

SREI INFRASTRUCTURE FINANCE INR 122**Earnings marred by one-offs****BUY**

June 18, 2008

Business growth intact; lower margins and one-offs were drag on earnings

In Q4FY08, SREI Infrastructure Finance's (SREI) consolidated PAT grew 40% Y-o-Y to INR 475 mn; in FY08, it grew 57% Y-o-Y to INR 1.3 bn. While the equipment financing business grew in-line with our expectations; we believe, compression in net interest margins and a few exceptional items proved to be drag on its earnings.

Project finance to scale up, going forward

Loan assets (excluding securitisation and Quipo funding) grew 44% to INR 46 bn in FY08; out of this, equipment financing book is at INR 43 bn. The management expects growth trajectory in equipment finance to continue at 35-40% and will aggressively ramp up its project financing book by disbursing ~INR 25 bn in FY09E.

Margins under pressure due to increased funding cost

Interest expenses during the quarter include costs incurred on few non-interest earning assets. SREI aided Quipo by providing INR 6.3 bn in December 2007, to fund the acquisition of Spice Telecom's tower business. Income on the same is expected to be recovered/booked in the coming quarters. SREI booked mark-to-market (MTM) forex loss of INR 120 mn during the quarter in interest expenses. Adjusting for Quipo financing and MTM provisioning, net interest margin compressed ~40-45bps.

Deferred tax liability written-back, JV to bear tax burden on future profits

Post de-merger of its equipment financing business into a JV—SREI Equipment Finance—with BNP Paribas, SREI reviewed its deferred tax liability and has written back INR 643 mn in Q4FY08 (booked under other income). Consequently, the JV will have to provide for deferred tax liability on future profits, while the parent company will continue to provide tax as per minimum alternate tax (MAT) rates.

JV with BNP Paribas came to a logical conclusion

In Q4FY08, the infrastructure financing business (now with JV) reported net interest income of INR 707 mn and PAT of INR 239 mn. SREI Equipment Finance, a 50:50 JV with BNP Paribas, came to a logical conclusion and the consideration of INR 7.5 bn from BNP Paribas flowed into the business in April.

Outlook and valuations: Business momentum to gain strength; maintain 'BUY'

SREI is transforming itself from an infrastructure-financing player to a comprehensive infrastructure services company by venturing into infrastructure advisory and project development as well. We expect the company's consolidated EPS to grow at 30% CAGR over FY08-10E. The stock currently trades at 1.2x FY09E consolidated book and 11x FY09E consolidated earnings. Using SOTP methodology, we arrive at fair value of INR 25 bn or INR 189/share for its equipment finance, project financing, and equipment rental businesses. We believe the targeted infrastructure development projects will add incremental value of INR 17.7 bn or INR 132/share at fair value and INR 6 bn or INR 46/share on book value basis. We maintain 'BUY'.

Financials

Year to March	Q4FY08	Q4FY07	Growth (%)	Q3FY08	Growth (%)	FY08	FY09E
Net oper. Inc. (INR mn)	464	705	(34.2)	919	(49.5)	1,776	2,615
Net profit (INR mn)	475	338	40.5	279	70.3	1,320	1,447
BV per share (INR)*						53.5	102.5
Diluted EPS (INR)	4.5	3.1	42.8	2.6	75.3	9.9	10.8
Price/ Book (x)						2.3	1.2
Price/ Earnings (x)						12.3	11.3

* Book value for FY09E includes 50% stake in equity of JV with BNP Paribas

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Reuters : SREI.BO
Bloomberg : SREI IN

Market Data

52-week range (INR) : 292 / 84
Share in issue (mn) : 116.1
M cap (INR bn/USD mn) : 14.0 / 327.4
Avg. Daily Vol. BSE/NSE ('000) : 624.9

Share Holding Pattern (%)

Promoters : 25.1
MFs, FIs & Banks : 9.9
FIIs : 44.6
Others : 20.5

Relative Performance (%)

	Sensex	Stock	Stock over Sensex
1 month	(10.0)	(19.9)	(9.9)
3 months	6.0	(6.2)	(12.2)
12 months	11.5	28.5	17.1

Key conference call highlights

- As of date (post March 2008), the company has not witnessed any slowdown in disbursements and expects robust disbursement growth from the first quarter itself. The management expects equipment finance's growth trajectory to continue at 35-40% and will aggressively ramp up its project-financing book by disbursing ~INR 25 bn in FY09E.
- The management expects cost of funds to go up in the next few quarters due to tight monetary conditions and high inflation; however, it believes that it has the pricing power to maintain margins at the current level. Margins in Q4FY08 (adjusting for project financing and MTM loss provision) have been compressed ~40-45bps.
- Quipo is planning to raise ~INR 7.5-8.0 bn from new and existing investors in the next six months (first tranche) to fund its expansion plan.
- SREI has concluded an advisory contract for Ganga Expressway road project and will book fee income on actual cash receipt (anticipated in the next three-four months).
- The parent company, as well as SREI Equipment Finance, have adequate capital as of now; sufficient to fund its growth targets over the next two years.

Growth trajectory of equipment finance intact; project finance to be scaled up

SREI disbursed loans of INR 15 bn during the quarter (up 15% Y-o-Y), with growth trajectory sustaining in its equipment financing business. For the full year, disbursement grew 57% Y-o-Y to INR 57 bn. It has started focusing on project finance, building a book of INR 3-4 bn and plans to grow disbursements in this segment to INR 25-30 bn in the next 12-18 months. Despite the delays anticipated in some infrastructure projects due to the upcoming general elections, the management is sanguine on the continued traction in equipment financing business (anticipating growth of 35-40% over the next two-three years) on the back of a healthy pipeline and lower asset base. On consolidated basis, we estimate the loan book to grow 60% to INR 118 bn (considering 100% of equipment financing book), primarily driven by scale up of its project finance business.

Margins under pressure due to increased funding cost

Net operating income grew 11% in Q4FY08 to INR 784 mn (adjusting for Quipo financing and MTM loss provisions). Net interest margin, on like-to-like basis, compressed ~40-45bps in the equipment financing business.

Interest expenses in the quarter include funding costs incurred on few non-interest earning assets. In December 2007, SREI aided Quipo by providing INR 6.3 bn from its own balance sheet to fund the acquisition of Spice Telecom's tower business. Quipo's balance sheet was not strong enough to fund the acquisition when the opportunity cropped up. The transaction was executed at an arm's length and SREI is likely to charge Quipo 15% interest for this deal. As the due diligence and actual transfer of these telecom towers took place only post March 2008, SREI has not recovered/booked any income on this funding during Q4FY08. Quipo is planning a fund raising exercise in its telecom subsidiary in the near term and once it goes through, the amount will be repaid to SREI.

The company has invested INR 1.5 bn in the development of various road projects, but no income has been realised on the same during the quarter. It also booked MTM losses of INR 120 mn as a part of interest expenses.

The company expects its cost of funds to go up in the next few quarters due to tight monetary conditions and high inflation; however, it believes that it has the pricing power to maintain margins at the current level.

JV with BNP Paribas came to a logical conclusion

SREI Equipment Finance, a 50:50 JV with BNP Paribas for the equipment financing and leasing business, came to a logical conclusion in early April and commenced operations with effect from April 3, 2008. The consideration of INR 7.5 bn from BNP Paribas for 50% stake flowed into the business in April; of this, INR 3.8 bn will be transferred to SREI on account of transfer of assets, while the balance will be deployed to aggressively ramp up its project financing book. Till April 2, SREI held 100% of this entity and consequently 100% of income from this business was consolidated in its financials as against our expectation of only 50% as the JV was supposed to come in to effect from mid-February. In Q4FY08, the infrastructure financing business (now with JV) reported net interest income of INR 707 mn and PAT of INR 239 mn.

Quipo tapping capital infusion to fund expansion

Quipo is planning to raise ~INR 7.5-8.0 bn from existing and new investors in the next six months (first tranche) in its telecom subsidiary Quipo Telecom, so as to fund its expansion plan. Quipo Telecom had ~3,500 towers at the end of March 2008, while it expects to end Q1FY09 with ~4,500 towers. Quipo currently holds 77.5% in Quipo Telecom, expected to be diluted post capital infusion.

Though SREI will start accruing financing income Q1FY09 onwards on the INR 6.5 bn provided for the acquisition from Spice Telecom, the cash will flow in post capital infusion in Quipo Telecom.

MTM loss of INR 120 mn on forex derivatives

SREI has provided for MTM losses of INR 120 mn during Q4FY08 on its forex derivative exposure. By end-December 2007, outstanding forex borrowings included USD 228 mn, JPY 5.4 bn, and EUR 22 mn. MTM on the same have been adequately provided for, with cumulative provisioning being made till date to the extent of INR 700-800 mn.

Advisory on Ganga Expressway project to boost fee income

SREI was awarded a project management and advisory contract from the UP government for the INR 250 bn Ganga Expressway road project in Q3FY08, which was completed in the previous quarter. Since the company follows cash accounting policy to accrue fee income, it is expected to book fee income from the project in its financials on actual receipt, which is anticipated over the next three-four months.

Outlook and valuations: Business momentum to gain strength; maintain 'BUY'

SREI is transforming itself from an infrastructure-financing player to a comprehensive infrastructure services company by venturing into infrastructure advisory and project development as well. We expect the company's consolidated EPS to grow at 30% CAGR over FY08-10E. The stock currently trades at 1.2x FY09E consolidated book and 11x FY09E consolidated earnings. Using SOTP methodology, we arrive at fair value of INR 25 bn or INR 189/share for its equipment finance, project financing, and equipment rental businesses. We believe the targeted infrastructure development projects will add incremental value of INR 17.7 bn or INR 132/share at fair value and INR 6 bn or INR 46/share on book value basis. We maintain **'BUY'**.

Financial snapshot (Consolidated)						(INR mn)	
Year to March	Q4FY08	Q4FY07	Growth (%)	Q3FY08	Growth (%)	FY08	FY09E
Income statement							
Operating income	2,464	1,327	85.7	1,935	27.3	6,360	7,014
Interest expended	2,000	622	221.7	1,017	96.7	4,584	4,400
Net operating Income	464	705	(34.2)	919	(49.5)	1,776	2,615
Other income	665	13	NA	25	NA	1,190	468
Net revenues	1,129	718	57.1	943	19.6	2,966	3,083
Operating expense	338	228	48.3	379	(10.8)	1,111	1,104
-Employee expenses	127	96	32.2	151	(15.8)	450	438
-Other operating expenses	211	132	60.1	228	(7.6)	660	667
Pre-provisioning profit	791	490	61.2	564	40.1	1,855	1,979
Depreciation	128	123	3.8	125	1.8	33	23
Provision for bad debts	94	114	(18.0)	117	(20.2)	295	224
PBT	570	254	124.6	322	76.9	1,528	1,732
Provision for tax	92	(97)	NA	24	279.3	180	294
PAT	478	351	36.3	298	60.5	1,348	1,437
Less: share of profit from minority	0	(1)		8		(5)	2
Add: share of profit(loss) from	(3)	(14)		(11)		(23)	8
PAT after adjustments	475	338	40.5	279	70.3	1,320	1,447
EPS (INR)	4.5	3.1	42.8	2.6	75.3	9.9	10.8
Ratios							
NII / GII (%)	18.8	53.1		47.5		27.9	37.3
Cost-income (%)	29.9	31.7		40.2		37.5	35.8
Tax-rate (%)	16.1	(38.3)		7.5		11.8	17.0

Company Description

SREI is primarily into financing infrastructure equipment and projects as well as renewable energy projects. The company has 52 offices across India and is a market leader in infrastructure equipment financing with 30% market share. Equipment finance forms a chunk of SREI's portfolio (~90%), infrastructure project finance forms ~10%, while renewable energy financing makes up the rest. To further scale up its equipment financing and leasing business, the company entered into a 50:50 JV with BNP Paribas Lease Group (BPLG), which commenced operations in April 2008.

Along with the above-mentioned financing businesses, SREI undertakes other businesses through its wholly-owned subsidiaries. It is tapping emerging business opportunities in venture capital, asset management, investment banking, and insurance broking through its subsidiaries. SREI also runs a fleet management business through Quipo, wherein it has 17% stake, to provide equipment on rental, primarily in the construction, mining, oil & gas, telecom, and energy spaces.

Investment Theme

SREI is well-positioned to participate in the Indian infrastructure sector's growth. The company's market leadership and expertise in financing construction equipment enable its growth in emerging business segments such as private equity, investment advisory, and insurance broking. We believe SREI's JV with BPLG will be highly value-accretive and BPLG, as a strategic investor, will help the company capture huge growth opportunities in its business with better margins and without equity dilution in the near term.

Key Risks

A key risk on the upside will be better-than-expected margins and better fee income performance. The ability to refinance growth is pivotal. Being an NBFC, the source of funding for SREI is limited to wholesale funding, securitisation, and equity issuance. A spike in interest rates could hamper its margins in case of its inability to pass on the hike to the customer.

Financial Statements

Income statement		(INR mn)				
Year to March	FY06	FY07	FY08	FY09E	FY10E	
Interest income	1,891	3,204	5,932	6,578	11,248	
Non interest income	287	467	439	456	438	
Income from operations	2,178	3,671	6,371	7,034	11,686	
Interest charges	1,067	2,166	4,584	4,400	7,325	
Operating income (net of interest expenses)	1,110	1,505	1,787	2,635	4,360	
Other income	110	226	1,179	448	560	
Net revenues	1,221	1,731	2,966	3,083	4,920	
Operating expense	449	687	1,143	1,127	1,612	
Preprovision profit	771	1,044	1,823	1,956	3,308	
Provisions	72	131	295	224	457	
PBT	699	913	1,528	1,732	2,851	
Taxes	196	67	180	294	627	
PAT	503	846	1,348	1,437	2,224	
Share of associates/minority interest	14	(3)	(28)	10	10	
PAT after minority interest	516	843	1,320	1,447	2,234	
Diluted EPS (INR)	4.7	7.7	9.9	10.8	16.7	
DPS (INR)	2.0	1.0	1.2	1.5	1.5	
Payout ratio (%)	48.1	15.1	12.3	16.3	10.5	

Growth ratios (%)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Operating income growth	51.9	35.5	18.7	47.5	65.5
Net revenues growth	56.6	41.8	71.4	3.9	59.6
Opex growth	42.4	52.9	66.4	(1.4)	43.1
PPP growth	66.3	35.3	74.6	7.3	69.1
Provisions growth	5.6	81.6	124.8	(23.8)	103.7
PAT growth	78.0	68.1	59.4	6.6	54.7

Operating ratios (%)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Yield on assets	13.1	12.2	12.6	10.4	13.2
Cost of funds	8.5	8.9	10.7	8.0	10.2
Spread	4.6	3.2	1.9	2.5	3.0
Net interest margins	6.7	5.0	3.5	3.9	4.9
Tax rate	28.1	7.3	11.8	17.0	22.0

RoE decomposition (%)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Operating income (net of int exp)/Assets	6.7	5.0	3.5	3.9	4.9
Other income/Assets	0.7	0.7	2.3	0.7	0.6
Net revenues/Assets	7.3	5.7	5.9	4.6	5.6
Operating expense/Assets	2.7	2.3	2.3	1.7	1.8
Provisions/Assets	0.4	0.4	0.6	0.3	0.5
Taxes/Assets	1.2	0.2	0.4	0.4	0.7
Total costs/Assets	4.3	2.9	3.2	2.4	3.1
ROA	3.0	2.8	2.7	2.1	2.5
Equity/Assets	17.5	15.3	12.1	15.6	16.7
ROAE	17.3	18.3	21.9	13.7	15.0

Balance sheet**(INR mn)**

Year to March	FY06	FY07	FY08	FY09E	FY10E
Liabilities					
Equity capital	1,091	1,091	1,341	1,341	1,341
Reserves	3,071	3,972	5,888	12,453	14,452
Net worth	4,161	5,062	7,228	13,794	15,793
Secured loans	13,322	23,552	41,805	49,614	76,409
Unsecured loans	2,867	8,681	11,487	7,709	10,214
Deferred tax liability	638	638	108	281	709
Others	819	1,275	2,229	1,589	1,591
Total liabilities	21,807	39,208	62,857	72,987	104,716
Assets					
Loans	18,945	36,152	50,094	64,980	97,302
Investments	997	1,438	3,219	4,030	4,689
<i>Current Assets</i>	<i>2,531</i>	<i>3,107</i>	<i>12,033</i>	<i>5,788</i>	<i>5,312</i>
<i>Current liabilities</i>	<i>940</i>	<i>1,820</i>	<i>2,893</i>	<i>2,214</i>	<i>3,119</i>
Net current assets	1,591	1,287	9,140	3,575	2,193
Fixed Assets (net block)	213	269	348	354	491
Miscellaneous exp written off	61	61	57	49	41
Other assets					
Total assets	21,807	39,208	62,857	72,987	104,716
Balance sheet ratios (%)					
Loan growth	59.3	90.8	38.6	29.7	49.7
EA growth	82.2	80.5	60.6	16.2	43.5
Net NPA ratio	0.2	0.5	0.2	0.2	0.3
Provision coverage	88.8	67.4	85.0	75.0	75.0

Valuation metrics

Year to March	FY06	FY07	FY08	FY09E	FY10E
Diluted EPS (INR)	4.7	7.7	9.9	10.8	16.7
<i>EPS growth (%)</i>	<i>(12.2)</i>	<i>63.0</i>	<i>28.3</i>	<i>9.0</i>	<i>54.4</i>
Book value per share (INR)*	37.6	45.8	53.5	102.5	117.5
Adjusted book value per share (INR)*	37.4	44.9	53.3	101.8	116.1
Diluted P/E (x)	25.7	15.8	12.3	11.3	7.3
Price/ BV (x)	3.2	2.7	2.3	1.2	1.0
Price/ Adj. BV (x)	3.3	2.7	2.3	1.2	1.0
Dividend yield (%)	1.7	0.8	1.0	1.2	1.2

* Book value for FY09E and FY10E includes 50% stake in equity of JV with BNP Paribas

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SREI Infrastructure Finance



Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	104	60	15	2	193

* 11 stocks under review / 1 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	85	73	35

Recent Research

Date	Company	Title	Price (INR)	Recos
12-Jun-08	Banking	Repo rate hiked 25bps to 8%; <i>Sector Update</i>		
3-Jun-08	BFSI	Reduced leverage; increased disclosures <i>Sector Update</i>		
23-May-08	Federal Bank	Higher provisions depress earnings; <i>Result Update</i>	236	Buy
21-May-08	Karnataka Bank	Muted business performance; <i>Result Update</i>	208	Accum.

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 20% over a 12-month period
Accumulate	appreciate up to 20% over a 12-month period
Reduce	depreciate up to 10% over a 12-month period
Sell	depreciate more than 10% over a 12-month period

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