Deutsche Bank

29 August 2007

IDFC

Reuters: **IDFC.BO** Bloomberg: **IDFC IN** Exchange: **BSE** Ticker: **IDFC**

One for the road; initiate with Buy

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Buy not just for growth but long-term profitability improvement
We initiate on IDFC, India's only listed infrastructure funding company, with a Buy and a TP of Rs150 implying ~25% upside potential. Our confidence stems from perceptible progress made - and much more to come - in having foreseen the lending business margin decline and switching increasingly to non-lending forms of infrastructure finance.

Utilizing domain expertise for better capital productivity and returns
We project IDFC's fee incomes will grow aggressively at an estimated CAGR of 66% during FY07-FY10E, and from 17% of total income in FY07 to 33% in FY10E. It is utilizing its infrastructure domain expertise to boost its syndication, advisory, debt/equity capital markets, securitization, and funds management fees. Ramp-up of the principal investment business provides "icing" through equity returns. However, due to the smaller size of the private equity business relative to lending and gains on principal investments booked only opportunistically, this transition may not meaningfully reflect in the projected RoE.

High growth, and sights trained on higher levels of profitability
We demonstrate, through a comparison with Macquarie and Babcock & Brown – two key Australian comparables for IDFC – that principal investment, specialist funds management and advisory are a natural evolution for an infrastructure lender. This is accompanied by a significantly enhanced role of fee income and results in much higher levels of profitability, even as loan spreads decline. These entities report a 25%+ RoE and ~50% of total income from fees as against IDFC's current 15% and 17%, respectively.

SOTP value Rs150; high lending rates and fund closure delays the key risks
Our TP of Rs150 is SOTP-based and derived from Rs120 for the core business and Rs30 for the other businesses (see page 15). Key risks: i) higher rates can influence profitability of infrastructure projects and hurt demand, ii) inordinate delays in fund closures can affect fees from private equity, and iii) tightness in credit markets could prevent increase of leverage, necessary for improving RoE.

Forecasts and ratios

Year End Mar 31	2006A	2007A	**2008E**	2009E	2010E
Net profit (INRm)	3,907.7	5,039.2	**6,257.7**	7,902.7	9,793.7
EPS (INR)	3.62	4.48	**5.18**	6.12	7.58
EPS growth	18.9	23.9	**15.6**	18.2	23.9
PER (x)	19.3	15.9	**23.1**	19.5	15.8
Price/book (x)	2.9	3.2	**2.8**	2.5	2.2

Source: Deutsche Bank estimates, company data

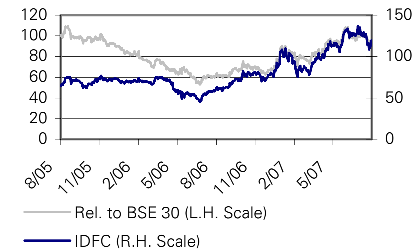
[1]) DB EPS is fully diluted and excludes non-recurring items 2) for past years and spot prices for current and future years, except P/B which uses the year end close

Initiation of Coverage

Buy

Price at 27 Aug 2007 (INR)	**119.60**
Price target - 12mth (INR)	**150.00**
52-week range (INR)	**136.55 - 58.50**
BSE 30	**14,842**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*-6.2*	*6.4*	*103.4*
BSE 30	*-2.6*	*3.5*	*28.3*

Stock data

Market cap (INRm)	**154,431**
Market cap (USDm)	**3,764**
Shares outstanding (m)	**1,208.6**
Major shareholders	**GoI & IDBI (23%)**
Free float (%)	**77**

Key indicators (FY1)

ROE (%)	**14.8**
Book value/share (INR)	**42.64**
Price/book (x)	**2.8**
NPL/total loans (%)	**0.2**
Net int margin (%)	**2.81**

DB vs. consensus (FY08E, INR)

	NP (INR m)	TP	EPS
Mean	6188	157	5.15
High	6937	162	5.54
Low	4500	85	4.60
DB	6258	150	5.18

Source: Bloomberg, DB

Model updated:27 August 2007

Running the Numbers

Asia Pacific

India

IDFC

Reuters Code	IDFC.BO
Buy	
Price as of 28 August	INR 118.80
Price Target	INR 150.00

Web Site
http://www.idfc.com

Company Description

IInfrastructure Development Finance Co. Ltd. (IDFC) is one of the leading infrastructure financing institution that offers a wide range of financial products and fee based services to infrastructure projects and their sponsors. Established in 1997 as a private sector enterprise IDFC provides assistance in major sectors such as energy, telecommunications and transportation projects. The company views itself as a specialized intermediary in infrastructure financing. Apart from providing project finance, it also facilitates flow of private capital to infrastructure development by creating appropriate structures and financing vehicles for a wide range of market participants.

Research Team

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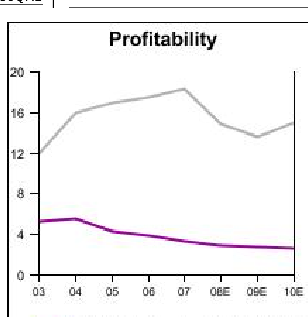
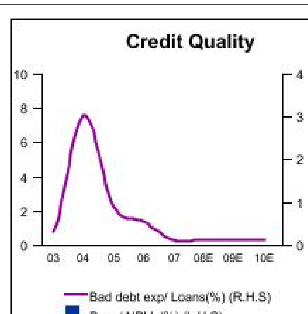
Absolute Price Return	1m	3m	12m
	-6.8%	5.0%	94.0%

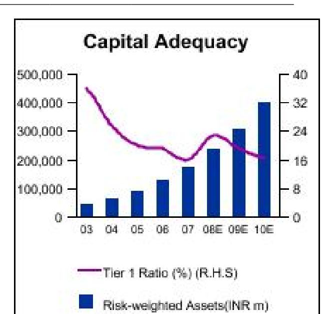
52-week Range	INR 58.50 - 136.55
Market Cap	INR 153,398 m
	USD 3,726 m

Company Identifiers	
Bloomberg	IDFC IN
Cusip	–
SEDOL	B0C5QR1

Y/E 31 March	2003	2004	2005	2006	2007	2008E	2009E	2010E
Data Per Share								
EPS (stated) (INR)	1.80	2.59	3.04	3.62	4.48	5.18	6.12	7.58
EPS FD (stated) (INR)	1.78	2.57	3.02	3.59	4.45	5.15	6.09	7.54
EPS FD (DB adj.) (INR)	1.78	2.57	3.02	3.59	4.45	5.15	6.09	7.54
Growth rate - EPS (stated) (%)	NM	44.0	17.3	18.9	23.9	15.6	18.2	23.9
DPS (INR)	1.13	1.13	1.14	1.14	1.17	1.29	1.42	1.56
BVPS (stated) (INR)	15.53	16.99	18.89	22.88	26.18	42.64	47.34	53.37
BVPS (DB adj.) (INR)	15.26	16.99	18.89	22.88	26.18	42.64	47.34	53.37
Average market cap (INRm)	0	0	0	78,350	80,251	153,398	153,398	153,398
Shares in Issue (m)	1,000	1,000	1,000	1,122	1,126	1,291	1,291	1,291
Valuation Ratios & Profitability Measures								
P/E (stated)	–	–	–	19.3	15.9	22.9	19.4	15.7
P/E FD (stated)	–	–	–	19.5	16.0	23.1	19.5	15.7
P/E FD (DB adj.)	–	–	–	19.5	16.0	23.1	19.5	15.7
P/B (stated)	–	–	–	2.91	3.20	2.79	2.51	2.23
P/B (DB adj.)	–	–	–	2.91	3.20	2.79	2.51	2.23
ROE (stated) (%)	11.9	15.9	16.9	17.5	18.3	14.8	13.6	15.1
ROA (stated) (%)	5.26	5.51	4.31	3.83	3.38	2.91	2.73	2.60
Dividend yield(%)	–	–	–	1.64	1.65	1.09	1.19	1.31
Dividend cover(x)	1.60	2.30	2.66	3.16	3.82	4.01	4.31	4.86
Payout ratio (%)	62.7	43.5	37.6	32.8	26.2	26.6	23.2	20.6
Profit & Loss (INRm)								
Net interest revenue	1,682	1,935	2,402	2,767	4,106	5,616	7,456	9,491
Non interest income	870	2,172	1,627	2,683	3,026	4,744	6,039	7,677
Fees & Commissions	107	165	198	955	1,239	2,985	4,152	5,653
Trading Revenue	444	1,455	1,166	1,651	1,578	1,508	1,586	1,664
Insurance revenue	0	0	0	0	0	0	0	0
Dividend income	115	408	91	73	101	121	146	175
Other revenue	204	144	172	4	108	129	154	185
Total revenue	2,552	4,107	4,029	5,450	7,132	10,360	13,494	17,168
Total operating costs	474	308	280	546	821	1,820	2,551	3,573
Pre-provision profit/(loss)	2,079	3,799	3,749	4,904	6,310	8,540	10,943	13,595
Bad debt expense	75	1,080	519	478	148	229	302	393
Operating Profit	2,004	2,719	3,230	4,426	6,162	8,311	10,641	13,201
Goodwill	0	0	0	0	0	0	0	0
Pre-tax associates	0	0	0	0	0	0	0	0
Extraordinary & Other Items	0	0	0	0	0	0	0	0
Pre-tax profit	2,004	2,719	3,230	4,426	6,162	8,311	10,641	13,201
Tax	204	128	189	517	1,241	1,911	2,554	3,168
Minorities	0	0	0	2	-118	142	184	239
Preference dividends	0	0	0	0	0	0	0	0
Stated net profit	1,799	2,591	3,040	3,908	5,039	6,258	7,903	9,794
DB adj. core earnings	1,799	2,591	3,040	3,908	5,039	6,258	7,903	9,794
Key Balance Sheet Items (INRm) & Capital Ratios								
Risk-weighted assets	43,214	64,274	89,467	127,012	175,350	236,723	307,739	400,061
Interest-earning assets	31,069	47,584	79,102	112,098	167,585	232,673	308,007	408,680
Total loans	26,596	44,189	70,504	100,871	139,184	187,860	244,217	317,483
Total deposits	1	1	1	1	1	1	1	1
Stated shareholders equity	15,528	16,991	18,889	25,685	29,476	55,061	61,131	68,909
Preference share capital	–	–	–	–	–	–	–	–
Tier 1 capital	15,528	16,991	18,889	25,685	29,476	53,937	59,426	66,514
Tier 1 ratio (%)	35.93	25.61	20.14	19.23	16.10	22.79	19.31	16.63
Tangible equity/ total assets (%)	41.65	29.95	22.40	21.50	16.51	21.84	18.74	16.14
Credit Quality								
Gross NPLs / Total loans (%)	1.11	0.67	0.72	0.50	0.20	0.16	0.17	0.19
Provisions / NPLs (%)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bad debt exp/ Avg loans (%)	0.32	3.05	0.91	0.56	0.12	0.14	0.14	0.14
Growth Rates & Key Ratios								
Growth in net interest income (%)	NM	15.0	24.1	15.2	48.4	36.8	32.8	27.3
Growth in fee income (%)	–	54.2	20.2	381.6	29.7	141.0	39.1	36.1
Growth in non-interest income (%)	–	149.7	-25.1	64.9	12.8	56.8	27.3	27.1
Growth in revenues (%)	NM	60.9	-1.9	35.3	30.9	45.3	30.3	27.2
Growth in costs (%)	NM	-35.0	-9.2	95.1	50.6	121.5	40.2	40.1
Pre-provision earnings growth (%)	–	82.8	-1.3	30.8	28.7	35.3	28.1	24.2
Growth in bad debts (%)	NM	1,347.2	-51.9	-8.0	-68.9	54.2	32.1	30.0
Growth in RWA (%)	NM	48.7	39.2	42.0	38.1	35.0	30.0	30.0
Growth in loans (%)	–	66.2	59.6	43.1	38.0	35.0	30.0	30.0
Growth in deposits (%)	–	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loan-to-deposits ratio (%)	2,659,598.2	4,418,923.4	7,050,446.3	NaN	NaN	NaN	NaN	NaN
Net int. margin (%)	5.96	4.92	3.79	2.89	2.94	2.81	2.76	2.65
Cost income ratio (%)	18.6	7.5	6.9	10.0	11.5	17.6	18.9	20.8
Cost asset ratio (%)	1.4	0.7	0.4	0.5	0.6	0.8	0.9	0.9
Trading income/ Total Rev (%)	17.4	35.4	29.0	30.3	22.1	14.6	11.8	9.7







Source: Deutsche Bank AG estimates, company data

Investment thesis

Outlook: evolution of an infrastructure lender

Even as we project lending to grow at 30% over the coming years, IDFC's fee incomes are growing aggressively. Taking commoditization of lending in its stride, IDFC is utilizing its infrastructure domain expertise to boost its syndication, advisory, debt/equity capital markets, securitization, and funds management fees. Fees are expected to rise from 17% of total income in FY07 to 33% in FY10E. Ramp-up of the principal investment business provides added equity upside potential. But due to the relatively smaller size of the private equity business relative to lending and the gains on principal investments booked only opportunistically, this transition may not meaningfully reflect in the projected RoE.

A comparison with Macquarie and Babcock & Brown – two key Australian comparables for IDFC – shows that principal investment, specialist funds management and advisory to be a natural evolution for an infrastructure lender. This is accompanied by a significantly enhanced role of fee income and results in much higher levels of profitability, even as loan spreads decline. These entities report a 25%+ RoE and ~50% of total income from fees.

Valuation: SOTP-based TP at Rs150

We value IDFC as sum-of-parts, adding values of the core and non-traditional businesses. The core lending (i.e., standalone) business is valued on 2-stage Gordon Growth model with the following assumptions: g = 25%, g_n = 4%, p = 30%, p_n = 45%, risk-free = 7.0% (DB), beta = 1.1 (Bloomberg), risk-premium = 4.5% (DB) and Normalised RoE of 18.5%. The private/project equity businesses are valued on % of FUM, investment banking on P/E and principal investment on expected unrealized gains (see pg 15). Our value for the lending business comes to Rs120/share and all else Rs29/share, giving a total of Rs150/share (rounded off).

Risks: high interest rates remain a top concern

Interest rates have risen sharply recently. Higher rates can influence profitability of infrastructure projects and thereby adversely affect demand, at least at the margin. Inordinate delays in fund closures can hurt fees from the private equity business. Tightness in credit markets could prevent the increase of leverage, necessary for improving RoE, central to our valuation.

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The author of this report wishes to acknowledge the contribution made by Amit Jain, employee of Evalueserve, a third party provider to Deutsche Bank for offshore research support service.

Core business outlook

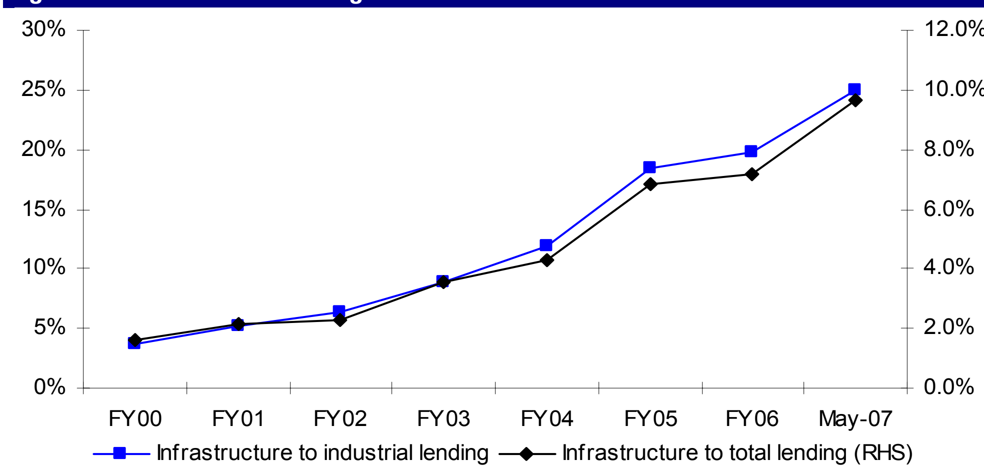
Consciously taking commoditization in stride

We believe that competitive pressures in IDFC's core infrastructure lending business are well priced in. There have been several months of discussion in the press, among sell-side analysts and in other forums about this, and better still, management has more than adequately guided towards a decline in RoA over time. In fact, we see two forces that could counterbalance the pressure more effectively than the market is currently presuming – increase in fee income and leverage, and the business strategy is being worked towards that.

Repeat of irrational competition from banks appears unlikely
We think the circumstances that led to irrational competition from banks (in almost all fields, including infrastructure) in the early 2000s are unlikely to repeat in the near future. Liquidity is getting tighter, not easier. Banks, more so the PSU banks, are getting depleted of capital – they are also constrained by the 51% government ownership. NPLs are starting to become a concern. Banks can ill-afford to give short shrift to profitability.

The other important consideration is that unlike five years ago, infrastructure has become a large part of bank lending and cannot be taken lightly in profitability terms (Figure 1).

Figure 1: Infrastructure lending now sizeable for banks



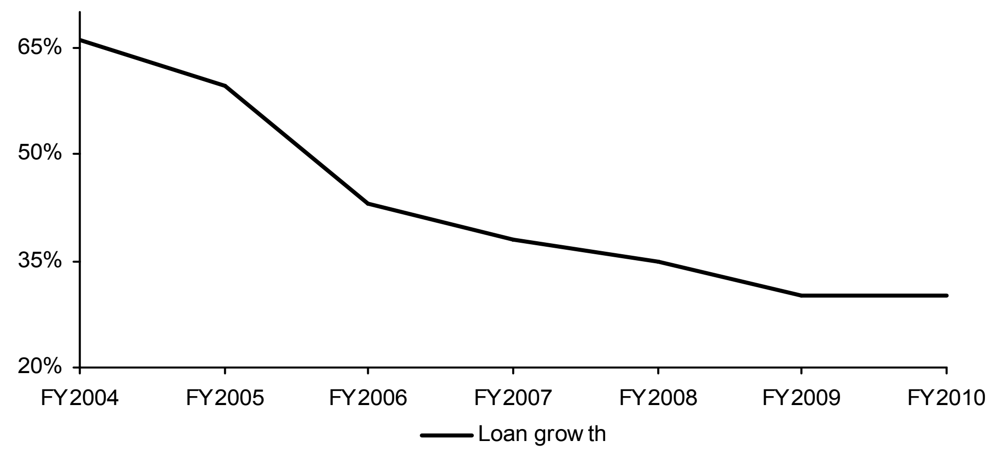
Source: RBI, Deutsche Bank

Loan growth to remain strong, but selective

Sector portfolio has been managed commendably well
IDFC's loan growth has been deliberately managed, in a sector where it is easy to get carried away by seemingly high growth potential. We see two reasons for this stance. Firstly, much of this growth is illusory because the regulatory structure is not sufficiently evolved to incentivise investment, e.g., power generation. Secondly, some lucrative infrastructure segments can become less profitable as competition creams off super profits or consolidation leads to stronger players who may not want as much debt funding, e.g., telecom. It then makes sense to reduce exposure to this segment.

The sector's overall momentum makes IDFC's selective policy feasible. So, though loan growth is expected to remain strong, it will still be measured, and will be lower compared with historical levels as the base increases and the focus shifts from pure funding to other forms of taking infrastructure exposure (Figure 2).

Figure 2: Loan growth to remain strong but base is getting larger



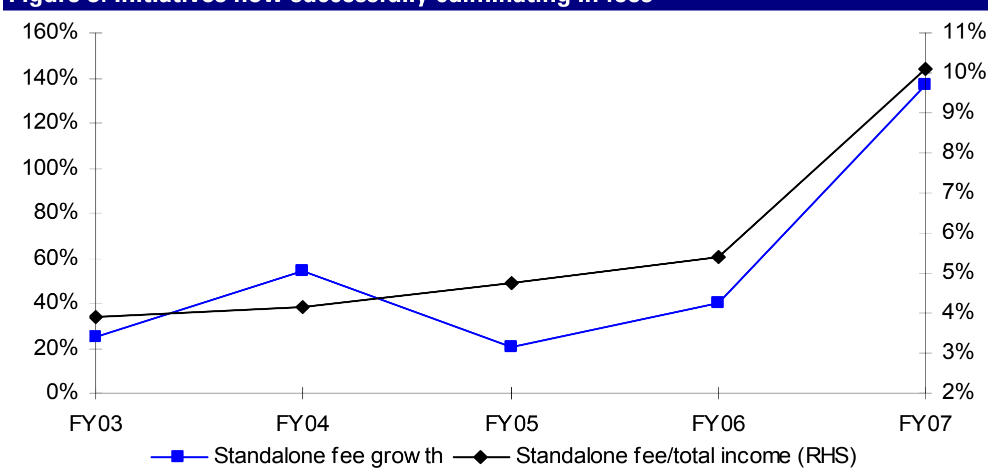
Source: Company data, Deutsche Bank

Steep swing to non-interest income already evident

In the standalone business, fee income has increased from 3.9% of total income in FY03 to 10.1% in FY07 (Figure 3). The fact that a similar trend has been noticed in the consolidated business is of course well-known, but there it is more a function of the asset management and securities business' fees (more about it in the later sections). The core business fees are now accelerating due to some initiatives started a few years back and now delivering:

- Advisory business, now gaining traction with personnel dedicated to it
- Upfront fees from project finance written – this grows linearly with the loan book
- Debt syndication fees
- Equity capital markets – fees from finding equity to add to sponsor's contribution
- Securitisation profits

Figure 3: Initiatives now successfully culminating in fees



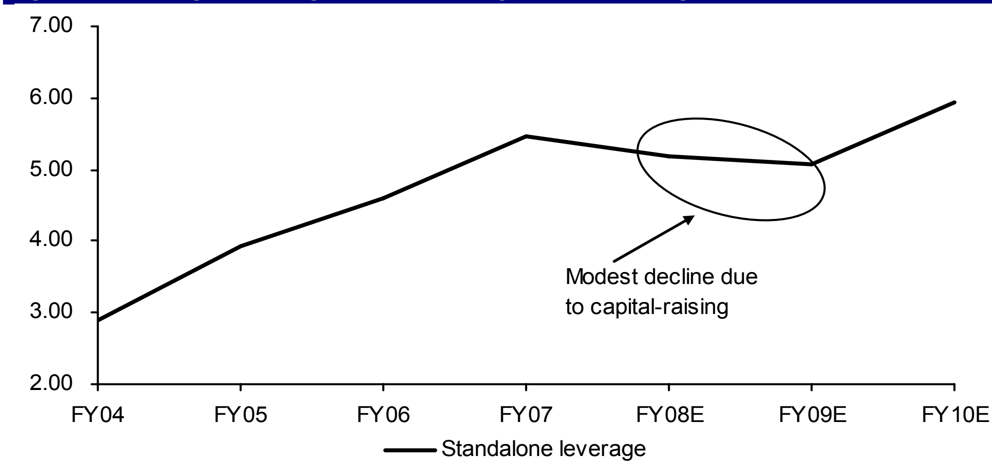
Source: Company data, Deutsche Bank

Leverage increase likely to partly compensate fall in spreads

In the longer run, it is possible that credit rating companies will be comfortable with a higher level of leverage for IDFC – they have been relenting over the years in bits. Then progressively some of the spread compression can be offset by increase of leverage (Figure 4).

This will, however, not be so apparent from the company's standalone or consolidated financials. This is because the entire equity of the company is not going towards creation of assets held on the company's books. For example, seed investments in the private equity business do not fully realize in that year. Principal investments are held at cost till they are sold. So, the equity may actually be put to very effective use but the asset value will not reveal that. Our sum-of–the-parts valuation of course takes that into account.

Figure 4: Leverage trending upwards, though actual leverage understated



Source: Company data, Deutsche Bank

Key value driver: increase in capital productivity

Slow but steady transition to more profitable business model

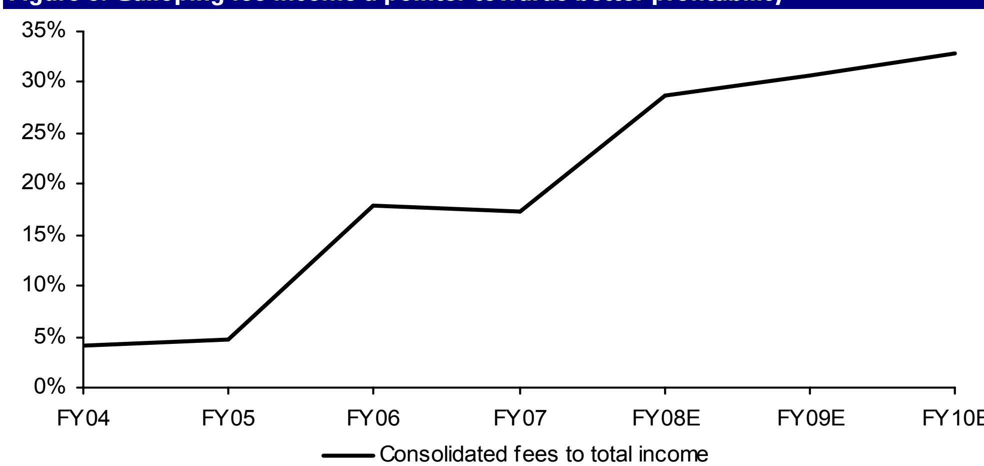
Since it is not realistically possible to improve the RoE of the lending business to beyond 18-19% because of the expected spread compression, IDFC has been deliberately allocating more capital and management time to the other forms of serving the same infrastructure finance objective. These are principal investments, private equity, project equity and investment banking. Globally, infrastructure lending has progressed in this direction.

Do not look only at RoE estimates for evidence of the above

It is important to recognize that *all of the capital productivity increase will not be reflected in the RoE of the consolidated entity*. That is primarily on two accounts, none of which invalidates the premise itself: i) a timing issue – the core lending business is currently too large and the less capital consuming businesses relatively small to be able to make a difference to RoE immediately, and ii) the principal investment business favourably affects RoE only if gains are booked, else they show up as unrealized gains.

A more obvious financial indicator of the strategy is the expected increase in the importance of fee income to total income (Figure 5).

Figure 5: Galloping fee income a pointer towards better profitability



Source: Company data, Deutsche Bank

Principal investment business provides the equity upside

Though this segment has always existed for IDFC, the company has now consciously decided to allocate a third of its capital (incrementally) to principal investment. This is direct balance sheet equity exposure to infrastructure companies. Many investments of the past have given IDFC handsome returns, realized or unrealized. On a portfolio, risk-adjusted basis, this has the potential to generate returns far in excess of the 17-18% of the lending business.

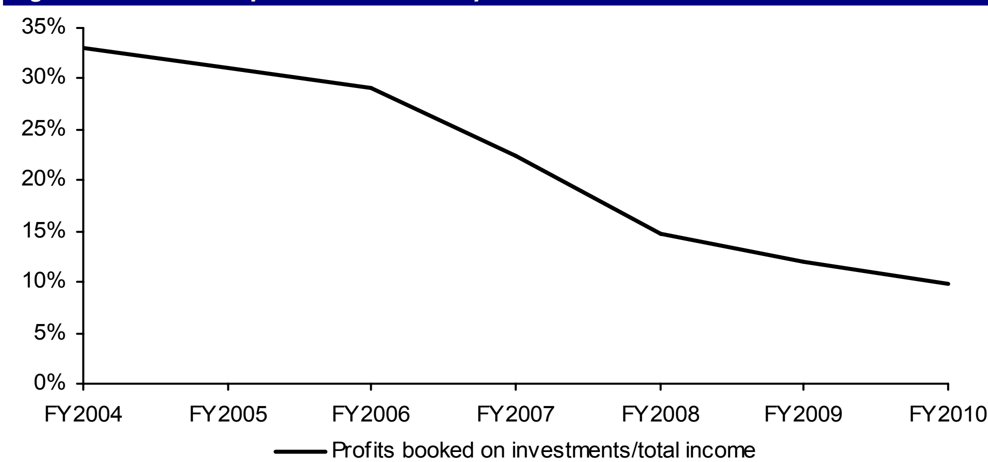
Figure 6: Examples of equity investments on IDFC's balance sheet

Company	Cost/share (31.3.07, INR)	Value (30.3.07, INR)	Unrealised appreciation/share (%)
Bharti Airtel	45	763.2	1596
Gujarat State Petronet	20	46.8	134
GTL Infrastructure	10	20.4	104
Indraprashtha Gas	10	100.0	900
Jet Airways	1,100	632.3	-43
NTPC	62	149.8	142
ONGC	500	878.2	76

Source: Bloomberg, Company data, Deutsche Bank

At the same time, the management has clearly said that they will only be opportunistic about the booking of gains and not have targets for the same. They will be averse to let these profits contributing to P&L volatility – an obvious risk of the principal investment business. This could potentially lead to the actual gains booked progressively declining as a proportion of total income (Figure 7). In our price target computation, we have taken a commensurate amount of unrealized gains to reflect true value of this business.

Figure 7: Investment profits booked likely to fall as % of total income



Source: Deutsche Bank

Private equity and project equity – high RoE businesses

These businesses, still in their formative stages, are enormously profitable vehicles for taking advantage of the same infrastructure boom. They sidestep the rate competition of the lending business and are far more driven by domain expertise. The carry, along with fees, boosts the returns to levels that can never be achieved by the lending business. Our sample model on the private equity business, based on our understanding and assumptions only, is shown in Figure 8. The project equity model is structurally similar.

Figure 8: Working of a typical private equity business

		Remarks
Fund size	$1,000	
Seed capital	10%	Conservative, would generally be 7-8%
Seed capital value	$100	
Assumed per annum return normalised	20%	
Hurdle rate	10%	
Probability of reaching hurdle rate	80%	
Agreed carry	20%	
Fee rate	2%	
Avg duration of carry	4.0yrs	To factor in the typically delayed beginning of carry
Discount rate	15%	
Avg assets	$1,100	
Fee amount	$22.0	
Carry amount (duration-discounted)	$9.1	
Capital gains on manager's account	$20.0	
Total income to manager firm	$51.1	
Cost-income ratio - base	40%	Close to HDFC Mutual Fund's figures
Fund manager's share of income	30%	Fund managers usually take a part of the carry
Hence total operating expenses	$21.8	
Leverage adopted by manager firm	3.0x	As per IDFC's guidance
Interest cost	10%	
Hence cost of debt for operations	$2.50	
Profit before tax	$26.8	
Tax rate	35%	
Profit after tax	$17.45	
Equity investment in seed done by manager	$25.00	
Return on equity investment	**69.8%**	
Earnings multiplier	15x	
Value of company, net of seed capital	$236.7	
As % of AUM	23.7%	

Source: Deutsche Bank

IDFC currently has $670mn FUM under private equity. One fund of $220mn is already fully deployed. Of the next proposed fund of $450mn, 35% is already committed, and should be 65-70% committed by June 2008. IDFC at that point in time intends to start talking to investors about a third fund of around $750mn. These funds typically run on the 2:20 structure common for hedge funds. Investments by definition are made into early-stage projects, and typically, the exit is through public markets.

The company's first foray into project equity is a $1bn fund in collaboration with Citigroup and Blackstone. The closure of the first tranche should happen very soon from now, and the fund is expected to be fully committed by June 2008. The aim is to have $3bn in FUM by June 2010. Investment is in later stage, mostly stable cash flow projects. The funds themselves will be listed – this has been a very successful model in Australia. Similar to private equity, this also earns fees and carry for IDFC's fund management arm, although lower than private equity as the investment risks are correspondingly lower.

Investment banking a rising fee income generator

SSKI is likely to be a major contributor to fees in the coming years. In Q1FY08, the first quarter of consolidation with IDFC, SSKI was 39% of IDFC's consolidated fee income. This stream did not exist for IDFC before, and is certainly not as capital intensive as the lending business. This business in India has generally been very profitable (Figure 9).

Figure 9: ROEs of some prominent brokerage/investment banking houses in India

	FY06 ROE
India Infoline	24%
IL&FS Investsmart	19%
Motilal Oswal	55%
ICICI Securities	36%
Kotak Mahindra Capital	48%
Kotak Securities	55%

Source: Company data, Deutsche Bank

SSKI, which has been around longer than IDFC, has meaningful small and mid-tier company contacts in the infrastructure space. Public markets execution capability – the last missing piece in IDFC – now has also come in through SSKI.

Note that IDFC plans to treat SSKI as an origination engine per se, and thereafter the deal can be parked (and hence fees booked) somewhere else in the group. Thus, the contribution of SSKI to fees may not be visible in SSKI itself but certainly in the consolidated accounts.

Comparison with Babcock & Brown and Macquarie Bank

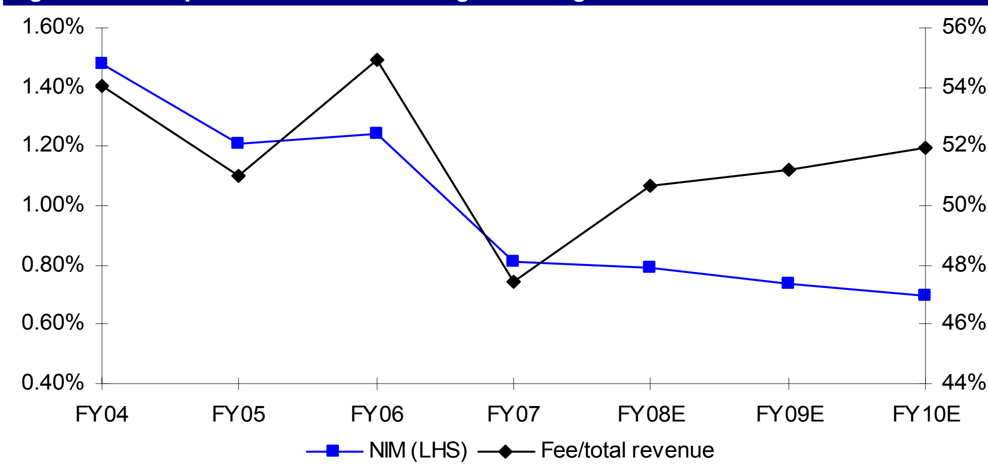
If peer examples are any indication, it is likely that IDFC could be significantly improving its RoE in the longer run and trade at substantially higher multiples.

IDFC's business model closely resembles (or is intended to resemble) that of two Australian financial companies – Macquarie and Babcock & Brown. Hence, it is instructive to look at these companies to get an idea of where IDFC could be heading. There is no close comparable in India.

NIMs declining and fees a large component of total income

With maturing of the borrowers' market, Macquarie's NIMs have been falling year after year. This is probably the course that IDFC sees for itself, though we do not believe that such a precipitous decline in India is near. At the same time, Macquarie's fees constitute close to 50% of total revenue (defined as NII + other income), which is around 17% now for IDFC (Figure 10).

Figure 10: Macquarie's business – falling NIMs, high fees



Source: Company data, Deutsche Bank

B&B is not a bank – it is not a lender (and hence no concept of NIM) and its model runs on principal investment, advisory, co-investment and fund management fees (both base and carry). Fees comprised 48.9% of net revenue in CY06, the balance being investment related incomes and development. At the end of CY06, unrealized revenue from the investment function was as much as 40% of net revenue.

Fund management an important part of business strategy

The best way to understand this is the gap between balance sheet assets and funds under management. As described in the previous sections, this gap will be distinctly widening for IDFC with the heightened importance of the funds management businesses.

Structurally higher RoEs than IDFC

It is understandable that B&B's RoE is much higher than that of IDFC as it does not have a lending business, but Macquarie, whose model maps IDFC more closely, also reports a much higher RoE. IDFC's consolidated RoE in recent years has been 17-18% (and this was prior to the recent capital raising, so not disturbed by additional equity). Macquarie's RoE for FY07 and B&B's CY06 RoE were 28.7% and 31.9%, respectively. And the difference is made by core profitability – RoA – and not leverage (Figure 11).

Figure 11: Comparison with Macquarie and Babcock & Brown

	RoA	RoE
IDFC *	3.38%	18.3%
B&B **	7.30%	31.9%
Macquarie *	4.30%	28.7%

*Source: Company data, Deutsche Bank * FY07 ** CY06*

One key insight about IDFC from the two examples above is that *once the managed funds are listed, the fund manager firm usually enjoys a 'beta effect', i.e., its own stock price responds more to the price of these funds than it would, based just on the financial impact of fees and carry*. This is an additional kicker that we conceivably cannot factor into the target price. In common parlance, this is described as better value unlocking through listing.

Financials and valuation

Overall strength despite decline in spreads assumed

Earnings growth and return on equity

There are a few considerations that need to be borne in mind while assessing IDFC's financials: i) there has been a large dilution of $500mn at the beginning of FY08, and hence, FY08 financials will not be encouraging, but should quickly normalize thereafter, ii) the jump in fee growth to triple digits in FY08E is primarily due to the SSKI consolidation – FY09E/FY10E figures that are more representative show a fee income acceleration, and iii) we have been conservative about the profit on sale of investments – that's the one most difficult to predict – but profitability figures for any year can be much better if more than estimated gains are booked (Figure 12).

Figure 12: Key financial projections

	FY07	FY08E	FY09E	FY10E	Remarks
EPS growth	28.6%	8.3%	26.3%	23.9%	Dilution in FY08
RoE	18.3%	14.8%	13.6%	15.1%	Dilution in FY09
Loan growth	38%	35%	30%	30%	
Fee growth	29.7%	141.0%	39.1%	36.1%	Consolidation of SSKI for first time in FY08
NIM	2.94%	2.81%	2.76%	2.65%	
Growth in profit on sale of investments	2.8%	-4.2%	4.8%	4.8%	

Source: Deutsche Bank

SOTP valuation at Rs150, 20% from non-traditional businesses

Core business Rs120/share on two-stage Gordon Growth

We multiply the P/BV arrived at through the following two-stage Gordon Growth model with the FY09E to come to Rs120/share for the core (standalone) business.

$$\mathbf{P/BV = RoE * \{(p(1+g) * (1- (1+g)^n/(1+r)^n)) + (p_n(1+g)^n(1+g_n))/((r-g_n)(1+r)^n)\},}$$

where g=growth rate for the first n (high-growth period) years,

p=payout ratio in the first n years,

g_n=perpetual growth rate,

p_n=perpetual payout ratio,

RoE=normalized (sustainable) RoE

r = cost of equity = risk-free + beta * risk premium

Assumptions are g = 25%, g_n = 4%, p = 30%, p_n = 45%, risk-free = 7.0% (DB), beta = 1.1 (Bloomberg), risk-premium = 4.5% (DB). Normalised RoE of 18.5% is derived as follows (Figure 13).

Figure 13: Sustainable RoE for the core business

		Comments
Net interest income/ avg. total assets	2.50%	FY07 figure 2.74%, expected to fall with spreads going down
Non-interest income/ avg. total assets	1.5%	
Total income/ avg. total assets	4.0%	
Operating expenses/ avg. total assets	0.45%	
Operating profit/ avg. total assets	3.6%	
Provisions/ Avg. total assets	0.1%	
(1 - tax rate)	77.0%	
Minority interest/ avg. total assets	0.0%	
Return on avg. total assets	2.64%	
Avg. total assets/ average equity	7.0x	Currently hovering around 5-6x, to improve with more effective capital utilization and rating agencies allowing more leverage
Return on equity	**18.5%**	

Source: Deutsche Bank

Businesses other than lending contribute Rs29/share

Valuing the securities business on P/E of 25x (similar to global investment banks as there are no reliable listed comparables in India), the unrealized gains on NSE and ARCIL based on recent transactions, and the principal investment business on 10% equity gains a year, the non-lending parts of the business tot up to Rs29/share. Hence, the total rounded off SOTP is Rs150/share (Figure 14).

Figure 14: Sum-of-the-parts valuation

(Rs/share)		Comments
IDFC Standalone business - Infrastructure Financing	120	Two-stage Gordon Growth model
Value form SSKI	7.2	Assuming 35% growth in profits of SSKI for the next 2 years
Value from unrealised gains on listed investments	3.0	10% equity gains a year on portfolio basis
Value from NSE and ARCIL stake	7.0	Based on past deals and transactions involving selling of NSE and ARCIL stakes by other players
Value from IDFC Private Equity	8.3	69.8% RoE on FY09E assets as per pro forma model of private equity
Value from IDFC Project Equity	5.1	49.2% RoE on FY09E assets based on pro forma model similar to private equity
Less Investments in SSKI	(1.9)	
Target Price (rounded off)	**150**	

Source: Deutsche Bank

Full value of non-traditional business not yet priced in

Since our EPS estimates are below consensus and net profit estimates well above consensus, it appears consensus may not have adjusted for the recent equity increase of $500mn (Figure 15). Decomposition of our TP suggests that the market is factoring in value primarily from the core business and the traditional business is under-priced. And we are not even considering the value unlocking possibility from listing of the project equity funds (because it is too nascent to build in).

Figure 15: Comparison – DB vs. Consensus

(INR)	2008	2009	2010
EPS			
Mean	5.16	6.22	8.34
High	5.54	7.2	9.90
Low	4.6	5.0	7.2
DB	**5.18**	**6.12**	**7.58**
TP			
Mean	157		
High	162		
Low	85		
DB	**150**		
Net Profit (INR m)			
Mean	6,188	7,844	9,573
High	6,937	9,300	12,490
Low	4,500	6,401	6,058
DB (INR m)	**6,258**	**7,903**	**9,794**

Source: Bloomberg, Deutsche Bank   Note H: highest, L: lowest   Others are mean figures excluding data more than six months old

Risks

High interest rates upsetting IRRs of projects

Interest rates have just not increased sharply in the last one year but the curve has steepened, thereby leading to higher increases for longer tenors and/or lower credit ratings. Contrary to popular perception, loans for infrastructure are not fixed rate loans – they reset every two years or so even though the tenor could be 10/15 years. It is inconceivable that higher interest rates will not influence profitability of infrastructure projects and thereby adversely affect demand, at least at the margin.

Uncontrollable delays in fund closures

Private equity (or less capital intensive business streams in general) is now a key driver of IDFC's expected returns. However, it is critically dependent on how fast the company can close the funds. Else both carry and fees are delayed. The ongoing turmoil in the public equity and credit markets can delay fund closures.

Tightness in credit markets preventing increase in leverage

A meaningful increase in IDFC's RoE is predicated on increase of its leverage from the current 5-6x to 7-8x, which in turn is dependent on credit rating companies getting comfortable with a higher leverage for IDFC. Though, over the years, rating agencies have relaxed some of the conservatism associated with leverage, the present volatility in interest rates could deter them from further liberalisation soon.

Appendix A: Company background

Description

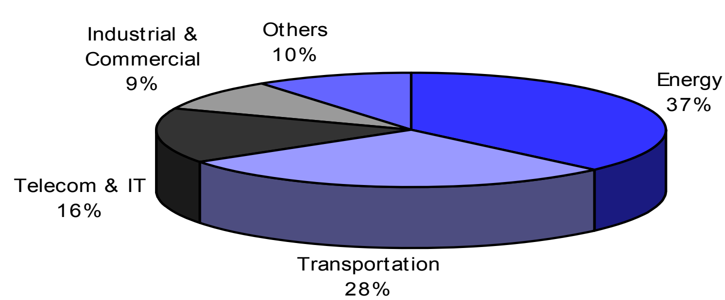
IDFC is one of the leading infrastructure financing institutions in India providing a wide range of financing products and fee-based services to infrastructure projects and their sponsors. Established in 1997 on the recommendation of "Expert Group on Commercialization of Infrastructure Projects", the company acts as a "one stop shop" to catalyze private investment in commercially viable infrastructure projects. Apart from providing finance for projects, the company also acts as an intermediary to arrange capital for infrastructure development by creating specialized structures and financing vehicles. IDFC's main focus areas are energy, transportation, telecom and IT, and other industrial projects.

Key business areas

Infrastructure financing

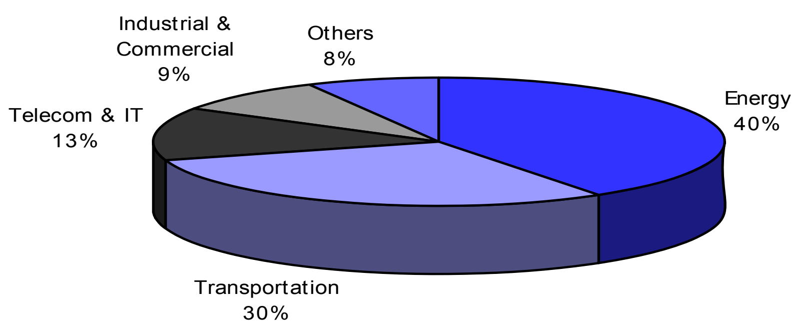
The core activity of the company still remains of providing debt finance to infrastructure projects. IDFC focuses on four main infrastructure sectors - energy, transportation, telecommunication and IT, and industrial and commercial infrastructure. Out of these, energy sector continues to dominate with almost 37% of total exposure. As of June 2007, the total exposure to infrastructure projects was Rs24.6bn as compared to Rs18.2bn in the same quarter last year.

Figure 16: Total exposure in different sectors as on June 2007



Source: IDFC, Deutsche Bank

Figure 17: Total disbursements in different sectors as on June 2007



Source: IDFC, Deutsche Bank

Project finance

It includes senior debt financing in the form of loans, debentures and securitized debt; mezzanine products, including subordinated debt and preference capital, and equity financing through proprietary investments in unlisted equity as well as in public offerings of infrastructure companies.

Principal investments/proprietary book

It comprises equity investments made by the company with a view to procure non-interest income. The prop book size is around Rs10bn which constitutes 6% of total asset book of IDFC.

Asset management

It includes private equity investments and asset management services for third party funds to provide long-term equity capital to infrastructure companies requiring financing support during their growth stages. The company managed investments worth \$670m as of June 2007 and plans to take this figure to \$1.5-2bn during FY08.

Financial markets and investment banking

The company operates in four domains in the financial markets namely debt/equity syndication, structured finance and debt capital markets. With a view to acquire a significant presence in investment banking domain, the company acquired an additional 33.3% stake in SSKI. As a result, the company now owns 66.67% in SSKI (domestic mid-size investment bank) and plans to re-brand it as IDFC-SSKI.

Advisory services

It includes strategic consulting, advice on project and financial structuring, corporate restructuring, bid advisory services (for both sellers and buyers), investment appraisal, IPO monitoring, advice on mergers and acquisitions to companies as well as advisory services to government and multilateral agencies.

Management team

Mr. Rajiv B Lall is the CEO and MD of the company. He has over two decades of experience with Warburg Pincus, Morgan Stanley and other leading institutions. Mr. Deepak Parekh, who is the non-executive Chairman of the company, is also the Chairman of HDFC (India's largest housing finance company) since 1993.

Figure 18: Key management personnel

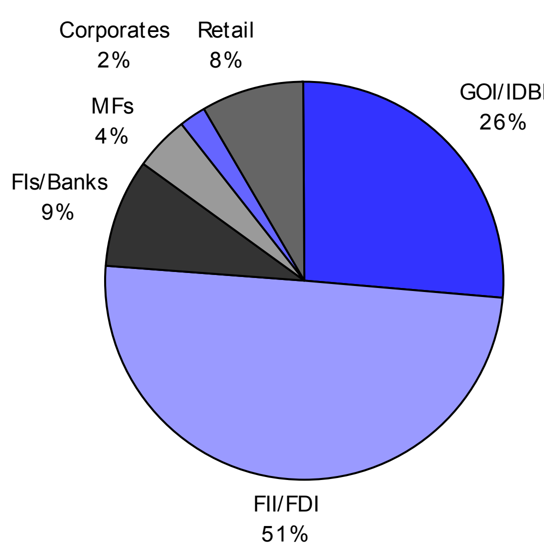
Name	Designation	Previous work-ex
Deepak Parekh	Non – executive Chairman	Chairman, HDFC since 1993
Rajiv B. Lall	MD and CEO	Experience with Warburg Pincus, World Bank and other leading financial institutions
A.K.T. Chari	Senior Advisor	IDBI
L K Narayan	Executive Director, Finance	Two decades of experience with DSP Merrill Lynch, Crisil and other accountancy firms
Vikram Limaye	Executive Director, Corporate finance, New products and New businesses	Over 18 years of experience with leading investment banks and accounting firms
M K Sinha	Executive Director, Business Development & Corp Strategy	Over 15 years of broad based financial services experience
Cherian Thomas	Senior Director, Advisory	Over a decade of experience with ICICI, SCICI and Citibank
Luis Miranda	President and CEO, IDFC Private Equity Company Limited	NA
Nishid Shah	President and CIO, IDFC Investment Advisors Limited	NA

Source: Company data, Deutsche Bank

Shareholding pattern

Currently, the Government of India along with IDBI holds 26% stake in the company with the largest institutional investor being an investment arm of Khazanah Nasional Bhd (Malaysian Government Investment arm). Other large investors include Barclays with 4.95% and Indivest Pte Ltd with 3.78% share. Amongst the Indian shareholders, IDBI holds 3.1% stake followed by LIC with 2.9%. Total foreign shareholding (FII+GDR/ADR+NRI+OCB) in the bank is almost 50% as of June 2007. Post the $500mn QIP in July 2007, government shareholding (along with IDBI) has come down to 23% with foreign shareholding at 47%.

Figure 19: Shareholding pattern as of June 2007



Source: Company data, Deutsche Bank

Key group companies

IDFC Private Equity Co Ltd

IDFC Private Equity Co. is the private equity arm of IDFC. Set up in 2002, the company manages a corpus of Rs28,317mn through two funds, the India Development Fund and IDFC Private Equity Fund II. The India Development Fund, which closed in March 2004, has capital commitment worth Rs8,438mn. The second fund, IDFC Private Equity Fund II, closed in June 2006 with capital commitments worth Rs19,879mn, of which 75% was received from global institutional investors. The private equity fund follows a 2:20 structure (2% of AUM as fees and 20% carry above a certain hurdle rate). The funds are long-term close-ended 10-year funds.

IDFC Project Equity Co Ltd

In FY07, IDFC, in partnership with Citigroup, India Infrastructure Finance Company Limited (IIFCL) and Blackstone, a global private equity player, launched a US$5bn initiative including an equity fund of US$2bn for financing infrastructure projects in India. Initially, IDFC would contribute US$100mn while Citigroup and Blackstone would together contribute US$150mn. IIFCL would contribute US$25mn separately. Typically, the project equity contributes equity to mid-size projects which are in the stabilisation phase and are fully operational.

SSKI

During FY07, IDFC acquired 33.33% stake in SSKI, a domestic mid-size investment bank and institutional brokerage firm, for Rs1bn. IDFC further acquired another 33% stake in SSKI during 1QFY08 for a consideration of Rs1.5bn. The remaining 33.33% stake is owned by the employees of SSKI. SSKI's corporate finance business is primarily focused on the infrastructure space. The SSKI acquisition is a part of IDFC's strategy to diversify its revenue base, increase fee-based revenue and participate in all aspects of the value chain for an infrastructure client. The SSKI platform is expected to enhance equity capital markets product offering for IDFC.

Appendix B: Indian infrastructure outlook

India is all set for a "big bang" in infrastructure development. The government has set an ambitious target of 10% GDP growth rate by 2012. To achieve this, investment in infrastructure needs to be increased from the present level of 4.5% of GDP to almost 8% by 2012. Infrastructure requirements are expected to be to the tune of US$270bn in the 11th plan which is expected to put a significant pressure on the public sector. Due to a dearth of resources with the public sector, the onus lies in promoting private investment in this field. Therefore, Public Private Partnership (PPP) will become the key to bridge the deficit that is expected to be created. Favorable policies have been implemented in various sectors, opening up a plethora of opportunities in airports, merchant power plants, roads and ports.

Figure 20: Infrastructure spending in different sectors (Rs bn)

	FY97-02	FY02-07E	FY07-12E	Change (%)
Airports	66	103	250	143
Irrigation	574	1,452	2,100	45
Ports	50	100	300	200
Power	866	1,452	2,400	65
Thermal	475	820	1,100	34
Hydel	351	432	1,000	131
Nuclear	40	200	300	50
Railways	464	606	800	32
Roads	546	1,051	1,735	65
Telecom	801	870	870	0
Tourism	6	29	30	3
Urban infrastructure	586	1,379	1700	23
Total	3,959	7,042	10,185	45
Annual run-rate	792	1408	2037	
Total (in Bn US$) *	97	172	248	
Annual run-rate (in Bn US$) *	19	34	50	
Growth (%)		78%	45%	

*Source: Planning Commission, Deutsche Bank *at constant exchange rate or Rs.41/US$*

Telecom

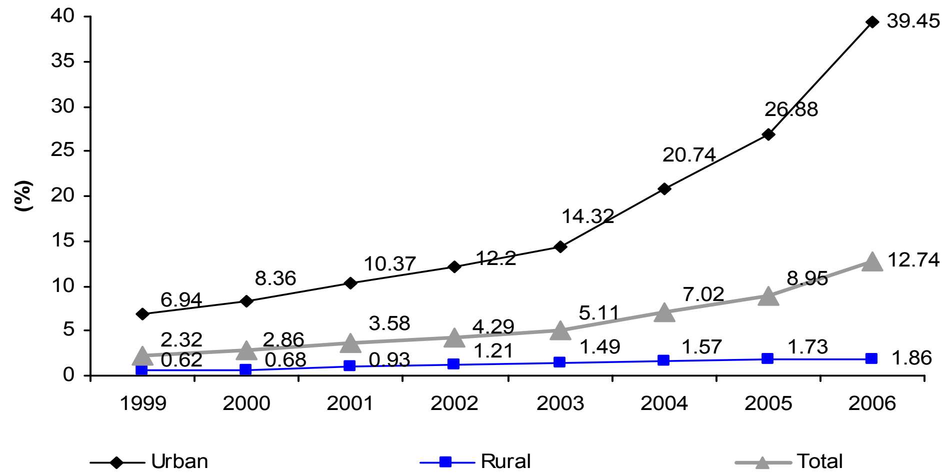
India has witnessed a spectacular revolution in the telecom sector and the best is yet to come. The government has taken proactive measures to bring in the best in this sector. There has been significant reduction in tariffs without compromising on quality. The sector has been opened to private players as a result of which the telecom subscriber base touched 202mn (including fixed and wireless) by February 2007. The 11th plan has set a target of 575mn subscriber base. As a result of the rapid growth, the tele-density has risen from 2.8% in March 2000 to 12.7% in March 2006 and further to 18.3% in March 2007. However, there is a wide disparity between rural and urban density that needs to be bridged.

Figure 21: Growth in subscriber base (m)

	Mar-06	Feb-07	Growth (%)
Fixed Line	41.5	40.4	-2.8
Wireless	98.8	162.5	64.5
Total	140.3	202.9	44.6

Source: Deutsche Bank, AR 2007

Figure 22: Tele-density (%) – Telephones per 100 population



Source: Deutsche Bank, Planning Commission

Power

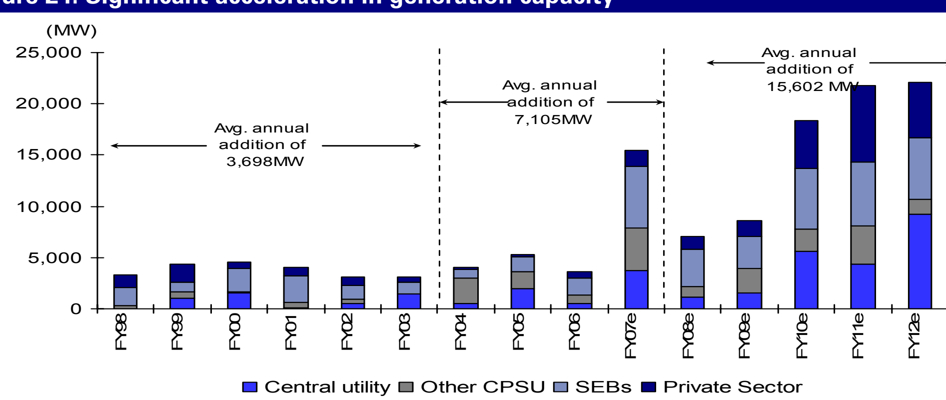
India faces one of the most pitiable power scenarios in the world. The country currently faces huge power shortages of approx. 15% during peak demand and 10% deficit in energy demand. Load shedding is witnessed in most parts of the country almost on a daily basis. Distribution of energy remains a major concern that is entirely the domain of the states. Although the enactment of the Electricity Act in 2003 has improved the situation, it is yet to show a significant impact.

Figure 23: Capacity projections in power sector

Yr to Mar	FY06	FY07*	FY08e	FY09e
Installed Capacity (MW)	119,373	128,644	136,941	147,226
YoY % chg	3.0	7.8	6.4	7.5
Thermal capacity (MW)	64,328	72,728	79,728	87,728
YoY % chg	2.5	13.1	9.6	10.0
Total Electricity Generation (bn units)	**652**	**704**	**768**	**838**
YoY % chg	**7.5**	**8.0**	**9.0**	**9.2**
PLF - Thermal Plants (%)	73.6	75.0	75.5	76.0

**Provisional data; Source: Deutsche Bank, Planning Commission, Ministry of Power*

Figure 24: Significant acceleration in generation capacity



Source: Deutsche Bank, Central Electricity Authority

Transportation: Roads

In India, roads carry nearly 85% of passenger traffic and 70% of freight. Out of this, highways constitute approx 40% of the entire road trafficking. The implementation of National Highway Development Project (NHDP) remains the key focus area. The NHDP Phase-I is on the verge of completion and now the focus is on NHDP Phase-II. NHDP Phase-III, Phase-V and Phase-VI have also been initiated.

Figure 25: Progress of NHDP as on February 2007

	GQ	NS-EW	Port Connectivity	Other NHs	NHDP IIIA	NHDP V
Total Length (km)	5846	7300	380	945	4035	6500
Already 4-Laned (km)	5540	1080	145	287	30	
Under implementation (km)	306	5150	214	638	1404	148
Balance length for award (km)	-	908	21	20	2566	6352
Completion Date	Mar-07	Dec-09	Dec-09	Dec-09	Dec-09	Dec-12

Source: NHAI, Deutsche Bank

It is apparent that the projects of this magnitude will require huge investments. The 11th plan has worked out an outlay of Rs1,735bn for these projects to be funded by various sources. Although the private sector's share in the overall risk capital has been small in the past, the scenario is going to change. It has been decide that from Phase III all future work of NHDP will be on Build Operate Transfer (BOT) basis. This means there will be a rapid shift on toll tax being a dominant source of funding and thereby increase in share of private sector.

Railways

Indian Railways is the one of the busiest rail network with more than 6bn passenger travelling each year. It employs around 1.5mn people and runs approx. 14,300 trains. The track length is approx. 63,000km only after US, Russia, China and Canada. In the recent years, railways have made significant improvement in revenues from freight and passenger traffic. There has been rationalization of fares and other operational advancements to improve efficiency. This is reflected in a sharp decline in operating ratio from 91.2% in 2005-06 to 78.7% in 2006-07. The opening of container movement for private sector, which was earlier a monopoly of CONCOR, is a major step in inviting private participation in this sector. The railways exceeded the projections set in the 10th five year. Therefore, the planning commission is optimistic in the 11th plan and has set the targets accordingly.

Figure 26: Rail traffic projections

	FY06	FY07	FY08E	FY09E	FY10E	FY11E
Freight tons handled (BTKMs)	497	532	570	610	653	701
YoY % chg	8.0%	7.0%	7.1%	7.0%	7.0%	7.4%
Originating Passengers (m)	6242	6751	7136	7539	7969	8429
YoY % chg		8.2%	5.7%	5.6%	5.7%	5.8%

Source: Deutsche Bank, Planning Commission

Civil Aviation

Civil Aviation is a fast growing means of communication which is now fast competing with rail and road transport. Post liberalization in 1990s, India now has eight airlines competing with each other. With the introduction of low-cost airlines by the private carriers, there has been a significant rise in the passenger traffic, and as such, it has become a substitute for rail. The passenger traffic has grown by more than 30% during the period 2006-07. Private airlines contribute to nearly 60% of the total passenger traffic. The Government of India has taken major initiatives to modernize major airports (Delhi and Mumbai) and develop Greenfield ones (Hyderabad, Bangalore and Cochin). The estimated total investment of Rs400bn is envisaged for this sector in the 11th five year plan.

Figure 27: Airport projects: Target 2010

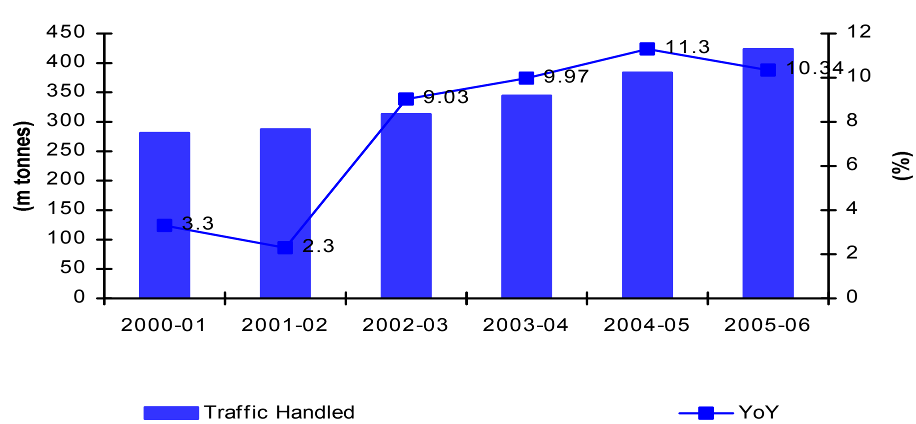
Particulars	Airport	Indicative Cost (Rs bn)
Restructuring/Modernization for world class airports	Delhi & Mumbai Chennai & Kolkata	150
Greenfield airports	Bangalore, Hyderabad, Goa, Pune, Navi Mumbai, Nagpur, (Hub) & Greater Noida	100
Upgradation	25 selected airports	70
Modernisation / Improvement	55 airports	30
Total investment by 2010		400

Source: Deutsche Bank, Planning Commission

Ports

India has 12 major ports and 187 minor ports with bulk of traffic (almost three-fourths) being handled by major ports. The growth of traffic at the ports has been more than 10%. Container traffic has grown at the rate of 17.9% and is expected to follow a similar trend in the future.

Figure 28: Traffic handled (m tonnes)



Source: Deutsche Bank, Planning Commission

Indian ports are faced with problem of low levels of capacity utilization and therefore their competitiveness. The average turnaround time at major ports in India is 3.5 days as compared to 10 hours in Hong Kong. Keeping in view this fact, the Government of India has envisaged an investment outlay of Rs500bn in the 11th plan.

Figure 29: Ports - Capacity projections

Yr to Mar	FY06	FY07*	FY08e	FY09e
Capacity (mn tons)	619	676	726	798
YoY % chg	*14.6*	*9.2*	*7.3*	*9.9*
Traffic handled (mn tons)	**575**	**636**	**699**	**769**
YoY % chg	***10.2***	***10.6***	***10.0***	***10.0***
Utilization level (%)	92.8	94	96	96
Turnaround time (# of days)	3.5	3.4	3.3	3.3
Average berth size (tons)	9,267	9,350	9,500	10,000

**Provisional data; Source: Deutsche Bank, Planning Commission*

Commercial and industrial infrastructure

A number of favorable regulations have been passed, which create conducive environment for private investments in this sector, such as 100% FDI in township construction, reduction in minimum acreage to 25 acres for FDI and the SEZ bill getting cleared by the parliament. The development of IT parks, townships, real estate projects in commercial and retail sector, etc., would result in demand for funds. The tourism sector is expected to grow at 8.8% CAGR over the next 10 years offering significant investment opportunities in accommodation, building / upgrading supporting infrastructure around tourist location.

Appendix 1

Important Disclosures

Additional information available upon request

Disclosure checklist			
Company	**Ticker**	**Recent price***	**Disclosure**
IDFC	IDFC.BO	118.80 (INR) 28 Aug 07	8
Babcock & Brown	BNB.AX	23.78 (AUD) 28 Aug 07	6,7,8, SD 11

*Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies.

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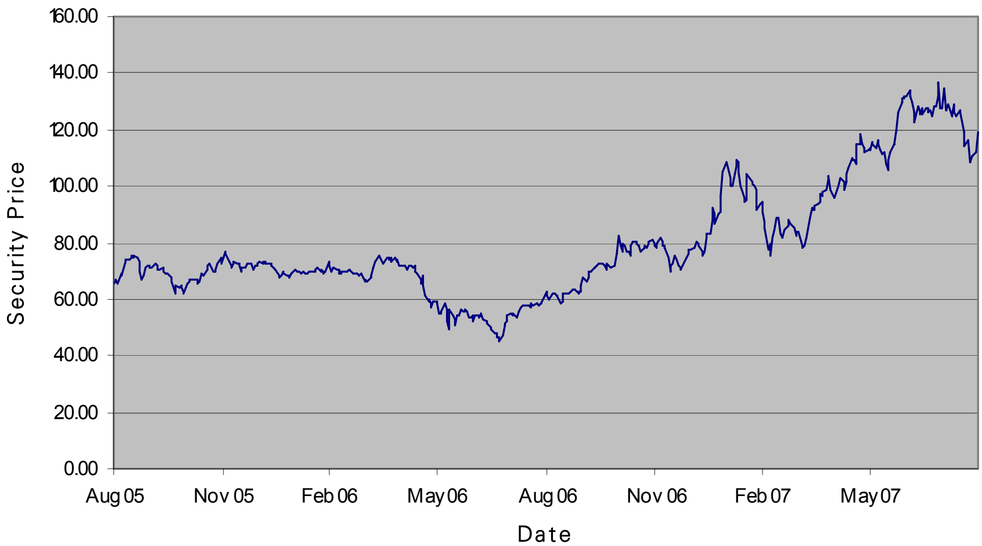
Historical recommendations and target price: IDFC (IDFC.BO)

(as of 28/08/2007)



Previous Recommendations

Strong Buy
Buy
Market Perform
Underperform
Not Rated
Suspended Rating

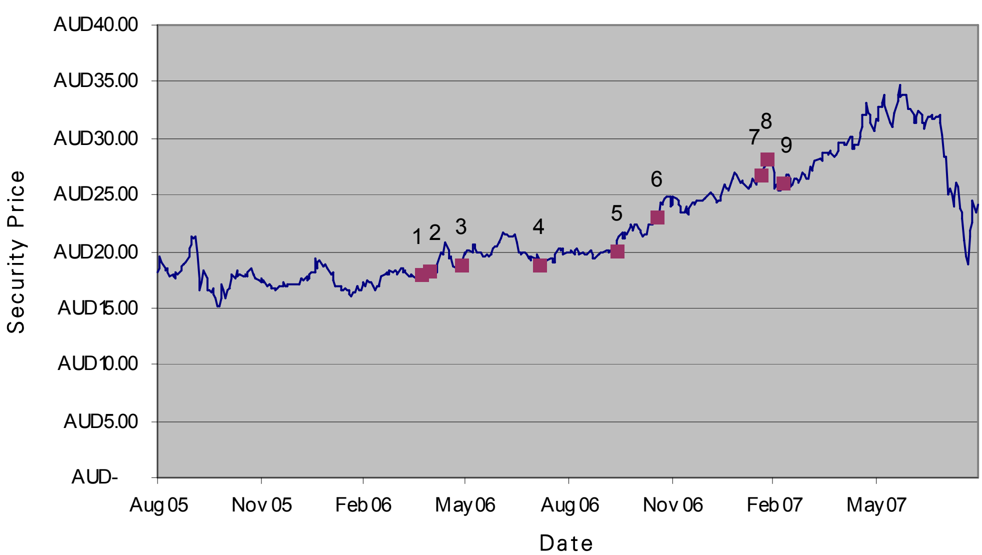
Current Recommendations

Buy
Hold
Sell
Not Rated
Suspended Rating

*New Recommendation Structure as of September 9, 2002

Historical recommendations and target price: Babcock & Brown (BNB.AX)

(as of 28/08/2007)



Previous Recommendations

Strong Buy
Buy
Market Perform
Underperform
Not Rated
Suspended Rating

Current Recommendations

Buy
Hold
Sell
Not Rated
Suspended Rating

*New Recommendation Structure as of September 9, 2002

1. 21/4/2006: Buy, Target Price Change AUD20.00
2. 28/4/2006: Buy, Target Price Change AUD20.50
3. 26/5/2006: Buy, Target Price Change AUD25.00
4. 4/8/2006: Buy, Target Price Change AUD22.50
5. 11/10/2006: Buy, Target Price Change AUD24.00
6. 16/11/2006: Buy, Target Price Change AUD26.00
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8. 22/2/2007: Buy, Target Price Change AUD31.00
9. 8/3/2007: No Recommendation, AUD31.00

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Buy: Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus pro-jected dividend yield) , we recommend that investors buy the stock.

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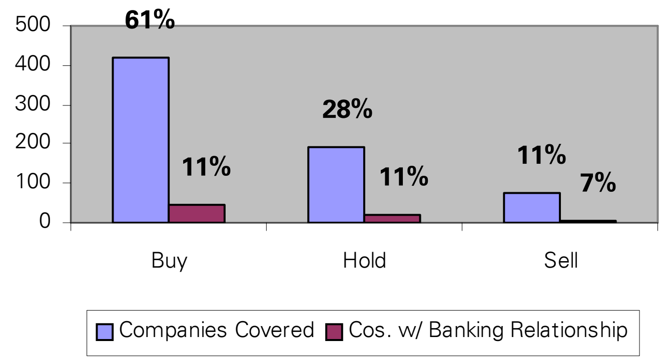
Sell: Expected total return (including dividends) of -10% or worse over a 12-month period

Equity rating dispersion and banking relationships



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