

Annexure I

Rationale

IL& FS Financial Services Ltd.

Ratings

Instrument/Facilities	Amount (Rs. crore)	Ratings¹	Remarks
Non Convertible Debentures	300	CARE AAA (Triple A)	Assigned
Subordinated debt	200	CARE AAA (Triple A)	Assigned
Short term Debt programme	750	CARE A1+ (A One Plus)	Reaffirmed

Rating Rationale

The rating factors in strong parentage (IFIN is a wholly owned subsidiary of IL&FS) as well as operational, managerial and financial support from IL&FS. The rating also factors in healthy capitalisation and solvency parameters, reduced exposure to promoter financing segment, strong risk management systems, comfortable liquidity position and good asset quality. Continued support from the parent IL&FS, profitability, business growth and asset quality are IFIN's key rating sensitivities.

Background

Incorporated in September 1995, IL&FS Financial Services Ltd. (IFIN) is a 100% subsidiary of IL&FS Ltd. IFIN's business profile is broadly divided into investment banking business (asset & structured finance), Project debt syndication business, corporate advisory services business and project finance advisory. As on March 31, 2011, IFIN had a balance sheet size of Rs.8,490 crore with a networth of Rs.1,530 crore. IFIN has international presence through its fully owned subsidiaries in Singapore, United Kingdom and Dubai. These subsidiaries were set up mainly to assist corporates for their overseas borrowing, through private equity syndication and advisory services.

¹ Complete definitions of the ratings assigned are available at www.careratings.com and in other CARE publications

Credit Risk Assessment

Strong parentage- IFIN is the wholly owned subsidiary of IL&FS (rated CARE AAA), one of India's leading infrastructure development companies. By the virtue of being the subsidiary of IL&FS, the company enjoys high financial flexibility in addition to benefits arising from group synergies. The rating further derives strength from the operational and managerial support extended to it by IL&FS.

Healthy capitalisation levels and solvency parameters- IFIN has healthy capitalisation levels with overall CAR being 19.41% [Tier I CAR: 18.16%] as on Sept 30, 2011. The high Tier I CAR provides the company sufficient headroom to raise Tier II capital in order to fund the asset book growth in the coming years. The company is moderately geared at 4.88x.

Reduced exposure to promoter financing segment- Given the difficult operating environment in FY09, the company had consciously started reducing its exposure to promoter funding segment. Since FY09 the share of the portfolio has reduced from 66% of the total advances mix as on March 31, 2009 to 42% as on March 31, 2011. Although promoter financing continues to account of a major chunk of lending portfolio, over the last few years, infrastructure finance has emerged as a key focus area for the company with its share rising to 22% of the total loan book as on March 31, 2011 from around 15% as of March 2009.

Risk management- Risk management systems play a critical role since majority of IFIN's funding is towards high ticket promoter funding and infrastructure loans. As a result, the company has high concentration risk with top 25 borrowers constituting around 65.7% [P.Y.: 61.9%] of the total loan portfolio. On the promoter funding side, top 15 borrowers comprised around 71.6% of the total promoter funding portfolio leading to significant asset quality risk during slowdown. However, the asset quality risk is somewhat mitigated since IFIN has superior risk management systems given its parent expertise in infrastructure projects credit appraisal and execution. As a result, the company was able to maintain its asset quality despite difficult operating environment since H2 FY09. In order to counter the risk arising from its borrower concentration in promoter funding, the company maintains an average share cover of around 2x.

Liquidity and repricing risk- IFIN faces liquidity mismatches in short to medium time buckets on account of rise in proportion of medium term (average tenor of around 3 years) infrastructure loans over past two years as well as rise in medium term investments (PTCs and NCDs) in nature of credit substitutes in FY11. Therefore, in order to match the medium term nature of lending, IFIN has been consciously trying to reduce reliance on short term borrowings. Short Term borrowings (excl ICDs) accounted for around 25% of the borrowing profile as of June 30, 2011 vis-à-vis 30% in March 31, 2010. Besides, the company maintains adequate back-up lines of credit which should help it mitigate the liquidity gaps.

The interest rate sensitivity statement of the company seems to be comfortable with positive cumulative mismatches across all the time buckets. However, despite the positive gaps, competitive

pressures as well as asset quality concerns have impacted IFIN's ability to pass on higher interest costs thereby impacting its margins.

Good asset quality- Over the last few years, IFIN has been able to maintain sound asset quality. Since FY08, the NPA levels of the company have largely remained stable in absolute terms. As on Sept. 30, 2011, the GNPA and NNPA ratios stood at 1.37% and 0.57% respectively; net NPA/networth being 2.49%.

Subdued financial performance- During the last two years, fund based income of IFIN has been declining primarily due to lower interest income on loan book. While credit portfolio de-growth led to decline in interest income during FY10, the same has marginally declined to Rs.663 crore during FY11 on account of fall in portfolio yields given the surplus liquidity conditions during H1 FY11 and competitive pressures. As a result, NIMs declined to 3.79% during FY11. IFIN reported a subdued 3% rise in net profit to Rs.326 crore during FY11 on total income of Rs.1,104 crore.

Declining margins led by higher borrowings costs as well as limited ability to pass on the interest rate hikes have impacted the company's profits, resulting into a 10% y-o-y dip during H1 FY12. Despite the rising interest costs, the company has been refraining from passing on the higher costs to customers in order to prevent asset quality issues. However despite the decline, the margins and ROTA continue to be healthy.

Prospects

The NBFC sector showed significant growth during the last two years of FY10 and FY11 backed by strong growth in all the underlying sectors of infrastructure, commercial vehicles and overall industry. While the high growth in disbursements in FY10 was partly due to the lower base of FY09, the momentum continued during FY11 on fundamental factors.

The recent period also saw the entry and growth of the new players in the market either backed by the product manufacturers or as the financing forays of large conglomerates. While the traditional product segments of commercial vehicle and construction equipment financing remain the core focus; segments such as loan against property, SME loans and loans against security have shown substantial growth.

Structurally the capital adequacy, liquidity and asset quality for most NBFCs has remained good. Capital adequacy has been driven to a large extent by the increasing regulatory requirements which have risen to a minimum of 15% from March 31, 2011 for non-deposit accepting NBFCs and from March 31, 2012 for deposit accepting NBFCs. Liquidity risk materialized significantly during the credit crisis in 2008 and since then most NBFCs have managed their ALM conservatively. Asset quality was weak for the unsecured lending portfolio during the credit crisis and was shunned as an asset class by the NBFC sector during the last few years. If we exclude the microfinance sector, NBFCs have focused solely on secured lending either through the security of income generating assets or through the security of property / shares collateral. This has the dual impact of improving the current asset quality and building a secured portfolio that is expected to have lower credit costs in future also.

The impact however was felt in terms of margins for most NBFCs in terms of their spreads as the focus towards secured lending reduces the scope for high interest rates on the asset side and conservative ALM with rising interest rates affect borrowing costs.

Going forward the key factors affecting NBFC space are regulatory environment, interest rates, competition and overall economic growth. The RBI has either changed some regulations or is in the process of reviewing some of them which may affect the NBFC sector. The indirect priority sector tag from loans given by the banks to NBFCs has been withdrawn (except for qualifying MFI NBFCs). This may affect the borrowing costs for loans taken by NBFCs from the banks as they would have to be on purely commercial terms as against a mix of commercial and priority sector considerations earlier. Overall the regulatory scenario for NBFCs is being reviewed by RBI with a view to reduce 'regulatory arbitrage' between banks and NBFCs. While these changes have made the environment challenging for many players, the stronger NBFCs are expected to manage the higher compliance costs. Increased RBI interest in the sector also reflects the systematic importance of the sector which is a positive development.

Interest rates have been continuously rising with increasing domestic inflation. The ability of NBFCs to pass on the costs without affecting the asset quality is a key factor to be monitored. In addition there is increased competition in the space with the entry of new players which may not allow lenders to pass on the full increase in their borrowing costs. In the current rising interest rate scenario, the spreads of the industry players are expected to witness downward pressure as it would be difficult to pass on the higher interest rates entirely.

Standalone Financials

	(Rs. Crore)		
Particulars as on / for the period ended	FY09	FY10	FY11
Interest Income	990	748	741
Interest Expenses	701	412	454
Net Interest Income	289	336	288
Other Fund Based Income	26	128	100
Fee Income	81	155	258
Other income	1	3	5
Total Income	1099	1034	1104
Operating Expenses	97	108	114
Provisions	120	46	66
PBT	181	467	471
PAT	123	315	326
Total Assets	6614	6694	8490
Loans & advances	4349	4093	4944
Investments	1751	1432	2517
Tangible Networth (Excl. DTA)	1249	1381	1530
Borrowings	4856	4660	6206
Key Ratios (%)			
Int. income/ avg. Int. earning assets	17.27	16.24	14.93
Int. expense/ avg. Int. bearing liabilities	12.32	8.67	8.35
Interest Spread	4.95	7.58	6.58
NIM	3.89	5.05	3.79
ROTA	1.65	4.73	4.29
Gearing (times)	3.89	3.37	4.05
CAR	22.2	25.99	21.19
Tier I CAR	20.95	24.74	19.94
Interest coverage (after provisions & tax)	1.18	1.76	1.72
Fee income / total income	7.41	14.95	23.32
Oper. Expns./Avg.Total Assets	1.3	1.62	1.5
Gross NPA (%)	1.26	1.57	1.72
Net NPA (%)	0.51	0.74	1.44
Net NPA to Networth (%)	1.61	2.17	5.59

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Credit Analysis and Research Limited proposes, subject to receipt of requisite approvals, market conditions and other considerations, to make an initial public offer of its equity shares and has filed a draft red herring prospectus ("DRHP") with the Securities and Exchange Board of India (the "SEBI"). The DRHP is available on the website of SEBI at www.sebi.gov.in as well as on the websites of the Book Running Lead Managers at www.investmentbank.kotak.com, www.dspml.com, www.edelcap.com, www.icicisecurities.com, www.idbicapital.com, and www.sbicaps.com. Investors should note that investment in equity shares involves a high degree of risk and for details relating to the same, see the section titled "Risk Factors" of the DRHP.

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Annexure II

Press Release

CARE assigns 'CARE AAA' to long term debt instruments of IL&FS Financial Services Ltd. (IFIN) and reaffirms 'CARE A1+' rating to Short term debt programme

Ratings

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Background

Incorporated in September 1995, IL&FS Financial Services Ltd. (IFIN) is a 100% subsidiary of IL&FS Ltd. The company is operationally integrated with its parent in key areas such as resource raising and liquidity management, risk management etc. IFIN's business profile is broadly divided into investment banking business (asset & structured finance), Project debt syndication business, corporate advisory services business and project finance advisory. As on March 31, 2011, IFIN had a balance sheet size of Rs.8490 crore with a networth of Rs.1530 crore. IFIN has international presence through its fully owned subsidiaries in Singapore, United Kingdom and Dubai. These subsidiaries were set up mainly to assist corporates for their overseas borrowing, through private equity syndication and advisory services.

After witnessing loan book contraction as a result of conscious strategy, the asset portfolio growth of IFIN rebounded during FY11 with a major focus on infrastructure lending. The total loan portfolio of IFIN increased by 15% to Rs.4944 crore as on March 31, 2011 while YTD portfolio growth upto Sept. 30, 2011 stood at 27%. During FY11, IFIN reported PAT of Rs.325.7 crore on total income of

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Rs.1104.3 crore. The earnings profile reported subdued growth of 7% primarily on account of decline in portfolio yields given the surplus liquidity conditions during H1 FY11 and competitive pressures. During H1 FY12, IFIN reported PAT of Rs.93 crore on total income of Rs.590 crore. The company continued to report comfortable asset quality parameters. As on Sept. 30, 2011, the GNPA and NNPA ratios stood at 1.37% and 0.57% respectively; net NPA/ networth being 2.49%. IFIN has robust capitalisation levels with overall CAR being 19.41% [Tier I CAR: 18.16%] as on Sept 30, 2011. The company is moderately geared at 4.88x.

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CARE has classified instruments rated by it on the basis of complexity. This classification is available at www.careratings.com. Investors/market intermediaries/regulators or others are welcome to write to care@careratings.com for any clarifications.

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Credit Analysis and Research Limited proposes, subject to receipt of requisite approvals, market conditions and other considerations, to make an initial public offer of its equity shares and has filed a draft red herring prospectus ("DRHP") with the Securities and Exchange Board of India (the "SEBI"). The DRHP is available on the website of SEBI at www.sebi.gov.in as well as on the websites of the Book Running Lead Managers at www.investmentbank.kotak.com, www.dspml.com, www.edelcap.com, www.icicisecurities.com, www.idbcapital.com, and www.sbicaps.com. Investors should note that investment in equity shares involves a high degree of risk and for details relating to the same, see the section titled "Risk Factors" of the DRHP.

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