IDFC – SELL

IDFC IN	Rs82	Banking	16 Sep 2008	Visit Note

Cap on leveraging

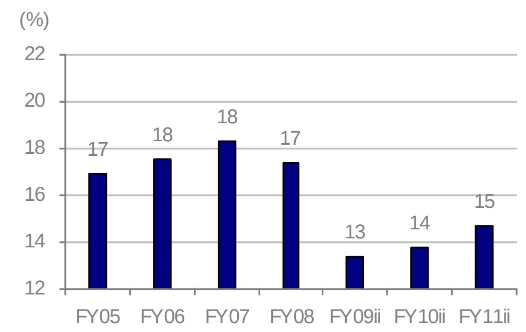
Our recent meeting with IDFC management inclines us to believe that there is a marked slowdown in the core project lending business, caused by a combination of demand slowdown and the need to conserve capital. The company is unable to leverage more than 5x (versus 7x earlier), so as to retain its "AAA" rating. A slowdown in the low-RoE project lending is not negative per se, as long as it does not adversely affect other income streams. But that remains to be seen. IDFC's management plans to raise US$250m in new equity before end of this fiscal and this would translate to ~9% dilution. The silver lining is the AMC business, whose AuM the company reckons will reach US$2.3bn by end-FY09. We expect IDFC's earnings CAGR to decelerate to 14% over FY08-10 from 29% over FY06-08. SELL.

Core lending business to slow down... We expect IDFC's core project finance business to slow down considerably from current levels (42% YoY in 1QFY09), mainly because of its need to conserve capital and partly because of delays in new infrastructure projects. Consequently, we estimate loan growth at 20% CAGR over FY08-10 compared to 40% CAGR in the last two years. Infrastructure loan approvals have dipped sharply in recent months.

...but will this affect other businesses? It remains to be seen if this slowdown will hurt the company's other income streams such as advisory, investment banking fees and principal investments. In the past, the company maintained that project lending is important for garnering other related businesses and it even considered acquiring a commercial bank to get access to retail deposits.

Cap on leveraging is a structural negative: IDFC has the highest Tier-I CAR of 17.7% in its peer group. However, this needs to be raised to a minimum of 20% to satisfy rating agencies and retain its AAA rating. An equity issuance of US$250m is planned in the current year, and this should be enough for the next two years. But this would entail slower asset growth of below 20% during this period, compared to 53% CAGR in the past two years. Inability to leverage will likely cap IDFC's peak ROE at not more than 15%, compared with 19% before the last round of capital raising in July 2007.

ROE trends



Source: Company, IIFL Research

Financial summary

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Op income (Rs m)	7,158	13,236	15,515	19,157	22,744
Net profit (Rs m)	5,039	7,422	8,610	10,670	12,659
EPS (Rs)	4.5	5.8	6.1	7.6	9.0
Growth (%)	28.6	29.9	5.4	23.8	18.6
PER (x)	18.3	14.1	13.4	10.8	9.1
Dividend yield (%)	1.1	1.3	1.3	1.6	2.2
Price/Book (x)	**3.1**	**1.9**	**1.6**	**1.4**	**1.3**
ROA (%)	3.4	3.2	2.9	3.1	3.1
ROE (%)	18.3	17.4	13.3	13.8	14.7
CAR (%)	20.4	22.2	25.4	24.6	23.7

Price as at close of business on 15 Sept 2008

12-mth Target price (Rs) 78 (-5%)

Market cap (US$ m)	**2,326**
52Wk High/Low (Rs)	235/81
Diluted o/s shares (m)	1295
Daily volume (US$ m)	27.8
Dividend yield FY08ii (%)	1.3
Free float (%)	77.9

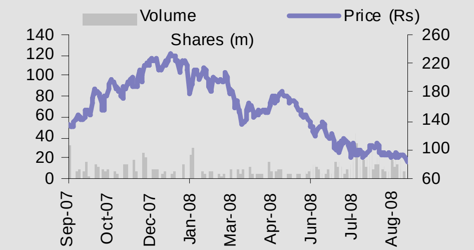
Shareholding pattern (%)

GOI / IDBI	22.1
FIIs	43.9
Domestic MF/Insurance cos	24.5
Others	9.5

Price performance (%)

	1M	3M	1Y
IDFC	-14.3	-37.7	-36.8
Rel. to Sensex	-6.2	-26.8	-23.5
HDFC	-3.7	3.5	-0.8
SBI	2.4	11.6	-4.3
Power Finance	-4.0	5.8	-35.6

Stock movement



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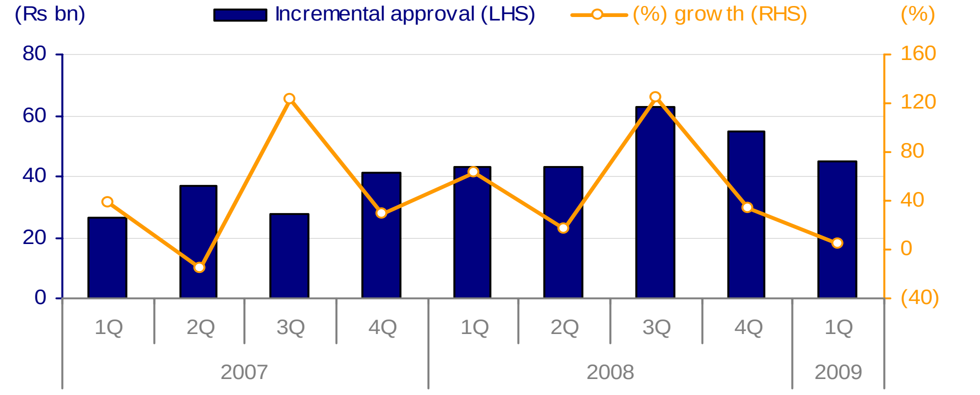
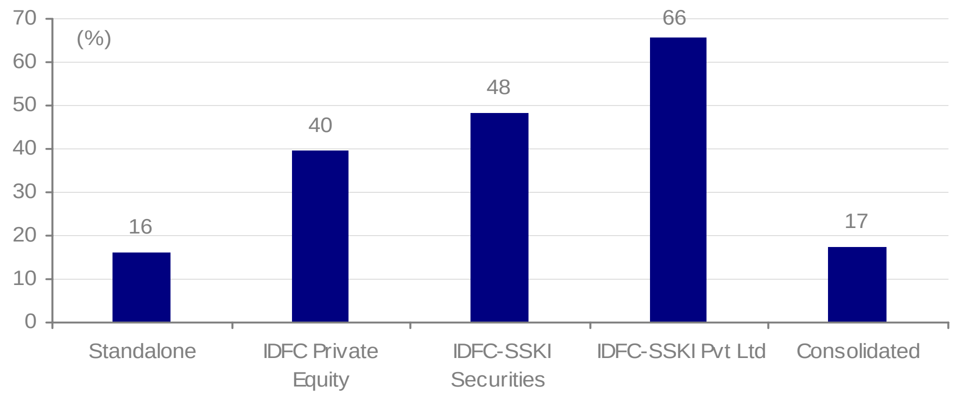
Cap on leveraging

Figure 1: Loan approvals – beginning to slow down



Source: Company, IIFL Research

Figure 2: ROE break-up (FY08) – RoE remains low for core lending business

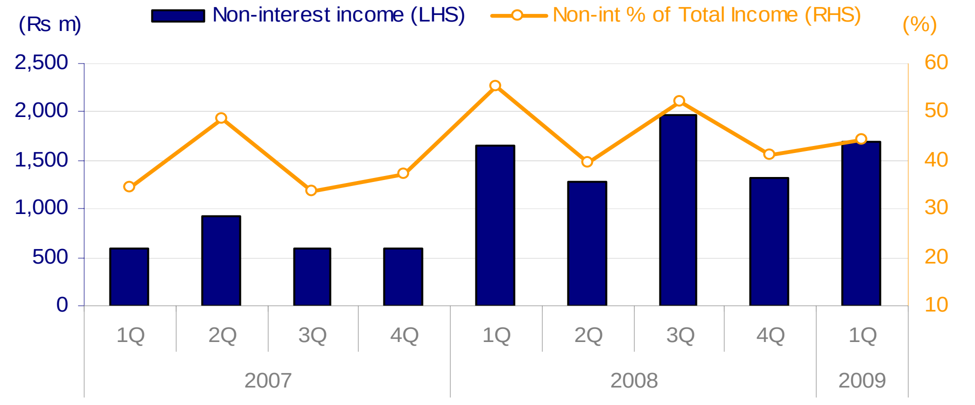


Source: Company, IIFL Research

Equity issuance of US$250m in FY09: IDFC has received shareholders' approval to raise up to US$750m in a combination of Tier-I and Tier-II capital. However, equity issuance is likely to be limited to US$250m. Assuming new equity issue of US$250m at Rs95/share, this would be dilutive by 9%. Shareholders' funds would expand by 20%, driving down current-year ROE to 13.3% from the 15.2% estimated earlier.

Income from capital markets and principal investments slowing down too: Decline in gains from principal investments (down 18% YoY in 1QFY09) and investment banking fees (down 28% YoY) were on expected lines. While the company still has Rs2.5bn of unrealised gains on its investments, we believe it would be increasingly difficult to book these gains. On the investment banking side, IDFC successfully completed a QIP (Gammon Infra) and IPO (KSK Energy) in 1QFY09. Absent more such deals going forward, this income stream will likely decline. We have assumed a 30% decline in principal gains and a 25% decline in investment banking fees in FY09. Advisory fees, though not affected by capital market conditions, would also see a slowdown, with growth in disbursements tapering off. We estimate fee income from advisory fees will grow by a slower 12.5% in FY09 and by 10% in FY10.

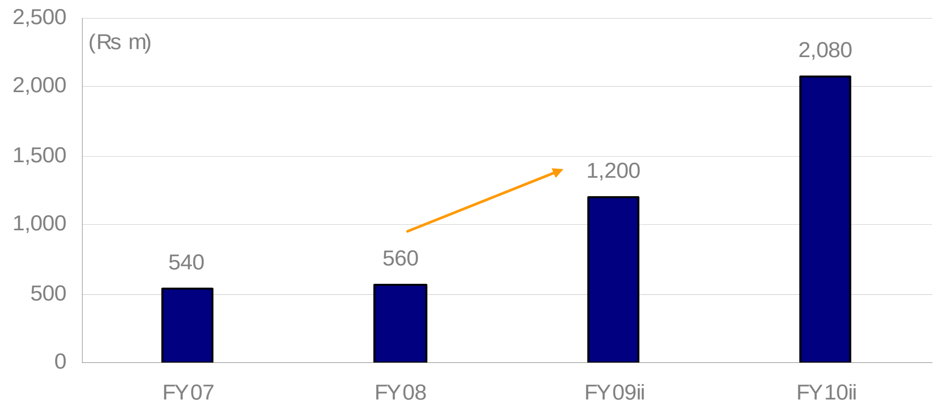
Figure 3: Non-interest income growth declining



Source: Company, IIFL Research

AuM mobilisation is on track: A silver lining is the AMC business, whose AuM we estimate will reach US$2.35bn by end-FY09, as guided earlier. IDFC has already raised US$500m as the first tranche of its infrastructure fund launched with Citigroup. For the second tranche of US$500m to be launched soon, it has firm commitments of US$380m. For its third PE fund of US$700m, it has received firm commitments and is awaiting RBI approval. IDFC earns fees on total fund size from the first date of close. Hence, we expect fees from asset management to more than double in FY09 to Rs 1.2bn and grow by a further 73% to Rs2bn in FY10.

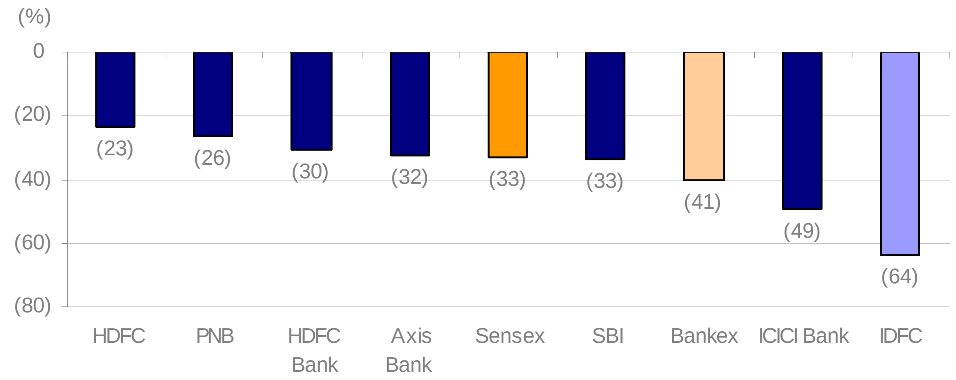
Figure 4: AMC fees expected to double in FY09



Source: Company, IIFL Research

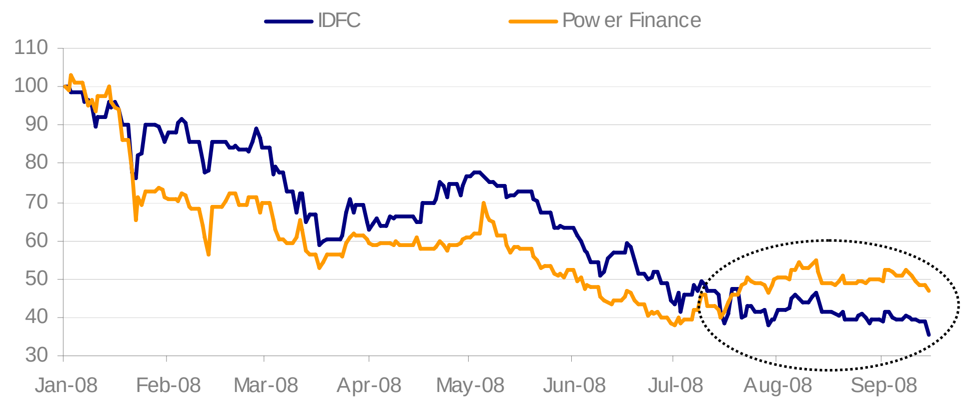
No major deterioration in asset quality: IDFC has exposure to about 300 projects and none has been restructured so far. Management believes that some ongoing projects may get delayed by 18-24 months but are unlikely to be shelved. However, financial closure of new projects may be prolonged in the current environment. Net NPLs remain zero and the company has stepped up loan-loss provisioning (from 0.5% to 1.0%) on some risky exposure.

Figure 5: YTD performance – IDFC vis-à-vis peers



Source: Bloomberg, IIFL Research

Figure 6: IDFC relative performance (YTD) vis-à-vis Power Finance Corporation



Source: Bloomberg, IIFL Research

Financial summary

Sharp deceleration in fee income growth

Cost-to-income ratio set to rise

EPS CAGR of 14% over FY08-10ii

Loan growth to moderate

Income statement summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Interest income	13,043	21,885	28,775	33,783	40,369
Interest expense	8,555	14,829	19,164	22,090	26,286
Net interest income	**4,488**	**7,056**	**9,612**	**11,693**	**14,083**
Fee Income	1,340	4,020	4,391	5,801	6,748
Others	1,330	2,160	1,512	1,663	1,913
Non-interest income	**2,670**	**6,180**	**5,903**	**7,464**	**8,661**
Total op income	**7,158**	**13,236**	**15,515**	**19,157**	**22,744**
Employee cost	480	1,677	2,138	2,619	3,182
Other operating expenses	341	855	1,140	1,376	1,525
Total op expenses	**821**	**2,532**	**3,278**	**3,995**	**4,707**
Op profit pre prov	**6,337**	**10,705**	**12,237**	**15,162**	**18,037**
Provisions	175	700	719	899	1,123
Profit before tax	**6,162**	**10,004**	**11,518**	**14,263**	**16,914**
Taxes	1,241	2,480	2,879	3,566	4,228
Minorities and other	118	102	28	27	26
Net profit	**5,039**	**7,422**	**8,610**	**10,670**	**12,659**

Balance sheet summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Net loans & advances	139,184	199,051	238,861	285,439	338,245
Cash & equivalents	10,800	18,081	16,886	14,618	14,056
Other int-earning assets	23,903	52,257	59,217	68,586	80,926
Total int-earning assets	**173,888**	**269,391**	**314,967**	**368,647**	**433,233**
Fixed assets	490	3,850	565	650	747
Other assets	9,463	16,172	20,976	27,751	34,127
Total assets	**183,841**	**289,413**	**336,509**	**397,048**	**468,107**
Other int-bearing liabs	149,028	223,277	248,735	295,364	352,062
Total int-bearing liabs	**149,029**	**223,279**	**248,738**	**295,368**	**352,067**
Other non-int-bearing liabs	5,335	10,201	14,282	19,995	24,993
Total liabilities	**154,365**	**233,480**	**263,019**	**315,363**	**377,060**
Net worth	**29,476**	**55,933**	**73,489**	**81,686**	**91,047**
Total liabs & equity	**183,841**	**289,413**	**336,509**	**397,049**	**468,108**

Source: Company data, IIFL Research

Net interest margins to improve

ROE declining due to equity dilution

Asset quality remains comfortable

Higher Tier I as per rating agency requirements

Ratio analysis

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Balance Sheet Structure Ratios (%)					
Loans / Borrowings	93.4	89.1	96.0	96.6	96.1
Loan Growth	38.0	43.0	20.0	19.5	18.5
Growth in Borrowings	58.9	49.8	11.4	18.7	19.2
Growth in Total Assets	49.4	56.4	15.4	17.0	17.5
Profitability Ratios (%)					
Net Interest Margin	3.0	3.2	3.3	3.4	3.5
Return on Average Assets	3.4	3.2	2.9	3.1	3.1
Return on Average Equity	18.3	17.4	13.3	13.8	14.7
Non-Int Inc as % of Tot Inc	37.3	46.7	38.0	39.0	38.1
Net Profit Growth	29.0	47.3	16.0	23.9	18.6
FDEPS Growth	28.6	29.9	5.4	23.8	18.6
Efficiency Ratios (%)					
Cost to Income Ratio	11.5	19.1	21.1	20.9	20.7
Salaries as % of Non-Int Costs	58.4	66.2	65.2	65.6	67.6
Credit Quality Ratios (%)					
Gross NPLs as % of loans	0.2	0.2	0.3	0.3	0.3
NPL coverage ratio	284.3	105.6	81.9	92.0	129.3
Total prov as % avg loans	0.1	0.2	0.2	0.3	0.3
Net NPLs as % of net loans	0.0	0.0	0.0	0.0	0.0
Capital Adequacy Ratios (%)					
Total CAR	20.4	22.2	25.4	24.6	23.7
Tier I capital ratio	16.1	19.5	22.5	21.8	21.0
Key earnings drivers (%)					
Loan growth	38.0	43.0	20.0	19.5	18.5
Net interest margin	3.0	3.2	3.3	3.4	3.5
Net int income growth	57.8	57.2	36.2	21.7	20.4
Core fee income growth	40.3	200.0	9.2	32.1	16.3
Non-int inc as % of total	37.3	46.7	38.0	39.0	38.1
Operating costs growth	50.6	208.2	29.5	21.9	17.8
Cost/income ratio	11.5	19.1	21.1	20.9	20.7
Gross NPAs as % of loans	0.2	0.2	0.3	0.3	0.3
Total prov as % of loans	1.4	1.5	1.5	1.7	1.9
Tax rate	20.1	24.8	25.0	25.0	25.0

Source: Company data, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.