Emkay Research

Credit Rating Sector

Basel II Booster

- Basel II norms - opens a new set of opportunities
- India in the midst of a structural investment overdrive
- Under penetrated corporate bond market offers huge market potential
- High earning visibility - CAGR of 40% in revenues and earnings
- Compelling valuations

Reco	Company	CMP (Rs)	TP (Rs)
BUY	ICRA	551	750
BUY	CRISIL	3316	4150

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Synopsis

The credit rating business in India is in a sweet spot as it is on the cusp of robust growth potential, driven by three triggers a) strong CapEx cycle in Indian economy b) lower penetration of corporate bond market and c) regulatory push, due to implementation of Basel II norms.

The outstanding project investments in India have grown at a CAGR of 39% over FY03-08 to USD1.5tn (Source: CMIE) driven by increased outlay on a) industrial CapEx by corporates and b) increased expenditure on infrastructure. For such large investments, debt financing would be very critical. Besides that, the total amount of *private non-financial* instruments rated by the Indian credit rating agencies in FY08 was just USD8bn. That speaks volumes about the abysmally low levels of penetration in the industry.

However, the introduction of Basel II norms is likely to give a big boost to the rating business in India. The number of entities to be rated is likely to expand to 6,500 over the next 2-3 years from the current 1,400 (source: CRISIL). We expect a big volume boost from implementation of the Basel II norms for credit rating agencies, albeit with the pricing on a tricky wicket.

Based on the above factors, we believe CRISIL and ICRA, which are the only listed rating companies in India, are likely to grow at a CAGR of ~40%, in terms of revenue as well as earnings over the next two years. We believe that a confluence of strong fundamentals, high earnings visibility and favourable regulations ensure superior stock performance of these companies. We initiate coverage on CRISIL and ICRA with a BUY rating and a target price of Rs4,150 and Rs750 respectively.

Strong capex cycle in Indian economy to increase debt activity

Credit rating agencies in India are likely to benefit significantly from the strong investment environment in the Indian economy. The outstanding project investments in India, at the end of March 2008, were pegged at USD1.5tn, driven by an upturn in the CapEx cycle for industrial and infrastructure CapEx. The outstanding industrial CapEx as on March 2008 has grown at CAGR of 31.7% over the last five years to USD856bn. Moreover, the Planning Commission has estimated that infrastructure investment ought to grow from the current levels of around 4.6% of GDP to 8%, for sustaining over 8% real GDP growth, as envisioned in the Eleventh Plan. Commensurately, the outstanding project investments in the infrastructure space have grown at a CAGR of 53.5% to USD700bn as at March 2008. We believe that the strong CapEx cycle has put the credit rating agencies in a sweet spot, with visible volume growth and pricing power.

Under penetrated corporate bond market offers huge market potential

The corporate bond market in India is the least developed amongst the emerging economies in East Asia. India's corporate bond market remains under penetrated at just 3% of GDP, while in the other east Asian regions like Singapore, Malaysia, Hongkong, Korea, it is above 30%. In FY07, USD35bn worth of corporate bonds were issued, out of which, public sector entities accounted for 42%, private financial companies-largely banks represented 35%, while private, non-financial corporate issuers, represented only 23% of value or roughly USD8bn. Indian firms are still seeking bank finance for their funding requirements. Bank loan still forms a major source of finance for Indian corporates, accounting for roughly around 90% of their borrowings. In contrast to equity markets, corporate bond markets have been held back by the more restrictive regulatory framework. However, the rising investment needs of the corporates coupled with more reforms in the debt market, are likely to result in more corporate bond issuance going forward, thereby benefiting the credit rating industry.

Basel II norms - opens a new set of opportunities

We believe that the biggest push for the volumes for credit rating will come from the regulatory side, in the form of Basel II norms. Basel II norms help banks to make efficient use of capital by assigning risk weights to loans, based on the credit rating of the borrower i.e higher rating will get a lower risk weight and vice versa. The BLR (Bank Loan Rating) market opens up huge business opportunities for the credit rating firms. As per CRISIL management, 6,500 entities need to be rated by FY2010 under Basel II. This number looks huge as all four credit rating agencies put together currently have 1,400 entities under rating.

We initiate coverage on CRISIL and ICRA with a BUY rating

We believe the new set of opportunities coupled with strong economic environment is likely to boost the earning performance of the companies in the sector. We firmly believe that these companies have a strong growth potential, by virtue of India being in the midst of a structural investment super cycle. We expect CRISIL's and ICRA's earnings to grow at a CAGR of 36-41% over CY07/FY08-CY09E/FY10E[1]. Based on their strong earnings growth, we have valued both the companies on PE multiple basis. At CMP, the CRISIL stock is trading at 19.9x CY08E EPS of Rs167 and 14.4x CY09E EPS of Rs230. ICRA stock at CMP, is trading at 14.1x FY09E EPS of Rs39 and 10.4x FY10E EPS of Rs52.9. At these valuations, they are trading almost at par with their global counterpart Moody. CRISIL is currently trading near its 10 year average valuation, despite high growth and strong earnings visibility. Moreover, considering the fact that the Indian economy is growing at a much faster pace than the global economy, and with no visible risk to volume unlike their global counterparts, we believe that their current valuations are very attractive and offer great upside from the current levels. We initiate coverage on CRISIL with a 'BUY' rating and price target of Rs4,150 implying an upside of 25% from current levels. We also initiate coverage on ICRA with a 'BUY' rating and price target of Rs750 and an upside of 36% from current levels.

1. CRISIL has calendar year end

Investment Argument

Strong capex cycle in Indian economy to benefit rating agencies

The outstanding project investments in India have grown at a CAGR of 39% over FY03-08 to USD1.5tn.

Credit rating agencies in India are likely to benefit significantly from the imminent acceleration in the debt raising activities, led by strong investment in the Indian economy. India's economy has been growing at an average annual growth rate of 8.9% over the last four years. The outstanding project investments in India have grown at a CAGR of 40% over FY03-08 to USD1.5tn. The outstanding CapEx to GDP ratio stood at 1.9x in FY08 against 0.7x in FY2000 - the highest in the last decade. We believe that rising spends on capacity expansion create a strong macro framework for robust growth and reinforces our positive view on the sustainability of the capex cycle.

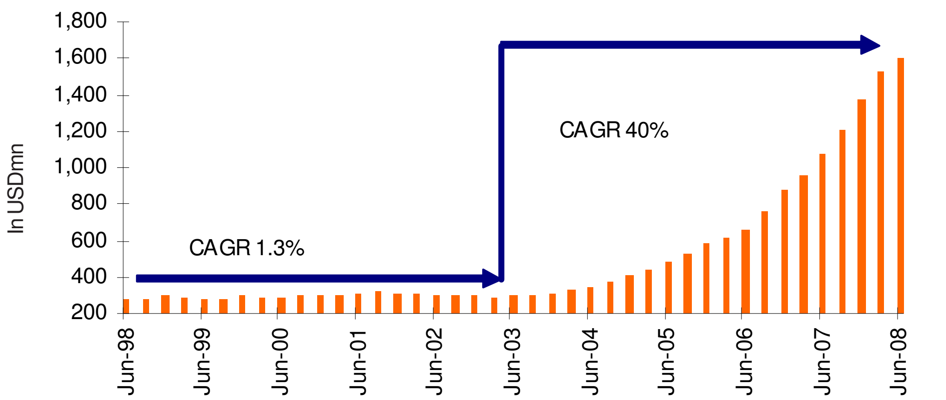
The Planning Commission has estimated that infrastructure investment ought to grow from the current levels of around 4.6% of GDP to 7.5% for sustaining over 8% real GDP growth as envisioned in the Eleventh Plan. Thus, investment in infrastructure is expected to rise by over three percentage points of GDP over the Plan period. Over the same period, the Planning Commission anticipates that overall investment rate of the Indian economy should grow by six percentage points. For such an increase in infrastructure investment to take place over the Plan period, both public sector and private sector investment will need to grow much faster than in any previous period. Naturally for such large investments, the debt financing would be very critical. We firmly believe that credit rating agencies like ICRA and CRISIL have a strong growth potential by virtue of India being in the midst of a structural investment super cycle.

Government infrastructure target in 11th Plan- 7.5% of GDP

(Rs Billion)	9th Plan (FY97-02)	10th Plan (FY02-07)	11th Plan (FY07-12)
Airports	66	99	400
Irrigation	574	972	1,258
Ports	50	47	500
Power	866	1581	4,200
Railways*	464	694	3,220
Roads	546	1,329	2,140
Telecom	801	579	870
Tourism	6	25	29
Urban infrastructure & Housing	586	991	2,100
Total	3,959	6,317	14,717
Growth (%)		59.6	133.0
% of GDP	3.0	4.6	7.5

Source: Emkay Research, Plan Document **Includes proposed outlay on freight corridor*

Total Outstanding Capex



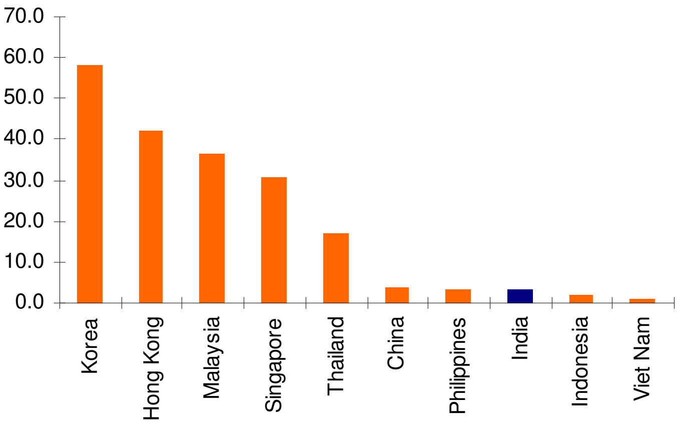
Source : Emkay Research , CMIE

Under penetrated corporate bond market offers huge market potential

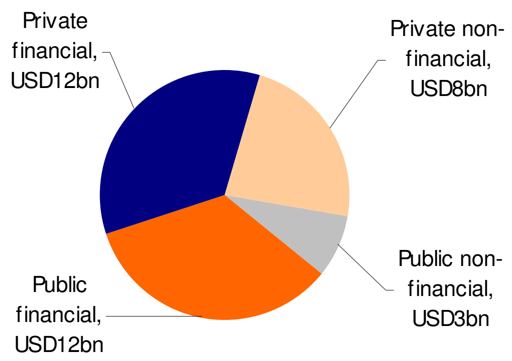
India's corporate bond market remains under penetrated at just 3% of GDP

The corporate bond market in India is one of the least developed amongst economies in emerging East Asia. India's corporate bond market remains under penetrated at just 3% of GDP, while in other east Asian regions like Singapore, Malaysia, Hongkong, Korea, it is above 30%. In FY07, corporate bonds worth USD35bn were issued, out of which, public sector entities accounted for 42%, private financial companies-largely banks represented 35%, while private, non-financial corporate issuers represented only 23% of value (or roughly about USD8bn). While the bank loans still remain a preferred source of funds for Indian corporates, the corporate bond markets have been held back by the more restrictive regulatory framework. We believe that the rising investment needs of the corporates, coupled with more regulatory reforms will provide a boost to the corporate bond issuance going forward, thereby benefiting the credit rating industry.

Penetration of corporate bonds in India (%)



Bond issuance for FY07



Sources: AsianBondsOnline, Bank for International Settlements, Reserve Bank of India

........Basel II norms - opens a new set of opportunities

Basel II norms help banks to make efficient use of capital

The rating business is likely to get a regulatory push with the implementation of Basel II norms. Basel II norms help banks to make efficient use of capital by assigning risk weights to loans based on the credit rating of the borrower i.e higher rating will get a lower risk weight and vice versa. Though BLR, as envisaged under the new Basel II norms is not mandatory, it creates a win-win situation for both, the borrower as well as lender and thereby will push the credit rating volumes.

Capital release for banks

Lower risk weights lead to release of capital for banks

The new guidelines from RBI create an incentive for banks to use BLRs, by giving significant relief in the capital that banks must hold against their corporate loan exposures. Under the revised framework, banks can lower their capital allocation to as much as one-fifth of the earlier requirement for rated exposures, depending on the level of the external credit rating. Till now, the banks had to apply a uniform 100% risk weight to all exposures, irrespective of the underlying credit risk, which actually tantamounts to mispricing of credit. What Basel II norms eventually leads to, is, efficient allocation of capital for banks, thereby increasing their lending capacity. As equity capital is the most expensive source of funding, any reduction in capital allocation would translate into substantially higher RoEs for the bank.

Capital-saving potential by banks on a loan of Rs1bn

Rating	Basel I		Basel II		
	Risk weight	Capital required[1] (Rs. Mn)	Risk weight	Capital required (Rs. mn)	Capital saved (Rs. Mn)
AAA	100%	90	20%	18	72
AA	100%	90	30%	27	63
A	100%	90	50%	45	45
BBB	100%	90	100%	90	0
BB and below	100%	90	150%	135	-45
Unrated	100%	90	150%	135	-45

[1]Capital required is computed as Loan Amount x Risk Weight x 9%

Basel I vs. Basel II-Risk Weights and Capital Release

Basel I			Basel II					
			CAPITAL REQUIRED				CAPITAL RELEASE	
Rating	Risk Weights	Capital Required	Risk Weights for Rated Exposures	Rated Exposures	Unrated Existing/ Unrated Category A Exposure (<500mn)	Unrated Category B Exposure (>500mn)	Rated Existing/ Category A Exposure	Rated Category B Exposure
AAA	100%	9.0%	20%	1.8%	9.0%	13.5%	7.2%	11.7%
AA	100%	9.0%	30%	2.7%	9.0%	13.5%	6.3%	10.8%
A	100%	9.0%	50%	4.5%	9.0%	13.5%	4.5%	9.0%
BBB	100%	9.0%	100%	9.0%	9.0%	13.5%	0.0%	4.5%

Note: Category A and B resembles Fresh unrated disbursals lesser than Rs500mn and greater than Rs500mn respectively. Risk weight on category A loans is 100% whereas on the higher amount it is 150%. Total Exposure threshold of Rs500mn would be reduced to Rs.100mn from 2009-10 onwards

Efficient allocation of tier I capital helps RoE expansion

(%)	Under Basel I	Under Basel II
Yield	10.0	10.0
Cost of funds	6.3	6.3
NIM	3.7	3.7
Operating expenditure	1.8	1.8
Pre provision profits	1.9	1.9
Provisions	0.2	0.2
Profit before tax	1.7	1.7
Tax	0.6	0.6
Profit after tax	1.1	1.1
Capital required (Rs)	6	3
RoE	18.7	37.4

Source: Emkay Research

Borrowers save on borrowing costs

Borrowers with lower risk weight benefit

The Basel I norms on capital adequacy didn't differentiate between the borrowers. The differential would not be big between the pricing of a very risky and a less risky loan, as the capital allocation was similar for both. However, under Basel II norms, a better rated corporate would be in a position to differentiate himself from others and due to the huge expansion in the RoE of the bank from his loan, he would be able to get his borrowing cost lowered.

The bank loan rating market opens up huge business opportunities for the credit rating firms. As per CRISIL management, 6500 entities need to be rated by FY2010 under Basel II. This number looks huge when compared to the fact that all four credit rating agencies put together have 1,400 entities under rating.

....Pricing to be a tricky issue

Pricing to be tricky for BLR; we believe lumpsum pricing will be best suited

We believe that the pricing in the BLR business is going to be a very tricky issue for a variety of reasons:

- Unlike a bond rating, where you first get a rating and then find an investor, in BLR, the investor (bank) is already identified and the borrower gets a rating at the investor's behest. Here, the borrower may not be inclined to spend money on the BLR, if the bank does not pass the benefit of the same to the borrower.
- A borrower will have to get a separate rating for each separate instrument. For example, short term and long term loans by the same borrower require separate rating. Funded and non-funded exposures would also require separate ratings. Thus, the pricing may happen in an adhoc manner rather than ad-Valorem, based on the volume of rating.

Structured finance market not impacted by global turbulence

The domestic structured finance issuance volume grew by 59%yoy to Rs587bn in FY08

India's structured finance market maintained its momentum despite the global turbulence in that space. The strong growth in FY08 shows that the Indian domestic market was quite insulated from the global credit environment. This was mainly because, domestic securitisation transactions have very low structural complexity, unlike in the more advanced capital markets.

The domestic structured finance issuance volume grew by 59%yoy to Rs587bn during FY08, primarily driven by 166%yoy growth in single corporate loans, the largest product class in the segment. In addition, Asset backed securities (ABS) witnessed a 13%yoy growth, constituting 45% of the overall issuances. This class covers a variety of assets, such as cars and utility vehicles, commercial vehicles, construction equipment, two-wheelers and personal loans. The growth in ABS and Mortgage Backed Securitisation (MBS) has slowed down, post RBI guidelines issued in February 2006 on securitisation of performing assets. The RBI guidelines prohibit originators from booking profit up-front at the time of securitisation, stipulate a higher capital charge on credit enhancements provided, and disallow release of credit enhancement during the course of the transaction.

However, going forward, we expect the ABS volume to pick up, as it

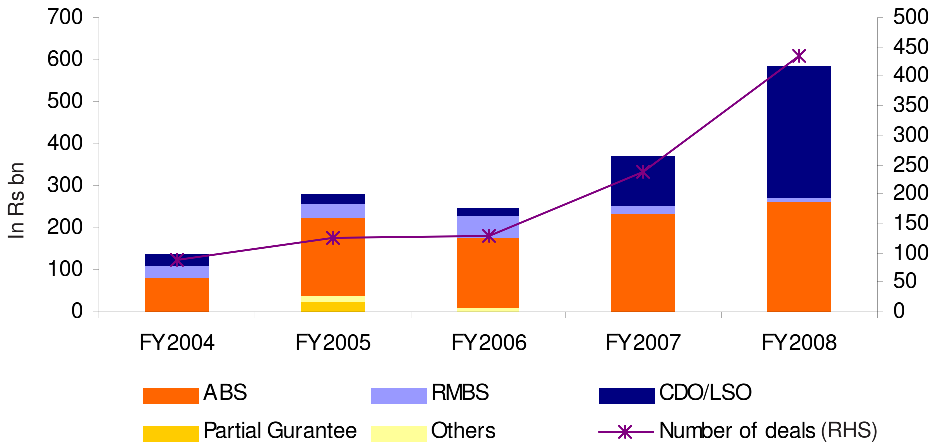
a) is an important funding tool for many originators,

b) is an effective tool in managing capital under Basel II,

C) can be used to meet priority sector lending requirement (in case of some CV/CE loans).

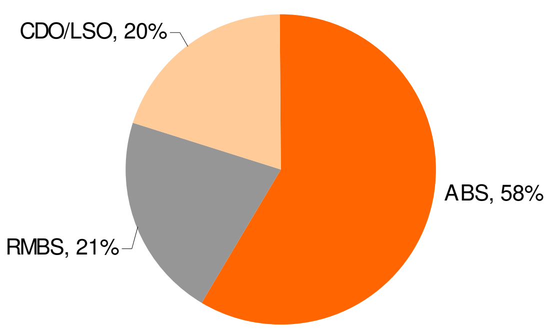
While traditionally, ABS has been the dominant product, during FY2008 Loan Sell-Off (LSO), or securitisation of single corporate loans became the largest product class, accounting for 54% of the total issuance volumes. The LSO issuances have grown at a CAGR of 83% over FY04-08 to Rs318bn, because of higher investors interest in the product. Investors prefer Pass Through Certificates (PTCs), backed by single loans as these are simple short-tenure instruments, similar to corporate bonds, with no prepayment risk and tenure uncertainty-unlike ABS and MBS. We expect LSO issuance volumes to increase further, with more originators preparing to enter the segment. Another trigger for growth in this segment could be the commencement of bank loan ratings, which has already led to a large addition to the universe of rated companies. The growing securitization market augurs well for the rating agencies as SEBI in 2008 made rating mandatory on these instruments.

Trend in structured finance issuance volumes



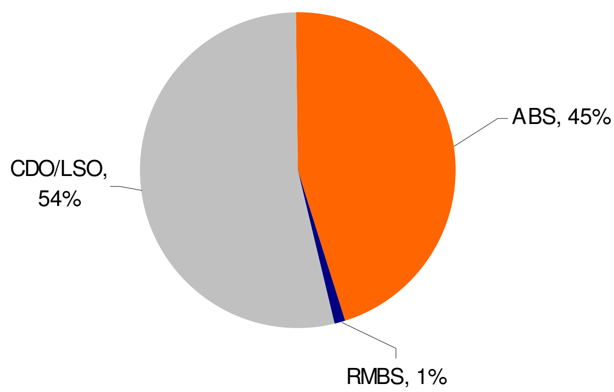
Source: ICRA Estimates

Structured product mix - FY04



Source: ICRA estimates

Structured product mix - FY08



Source: ICRA estimates

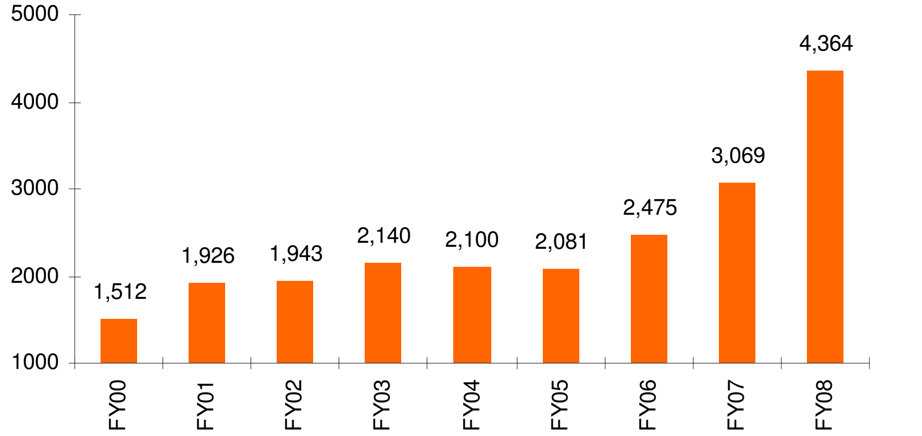
The share of MBS has declined to a negligible level of less than 1% in FY2008 from 21% in FY04. While MBS has huge potential ,given the significant expansion of the underlying housing finance business, the long tenure of MBS paper, the lack of secondary market liquidity, tenure uncertainty, and interest rate risk continue to hinder growth of this segment. Nevertheless, regulatory requirements (certain category of home loans qualify as priority sector lending) provide the motive for trading in home loans too.

Favourable regulatory reforms to benefit rating agencies

The new guidelines allow banks to link the minimum size of their capital to the credit risk in their portfolios

In 1987, when India's first credit rating company, CRISIL was incorporated, there was hardly any market for credit rating as the interest rates at that time were government determined and even the secondary markets for debt in India was at an evolving stage. However, since then, things have turned a lot in favour of rating agencies with favorable regulations and reforms in the debt market. In 1992, credit rating became mandatory for the issuance of debt instruments with maturity/convertibility of 18 months and above. Subsequently, the RBI guidelines made rating mandatory for issuance of commercial paper. RBI also made rating of public deposit schemes mandatory for NBFCs. All these regulations resulted in significant rise in number and value of instruments, which were rated. Further in 2003, SEBI along with stock exchanges, made ratings mandatory for debt instruments placed under private placement, which were proposed to be listed. And now, the Reserve Bank of India's (RBI's) April 2007 Guidelines for Implementation of the New Capital Adequacy Framework has allowed banks to link the minimum size of their capital to the credit risk in their portfolios. These favorable regulations altogether open a huge market for the credit rating industry.

Number of instruments rated



Source: Companies

Regulatory reforms over the years

Year	Regulatory Reforms
1987	India's first credit rating agency, CRISIL was incorporated
1992	Credit rating became mandatory for the issuance of debt instruments with maturity/ convertibility of 18 months and above
1992	The RBI guidelines made rating mandatory for issuance of commercial paper
1994	Rating of public deposit schemes made mandatory for NBFCs.
2003	SEBI made ratings mandatory for debt instruments placed under private placement basis, which were proposed to be listed
2008	Basel II norms implemented, which allows banks to link the minimum size of their capital to the credit risk in their portfolios
2008	Rating of securitised debt instrument made mandatory

Source: RBI, Emkay Research

Life insurance companies in India mobilized Rs1.6tn in FY07

Growing insurance industry to benefit credit rating industry

We believe that the credit rating industry is likely to benefit from the growing insurance industry in India. Over the last few years, India has seen the emergence of private insurance companies, which have shown remarkable growth. During FY08, the Indian private life insurance companies gathered new business premium of Rs.338bn, an increase of 74% over last year. India's insurance sector accounted for 4.1 per cent of GDP in FY07, up from 1.2 per cent in 1999-2000. We expect the premium mobilization to go up further in the coming years. Currently, as per the IRDA guidelines, the life insurance companies in India have to invest at least 50% in government securities & other approved securities and another 35% in other approved investments. We believe that in the future, IRDA may allow insurance companies to invest higher amount in rated papers for the following reasons:

1) There are not many higher yielding papers available to them.

2) The saving in form of premium need to be channelised into capital and infrastructure spend.

3) Rated bonds provide security also .

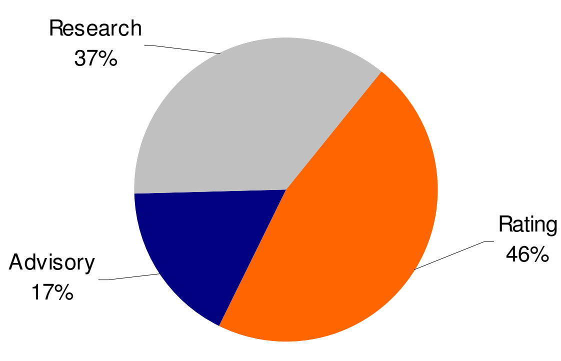
CRISIL and ICRA non rating business contribute 69% and 44% respectively to the total revenues.

Diversified business model reduces risk

CRISIL and ICRA both have, over the years, expanded their business portfolio to other related segments like research, advisory and information services in order to reduce their sole dependence on the rating business and to leverage their existing capabilities. While ICRA's non-ratings business contribution to the total revenue has increased from 33% in FY05 to 44% in FY08, CRISIL's non rating business contribution to the total revenue has increased from 51% in FY05 to 69% in CY07. Strategic diversification in the revenue model has resulted in a well balanced business portfolio and reduced the companies' dependence on rating business, which used to be the sole major contributor to their revenues earlier.

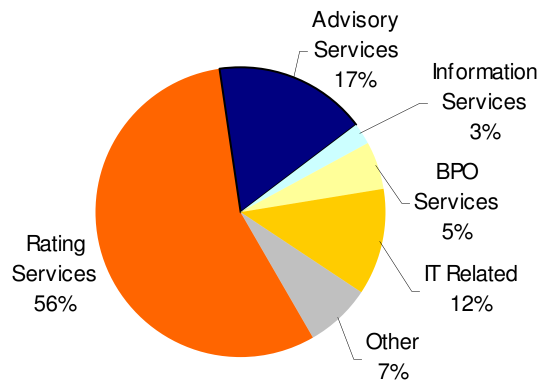
As part of their diversification strategy, both the companies acquired various businesses and made strategic investments in other businesses over the years. For instance, CRISIL increased its presence in information services and advisory with the acquisition of Information Products and Research Services (India) Pvt. Ltd and Irevna. Similarly, ICRA acquired 100% stake in Computer Exchange Private Limited (name changed to ICRA Techno Analytics Limited) and ICRA Online Ltd, which diversified the company's presence into information technology solutions and knowledge process outsourcing services.

CRISIL segment-wise revenue break-up - CY07



Source: Company, Emkay Research

ICRA segment-wise revenue break-up - FY08



Source: Company, Emkay Research

Strong cash position to aid in further acquisition

CRISIL and ICRA have surplus cash of around Rs1.4bn and Rs1.2bn respectively

Both the companies, ICRA and CRISIL have historically enjoyed a strong cash position, due to their high margin rating business. Over the years, both the companies have leveraged on their strong cash position, by acquiring businesses in various business segments including information services, research and advisory segments. For instance, CRISIL, in FY00 acquired the business of Information Products and Research Services (India) Pvt. Ltd., along with its brand INFAC. The information services business got a boost by the acquisition of INFAC (now CRIS INFAC, a subsidiary of CRISIL), India's leading provider of industry and company information. Further, in FY04 it acquired Gas Strategies Group Limited (earlier known as EconoMatters Limited), a London-based company engaged in gas consulting, information and training/conferences for around £1.5mn. This was CRISIL's first major investment in the advisory business and provided it with international exposure. CRISIL further strengthened its position in research by acquiring Irevna group of companies for USD8.6mn. Irevna provides high-end customised equity research and analytics to the world's leading investment banks, commercial banks, accounting firms, management consultancy firms, Fortune 500 consumer finance companies and global law firms in UK and the US. The above investments strengthened CRISIL's presence in Information & research and advisory segments, which now jointly contribute 68% to the company's revenues and 54% to the EBIDTA.

ICRA also diversified its business portfolio by acquiring various companies over the last few years. In FY06, the company acquired a 100% stake in Computer Exchange Private Limited (name changed to ICRA Techno Analytics Limited) and ICRA Online Ltd, which diversified the company's presence into information technology solutions and knowledge process outsourcing services. The company further strengthened its presence in these areas as ICRA Techno Analytics Limited (ICTEAS), the company's 100% subsidiary, acquired Axiom Technologies Private Limited (Axiom), a Kolkata-based software services company in June 2008. Axiom specialises in customisation and implementation of popular Enterprise Resource Planning (ERP) packages. The Axiom acquisition has provided the company an entry into ERP implementation. Both the subsidiaries together contributed Rs211.4mn in FY08, 20% of the overall revenue.

While CRISIL has a surplus cash of around Rs1.4bn (including liquid investments), ICRA has around Rs1.2bn of cash and investment lying in the balance sheet. As the rating business doesn't require much capital expenditure, the companies could use this surplus cash for further acquisitions in non rating segments, to further strengthen their presence in these areas.

In Rsmn	CRISIL CY07	ICRA FY08
Investments	975	910
Cash balance	424	255
Total (Cash+ Investments)	1399	1157
Cash per share (Rs)	194	116
Cash per share as % of CMP	5.8	21.0

Source: Company, Emkay Research

Strong operating leverage if they get pricing power

Both the companies enjoy strong operating leverage in the rating business. For example, if the yield per Rs100 of debt rated goes up by 1bp, then the net profit can grow by an incremental 35% keeping other things constant. For ICRA, the growth could be 64%, if there is 1bp increase in the yield per Rs100 of debt rated.

Operating leverage

In Rs mn	CRISIL CY07	Post 1BPS increase in yield	ICRA FY08	Post 1BPS increase in yield
Rating Services	1,301	1,687	603	861.2
Non Rating Services	2,834	2,834	471	470.7
Total Revenue	4,135	4,521	1073	1331.9
Total Expenditure	2,872	2,872	631	631.1
EBIDTA	1,263	1,649	442	701
Depreciation	157	157	38	38.0
EBIT	1,106	1,492	404	663
Interest	0	0	0	0
PBT	1,106	1,492	404	663
Provision for taxation	270	364	119	195
PAT	837	1,129	285	468
Incremental growth		35%		64%

Source: Company, Emkay Research

Strong financial performance for the quarter

CRISIL and ICRA net profit for Q2CY08 and Q1FY09 grew by 121%yoy and 65%yoy

Both the companies reported a good set of numbers for the last quarter. While CRISIL reported a strong 30.4% yoy growth in operating revenues to Rs1.25bn for Q2CY08, ICRA's operating revenues grew by 27.6%yoy to Rs254mn for Q1FY09, driven by robust growth in their respective rating services segment. While CRISIL's rating segment grew by 62%yoy to Rs464mn, ICRA's rating segment reported a healthy growth of 34.5% to Rs163mn for the quarter ended 30th June'08. The EBIDTA margin gap between the companies narrowed down as CRISIL's EBIDTA margin expanded by a strong 732bps to 32%, while ICRA reported only a decent 161bps expansion in margins to 31%. CRISIL's margin expansion was primarily led by 1907bps and 1037bps increase in their research and advisory segments margins respectively. As a result of the margin expansion coupled with higher other income, CRISIL and ICRA reported 121% and 65% growth in net profit. However, adjusted for forex gain of Rs51.1mn, CRISIL's net profit grew by 74%yoy.

CRISIL Quarterly performance

In Rs mn	Q2CY08	Q2CY07	Q1CY08	% yoy chg	% qoq chg
Operating income	1,251	960	1167	30.4	7.2
EBIDTA	400	237	416	69.1	-3.9
Margin	32.0	24.7	35.6		
Adjusted Net Profit	314	181	315	74.0	-0.1
Margin	23.8	18.7	26.2		

Source: Company, Emkay Research

ICRA Quarterly performance

In Rs mn	Q1FY09	Q1FY08	Q4FY08	% yoy chg	% qoq chg
Operating income	254	199	289	27.6	-11.9
EBIDTA	78	58	117	34.7	-33.2
Margin	30.6	29.0	40.4		
Adjusted Net Profit	72	44	91	65.0	-21.0
Margin	25.1	20.5	29.2		

Source: Company, Emkay Research

Financials

Financials

Robust growth in revenue and earnings growth

CRISIL's and ICRA revenues to grow at a CAGR of 35-40% over CY07/ FY08-CY09E /FY10E

The upcoming opportunities in the credit rating industry, which includes implementation of BASEL II norms coupled with rising activity in the debt market is likely to push ICRA and CRISIL into a strong growth trajectory. We expect CRISIL's revenues to grow at a CAGR of 40% to Rs8.2bn over CY07-CY09E, while ICRA's revenues are likely to grow at a CAGR of 35% to Rs2.0bn over FY08-FY10E. Moreover, we expect the demand for information and research outsourcing services to remain firm driven by growing domestic financial services industry coupled with rising outsourcing of research activities. Furthermore, rising investments in the infrastructure sector will provide a boost to the advisory segment. The benefit of higher revenue growth will trickle down to the bottom-line as the same is expected to grow at 36-41% CAGR over the same period.

Higher return on equity

CRISIL and ICRA have core RoE of 44% and 24% respectively

CRISIL reported RoE has increased over to 36.0% in CY07 from 20.1% in FY05, driven by increase in profit margin and higher asset use efficiency. However, adjusted for investments, core RoE is as high as 44.1%. Contrary to CRISIL, ICRA core RoE has declined over FY05-08 to 24% from 34.2% in FY05. The pressure on the same was due to decline in asset use efficiency. However, going forward, we expect the asset use efficiency and margins to improve, as the company encashes on the upcoming opportunities in the rating business and company's other businesses achieving commendable scale. Consequently, the ICRA core RoE is expected to improve to 27% in FY10 from 24% in FY08.

Valuations

We have valued both the companies on PE multiple basis.

Valuations

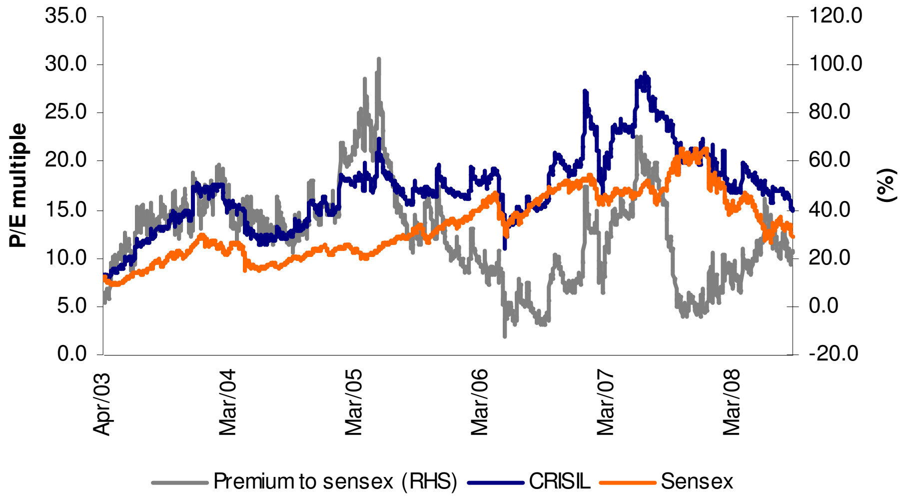
The outlook for credit rating industry looks positive as the rating business will get a big boost from a) strong CapEx cycle in the Indian economy, b) increase in corporate bond penetration and c) implementation of Basel II norms. We firmly believe that ICRA and CRISIL have a strong growth potential by virtue of the above factors. We believe the new set of opportunities coupled with a strong economic environment, is likely to boost the earnings performance of the companies in the industry.

We expect CRISIL and ICRA earnings to grow at a CAGR of 36-41% over CY07/FY08-CY09E/FY10E. Based on their strong earnings growth, we have valued both the companies on PE multiple basis. At CMP, the CRISIL stock is trading at 19.9x CY08E EPS of Rs167 and 14.4x CY09E EPS of Rs230. ICRA stock at CMP, is trading at 14.1x FY09E EPS and 10.4x FY10E EPS. CRISIL is trading at comparatively higher valuations than ICRA, because of its larger size and consequently higher market share.

Historically, both the stocks have traded in the range of 14 - 28x, whereas their foreign peer, Moody has traded in the higher range of 20-30x. However, Moody's P/E multiple declined drastically to around ~15x in CY07, led by global turmoil in the financial markets, and has been trading in that range since then. However, the domestic rating agencies' stocks didn't witness a fall to that extent, as Indian credit market remained broadly insulated from the global turmoil.

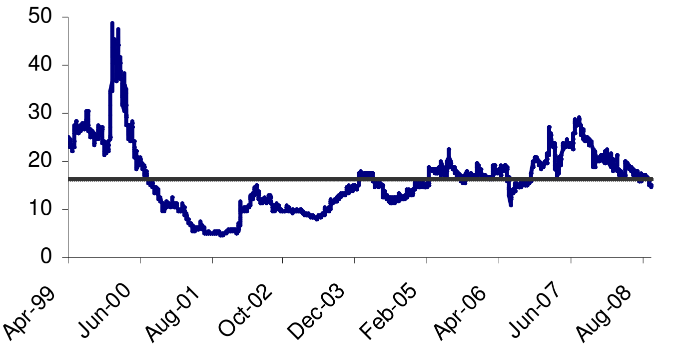
We believe both the stocks offer an attractive investment opportunity, given their strong earnings growth visibility. Also, CRISIL has always traded at 40-50% premium to sensex. In recent times the premium has contracted to 20% which we believe is attractive. We value CRISIL at Rs 4,150, which is 18x (30% premium to Sensex) our CY09 EPS estimates and ICRA at 750, which is 14.2x (10% premium to Sensex) our FY10 EPS estimates. We initiate coverage on CRISIL with a 'BUY' rating and upside of 25% from current levels. We also initiate coverage on ICRA with a 'BUY' rating and upside of 36% from current levels.

Premium to Sensex



Source: Emkay Research

CRISIL - 1-yr forward PE

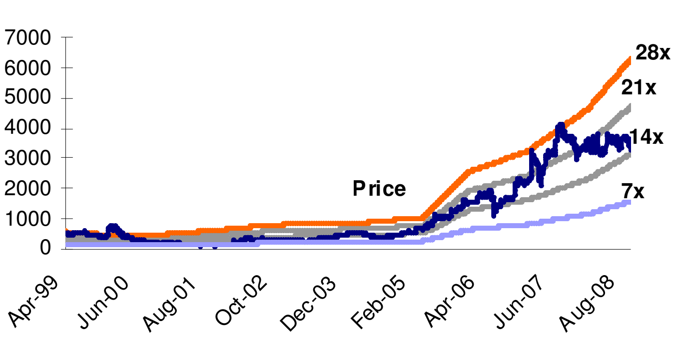


Source:Company, Emkay Research

ICRA - 1-yr forward PE

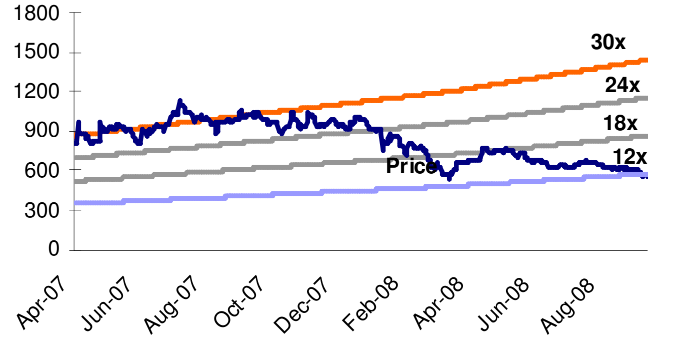
Source:Company, Emkay Research

CRISIL - PE Band



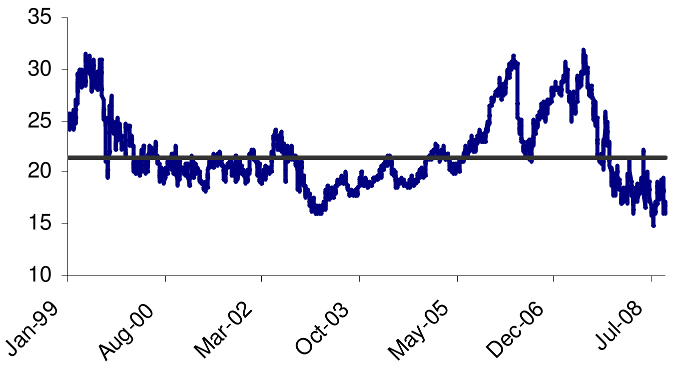
Source:Company, Emkay Research

ICRA -PE Band



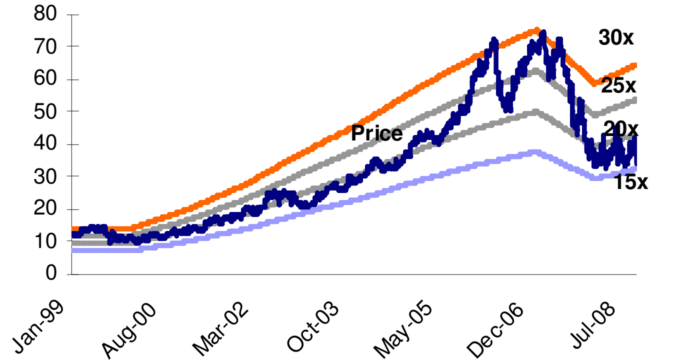
Source:Company, Emkay Research

Moody's - 1-yr forward PE



Source:Company, Emkay Research

Moody's - PE band



Source:Company, Emkay Research

Key Concerns

Volatility in interest rates and financial markets can negatively impact the industry

Any disturbance in the domestic financial market could have a negative impact on the credit rating industry.

Credit rating industry is largely linked to the activity in the domestic financial market and any disturbance in the same, could have a negative impact on the credit rating industry. Any increase in interest rates and credit spreads, volatility in the corporate bonds market or interest rate environment, foreign exchange fluctuations, defaults of significant issuers and other market and economic factors, both domestically and globally may negatively impact the issuance of credit sensitive products and other financial services. A sustained period of volatility in the financial markets or a weakness or decline in the financial markets-domestic or international, could have a material adverse effect on the industry.

Talent crunch

The rating industry is currently facing acute shortage of skilled manpower coupled with high attrition rate. CRISIL and ICRA both are struggling with an attrition rate of above 20%. Human resource is the main resource for the industry. The industry being in a growth phase, any shortfall in the human resource could limit the industry's ability to exploit the current opportunities and hence, can impact their profitability.

Slowdown in economic growth

Any slowdown or delay in investment plans could restrict the performance of the rating industry.

Indian economy has been growing at above 8% over the last 4 years and experiencing huge investment activities. The Planning Commission has estimated that infrastructure investment ought to grow from the current levels of around 4.6 per cent of GDP to 8% for sustaining over 8% real GDP growth as envisioned in the Eleventh Plan. However. rising inflation levels globally, amidst higher oil and food prices, could lead to further tightening of monetary policy, resulting in higher interest rates. This will result in higher cost of capital for the corporates, resulting in cancellation or postponement of investment activities by them. Debt, being the main source of raising capital, any slowdown or delay in investment plans could restrict the performance of the rating industry.

Exchange rate volatility

Both the companies derive a significant portion of their revenue in foreign currency, especially CRISIL which gets around 65% of its revenue from international markets. Therefore, further depreciation in the foreign currency like USD and pound against Indian rupee, could have a material impact on the company's revenues.

Subsidiary floated by foreign players is a concern

As per the government of India guidelines foreign investors can set up 100% operating subsidiaries subject to bringing in US$50mn as capital. In line with this S&P has recently floated it's wholly owned subsidiary in India, apart from CRISIL, in which it is a majority shareholder. Opening of more subsidiaries by foreign players is a cause for concern for domestic players as lot of work of parent which is outsourced to Indian listed subsidiaries can be diverted to other subsidiaries.

ICRA Financials

Consolidated Income Statement (Rs. Mn)

(Year Ending Mar 31)	FY07	FY08	FY09E	FY10E
Net revenues	706	995	1,361	1,850
Establishment Expenses	71	79	102	137
As a % to Net revenues	10.1	7.9	7.5	7.4
Staff Cost	297	427	597	805
As a % to Net revenues	42.1	42.9	43.8	43.5
Other Expenses	96	125	175	236
As a % to Net revenues	13.6	12.6	12.8	12.7
Total Exp	465	631	873	1,178
EBITDA (Core)	241	363	488	672
EBITDA (%)	34.2	36.5	35.8	36.3
Other Income	60	79	95	113
Depreciation	29	38	29	36
EBIT	272	404	553	750
Interest	0	0	0	0
PBT	272	404	553	750
Tax	72	119	163	221
ETR (%)	26.4	29.5	29.5	29.5
A PAT	200	285	390	529
Minority interest	0	0	0	0
APAT after MI	200	285	390	529

Source: Company, Emkay Research

Consolidated Balance Sheet (Rs. Mn)

(Year Ending Mar 31)	FY07	FY08	FY09E	FY10E
Equity Capital	100	100	100	100
Reserves & Surplus	1,374	1,539	1,866	2,321
Networth	1,474	1,639	1,966	2,421
Total Debts	0	0	0	0
Net def Liabilities	7	3	3	3
Capital Employed	1,482	1,641	1,969	2,424
Gross Block	414	452	571	665
Less Depreciation	(138)	(168)	(198)	(233)
CWIP	4	6	6	6
Net Fixed Assets	281	289	379	437
Investments	686	902	752	802
Debtors	196	217	372	502
Cash and Bank	28,352	255	59	84
Other current assets	3	6	3	3
Loans & Advances	416	495	790	1,066
Total Cur. Assets	28,966	973	1,224	1,654
Current Liabilities	28,307	239	239	323
Provisions	147	283	147	147
Total Cur. Lia. & Prov.	28,454	522	386	470
Net Current Assets	512	451	838	1,185
Total Assets	1,482	1,641	1,969	2,424

Source: Company, Emkay Research

Consolidated Cash Flow (Rs. Mn)

(Year Ending Mar 31)	FY07	FY08	FY09E	FY10E
Profit before Tax	272	404	553	750
Add : Depreciation	29	38	29	36
Add : Non Cash	(51)	(63)	0	0
Less: Tax Paid	(74)	(147)	(163)	(221)
Net changes in WC	(16)	81	(583)	(322)
Operational Cash Flows	159	313	(164)	243
Capital expenditure	(62)	(47)	(120)	(94)
Investments	(336)	(136)	150	(50)
Investing Cash Flows	(398)	(183)	30	(144)
Borrowings	(1)	(0)	0	0
Issue of shares	28,186	(28,174)	0	0
Add/Redn of Reserves	382	0	0	0
Dividend paid	(40)	(53)	(62)	(74)
Pymt to/from Minority Interest	(0)	0	0	0
Financing Cash Flows	28,527	(28,227)	(62)	(74)
changes in cash	28,289	(28,097)	(196)	25
Opening balance	63	28,352	255	59
Closing balance	28,352	255	59	84

Source: Company, Emkay Research

Consolidated Profitability Ratios (%)

(Year Ending Mar 31)	FY07	FY08	FY09E	FY10E
EBIDTA Margin	34.2	36.5	35.8	36.3
EBIT Margin	35.5	37.7	38.0	38.2
Net Profit Margin	26.1	26.6	26.8	26.9
RoA	16.5	18.3	21.6	24.1
ROE	16.6	18.3	21.6	24.1
Core RoE	21.9	24.0	27.5	27.0

Source: Company, Emkay Research

Consolidated Valuation table

(Year Ending Mar 31)	FY07	FY08	FY09E	FY10E
EPS (Rs)	20.0	28.5	39.0	52.9
FDEPS (Rs)	20.0	28.5	39.0	52.9
Cash per share (Rs)	-	115.7	81.1	88.6
Book Value (Rs)	147.4	163.9	196.6	242.1
FDPER (x)	27.6	19.3	14.1	10.4
P/BV (x)	3.7	3.4	2.8	2.3

Source: Company, Emkay Research

CRISIL Financials

Consolidated Income Statement (Rs. Mn)

(Year Ending Mar 31)	CY06	CY07	CY08E	CY09E
Net revenues	2,873	4,043	5,858	8,018
Establishment Expenses	275	391	509	693
As a % to Net revenues	9.6	9.7	8.7	8.6
Staff Cost	1,146	1,520	2,322	3,178
As a % to Net revenues	39.9	37.6	39.6	39.6
Other Expenses	647	960	1,317	1,793
As a % to Net revenues	22.5	23.8	22.5	22.4
Total Exp	2,067	2,872	4,148	5,664
EBITDA (Core)	806	1,172	1,711	2,354
EBITDA (%)	28.1	29.0	29.2	29.4
Other Income	67	92	127	132
Depreciation	79	157	254	297
EBIT	795	1,106	1,583	2,188
Interest	0	0	0	0
PBT	795	1,106	1,583	2,188
Tax	188	270	380	525
ETR (%)	23.7	24.4	24.0	24.0
A PAT	607	837	1,203	1,663
Minority interest	0	0	0	0
APAT after MI	607	837	1,203	1,663

Source: Company, Emkay Research

Consolidated Balance Sheet (Rs. Mn)

(Year Ending Mar 31)	CY06	CY07	CY08E	CY09E
Equity Capital	68	72	72	72
Reserves & Surplus	1,821	2,692	3,715	5,129
Networth	1,889	2,764	3,787	5,201
Total Debts	0	0	0	0
Net def Liabilities	30	(33)	(33)	(33)
Capital Employed	1,919	2,732	3,755	5,168
Gross Block	1,620	1,860	2,691	3,665
Less Depreciation	(450)	(568)	(822)	(1,119)
CWIP	3	81	81	81
Net Fixed Assets	1,172	1,372	1,950	2,626
Investments	400	975	975	975
Debtors	667	897	1,328	1,809
Cash and Bank	385	424	891	1,517
Other current assets	1	4	4	4
Loans & Advances	162	407	359	489
Total Cur. Assets	1,215	1,733	2,582	3,818
Current Liabilities	700	959	1,364	1,862
Provisions	168	390	390	390
Total Cur. Lia. & Prov.	868	1,349	1,753	2,252
Net Current Assets	347	384	829	1,567
Total Assets	1,919	2,732	3,755	5,168

Source: Company, Emkay Research

Consolidated Cash Flow (Rs. Mn)

(Year Ending Mar 31)	CY06	CY07	CY08E	CY09E
Profit before Tax	795	1,106	1,583	2,188
Add : Depreciation	79	157	254	297
Add : Non Cash	(15)	20	0	0
Less: Tax Paid	(172)	(328)	(380)	(525)
Net changes in WC	(61)	(247)	22	(112)
Operational Cash Flows	625	709	1,479	1,849
Capital expenditure	(73)	(189)	(832)	(974)
Investments	(323)	(541)	0	0
Investing Cash Flows	(397)	(730)	(832)	(974)
Borrowings	0	0	0	0
Issue of shares	73	194	0	0
Add/Redn of Reserves	0	0	0	0
Dividend paid	(82)	(125)	(181)	(249)
Pymt to/from Minority Interest	0	0	0	0
Financing Cash Flows	(9)	68	(181)	(249)
changes in cash	219	47	467	626
Opening balance	166	377	424	891
Closing balance	385	424	891	1,517

Source: Company, Emkay Research

Consolidated Profitability Ratios (%)

(Year Ending Mar 31)	CY06	CY07	CY08E	CY09E
EBIDTA Margin	28.1	29.0	29.2	29.4
EBIT Margin	27.0	26.8	26.5	26.9
Net Profit Margin	20.6	20.2	20.1	20.4
RoA	37.6	36.0	37.1	37.3
ROE	38.3	36.0	36.7	37.0
Core RoE	45.6	44.1	45.5	42.6

Source: Company, Emkay Research

Consolidated Valuation table

(Year Ending Mar 31)	CY06	CY07	CY08E	CY09E
EPS (Rs)	90.9	115.8	166.6	230.2
FDEPS (Rs)	90.9	115.8	166.6	230.2
Cash per share (Rs)	116.2	193.7	258.3	344.9
Book Value (Rs)	279.6	382.6	524.2	719.9
FDPER (x)	36.5	28.6	19.9	14.4
P/BV (x)	11.9	8.7	6.3	4.6

Source: Company, Emkay Research

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Emkay Research

26 September, 2008

ICRA Ltd.

In sweet spot

Initiating

BUY

Price	Target
Rs551	**Rs750**

Sensex - 13,547

Price Performance

(%)	1M	3M	6M	12M
Absolute	(9)	(12)	(5)	(45)
Rel. to Sensex	(3)	(7)	13	(32)

Source: Bloomberg

Stock Details

Sector	Financial Services
Reuters	ICRA.BO
Bloomberg	ICRA@IN
Equity Capital (Rs mn)	100
Face Value (Rs)	10
No of shares o/s (mn)	10
52 Week H/L (Rs)	1,075/525
Market Cap (Rs bn/USD mn)	6/130
Daily Avg Vol (No of shares)	8414
Daily Avg Turnover (US$ mn)	0.1

Shareholding Pattern (%)

	30/06/08	31/03/08	31/12/07
Promoters	28.5	28.5	28.5
FII/NRI	1.0	0.5	0.5
Institutions	46.8	47.2	46.5
Private Corp	6.4	6.6	6.9
Public	17.2	17.3	17.7

Source: Capitaline

We initiate coverage on ICRA with a BUY rating and a target price of Rs750. ICRA, being the second largest player after CRISIL in the industry, will benefit from the strong CapEx cycle in Indian economy b) lower penetration of corporate bond market and c) regulatory push due to implementation of Basel II norms. ICRA is likely to benefit from this favorable scenario with its strong parentage (Moody) and its domain expertise.

ICRA has, over past three years, used its strong cash flows and domain expertise to expand its services offering beyond main bread and butter ratings business. The IT and outsourcing services have given further boost to revenues. The boost to profitability will be more meaningful once it achieves commendable scale in these new businesses. A chest of ~Rs1bn of cash plus investments (16% of MCap), provides opportunities for brownfield expansion as well. At CMP, the stock trades at 14.1x FY09E and 10.4x FY10 EPS. We initiate coverage with a BUY and a target price of Rs750, an upside of 36%.

Rating business- major growth driver

The company's rating segment is the major growth driver for the company. The segment has grown at a CAGR of 25% over the last five years. During FY08, it contributed 56% to the company's overall revenues. We believe that the growing thrust on infrastructure and implementation of Basel II norms are likely to benefit ICRA's rating business, going forward.

Basel II rollout- opens a new business opportunity

ICRA's rating business will get a big boost with the implementation of Basel II norms. The Basel II rollout has opened up huge business opportunities for the credit rating firms as more than 6500 entities need to be rated by FY2010. Inline with this, ICRA has signed MOU's (non-exclusive) with around 15 banks to assist them in implementing RBI's New Capital Adequacy Framework under Basel-II.

… Diversification to reduce business risk

The company has over the years reduced its dependence on its core business of rating by investing its surplus cash in other business segments like consultancy, information technology service and outsourcing activities. The company's non-ratings business contribution to the total earnings has increased from 33% in FY05 to 44% in FY08. However, the company's non-rating businesses have been putting pressure on its margins because of high operating costs incurred for scaling its operations.. However, the non rating segment will add to profitability once the company achieves commendable scale in the new businesses, thereby reducing the business risk.

Valuation

At CMP, the stock trades at 14.1x FY09E and 10.4x FY10 EPS. We expect its core RoE to improve to 27% in FY10 from 24% in FY08. We therefore assign a target P/ E multiple of 14.2x, over the company's FY10 EPS. Based on this multiple, we value ICRA stock at Rs750.

Key Financials (Rs.mn)

Y/E March 31	Net Revenues	Net profit	EPS (Rs)	BV (Rs)	Core RoE (%)	RoE (%)	PE (x)	P/BV (x)
FY2007	706	200	20.0	147	21.9	16.6	27.6	3.7
FY2008	995	285	28.5	164	24.0	18.3	19.3	3.4
FY2009E	1,361	390	39.0	197	27.5	21.6	14.1	2.8
FY2010E	1,850	529	52.9	242	27.0	24.1	10.4	2.3

Company Background

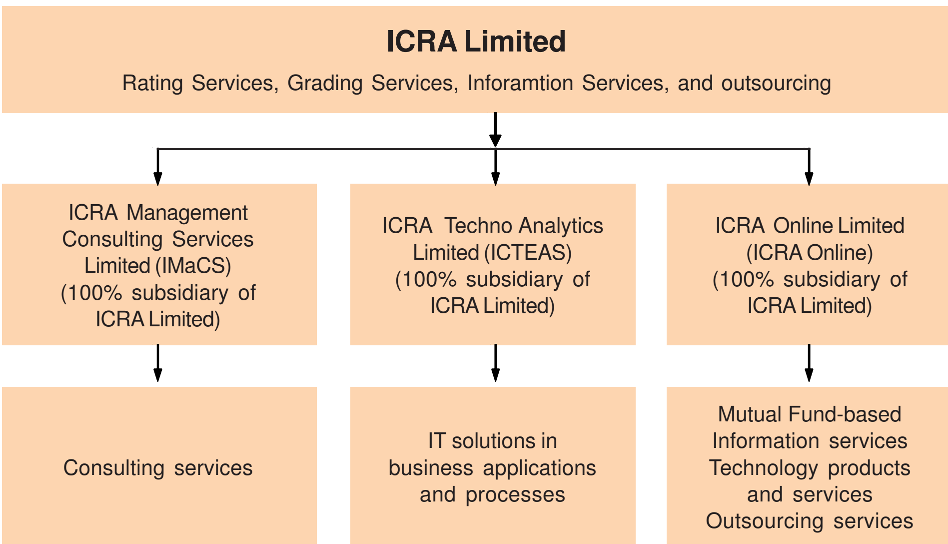
ICRA is one of the four credit rating agencies in India and the second largest after CRISIL. The company, earlier known as Investment Information and Credit Rating Agency of India Limited, was incorporated in 1991 as a credit rating agency. The company was promoted by IFCI and other financial institutions, commercial banks and financial services companies. Moody's India, which is an indirect subsidiary of the Moody's Corporation, picked up an 11% stake in 1999 (later on increased to 29% and now termed as a promoter). In addition, Moody's Investors Service, which is an international rating agency, has entered into a Technical Services Agreement with ICRA, pursuant to which, it has been providing technical services to the company.

Over the years, the company has expanded its operations into other areas to leverage its core competitiveness and diversify its cash flows. ICRA operates along with its three wholly owned subsidiaries viz. ICRA Management Consultancy Services (IMaCS), ICRA Techno Analytics (ICTEAS) and ICRA online. ICRA and its three subsidiaries together form the ICRA group of companies. Beside Ratings, ICRA Group offers Consulting services, IT-based services, Information services, and Outsourcing services. In March 2007, ICRA came out with a Public Offer of 2.6mn equity Shares (Rs850mn) through an Offer for Sale by the existing shareholders, namely IFCI Limited, Administrator of the Specified Undertaking of The Unit Trust of India and State Bank of India.

Business profile

ICRA, India's premier rating agency along with its three wholly owned subsidiaries IMaCS, ICTEAS and ICRA online, provides ratings, consulting services, information technology based services, information services, and outsourcing services. A significant portion of the company's revenue comes from rating services. The company derives 55% of its revenue from rating business, 17% from consultancy business, 12% from information technology based services and the rest 16% from other services. Revenue from the rating business is mainly linked to the issuance of debt securities in the Indian capital markets.

Business flow chart



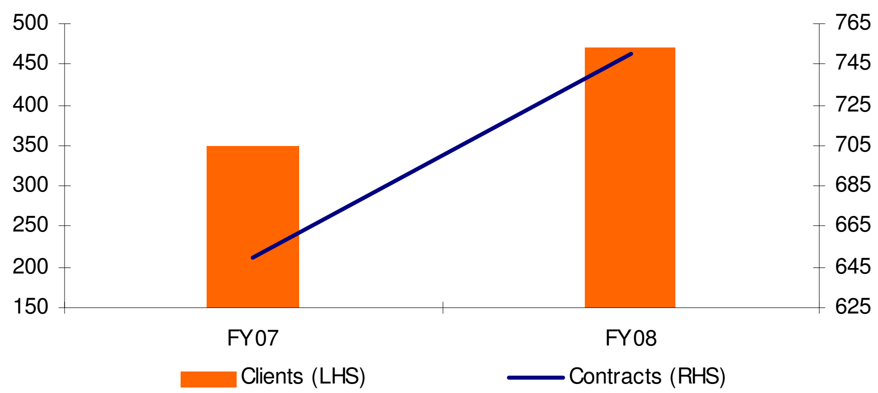
Source: Company, Emkay Research

Subsidiaries

IMaCS- ICRA Management & Consultancy Services Ltd

IMaCS, was incorporated in December 2004, as a wholly owned subsidiary of the company. The consultancy business has been a natural extension of ICRA's rating business as it has gotten requisite domain knowledge as well as corporate relationships. It provides management consulting services like risk management, strategy, corporate advisory and IT, across various sectors to clients based in India and abroad through five business groups namely Infrastructure, Energy, Banking and Insurance, Corporate Advisory and Government. These consulting services were provided by a division of the company till fiscal 2005, when the consulting division was demerged into IMaCS. The company has been getting a large number of government and infrastructure projects from bilateral and multilateral agencies like The World Bank Institute (WBI), Asian Development Bank, etc. IMaCS has executed over 750 projects for about 470 national and international clients. IMaCS contributed 17 % to the consolidated revenue in FY2008. Over the next five years, India is likely to see a massive USD500bn investment in infrastructure and energy space and ICRA, being a key player in this segment, is likely to be a key beneficiary.

Growth in advisory clients & contracts executed



Source: Company, Emkay Research

ICTEAS and ICRA Online

ICRA Techno Analytics Limited (ICTEAS) earlier known as Computer Exchange Private Limited became a wholly owned subsidiary of ICRA in the year 2005. It offers a complete portfolio of Information Technology (IT) solutions. The services range from the traditional development of client-server, web-centric and mobile applications to the generation of cutting edge business analytics. The company recently acquired Axiom Technologies Private Limited (Axiom), a Kolkata-based software services company, which .provided the company an entry into ERP implementation.

ICRA Online Limited, another 100% owned subsidiary of ICRA, provides outsourcing services in the areas of Knowledge process outsourcing, and data aggregation, besides technical services to financial sector. The focus is on high-end knowledge processing like financial modelling, data analysis, valuation, outsourced research, equity research, fixed income research, financial assets pricing, financial report writing, and econometric analysis. It also provides information management services to Moody's Investor Service. Both the subsidiaries together contributed Rs211mn in FY08, 20% of the overall revenue.

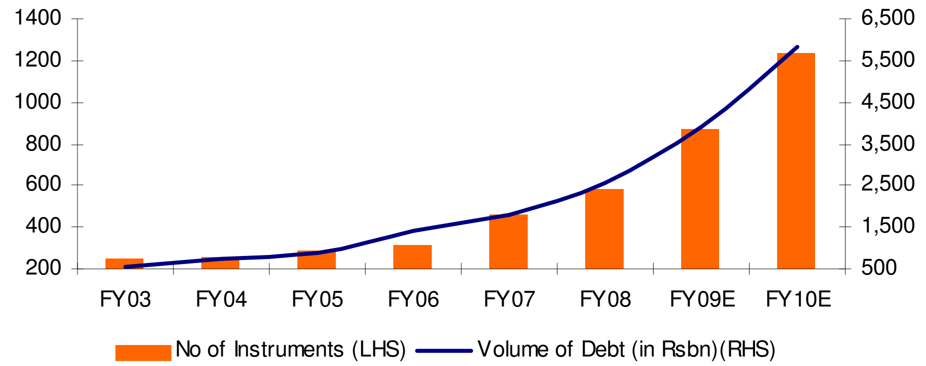
Investment Argument

Rating business- major growth driver

The rating business has grown at a CAGR of 25% over the last five years

The company's rating segment has been historically the major growth driver for the company. The acceleration in the economic activities in India, particularly the fixed asset investment activities (CAGR of 24% over FY04-08) coupled with lower penetration level of the corporate bond (3%) has resulted in a CAGR of 37% in the rating business volumes for ICRA over FY04-08. During FY08, it contributed 56% to the company's overall revenues. The Company's rating services can be classified into (i) Corporate & Infrastructure (ii) Financial Sector (iii) Structured Finance (iv) Public Finance. Among the four segments, the financial sector reported the highest CAGR of 34.7% over the last three years, driven by high activity in the domestic financial sector. We believe that the growing thrust on infrastructure and implementation of Basel II norms are likely to benefit the Corporate & Infrastructure segment, going forward.

Rating business - volumes for ICRA



Source: Emkay Research, Company DRHP

Key segments	Share in rating revenues	Growth Drivers
Corporate & Infrastructure	34%	Growth in economy - investments in capacity Basel II norms - banks want efficient use of capital Regulatory changes - compulsory grading of IPOs (17 till date for ICRA)
Financial Sector	51%	Credit growth - banks looking at raising tier II and qausi tier I capital
Structured finance	13%	Growing presence of NBFCs - Originate to securitize model Basel II norms - lower risk weight on enhancements if the instrument is rated (Currently 100% deduction from tier I capital) Regulatory changes - SCRA amendment to include PTCs to allow them to be listed on stock exchanges
Public finance	2%	To be stable business, fresh issuance by the government not rising

Source: Company, Emkay Research

Basel II rollout-opens a new business opportunity

More than 6500 entities need to be rated by FY2010, due to Basel-II implementation

Company's rating business will get a big boost with the implementation of Basel II norms. Under the RBI New Capital Adequacy Framework under Basel-II, corporates taking bank loans would need to take a bank loan rating (BLR) from a credit rating agency. The bank loan rating market will open up huge business opportunities for the credit rating firms as more than 6500 entities need to be rated by FY2010. Inline with the same, already signed MOU (non-exclusive) with around 15 banks to assign ratings to the bank's loans and other exposures under the standardized approach of RBI's New Capital Adequacy Framework for Basel-II. Under the MOU, ICRA will assign ratings to the bank's loans and its other exposures under the standardized approach of RBI's New Capital Adequacy Framework for Basel-II. Going forward, we expect the company to enter into more such kind of MOU's with banks, which is likely to further boost the company's revenue.

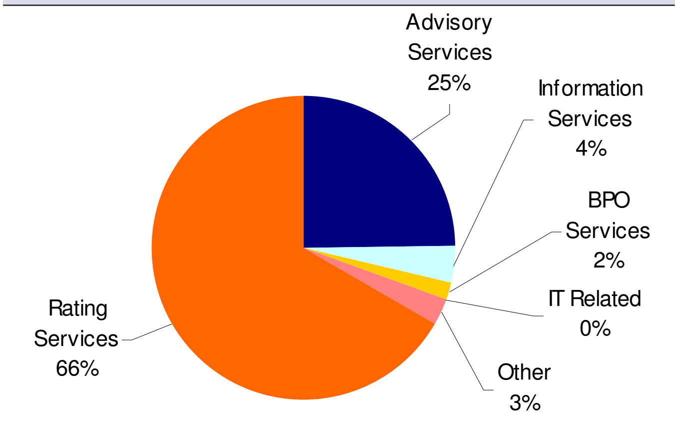
Surplus liquidity used to diversify businesses

The company has Rs633mn worth of surplus cash, invested in liquid mutual funds.

ICRA made a couple of acquisitions in the recent past to diversify its presence in other areas. In FY06, the Company acquired a 100% stake in Computer Exchange Private Limited (name changed to ICRA Techno Analytics Limited) and ICRA Online Ltd, which diversified the company's presence into information technology solutions and knowledge process outsourcing services. The company further strengthened its presence in these areas as ICRA Techno Analytics Limited (ICTEAS), the company's 100% subsidiary, acquired Axiom Technologies Private Limited (Axiom), a Kolkata-based software services company in June 2008. Axiom specialises in customisation and implementation of popular Enterprise Resource Planning (ERP) packages. The Axiom acquisition has provided the company an entry into ERP implementation.

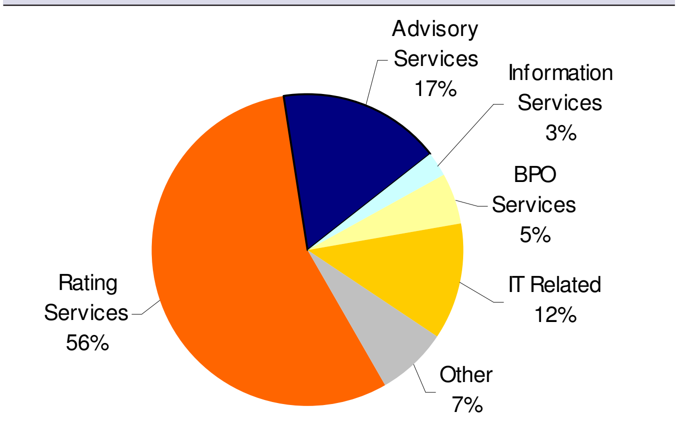
The company has around Rs633mn worth of surplus cash, invested in liquid mutual funds. As the rating business doesn't require much capital expenditure, the company could use this surplus cash for further acquisitions in non rating segments such as BPO services, information services and IT related services, to further strengthen its presence in these areas.

Revenue mix - FY05



Source: Company, Emkay Research

Revenue mix - FY08



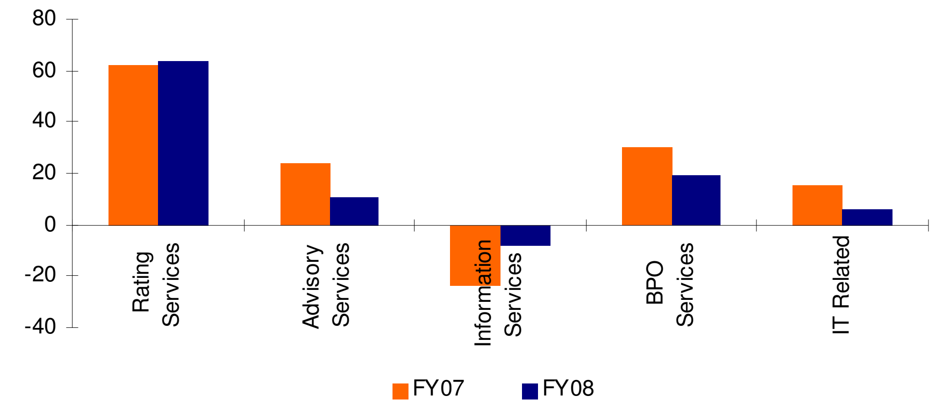
Source: Company, Emkay Research

… Diversification to reduce business risk

The company's non-ratings business contribution to the total earnings has increased from 33% in FY05 to 44% in FY08.

The company has, over the years, reduced its dependence on its core business of rating. Being an established player in the rating industry, ICRA has been raising its presence in other business segments like consultancy, information technology service and outsourcing activities. The company's non-ratings business contribution to the total earnings has increased from 33% in FY05 to 44% in FY08. As the ratings business is linked to the capital market, any slowdown in the latter would directly impact earnings. So, the company is broadening its product range and has been increasing it's presence into other segments. However, the company faced pressure on its margins in the non rating segments during FY08, as it is scaling up the size of operations. Moreover, appreciation of Indian Rupee against US Dollar also negatively impacted profitability in the non rating segments during the year. However, the non rating segment will add to profitability once the company achieves commendable scale in these new businesses. Nevertheless, due to buoyancy in the rating business, the overall operating margin expanded by 100bps yoy to 43% in FY08.

Operating Margin (%)



Source: Company, Emkay Research

Rising infrastructure activity to boost consulting revenues

ICRA has ramped up its consultancy business at a good pace since the incorporation of IMAcS (wholly owned subsidiary of the Company) in December 2004. The revenue from the consultancy business has grown at a CAGR of 24% over FY05-08 to Rs181mn, constituting 17% to the total revenue. The company has been getting a large number of government and infrastructure projects from bilateral and multilateral agencies like The World Bank Institute (WBI), Asian Development Bank, etc. IMaCS has executed over 750 projects for about 470 national and international clients. During FY08 itself, the company bagged 123 new projects, which reflects the growth potential in this business. We believe the continuous rise in investments by Indian corporates coupled with rising government spend on infrastructure activities, will create more opportunities for consulting services and hence, benefit the company going forward. However, the rising employee cost and increasing competition are major concerns in this area.

Strong relationship with Moody

Moody's has around 29% stake in the company

The company has a close association with its promoter, the Moody's Group, which is ICRA's largest shareholder. The company has technical services agreement with Moody, pursuant to which it receives certain high-value technical services. Moody also advises ICRA on rating-products strategy and the ratings business, in general.

Moreover, the company and its subsidiaries provide certain outsourcing services to the Moody's Group. The company has entered into a service agreement in FY05, with Moody's Investors Service to provide information management services to it. We believe that the growing relationship between the two will provide the company with larger business opportunities, going forward.

Strong operating leverage, if it gets pricing power

The company has strong operating leverage in the rating business. For example, if the yield per Rs100 of debt rated goes up by 1bp, then the net profit can grow by incremental 64%, keeping other things constant.

Operating leverage

In Rs mn	FY07	Post 1BPS increase in yield
Rating Services	603	861
Non Rating Services	471	471
Total Revenue	1073	1332
Total Expenditure	631	631
EBIDTA	442	701
Depreciation	38	38
EBIT	404	663
Interest	0	0
PBT	404	663
Provision for taxation	119	195
PAT	285	468
Incremental growth		64%

Source: Company, Emkay Research

Key risks and concern

Unfavorable economic conditions

Unfavourable economic conditions can affect the debt issuance and thereby, company's earnings

ICRA is primarily engaged in the business of rating services, 54% of its income comes through the ratings business, which is linked to the issuance of debt securities in the capital market. Unfavourable economic conditions can directly affect the securities market and thereby, the company's earnings through rating business.

High attrition rate

ICRA, being in the services sector, its performance is highly dependent on its ability to nurture and retain its employees. The company has been experiencing high attrition rate of around 22-23%, which though higher, is in line with its other peers in the industry. To counter this, the company has adopted an Employee Stock Option (ESOP) Scheme, under which, the company will grant options up to a maximum of 906,000 equity shares, constituting 9.06% of its paid-up equity capital. This is likely to control the high attrition rate and hence, improve the company's performance, going forward.

Turmoil in global financial markets

ICRA receives certain portion of its revenues from outsourcing services provided to Moody. The turmoil in the global financial markets and the structured products market has affected volumes of services being outsourced by Moody's. The performance of outsourcing business has also been affected by Rupee appreciation. Further strengthening of Rupee against US Dollar, could negatively impact company's outsourcing business in the future.

Financials and Valuations

Revenues to grow at 35% CAGR during FY08-10E period

Rating business to get push from the Basel II rollout

We expect ICRA's net revenues to grow at a CAGR of 35% to Rs2.0bn over FY08-FY10E, driven by robust growth in rating and non rating business. Rating business which is a major revenue contributor, will get a push from the Basel II rollout, increased issuance from financial sector entities and real estate issuers. Furthermore, information services and outsourcing services will benefit from growing financial services industry and rising outsourcing research activities. Moreover, rising investments in the infrastructure sector will provide a boost to the advisory segment.

EBIDTA margin likely to remain at ~36% over FY08-10E

We expect the EBITDA margins to remain at a higher ~36% over FY07-09E period. We expect expansion in EBIDTA margin of the non rating business. However, the same is likely to set off by low margin BLR business. Hence, we do not expect any significant expansion in company's EBIDTA margin over the period. Consequently, we expect the consolidated EBITDA to grow at 36% CAGR in FY08-10E period from Rs363mn in FY07 to Rs672mn in FY09E.

Earnings to grow at 36% CAGR over FY08-10E

Driven by a strong 35% growth in topline and high operating leverage, we expect ICRA's earnings growth to maintain its momentum at a CAGR of 36% over FY08-10E with an EPS of Rs39 in FY09 and Rs52.9 in FY10.

Valuation

At CMP, the stock is trading at 10.4x FY10E EPS, valuation offers significant upside

We have valued the company on PE multiple, in view of its healthy earnings growth. We expect the company to register an EPS of Rs39 in FY09E and Rs52.9 in FY10E. At CMP, the stock is trading at 14.1x FY09E EPS and 10.4x FY10E EPS. Considering the growth potential in the ratings business and ICRA's presence in high growth consulting and outsourcing services, we believe the company is well placed for future growth. With strong earnings growth of 36% over FY08-10E and core RoE of ~24%, we believe that ICRA is an excellent investment opportunity. We expect its core RoE to improve to 27% in FY10. We therefore, assign a target P/ E multiple of 14.2x, over the company's FY10 EPS. Based on this multiple, we value ICRA stock at Rs750. We initiate our coverage on the stock with a BUY rating and a price target of Rs750.

Consolidated Income Statement (Rs. Mn)

(Year Ending Mar 31)	FY07	FY08	FY09E	FY10E
Net revenues	706	995	1,361	1,850
Establishment Expenses	71	79	102	137
As a % to Net revenues	10.1	7.9	7.5	7.4
Staff Cost	297	427	597	805
As a % to Net revenues	42.1	42.9	43.8	43.5
Other Expenses	96	125	175	236
As a % to Net revenues	13.6	12.6	12.8	12.7
Total Exp	465	631	873	1,178
EBITDA (Core)	241	363	488	672
EBITDA (%)	34.2	36.5	35.8	36.3
Other Income	60	79	95	113
Depreciation	29	38	29	36
EBIT	272	404	553	750
Interest	0	0	0	0
PBT	272	404	553	750
Tax	72	119	163	221
ETR (%)	26.4	29.5	29.5	29.5
A PAT	200	285	390	529
Minority interest	0	0	0	0
APAT after MI	200	285	390	529

Source: Company, Emkay Research

Consolidated Balance Sheet (Rs. Mn)

(Year Ending Mar 31)	FY07	FY08	FY09E	FY10E
Equity Capital	100	100	100	100
Reserves & Surplus	1,374	1,539	1,866	2,321
Networth	1,474	1,639	1,966	2,421
Total Debts	0	0	0	0
Net def Liabilities	7	3	3	3
Capital Employed	1,482	1,641	1,969	2,424
Gross Block	414	452	571	665
Less Depreciation	(138)	(168)	(198)	(233)
CWIP	4	6	6	6
Net Fixed Assets	281	289	379	437
Investments	686	902	752	802
Debtors	196	217	372	502
Cash and Bank	28,352	255	59	84
Other current assets	3	6	3	3
Loans & Advances	416	495	790	1,066
Total Cur. Assets	28,966	973	1,224	1,654
Current Liabilities	28,307	239	239	323
Provisions	147	283	147	147
Total Cur. Lia. & Prov.	28,454	522	386	470
Net Current Assets	512	451	838	1,185
Total Assets	1,482	1,641	1,969	2,424

Source: Company, Emkay Research

Consolidated Cash Flow (Rs. Mn)

(Year Ending Mar 31)	FY07	FY08	FY09E	FY10E
Profit before Tax	272	404	553	750
Add : Depreciation	29	38	29	36
Add : Non Cash	(51)	(63)	0	0
Less: Tax Paid	(74)	(147)	(163)	(221)
Net changes in WC	(16)	81	(583)	(322)
Operational Cash Flows	159	313	(164)	243
Capital expenditure	(62)	(47)	(120)	(94)
Investments	(336)	(136)	150	(50)
Investing Cash Flows	(398)	(183)	30	(144)
Borrowings	(1)	(0)	0	0
Issue of shares	28,186	(28,174)	0	0
Add/Redn of Reserves	382	0	0	0
Dividend paid	(40)	(53)	(62)	(74)
Pymt to/from Minority Interest	(0)	0	0	0
Financing Cash Flows	28,527	(28,227)	(62)	(74)
changes in cash	28,289	(28,097)	(196)	25
Opening balance	63	28,352	255	59
Closing balance	28,352	255	59	84

Source: Company, Emkay Research

Consolidated Profitability Ratios (%)

(Year Ending Mar 31)	FY07	FY08	FY09E	FY10E
EBIDTA Margin	34.2	36.5	35.8	36.3
EBIT Margin	35.5	37.7	38.0	38.2
Net Profit Margin	26.1	26.6	26.8	26.9
RoA	16.5	18.3	21.6	24.1
ROE	16.6	18.3	21.6	24.1
Core RoE	21.9	24.0	27.5	27.0

Source: Company, Emkay Research

Consolidated Valuation table

(Year Ending Mar 31)	FY07	FY08	FY09E	FY10E
EPS (Rs)	20.0	28.5	39.0	52.9
FDEPS (Rs)	20.0	28.5	39.0	52.9
Cash per share (Rs)	-	115.7	81.1	88.6
Book Value (Rs)	147.4	163.9	196.6	242.1
FDPER (x)	27.6	19.3	14.1	10.4
P/BV (x)	3.7	3.4	2.8	2.3

Source: Company, Emkay Research

Emkay Research

26 September, 2008

CRISIL

Initiating

Geared for growth

BUY

Price	Target
Rs3,316	Rs4,150

Sensex - 13,547

Price Performance

(%)	1M	3M	6M	12M
Absolute	(7)	(4)	6	(7)
Rel. to Sensex	(1)	0	26	17

Source: Capitaline

Stock Details

Sector	Financial Services
Reuters	CRSL.BO
Bloomberg	CRISIL@IN
Equity Capital (Rs mn)	72
Face Value (Rs)	10
No of shares o/s (mn)	7
52 Week H/L (Rs)	3,885/2,651
Market Cap (Rs bn/USD mn)	24/520
Daily Avg Vol (No of shares)	3229
Daily Avg Turnover (US$ mn)	0.3

Shareholding Pattern (%)

	30/06/08	31/03/08	31/12/07
Promoters	51.5	51.5	51.5
FII/NRI	10.4	10.2	10.2
Institutions	15.6	15.0	14.1
Private Corp	1.7	2.0	2.2
Public	20.9	21.3	22.0

Source: Capitaline

We initiate coverage on CRISIL with a BUY rating and a target price of Rs4450. CRISIL, India's largest rating agency, will be the major beneficiary of the upcoming opportunities in the credit rating industry. Implementation of BASEL II norms coupled with rising activity in the debt market is likely to push the company into a strong growth trajectory. There are around 6500 entities, which will require rating by 2010, and being a leader in the industry, CRISIL is likely to garner a major chunk of this opportunity. CRISIL has been investing the strong cash flows from the rating business into diversified businesses like research and knowledge process outsourcing. This diversification has borne fruit with all segments contributing equally to CRISIL's revenues. We believe that the low CapEx requirement and sharp operating leverage of its businesses would help the company sustain strong ROEs in the future. At CMP, the stock trades at 14.4x CY09E EPS. CRISIL, despite being a high growth company and having high earnings visibility, is trading near its 10 year average valuation. We believe that at the current valuations, the stock looks attractive and offers significant upside.

Leadership position across business segments

CRISIL has established itself as a market leader in all of its business segments viz. Rating, Research and Advisory. CRISIL provides rating to the 70% of the USD27bn (Rs.1.1tn) domestic debt market. CRISIL research division (CRIS INFAC and Irevna) is India's leading independent, integrated research house. CRISIL is also the preferred consultant to governments, multi-lateral lending agencies, and private sector clients.

BLR rating - a big boost to the rating business

The rating business is likely to get a regulatory push with the implementation of Basel II norms. All the four players - CRISIL, ICRA, CARE and Fitch cumulatively have ratings on around 1,400 firms and this number is likely to increase exponentially with the implementation of Basel II norms. There are around 6500 entities, which will require rating by 2010, and being a leader in the industry, CRISIL is likely to garner a major chunk of this opportunity. Till date, CRISIL has done around 300 bank loan ratings.

Strong outlook for non-rating segment

CRISIL derives ~70% of its revenue from Research and Advisory segments, which has grown at a CAGR of 40% and 125% respectively over CY04-07. We believe both these businesses will continue to report strong growth going forward. We expect the demand for research services to remain firm driven by growing domestic financial services industry coupled with rising outsourcing of research activities. Furthermore, rising investments in the infrastructure sector will provide a boost to the advisory segment.

Valuation

At CMP, the stock trades at 14.4x CY09E EPS. With strong earnings growth of 41% over CY07-09E and core RoE of ~42%, we believe that CRISIL is an excellent investment opportunity. We have valued CRISIL at 18x CY09E EPS, giving a target price of Rs4,150.

Key Financials (Rs.mn)

Y/E Dec (Rs mn)	Net Revenues	Net profit	EPS (Rs)	ABV (Rs)	Core RoE (%)	RoE (%)	PE (x)	P/ABV (x)
CY06	2,873	614	91	280	45.6	38.3	36.5	11.9
CY07	4,043	837	116	383	44.1	36.0	28.6	8.7
CY08E	5,858	1,203	167	524	45.5	36.7	19.9	6.3
CY09E	8,018	1,663	230	720	42.6	37.0	14.4	4.6

Company Background

The Credit Rating Information Services of India (CRISIL) is India's first and the largest rating agency. It was established in 1987 by leading financial institutions, nationalised banks, foreign banks and private sector banks. The company is involved in credit ratings and risk assessment; research on India's economy, industries and companies; investment research outsourcing; fund services; risk management; and gas and infrastructure advisory services. The company provides all these services through three business segments-rating, research and advisory.

CRISIL came out with a public issue of equities in November 1993, making it one of the few rating agencies in the world to be listed on a stock exchange. Soon after that, in 1996, CRISIL entered into a strategic alliance with Standard and Poor's (S&P) Rating Services, USA, the leading rating agency in the world. The alliance, which was initially in the nature of a technical tie-up, was cemented in May 2005, when Standard & Poor acquired the majority shareholding in the company.

CRISIL, over the years, has strengthened its presence in research and advisory services segment, and now all the three segments of the company contribute equally to the company's revenue. The rating, research and advisory contribute 32%, 41% and 26% respectively to the company's revenue. The company has also improved its geographic mix over the years by strengthening its presence in US and UK through various acquisitions.

Major Shareholders

Name of the Shareholder	% shareholding
Group Holding of the The McGraw-Hill Companies	
a) Standard & Poor's International LLC, USA	8.30
b) S&P India LLC, USA	43.20
Rakesh Jhunjhunwala	7.61
Acacia Institutional Partners LP	5.71
General Insurance Corporation of India	4.19
Unit Trust of India	3.18
State Bank of India (Equity)	2.77
Clayon / CLSA Merchant Bankers Ltd	2.55
Life Insurance Corporation of India	2.37
Bright Star Investment Pvt Ltd	1.30

Source: BSE

Business profile

CRISIL has equal presence amongst domestic as well as international clients. Company derives 35% of its revenue from India, 45% from UK, 18% from USA and 2% from rest of the world. The company operates through three business divisions viz. research, advisory and rating.

Rating business

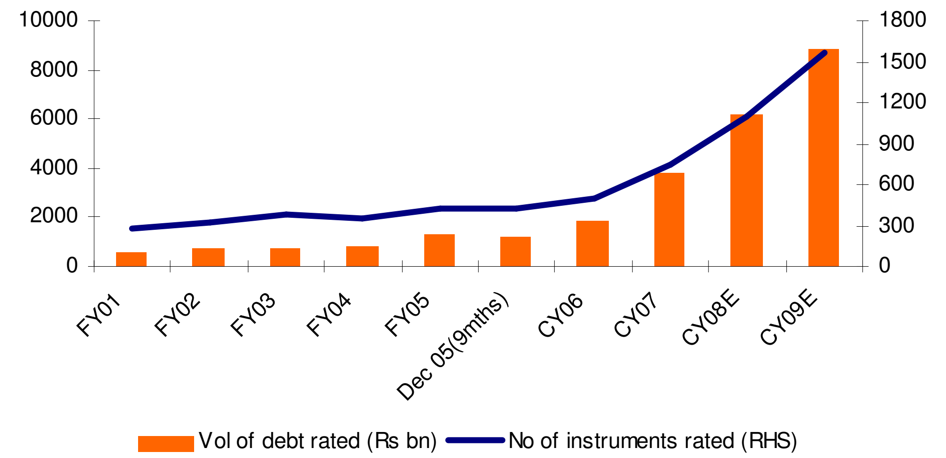
CRISIL Ratings is India's largest rating agency, having rated more than 7,000 debt instruments, of around USD295bn (Rs.11.8tn), issued by over 4,200 companies globally. The company has 70% penetration in USD27bn (Rs1.08tn) domestic debt market. Rating business contributes ~30% of CRISIL's operating revenue. The rating segment has grown at a CAGR of 31% over CY04-07, driven by robust growth in credit and retail sector.

Research business

CRISIL research division does research spanning the entire Economy - Industry - Company spectrum for its 600 domestic and 100 international clients, including 90 per cent of India's commercial banks. CRISIL has recently added equity research to its wide array of work, by acquiring Irevna, a leading global equity research and analytics company. Now, more than 70% of the company's research revenue comes from international business. Irevna has also established itself into derivative and credit research, which is an untapped space.

Research business contributes ~40% to the operating revenue of CRISIL. The revenue has grown at a CAGR of 125% over CY04-07.

The number of instruments and volume of debt rated by the Company

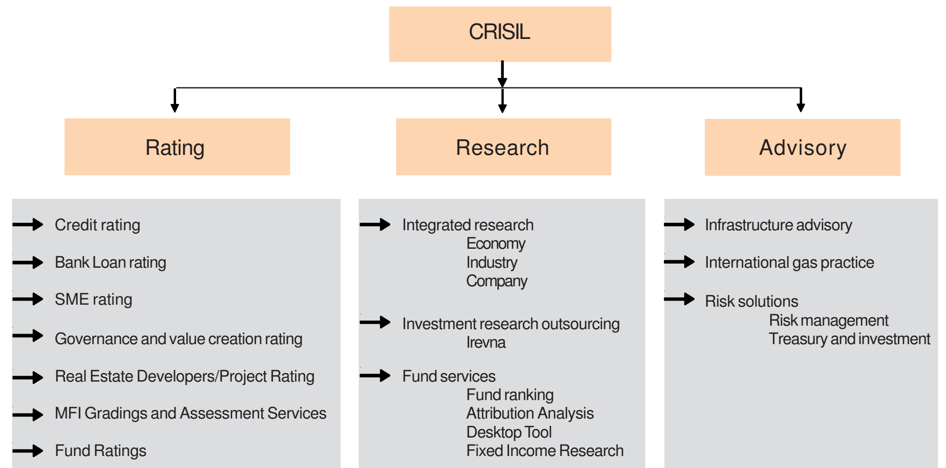


Source: Company

Advisory business

CRISIL has expertise in policy advisory, and also specializes in commercial and contractual issues in the areas of energy, urban infrastructure and public-private partnerships. It is also the preferred consultant to governments, multi-lateral lending agencies, and private sector clients. CRISIL's UK-based subsidiary, Gas Strategies Group (GSG), also contributes to the CRISIL group's information and advisory capabilities in the global gas and LNG domains.

Advisory business contributes ~25% to the operating revenue of CRISIL. The segment has grown at a CAGR of 40% over CY04-07.



Source: Company, Emkay Research

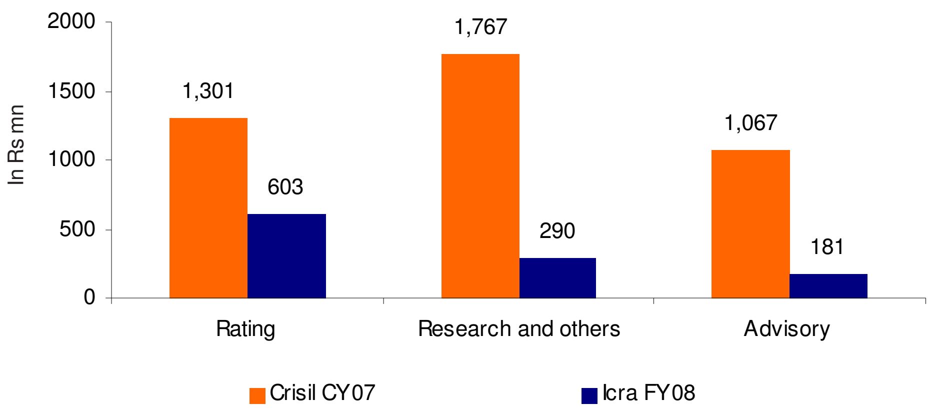
Investment Argument

Leadership position across business segments

CRISIL has a 70% market share of the Indian rating industry

CRISIL maintains a leadership position across ratings, research and advisory segments. CRISIL is far ahead of its next big competitor ICRA, in terms of revenue. CRISIL Ratings is India's largest rating agency, having rated more than 7,000 debt instruments, of more than USD295bn (Rs.11,80,000 crores), issued by over 4200 companies globally. Moreover, in the USD27bn (Rs1.1tn) worth domestic debt market, CRISIL Ratings has a 70% penetration. CRISIL research division is India's leading independent, integrated research house. It meets the business research requirements of more than 600 domestic and international clients, including 90% of India's commercial banks. Irevna, now a division of CRISIL Limited, has been voted the leader in high-end investment research and analytics outsourcing, for the second year in a row, by the US-based Brown & Wilson Group. CRISIL's is also the preferred consultant to governments, multi-lateral lending agencies, and private sector clients. CRISIL is not only India's premier advisor on policy, infrastructure and energy, but also has operations in Africa, the Middle East, and South-East Asia.

Peer group Revenue comparison



Source: Company, Emkay Research

BLR rating - a big booster to the rating revenues

Total business from the BLR in CY08 will be one-third of company's domestic rating business in the year.

The rating business is likely to get a regulatory push with the implementation of Basel II norms. All the four players - CRISIL, ICRA, CARE and Fitch cumulatively have ratings on around 1400 firms and this number is likely to increase exponentially with the implementation of Basel II norms. There are around 6500 entities, which will require rating by 2010, and being a leader in the industry, CRISIL is likely to garner a major chunk of this opportunity. CRISIL management expects an 8-fold increase in the volume to be rated on a full scale basis, if all the loans which require credit rating under the Basel II norms come under the purview. Till date, they have done around 300 bank loan ratings. The management believes that their total business from the BLR in CY08 will be one-third of their domestic rating business in the year. In CY07, the company derived Rs1.3bn from rating business

The retail finance market in India is expected to grow ~20% annually over the next five years

CRISIL to enter retail credit space- a fast growing market….

CRISIL, which already provides rating for large corporates and small and medium enterprises, is planning to enter the ~Rs2.7tn retail credit market. CIBIL is the only credit information company currently operational in India, and the company's entry into this space is a big positive. The retail finance market in India is expected to grow ~20% annually over the next five years, buoyed by favorable demographics and substantial increases in disposable income.

In February 2008, CRISIL entered into a preliminary agreement with Equifax Inc.,USA, (leading global credit information solutions company) and Tata Capital Limited (non-banking finance company and a wholly-owned subsidiary of Tata Sons Ltd) to form a credit information company (CIC). A CIC provides credit histories and checks on retail borrowers. The proposed initiative will capitalise on CRISIL's understanding of the Indian markets, Equifax's sophisticated tools and analytics, and the Tata Group's credibility and capability. However, the venture is subject to RBI approval. We believe the above initiative will provide a boost to the company's earnings, going forward.

The government projects a total investment of US$456bn in the 11th five year for infrastructure development

Rising infra spend to bring in more advisory business

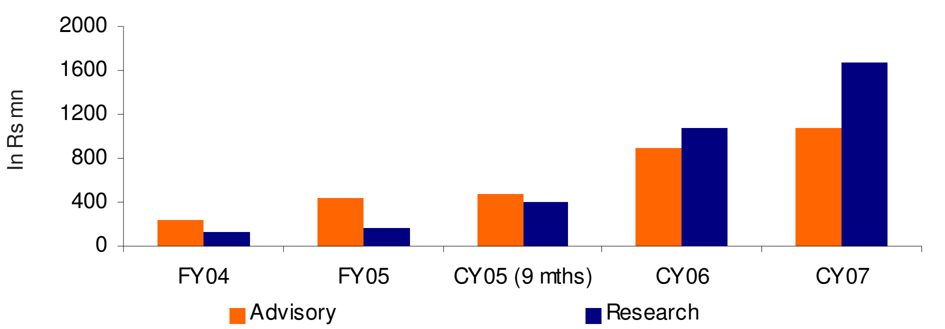
CRISIL is a preferred consultant to governments, multi-lateral lending agencies and private sector clients. The company is likely to benefit immensely from the rising investments in the infrastructure sector. The government projects a total investment of US$456bn in the 11th five year plan (2007-12) for infrastructure development. Moreover, with the Govt.'s thrust on urbanization and the implementation of the PPP model, demand for advisory services will see further rise. CRISIL's UK-based subsidiary, Gas Strategies Group (GSG) which provides advisory services to the oil & gas sector, is also likely to see a heightened demand for advisory services, driven by rising investments in the sector globally.

All the three business segments of the company - rating, advisory and research contribute significantly to the revenues

Diversified business model reduces risk

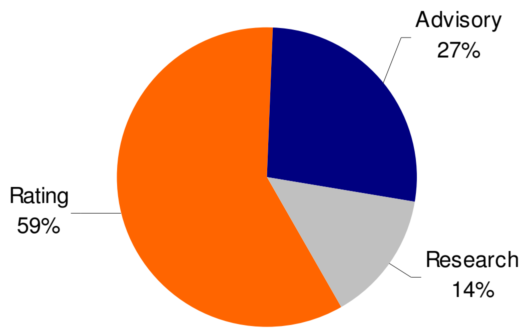
CRISIL business model is the best in the industry as the company is neither majorly dependent on any single activity nor restricted to a single territory for its revenue generation. Starting in the mid-90s, CRISIL embarked on a diversification program. Under the diversification program, the company aimed to diversify its cash flows, leverage existing capabilities, and generate synergies with existing businesses. The company has, over the years, expanded its research and advisory business as part of its diversification strategy. Now all the three business segments of the company -rating, advisory and research contribute significantly to the revenues, thereby de-risking the business model. The company is also well placed in terms of geographical diversification with significant presence in India, UK, and USA. In FY04, ~60% of the company's revenue used to come from rating business, 27% from advisory and the rest 14% from research. However, now all the three segments contribute equally to the company's revenue, with no business contributing less than 25%.

Revenue growth in Research and Advisory segment



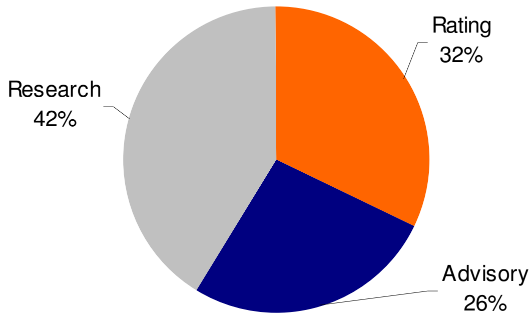
Source: Company, Emkay Research

Segmental revenue - FY04



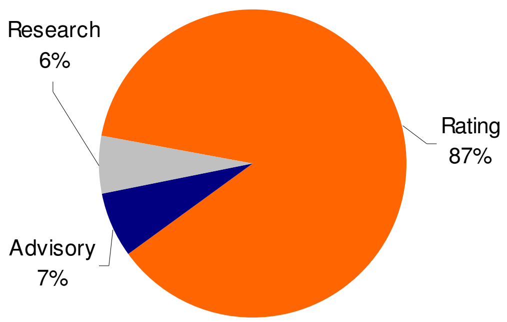
Source: Company, Emkay Research

Segmental revenue - CY07



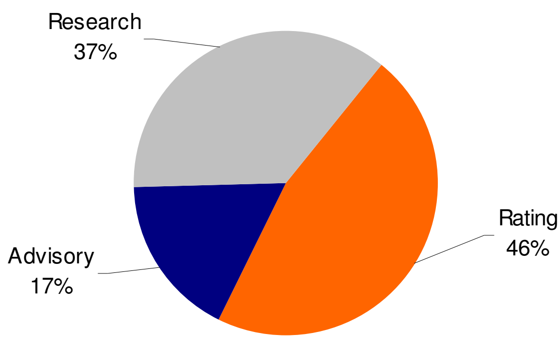
Source: Company, Emkay Research

EBITDA break-up - FY04



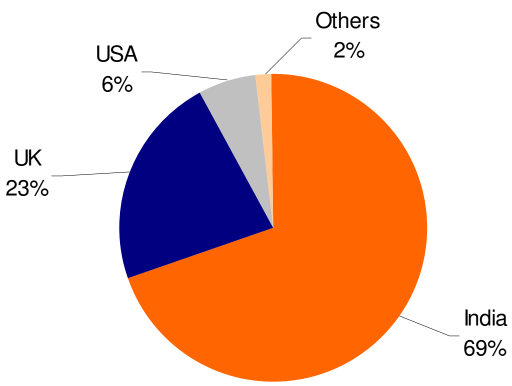
Source: Company, Emkay Research

EBITDA break-up- CY07



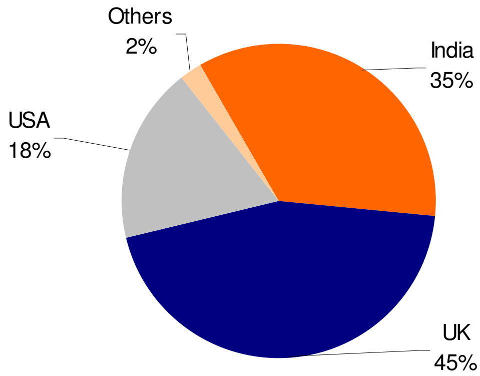
Source: Company, Emkay Research

Geographical break-up of revenue - FY05



Source: Company, Emkay Research

Geographical break-up of revenue - CY07



Source: Company, Emkay Research

Acquisition - a part of diversification strategy

CRISIL strengthened its presence in research and advisory segments through various acquisitions over the last few years

As part of its diversification strategy, CRISIL acquired various businesses and made strategic investments in the last decade. In FY00, it acquired the business of Information Products and Research Services (India) Pvt. Ltd., along with its brand INFAC. The Information Services business got a boost by the acquisition of INFAC (now CRIS INFAC, a subsidiary of CRISIL), India's leading provider of industry and company information. Further, in FY04 it acquired Gas Strategies Group Limited (earlier known as EconoMatters Limited), a London-based company engaged in gas consulting, information and training/ conferences for around £1.5mn. This was CRISIL's first major investment in the advisory business and provided it with international exposure.

In the same year, CRISIL made strategic equity investments in Caribbean Information and Credit Rating Agency Limited (world's first regional credit rating agency covering 19 countries.) and National Commodity & Derivatives Exchange Ltd (commodity exchange in India). While CRISIL took an equity stake of about 9% in the share capital of the Caribbean Information and Credit Rating Agency Limited, with an investment of US$300,000, it took 12.1% stake in the equity capital of the National Commodity & Derivatives Exchange Ltd (NCDEX) for Rs26.6mn. CRISIL further strengthened its position in research by acquiring Irevna group of companies for USD8.6mn. Irevna provides high- end customised equity research and analytics to the world's leading investment banks, commercial banks, accounting firms, management consultancy firms, Fortune 500 consumer finance companies and global law firms in UK and the US.

The above investments strengthened the company's presence in research, advisory segments, which now contribute significantly to the company's revenues.

…Surplus cash to fund further expansion

CRISIL has surplus cash of around Rs1.4bn lying in its books

CRISIL has surplus cash of around Rs1.4bn (including liquid investments) lying in its books. As the rating business does not require much capital expenditure, the company could use this surplus cash for further acquisitions in non rating segments such as BPO and KPO services, to further strengthen its presence in these areas.

Growing financial services space to benefit research business

With rising cost pressures overseas, more and more research activities are being outsourced

The company's research business is likely to see a further rise in demand, driven by growing domestic financial services industry coupled with rising outsourcing of research activities. As more and more players are entering into wealth management space, the demand for customized research services is on the rise. Moreover, with the rising cost pressures overseas, more and more research activities are being outsourced, benefiting CRISIL. The company has been able to garner a significant share of the outsourcing business through its subsidiary Irevna, a leading global equity research and analytics company. Irevna has also helped the company gain a foothold into the credit and derivatives offshore space, which is largely an untapped area in India.

Strong operating leverage if they get pricing power

The company has strong operating leverage in the rating business. For example, if the yield per Rs100 of debt rated goes up by 1bp, then the net profit can grow by incremental 35%, keeping other things constant.

Operating leverage

In Rs mn	CY07	Post 1BPS increase in yield
Rating Services	1,301	1,687
Non Rating Services	2,834	2,834
Total Revenue	4,135	4,521
Total Expenditure	2,872	2,872
EBIDTA	1,263	1,649
Depreciation	157	157
EBIT	1,106	1,492
PBT	1,106	1,492
PAT	837	1,129
Incremental growth		35%

Source: Company, Emkay Research

Key Concerns

Subsidiary floated by parent a concern

S&P has recently floated it's wholly owned subsidiary in India, apart from CRISIL, in which it is a majority shareholder. Although the management has assured that the areas of work for both the companies do not overlap significantly, floating of another subsidiary is a cause of concern for investors.

High attrition rate

CRISIL has been experiencing high attrition rate in the range of 20-25%,

CRISIL has been experiencing high attrition rate in the range of 20-25%, which is a cause for concern. CRISIL employs 1750 people with 40% workforce each in Rating and Research, and 10% each in Advisory and Corporate segment. Being a service oriented business, the company's profitability depends a lot on the ability to nurture and retain employees. To combat the problem of high attrition, the company launched Certified Analyst Program in March 2007. This new certification program will help the company in meeting its talent requirement. In addition, the company has been offering global training and job rotation to its employees to develop its talent pool. In 2007, the company conducted 117 training programmes for its employees and 108 employees attended various global training programmes.

Financials and Valuations

Revenues to grow at 40.4% CAGR during CY07-09E, driven by strong performance across segments

Rating segment is likely to grow at a CAGR of 50% over CY07-09E

We expect CRISIL's net revenues to grow at a CAGR of 40% to Rs8.2bn over CY07-CY09E The strong growth is attributed to robust performance of all the three business segments-Rating, Research and Advisory. Rating segment is likely to grow at a CAGR of 50% over the period, primarily driven by implementation of Basel II norms and rising debt issuance to fund the huge capex plans. Moreover, we expect the demand for research services to remain firm driven by growing domestic financial services industry coupled with rising outsourcing of research activities. Furthermore, rising investments in the infrastructure sector will provide a boost to the advisory segment.

Net profit to grow at 41% CAGR during CY07-09E

Net profit expected to grow at 41% CAGR over CY07-09E period to Rs1.7bn

CRISIL is expected to benefit from the upcoming opportunities in the credit rating industry. Implementation of BASEL II norms coupled with rising activity in the debt market is likely to push the company into a strong growth trajectory. The core segments are well poised for robust growth and strong performance in coming years. We expect healthy revenue growth at 40.4% CAGR during CY07-09E period and revenues of Rs8.2bn in CY09E. We expect the net profit to grow at 41% CAGR in CY07-09E period from Rs837mn in CY07 to Rs1.7bn in CY09E.

Higher return on equity

The company historically has generated higher return on equity. During CY07, the company reported a ROE of 36%. However, adjusted for cash and investments, ROE comes out to be much higher at 44%. We believe that the low CapEx requirement and sharp operating leverage of its businesses would help the company sustain strong ROEs in the future.

Strong earnings growth makes the stock an attractive BUY

We expect the company's earnings to grow at 46% CAGR over CY07-09E

We have valued the company on PE multiple, in view of it's healthy earning growth. We expect the company to register an EPS of Rs167 in CY08E and Rs230 in CY09E. At CMP, the CRISIL stock is trading at 19.9x CY08E EPS and 14.4x CY09E EPS. It is trading almost at par with its global counterpart, Moody. Despite being a high growth company with high earnings visibility, CRISIL is trading near its 10 year average valuation. Moreover, considering the fact that the Indian economy is growing at a much faster pace than the global economy, we believe that their current valuations are very attractive and offer significant upside from the current levels. We firmly believe that CRISIL is well placed to capitalize on the huge opportunities lying ahead in the Indian credit rating space. With strong earnings growth of 41% over CY07-09E and core RoE of ~42%, CRISIL is an excellent investment opportunity. Based on the above factors, we expect CRISIL stock to trade at 18x our CY09 EPS estimates. We initiate our coverage on the stock with a BUY rating and a price target of Rs4,150.

Consolidated Income Statement (Rs. Mn)

(Year Ending Mar 31)	CY06	CY07	CY08E	CY09E
Net revenues	2,873	4,043	5,858	8,018
Establishment Expenses	275	391	509	693
As a % to Net revenues	9.6	9.7	8.7	8.6
Staff Cost	1,146	1,520	2,322	3,178
As a % to Net revenues	39.9	37.6	39.6	39.6
Other Expenses	647	960	1,317	1,793
As a % to Net revenues	22.5	23.8	22.5	22.4
Total Exp	2,067	2,872	4,148	5,664
EBITDA (Core)	806	1,172	1,711	2,354
EBITDA (%)	28.1	29.0	29.2	29.4
Other Income	67	92	127	132
Depreciation	79	157	254	297
EBIT	795	1,106	1,583	2,188
Interest	0	0	0	0
PBT	795	1,106	1,583	2,188
Tax	188	270	380	525
ETR (%)	23.7	24.4	24.0	24.0
A PAT	607	837	1,203	1,663
Minority interest	0	0	0	0
APAT after MI	607	837	1,203	1,663

Source: Company, Emkay Research

Consolidated Balance Sheet (Rs. Mn)

(Year Ending Mar 31)	CY06	CY07	CY08E	CY09E
Equity Capital	68	72	72	72
Reserves & Surplus	1,821	2,692	3,715	5,129
Networth	1,889	2,764	3,787	5,201
Total Debts	0	0	0	0
Net def Liabilities	30	(33)	(33)	(33)
Capital Employed	1,919	2,732	3,755	5,168
Gross Block	1,620	1,860	2,691	3,665
Less Depreciation	(450)	(568)	(822)	(1,119)
CWIP	3	81	81	81
Net Fixed Assets	1,172	1,372	1,950	2,626
Investments	400	975	975	975
Debtors	667	897	1,328	1,809
Cash and Bank	385	424	891	1,517
Other current assets	1	4	4	4
Loans & Advances	162	407	359	489
Total Cur. Assets	1,215	1,733	2,582	3,818
Current Liabilities	700	959	1,364	1,862
Provisions	168	390	390	390
Total Cur. Lia. & Prov.	868	1,349	1,753	2,252
Net Current Assets	347	384	829	1,567
Total Assets	1,919	2,732	3,755	5,168

Source: Company, Emkay Research

Consolidated Cash Flow (Rs. Mn)

(Year Ending Mar 31)	CY06	CY07	CY08E	CY09E
Profit before Tax	795	1,106	1,583	2,188
Add : Depreciation	79	157	254	297
Add : Non Cash	(15)	20	0	0
Less: Tax Paid	(172)	(328)	(380)	(525)
Net changes in WC	(61)	(247)	22	(112)
Operational Cash Flows	625	709	1,479	1,849
Capital expenditure	(73)	(189)	(832)	(974)
Investments	(323)	(541)	0	0
Investing Cash Flows	(397)	(730)	(832)	(974)
Borrowings	0	0	0	0
Issue of shares	73	194	0	0
Add/Redn of Reserves	0	0	0	0
Dividend paid	(82)	(125)	(181)	(249)
Pymt to/from Minority Interest	0	0	0	0
Financing Cash Flows	(9)	68	(181)	(249)
changes in cash	219	47	467	626
Opening balance	166	377	424	891
Closing balance	385	424	891	1,517

Source: Company, Emkay Research

Consolidated Profitability Ratios (%)

(Year Ending Mar 31)	CY06	CY07	CY08E	CY09E
EBIDTA Margin	28.1	29.0	29.2	29.4
EBIT Margin	27.0	26.8	26.5	26.9
Net Profit Margin	20.6	20.2	20.1	20.4
RoA	37.6	36.0	37.1	37.3
ROE	38.3	36.0	36.7	37.0
Core RoE	45.6	44.1	45.5	42.6

Source: Company, Emkay Research

Consolidated Valuation table

(Year Ending Mar 31)	CY06	CY07	CY08E	CY09E
EPS (Rs)	90.9	115.8	166.6	230.2
FDEPS (Rs)	90.9	115.8	166.6	230.2
Cash per share (Rs)	116.2	193.7	258.3	344.9
Book Value (Rs)	279.6	382.6	524.2	719.9
FDPER (x)	36.5	28.6	19.9	14.4
P/BV (x)	11.9	8.7	6.3	4.6

Source: Company, Emkay Research

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Emkay Rating Distribution

BUY	Expected total return (%) of stock price appreciation and dividend yield) of over 25% within the next 12-18 months.
ACCUMULATE	Expected total return (%) of stock price appreciation and dividend yield) of over 10% within the next 12-18 months.
REDUCE	Expected total return (%) of stock price appreciation and dividend yield) of below 10% within the next 12-18 months.
SELL	The stock is believed to under perform the broad market indices or its related universe within the next 12-18 months.
NEUTRAL	Analyst has no investment opinion on the stock under review.