

MARCH 02, 2010
UPDATE

Coverage view: **Attractive**

Price (Rs): **161**

Target price (Rs): **145**

BSE-30: **16,773**
Valuations expensive, current excitement may not support earnings upgrade.

Positive regulatory changes, the government's impetus for the sector and rumors of a banking license have likely driven the recent spurt in IDFC's stock. However, given the near-term challenges to margins (rising interest rates, implementation of the 'base-rate' benchmark for banks) and our healthy loan growth estimates, we don't find any reason for an earnings revision. Current valuation appears expensive (2.6X PBR FY2011E for RoE of 16-17% and 17% core EPS CAGR between FY2009 and FY2012E). Retain REDUCE.

Company data and valuation summary

IDFC				Forecasts/Valuations				
Stock data				2010	2011E	2012E		
52-week range (Rs) (high,low)		180-44		EPS (Rs)	8.4	9.1	10.6	
Market Cap. (Rs bn)		208.1		EPS growth (%)	18.7	8.0	16.3	
Shareholding pattern (%)				P/E (X)	19.1	17.7	15.2	
Promoters		0.0		NII (Rs bn)	11.0	12.2	14.4	
FII's		43.9		Net profits (Rs bn)	10.9	11.8	13.7	
MFs		5.8		BVPS	54.7	61.9	70.3	
Price performance (%)		1M	3M	12M	P/B (X)	2.9	2.6	2.3
Absolute		9.2	(7.5)	215.9	ROE (%)	16.4	15.6	16.0
Rel. to BSE-30		6.5	(4.9)	67.5	Div. Yield (%)	0.9	0.9	1.1

Pressure on margins in the current environment

We expect IDFC's NIM (calculated as per our estimates, excluding treasury income) to decline marginally to 3.2% in FY2011E from 3.4% in FY2010E due to rising interest rates in the system.

Base rate implementation in banks is a risk. We believe that the rising interest rates will pressure IDFC's margins in the near term. RBI's proposal to benchmark bank lending to a base rate from PLR will likely increase IDFC's borrowings cost in the medium term. Most high-rated bulk borrowers have been enjoying low interest rates for short-to-medium-term loans from banks due to excess liquidity in the system—AAA and AA-rated companies have raised six months to three year loans at 5-7%; the rate of interest on bank loans will move up as loan pricing becomes more methodical for banks. Banks have indicated a base rate of 8-9%, thus all bank loans will need to be priced above these rates. Short-term loans for IDFC form about 15% of the total borrowings.

Classification as an 'infrastructure NBFC' may provide some respite. IDFC may be classified as an 'infrastructure NBFC', a segment carved out by RBI in the recent guidelines. According to RBI, an NBFC should deploy over 75% of its total assets in infrastructure loans to classify as infrastructure NBFC. However, the definition of 'infrastructure loans' is not clear. As of December 2009, about 43% of IDFC's total assets were categorized as 'project loans'; while a large portion of other assets (non-project loans) are also linked to infrastructure, we are not clear if this can be considered for the aforesaid categorization.

Key measures—we find these measures positive though the impact is difficult to quantify:

- ▶ RBI has linked the risk weight for banks' lending to infrastructure NBFCs to its credit rating from 100% risk weight in the past (irrespective of NBFC's credit rating). Thus, risk weight for AAA-rated NBFC would be 20% versus 100% earlier.
- ▶ The single party exposure for bank's lending to infrastructure NBFCs has been increased to 20% of banks net owned funds from 15% earlier—this will improve NBFCs' negotiating power while dealing with banks.

Nischint Chawathe
nischint.chawathe@kotak.com
Mumbai: +91-22-6634-1545

Manish Karwa
manish.karwa@kotak.com
Mumbai: +91-22-6634-1350

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

Higher exposure limits for infrastructure NBFCs. RBI has allowed infrastructure NBFCs to increase their single party exposures by 10%—thus loans to a single corporate can be 25% of NBFC's net owned funds from 15% earlier. In the light of risks in infrastructure lending, most NBFCs follow a stringent single-party exposure norm. As such, we believe NBFCs will be anyway cautious in increasing their large exposure.

We remain positive on business traction

We expect IDFC to report about 21% loan growth in FY2010E and 24% yoy in FY2011E and FY2012E, each within the management guidance of 20-25%. The company has reported about 12% growth till 9MFY10, we are factoring an improvement in traction for 4QFY10, in case of other infrastructure finance companies. Thus, we find limited scope for raising our current EPS estimates—FY2010E: Rs8.4 (consensus Rs8) FY2011E: Rs9.1 (consensus Rs9.3) and Rs10.6 (consensus Rs10.7).

Banking—no game changer in the near term

The stock markets reacted sharply after the Finance Minister's announcement to award new banking licenses given IDFC's strong candidature to procure the same. In case IDFC is converted to a bank, IDFC's near-term earnings will likely decline due to the negative spreads on regulatory requirements for banks though the development may be positive over the longer term.

IDFC management has however clarified that they are not keen to convert themselves into a bank at the current stage. Further, at 2.6XPBR FY2011E, IDFC is more expensive than most private sector banks and hence, we do not expect any move towards a banking license to make much difference for IDFC.

Valuations factor a positive scenario

Our SOTP valuation for IDFC has two key components: (1) The core business (Rs71) and (2) other businesses/investments (these are mainly linked to equity markets and add Rs72 to our SOTP). We analyze the likely implied assumptions that the current market price is building in for these two components.

Case I: High RoE for core business. We believe that IDFC's core business will likely report moderate RoE of 16-17% over the medium term. After adjusting IDFC's market price with our valuation estimate for other business, the core business is trading at 2.5X PBR FY2011E. This implies that the market is factoring about 21% RoE and 18% earnings CAGR over the next ten years versus our core RoE estimate of ~17%. We believe that the core business has limited scope of delivering higher RoEs on the back of low/moderate spreads in the infrastructure-lending business.

Case II: 25% premium to our valuation estimate for other businesses. IDFC's other businesses are primarily market-linked (investment banking, asset management, prop. investments) and will likely report high earnings in the current environment. These businesses have a significant contribution to IDFC's earnings growth in FY2010E and likely optimism on the performance of these segments is one of the key drivers for the stock price appreciation. Earnings from these segments can be patchy, cyclical and challenging to predict due to their strong linkages with equity markets. After adjusting our estimate for IDFC's core business (Rs71, i.e. 1.9X core PBR FY2011E), it appears that the market is assigning a value of Rs88 to these business, 25% above estimate of Rs72. The valuation multiples assigned in our SOTP are already high/in the high-end of mid cycle multiples (1) 18X PER for IDFC SSKI/ NSE , (2) 10-15% of AUM for private equity, (3) 4% of AUM for mutual fund business and 2X book value of equity investments (to capture unrealized gains).

IDFC : Sum-of-the parts-based valuation

	Valuation (Rs mn)	Value per share (Rs)	Comments
IDFC (core)	91,491	71	Based on residual growth model- implies 1.9X core BVPS; we estimate 17% core RoE over next two years
IDFC (India Development fund)	2,250	2	25% of AUMs - US\$200 mn
IDFC (Private equity)	7,728	6	15% of FY2011E AUM - US\$1.15 bn
IDFC (Project equity)	8,400	6	12% of FY2011E AUM - US\$1.4 bn
IDFC investment advisors (PMS)	331	0	10% of FY2011E AUMs - US\$100 mn
IDFC MF	16,250	11	4% of FY2011E AUMs
IDFC SSKI	14,623	11	18X FY2011E PER-100% stake
IDFC's investment in NSE	15,300	12	18X FY2011E PER
Value of market investments	29,634	23	2X book value (including unrealised value)
Total	156,373	142	

Source: Kotak Institutional Equities estimates

Current market price is factoring higher RoE and earnings growth for IDFC

	Our assumptions (data input in model)					What we expect		What the market is assuming	
	Core RoE 2009 (%)	Cost of equity (%)	RoE in steady state (%)	Earnings growth in the steady state (%)	Dividend payout ratio - high growth phase (%)	Growth in earnings - high growth phase (%)	Avg RoE - high growth phase period (%)	Growth in earnings - high growth phase (%)	Avg RoE - high growth phase period (%)
IDFC (core business)	14.1	13	16	7	25	13	17	18	21

Note.

High growth phase is assumed to be between FY2011E and FY2020E

Source: Company, Bloomberg, Kotak Institutional Equities estimates

IDFC (consolidated) key ratios, March fiscal year-ends, 2007-2012E

	2007	2008	2009	2010E	2011E	2012E
Income Statement						
Operating income	64	70	38	2	20	21
Net fund based income	51	63	35	19	11	18
Fee income	160	64	8	41	23	15
On AUM	84	5	287	31	23	13
Other operating income	7	29	(15)	36	(12)	27
Operating expenses	43	228	55	12	20	18
Net profit	60	21	1	44	8	16
Core operating profit (PBT-treasury+provisions)	84	42	16	32	13	16
Balance Sheet						
Assets						
Investments	52	174	40	0	14	11
Infrastructure loans	37	43	3	21	24	24
Total assets	44	61	7	16	21	20
Liabilities						
Loan funds	57	57	7	17	24	23
Total liabilities	52	55	6	16	23	22
Shareholders equity	14	90	10	15	13	13
Key ratios (%)						
Yield on						
Earning assets excld treasury assets	9.1	10.2	11.3	10.3	10.3	10.3
Earning assets incl treasury income and assets	9.7	10.5	11.0	10.3	10.2	10.2
Infrastructure loans	9.3	10.2	11.8	10.5	10.5	10.5
Interest on bank deposits	8.4	16.0	9.9	19.7	18.9	18.0
Average cost of funds	7.2	8.1	9.1	7.7	8.0	8.0
Capital gains to eqty investments	21.3	20.6	10.1	11.2	9.0	9.7
NIM (excl treasury inc)	2.8	3.0	3.2	3.4	3.2	3.1
Op.exp to average assets	0.5	1.1	1.3	1.3	1.3	1.3
Operating expnses/ income	9.0	18.9	24.8	21.8	23.5	23.5
Du Pont (%age of average assets)						
Net interest income	2.8	3.0	3.1	3.3	3.1	3.1
Loan loss provisions	0.1	0.3	0.5	0.2	0.2	0.3
Other operating income	2.7	2.7	2.1	2.6	2.5	2.4
Operating expenses	0.5	1.1	1.3	1.3	1.3	1.3
Invt. depreciation	—	—	—	—	—	—
ROA	4.1	3.2	2.5	3.3	3.0	2.9
Average assets/average equity	5.5	5.5	5.0	5.0	5.2	5.5
ROE	22.6	17.6	12.9	16.4	15.6	16.0

Source: Company, Kotak Institutional Equities estimates

IDFC (consolidated) : Income statement and balance sheet, March fiscal year-ends, 2007-2012E

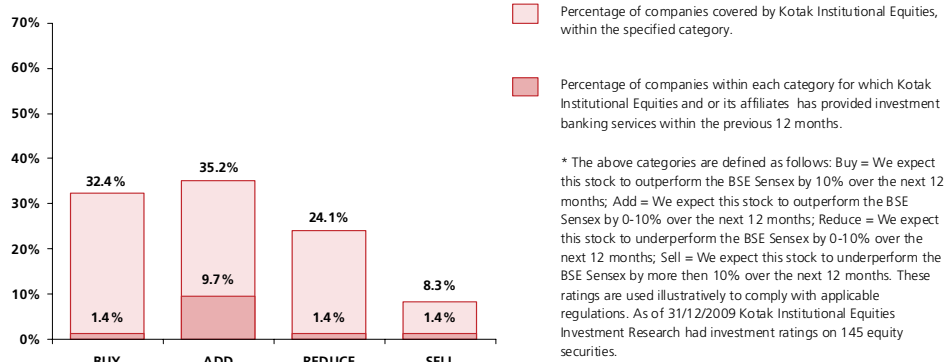
	2007	2008	2009	2010E	2011E	2012E
(Rsmn)						
Total income	16,917	27,928	36,339	39,383	46,483	55,994
Operating income	12,778	21,700	30,032	30,668	36,695	44,514
Dividend	91	62	542	149	156	183
Interest on deposits	100	—	—	—	—	—
Other charges	136	101	-	15	15	15
Net fund based income	4,223	6,866	9,237	11,031	12,218	14,421
Less: provisions for NPLs	174	688	1,495	796	975	1,380
Net fund based income post provisions	4,049	6,178	7,742	10,235	11,243	13,041
Fee income	2,406	3,944	4,253	5,990	7,365	8,460
SSKI	—	1,873	1,071	1,809	2,242	2,579
Fees - upfront fees, prepayments	—	—	—	—	—	—
On guarantees/commissions- standalone	656	1,515	1,032	1,365	1,672	1,967
Fees on AMC	528	556	2,150	2,816	3,451	3,914
Net operating income	8,137	12,288	13,835	18,736	20,817	24,307
Operating expenses	745	2,447	3,795	4,251	5,117	6,039
Profit before tax	7,444	9,959	10,254	14,699	15,913	18,482
Tax	1,235	2,463	2,697	3,799	4,138	4,789
Net profit	6,209	7,496	7,558	10,900	11,775	13,692
% growth	60	21	1	44	8	16
Minority interest	—	143	62	-	-	-
Net profit post minority interest	6,209	7,353	7,495	10,900	11,775	13,692
PBT - treasury	5,710	7,675	8,201	11,974	13,490	15,462
% chg	112	34	7	46	13	15
PBT - treasury + provisions	5,884	8,363	9,695	12,770	14,465	16,842
No. of shares	1,126	1,294	1,295	1,295	1,295	1,295
Balance Sheet						
Assets						
Mutual Funds	3,477	7,148	-	-	-	-
Equity Shares	6,147	12,606	19,652	17,687	21,225	24,408
Venture Capital Units	954	1,273	2,983	4,386	5,935	6,131
Infrastructure loans	139,155	199,024	205,918	249,020	308,258	381,903
Current assets	18,287	28,674	18,987	23,435	27,297	30,236
Fixed assets	486	3,812	4,449	4,596	4,766	4,963
Other assets	854	953	1,393	1,463	1,536	1,613
Total assets	178,506	286,600	306,530	354,566	428,538	514,919
Liabilities						
Subordinated debt (unsecured)	6,500	6,500	6,500	6,500	6,500	6,500
Loan funds	137,136	214,784	229,259	267,536	331,603	406,558
Current liabilities and provisions	5,561	9,484	9,101	9,632	10,202	10,812
Total liabilities	149,197	230,767	244,860	283,669	348,305	423,870
Paid-up capital	11,259	12,943	12,953	12,953	12,953	12,953
Reserves and surplus	18,049	42,889	48,717	57,945	67,280	78,096
Shareholders equity	29,308	55,832	61,670	70,898	80,233	91,048

Source: Company, Kotak Institutional Equities estimates

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Source: Kotak Institutional Equities

As of December 31, 2009

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ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

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Corporate Office

Kotak Securities Ltd.
Bakhtawar, 1st Floor
229, Nariman Point
Mumbai 400 021, India
Tel: +91-22-6634-1100

Overseas Offices

Kotak Mahindra (UK) Ltd
6th Floor, Portsoken House
155-157 The Minories
London EC 3N 1 LS
Tel: +44-20-7977-6900 / 6940

Kotak Mahindra Inc
50 Main Street, Suite No.310
Westchester Financial Centre
White Plains, New York 10606
Tel:+1-914-997-6120

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