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Stock Rating
**Overweight-V**

Industry View
**In-Line**

# IDFC

## Strong Earnings Progression

**IDFC** reported F1Q07 earnings (consolidated) at Rs1.3 bn, up 21% YoY and 59% sequentially – excluding non-recurring interest income, growth was also strong at 7% YoY (despite a significant decline in equity gains) and 41% sequentially. The most appropriate earnings measure for IDFC is core earnings (i.e. operating profit – gains from sale of equity), and this number grew by 30% YoY and 23% sequentially. The strength in earnings was primarily driven by expansion in NIM over the last quarter. Highlights of the results are as follows:

**NIM expansion resulted in strong NII growth -** The loan book for IDFC grew by 56% YoY and 10% sequentially; total assets increased by 60% YoY and 18% sequentially. In comparison, sequentially net interest income progression was stronger at 38%, indicating that fourth-quarter results were an aberration (for instance, net interest loss on treasury book). This NIM improvement was driven by lower pressure to re-price loans downwards, stability in interest costs and lack of any one-offs (unlike in the last quarter), in our view.

We continue to expect NIM contraction to about 2.2 - 2.3% (given the wholesale nature of the business – both lending and borrowing) from 2.9% currently, but the pace of NIM decline is likely to be slow.

**Fee income grew by 13% YoY and declined by 28% sequentially -** Given the nature of IDFC's business, fee income is usually chunky. For instance, this quarter fees from private equity business were Rs150 million, up from Rs30 million in F1Q06. Hence, fees from other businesses (excluding private equity) were Rs110 million, down from Rs200 million in F1Q06. This was mainly on account of IDFC booking some chunky fees in F1Q06.

### Key Ratios and Statistics

**Reuters: IDFC.BO Bloomberg: IDFC IN**

| India Financial Services | |
|---|---|
| Shr price, close (Jul 24, 2006) | Rs47.1 |
| 52-Week Range | Rs78.0-45.5 |
| Mkt Cap, Curr (bn) | US$1.1 |
| Sh out, basic, per-end (06e) (mn) | 1,122.5 |
| Tier 1 ratio (06e) (%) | 20.0 |

e = Morgan Stanley Research estimates

We expect fee income progression to be stronger with fees from private equity operations supplementing the fee income from the lending business and various other initiatives.

**Operating costs continued to rise** - Operating expenses increased by 39% YoY but declined by 30% sequentially – in F4Q06, the employee costs were significant due to year-end expenses. The cost /income ratio was 9% and operating costs as a percentage of assets remained benign at about 0.4% (annualized).

**Gains from equity reduced -** This quarter IDFC booked Rs340 million in equity gains compared to Rs520 million last year. The unrealized gains on the listed equity book stood at Rs1.9 billion compared to Rs2.8 billion in March 2006 (down due to the booking of gains and weak capital markets).

**Provisions** were almost nil as IDFC wrote back a provision of Rs67 million that it had made on some restructured assets in earlier quarters. We believe that it had made some aggressive provisions on restructured assets in earlier quarters, and hence there may be some more write-backs in the next few quarters, keeping the total provisioning requirement low.

**Tax rate** increased to about 18% for the quarter, up from 8% last year and 17% in F4Q06. With the change in income mix (in favor of fees, which are taxed at marginal rates compared to the lending business, which still gets some tax benefits) tax rates are expected to rise. But we expect the rate to be about 14-15% for F2007 and stabilize at around 18% in F2008.

The profits on a stand-alone basis (excluding the non-recurring NII) were also strong at 44% sequential growth and flat YoY (despite lower equity gains). However, given the growing share of the private equity business in fees, we think the better way to look at earnings progression is to track the consolidated earnings.

The management is hosting a post earnings call. Details of the call are:

Time: 11:00 AM on 25th July. Call in numbers - +912227812277 / +912267917977.

### Company Description

IDFC was started in 1997 as a private enterprise for infrastructure financing with the Government of India and IDBI being the key shareholders. Even though the government is the key shareholder, IDFC is a professionally managed institution. The key sectors IDFC lends to are energy, telecom, transport and commercial & industrial infrastructure. As of March 2005, IDFC had a balance sheet size of about US$2 bn. It completed its IPO in July 2005.

### Industry View: In-Line

### MSCI Country: India

Asia Strategist's Recommended Weight: 1.3%
MSCI Asia/Pac All Country Ex Jp Weight: 5.9%

Exhibit 1

**IDFC: F1Q07 (Consolidated Earnings)**

| Rs. Mn | 1Q06 | Q406 | 1Q07 | YoY | QoQ |
|---|---|---|---|---|---|
| **Net Interest Income** | **710** | **720** | **990** | **39.4%** | **37.5%** |
| ---Loan | 670 | 750 | 930 | 38.8% | 24.0% |
| ---Treasury | 40 | -30 | 60 | 50.0% | -300.0% |
| **Non Interest Income** | **770** | **550** | **610** | **-20.8%** | **10.9%** |
| ---Fees & Advisory | 230 | 360 | 260 | 13.0% | -27.8% |
| ---Dividend & Others | 10 | 30 | 20 | 100.0% | -33.3% |
| ---Profit on sale of equity | 520 | 160 | 340 | -34.6% | 112.5% |
| **Total Income** | **1480** | **1270** | **1600** | **8.1%** | **26.0%** |
| Total Income (ex sale of equity) | 960 | 1110 | 1260 | 31.2% | 13.5% |
| **Operating Expense** | **101** | **200** | **141** | **39.3%** | **-29.5%** |
| ---Staff Expenses | 49 | 136 | 76 | 54.3% | -44.0% |
| ---Other Expenses | 43 | 58 | 55 | 26.8% | -5.3% |
| ---Depreciation | 9 | 11 | 10 | 16.3% | -10.7% |
| **Operating Profit** | **1379** | **1070** | **1459** | **5.8%** | **36.3%** |
| Provisions | 204 | 90 | 0 | -99.8% | -99.6% |
| **PBT** | **1175** | **980** | **1458** | **24.1%** | **48.8%** |
| One off NII | 0 | 0 | 150 | NA | NA |
| Tax | 88.9 | 170 | 298 | 234.9% | 75.1% |
| **PAT** | **1086** | **824** | **1311** | **20.7%** | **59.1%** |
| **Core Profits** | **859** | **910** | **1119** | **30.3%** | **22.9%** |
| | | | | | |
| Infrastructure Loans | 71756 | 101910 | 111940 | 56.0% | 9.8% |
| Total Assets | 87888 | 119490 | 140620 | 60.0% | 17.7% |
| | | | | | |
| | **1Q06** | **F2006** | **1Q07** | | |
| Yield on Infrastructure Assets* | 9.1% | 8.9% | 9.0% | | |
| Yield on Treasury Assets | 6.6% | 5.9% | 6.8% | | |
| Overall Yield* | 8.7% | 8.4% | 8.7% | | |
| | | | | | |
| Gross NPL | 0.7% | 0.5% | 0.4% | | |
| Net NPL | 0.0% | 0.0% | 0.0% | | |

* this is ex the non recurring net interest income of Rs150 Mn. Source: Company data, Morgan Stanley Research

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| | Coverage Universe | | Investment Banking Clients (IBC) | | |
|---|---|---|---|---|---|
| Stock Rating Category | Count | % of Total | Count | % of Total IBC | % of Rating Category |
| Overweight/Buy | 760 | 38% | 284 | 43% | 37% |
| Equal-weight/Hold | 881 | 45% | 293 | 45% | 33% |
| Underweight/Sell | 334 | 17% | 76 | 12% | 23% |
| Total | 1,975 | | 653 | | |

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## Industry Coverage:India Financial Services

| Company (Ticker) | Rating (as of) | Price (07/24/2006) |
|---|---|---|
| **Anil Agarwal** | | |
| Canara Bank (CNBK.BO) | O (05/25/2006) | Rs178.10 |
| Corporation Bank (CRBK.BO) | E (05/25/2006) | Rs224.00 |
| HDFC (HDFC.BO) | E (04/08/2004) | Rs1076.75 |
| HDFC Bank (HDBK.BO) | O (04/04/2006) | Rs729.20 |
| ICICI Bank (ICBK.BO) | E (04/04/2006) | Rs514.90 |
| IDBI (IDBI.BO) | U (10/21/2005) | Rs52.60 |
| IDFC (IDFC.BO) | O-V (09/16/2005) | Rs47.10 |
| Kotak Mahindra Bank (KTKM.BO) | E (04/24/2006) | Rs264.30 |
| Oriental Bank of Commerce (ORBC.BO) | E (05/25/2006) | Rs161.50 |
| Punjab National Bank (PNBK.BO) | U (05/05/2005) | Rs329.85 |
| State Bank of India (SBI.BO) | U (11/19/2004) | Rs740.70 |
| UTI Bank (UTBK.BO) | E (07/15/2005) | Rs276.10 |
| Union Bank of India (UNBK.BO) | O (05/15/2006) | Rs89.30 |

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