

## HDFC Ltd (HDFC)

**SELL**

Challenging times ahead

Current price: Rs1372

**Table 1: Valuation (Standalone)** (Rs mn)

Year ended	Net Interest Income	Other Income	Net Profit	EPS (Rs)	EPS growth (%)	P/E (x)	P/BV (x)	RoE (%)	RoA (%)	DPS (Rs)
FY06	12,155	5,718	12,573	50.3	--	15.2	3.9	26.7	2.6	20
FY07	16,472	5,822	15,704	62.1	23.2	22.2	5.5	24.1	2.6	22
FY08	26,411	10,483	23,586	85.7	38.1	23.1	4.5	29.9	3.1	25
FY09E	32,335	8,508	26,758	94.2	9.9	14.6	2.7	20.5	2.8	28
FY10E	36,873	8,196	29,406	103.5	9.8	16.9	2.4	19.4	2.5	31

Source: Brics Research

Major shareholder: Promoters: Nil, Public: 100% Citigroup 9.1%, CMP Asia 5.4%, DB International 4.2  
Issued Capital: 284.4 mn shares of Rs. 10 each

HDFC's Q3FY09 net interest income (NII) at Rs7.8bn increased 18% yoy, driven by assets growth of 23% and interest spread of 2.1%. Other income from operations at Rs898mn increased 37% yoy led by growth in dividend income. Adjusted for Q3FY08 exceptional income of Rs1.2bn on stake sale in life insurance subsidiary and BPO business, net profits are up 15% yoy. Portfolio quality remained healthy with Gross NPAs down to 1.01% vis-à-vis 1.12% in Q3FY08.

At the current market price of Rs1372, the stock is quoting at 14.6x FY09E earnings and 2.7x FY09E book value. We value HDFC's core business at Rs742. Valuations of subsidiaries at Rs416 imply a fair value of Rs1183 - downside of 13% from current levels. Recommend SELL.

### Key Parameters

- **NII up 21% yoy, approvals up 15% yoy - Slowdown evident**  
NII at Rs7.8bn increased 18% yoy led by assets growth of 23% and interest spread of 2.1% in Q3FY09 compared to 2.3% in Q3FY08 (refer to table 6). Loan approvals at Rs338bn increased 15% yoy and disbursements at Rs272bn increased 22% yoy, clearly showing signs of slowdown in growth, going forward.

- **Other income up 37% yoy, adjusted net profits up 15% - Challenging the 25% benchmark**

Other income from operations at Rs898mn increased 37% yoy driven by higher dividend income. Adjusted for Q3FY08 extra-ordinary income of Rs1.2bn on sale of stake in Life Insurance subsidiary and BPO business, net profits are up 15% yoy. Slowing growth in net profits clearly challenges the management benchmark of consistent growth of 25%, which has helped HDFC command premium valuations.

- **NPAs under control - but can the good times last?**

Non performing assets (NPAs) reduced to 1.01% in Q3FY09 from 1.12% in Q3FY08, lower than our estimates of 1.25%. We estimate NPAs to rise to 2%-3% in FY10E due to deteriorating economy. Almost 30% of the loan book comprises corporate borrowers; of which, 66% constitutes project finance to real estate developers and lease rental discounting. Our channel checks indicate that many real estate developers are facing severe liquidity issues, and most of the projects have come to a halt. HDFC's NPAs in the corporate segment has been ~1%, which we estimate will rise to 2%-3% in FY10E.

- **Changing liabilities profile - Rising share of public deposits**

**Table 2: Breakup of Loan Funds** (Rs mn)

	Q3FY08	% of Total	Q3FY09	% of Total
Term Loans	201,820	31.8	225,305	27.6
Debentures	321,303	50.6	415,487	50.9
Public Deposits	112,088	17.6	175,512	21.5
Total	635,211	100.0	816,304	100.0

Source: Brics Research

Share of public deposits has increased to 21.5% in Q3FY09 vis-à-vis 17.6% in Q3FY08, clearly indicating HDFC's difficulty in raising resources in wholesale markets. We estimate public deposits to be a major source of funding in the short run due to liquidity constraints in wholesale debt markets

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### Management Guidance:

- Interest spreads to be maintained**

Interest spreads are likely to be maintained in the range of 2.1%-2.2%, going forward. We estimate pressure in FY10E, as growth in corporate loans slows down significantly, which has been one of the growth drivers for ROE.

- NPAs to be under check**

Management does not expect any increase in NPAs. We are of the view that NPAs will rise to around 2%-3% from current levels of ~1% on exposure to commercial real estate and slowing economy.

### Valuations expensive - 13% downside expected from current levels

At the current market price of Rs1372, the stock is quoting at 14.6x FY09E earnings and 2.7x FY09E book value. We value HDFC's core business at Rs742 (refer to table 7). Valuations of subsidiaries at Rs416 imply a fair value of Rs1183 (refer to table 3 & 4), representing 13% downside from current levels.

HDFC is expected to underperform the financial services space in the short run due to (i) High exposure to commercial real estate which has seen significant slowdown and liquidity concerns, resulting in high NPAs going forward (ii) Slowdown in lending to retail borrowers (iii) Drop in the value of subsidiaries due to derating of the financial services sector. Recommend SELL

**Table 3: Sum-of-parts valuation**

	Valuation Metric	Value (INR mn)	Value / Share (INR)
Core Business	DDM	210,754	742
Subsidiaries	SOP	118,174	416
Unrealized gains on Investments		7,167	25
Firm Value		336,095	1,183

Source: Brics Research

**Table 4: Sum-of-parts valuation details**

Subsidiary	Value (Rs mn)	Basis for Valuation	HDFC's stake (%)	HDFC's value (Rs mn)	Value/Share (Rs)
HDFC Bank	230,360	Target Price of Rs650	23.3	53,605	189
HDFC Standard Life	68,740	12x FY10E NBAP	74.0	50,868	179
HDFC Asset Management Company	11,667	2.5% of Equity AUM & 1% of Debt AUM	60.0	7,000	25
HDFC Ergo General Insurance	3,351	12x FY09E combined surplus	74.0	2,480	9
Gruh Finance Limited	3,812	2x FY08 Book Value	61.5	2,344	8
Venture Capital / Real Estate Funds	2,332	5% of AUM	80.5	1,877	7
Total Value of Subsidiaries	320,262			118,174	416

Source: Brics Research

**Table 5: Valuations\***

	CMP (Rs)	Mkt Cap (Rs mn)	Avg Vol (Nos)	PE (x)			ROE (%)			PB (x)			ROA (%)		
				FY08	FY09E	FY10E	FY08	FY09E	FY10E	FY08	FY09E	FY10E	FY08	FY09E	FY10E
HDFC	1,377	391,012	2,153,150	23.1	14.6	16.9	29.9	20.5	19.4	4.5	2.7	2.4	3.1	2.8	2.5
Lic Housing Fin	221	18,770	872,806	4.8	4.0	3.7	22.9	23.6	20.9	1.0	0.9	0.7	1.9	1.9	1.8
Axis Bank Limited	414	148,544	4,734,857	13.0	9.6	7.9	17.4	16.1	17.4	1.7	1.5	1.3	1.2	1.2	1.1
ICICI Bank Ltd	376	419,113	15,267,190	11.7	10.5	8.8	9.9	8.4	9.3	0.9	0.8	0.8	0.8	1.0	1.1
HDFC Bank Ltd	894	379,261	2,266,276	19.2	16.9	13.8	17.7	16.4	16.8	2.7	2.5	2.0	1.4	1.3	1.4
Bank of Baroda	242	88,298	1,405,530	5.7	5.3	4.7	15.3	15.4	16.1	0.8	0.8	0.7	0.9	0.8	0.8
Bank of India	248	130,217	3,317,115	6.2	5.2	4.5	23.5	23.7	22.5	1.2	1.1	1.0	1.2	1.3	1.2
Punjab National Bank	432	136,447	1,055,289	6.2	5.7	4.9	18.3	19.5	19.2	1.0	1.0	0.9	1.2	1.1	1.1
State Bank India	1,089	690,686	4,259,559	6.8	8.1	7.2	17.3	15.1	14.9	1.1	1.1	1.0	1.0	1.0	1.0

\* Bloomberg consensus estimates

**Table 6: Profit and Loss a/c**
**(Rs mn)**

Period Ending	31-Dec-07	30-Sep-08	31-Dec-08	y-o-y (%)	q-o-q (%)
Interest Earned	19,815	25,034	28,280	42.7	13.0
Interest Paid	13,160	17,573	20,427	55.2	16.2
Net Interest Income	6,656	7,461	7,853	18.0	5.2
Interest Spread (%)	2.3		2.1		
Other Income from Operations	654	1,117	898	37.3	-19.6
Total Income	7,310	8,578	8,751	19.7	2.0
Total Expenditure	785	1,034	1,006	28.1	-2.7
Profit before Other Income and exceptional items	6,525	7,545	7,745	18.7	2.7
Other Non-operating Income	1,078	55	71	-93.4	28.8
Profit before exceptional items	7,602	7,600	7,816	2.8	2.8
Exceptional Items	1,209	-	-	-100.0	-
Profit before tax	8,812	7,600	7,816	-11.3	2.8
Tax	2,323	2,258	2,348	1.1	4.0
Net Profit	6,489	5,342	5,468	-15.7	2.4
Adjusted Net Profit	4,719	5,342	5,420	14.9	1.5
Equity Capital	2,816	2,842	2,845	1.0	0.1
Basic EPS after Extraordinary items	23.5	18.8	19.2		

*Source: Brics Research*

**Table 7: Valuation of HDFC Bank using dividend discount model**

Initial growth rate (%)	20
Final growth rate (%)	5
Discounting rate (%)	13.5
Step decrease in growth rate (%)	2.5
Sustainable ROE (%)	22.0
Leverage	12.0
Sustainable RoA (%)	1.8
P/BV	2.0

	(Rs mn)									
	2006	2007	2008	2009	2010	2011	2012	2013	2014	Terminal
Earnings	11,292	14,525	17,313	20,557	23,085	25,049	29,062	34,293	40,465	42,489
growth rate - earnings (%)			19	19	12	9	16	18	18	5
growth rate - RWA (%)				20	18	18	18	18	18	5
Payout ratio (%)			25	25	25	25	25	25	25	77
Dividend			4,328	5,139	5,771	6,262	7,265	8,573	10,116	386,260
Dividend/shr			15	18	20	22	26	30	36	1,360
Retained earnings				15,417	17,314	18,786	21,796	25,720	30,349	
Discount factor			1.0	0.9	0.8	0.7	0.6	0.5	0.5	0.5
Value			4,328	4,528	4,480	4,283	4,378	4,552	4,732	180,678
Value/shr			15	16	16	15	15	16	17	636
Mcap	211,959									
Less NPA	(1,205)									
Value	210,754									
Shares outstanding	284									
Share price adjusted for further dilution	742									

Source: Brics Research

<b>Income Statement</b>		<b>(Rs mn)</b>				
<b>Year ended 31 March</b>	<b>FY06</b>	<b>FY07</b>	<b>FY08</b>	<b>FY09E</b>	<b>FY10E</b>	
Interest income	37,066	53,140	77,840	99,056	119,918	
- on advances	34,613	48,502	72,164	92,813	113,050	
- on others	2,453	4,638	5,676	6,244	6,868	
Interest expense	(24,911)	(36,669)	(51,429)	(66,721)	(83,046)	
Net interest income	12,155	16,472	26,411	32,335	36,873	
Non-interest income	5,718	5,822	10,483	8,508	8,196	
Fee/Commission income	675	686	632	771	926	
Other operating income	2,681	1,884	2,156	1,580	1,730	
Trading gains/(losses)	2,362	3,253	7,695	6,156	5,541	
Operating income	17,873	22,294	36,894	40,843	45,069	
Core operating income	15,511	19,041	29,199	34,687	39,529	
Operating expenses	(2,150)	(2,366)	(2,839)	(3,271)	(3,777)	
Employee expenses	(803)	(913)	(1,178)	(1,414)	(1,696)	
Administrative expenses	(1,159)	(1,279)	(1,495)	(1,690)	(1,911)	
Depreciation	(187)	(175)	(166)	(168)	(169)	
Operating profit	15,723	19,928	34,055	37,573	41,293	
Provision Charges	(150)	(250)	(320)	(409)	(450)	
Bad and doubtful debts charge	(150)	(250)	(320)	(409)	(450)	
Other provisions						
Profit before tax and exceptionals	15,573	19,678	33,735	37,164	40,842	
Exceptionals	0	0	0	0	0	
Profit before tax	15,573	19,678	33,735	37,164	40,842	
Tax provided	(3,000)	(3,974)	(9,373)	(10,406)	(11,436)	
Net profit	12,573	15,704	24,362	26,758	29,406	
Adjusted profit	11,292	14,525	17,313	20,557	23,085	

<b>Balance Sheet</b>		<b>(Rs mn)</b>				
<b>Year ended 31 March</b>	<b>FY06</b>	<b>FY07</b>	<b>FY08</b>	<b>FY09E</b>	<b>FY10E</b>	
Cash	417	1,014	837	14,201	35,658	
Balances with RBI	1	1	0	0	0	
Balances with other banks	11,598	12,718	6,940	7,495	8,095	
Net advances	449,901	565,124	729,979	905,486	1,095,405	
Investments	38,762	36,662	69,150	76,350	92,379	
Investments in government securities	3,217	3,217	3,093	3,402	3,742	
Other investments	35,546	33,445	66,058	72,948	88,637	
Other interest earning assets	29,486	36,129	32,938	37,879	43,561	
Interest earning assets	530,165	651,647	839,845	1,041,411	1,275,097	
Fixed assets	2,474	2,131	2,085	2,189	2,299	
Other assets	1,342	1,934	2,275	849	892	
Total assets	533,980	655,712	844,205	1,044,450	1,278,288	
Deposits from customers	87,230	103,693	112,782	124,061	136,467	
Borrowings	379,797	468,085	578,550	741,824	940,693	
Other interest bearing liabilities	185	151	180	189	199	
Interest bearing liabilities	467,211	571,929	691,512	866,073	1,077,358	
Other liabilities	22,085	28,269	33,220	36,542	40,196	
Total liabilities	489,296	600,198	724,732	902,615	1,117,554	
Shareholders funds	44,683	55,514	119,473	141,835	160,734	
Capital	2,496	2,530	2,840	2,840	2,840	
Reserves and surpluses	42,188	52,984	116,633	133,831	152,730	
Total liabilities and equity	533,980	655,712	844,205	1,044,450	1,278,288	

Year ended 31 March	FY06	FY07	FY08	FY09E	FY10E
<b>Basic data</b>					
No. of shares outstanding	250	253	284	284	284
Avg. no. of shares outstanding	250	253	284	284	284
Market capitalisation	333,612	384,525	675,930	389,695	389,695
<b>Per share data</b>					
EPS	50.4	62.1	85.8	94.2	103.5
Adj. EPS	45.3	54.1	60.2	72.4	81.3
DPS	20.0	22.0	25.0	28.3	31.1
BVPS	179.1	219.4	420.6	499.4	565.9
<b>Profitability</b>					
RoE (%)	30.1	31.3	27.8	20.5	19.4
Adj. RoE (%)	26.2	24.1	21.8	20.7	21.6
RoA (%)	2.6	2.6	3.3	2.8	2.5
Adj. RoA (%)	2.4	2.4	2.3	2.2	2.0
<b>Growth ratios</b>					
Operating income growth (%)	23.2	24.7	65.5	10.7	10.3
Core operating income growth (%)	21.5	22.8	53.3	18.8	14.0
Operating cost growth (%)	19.3	10.1	20.0	15.2	15.5
Operating profit growth (%)	23.7	26.7	70.9	10.3	9.9
Net profit growth (%)	21.3	24.9	55.1	9.8	9.9
EPS growth (%)	21.1	23.2	38.2	9.8	9.9
Adj. EPS growth (%)	18.7	19.5	11.3	20.3	12.3
BVPS growth (%)	14.9	22.5	91.7	18.7	13.3
Advances Growth (%)	24.9	25.6	29.2	24.0	21.0
<b>Yields</b>					
Yield on advances (%)	8.6	9.6	11.1	11.4	11.3
Yield on investments					
Yield on interest earning assets (%)	7.8	9.0	10.4	10.5	10.4
Cost of deposits					
Cost of liabilities (%)	6.0	7.1	8.1	8.6	8.6
NIM (%)	2.6	2.8	3.5	3.4	3.2
Interest spread (%)	1.8	1.9	2.3	2.0	1.8
<b>Efficiency ratios</b>					
Cost-income ratio (%)	12.0	10.6	7.7	8.0	8.4
Core cost-income ratio (%)	13.9	12.4	9.7	9.4	9.6
Staff costs to total costs (%)	37.4	38.6	41.5	43.2	44.9
Operating costs to assets (%)	0.4	0.4	0.4	0.4	0.3
Assets per employee	398	472	603	720	852

Year ended 31 March	FY06	FY07	FY08	FY09E	FY10E
<b>Dupont analysis</b>					
Net interest income (%)	2.5	2.8	3.5	3.4	3.2
Non-interest income (%)	1.2	1.0	1.4	0.9	0.7
Trading profit (%)	0.1	0.1	0.0	0.0	0.0
Operating income (%)	3.7	3.8	4.9	4.3	3.9
Operating costs (%)	-0.5	-0.4	-0.4	-0.4	-0.3
Pre-provision profits (%)	3.3	3.4	4.5	4.0	3.6
Provisions (%)	0.0	0.0	0.0	0.0	0.0
Bad debt provisions (%)	0.0	0.0	0.0	0.0	0.0
<b>Other provisions</b>					
PBT (%)	3.3	3.3	4.5	3.9	3.5
Tax (%)	-0.6	-0.7	-1.3	-1.1	-1.0
ROA (%)	2.6	2.4	3.0	2.6	2.3
Leverage	11.5	11.9	8.6	7.2	7.7
ROE (%)	29.4	28.3	26.0	18.9	17.7
<b>Asset quality</b>					
Gross NPLs	4,464	5,338	5,338	6,338	9,338
Net NPLs	659	934	614	1,205	3,755
Gross NPLs (%)	1.0	0.9	0.7	0.7	0.9
Net NPLs (%)	0.2	0.2	0.1	0.1	0.3
PL provisions/avg. loans (%)	0.0	0.1	0.1	0.1	0.1
Inc. NPA/avg. loans (%)	0	0.0	0.0	0.5	0.5
<b>Capitalisation ratios</b>					
Tier 1 ratio (%)	8.5	7.6	14.6	13.7	12.7
Tier 2 ratio (%)	6.5	5.3	2.2	3.8	3.1
CAR (%)	15.0	12.9	16.8	17.5	15.7

#### Valuations

Year ended 31 March	FY06	FY07	FY08	FY09E	FY10E
P/E	27.2	22.1	16.0	14.6	13.3
P/Adj. E	30.3	25.4	22.8	19.0	16.9
P/BV	7.7	6.3	3.3	2.7	2.4
Dividend yield	1.5	1.6	1.8	2.1	2.3

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