IRFC

NOT RATED

PRE-IPO NOTE | January 18, 2021

A quasi-bond investment?

A common question on investors' minds would be, "Is IRFC same as other state-owned infrastructure lenders (PFC/REC)?" Explicit allocation of lease receivables in the Union Budget implies receivables are guaranteed. Common sovereign ownership with its counterparty makes IRFC unique. Lower risk vs other PSUs is also reflected in NIL NPA status and 20-80bps lower bond spreads. Strategic importance to Indian Railways and the Ministry of Railways' expansion plans imply AUM growth of >25% over next 5 years and margin continuity (though capped) in the longer run. Nevertheless, RoE expansion beyond 10-11% depends on increase in margins. Given profitability not being primary objective of both IR and IRFC, sustained margin improvement looks unlikely. Government intent to privatize IR could expose IRFC to higher risk assets. Already low opex (~0.04% to assets) leaves no room for operating leverage play. Any meaningful upside beyond 1x P/B looks unlikely. Sustained expansion in margins is a key risk.

Dedicated borrowing arm of Indian Railways

IRFC leases rolling stock and other assets of Indian Railways (IR) and collects lease rental proceeds. It has a cost plus mark-up structure and earns spread of 30-50bps over all-inclusive cost of borrowing. IRFC has been financing ~1/3rd of IR's annual capital outlay. Given status of sole market borrowing arm of IR and expected surge in volumes backed by the Ministry of Railways' (MoR) aggressive plans to expand, we expect IRFC to continue earning similar spreads over a longer term (expansion unlikely). Slated diversification plans would only form a small part of the total portfolio with exposure to entities having linkages with IR.

Modest earning profile

Earnings grew at a CAGR of ~50% between FY17-1HFY21 led by ~26% AUM growth. Margins capped at 30-50bps over all-inclusive cost of funds led to RoE caped at 10-11%. MoR's aggressive growth plan of ~Rs50bn capex by 2030 implies annual capex run-rate of Rs4.2bn much higher than current outlay of Rs1.6bn. Though the growth opportunity is large, it would not be RoE accretive as margins would largely be capped. Single-party exposure (all within IR ecosystem) exposes IRFC to vagaries of IR.

Unique repayment structure – Not same as PFC/REC

IRFC's lease receivables and MoR's capital outlay both form a part of Union Budget allocation. This makes IRFC unique and different when compared to PFC and REC as its lease receivables are effectively guaranteed. Common sovereign ownership with its counterparty makes it a very low risk vehicle. Even lending to other entities under MoR has either cash flows originating from MoR or carries a repayment assurance. This has enabled IRFC to have NIL NPA status. Lower credit risk vs other PSUs is also reflected in its bonds issues typically being subscribed at 20-80bps cheaper rates. IRFC also enjoys an explicit liquidity assurance from MoR which it hasn't utilized till date.

Valuations: Where is the upside?

Expected valuation of ~1x P/B is at 30-40% premium to PFC/REC. But at this point IRFC enjoys higher earnings visibility backed by very low credit risk and almost assured business flow; expansion into private sector cannot be ruled out. Effectively, IRFC's equity is a quasi-sovereign bond earning marginally higher than g-sec. With no benefit of an operating leverage play and capped margins, expected RoE of 10-12% leaves no meaningful fundamental-based upside on table. With fate of IRFC being largely tied to IR with possibility of private sector risk build-up investing in bond instrument of IRFC could be a better alternative.

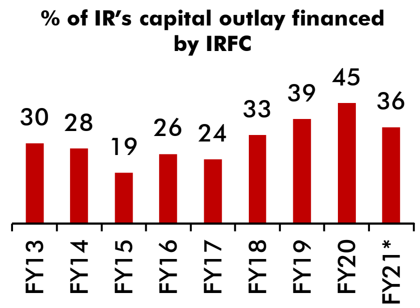
BFSI

IPO/OFS Snapshot

Particulars	Amount
Fresh issue (Rs mn)	30,889
Offer for sale (Rs mn)	15,445
Total IPO size (Rs mn)	46,334
Offer for sale (shares mn)	594
Total no of shares (mn)	13,069
% of offer for sale	4.55%
Fresh issue (shares mn)	1,188
Total no of shares post fresh issue (mn)	13,069
Implied market cap (Rs bn)	340
Price per share (Rs)	26

Source: Company, Ambit Capital research

Percentage of IR's capital outlay financed by IRFC (refer to exhibit 5)



*Source: Ministry of Railways, Company, Ambit Capital research. * Budgetary estimates*

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Stable business with modest profitability

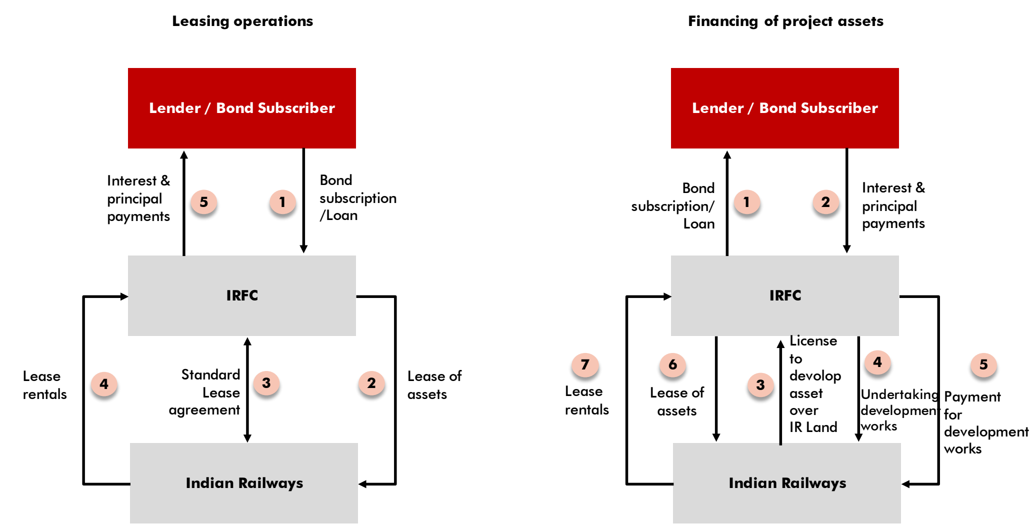
IRFC is a dedicated borrowing arm of Indian Railways with 100% ownership with GoI. It leases rolling stock to IRs and collects lease rental proceeds. It has a cost plus mark-up structure and earns spread of 30-50bps over its all-inclusive cost of borrowing. Its PAT CAGR was ~50% over FY17-1HFY21 with RoAE of 10-11% during the period; lower than PFC/REC. On an average it finances close to one-third of the actual capital expenditure of Indian Railways and hence is strategically important to and gets support from GoI. The proposed IPO consists of fresh issuance to raise Rs30.9bn (~9.7% of existing net worth) and offer for sale of ~4.5% stake of existing holders amounting to Rs15.4bn. Issue price range of Rs25-26 per share implies pre-money valuation of Rs297-308bn which translates into multiple of ~0.97x Sep'20 net worth and ~8.6x TTM earnings. Our back-of-the-envelope calculations suggest post-money P/B of 0.98x.

Dedicated borrowing arm of Indian Railways

Indian Railway Finance Corporation Limited (IRFC) was established in 1986 as the dedicated funding arm of Ministry of Railways (MoR). IRFC is a systemically important non-deposit taking NBFC registered with RBI under the category of an "Infrastructure Finance Company". It is a wholly-owned by the Government of India under the administrative control of MoR. It raises funds from the capital market and banks, to finance the rolling stock (wagons and coaches) assets and other railway infrastructure asset (project assets) requirements of IR. IRFC also lends to other entities under MoR. Project assets include lending to projects pertaining to expansion of existing rail network, electrification projects and other national projects of GoI. It leases (financial lease) rolling stock to IR and collects lease rentals from IR in advance, at half-yearly intervals.

The MoR is responsible for the procurement, expansion and maintenance of rolling stock assets. IRFC is responsible for raising funds necessary for such activities.

Exhibit 1: IRFC enters into a financial lease with MoR for financing assets required by Indian Railways



Source: Company, Ambit Capital research

Cost-plus lease agreement

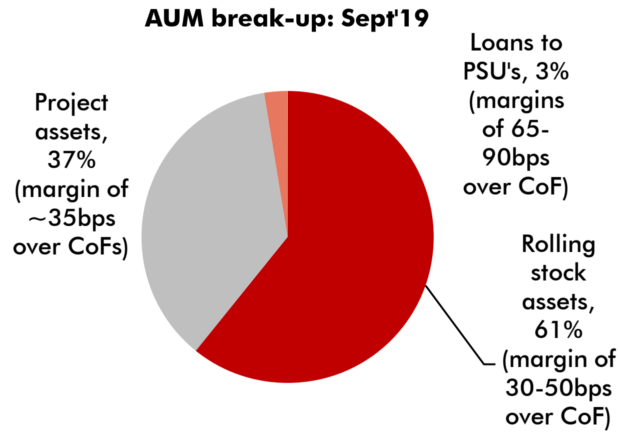
IRFC is a funding vehicle and enhancing profitability is not its primary objective. It earns by way of charging a spread over its borrowing cost (including any hedging cost incurred). Lease agreements with MoR are entered into annually. Historically the mark-up has been in the range of 30-50bps for rolling assets and 35-40bps for project assets over its all-inclusive cost of borrowing. Typically lease is for 30 years; comprising of a primary and a secondary period of 15 years each. Principal plus interest cost of the leased asset is effectively payable in the first 15 years. For the second 15-year period, IRFC charges a nominal rate subject to revision on mutually acceptable terms. Funds lent to other PSU entities under MoR are also under cost-plus structure. Mark-up on this lending is higher - typically between 65-90bps. Given its status of being the sole market borrowing arm of IR and expected surge in volumes backed by MoR's aggressive plans to expand, we expect IRFC to continue earning similar spreads over a longer term (expansion unlikely).

Exhibit 2: Mark-up over borrowing cost ensures stable margin profile

Period	Cost to MoR	Weighted average cost of borrowing (rolling stock assets)	Margin on incremental rolling stock assets leased
FY17	7.65%	7.15%	0.50%
FY18	8.05%	7.75%	0.30%
FY19	8.49%	8.09%	0.40%
30-Sep-19	7.80%	7.40%	0.40%*

*Source: Company, Ambit Capital research. * Provisional figure*

Exhibit 3: >60% of total assets financed are rolling stock assets



Source: Company, Ambit Capital research

Modest earning profile

Over FY17-1HFY21, IRFC's PAT CAGR was ~50% driven by ~26% CAGR in AUM. During the period RoAA has ranged between 1.2-1.3x. Mark-up over all-inclusive costs (30-50bps), part of the lease agreement between IRFC and IR, protect the former's net interest margin, as interest and foreign exchange risks on its borrowings are transferred to IR. IRFC also plans to diversify its business profile by lending outside IR; however, this will form only a small part of the total portfolio and advances will be to entities having linkages with IR.

Exhibit 4: Financial snapshot – Modest but low risk and sustainable earnings profile

Rs mn	FY17	FY18	FY19	FY20	1HFY21	FY18	FY19	FY20	1HFY21
Income statement						YoY growth (%)			
Net interest income	**21,390**	**26,294**	**29,500**	**37,581**	**19,419**	**23%**	**12%**	**27%**	**19%**
Other income	9	14	5	7	19	54%	-62%	29%	-9%
Total Income	**21,399**	**26,308**	**29,505**	**37,588**	**19,438**	**23%**	**12%**	**27%**	**19%**
Opex	264	383	214	642	570	**45%**	**-44%**	**200%**	**521%**
Operating profit	**21,135**	**25,925**	**29,291**	**36,946**	**18,868**	**23%**	**13%**	**26%**	**16%**
Provisions and write-offs	0	0	275	21	0				
PBT	**21,135**	**25,925**	**29,016**	**36,924**	**18,868**	**23%**	**12%**	**27%**	**16%**
Taxes	11,923	5,434	6,469	-	-		19%		
PAT	**9,212**	**20,491**	**22,547**	**36,924**	**18,868**	**122%**	**10%**	**64%**	**16%**
Balance sheet									
Net worth	1,86,031	2,03,719	2,50,287	3,09,624	3,16,870	10%	23%	24%	21%
Borrowings (incl. debt securities)	10,55,893	13,40,055	17,39,327	23,43,767	24,53,493	27%	30%	35%	33%
AUM	12,38,980	15,45,347	20,09,373	26,61,370	28,14,751	25%	30%	32%	23%
Total assets	**12,87,504**	**16,14,684**	**20,66,036**	**27,59,342**	**29,19,866**	**25%**	**28%**	**34%**	**23%**
Du Pont analysis									
Interest income		6.4%	6.0%	5.7%	5.2%				
Interest expense		4.6%	4.4%	4.2%	3.8%				
Net interest income		**1.8%**	**1.6%**	**1.6%**	**1.4%**				
Other income		0.0%	0.0%	0.0%	0.0%				
Total income		**6.4%**	**6.0%**	**5.7%**	**5.2%**				
Employee expense		0.0%	0.0%	0.0%	0.0%				
Operating expense		0.0%	0.0%	0.0%	0.0%				
Total operating expense		**0.0%**	**0.0%**	**0.0%**	**0.0%**				
Pre-provisioning profits		**1.8%**	**1.6%**	**1.5%**	**1.3%**				
Provisions		0.0%	0.0%	0.0%	0.0%				
PBT		**1.8%**	**1.6%**	**1.5%**	**1.3%**				
Tax		0.4%	0.4%	0.0%	0.0%				
RoAA		**1.4%**	**1.2%**	**1.5%**	**1.3%**				
Leverage (x)		7.4	8.1	8.6	9.1				
RoAE		**10.5%**	**9.9%**	**13.2%**	**12.0%**				
Important ratios									
Yield on loans**		7.8%	7.8%	7.9%					
Cost of borrowings		6.8%	7.1%	7.2%					
NIM		1.9%	1.7%	1.6%					
Cost to income ratio (%)		1.5%	0.7%	1.7%					
Gross NPA (%)		0.0%	0.0%	0.0%					
Net NPA (%)		0.0%	0.0%	0.0%					
Debt/Equity		7.4	6.8	7.3					
Tier I ratio		321%	349%	404%					
CAR		321%	349%	404%					

*Source: Company, Ambit Capital research. *1HFY21 ratios are annualized; * calculated; AUM for 1HFY20 and 1HFY21 has been derived using assumptions*

Strategic importance to and support from GoI

IRFC is strategically important to India's railway sector as it is the sole financing arm of MoR. Currently 100% of its ownership is with GoI. It has a close working relationship with IR and has MoR's officials as directors on its board. On an average it finances close to one-third of the actual capital expenditure of Indian Railways every year. Even post IPO, GoI is still expected to be the majority shareholder. GoI has been regularly infusing equity in IRFC.

Exhibit 5: IRFC has been financing on an average 1/3rd of IR's annual capital outlay

Period (Rs bn)	Total budgeted capital outlay - Indian Railways	Sources of funds								
		Gross budgetary support	Internally generated funds	Public private partnership	Railway safety fund	Rashtriya Rail Sanraksha Kosh (RRSK) reserve fund	Market borrowings			
							IRFC	Extra budgetary borrowings-IF through IRFC	Total - IRFC	% of IR's capital outlay financed by IRFC
FY21*	1,610	467	25	253	85	200	300	280	580	36%
FY20	1,481	456	17	126	69	150	334	329	663	45%
FY19	1,334	349	16	243	30	180	237	279	516	39%
FY18	1,020	270	18	221	16	161	188	146	334	33%
FY17	1,083	345	105	268	107	-	143	115	258	24%
FY16	935	350	168	151	26	-	141	99	240	26%
FY15	587	301	153	-	22	-	110	-	110	19%
FY14	540	271	97	-	20	-	152	-	152	28%
FY13	503	241	95	-	16	-	151	-	151	30%

*Source: Ministry of Railways, Company, Ambit Capital research. * Budgetary estimates*

IPO is a combination of fresh issuance and offer for sale

The IPO consists of fresh issuance of Rs30.9bn (should result in additional issuance of ~1.19mn shares) and offer for sale of Rs15.4bn where GoI (exiting shareholder) would sell out ~0.59bn shares. GoI's (promoter) stake should come down to ~86.4% post IPO and OFS.

Exhibit 6: GoI's (promoter) holding would still be high post IPO

Name of shareholders	Pre-IPO		Post-IPO	
	# of shares (mn)	% holding	# of shares (mn)	% holding
Promoter				
President of India, acting through the MoR	11,880	100%	11,286	86%
Non-Promoter				
IPO subscribers*	-	0%	1,782	14%
Total	**11,880**	**100%**	**13,069**	**100%**

*Source: Company, Ambit Capital research; * assuming an issue price of Rs26 per share*

Issue price range of Rs25-26 per share implies pre-money valuation in the range of Rs297-308bn which translates into multiple of ~0.97x on Sep'20 net worth and a multiple of ~7.8x trailing 12-month earnings. Our back-of-the-envelope calculations show post money P/B of ~0.98x on Sept'20 book value.

Exhibit 7: Reported IPO valuation considering issue price band

All number in Rs mn except per share	Likely valuation
Pre-money	
Expected valuation for IRFC	3,08,892
Net worth (1HFY21)	3,16,870
Net profit (TTM)	39,489
No of shares (#mn)	11,880
BVPS (1HFY21)	27
PB (Trailing, 1HFY21)	**1.0**
PE (TTM)	**7.8**
Offer details	
Stakes offload in OFS (%)	4.55%
Amount offload in OFS	15,445
Fresh Issue	30,889
Total IPO Issue size	46,334
Expected issue price (Rs/share)	26
Post-money	
Valuation of IRFC	3,39,781
Net worth post issuance	3,47,759
No of shares (#mn)	13,069
BVPS post issuance	27
PB	**1.0**

*Source: Company, Ambit Capital research; * assuming an issue price of Rs26 per share*

Is IRFC any different from PFC/REC?

Virtually guaranteed repayment structure makes IRFC unique and different when compared to PFC and REC. Lease payments from Indian Railways to IRFC have allocation in the Union Budget and hence entail zero credit risk. Even lending to other entities under MoR has either cash flows originating from MoR or carries a repayment assurance. This has enabled IRFC to have NIL NPA status. Thus IRFC has higher earnings visibility, assured business flow and low/NIL competition. Lower credit risk vs other PSUs is also reflected in its bonds issues typically being subscribed at 20-80bps cheaper rates. IRFC's RoE can be argued to be more sustainable but capped between 10-12% over the next 4-5 years.

Unique repayment structure

Given sole market borrowing arm of Indian Railways, IRFC's business model entails low risk. One key risk envisaged is delay in receiving payments from Indian Railways. This was one issue which had plagued other state-owned infrastructure finance companies, namely PFC and REC. In the following section we attempt to differentiate safety net of IRFC vs PFC and REC.

Exhibit 8: IRFC's lease receivables and MoR's annual capital outlay both form a part of Union Budget allocation, making it much safer bet when compared to other PSU infrastructure finance companies like PFC and REC

Particulars	IRFC	PFC/REC	Comments
Counterparty	Indian Railways through the Ministry of Railways	State owned and private sector power generation, transmission and distribution companies	IRFC has relatively safer counterparty given sovereign status for Indian Railways
Tighter repayment structure	Lease payments to IRFC by MoR form a part of the annual railway budget in the Union Budget of India	Repayment ability a function of financial health of the counterparty	IRFC practically has zero credit risk as lease payments from IR have allocation in Union Budget. Even lending to other entities under MoR has either cash flows originating from MoR or carries a repayment assurance by MoR
Margin profile	Margins a function of cost mark-up agreed annually with MoR for leases to be entered into the following year	Margins a function of competitive landscape in the industry	IRFC enjoys a relatively stable margin profile
Coverage assurance	MoR to cover for any financial shortfall by making advance payments for leases if IRFC does not have sufficient resources to redeem bonds/repay loans	No explicit liquidity guarantee	For IRFC; MoR acts as lender of last resort giving liquidity comfort

Source: Company, Ambit Capital research

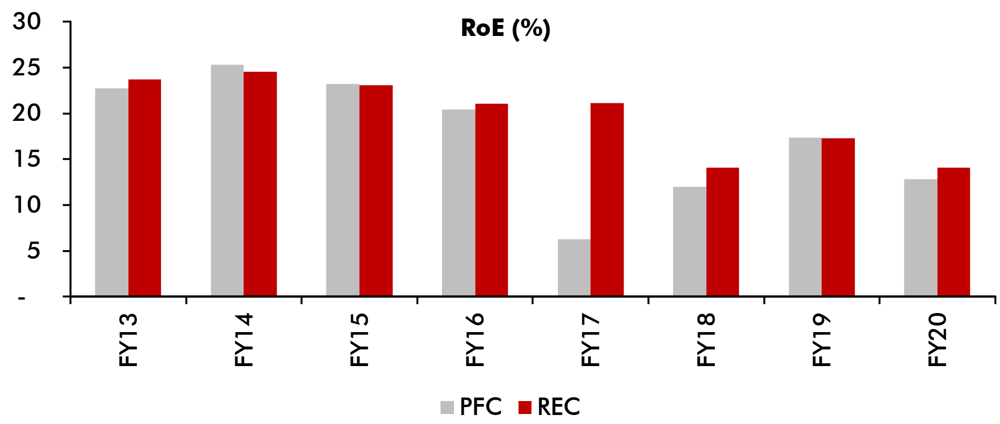
These benefits flow through the asset quality numbers. Non-performing assets for IRFC have always remained NIL as MoR has never defaulted on any of its payment obligation under the standard lease agreement. Though there is an explicit coverage assurance, IRFC has historically never availed any liquidity support (permanent of leases if need be) from MoR. Lower credit risk of IRFC vs other PSUs is also reflected in its bonds issues typically being subscribed at 20-80bps cheaper rates. Following table highlights the same for similar tenor issuance in the within 30 days of issuance.

Exhibit 9: IRFC's lower credit risk profile is reflected in its lower cost of bond issuances

Company	Issue date	Maturity in years	Coupon (%)	Currency	Amt. (Rs bn)	Difference in bps
IRFC	28-02-2020	10	7.08	INR	30	
PFC	25-02-2020	10	7.41	INR	40	-0.33
NABARD	14-02-2020	10	7.27	INR	7	-0.19
REC	28-01-2020	10	7.92	INR	31	-0.84

Source: Bloomberg, Ambit Capital research

Exhibit 10: PFC/REC, though plagued with asset quality issues, have had higher RoE



Source: Bloomberg, Ambit Capital research

Railway capex momentum has legs

Ministry of Railways estimates capex requirement of Rs50tn by 2030 for network expansion and capacity augmentation, rolling stock induction and other modernization works. This would enable better delivery of passenger and freight services and improve share in freight transport (45% by 2030 vs 35% in 2017). The implied annual run-rate is Rs4.2tn, significantly higher than current run-rate of Rs1.6tn, implying growth opportunity for IRFC. EBR funding and PPP model would play an important role to bridge this gap. DFC, rolling stock, hi-speed rail, station redevelopment and electrification would benefit the most. Railway capex has risen to 0.8% of GDP in FY20 vs 0.3-0.4% historically. Railway's share in total infra capex would rise to 17% over FY20-25E vs 8% seen over FY12-17. IRFC would play a key role in financing of this capex requirement (40% of total EBR in FY20).

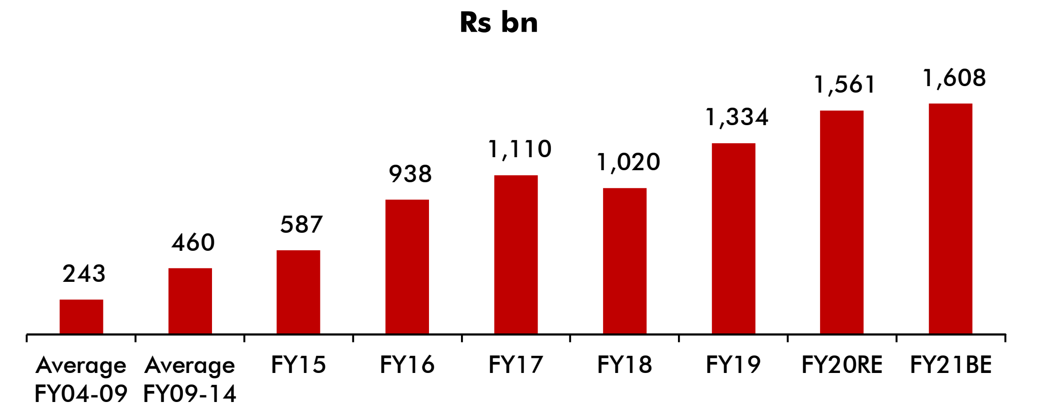
IR capex at historical high; momentum to continue

Ministry of Railways unveiled Draft National Rail Plan to plan infrastructural capacity enhancement to increase modal share of the Railways. The National Rail Plan will be a common platform for all future infrastructural, business and financial planning of the Railways. The government intends to finalize the final plan by end of Jan 2021.

Key objectives of the plan:

- To create capacity by 2030 which in turn would cater to demand growth until 2050 and increase the modal share of Railways to 45% by 2030.
- Forecast growth of traffic in both freight and passenger year on year up to 2030 and on a decadal basis up to 2050.
- Reduce transit time of freight by increasing average speed of freight trains from present 22Kmph to 50Kmph.
- Reduce overall cost of rail transportation by nearly 30%.

Exhibit 11: Indian railway capex (budgetary support + EBR) has reached all-time high…



Source: Ministry of Railways, Government Budget documents, Ambit capital research

Exhibit 12: …led by higher capex on rolling stock, line doubling and electrification projects

Rs bn	FY16	FY17	FY18	FY19	FY20RE	FY21BE	5-year CAGR
Rolling Stock	194	196	201	283	417	351	**13%**
Leased Assets-Capital Component	63	70	80	91	106	119	**14%**
Doubling	105	91	112	154	238	215	**16%**
New Lines (Construction)	202	143	82	94	85	125	**-9%**
Gauge Conversion	36	38	29	42	32	28	**-5%**
Track Renewals	44	51	77	97	85	106	**19%**
Electrification Projects	23	29	38	59	76	63	**23%**
Bridges	42	32	32	35	37	44	**1%**

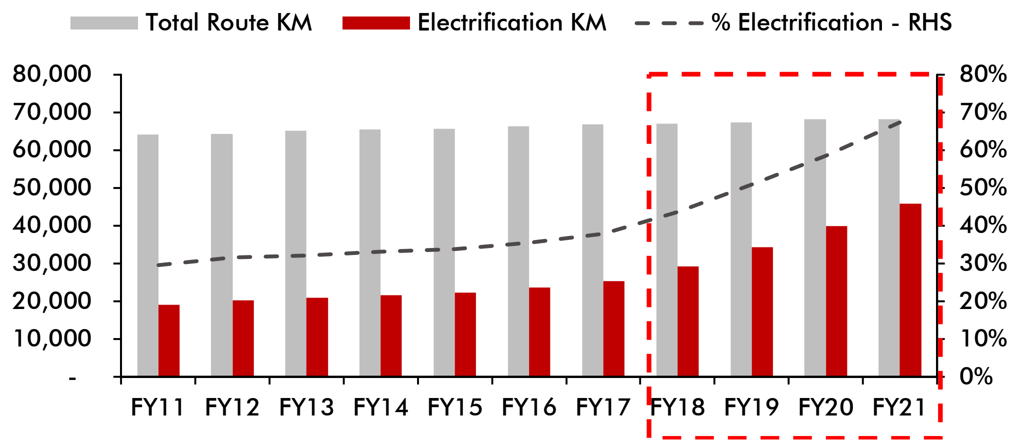
Source: Ministry of Railways, Government Budget documents, Ambit capital research

Exhibit 13: The pace of electrification has picked up over last couple of years…

Route kms	FY16	FY17	FY18	FY19	FY20RE	FY21BE
Electric Locomotives - units	198	185	240	420	725	725
Doubling	972	882	999	2,519	2,450	2,650
New Lines (Construction)	813	953	409	479	300	500
Gauge Conversion	1,043	1,020	454	597	400	600
Track Renewals	2,794	2,487	4,023	4,181	3,900	4,000
Electrification	1,331	1,812	3,861	5,091	5,547	6,000

Source: Ministry of Railways, Government Budget documents, Ambit capital research

Exhibit 14: …which has risen to 67% by FY21E vs 30% in FY11; the government plans to electrify 100% by 2024E



Source: Ministry of Railways, Government Budget documents, Ambit capital research

Key drivers of higher railway capex

As per Indian Railways, one DFC train can remove 1,300 trucks from the road.

1. Dedicated Freight Corridor

- Golden quadrilateral and its two diagonals comprise 10,122km or 16% of total route kilometers of IR.
- In the absence of DFCC, railways would have lost >1bn tonnes of freight traffic to other modes in future and hence this project is key for IR.
- Future corridors: IR is also planning four more corridors for which feasibility study is being carried out. The total length would be 6,668km.

Exhibit 15: New corridors are expected to come up

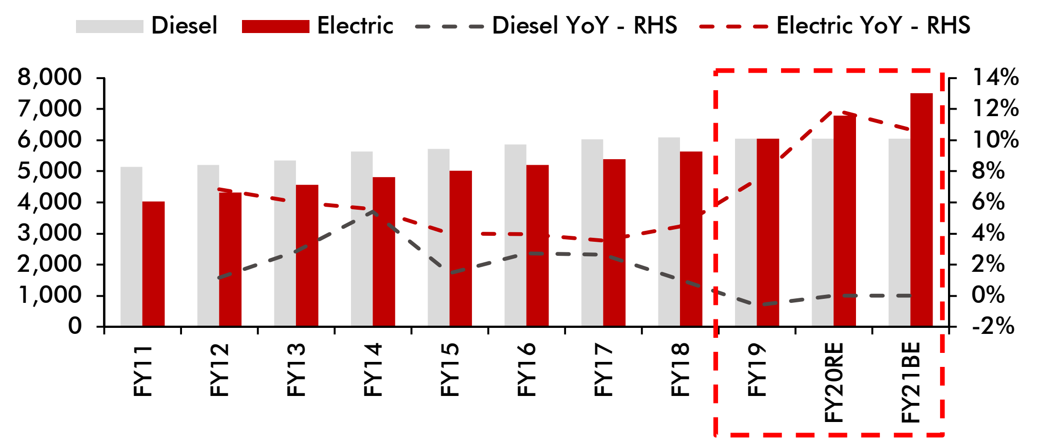
	Between		Length (km)	Construction cost (Rs bn)	Construction cost (Rs/km)
East West corridor	Kolkata	Mumbai	2,328	1,055	45
North South corridor	Delhi	Chennai	2,328	1,089	47
East coast corridor	Kharagpur	Vijayawada	1,115	490	42
Southern corridor	Chennai	Goa	893	406	46
Total			**6,664**	**3,041**	**46**

Source: Government documents, Ambit Capital Research

2. Rolling Stock

With the expansion of the freight network and passenger demand, the requirement of rolling stock will increase materially. IRFC is responsible for financing the acquisition of the majority of the rolling stock purchased by the IRFC and leased to Ministry of Railways. IRFC was responsible for financing 72%, 93% and 82% of rolling stock financing in FY17, FY18 and FY19 respectively. We are also witnessing a trend of electrification of locomotives. The government plans to acquire 725 electric locomotives every year over the next few years.

Exhibit 16: Electric locomotives annual acquisition to remain elevated



Source: Ministry of Railways, Government Budget documents, Ambit capital research

3. High Speed Rail

- The project will have a total length of 508km - 156km in Maharashtra, 4km in Dadra & Nagar Haveli and 348km in Gujarat.
- The project is expected to be completed by Dec 2024.

4. Station redevelopment

The project is undertaken by Indian Railway Stations Development Corporation Limited (IRSDC), a 50:50 JV between Rail Land Development Authority (RLDA) and IRCON. Government plans to redevelop 400 stations and commercial establishments around it at a total cost of Rs960bn – Rs280bn for station redevelopment and Rs680bn for commercial development. IRSDC is a nodal agency as well as project development agency. 46 stations have been awarded to 6 CPSEs (Rites, MECON, NPCC, EPIL, B&R and IRCON) to act as PMCs to IRSDC.

Exhibit 17: Commercial redevelopment will form 70% of the proposed budget for station redevelopment

Particulars	
No of stations to be developed	400
Total cost (Rs bn)	960
Commercial redevelopment (Rs bn)	680
Station redevelopment (Rs bn)	280

Source: Government documents, Ambit Capital Research

Valuations seem capped

Valuation benchmarking for IRFC becomes difficult given lack of strict comparable players (single counterparty risk-free structure). PFC and REC, the other state-owned infra lenders, are the closest comparatives which we use to benchmark. Expected valuation of ~1x P/B is at a 30-40% premium to PFC/REC. Though at this point IRFC enjoys higher earnings visibility backed by very low credit risk and almost assured business flow, expansion into the private sector cannot be ruled out. Effectively, IRFC's equity is a quasi-sovereign bond earning marginally higher than g-sec. With no benefit of an operating leverage play and capped margins, expected RoE of 10-12% leaves no meaningful fundamentals-based upside on the table.

Where are the returns?

PFC and REC trade around 0.6-0.7x FY21 P/B, a 30-40% discount to the expected valuation of IRFC. Given profitability not being the primary objective of both IR and IRFC, sustained improvement in margins looks unlikely. GoI's intent to privatize IR could expose IRFC to higher risk assets. Already low opex (~0.04% to assets) leaves no room for operating leverage play. Any fundamentals-linked upside beyond 1x P/B looks unlikely.

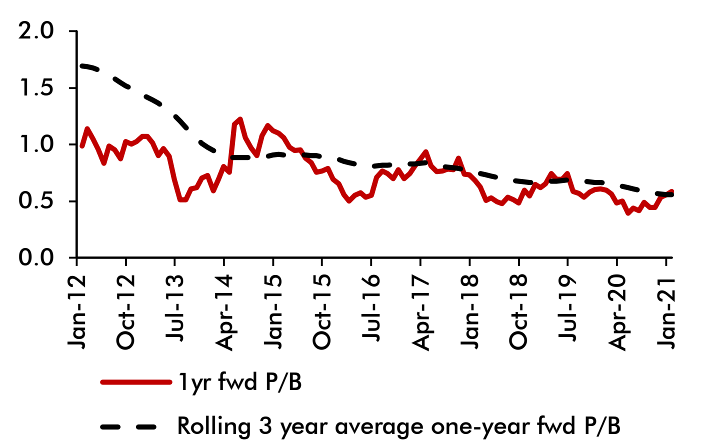
Exhibit 18: Post money valuation is expected to ~1x P/B; 30-40% higher than PFC and REC

Company	M-Cap (USD bn)	Forward P/E(x)			Fwd P/B(x)			ROE (x)			ROA (x)		
		FY20	FY21E	FY22E	FY20	FY21E	FY22E	FY20	FY21E	FY22E	FY20	FY21E	FY22E
SBI	37.1	15.8	17.2	11.4	1.2	1.2	1.1	8.0	7.7	10.4	0.5	0.4	0.6
PFC	4.4	5.2	4.4	3.7	0.7	0.6	0.6	12.8	15.2	16.3	1.6	2.0	2.1
REC	3.9	4.9	4.1	3.5	0.8	0.7	0.6	14.1	15.3	14.7	1.5	2.0	2.0
IRFC**	4.7	8.7	NA	NA	0.9	NA	NA	13.2	NA	NA	1.5	NA	NA

*Source: Bloomberg, Ambit Capital research. * For PFC and REC Bloomberg estimates have been used; ** Ambit estimates*

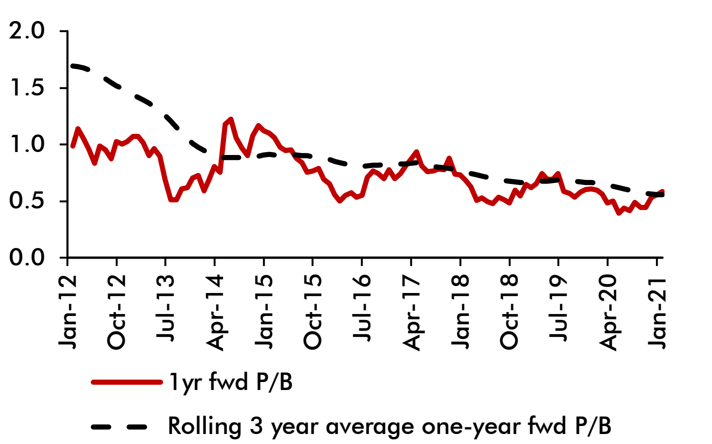
Historical asset quality issues, negative outlook for power sector and delay in payment from SEBs have lowered investor confidence and suppressed valuations for PFC and REC.

Exhibit 19: PFC – Asset quality issues and poor state of SEBs have suppressed valuation below book…



Source: Bloomberg, Ambit Capital research

Exhibit 20: …same is the case with REC. Power sector continues to have a negative outlook



Source: Bloomberg, Ambit Capital research

Unlike other lenders, IRFC is a mono-line business with practically no optionality to lend outside IR's ecosystem. This restricts its growth and diversification prospects but given common sovereign ownership with its counterparty makes its equity investment a quasi-sovereign bond earning higher than g-sec. Even though IRFC intends to diversify into i) financing other activities of IR (e.g. funding financially viable project assets); ii) provide financial structuring advisory/consultancy services and iii) venture into syndication activities, all these activates with continue to be under the ambit of MoR and hence would not improve its margin profile in a meaningful way. Compared to some other PSE lenders, though, IRFC scores high on most parameters; capped RoE doesn't leave any meaningful fundamentals-based upside.

Exhibit 21: IRFC showcases sovereign bond investment traits

Metric	PFC/REC	SBI	IRFC	Comments
Growth potential	◐	◕	◕	MoR's aggressive expansion plan can enable IRFC to growth >25% over next 5 years
Cross cycle ROE of core business	◐	◐	◔	Effectively capped given no visibility around margin expansion and no room for operating leverage benefit
Asset quality risk	◔	◐	●	Explicit allocation of lease receivables in the Union Budget implies receivable for IRFC are guaranteed
Diversified loan book	◐	●	◔	Unlike other lenders, IRFC is a mono-line business with practically no optionality to lend outside IRs eco-system. This restricts its growth and diversification prospects
Cost of funds	◐	◐	◕	IRFCs market borrowings are 20-80bps lower than other PSUs reflecting safer credit perception

Source: Ambit Capital research, Note: ● - Strong; ◕- Relatively Strong; ◐- Average; ◔- Relatively weak.

Key risks

GoI's ownership reducing below 51%: This would not only adversely impact IRFC's cost of funds but also question its position of being the dedicated funding arm of IR. Also, this would lead to diminution in all the expected support to IRFC.

IRFC lending outside IR ecosystem: History suggests dedicated PSU lenders build exposure to the private sector in the quest for higher yields. At this point, IRFC is not exposed to this risk but it remains a possibility given GoI's intent to privatize IR. Lending outside the IR ecosystem would expose IRFC to asset quality risks.

Financials

Balance sheet

Year to March (Rs mn)	FY17	FY18	FY19	FY20	1HFY21
Net worth	186,031	203,719	250,287	309,624	316,870
Borrowings (incl. debt securities)	1,055,893	1,340,055	1,739,327	2,343,767	2,453,493
Other Liabilities	45,580	70,910	76,423	105,950	149,503
Total Liabilities	**1,287,504**	**1,614,684**	**2,066,036**	**2,759,342**	**2,919,866**
Cash & Bank Balances	75	998	811	1,008	959
Investments	146	140	131	115	114
Loans	21,640	52,380	58,955	64,234	62,430
Receivable	982,062	1,094,717	1,250,265	1,485,798	1,538,468
Other Assets	283,581	466,450	755,874	1,208,187	1,317,894
Total Assets	**1,287,504**	**1,614,684**	**2,066,036**	**2,759,342**	**2,919,866**

Source: Company, Ambit Capital research

Income statement

Year to March (Rs mn)	FY17	FY18	FY19	FY20	1HFY21
Interest Income	80,129	92,670	111,331	138,379	73,829
Interest expenses	58,739	66,376	81,831	100,798	54,410
Net Interest Income	21,390	26,294	29,500	37,581	19,419
Total Non-Interest Income	9	14	5	7	19
Total Income	21,399	26,308	29,505	37,588	19,438
Total Operating Expenses	264	383	214	642	570
Employees expenses	31	55	63	63	27
Other Operating Expenses	233	328	152	579	544
Pre Provisioning Profits	21,135	25,925	29,291	36,946	18,868
Provisions	-	-	275	21	-
PBT	21,135	25,925	29,016	36,924	18,868
Tax	11,923	5,434	6,469	-	-
PAT	9,212	20,491	22,547	36,924	18,868

Source: Company, Ambit Capital research

Key parameters

Year to March (Rs mn except for %)	FY17	FY18	FY19	FY20
AUM	1,238,980	1,545,347	2,009,373	2,661,370
AUM Growth	21%	25%	30%	32%
Average AUM	1,130,651	1,392,163	1,777,360	2,335,372
Disbursements	274,880	367,223	525,352	713,921
Disbursement Growth	16%	34%	43%	36%
Adjusted Interest Income	88,051	107,893	138,434	184,810
Adjusted Finance Costs	67,096	81,750	109,156	147,561
Net Interest Income	20,955	26,143	29,278	37,249
Adjusted Total Income	21,395	26,299	29,505	37,587
Operating Expense	264	383	214	642
Credit Cost	-	-	275	21
Cost of Borrowings	7.0%	6.8%	7.1%	7.2%
Net Interest Margin	1.9%	1.9%	1.7%	1.6%
Cost to Income Ratio	1.2%	1.5%	0.7%	1.7%
Operating Expense/ Average AUM	0.02%	0.03%	0.01%	0.03%
Gross NPA/ Net NPA	-	-	-	-

Source: Company, Ambit Capital research

Du-pont analysis

Year to March	FY17	FY18	FY19	FY20	1HFY21
Interest income		6.4%	6.0%	5.7%	5.2%
Interest expense		4.6%	4.4%	4.2%	3.8%
Net interest income		**1.8%**	**1.6%**	**1.6%**	**1.4%**
Other income		0.0%	0.0%	0.0%	0.0%
Total income		**6.4%**	**6.0%**	**5.7%**	**5.2%**
Employee expense		0.0%	0.0%	0.0%	0.0%
Operating expense		0.0%	0.0%	0.0%	0.0%
Total operating expense		**0.0%**	**0.0%**	**0.0%**	**0.0%**
Pre-provisioning profits		**1.8%**	**1.6%**	**1.5%**	**1.3%**
Provisions		0.0%	0.0%	0.0%	0.0%
PBT		**1.8%**	**1.6%**	**1.5%**	**1.3%**
Tax		0.4%	0.4%	0.0%	0.0%
RoAA		**1.4%**	**1.2%**	**1.5%**	**1.3%**
Leverage (x)		7.4	8.1	8.6	9.1
RoAE		**10.5%**	**9.9%**	**13.2%**	**12.0%**

Source: Company, Ambit Capital research.

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