

## ICRA

Short term pain, long term gain

Sensex: 15,815

CMP: INR 805

Target Price: INR 1,038



## Credit Rating

ICRA Ltd. (ICRA), an associate company of international rating agency Moody's Investors Service, is the second largest credit rating agency in India. Due to ongoing economic concerns, there has been slowdown in credit off-take in the form of bank loans and debt market activities which has impacted the revenue and profitability of the company. We therefore expect consolidated revenue CAGR of 6% for next two years for the company. Despite short term headwinds, we are very positive on the huge long term opportunity for the credit rating sector on the back of development in debt market which is at nascent stage in India. We believe that all the short term negatives (i.e. lower rating revenue growth and pressure on profitability) are already discounted in the stock price and there is a good upside potential from here. We therefore initiate coverage with BUY recommendation.

**Sluggish debt issuance to impact revenue in short term**

The Corporate Debt Rating (CDR) segment of the company reported revenue of INR 713mn in FY11 (~55% of standalone revenues) at 4 year CAGR of 16.35%. This was largely on the back of strong volume growth in corporate debt market in the form of corporate bonds, debentures, short term corporate instruments (CPs, CDs etc.). However, unfavorable current financial and economic conditions in India resulted in slower growth issuances of debt market instruments offerings that have impacted the overall revenue. We expect rating revenue from ICRA's CDR segment to witness a CAGR of 6.33% in next two years and report revenue of INR 806mn in FY13.

**Bank credit growth to drive revenue in BLR segment**

Since the implementation of Basel II norms in FY2008, rating revenue from Bank Loan Rating (BLR) segment of ICRA now contributes ~45% (INR 580mn in FY11) of its overall rating revenues from NIL. This was on the back of 2 year CAGR of 23.47% majorly on account of increased coverage of existing bank loans and remaining from fresh issuances of loans. According to the industry sources, 65% of the outstanding bank loans have already been rated. We, therefore, don't see any major upside in revenue growth from further coverage of outstanding bank loans. We expect ICRA's Bank Loan Rating (BLR) segment revenue to grow marginally at INR 595mn in FY13 on the back of lower growth contribution from expanding coverage of outstanding loans. Also, increased coverage of small size loans has been putting pressure on the overall profitability. Despite short term headwinds, we are positive about the long term potential on the back of expected revival in economic growth momentum in next 1-2 years that would stimulate expansion in bank lending to the corporate sector and correspondingly add to BLR segment revenues.

**Strong competitive positioning, courtesy Moody's**

ICRA is an associate company of Moody's Investors Service (28.51% stake in ICRA) which is amongst the largest international credit rating agencies in the world. ICRA has established strong market presence on back of high value technological, strategic and methodological support provided by Moody's. Company is the second largest player in Indian credit rating industry in terms of market share. The alliance also provides ICRA with access to Moody's global research base and in turn benefitting ICRA's in-house research capabilities.

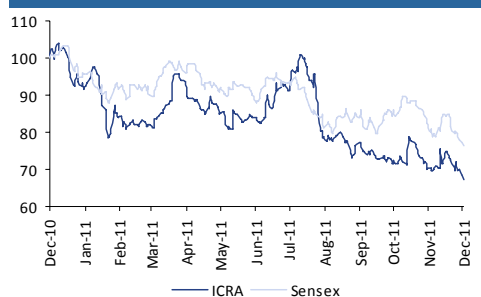
**Other businesses stay the course**

ICRA's other businesses (~33% of consolidated revenue in FY11) include consulting services, outsourced & information services, and professional & IT services. With increased scale of businesses by addition of newer clients and increased revenue from existing clients, we expect the combined other businesses to achieve a turnover of INR 766mn in FY13 at 2 year CAGR of 9.65%.

**Valuation and Outlook**

Despite short term headwinds, we are very positive on the huge long term opportunities for the credit rating sector on the back of development in debt market which is at nascent stage in India. ICRA, being the second largest player in the industry is positioned strongly on back of years of rating experience across various industries along with high brand recognition, good service quality and strong industry network. We believe that all the short term negatives are already discounted in the stock price which is currently trading at 15.51x FY12E adj. EPS against average 5 year historical multiple of 22.43. We have valued the stock using discounting cash flow (DCF) and relative EPS multiple method and arrived at an average 15 months target price of INR 1,038. We initiate coverage with BUY recommendation.

Shareholding (%)	Sep-11
Promoters	28.51
FIIIs	8.44
DIIIs	43.67
Others	19.38

**Relative Price Performance**

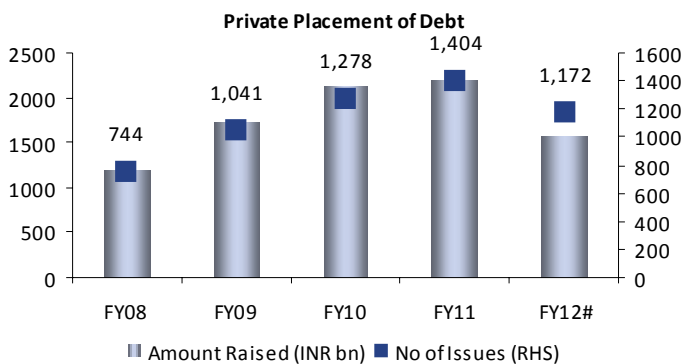
Key Data	
BSE Code	532835
NSE Code	ICRA
Bloomberg Code	ICRA IN
Reuters Code	ICRA.BO
Shares Outstanding (mn)	10.00
Face Value	10
Mcap (INR bn)	8.05
52 Week H/L	1374/865
2W Avg. Qty, NSE	2062
Beta (1 yr Nifty)	0.50

(INR mn)	FY10	FY11	FY12E	FY13E
Net Sales	1,623	1,930	2,035	2,167
Growth (%)	19.51%	18.92%	5.41%	6.50%
EBIDTAM (%)	37.42%	33.97%	27.63%	31.99%
Net PAT	535	481	372	504
Growth (%)	37.51%	-10.04%	-22.74%	35.47%
EPS (INR)	53.48	48.11	37.17	50.36
P/E (x)	16.45	22.53	21.66	15.99
adj. P/E (x)	16.45	19.49	15.51	14.36
EV/EBIDTA	11.3	13.0	10.4	8.0
Net Debt/Equity	(0.9)	(0.9)	(0.8)	(0.8)
RoANW (%)	26.06%	20.10%	13.99%	17.50%

## Investment Rationale

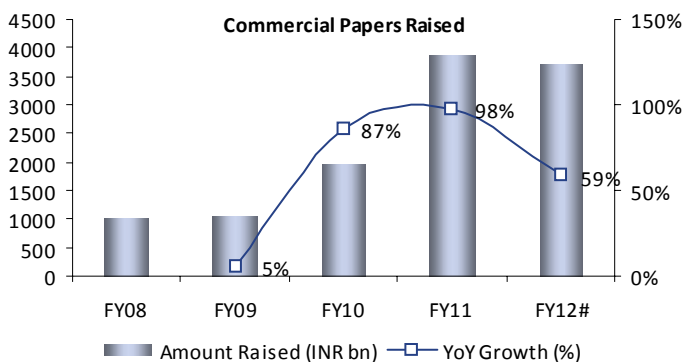
### Sluggish growth in debt issuance to impact revenue in short term

Demand for rating services is derived from the overall resource mobilization in the economy particularly from the growth of debt markets. Indian economy has been growing at an average of 8.5% since last 7 years which fueled both operational and investment related funding demand. Share of debt in overall resource mobilization stands at ~75%. Major part of debt mobilization is through private placements. Private placement of corporate bonds, with a tenor greater than one year, has registered a CAGR of 23% in last 3 years to reach INR 2,188bn in FY11.



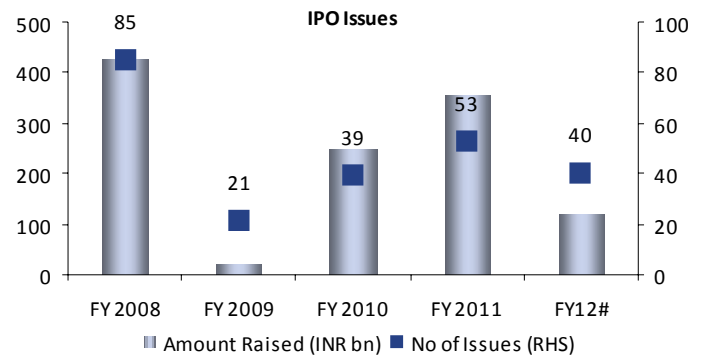
Source: SEBI, SPA Research # Year till Nov. 2011

However, unfavorable financial and economic conditions in India resulted in slower YoY growth at ~6% in long term corporate debt issuances of INR 1,566bn in first 8 months of the current fiscal. Growth in CPs (Commercial Papers) and CDs (Certificate of Deposits) have been strong but lower compared to last three years.



Source: RBI, SPA Research # Year till Nov. 2011

Further there has been considerable drop in IPOs in current fiscal owing to unfavorable capital market situation that resulted in loss of rating revenue.

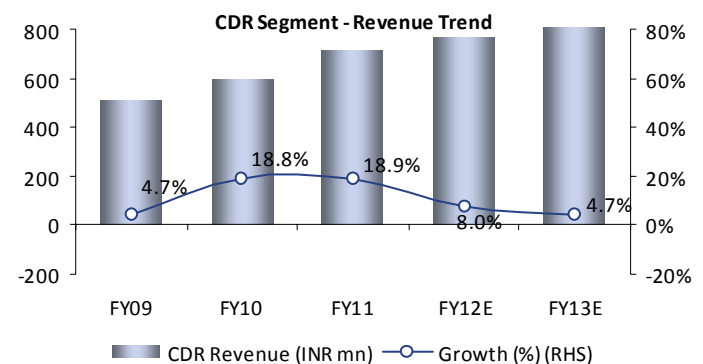


Source: SEBI, SPA Research # Year till Dec. 2011

Slower growth in resource mobilization from the markets would result in sluggish growth in rated volumes of long and short term corporate debt instruments and thus impact the rating revenues in the current fiscal. Further there has been drop (of ~15-20% in last 1.5 years) in average rating fees due to excessive competition among rating agencies to garner market share.

On the positive front, company is planning to expand its coverage of ratings in SME sector where CRISIL currently has a strong hold. ICRA has also proposed to conduct credit ratings of the municipal bodies in Orissa. The move is aimed at attracting private capital into the municipal sector in Orissa along with improvement in operational efficiency through benchmarking of the services. In states like Andhra Pradesh and Tamil Nadu, the municipal corporations have not only undergone credit ratings but their performance has prompted them to float bonds in the debt markets. We, however, have not accounted for this in our current projections.

We expect rating revenue from ICRA's Corporate Debt Rating (CDR) segment, which contribute ~55% to standalone revenue, to witness a CAGR of 6.33% in next two years and report revenue of INR 806mn in FY13.

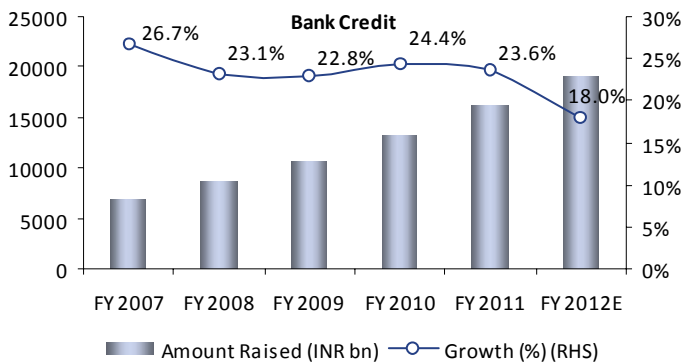


Source: Company, SPA Research

**Bank credit growth to derive revenue in BLR segment**

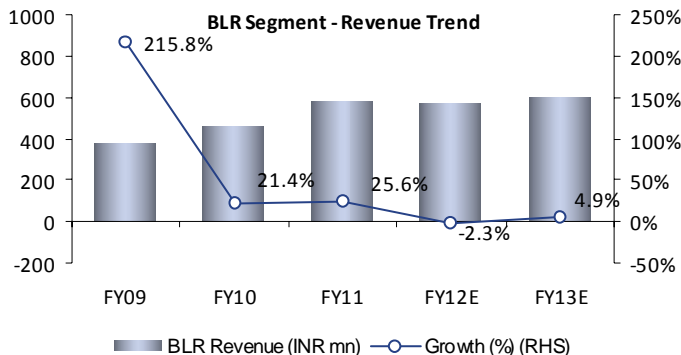
Since the implementation of Basel II norms in FY2008, rating revenue from Bank Loan Rating (BLR) segment of ICRA now contributes ~45% (INR 580mn in FY11) of its overall rating revenues from NIL. This was on the back of 2 year CAGR of 23.47% majorly on account of increased coverage of existing bank loans and remaining from fresh issuances of bank loans. According to the industry sources, 65% of the outstanding bank loans have already been rated.

We therefore don't see any major upside in revenue growth from further coverage of outstanding bank loans as remaining loans would attract lower credit rating which would not help banks to save capital and therefore are not required to be rated. The revenue would primarily be sustained from increased issuance of fresh loans to corporate. Bank credit has witnessed a CAGR of 24.11% in last 5 years to INR 16,208bn in FY11. However, on the back of slowing economic activities and increasing interest rates, RBI has set a target of 18% YoY growth in non-food bank credit during FY12 against 23.59% witnessed in FY11.



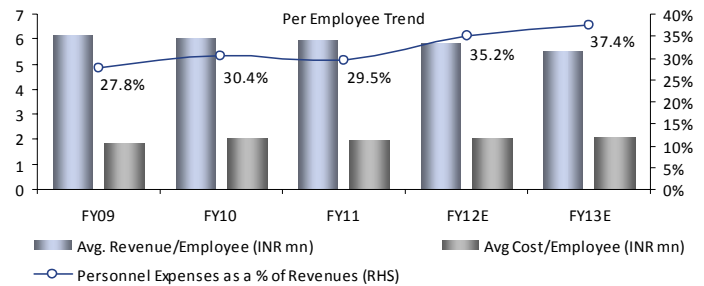
Source: RBI, SPA Research

We expect ICRA's BLR segment revenue to grow marginally by 1.23% in next two years at INR 595mn in FY13 on back of lower growth contribution from increased coverage of existing outstanding loans.



Source: Company, SPA Research

Also with majority of large size outstanding loans covered in last 4 years, increased coverage of existing small size loans has been putting pressure on the overall profitability due to lower revenue realization/employee against increasing cost realization/employee.



Source: Company, SPA Research

Despite short term headwinds, we are positive about the long term potential. Expected revival in the capex cycle, in addition to an increase in the economic growth momentum in next 1-2 years, would stimulate expansion in the bank lending to the corporate sector, and correspondingly add to BLR segment revenues.

**Strong competitive positioning, courtesy Moody's**

ICRA is an associate company of Moody's Investors Service which is amongst the largest credit rating agencies in the world. Moody's holds 28.51% stake in ICRA. ICRA has established strong market presence on back of high value technological, strategic and methodological support provided by Moody's. The alliance also provides ICRA with access to Moody's global research base and in turn benefitting ICRA's in-house research capabilities. ICRA is the second largest player in Indian credit rating industry after CRISIL in terms of market share.

Market Share Data as in Nov 2011	CDR (Issues Outstanding)	BLR (Volume)
CRISIL	36%	47%
ICRA	35%	30%
CARE	32%	19%
FITCH	15%	4%
Brickworks	7%	NA

Source: Industry, SPA Research

Company also benefitted from early mover advantage in Indian market (ICRA was established in 1991, the second credit rating agency in India after CRISIL that was incorporated in 1987) where strong industry network plays a critical role beside credibility of the brand, quality of service, ability to offer competitive rating fees and wide exposure & expertise in various industries. ICRA therefore is well poised to reap dividends in expected huge long term surge in Debt market in India which is currently at nascent stage.

**Other businesses stay the course**

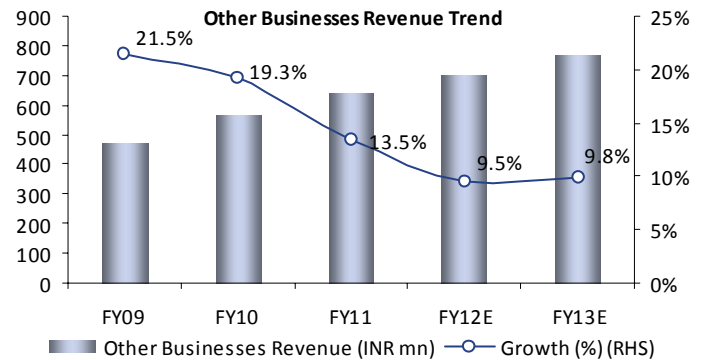
ICRA's other businesses (~33% of consolidated revenue in FY11) include consulting services, outsourced & information services, and professional & IT services which contributed 13.01%, 8.23% and 11.91% respectively in FY11 consolidated revenues. With increased scale of businesses, other businesses have registered a CAGR of 24.73% in last 5 years and achieved revenue of INR 637mn in FY11.

**Consulting Services:** This division of ICRA provides management consulting solutions to companies for strategy, risk management, process consulting and advisory services. The growth in this division is the function of higher third party spends by companies for advisory services that mostly happen during times of higher economic growth. The division has achieved a turnover of INR 251mn in FY11 at 3 year CAGR of 11.62%. We expect this division to record revenue of INR 280mn in FY13 at a slower CAGR of 5.65% on the back of ensuing current economic slowdown.

**Outsourced & Information Services:** This division provides KPO services (~95% for Moody's), information services (mutual fund & ULIP data and content provider, IT tools for financial planning and analytics) and equity research services. The growth in the division has been driven on back of increased outsourcing activities by Moody's and demand for Mutual Funds and ULIP content and data with growth in the financial industry. The division has recorded a 3 year CAGR of 24.93% and revenues of INR 159mn in FY11. We expect this division to achieve revenues of INR 220mn in FY13, a 2 year CAGR of 17.81%, on back of increased work for its KPO division due to undergoing cost cutting measures to combat global slowdown.

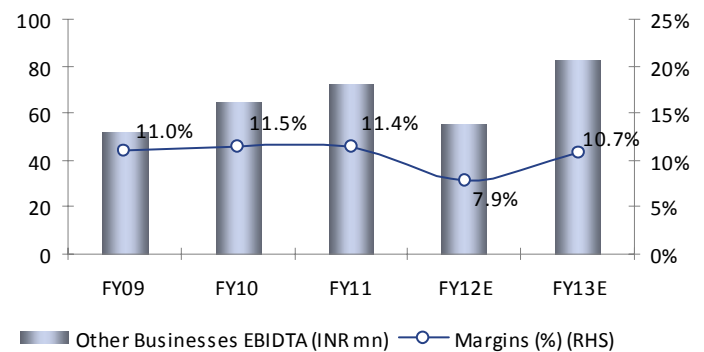
**Professional & IT services:** The division provides solutions for client server, web centric and mobile applications along with solutions for predictive modeling and data mining activities required for business intelligence/analytics. It also provides services in engineering space like engineering design and resourcing services. This division grew at a CAGR of 22.31% in last 3 years and recorded revenues of INR 230mn in FY11. Owing to current economic slowdown we expect the division to report revenues of INR 266mn in FY13, a 2 year CAGR of 7.50%.

We expect the combined other businesses to achieve a turnover of INR 766mn in FY13 at 2 year CAGR of 9.65%.



Source: Company, SPA Research

On margin front, we expect some pressure on EBIDTA margins in FY12 (at 7.86%, down from 11.37% in FY11) but improvement in FY13 (at 10.72%).



Source: Company, SPA Research

**Regulations ensure good long term opportunities**

Since the opening up of the economy in 1991, the RBI and other regulatory authorities have enacted series of regulations and policies for risk optimization. Various steps taken to develop debt market activities in the economy led to the rise in credit rating industry revenues. Below mentioned are some of the guidelines which have encouraged industry players to demand for rating services which augured well for the credit rating industry and thus for ICRA.

**Guidelines that encouraged rating revenues in CMR segment:**

- Rating mandatory for issuance of commercial papers
- RBI made rating of public deposit schemes mandatory for NBFCs
- In 2003, SEBI along with stock exchanges made rating mandatory for debt instruments placed under private placement basis and having a maturity of year or more, which are proposed to be listed
- RBI in 2003 issued prudential guidelines on the management of the non-SLR investment portfolio of all scheduled commercial banks except regional banks and local area banks to make fresh investment only in rated non-SLR securities

- Non-government provident fund, superannuation funds, gratuity funds can invest in bonds issued by public financial institutions, public sector companies/banks and private sector companies only when they are dual rated. Further such provident funds, superannuation funds, gratuity funds can invest in shares of only those companies which have investment grade debt rating from atleast two credit rating agencies
- Investment by mutual funds and insurance companies in unrated paper/non-investment grade paper is also restricted
- The National Small Industries Corporation Ltd (NSIC) was established by GOI to promote, aid and foster the growth of SMEs in the country on a commercial basis. NSIC has implemented the "Performance & Credit Rating Scheme" which encourages SME's to get rated as good rating enhances the acceptability of the rated unit in the market and also enables it to access cheaper credit, faster
- As per the SEBI regulations, no company shall make an initial public offer, unless it has obtained grading for the initial public offer from at least one credit rating agency registered with SEBI

**Regulatory implementations that encouraged rating revenues in BLR segment:**

Although credit rating is not mandatory under Basel II, banks are likely to save capital if they get their loans rated as depicted below.

Rating	Basel I		Basel II		Capital Saved
	Risk Weight	Cap Required	Risk Weight	Cap Required	
AAA	100%	90	20%	18	72
AA	100%	90	30%	27	63
A	100%	90	50%	45	45
BBB	100%	90	100%	90	-
BB & Below	100%	90	150%	135	(45)
Unrated	100%	90	100%	90	-

Source: Industry, SPA Research

In terms of RBI instructions on the 'New Capital Adequacy Framework (Basel II)' issued in April 2007, banks were required to initially assign a risk weight of 100% in respect of unrated claims on corporates with the caveat that such claims would be assigned higher risk weights over time.

To begin with, for the financial year 2008-09, all fresh sanctions or renewals in respect of unrated claims on corporates in excess of INR 500 million were to attract a risk weight of 150%, and with effect from April 1, 2009, all fresh sanctions or renewals in respect of unrated claims on corporates in excess of INR 100 million were to attract a risk weight of 150%. This higher risk weight of 150% for unrated corporate claims was equivalent to the risk weight to be assigned to exposures rated BB and below. However, in November 2008, as a counter cyclical measure, RBI relaxed the regulatory prescription of 150% risk weight for unrated claims. Accordingly, all unrated claims on corporates, irrespective of the amount currently attract a uniform risk weight of 100%. This relaxation is temporary and will be reviewed at an appropriate time.

The implementation of Basel II standards by the RBI resulted in large scale penetration of credit ratings across sectors and geographies which were previously limited to a small group of clients. The capital freed on rated loans can be utilized for further loan disbursement increasing the interest income for banks. Banks thus passes some benefit to corporate by offering lower interest rate for the rated loans. Corporates, therefore, have an incentive to get their loans rated to avail loans faster and at lower interest cost. We expect bank credit to industry to grow by 17% in next 3 years to reach ~INR 26,000bn in FY14. This would present a revenue potential of INR ~3.5bn to credit rating industry.

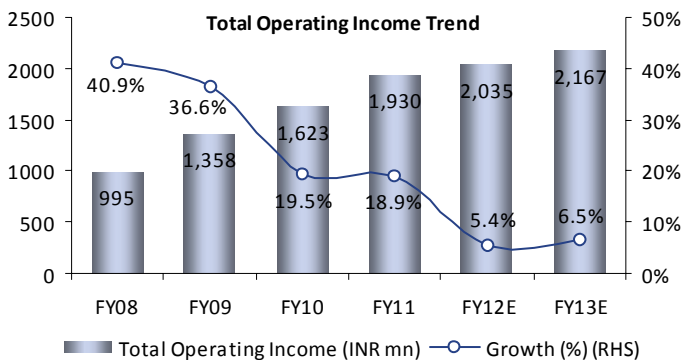
## Financial Overview

### Half Yearly Financials

Particulars (INR mn)	H1 FY12	H1 FY11	YoY (%)
Total Operating Income (TOI)	906	895	1.31%
Employee Cost	527	390	35.13%
as a % of TOI	58.10%	43.56%	1455bps
Administrative Expenses	75	67	12.37%
as a % of TOI	8.27%	7.45%	+81bps
Other Operating Expenses	106	107	-1.15%
as a % of TOI	11.67%	11.96%	-29bps
<b>EBIDTA</b>	<b>199</b>	<b>331</b>	<b>-39.92%</b>
EBIDTA Margins (%)	21.96%	37.03%	-1507bps
Depreciation	22	21.60	2.25%
<b>EBIT (excl. OI)</b>	<b>177</b>	<b>310</b>	<b>-42.86%</b>
Other Income (OI)/Value Adj.	48	62	-22.86%
<b>EBIT</b>	<b>224</b>	<b>371</b>	<b>-39.54%</b>
Interest	-	0.01	-100.00%
Tax Expense	102	121	-15.54%
<b>PAT</b>	<b>122</b>	<b>250</b>	<b>-51.14%</b>
Minority Interest	(0.39)	(0.07)	452.86%
Net PAT	123	250	-51.00%
PAT Margins (%)	13.54%	27.99%	-1445bps

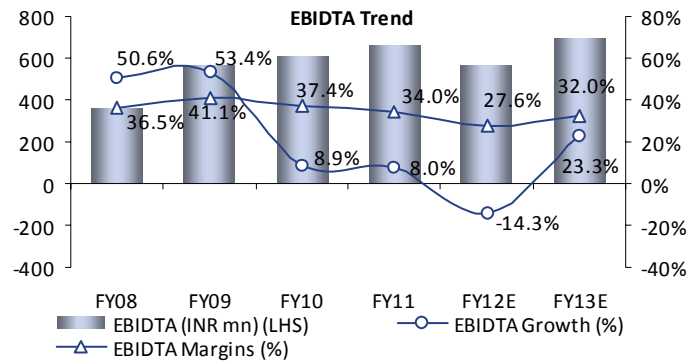
Source: Company, SPA Research

We expect economic headwinds to persist in the current fiscal and first half of FY13 which would impact overall growth of revenue. We therefore expect ICRA's consolidated revenue to reach INR 2,035mn (YoY 5.41%) in FY12 and INR 2,167mn (YoY 6.50%) in FY13, a two year CAGR of 5.95%.



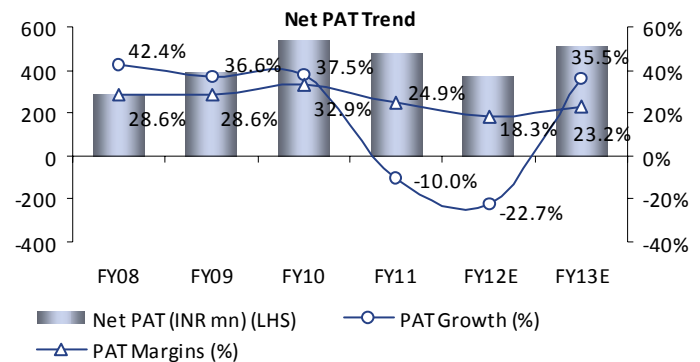
Source: Company, SPA Research

With increase in coverage of small size loans in BLR segment, there is going to be some pressure on overall profitability due to increased employee cost as a % of revenues. Also, due to amortization of cost of ESOP plan of INR 147mn in FY12 and INR 57mn in FY13 respectively, EBIDTA margins would decline by 634bps YoY to 27.63% but improve in FY13 to 31.99%.



Source: Company, SPA Research

We expect PAT to reduce by 22.74% in FY12 on back of higher EBIDTA contraction and higher tax outgo (as expense related to ESOP amortization is not allowed for income tax filing when vested). However, we expect PAT to register a jump of 35.47% in FY13 to INR 504mn.



Source: Company, SPA Research

### Assumptions

	FY09	FY10	FY11	FY12E	FY13E
<b>CDR Segment</b>					
Fresh Debt Rated (INR bn)	3,324	2,558	3,463	3,949	4,242
Growth in Fresh Debt Rated (%)	28.54%	-23.04%	35.38%	14.04%	7.43%
No of Fresh Issues	427	420	369	343	326
Growth in No of Issues (%)	-27.38%	-1.64%	-12.14%	-7.00%	-5.00%
Avg Ticket Size/Issue (INR bn)	7.78	6.09	9.38	11.51	13.01
Avg. Rating Fees (%)	0.0152%	0.0234%	0.0206%	0.0195%	0.0190%
<b>BLR Segment</b>					
Fresh Debt Rated (INR bn)	4,004	2,946	2,887	2,907	3,049
Growth in Fresh Debt Rated (%)	41.70%	-26.42%	-2.00%	0.70%	4.87%
No of Fresh Issues	1,103	1,843	2,289	2,701	3,025
Growth in No of Issues (%)	379.57%	67.09%	24.20%	18.00%	12.00%
Avg Ticket Size/Issue (INR bn)	3.63	1.60	1.26	1.08	1.01
Avg. Rating Fees (%)	0.0095%	0.0157%	0.0201%	0.0195%	0.0195%

Source: Company, SPA Research

### Peer Comparison

Currently there are 4 major players in credit rating sector which are CRISIL, ICRA, CARE and FITCH (in order of market share). Amongst these, only CRISIL and ICRA are listed on the stock exchange. CRISIL being the largest player with strong presence in rating, outsourcing and research businesses attracts premium valuation and is currently trading at 25.58x CY12E EPS. In comparison, ICRA is trading at 14.36x FY13E adj. EPS which is ~44% discount (as against ~10% historically) to CRISIL which we believe is unwarranted and should narrow down in due course of time.

Peer Comparison (INR mn)	Market Cap (INR mn)	FY 12E Revenue (INR mn)	Adj. EBIDTA Margins FY12E (%)	FY12E adj. RoNW (%)	EPS (INR)		P/EPS (x)	
					FY12E	FY13E	FY12E	FY13E
CRISIL*	62,150	8,021	34.35%	50.20%	29.26	34.95	30.55	25.58
ICRA	8,050	2,035	34.87%	19.53%	51.89	56.05	15.51	14.36

Source: Bloomberg, SPA Research

\*CRISIL figures for CY

### Valuation and Outlook

Despite short term headwinds, we are very positive on the huge long term opportunities for the credit rating sector on the back of development in debt market which is at nascent stage in India. ICRA, being the second largest player in the industry is positioned strongly on back of years of rating experience across various industries along with high brand recognition, good service quality and strong industry network. We believe that all the short term negatives are already discounted in the stock price which is currently trading at 15.51x FY12E adj. EPS against average 5 year historical multiple of 22.43. We have valued the stock using discounting cash flow (DCF) and relative EPS multiple method and arrived at a target price which is the average of values arrived from the two methods.

#### Snapshot of DCF:

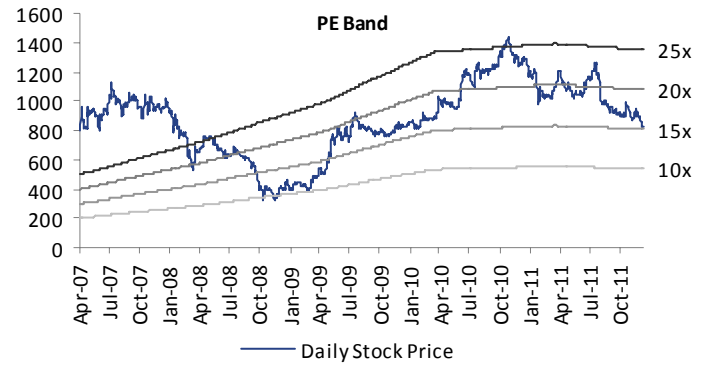
Particulars (INR mn)	FY08	FY09	FY10	FY11	FY12E	FY13E	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E	FY20E	FY21E
EBIDTA	363	558	607	656	562	693	845	972	1,117	1,285	1,439	1,612	1,773	1,950
Growth (%)		53.44%	8.92%	7.97%	-14.25%	23.28%	21.88%	15.00%	15.00%	15.00%	12.00%	12.00%	10.00%	10.00%
Depreciation	38	36	41	45	50	55	60	64	70	78	86	96	106	118
Interest Cost	0.01	0.17	0.05	0.01	-	-	-	-	-	-	-	-	-	-
EBT	325	521	566	610	512	638	785	908	1,047	1,207	1,353	1,516	1,667	1,833
Tax	111	177	192	208	174	217	267	309	356	410	460	515	567	623
Change in NWC		(76)	(160)	(81)	339	(54)	46	34	36	42	39	43	40	44
Capex	39	32	36	47	40	40	40	63	73	84	94	105	115	127
FCFF		424	540	482	9	490	492	566	652	749	847	948	1,051	1,156
Discounting Factor							1.13	1.27	1.43	1.61	1.81	2.04	2.30	2.59
Present Value (PV)							437	446	457	466	467	465	457	447

Discount Rate	12.63%	Terminal Value	13,941
Rf	8.50%	PV of Terminal Value	5,385
Market Premium	7.50%	Total PV	9,027
Beta	0.55	Investment/Cash	1,652
Equity Risk Premium	4.13%	Debt	-
Required Equity Return (Re)	12.63%	Total PV of Equity	10,679
Terminal Growth Rate (%)	4.00%	<b>Value/share</b>	<b>1,068</b>

Sensitivity Analysis	Rf (%)	7.50%	8.00%	8.50%	9.00%	9.50%
<b>Terminal Growth Rate (%)</b>						
<b>3.50%</b>		1,155	1,092	1,036	986	941
<b>3.75%</b>		1,176	1,110	1,052	999	952
<b>4.00%</b>		1,199	1,129	<b>1,068</b>	1,013	965
<b>4.25%</b>		1,222	1,149	1,085	1,029	978
<b>4.50%</b>		1,248	1,171	1,104	1,044	992

Source: Company, SPA Research

Discounted Cash Flow methodology yields a value of INR 1,068. Using relative EPS multiple method, we assign a multiple of 18 (~20% discount to average historical multiple) to FY13E adj. EPS of INR 56.05 and arrive at a value of INR 1,009. Taking average of values estimated from both the methods, we arrive at 15 months target price of INR 1,038. We initiate coverage with BUY recommendation.

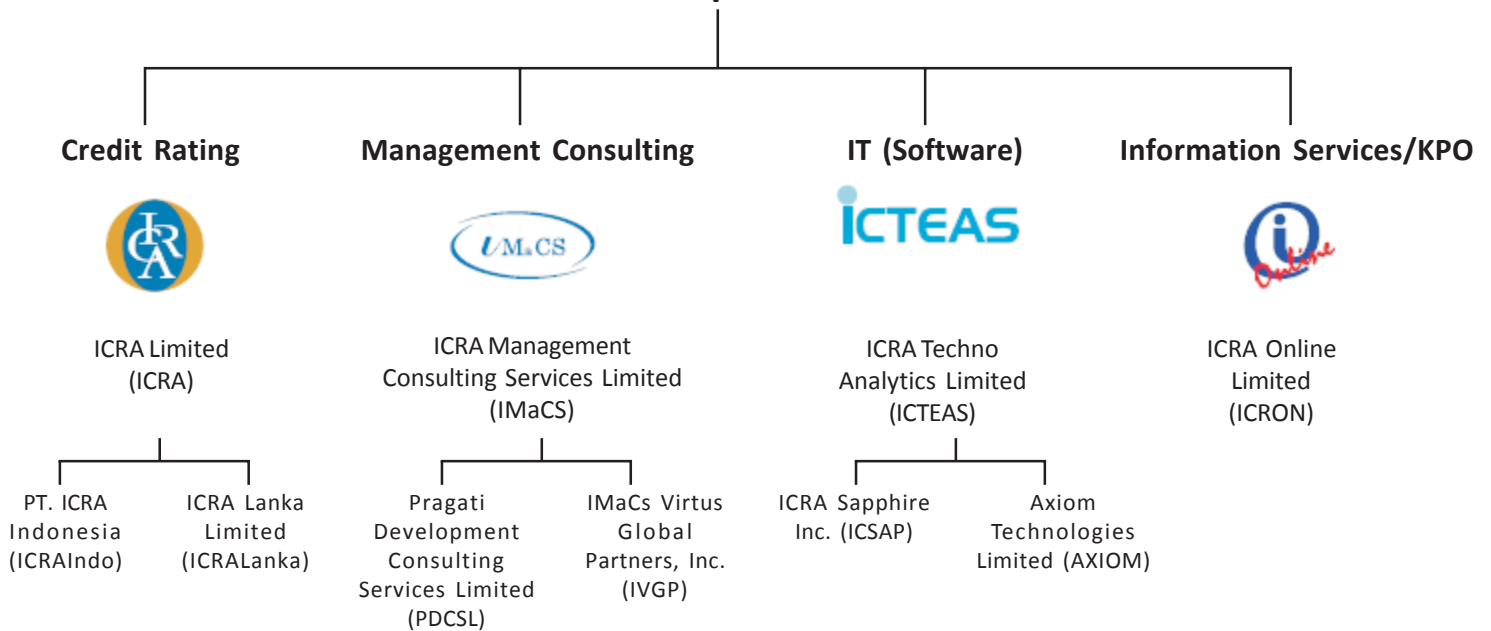


Source: Capitaline, SPA Research

### Company Brief

ICRA, an associate company of Moody's Investors Service, is the second largest credit rating agency in India. Apart from credit rating business which contributes (67% to the consolidated revenues), it also manages consulting services (13%), outsourced & information services (8%) and professional & IT services (12%) through its subsidiaries. Except PT. ICRA which is owned 99% by ICRA and IMAcS Virtus Global Partners which is owned 66.67% by ICRA Management Consulting services, all other are wholly owned subsidiaries.

### Group ICRA



## Industry Overview

In India, the first credit rating agency, Credit Rating and Information Services of India Limited (CRISIL), was set up in 1987. A second rating agency, ICRA Limited (then known as, Investment Information and Credit Rating Agency of India Limited) was established in 1991 and a third agency CARE began operations in 1993. Duff and Phelps Credit Rating India (P) Ltd which started its operations in 1996 was renamed Fitch Ratings India Private Limited (Fitch) in 2001. Brickworks Ratings India Private Limited (Brickworks) began its rating business in 2008. SME Rating Agency of India Limited (SMERA) also began its rating business in 2008.

In the initial stages, the rating agencies faced several challenges as the corporate debt market in India was at an embryonic stage. However, after subsequent regulatory guidelines and requirements that encouraged and made rating mandatory, credit rating has made rapid strides in terms of the number and value of instruments which have been rated. Ratings over the years have achieved market penetration across various industries and companies. The penetration level of privately placed debt (i.e. no. of rated issues out of total issues) was 99% and 99.88% in 2010 and 2011 respectively (Source: Prime Database). Rating for the non-regulated debt issuances stems from demands made by the investor community, comprising banks, mutual funds, and pension funds, which have restrictions on investment in unrated and unlisted bonds.

Credit ratings sector cover the credit ratings of debt/debt related and equity/ equity related instruments of corporates including banks, financial institutions and NBFCs. The demand for funds from the corporate sector has witnessed an increase due to increase in capital investment, capacity creation and business growth leading to increasing working capital requirements. Corporates raising funds through bonds/debentures or commercial papers creates substantial demand for credit rating. The debt instruments for the banks are Tier II bonds, hybrid debt capital, certificate of deposits and fixed deposit programmes. For the NBFCs and financial institutions, the debt instruments are primarily long/short term debentures and commercial paper.

Implementation of Basel II standards by the RBI in 2008 resulted in large scale penetration of credit ratings across sectors and geographies, which was previously limited to a small group of clients. Although credit rating is not mandatory under Basel II,

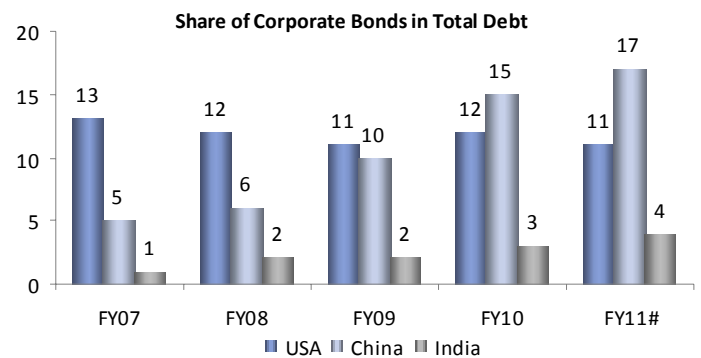
banks are likely to save capital if they get their loan rated. With this, a large number of Indian companies, hitherto unrated by rating agencies, have now come forward to get their bank facilities rated. Basel-II norms hold significant potential for further development of the domestic debt markets, by introducing into the public domain easily accessible credit information about a large pool of mid-sized companies.

The demand for rating also depends upon the development of debt market in the economy. India's corporate bond market (comprising public debt offers, debt private placements and commercial paper) is relatively small in comparison with the other markets. The ratio of corporate debt to GDP in India is ~14% which is quite low as compared to other nations.



Source: Bloomberg, SPA Research

Also, share of corporate bonds in total debt is also lower at ~4% compared to 17% in China and 11% in USA. This therefore presents large scope for the development of corporate debt market which will consequently benefit credit rating industry.

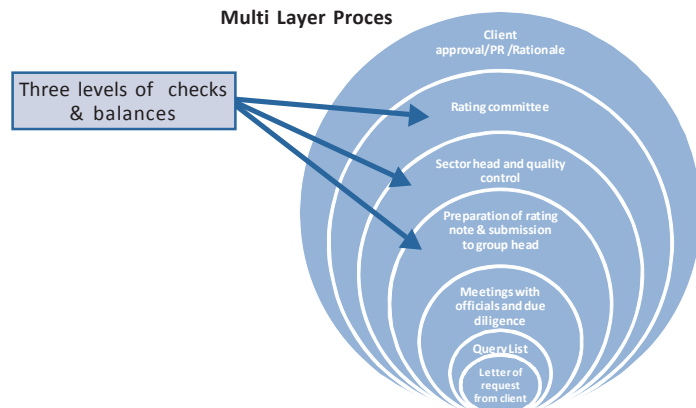


Source: CCIL, SPA Research

# Year till Dec. 2010

### Credit Rating Mechanism

The following diagram depicts the multi layer steps involved in assigning credit rating to a client.



Source: CARE, SPA Research

Rating agencies monitor accepted ratings over the tenure of the rated instrument. The rating may be upgraded, downgraded or reaffirmed on periodic reviews, including surveillance. As the rating of debt instruments and bank loans/ facilities which are accepted and used by the clients must remain under surveillance until the entire debt is repaid, and agencies continue to charge an annual surveillance fee over the lifetime of the debt instrument/ bank loan/facility, which provides them with annuitized revenue.

### Investment Risk

#### Higher than expected economic slowdown

Unfavorable financial and economic conditions reduce investor demand for debt instruments or bank loans/facilities or reduce the issuer's willingness and ability to issue debt instruments. This could directly impact the demand for rating services as well as advisory services. Higher than expected fall in bank credit demand and debt issuances could act as a risk factor to our revenue projections.

#### Competitive Intensity

The intensifying competition in the rating industry with the advent of new players (like Brickworks, Dun and Bradstreet and SMERA) and increase in aggressiveness of existing players to maintain/gain market share amid slowing economy has resulted in sharp decline of rating fees in the last few years. Higher than expected fall in rating fees would act as a damper on revenues and profitability front.

#### Attrition Rate

Employees and processes are the core strength of rating agencies. Higher than expected attrition could force the company to offer higher remuneration for retaining the talent within the organization, that could stress the profitability. However, ongoing economic conditions have currently reduced the attrition rate between 12-15% which is much lower than ~20% witnessed in last few years.

#### Long Term Risk

RBI has pursuant to a circular dated July 7, 2009 advised banks that they may apply for migration to an "internal rating based" approach for measuring credit risk from April 1, 2012 onwards. As per the timeframe specified for implementation of the IRB Approach as set forth in the Circular, RBI may, subject to an 18 months detailed analysis of the applicant bank, commence grant of approvals by March 31, 2014. However, the impact could be minimal as it would be expensive for corporate to get rated from different banks than getting rated from one agency, whose rating would be acceptable for the loans from all the banks.

## Financials Consolidated

### Income statement

Year End March (INR mn)	FY10	FY11	FY12E	FY13E
Total Operating Income	1,623	1,930	2,035	2,167
Growth (%)	19.51%	18.92%	5.41%	6.50%
Employee Cost	685	885	1,066	1,052
Other Operating Expenses	331	390	407	422
Total Operating Expenses	1,016	1,275	1,472	1,474
EBIDTA (exl. OI)	607	656	562	693
EBIDTA Margin (%)	37.42%	33.97%	27.63%	31.99%
Dep./Amortization	41	45	50	55
EBIT	566	610	512	638
Other Income (OI)	142	129	127	164
Adj. (Prior Prd/Value of Invstmt)	85	0	(15)	-
EBT	793	740	624	803
Tax Expenses	258	259	253	300
PAT	535	481	371	503
Minority Interest	0	0	1	1
Net PAT	535	481	372	504
Growth (%)	37.51%	-10.04%	-22.74%	35.47%
PAT Margin (%)	32.95%	24.92%	18.27%	23.24%

### Key Ratio

Year End March	FY10	FY11	FY12E	FY13E
<b>Per Share Data (INR)</b>				
Reported EPS	53.48	48.11	37.17	50.36
Growth (%)	37.52%	-10.04%	-22.74%	35.47%
Adj. EPS	53.48	55.62	51.89	56.05
Growth (%)	37.51%	4.01%	-6.71%	8.01%
DPS	17.00	17.00	17.00	20.00
BVPS	221.72	257.05	274.28	301.18
<b>Return Ratios (%)</b>				
RoACE	26.06%	20.09%	13.97%	17.48%
RoANW	26.06%	20.10%	13.99%	17.50%
RoIC	28.34%	21.70%	14.46%	18.36%
<b>Liquidity Ratios</b>				
Net Debt/Equity	(0.86)	(0.91)	(0.79)	(0.84)
Current Ratio	2.09	1.30	2.01	2.00
<b>Efficiency Ratios</b>				
Asset Turnover Ratio	0.50	0.54	0.55	0.54
Debtor Days	73	65	66	72
Creditor Days	10	6	7	9
<b>Valuation Ratios</b>				
P/E (x)	16.45	22.53	21.66	15.99
adj. P/E (x)	16.45	19.49	15.51	14.36
P/BV (x)	3.97	4.22	2.93	2.67
Dividend Yield (%)	1.93%	1.57%	2.11%	2.48%
EV/Net Sales (x)	4.24	4.41	2.89	2.55
EV/EBIDTA (x)	11.34	12.97	10.44	7.98

### Balance Sheet

Year End March (INR mn)	FY10	FY11	FY12E	FY13E
<b>Source of Funds</b>				
Share Capital	100	100	100	100
Reserves and Surplus	2,117	2,470	2,643	2,912
Total Network	2,217	2,570	2,743	3,012
Deferred Tax Liability (Net)	(10)	(21)	(19)	(19)
<b>Total</b>	<b>2,208</b>	<b>2,550</b>	<b>2,724</b>	<b>2,993</b>

### Application of Funds

Net Block	242	243	233	218
Goodwill on Consolidation	96	95	95	95
Investments	746	1,912	1,436	1,652
Current Assets	2,154	1,305	1,914	2,053
Current Liabilities & Provisions	1,029	1,005	955	1,026
Net Current Assets	1,124	299	960	1,027
<b>Total</b>	<b>2,208</b>	<b>2,550</b>	<b>2,724</b>	<b>2,993</b>

### Cash Flow

Year End March (INR mn)	FY10	FY11	FY12E	FY13E
EBT	793	740	624	803
Less: OI/Exceptionals	141	129	127	164
Add: Depreciation	41	45	50	55
Add: Interest Paid	0	0	-	-
Direct Taxes Paid	(258)	(241)	(253)	(300)
Change in Working Capital (WC)	160	81	(339)	54
Others	(178)	(21)	5	(36)
<b>Cash Flow from Operations (a)</b>	<b>417</b>	<b>475</b>	<b>(40)</b>	<b>412</b>
Change in Capex	(36)	(47)	(40)	(40)
Change in Investment	(447)	(1,166)	476	(216)
Others	244	192	127	164
<b>Cash Flow from Investments (b)</b>	<b>(238)</b>	<b>(1,022)</b>	<b>563</b>	<b>(92)</b>
Dividend paid (incl. tax)	(141)	(198)	(202)	(199)
Interest Paid/Others	0	1	-	-
<b>Cash Flow from Financing (c)</b>	<b>(141)</b>	<b>(198)</b>	<b>(202)</b>	<b>(199)</b>
<b>Net Change in Cash (a+b+c)</b>	<b>39</b>	<b>(744)</b>	<b>321</b>	<b>122</b>
Opening Cash	1,126	1,165	420	742
Closing Cash	1,165	420	742	863

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1. Analyst ownership of the stock - No
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