

Company Results Review

31 January 2007 | 7 pages

IL & FS Investsmart (ILFI.BO)

Sell: 3Q07 Results - Disappointing Quarter, No Revival Yet

- 3Q07 results: well below expectations** — Investsmart's 3Q07 profits of Rs83m are 49% lower than estimates and 58% and 33% lower yoy and sequentially. Operationally, no signs of a revival yet; it continues to lose market share and management still appears in transition. Maintain Sell/ Medium Risk.
- Lack of momentum, market share** — Though capital market volumes are up 30% qoq, Investsmart's revenues have declined 28% qoq. Where we were expecting only a modest revival, it has not come. Investsmart continues to lose market share, and the lack of business momentum this year has hit the core business hard. We see further flux, at least at the operational level, over the near term.
- E*Trade has extended offer deadline, transition period** — E*Trade has extended its open offer for 20% shares to 13th February, 2007. It is now the dominant shareholder and appears to be driving strategy and positioning over the medium term and possible upsides as well. Near term though, there still remains a period of transition and rebuilding.
- Fundamental value lower, recommend exit** — We believe the fundamental value is closer to our target price of Rs161. The current market price appears driven by the open offer price of Rs210; we recommend investors exit at the current price or during the offer period.

Sell/Medium Risk	3M
Price (31 Jan 07)	Rs204.55
Target price	Rs161.00
Expected share price return	-21.3%
Expected dividend yield	1.3%
Expected total return	-20.0%
Market Cap	Rs14,177M US\$322M

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



Figure 1. Statistical Abstract (Rupees Million)

Year to	Net Profit	FD EPS	EPS Growth	P/E	P/BV	ROAE	ROAA	Div Yld
March	(Rs Mils.)	(Rs)	(%)	(X)	(X)	(%)	(%)	(%)
FY05	330.6	9.4	50%	21.6	8.2	44.4	17.0	1.1
FY06	691.2	13.6	44%	15.0	2.1	18.5	11.7	1.6
FY07E	674.1	10.1	-26%	20.3	1.9	9.9	6.8	1.3
FY08E	799.3	11.9	19%	17.1	1.8	10.9	7.6	1.3
FY09E	815.2	12.2	2%	16.8	1.7	10.2	7.3	1.3

Source: Citigroup Investment Research

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See page 5 for Analyst Certification and important disclosures.

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	21.7	15.1	20.3	17.1	16.8
P/E reported (x)	21.7	15.1	20.3	17.1	16.8
P/BV (x)	8.3	2.1	1.9	1.8	1.7
P/Adjusted BV diluted (x)	8.3	2.1	1.9	1.8	1.7
Dividend yield (%)	1.1	1.6	1.3	1.3	1.3
Per Share Data (Rs)					
EPS adjusted	9.45	13.56	10.07	11.94	12.18
EPS reported	9.45	13.56	10.07	11.94	12.18
BVPS	24.75	98.68	105.52	114.46	123.64
Tangible BVPS	24.75	98.68	105.52	114.46	123.64
Adjusted BVPS diluted	24.75	98.68	105.52	114.46	123.64
DPS	2.33	3.22	2.73	2.73	2.73
Profit & Loss (RsM)					
Net interest income	5	51	287	365	378
Fees and commissions	1,098	2,010	1,857	2,152	2,408
Other operating Income	39	89	98	105	114
Total operating income	1,142	2,150	2,242	2,622	2,900
Total operating expenses	-652	-1,139	-1,219	-1,408	-1,661
Oper. profit bef. provisions	490	1,011	1,023	1,214	1,239
Bad debt provisions	0	-2	-6	-9	-9
Non-operating/exceptionals	-3	-4	0	0	0
Pre-tax profit	487	1,006	1,017	1,206	1,230
Tax	-156	-314	-343	-406	-414
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	331	691	674	799	815
Adjusted earnings	331	691	674	799	815
Growth Rates (%)					
EPS adjusted	49.6	43.6	-25.7	18.6	2.0
Oper. profit bef. prov.	63.1	106.3	1.2	18.7	2.0
Balance Sheet (RsM)					
Total assets	2,127	9,722	10,189	10,800	11,428
Avg interest earning assets	1,187	4,529	7,672	7,905	8,239
Customer loans	734	2,548	5,346	3,208	4,010
Gross NPLs	0	0	0	0	0
Liab. & shar. funds	2,127	9,722	10,189	10,800	11,428
Total customer deposits	0	0	0	0	0
Reserve for loan losses	0	0	0	0	0
Shareholders' equity	866	6,604	7,061	7,660	8,274
Profitability/Solvency Ratios (%)					
ROE adjusted	44.4	18.5	9.9	10.9	10.2
Net interest margin	0.4	1.1	3.7	4.6	4.6
Cost/income ratio	57.1	53.0	54.4	53.7	57.3
Cash cost/average assets	33.6	19.2	12.2	13.4	14.9
NPLs/customer loans	0.0	0.0	0.0	0.0	0.0
Reserve for loan losses/NPLs	na	na	na	na	na
Bad debt prov./avg. cust. loans	0.1	0.1	0.2	0.2	0.3
Loans/deposit ratio	na	na	na	na	na
Tier 1 capital ratio	na	na	na	na	na
Total capital ratio	na	na	na	na	na

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Figure 2. 3Q07 Results: Key Highlights (Rupees Million)

	3Q07	3Q06	YoY %	2Q07	QoQ%
Income from Operations	165	463	-64.4	228	-27.7
Other Income	30	15	93.9	11	181.3
Gross Total Income	195	479	-59.3	239	-18.4
Interest expense	(15)	(3)	322.9	(4)	311.0
Total Operating Income	180	475	-62.1	235	-23.4
Operating Expenses	(39)	(185)	-78.8	(66)	-40.3
Pre-Tax Profit	141	290	-51.5	169	-16.9
Tax	(58)	(96)	-39.3	(46)	27.8
Net Profit	83	194	-57.5	124	-33.4

Source: Company Reports and Citigroup Investment Research

IL & FS Investsmart

Company description

IL&FS Investsmart was established as a fully owned subsidiary of IL&FS Ltd. in 1997. IL&FS is a Non-Banking Finance Company (NBFC) engaged in infrastructure lending, formulating policy and financing of infrastructure investments. E*Trade has increased its stake in Investsmart to about 38% currently and is the single largest shareholder. Investsmart and its subsidiaries engage in various businesses including: retail and institutional brokerage, distribution of equity research products and third-party financial products such as mutual funds and insurance products, margin financing, project syndication, portfolio management, merchant banking and also commodity broking. Investsmart has also entered into insurance training through one of its subsidiaries. Investsmart operates through a franchisee business model in addition to its own branches, and has built a sizeable customer base of about 100,000 customers as at November 2006. The company operates in over 90 cities and over 210 offices.

Investment thesis

We rate Investsmart Sell/Medium Risk (3M) with a target price of Rs161. Investsmart's 1H07 earnings have been below expectations due to a drop in secondary market volumes and sharp reduction in primary market and investment banking activity. Though the ban on new account openings has been lifted, the company has yet to pick up significant momentum on its core retail broking and margin finance businesses. E*Trade now appears to be the dominant shareholder and would likely drive the strategy, positioning and growth over the medium term, however, over the immediate term, there is a likely period of transition.

We believe that E*Trade adds longer-term value to the company in terms of a) an established and stronger brand, b) strategic positioning of the businesses and c) longer-term stronger growth, especially on the retail distribution franchise. In the immediate term, however, we see the business model still evolving and relative lack of strategic clarity for the different businesses including investment banking. E*Trade has committed management resources to Investsmart, and we expect more strategic clarity and direction post completion of the open offer.

In the current context, however, we believe that the fundamental value of the

stock is lower at Rs161 and the stock price is supported by the open offer price of Rs210. We recommend investors exit at current prices or tender shares during the offer period.

Valuation

Our target price of Rs161 is based on a 15% discount to the Sensex P/E on a 1-year forward multiple. We are increasing the discount to factor in lower capital market volumes and a meaningful slowdown in Investsmart's capital markets business. This translates into 14.6x 1-year forward EPS, or Rs161. We also benchmark Investsmart off a 1.4x 1-year forward P/BV for a 10% FY07E RoE. This translates into a fair value of Rs154. We apply a 65% discount to the Sensex 1-year forward P/BV of 4.0x (on a 23.7% expected RoE for FY07). We believe this discount factors in the substantially lower RoE that Investsmart earns. Our target price is based on our P/E-based valuation methodology, which we believe is appropriate given the relatively similar nature of Investsmart's capital markets businesses - both equity and debt - and it being largely fee-based business.

Risk

We rate Investsmart as Medium Risk based on Investsmart's diversified capital markets franchise and the relatively low-risk approach of management - a franchise model and substantial capital infusion that lends a basic cushion to the business. Its ownership structure (i.e., a large domestic government-owned financial institution) also provides a slight hedge against any meaningful (though non-business related) developments, in our view.

Key risks to our target price include the following: a) Its businesses and earnings are highly correlated to the capital markets, which could result in significant volatility. The capital markets related broking and IPO Finance businesses could perform better than expected. b) Margin financing - Faster expansion of margin finance portfolio and lower than expected losses on this portfolio. c) Earlier than expected execution of strategic expansion for the retail broking and distribution businesses.

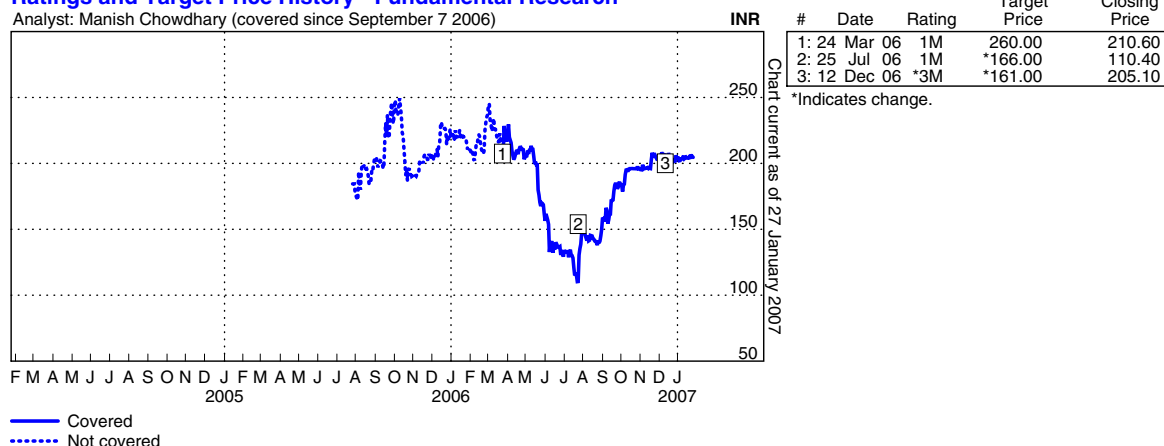
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Analyst: Manish Chowdhary (covered since September 7 2006)



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