Rationale

IL&FS Financial Services Ltd

CARE has retained the existing **PR1+ [PR One Plus]** rating assigned to the short term borrowing programme (including commercial paper) with an aggregate limit of Rs 500 crore (enhanced from Rs.300 crore) of IL&FS Financial Services Ltd (IFIN) and removed the rating from ‘credit watch’. 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 ratings of IFIN as well as parent Infrastructure Leasing & Financial Services Ltd. (IL&FS) were placed on ‘credit watch’ on Feb. 13, 2008 following the announcement of a scheme of demerger through which the investment banking portfolio of IL&FS was to be transferred to IFIN effective from April 1, 2007. The said demerger was approved by the Bombay High Court on Apr. 11, 2008. IFIN’s accounts for FY 08 take into consideration the transfer of assets and liabilities from the investment banking division of IL&FS.

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 growing asset book and profits in FY08 and satisfactory liquidity position. IFIN’s limited track record of operations, its ability to maintain spreads and asset quality of its portfolio post the transfer of the investment banking assets (from IL&FS) in FY08, as well as sizable proportion of promoter funding portfolio (46% of total loans and advances) especially in a declining market scenario and value unlocking from the sizable 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 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 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. The demerger was done through transfer of assets at book value. About Rs 1084 crore of net assets (effective as on April 1, 2007) have been transferred by IL&FS to IFIN and this has been settled mainly through issue of IFIN's equity shares worth Rs 1000 crore to IL&FS.

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. Loans & advances (including lease, term loans as well as debentures & Loans against Demat shares) constituted a major proportion (about 82%) of IFIN's asset book as on Mar. 31, 2008. IFIN has a significant portion of the advances portfolio in the form of promoter funding (primarily against shares as the security). Promoter funding formed about 46% of the total loans & advances portfolio as on Mar. 31, 2008. These loans carry tenure of 1 to 3 years (or with put/call option at the end of 1 year). The company has a policy to maintain about 2 times the disbursed amount as margin against promoter funding. Infrastructure financing of a relatively larger tenure (typically 5 – 7 year loans) accounted for about 3.7% (Rs 239 crore) of total advances as on Mar. 31, 2008. IFIN follows the practice of restricting exposure to single industry at 25% of total advances & all industry exposures as on Mar. 31, 2008 were within this ceiling.

Resource Mix:

Being a relatively new entity, IFIN has relied mainly on bank borrowings for funding its asset book. Term loans from banks & FIs form a significant 80.4% (Rs 6438 crore) of total liabilities followed by networth forming about 15.3 % (Rs 1227 crore) of total liabilities as on Mar. 31, 2008. A large part of borrowings (about Rs 2871 crore) is of short term nature. Sub debt and debentures (Rs.75 crore) constituted small proportion of liabilities (0.93%) on Mar. 31, 2008. During FY 08, IFIN issued one crore equity shares (at Rs.10 + premium of Rs.15) to IL&FS, thus raising Rs 25 crore.

Investment Profile:

IFIN's investment portfolio as on Mar. 31, 2008 stood at Rs 1318 crore, of which investments in various private equity funds were of Rs 863.2 crore forming about 70% of the tangible networth as on Mar.31, 2008. Going forward, given the uncertainty in the capital markets, value unlocking in terms of right price & timing from this portfolio could pose a significant challenge for IFIN. On current investments, the company had made provisions of about Rs 17 crore in FY08 as diminution towards the value of investments.

Asset Quality

- IFIN has in place internal rating for all proposals on a scale of 8 grades from AAA to D. As on Mar. 31, 2008, the portfolio was more skewed towards 'A-' and 'BBB+' categories (around 75% of total advances belong to these two categories).
- Gross & Net NPAs of IFIN as on Mar. 31, 2008 stood at Rs 57.2 crore and Rs 29.7 crore respectively. The gross and net NPA ratios were 0.88% and 0.45%

respectively as on Mar. 31, 2008. The above non performing assets correspond to the investment banking assets transferred to IFIN by IL&FS post demerger.

Liquidity and interest rate risk

- IFIN faces a cumulative negative mismatch in the immediate short term buckets of up to six months. The company however has unutilized Working Capital limits of about Rs 1190 crore from a consortium of banks as on Aug. 29, 2008. IFIN's experience suggests that most of the loans by the banks also get rolled over. 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

- IFIN started operations in August 2006 and FY08 has been the first full year of operations for the company.
- Following the transfer of assets & liabilities, incomes as well as expenses attributable to the investment banking division of IL&FS. have been recognised on IFIN's books. This has resulted in IFIN's PAT to rise significantly during the year. PBT of about Rs 133 crore (of the total PBT of Rs. 246 crore) has been booked in IFIN on account of the transferred Investment banking unit in FY08.
- Interest income has been the major contributor to IFIN's top-line, with the contribution of interest income being close to 82%. Interest income also included dividend income from investments of about Rs 54 crore. Interest (fund based income for IFIN) has been significantly higher on account of the assets transfer from IL&FS. The proportion of fee based income in total income has gone down to about 18% in FY08 and syndication fees formed the major proportion (43%) of fee income during the year.
- IFIN has managed to earn a healthy NIM of 3.1% & PAT margin of 17.49% in FY08, and expects to continue to report better spreads by focusing on innovative financial products.
- As per the scheme of restructuring approved by the High Court, consideration of Rs.1000 crore towards assets and liabilities transferred from IL&FS (transfer at book value), has been shown by IFIN as Share Capital Suspense A/c. This

along with retention of PAT has bolstered networth and consequently Debt/Equity has been managed at a level of 5.31 on Mar.31, 2008.

- IFIN has reported a capital adequacy ratio of 17.08% as on March 31, 2008 which is well above the existing 10% and proposed 12% stipulated by RBI for ND-SI-NBFCs (Non Deposit taking Systematically Important Non Banking Finance Companies) applicable from March 2009. The Tier I capital adequacy ratio of the company was 15.83% and Tier II Capital adequacy ratio was 1.26% as on Mar. 31, 2008 providing enough cushion to raise Tier II capital and expand operations going forward.
- Though IFIN faces some negative mismatches in the short term buckets, the company tends to match disbursements by raising term loans of equivalent maturity. IFIN also enjoys some flexibility in terms of un-availed working capital limits from a consortium of banks.

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 will enable IFIN to generate adequate income levels in near future. Besides, after the transfer of the investment banking book from IL&FS in FY08; IFIN has a strong base to expand its business. The threats however in the current scenario are the hardening interest rates and slowdown in the economy as a whole. IFIN's profitability will however depend on its ability to get significant high yield mandates and sustain high non fund based income. IFIN's track record of operations is limited. However, the investment banking portfolio that was transferred in FY08 would be handled by the same team as in IL&FS. The company's ability to maintain the asset quality of the growing asset book and unlocking value of PE investments would be a key rating sensitivity going forward.

Brief Financials:

(Rs. Crore)

Particulars as on / for the period ended	31.03.07	31.03.08
Interest Income (A)	21.3	793.0
Interest Expenses (B)	15.2	564.6
Net Interest Income (C) (A – B)	**6.1**	**201.4**
Fee Income (D)	24.3	170.2
Other income (E)	7.5	(0.1)
Total Income (G= A+D+E)	**53.1**	**963.1**
Operating Expenses	19.0	111.8
PAT	**10.8**	**168.4**
Total Assets	620.4	8006.1
Loans (including advance payments etc)	592.8	6523.7
Tangible Networth	**102.2**	**1227.4**
Borrowings	**515.0**	**6513.5**
Key Ratios (%)		
Int. income/ avg. Int. earning assets	6.96	13.03
Int. expense/ avg. Int. bearing liabilities	5.88	10.96
Interest Spread	**1.08**	**2.08**
ROCE	10.17	12.98
Cost of capital	7.16	9.48
Net Spread	**3.01**	**3.49**
NIM	**1.90**	**3.10**
PAT Margin	20.35	17.49
RONW	17.23	13.95
ROTA	**3.34**	**2.59**
Overall Debt / Networth (times)	5.10	5.31
CAR	**16.54**	**17.08**
Interest coverage (after provisions & tax)	1.71	1.40
Fee income / total income	45.77	17.70
Fund based income / total income	42.90	82.30
Oper.Expns./Av.Total Assets	5.87	1.70
Gross NPA to gross advances	**-**	**0.88**
Net NPA to net advances	**-**	**0.45**
Net NPA to Networth	**-**	**2.41**

Note: *Financials are not comparable over years considering the transfer of the investment banking portfolio to IFIN by IL&FS in FY08.*