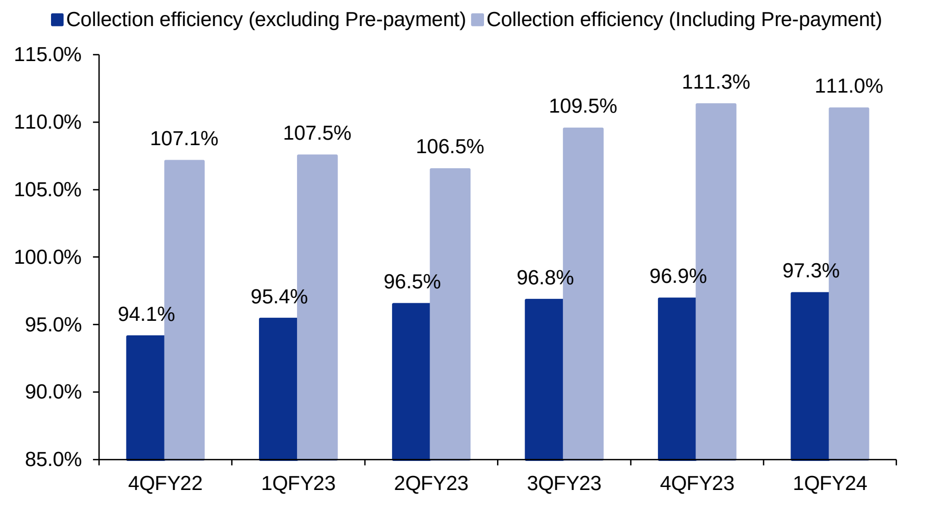
Focused efforts towards improving collection efficiency…

FMFL's management has been actively focusing on improving its overall collection efficiency across states. To give a flavour on the top five states, in Bihar, the collection efficiency (including the previous quarter's dues) for the quarter ended Mar 2023 remained at ~99.3% whereas the same number for Uttar Pradesh had been ~98.6%. In states like Odisha and Madhya Pradesh, the collection efficiency was closer to ~96% whereas in Tamil Nadu it was around ~96% as of Mar 2023-end.

…but further improvement remains challanging

Though FMFL's management is confident of achieving a further improvement in collection efficiency, we remain sceptical amid the rising leverage in core states whereas new states are still evolving and should witness relatively higher defaults compared to core states of the company. This may ensure stagnancy in the collection efficiency matrix in the near term. Thus, the trend in fresh slippage needs to be monitored to gauge the trend in headline NPAs of the company.

Figure 17: Collection efficiency post-pandemic remains robust



SOURCE: INCRED RESEARCH, COMPANY REPORTS

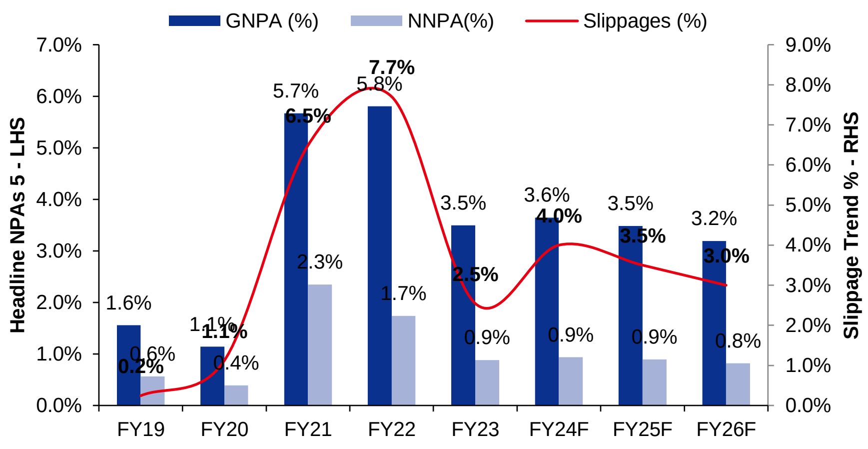
We are building in a gradual easing in headline NPAs…

Microfinance generally remains a volatile business whereby some political/geographical event could disrupt the payment culture of a particular geography. However, considering the process-driven approach of the company, we are building in a gradual improvement in headline NPAs over FY24F-26F backed by fresh slippage easing and focused recoveries.

…but we are keeping credit cost elevated

Though we expect headline NPAs to ease gradually, considering the volatility in the sector with the floods affecting the key states of FMFL, we believe the overall credit cost will remain elevated in FY24F-26F.

Figure 18: With the rise in headline NPAs, overall credit cost to remain elevated

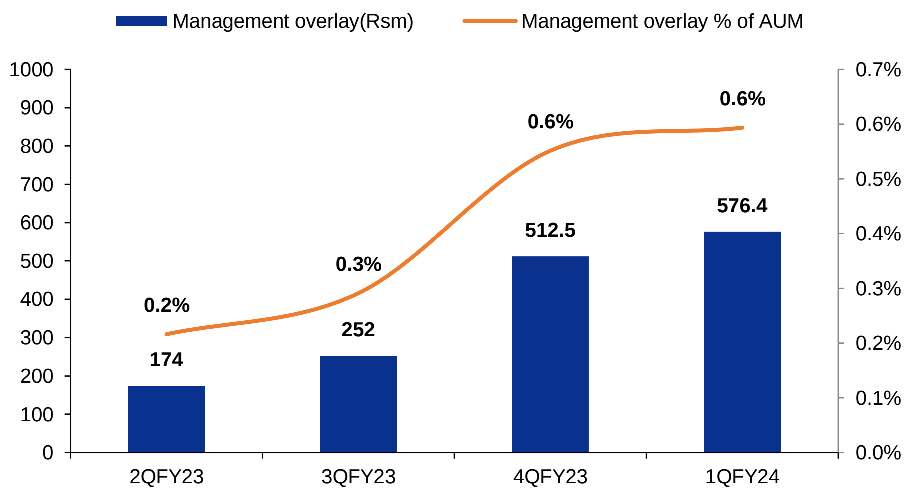


SOURCE: INCRED RESEARCH, COMPANY REPORTS

Buffer provision does provide comfort

FMFL was the first company in the MFI sector to come out with a strategy to create extra provisions under management overlay to avoid volatility in credit cost. The company currently holds management overlay of Rs576.8m and management intends to keep building this provision item in the coming quarters.

Figure 19: Buffer provision provides comfort over future asset quality cycle of FMFL



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Outlook and valuation

- Fusion Micro Finance (FMFL) is one of the fastest-growing MFIs in India, with a diversified presence and offering income-generation loans under the joint liability group model, predominantly to women from low-income households in rural areas.
- We remain positive on MFIs post Covid-19 pandemic due to healthy balance sheet, sufficient provision buffer and a superior customer profile amid rising consumption in semi-urban and rural areas. FMFL, with ~93% presence in rural India, remains well-placed to gain momentum due to a diversified geographical presence, experienced management, and a strong balance sheet.
- **We are factoring in ~29.6% CAGR in AUM backed by ~27.5% CAGR in loan disbursement over FY23-26F. We are not factoring in the sharp growth in the MSME book of the company amid a granular growth approach of its management.**
- **We are factoring in ~33% CAGR in net interest income or NII over FY23-26F, which is better than AUM growth, as we believe the overall margin trajectory for the company will remain healthy due to higher yields and declining cost of funds.**
- **On the margin front, we are building an improved margin trajectory of ~12.5% for FY23-26F after the RBI restricted pricing ban on the MFI sector.**
- **We expect operating expenses of the company to remain elevated amid expansion into new geographies and keep the cost-to-income ratio in the range of ~34-36% whereas the cost-to-average assets ratio to remain stable at ~5.5% by FY26F.**
- We are building in headline NPAs remaining stagnant in the coming years amid collection efficiency peaking as well as the floods in North India impacting slippage in the near term. We are building in credit cost at ~2.8% of AUM for FY24F and then improve to ~2.2% in FY25F-26F.
- **Accordingly, we are building in a PAT CAGR of ~33.5% over FY23-26F backed by superior margins and steady credit cost.**

Though we expect a significant improvement in profitability and a rise in AUM, the same is low compared to management's guidance and we prefer to remain conservative, especially on the growth and asset quality fronts.

- **We are building in healthy return ratios whereby RoE is in the range of 21-22% and RoA in the range of ~5.5% for FY23-26F.**

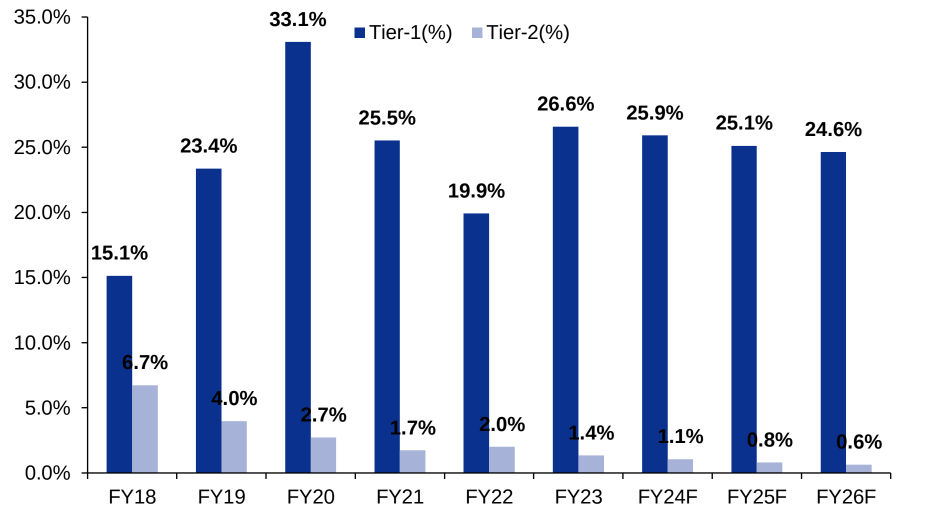
Figure 20: DuPont analysis of FMFL (based on average assets)

RoE Decomposition	FY18	FY19	FY20	FY21	FY22	FY23	FY24F	FY25F	FY26F
Interest Income	16.2%	16.9%	17.0%	16.4%	16.2%	19.2%	20.6%	20.9%	20.5%
Interest Expended	8.7%	9.2%	8.6%	7.4%	7.6%	7.7%	7.6%	7.4%	7.1%
Net Interest Income	7.5%	7.8%	8.4%	9.0%	8.7%	11.5%	13.0%	13.5%	13.4%
Other Income (Fee/ Others) / Avg. Assets	0.8%	1.0%	1.6%	0.9%	2.1%	2.4%	2.5%	1.9%	1.7%
Income Yield / Avg. Assets	8.3%	8.8%	10.0%	9.9%	10.7%	13.9%	15.5%	15.5%	15.2%
Op. Cost/ Avg. Assets	8.5%	5.6%	5.1%	4.4%	4.8%	5.3%	5.5%	5.5%	5.4%
Operating Profit / Avg. Assets	-0.2%	3.2%	4.9%	5.5%	6.0%	8.6%	10.0%	10.0%	9.8%
Provisions / Avg. Assets	3.2%	0.7%	2.4%	4.4%	5.6%	2.4%	2.9%	2.6%	2.4%
Pre-Tax RoA	-3.4%	2.5%	2.6%	1.1%	0.4%	6.1%	7.1%	7.4%	7.4%
Tax Retention Rate	-0.90%	0.64%	0.77%	0.25%	0.04%	1.50%	1.84%	1.93%	1.93%
Post Tax RoA	-2.5%	1.8%	1.8%	0.9%	0.3%	4.6%	5.2%	5.5%	5.5%
Leverage = Avg. Assets / Avg. Equity	6.3	6.2	4.3	4.1	5.1	4.6	4.0	4.1	4.1
RoE (Leverage * ROA)	-15.9%	11.3%	7.7%	3.6%	1.7%	21.2%	21.1%	22.3%	22.8%

SOURCE: COMPANY REPORTS, INCRED RESEARCH

- A healthy capital adequacy ratio had been another support for keeping the overall cost of funds under check and maintaining overall lenders' confidence intact.

Figure 21: Healthy capital adequacy has been key support for augmenting liability



SOURCE: INCRED RESEARCH, COMPANY REPORTS

- We are valuing FMFL on an excess return on equity (ERoE) basis with a risk-free rate of 7%, which is equivalent to the State Bank of India or SBI's five-year fixed deposit rate and market risk premium of 6% each and beta of 1.3 (Bloomberg adjusted beta).

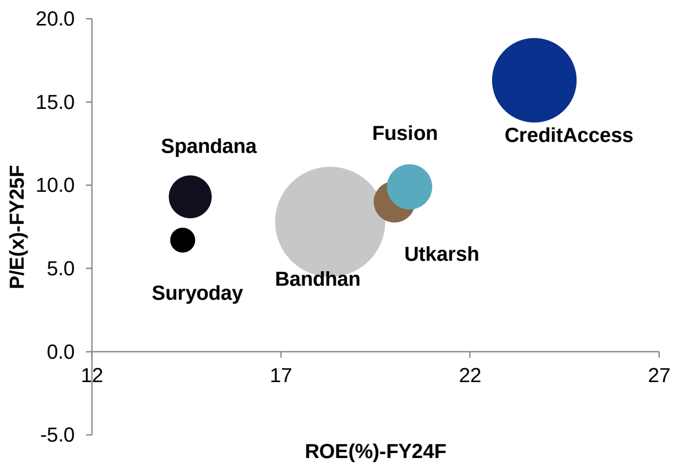
Figure 22: Valuation parameters

Parameter	Rate	Methodology
Risk-free rate	7.0%	SBI's five-year fixed deposit rate
Risk premium	6.0%	Standard for our entire coverage
Beta	1.3	From Bloomberg: adjusted daily beta vs. Nifty-50 over last two years
Cost of equity	**14.8%**	

SOURCE: INCRED RESEARCH, BLOOMBERG

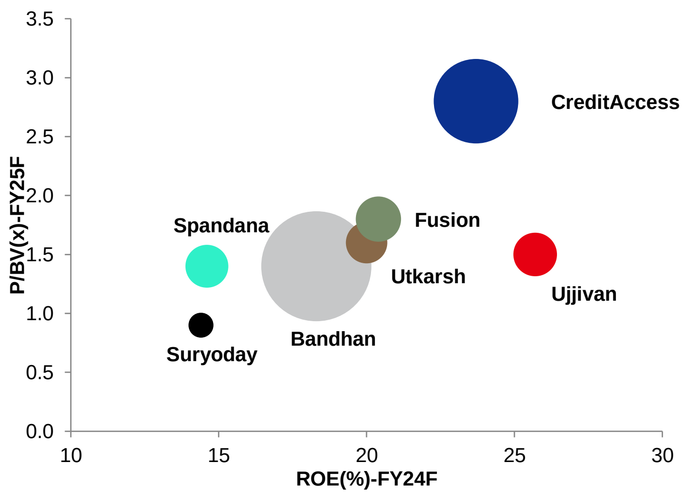
- Accordingly, we have arrived at our target price of Rs800 for FMFL, corresponding to ~2.2x P/BV and ~12x P/E on Mar 2025F. We initiate coverage on FMFL with an ADD rating and maintain our Outperform view on the BFSI sector.
- While comparing FMFL on a P/BV basis compared to peers, we can clearly identify that the stock trades fairly at current levels with a decent potential upside to reach the peer trend line. This further reiterates our positive view on the stock.

Figure 23: P/BV valuation comparison with peers



SOURCE: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG, SIZE OF BUBBLE IS MARKET CAPITALIZATION

Figure 24: P/E valuation comparison with peers



SOURCE: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG, SIZE OF BUBBLE IS MARKET CAPITALIZATION

Risks to our investment thesis

- **Elevated slippage trend to adversely affect investor perception:** FMFL has witnessed a volatile asset quality trend during the pandemic. Management has assured the investors that major pain from the legacy loan book has been recognized, but any further surge in delinquency remains a key risk to our investment thesis as that will not only change our earnings estimates but more importantly, investor perception towards the stock.
- **Microfinance historically has remained a cyclical business:** Microfinance in India, despite being present since the past two decades, has always remained a cyclical business, being affected by various reasons including natural calamities, pandemics, political intervention, etc. which are beyond the control of management. Any such event in future will have an impact on our estimates and investment thesis for FMFL.
- **Geographical concentration risk:** Management remains committed to expand FMFL's presence across India, but the company remains concentrated in states like Uttar Pradesh, Bihar, Madhya Pradesh, West Bengal, and Tamil Nadu with more than ~10% of AUM exposure to each state. Any adverse event in any of these states could affect the company's earnings.
- **Key management risk:** FMFL is promoted and run by Mr. Dhiraj Sachdev, who has been a veteran banker and has built the business from scratch. He also holds some stake in the company. In the event of his leaving the company, the business continuity may get impacted. Any change in the company's management or promoter structure could severely affect its growth and earnings profile in future, in our view.
- **Regulatory risks:** Microfinance institutions in India have remained one of the most regulated entities due to their dealings with low-income individuals across India. The RBI has become more accommodative recently with some relaxation in norms, but we need to keep a close eye over any change in regulations pertaining to MFIs in India as that will affect our investment thesis.
- **Interest rate risk:** Change in interest rates remains the key macro risk which needs to be monitored for all lenders as it impacts margins as well. FMFL has managed a well-balanced liability profile in the past couple of years, but almost ~100% of its loan book has a fixed-rate yield and any tightening of interest rates could result in margin pressure for the company in the near term.
- **Underwriting risk:** Underwriting refers to a process that a large financial service provider (bank, insurer, investment house) uses to assess the eligibility of a customer to receive its products like equity capital, insurance, or credit. Any such risk is a negative development for the company.
- **Credit risk:** It mainly arises due to the uncertainty over a counterparty's ability to meet the obligations.

About the company

Fusion Micro Finance (FMFL) is a public limited company registered with the RBI as an NBFC-MFI and having a geographically diversified presence in India. The company offers income-generation loans under the joint liability group model, predominantly to women from low-income households in rural areas.

FMFL – The formation and initial business

FMFL MFI was originally incorporated as Ambience Fin Cap Private Limited on 5 Sep 1994 in New Delhi as a private limited company under the Companies Act, 1956. On 9 Jan 2003, the RBI granted a certificate of registration to the company as a non-deposit accepting non-banking financial company under Section 45IA of the Reserve Bank of India Act, 1934. Subsequently, the name of the company was changed to Fusion Micro Finance Private Limited. The company was granted an 'NBFC – Microfinance Institution' status by the RBI with effect from 28 Jan 2014. The name of the company was further changed to Fusion Micro Finance Limited upon conversion to a public limited company on 20 Jul 2021.

During the pandemic – FMFL was on the road to recovery

The Covid-19 pandemic and the related lockdowns in FY20 and FY21 were tough for people with limited means as they had a severe impact on their income and their ability to run their household. The direct impact of this was on their ability to service their existing debt repayment and hence, impacting their credit score and avenues to secure future funding for their livelihood.

FMFL's management handled the situation dynamically by keeping the customer interest in mind. The company continued to disburse loans and expand during the pandemic, with equal focus on collection and recoveries. The focus remained on growing in the geographies (like Uttar Pradesh, Bihar, etc.) where the impact of the lockdown had been limited. The company also kept close monitoring of customer behaviour and their default history, based on which incremental lending was done. This approach of FMFL's management allowed the company to navigate well through the turbulent times and return to normalcy.

Post-pandemic – the focus is on diversified growth

Post-pandemic, the company witnessed strong credit momentum, with AUM at the end of FY23 standing at R93bn (+37% YoY) and growth in the client base of ~29% YoY at ~3.5m clients, with an addition of ~0.8m clients during FY23. The company equally focused on diversity by entering different states and opening branches (~152 branches in FY23).

From operating in 12 states in 2017, FMFL is present in 20 states as of Mar 2023-end by increasing its presence in new states including other large states like Odisha, Madhya Pradesh, Gujarat, Rajasthan, and Tamil Nadu.

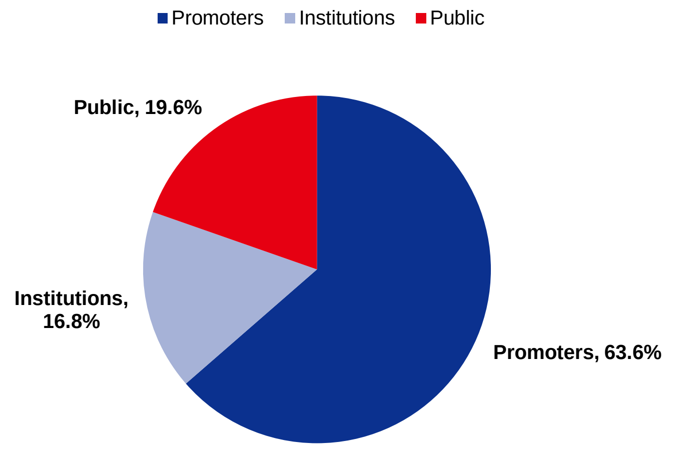
The top five states for the company remain Bihar, Uttar Pradesh, Odisha, Madhya Pradesh, and Tamil Nadu, with a concentration of ~69% as of Mar 2023-end versus ~74% as of Mar 2017-end. FMFL has always been rural focused, and the composition of its rural portfolio has been ~93% over the last few years.

Figure 25: Key management profile as at end-Jun 2023

Name	Designation	Background
Mr. Devesh Sachdev	Managing Director & CEO	An XLRI post-graduate with 25 years of experience in the service industry prior to starting FMFL in 2009-10. Under his leadership, FMFL has grown into one of the leading microfinance institutions and continues to expand its operations.
Mr Gaurav Maheshwari	CFO	Mr. Maheshwari is a Chartered Accountant (CA) by profession and has several years of experience in corporate finance with Aditya Birla Group and Avantha.

SOURCE: INCRED RESEARCH, COMPANY REPORTS

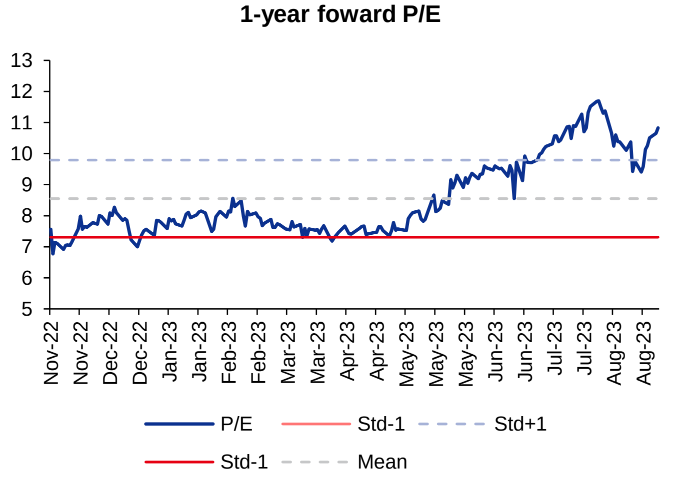
Figure 26: Shareholding pattern of FMFL as of end-Jun 2023



SOURCE: INCRED RESEARCH, COMPANY REPORTS

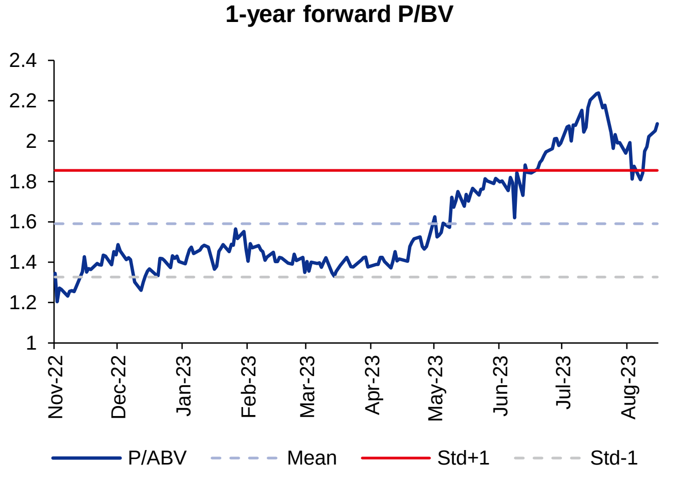
Historical valuation band of FMFL

Figure 27: One-year forward P/E (x) band with standard deviation



SOURCE: INCRED RESEARCH, BLOOMBERG

Figure 28: One-year forward P/BV (x) band with standard deviation



SOURCE: INCRED RESEARCH, BLOOMBERG

Peer comparison

Figure 29: In the lending business, many NBFC MFIs and small finance banks (SFBs) are the competitors of FMFL

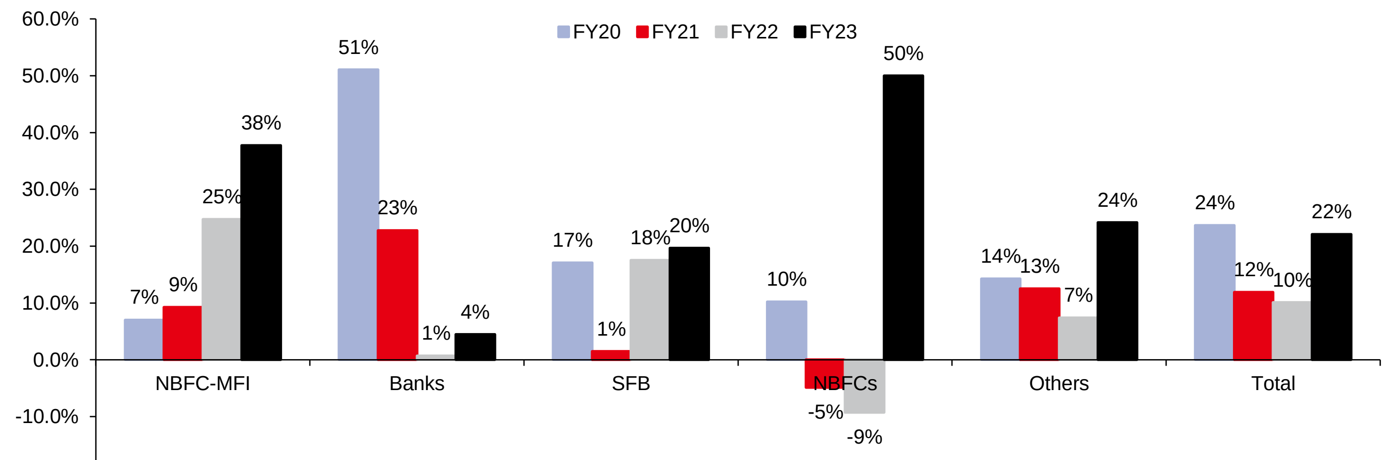
	BBG Ticker	Rating	Price (LP)	Target Price	Mcap (Rsbn)	PAT(Rsm)		Price/Book Value		Price/Earnings	
Lenders			Rs	Rs		FY23	FY24F	FY24F	FY25F	FY24F	FY25F
Fusion Micro Finance	FUSION IN	ADD	629	800	62.5	3,871	5,471	2.2	1.7	11.9	8.8
Spandana Sphoorty	SPANDANA IN	ADD	777	1,000	58	123	4,783	1.7	1.4	11.3	9.3
CreditAccess	CREDITAG IN	NR	1,374	NA	227	8,260	13,386	3.4	2.8	22.2	16.6
Suryoday SFB	SURYODAY IN	NR	176	NA	18	777	2,495	1.2	0.9	8.2	6.7
Bandhan Bank	BANDHAN IN	NR	235	NA	378	21,946	39,623	1.7	1.4	9.5	7.8
Ujjivan SFB	UJJIVANS IN	NR	49	NA	95	10,985	12,455	1.8	1.5	8.9	7.3

SOURCE: INCRED RESEARCH, BLOOMBERG

Microfinance in India: The favourable cycle

The microfinance industry or MFI faced growth slowdown during the Covid-19 pandemic, which led to a disruption and resulted in muted AUM growth of a 14% CAGR over FY20-23. However, due to faster economic recovery, full resumption of business activity and customer acquisition, the microfinance industry witnessed strong growth in FY23, posting a 22% yoy AUM growth.

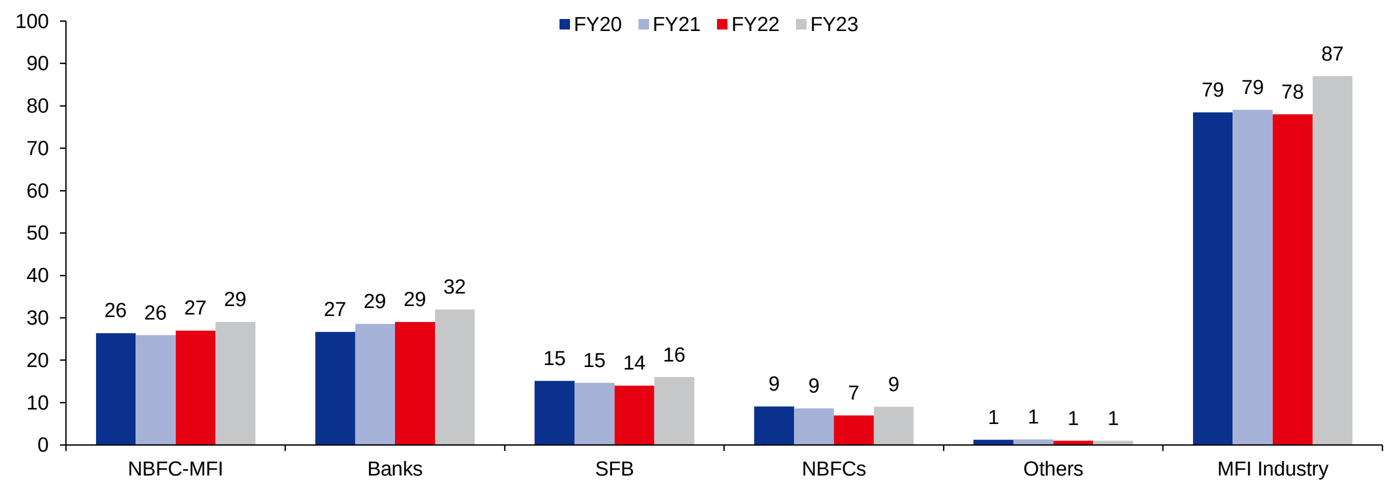
Figure 30: AUM growth of the microfinance industry regains its momentum post Covid-19 pandemic



SOURCE: INCRED RESEARCH, MFIN MICROMETER

Unique borrowers of the microfinance industry grew at ~3.5% CAGR over FY20-23, which indicates that the major growth of the industry during FY20-23 was driven by ticket size. However, as the RBI has now increased the household income limit to Rs0.3m from Rs0.125m earlier along with the focus on growth, we expect the microfinance industry to witness strong customer acquisition.

Figure 31: Banks added the highest number of unique MFI borrowers post Covid-19 disruption (in m)

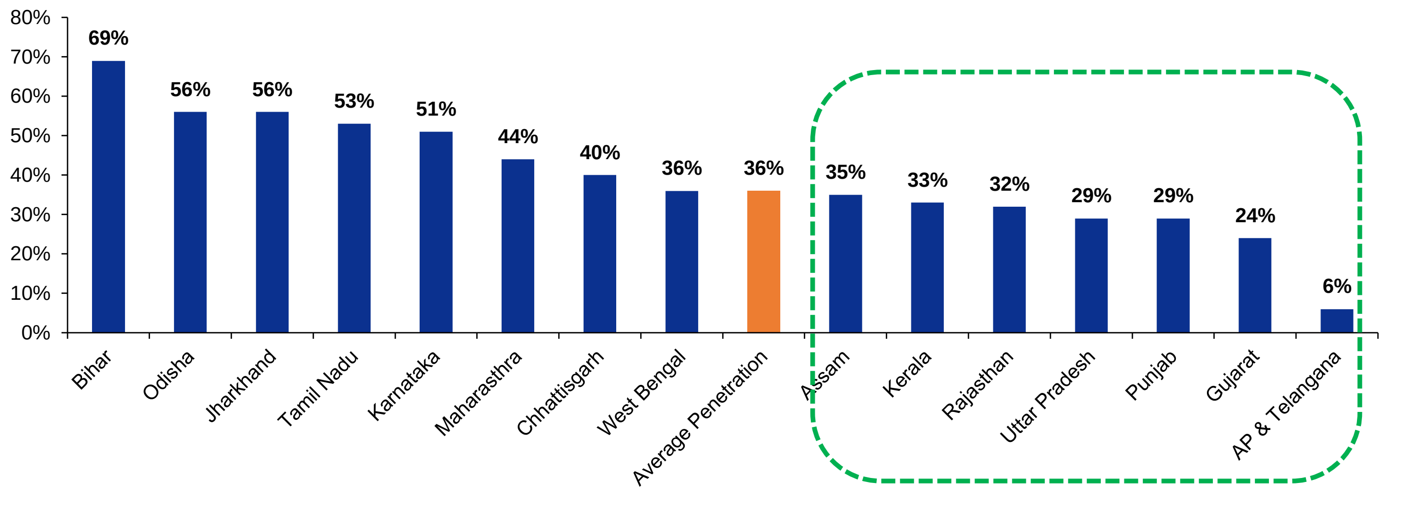


SOURCE: INCRED RESEARCH, MFIN

Higher growth in states with low market penetration

India has a unique MFI borrower base of ~61m out of total addressable households of ~168m, indicating ~36% penetration in terms of the number of borrowers. However, states like Bihar, Tamil Nadu, Odisha, Karnataka, etc. have a higher penetration of 50-70% while states like Uttar Pradesh, Maharashtra and Gujarat have a penetration lower than ~30%. Thus, there is enough headroom to grow in the underpenetrated states of India.

Figure 32: Underpenetrated states to provide enough growth opportunities for the MFI



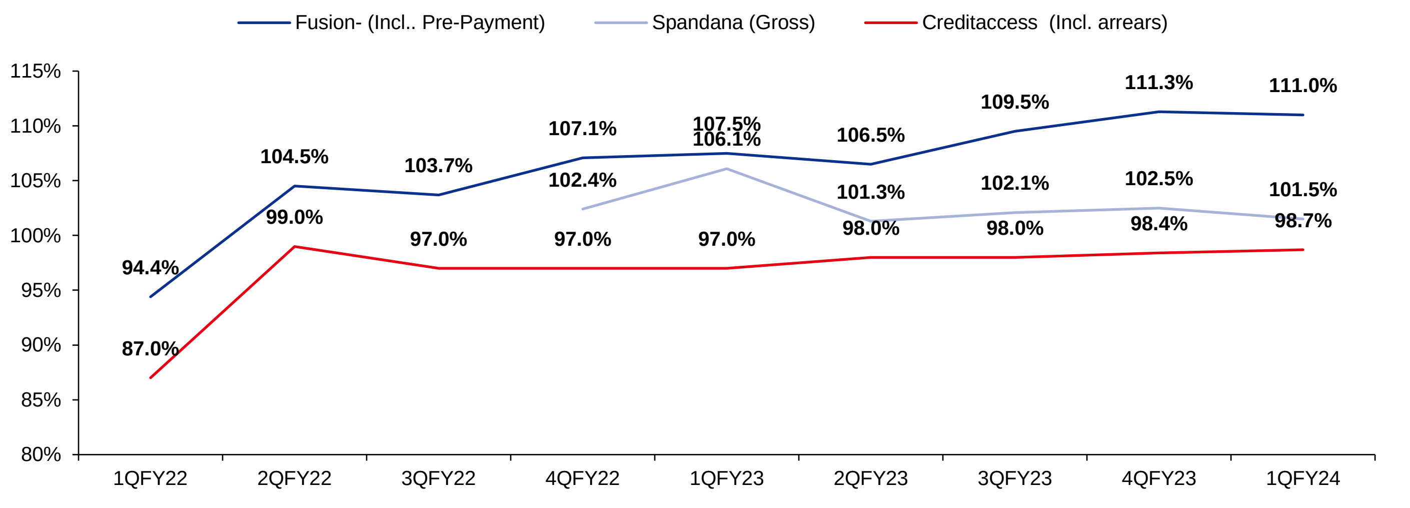
SOURCE: INCRED RESEARCH, COMPANY REPORTS, MFIN DATA

Collection efficiency has peaked already, focus on underwriting

We have witnessed a spurt in collection efficiency for most MFI players in the past few quarters amid recoveries improving post-pandemic remaining healthy. Interestingly, even previously defaulted customers have returned to repay to improve their credit scoring and obtain fresh credit from MFIs.

Going forward, we expect limited probability for further improvement in collection efficiency and the incremental focus should be on overall underwriting practices of individual MFI which will derive the future asset quality trend. However, sustaining this healthy collection mechanism will continue to play an important role in determining headline NPA numbers.

Figure 33: Collection efficiency (including arrears) for NBFC-MFIs has reached its peak with limited probability for improvement

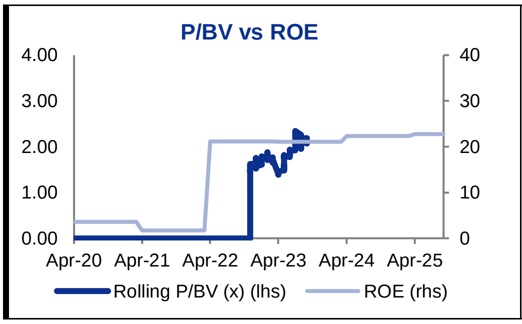


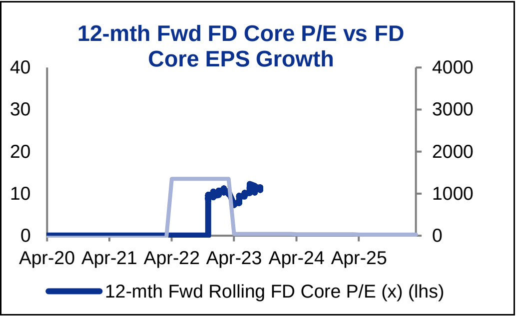
SOURCE: INCRED RESEARCH, COMPANY REPORTS
* DATA FOR SPANDANA IS AVAILABLE FROM 4QFY22 ONLY

Improved data availability: another driver for managing quality

The RBI has mandated collection of household income data by MFI players and supplying the same to credit information companies which, we believe, will assist MFI players to understand the customer profile and identify other members of the household who may have defaulted in microfinance loans, thereby improving the underwriting and asset quality. However, we believe the underwriting practices of individual companies remain the key factor, which will lead to a wide difference in asset quality performance in a downcycle, despite the availability of strong household credit and income history.

BY THE NUMBERS





Profit & Loss

(Rsm)	Mar-22A	Mar-23A	Mar-24F	Mar-25F	Mar-26F
Net Interest Income	5,684	9,573	13,609	17,791	22,519
Total Non-Interest Income	**1,370**	**1,999**	**2,589**	**2,538**	**2,892**
Operating Revenue	7,054	11,572	16,198	20,329	25,412
Total Non-Interest Expenses	**(3,122)**	**(4,448)**	**(5,784)**	**(7,196)**	**(8,975)**
Pre-provision Operating Profit	3,932	7,124	10,414	13,133	16,437
Total Provision Charges	**(3,687)**	**(2,004)**	**(3,021)**	**(3,384)**	**(3,977)**
Operating Profit After Provisions	245	5,120	7,393	9,748	12,460
Pretax Income/(Loss) from Assoc.					
Operating EBIT (incl Associates)	245	5,120	7,393	9,748	12,460
Non-Operating Income/(Expense)					
Profit Before Tax (pre-EI)	245	5,120	7,393	9,748	12,460
Exceptional Items					
Pre-tax Profit	245	5,120	7,393	9,748	12,460
Taxation	(26)	(1,248)	(1,922)	(2,535)	(3,240)
Consolidation Adjustments & Others					
Exceptional Income - post-tax					
Profit After Tax	219	3,871	5,471	7,214	9,220
Minority Interests					
Pref. & Special Div					
FX And Other Adj.					
Net Profit	219	3,871	5,471	7,214	9,220
Recurring Net Profit					

Balance Sheet Employment

(Rsm)	Mar-22A	Mar-23A	Mar-24F	Mar-25F	Mar-26F
Gross Loans/Cust Deposits					
Avg Loans/Avg Deposits					
Avg Liquid Assets/Avg Assets					
Avg Liquid Assets/Avg IEAs	**124.2%**	**115.9%**	**109.7%**	**105.5%**	**103.7%**
Net Cust Loans/Assets					
Net Cust Loans/Broad Deposits					
Equity & Provns/Gross Cust Loans					
Asset Risk Weighting					
Provision Charge/Avg Cust Loans					
Provision Charge/Avg Assets					
Total Write Offs/Average Assets					

SOURCE: INCRED RESEARCH, COMPANY REPORTS

BY THE NUMBERS…cont'd

Balance Sheet

(Rsm)	Mar-22A	Mar-23A	Mar-24F	Mar-25F	Mar-26F
Total Gross Loans	**59,181**	**80,416**	**106,250**	**138,488**	**178,084**
Liquid Assets & Invst. (Current)					
Other Int. Earning Assets					
Total Gross Int. Earning Assets	59,181	80,416	106,250	138,488	178,084
Total Provisions/Loan Loss Reserve					
Total Net Interest Earning Assets	59,181	80,416	106,250	138,488	178,084
Intangible Assets					
Other Non-Interest Earning Assets	**1,129**	**1,200**	**1,499**	**1,874**	**2,343**
Total Non-Interest Earning Assets	**1,321**	**1,409**	**1,730**	**2,128**	**2,622**
Cash And Marketable Securities	11,535	10,650	7,456	5,887	5,923
Long-term Investments					
Total Assets					
Customer Interest-Bearing Liabilities					
Bank Deposits					
Interest Bearing Liabilities: Others	57,757	67,784	80,488	102,622	131,598
Total Interest-Bearing Liabilities	57,757	67,784	80,488	102,622	131,598
Banks Liabilities Under Acceptances					
Total Non-Interest Bearing Liabilities	1,768	2,632	6,258	7,977	9,907
Total Liabilities	59,525	70,416	86,746	110,599	141,505
Shareholders Equity	13,379	23,219	28,690	35,904	45,124
Minority Interests					
Total Equity					

Key Ratios

	Mar-22A	Mar-23A	Mar-24F	Mar-25F	Mar-26F
Total Income Growth	25.6%	68.4%	42.2%	30.7%	26.6%
Operating Profit Growth	41.6%	81.2%	46.2%	26.1%	25.2%
Pretax Profit Growth	(57%)	1,991%	44%	32%	28%
Net Interest To Total Income	80.6%	82.7%	84.0%	87.5%	88.6%
Cost Of Funds	9.72%	10.24%	10.75%	10.60%	10.10%
Return On Interest Earning Assets	20.7%	22.9%	23.1%	22.5%	21.7%
Net Interest Spread	10.99%	12.68%	12.37%	11.87%	11.60%
Net Interest Margin (Avg Deposits)					
Net Interest Margin (Avg RWA)					
Provisions to Pre Prov. Operating Profit	94%	28%	29%	26%	24%
Interest Return On Average Assets					
Effective Tax Rate	10.6%	24.4%	26.0%	26.0%	26.0%
Net Dividend Payout Ratio					
Return On Average Assets					

SOURCE: INCRED RESEARCH, COMPANY REPORTS

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