

IDFC Ltd.

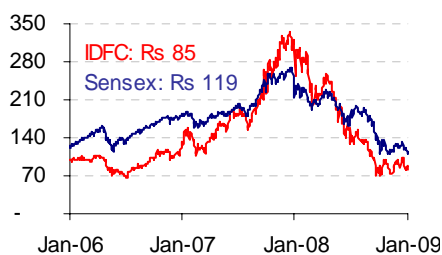
Buy

Target Price: Rs 170

Market data

Current price	Rs 58 (BSE)
Market cap	Rs 75,122 m
Face value	Rs 10.0
FY08 DPS (Rs)	1.0
BSE Code	532659
NSE symbol	IDFC
No. of shares	1,295.2 m
Free float	79.8%
52 week H/L	Rs 216 / 45

Rs 100 invested is now worth



Stock price Performance

	IDFC	Index*
1-Yr	-74.5%	-47.9%
2-Yr	-28.4%	-19.4%
3-Yr	-5.0%	-2.2%

Returns over 2 years are compounded annual averages (CAGR)

*BSE Sensex

Shareholding (Dec - 2008)

Category	(%)
Government	20.2
Banks, MFs and FIs	13.8
FIIIs	32.8
FDI	8.8
Public	11.7
Others	12.7
Total	100.0

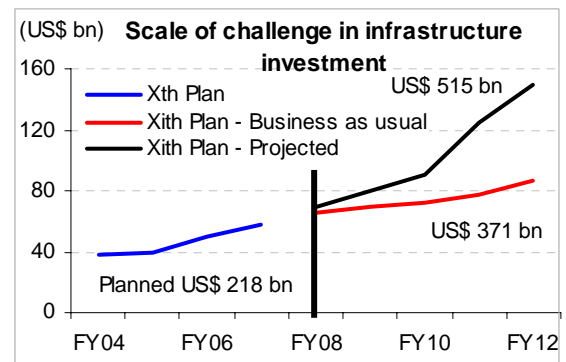
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Investment Rationale

- Commitment despite challenges:** Poor infrastructure had been one of the key factors holding back a double digit growth rate for India even during times of economic buoyancy. With infrastructure spending currently at around 4% of GDP, India is way behind achieving the level of 12% by the end of the Eleventh Plan period (FY12), as suggested by the Asian Development Bank (ADB). In fact, the National Council of Applied Economic Research (NCAER) has projected the gap in India's infrastructure funding to be to the tune of Rs 144 bn until 2012 under 'business as usual' conditions.



Source: NCAER presentation

Both the World Bank and the International Monetary Fund have been unanimous in their opinion that the GDP growth rate for India in 2009 is set to drop below the average for the past decade i.e., below 6%. Will this pose challenges to the growth of infrastructure in the economy? Certainly! Will it obliterate the necessity for infrastructure development? Certainly not! And not just we, but even the government believes so. It is for this reason that the stimulus packages announced by the Indian government, although miniscule as compared to that in China, the US and UK, had plenty of focus on ensuring sustainability in infrastructure funding. In fact, the Planning Commission has clearly stated that going forward, the state-owned India Infrastructure Finance Company (IIFCL) will play a major role in financing Rs 1,000 bn worth of infrastructure projects to boost economic demand. Also, IIFCL was allowed to raise Rs 400 bn through tax-free bonds as part of the economic stimulus package. This goes to show that despite challenges the government's commitment towards infrastructure funding remains undiluted.

IDFC being the largest private sector infrastructure financing institution in the country (with a 20% share of the private sector pie) certainly has a prominent role to play in this. The shares of public and private investment in total infrastructure investment during the Eleventh Plan are projected to be about 70% and 30% respectively, in contrast with 82% and 18% respectively during the Tenth Plan. Further, as per the Planning Commission, during the Eleventh Plan period, private sector is expected to provide 38% of the incremental infrastructure funding and the share of private sector in total investment will increase from 19% currently to 30%. With this, even if

the share of IDFC in the total private sector infrastructure funding pie is to come down, the institution will still see a reasonable growth in its balance sheet even if the most conservative growth estimates of the economy are to fructify. We have estimated a compounded annual growth rate of 16% in IDFC's advance book until 2011.

- **Higher AUM fees to cushion NIMs:** IDFC's strong relationship with its chief promoter, the government (which holds 20% stake), gives it access to decision makers in government entities and multilateral development agencies. As a consequence, IDFC is able to play a significant role in the direction of infrastructure policy in the country, thus placing itself ideally to cater to the infrastructure-financing requirements. While project finance remains the mainstay of its business, to de-risk its revenue stream from the volatility and lumpiness of earnings in project financing business, the institution has been concentrating on private equity funding and asset management, both of which have yielded good returns in terms of fee income.

IDFC's share of non-interest income in consolidated total income has remained at an average of 45% over the past 5 years and we see it sustaining at these levels going forward as well. Also, the stable fee income growth due to the increased AUM in the private equity and domestic retail asset management business will help the institution cushion the pressure on net interest margins (NIMs - 2.9% in 9mFY09). We expect the above initiatives to stand in good stead for the institution in the coming years even when the sectors get mature and the high yielding assets in project finance get re-priced.

Funds under management (as on Dec 31, 2008)

Funds	US\$ m	Rs m
IDFC Private Equity	1,248	59,920
Fund I	176	8,440
Fund II	414	19,880
Fund III	658	31,600
IDFC Project Equity	748	35,890
IDFC Mutual Fund	2,038	97,820
IDFC Invest. Advisory	19	930
Total	4,053	194,560

Source: IDFC

Further, with respect to NIMs, IDFC's management has clarified that despite a downward trend in interest rates, the current economic environment has increased the refinancing risk because of flight of capital to safety. This would therefore reduce pressure on loan yields to that extent.

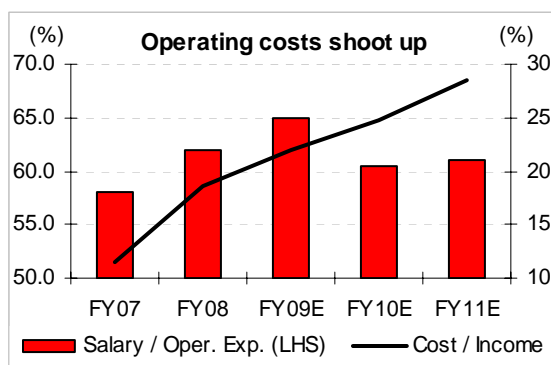
- **Unrealised gains to be booked:** Going forward, as the risk weightage on IDFC's asset profile (infrastructure advances) reduces, with projects nearing completion and revenue streams getting unlocked, it plans to securitise them at a premium to asset hungry financial entities. Also, IDFC's books carried proprietary equity investments (excluding strategic investments) to the tune of Rs 13.5 bn at the end of December 2008 (Source: IDFC presentation). While the time frame for unlocking the gains therein is uncertain, it will certainly add fillip to the investment value per share over the longer term.
- **Excellent asset quality:** IDFC has one of the strongest asset quality positions amongst the financial entities in India (rivaled only by HDFC). According to the institution, this has been achieved due to its strong credit and project appraisal skills and disciplined risk management practices. Due to this, it had lower than 1% gross NPAs and Nil net NPAs at the end of December 2008. Also, since top 20 company exposures comprise 35% of IDFC's total exposure, its books remain reasonably well diversified. Having said that, IDFC plans to have a one-time provisioning in 4QFY09 so as to have a higher loan loss reserve ratio (as a percentage of assets) going forward (1.2% in 9mFY09). We have factored the same in our estimates.

Investment Concerns

- **Impact of lower return ratios on valuations:** IDFC's return ratios have been impacted in FY08, largely due to equity dilution and the fall in return on assets (RoA) from project financing business and non fund business. While the entity has historically enjoyed high return ratios in the past (5-year average return on equity of 17.5% until FY08), we see the same getting diluted in the medium term. Also, despite higher leverage (4.8 times in FY09), a lower RoA on the investment banking and broking is expected to keep IDFC's return on equity at an average of

12% until FY11. Taking this into consideration, we have lowered the multiple that we accord to IDFC's estimated adjusted book value for valuing the stock.

- Integration and execution:** IDFC faces risks in terms of integration of the businesses that the institution has acquired over the last two years, especially equity linked offerings (SSKI) and asset management company (Stanchart). Further, the company will also continue to face risks on the execution front as its assets under management (AUM) for the project finance business increases. The same may lend some volatility to the institution's revenues in the medium term.
- High operating cost:** IDFC has witnessed exponential growth in its salary costs over the last two fiscals due to the growth in its own employee base as also the integration of costs of the additional employees of SSKI and Stanchart AMC. Also, the salary costs comprised 60% of the total operating costs in 9mFY09 (similar to that of public sector financial institutions) despite the institution's lean structure. While the benefits of the same are yet to filter in, the management is keen on constraining the overall rise in operating costs. It sees the operating costs to income ratio remaining below 25% level, which is half the average cost to income of 50% maintained by banking entities. Further, the institution also faces concerns in terms of attracting and sustaining (attrition rate 5% in middle management level) skilled manpower for its growing business.



Background

Established in 1997 as a private sector enterprise by a consortium of public and private investors, IDFC

operates as a professionally managed infrastructure financing entity whose focus areas are energy, telecom, transportation and industrial and commercial projects. IDFC financed nearly 20% of the total infrastructure outlay in the country in FY08. Its expertise in the infrastructure sector and strong relationship with government and infrastructure sponsors provides it with a platform for facilitating private investment and public-private partnerships in infrastructure projects in sectors where market structures, government policy and regulations are evolving. IDFC has capitalised on its domain knowledge and structuring expertise in financing activities to garner fee-based revenues.

Comparative Parameters

(FY09E)	IDFC	HDFC
Return on assets	2.1%	2.2%
Return on equity	11.5%	14.7%
Net interest margin	2.8%	3.3%
Net NPA/Advances	0.0%	0.3%
Cost/income	22.0%	11.2%
Business per employee (Rs m)	429	603
Business per branch (Rs m)	21,707	3,478
Valuations (FY11E)		
Price to earnings	9.3	13.8
Price to adjusted book value	1.0	2.3
Dividend yield	1.7%	1.8%

Industry Prospects

The single most important macro constraint on the Indian economy, holding back its average growth rate, is the low spending on infrastructure. India is currently spending a miniscule proportion of the required outlay. Asian Development Institution's analysis indicates that China spends seven times as much as India on infrastructure (excluding real estate) in absolute terms. In 2003, the total capital spending on electricity, roads, airports, seaports and telecom was US\$ 150 bn in China (10.6% of GDP) compared with US\$ 21 bn in India (3.5% of GDP). The analysis stipulates the need to increase infrastructure spending in the country gradually to US\$ 100 bn per annum (8% of GDP) by 2010, to position India on to a sustained GDP growth trail of 8% to 9% per annum. As the government funding cannot suffice the said investment requirement, private sector players need to fill the void. The volume of private sector financing in Indian infrastructure has multiplied 6 times over the last decade, thus suggesting the scope for exponential growth of private sector infrastructure financing players.

Key Management Profile

Mr. Deepak S. Parekh, the Non-Executive Chairman of IDFC, is a Chartered Accountant by qualification and is a member of the Institute of Chartered Accountants, England and Wales. He is currently the Chairman of HDFC.

Dr. Rajiv B. Lall, the Managing Director and Chief Executive Officer of IDFC, is a graduate of Oxford University and has a doctorate in economics from the Columbia University, New York. Between 1995 and 2005, Dr. Lall was the executive director and the head, Asian economics research at Morgan Stanley, and Managing Director at Warburg Pincus in Hong Kong, Singapore and New York.

Mr. L.K. Narayan, Chief Financial Officer of IDFC, is a Chartered Accountant, in addition to having a degree in law. Overall, he has 24 years of experience in the fields of risk management, debt capital markets, credit rating, resource mobilization and structured products.

Risk Analysis

Please see 'Risk Matrix' table on page 6 of this report

Sector: The growth in infrastructure spending is pertinent for a sustained GDP growth of the economy. With the infrastructure funding to GDP ratio having remained stagnant at 3.5% for nearly a decade, we see a higher proportion of the same being inevitable to keep the GDP growth of the country at a sustainable 7.5% per annum. Also, the entire funding cannot be provided by the government and thus arise the need for the active participation of private sector players. IDFC being one of the key players in this space assumes prime importance in delivering the government's targets. However, the possible re-pricing of margins in its mature businesses caps the upsides. Based on these factors, we have assigned a 'medium' risk rating to the stock.

Company standing: IDFC features amongst the frontrunners in the private sector infrastructure financing space in terms of overall operating efficiency. Despite having relatively smaller asset book as compared to its banking peers, the institution offers very stiff competition to its peers in the PSU and private sector banking space. Being a nodal agency of the government for funding PPP (public private partnership) projects and sustenance of one of the best asset qualities across interest rate cycles sets IDFC apart from its peers. The acquisition of stakes in SSKI and Stanchart's AMC

businesses position the institution very favourably in terms of diversity of revenue streams. Thus, we rate the institution's standing in the sector as 'Strong'.

Revenue growth: IDFC has witnessed a compounded annual growth (CAGR) of 34% in its revenues over the past 5 years, which is higher than the industry average of 25%. Further, acquisition of stakes in SSKI and Stanchart's AMC businesses have helped the institution propel its non fund revenue growth. The possibility of the institution's inability to integrate its businesses, and poor growth in investment banking and broking business caps the rate of future growth in revenues. We see IDFC clocking a CAGR of 10% in revenues over the next three years due to the economic downturn and hence assign a high risk rating of 3 to the stock.

Advance growth: IDFC has witnessed a compounded annual growth rate (CAGR) of 45% in its loan book over the past 5 years, which is nearly double the industry average. Going forward, however, we see the institution clocking a CAGR of 19% in its advances over the next two years. We therefore assign a medium risk rating of 5 on this parameter.

NIMs: IDFC has historically had NIMs between 2.5% to 3.5% over the last 4 years. However, given that it will face pricing pressures at the start of a falling interest rate cycle, we expect the NIMs to remain in the range of 1.9% to 2.4% until FY11. We therefore assign a medium risk rating of 4 to the stock.

Fee / Total income: This ratio indicates the institution's ability to hedge its revenues against the volatility in interest rate cycles. IDFC's fee to total income has been at an average of 20% and we see it remaining in the range of 20% to 25% over the next three years. This will be largely on the back of growth in AUM in the mutual fund and private equity businesses and the benefit of synergies therein. As such, the rating assigned to the stock on this factor is 6.

Cost / Income ratio: This ratio indicates the operating efficiency of the company. IDFC's cost to total income has been at an average of 12% over the past 5 years. Going forward, and we see it remaining in the range of 24% to 28% over the next three years. As such, the rating assigned to the stock on this factor is 4.

Return on equity: RoE is an important tool to assess a company's potential to be a quality investment by determining how well the

management is able to allocate capital into its operations for future growth. For a financial lending company, the same is particularly important since the capital ploughed back is once again deployed for future growth. A RoE of above 15% is considered decent for institution's that are in an expansionary phase. Considering IDFC's last five years' average RoE of almost 17%, and the fact that we expect the institution's RoE to remain at an average of 12% until FY11, we have assigned a rating of 3 to the stock on this parameter.

Dividend payout: IDFC has maintained an average dividend payout ratio of 25% over the last 5 years. We expect this to remain in the range of 15% to 20% until FY10. The rating assigned on this parameter is 5.

Promoter holding: A larger share of promoter holding indicates the confidence of the people who run it. We believe that greater than 40% promoter holding indicates safety for retail investors. While IDFC is a professionally managed company, the government had 20.2% stake in the institution at the end of December 2008. We have assigned a high risk rating of 3 to the stock on this parameter.

Liquidity: The past 52 weeks average daily volume of the stock is in the range of 2.9 m shares, which is above average and provides ample liquidity to investors. The rating assigned on this parameter is 9.

NPAs: The institution has, over the last 8 years, had zero net NPA levels and has one of the most conservative provisioning norms. Going forward as well, we expect the net NPA levels to sustain below 1% going forward and have therefore assigned a low risk rating of 10 to the stock.

Capital adequacy ratio: This is one of the most important factors that are used to judge the soundness and sustainability of a financial institution's business over the longer term. It shows the ratio of capital to assets financed. While the RBI has stipulated a minimum CAR of 15% for NBFCs, IDFC's CAR of 22% in 9mFY09 (Tier I - 18.9%) offers it enough headroom for growth. We have assigned a low risk rating of 9 to the stock.

Considering the above analysis, the total ranking assigned to the company is 61 that, on a weighted basis, stands at 6.0. This makes the stock a medium-risk investment from a long-term perspective.

Valuations

Being the largest private sector infrastructure-financing player in the country makes the rationale for IDFC's growth uncontested. Nonetheless, increasing penetration of institutions in this segment and their cost advantage (due to the ability to raise low cost deposits) has intensified competition for IDFC over the past few years. However, having the domain expertise for project appraisals, and diversification of its business model to infrastructure fund management in association with globally recognised institution has reasonably de-risked its business. With one of the highest capital adequacy ratios (CAR above 20% in 9mFY09), and one of the best asset qualities in a low liquidity- high risk environment, IDFC is amongst our preferred plays in the financial sector. Even if the share of IDFC in the total private sector infrastructure funding pie is to come down to 20% (from 25% currently), we see the institution sustaining reasonable growth over the longer term, if the most conservative infrastructure growth estimates of the economy are to fructify.

At the current price, the stock is trading at 1.0 time our estimated FY11 adjusted book value. We would, therefore, recommend investors to 'BUY' the stock with a March 2011 target price of Rs 170. This will deliver compounded annual returns of 55% over a 2-year period.

Valuation table

Standalone (Rs m)	FY08	FY09E	FY10E	FY11E
Total Revenues (Rs m)	13,236	14,390	15,646	16,760
Net Profit (Rs m)	7,523	6,763	7,735	8,059
EPS (Rs)	5.8	5.2	6.0	6.2
Adj. book value (Rs)	43.2	47.4	52.4	57.6
P/E (x)	10.0	11.1	9.7	9.3
P/Adj BV (x)	1.3	1.2	1.1	1.0

Risk Matrix

Rating	Weightage* (A)	Rating accorded	
		Rating# (B)	Weighted (A*B)
Sector risk	-	Medium	NA
Company's standing	-	Strong	NA
Performance parameters			
Revenue growth (%)	5.0%	3	0.2
Advance growth (%)	10.0%	5	0.5
Net interest margins (%)	10.0%	4	0.4
Fee income / total income (%)	5.0%	6	0.3
Cost / Income ratio (%)	5.0%	4	0.2
Return on equity (%)	15.0%	3	0.5
Technical parameters			
Dividend payout (%)	10.0%	5	0.5
Promoter holding (%)	5.0%	3	0.2
Liquidity (Nos. '000)	10.0%	9	0.9
Safety parameters			
Net NPAs to advances (%)	15.0%	10	1.5
CAR (%)	10.0%	9	0.9
Final Rating**		61	6.0

Rating has been assigned on the basis of the company's performance over the past five years and expected performance over the next 3 to 5 years. Rating is on a scale of 1 to 10, with 1 indicating highest risk and 10 indicating lowest risk.

* 'Weightage' indicates the relative importance in percentage terms of the parameter. For instance, for an investor, given all the performance metrics, return on equity should be the foremost criteria for buying/not buying stocks.

** The final rating has been arrived at by multiplying the rating/points given on each parameter with the respective weightage

Financials at a glance

(Rs m)	FY08	FY09E	FY10E	FY11E
Interest income	20,640	28,149	31,430	36,614
Interest expense	14,829	20,758	24,248	29,106
Net interest income	5,811	7,390	7,181	7,509
Other income	7,425	7,000	8,465	9,251
Other expenses	2,459	3,147	4,028	5,277
Provisions and contingencies	773	2,103	949	368
Profit before tax	10,004	9,140	10,668	11,115
Tax	2,480.4	2,376.5	2,933.6	3,056.5
Profit after tax/(Loss)	7,523	6,763	7,735	8,059
Net profit margin (%)	36.5%	24.0%	24.6%	22.0%
No of shares (m)	1,294.3	1,295.2	1,295.2	1,295.2
Diluted earnings per share (Rs)	5.8	5.2	6.0	6.2

Balance Sheet

Goodwill on consolidation	2,943	1,118	447	358
Infrastructure loans	199,051	217,065	256,210	307,890
Investments	52,257	58,528	66,722	74,728
Fixed assets	3,850	3,869	3,888	3,908
Deffered tax assets	972	486	243	122
Current assets	30,338	60,675	94,046	145,772
Total assets	289,411	341,741	421,557	532,777
Net worth	55,933	61,411	67,850	74,613
Subordinated debt	6,500	6,500	6,500	6,500
Unsecured loans	216,535	270,669	330,216	412,771
Current liabilities	10,201	2,968	16,837	38,771
Minority interest	241	193	154	123
Total liabilities	289,411	341,741	421,557	532,777

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