Infrastructure Development Finance (IDFC.BO)

Sell: 3Q08 Results – Thrust on Fee Incomes

- **3Q08 profits up 74% yoy; in-line with expectations** — IDFC's net profits grew rapidly in a strong quarter, driven by NII expansion (+52%) and fees. Fee growth was led by brokerage and capital gains; while NII was supported by its expanding loan book (+45%). Qualitatively it was a strong quarter – with sustained growth and momentum in lending and fees.

- **Margins hold but funding costs are rising** — IDFC's overall NIMs and spreads have remained fairly stable (at about 320bps and 200bps respectively). While management suggested improving yields, increase in funding costs kept margins relatively stable. We see declining interest rates as beneficial for IDFC's margins (our near-term view) while tighter liquidity will be the key risk.

- **Fee income growth led by brokerage; fund raising near-term kicker** — Fee incomes have increased rapidly (+250% yoy) led by brokerage (increased stake to 79.8%) and capital market gains; and well supported by growth in advisory and fees. Planned fund raisings (US$1.5bn+ over the year) near term, and performance fees longer term, should further bolster fee income growth.

- **Maintain Sell (3M) on relatively high valuations** — While the business momentum continues to remain strong and in-line with expectations; we believe wholesale funded institutions such as IDFC are relatively more exposed to interest rate tightness/cyclicality (as is the case with many global markets currently) and should be valued at a discount to private banking peers.

Sell/Medium Risk	**3M**
Price (15 Jan 08)	Rs219.05
Target price	Rs195.00
Expected share price return	-11.0%
Expected dividend yield	0.5%
Expected total return	**-10.5%**
Market Cap	Rs283,516M
	US$7,215M

Price Performance (RIC: IDFC.BO, BB: IDFC IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	3,908	3.68	21.1	59.5	9.6	17.5	0.5
2007A	5,039	4.48	21.7	48.9	8.4	18.3	0.5
2008E	7,908	6.54	45.8	33.5	4.9	18.2	0.5
2009E	11,413	8.82	35.0	24.8	4.2	18.4	0.5
2010E	14,434	11.16	26.5	19.6	3.6	19.7	0.5

Source: Powered by dataCentral

Manish Chowdhary, CFA[1]
+91-22-6631-9853
manish.chowdhary@citi.com

Aditya Narain, CFA[1]
+91-22-6631-9879
aditya.narain@citi.com

Himani Shah, CFA[1]
himani.shah@citi.com

See Appendix A-1 for Analyst Certification and important disclosures.

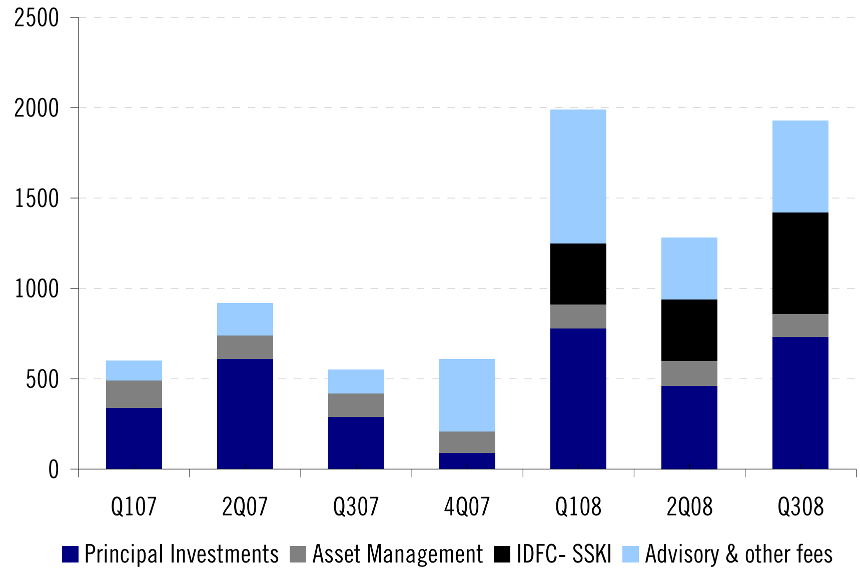
[1]Citigroup Global Markets India Private Limited

Figure 1. 3Q08 Results: Key Highlights (Rupees Million, Percent)

	3Q08	3Q07	YoY %	2Q08	QoQ%	Citi Investment Research Comments
Interest Income	5,733	3464	65.5	5266	8.9	Growth supported by strong growth in loans and improving yields
Interest Expense	(3,953)	-2,291	72.6	-3,306	19.6	Cost of funds do appear to have increased as spreads remained stable with higher yields and the effect of additional capital in 2Q08 wears away
Net Interest Income	**1,780**	**1,173**	**51.7**	**1,960**	**-9.2**	**About 10% lower than expected on higher cost of funds - we see funding costs to relatively stabilise going forward on easy liquidity environment**
Fee-Based Income	1,240	270	359.3	840	47.6	Strong growth from brokerage and advisory fees lead the sharp increase (3Q07 data do not include SSKI revenues)
Other Non-Interest Income	730	290	151.7	460	58.7	Performance related pay on private equity funds help to increase capital gains, management suggests cushion from unrealized equity gains are rising
Non Interest Income	1,970	560	251.8	1,300	51.5	Continues to broaden the non-interest income franchise - though in part augmented by strong capital market related incomes; 22% ahead of expectations
Operating Income	**3,750**	**1,733**	**116.4**	**3,260**	**15.0**	
Operating Expenses	(690)	(194)	256.4	(499)	38.4	Relatively high and rapid increase in costs, we expect cost pressures to continue as employee costs continue to rise
Pre-Provision Profit	**3,060**	**1,539**	**98.8**	**2,761**	**10.8**	**Strong growth with a diversifying revenue base**
Charges for Bad Debts	(70)	(43)	61.7	(164)	NM	
Pre-Tax Profit	**2,990.0**	**1,496**	**99.9**	**2,597**	**15.1**	
Tax	(774)	(268)	188.9	(621)	24.7	
Minorities	(42)	21.5	NM	-32.4	30.9	
Extraordinary Items	(2)	0	NM	0	NM	
Net Profit	**2,172**	**1,250**	**73.8**	**1,944**	**11.7**	**Overall a strong set of results, with sustained growth, quality and momentum. Profits were in-line with expectations**
EPS	1.68	1.11	50.7	1.50	11.7	
Customer Loans	192,420	134,830	42.7	168,180	14.4	Relatively rapid growth - builds on the strong momentum from previous quarter. Management suggests robust pipeline - could lead to continued high growth in the next 1-2 quarters
AIEA	199,915	141,035	41.7	174,885	14.3	
AIBL	203,920	133,860	52.3	171,300	19.0	
Total Assets	259,030	163,770	58.2	224,420	15.4	
Avg Assets	241,725	158,850	52.2	215,575	12.1	
Shareholders' Funds	55,110	29,770	85.1	33,255	65.7	
Book Value Per Share	43	27	60.6	26	65.7	
Key Ratios (%)	**3Q08**	**3Q07**	**Bps Δ YoY**	**2Q08**	**Bps Δ QoQ**	**Citi Investment Research Comments**
ROAA (annualized)	3.35	3.05	30	3.46	-11	
ROAE (annualized)	15.76	16.79	-103	23.38	-761	
Net Interest Margin (bps)	330	333	-3	320	10	Margins continue to hold despite strong growth and relatively higher cost of funds
Fee Inc/Operating Income	33.1	15.6	1749	25.8	730	Significant broadening of revenue mix; though well supported by capital market related activities in a strong operating quarter
Other Non-Interest Inc/Op Inc	52.5	32.3	2022	39.9	1266	
Op. Cost/ Operating Income	18.4	11.2	723	15.3	310	Costs trend higher - expect pressure to be maintained

Source: Company Reports and Citi Investment Research

Figure 2. IDFC – Non interest Income Breakup (Rs Million)



Source: Company Reports, Citi Investment Research

Infrastructure Development Finance

Company description

IDFC was established in 1997 as a specialized Infrastructure financier / advisor and to encourage private sector investments in the infrastructure sector. It has been actively associated with the government in policy formulation, and has probably the foremost set of skills in this space. It enjoys a central positioning as amongst the forerunners on the policy advisory space in infrastructure and is seen as the preferred investor, lender and advisor. Though IDFC has diversified its product offerings to include non-fund based products, asset management and private equity along with debt finance and syndication opportunities; the lending business remains its key operational focus.

Investment strategy

We rate IDFC shares Sell/Medium Risk (3M) with an Rs195 target price. IDFC appears particularly well positioned to benefit from India's large infrastructure opportunity. We believe IDFC has a quality management team, is one of the few pure plays on infrastructure financial services and offers long-term growth potential.

However, the stock has had a sharp run and has outperformed the market significantly. We believe, the current price is factoring in further upside surprises in addition to the already strong performance in YTD FY08. While we believe the business is still in a sweet spot, it will be challenging to exceed the current high expectations built in the stock.

IDFC faces challenges from – a) Competition - from larger scale and lower funding cost banks; b) Wholesale funding – borrowing costs are exposed to sharp hikes in interest rates and tightness in market liquidity; c) Business model – relatively higher portfolio concentrations as against banks; d) Finance company platform – limits leverage relative to banks; and e) Modest profitability – we expect core RoEs to remain relatively modest at sub 15% levels in the medium term.

Valuation

We value IDFC at Rs195 based on our sum-of-parts methodology. For IDFC's core lending business (Rs149 per share), we prefer a P/BV multiple of 3.0x FY09E BV benchmarked towards the lower band private banks' target P/BV multiples, with a sub15% core ROE. This reflects IDFC's premium positioning in the infrastructure segment, strong management, long track record of low asset risks and relatively high growth profile. However, its target multiple is constrained by its lack of retail asset, liability and distribution franchises relative to premier private bank franchises.

For the asset management business we prefer to use a DCF approach and value this business at Rs23 per share. We now value IDFC's stake in SSKI at Rs14 per share based on 22x FY09E profits. Finally, we also add Rs9 for IDFC's unrealized investment gains including the NSE.

Risks

We rate IDFC shares Medium Risk based on our quantitative risk system that tracks 260-day historical share price volatility. Key risks to our recommendation include: a) Continued low interest rates. b) Steepening yield curve. c) Continued buoyancy in capital markets. d) Regulatory concessions and a favorable tax regime.

Appendix A-1

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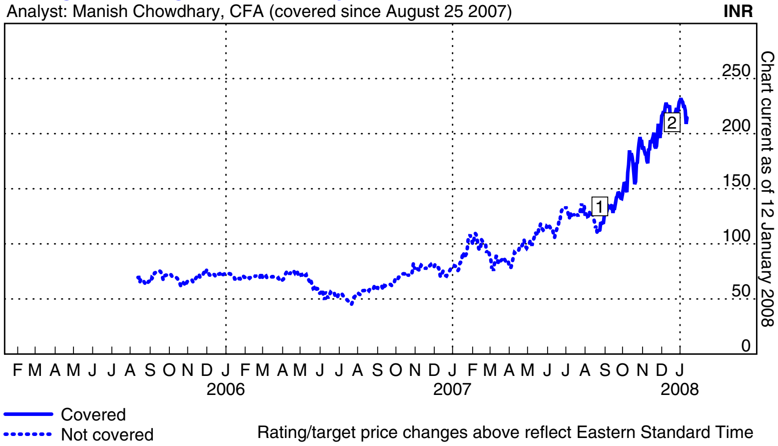
Infrastructure Development Finance (IDFC.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Manish Chowdhary, CFA (covered since August 25 2007)



#	Date	Rating	Target Price	Closing Price
1:	24 Aug 07	1M	140.00	112.40
2:	19 Dec 07	*3M	*195.00	212.90

*Indicates change.

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