Prabhudas Lilladher

Edelweiss Capital

Annual report analysis

June 24, 2008

Rating	**Outperformer**
Price	Rs649
Target Price	Rs820
Implied Upside	26.3%
Sensex	14,107

(Prices as on June 24, 2008)

Trading Data	
Market Cap. (Rs bn)	48.9
Shares o/s (m)	75.3
Free Float	61.9%
3M Avg. Daily Vol ('000)	62.2
3M Avg. Daily Value (Rs m)	49.3

Major Shareholders	
Promoters	38.1%
Foreign	6.1%
Domestic Inst.	0.3%
Public & Others	55.5%

Stock Performance

(%)	1M	6M	12M
Absolute	(13.9)	(53.6)	NA
Relative	0.2	(25.7)	NA

Annual Report 2008

- **MD&A stresses on diversified business model:** Edelweiss Capital's (EDEL) management, in its first annual report post listing, has stressed the importance of its diversified business model. With just 26.0% of its revenue in FY08 coming from broking (going down to 20.4% in FY10E), EDEL is one of the more diversified capital market companies in India.
- **Capital base has grown dramatically:** EDEL's capital employed has grown at a CAGR of 288% over FY05-08. In FY08 itself it grew by 279% due to external capital infusion, strong earnings growth and higher debt. With over Rs30bn in cash-n-equivalents and treasury positions, EDEL has one of the most liquid balance sheets within its peers.
- **Revenue shifting in favour of interest income:** NII (from wholesale financing) was 3.5% in FY07 and grew to 20.0% of revenue in FY08. With a larger capital base, we expect this segment to contribute 30.7% and 36.1% to revenue in FY09 and FY10 respectively. Thus, despite the weak market, revenue is expected to grow at a CAGR of 25.8% over FY08-10.
- **Growing capital base, interest depress RoE:** EDEL's RoE has been on a decline since FY05. This has essentially been due to rapidly expanding capital base. Some of the decline is arrested due to greater leverage. We expect the trend to continue into FY09 and improve in FY10 along with better market conditions.
- **Valuation attractive; outlook cloudy:** At 2.3x FY08E book value and 2.0x FY09E down-cycle earnings, valuations are clearly attractive for a long-term investor. Given the near-term uncertainty in the equity markets and the high-beta nature of the stock we remain neutral on its near-term prospects, though rate it Outperformer from a 12-18 month perspective.

Key financials (Y/e March)	FY07	FY08	FY09E	FY10E
Revenue (Rs m)	3,691	10,868	12,785	17,194
Growth (%)	*135.1*	*194.4*	*17.6*	*34.5*
EBITDA (Rs m)	1,941	6,531	7,402	10,422
PAT (Rs m)	1,092	2,732	2,869	4,117
EPS (Rs)	22.0	39.6	38.2	54.5
Growth (%)	*134.0*	*80.0*	*(3.5)*	*42.8*
Net DPS (Rs)	—	1.8	3.3	5.0

Source: Company Data; PL Research

Profitability & valuation	FY07	FY08	FY09E	FY10E
EBITDA margin (%)	*52.6*	*60.1*	*57.9*	*60.6*
RoE (%)	*31.1*	*23.4*	*15.5*	*18.3*
RoCE (%)	*18.0*	*14.8*	*8.7*	*9.6*
EV / sales (x)	-	6.3	6.0	5.0
EV / EBITDA (x)	-	10.4	10.4	8.2
PE (x)	-	16.4	17.0	11.9
P / BV (x)	-	2.6	2.3	2.0
Net dividend yield (%)	-	*0.3*	*0.5*	*0.8*

Source: Company Data; PL Research

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MD&A stresses on diversified business model

EDEL's FY08 annual report is the first after the company got listed in December 2007. Hence, the management has spent considerable space in explaining the business model of the company, its business philosophy and long-term prospects. One of the aspects stressed repeatedly in the letter to shareholders, MD&A and the director's report is the diversity of revenue model, liquidity of its balance sheet and robustness of its risk-management systems.

The management states that while the firm will obviously be affected due to the weak equity market conditions, given its diverse revenue profile it expects to be impacted much less than its peers.

Revenue reasonably well diversified; will improve further

EDEL generates about only 26.0% of its revenue from broking. It gets another 7.4% from investment banking and 6.2% from advisory services. But the company gets a bulk of its revenue – 32.1% - from trading & arbitrage/treasury. This makes EDEL one of the most diversified companies in its peer set. Over the next two years the company's wholesale financing business will grow substantially, further adding to the diversity of its revenue model.

Revenue break-up

	FY07	FY08	FY09E	FY10E
Agency business	2,154	4,438	4,864	6,569
Broking	1,407	2,831	2,844	3,515
Investment banking	545	800	1,000	1,360
Others	201	807	1,020	1,694
Capital business	1,537	6,430	7,921	10,626
Treasury	1,142	3,493	3,191	3,506
Financing (interest inc.)	130	2,171	3,930	6,200
Investments	265	766	800	920
Total	**3,691**	**10,868**	**12,785**	**17,194**

'Prop book' is actually like the treasury of a bank

The company's largest revenue contributor currently is the least understood of its various businesses. The management takes pains to explain the trading & arbitrage business (the so called 'prop book' is to them what a treasury is to a bank. The company maintains an extremely liquid balance sheet, given the nature of its business and its future expansion plans in the capital market. The first charge on the firm's capital is with the agency and other operating businesses. But since demand from these businesses comes in spurts, funds are deployed in various arbitrage and low risk strategies in the market during the remaining time. Hence, when demand for funds from other divisions is high, the size of the treasury book is small and vice-versa. In periods of extreme market turbulence too, the firm moves a bulk of its resources into cash thus reducing its book size. Almost all its positions are either risk-free or low risk. The company has an internal overnight VAR limit of Rs200m, but the management says it rarely crosses Rs50m.

We have taken no growth in treasury income over the next two years, and have actually modelled a decline of 8.6% in FY09.

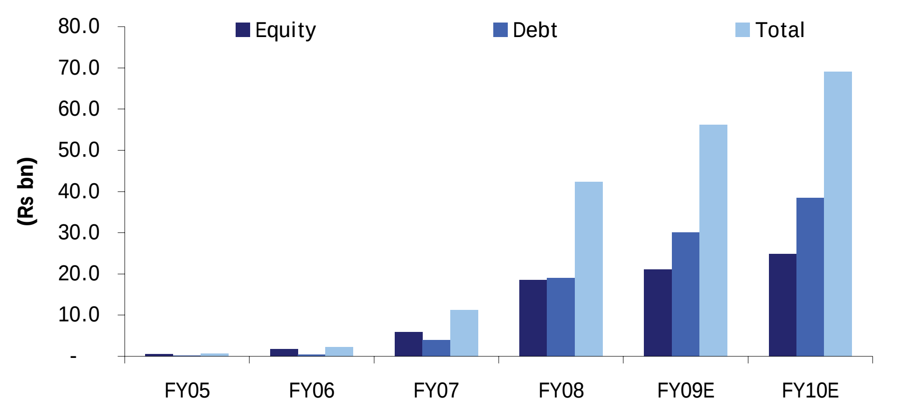
Balance sheet size has grown dramatically

EDEL's balance sheet has grown at a CAGR of 288% over FY05-08. In FY08 itself it grew by 279%. Its networth (excl. minority interest) stood at Rs18.5bn as of March 2008, while total debt (including ST Bank overdrafts) stood at Rs19.1bn. This strong balance sheet, coupled with ample scope for further leverage, will enable the company to scale-up its wholesale financing business rapidly over the next couple of years.

Both fresh capital infusion and retained earning contribute

From FY05 onwards, EDEL's shareholder funds have grown by Rs17.9bn. Of this about Rs4.1bn (23%) was from retained earnings and Rs13.8bn (77%) from fresh equity infusion, including the IPO in FY08. Clearly, EDEL has captured opportunities thrown up by good market conditions to both grow its business (and hence networth) rapidly as well as raise timely financing at attractive valuations.

Growth in capital employed

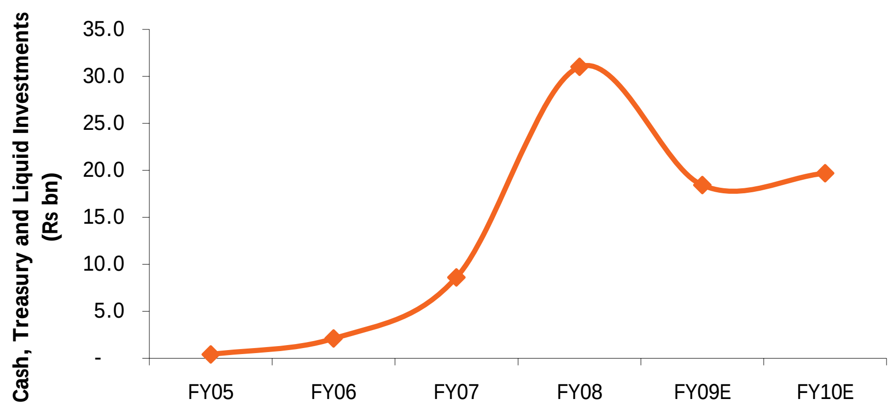


Source: Company Data, PL Research

Liquidity position is one of the best amongst peers

Of the Rs42.3bn balance sheet, the company has nearly 71% in cash, liquid investments & treasury investments. This enormous liquidity pool is the highest amongst peers. It is clearly excessive at this point and also the main reason for the poor RoCE and RoE of the company. Much of the high liquidity is due to the recent IPO and capital raising in its wholesale financing subsidiary, ECL Finance; but a lot of it is also driven by the management's belief that strong liquidity allows the company to smoothly tide over periods of extreme volatility and also allows it to capture business opportunities that its competitors are not in a position to cater at that point. Over the next two years, as the advances book grow, surplus liquidity is likely to reduce, thus improving overall capital efficiency.

Balance sheet liquidity



Source: Company Data, PL Research

Leverage will rise as financing business grows

For a financial services company, at 0.82 DER, EDEL's balance sheet is clearly under leveraged. In FY08 the company raised Rs3bn from financial investors in ECL Finance (its NBFC subsidiary) taking its networth to about Rs7.0bn. Its total advances book at this point is about Rs9.0bn. We expect the advances book to grow to Rs25bn by end FY09 and Rs35bn by end FY10. Consequently, total debt of EDEL is expected to grow to Rs38.5bn in FY10 (from Rs19.1bn in FY08) taking its DER to 1.26 by FY10. We believe a 3.5-4.0 DER is appropriate for a company with a business model like EDEL and hence even at FY10 levels it will have ample room to further increase leverage and not resort to equity dilution.

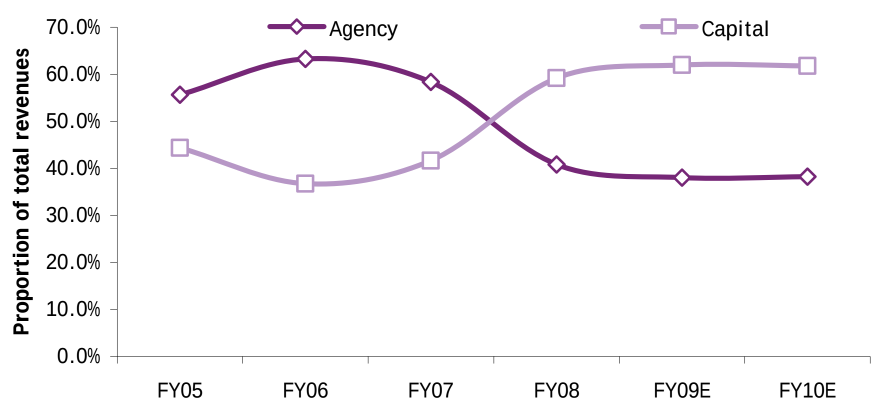
No signs of stress on receivables; risk management impressive

The extreme volatility in equity markets towards the end of January and early February had raised fears of significant bad debts across Indian brokerages. While the subsequent quarterly results did reassure investors that the losses were very minor (at least amongst the leading brokers), it is believed that the balance sheet when released will provide a more real picture. EDEL's receivables stand at Rs1,781m as of March 2008 compared to Rs583m as of March 2007. This is very much in-line with the growth in revenue and shows no signs of any stress on this count. EDEL's management has consistently claimed that far from facing any problems during the turbulence, given their strong liquidity position, it has benefited from more business during that period. Overall, given its significant size and treasury positions in the market, risk management has been impressive.

Revenue will shift in favour of interest income going forward

EDEL's revenue grew by a solid 194% in FY08 and at a CAGR of 143% over FY05-08. Its revenue is broken into two broad categories – agency business (which is fee/commission based) and capital business (which involves putting its capital to work). For FY08, the agency business (which forms 41% of revenue) grew by 106% and the capital business (which forms 59% of revenue) grew 318%. While the overall break-up of agency and capital business may not change much going forward, we expect interest to form a significant portion of revenue by FY10.

Revenue profile



Source: Company Data, PL Research

Broking still forms bulk of agency business

While overall revenue appears quite diversified, the diversification is not quite as impressive in the agency business as compared to, say, India Infoline. Almost 64% of the agency business is equity broking and 18% is investment banking. EDEL is relatively weak in insurance broking (compared to say India Infoline), wealth management (compared to say Kotak) and asset management (compared to say IDFC). We expect the company to get stronger in all three areas over the next couple of years.

Capital businesses will remain dominant

Capital business (59% of revenue in FY08) will grow at a CAGR of 30% over FY08-10 led by the wholesale financing business of ECL Finance. Interest income is expected to grow from Rs2,171m in FY08 to Rs6,200m in FY10. Since we have modelled no growth in treasury income till FY10, our overall break-up between agency and capital business remains nearly same in FY10 over FY08.

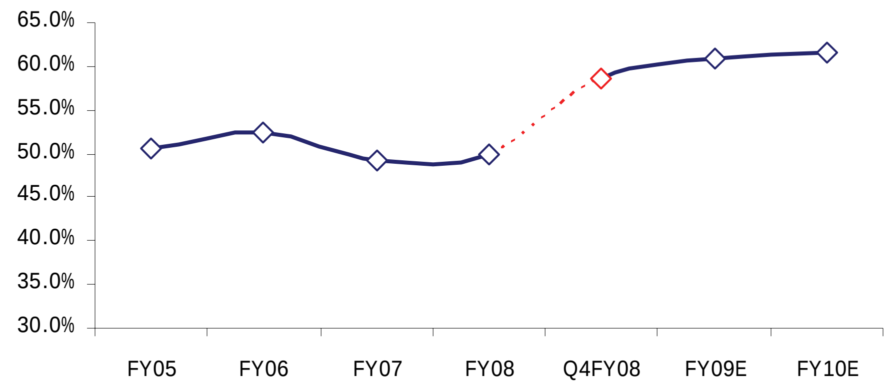
Costs appear stable, but will shoot as percent of non-interest income

EDEL has seen its EBITDA margin grow from 50.3% in FY05 to 60.1% in FY08 hitting a peak of 65.7% in Q3FY08. Going forward, given the magnitude of the drop in equity and IB volumes, one would expect EDEL's EBITDA margin to reduce drastically. However, this is unlikely to happen essentially due to the growing contribution of interest income in FY09 and FY10.

Costs as percent of non-interest income shot-up in Q4FY08

EDEL has substantially scaled up its operations in the last 4-6 quarters. Its employee strength has grown from 750 in March 2007 to 1,600 in March 2008. It has scaled-up infrastructure for several new initiatives such as asset management, wealth management and a few others that the company is not discussing currently. A lot of this scale-up in cost has been possible due to extraordinary growth in revenue supported by good markets. With volumes in broking and investment banking substantially reduced and profitable arbitrage opportunities scarcer, we expect operating costs to shoot up as a percent of non-interest income. In Q4FY08, cost as percentage of non-interest income was 58.5% as compared to 43.2% in Q3FY08. We believe this ratio will get worse in Q1FY09.

Costs as percent of non-interest income

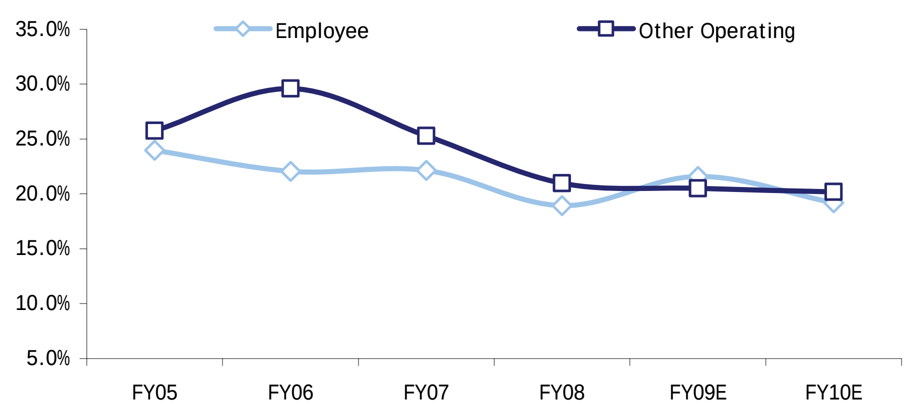


Source: Company Data, PL Research

Cost structure is 50% variable, but still vulnerable to bear markets

While we don't have an accurate break-up of variable and fixed costs, we have gone by the management's view that 50% of costs are variable with the remaining 50% being fixed. But even with 50% variable costs, EDEL like all other capital market focused firms, is highly vulnerable to a bear market.

Key cost items as proportion of total revenue



Source: Company Data, PL Research

RoE decomposition

EDEL's RoCE has been declining from FY05 and will continue to decline even further in FY09. The decline, in the face of improving EBIT margin, has been essentially due to reducing asset turnover as a result of a rapidly expanding capital base. The entire decline in RoCE has not transmitted to lower RoE due to rising leverage. As the company's financing business grows, going forward the leverage will continue to increase. We expect both RoCE and RoE to expand in FY10 as equity market volumes and IB activity picks up resulting in better financial performance. However, overall RoE is likely to remain weak as a large part of the capital remains deployed in low-yield treasury strategies.

RoCE decomposition

	FY05	FY06	FY07	FY08	FY09E	FY10E
EBIT margin	49.5%	47.4%	51.9%	59.5%	57.3%	60.0%
Asset turnover	106.8%	104.8%	55.2%	40.7%	26.0%	27.5%
Tax impact	64.7%	61.4%	62.8%	61.2%	58.8%	58.1%
RoCE	**34.2%**	**30.5%**	**18.0%**	**14.8%**	**8.7%**	**9.6%**
Leverage impact	133.8%	128.5%	191.9%	229.3%	266.6%	278.0%
Interest impact	91.0%	92.8%	90.3%	69.0%	66.5%	68.5%
RoE	**41.6%**	**36.4%**	**31.1%**	**23.4%**	**15.5%**	**18.3%**

Source: Company Data, PL Research

Financials

Income Statement *(Rs m)*

Y/e March	FY05	FY06	FY07	FY08	FY09E	FY10E
Revenue						
Commission and fees	424	993	2,154	4,438	4,864	6,569
Trading and arbitrage	213	447	1,142	3,493	3,191	3,506
Interest	13	26	130	2,171	3,930	6,200
Investment & dividends	112	104	265	766	800	920
Total revenue	**762**	**1,570**	**3,691**	**10,868**	**12,785**	**17,194**
Expenses						
Employees	183	346	817	2,057	2,760	3,300
% of revenue	*24.0*	*22.1*	*22.1*	*18.9*	*21.6*	*19.2*
Operating	196	465	933	2,280	2,623	3,472
% of revenue	*25.8*	*29.6*	*25.3*	*21.0*	*20.5*	*20.2*
Total expenses	379	811	1,750	4,337	5,383	6,772
EBITDA	**383**	**759**	**1,941**	**6,531**	**7,402**	**10,422**
% of revenue	*50.3*	*48.3*	*52.6*	*60.1*	*57.9*	*60.6*
Depreciation	10	21	38	73	85	105
EBIT	**373**	**738**	**1,903**	**6,458**	**7,317**	**10,317**
Interest	34	54	187	2,011	2,454	3,254
Other income	8	10	23	21	20	20
PBT	**347**	**694**	**1,739**	**4,467**	**4,882**	**7,083**
Tax	113	230	646	1,540	1,660	2,408
PAT	**234**	**465**	**1,093**	**2,927**	**3,222**	**4,675**
Minority interest	9	38	2	194	354	558
PAT for equity shareholders	**225**	**427**	**1,092**	**2,732**	**2,869**	**4,117**
% of revenue	*29.5*	*27.2*	*29.6*	*25.1*	*22.4*	*23.9*
Growth (%)	*95.9*	*90.0*	*155.9*	*150.3*	*5.0*	*43.5*
Extraordinary item	-	-	-	-	0	0
Net profit after extraordinary	225	427	1,092	2,732	2869	4117
Equity dividends	-	-	-	150	300	453
Dividend tax	-	-	-	26	51	77
Retained earnings	225	427	1,092	2,557	2517	3587
Shares outstanding (m)	45.4	45.4	53.9	74.9	75.3	75.7
Weighted avg. shares out. (m)	45.4	45.4	49.7	69.1	75.1	75.5
EPS (Rs.)	**4.9**	**9.4**	**22.0**	**39.6**	**38.2**	**54.5**
EPS growth (%)	*95.9*	*90.0*	*134.0*	*80.0*	*-3.5*	*42.8*
Effective tax rate (%)	*32.6*	*33.1*	*37.1*	*34.5*	*34.0*	*34.0*
Dividend per share (Rs.)	-	-	-	2.2	4.0	6.0
Payout ratio	-	-	-	6.4	12.3	12.9

Balance Sheet *(Rs m)*

Y/e March 31	FY05	FY06	FY07	FY08	FY09E	FY10E
Equity (Rs5 FV)	29	38	50	375	377	378
Stock option O/S	14	25	2	6	-	-
Share premium a/c	162	987	3,918	13,682	13,716	13,768
Reserves & surplus	335	734	1,847	4,411	7,003	10,684
Total shareholders funds	**539**	**1,784**	**5,818**	**18,473**	**21,095**	**24,831**
Loan funds	120	505	3,942	19,085	30,000	38,500
Minority interest	62	3	1,399	4,798	5,152	5,710
Other long-term liabilities	-	-	6	3	-	-
Total liabilities	**722**	**2,293**	**11,164**	**42,359**	**56,247**	**69,041**
Gross fixed assets	59	106	213	500	700	900
Acc. depreciation	18	38	76	145	230	335
Net fixed assets	41	67	137	355	470	565
CWIP	-	-	33	79	50	50
Investments	102	324	814	7,601	7,601	7,601
Deferred tax assets	2	4	11	168		
Current assets						
Stock in trade	271	1,405	5,756	9,679	14,499	15,604
Debtors	122	364	583	1,781	6,597	8,022
Cash & bank	120	637	2,651	19,441	2,030	2,199
Other current assets	3	10	75	389	-	-
Loans & advances	500	700	2,589	12,125	25,000	35,000
Total current assets	**1,017**	**3,116**	**11,655**	**43,416**	**48,126**	**60,825**
Less: current liabilities	440	1,218	1,486	9,260		
Net current assets	**577**	**1,898**	**10,168**	**34,156**	**48,126**	**60,825**
Total assets	**722**	**2,293**	**11,164**	**42,359**	**56,247**	**69,041**

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PL's Recommendation Nomenclature

BUY	:	> 15% Outperformance to BSE Sensex	**Outperformer** (OP)	:	5 to 15% Outperformance to Sensex
Market Performer (MP)	:	-5 to 5% of Sensex Movement	**Underperformer** (UP)	:	-5 to -15% of Underperformace to Sensex
Sell	:	<-15% Relative to Sensex			
Not Rated (NR)	:	No specific call on the stock	**Under Review** (UR)	:	Rating likely to change shortly