Infrastructure Development Finance (IDFC.BO)

Target price change ☑
Estimate change ☑

Sell: Capital Pressures

- **Reduce earnings and target price, maintain Sell (3M)** — Stock's down 54% from peak, but we maintain our Sell recommendation. We also cut our target price to Rs112 (from Rs195) on a mix of lower earnings (reduce 28-30% over FY09-10E) and lower target multiple (2x PBV 1yr fwd, from 3x FY09E). More importantly, here's why we believe IDFC's business outlook is challenging:

- **A) Up goes capital adequacy, down goes growth** — RBI has proposed raising capad for NBFCs to 15% (10%). This fundamentally lowers IDFC's leverage and ROE profile, raises its capital raising frequency, and further challenges its competitiveness to banks. Cumulatively, it risks IDFC's strong growth outlook.

- **B) Down goes liquidity, up go funding costs** — IDFC's wholesale funding platform suffers in a rising rate environment, on availability and pricing. With 2yr bond yields up 200bps since Feb (and AAA spreads a further 25bps) and a further tightening outlook, IDFC's funding could be further strained.

- **C) Down goes the market, down go IDFC's revenues** — Up to 50% of IDFC's revenues come from gains on principal equity investments, asset management and brokerage revenues. We believe all of these will now be at risk.

- **Business is OK for now, probably not its value** — IDFC's 1Q09 will probably be fine on growth and quality and will possibly meet expectations. But we expect it to get progressively tougher with earnings and valuation pressures ahead.

Sell/Medium Risk	**3M**
Price (14 Jul 08)	Rs106.70
Target price	Rs112.00
from Rs195.00	
Expected share price return	5.0%
Expected dividend yield	1.2%
Expected total return	**6.2%**
Market Cap	Rs138,200M
	US$3,230M

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

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	5,039	4.48	21.7	23.8	4.1	18.3	0.9
2008A	7,422	6.13	36.8	17.4	2.5	17.4	1.1
2009E	7,971	6.16	0.4	17.3	2.2	13.5	1.2
2010E	10,369	8.01	30.1	13.3	2.0	15.7	1.3
2011E	11,716	9.05	13.0	11.8	1.7	15.6	1.4

Source: Powered by dataCentral

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

[1]Citigroup Global Markets India Private Limited

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	23.8	17.4	17.3	13.3	11.8
P/E reported (x)	23.8	17.4	17.3	13.3	11.8
P/BV (x)	4.1	2.5	2.2	2.0	1.7
P/Adjusted BV diluted (x)	4.1	2.5	2.2	2.0	1.7
Dividend yield (%)	0.9	1.1	1.2	1.3	1.4
Per Share Data (Rs)					
EPS adjusted	4.48	6.13	6.16	8.01	9.05
EPS reported	4.48	6.13	6.16	8.01	9.05
BVPS	26.18	43.21	47.85	54.23	61.52
Tangible BVPS	26.18	43.21	47.85	54.23	61.52
Adjusted BVPS diluted	26.18	43.21	47.85	54.23	61.52
DPS	1.00	1.20	1.30	1.40	1.50
Profit & Loss (RsM)					
Net interest income	4,056	5,811	7,851	9,316	10,664
Fees and commissions	1,239	4,013	4,562	6,878	8,203
Other operating Income	1,863	3,413	2,387	2,964	3,508
Total operating income	**7,158**	**13,236**	**14,799**	**19,158**	**22,375**
Total operating expenses	-821	-2,532	-3,356	-4,244	-5,368
Oper. profit bef. provisions	**6,337**	**10,704**	**11,443**	**14,914**	**17,007**
Bad debt provisions	-175	-700	-796	-1,054	-1,332
Non-operating/exceptionals	118	46	46	46	46
Pre-tax profit	**6,280**	**10,050**	**10,693**	**13,906**	**15,721**
Tax	-1,241	-2,480	-2,662	-3,465	-3,919
Extraord./Min. Int./Pref. Div.	0	-148	-60	-72	-86
Attributable profit	**5,039**	**7,422**	**7,971**	**10,369**	**11,716**
Adjusted earnings	5,039	7,422	7,971	10,369	11,716
Growth Rates (%)					
EPS adjusted	21.7	36.8	0.4	30.1	13.0
Oper. profit bef. prov.	28.2	68.9	6.9	30.3	14.0
Balance Sheet (RsM)					
Total assets	**183,840**	**289,411**	**349,900**	**414,893**	**491,979**
Avg interest earning assets	146,517	221,917	298,364	357,209	423,469
Customer loans	139,459	199,334	250,615	299,853	360,256
Gross NPLs	506	275	351	900	1,717
Liab. & shar. funds	**183,840**	**289,411**	**349,900**	**414,893**	**491,979**
Total customer deposits	0	0	0	0	0
Reserve for loan losses	275	283	606	1,163	1,847
Shareholders' equity	**29,476**	**55,933**	**61,935**	**70,184**	**79,628**
Profitability/Solvency Ratios (%)					
ROE adjusted	18.3	17.4	13.5	15.7	15.6
Net interest margin	2.77	2.62	2.63	2.61	2.52
Cost/income ratio	11.5	19.1	22.7	22.2	24.0
Cash cost/average assets	0.5	1.1	1.1	1.1	1.2
NPLs/customer loans	0.4	0.1	0.1	0.3	0.5
Reserve for loan losses/NPLs	54.4	102.8	172.8	129.2	107.5
Bad debt prov./avg. cust. loans	0.1	0.4	0.4	0.4	0.4
Loans/deposit ratio	na	na	na	na	na
Tier 1 capital ratio	15.6	19.5	17.6	16.8	16.0
Total capital ratio	19.6	22.2	19.7	18.6	17.5

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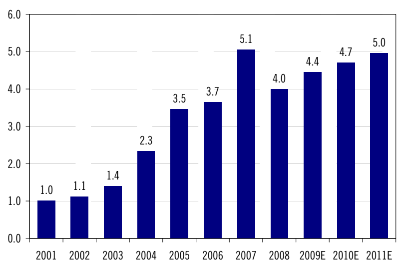
Figure 1. IDFC: Earnings Revision Summary

	Net Profit			EPS			DPS	
	Old	New	% change	Old	New	% change	Old	New
FY09E	11,412.6	7,971	-30.2	8.8	6.2	-30.2	1.2	1.3
FY10E	14,434.4	10,369	-28.2	11.2	8.0	-28.2	1.2	1.4
FY11E	NA	11,716	NA	NA	9.1	NA	NA	1.5

Source: Citi Investment Research

Capital requirements – likely to be raised

Figure 2. IDFC: Debt – Equity Ratio



Source: Company Reports and Citi Investment Research estimates

We believe a regulatory increase in capital requirements will impact growth in IDFC's infrastructure lending portfolio (has been growing at ~40% for the last 3-4 years). Fundamentally higher capital will constrain IDFC's ability to leverage its capital meaningfully beyond current levels, lower its already challenged return profile and increase risks and capital requirements. At the stock level, we believe it will tend to act as a cap on valuations for the lending business.

RBI has recently proposed to hike capital adequacy requirements for non-banking finance companies (NBFCs) in two stages to 15% (currently 10%) effective April, 2009. While the guideline is still in the draft stage, we believe that the probability of this being notified is high. Moreover, specifically for IDFC, rating agencies have historically insisted on a significant cushion (over the regulatory minimum) to maintain its highest (AAA) domestic credit rating. Currently its capital adequacy is about 18%. While IDFC has significant room to raise Tier 2 capital, it will come at a relatively high cost and still does not satisfy requirement of rating agencies.

Funding – no longer cheap and abundant

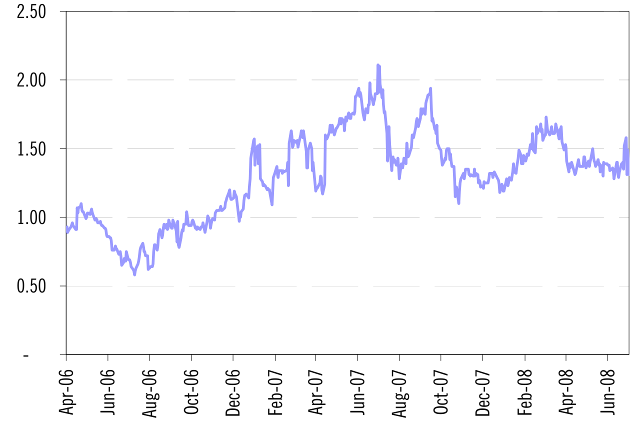
Wholesale funding is no longer easily available. This is likely to impact net interest margins and balance sheet growth over the medium term. While NIMs are currently fine, we expect pressures to build up progressively.

Domestic liquidity has tightened with availability of surplus funds coming down significantly. Cost of funds has increased substantially. Yields on 2yr government securities have increased about 200bps in the last 3-4 months. Moreover, AAA corporate spreads have also widened by 25bps during this period. We believe this will further challenge IDFC's ability to raise capital at affordable costs.

Figure 3. Yield on 2 Year Government Bonds, Percent

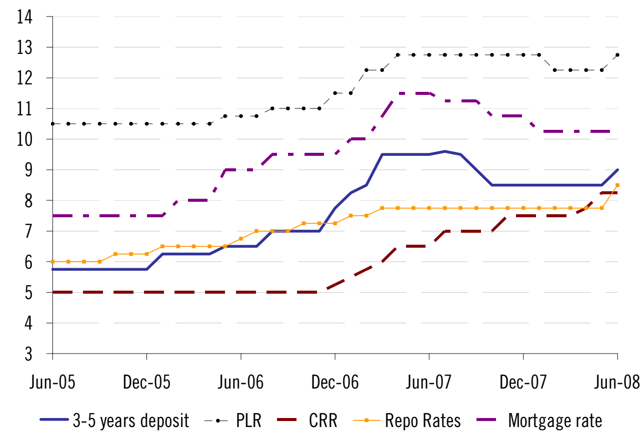
Source: Citi Investment Research

Figure 4. 5 Year AAA Corporate Spread, Percent



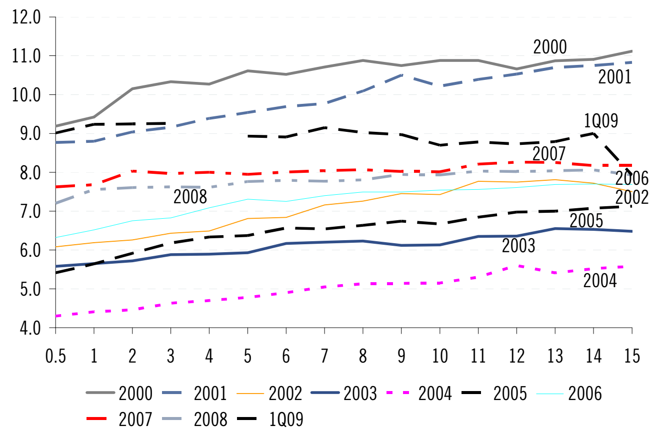
Source: Citi Investment Research

Figure 5. India - Movement of Key Interest Rates



Source: Citi Investment Research

Figure 6. Yield Curve has Inverted

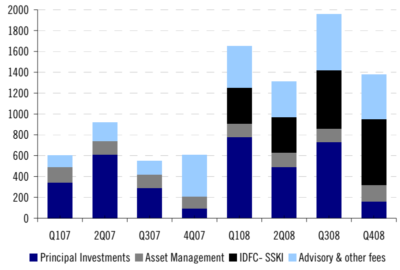


Source: Citi Investment Research

Capital market related incomes are significant

Capital market related segments contribute over 50% of IDFC's revenues. These are primarily from a) brokerage and investment banking; b) investments in equity markets; and c) asset management. We are lowering our revenue estimates for these segments by 30-40% due to continued uncertainty in the outlook for domestic equity markets. Increased capital market uncertainty and a weak outlook increases volatility and further risks earnings in these segments.

Figure 7. IDFC: Segmental Fee Incomes (Rsm)



Source: Company Reports

Business is Fine – but risks are increasing

IDFC's lending business is characterized by high, stable loan growth and strong asset quality, albeit with modest profitability. We believe risks to each of these are progressively increasing:

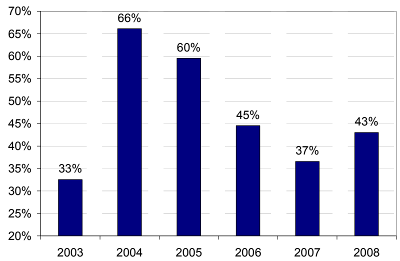
1. Slower GDP growth outlook and higher capital requirements are likely to bring down its historically high growth rates. We now estimate loan growth to slow down to 25% levels from 40% earlier.

2. We expect higher funding costs (and operating cost pressures) to strain its already challenged profitability in the lending business (typically about 10-12% ROEs). While near term margins should remain protected, we see medium term pressures due to increased borrowing costs.

3. Moreover, with increased uncertainty and weakness in capital markets, IDFC's non-interest incomes are likely to be volatile and under pressure. This will likely strain overall profitability over the medium term.

4. With growth slowing down, there is likely to be a trade-off between growth and margins. We are already seeing initial signs of the pressure building up with resultant higher risk exposures on its balance sheet. Its real estate segment is now about 6% of total exposure and proportion of loans against securities have risen to about 10%.

Figure 8. IDFC – Historical Loan Growth (%)



Source: Company Reports and Citi Investment Research

Valuations

We value IDFC at Rs112 based on a sum of parts basis. We value the core lending business (ex brokerage and AMC) at Rs79 per share, based on 2x 1yr Fwd P/BV (3x FY09E PBV earlier). For the asset management businesses, we value the private equity segment at Rs17 (Rs23) on higher risk-free rates and lower return assumptions, and we value the domestic AMC segment (Stanchart) at Rs5. We value SSKI stake at Rs5 (Rs14) based on 12x 1yr Fwd earnings (22x FY09E previously). Also we are not attributing any value to the unrealized equity gains due to the continued uncertainty in equity markets.

At a consolidated level IDFC trades at 2.2x FY09E BV and 17.3x FY09E earnings and is trading at par with quality private sector banks. We maintain our view that non-banking platforms (such as IDFC's) should trade at discounts to quality banks as they lack a commensurate liability and in some cases asset franchise. We reiterate our Sell (3M) recommendation.

Figure 9. IDFC: Sum Of The Parts Valuation

Business	Basis	Per Share (New)	Per Share (Old)	Remarks
Lending Business	BV	79	149	2x 1yr Fwd BV
Asset Management	DCF	17	23	DCF
Unrealized Equity Gains - Quoted	NAV	0	3	NAV
Unrealized gains on NSE Stake	NAV	6	6	Transaction value
SSKI Stake	NAV	5	14	12x 1yr Fwd PE
Stanchart AMC	AUM	5	0	5% of AUMs
Total		**112**	**195**	

Source: Citi Investment Research

Figure 10. Private Banks – Valuation Comparison (FY09E)

	Price (Rs)	P/E (x)	P/B (x)	ROE (%)	ROA (%)	Div. Yield (%)
ICICI Bank	579.9	13.4	1.3	10.0%	1.2%	2.0%
HDFC Bank	1032.7	18.6	2.4	15.1%	1.4%	0.8%
AXIS Bank	635.8	17.0	2.3	14.6%	1.1%	1.0%
Kotak Mahindra Bank	492.8	16.5	2.6	16.7%	2.4%	0.2%
IDFC	106.7	17.3	2.2	13.5%	2.5%	1.2%
Yes Bank	118.2	14.4	1.9	15.6%	1.1%	0.0%

Source: Citi Investment Research (prices as of July 14, 2008)

Figure 11. IDFC: 1Q09 Results Preview (Rupees Million, Percent)

INR Mn	1Q09E	1Q08	YoY (%)	4Q08	QoQ (%)
Interest Income	6,714	4,438	51%	6,321	6%
Interest Expense	-4,807	-3,112	54%	-4,451	8%
Net Interest Income	1,907	1,326	44%	1,870	2%
Fee-Based Income	971	870	12%	1,220	-20%
Other Non-Interest Income	335	790	-58%	160	109%
Non Interest Income	1,306	1,660	-21%	1,380	-5%
Operating Income	**3213**	**2986**	**8%**	**3250**	**-1%**
Operating Expenses	-862	-498	73%	-863	0%
Pre-Provision Profit	2351	2488	-6%	2387	-2%
Charges for Bad Debts	-154	-63	144%	-400	-61%
Pre-Tax Profit	**2196**	**2425**	**-9%**	**1988**	**11%**
Tax	-469	-582	-19%	-503	-7%
Minorities	0	-33	-100%	7	-100%
Net Profit	**1727**	**1810**	**-5%**	**1492**	**16%**
EPS	1.3	1.6	-17%	1.2	16%

Source: Company reports, Citi Investment Research estimates

Infrastructure Development Finance

Company description

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

Investment strategy

We rate IDFC shares Sell/Medium Risk (3M) with an Rs112 target price. IDFC appears particularly well positioned to benefit from India's large infrastructure opportunity. We believe IDFC has a quality management team, is one of the few pure plays on infrastructure financial services and offers long-term growth potential.

However, we believe IDFC faces significant challenges – regulatory, competitive and capital market related. The stock has corrected significantly, but the macro (and business) headwinds will likely pressure IDFC's fundamentals over the medium term. Specifically we expect challenges for IDFC's a) cost of funds, b) net interest margins, c) capital market related fee incomes, d) asset quality, and e) profitability.

IDFC's key challenges come from a) Higher capital requirements – RBI has recently sought to increase capital adequacy to 15% (from 10% now); b) Competition – from larger scale and lower funding cost banks; b) Wholesale funding – borrowing costs are exposed to sharp hikes in interest rates and tightness in market liquidity; c) Business model – relatively higher portfolio concentrations as against banks; d) Finance company platform – limits leverage relative to banks; and e) Capital market related revenues – over 50% of IDFC's revenues are linked to capital markets. Given current weak equity outlook, we expect these revenues to be under significant risks.

Valuation

We value IDFC at Rs112 (Rs195 earlier) based on our sum-of-parts methodology. We value IDFC's core lending business at Rs79 per share (Rs149). We prefer a P/BV multiple of 2.0x 1yr Fwd BV (3.0x FY09E BV) benchmarked towards the lower band private banks' target P/BV multiples, with a sub-15% core ROE. This reflects IDFC's premium positioning in the infrastructure segment, strong management, long track record of low asset risks and relatively high growth profile. However, its target multiple is constrained by its lack of retail asset, liability and distribution franchises relative to premier private bank franchises.

For the asset management business we prefer to use a DCF approach and value this business at Rs22 per share (Rs23) sub-divided into Rs17 for the private equity segment and Rs5 for the Stanchart AMC business. We now value IDFC's stake in SSKI at Rs5 per share (Rs14) per share based on 12x 1yr Fwd profits (22x FY09E profits). Finally, we also add Rs6 (Rs9) for IDFC's unrealized investment gains including the NSE.

Risks

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

Other companies mentioned:

ICICI Bank (ICBK.BO; Rs579.85; 1L)

HDFC Bank (HDBK.BO; Rs1,032.70; 1L)

AXIS Bank (AXBK.BO; Rs635.80; 1L)

Kotak Mahindra Bank (KTKM.BO; Rs492.75; 2M)

Yes Bank (YESB.BO; Rs118.15; 1M)

Appendix A-1

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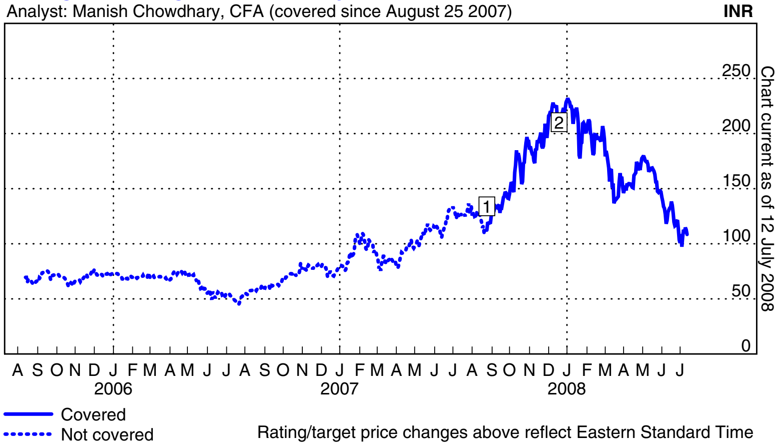
IMPORTANT DISCLOSURES

Infrastructure Development Finance (IDFC.BO)

Ratings and Target Price History - Fundamental Research

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



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

*Indicates change.

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Citi Investment Research Ratings Distribution ***Data current as of 30 June 2008***	**Buy**	**Hold**	**Sell**

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% of companies in each rating category that are investment banking clients	53%	52%	42%

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