Company In-Depth

24 August 2007 | 44 pages

Infrastructure Development Finance (IDFC.BO)

Initiating at Buy: Big Space, Broad Plans

- Initiating at Buy — We initiate coverage on IDFC shares at Buy / Medium Risk (1M) with an Rs140 SOTP-based target price. IDFC is the most levered and broad-based infrastructure play in the Indian financial sector. Stock and value drivers include the infrastructure opportunity, management skill and strategy, a more balanced business model, and likely favorable interest rate outlook.
- Well positioned for India's infrastructure opportunity — IDFC brings to the table a) Integrated offering as a lender, advisor and investor, b) Management – track record, defined strategy and pedigree, c) A broadening business model – trending towards more annuity and risk-linked fees, d) Risk management systems – proven asset quality record, and e) Capital – to leverage and invest.
- Structural and competitive challenges — Challenges take form of a) Competition – larger scale, and lower-cost funded banks, b) Wholesale funding – relatively sensitive to interest rates, market liquidity, particularly given recent global pressures for similar borrowers, c) FinCo platform – limits leverage relative to banks, d) Earnings trajectory – transition risks, as fees substitute margins.
- Strong profit expansion, modest ROEs — We estimate IDFC's profits to grow at a strong 26% CAGR over FY07E-10E, backed by asset expansion and stronger asset management-driven fee income growth. We estimate ROEs, however, to remain moderate at 14-15%, with leverage and fee incomes the driver beyond.
- Risks — Key risks include a) Infrastructure policy or execution, b) Interest rates and liquidity, c) Capital market exposure, d) Regulatory changes.

Buy/Medium Risk	1M
Price (23 Aug 07)	Rs110.65
Target price	Rs140.00
Expected share price return	26.5%
Expected dividend yield	0.9%
Expected total return	**27.4%**
Market Cap	Rs143,207M
	US$3,501M

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

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

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	30.1	4.8	17.5	0.9
2007A	5,039	4.48	21.7	24.7	4.2	18.3	0.9
2008E	6,438	5.32	18.7	20.8	2.6	15.1	0.9
2009E	8,235	6.36	19.6	17.4	2.3	13.9	1.1
2010E	10,198	7.88	23.8	14.0	2.0	15.3	1.1

Source: Powered by dataCentral

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[1]Citigroup Global Markets India Private Limited

Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	30.1	24.7	20.8	17.4	14.0
P/E reported (x)	30.1	24.7	20.8	17.4	14.0
P/BV (x)	4.8	4.2	2.6	2.3	2.0
P/Adjusted BV diluted (x)	4.8	4.2	2.6	2.3	2.0
Dividend yield (%)	0.9	0.9	0.9	1.1	1.1
Per Share Data (Rs)					
EPS adjusted	3.68	4.48	5.32	6.36	7.88
EPS reported	3.68	4.48	5.32	6.36	7.88
BVPS	22.88	26.18	43.12	48.13	54.67
Tangible BVPS	22.88	26.18	43.12	48.13	54.67
Adjusted BVPS diluted	22.88	26.18	43.12	48.13	54.67
DPS	1.00	1.00	1.00	1.20	1.20
Profit & Loss (RsM)					
Net interest income	2,749	4,056	5,062	7,068	7,963
Fees and commissions	955	1,239	2,289	3,565	4,959
Other operating Income	1,785	1,863	2,899	2,907	3,924
Total operating income	**5,488**	**7,158**	**10,250**	**13,540**	**16,846**
Total operating expenses	-546	-821	-1,471	-1,868	-2,285
Oper. profit bef. provisions	**4,942**	**6,337**	**8,779**	**11,672**	**14,561**
Bad debt provisions	-516	-175	-361	-621	-877
Non-operating/exceptionals	0	118	0	0	0
Pre-tax profit	**4,426**	**6,280**	**8,418**	**11,052**	**13,684**
Tax	-517	-1,241	-1,936	-2,763	-3,421
Extraord./Min. Int./Pref. Div.	-2	0	-43	-54	-65
Attributable profit	**3,908**	**5,039**	**6,438**	**8,235**	**10,198**
Adjusted earnings	3,908	5,039	6,438	8,235	10,198
Growth Rates (%)					
EPS adjusted	21.1	21.7	18.7	19.6	23.8
Oper. profit bef. prov.	27.5	28.2	38.5	33.0	24.7
Balance Sheet (RsM)					
Total assets	**124,008**	**183,840**	**247,586**	**315,236**	**386,198**
Avg interest earning assets	100,920	146,517	205,258	269,307	335,770
Customer loans	102,415	139,459	200,972	263,956	329,158
Gross NPLs	0	506	275	970	1,848
Liab. & shar. funds	**124,008**	**183,840**	**247,586**	**315,236**	**386,198**
Total customer deposits	0	0	0	0	0
Reserve for loan losses	506	275	636	1,190	1,936
Shareholders' equity	**25,687**	**29,476**	**55,794**	**62,282**	**70,733**
Profitability/Solvency Ratios (%)					
ROE adjusted	17.5	18.3	15.1	13.9	15.3
Net interest margin	2.72	2.77	2.47	2.62	2.37
Cost/income ratio	10.0	11.5	14.3	13.8	13.6
Cash cost/average assets	0.5	0.5	0.7	0.7	0.7
NPLs/customer loans	0.0	0.4	0.1	0.4	0.6
Reserve for loan losses/NPLs	na	54.4	231.4	122.7	104.8
Bad debt prov./avg. cust. loans	0.6	0.1	0.2	0.3	0.3
Loans/deposit ratio	na	na	na	na	na
Tier 1 capital ratio	19.2	15.6	21.0	18.1	16.7
Total capital ratio	25.6	19.6	23.8	20.3	18.5

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Investment Thesis

Initiating at Buy

We initiate coverage on IDFC shares with a Buy / Medium Risk (1M) rating and Rs140 target price implying a 27% expected total return from current price levels. Our target price is based on a sum-of-parts methodology with the core lending business valued at 2.5x FY09E PBV or Rs113 per share. In addition, we value the asset management business at Rs17 per share based on our DCF analysis. Finally we value the unrealized investment gains at Rs10 including NSE and SSKI stakes. We believe IDFC is one of the few pure plays on infrastructure financial services and offers long-term value.

We believe that India's domestic growth is largely decoupled from global financial events, and that the worst of the tightness in domestic liquidity is over – and IDFC is among the better positioned companies to benefit in such a scenario. Nevertheless, adverse developments in the global credit markets could be an overhang on the stock. Specifically, we see key see downside risks to the stock due to a) higher interest rates or money market tightness, b) delays in expected asset acquisition on the asset management side, and c) any additional regulatory pressures, which IDFC has been subject to in the recent past.

Additional upside kickers could come in the form of a) falling interest rate environment, b) accelerated developments, build-out and returns from the asset management business, c) upside surprises on margins – consensus (including us) expects incremental pressure on margins.

Infrastructure – A significant India opportunity

India today offers many opportunities, and the Infrastructure space is amongst the largest of them all. This is because the Infrastructure sector is a) massively and visibly deficient, and is restraining the rest of the economy's growth; b) has witnessed meaningful (though still inadequate) policy resolution; c) has experienced successes which are emboldening investors and operators; and d) is seeing an increasing sophistication in financing instruments. In sum, we believe India's infrastructure space is getting ready for a long ride.

IDFC's opportunity: Dedicated 'Infrastructure Financial Services' provider

We believe IDFC is well positioned to ride this large opportunity and should be able to create a niche for itself as a dedicated infrastructure services provider. The key differentiating factors for the company are a) comprehensive positioning as a lender, co-investor, advisor, and an infrastructure-policy think tank for the government; b) strong management with long track record and pedigree and a defined business strategy; c) strong risk management systems with proven low asset risks; d) transforming business model – increasingly annuity-driven, rather than asset-driven, with key parts of the strategy setting in place through the asset management and capital market businesses; and e) capital appears to be tied-up – for both on- and off-balance sheet exposures, for lending and investing activities.

IDFC's challenges: Competition, funding and performance

The large opportunity does bring along challenges, in the form of a) competition – asset franchise in the segment tends to be low and, combined with the large opportunity, results in increased competition from scale and lower funding cost banks; b) wholesale funding – IDFC does not have a retail deposit franchise and borrowing costs are relatively more exposed to sharp hikes interest rates and market liquidity. This challenge has in fact has been highlighted meaningfully in the recent global credit turmoil – where similarly structured borrowers have faced a sharp squeeze on liquidity, price and ratings; c) business model in transition – its switch to a more fee-based model from a predominantly asset-based model will carry interim risks, and could see some transition pains as fees substitute margins; d) lending business leverage effectively capped at lower levels relative to banks (credit rating agencies comfortable with maximum 7x leverage currently - to retain its AAA credit rating) and therefore is relatively capital inefficient; and e) modest profitability – we expect RoEs to remain relatively modest at 14-15% levels in the medium term as competitive intensity increases and leverage levels remain capped.

Earnings and business momentum

We estimate IDFC to post relatively rapid 26% profit CAGR over FY07E-10E, driven by 33% loan growth, stronger fee income growth, partly offset by falling margins. We expect fee income growth to be driven mainly by increase in its assets under management in the private equity business and growth in capital market-linked incomes. We also expect a level of earnings cushion, given relatively large unrealized investment gains. ROEs should however, be relatively modest in the 14-15% range until IDFC fully leverages up and investment returns start kicking through.

Valuations

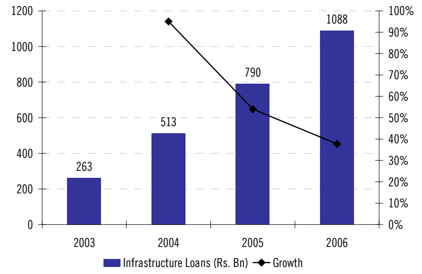
Our 2.5x FY09E P/BV target multiple for the lending business is well above a normalized ROE/PBV benchmark, which reflects IDFC's strong management, defined strategy, long track record of low asset risks, premium positioning in infrastructure, and relatively high growth profile. Our target multiple is in-line with the lower band of private sector banks' target multiples, but lower than some of the premier private bank franchises; which have strong retail asset, liability and distribution franchises, bolstering their valuations.

Our target multiple is also lower than India’s premier housing finance company, which also operates off a relatively similar regulatory platform. However, adjusted for returns (ROE) and the mortgage company's strategic initiatives, we believe target multiples are largely in line. This reflects both IDFC's business opportunity, and its positioning to tap the opportunity.

Risks

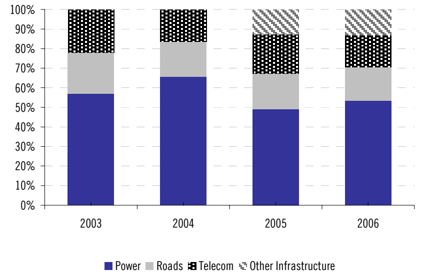
Key risks include a) policy or execution risks in different infrastructure segments; b) sharp increases in interest rates – IDFC's funding is completely wholesale and relatively more exposed to interest rate fluctuations; c) increasing exposure to capital markets performance and volatility; d) concentration of lending portfolio only to infrastructure related sectors; e) withdrawal of regulatory concessions and a favorable tax regime.

Figure 1. India Infrastructure - Sectoral Loans and Loan Growth (Rsbn, %)



Source: RBI

Figure 2. India Infrastructure – Segment Loan Composition (%)



Source: RBI

Competitive Positioning

- Strong domain knowledge; closely associated with the infrastructure opportunity in India
- Evolving business structure to offer a comprehensive infrastructure-linked product suite
- Competes directly with banks and institutions in its lending operations
- Wholesale funding, but costs are significantly lower
- Strong management team – a key advantage
- Established risk assessment track record – among the best

1. Strong domain knowledge, linkage with infrastructure sector

Conceptualized as a specialized infrastructure lending and advisory institution, IDFC has built amongst the foremost skill sets in the sector within a short period of time. IDFC has actively associated with the government in policy formulation and advisory and commands a preferred lender, investor and advisor positioning in the infrastructure sector. IDFC's key business segments are lending to infrastructure projects/companies and asset management.

IDFC's linkage to the infrastructure opportunity in India has been historically large and is increasing with the recent initiatives taken on broad-basing its product and revenue opportunities. We believe that IDFC is amongst the best positioned and is likely to gain disproportionately from the opportunities on offer.

2. Offers a comprehensive product suite for the sector

IDFC offers a comprehensive product offering for the infrastructure sector and is positioned as a complete solutions provider. Its products encompass the entire risk spectrum from debt to equity and hybrid products – a) vanilla debt to mezzanine debt, b) access to debt and equity capital markets, c) seed equity in the form of co-investing, and d) larger access to venture equity. It also offers a strong investment banking and advisory platform for structured finance, loan syndications, as well as performing a corporate advisory role.

Figure 3. Regulatory Differences Between IDFC and Banks

Regulations	IDFC	Banks
Capital Adequacy Ratio	10% minimum	9% minimum
SLR requirements	Nil	25% of deposits
CRR requirements	Nil	7.0% of deposits
NPL recognition	180 days	90 days
Single borrower debt exposure limit	single company - 20% of net owned funds; group - 35% of net owned funds	single company - 20% of net owned funds; group - 50% of net owned funds for infrastructure
Public Deposits	Cannot accept deposits from public	Allowed to mobilize public deposits
Effective and Marginal Taxation	Effective tax rate at 25-28%; Marginal tax rate at 33%	Effective and marginal tax rates at 33%
lending to NBFCs	Not Applicable	Maximum limit 10% of networth; 15% for infrastructure lending

Source: Citigroup Investment Research

3. Financing business competes directly with banks / institutions

Historically infrastructure financing in India was undertaken mainly by specialized lending agencies promoted by the government for the sole purpose of financing infrastructure initiatives. Traditionally the key players have been ICICI, IDBI and IDFC. However, more recently and with the transformation of some of these institutions into banks, notably ICICI and IDBI, banks have started competing directly with IDFC for lending to the infrastructure sector.

Another infrastructure funding institution, India Infrastructure Finance Company Limited (IIFCL), has also been set up recently by the government to fund the increasing requirements in the infrastructure sector. IDFC has entered into an MOU with IIFCL and is collaborating with IIFCL for financing of infrastructure projects, which would leverage IDFC's project appraisal skills and enable it to co-invest with IIFCL.

IDFC relative to banks

Though IDFC directly competes with banks on the lending side, its business model is distinct from that of banks and has both its pros and cons. The pros are:

- No regulatory reserves and/ or liquidity requirements to be met, as against banks which have to keep a minimum of 32.0% (25% liquidity reserves, SLR + 7.0% cash reserves, CRR) in reserves and liquidity requirements;
- Lower costs of operations as there is no retail element to the business.

The cons are largely:

- Relatively higher costs and increased volatility in interest costs as funding is completely wholesale;
- Mono-segment lending business relative to banks which have a significantly more diversified loan portfolio.

We highlight the key impact of competition with banks on IDFC.

Figure 4. Comparative ROA Decomposition of IDFC with Typical PSU and Private Banks, FY2007 (%)

	IDFC	Typical PSU Bank	Typical Private Bank
Net interest income	2.8	3.0	2.5
Fee Income	1.7	1.4	1.7
Operating revenue	**4.6**	**4.4**	**4.2**
Operating expenses	(0.5)	(2.2)	(2.0)
Operating profit	**4.1**	**2.2**	**2.2**
Loan loss provisions	(0.1)	(0.3)	(0.3)
Others	0.1	(0.5)	(0.3)
Tax	(0.8)	(0.6)	(0.5)
Net profit (ROA)	**3.3**	**0.9**	**1.1**
Assets / Equity (Times, x)	5.6	18.0	19.6
ROE	**18.3**	**15.4**	**21.0**

Source: Citigroup Investment Research estimates

4. Relatively higher funding costs ... offset by structurally lower costs

Fully wholesale funded

IDFC is dependent on wholesale lenders, i.e. banks and institutions for its funding requirements

IDFC does not have access to deposits and is therefore dependent on wholesale lenders i.e. banks and institutions for its funding requirements. This results in a) lower franchise value for the lending business, and b) absence of stable low-cost deposits, raising the cost of funding for IDFC.

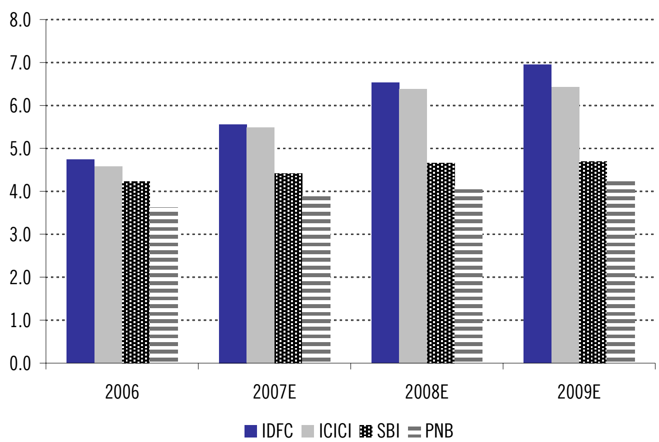
We believe the domestic interest rate outlook has eased meaningfully over the last couple of months and there is ample liquidity currently which favors IDFC. However, although India is relatively de-linked with global credit events, any such linkage, whether direct or perceptive, could impact IDFC's borrowing costs meaningfully.

During periods of rising interest rate and/or tight liquidity environments, interest rates on wholesale funds tend to reprice faster than retail deposits, putting adverse pressure on the cost of funds. The converse also holds true for IDFC – with a matched ALM, falling interest rates should reduce funding costs faster than lending rates.

Costs are significantly lower than banks

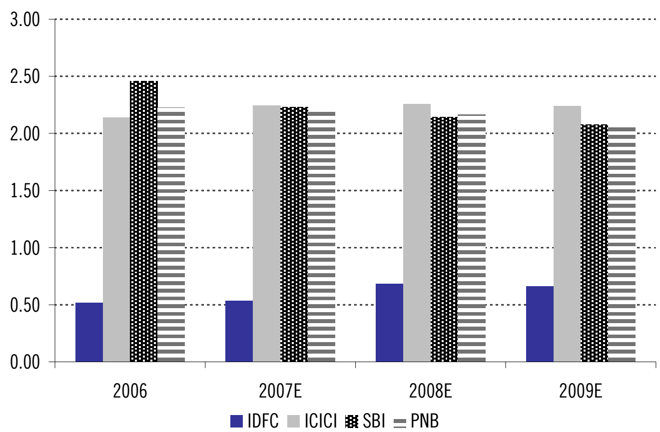
IDFC however, has the advantage of being a wholesale lender and borrower, in keeping operating costs structurally lower as compared to banks. IDFC's operating costs to average assets are around 0.5% in FY07 as compared to around 2% for banks. We expect IDFC to maintain its cost advantage over banks.

Figure 5. Comparative Interest Expense to Average Assets (%)



Source: Citigroup Investment Research

Figure 6. Comparative Operating Costs to Average Assets (%)



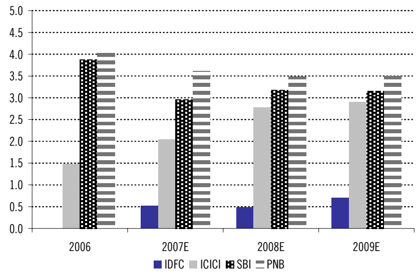
Source: Citigroup Investment Research

5. Scale - Relatively modest

Scale banks with balance sheet strength and surplus liquidity have eroded IDFC's market share over the last 3-4 years. However, given the large funding requirements and sector opportunity, IDFC has maintained strong growth over this period. IDFC has also tied up with a number of banks including Bank of

India and Union Bank of India as well as SBI Capital Markets, for debt syndication opportunities leveraging on the banks' large balance sheet to fund significant opportunities. We believe IDFC's strong project appraisal and risk assessment skills leave it well positioned to continue expanding its lending operations at a rapid pace.

Figure 7. Comparative Gross NPL's (%)



Source: Company Reports and Citigroup Investment Research

6. Strong management team

IDFC has created a strong management team, both at the board level and at the operating level. The management team has lengthy experience in economic and financial analysis, asset management, structured products, policy making and infrastructure lending. We believe that IDFC probably has the strongest skill sets dedicated to infrastructure financing and advisory in India.

7. Risk assessment skills are probably the best

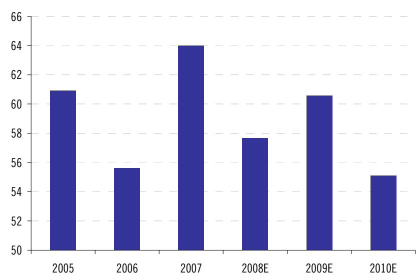
IDFC has a superior track record in assessing risks on infrastructure projects and has built up probably the foremost skill sets in the space. This is reflected in its low stock of NPLs (NPLs net of provisions are currently nil) and lower incremental slippages than those of banks. However, IDFC's lending portfolio is not truly seasoned, as its lending is to long gestation infrastructure projects and has seen strong growth of CAGR 52% over the last four years since FY03.

Figure 8. IDFC – Business Strategy

No	Strategy
1	**Project Finance:** Continue as core business with focus on Transport, Energy, Telecom and IT, and Industrial and Commercial Infrastructure
2	**Principal Investments:** Leverage proprietary knowledge and capture a larger pie of returns
3	**Private Equity and Asset Management:** Plans to develop alternative public market asset management platform
4	**Financial Markets and Investment Banking:** Offer innovative products and increase reach through building on distribution
5	**Advisory Services:** Build on corporate and government advisory and promote thought leadership

Source: Company Reports

Figure 9. IDFC – NII to Operating Income (%)



Source: Company Reports and Citigroup Investment Research estimates

Strategy

- Remain focused on the infrastructure opportunities, but in a more comprehensive manner
- Transitioning towards becoming an "infrastructure financial services provider" with higher annuity-based revenues; focus on asset management
- Increase additional opportunities for revenues from alliances and possible acquisitions
- Sustain strong growth across business segments

1. Remain focused on Infrastructure

IDFC will remain focused on the infrastructure sector – it is adding capabilities and skill sets through increasing product developments and alliances, and offering integrated solutions to all participants whether corporates or investors, across the risk spectrum and at all stages of the project life cycle.

Funding business to contribute significantly

Historically IDFC has been dependent on its lending business for a significant proportion of its operating income. IDFC has tied up various banks including Bank of India and Union Bank of India as well as SBI Capital Markets to syndicate loans on their balance sheet. While leveraging on the meaningful gap in their relative risk assessment skills as compared to IDFC, it will also seek to address its relative modest balance sheet strength and allow IDFC to participate in larger deals than its standalone size would suggest.

With diversification in revenue streams to more fee-based products, we expect the reliance on net interest income to decrease to 50% of operating income in FY08E from 72% in FY03. However, IDFC's business model is likely to retain its lending focus with close to 50% of operating income coming from NII over the medium term.

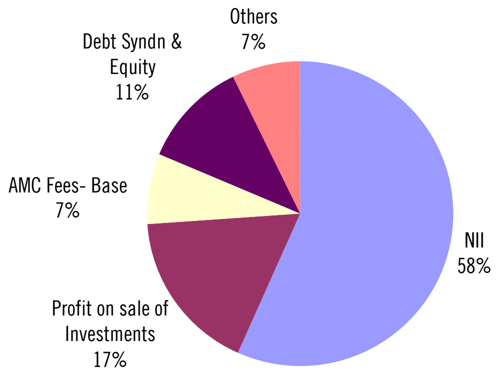
Maintain leadership position in advisory and policy formulation

IDFC will continue to engage with the government on important policy advisory and formulation relating to the infrastructure industry and specifically in the Public-Private-Partnership domain. IDFC's leadership position in the policy area, management's access to the government and their track record of expertise in this specialized area, increases IDFC's opportunities in the sector.

2. Transitioning business model towards annuity incomes

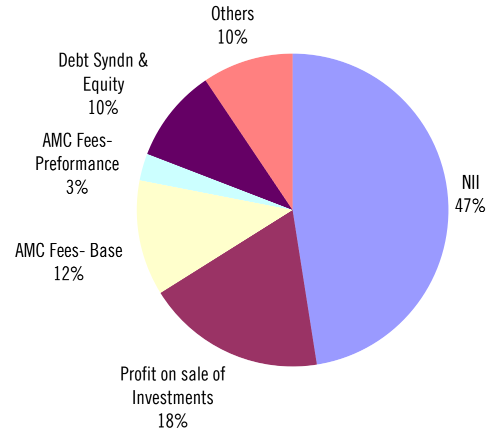
IDFC is transitioning from being a pure lender to more annuity-based stable revenues. It is focusing on diversifying revenue streams from having predominantly interest incomes and gains from proprietary investments to more annuity-based revenues from the asset management business. IDFC has been positioning itself to become a complete “infrastructure sector financial services provider.”

Figure 10. Changing Composition of Operating Income in 2007...



Source: Company Reports and Citigroup Investment Research

Figure 11. ... And in 2010E (Percent)



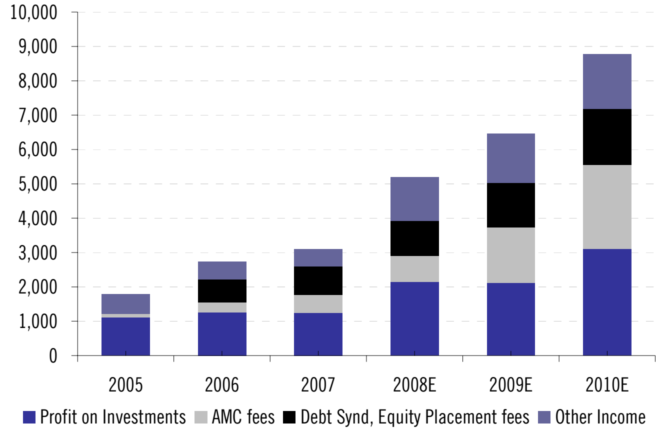
Source: Citigroup Investment Research estimates

IDFC's transition towards more annuity-based earnings will lend more stability to earnings as these are more predictable and recurring

We believe this transition will lend more stability to the earnings as asset management fees are of a predictable and recurring nature. To this extent, IDFC is increasingly modelling itself on the "Macquarie Bank model" (albeit with a significantly higher share of lending), leveraging on its central positioning and franchise in the infrastructure domain.

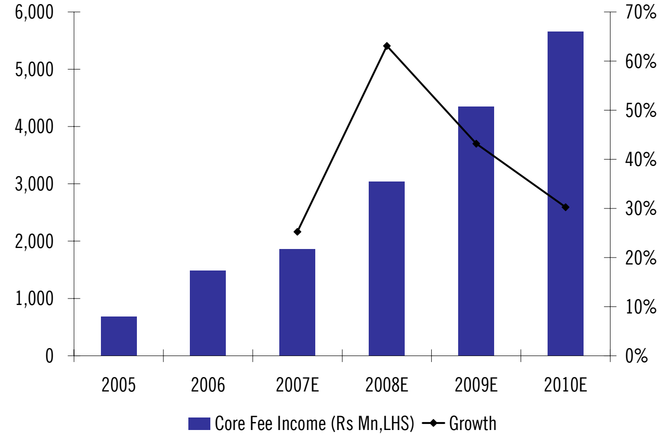
The aggressive push on fee-based revenue has increased the proportion of fees to operating income to 42% in FY07 from 28% in FY03. Fees have registered a healthy growth of 43% in FY07, though a large portion of the fee income is still contributed by capital market gains. Over the medium term, each of asset management and other capital market-related fees will likely become equally important as capital gains within the overall non-interest income. We expect fee-based income to grow to 50% of operating income over the medium term and within fees, capital market gains to form about 40-45%, with the balance coming from asset management and other fee-based products.

Figure 12. IDFC - FY2007 Fee Income Composition (%)



Source: Company Reports

Figure 13. IDFC - Core Fee Income and Growth, FY05-10E (Rsm, %)

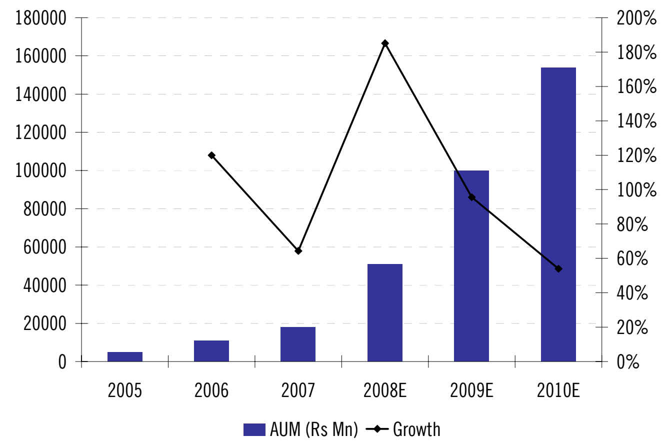


Source: Company Reports and Citigroup Investment Research

Focus on asset management

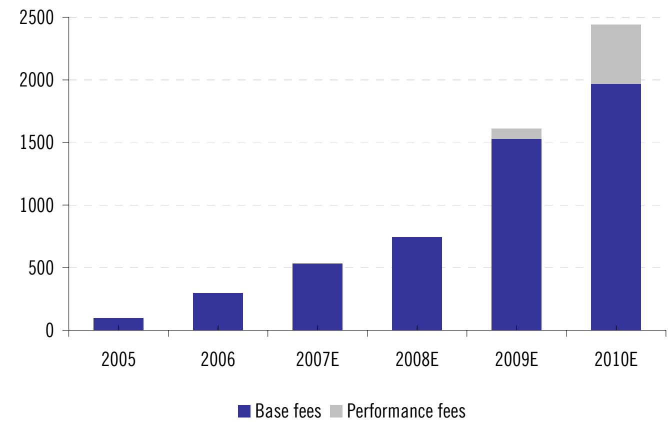
One of the key initiatives for expanding stable fee income for IDFC is through asset management. This is broadly divided into three parts: private equity, project equity and proprietary investments. On the private equity side, IDFC has raised a total of about US$630mn through two funds. The first was closed in 2004 with US$190mn and the second was closed in 2006 at US$440mn. The fee structure provides IDFC with base fees of 2% and a performance fees above a threshold return (between 8-10%). In the current environment, these funds are performing well and could generate meaningful upside.

Figure 14. IDFC - AUMs and Growth FY05 – 10E (Rs Mn, %)



Source: Citigroup Investment Research estimates

Figure 15. IDFC - AUM base and performance linked fee, FY05 – 10E (Rs Mn)



Source: Citigroup Investment Research estimates

IDFC has tied-up with Citigroup, Blackstone and IIFCL to raise and manage about US$2bn in private equity assets

On the project equity side, IDFC has tied-up with Citigroup, Blackstone and IIFCL to raise and manage about US$2bn with a similar carry and a profit sharing arrangement. Management has indicated that the base fees on these funds would be between 1.5-2% and about 2/3rd of the performance fees would accrue to IDFC. The funds will be raised over a period of 24-36 months and management is expecting about US$1.5-2.0bn to be raised in the next 2-3 years with an initial closing expected in 2QFY08. We expect the asset management business to be a significant contributor to IDFC's overall earnings and profitability.

IDFC also makes own contributions for each of these private equity funds as well as having a separate proprietary trading portfolio. Management has indicated it would be co-investing to the extent of 8-10% in each of its funds.

Figure 16. IDFC – Existing Funds and Expected Launches and Performance to FY2010E

Fund	AUM, US$ mn	Year of launch	Estimated returns
India Development Fund	190	FY2004	30%
IDFC - PE Fund 2	440	FY2007	20%
Citi-Blackstone	2000	FY2008	18%
New PE Funds	1500	FY2009	12-15%

Source: Company Reports and Citigroup Investment Research

3. Generate additional capabilities and synergies

IDFC has increased in stake in SSKI to 66.7% from 33.3% earlier

IDFC has increased in stake in SSKI, a domestic brokerage firm, to 66.7% from 33.3% earlier, in an attempt to vertically integrate its asset management business with corporate finance activities. Total cost of acquisition for IDFC has been Rs2.5bn for its 66.7% stake. Through the acquisition, IDFC gains a) distribution capabilities for off-the-shelf asset management products as well as more targeted marketing of structured products, and b) integration of its product offerings with corporate finance.

We believe IDFC will continue to look for more opportunities to increase its products and capabilities in the infrastructure sector through further alliances and acquisitions of newer players and service providers that are likely to increase with the growing opportunities in the sector. We believe IDFC's significant shift towards diversification of its revenue stream reduces overall earnings volatility and lumpiness.

4. Sustained strong growth

Infrastructure is one of the key bottlenecks for sustainable economic growth in India, and the sector has seen under-investment in the past. Much of this is expected to get corrected over the next few years, resulting in a significant opportunity for all players in the sector.

We believe IDFC will likely sustain its strong growth across business segments

We believe IDFC will likely sustain its strong growth across business segments – from vanilla lending to structured products – as well as aggressively drive its annuity-based asset management business. It will also seek to maintain momentum in its investment banking, corporate advisory and syndication businesses which are being helped by buoyant capital markets activity.

IDFC and the Macquarie Model – Where the Twain Shall Meet?

IDFC's management likens its transitioning business model to a couple of highly successful infrastructure-related companies in Australia, most notably Macquarie Bank and to some extent Babcock & Brown.

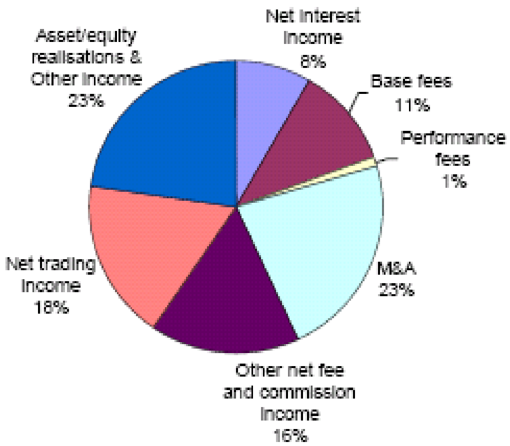
Macquarie Bank (MBL)

Macquarie Bank essentially evolved from a predominantly investment bank in 2001 to being significantly more balanced in terms of its revenue mix. The asset management business has seen a strong growth over the past 6-7 years with funds under management increasing from about US$44bn in Sep 2002 to over US$180bn in March 2007.

This strong growth in asset management, helped by strong global asset prices and equity markets, have significantly increased the proportion of recurring, stable earnings for MBL from the lumpy nature of its revenues earlier. MBL also earns incomes from lending activities to the projects it invests in and about 8-10% of its current revenues are from such lending activities.

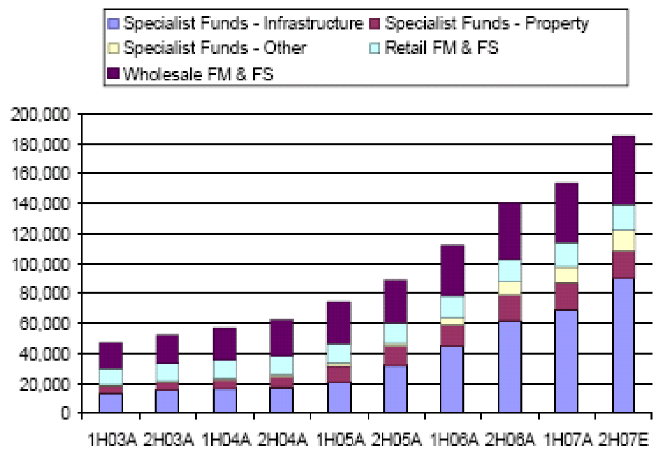
In terms of balance sheet exposure, the bank takes a funding exposure to some of its funded assets though it does typically does restrict leverage levels to about 20% of funded assets, with the majority funding being equity co-investments.

Figure 17. Macquarie - FY07E Operating Income Split



Source: Citigroup Investment Research estimates

Figure 18. Macquarie – AUM (Dollar ,Mn)



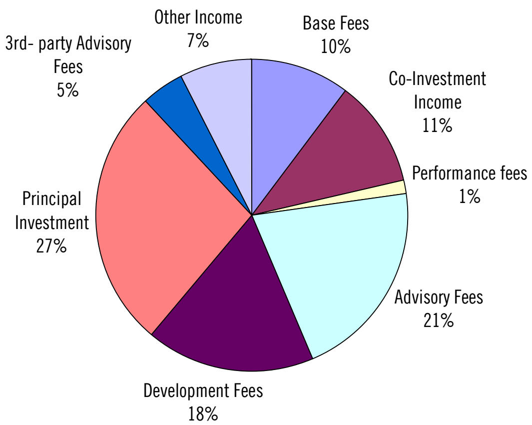
Source: Citigroup Investment Research estimates

Babcock & Brown (BNB)

BNB on the other hand does take a significantly higher leverage on its balance sheet with typical leverage ratios of around 40-50% of assets funded. However, majority of these loans are non-recourse to the company and based on the project financials.

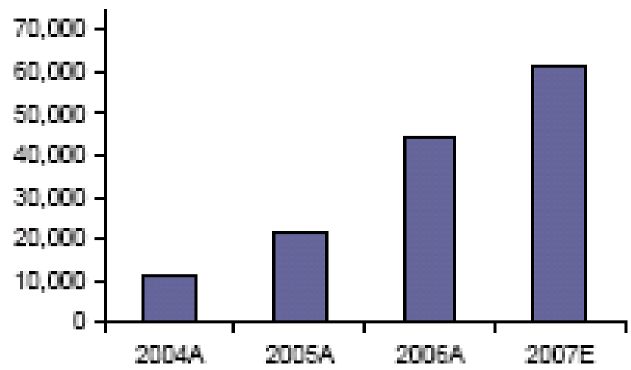
The difference between MBL and BNB is that BNB takes significant stakes in developing assets and sells them down after they are operational and commercially viable. MBL on the other hand takes a relatively smaller stake in greenfield developments and largely co-invests along with assets funded by it.

Figure 19. BNB – FY07E Net Revenue by Type



Source: Citigroup Investment Research estimates

Figure 20. BNB – AUM (A$ Mn)



Source: Citigroup Investment Research estimates

IDFC – Likely evolution of business

While IDFC is trying to transition towards asset management, we expect the shift to be more gradual with a strong bias towards income from core lending activity

While IDFC is trying to transition towards these models, its history as a lender is significantly different from the others and this we believe, would likely lend a strong interest income bias to revenues, at least over the medium term.

IDFC is targeting strong growth in infrastructure-related asset management business, and we believe there is a strong potential given a) strong skill sets in the domestic infrastructure sector, and b) large potential of the sector supported by buoyant asset and equity prices. The gap between the skill sets between IDFC and its competitors in the sector does appear to be large and IDFC is likely to capitalize on its expertise through the fee business.

However, while the mix of revenues will shift to more fee-based incomes, we expect the shift to be more gradual and likely much lower than the proportion of asset management fees seen in either MBL or BNB.

Figure 21. IDFC - Key Parameters Compared with MBL and BNB for FY2007, US$m, %

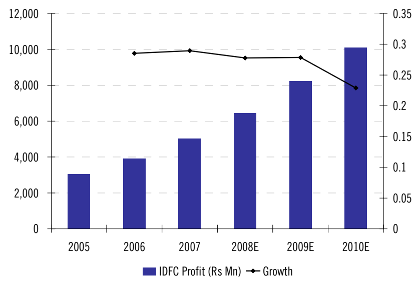
	IDFC	MBL	BNB
ROE (%)	18.3	26.6	37.3
ROAA (%)	3.3	1.2	12.4
Total Assets, US$m	4,484	111,752	3,563
AUM of funds managed, US$m	630	157,250	55,250
Fund AUMs / Assets (x)	0.1	1.4	15.5
Assets / Equity (x)	6.2	18.5	2.3
Asset Management Revenue / Operating Income (%)	7.5	12.0	11.0
NII / Operating Income (%)	56.7	8.0	Nil
Income from principal investments / Operating Income (%)	17.3	18.0	27.0

Source: Company Reports and Citigroup Investment Research

Financials: Profit and Loss

- Strong 26% profit CAGR over FY07E-10E
- Fee income mix changing to asset management from capital gains
- Margins likely to fall; higher rates and tighter liquidity will likely hurt
- Costs – structurally favorable, amongst lowest in the industry
- High taxes, capital raising to keep ROEs between 14-15% over FY08E-10E
- Large unrealized gains provide earnings cushion

Figure 22. IDFC – Profit Growth (Rs Million, %)



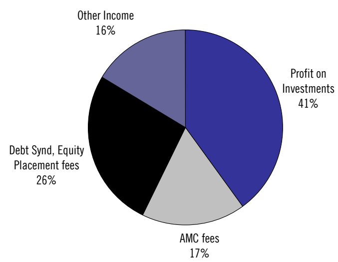
Source: Company Reports and Citigroup Investment Research estimates

Strong profit growth of 26% CAGR over FY07E-10E

IDFC's revenues are in a state of transition to being significantly more fee-income based from being predominantly interest income and trading gains based. While this transition is expected to take some time to fully evolve, we do see the earnings and revenue mix changing meaningfully over the next 2-3 years towards a greater share of fee income while continuing growth in profits.

We expect IDFC's net profits to grow at a strong 26% CAGR over FY07E-10E driven by an increasing proportion of non-interest income with robust core fee income CAGR of 41% and strong 33% loan growth over the same period.

Figure 23. IDFC - Fee Income Composition, FY07



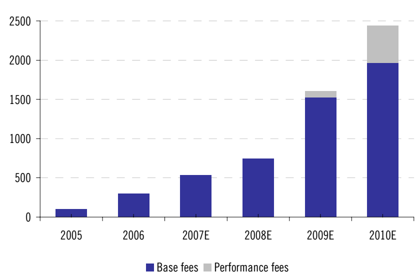
Source: Company Reports and Citigroup Investment Research

Fee income mix changing to asset management from capital gains

IDFC has in the last couple years focused on building its fee income sources other than capital gains on its proprietary investments. The sources of the additional revenues are mainly asset management and investment banking in the form of debt syndication and equity placements as well as corporate advisory. Fees other than capital gains have increased to 44% of total other income from being negligible till FY04. We expect core fee incomes (ex-capital gains) to increase to over 50% of total other incomes by FY10E.

IDFC has seen meaningful traction in the last year with core fees increasing 41% and AMC fees increasing almost 80% over the year and other fees increasing about 22%. Additional fund raising over about US$1.5-2.0bn over the next three years will likely fuel strong growth of 41% in core fees over FY07E-10E and 60% in asset management fees over the same period.

Figure 24. AUM Linked & Performance Fee, Rsm



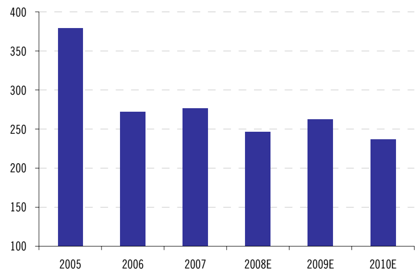
Source: Company Reports and Citigroup Investment Research estimates

Performance fees on asset management to be back-ended

The asset management business will have essentially two revenue streams – a) base fees, which would a percentage of AUMs (1.5-2.0% in the case of IDFC) and b) performance fees, which will be IDFC's share of the excess returns over a threshold level (about 8-10% for IDFC).

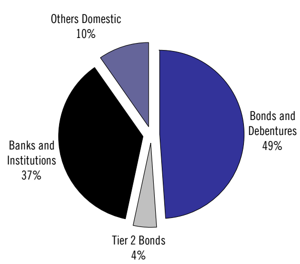
The base asset management fees will start accruing as the funds are committed and would increase with the AUMs. Performance fees however, are back-ended and lumpy in nature depending on a) capital market performance and b) timing and ease of exit from investments. We are factoring performance fees to start being booked on IDFC's first fund in FY09. For the other funds, we are factoring in a fully committed invested state for about 3-4 years, post which they will likely start generating performance fees depending on individual fund performance.

Figure 25. IDFC – NIM (bps)



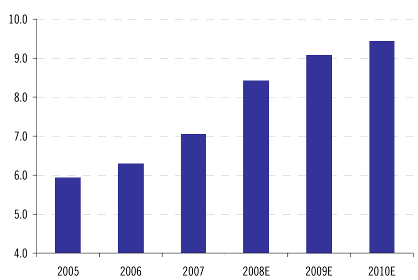
Source: Company Re reports and Citigroup Investment Research estimates

Figure 26. IDFC- FY07 Funding Mix



Source: Company Reports and Citigroup Investment Research estimates

Figure 27. IDFC – Average Cost of Funds



Source: Company Annual Reports and Citigroup Investment Research estimates

Margins shrinking from the lending business

IDFC's traditional infrastructure asset financing business is no longer a prerogative of specialized financial institutions. Scale private and public sector banks, sensing large opportunities in the sector, have developed skills in the sector and have become aggressive lenders in the last 3-4 years. IDFC has found it difficult to compete on pure vanilla lending to large infrastructure projects given it’s a) modest balance sheet size relative to the larger banks and b) higher relative cost of funds.

This intense competition has reduced IDFC's pricing power and commoditized pricing of the more vanilla financing products. This, coupled with significantly lower domestic interest rate levels, have reduced IDFC's yields on advances to 9.2% currently from over 15% in 2002, while its cost of funds has decreased to about 7% from 11% over the same period, resulting in lower net interest margins for IDFC – from 4.7% in 2002 to 2.8% currently. We expect competition to remain high in the sector and a further reduction in margins is likely; we expect margins to decline from current levels and stabilize around 230-240bps levels by FY10E.

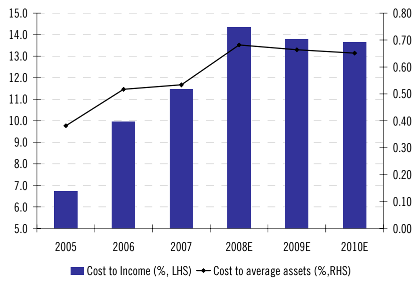
We expect IDFC to focus increasingly on the medium- to small-size loans as it can get better pricing on such loans due to a) its comprehensive product offerings which are intrinsically more appealing to the relatively smaller players with lesser ability to drive bargains with the larger, scale banks, and b) banks/institutions preferring to lend to larger, less risky projects due to focus on scale transactions and relatively lower risk assessment skills for smaller projects.

Higher rates, tighter liquidity will likely hurt

IDFC does not have access to low-cost retail deposits; its funding needs are primarily dependent on wholesale sources of funds, resulting in a relative cost disadvantage as compared to banks. Also wholesale funding is relatively disadvantageous in an environment where a) interest rates are rising and b) liquidity is tight.

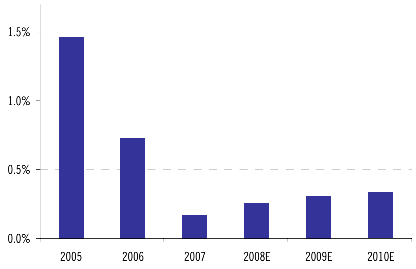
The disadvantage of wholesale borrowing has in fact has been highlighted meaningfully in the recent global credit turmoil – where similarly structured borrowers have faced a sharp squeeze on liquidity, price and ratings. We believe the domestic interest rate outlook has eased meaningfully over the last couple of months and there is ample liquidity currently which favors IDFC. However, although India is relatively de-linked with global credit events, any such linkage, whether direct or perceptive, could impact IDFC's borrowing costs meaningfully. We expect IDFC's cost of funding to increase to 8.4% in FY08E from about 7.1% levels in FY07.

Figure 28. IDFC – Cost to Income and Cost to Average Assets (%)



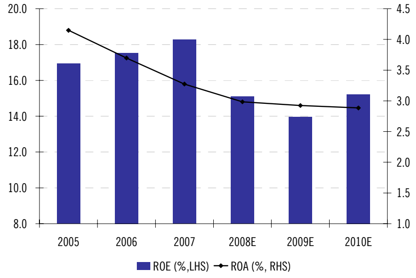
Source: Company Reports and Citigroup Investment Research estimates

Figure 29. IDFC - NPL Provisioning to Opening Loans



Source: Company Reports and Citigroup Investment Research estimates

Figure 30. ROE & ROA (%)



Source: Company Reports and Citigroup Investment Research estimates

Costs remain among the lowest in the industry

IDFC's operating costs are amongst the lowest in the domestic financial services industry due to an absence of a retail branch network and associated overhead and employee costs. IDFC's cost to average assets ratio is about 0.5% currently and has declined from about 1.3% in FY03. We expect costs to increase rapidly over the next three years driven by increasing employee costs as IDFC tries to attract and retain skilled employees. We however, believe that additional scale and focus on maintaining costs will enable IDFC to maintain cost to average asset ratio at current levels.

Provisioning charges likely to increase but remain low

Provisioning charges to total assets for IDFC has remained low reflecting strong risk assessment processes, rapidly growing balance sheet and a favorable asset quality environment over the last few years. IDFC's NPL provisioning declined significantly during FY07; loan loss charges to loan assets were around 0.1% for FY07, declining from a peak of 3.1% in FY04. Management attributes this largely to write-back of excess provisions made in the past. We believe that IDFC's book is not truly seasoned as infrastructure financing is long gestation and a large portion of its loan book has been accumulated over the last three years. We expect IDFC's provisioning charges to increase moderately over the medium term, even as loan growth and asset quality continue to remain high.

Effective tax rates likely to increase

Infrastructure financing has enjoyed a favorable tax structure with specific tax deductions and rebates that were being utilized by IDFC. Recently however, some of these concessions have been / are being withdrawn and will lead to a higher effective tax rate for IDFC. More recently, IDFC had a tax break available of up to 40% of its profits, which have now been reduced to 20% of profits. The gradual withdrawal of tax benefits have increased IDFC's tax rates to about 20% inFY07 from a low of 5% in FY04. We expect effective tax rates to continue to increase gradually and stabilize at about 25% by FY09E.

Capital raising to be a medium term drag on RoEs

IDFC has recently raised US$500m of additional capital. We believe the additional capital will likely be a drag on RoEs in the medium term. IDFC's return on equity increased to 18% in FY07 from about 12% in FY03, despite a contraction in NIMs due to a) increase in leverage from 1.3x to 5.4x and b) increase in proportion of fee income to operating income from 17% to 28% over the same period. We expect RoEs to range between 14 to 15% over FY08-10E.

We also expect IDFC's RoAs to decline over the medium term and stabilize at around 2.8% by FY10E. This compares with a return on assets of about 3.3% in FY07. The decline in RoAs will be driven by a decline in margins from its lending business to 2.4-2.5% over the same period, from 2.8% levels currently and a rapidly expanding asset base.

Earnings cushion from large unrealized gains

IDFC makes proprietary investments in the infrastructure space to manage its treasury and also co-invests to the extent of 6-8% of the funds managed by it. Indian equity markets have performed well over the last 3-4 years resulting in significant unrealized gains for IDFC. The current unrealized gains on its listed equity portfolio is around Rs2.4bn. IDFC continues to book part of its equity portfolio gains on a regular basis and this income forms an important portion of its fee income.

IDFC also has equity investments that are unlisted. Significant among them is its 8.2% stake in NSE (National Stock Exchange) and it 66.7% stake in SSKI. This puts the value of these investments at about US$270m with the unrealized gains on this representing Rs7 per share of IDFC. We have discounted the unrealized gains on investments at 30% to reflect the uncertainty in timing of booking these gains and the volatility in the capital markets in the intervening period. Depending on the performance of the capital markets, IDFC's investing activities could be a meaningful source of profits, as near-term earnings volatility is reduced due to high current unrealized gains.

Figure 31. IDFC – Profit and Loss Account, FY06-10E (Rupees, Million)

	2006	2007	2008E	2009E	2010E
INCOME					
Interest income	7,757	12,611	19,147	26,624	33,964
Dividends	73	101	316	378	425
Profit from sale of treasury investments	310	365	250	200	150
Profit from Infra equity investments	1,253	1,240	2,152	2,121	3,110
Fee Income	955	1,239	2,289	3,565	4,959
Other income	149	157	181	208	239
Total other income	2,740	3,102	5,188	6,468	8,772
Total income	**10,496**	**15,713**	**24,335**	**33,096**	**42,848**
EXPENSES					
Interest	5,008	8,555	14,085	19,555	26,002
Employee expenses	315	480	648	810	972
Other Operating expenses	193	297	776	1,009	1,262
Depreciation	39	44	46	49	51
Total operating expenses	546	821	1,471	1,868	2,285
Provisions and contingencies	516	175	361	621	877
Total expenses	**6,070**	**9,551**	**15,917**	**22,044**	**29,163**
Profit before Tax	**4,426**	**6,162**	**8,418**	**11,052**	**13,684**
Tax	517	1,241	1,936	2,763	3,421
Minority share	(2)		(43)	(54)	(65)
Associate income		118			
Profit after tax	**3,908**	**5,039**	**6,438**	**8,235**	**10,198**
Dividend	1,124	1,124	1,294	1,553	1,553

Source: Company Reports and Citigroup Investment Research estimates

Figure 32. IDFC- Key Operating Ratios, FY06-10E (Rupees, Million)

Key Operating Ratios	2006	2007	2008E	2009E	2010E
Tax Rate	12%	20%	23%	25%	25%
Interest Exp. / Interest Income	65%	68%	74%	73%	77%
Non Int. Income / Total Income	26%	20%	21%	20%	21%
Non Int. Income / Operating Income	50%	43%	51%	48%	52%
Core Fee Income / Operating Income	20%	20%	24%	28%	30%
Cost / Income	10%	11%	14%	14%	14%
Loan Charges / Preprov. Profit	10%	3%	4%	5%	6%

Source: Citigroup Investment Research estimates

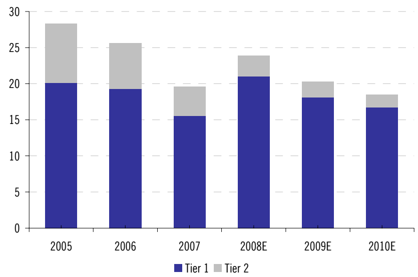
Financials: Balance Sheet

- Modest balance sheet size; leverage levels relatively lower
- Lending growth to remain strong at 33% CAGR over FY07 – FY10E
- Asset liabilities matched closely, reducing interest rate shocks
- Asset quality amongst the best with zero net NPLs; however, portfolio not yet truly seasoned

Modest size, leverage effectively capped

IDFC has a comparatively modest balance sheet size as against the larger banks with which it directly competes for lending, putting it at a relative disadvantage when lending to large corporates or projects and also limiting exposure to a single company/group. IDFC does enjoy the highest domestic credit rating, but it also effectively caps its leverage to 7x, beyond which rating agencies are currently not comfortable given its credit rating. IDFC's current leverage is 5.4x as compared to 1.6x in FY03. We expect leverage to remain between 3.5x -4.5x over FY08-10E on an expanded net worth.

Figure 33. IDFC – Tier 1 Tier 2 Capital (%)



Source: Company Reports and Citigroup Investment Research estimates

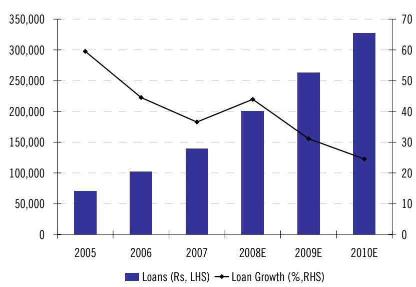
Capital raising – Increases balance sheet strength

IDFC has recently raised US$500m of additional capital primarily due to a) increase single company/group exposure limits as this was limited by a smaller net worth compared to its larger competitors, b) co-investing requirement of an additional US$150-200mn over the next three years in its asset management initiatives and c) expectation of continued strong loan growth.

With increasing development of the infrastructure sector in India, the set of available opportunities are likely to become larger in size and complexity. We believe this additional capital will provide IDFC much-needed balance sheet support and coupled with its superior skills, should enable IDFC to benefit from the more scale opportunities as they present themselves.

Lending growth to remain strong at 30-35%

Figure 34. IDFC - Loan & Loan Growth



Source: Company Reports and Citigroup Investment Research estimates

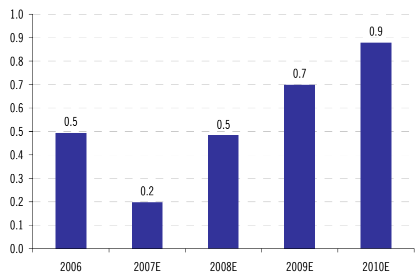
We expect lending growth for IDFC to remain strong, driven by the robust domestic capex cycle and an acute shortage of infrastructure assets. IDFC's loan book has grown at a rapid pace over the last 4-5 years with loan book CAGR of 52% over FY03-FY07. We expect the growth to remain strong but moderate slightly compared to historical levels due to higher competition.

We estimate IDFC's loan growth at a strong 33% CAGR over FY07E-10E. We believe IDFC's strengths in identifying opportunities, risk assessment, evolving niche products and partnering with various players in the sector will keep its loan growth strong despite a highly competitive environment. We do expect IDFC to focus increasingly on the mid-sized loans offering better yields and requiring greater risk assessment skills.

Asset/liabilities matched closely, reducing interest rate shocks

While infrastructure financing requires long-duration assets, in the current domestic environment, availability of matching long-dated liabilities is very limited. This reduces the ability of the lenders to structure long-dated fixed-rate instruments. Most of IDFC's loan book therefore, is on a floating-rate basis with an agreed reset interval; thereby reducing the duration of assets significantly. IDFC has mostly kept a closely matched ALM profile, with matching asset and liability durations to avoid any significant adverse interest rate movements.

Figure 35. IDFC- GNPL (%)



Source: Company Reports and Citigroup Investment Research estimates

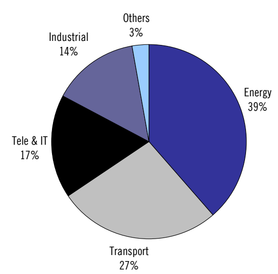
Asset quality amongst the best; portfolio not yet truly seasoned

Despite a strong growth in its loan portfolio, IDFC's asset quality remains amongst the best in the industry with 0.2% gross NPLs and nil net NPLs. However, we believe that IDFC's loan portfolio is not truly seasoned due to the long gestation periods required for infrastructure projects and its strong loan growth over the last three years. Almost 70% of IDFC's current loan portfolio has been disbursed over the last three years, or in other words, during FY04-07 IDFC's loan portfolio has increased 3.2x. We expect modest increases in NPLs in cognizance of its superior risk assessment and management track record.

Lending concentrated in few sectors ... to remain so

IDFC's lending operations are focused on the infrastructure sector, leading to a concentration in loan portfolio in a few sectors. The important sectoral exposures for IDFC are mainly a) energy, 39% of total exposures; b) transportation, 27% of total exposures; c) telecom, 17% of total exposures; d) commercial and industrial, representing 14% of total and e) others, 3% of total. This puts the combined exposure to the energy and telecom sectors at almost 66% of total exposures, increasing concentration. While we believe that industrial and commercial will becoming more meaningful relative to history, the overall portfolio will remain concentrated to the infrastructure sector.

Figure 36. IDFC – Sectoral Loan breakup- FY07



Source: Company Reports

Figure 37. IDFC – Balance Sheet, FY06-10E (Rupees, Million)

	2006	2007	2008E	2009E	2010E
Cash and Short-term Funds	3,530	10,800	4,715	3,073	3,246
Advances to Customers	101,909	139,184	200,335	262,766	327,222
Investments	12,928	23,903	30,667	35,228	38,724
Fixed Assets	508	489	514	540	567
Other Assets	5,134	9,463	11,356	13,627	16,352
Total Assets	**124,008**	**183,840**	**247,586**	**315,233**	**386,111**
Deposits and Balances of Banks	87,302	142,528	178,890	238,772	299,745
Other Liabilities	4,519	5,335	6,402	7,683	9,219
Total Liabilities	**91,821**	**147,864**	**185,292**	**246,455**	**308,965**
Share Capital	11,227	11,259	12,939	12,939	12,939
Reserves	14,460	18,217	42,855	49,339	57,707
Shareholders' Funds	**25,687**	**29,476**	**55,794**	**62,278**	**70,646**
Subordinated Debt	6,500	6,500	6,500	6,500	6,500
Liabilities & Capital Resources	**124,008**	**183,840**	**247,586**	**315,233**	**386,111**

Source: Company Reports and Citigroup Investment Research estimates

Figure 38. IDFC – Key Financial Ratios, FY06-10E (Percent)

	2006	2007	2008E	2009E	2010E
ROAA	3.7	3.3	3.0	2.9	2.9
ROAE	17.5	18.3	15.1	13.9	15.3
NPL / Total Loans	0.5	0.2	0.5	0.7	0.9
Loan Loss Reserve / NPLs	100.0	100.0	65.6	64.4	67.0
Operating Pofit / Assets	4.7	4.1	4.1	4.1	4.1
Equity / Loans	25.2	21.2	27.9	23.7	21.6
Equity / Assets	20.7	16.0	22.5	19.8	18.3

Source: Company Reports and Citigroup Investment Research estimates

Figure 39. IDFC – Key Assumptions, FY06-10E (Percent)

	2006	2007	2008E	2009E	2010E
Loan Growth	44.5	36.6	43.9	31.2	24.5
Loan Yield	8.34	9.34	10.28	10.44	10.58
NIM (bps)	272	277	247	262	237
Loan Spread	2.05	2.30	1.85	1.36	1.15
Capital Adequacy	25.6	19.6	23.8	20.3	18.5

Source: Citigroup Investment Research estimates

Valuations

- We value IDFC on a sum-of-parts basis for lending, asset management and unrealized gains on equity investments
- Lending business comparable to banks; P/B is the favored methodology
- Asset management benchmarked off discounted cash flows
- We value IDFC shares at Rs140 based on our sum of parts methodology

Sum-of-parts valuation methodology

We prefer to apply a sum-of-parts methodology for IDFC

We prefer to apply a sum-of-parts methodology for IDFC as we believe the different businesses, especially lending and asset management, have widely different operational as well as valuation drivers, and they would be best valued separately as opposed to a combined value. For a sum-of-parts methodology, we prefer to value separately the lending business, the asset management business, and the unrealized gains on the listed equity portfolio. From the unlisted portfolio, we add the estimated unrealized gains on the NSE and SSKI stake to our value.

A. Financing business – Valuations and benchmarks

We believe India's banks and financial companies valuations have been primarily influenced by the following

1. Market opportunity: The high growth potential (which has materialized) in the lending and the financial services space, has been a key driver of relatively high valuations over the recent few years. We expect this to remain – as a long as growth does not appear to be running out.

2. Ownership and management: The market has meaningfully and consistently differentiated on both these counts. Private banks have sustained a large premium over government banks. And strong and credible managements have been valued substantially above more average ones. While there could in more than a few cases be a mix of the above, we believe credible and respected private sector bank managements will continue to maintain a substantial premium over others.

3. Regulatory / operating platform: The market has historically valued a commercial banking platform over finance company or financial institutions operating platforms. This has been reflected in valuations historically, and evidenced by the fact that most non-bank players have converted to banks, when given the opportunity.

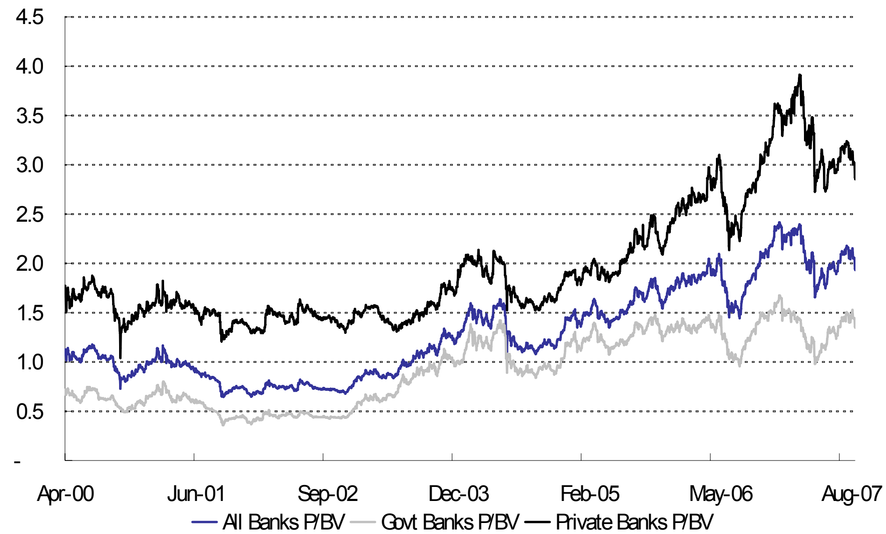
4. Finance companies operate at lower valuations relative to commercial banks – managements and opportunity being equal? We do not believe there is enough evidence of this (most finance companies have tended to carry a management discount, relative to best-of-breed private commercial banks). We would however believe the relative lack of a retail liability franchise could keep finance companies valuations a tad lower than comparable banks (more so in a rising rate environment, and less so in a falling rate environment), though there is a premium mortgage company

whose core lending business trades at premium to most private sector banks.

5. **Finance company valuations have been moving up:** There has been a decisive re-rating of a few finance companies (Reliance Capital /Indiabulls) over the recent past – part of which we believe can be attributed to the perception that a) regulatory structure is more supportive of asset side flexibility and b) growing and evolving institutional funding market, limits the downsides of no retail funding franchise.

We expect the private sector banks to maintain a valuation premium over business cycles

Figure 40. India Banks – Price-to-Book (x)



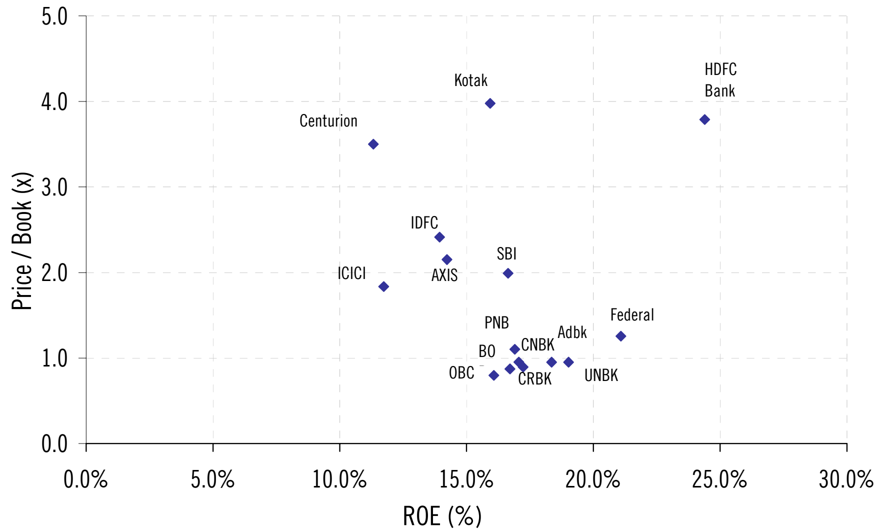
Source: Citigroup Investment Research

Figure 41. India Bank Valuations Comparables – FY09E (Price as at 20th August 2007)

	Price (Rs)	Price Target (Rs)	SB Rating	P/E (x)	P/B (x)	ROE (%)	ROA (%)	Div. Yield (%)	Market Cap (US$m)	2-year EPS growth
Private Sector Banks										
Centurion Bank	39.8	45.0	2M	37.3	3.5	11%	0.9%	0.0	1,519	33%
Federal Bank	323.5	438.0	1M	6.5	1.3	21%	1.3%	1.1	673	46%
HDFC Bank	1125.0	1155.0	2L	17.6	3.8	24%	1.5%	0.7	9,667	33%
ICICI Bank	872.0	1235.0	1L	16.6	1.8	12%	1.1%	1.3	22,611	24%
Kotak Mahindra Bank	686.5	825.0	2M	27.0	4.0	16%	2.0%	0.1	5,462	23%
AXIS Bank	604.0	675.0	2L	16.3	2.2	14%	1.2%	0.7	5,238	27%
IDFC	116.2	130.0	2M	18.3	2.4	14%	2.9%	1.0	3,660	19%
Govt. Banks										
Andhra Bank	78.3	107.0	1L	5.5	1.0	18%	1.2%	5.4	925	25%
Bank of Baroda	269.8	390.0	1M	5.6	0.9	17%	1.0%	2.2	2392	31%
Corporation Bank	308.6	455.0	1M	5.6	0.9	17%	1.2%	3.2	1078	22%
Canara Bank	247.0	295.0	1M	6.0	1.0	17%	0.8%	2.7	2465	12%
Oriental bank	203.7	285.0	2M	5.3	0.8	16%	1.2%	2.2	1242	27%
Punjab National Bank	492.1	608.0	1M	7.0	1.1	17%	1.2%	1.6	3777	25%
State Bank of India	1550.5	1825.0	1L	12.8	2.0	17%	0.9%	1.1	19866	18%
Union Bank Of India	132.7	180.0	1L	5.4	1.0	19%	1.0%	3.0	1632	21%

Source: Citigroup Investment Research estimates

Figure 42. FY09E- Price-to-Book and ROE Comparables



Source: Citigroup Investment Research estimates

In this context, how would we value IDFC's lending business?

a) P/B is the favored methodology

IDFC is directly competing with banks for its lending business. We believe the larger and scale banks with strong balance sheets will be a direct comparable with IDFC.

Prospects for the economy are a key driver of valuations

b) Benchmarked to private sector banks

We believe IDFC will trade at a significant premium to government banks and closer to the private banks. IDFC has significant resemblance to the premium private sector banks in terms of: a) significantly large and profitable growth opportunities in the sector; b) strong and competitive management; c) relatively higher and sustainable profitability; d) strong fee incomes in relation to total operating incomes; and e) a strong balance sheet with healthy asset quality.

However, the key differences between IDFC and most private sector banks is: a) the presence of retail business for banks which are perceived as lower risk exposures than a completely wholesale lending model; b) within the lending wholesale lending business, banks have wide exposure to a large segment of the economy thereby reducing concentration risks and cyclicality; and c) large exposure to capital markets can be a source of earnings volatility. This would likely result in a slight discount to private sector peers

c) Valuing IDFC towards the lower end of private sector banks on P/B

IDFC could trade at the lower end of private sector bank valuations due to its higher risk profile compared to private sector banks

Given IDFC's strong track record and skill sets in the rapidly growing infrastructure sector – and it being one of only few direct plays on infrastructure in India – it is likely to sustain its premium valuations. However, IDFC could trade at the lower end of private sector bank valuations due to higher risk profile of IDFC as compared to private sector banks owing to a) limited liability franchise, and no retail exposure, b) lending concentration within the infrastructure sector, and c) higher capital market exposure.

The private banks are trading at PBV range of 2.0x-4.0x FY09E, with ROEs in the range of 11% -18%. Within this framework, would expect IDFC to trade towards the lower end of this multiple band, with an ROE in the middle of the range. Our target multiple is above a normalized PBV/ROE benchmark and reflects IDFC's strong management, defined strategy, long track record of low asset risks, premium positioning in infrastructure, and relatively high growth profile.

We value IDFC at 2.5x FY09E P/BV (translating to Rs113 per share) which is lower than our target multiples for premier private sector banks with strong retail asset, liabilities and distribution franchises. It is also lower than India's premier mortgage finance company which operates off a similar finance company platform. However, adjusted for strategic initiatives and the mortgage company's higher RoE's we believe our target multiples are largely in line.

We would see a relatively easy liquidity environment as an upside risk to this trading band, with higher interest rates working against these valuations.

d) P/E to likely support valuations

We see IDFC's strong earnings growth supporting and improving mix of fee based revenues supporting valuation on P/E basis

We see IDFC's strong earnings growth supporting and improving mix of fee based revenues supporting valuation on P/E basis, especially as the business transitions to a more annuity-based income model. We would expect P/E multiples to become a more dominant valuation multiple, as the share of annuity incomes rises, and capital based returns moderate. We would however expect IDFC to trade at a slight discounts to P/E multiples for the premium private banks, over the near to medium term.

B. Asset management – Valuations and assumptions

We value the asset management business as a continuing business and based on a DCF methodology

The asset management business has two primary sources of revenues – a) base management fees linked to AUMs and b) performance fees linked to excess returns over an agreed threshold return. While the base fees are stable and recurring, the performance fees are more difficult to predict due to their back-ended nature, volatility in fund performance due to underlying asset prices and equity market uncertainty as well as the timing of the fund exits, which is difficult to predict.

We value the asset management business as a continuing business and based on a DCF methodology. The assumptions used for the valuation of the asset management business are as given below:

Figure 43. Assumptions for DCF Valuation

Parameters	Values
Base Fees	1.5% - 2.0%
Expenses	0.50%
Hurdle Rates	8%-10%
Performance Fees	20% carry over hurdle returns
Discount Rate	14%
Terminal Growth Rate	5%

Source: Citigroup Investment Research estimates

Figure 44. IDFC – Asset Management Valuations

	FY08	FY09
Discount Rate	14%	14%
NPV	15,259	18,412
Terminal Growth Rate	5%	5%
Terminal Cash Flow	4,450	11,662
Value of Terminal Cash Flow	1,544	3,303
Total Value	16,803	21,715
Terminal Value % fo Total	9.2	15.2
AUM	46,928	90,052
% of AUM	35.8	24.1
Per share value, Rs	**13.0**	**16.8**

Source: Citigroup Investment Research estimates

Based on the above, we believe the value range for the business could be about Rs12.7bn or Rs17 per share based on an FY09E basis. This would also translate to about 24% of IDFC's FY09E AUMs from asset management. This is distinctly higher than valuations of traditional asset management business; there are however a few specialized investment vehicles – Fortress and Blackstone which have traded at higher 30-35% of AUMs.

Figure 45. Global Asset Management Valuation Comparatives

Company	Price	Mkt Cap	P/E 2007E	P/E 2008E	Mkt Cap / Equity AUM (%)
Blackstone	24.1	27,139	14.6	12.7	29.5
BlackRock	161.3	18,679	22.4	19.9	4.3
Calamos	23.1	2,263	20.0	16.5	5.2
Federated Investors	35.0	3,606	15.9	14.3	8.8
Fortress Inv Group	17.6	7,145	14.6	12.6	16.6
Franklin Resources	131.5	32,342	18.6	16.9	9.4
Legg Mason	88.8	11,790	19.8	16.1	3.7
Nuveen Investments	61.3	4,896	23.1	19.2	2.9
T. Rowe Price	52.0	13,774	21.6	18.9	4.9

Source: Citigroup Investment Research estimates

C. Proprietary investments – Unrealized Gains

We discount unrealized investment gains by 30% to account for the uncertainty of capital markets and also the timing of booking these gains

We also add the current unrealized gains from IDFC's proprietary investments – both listed as well as unlisted. The current unrealized gains from listed equity investments are Rs2.4bn. From among the unlisted equity investments we value IDFC 8.2% stake in NSE in-line with the recent transaction multiples for the company and compute the current gains from this stake as Rs9.2bn. We also value the unrealized gains on IDFC's investment in SSKI at 2x acquisition price, given the substantial increase in valuations for brokerage companies over the past 12-18 months. Therefore the combined unrealized gains for IDFC are at Rs13.1bn or Rs10 per share.

D. IDFC – overall valuations

We therefore, value IDFC at Rs140 per share based on separate valuations for each of the businesses. We summarize IDFC's sum-of-parts value below.

Figure 46. IDFC – Sum of Parts Valuation, Rupees per share

Business	Parameter	Per share -FY08	Per share -FY09	Remarks
Lending Business	BV	100	113	2.5x BV
Asset Management	DCF	13	17	Based on estimated cash flows
Unrealized Equity Gains	NAV	2	2	As stated by management
NSE + SSKI Stake	NAV	8	8	Recent transactions
Total		**123**	**140**	

Source: Citigroup Investment Research estimates

Risks

We rate IDFC shares Medium Risk based on our quantitative risk rating system that tracks 260-day historical share price volatility. Key risks that could prevent the shares from reaching our target price include:

Slowdown in reform initiatives or infrastructure spending in the economy

IDFC' business fortunes are intricately linked to the development and growth of the infrastructure sector in the country. While there is an acute shortage of infrastructure, much of the sector is still regulated and controlled. Any delays in the reform process could postpone investments into the sector and would adversely impact IDFC's performance.

Lending concentration and reversal in credit environment

IDFC has large exposures to energy and telecom sectors in addition to transport and commercial infrastructure as well as exposure to the mid-tier companies. These segments have varying degrees of exposure to a reversal in the credit cycle and regulations. Some of these are cyclical in nature and IDFC's exposure to them could hurt asset quality in an economic downturn.

Sharp increases in funding costs

IDFC is dependent on wholesale sources i.e. banks and institutions for its funding needs and does not have access to more stable retail deposits. Borrowing costs are relatively more exposed to sharp hikes interest rates and market liquidity. This challenge has in fact has been highlighted meaningfully in the recent global credit turmoil – where similarly structured borrowers have faced a sharp squeeze on liquidity, price and ratings. Wholesale funding rates also reprice faster than retail funding; in a rising interest rate environment and tight liquidity conditions funding costs for IDFC will increase relatively faster compared to banks. Though we expect IDFC's cost of funds to remain relatively higher, sharp increases in funding costs are a key risk to our estimates.

Private equity business higher risk than traditional lending operations

Recently IDFC has been aggressively increasing its exposure to private equity and asset management businesses and will contribute own capital to some of its funds. While these are potentially high return venture, they also entail higher risks than its traditional financing operations. IDFC is also increasingly exposed to the performance of capital markets due to its increasing focus on private equity and asset management. It also has a large proprietary investment portfolio which is exposed to the cyclical nature of capital markets.

Leverage levels are restricted by rating agencies and regulator

IDFC's current leverage is at 5.4x and are effectively capped by rating agencies, who are currently comfortable with a 7x leverage for IDFC's current debt rating. While we are expecting this to be relaxed over time, capping of maximum leverage to lower than expected levels by rating agencies, remains a risk. However, with an increase in its equity base, IDFC breaching the cap on leverage would be lesser of a risk over the medium term.

Regulatory concessions could be withdrawn

IDFC enjoys a concessionary tax regime by virtue of it being a long-term lender in the infrastructure sector. It also has an advantage over banks due to its lower reserve and liquidity requirements. Some of these concessions have been reduced / withdrawn in the past; increasing effective tax rates. While we expect a gradual increase in tax rates, a sharper or earlier-than-expected reduction in benefits could reduce earnings to shareholders.

Company Background, Ownership and Management

Background

IDFC was established in 1997 as a specialized Infrastructure financier / advisor and to encourage private sector investments in the infrastructure sector. IDFC was set up as a private company with substantial stakes from the Government of India (40%), multilateral agencies including ADB, CDC, GIC and IFC (40% overall) and supported by PSU banks and institutions (balance 20%). The structure of ownership changed in FY2006 with the company's Initial Public Offering.

IDFC 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.

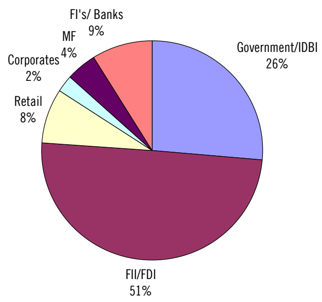
IDFC has diversified its product offerings to include non-fund based products, asset management and private equity along with debt finance and syndication opportunities. However, lending remains a key focus area of operations.

IDFC has entered into tie-ups with various banks including Bank of India and Union Bank as well as with SBI Capital Markets for loan syndication and project finance. IDFC has a 33% stake in the institutional broking and investment banking arm of SSKI, a domestic brokerage. It has also entered into an agreement with IIFCL, Blackstone and Citigroup to manage equity assets of around US$2bn, in the domestic infrastructure sector.

Ownership

Government of India remains the largest shareholder in IDFC with 26% stake (including 3% stake held by IDBI). However, the ownership structure of the company is widely dispersed with about 48% foreign ownership.

Figure 47. IDFC- June'07 Shareholding Pattern



Source: Company Reports

Management

IDFC has created a strong management team – both at the board level and at the operating level. The management team has a large experience in economic and financial analysis, asset management, structured products, policy making and infrastructure lending. At the board level, IDFC is chaired by Mr Deepak Parekh, also the Chairman of HDFC. The management team is headed by the MD and CEO, Mr Rajiv Lall. The operations are also vertically split with each business headed by different individuals. Mr Vikram Limaye, ED, heads Corporate Finance, New products and businesses, Mr AKT Chari and Mr Cherian Thomas are senior advisors on the infrastructure projects, Mr LK Narayan, ED, heads Finance and Mr MK Sinha, ED, heads Business Development and Corporate Advisory.

IDFC has historically attracted skilled people. However, increasing shortage of skills at the mid-management level has led IDFC to increase its compensation levels and institute an ESOP programme to attract and retain key employees. IDFC's total employee base is 175 people currently and is expanding rapidly.

Appendix: Infrastructure Industry Outlook

- Infrastructure investments a necessity to sustain 7-8% GDP growth
- Availability of financing no longer an issue; banks are gearing up for the requirements
- Private-Public Partnerships seem the most promising way forward
- Current industry structure is concentrated in a few sectors

Infrastructure – An essential precondition for major economic transformation

We believe the Indian infrastructure sector has just entered the beginning phase of major growth

According to our infrastructure analyst *Venkatesh Balasubramaniam*, a burgeoning population, rapid economic growth and increased urbanization have started making pressing demands on India's existing infrastructure. We believe that in order to maintain rapid economic growth over the next decade and beyond, India will need to invest very significantly in upgrading its infrastructure. Infrastructure investment by the government or the private sector goes a long way in creating employment, catalyzing consumption and providing a kicker to economic growth. Fortunately, the government appears to have recognized the pressing need to upgrade infrastructure.

Figure 48. India Capex Opportunity Matrix

Sector (US $bn)	10th five year plan FY02-07	11th five year plan FY08-10	Growth %	Opportunities
Power	67.5	142.7	111	Shortage of 15% in peak demand Unbundling & open access Ultra mega power projects
Transport	51.6	175.0	239	Significant public-private partnership model for roads
"-Road	30.4	81.1	167	Golden Quadrilateral, rural roads
"-Ports	0.8	19.1	2229	Privatization of ports & airports
"-Airports	1.0	9.0	787	Selective opening up of railways for container traffic
"-Railways	19.5	65.9	239	Urban mass transportation
Telecom	21.5	47.1	119	Low tele-density Gradual liberalization of policies.
Others	50	80	60	Industrial & Commercial SEZs
Total	**190.7**	**444.7**	**133**	

Source: Company Reports

Availability of debt financing no longer an issue

Historically, financing was a big barrier that prevented infrastructure projects from taking off. With interest rates as high as 16-18% in the 1990s and infrastructure projects offering an IRR 14-17%, few infrastructure projects were viable. Private sector investors shied away from investing and the banks were relatively unenthused about providing funding for infrastructure projects.

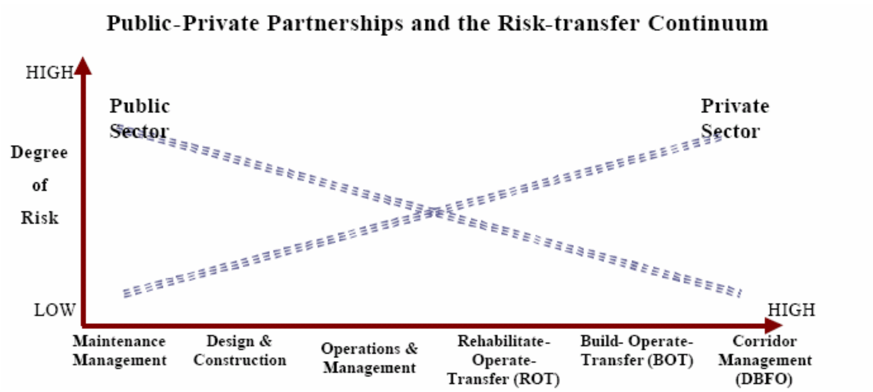
However, interest rates have now declined to levels well below the IRRs offered by infrastructure projects. This has resulted in the weighted average cost of capital for infrastructure projects reducing sharply, making them viable. Consequently, we see rising private sector participation in infrastructure. Bank lending to the infrastructure sector has also increased sharply.

PPP – The most promising way forward

The central and state governments have realized that the funding needs of the infrastructure sector are far beyond its means. This has resulted in a change in policy stance with a spate of roads, ports, airports, power and water BOT projects being announced, tendered and given out. As a consequence, public-private partnerships seems to be the most promising way forward.

The opportunity in infrastructure is becoming more and more appealing for private players with increasing acceptance of PPP model, availability of finance with relative ease and most importantly the realization on the part of the policy makers that huge investment demands by core sector can't be met by the government alone.

Figure 49. Risk/Return Continuum in the Public-Private Partnership



Source: World Bank

Industry analysis - Power

According to our latest estimates in our "India Power Sector Model"[1] India will add 24GW of capacity in the 10th Plan (58% achievement). Further, we expect India to add 54GW in the 11th Plan, an achievement of 71% against targets. Post adding 24GW and 54GW in the 10th Plan and 11th Plans respectively, India would continue to have a peak load deficit of 8.7%, base demand deficit of 7.6% and per capita consumption of power of 824kwh in FY12E.

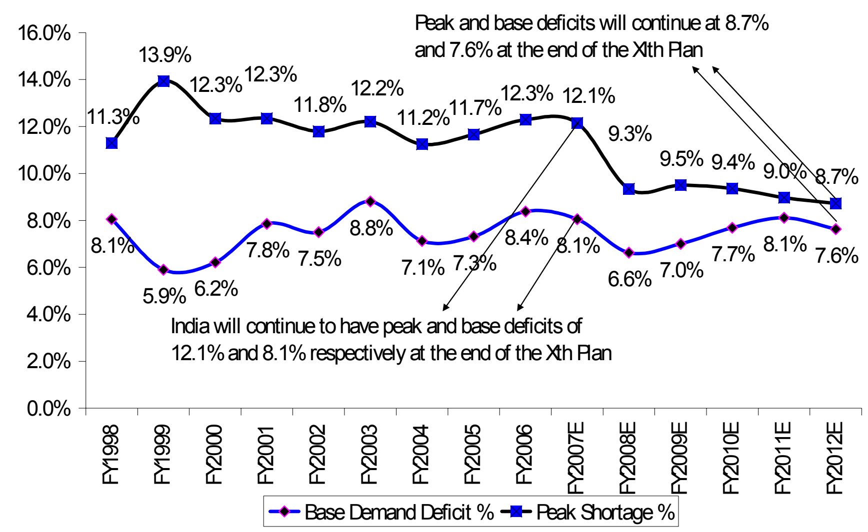
[1] Refer to our NTPC report – "Revisiting The Power Behemoth", on November 28, 2006

Figure 50. India Plan Capacity Addition

Plan Period	Target (GW)	Actual (GW)	Achievement	Growth
V (74-79)	12	10	82%	
VI (80-85)	20	14	72%	39.4%
VII (85-90)	22	21	96%	50.4%
VII (92-97)	31	16	54%	-23.3%
IX (97-02)	40	19	47%	15.8%
X (02-07E)	41	24	58%	26.2%
XI (07-12E)	76	54	71%	125.0%
XII (12-17E)	87	65	75%	20.1%

Source: CEA and Ministry of Power and Citigroup Investment Research

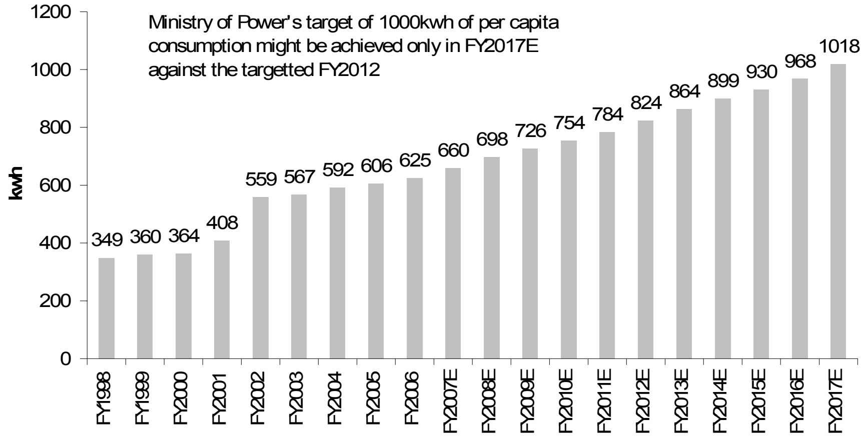
Figure 51. India Base Demand and Peak Load Deficits



Source: CEA and Ministry of Power and Citigroup Investment Research

According to the latest figures available from Central Electricity Authority (CEA) in the *"Requirement of Equipment & Material for Development of Power Sector"* report India is likely to target addition of 86.5GW in the 12th Plan.

Figure 52. India Per Capita Consumption of Power



Source: Citigroup Investment Research estimates

Quick Facts

India has second-largest road network (3.3mn km) in the world

Roads now carry 85% of passenger traffic and 70% of freight traffic.

Highways make up just 2% of the overall road network by length, but account for around 40% of traffic.

Industry Analysis - Roads

To modernize India's national highways and the network of trunk roads linking major economic centers, the National Highways Authority of India (NHAI) devised the National Highways Development Project (NHDP) in FY99 to undertake the NHDP Phase I and NHDP Phase II projects. Rs540bn of road spending was funded through a mix of taxes on petrol, multilateral assistance, as well as through market and private participation.

Figure 53. NHDP / NHAI projects Status as of Feb 2007

	GQ	NSEW - Phase I &II	Phase III A	Phase V	Total	Port Connectivity	Others	Total by NHAI
Total Length (Km)	5,846	7,300	4,000	6,500	23,646	380	945	24,971
Already 4-Laned (Km)	5,540	1,080	30	0	6,650	145	287	7,082
% Completion	**95%**	**15%**	**1%**	**0%**	**28%**	**38%**	**30%**	**28%**
Under Implementation (Km.)	306	5150	1404	148	7008	214	638	7860
Contracts Under Implementation (No.)	35	146	22	2	205	7	16	228
Balance length for award (Km)	-	908	2566	6352	9826	21	20	9867

Source: NHAI

New plans announced to drive growth

The government has ambitious plans drawn up for NHDP Phases III to VII, with most of the projects likely to be undertaken through BOT model, where the central government would extend up to 40% of the project cost as a grant. In addition, there have been discussions about extending taxes on petrol and diesel beyond 2018 to meet the financing requirements.

New projects through the BOT route

Most of the new projects to be awarded under the NHDP are going to be through the Public-Private Partnership route as highlighted below. While this has positive implications for the government in terms of reducing the burden on its finances, it significantly increases the risk profile of the projects as construction companies will now have to invest equity in the projects and assume commercial & financial risk.

Figure 54. Future NHDP Phases and Mode of Implementation

NHDP Phase	Particulars	Cash Contracting	BOT (Toll)	BOT (Annuity)	Length	Estimated Cost
NHDP Phase III	4- Laning		10,000		10,000	652
NHDP Phase IV	2-Laning		5,000	15,000**	20,000	278
NHDP Phase V	6- laning of selected stretches		6,500		6,500	412
NHDP Phase VI	Development of expressways		1,000		1,000	167
NHDP Phase VII	Ring roads, bypass, grade separators, Service roads etc				To be determined	167
Total		**-**	**22,500**	**15,000**	**37,500**	**1,676**

Source: Report of Core Group, Committee on Infrastructure, Citigroup Investment Research estimates. Note :** To be determined based on budgetary resources and the tolling policy for two lane highways

Figure 55. Summary of BOT Projects to Date

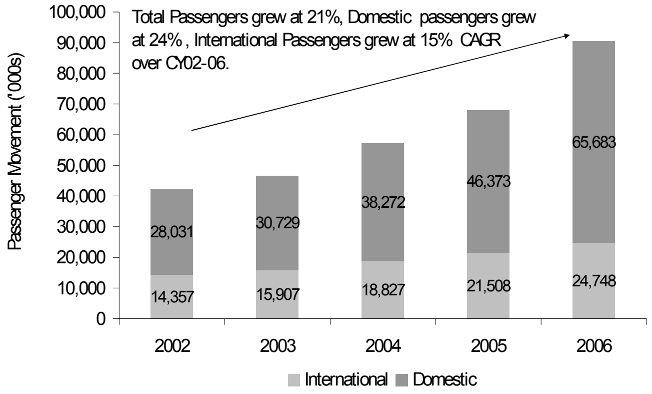
BOT Toll based	Under Implementation				Completed	
Category	No of contracts	Length (km)	Total Project Cost	Grant	No of contracts	Length (km)
NHDP Phase I	9	464	3,443	719	6	287
NHDP Phase II	16	813	5,371	(103)		
NHDP Phase III	17	1,090	5,752	492	1	30
Total	**42**	**2,367**	**14,566**	**1,108**	**7**	**317**
BOT Annuity based	Awarded				Completed	
	No of contracts	Length (km)	Total Project Cost	Annuity	No of contracts	Length (km)
NHDP Phase I	8	476	2354	288.8	8	476
NHDP Phase II	4	299	2121	199		
Total	**12**	**775**	**4475**	**488**	**8**	**476**

Source: PPP in National Highways – Secretary, Dept of Road Transport & Highways, Govt of India (20 May 2006)

Industry analysis – Airports

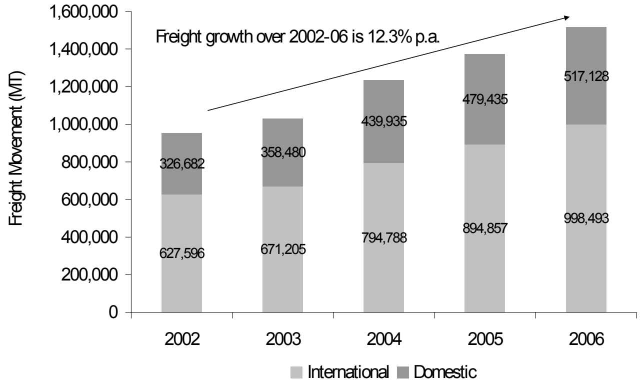
India's booming economy and rapid industrialization have necessitated increased movement of people and goods both domestically and internationally. Growth of tourism in India spawned a host of low-cost carriers which has led to a surge in the airborne passenger traffic as they compete with other options like the railways. This has led to an unprecedented increase in the passenger and cargo traffic across all airports in India stretching the capacities which were not equipped to handle such traffic.

Figure 56. India – Passenger Growth



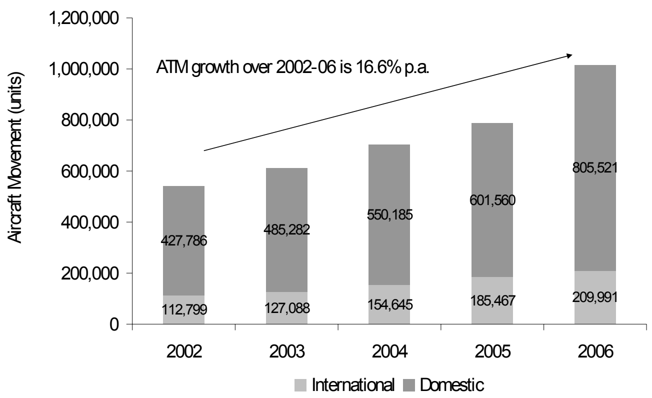
Source: Airports Authority of India

Figure 57. India- Freight Growth



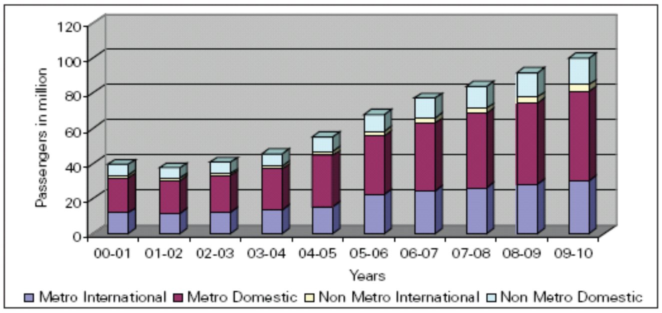
Source: Airports Authority of India

Figure 58. India – Air Traffic Movement Growth (ATM)



Source: Airports Authority of India

Figure 59. Passenger Growth estimates



Source: KPMG

The government has decided to revamp the airport sector and has taken steps in this direction. The Airports Authority of India has already started the process of inviting private sector in the field and has handed over the Delhi and Mumbai airports for development to private sector consortiums. The AAI also has plans to modernize 35 non-metro airports under the airport development plan. The government is now looking to privatize the Kolkata and Chennai Airports as per the Committee of Infrastructure.

Figure 60. Airport Private Investment

Airports	Rsbn
Delhi and Mumbai	114
Bangalore and Hyderabad	40
Chennai and Kolkata	57
Five Greenfield airports	85
City side development	15
Total	**311**

Source: Report of the Task Force - Financing Plan for Airports , Committee on Infrastructure

Appendix A-1

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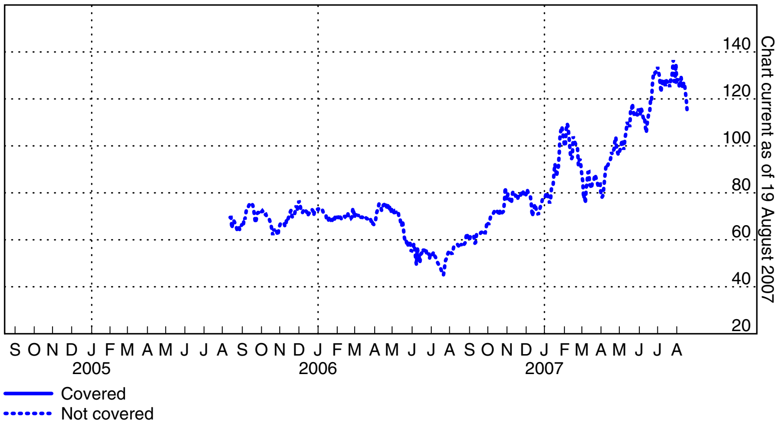

#	Date	Rating	Target Price	Closing Price

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