11 January 2012

Update | Sector: Financials

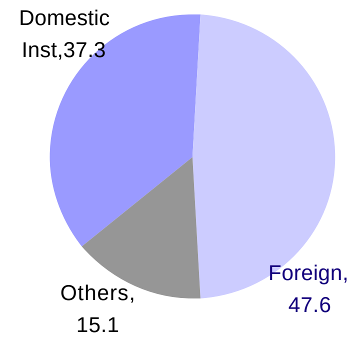
IDFC

BSE Sensex	S&P CNX
16,165	4,850

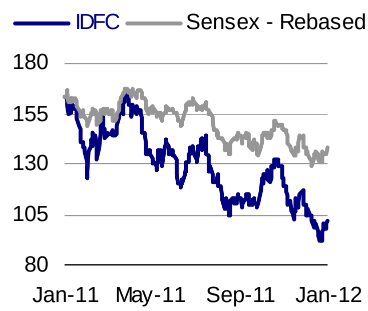
Bloomberg	IDFC IN
Equity Shares (m)	1,460.9
52-Week Range (INR)	170/90
1,6,12 Rel.Perf.(%)	-7/-9/-22
M.Cap. (INR b)	149.1
M.Cap. (USD b)	2.9

Y/E March	2011	2012E	2013E
NII (INR b)	15.9	20.4	24.2
OP (INR b)	20.1	24.2	25.8
NP (INR b)	12.8	15.5	16.2
EPS (INR)	8.8	10.3	10.7
EPS Gr. (%)	7.4	17.1	4.3
BV/Sh. (INR)	71.2	81.9	89.5
P/E (x)	11.6	9.9	9.5
P/BV (x)	1.4	1.2	1.1
ABV (INR)	60.7	73.9	82.4
P/ABV (x)	1.2	1.1	0.9
RoE (%)	14.7	13.6	12.5
RoA (%)	3.2	3.0	2.7

Shareholding pattern % (Sep-11)



Stock performance (1 year)



CMP: INR102 | TP: INR150 | Buy

Risk-reward turns favorable; upgrading to Buy

Healthy fundamentals; multiple re-rating catalysts

- **IDFC has corrected 17%/23%/37% in the last 3M/6M/12M-period, underperforming the broader indices by a wide margin. Concerns relating to slowing growth momentum and possible worsening of asset quality have impacted stock performance.**
- **However, IDFC's focused strategy of profitable growth, proven track record of qualitative growth across cycles, and higher standard asset provisioning makes it well positioned v/s its peers in the infrastructure financing space.**
- **The stock is trading at historical low valuations. Multiple re-rating catalysts exist: (1) expected monetary easing, leading to improvement in liquidity scenario and fall in interest rates, (2) government intervention to address key issues faced by the Indian Infrastructure sector.**

Expect loan growth to pick up; positive surprises likely: Asset growth was muted in 1HFY12, with loans growing just 4% YTD (14% YoY) – the slowest in the last five years. However, we expect loan growth to pick up despite the uncertain environment, given IDFC's focused strategy to improve wallet share in existing projects. We have built in 18% loan CAGR (a conservative estimate) over FY12/13. Government intervention to address some key issues faced by the Indian infrastructure sector (which is highly likely) could significantly alter the growth outlook for IDFC.

Asset quality risks lower; diversified loan book: IDFC's loan book is fairly diversified with its exposure distributed across Energy (43%), Transportation (24%) and Telecom (22%). Though majority of its portfolio is under the Energy segment, Power Generation constitutes just 28% of its overall portfolio. Moreover, IDFC's exposure to power projects under construction is only 15%. While it has 7% exposure to IPP/Merchant Power, ~60% of the projects it is exposed to have linkage to captive mines. Moreover, factors like no direct exposure to SEBs, impeccable asset quality track record (with GNPA at ~20bp), and loan loss reserve of 1.6% provide comfort on the asset quality front.

Spreads back to normalized levels, monetary easing to provide relief: IDFC's spreads have returned to normalized levels of 2.2-2.4% from the peak of 2.7%. With (1) the interest rate cycle nearly peaking out, (2) wholesale rates stabilizing/cooling off, and (3) increased FII limit/lowering of lock-in period in bonds issued by IFCs resulting in relatively low cost borrowings, IDFC should be able to maintain a tight leash on its cost of funds. We expect IDFC to pass on the fall in cost of funds to borrowers, which will help to gain market share. Spreads are likely to remain stable at 2.2-2.4% over FY12/13.

Risk-reward favorable; upgrade to Buy: Monetary easing and expected government intervention to address the key issues faced by the Indian infrastructure sector could act as major catalysts in improving the growth and profitability outlook for IDFC, leading to its re-rating. Among the IFCs, IDFC is well poised (compared to peers) to tide through the current phase of moderation in economic growth. We believe risk-reward is favorable and upgrade our rating to **Buy**, with an SOTP-based price target of INR150.

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Expect loan growth to pick up; positive surprises likely

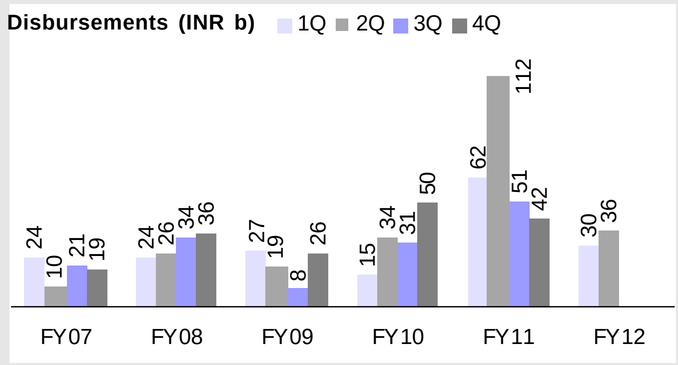
Asset growth was muted in 1HFY12, with loans growing just 4% YTD (14% YoY) – the slowest in the last five years. However, we expect loan growth to pick up despite the uncertain environment, given IDFC's focused strategy to improve wallet share in existing projects. We have built in 18% loan CAGR (a conservative estimate) over FY12/13. Government intervention to address some key issues faced by the Indian infrastructure sector (which is highly likely) could significantly alter the growth outlook for IDFC.

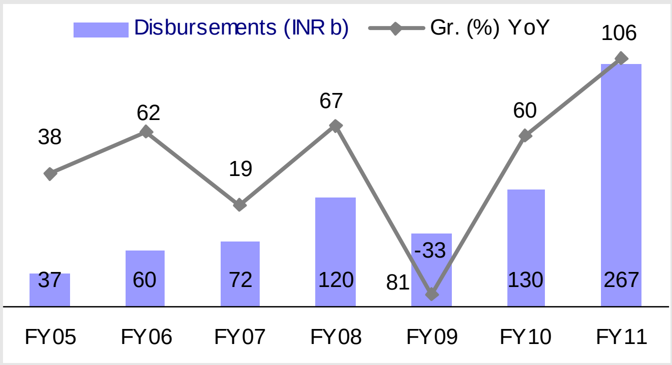
Policy paralysis and uncertain macro leading to moderation in growth

During 1HFY12, IDFC's loan growth was muted at 4% YTD (14% YoY) – the slowest in the last five years. After a sharp increase in FY11 (largely in 1HFY11), disbursements have seen a sharp decline. The slowdown in disbursements can be attributed to:

- Languishing investments for new capacities in power sector due to government inaction on critical issues such as fuel supply, PPA concerns, and environmental clearances
- Management's focus on asset quality (not growing aggressively in an uncertain environment) and spreads (cost of funds increased sharply due to sharp rise in benchmark rates)

Moderation in economic growth, policy paralysis and high base leading to moderation in disbursements growth



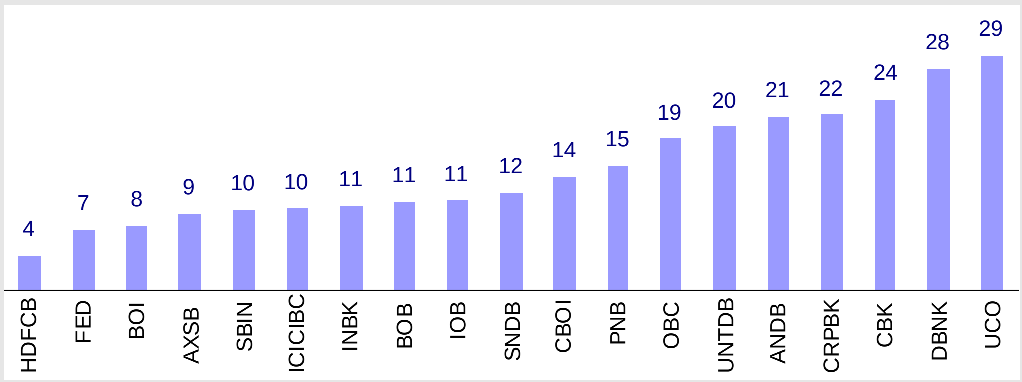


Source: Company/MOSL

Flexibility on borrowings, market share gains to help accelerate growth

Growth is likely to gain momentum during 2HFY12, as (1) IDFC gains market share by offering competitive rates vis-à-vis its peers (also resulting in lower repayments) on the back of easing cost pressures, and (2) competitive intensity eases, with banks becoming less aggressive on the back of higher asset quality pressure, increased concerns in the Infrastructure space, and most banks hitting their internal exposure limits to Infrastructure.

Smaller state-owned banks have higher exposure to the Infrastructure sector

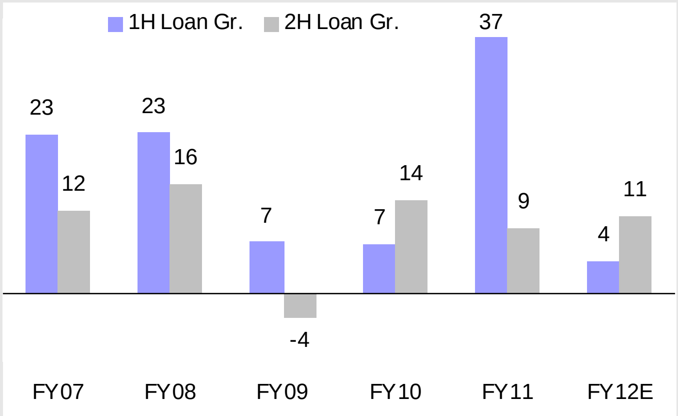


Source: Company/MOSL

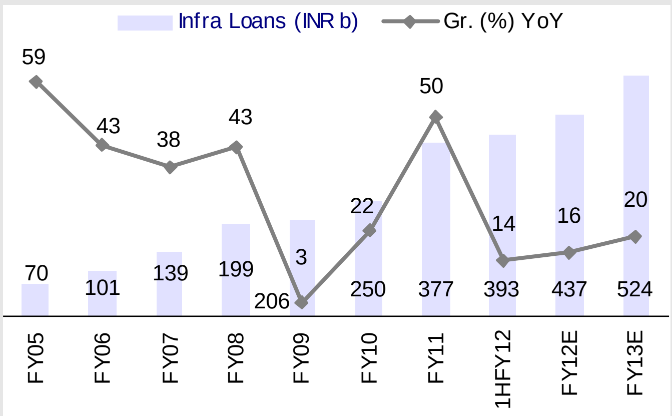
Estimates conservative; positive surprise likely

We model in loan CAGR of 18% over FY12/13, which we believe is conservative. Growth could accelerate further, as we expect government to intervene to address some key issues facing the Indian power sector. Fall in cost of funds will also make IDFC more competitive, helping it to gain market share and post strong growth. Neverthelss, if the policy paralysis continues, it will keep growth moderate (though better than current levels due to flexibility on cost of funds).

1HFY12 loan growth slowest in five years



Estimates remain conservative

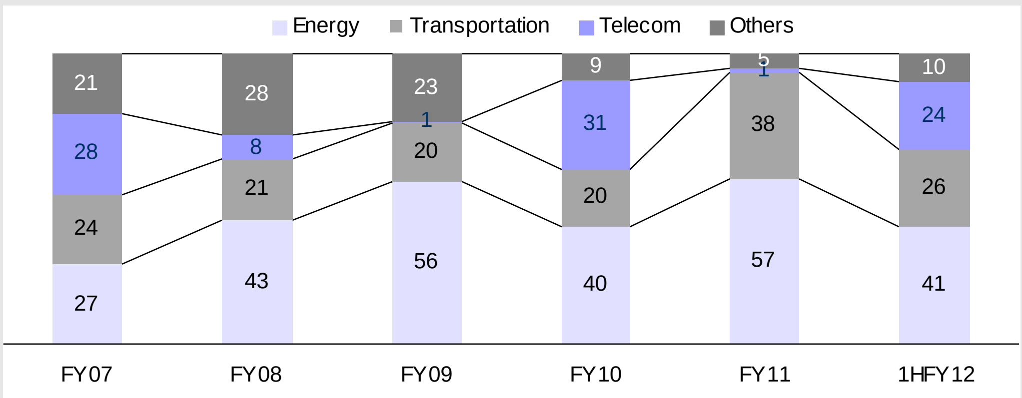


Source: Company/MOSL

Outstanding pipeline 0.5x the outstanding loan book

IDFC has an outstanding pipeline of INR184b, which constitutes ~50% of its outstanding loan book. While the share of the Energy segment had increased sharply over FY08-11 on account of buoyancy in the sector, an uncertain environment led to a sharp decline in 1HFY12. While loans grew 4% YTD, the outstanding pipeline has increased 12% YTD, led by Telecom and other Infrastructure projects. We believe that the current outstanding pipeline will be sufficient to help achieve 15-20% loan growth.

With increase in Telecom exposure, outstanding pipeline is more diversified now

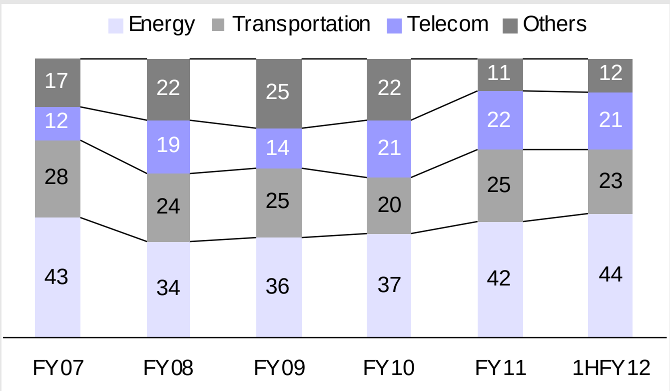


Source: Company/MOSL

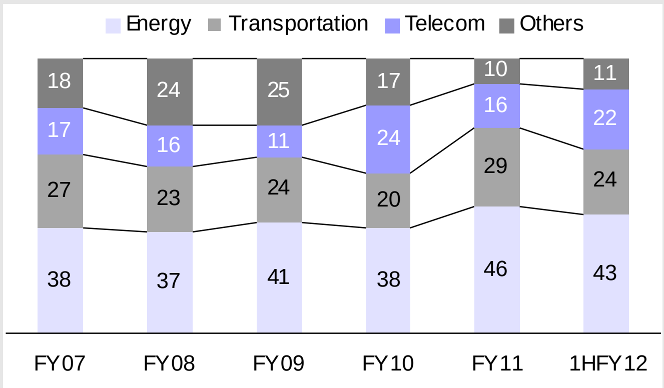
Asset quality risks lower; diversified loan book

IDFC's loan book is fairly diversified with its exposure distributed across Energy (43%), Transportation (24%) and Telecom (22%). Though a significant chunk of its portfolio is under the Energy segment, Power Generation constitutes28% of its overall portfolio. Moreover, IDFC's exposure to projects under construction is only 15%. While it has 7% exposure to IPP/Merchant Power, ~60% of the projects it is exposed to have linkage to captive mines. Moreover, factors like no direct exposure to SEBs, impeccable asset quality track record (with GNPA at ~20bp), and outstanding loan loss reserve of 1.6% provide comfort on the asset quality front.

Outstanding disbursements mix has remained fairly stable



Outstanding exposure to Telecom sector has increased



Source: Company/MOSL

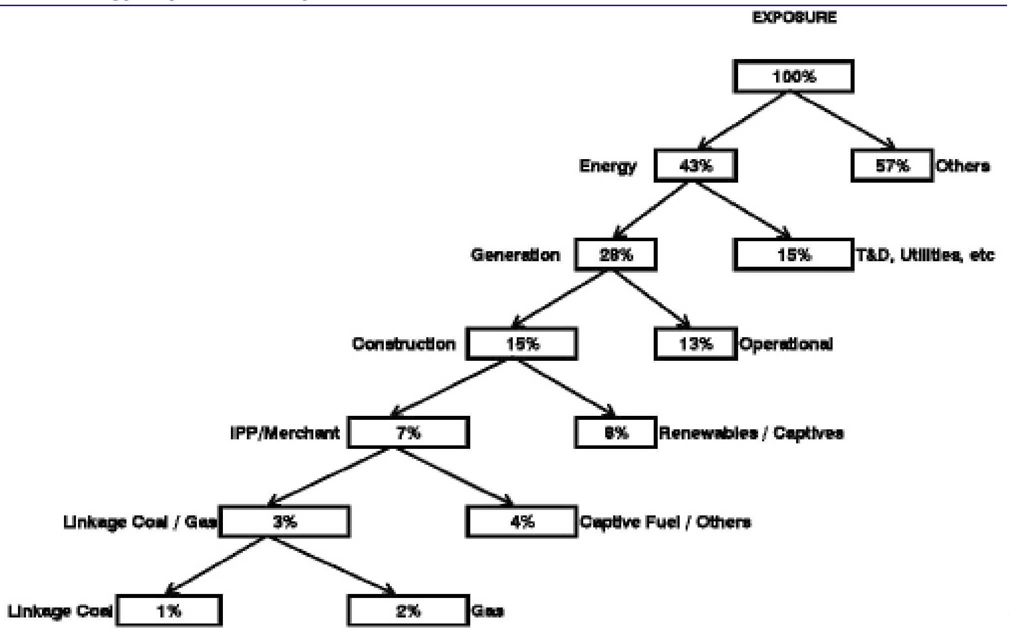
Projects under construction constitute 15% of overall power exposure

What currently worries investors is IDFC's exposure to troublesome energy sector. However, despite 43% of loan book being in energy sector, exposure to generation segment is 28% and that to projects under construction is 15% of total. Notably, ~60% of the IPP / Merchant Power projects have linkage to captive mines. We believe limited exposure to troublesome assets restricts the threat to IDFC's asset quality. Nevertheless, continued policy paralysis may lead to restructuring in 2HFY13/FY14 in some power projects.

Exposure to Power projects under construction is 15% of total, nearly 50% of which is to IPP/Merchant Power projects

Notably, ~60% of the IPP/Merchant Power projects have linkage to captive mines

IDFC's Energy exposure analysis

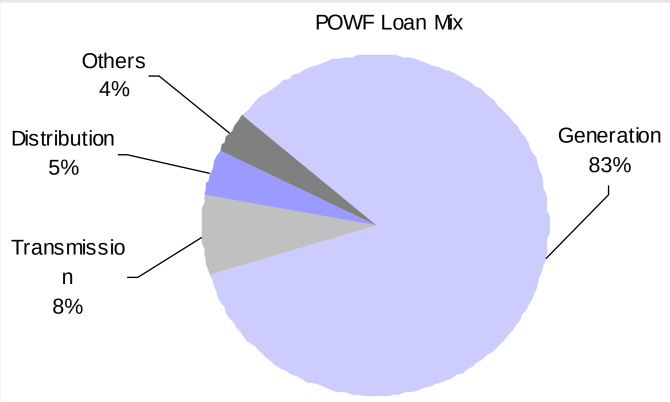


Source: Company

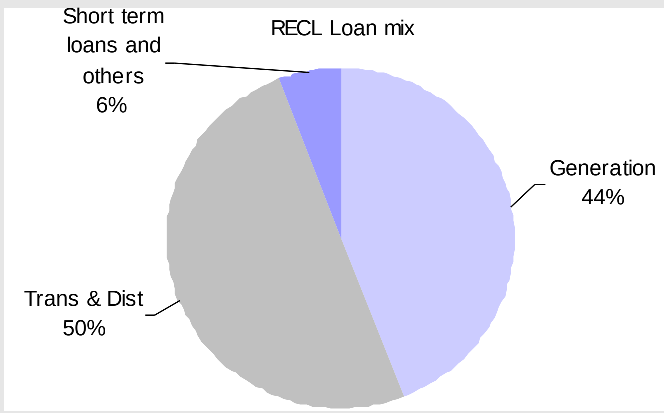
Better placed than peers

IDFC's loan portfolio stacks up well when its energy sector exposure is compared with those of POWF and RECL. POWF's exposure to the Generation segment remains as high as 84%, with ~70% of the projects under construction and ~65% of generation projects being coal-based. On the other hand, although RECL's exposure to the generation segment remains limited to 44%, projects under construction account for ~70% and its exposure to coal-based generation projects is ~80%. IDFC's exposure to Generation projects is 28%, with ~50% (15% of overall portfolio) being under construction.

POWF: Loan mix (September 2011)

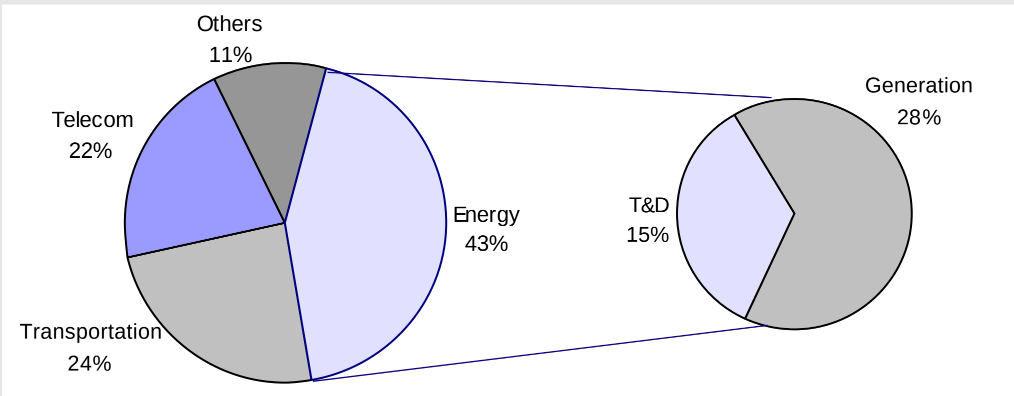


RECL: Loan mix (September 2011)

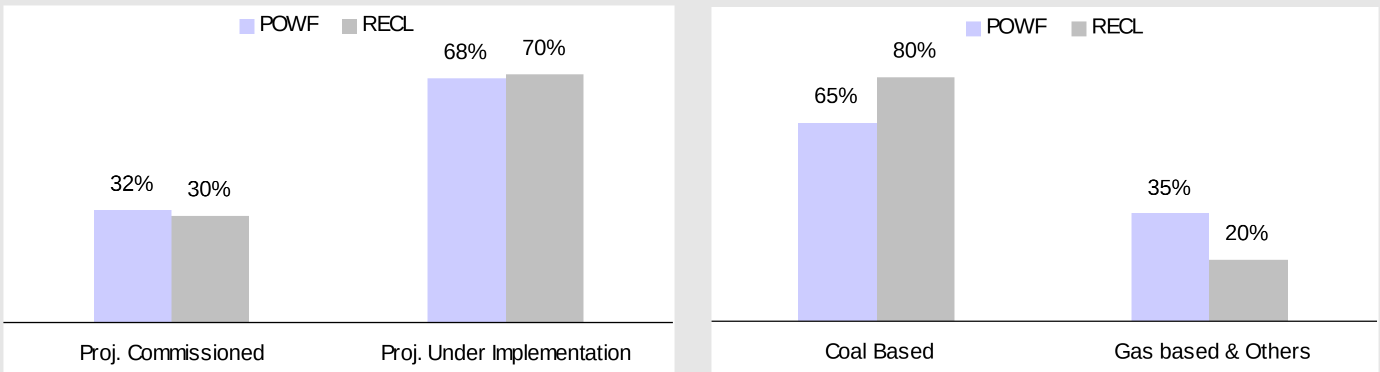


IDFC: Loan mix (September 2011)

Exposure to generation segment is limited

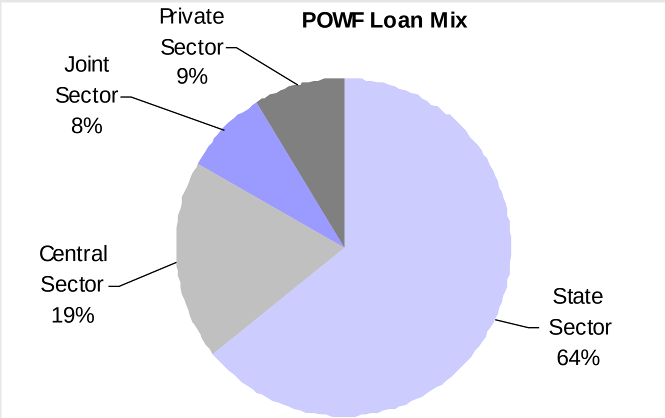


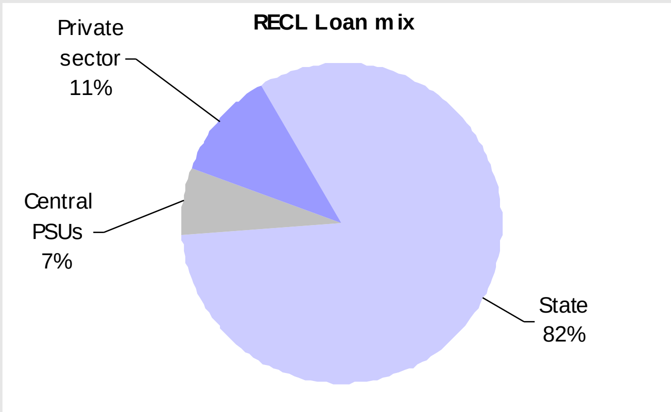
Proportion of coal-based generation projects under construction remains fairly high for POWF and RECL



Source: Company/MOSL

POWF and RECL's exposure to state and central entities remains much higher than IDFC



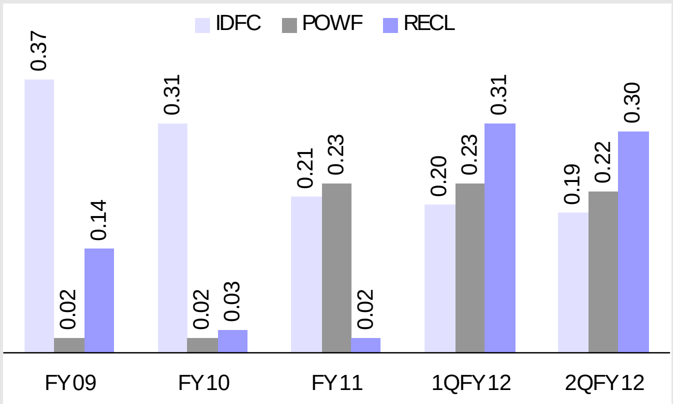


Source: Company/MOSL

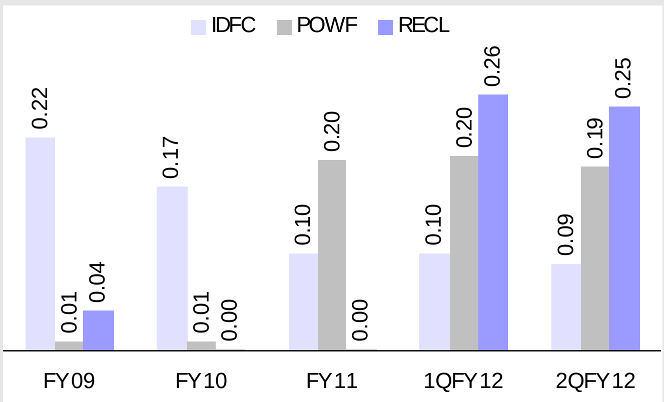
Impeccable asset quality track record; high standard asset provisioning on balance sheet

IDFC has had an impeccable asset quality track record, with GNPA at ~20bp and has an outstanding loan loss reserve of 1.6% of loan book, which would help the company to absorb any asset quality shocks without significant impact on earnings. On the other hand, there are NIL standard asset provisions on RECL and POWF's balance sheet, which makes them vulnerable in case of any substantial asset quality deterioration. Moreover, IDFC's higher exposure to operational projects also provides comfort.

Trend in gross NPAs

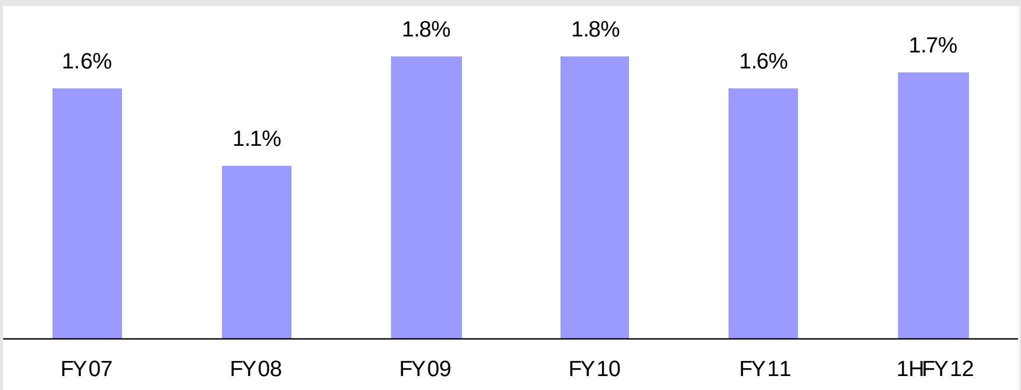


Trend in net NPAs



Conservative provisioning policy provides margin of safety

Loan loss reserve ratio maintained consistently at ~1.7% levels

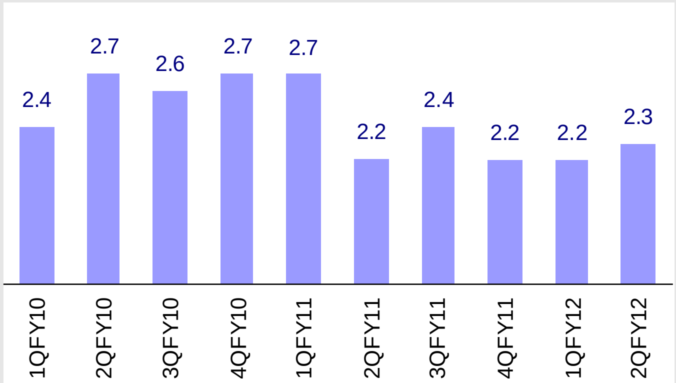


Source: Company/MOSL

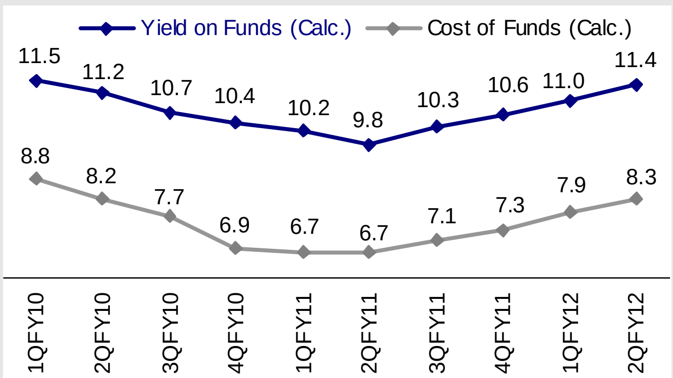
Spreads back to normalized levels, monetary easing to provide relief

IDFC's spreads have returned to normalized levels of 2.2-2.4% in the last five quarters from the peak of 2.7%. The steep decline could be attributed to sharp rise in interest rates. With (1) the interest rate cycle nearly peaking out, (2) wholesale rates stabilizing/cooling off, and (3) increased FII limit in bonds issued by IFCs resulting in relatively low cost borrowings, the company should be able to maintain a tight leash on its cost of funds. We expect IDFC to pass on the fall in cost of funds to borrowers, which will help to gain market share. Spreads are likely to remain stable at 2.2-2.4% over FY12/13.

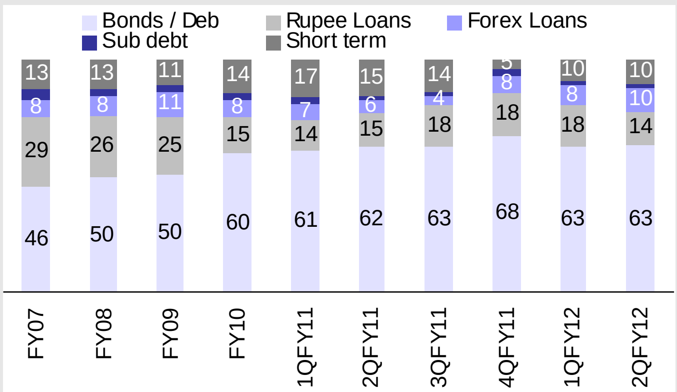
Spreads declined sharply, but unlikely to fall further



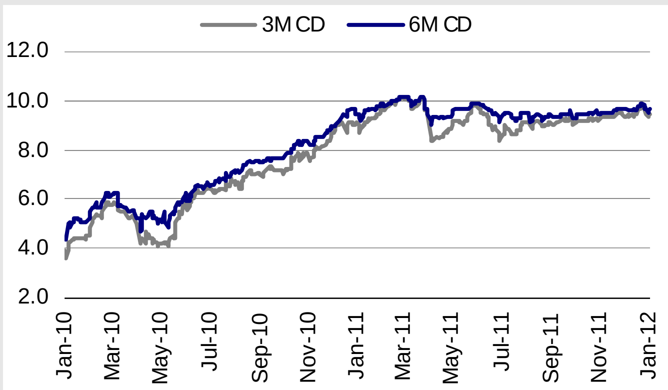
Yields and costs have moved in tandem in last few quarters



Share of foreign borrowings is increasing

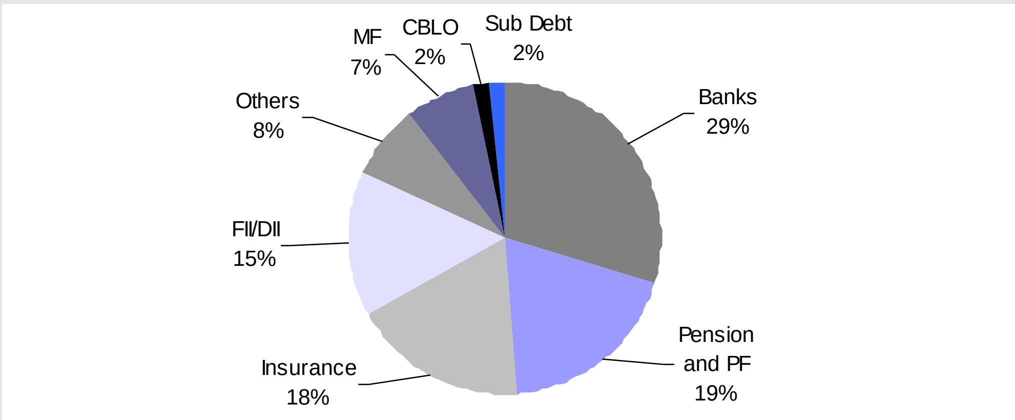


Wholesale rates are stabilizing



Borowing profile remains well diversified with banks contributing a large chunk

Diversified borrowing mix (based on sources)

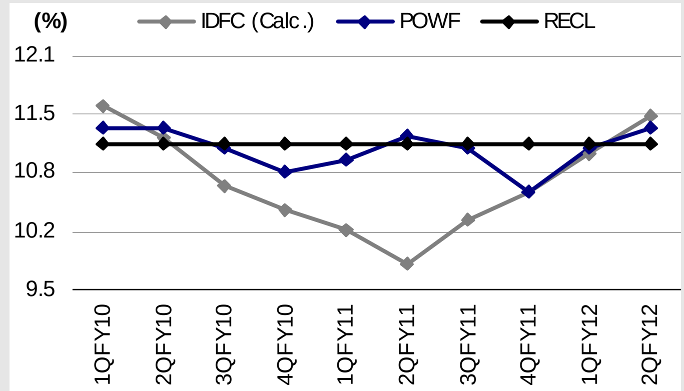


Source: Company/MOSL

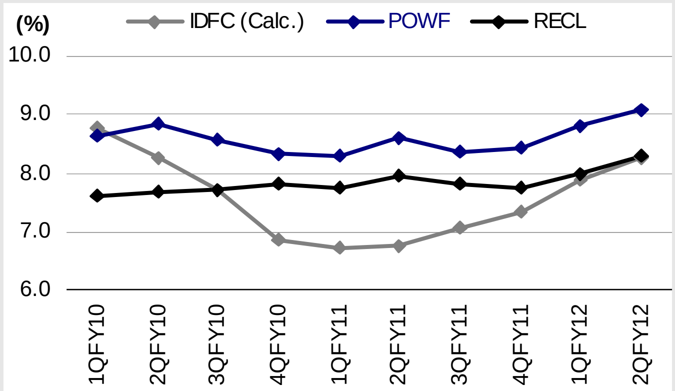
Yields in line with peers

IDFC's yields are currently in line with those of POWF and RECL. Its yields took a hit in FY11, when the company had aggressively grown its asset base. With reducing competitive pressures, IDFC should be able to maintain its yields. It has been able to manage its cost of funds fairly well despite not having the benefit of tax free bonds, which is available to RECL and POWF. We believe increasing share of foreign currency borrowings and IDFC not being too aggressive on growth should help the company to contain its costs and protect its spreads at current levels.

IDFC's yields are now in line with those of POWF and RECL



IDFC's cost management has been better than peers



Source: Company/MOSL

IFC status gives access to relatively lower cost borrowings

- RBI increased the limit for investments by foreign institutional investors (FIIs) in bonds/ debentures issued by NBFC-IFCs from USD5b to USD25b. Moreover, the lock-in period for investments up to USD5b has been reduced to one year from three years earlier. This allows IFCs to raise relatively low cost foreign currency borrowings, while domestic rates remain high.
- Under section 80CCF, IFCs are allowed to raise funds by issuing tax-free infrastructure bonds to retail investors. This opens up another avenue of capital for IFCs.
- Banks are allowed lower risk weights for lending to NBFC-IFCs (20% for AAA borrowers), translating into lower cost of borrowing for NBFC-IFCs.
- The permissible limit for bank lending to NBFC-IFCs has been set higher at 20% vis-à-vis 15% for other NBFCs, which gives IFCs greater access to bank funding.

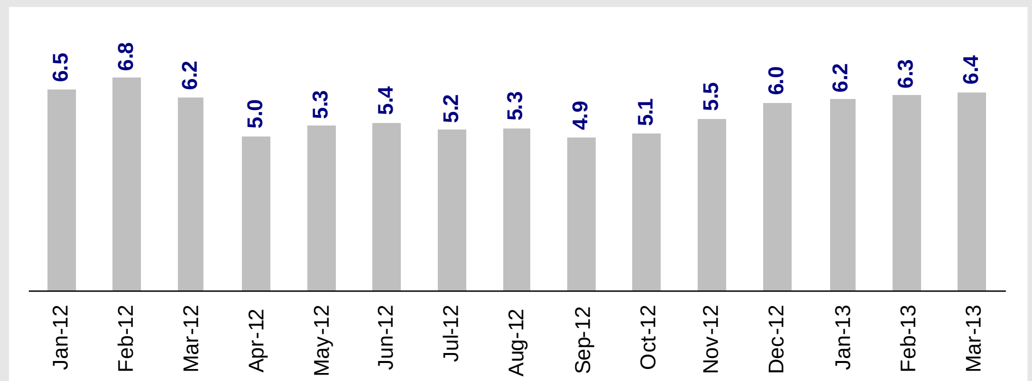
Risk-reward favorable; upgrade to Buy

Monetary easing and expected government intervention to address the key issues faced by the Indian infrastructure sector could act as major catalysts in improving the growth and profitability outlook for IDFC, leading to its re-rating. Among the IFCs, IDFC is well poised (compared to peers) to tide through the current phase of moderation in economic growth. At 0.9x FY13E BV, the stock is trading near its historical low valuations and discounts the concerns related to growth and asset quality. We believe risk- reward is favorable and upgrade our rating to **Buy**, with an SOTP-based price target of INR150.

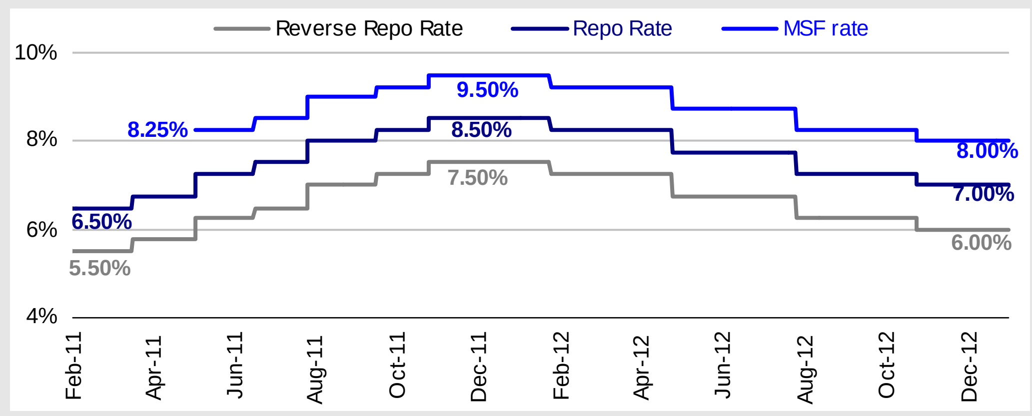
Monetary easing expected sooner than later

In CY11, while growth slowed down, inflation was stubbornly high, which led to successive rate hikes by RBI. Inflation remained above 9% in each of the 11 months of 2011 up to November 2011 and touched double digits in September 2011. With moderation in food inflation, slowdown in industrial growth and high base, inflation is likely to decline rapidly to ~7% by the end of 4QFY12. Our Economist expects inflation to remain range-bound at 5-6% for a large part of FY13. In his view, the growth-inflation balance is tilting in favor of growth and RBI may effect larger than expected rate cuts soon. The rate cut cycle could begin as early as January 2012 and RBI is likely to continue with its series of OMOs aggregating INR860b for FY12, especially in the backdrop of currency intervention draining out liquidity. Further, depending upon the prevailing liquidity situation, a CRR cut too may be effected along with rate cuts. In aggregate, our Economist expects RBI to ease rates by 150bp over CY12/FY13.

In 2012, expect the inflation genie to be bottled (%)



Expect 150bp cut in policy rates over CY12 / FY13

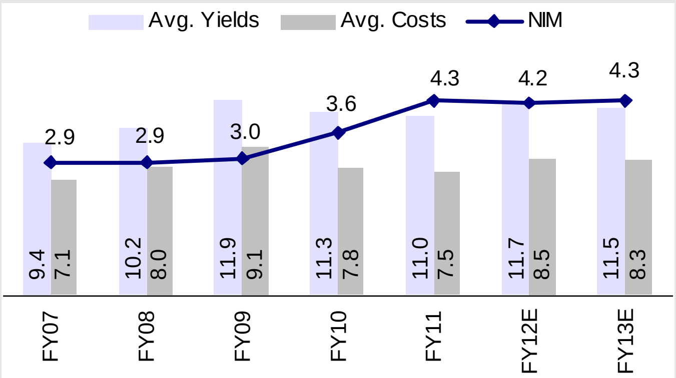


Source: Industry/RBI

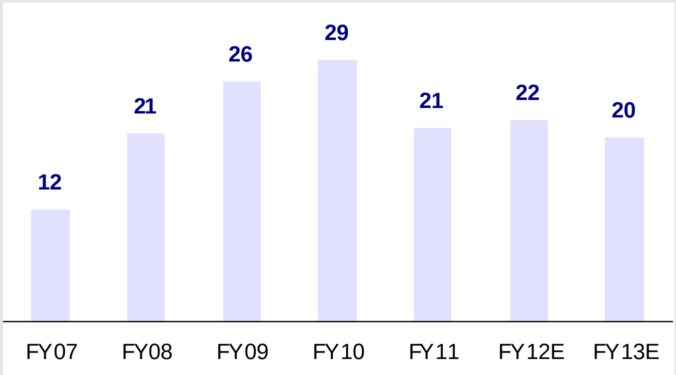
RoA to remain healthy; excess capitalization to keep RoE moderate

With RoA expected to remain strong at 2.7%+ due to stable spreads, reducing wage pressure on capital market business and continued high provisioning on the balance sheet. One of stake sale in equity business or monetization of carry income may provide surprise on profitability. However, on back of moderate growth outlook (till policy paralysis persist) RoE's are likely to remain subdued due to excess capital on the balance sheet. We believe current valuations factors in the concerns over growth and asset quality and materialization of key catalysts (as discussed above) will lead to re-rating. At CMP, IDFC trades at 0.9x FY13E AP/ABV, near its historical low valuations and risk reward remains favourable. We upgrade our rating on the stock to **Buy** with a price target of INR150.

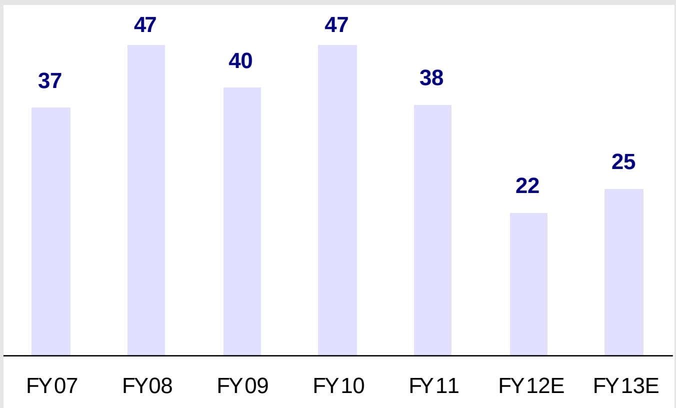
Cost of funds to moderate in FY13 (%)



Cost to income ratio (ex-trading gains and one-offs) to stabilize at around current levels

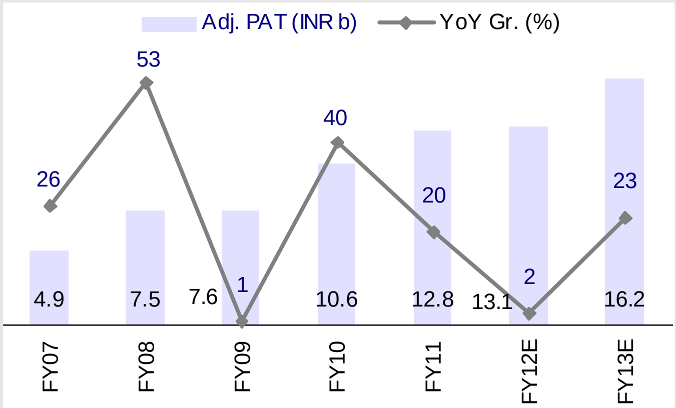


Dependence on non interest income has reduced



Note: Noninterest income has been calculated excluding one off gains in FY12

Earnings growth likely to gain momentum in FY13



FY12E PAT adjusted for one-off gains

Source: Company/MOSL

SOTP FY13 based

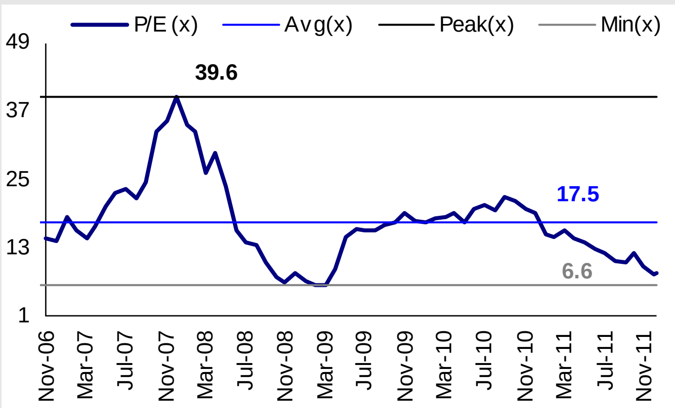
	(INR B)	USD B	Per Sh. (INR)	Valuation rationale
Financing/Investment bus	186.7	3.5	124	1.5x FY13E stand alone core NW. (please see below)
Alternative assets mgt	9.9	0.2	7	10% of AUM of USD2.5b
NSE Stake	13.2	0.2	9	6.5% stake, base price of last deal
IB and Broking	3.6	0.1	2	12x FY13E PAT
Mutual Fund Business	11.4	0.2	8	3.4% of AUM FY13E
Total Value	**224.9**	**4.2**	**150**	
CMP (INR)			102	
Upside (%)			47	

Source: MOSL

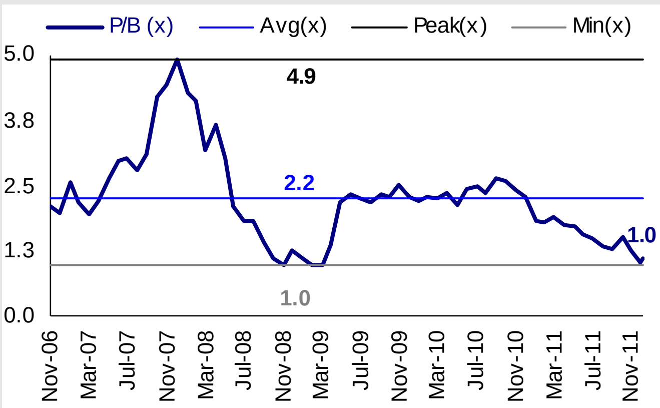
Calculation of Adjusted Networth

	(INR B)	USD B	Per Share (INR B)
FY13E Stand alone networth	135.9	2.6	90.0
Less: Investments in			
a) IB and Broking	4.4	0.1	2.9
b) Mutual Fund	6.1	0.1	4.1
c) NSE	0.9	0.0	0.6
Core Networth	**124.5**	**2.3**	**82.4**

1-year forward P/E (x) band



1-year forward P/B (x) band



Financials and Valuation

Income Statement (Consolidated) (INR Million)

Y/E March	2009	2010	2011	2012E	2013E
Interest Income*	30,092	30,797	39,754	54,738	64,019
Interest Expended	20,812	19,535	23,875	34,376	39,810
Net Interest Income	**9,280**	**11,262**	**15,878**	**20,363**	**24,209**
Change (%)	31.8	21.4	41.0	28.2	18.9
Other Income	**6,275**	**9,829**	**9,577**	**9,713**	**8,102**
Fees Based income	4,287	6,182	6,413	5,237	5,683
Principal Invt (Incl Carry Inc)**	1,840	3,330	2,790	4,277	2,119
Miscellanous Income	149	317	374	200	300
Net Income	**15,556**	**21,091**	**25,455**	**30,076**	**32,312**
Change (%)	17.5	35.6	20.7	18.2	7.4
Operating Expenses	3,666	5,526	5,321	5,902	6,476
Operating Income	**11,890**	**15,566**	**20,135**	**24,173**	**25,835**
Change (%)	11.1	30.9	29.4	20.1	6.9
Other Provisions	1,532	1,283	2,346	2,252	2,492
PBT	**10,358**	**14,283**	**17,788**	**21,921**	**23,343**
Tax	2,782	3,666	4,998	6,413	7,174
Tax Rate (%)	26.9	25.7	28.1	29.3	30.7
PAT	**7,576**	**10,617**	**12,791**	**15,509**	**16,169**
Change (%)	0.7	40.1	20.5	21.2	4.3
(MI)/Associate profit	79.0	-5.2	-25.7	-15.0	-15.0
Consolidated PAT	**7,497**	**10,623**	**12,817**	**15,524**	**16,184**
Change (%)	1.0	41.7	20.7	21.1	4.3
Proposed Dividend	1,555	1,951	2,925	3,881	4,046

* Includes debt trading gains; ** Excludes debt trading gains

Balance Sheet (INR Million)

Y/E March	2009	2010	2011	2012E	2013E
Capital	12,953	13,006	14,609	15,111	15,111
Reserves & Surplus	48,806	57,097	89,475	108,635	120,086
Net Worth	**61,759**	**70,103**	**104,084**	**123,747**	**135,197**
Minority Interest	281	63	2	2	2
Borrowings	235,481	265,439	371,439	424,406	516,797
Change (%)	5.6	12.7	39.9	14.3	21.8
Total Liabilities	**297,521**	**335,605**	**475,526**	**548,154**	**651,996**
Investments	65,000	46,554	69,611	87,399	108,186
Change (%)	24.4	-28.4	49.5	25.6	23.8
Loans	**205,962**	**250,311**	**376,523**	**436,767**	**524,120**
Change (%)	3.5	21.5	50.4	16.0	20.0
Goodwill	10,790	11,596	11,638	9,678	9,678
Net Fixed Assets	4,543	4,415	4,469	4,561	4,509
Deferred Tax Assets	1,421	1,755	2,480	2,499	2,549
Net current Assets	20,594	32,570	22,442	16,929	12,632
Total Assets	**297,521**	**335,605**	**475,526**	**548,154**	**651,996**

E: MOSL Estimates

Financials and Valuation

Ratios - Standalone

Y/E March	2009	2010	2011	2012E	2013E
Spreads Analysis (%)					
Avg. Yield - Infrastructure loans	11.9	11.3	11.0	11.7	11.5
Avg. Yield - Earning Assets	11.0	10.7	10.8	11.5	11.3
Avg. Cost-Int. Bear. Liab.	9.1	7.8	7.5	8.5	8.3
Interest Spread on loans	1.9	2.9	3.3	3.0	3.0
Net Interest Margin	3.0	3.6	4.3	4.2	4.3
Profitability Ratios (%)					
RoE	12.7	16.1	14.7	13.6	12.5
Core RoE#		17.6	17.8	14.0	14.6
RoA	2.6	3.4	3.2	3.0	2.7
Int. Expended/Int.Earned	69.2	63.4	60.1	62.8	62.2
Other Income./Net Income	40.3	46.6	37.6	32.3	25.1
Efficiency Ratios (%)					
Fee income/Net Income	27.6	29.3	25.2	17.4	17.6
Op. Exps./Net Income	23.6	26.2	20.9	19.6	20.0
Empl. Cost/Op. Exps.	48.4	55.8	55.6	57.3	56.1
Valuation					
Book Value (INR)	47.7	53.9	71.2	81.9	89.5
Price-BV (x)	2.1	1.9	1.4	1.2	1.1
Adjusted BV (INR)*	38.9	42.1	60.7	73.9	82.4
Price-ABV (x)	1.9	1.7	1.2	1.1	0.9
EPS (INR)	5.8	8.2	8.8	10.3	10.7
EPS Growth (%)	0.9	41.1	7.4	17.1	4.3
Price-Earnings (x)	17.6	12.5	11.6	9.9	9.5
OPS (Rs)	9.2	12.0	13.8	16.0	17.1
OPS Growth (%)	11.0	30.4	15.2	16.1	6.9
Price-OP (x)	11.1	8.5	7.4	6.4	6.0
Dividend per Share (INR)	1.2	1.5	2.0	2.6	2.7
Dividend Yield (%)	1.2	1.5	2.0	2.5	2.6

E: MOSL Estimates; *Adj. for Goodwill and Inv. in subsidaries, Prices adjusted for other ventures
Core RoE for FY12E adjusted for stake sale in NSE and AMC business

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