

# Microsec Financial Services Limited

CRISIL IPO Grade 2/5 (Below average)

July 26, 2010

## Grading summary

CRISIL has assigned a CRISIL IPO grade of '2/5' (pronounced "two on five") to the proposed IPO of Microsec Financial Services Ltd (MFSL). This grade indicates that the fundamentals of the IPO are **below average** relative to other listed equity securities in India. However, this grade is not an opinion on whether the issue price is appropriate in relation to the issue fundamentals. The offer price for the issue may be higher or lower than the level justified by its fundamentals. The grade is not a recommendation to buy, sell or hold the graded instrument, its future market price or suitability for a particular investor. To arrive at the overall grade, amongst various other parameters, CRISIL has considered the company's business prospects, its financial performance, management capabilities and corporate governance practices.

The assigned grade reflects the company's position as one of the established equity broking and investment banking companies in Eastern India. However, in its move to expand pan-India, the company faces strong competition from national brokers. Also, the experience in investment banking seems to be limited as it has done only a few small-ticket deals. Limited deal execution and reach are expected to limit the company's ability to bag deals, especially in the newer markets. The grade also takes into account the concentrated presence in Eastern India, which so far has registered low fund-raising activity compared to other regions in the country. In addition, the grade factors in the fragmented nature and inherent volatility of the capital market business. Talent retention, which is an industry-wide challenge, is more so for a player like MFSL.

In FY09, the company reported consolidated net profit of Rs 78.7 mn on a top line of Rs 377 mn, translating to a net margin of 20.9%. It posted an EPS of Rs 3.9 during the same period, while its book value per share was Rs 38.6. For the half year ended September 2009, the company posted top line of Rs 268.5 mn, boosted by capital market recovery, and PAT of Rs 109.4 mn.

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1

## About the company

MFSL is a financial services company primarily providing retail broking and investment banking services. The company also offers loan against shares (LAS) to support the broking business. Commodity broking, insurance broking and distribution of financial products complete its bouquet of offerings. Further, the company recently set up an institutional equities broking desk in Mumbai. Headquartered in Kolkata, MFSL has a presence in 17 states with 235 branches, out of which 100 branches are located in Kolkata and overall 169 in West Bengal. The company derives a major portion of its revenues from Eastern India, especially Kolkata.

The Microsec Group was started by Mr B. L. Mittal and Mr Ravi Kant Sharma in 2000. Mr Rakesh Sony joined the company as a promoter in 2002 to build its investment banking business. However, he exited the company in October 2008.

## Issue details

|   |  |
|---|--|
| <b>Shares offered to public</b>         | 12,500,000   |
| <b>As per cent of post issue equity</b> | 39.3%  |
| <b>Object of the issue</b>              | Funding for loan against shares, capital expenditure for branch expansion and technological infrastructure |
| <b>Amount proposed to be raised</b>     | Not available at the time of grading   |
| <b>Price band</b>                       | Not available at the time of grading   |
| <b>Lead manager</b>                     | SBI Capital Markets Limited  |

## Detailed Grading Rationale

### A. Business Prospects

- *Established player in Eastern India ...*

MFSL is an established player in Eastern India with a presence in retail broking and investment banking segments. As on January 31, 2010, the company has a network of 169 branches in West Bengal, out of a total 235, mainly for retail broking. The company has a good network of HNI clients, which has resulted in growth of the LAS segment. In the investment banking business, the company is largely focused on SME client base. Most of its clients are small medium enterprises (SME). The company seems to have certain competitive advantage such as good relationships and networking with corporate in the Eastern region, knowledge based distribution model named as Club Kautilya & PRP etc

- *...but the region's share is low*

As mentioned, the company is mostly present in the Eastern region, especially West Bengal. Eastern India accounts for only 11-12% of the total equity trade in the country. Also, the region's economic activity has lagged behind the country's average growth rate over the past three-five years, though it has recently picked up, resulting in lower fund-raising activities by corporates. Due to concentrated presence in a low activity area, the company's deal execution in investment banking has been limited. Though the region's fund-raising activity is expected to improve, the share of the same is expected to be lower compared to other regions in the country.

- *Highly competitive broking industry and investment banking*

The broking industry is characterised by high competition and a fragmented nature. According to the NSE Fact Book for 2009, top 25 brokers account for only 44% of the total volume. National brokers like Kotak Securities, Religare Securities and IIFL rank among the top brokers in the country with a nationwide presence. On the investment banking side, the industry is also dominated by big domestic players like JM, Kotak Bank, SBI Capital Markets and foreign investment banks, who have established a strong relationship with institutional clients and corporates. Also, there are many small boutiques investment banks which cater to specific regions.

- *Expansion to face challenges*

MFSL has chalked out plans to expand pan-India. The company has set an ambitious target to roll out branches aggressively over the next two-three years to grow its broking and LAS businesses, for which IPO money is being raised. However, we believe the company will face challenges due to strong competition from national brokers with a pan-India presence. Moreover, the company is relatively unknown outside the Eastern region and may find it difficult to penetrate the other markets. In the investment banking segment, the company is a small player where it mostly caters to SME clients. The experience in investment banking seems to be limited as it has mainly done small deals in the region. To supplement its investment banking segment, MFSL has recently started an institutional sales desk in Mumbai and so far has got empanelled with three institutions. Limited deal execution and reach are expected to limit the company's ability to bag deals especially in the newer markets.

- *Franchisee roll-out to face integration challenges*

The company's strategy to roll out branches and franchisee aggressively over the next two-three years is expected to face integration challenges. Though the company has successfully managed to roll out and integrate in the past, (the number of business locations has increased from 180 in FY07 to more than 235 in FY10) the large scale of roll-out for the future is likely to pose management challenges. The management has the relevant experience in the financial industry and has handled challenges before. It has previously integrated roll-outs though not at the same scale as currently planned.

- *Risk management system adequately covers the volatility risk*

MFSL has implemented a risk management system for the broking and LAS businesses. The cutoff for margin funding and LAS on the security is based on its volatility, liquidity and other important parameters. The company continuously monitors the margin requirement and the outstanding positions are squared off in case the client fails to furnish the additional security requirement. The system has helped the company to cut down its overall credit losses to minimal levels despite a volatile equity market.

4

- *Inherent volatility in key business areas due to strong linkages with the equity market*

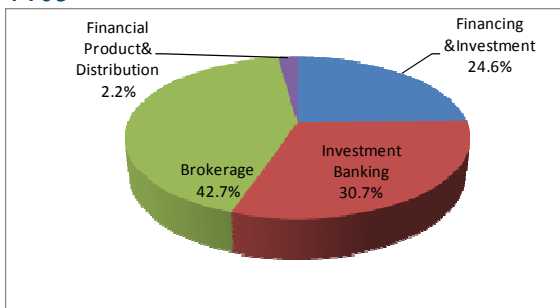
The volumes and earnings from broking, one of the key businesses of the Microsec Group, depend heavily on the level of trading activity in the equity market. The equity market is inherently volatile, driven by economic and political factors as well as sentiment. The group derives nearly 66% of its business from the equity market (equity broking and financing activities). We believe that the company's main businesses will continue to be driven by the state of the equity market whereby any volatility in the market would significantly impact its ability to deliver earnings growth. However, with stable government, expectation of global economic recovery and the favourable growth for the Indian economy, the capital market is expected to do well in the short to medium term.

- *Ability to retain key management personnel*

Talent retention, which is an industry-wide challenge, is more so for a player like MFSL. In the past, the company faced attrition challenges in its investment banking team.

**Segment Revenue Split**

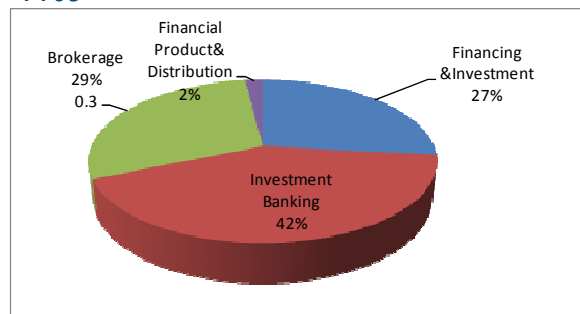
FY09



Source: DRHP

**Segment Result Split(EBIT)**

FY09



## B. Financial Performance

MFSL's revenues grew at a four-year CAGR of 44% to Rs 377 mn in FY09. Of the total revenue, the company realised 30% from investment banking, 41% from the broking business, 25% from the LAS portfolio and balance from others. The operating margin improved from 50.6% in FY06 to 60.9% in FY08 and then plummeted to 39.9% in FY09 due to poor capital market conditions. Net profit margin for FY09 was 20.9% against 43.7% in FY08. During FY06-09, PAT grew at a CAGR of 22.9% to Rs 78.7 mn. In FY09, return on equity (RoE) was 10% and debt equity level was low at 0.02.

In FY10, the company has bought back 1 mn equity shares at Rs 125, from existing shareholders, translating into a total outgo of Rs 125 mn. For the half year ended FY10, the company reported top line of Rs 268.5 mn and PAT of Rs 109.4 mn.

### Financial performance snapshot

|                    |       | FY07   | FY08   | FY09   |
|--------------------|-------|--------|--------|--------|
|                    |       | Actual | Actual | Actual |
| Sales              | Rs mn | 185.3  | 416.8  | 377.0  |
| Operating margin   | %     | 55.2   | 60.9   | 39.9   |
| Net profit         | Rs mn | 76.0   | 183.1  | 78.7   |
| Net margin         | %     | 40.9   | 43.9   | 20.9   |
| ROCE               | %     | 35.2   | 26.9   | 14.7   |
| RONW               | %     | 34.3   | 26.0   | 10.0   |
| Basic EPS          | Rs    | 7.6    | 9.0    | 3.9    |
| Net worth          | Rs    | 221.2  | 704.7  | 783.4  |
| No. of eq. shares  | mn    | 10.0   | 20.3   | 20.3   |
| Book value         | Rs mn | 22.1   | 34.7   | 38.6   |
| Dividend per share | Rs    | 1.1    | 0.6    | 0.0    |
| Debt/Equity        | Times | 0.13   | 0.21   | 0.02   |

*\*Note: Numbers have been reclassified as per CRISIL standards*

Source: DRHP

## C. Management Capabilities and Corporate Governance

Mr B. L. Mittal, the promoter, and Mr Ravi Sharma are fairly experienced in the financial services industry. The promoters have elevated MFSL to the level of leading brokers in Eastern India. Both seem to have a good business relationship and networking, especially in the region. Mr Rakesh Sony, one of the co-promoters, who was heading the investment banking division, quit the company in September 2008. The investment banking arm now is overlooked by Mr Mittal who is supported by Mr Pankaj Harlalka, the functional head. Mr Harlalka has been associated with the company for the past six years. The management team, especially the investment banking team, requires to be ramped up for the company's ambitious plan to expand outside the Eastern region.

MFSL's board comprises five directors, which includes two promoters and three independent directors. Mr. Parimal Kumar Chattaraj joined the board as an independent director in April 2007. The other two independent directors – Dr. B. Samal and Mr Vinod Kumar Kothari - resigned in September 2008. The company has inducted Mr Raj Narain Bhardwaj (joined on September 05, 2009) and Mr Deba Prasad Roy (joined on October 12, 2009) as independent directors to comply with the listing norms. Based on our interaction with them, we believe the involvement of all independent directors at the board level is reasonable.

## Annexure I

### Business Profile

MFSL is a financial services company primarily providing retail broking and investment banking services. The company also offers loan against shares (LAS) to support the broking business. Commodity broking, insurance broking and distribution of financial products complete its bouquet of offerings. Further, the company recently set up an institutional equities broking desk in Mumbai. Headquartered in Kolkata, MFSL has a presence in 17 states with 235 branches, out of which 100 branches are located in Kolkata and overall 169 branches in West Bengal. The company derives a major portion of its revenues from Eastern India, especially Kolkata.

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The group started operations as Microsec India Ltd in 2000. The company was registered as a merchant banker with SEBI in 2003. It obtained NSE membership in 2004 and BSE membership in 2005. The company was registered as a depository participant of NSDL in 2005, followed by CDSL in 2007. In 2003, the company started insurance broking through its wholly-owned subsidiary Microsec Insurance Brokers Ltd as an IRDA-registered insurance broker. It also started commodity broking through its subsidiary Microsec Commerce Ltd on NCDEX in 2003 and MCX in 2004. In 2005, the name of Microsec India Ltd. was changed to Microsec Capital Ltd. In the same year, the promoters acquired RBI-registered NBFC – Satyam Fiscal Services Pvt. Ltd. The name of the company was changed to MFSL and the promoters transferred their holding in Microsec Capital to MFSL.

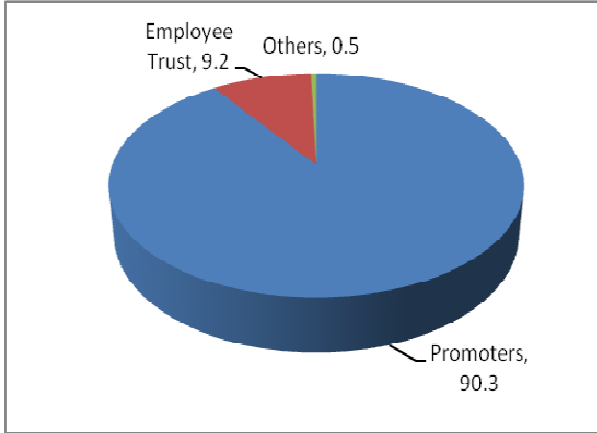
### Management and Board Profile

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MFSL's board comprises five directors, which includes two promoters and three independent directors. Mr. Parimal Kumar Chattaraj joined the board as an independent director in April 2007. Mr Raj Narain Bhardwaj and Mr Deba Prasad Roy joined on September 05, 2009 and October 12, 2009 respectively as independent directors. Based on interaction with them, we believe the involvement of all independent directors at the board level is reasonable.

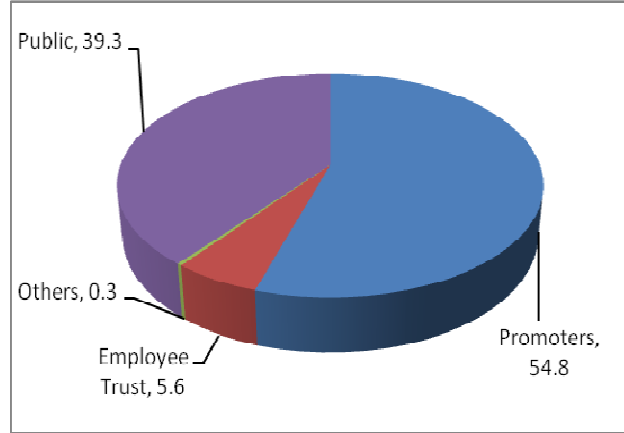
Shareholding Pattern (rounded off to the nearest decimal)

**Pre-IPO**



Source: DRHP

**Post-IPO**



Source: DRHP



## Annexure II: Profile of the Directors

| Name of Directors          | Designation                    | Age | Qualification   | Experience (years) | Key position held   |
|----------------------------|--------------------------------|-----|---|--------------------|---|
| Mr Banwari Lal Mittal      | Chairman and Managing Director | 41  | B.Com, Member of ICAI, ICSI, ICWAI  | 17                 | Promoter  |
| Mr Ravi Kant Sharma        | Non-Executive Director         | 35  | B.Com, Member of ICAI   | 12                 | Promoter  |
| Mr Parimal Kumar Chattaraj | Independent Director           | 64  | B.Sc, Calcutta University<br>PG Diploma in Management, Calcutta University,<br>Bachelor's in Law, Ranchi University     | 30                 | Associated with IIM Kolkata, XLRI, Jamshedpur, XISS, Ranchi in the past |
| Mr Raj Narain Bhardwaj     | Independent Director           | 65  | PG in Economics, Delhi School of Economics<br>Diploma in Industrial Relations & Personnel Management, Punjab University | 37                 | Ex- Managing Director and Chairman, Life Insurance Corporation of India |
| Mr Deba Prasad Roy         | Independent Director           | 68  | PG in Science (Chemistry), Jadavpur University, Kolkata   | 35                 | Ex-Chairman, SBI Capital Markets Ltd                                    |

### **Disclaimer**

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