INFRASTRUCTURE DEVELOPMENT FINANCE

INR 92

Edelweiss
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Wings clipped

ACCUMULATE

August 29, 2008

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We met the management of IDFC to understand the near term business outlook and with Crisil on capital adequacy requirements (CAR). IDFC indicated that it would look to slowdown its current pace of loan growth and will raise USD 250 mn in tier 1 capital by FY09E. It also expects a slowdown in income from capital markets, but is positive on the growth of the asset management business. Following are the key takeaways of our meeting with IDFC and Crisil. We believe higher capital requirements are due to gradual change in the business model in the past few years and increased equity investments.

Business growth outlook to remain subdued

IDFC's management believes that loan book growth for FY09E will remain muted. Despite the current tight interest rate environment, management believes that the outlook on credit growth in the infrastructure space remains strong. However, it would focus on its net interest margins (NIM) more closely than before and hence would slowdown its current pace of growth.

Edelweiss comment: *Being a wholesale player, the move of slowing loan growth and maintaining margins is positive as the infrastructure spending has not slowed down while margins are under pressure. Given this environment, we expect the loan growth to decelerate from the current run rate of over 40% CAGR to more conservative levels of ~19%, while NIMs, adjusting for the capital raising plans, are likely to dip below the 3% to 2.7% level.*

Capital raising plans on track; raising USD 250 mn by FY09

The company plans to raise USD 250 mn by FY09 to maintain its tier 1 ratio (in Q1FY09 it was at 17.7%) in excess of 20%. This leaves little headroom to leverage (currently at ~5.2x) current capital any further. The rating agency is of the view that there is a gradual change in IDFC's business model. It initially enjoyed AAA rating as it was backed by the government (pre-IPO). Subsequently, the private equity business brought in stable fee revenues that diversified its business model from a pure play infrastructure lender practise. However, the recent acquisition of Standard Chartered mutual fund was from a franchisee value point than an income generator. Hence, it has indicated that a higher capital will be **helpful** in maintaining the rating.

Edelweiss comment: *IDFC's equity investment book (including investments in subsidiaries) is ~33% of networth. We understand that IDFC will want to maintain the 'AAA' rating by keeping higher capital ratios and therefore, will raise USD 250 mn in equity.*

Outlook and valuations: Headwinds getting stronger; maintain 'ACCUMULATE'

We have revised our earnings downwards by 5% for FY09E and 7% for FY10E factoring in slowdown in loan growth. We have revised loan growth to 19% CAGR for FY08-10 compared to 33% earlier for FY08-10E. On our revised numbers, the sum-of-the-parts (SOTP) valuation stands at INR 109/share for FY10E.

Business	Method	AUM / Book / Earnings	Multiple	Value of Interest	Value per share
Core infrastructure	Price/book	72,924	1.6	117,869	86
Asset Management					
Private Equity	% of AUM	96,000	13%	12,480	9
IDFC AMC	% of AUM	160,000	4%	6,400	5
NSE	P/E	5,500	30	13,530	10
Total				**150,279**	**109**

Reuters	:	IDFC.BO
Bloomberg	:	IDFC IN

Market Data

52-week range (INR)	:	235 / 87
Share in issue (mn)	:	1,295.2
M cap (INR bn/USD mn)	:	119.7 / 2,738.2
Avg. Daily Vol. BSE/NSE ('000)	:	9,933.2

Share Holding Pattern (%)

Promoters	:	0.0
MFs, FIs & Banks	:	51.4
FIIs	:	35.2
Others	:	13.4

Relative Performance (%)

	Sensex	Stock	Stock over Sensex
1 month	1.9	(8.3)	(10.2)
3 months	(15.0)	(39.3)	(24.3)
12 months	(6.3)	(25.0)	(18.7)

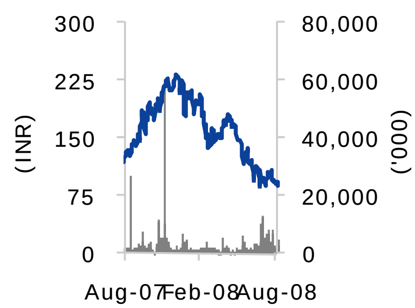

Table 1: Investments (including subsidiaries)

(INR mn)	FY03	FY04	FY05	FY06	FY07	FY08
Cost of investments	2,133	2,102	2,426	4,882	7,344	17,958
Market value investments*	269	2,069	3,019	3,678	3,410	6,731
Profits booked**	619	846	1,113	1,451	1,235	1,923
Contribution of various equity related instruments (%)						
Equity/investment (%)	23	18	32	38	29	33
% of networth	14	12	13	19	25	33
Listed	20	22	33	18	17	20
Unlisted	75	69	45	75	65	33
Venture capital	5	10	16	5	13	7

**Annual report*

*** estimated profits booked*

Source: Company, Edelweiss research

Merger of investment banking, broking, and private equity into one company

IDFC plans to merge three of its businesses into one company by FY09:

1) Investment banking and broking (IDFC-SSKI).
2) Private equity (AUM of ~USD 1.4 bn by FY09E through its three funds).
3) Project equity (AUM of ~USD 1 bn by FY09E).

IDFC Mutual Fund, which manages AUMs of ~USD 2.6 bn, will be kept outside this financial company. Currently, IDFC-SSKI has two companies handling investment banking (IDFC-SSKI Private) and equity broking (IDFC-SSKI Securities), while the asset management business has three different companies of private equity (IDFC Private Equity), project equity (IDFC Project Equity), and investment advisors (IDFC Investment Advisors).

Asset management practice growth in line with expectations; third fund awaiting regulatory clearance

With most businesses witnessing pressure in revenue growth, IDFC's asset management platform is growing strongly. Its current AUMs are at USD 3.8 bn, of which, ~USD 1.1 bn is in private equity and project equity, and the balance USD 2.7 bn is in mutual funds.

The company has raised another USD 300 mn in the project equity fund (it raised USD 520 mn in the first closure) and is on track to close FY09 with USD 1 bn. In the private equity space, while the first two funds are fully invested, the company has already raised USD 700 mn in a third fund, and is awaiting regulatory clearances. Revenue from the project equity fund is flowing from June onwards. We have forecasted AUMs (project and private equity) at USD 2.4 bn for FY09/10E, while mutual fund AUM is likely to be at USD 4 bn for FY10E.

Table 2: IDFC Mutual Fund financials

(INR mn)	CY03	CY04	CY05	CY06	CY07
Revenues	383	490	327	411	517
PAT	107	139	34	54	71
Average AUM	56,620	87,160	84,420	106,420	148,180
% of revenues (bps)	0.68	0.56	0.39	0.39	0.35
% of PAT (bps)	0.19	0.16	0.04	0.05	0.05
Acquisition Price					8,405

Source: Company

Table 3: Status of Mutual Funds

Name of the fund	Status	Size (USD mn)
India Private Equity Fund	Fully invested	630
India Project Equity	Fully invested	523
IDFC Investment Advisors	Fully invested	33
Total private equity funds		1,186
Equity to be raised		
India Private Equity Fund		700
India Project Equity		500
Total private equity funds		1,200
Total		2,386
IDFC AMC		2,651
Total FUM		5,037

Source: Company, Edelweiss research

Weakness in revenue growth from investment banking and broking

IDFC-SSKI, which reported revenues of INR 1.8 bn on a consolidated basis, is likely to witness pressure in revenues with the drying up of revenues from its investment banking and broking, in line with most other brokers.

Table 4: Revenue for IDFC-SSKI

(INR mn)	FY07	FY08	*Growth (%)*	FY09E
Institutional Broking				
Revenues	912	1,295	*42.0*	1,008
PAT	214	353	*65.0*	248
Investment Banking				
Revenues	390	678	*74.0*	801
PAT	106	215	*104.0*	307

Source: Company, Edelweiss research

We have forecasted revenues from broking to decline ~22% for FY09, while revenues from investment banking are likely to be flat, as the complete integration of debt syndication and equity markets (which was earlier at IDFC) was done in H2FY08. We also expect some traction between investment banking and private equity business in terms of revenues from deals through active entries and exits.

Unrealised gains of INR 2.5 bn in investments; will IDFC look to capitalise?

As of Q1FY09, IDFC had unrealised capital gains of INR 2.5 bn in its investment book. Given the current requirement of strengthening its net worth, IDFC could look at booking some profits consistently and also at fresh opportunities to invest in these weak markets.

Table 5: Listed investment book as of FY08

Company name	Number of shares	Cost (INR mn)	Current Price	Market value (INR mn)	Unbooked gains
Andhra Cements	8,740,000	250	25	222	(28)
Bharti Airtel	470,400	21	804	378	357
Brigade Enterprises	431,164	168	120	52	(116)
Container Corpn.	77,600	147	876	68	(79)
Gateway Distripacks	2,477,656	43	89	221	178
Great Offshore	100,000	64	480	48	(16)
GTL Infrastructure	32,978,136	330	39	1,286	956
Guj. St.Petronet	11,116,000	222	61	678	456
Indraprastha Gas	160,000	176	113	18	(158)
Mundra Port	739,182	305	557	412	106
NTPC	2,225,400	138	170	378	240
Orissa Sponge	1,000,000	225	280	280	55
Power Grid Corpn	4,608,766	240	89	412	173
Sarda Energy	1,842,105	350	275	507	157
Sical Logistics	452,737	53	86	39	(14)
TCS	41,370	1	794	33	32
Tech Mahindra	60,182	2	736	44	42
Torrent Power	9,600,000	67	108	1,037	970
Trent	140,000	8	511	72	64
Total		**2,810**		**6,184**	**3,374**

As of August 29, 2008

Source: Company, Edelweiss research

NSE stake unlikely to be divested

IDFC's 8.4% stake in NSE is unlikely to be divested in the near future, as there are talks of the shareholders' limit being increased to 15% (against the earlier guideline of limiting every investor to 5%). The recent transactions include Financial Technologies buying 1% NSE stake at INR 1.25 bn, valuing NSE at USD 3 bn. We have valued NSE at USD 4 bn (FY10E PAT of INR 5.5 bn and multiple of 30x) and IDFC's stake at INR 10/share.

Table 6: NSE valuation

(INR mn)	FY04	FY05	FY06	FY07	FY08
Revenues	2,958	3,704	4,728	6,885	10,387
PAT	945	1,233	1,928	3,066	5,225
Profit for NSE FY10					5,500
Multiple					30
Valuation of NSE					165,000
IDFC's stake					8.20%
Value for IDFC					13,530
Per share					10

Source: Company, Edelweiss research

Outlook and valuations: Headwinds getting stronger; maintain 'ACCUMULATE'

With the current capital adequacy requirements, we expect the overall business to be affected primarily because of the following two factors:

- **Growth for FY10 will be a direct function of only profits generated**

  IDFC had a net worth of INR 56 bn as of FY08, and with a capital infusion of INR 10 bn and expected FY09 profits, the net worth is likely to increase to INR 73 bn by FY09E. With the current leverage for FY09 at ~5x, any balance sheet growth for FY10 will only be a function of FY09-10 profits.

- **Sustainable RoE will be postponed with current dilution**
  While we expect relaxation from credit rating agencies once the macro environment improves from the current level, the intermediate period will be painful for IDFC. With the current growth and higher degree of equity capital infusion, we expect the company's RoEs to be subdued at ~14% for FY09-10E compared to stable RoE of over 20%.

We have revised our earnings downwards by 5% for FY09E and 7% for FY10E factoring in slowdown in loan growth. We have revised loan growth to 19% CAGR for FY08-10 compared to 33% earlier for FY08-10E. We have valued the loan book on residual earnings model, which gives an implied book of 1.6x or INR 86/share. The asset management business valuation has been split between private/project equity and mutual funds. Private and project equity has been valued at 13% of AUM at INR 9/share, while the mutual fund has been valued 4% of AUM at INR 5/share. NSE stake has been valued at INR 10/share. On our revised numbers, the sum-of-the-parts (SOTP) valuation stands at INR 109/share for FY10E from INR 123/share mentioned in our Q1FY09 result update.

The company's growth continues to be stifled by enhanced capital requirements, rising interest rates for wholesale players, and sharp drop in revenues from the capital market. We maintain **'ACCUMULATE'**.

Company Description

IDFC was established in 1997 as a private sector enterprise by a consortium of public and private investors to provide infrastructure financing. It was mainly started as a government initiative, but the structure of ownership changed in 2005-06 with its IPO. Government of India has a 20% stake while FII hold ~40%.

It generates its income from core lending, as well has built a steady source of fee income business from its principal investments, asset management as well broking and investment from its acquisition of IDFC-SSKI.

Key Risks

There are risks of margin compression, as the infrastructure financing space is keenly contested. Being an NBFC, IDFC is dependent on wholesale funding. Hence, high interest rates will remain a risk.

Large ticket lending makes IDFC's loan book riskier than other banks. NPA occurrence, due to large ticket size, can dent its future earnings.

As it now generates more than 40% of non interest income, revenue can be a lumpy in nature (especially in investment banking and principal investment book)

Investment rationale

IDFC generates its business in four business segments

In the lending business, it has a balance sheet size of INR 279 bn as on FY08 and has been growing its balance sheet in excess of 40% CAGR. Of its INR 204 bn loan book (net NPA is 0%), energy, transportation, and telecom sectors constitute 80% of the outstanding. We expect the loan book to grow by 36% CAGR for FY08-10 to INR 351 bn and generate RoA's in the range of 3%.

It has sponsored IDFC Private Equity that manages two funds - India Development Fund and IDFC Private Equity Fund 2. The total corpus of the two funds as on FY08 was USD 650 mn. It generates fee income for managing the assets and also participates on upsides over the respective hurdle rates. In FY09, it acquired Standard Chartered Mutual Fund for USD 205 mn.

It has 80% stake in IDFC where it houses the investment banking and institutional broking business. As of FY08 it had a strong principal investment book of INR 13 bn which is invested through listed and unlisted entities.

Financial Statements

Income statement (INR mn)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Interest income	7,867	12,981	21,940	29,674	36,521
Interest expended	5,008	8,555	14,829	21,024	25,844
Net interest income	2,858	4,426	7,111	8,649	10,678
Non interest income	2,501	2,732	6,125	7,885	9,432
- Fee & forex income	764	570	3,021	3,555	4,291
- Investment profits	1,451	1,235	1,923	1,655	1,754
- Asset management fee	286	545	554	2,049	2,603
- Investment advisory fee	0	382	627	627	784
Income from operations	5,359	7,158	13,236	16,535	20,109
Net revenues	5,359	7,158	13,236	16,535	20,109
Operating expenses	546	821	2,532	3,328	4,080
- Employee exp	315	480	1,677	2,103	2,523
- Depreciation /amortisation	39	44	73	186	302
- Other opex	192	297	782	1,039	1,254
Preprovision profit	4,814	6,337	10,704	13,207	16,029
Provisions	387	175	700	1,121	1,052
PBT	4,426	6,162	10,004	12,086	14,977
Taxes	517	1,241	2,480	2,857	3,781
PAT	3,909	4,921	7,523	9,228	11,196
Share of associates/minority interest	(2)	118	(102)	(48)	(58)
PAT after minority interest	3,908	5,039	7,422	9,180	11,138
Reported PAT	3,908	5,039	7,422	9,180	11,138
Basic number of shares (mn)	1,122	1,126	1,294	1,375	1,375
Basic EPS (INR)	3.5	4.5	5.7	6.7	8.1
Diluted number of shares (mn)	1,122	1,133	1,301	1,375	1,375
Diluted EPS (INR)	3.5	4.4	5.7	6.7	8.1
DPS (INR)	0.9	0.8	1.0	1.0	1.0
Dividend pay out (%)	28	22	20	16	13

Growth metrics (%)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Net interest income	12.5	54.9	60.6	21.6	23.5
Net revenues growth	28.8	33.6	84.9	24.9	21.6
Opex growth	92.3	50.6	208.2	31.5	22.6
PPP growth	24.1	31.6	68.9	23.4	21.4
Provisions growth	(40.2)	(54.8)	300.2	60.0	(6.1)
PAT growth	28.5	29.0	47.3	23.7	21.3

Operating ratios (%)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Yield on assets	7.4	8.5	9.4	9.3	9.3
Yield on advances	8.5	9.5	10.1	10.8	10.9
Cost of funds	6.3	7.0	8.0	8.4	8.5
Spread	2.2	2.5	2.1	2.3	2.5
Net interest margins	2.7	2.9	3.0	2.7	2.7
Cost-income	10.2	11.5	19.1	20.1	20.3
Tax rate	11.7	20.1	24.8	23.6	25.2

Balance sheet (INR mn)

As on 31st March	FY06	FY07	FY08	FY09E	FY10E
LIABILITIES					
Equity capital	11,225	11,259	12,943	13,752	13,752
Share premium	2,853	2,880	22,027	31,330	31,330
Reserves & surplus	11,607	15,337	20,963	28,534	38,064
Net worth	25,685	29,476	55,933	73,616	83,146
Subordinate debt	6,500	6,500	6,500	7,500	15,500
Unsecured loans	87,302	142,528	216,535	267,466	320,078
Total liabilities	**119,487**	**178,505**	**278,968**	**348,582**	**418,723**
ASSETS					
Loans	100,871	139,184	199,051	238,804	283,942
Investments	12,928	23,903	52,257	70,596	90,759
Current assets	8,671	19,294	31,310	46,502	51,320
Current liabilities	3,491	5,335	10,443	10,634	10,107
Net current assets	5,181	13,959	20,867	35,867	41,214
Fixed assets (net block)	508	1,459	6,793	3,315	2,809
Total assets	**119,487**	**178,505**	**278,968**	**348,582**	**418,723**
Balance sheet ratios (%)					
Loan growth	43	38	43	20	19
EA growth	41	50	56	25	20
Gross NPA ratio	0.5	0.2	0.2	0.2	0.3
Net NPA ratio	0.0	0.0	0.0	0.0	0.0
Provision coverage	100.0	100.0	100.0	100.0	100.0
CAR	25.6	20.4	20.3	19.7	19.9

Sanctions and disbursements

Year to March	FY06	FY07	FY08	FY09E	FY10E
Sanctions (INR mn)	106,310	130,530	203,090	223,399	250,207
Disbursements (INR mn)	60,450	72,070	120,060	111,700	125,103
Disbursements to sanction ratio (%)	57	55	59	50	50
Disbursements growth (%)	62	19	67	(7)	12
Sanctions growth (%)	66	23	56	10	12

RoE decomposition (%)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Net interest income/assets	2.7	2.9	3.0	2.7	2.7
Non interest income/assets	1.0	1.0	1.8	1.9	2.0
Investment gains/assets	1.4	0.8	0.8	0.5	0.4
Net revenues/assets	5.1	4.7	5.6	5.2	5.1
Operating expense/Assets	0.5	0.5	1.1	1.0	1.0
Provisions/Assets	0.4	0.1	0.3	0.3	0.3
Taxes/Assets	0.5	0.8	1.1	0.9	1.0
Total costs/Assets	1.4	1.5	2.4	2.3	2.3
ROA	3.7	3.2	3.2	2.9	2.9
Equity/Assets	21.0	18.0	18.2	20.2	20.0
ROAE	17.5	17.8	17.6	14.2	14.3

Valuation metrics

Year to March	FY06	FY07	FY08	FY09E	FY10E
Diluted EPS (INR)	3.5	4.4	5.7	6.7	8.1
EPS growth (%)	*14.5*	*27.7*	*28.3*	*17.0*	*21.3*
Book value per share (INR)	22.9	26.2	43.2	53.5	60.5
Adjusted book value per share (INR)	22.9	26.2	43.2	53.5	60.5
Diluted P/E (x)	27.2	21.3	16.6	14.2	11.7
Price/ BV (x)	4.1	3.6	2.2	1.8	1.6
Price/ Adj. BV (x)	4.2	3.6	2.2	1.8	1.6
Dividend yield (%)	0.9	0.9	1.1	1.1	1.1

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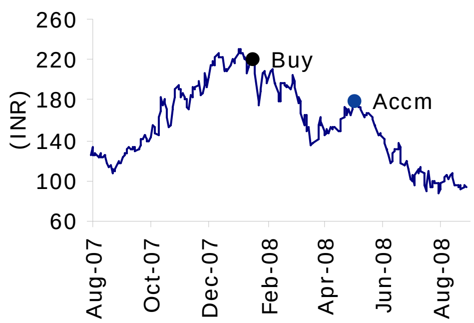
Coverage group(s) of stocks by primary analyst(s): Banking and Financial Services:

Allahabad Bank, Axis Bank, Centurion Bank of Punjab, Federal Bank, Future Capital Holdings, HDFC Bank, ICICI Bank, ING Vysya Bank, IOB, Karnataka Bank, Kotak Mahindra Bank, OBC, SBI, Yes Bank, IDFC, HDFC, LIC Housing Finance, PNB, Power Finance Corporation, Reliance Capital, South Indian Bank, SREI Infrastructure Finance, Shriram City Union, Syndicate Bank and Union Bank.

IDFC



Recent Research

Date	Company	Title	Price (INR)	Recos
28-Aug-08	**Banking**	Six reasons why we; Currently prefer SBI over ICICI*; Sector Update*		
26-Aug-08	**ICICI Bank**	Challenging business environment; *Result Update*	656	Buy
04-Aug-08	**Shriram City Union Finance**	Robust disbursemens, spreads intact; *Result Update*	380	Buy
1-Aug-08	**Yes Bank**	Good show; *Result Update*	127	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	101	56	14	7	189

* 10 stocks under review / 1 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	82	71	36

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 20% over a 12-month period
Accumulate	appreciate up to 20% over a 12-month period
Reduce	depreciate up to 10% over a 12-month period
Sell	depreciate more than 10% over a 12-month period