

31 Mar, 2011

Magma Fincorp Ltd

Background

Magma Fincorp Ltd (Magma), promoted by Mayank Poddar and Sanjay Chamria is a Kolkata based asset financing company. The company is engaged in financing of commercial vehicles, cars, construction equipment, tractors and utility vehicles. The company's target customers are mostly first time users and small entrepreneurs. Magma has a customer base of over 225,000 and has assets under management of approximately ₹87.6 billion as at the end of Dec 2010.

Investment Rationale

Robust demand witnessed by Auto Sector: The automobile Industry is witnessing strong volumes across all the segments attributable to improvement in macro economic condition, conducive financing environment and product launches by existing players. Funding is important part of the auto sales as nearly 70% to 80% of the vehicle sales are backed by auto loans extended by banks or financial institution. This in turn bodes well for auto financing companies.

Diversified Business: Magma has a diversified business model with no product or regions specific risk. The company has 172 branches on a pan India basis and is largely present in rural and semi urban areas. Magma has a diverse mix of products under its portfolio, which includes commercial vehicles, cars, construction equipment, tractors and SME loans. The Asset Under Management (AUM) (on the book as well as off the book assets) has registered a 17.8% CAGR during FY07-FY10. Magma is now focusing on increasing the proportion of high yielding loan segments in the book.

Strong growth in loan book: The loan book for Magma grew at a 37% CAGR during FY07-FY10 driven by 22% growth in disbursements during the period. Going forward, the strategy of the company is to increase the share of high yield loan segments in the total portfolio. Within the high yield segment, the company intends to focus more on the tractor and used CV segment. We expect the disbursements to grow at a 25% CAGR during FY10-13. Further, we expect the securitisation levels to come down to 30% by FY13 from 50% at present which in turn will lead to a 45% CAGR in the loan book during FY10-13.

Robust asset quality and collection efficiency: Magma follows a policy of writing off entire loan contracts which go beyond 180 days past due. This risk management practice has enabled Magma maintain 'NIL' NPA's on its books for the past 5 years. Magma has a strong cash collection system in place, where it largely relies on its own employee rather than being dependent on DSA and collection agents. Out of the total employees, 62% of its employees are field officers.

Valuation and Recommendation

Magma Fincorp has been consistently improving its operating performance. On the back of strong growth in disbursements we expect the Net Interest Income to register a 32% CAGR during FY10-12. We expect the earnings to register a CAGR of 33% during the same period. We initiate coverage on Magma Fincorp Ltd with a "BUY" recommendation for a target of ₹94. (1.5x its book value of ₹62.9 of FY13).

Key Data	(₹)
CMP	61
Target Price	94

Key Data	
Bloomberg Code	MGMA IN
Reuters Code	MAGM.BO
BSE Code	524000
NSE Code	MAGMA
Face Value (₹)	2
Market Cap. (₹ bn)	7
52 Week High (₹)	88
52 Week Low (₹)	51
Avg. Daily Volume (6m)	490638

Shareholding Pattern (%)	
Promoters	41.6
Mutual Funds / Bank/ FI	1.9
Foreign Institutional Investors	42.4
Bodies Corporate/Individuals/others	14.1
Total	100.0

(₹ mn)	FY11E	FY12E	FY13E
Net Interest Income	4,227.0	6,046.6	7,280.8
Net Profit	986.2	1,299.6	1,579.2
EPS (₹.)	7.6	10.0	12.2
Book value (₹)	43.1	52.0	62.9

Analyst

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Robust growth in auto volumes
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Automobile Industry

The automobile Industry witnessed strong growth till 2007-08. However in 2008-09, there was a drop in the overall volumes, attributed to the economic slowdown that led to demand contraction in all the underlying assets. Thereafter the government introduced various stimulus packages, which have helped in revival of demand. Therefore after 2008-09, the economy started picking up and this resulted in improvement in sales volume.

	FY06	FY07	FY08	FY09	FY10	11mFY11	11mFY10	Growth
Passenger cars	882,094	1,076,408	1,203,102	1,220,475	1,526,259	1,786,512	1,371,131	30.3
Growth	7.6	22.0	11.8	1.4	25.1			
Utility Vehicles	261,951	302,863	346,332	330,379	422,989	486,050	379,488	28.1
Growth	7.4	15.6	14.4	-4.6	28.0			
Commercial vehicles	350,553	467,423	490,161	384,952	530,936	598,682	464,927	28.8
Growth	10.0	33.3	4.9	-21.5	37.9			
Total	1,494,598	1,846,694	2,039,595	1,935,806	2,480,184	2,871,244	2,215,546	29.6
Growth	8.1	23.6	10.4	-5.1	28.1			

Source: CRISIL

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70% to 80% of the vehicle sales are backed by auto loans.
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Easy availability of Finance- An important growth driver for the auto Industry

Apart from rising disposable incomes, Auto financing has emerged as an important driver for demand in the auto Industry. Funding is important part of the auto sales as nearly 70% to 80% of the vehicle sales are backed by auto loans extended by banks or financial institution. The availability of vehicle finance at the point of purchase can foster sales. Therefore in order to provide complete buying assistance to the purchasers at the point of purchase, many of the Auto companies have set up their own financing companies or tied up with banks.

Sources of Finance –Auto Financing Industry

The auto finance Industry has both organised and unorganised players. The organised players comprise of

- Banks: Private, foreign, public and co-operative
- NBFC's can be further categorised as standalone NBFC's and captive NBFC's.
- Captive NBFC's are financing arms of auto manufacturers set up with the objective of primarily financing the products of their parent manufacturer.
- The unorganised players include local moneylenders, dealers etc.

The auto finance industry was once dominated by the NBFC's. It was found that while banks dominated the low risk car-financing segment, NBFC dominated the commercial vehicle space, which was perceived to be risky. However the entry of banks in the retail finance space led to severe competition for NBFC. Banks had an edge over the NBFCs because of their access to low cost funds in the form of CASA (Current and savings account). With the advantage of low-cost funds, banks have eaten into the market share of NBFCs.

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Banks have eaten into the market share of Auto Finance companies.
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Regulatory requirements are less stringent for Auto finance companies.
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Competitive advantage of NBFC over banks

- **Regulatory requirements are less stringent for Auto finance companies as compared to banks**

The auto Finance companies are governed by the NBFC norms stipulated by RBI and RBI also governs banks. However the regulatory requirements for auto finance companies are less stringent than those for banks as they don't need to maintain a cash reserve ratio (CRR), do not need to make loans to priority sectors (whereas the banks have to lend 40% of their loan book to the priority sector) and have lower SLR requirements (15% vs 24% for banks). Hence despite being disadvantaged on the cost of the funds (due to access to CASA), the auto finance companies can compete with banks on pricing of loans. Moreover, some portion of the loans of the auto finance companies is eligible for being classified under priority sector lending. Therefore the auto finance companies securitise these assets with banks. This not only frees cash flows for the auto finance companies but also reduces the cost of funds, as these funds are available at relatively lower cost compared to borrowing from banks directly.

	Auto Finance Companies	Banks
Capital Adequacy Ratio	15%	9%
Cash Reserve Ratio	0%	6%
Statutory Liquidity Ratio	15%	24%
Priority Sector Lending	0%	40%

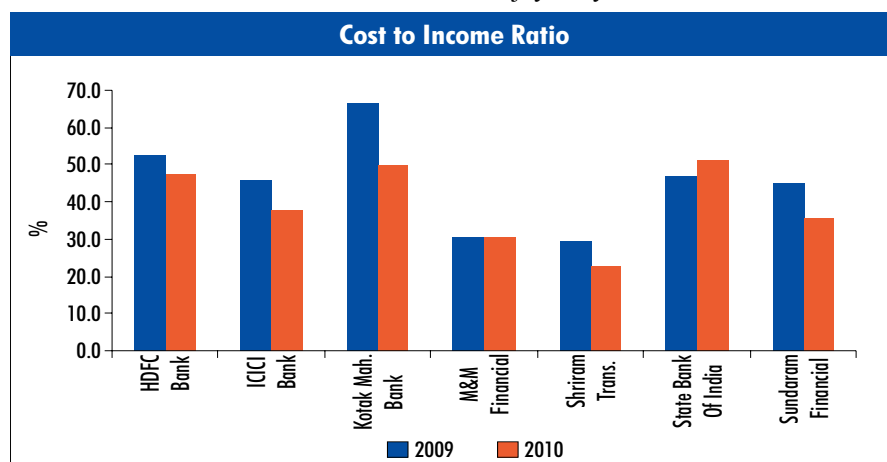
- **Class of consumers**

NBFC's serve consumers, which are perceived to be risky and high NPA prone as per the banking standards. For example Mahindra finance serves consumers from the rural areas, which are unable to meet the documentation requirements of the banks. Further companies like Shriram transport finance are into financing of preowned vehicle which although are high yielding segment but are considered to be risky due to poor credit history of the customers. Therefore banks generally stay away from this class of consumers, which acts as an advantage for these NBFC's.

- **NBFC have better operational efficiency**

Due to the advantage of low cost funds, banks enjoy higher spreads as compared to Auto finance companies. However NBFC have better operational efficiency reflected in the low cost to income ratios enjoyed by these NBFC's.

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NBFC have low cost to income ratios.
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Source: Company Data, RBI, ACMIIL Research

They have greater cost efficiency than banks. NBFCs enjoy greater leeway on both the assets and liabilities sides of their balance sheets than the tightly regulated banks. That gives them greater flexibility in product selection and in pricing their services.

● **Reach into a number of non-metro locations;**

In Billion	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
Total loans and advances	11250.6	14737.2	18937.8	23320.0	27935.7	33456.2
Retail portfolio of banks	2666.1	3756.8	4878.6	5707.8	5938.2	6227.5
Auto Loans	350.4	613.7	825.6	880.0	839.2	783.46
Retail loans/Total loans	23.7	25.5	25.8	24.5	21.3	18.6
Auto Loans/Total Loans	3.1	4.2	4.4	3.8	3.0	2.3

Source: RBI

HDFC Bank, SBI and ICICI bank together account of almost 50% of the auto loan market within Banks

Bank	Retail Loans as on March 2010	% to total
Total Auto Loans	783.46	100
HDFC Bank	196.0	25
ICICI Bank	89.8	11
SBI Bank	141	18
Others	356.7	46

Source: Company Data, ACMIIL Research

Branch Network of these Banks

Branch presence	ICICI bank	HDFC Bank	SBI	Magma	MMFSL
Total Branches	1707	1780	12496	172	537
Rural/ Semi urban	67%	60%	67%	100%	98%
Metro	33%	40%	33%	-	2%

Source: Company Data, RBI, ACMIIL Research

The share of banks in the auto financing is declining as can be seen from the above table. Also most of the banks, which have significant exposure to the auto loan market, are present in metros and are increasing presence in the rural areas. On the other hand the NBFC already have major presence in the rural areas. Therefore this works as a first mover advantage to the NBFC. Also future growth coming from rural areas bodes well for the NBFC's.

Conclusion

While the auto finance companies are disadvantaged on the cost of funds, they score better in terms of credit assessment skills, better operational efficiency, higher loan yields and lower regulatory requirements. This result in return on assets for the auto finance companies for auto finance companies in this segment compared to banks.

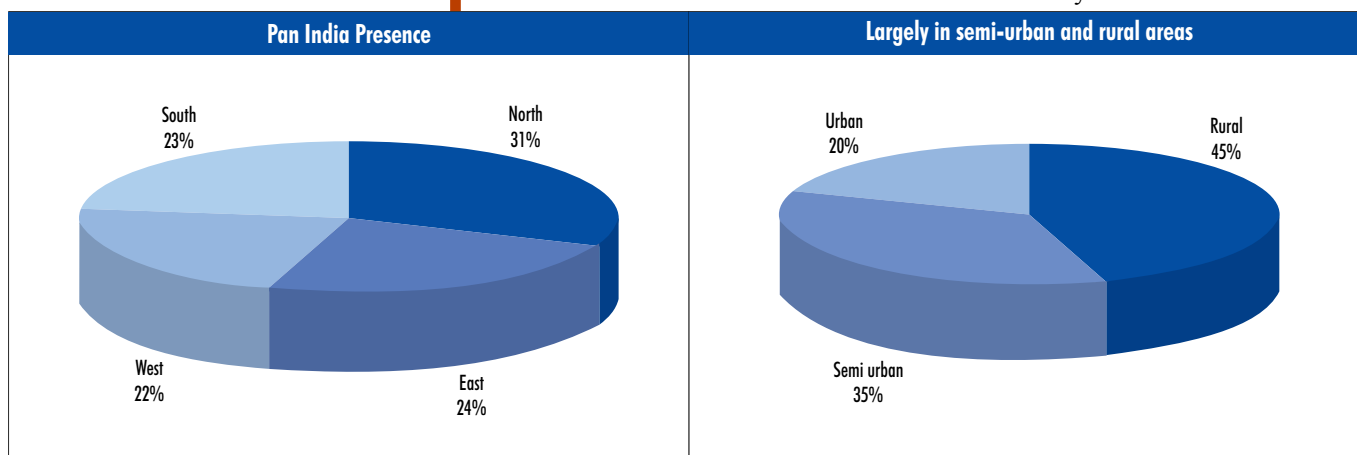
Considering the growth expected in auto industry particularly in the non-urban areas and the need for finance we believe that this would bode well for the auto finance companies. In spite of the growing competition from banks, NBFC's like Mahindra Finance, Magma Fincorp and Shriram Transport Finance continue to register robust growth due to their high penetration in unbanked areas, their competence in understanding the local customer and their recovery capabilities.

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**Auto finance companies
score in terms of better credit
assessment skills.**
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Company Overview

Geographical presence

The company has 172 branches on a pan India basis but is largely present in rural and semi urban areas. Over 80% of its branches are in these locations. The company was predominantly present in the northern and eastern regions, however the company is increasing its presence in western and southern India. The company intends to increase the number of branches to 225 in the next two years.



Source: Company

Product Profile

Business segment	Average Yields: 11.9%			Average Yields: 17.9%		
	Low risk and Low return			High risk and High return		
	Commercial Vehicles	Passenger cars and multi-utility vehicles	Construction equipment	Used Commercial vehicles	Tractors	SME loans
Share in total Loans as On FY10	43	20	27	2.5	2.7	4.6
Average Ticket Size	₹ 13 lacs	₹ 2.8 lacs	₹18.9 lacs	₹ 4 lacs	₹3 lacs	₹17.2 lacs
Tenure	43 months	43 months	34-40 months	33 months	49 months	31 months
Loan to Value (LTV)	75%	67%	79%	72%	63%	NA
Internal Rate of Return	11.4%	12.7%	11.8%	18.2%	19.6%	16.1%
Alliances	Tata Motors, Mahindra & Mahindra, Ashok Leyland, Volvo and EicherMotors.	Maruti, Hyundai, General Motors, Mahindra & Mahindra and International Cars & Motors Limited.	Telcon and JCB, L&T, Ace, Caterpillar and Volvo.	Tata Motors and Ashok Leyland.	International tractors limited, TAFE, Escorts, John Deere, and Mahindra.	-

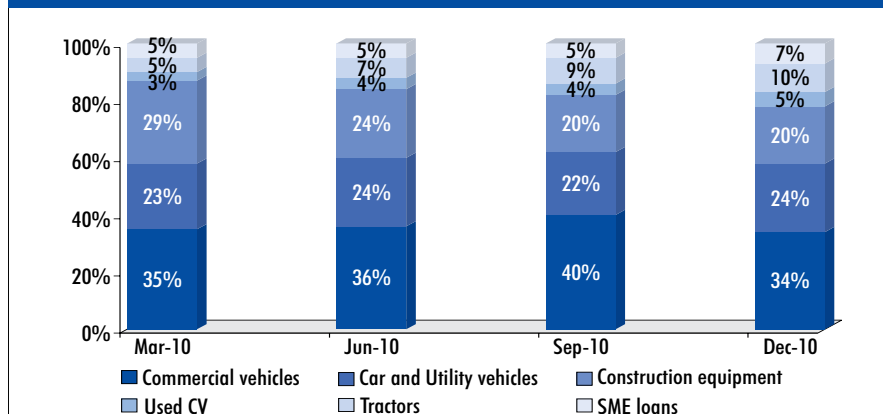
Source: Company

Product Mix

Magma has a diverse mix of products under its portfolio, which includes commercial vehicles, cars, construction equipment, tractors and SME loans. The new commercial vehicles finance forms the largest segment for Magma with 34% share in the disbursements, followed by construction equipment segment with 20% and cars at 24%. The mix is gradually shifting to high yield segments such as used CVs, SMEs and tractor loans (currently 19% of disbursements for YTD FY11). The management expects the contribution from these segments to reach 25% by FY12 and 30% by FY13. These segments being high yield are likely to increase the overall yields and thereby aid improvement in margins for the company.

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Diverse mix of product reduces concentration risk.
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High Yield Loans rising



Source: Company

Segmental Overview

- Commercial vehicles:** Magma finances all categories of commercial vehicles - light, medium and heavy - through tie-ups with manufacturers like Tata Motors, Ashok Leyland, Mahindra & Mahindra, Eicher, Bajaj and Volvo India. For Magma, the First-Time Buyers & small customers, owning 0-5 vehicles are prime customers. Out of its portfolio, 90% is in small road transport sector (SRTO), a sector given priority status by the RBI.
- Passenger cars and multi-utility vehicles:** Within this segment, Magma focuses on financing segment A & B cars (mid size and entry level cars) as well as multi-utility vehicles, which find commercial applications. Magma focuses on un-penetrated and un-contested rural and semi urban areas. The semi-urban segment is growth oriented and the rural segment is a fast developing market. For passenger cars and utility vehicles, it has forged alliances with Maruti, Hyundai, Mahindra & Mahindra and General Motors. Further around 25% of its portfolio is for commercial use and is eligible under the small road transport sector (SRTO).
- Construction equipment:** The Company provides construction equipment finance across retail and strategic customer segments. In the retail segment, it focuses on first-time buyers and small customers. The Company has established contracts with large value vendors addressing multiple projects. It finances a range of construction equipment like excavators, backhoe loaders, compactors, compressors, cranes, tippers and drillers of prominent brands like JCB, Telcon, L&T, Ingersoll-Rand, Caterpillar, ECEL, Escorts and Atlas Copco etc.
- SME loans:** Magma provides unsecured EMI-based loans to SMEs for working capital, business expansion and business maintenance. Magma is among the top five players in the market to service SME unsecured loans (Source: Company). The Company's risk management are very stringent in these loans are offered strictly on income basis after a careful evaluation of financial and credit track record. It has developed proprietary financial analysis tools to make safe credit assessments. The share of this segment is increasing in the total disbursements (5% in FY10). Going forward the company intends to maintain the proportion of these loans at 5% and would adopt a cautious approach while lending.
- Tractor Segment:** Tractor financing plays an important role in the tractor industry as out of the total tractors sold in India, 85-90% of the tractors are purchased on Finance. Magma entered into a joint venture with agri-equipment manufacturer International Tractors Limited through Magma ITL Finance Limited. Tractors represent a profitable addition to the Company's portfolio considering that the yield on tractor financing is higher than other products.

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Contribution from high yield segments to increase going forward.
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Expect the disbursements to grow at a 25% CAGR during FY10-13.
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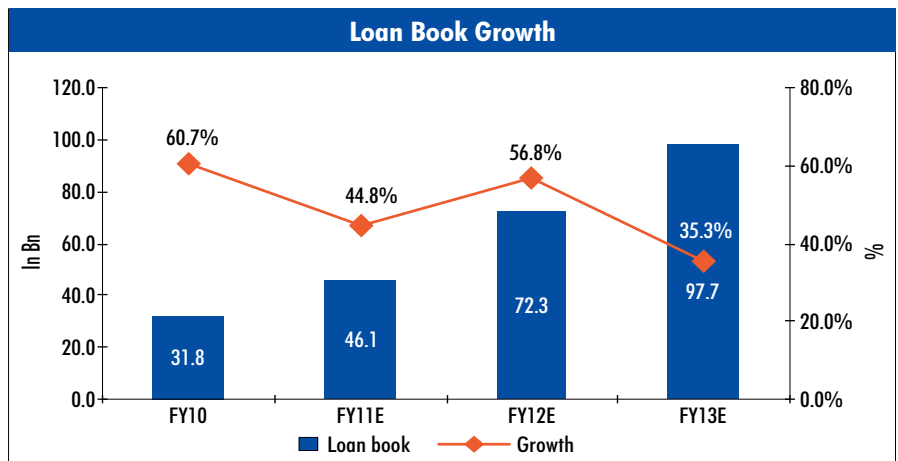
- **Used Commercial Vehicle Finance Segment:** In this segment, Magma provides loans on used commercial vehicles and construction equipment. Magma refinanced popular models of Tata Motors and Ashok Leyland. Shriram Transport Finance Ltd (STFL) dominates used CV segment wherein even Magma operates. However, eastern belt is dominated by Magma’s presence that STFL lacks. Magma plans to increase average disbursement and garner a larger share of the refinance market

Loan book

Magma Fincorp predominantly was engaged in financing of construction equipment and passenger cars, utility vehicles and commercial vehicles (CVs). These business verticals accounted for 90% of the company’s disbursements in FY10. Recently the company has ventured into high-yield segments, viz; financing of used CVs, tractors and SME loans. Most of the loans disbursed are retail loans and have small ticket size except in the construction equipments segment. The weighted average tenor comes to ~40 months. MFL has a concentrated focus on the under tapped semi urban and rural market to finance first time users, Small Road Transport operators, small contractors etc.

The strategy of the company is to increase the share of high yield loan segments in the total portfolio. Within the high yield segment, the company intends to focus more on the tractor and used CV segment. The share of SME segment is expected to be maintained at 5% as the company is adopting a more cautious approach.

The loan book for Magma grew at a 37% CAGR during FY07-FY10 driven by 22% growth in disbursements during the period. Going forward, with the traction being witnessed in disbursals across all the segments, we expect the disbursements to grow at a 25% CAGR during FY10-13. Further, we expect the securitisation levels to come down to 30% by FY13 from 50% at present, which in turn will lead to a 45% CAGR in the loan book during FY10-13.



Source: Company & ACMIIL Research

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**Securitization as a tool to meet
 funding needs of the company.**
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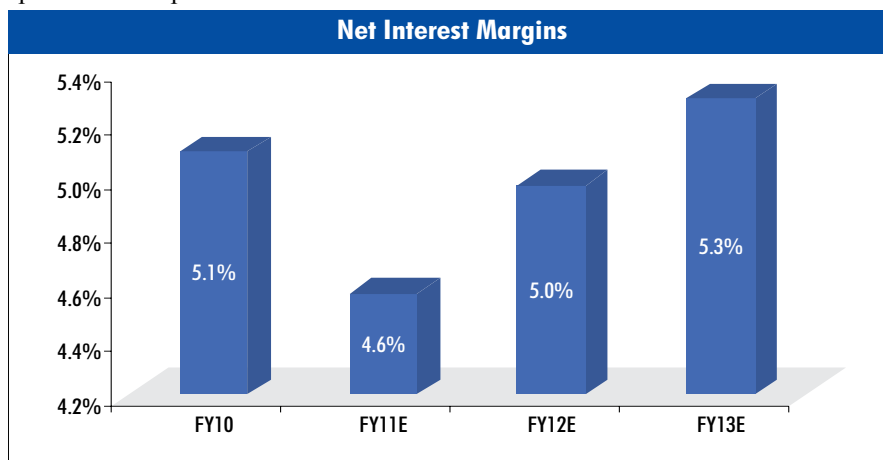
Borrowing Profile

Magma funds its business through a mix of long-term debt funds such as term loans/ debentures, securitization and working capital. Magma has enjoyed consistent investment grade rating for its debt instruments, which enables it to raise funds at competitive rates. Further almost 70% of its loans are eligible to be classified as priority sector loans. Since banks have to meet their priority sector lending targets, they readily purchase these securitized assets at a discount. This results in better cash flows and reduced borrowings for the company.

Magma’s funding mix in the recent past has moved in favour of working capital (50% of total borrowings). With interest rates forming up, the company’s cost of funds has increased from 7.4% in Q1FY11 to 8.5% in Q3FY11, hereby impacting NIMs.

Spreads to improve

Magma reported spreads of 5.1% as on March 2010. The company intends to increase the proportion of high yielding loans with a view to improve its margins. However in the last few quarters, with firming up of interest rates the cost of funds increased for Magma. Further, although the proportion of high yield loan segment increased, the yields declined, as the company was not able to pass on the rising cost thereby impacting spreads. We therefore expect the spreads to be under pressure in FY11. However the company has increased the lending rates with effect from Jan 2011 and with the consequent increase in the high yielding loan segments, we believe the spreads will improve in FY12 and FY13.



Source: Company & ACMIIL Research

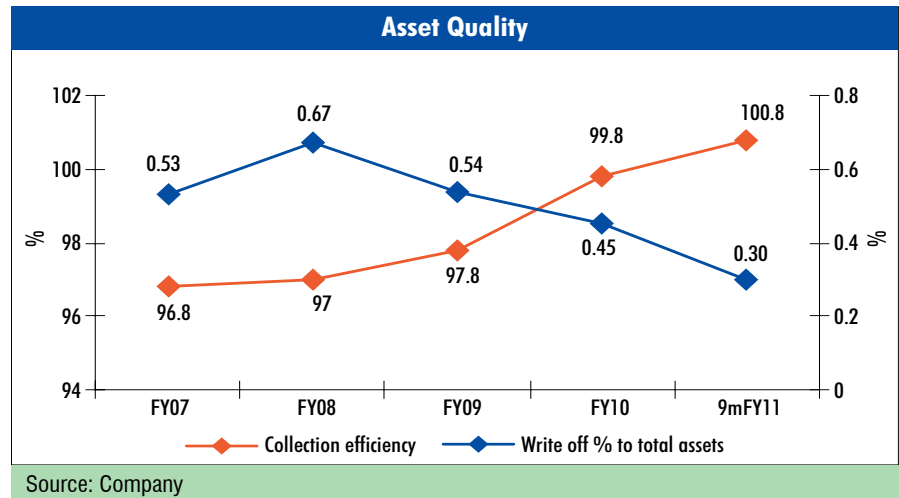
Robust Asset quality & recovery mechanism

Magma has a policy of servicing customers with its own employees, who understand the nuances of the market. The company provides regular training for functional and soft skills to its employees. Having large rural customer base, which lacks banking habits; all transactions are carried out in cash only. Magma has a strong cash collection system in place. To reduce the risk of frauds and leakages in its cash collection system, Magma largely relies on its own employee rather than being dependent on DSA and collection agents. Out of the total employees, 62% of its employees are field officers. Also the company is adequately insured for cash in transit and cash on counter. Over the years, the company has had a very good collection ratio and has been in a position to curtail its non performing assets.

Further, the company follows a policy of writing off entire loan contracts (treating the same as loss assets) which go beyond 180 days past due. This risk management practice has enabled Magma maintain ‘NIL’ NPA’s on it books for the past 5 years.

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**Magma has maintained ‘NIL’
 NPA’s on it books for the past 5
 years.**
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Although the credit cost have been coming down over the last few years, we believe that as the company focuses more on the high yield loan segments, the risk profile is likely to increase thereby impacting the credit/default cost going forward.



Capital Adequacy

The company maintains capital adequacy (CAR) at 19.2% as on December 2010. RBI has recently mandated NBFC's to maintain CAR at 15% before March 2011. Although the company is adequately capitalised at present, the company may need to raise capital later in FY12 to fund its future growth plans.

Peer Group Comparison

Particulars	Magma Fincorp Ltd	Mahindra Finance Ltd	Shriram transport Ltd
Product Profile	Finances commercial vehicles, cars, construction equipment, tractors, used CV and SME loans	Tractor, Car, Utility Vehicles, Commercial vehicles, Used car financing.	Used & New Commercial vehicle Financing
Presence	Pan India Presence	Large presence in North and South India (56% of branches)	50% of branches in South India
Branch Network	172	537	487
Focus Segment	First Time Users & small entrepreneurs	50% of business derived from parent Mahindra	Small Fleet Operators (SFO).
Assets under management-Dec 2010	₹88 billion	₹134 billion	₹337 billion
Growth CAGR FY07-10			
Net Interest Income	20.7%	26.0%	34.3%
Net Profits	28.4%	37.1%	66.1%
Loan Book	36.9%	12.6%	29.9%
Ratios as on Dec 2010			
Yields on Advances	13.1%	18.7%	18.5%
Cost of Funds	7.9%	8.4%	7.1%
Margins	5.1%	12.0%	8.9%
RONW	20.4%	20.9%	26.5%
ROE	2.1%	3.2%	4.0%
Asset quality-Net NPA	0%	1.1%	0.5%
Valuations -FY13E			
EPS	12.2	72.0	81.5
Book Value	62.9	345.2	350.2
PE	5.0	9.8	9.5
P/BV	1.0	2.0	2.2

Source: Company, ACMIIL Research

Key Concerns

- **Risk of cash loss:** The business model of Magma is based on cash collection model wherein the field officers collect repayments from borrowers. This exposes the company to the risk of fraud and misappropriation of funds.
- **Focus on high yielding products:** As the company focuses more on the high yield loan segments, the risk profile is likely to increase thereby impacting the credit/default cost going forward.

Valuation and Recommendation

Magma Fincorp has been consistently improving its operating performance. The core strength for the company lies in its wide product mix, which reduces concentration risk. Also the company is present on a Pan India basis and major concentration is in the rural and semi urban areas, which have large untapped opportunity. The company is focusing on high yielding loan segment with a view to improve margins. The company's asset quality is robust and has strong collection efficiency.

On the back of strong growth in disbursements, we expect the Net Interest Income (NII) to register a 32% CAGR during FY10-12. We expect the earnings to register a CAGR of 33% during the same period. We initiate coverage on Magma Fincorp Ltd with a **"BUY"** recommendation for a target of ₹94. (1.5x its book value of ₹62.9 of FY13).

Earnings Summary				₹ Mn
Particulars	FY10	FY11E	FY12E	FY13E
Interest Income	6,365.3	7,742.2	11,338.2	14,874.0
Interest expended	3,162.5	3,515.2	5,291.7	7,593.2
Net Interest Income	3,202.8	4,227.0	6,046.6	7,280.8
Growth %	12.8	32.0	43.0	20.4
Other Income	664.8	579.0	510.9	576.3
Operating Income	3,867.6	4,806.0	6,557.5	7,857.1
Operating Expenses	2,441.1	2,974.8	3,944.9	4,647.9
Pre Provisioning Profits	1,426.5	1,831.3	2,612.6	3,209.1
Provisions & contingencies	396.2	348.2	643.5	816.4
Profit before Taxes	1,030.3	1,483.0	1,969.1	2,392.8
Provisions for taxes	365.8	496.8	669.5	813.5
Net Profits	664.5	986.2	1,299.6	1,579.2
Growth %	70.2	48.4	31.8	21.5

Source: Company and ACMIIL estimates

Sources and Application of Funds				₹ Mn
Particulars	FY10	FY11E	FY12E	FY13E
Liabilities				
Capital	1,378.8	1,728.4	1,686.2	1,514.0
Equity Share Capital	217.8	259.5	259.5	259.5
Preference Share capital	1161.0	1468.8	1426.7	1254.4
Reserves & Surplus	3,267.1	5,329.7	6,490.5	7,901.1
Networth	4,645.9	7,058.1	8,176.7	9,415.1
Borrowings	35,670.9	45,834.9	70,147.3	93,090.8
Deferred Tax liability	479.2	479.2	479.2	479.2
Total	40,795.9	53,372.1	78,803.2	102,985.1
Assets				
Fixed assets	2,079.6	2,151.6	1,899.3	1,858.4
Investments	302.2	302.2	302.2	302.2
Loans and Advances	31,815.9	46,065.2	72,251.7	97,745.4
Net Current Assets	6,598.3	4,853.2	4,350.0	3,079.2
Total	40,795.9	53,372.1	78,803.2	102,985.1

Source: Company and ACMIIL estimates

Ratio				
Particulars	FY10	FY11E	FY12E	FY13E
Spreads				
Yield on Advances	13.8%	13.2%	14.1%	14.6%
Cost of Borrowings	8.7%	8.6%	9.1%	9.3%
Net Interest Income	5.1%	4.6%	5.0%	5.3%
Profitability ratios				
Return On Average Assets (ROAA)	1.9%	2.1%	2.0%	1.7%
Return On Average Net worth (ROANW)	20.6%	21.7%	21.1%	21.2%
Balance sheet ratios				
Loan to borrowings ratio (%)	89.2	100.5	103.0	105.0
Debt/Equity Ratio (Times)	7.7	6.5	8.6	9.9
Growth Ratios				
Borrowings	44.3%	28.5%	53.0%	32.7%
Loans	60.7%	44.8%	56.8%	35.3%
Networth	12.6%	51.9%	15.8%	15.1%
NII	12.8%	32.0%	43.0%	20.4%
Valuation ratios				
EPS (₹.)	6.1	7.6	10.0	12.2
Book value (₹.)	32.0	43.1	52.0	62.9
P/E (X)	10.0	8.0	6.1	5.0
P/BV (X)	1.9	1.4	1.2	1.0

Source: Company and ACMIL estimates

Notes:

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