Company Focus

SMALL & MID CAP

6 December 2008 | 11 pages

Indiabulls (IBUL.BO)

Target price change ☑
Estimate change ☑

Sell: Too Many Unanswered Questions

- **Still a Sell** — Ibulls' stock price has corrected almost 90% from its peak and current valuations are at historic lows (0.6x P/BV, 4x P/E). However, we believe the stock is likely to continue to underperform in the current environment, given: a) Asset quality concerns; b) Funding is wholesale, availability and cost challenges; c) Increasing dependence on investment gains; d) Sharp drop in fees recently.
- **Reducing Earnings, Target Price; Maintain Sell** — We reduce earnings 28-37% over FY09-11E to factor in lower asset growth and fee incomes. We cut target price to Rs87 (Rs230), valuing the stock at 0.6x 1yr fwd P/BV (1.5x P/BV).
- **Asset Quality: Little Comfort** — Ibulls' loan mix is weighed towards higher risk segments – real estate (60%), margin finance (15%), SMEs (10%) and CVs (8%) – suggesting its better than peers' asset quality could be under pressure.
- **Wholesale Funded: Non-Bank model facing challenges** — Ibulls' leverage is relatively low (2.4x), but its funding is fully wholesale. Increasing redemption pressures for MFs (20%+ of borrowings), availability and costs will be tighter.
- **Investment Gains: Too high to be sustainable** — 64% of Ibulls pre-tax income (17% of total revenues) in 2Q09 came from realised investment gains, despite unrealized losses of about Rs1.4bn in March08 on the investment portfolio. We believe these levels are unsustainable and represent downside earnings risk.
- **Fees: Sharp drop in 2Q is a concern**— Ibulls' fee incomes dropped in 2Q (-87% qoq), reflecting drop in distribution and processing fees - an area of concern.

Sell/High Risk	**3H**
Price (05 Dec 08)	Rs95.90
Target price	Rs87.00
from Rs230.00	
Expected share price return	-9.3%
Expected dividend yield	8.9%
Expected total return	**-0.4%**
Market Cap	Rs24,323M
	US$488M

Price Performance (RIC: IBUL.BO, BB: IBULL IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	3,806	19.81	29.3	4.8	1.2	26.8	3.2
2008A	5,637	24.23	22.3	4.0	0.7	23.7	8.9
2009E	5,318	20.69	-14.6	4.6	0.7	15.7	8.9
2010E	6,207	24.15	16.7	4.0	0.6	16.7	8.9
2011E	7,247	28.20	16.8	3.4	0.6	17.4	8.9

Source: Powered by dataCentral

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

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Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	4.8	4.0	4.6	4.0	3.4
P/E reported (x)	4.8	4.0	4.6	4.0	3.4
P/BV (x)	1.2	0.7	0.7	0.6	0.6
P/Adjusted BV diluted (x)	1.3	0.8	0.7	0.6	0.6
Dividend yield (%)	3.2	8.9	8.9	8.9	8.9
Per Share Data (Rs)					
EPS adjusted	19.81	24.23	20.69	24.15	28.20
EPS reported	19.81	24.23	20.69	24.15	28.20
BVPS	82.56	128.20	139.62	154.55	173.59
Tangible BVPS	82.56	128.20	139.62	154.55	173.59
Adjusted BVPS diluted	72.62	126.40	137.67	152.39	171.15
DPS	3.02	8.50	8.50	8.50	8.50
Profit & Loss (RsM)					
Net interest income	6,449	8,377	11,116	13,334	15,828
Fees and commissions	2,333	0	0	0	0
Other operating Income	2,379	4,599	3,861	4,782	5,741
Total operating income	**11,161**	**12,976**	**14,977**	**18,116**	**21,569**
Total operating expenses	-3,809	-3,627	-5,743	-7,099	-8,533
Oper. profit bef. provisions	**7,352**	**9,349**	**9,234**	**11,017**	**13,036**
Bad debt provisions	-722	-1,039	-1,085	-1,527	-1,977
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	**6,631**	**8,310**	**8,149**	**9,490**	**11,059**
Tax	-2,197	-2,504	-2,746	-3,198	-3,727
Extraord./Min. Int./Pref. Div.	-628	-169	-85	-85	-85
Attributable profit	**3,806**	**5,637**	**5,318**	**6,207**	**7,247**
Adjusted earnings	3,806	5,637	5,318	6,207	7,247
Growth Rates (%)					
EPS adjusted	29.3	22.3	-14.6	16.7	16.8
Oper. profit bef. prov.	90.8	27.2	-1.2	19.3	18.3
Balance Sheet (RsM)					
Total assets	**40,611**	**161,771**	**126,063**	**145,058**	**187,764**
Avg interest earning assets	30,870	99,017	142,206	133,317	163,406
Customer loans	23,872	83,039	94,347	117,276	152,238
Gross NPLs	0	0	0	0	0
Liab. & shar. funds	**40,611**	**161,771**	**126,063**	**145,058**	**187,764**
Total customer deposits	0	0	0	0	0
Reserve for loan losses	0	0	0	0	0
Shareholders' equity	**15,131**	**32,489**	**35,384**	**39,167**	**43,991**
Profitability/Solvency Ratios (%)					
ROE adjusted	26.8	23.7	15.7	16.7	17.4
Net interest margin	20.89	8.46	7.82	10.00	9.69
Cost/income ratio	34.1	28.0	38.3	39.2	39.6
Cash cost/average assets	11.5	3.6	4.0	5.2	5.1
NPLs/customer loans	0.0	0.0	0.0	0.0	0.0
Reserve for loan losses/NPLs	na	na	na	na	na
Bad debt prov./avg. cust. loans	4.0	1.9	1.2	1.4	1.5
Loans/deposit ratio	na	na	na	na	na
Tier 1 capital ratio	na	na	na	na	na
Total capital ratio	na	na	na	na	na

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Multiple Concerns – Reducing Earnings, Target Price

We are reducing our earnings estimates for Indiabulls 28-37% over FY09-11E to reflect slower asset growth (though at over 30% for FY09E still high relative to the industry), increasing provisioning charges and drop in fee incomes. This is, however, partly offset by high realised gains on the investment portfolio.

Figure 1. Earnings Revision Summary

	Net Profit (RsM)			EPS			DPS	
	Old	New	% change	Old	New	% change	Old	New
FY09E	7,437	5,318	-28.5	28.9	20.7	-28.5	9.0	8.5
FY10E	9,431	6,207	-34.2	36.7	24.1	-34.2	9.5	8.5
FY11E	11,478.8	7,247	-36.9	44.7	28.2	-36.9	10.0	8.5

Source: Citi Investment Research

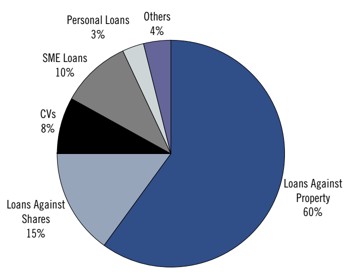
Fundamentally, we believe Indiabulls' business continues to face multiple challenges over the near to medium term – a) Asset quality – its loan is predominantly skewed towards relatively higher risk segments; b) Funding – wholesale funded, non-banking platforms are globally (and in the domestic context) facing significant challenges in terms of availability and cost of incremental funding; c) Dependence on investment gains – over 60% of pre-tax income in the previous quarter was on account of realised investment gains, which in our view is unsustainably high; and d) Fee incomes – sharp slowdown evidenced in 2Q09; while we are currently treating it as an aberration, it is another area of concern for now.

We reduce our target price to Rs87 per share, valuing the company at 0.6x 1 yr Fwd P/BV to reflect the challenges it faces in the current environment. Also we continue to avoid valuing its proposed new ventures (commodity exchange, life insurance and asset management) as they are yet to start operations. Moreover, they are likely to draw on the parent's capital for funding (which can be continuous as in the case of life insurance), increasing effective leverage for the parent.

Loan Composition provides little comfort on quality

Indiabulls' loan mix, in our view, is skewed towards relatively higher risk segments – real estate loans (60%), margin finance (15%), SMEs (10%) and commercial vehicles (8%). So far, Indiabulls' asset quality performance has been significantly above industry levels - even for the small ticket personal loan segment which has seen close to double digit NPLs for some of the larger institutions in the country. However, we believe, Indiabulls' loan book is also not yet fully seasoned due to relatively strong historical growth (still over 100% yoy despite the sharp deceleration in the last couple of quarters). We therefore remain cautious of asset quality performance and expect incremental pressures to rise, leading to an increase in provisioning levels.

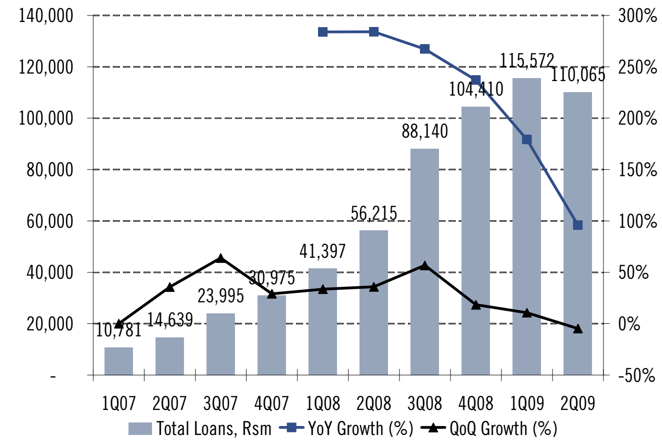
Figure 2. Composition of Loan Portfolio (%)



Source: Company Reports

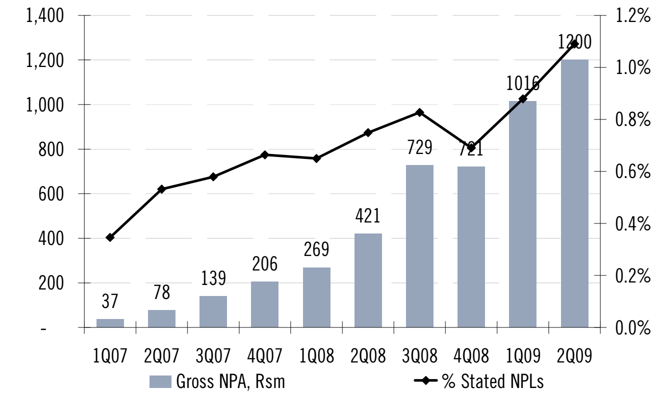
We are also lowering our loan growth estimates to 31% for FY09E and 27%p.a. for FY09-11E (54% for FY09E and 40% p.a. in FY09-11E). However, these still remain fairly high relative to the economic and industry growth environment and could have further downsides.

Figure 3. Indiabulls – Total Loans (LHS, Rsm) and Loan Growth (RHS, %)



Source: Company Reports

Figure 4. Indiabulls – NPLs (LHS, Rsm) and NPL Ratio (RHS, %)



Source: Company Reports

Funding – Wholesale, Availability and Cost Challenges

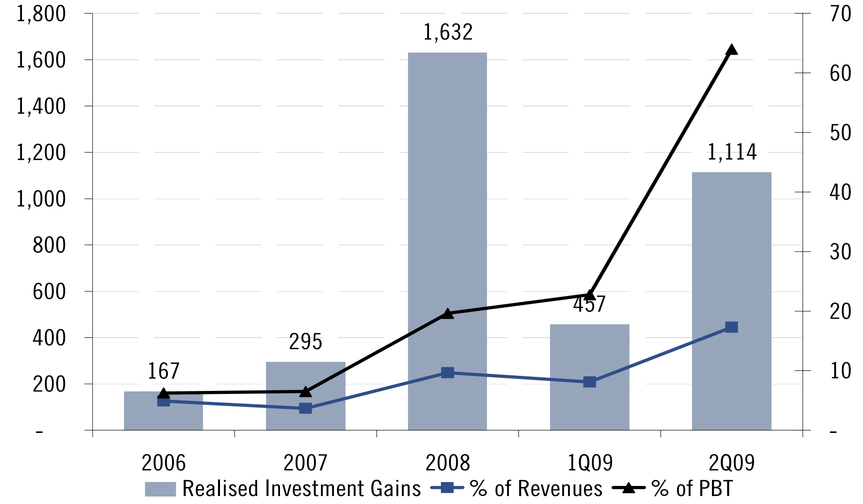
Indiabulls operates on a finance company platform with no access to retail deposits and is therefore fully dependent on wholesale finance. While interest rates recently have started coming off (likely to decline some more), we believe that liquidity in the domestic system is likely to remain tight and cost of funding will also remain relatively high.

About 20% of Indiabulls' borrowings are from Mutual Funds / Commercial Paper (usually MFs have been large investors in CPs). Over the last few months – MFs have not been rolling over a large portion of their loans due to significant redemption pressures on them. As these are also relatively short term loans, this will put pressure on Indiabulls due to the availability and the cost of refinancing of these borrowings. In addition, Indiabulls was recently shifting to more longer term loan from the banks, which could possibly lock them in for a longer duration at the peak of the interest rate cycle.

Investment Gains – Increasing Earnings Risk

Indiabulls' realised investment gains (surprisingly) increased to Rs1.1bn in 2Q09 and formed 17% of total revenues and 64% of pre-tax earnings. This is particularly surprising as the company had reported unrealized losses of about Rs1.4bn in the investment portfolio as at March 2008 (the broader market has declined 41% during this period). Investment gains as a proportion of pre-tax earnings have increased sharply over the last few quarters (20% in FY08, 64% currently) and we believe is unsustainable at current levels. While we have increased our estimates for investment gains for 2H09, in our view, continued volatility and persistent equity market weakness could result in a significant earnings risk for the company going forward.

Figure 5. Realised Investment Gains as Proportion of Revenues and Profit Before Tax (Rsm, %)

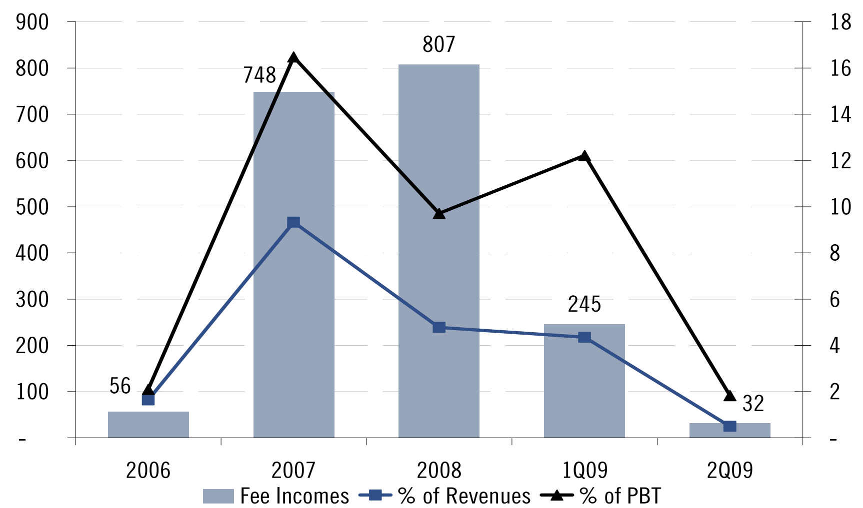


Source: Company Reports and Citi Investment Research Estimates

Sharp drop in fees; Is it an aberration?

Indiabulls' fee incomes dropped 87% qoq in 2Q09 – while this may be an aberration (and we are currently treating it as such) – it does raise concerns on the sustainability of future revenues. Ibulls' fee revenues have been coming from third party distribution of financial products (insurance and mutual funds) and loan processing fees. A combination of weaker capital markets and sharp decline in fresh loan disbursals has led to a steep decline in fees. We do not expect a quick recovery in either of these and therefore it remains an overhang on Ibulls' earnings profile.

Figure 6. Fees have dipped sharply (Rsm, %)



Source: Company Reports

Indiabulls

Company description

Sameer Gehlaut (CEO), Rajiv Rattan (CFO) and Saurabh Mittal (Director), founded Indiabulls (IBFSL) in 2000. The company and its subsidiaries are engaged in lending activities, offering personal loans, mortgages, commercial credit and loans against securities. It also undertakes third-party insurance product sales and distribution. Indiabulls is seeking to diversify into commodity exchanges, asset management and life insurance manufacturing. IBFSL listed on the Indian stock exchanges in Sep 2004.

Investment strategy

We rate Indiabulls shares as Sell/High Risk (3H). Indiabulls has aggressively entered new business areas: mid-market consumer financing, SME loans, IPO financing and loans against property. Growth in the consumer finance businesses has been strong. Potentially high-return, high-risk ventures, these businesses are in the stage of building up aggressively. However, we see potential pressures in these businesses due to a) higher interest rates and tight liquidity environment, b) lower economic growth, and c) increased environmental risks to asset quality. Indiabulls operates off a wholesale funding platform which suffers in a rising interest rate environment due to higher costs and availability. Indiabulls has been growing its asset portfolio very aggressively and a significant proportion of its loans are from SME, commercial vehicle loans and loan against shares and property. Growth in this portfolio is highly leveraged to strong growth in the domestic economy and capital markets – current deceleration in growth would likely result in a sharp decline in its growth rates. Also, in a rising rate environment, there are significant risks to asset quality, especially in the SME, commercial vehicles and loans against property segments, which is another source of risk for Indiabulls.

Valuation

Our target price on Indiabulls is Rs87. Our target price is based on 0.6x 1yr Fwd PBV for the financing businesses. Our target multiple is at a significant discount to other private sector banks (HDBK, Axis, Yes Bank) and best of breed non-banking finance companies (IDFC) due to its fully wholesale funded model, aggressive growth rates (raising asset quality risks), relatively higher yields and significant SME, real estate and capital markets exposure.

Risks

We rate Indiabulls High Risk in-line with our quantitative risk-rating system, which tracks 260-day historical share price volatility. The rating is also due to the demerger of its securities business (reduces revenue diversification), its dependence on wholesale funding (current rising interest rates are likely to raise funding costs, reduce availability) and increasing leverage. Moreover, Ibull's asset quality is also fundamentally under pressure due to a higher interest rate environment. Specific upside risks to our target price include a) decline in interest rates or easy liquidity environment, b) reversal in the asset quality environment, c) higher than expected margins on the lending portfolio, and d) faster than expected scale up / value accretion in announced new business ventures (life insurance, commodity exchange, asset management).

Appendix A-1

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Indiabulls (IBUL.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Manish Chowdhary, CFA
Covered since September 7 2006

	Date	Rating	Target Price	Closing Price
1	23-Mar-06	*3M	*98.10	100.16
2	2-Apr-07	3M	*350.00	400.45
3	25-Jul-07	3M	*550.00	611.40
4	27-Jul-08	*3H	*230.00	280.00

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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