IDFC Ltd.

EQUITY REPORT

August 22nd, 2014

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Incorporated on January 30, 1997, IDFC is indulged in providing loan to Infrastructure projects and also engaged in the business of Merchant Banking, Asset Management, Private Equity and Broking business through its subsidiary. It is a conglomerate of 10 direct subsidiaries and 11 step-down subsidiaries. IDFC provides financing through various routes such as Senior Debt-Financing through Debentures, Mezza nine products-Subscribing to preference capital or debts, proprietary equity, private equity, Debt Capital, are amongst its product offerings. Recently, the company had got "in-principle" approval from the RBI to set up bank, which we believe that it may act as a growth driver in long term.

Investors' Rationale

IDFC's banking business to operationalize by October, 2015: IDFC has received an approval for legal demerger approvals in order to operationalize its new bank and the process will start soon in the near future. The management of the company expects demerger of IDFC and IDFC Bank to complete by H1FY16. With a capital adequacy ratio (CAR) of 23.9%, IDFC is well capitalized to keep its credit costs under control and could be the key beneficiary when the infra cycle revives. Foray into banking operation will not only help the company in diversifying its assets but also minimize its dependence on wholesale loan item. This will make it more resilient to economic cycles in certain sectors it lends to, and also have a more reliable funding base.

Well positioned to take advantage from positive regulatory reforms: With a market capitalization over ₹220 billion, IDFC is a well-established player in the Infrastructure financing space. With a strong track record of funding nearly one-fifth of the country's National Highways constructions and more than half of India's telecom towers, IDFC is well poised to benefit from recent regulatory announcements made on long-term infrastructure bonds and introduction of Real Estate Investment Trust (REITs) in India. However, operational challenges in the short term on transition to a bank is likely to persist, but the waiver on cash reserve ratio (CRR), statutory liquidity ratio (SLR), and priority sector lending (PSL) is expected to keep IDFC'S RoE and RoA stable in FY16E.

Loan book growth to remain flat in FY15E: Despite operating in an underperforming economic environment, IDFC has succeeded in protecting the overall health of its business by posting 6% YoY growth in its consolidated balance sheet at ₹752 billion as on March 31, 2014. Currently, 85% of its loan book of ₹523.0 billion is in infrastructure with 44% in energy, 23% in transport and 18% in telecom. Owing to on-going structural changes, we expect IDFC's loan growth to remain subdued in FY16E.

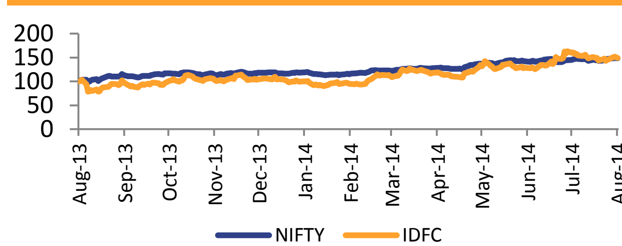
Market Data

Rating	**BUY**
CMP (₹)	148.3
Target (₹)	**168**
Potential Upside	~14%
Duration	Long Term
Face Value (₹)	10.0
52 week H/L (₹)	166.7/76.3
Adj. all time High (₹)	235
Decline from 52WH (%)	11.0
Rise from 52WL (%)	94.4
Beta	1.8
Mkt. Cap (₹bn)	224.8
Enterprise Value (₹bn)	786.5

Fiscal Year Ended

Y/E	FY13A	FY14A	FY15E	FY16E
NII (₹bn)	24.4	24.9	25.9	28.2
Other income	10.4	12.5	13.6	14.4
EBITDA (₹bn)	29.8	32.2	34.1	36.9
Net Profit (₹bn)	18.4	18.0	19.4	21.0
EPS (₹)	12.1	11.9	12.8	13.8
P/E (x)	12.2	12.5	11.6	10.7
P/BV (x)	1.6	1.5	1.3	1.1
ROE (%)	13.4	12.0	11.3	10.4

One year Price Chart



Shareholding Pattern	Jun'14	Mar'14	Diff.
Promoters	-	-	-
FII	51.81	52.61	(0.80)
DII	29.62	29.41	0.21
Others	18.57	17.98	0.59

IDFC: an integrated Infrastructure fund provider

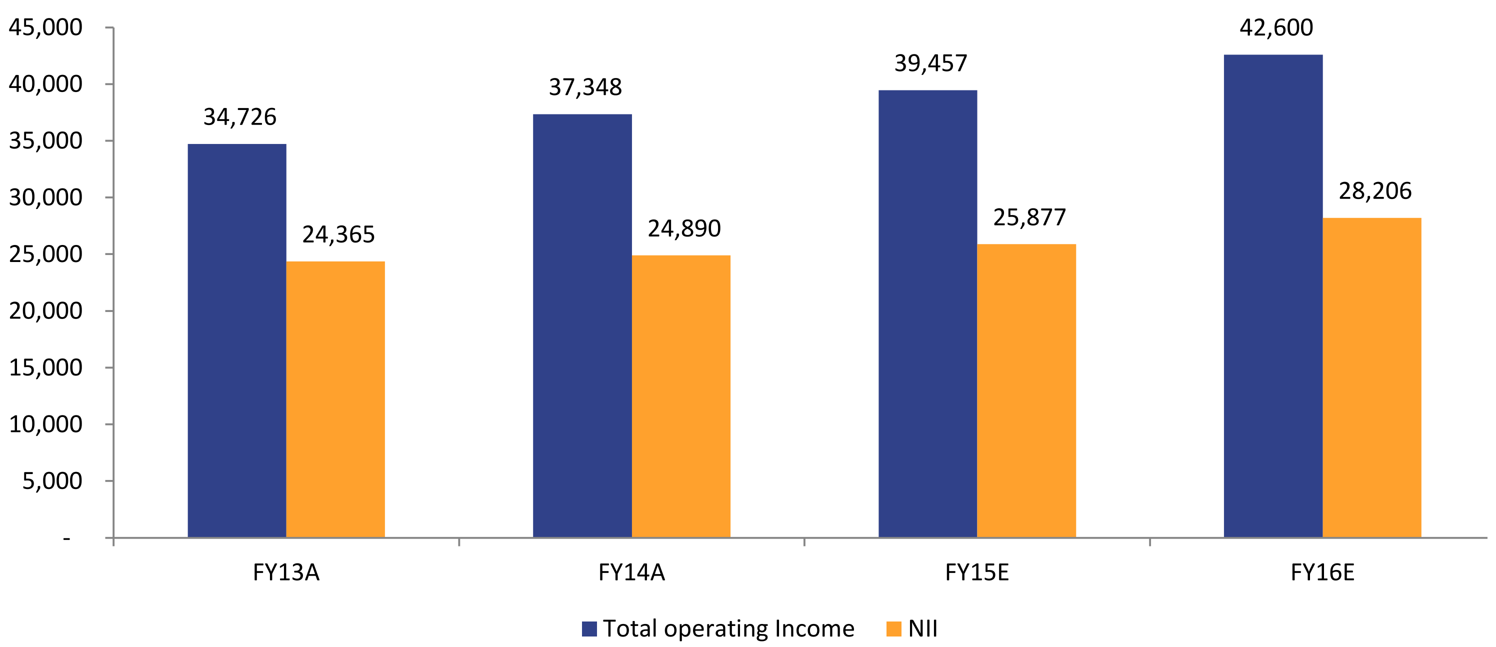
IDFC's move into banking will likely come with challenges and benefits. The near-term benefits include greater asset diversification and higher funding flexibility, while some challenges include building a branch network and the need to meet regulatory targets for extending loans to PSL.

Infrastructure Development Finance Company Ltd (IDFC) is a leading integrated infrastructure finance player established in 1997, to provide end-to-end infrastructure financing and project implementation services. IDFC represents a portfolio of businesses which serves the needs of infrastructure finance and project implementation in India. The company stands out to be a conglomeration of 10 direct subsidiaries, 11 indirect subsidiaries and the IDFC Foundation which, in turn, includes three Joint Ventures (JVs) and two trusts.

The company's business operations are structured into four broad platforms, namely, Project Finance, Investment Banking, Alternative Asset Management and Public Markets Asset Management. The project finance platform forms the company's core business, which provides solutions for the complexities associated with different projects through alternative financing structures. Through its investment banking business, the company provides advisory/capital raising services and institutional broking to its various clients. IDFC provides these services through its subsidiaries - IDFC Capital Ltd, which provides a range of advisory services like private equity syndication, initial public offers (IPOs), international offerings like GDRs, ADRs, and project advisory and merger & acquisition services; and IDFC Securities Ltd which provides broking services through research-led investment ideas. IDFC's Alternative Asset management business and Public Markets Asset Management business focus on providing equity capital to infrastructure developers and manage Mutual funds for institutional and retail investors.

The company raises capital from both domestic as well as international markets through term loans, issuance of bonds, commercial papers and through External Commercial Borrowings (ECBs). Recently, Fitch ratings have affirmed the company's long-term debt ratings with a stable outlook which would be quite beneficial for the company. The affirmation by Fitch simply reflects the company's stand-alone credit strength and the expectation that this is unlikely to change in the near- to medium-term even though IDFC is building its banking business after receiving an in-principle banking license in April 2014.

Total operating income and NII trend (₹in mn)



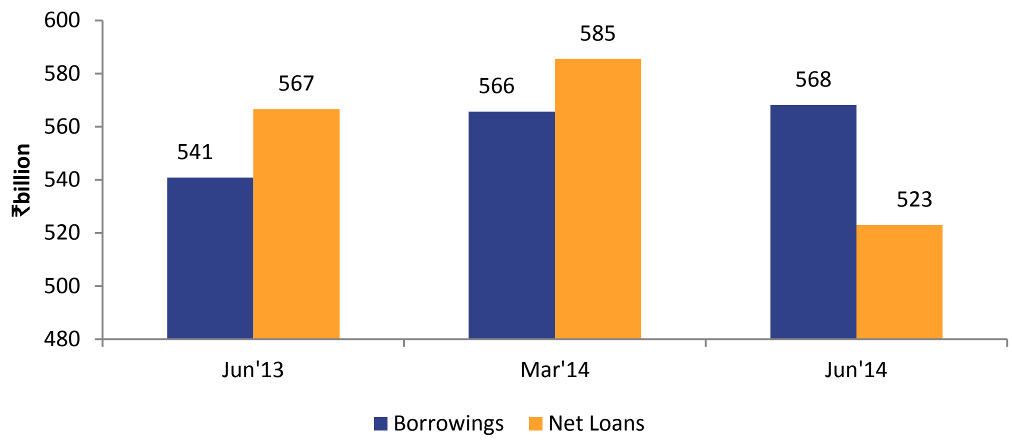
Subdued Q1FY15 performance

IDFC's balanced mix of businesses provides steady core income and non-interest income.

In Q1FY15, IDFC has delivered a disappointing performance with 14% YoY decline in net profit at ₹4.8 billion as compared to ₹5.6 billion during the same period last year, mainly due to a sharp drop in non-interest income and an increase in provisioning. Non-interest income fell steeply 39%YoY primarily due to trading loss, meager loan related fees and decline in capital market linked business (IB, broking & asset management) IDFC reported a contraction in the loan book as it prepares to convert itself into a bank. Gross loans and net loans fell 7% YoY and 8% YoY to ₹538.5 billion and ₹523.0 billion, respectively. In line with subdued loan growth, consolidated NII of the company remained flat at `6.82 billion over Q1FY14. Non-interest income declined 60% to ₹1.34 billion, due to a fall in growth of fixed income, loan related fees and principal gains. However, asset management fees and investment bank/broking income grew 6% and 28% to ₹0.98 billion and ₹0.17 billion, respectively, providing some support to non-interest income.

During Q1FY15, IDFC also made a one-time write-back on depreciation of ₹0.8 billion as it moves to the industry standard of the straight-line method of depreciation of its loan book, versus the more conservative written-down value method being used previously. However, a 3.5 times surge in total provisioning to ₹2.0 billion, coupled with muted revenue growth, led to a 14% YoY fall in net profit to ₹4.82 billion.

Muted growth in Loans & borrowing during Q1FY15



New government focus on infrastructure to revive investment cycle

Increasing government's focus on infrastructure development in India and increased capital expenditure in the Infra-sector opens huge funding opportunities for IDFC.

Strong IDFC's lending business during the XIth five year plan, marked a significant growth of 30% CAGR, with a well-balanced focus towards - Energy, Telecom and Transportation sectors. Following the dismal performance of Indian infrastructure sector during 2012-14, Indian Planning Commission's proposal to invest $1 trillion in the infrastructure sector during XIIth five year plan, appears to be virtually impossible, mainly due to persistently high headline inflation and a volatile currency and interest rates.

In order to pace up the domestic economic growth, the Narendra Modi led government is banking higher on the infrastructural development. Thus, with strong domain knowledge and dominance in the infra-funding space, IDFC is well poised to emerge as one of the biggest beneficiaries of government's focus on infrastructure development in the coming years.

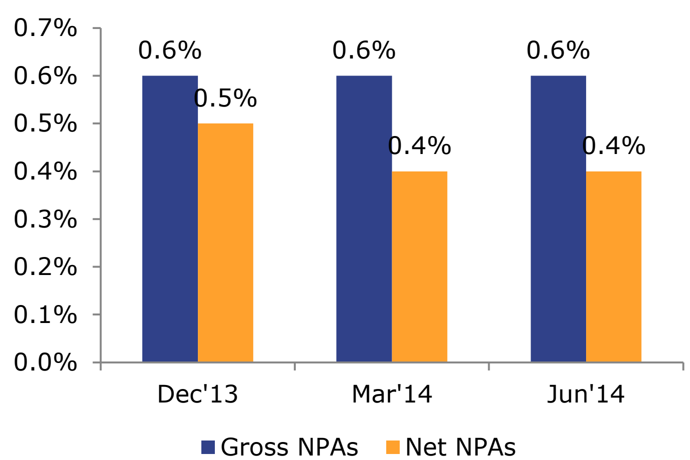
IDFC disclosed a restructured book to the tune of 4.5% (₹26.0 bn) and provision of 5% has been made of ₹1.6 bn vs. regulatory 2.75% in FY14. The restructured asset book has remained stable around 5.3% of loan book at ₹28.5 bn.

Asset quality concern to ease in the near term

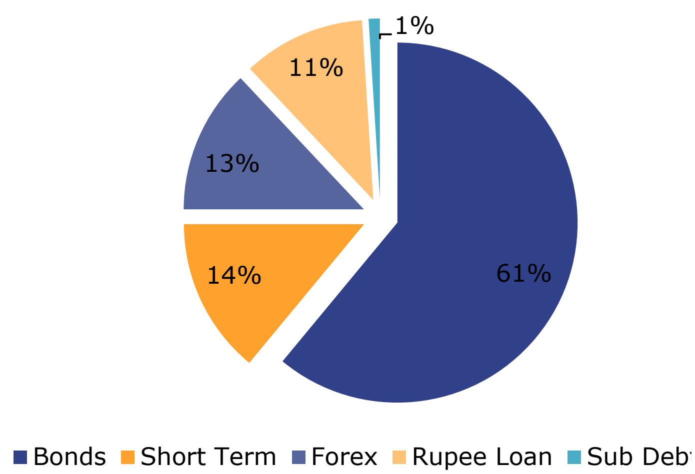
Strong domain knowledge and expertise of company in various business segments, coupled with a proactive approach in credit selection and stress testing have enabled IDFC to have the best-in-class asset quality, despite higher exposure into troubled sectors like power. IDFC has managed to maintain stable asset quality gross NPA and net NPA remained flattish sequentially. Gross NPA at 0.6% was largely stable sequentially which eases some concerns for now. Restructured book increased from 4.5% in Q4FY14 to 5.1% in Q1FY15 with the management indicating of more pain from restructuring in next few quarters before it starts improving in next 12 - 18 months.

Provision coverage ratio (PCR) of the company declined 60 bps on QoQ to 33.2% as compared to 33.8% a quarter ago. Thus, the decline in provisioning on a sequential basis indicates stabilisation of asset quality trends in the coming quarter. Outstanding restructured loans stood at ₹27.7 billion, which is 5.3% of loan book v/s 4.5% a quarter ago. IDFC expects the restructuring to increase over next 12 months, however healthy provisioning buffer of 3.1% will take care of any slippages. Of restructured loan book 85% is from power sector of which 45% is gas based projects (38% of restructured loans). We do not see asset quality stress coming off as gas based power projects still remain a concern for the company and infrastructure bottlenecks are to be resolved.

Asset quality trend



Borrowings structure in FY14



Cost effective source of borrowing

During FY14, IDFC's borrowings increased by 4% to ₹565.7 billion. IDFC has a diversified borrowing mix with long-term loans and bonds forming a majority of the portion. The infrastructure finance company (IFC) status enables IDFC to access cost-effective sources of borrowings such as Commercial Paper, Bonds, and Infrastructure Bonds having tax benefits. Since the last three years, IDFC has been focusing on reducing its dependence on bank borrowings by raising higher short term and foreign currency loans, which resulted in lowering in the cost of funds.

During Q1FY15, IDFC has also set up project management office to assist in its banking venture, which in turn would help the group to keep its C/I ratio lower than the industry average. Thus, we believe that with the increased proportion of short term borrowings to offset the impact of high rates has helped the company to block its cost to income ratio at 13.6% and 13.4% in FY15E and FY16E, respectively.

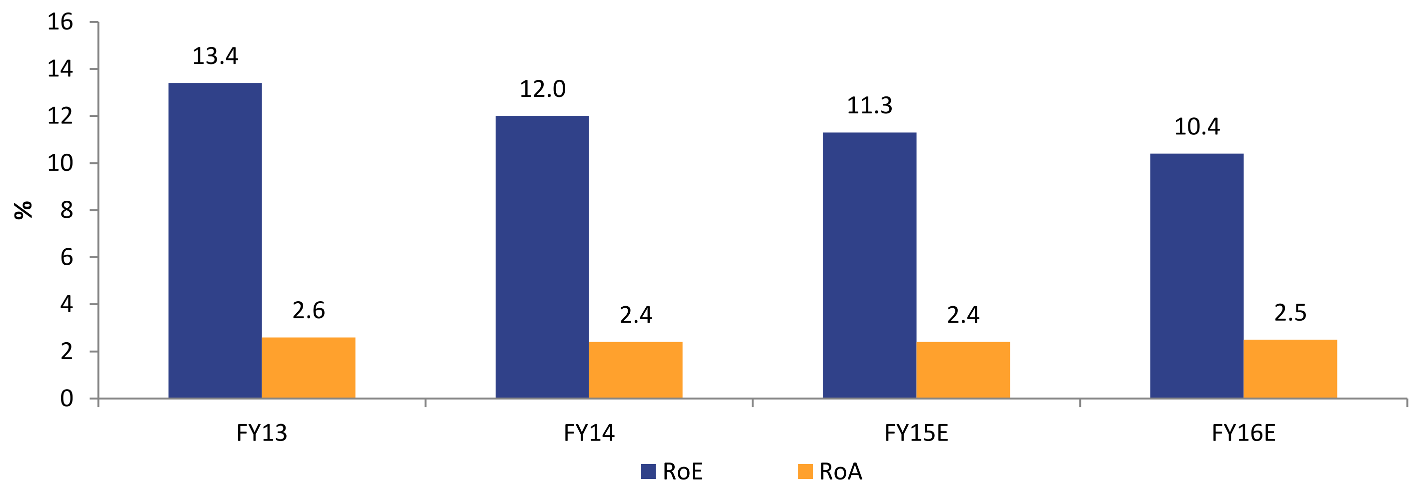
IDFC's loan book growth has been declining over the last few quarters due to a continued lull in new infrastructure project awards. However, given the recent clearance of major infrastructure projects by the Cabinet Committee on Investment, IDFC's loan book growth may pick-up in the next few quarters.

Loan book growth to remain flat in FY15E

With a strong track record in infrastructure financing in India, the net loan book of IDFC recorded a significant ~20% CAGR in the past 5 years. During FY14, IDFC has succeeded in protecting the overall health of its business by posting 6% YoY growth in its consolidated balance sheet at ₹752 billion. The modest growth in balance sheet came on account of disbursement of some short-term loans at the end of FY14, excluding which there is no growth. In the current underperforming economic environment, we expect FY15E loan book growth of the company to be flat. However, IDFC can see structural changes in FY16E, with the proposed foray into the banking sector.

In FY14, while IDFC has delivered muted performance, with 2.2% YoY marginal growth in NII at ₹24.9 as compared to ₹24.4 billion in FY13, non-interest income of the company increased by a healthy 20% YoY to `12.5 billion in FY14 from ₹10.4 billion in FY13. IDFC's loan book fee based income decreased in line with lower disbursements by almost 39% YoY to ₹1.2 billion in FY14 from ₹1.9 billion in FY13. IDFC's income from the asset management business (AMB) rose significantly by 33% YoY. Meanwhile, income from institutional broking business and investment banking businesses fell 14% and 1% YoY respectively. Taking a cautious stance, the company increased the provisions by 80% YoY to ₹6.28 billion in FY14 from ₹3.50 billion in FY13. Going ahead, we expect IDFC's fee based income to deliver strong growth even post conversion as a bank, as this business is expected to demerge into a new subsidiary.

RoA & RoE trend during FY13-16E (%)



RoE and RoA to remain stable

Historically, IDFC has maintained RoE of 12-14% and leverage of 4-6x. With banking licence, it is expected that higher leverage moving from 5-6x to 18-20x will keep the return ratios under pressure in near term. However, in order to increase private sector participation, now it is expected that IDFC would be allowed to fund infrastructure projects and will have a lower SLR and CRR ratio which is seen as a huge positive for the company as steep RoE and RoA pressures due to CRR/SLR/PSL now stand muted. We expect IDFC to manage its RoE and RoA to stay above 10% and 2%, respectively in the first two years as a bank.

IDFC's banking business to commence by October, 2015

On 2nd April 2014, , out of twenty-six companies applied for banking license, the Reserve Bank of India (RBI) has given its in-principal approval to IDFC and Bandhan Financial Services Pvt. Ltd. to set up banks. The approvals will be valid for 18 months, during which the firms have to comply with RBI norms for setting up a bank. IDFC is required to meet key regulatory requirements while transformation into a bank:-

- IDFC Bank will be listed on day one of operation – Under demerger route; IDFC parent shareholder will receive IDFC Bank shares also.
- Non-operating Finance Holding Company (NoFHC) to be incorporated and additional subsidiaries of NoFHC to be created by transferring Asset management companies (AMC), Alternatives and Securities businesses.
- IDFC is required to gradually bring down foreign ownership below 50% from current 53%. The company is planning to offer preferential shares to domestic investors in the immediate near term to meet the norm.

Being one of only two companies to receive in-principle approval to set up a bank, IDFC is in sweet spot to take advantage from RBI's move of exempting CRR/SLR/PSL requirements.

IDFC has received an approval for legal demerger and the process will start soon in the near future. The management of the company expects demerger of IDFC and IDFC Bank to complete by H1FY16. In NoFHC model, existing IDFC shareholders will receive shares of the bank and also have parent holding company IDFC. This should be a positive outcome for shareholders. There will be two listed entities IDFC and IDFC Bank. Currently, the company is in the process of creating an operating model that will offer quality banking services at a low cost. IDFC expects to operationalize its banking operation from October 2015 onwards.

RBI has stipulated that the new banks should have 25% of their branches in unbanked rural areas. Therefore, for the development of its upcoming banking business, IDFC is targeting southern and west central parts of the country to launch branches in unbanked areas. Thus, we continue to view the banking license development as favourable for the long-term profitability of the company. While operational costs are likely to go up considerably as IDFC invests in a branch network and ramps up employee strength, we see earnings and returns bouncing back in a few years. We are positive on IDFC's progress in establishing its banking presence, and believe the firm is on track in meeting key regulatory requirements such as paring down its foreign shareholding and restructuring its corporate entity.

Balance Sheet (Consolidated)

₹million	FY13A	FY14A	FY15E	FY16E
Share Capital	15,147	15,163	15,163	15,163
Reserve and surplus	121,679	135,240	156,879	186,843
Net Worth	**136,826**	**150,403**	**172,042**	**202,006**
Pending allotment	3	1	-	-
Minority Interest	254	402	402	402
Long Term Borrowing	542,273	565,653	592,979	613,733
Deferred tax liability	33	37	37	38
Other long term liabilities	3,231	5,314	6,376	7,652
Provisions	1,433	1,505	1,656	1,821
Current Liabilities	26,541	28,316	30,015	31,516
Capital Employed	**710,593**	**751,630**	**803,506**	**857,168**
Fixed assets	3,445	3,285	3,318	3,351
Goodwill on consolidation	9,571	9,571	9,571	9,571
Investments	33,093	38,882	44,715	51,422
Deferred tax assets	3,971	4,912	4,912	4,912
Loans and Advances	557,365	585,455	621,998	663,050
Current Assets	91,773	101,735	110,891	116,436
Other Assets	11,377	7,790	8,102	8,426
Capital Deployed	**710,593**	**751,630**	**803,506**	**857,167**

Profit & Loss Account (Consolidated)

₹million	FY13A	FY14A	FY15E	FY16E
Interest Income	71,123	75,442	79,968	87,166
Interest Expended	46,758	50,552	54,091	58,959
NII	24,365	24,890	25,877	28,206
Other Income	10,361	12,458	13,579	14,394
Operating Income	34,726	37,348	39,457	42,600
Operating Expenses	4,950	5,128	5,385	5,708
EBITDA	29,776	32,219	34,072	36,892
Depreciation	344	310	303	309
Provisions	3,496	6,283	6,911	7,602
Taxes	7,511	7,385	7,251	7,825
Sh. Of associate	19	20	7	7
Sh. Minority Interest	(81)	(235)	(200)	(210)
Net profit	18,362	18,027	19,412	20,953

Key Ratios (Consolidated)

Y/E	FY13A	FY14A	FY15E	FY16E
EBIT margin (%)	36.5	36.7	36.4	36.3
NPM (%)	22.5	20.5	20.8	20.6
ROE (%)	13.4	12	11.3	10.4
ROA (%)	2.6	2.4	2.4	2.5
Interest Expenses/ Interest Income (%)	65.7	67	67.6	67.6
C/I (%)	14.3	13.7	13.6	13.4
BVPS (₹)	90.3	99.2	113.5	133.2
P/BV (x)	1.6	1.5	1.3	1.1
EPS (₹)	12.1	11.9	12.8	13.8
P/E (x)	12.2	12.5	11.6	10.7

Valuation and view

With a diversified business portfolio, higher provision cushion, and higher proportion of non-interest income, IDFC is well placed compared to its peers in infrastructure financing space. Stable performance on asset quality and the margin front during Q1FY15 stands testimony to its ability to sustain business growth despite the sluggish economic environment. Expected monetary easing and reformatory steps by government would be major catalysts for IDFC in further improving the growth and profitability outlook.

Considering the above aspects, we rate the stock as 'BUY' at a CMP of ₹148.3, attractively placed at P/BVPS of ~1.3X and ~1.1X, for FY15E and FY16E, respectively to arrive at a target price of ₹163, with a potential upside of ~10% for the coming 12 months.

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