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January 27, 2010

Confidential

Dear Sir,

Annual Surveillance of ratings

Please refer to our rating letter dated January 8, 2010.

2. We enclose herewith final rationale for the rating assigned as **Annexure I**. The rationale is proposed to be included in our quarterly journal 'CAREVIEW'. A write-up on the above is also being issued to the press shortly. A draft of the press release is also annexed as **Annexure II**.
3. If you need any clarification, you are welcome to approach us in this regard.

Thanking you,

Yours faithfully,



[Ashvini Patil]
Senior Manager



[Milind Gadkari]
General Manager

Encl: A/a

Annexure I

Rationale

IL&FS Financial Services Ltd. (IFIN)	
Short Term Borrowing Programme of Rs.750 crore (enhanced from Rs.500 crore)	PR1+

CARE has retained the existing 'PR1+' [PR One Plus] rating for the short term borrowing programme (including commercial paper) of IL&FS Financial Services Ltd (IFIN) for an enhanced limit of Rs 750 crore (enhanced from Rs.500 crore). The above rating is for instruments with maturity up to one year. Instruments with this rating would have strong capacity for timely payment of short-term debt obligations and carry lowest credit risk.

The rating factors in strong parentage (IFIN is a wholly owned subsidiary of IL&FS), expertise and experience of IL&FS in infrastructure projects and track record of profitable operations. It also takes in to account presence of experienced professionals and senior management team drawn from the IL&FS group, comfortable capitalization level and profitability and satisfactory liquidity position. However its ability to maintain spreads and asset quality of its portfolio, and also the performance of its sizable proportion of promoter funding portfolio especially in a volatile market scenario and its ability to unlock value from its investments in various PE (Private Equity) funds would remain the key rating sensitivities.

Background

IL&FS Financial Services Ltd (IFIN) is a wholly owned subsidiary of IL&FS. IFIN (earlier known as IL&FS Finvest Ltd) obtained the certificate of registration to carry on non- banking financial activities from RBI on February 22, 2005. IFIN commenced its financing activities from August 2006 and FY08 was the first full year of operations for the company.

IL&FS' strategy to create distinct verticals for each business and the consequent demerger scheme to transfer its investment banking assets and liabilities to IFIN in FY08 has resulted in IFIN's balance sheet size to shoot up significantly and also led to a significant change in the composition of the company's asset book.

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Management

IFIN is a professionally managed company with Mr. Ravi Parthasarathy as Chairman. He is also the Executive Chairman of IL&FS. The Board of Directors and key managerial personnel are experienced professionals from the IL&FS Group having wide experience in financial services.

Operations

Asset Profile:

Asset size of IFIN grew significantly following the transfer of the investment banking portfolio in FY08 and the asset size stood at Rs 8006 crore as on Mar. 31, 2008 against Rs 620 crore as on March 31, 2007. However, as on March 31, 2009 asset book stood at Rs.6105 crore, as in the backdrop of a tough business environment prevailing in FY09, the company took a conscious decision to gradually curtail the Asset Book by reducing exposure to riskier and low yielding assets and increasing exposure to high yielding transactions. Consequently loan book was reduced to around Rs.4300 crore as of Mar 31, 09 as against around Rs.6500 crore previous year, a reduction of 33%. Loans & advances (including lease, term loans as well as debentures & Loans against Demat shares) constituted a major proportion (about 71%) of IFIN's asset book as on Mar. 31, 2009. IFIN has a significant portion of the advances portfolio in the form of promoter funding (primarily against shares as the security) forming about 66% of the total loans & advances portfolio as on Mar. 31, 2009. These loans have tenure of 1 to 3 years (or with put/call option at the end of 1 year). Infrastructure financing of a relatively larger tenure (typically 5 – 7 year loans) accounted for about 6% of total advances as on Mar. 31, 2009.

Resource Mix:

IFIN relies mainly on bank borrowings for funding its asset book. Term loans from banks & FIs form about 80% of the total borrowings as on March 31, 2009. A large part of borrowings (about 49% as on March 31, 2009) is of short term nature. During FY09, IFIN issued twenty crore equity shares (at Rs.10 + premium of Rs.40) to IL&FS, pursuant to scheme of demerger.

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Investment Profile:

IFIN's investment portfolio as on Mar. 31, 2009 stood at Rs.1776 crore, of which investments in various private equity funds were of Rs.712 crore forming about 57% of the tangible networth as on Mar.31, 2009. The investments in PE funds reduced to Rs.342 crore as on September 30, 2009 as a result of exit from one major PE investment.

Asset Quality

- The Net NPA and Net NPA to Networth ratios were 0.50% and 1.61% respectively as on Mar. 31, 2009.

Liquidity and interest rate risk

- IFINs liquidity position is comfortable. The company also had adequate back-up lines of credit to handle any short term mismatches. Most of IFIN's loans have a reset clause at the end of one year as also borrowings are of short term nature which thus provides a natural hedge to manage interest rate risks.

Financials

- Fund based activities of IFIN include funding in the form of LADS (Loan against Demat Shares), short term loans & term loans, subordinated debt, debentures etc. Debt syndication forms a significant portion of fee based income of the company.
- Fund Based income for the year ended Mar. 31, 2009 was about Rs.1016 crore which is higher than the fund based income of Rs.793 crore recorded in FY08 inspite of about 33% drop in Loans & Advances book as on Mar 31, 2009 as against Mar 31, 2008. Nearly 50% of the net interest income earned during 9MFY09 had been booked in Q3FY09 as the company charged higher risk premium with the deteriorating economic environment. IFIN has managed to improve its NIM on the back of higher yields.
- Profit was however lower in FY09 on the back of higher provisioning. The company saw substantial jump in provisions mainly on account of higher mark to market provision on Equity investments and general contingency provision.
- CAR increased to 22.20% as on Mar 31, 2009 as against 17.08% as on Mar 31, 2008 primarily on account of shrinking of loan book.

AKP

Update on H1FY10

- IFIN recorded a PAT of Rs.212 crore on a Total Income of Rs.583 crore for the half year ended Sept 30, 2009. The Loan book stood at Rs.4141 crore as on Sept 30, 2009.
- Net Interest Income surged in H1FY10 as a result of decrease in interest expenses both as result of decline in borrowings as well softening of interest rates and thereby reduction in the company's borrowing cost and lag in passing on the benefit to its customers through repricing of loans.
- Fund based income also included profit on sale of investments including Rs.57.8 crore on account of divestment of PE Fund investments.
- PAT Margin increased to 40% in H1FY10 as against about 11% in FY09 backed by both reduction in interest & operating costs as well as Rs.67 crore write-back on Investment provisions made earlier.

Prospects

With its experienced management, IFIN plans to provide innovative products and its strategy to target niche markets coupled with high demand for credit as well as need for advisory services in infrastructure sector and other sectors can help it to generate adequate income levels in near future. IFIN's profitability will however depend on its ability to get significant high yield mandates and sustain high non fund based income.

The company's ability to maintain the asset quality with the growth in asset book and unlocking value of PE investments would be a key rating sensitivity going forward.

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Brief Financials:
(Rs. Crore)

Particulars as on / for the period ended	FY08	FY09
Interest Income (A)	765.98	989.90
Interest Expenses (B)	564.59	700.60
Net Interest Income (C) (A – B)	201.39	289.29
Other Fund Based Income (D)	27.00	26.35
Fee Income (E)	170.15	81.43
Other income (F)	(0.05)	1.03
Total Income (G= A+D+E+F)	963.08	1098.71
Operating Expenses	152.65	217.13
Of which Provisions	32.36	120.18
PBT	245.84	180.97
PAT	168.40	123.40
Loans & advances	6497.25	4349.34
Investments	1318.14	1775.95
Tangible Networkth	1227.39	1248.80
Borrowings	6513.47	4856.18
Key Ratios (%)		
Int. income/ avg. Int. earning assets	13.03	17.25
Int. expense/ avg. Int. bearing liabilities	10.96	12.32
Interest Spread	2.08	4.92
NIM	3.10	3.87
PAT Margin	17.49	11.23
ROTA	2.59	1.65
Overall Debt / Networth (times)	5.31	3.89
CAR	17.08	22.20
Interest coverage (after provisions & tax)	1.40	1.18
Fee income / total income	17.70	7.41
Op. Expn. /Av. Total Assets	1.70	1.30
Net NPA	0.46	0.50
Net NPA to Networth	2.42	1.61

DISCLAIMER

CARE's ratings are opinions on credit quality and are not recommendations to buy, sell or hold any security. CARE has based its ratings on information obtained from sources believed by it to be accurate and reliable. CARE does not, however, guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. Most issuers of securities rated by CARE have paid a credit rating fee, based on the amount and type of securities issued

Annexure II

Press Release

CARE reaffirms 'PR1+' rating to Short Term Borrowing Programme of IL&FS Financial Services Ltd. (IFIN) for an enhanced limit of Rs.750 crore

CARE has retained the existing 'PR1+' [PR One Plus] rating for the short term borrowing programme (including commercial paper) of IL&FS Financial Services Ltd (IFIN) for an enhanced limit of Rs.750 crore (enhanced from Rs.500 crore). The above rating is for instruments with maturity up to one year. Instruments with this rating would have strong capacity for timely payment of short-term debt obligations and carry lowest credit risk.

The rating factors in strong parentage (IFIN is a wholly owned subsidiary of IL&FS), expertise and experience of IL&FS in infrastructure projects and track record of profitable operations. It also takes in to account presence of experienced professionals and senior management team drawn from the IL&FS group, comfortable capitalization level and profitability and satisfactory liquidity position. However its ability to maintain spreads and asset quality of its portfolio, and also the performance of its sizable proportion of promoter funding portfolio especially in a volatile market scenario and its ability to unlock value from its investments in various PE (Private Equity) funds would remain the key rating sensitivities.

Instrument	Amount (Rs. crore)	Rating
Short Term Borrowing Programme (enhanced from Rs.500 crore)	750	PR1+

Background

IL&FS Financial Services Ltd (IFIN) is a wholly owned subsidiary of IL&FS. IFIN (earlier known as IL&FS Fininvest Ltd) obtained the certificate of registration to carry on non- banking financial activities from RBI on February 22, 2005. IFIN commenced its financing activities from August 2006 and FY08 has been the first full year of operations for the company.

IL&FS' strategy to create distinct verticals for each business and the consequent demerger scheme to transfer its investment banking assets and liabilities to IFIN in

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FY08 has resulted in IFIN's balance sheet size to shoot up significantly and also led to a significant change in the composition of the company's asset book.

IFIN recorded a PAT of Rs.123 crore on a Total Income of Rs.1099 crore in FY09. As on March 31, 2009 the company had a loan portfolio of Rs.4349 crore. IFIN's Capital Adequacy stood at 22.20% as on March 31, 2009. Net NPA and Net NPA to Networth stood at 0.50% and 1.61% respectively as on March 31, 2009. For H1FY10, IFIN recorded a PAT of Rs.212 crore on a Total Income of Rs.583 crore. The loan book stood at Rs.4141 crore as on Sept 30, 2009.

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