

4 May 2010

HDFC*Raising estimates, target price; maintain Buy*Rating: **Buy**

Target Price: Rs3,357

Share Price: Rs2,806

- **Higher NII and lower provisions.** HDFC's 4QFY10 profit rose 26.3% yoy, driven by an increase in net interest income (NII) and lower provisions. We raise FY11e EPS 4.2% and FY12e 4% given better business growth and lower NPA provision assumptions. We raise the target price from Rs3,095 to Rs3,334 and retain a Buy. We expect HDFC's RoEs to be above 20%, supported by business growth opportunities, an improving credit growth cycle and subsidiaries' robust operating performance.
- **Robust disbursements and loan growth, spreads improve.** Loan disbursements grew 27% yoy, with loan growth of 15% yoy (22% yoy adjusted for sell-down in loans to HDFC Bank). Spreads improved 10bp yoy to 2.3%, leading to 19% NII growth. We expect a 19% CAGR in HDFC's loans over FY10-12.
- **Fees subdued, asset quality strong.** Though fees declined 2.5% yoy (though up 51.5% qoq), they are a significant contributor to non-interest income. Capital gains also declined, down 46% yoy. Asset quality is the best in class, with NPAs at 0.79% of loans. We expect conservative growth and high provisioning to keep credit costs low over FY10-12.
- **Stock split.** The board has proposed, subject to shareholder approval, a 5:1 stock split.
- **Valuation.** A sum-of-parts valuation gives us a target price of Rs3,357. We value the mortgage business at Rs2,091 (3.5x FY11e BV) and the subsidiaries at Rs1,266.

Key data	HDFC IN /HDFC .BO
52-week high/low	Rs2,869/2,775
Sensex/Nifty	17386/5223
3-m average volume	US\$39.2m
Market cap	Rs806bn/US\$18.2bn
Shares outstanding	287.1m
Free float	100.0%
Promoters	0%
Foreign Institutions	73.0%
Domestic Institutions	14.9%
Public	12.1%

Quarterly results

Year end 31 Mar	4QFY09	4QFY10	% yoy	FY09	FY10	% yoy
Net interest income (Rsm)	8,802	11,333	28.7	31,134	34,606	11.2
Non-interest income (Rsm)	2,186	2,168	(0.8)	5,313	9,154	72.3
Operating expenses (Rsm)	(528)	1,129	(313.7)	2,745	4,261	55.2
Cost-Income (%)	(4.8)	8.4	1,316bps	7.5	9.7	220bps
Pre-provisioning profit (Rsm)	11,516	12,373	7.4	33,702	39,500	17.2
Provisions (Rsm)	1,240	(286)	(123.1)	1,512	340	(77.5)
PBT (Rsm)	10,276	12,659	23.2	32,190	39,159	21.7
Tax (Rsm)	2,943	3,395	15.4	9,365	10,895	16.3
PAT (Rsm)	7,334	9,264	26.3	22,825	28,264	23.8
EPS (Rs)	25.4	31.3	23.5	78.7	95.9	21.8

Source: Company, Anand Rathi Research

Financials

Year end 31 Mar	FY11e	FY12e
Net interest income (Rsm)	45,548	55,224
Net profit (Rsm)	32,779	39,428
EPS (Rs)	114.2	137.3
Growth (%)	16.0	20.3
PE (x)	24.6	20.4
PABV (x)	4.8	4.2
RoE (%)	20.3	21.5
RoA (%)	2.7	2.7
Dividend yield (%)	1.4	1.6
Net NPA (%)	0.4	0.4

Source: Bloomberg, Anand Rathi Research

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Quick Glance – Financials and Valuations

Fig 1 – Income statement (Rsm)

Year end 31 March	FY08	FY09	FY10	FY11e	FY12e
Net interest income	27,266	32,265	36,014	45,548	55,224
NII growth (%)	61.4	18.3	11.6	26.5	21.2
Non-interest inc	9,628	3,587	6,963	4,806	5,164
Total income	36,894	35,852	42,978	50,354	60,388
Total income growth (%)	65.5	(2.8)	19.9	17.2	19.9
Op. expenses	2,735	3,155	3,238	4,154	4,831
Operating profit	34,160	32,697	39,740	46,199	55,557
Operating profit growth (%)	70.7	(4.3)	21.5	16.3	20.3
Provisions	425	507	580	674	796
PBT	33,735	32,190	39,160	45,526	54,761
Tax	9,373	9,365	10,895	12,747	15,333
PAT	24,363	22,825	28,265	32,779	39,428
PAT growth (%)	28.7	15.5	23.8	16.0	20.3
FDEPS (Rs/share)	85.8	80.2	98.4	114.2	137.3
DPS (Rs/share)	25.0	30.0	36.0	40.0	45.0

Source: Company, Anand Rathi Research

Fig 2 – Balance sheet (Rsm)

Year end 31 March	FY08	FY09	FY10	FY11e	FY12e
Share capital	2,840	2,845	2,871	2,871	2,871
Reserves & surplus	116,633	128,529	149,106	168,656	193,194
Deposits	345,552	344,321	413,473	494,249	556,321
Borrowings	232,998	300,493	321,369	413,790	556,321
Minority interests	112,963	193,747	230,811	241,378	278,160
Total Liabilities	810,986	969,935	1,117,630	1,320,945	1,586,866
Advances	733,278	851,981	979,670	1,161,027	1,390,801
Investments	69,150	104,688	107,275	115,861	125,172
Cash & Bank Bal	5,006	9,074	25,607	38,656	64,498
Fixed & Other Assets	3,551	4,192	5,078	5,400	6,394
Total Assets	810,986	969,935	1,117,630	1,320,945	1,586,866
No. of shares (m)	284	284	287	287	287
Deposits growth (%)	n/a	n/a	n/a	n/a	n/a
Advances growth (%)	29.8	16.2	15.0	18.5	19.8

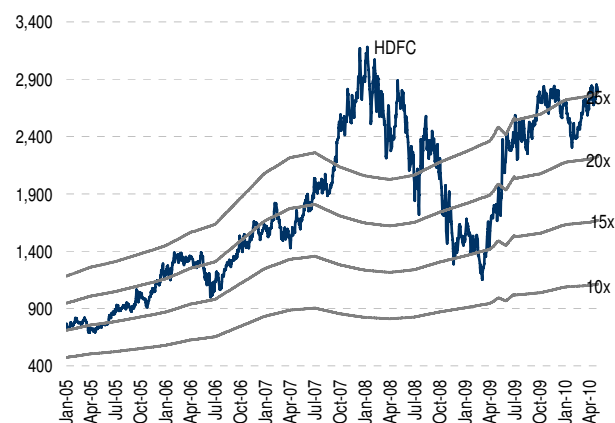
Source: Company, Anand Rathi Research

Fig 3 – Key Ratios

Year end 31 March	FY08	FY09	FY10	FY11e	FY12e
Interest spread (%)	2.9	2.2	2.4	2.7	2.9
NIM (%)	3.8	3.6	3.5	3.8	3.9
Other inc / Total inc (%)	26.1	10.0	16.2	9.5	8.6
Cost-Income (%)	7.4	8.8	7.5	8.3	8.0
Provision coverage (%)	35.9	37.4	36.6	35.0	32.8
Dividend Payout (%)	5.8	6.4	6.4	6.7	7.1
Credit-Deposit (%)	649.1	439.7	424.4	481.0	500.0
Investment-Deposit (%)	61.2	54.0	46.5	48.0	45.0
Gross NPA (%)	0.8	0.8	0.8	0.8	0.8
Net NPA (%)	0.5	0.4	0.4	0.4	0.4
BV (Rs)	420.6	461.9	529.3	597.4	682.9
Adj BV (Rs)	406.7	448.4	514.5	580.5	663.3
CAR (%)	16.8	15.1	14.9	14.5	13.8
- Tier 1 (%)	14.6	13.2	13.8	13.6	13.1
Dividend Yield (%)	0.9	1.1	1.3	1.4	1.6

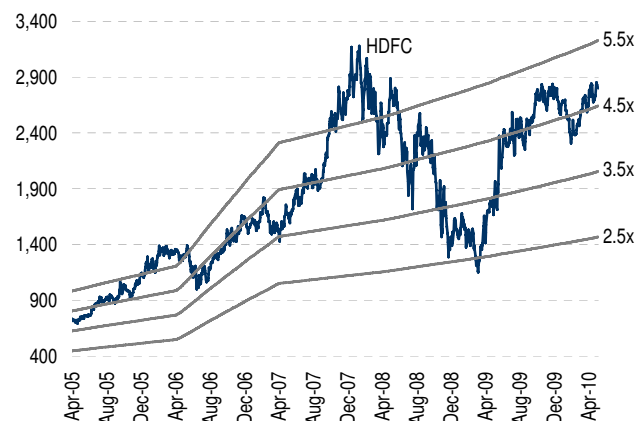
Source: Company, Anand Rathi Research

Fig 4 – PE Band



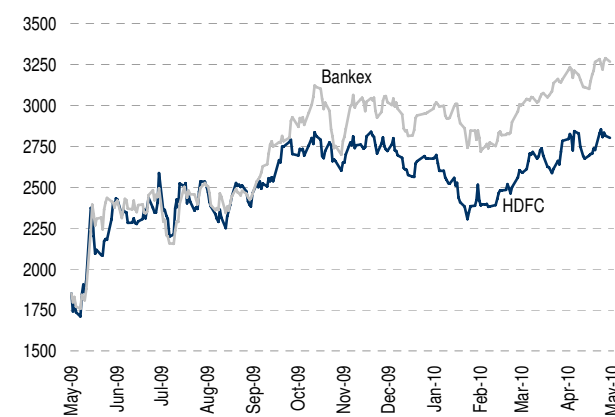
Source: Bloomberg, Anand Rathi Research

Fig 5 – Price-to-Book Band



Source: Bloomberg, Anand Rathi Research

Fig 6 – HDFC vs BANKEX



Source: Bloomberg, Anand Rathi Research

Results review

HDFC's 4QFY10 profits rose 26.3% yoy, driven by a rise in net interest income (NII) and by lower provisions. We raise FY11e EPS 4.2% and FY12e 4% given better business growth and lower NPA provision assumptions. We raise the target price from Rs3,095 to Rs3,335 and retain a Buy. We expect HDFC's RoEs to be above 20%, supported by business growth opportunities, an improving credit growth cycle and subsidiaries' robust operating performance.

Strong approvals and disbursements

In 4QFY10, disbursements grew 27% yoy, to Rs16.8bn; approvals 27%, to Rs19.5 bn. Disbursements and approvals saw strong growth qoq, up 51% and 54%, respectively. Loans to corporates comprised 36% of loans and grew 23.6% yoy, faster than retail housing loans (11.7% yoy). The strong continuing growth in approvals augurs well for the outlook on housing-loan growth. We expect a 19% CAGR in HDFC's loan book over FY10-12.

In FY10, HDFC sold down Rs57.6bn of loans to HDFC Bank. Adjusting for these, its loan book grew 22% yoy. HDFC made ~1.25% as its spread on loans sold to HDFC Bank. Ahead, we expect these loans to reduce, as systemic credit growth revives.

Fig 7 – Loan-book mix (Rsm)

	4QFY09	4QFY10	Growth %	
			YoY	QoQ
Individuals	548,890	613,050	11.7	6.5
Corporates	284,170	351,190	23.6	12.2
Others	18,920	15,440	(18.4)	(0.3)
Total advances	851,980	979,670	15.0	8.4

Source: Company

Fig 8 – Domestic loan-book composition (%)

	4QFY09	4QFY10
Individuals	64.4	62.6
Corporates	33.4	35.8
Others	2.2	1.6

Source: Company

NIM to gradually improve

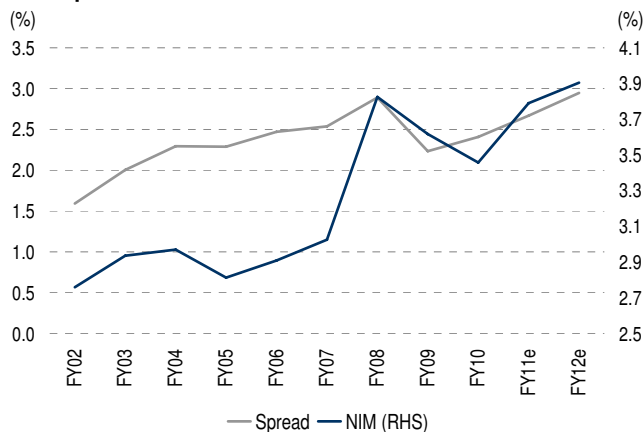
HDFC's net interest margin, unlike most NBFCs, is relatively less sensitive to changes in overall liquidity and the interest rate environment because of its diverse funding mix. We expect the high proportion of floating-rate loans and diversified funding base to help protect its spreads even in a rising interest-rate scenario. We do not expect any funding hurdles for HDFC with its established credit lines, priority sector status and AAA rating for its bond issuances.

HDFC's spreads expand when interest rates rise, as its assets usually re-price faster than its liabilities. Floating rate loans are matched by floating rate liabilities, and HDFC's lending rates are benchmarked to their PLRs, which reflect the cost of funds. Shorter-term borrowings such as commercial paper are used to finance relatively shorter-term corporate loans. Within lending to individuals, ~85% of disbursements are variable-

rate; all non-individual (i.e., corporate and developer) loans are variable-rate, reset every time the PLR is altered.

We expect this strategy to help improve margins in an increasing interest rate scenario – the NIM is likely to improve from 3.5% in FY10 to 3.9% two years on. So far, HDFC has effectively managed to contain its overall cost of borrowings within 10% through various rising interest rate periods, and has maintained its spreads within a range of 2.2% to 3%.

Fig 9 – HDFC's spreads and NIM



Source: Company, Anand Rathi Research

Operating costs held in check

HDFC's operating costs were kept in check, its cost-income declined from 8.8% last year to 7.9% in FY10. This is the best in its class, comparable with both banks and rival HFCs and has been difficult for any bank or banks' subsidiaries to replicate so far. We expect this cost-income to be sustainable, given our estimate of mortgage growth in the medium term.

Its home-loan arrangement with HDFC Bank is also likely to help keep costs low. The bank accounted for 29% of loan originations in FY09. We believe that the bank, being a distributor of HDFC's mortgage product, has helped keep HDFC's operating costs low. The bank has 1,725 branches and over 18m customers. These can be leveraged for more business growth for HDFC, without the need for significant investments in expansions.

Asset quality stable

HDFC's asset quality improved, with NPAs (90 days past due) at 0.79% in 4QFY10 (against 0.94% in 3QFY10). While cumulative provisioning declined by Rs290m qoq to Rs6.56bn, it is still much higher than the regulatory requirement of Rs3.25bn. The outlook on asset quality appears benign given the improved macro environment. We expect its conservative growth and high provisioning to keep credit costs low over FY10-12. Given its prudent growth and expertise in judging the credit-worthiness of the eventual borrower, we expect HDFC's gross NPAs to be <1% till FY12, with its NPA coverage sustained at +80%.

Revised estimates**Fig 10 – Estimate revisions**

(Rsm)	From		To		% change	
	FY11e	FY12e	FY11e	FY12e	FY11e	FY12e
NII (Rsm)	44,073	53,346	45,548	55,224	3.3	3.5
Non Interest Income(Rsm)	4,101	4,449	4,806	5,164	17.2	16.1
PAT (Rsm)	31,331	37,701	32,779	39,428	4.6	4.6
EPS (Rsm)	109.5	131.8	114.2	137.3	4.2	4.2
Book Value (Rs)	577	657	597	683	3.6	4.0
ABV(Rs)	561	638	581	663	3.5	3.9
RoE (%)	20.1	21.4	20.3	21.5	16bps	7bps

Source: Anand Rathi Research

Valuation

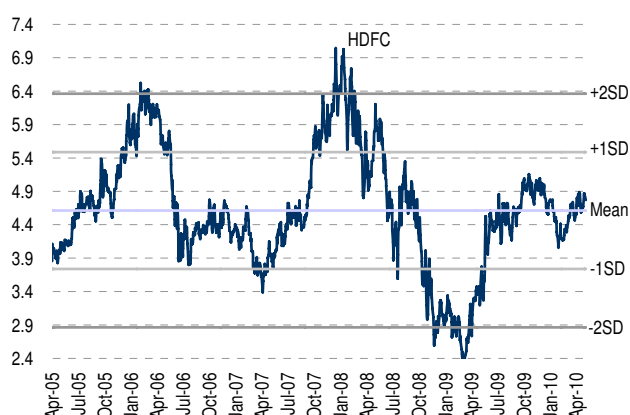
A sum-of-parts valuation gives us a fair value of Rs3,357 a share. We value the subsidiaries at Rs1,266. At our target, HDFC would trade at 3.1x FY11e and 2.7x FY12e BV (consolidated).

Fig 11 – HDFC subsidiaries – Valuation

	Stake	Value for HDFC	Per share value	Valuation Method
	%	Rsm	Rs	
HDFC Bank	23.9	184,032	641	3.2x FY11 BV
HDFC AMC	60.0	23,613	82	5% of equity AUM, 1.5% of Debt AUM and 8% of PMS AUM
HDFC Life Insurance	72.4	56,251	196	12x FY11e NBAP (18% NBAP margin)
HDFC General Insurance	74.0	11,988	42	10x FY11e earnings
HDFC Real Estate Fund	100.0	5,580	19	12% of AUM (\$1bn)
Gruh Finance	61.5	6,145	21	2.2x FY11BV
Unrealized gains on listed investments		166,677	581	Mgt indicated (4Q10)
Total Value of Subsidiaries		281,464	1,582	
Less: Holding company discount (20%)			316	
Net value of subsidiaries			1,266	
Value of the mortgage business			2,091	3.5 FY11eBV
Total			3,357	

Source: Anand Rathi Research

Fig 12 – Past one-year-forward PBV



Source: Bloomberg, Anand Rathi Research

Risks to our valuation

- Significant slowdown in the mortgage market, leading to loan growth being lower than we expect.
- Inability to pass on higher funding costs to customers and, hence, lower-than-anticipated interest-rate spreads.
- Unexpected increases in credit costs, deviating from HDFC's past asset quality standards, would trim our earnings estimates.
- Delay in listing subsidiaries and slowdown in insurance and asset management industry would impact our subsidiary valuations and target price.

Financials

We estimate a 19.2% CAGR in HDFC's loan book over FY10-FY12 and a 19.8% CAGR in net profit over the same period.

Fig 13 – Income Statement (Rsm)

Year end 31 Mar (Rsm)	FY08	FY09	FY10	FY11e	FY12e
Interest Income	79,112	106,590	106,645	144,101	174,532
Interest Expended	51,846	74,325	70,631	98,553	119,308
Net Interest Income	27,266	32,265	36,014	45,548	55,224
Growth (%)	61.4	18.3	11.6	26.5	21.2
Non-interest Income	9,628	3,587	6,963	4,806	5,164
Total Income	36,894	35,852	42,978	50,354	60,388
Non-interest income / Total Income (%)	26.1	10.0	16.2	9.5	8.6
Operating Expenses	2,735	3,155	3,238	4,154	4,831
Employee Expenses	1,088	1,279	1,467	1,662	1,932
Other Expenses	1,646	1,877	1,771	2,493	2,899
Pre-provisioning profit	34,160	32,697	39,740	46,199	55,557
Growth (%)	70.7	(4.3)	21.5	16.3	20.3
Provisions	425	507	580	674	796
Profit Before Tax	33,735	32,190	39,160	45,526	54,761
Taxes	9,373	9,365	10,895	12,747	15,333
Tax Rate (%)	27.8	29.1	27.8	28.0	28.0
Profit After Tax	24,363	22,825	28,265	32,779	39,428
Growth (%)	55.1	(6.3)	23.8	16.0	20.3
Number of Shares	284	284	287	287	287
Earnings Per Share	85.8	80.2	98.4	114.2	137.3

Source: Company, Anand Rathi Research

Fig 14 – Balance Sheet (Rsm)

Year end 31 Mar (Rsm)	FY08	FY09	FY10	FY11e	FY12e
Share Capital	2,840	2,845	2,871	2,871	2,871
Reserves and Surpluses	116,633	128,529	149,106	168,656	193,194
Net Worth	119,474	131,374	151,977	171,528	196,065
Borrowings	578,550	644,814	734,842	908,039	1,112,641
Deposits	112,963	193,747	230,811	241,378	278,160
Total Loans	691,512	838,561	965,653	1,149,417	1,390,801
Total Liabilities	810,986	969,935	1,117,630	1,320,945	1,586,866
Advances	733,278	851,981	979,670	1,161,027	1,390,801
Investments	69,150	104,688	107,275	115,861	125,172
Current Assets	30,449	38,523	50,918	50,269	57,842
Cash & Bank Balances	7,777	17,185	22,715	17,474	18,413
Net Current Assets	5,006	9,074	25,607	38,656	64,498
Fixed & Other Assets	3,551	4,192	5,078	5,400	6,394
Total Assets	810,986	969,935	1,117,630	1,320,945	1,586,866

Source: Company, Anand Rathi Research

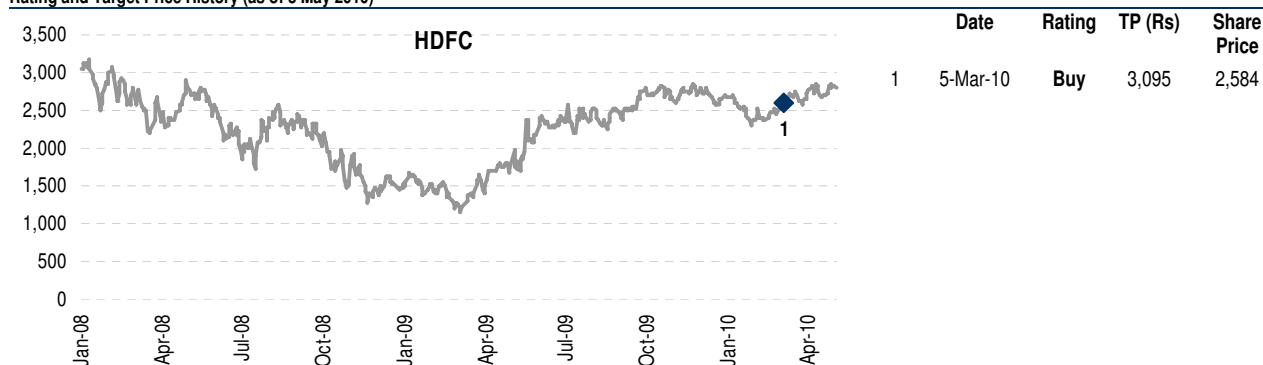
Appendix 1

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Rating and Target Price History (as of 3 May 2010)



Source: Bloomberg

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Large Caps (>US\$1bn)	>20%	5-20%	<5%
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% who are investment banking clients	8%	0%	0%

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