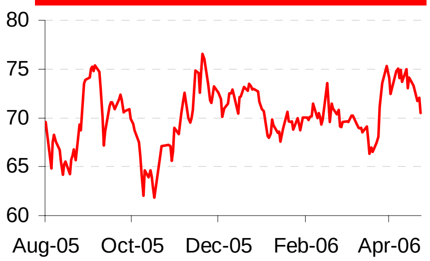
IDFC Limited

Hold **Target price: Rs 91**

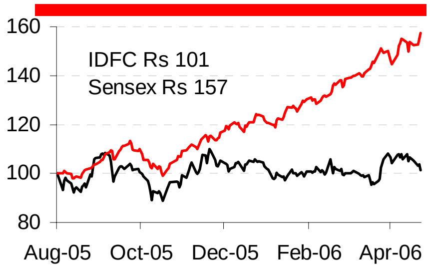
Market data

Current price	Rs 72 (BSE)
Market cap	Rs 80,784 m
Face value (Rs)	10
FY06 Div/share	1.0
NSE symbol	IDFC
No of shares	1,122.0 m
Free float	76.7%
52 week H/L	Rs 78 / 50

Share price chart



Rs 100 invested is worth



Shareholding

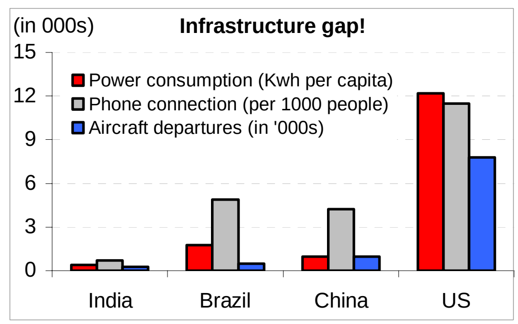
Category	(%)
Government	23.3
Banks/Fis, MFs	19.4
FIIs	44.4
Public	10.3
Others	2.6
Total	100.0

Report prepared by

Quantum Information Services
www.equitymaster.com
info@equitymaster.com

Investment Rationale

- **Infrastructure investments imminent:** The Indian economy, despite having grown at an average rate of 6.1% per annum over the last decade, has lagged behind many other developing and developed nations in terms of infrastructure development. Infrastructure is an integral part of economic development and the availability of quality infrastructure services is the key to sustained growth of any economy. The current rate of infrastructure investment in India at 3.5% of GDP is well below the target rate of 8.0% proposed by the Expert Group on Commercialisation of Infrastructure Projects (Source: ADB). This indicates significant opportunities for further infrastructure development and financing in India, particularly as regulatory, legal and market frameworks evolve and become more supportive of private investment. IDFC's strong relationship with its chief promoter, the government (23% stake), gives it access to decision makers in government entities and multilateral development agencies. As a consequence, IDFC is able to play a significant role in the direction of infrastructure policy in the country, thus placing itself ideally to cater to the infrastructure-financing requirements.



- **De-risked business:** While IDFC continued to enjoy 25% of the market share in the incremental infrastructure lending (project finance) in the country during FY06, shrinking yields and higher costs seems to have squeezed the profitability in this business (return on assets from infrastructure financing reduced from 3.7% in FY05 to 2.9% in FY06). This was also fallout of the rising interest rates in the domestic and global markets and IDFC's inability to immediately re-price its assets. While project finance remains the mainstay of its business, to de-risk its revenue stream from the volatility of earnings in project financing business, the institution undertook the following initiatives:
  - **Partnership with Feedback Ventures:** IDFC has taken a 19.4% stake (option to raise upto 30% in the next 3 years) in the Delhi based engineering company, Feedback Ventures. The alliance is expected to facilitate the institution in identifying viable infrastructure projects and catalyze private-public partnerships for financing the same.
  - **Stake in SSKI:** IDFC has bought a 33% stake in SSKI for having an exposure in equity market linked product offerings. The same

is expected to add to IDFC's fee-income stream, as SSKI has a substantial market share in the investment banking business.

- **MoU with Bank of Baroda:** Due to its small balance sheet size, IDFC is constrained in terms of large ticket borrowings. To get rid of this limitation, the institution has entered into a memorandum of understanding (MoU) with Bank of Baroda that can help IDFC raise funds for the projects appraised by it from the banking entity. Also, this will help IDFC overcome the handicap of limited geographical reach.

We expect the above initiatives to stand in good stead for the institution in the coming years even when the sectors get mature and the high yielding assets in project finance get re-priced. Although, we have not quantified and factored in the upsides accruing to the institution from the same, we anticipate the benefits to be incrementally value accretive to IDFC's business going forward.

- **Multiplying fees:** IDFC's share of non-interest income in consolidated total income has increased to 43% in FY06 from 40% in FY05. Also, the share of stable fee income (grew 96% YoY) in total consolidated non-interest income has increased to 42% from 28% in FY05. This has helped the institution cushion the lower treasury gains witnessed in FY06. It is, however, interesting to note that IDFC has garnered US$ 650 m as assets under management (AUM) through its second private equity fund. It is liable to receive a fee income of 2% of the AUM over and above the returns generated above the hurdle rate over the next 10 years (duration of the fund). This will give it a steady fee revenue stream. Also, the profits above the hurdle rate will be shared on a 20:80 basis (20% for IDFC).

- **Unrealized gains to be booked:** Going forward, as the risk weightage on its asset profile (infrastructure advances) reduces, with projects nearing completion and revenue streams getting unlocked, IDFC plans to securitise them at a premium, to asset hungry financial entities. Also, IDFC's proprietary minority equity investments carried an unrealized gain of Rs 2.2 bn at the end of FY06 (Source: IDFC). The management has indicated that it would be booking these unrealized gains over the next two to three fiscals. We have, however, not factored in the same in our projections due to the uncertainty of the time frame for unlocking the gains.

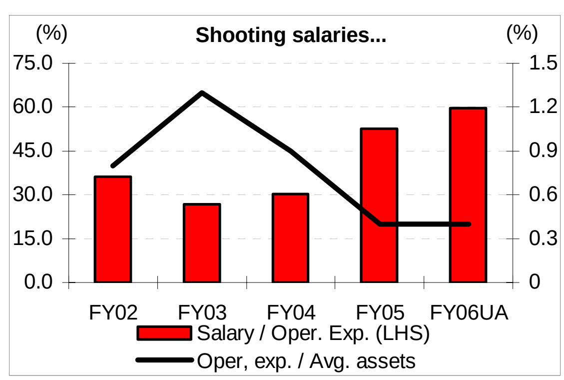
- **Excellent asset quality:** IDFC has the strongest asset quality positions amongst the financial entities in India (rivaled only by HDFC and HDFC Bank). According to the institution, this has been achieved due to its strong credit and project appraisal skills and disciplined risk management practices. Due to this, it had lower than 1% gross NPAs and Nil net NPAs at the end of FY06. Also, since a major chunk of such advances are concentrated on the top 5 borrowers in each sector, IDFC's books remain reasonably well hedged.

Comparative Valuations (FY06UA / FY06E)

(Rs m)	IDFC	HDFC	SBI
Return on assets	3.6%	2.6%	1.0%
Return on equity	16.9%	27.0%	17.5%
Net interest margin	2.7%	3.1%	3.3%
Net NPA/Advances	0.0%	0.1%	1.7%
Cost/income	8.6%	11.1%	50.0%
Business / employee	951	341	33
Business / branch	9,983	2,070	728
Profits / employee	35.1	8.9	0.2
Valuations			
Price to earnings	21.5	26.5	10.4
Price to adj. BV (x)	3.2	7.3	2.3
Dividend yield	1.4%	1.6%	1.5%

Investment Concerns

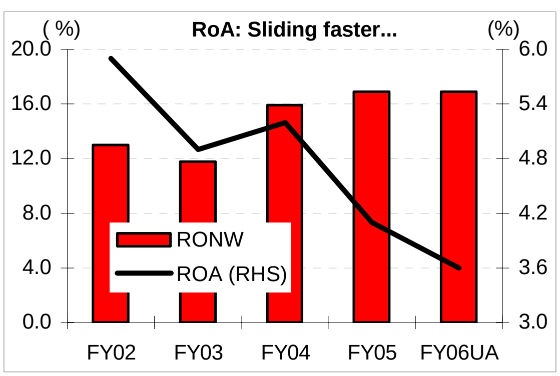
- **Rising staff costs:** IDFC has witnessed exponential growth in its salary costs over the last two fiscals.



This has been primarily due to the new recruitments at the top management level for managing its new business ventures. The salary costs have almost doubled in the said period. Also, the salary costs comprised 60% of the total operating costs in FY06 (similar to that of PSU banks) despite the institution's lean structure. While the benefits of the same are yet to filter in, the management is keen on constraining the overall rise in operating costs. It has set a metric of maintaining its operating costs below 0.5% of average assets going forward (0.4% in FY06).

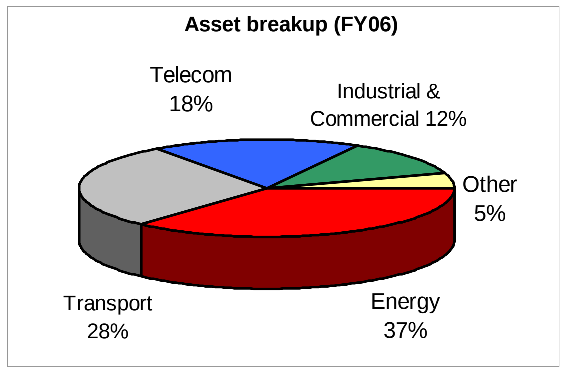
- **Taxing times:** The changing income mix (more contribution from other income) and the removal of benefits under section 10 (23 G) have almost doubled the effective tax rate for IDFC from 6% in FY05 to 10% in FY06. IDFC sees this trend continuing, in line with the growth in fee income. For FY07, the management expects 300 to 400 basis points hike in tax incidence and we have factored in the same in our projections for FY07 as well as FY08. Nevertheless, the management also believes that actual earnings impairment is likely to be lower depending upon the institution's ability to pass on the tax impact to its clients.

- **Returns - Not in line with targets:** As against the earlier target set by IDFC for sustaining its return on assets (RoA) above 4% for the next 2 fiscals, the same have already shrunk to 3.6% in FY06. This has primarily resulted from the fall in RoA from project financing as mentioned earlier. A pre-payment ratio of 25% has also been a drag on IDFC's return ratios. Nevertheless, the entity continues to enjoy the highest return ratios in the sector. Also, with increasing leverage (4.4 times in FY06), IDFC's return on equity has remained stable at 17% despite the post-IPO equity dilution.



Background

Established in 1997 as a private sector enterprise by a consortium of public and private investors, IDFC operates as a professionally managed infrastructure financing entity whose focus areas are energy, telecom, transportation and industrial and commercial projects. IDFC financed 25% of the total infrastructure outlay in the country in FY06. Its expertise in the infrastructure sector and strong relationship with government and infrastructure sponsors provides it with a platform for facilitating private investment and public-private partnerships in infrastructure projects in sectors where market structures, government policy and regulations are evolving. IDFC has capitalised on its domain knowledge and structuring expertise in financing activities to garner fee-based revenues.



Industry Prospects

The single most important macro constraint on the Indian economy, holding back its average growth rate, is the low spending on infrastructure. India is currently spending a miniscule proportion of the required outlay. Asian Development Bank's analysis indicates that China spends seven times as much as India on infrastructure (excluding real estate) in absolute terms. In 2003, the total capital spending on electricity, roads, airports, seaports and telecom was US$ 150 bn in China (10.6% of GDP) compared with US$ 21 bn in India (3.5% of GDP). The analysis stipulates the need to increase infrastructure spending in the country gradually to US$ 100 bn p.a. (8% of GDP) by 2010, from an estimated US$ 24 bn (3.5% of GDP) in 2004, to position India on to a sustained GDP growth trail of 8% to 9% per annum. As the government funding cannot suffice the said investment requirement, private sector players need to fill the void. The volume of private sector financing in Indian infrastructure has multiplied 6 times over the last decade, thus suggesting the scope for exponential growth of private sector infrastructure financing players.

Valuations

Being the largest private sector infrastructure-financing player in the country makes the rationale for IDFC's growth uncontested. Nonetheless, increasing penetration of banks in this segment and the their cost advantage (due to the ability to raise low cost deposits) has intensified competition for IDFC over the past few years. However, having the domain expertise for project appraisals, the highest operating efficiency in the financial sector and sufficient equity capital (capital adequacy ratio of 26% in FY06) to support growth makes IDFC well positioned to capitalise on the opportunities. Also, IDFC interestingly benchmarks itself against players like Australian 'Macquarie Bank' that is focussed in investment banking deals for infrastructure projects and has a large chunk of its revenue emanating from stable fee income rather than interest income.

At the current price of Rs 72, the stock is trading at 2.6 times our estimated FY08 adjusted book value. Though we have factored in a possible depression in margins, we believe that given the de-risking strategies adopted by the institution, the downside in income growth is limited. Also, the rise in fee income accruing from the new ventures will directly filter into the bottomline and to that extent there lies an upside to our estimates. We would, therefore, advise investors to HOLD* on to the stock with a FY08 target price of Rs 91.

**By this recommendation of HOLD, what we mean is that existing shareholders would be better off holding onto the stock with a long-term perspective. However, if an investor would like to BUY this stock, then the upside from the current levels is about 13% CAGR. Investors could take the investment decision based on this premise.*

Valuation table (Standalone)

(Rs m)	FY05	FY06UA	FY07E	FY08E
Total Revenues	4,157	5,149	6,406	8,176
Net Profit	3,040	3,756	4,527	5,856
EPS (Rs)	2.7	3.3	4.0	5.2
Adjusted BV (Rs)	20.0	22.7	25.0	28.1
P/E (x)	26.6	21.5	17.8	13.8
P/Adj BV (x)	3.6	3.2	2.9	2.6

Financials at a glance

(Rs m)	FY05	FY06UA	FY07E	FY08E
Interest income	5,481	7,639	10,129	13,768
Interest expense	3,119	5,008	7,274	10,707
Net interest income	2,362	2,631	2,855	3,061
Other income	1,795	2,518	3,552	5,114
Other expenses	280	440	617	832
Provisions and contingencies	648	516	464	371
Profit before tax	3,230	4,193	5,326	6,972
Tax	190	437	799	1,115
Profit after tax/(Loss)	3,040	3,756	4,527	5,856
Net profit margin (%)	55.5%	49.2%	44.7%	42.5%
No of shares (m)	1,000.0	1,122.0	1,122.0	1,122.0
Diluted earnings per share (Rs)	2.7	3.3	4.0	5.2
Balance Sheet				
Infrastructure loans	505	505	505	505
Investments	70,505	101,827	141,169	190,893
Fixed assets	7,688	12,949	13,208	14,529
Deffered tax assets	662	788	591	295
Current assets	7,956	6,315	15,422	38,463
Total assets	**87,315**	**122,384**	**170,895**	**244,686**
Net worth	18,889	25,440	28,074	31,479
Subordinated debt	6,500	6,500	6,500	6,500
Unsecured loans	58,951	87,171	130,757	196,136
Current liabilities	2,975	3,273	5,564	10,571
Total liabilities	**87,315**	**122,384**	**170,895**	**244,686**

Important Notice: Quantum Information Services Limited (Equitymaster) is an Independent Equity Research Company.

Disclosure: The author of this article does not hold shares in the recommended company. QIS does not hold shares in the recommended company.

© Quantum Information Services Limited

This Service is provided on an "As Is" basis by Equitymaster. Equitymaster and its Affiliates disclaim any warranty of any kind, imputed by the laws of any jurisdiction, whether express or implied, as to any matter whatsoever relating to the Service, including without limitation the implied warranties of merchantability, fitness for a particular purpose

Neither Equitymaster nor its affiliates will be responsible for any loss or liability incurred to the user as a consequence of his or any other person on his behalf taking any investment decisions based on the above recommendation. Use of the Service is at any persons, including a Customer's, own risk. The investments discussed or recommended through this service may not be suitable for all investors. Investors must make their own investment decisions based on their specific investment objectives and financial position and using such independent advisors as they believe necessary. Information herein is believed to be reliable but Equitymaster and its affiliates do not warrant its completeness or accuracy. The Service should not be construed to be an advertisement for solicitation for buying or selling of any securities.