

12 February 2007

HDFC

Reuters: **HDFC.BO** Bloomberg: **HDFC IN** Exchange: **BSE** Ticker: **HDFC**

Quite at home; raising TP to above consensus

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Changing target price and upgrading rating

This note marks the transfer of coverage from Thomas Quarmby to Dipankar Choudhury. We are upgrading the rating from Hold to Buy, and the target price from Rs1350 to Rs2200, due partly to moving to Mar'09E-based valuation and partly to a higher component of value from affiliates.

Catalysts in yields gaining momentum and value unlocking drawing near

Consistent firming up of home loan rates, with banks not hesitating to edge out prospective on-the-fence borrowers, bodes well for HDFC's competitive position, which was relatively weak in the first phase of rate increase. Banks now have an internal compulsion to slow down this fast-growing segment, to match deposit growth. We also believe that value realisation of subsidiaries is near – maybe 6-9 months – with possible listings of the insurance and BPO businesses.

Lending growth to cool off at worst, margins could improve

A combination of dynamic resource-raising and increased access to deposits should help HDFC maintain home loan spreads. Permission to raise external commercial borrowings could help cut costs further. More recently, due to RBI tightening real estate lending by banks, HDFC is seeing increased pricing power in this segment of its business, about 30% of its total lending. We have built in a tempering of loan growth for HDFC from 24.9% in FY07E to 20% in FY09E.

Sum-of-parts-based TP Rs2200; rate volatility the key risk

Valuing the basic business on P/E to EPS growth, life business on new business achieved profit (NBAP), stake in HDFC Bank on the latter's target price, the AMC business on AUM and the rest on earnings, we reach a fair value of Rs2200, which is 10% higher than the highest in the street (see p. 10). Further increase in interest rate volatility and requirement to amortise the foreign currency convertible bonds (FCCB) redemption premium are key risks.

Forecasts and ratios

Year End Mar 31	2005A	2006A	2007E	2008E	2009E
Provisioning (INRm)	140.0	150.0	218.0	319.7	471.9
Pre-prov profit (INRm)	12,707.9	15,723.0	19,664.0	23,872.3	29,069.4
Net profit (INRm)	10,365.9	12,573.0	15,338.3	18,342.2	22,271.5
EPS (INR)	41.82	50.43	61.46	73.50	89.24
EPS growth (%)	20.5	20.6	21.9	19.6	21.4
PER (x)	15.8	20.2	29.6	24.7	20.4
Price/book (x)	4.66	7.46	8.59	7.24	6.07
DPS (net) (INR)	17.00	20.00	24.58	29.40	35.70
Yield (net) (%)	2.6	2.0	1.4	1.6	2.0

Source: Deutsche Bank estimates, company data

¹ DB EPS is fully diluted and excludes non-recurring items

² Multiples and yields calculations use average historical prices for past years and spot prices for current and future years, except P/B which uses the year end close

Transferring Coverage

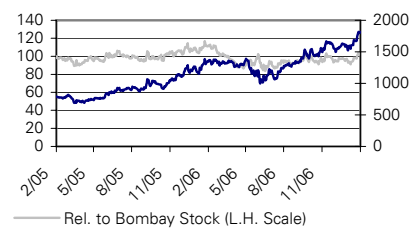
Buy

Price at 9 Feb 2007 (INR)	1,816.30
Price target - 12mth (INR)	2,200.00
52-week range (INR)	1,817.25 - 997.10
Bombay Stock Exchange (BSE 30)	14,652

Key changes

Rating	Hold to Buy	↑	
Price target	1,350.00 to 2,200.00	↑	63.0%
Provisioning (FYE)	234.1 to 218.0	↓	-6.9%
Net int margin (FYE)	2.76 to 3.03	↑	9.7%
Net profit (FYE)	14,084.3 to 15,338.3	↑	8.9%

Price/price relative



Performance (%)	1m	3m	12m
Absolute	16.4	20.8	35.3
Bombay Stock Exchange (BSE 30)	8.0	11.5	45.9

Stock data

Market cap (INRm)	453,276
Market cap (USDm)	10,275
Shares outstanding (m)	249.6
Major shareholders	Citigroup (10%)
Free float (%)	87

Key indicators

ROE (%)	31.5
Loan/deposit ratio (%)	429.0
Book value/share (INR)	211.50
Price/book (x)	8.6
NPL/total loans (%)	1.0
Net int margin (%)	3.03

Upcoming events

Event	Date
DB Namaste India Conference Hyderabad	5-8 Mar 2007

DB vs. consensus (Rs)

	FY08E EPS	TP
Mean	69.4	1,607
Highest	73.6	2,000
Lowest	61.7	1,200
DB estimate	73.5	2,200

Source: Bloomberg, DB

Deutsche Bank AG/Hong Kong

All prices are those current at the end of the previous trading session unless otherwise indicated. Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies.

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DISCLOSURES AND ANALYST CERTIFICATIONS ARE LOCATED IN APPENDIX 1

Model updated: 9 February 2007

Equity Research

Asia

India

Banking/Finance

HDFC

Reuters code **HDFC.BO**

Buy

Price as at 08-Feb **Rs1,807.70**

Target Price **Rs2,200.00**

Company Website **http://www.hdfc.com**

Company description

Housing Development Finance Corporation Ltd. (HDFC) provides housing finance in India. The Company provides long-term housing loans to low and middle income individuals, as well as to corporations. HDFC also provides construction finance to real estate developers, besides providing lease financing facilities to companies and development authorities for infrastructure and other assets.

Research Team

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Y/E 31 March	2001	2002	2003	2004	2005	2006	2007E	2008E	2009E
DATA PER SHARE									
EPS (stated) (Rs)	39.60	47.98	37.71	34.69	41.82	50.43	61.46	73.50	89.24
EPS FD (stated) (Rs)	38.96	46.71	37.31	34.28	41.52	48.61	57.84	69.17	83.99
EPS FD (DB adj.) (Rs)	38.96	46.71	37.31	34.28	41.52	48.61	57.84	69.17	83.99
Growth Rate - EPS (stated) (%)	17.4	21.1	-21.4	-8.0	20.5	20.6	21.9	19.6	21.4
DPS	12.50	15.00	11.00	13.50	17.00	20.00	24.58	29.40	35.70
BVPS (stated) (Rs)	197.53	222.07	124.54	137.62	155.87	179.05	211.50	250.90	299.06
BVPS (DB adj.) (Rs)	197.53	222.07	124.54	137.62	155.87	179.05	211.50	250.90	299.06
Average market cap (Rs m)	30,545	39,694	60,267	123,078	164,346	253,309	452,106	452,106	452,106
Shares in issue (m)	120	122	244	247	249	250	250	250	250

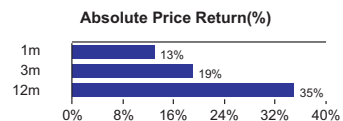
VALUATION RATIOS & PROFITABILITY MEASURES									
P/E (stated)	6.4	6.8	8.7	14.4	15.9	20.1	29.4	24.6	20.3
P/E FD (stated)	6.6	7.0	8.8	14.6	16.0	20.9	31.3	26.1	21.5
P/E FD (DB adj.)	6.6	7.0	8.8	14.6	16.0	20.9	31.3	26.1	21.5
P/B (stated)	1.38	1.54	2.66	4.68	4.66	7.46	8.55	7.20	6.04
P/B (DB adj.)	1.38	1.54	2.66	4.68	4.66	7.46	8.55	7.20	6.04
ROE (stated) (%)	21.2	22.9	24.0	26.5	28.5	30.1	31.5	31.8	32.5
ROA (stated) (%)	2.88	2.95	2.89	2.92	2.86	2.74	2.66	2.55	2.54
Dividend yield (%)	4.89	4.57	3.34	2.69	2.56	1.97	1.36	1.63	1.97
Dividend cover (x)	3.17	3.20	3.43	2.57	2.46	2.52	2.50	2.50	2.50
Payout ratio (%)	31.7	52.5	38.9	39.1	40.9	39.7	40.0	40.0	40.0

PROFIT & LOSS (Rs m)									
Net interest income	3,296	4,779	6,259	8,123	9,727	12,938	16,010	19,441	23,482
Non-interest income	3,631	3,510	3,800	3,919	4,780	4,935	6,176	7,372	9,012
Fees & Commissions	1,028	1,122	1,087	1,259	1,017	675	605	744	976
Trading revenue	853	1,043	1,075	1,308	1,741	2,362	3,609	4,435	5,566
Insurance revenue	0	0	0	0	0	0	0	0	0
Dividend income	1,217	760	967	866	872	1,080	1,261	1,414	1,584
Other revenue	533	585	670	486	1,150	819	702	780	886
Total revenue	6,927	8,289	10,058	12,043	14,507	17,873	22,186	26,813	32,495
Total Operating Costs	1,291	1,297	1,458	1,663	1,799	2,150	2,523	2,941	3,425
Pre-Provision profit / (loss)	5,637	6,992	8,600	10,380	12,708	15,723	19,664	23,872	29,069
Bad debt expense	80	83	90	110	140	150	218	320	472
Operating Profit	5,557	6,909	8,510	10,270	12,568	15,573	19,446	23,553	28,598
Goodwill	0	0	0	0	0	0	0	0	0
Pre-tax associates	0	0	0	0	0	0	0	0	0
Extraordinary & Other items	0	0	0	0	0	0	0	0	0
Pre-tax profit	5,557	6,909	8,510	10,270	12,568	15,573	19,446	23,553	28,598
Tax	820	1,109	1,607	1,752	2,202	3,000	4,108	5,210	6,326
Minorities	0	0	0	0	0	0	0	0	0
Preference dividends	0	0	0	0	0	0	0	0	0
Stated net profit	4,737	5,800	6,903	8,518	10,366	12,573	15,338	18,342	22,272
DB adj. core earnings	4,737	5,800	6,903	8,518	10,366	12,573	15,338	18,342	22,272

KEY BALANCE SHEET ITEMS (Rs m) & CAPITAL RATIOS									
Risk weighted assets	163,608	195,731	243,358	299,026	379,415	479,231	599,050	746,327	897,890
Interest-earnings assets	150,451	190,309	234,385	297,248	378,291	471,320	584,464	725,846	870,017
Total loans	134,119	174,035	220,623	283,174	363,884	453,706	562,106	687,767	825,298
Total deposits	72,498	84,910	91,215	93,376	78,401	87,414	131,038	183,386	238,351
Stated Shareholder Equity	23,719	27,028	30,439	33,938	38,831	44,683	52,781	62,614	74,633
Preference share capital	0	0	0	0	0	0	0	0	0
Tier 1 capital	20,711	24,351	28,103	30,730	34,705	36,651	44,308	53,749	65,458
Tier 1 ratio (%)	12.70	13.50	14.50	13.30	12.10	8.50	8.22	7.83	7.81
Tangible equity / total assets (%)	13.29	12.60	11.58	10.58	9.58	8.73	8.25	7.85	7.78

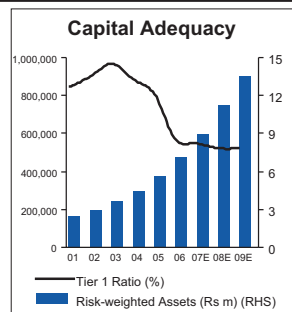
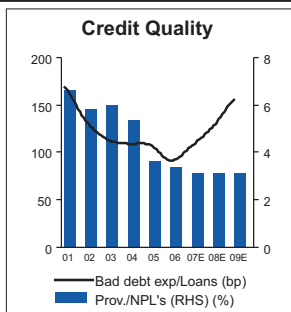
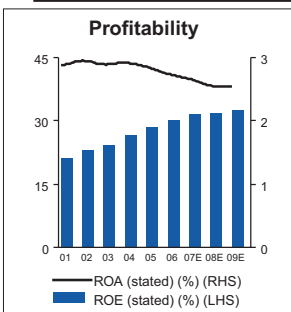
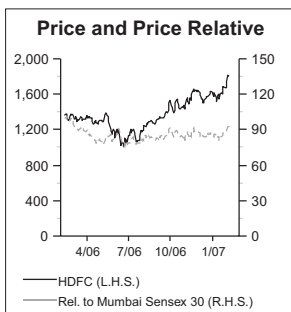
CREDIT QUALITY									
Gross NPLs / Total Loans (%)	0.84	0.92	0.95	0.91	1.13	0.98	0.97	0.98	0.97
Provisions / NPLs (%)	166.01	145.68	149.59	133.41	91.77	85.23	77.78	77.78	77.78
Bad debt chg / Avg loans (%)	0.07	0.05	0.05	0.04	0.04	0.04	0.04	0.05	0.06

GROWTH RATES & KEY RATIOS									
Growth in net interest income (%)	37.9	45.0	31.0	29.8	19.7	33.0	23.8	21.4	20.8
Growth in fee income (%)	35.8	9.1	-3.1	15.8	-19.2	-33.7	-10.4	23.1	31.1
Growth in non-interest income (%)	7.0	-3.3	8.2	3.1	22.0	3.2	25.1	19.4	22.2
Growth in revenues (%)	19.7	19.7	21.3	19.7	20.5	23.2	24.1	20.9	21.2
Growth in costs (%)	17.6	0.5	12.4	14.1	8.2	19.5	17.3	16.6	16.5
Pre-provision earnings growth (%)	20.2	24.0	23.0	20.7	22.4	23.7	25.1	21.4	21.8
Growth in bad debts (%)	0	3.1	9.1	22.2	27.3	7.1	45.4	46.6	47.6
Growth in RWA (%)	18.8	19.6	24.3	22.9	26.9	26.3	25.0	24.6	20.3
Growth in loans (%)	31.3	29.8	26.8	28.4	28.5	24.7	23.9	22.4	20.0
Growth in deposits (%)	16.5	17.1	7.4	2.4	-16.0	11.5	49.9	39.9	30.0
Loan-to-deposits ratio (%)	185.0	205.0	241.9	303.3	464.1	519.0	429.0	375.0	346.3
Net int. margin (%)	2.45	2.80	2.95	3.06	2.88	3.05	3.03	2.97	2.94
Cost income ratio (%)	18.6	15.7	14.5	13.8	12.4	12.0	11.4	11.0	10.5
Cost asset ratio (%)	0.8	0.7	0.6	0.6	0.5	0.5	0.4	0.4	0.4
Trading income / Total Rev (%)	12.3	12.6	10.7	10.9	12.0	13.2	16.3	16.5	17.1



52-week Range: **Rs997.10 - Rs1,817.25**
Market Cap (m): **Rs 452,106**
US\$ 10,275

Company identifiers
Bloomberg **HDFC IN**
Cusip **NA**
SEDOL **6171900**



Source: Deutsche Bank AG estimates, company data

Investment thesis

Outlook

While it is well-known that, after years of heady growth, mortgage lending is cooling off – bank mortgage lending growth has dropped to 32.3% in Sep'06 as against 44.6% in Mar'06 – this is less material for HDFC. The bank has hardly competed with the sector's growth and has always delivered a lower but steadier growth. However, we have built in a tempering of loan growth for HDFC as well, from 24.9% in FY07E to 20% in FY09E, with some of the industry effect rubbing off on them. Two distinct upside possibilities to this are real estate prices coming off and public sector banks competing less intensely.

A combination of dynamic resource-raising and increased access to deposits should help HDFC maintain home loan spreads, which is difficult to do in times of interest rate volatility as we see today. Permission to raise external commercial borrowings – not done for a long while now – could help cut costs further. More recently, due to RBI tightening real estate lending by banks, HDFC is seeing increased pricing power in this segment of its business, about 30% of its total lending. Lastly, though investments constitute a small portion of interest earning assets, HDFC's investment margins are not constrained, unlike those of banks that are required to put 25% of liabilities into investments, where yields are expected to remain steady due to high statutory demand and funding costs are rising.

Asset quality is expected to remain nearly as good as it is today, due to the less risky nature of mortgage lending, rapid rise in individual incomes and HDFC's historically choosy attitude to the business. We estimate NPLs to remain at the current level of ~1% during FY07E-FY09E. This scenario may improve (for the whole sector) as the credit bureau matures – HDFC is already using it actively. Capital position is comfortable even without assuming the FCCB conversion – with that, the Tier I may go up further to 12.3%.

Valuation

We value HDFC on sum-of-parts and reach a target price of Rs2200. The basic mortgage business is valued at 18x Mar'09E diluted EPS, based on the FY06-FY09E CAGR EPS of ~20% - HDFC has normally traded above EPS growth but we are taking a lower value to factor in the risk of earnings reduction if HDFC were to start amortising the FCCB redemption premium instead of passing it through the balance sheet. The life business is valued on multiples of new business achieved profit, asset management business on AUM, stake in HDFC Bank at the latter's target price and the rest on earnings.

Risks

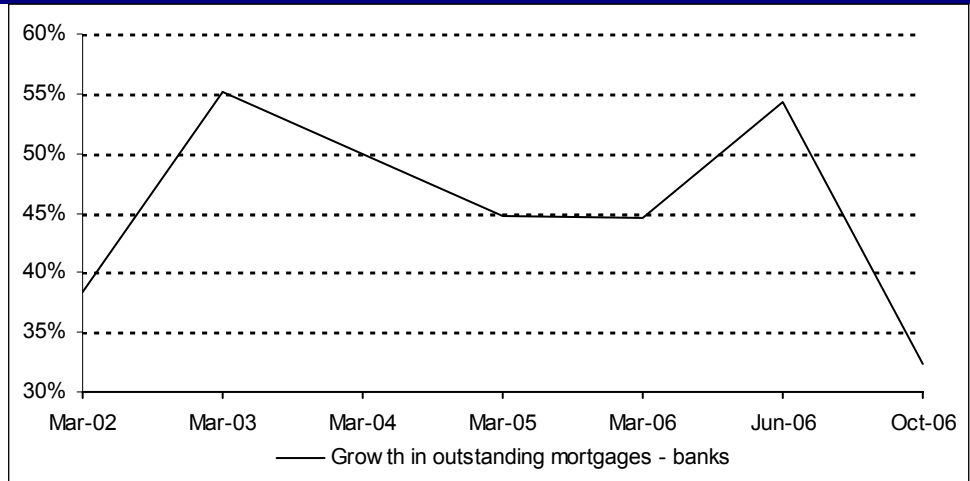
The three key company-specific risks are i) increased interest rate volatility, as HDFC does not have low-cost, fixed-cost liabilities, ii) the FCCB not converting and staying as debt, which is unlikely since the current market price is far ahead of the conversion price iii) the possibility of having to amortise the FCCB redemption premium rather than taking it through the balance sheet – we estimate an impact of 4.4% and 3.6% on FY08E and FY09E net profit respectively if that were to happen.

Lending: whither 'slowdown'?

Sector loan growth cooling off, but just that

The fact that after years of heady growth home loan growth is slowing down is apparent from several indicators – published and anecdotal. It is not the interest increases alone that have caused it but also high real estate prices. RBI data (which pertains only to commercial banks but is a good enough indicator) shows a tempering of loan growth (Figure 1).

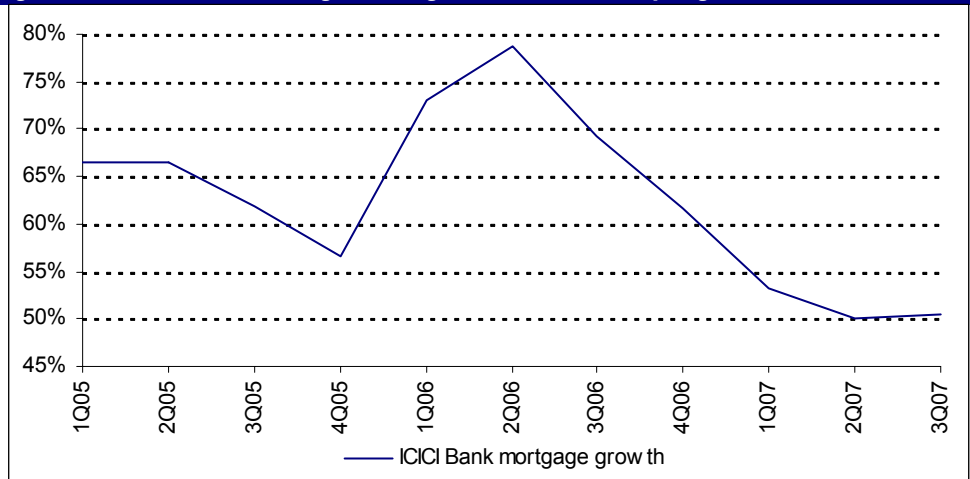
Figure 1: YoY home loan growth – commercial banks only



Source: RBI, Deutsche Bank

A more specific example – the growth rate of the largest player, ICICI Bank, has also been coming off (Figure 2). However, the number is still ~50% and is no cause for despondency, even if it were to go down a notch further. If these are the type of growth rates after home prices are up 100-300% from the bottom and interest rates are up 200-300bps, the growth in individual incomes should not be underestimated.

Figure 2: ICICI Bank – slowing on a larger base, but still rapid growth

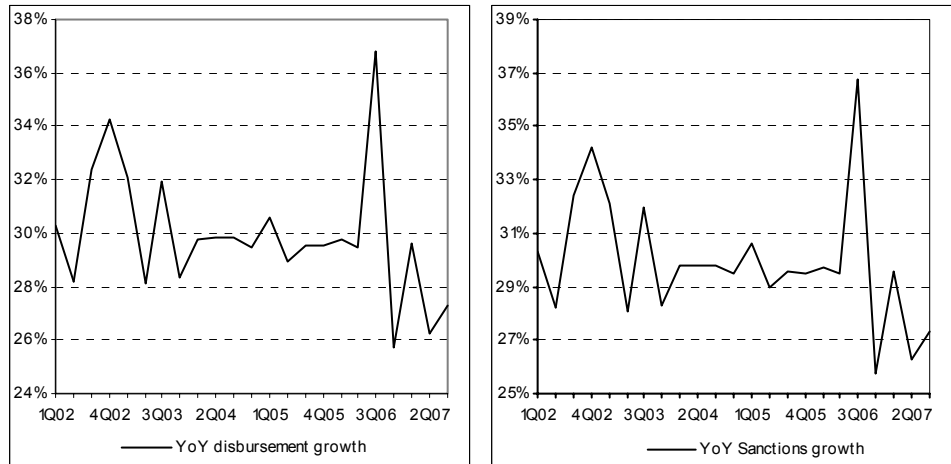


Source: Deutsche Bank

The above do not make a material difference to HDFC

That the above decline is predominantly a base-effect issue is clear from the observation that HDFC's own growth decline has been very modest (Figure 3).

Figure 3: Approvals and disbursements have fallen very marginally for HDFC



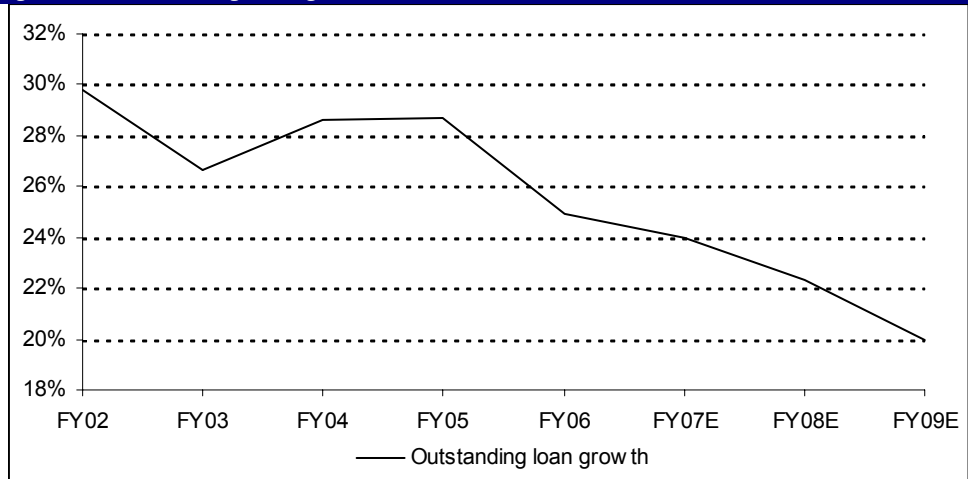
Source: Company data, Deutsche Bank

HDFC never competed with the industry growth rate, and has been reporting a steadier but lower growth. In fact, through most of the last five years, it has consciously kept its lending rates 25-50bps above competition (as yet it has not matched the last increase in rates by ICICI, but this is probably because it made one increase as recently as in Jan'07 itself).

Upside surprise cannot be ruled out

We are nevertheless factoring in slower lending growth by HDFC as the market base becomes bigger and some of the industry impact rubs off on them (Figure 4). Upsides are possible from two areas. Firstly, real estate price moderation may add further momentum to loan demand. Secondly, public sector banks (about 30% share) may compete less intensely as corporate lending is picking up and they have faced frauds in home loans.

Figure 4: Outstanding loan growth estimates for HDFC



Source: Company data, Deutsche Bank

Spreads: outlook favourable

Dynamic sourcing aiding loan spreads in tough environment

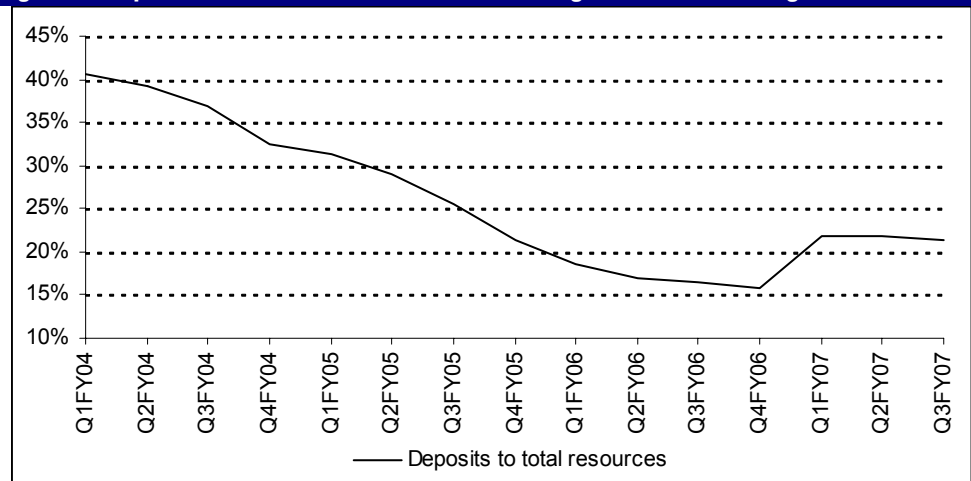
Greater diversity in funding

HDFC's strategy of keeping a matched book, as well as a predominantly borrowing-based resource profile, hurt spreads when rates started to move down in the late 1990s. Floating rate home loans had to be offered for the first time to match competition, and HDFC was stuck with very high-cost long-term borrowings. The problem took some time to mitigate and loan spreads were recovered in FY03.

With the preponderance of floating rate loans in the portfolio (despite some increase in the popularity of fixed-rate loans, due to a rising rate trend) and interest rate volatility, the act of matching and maintaining spreads is even more difficult. Currently HDFC is adopting a two-pronged approach to handle this situation.

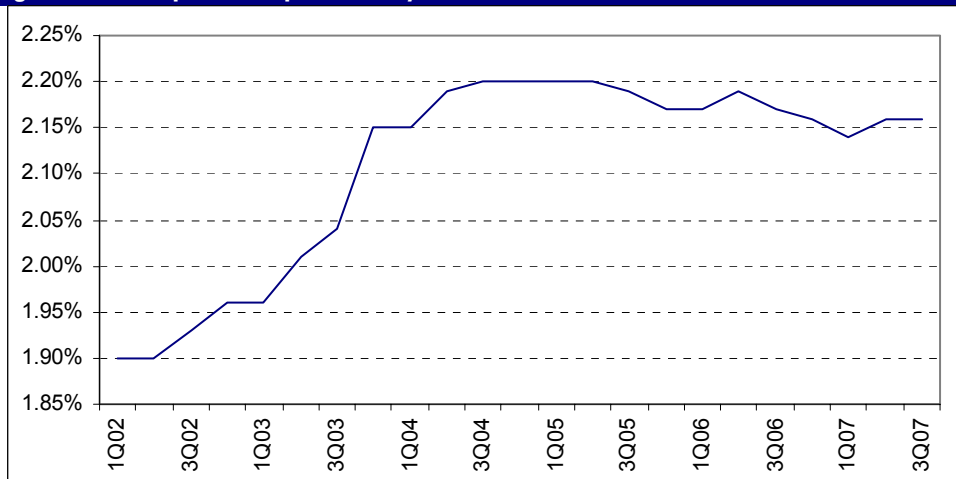
Firstly, resource-raising has been made more dynamic. For example, bank loans have now become very expensive and HDFC is switching partly to commercial paper, or even debentures (insurance and pension companies have enough appetite). Secondly, deposits have increased in importance (Figure 5). Though HDFC has raised deposit rates recently to re-activate a source which had been declining in importance, it is still cheaper than other forms of funding.

Figure 5: Deposits as % of total resources – starting to rise after a long decline



Source: Company data, Deutsche Bank

Quarterly trends indicate that HDFC has managed to do a good job with loan spreads for the last 3 years (Figure 6), a period when funding costs have only been going up.

Figure 6: Loan spreads – quite steady

Source: Company data, Deutsche Bank

Permission for more ECBs may help further

HDFC has not received permission to raise external commercial borrowings for a while (the last one was in 2003; note that foreign currency convertible bonds do not come under this category). Difficulties in managing debt-creating foreign exchange inflows are leading to RBI giving phased approvals to companies seeking to raise ECBs. As and when HDFC is in a position to raise ECBs, it will be another addition of a low-cost resource (even after hedging).

Investment spreads less constrained than banks

There is a marked difference between the outlook for investment spreads of banks and HDFC. Investments are a much smaller portion of HDFC's interest earning assets compared with banks, but the outlook for spreads is better for HDFC. This is because, unlike banks, HDFC is not required to put 25% of liabilities in government securities – and can match investments with type of resources. The somewhat artificial demand for government securities created by statutory requirements of banks (and insurance companies) is likely to keep government securities yields low, even as cost of funds rises. On the other hand, the general tightening and credit demand should see yields on non-gilt investments go up.

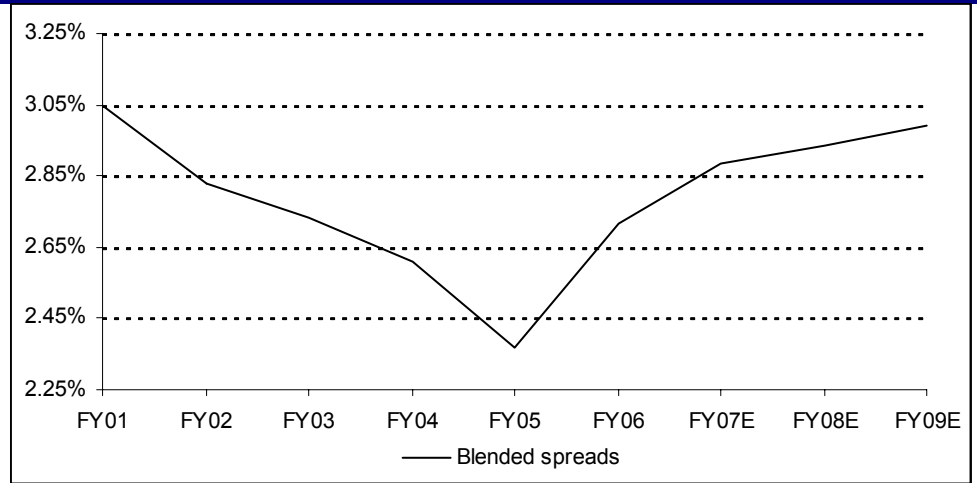
Positive kicker from commercial business yields

The 'corporate' business of HDFC, primarily loans to developers and builders, is now seeing considerable pricing power. The reason for this is RBI's moves to curb real estate lending by banks, which has led to banks vacating a lot of ground to HDFC. The central bank has progressively increased risk weight to 150% and general provisioning to 200bps (the last move was an increase from 100bps to 200bps). In addition RBI issued a circular to banks instructing them not to lend to developers unless they have all the requisite approval to develop, effectively ruling out loans for land purchase. These measures have made banks' lending to real estate a less attractive proposition than before.

This is 30% of HDFC's lending and hence very substantial. Like all forms of corporate lending, competition for assets during the period of excess liquidity had led to yields collapsing to levels that clearly mis-priced risk. Now the tide has clearly turned. HDFC continues to be choosy, as is usual in this segment of lending, but yields are better.

In a nutshell, we are expecting *blended* spreads to improve marginally (Figure 7).

Figure 7: Expecting spreads to improve



Source: Deutsche Bank

Comfortable capital position

Our Tier I estimates do not factor in FCCB conversion

The FCCB is taken as Tier II for mortgage companies. Even without assuming any conversion, HDFC will be comfortably capitalized on Tier I for the next two years. The situation changes for the better very materially if all the FCCBs are converted – the Tier I surges and opens up more headroom for Tier II. The likelihood of all FCCBs converting is very high as the current market price is ~28% higher than the conversion price.

Figure 8: Effect of FCCB conversion on capital structure

(FY07E)	Without conversion	With conversion
Tier I	8.22%	12.26%
Tier II	5.46%	1.29%
Total CAR	13.67%	13.55%

Source: Deutsche Bank

Regulator may allow perpetual debt

Banks have been permitted by the RBI to raise perpetual debt which qualifies for Tier I up to a specified limit. As yet, the housing finance regulator National Housing Bank has not allowed this for mortgage lending companies like HDFC. However, in the past it has been seen to follow RBI moves on home loans (such as increase in risk weights) with a lag. It is thus likely to permit perpetual debt as well some time in future. At this time there is no urgency on the part of housing finance companies for this instrument.

Asset quality – always good; could be getting better

Throughout the years HDFC has lost very little of its capital to bad loans. That is partly a function of the nature of the business – mortgages are not only a less risky form of lending but HDFC has 30 years' experience in the business. Some private sector banks' NPL outlook is being called into question because of the rapid growth in unsecured loan products, but this possibility does not exist for HDFC. Even some of the rare, chronic cases of HDFC have started paying up because of the increase in the value of the home.

There is one more, relatively under-emphasised, reason for better prospects for asset quality: the credit bureau. It has acquired critical mass by accumulating about 60m records. The management of HDFC mentioned that they are using it very actively. Our conversations with other banks also indicate increased used of the bureau. While a bureau cannot prevent existing loans from souring, it can reduce this risk for fresh loans.

Valuations

Our method of valuation of HDFC is sum-of-parts (just as we did for ICICI Bank), because of the substantial value coming from subsidiaries or other affiliates. We have once again valued the main mortgage business valued on a P/E to CAGR EPS basis, as we did for other private sector banks, keeping the P/E to growth ratio a notch below 1.0x. We have valued the affiliates separately and taken the unrealised gains into the target price computation. We discuss the major parts in detail below, and later summarise the results.

Mortgage business (i.e. HDFC standalone)

HDFC has historically traded off EPS growth, the P/E being slightly *higher* than the growth in EPS for the next year. However, we are assuming a P/E of 18x, which is slightly lower than the ~20% EPS CAGR, to factor in the risk of a downward revision to earnings if HDFC has to resort to FCCB premium amortisation instead of a balance sheet adjustment.

Figure 9: HDFC core business valuation

Earnings growth CAGR(F06-F09E)	20.13%
P/E Multiple Assumed	18.0x
Diluted EPS (FY2009) (Rs)	84.0
Business Value (Rs/share)	1,512

Source: Deutsche Bank

Life insurance

Note that HDFC's economic interest of 51% is considered and not the nominal 80%.

Figure 10: Valuation of stake in life company

Annualised premium equivalent (2009E)	38,878
Assumed NBAP Margin	22%
NBAP (Rs m)	8,553
Assumed Multiplier (based on sustainable growth rate of 15-20%)	16.0x
Estimated Value of Life Insurance business (Rs m)	136,850
HDFC's economic stake	51.0%
Cost of acquisition (Rs m)	3,155
Hence value per share (Rs)	267

Source: Deutsche Bank

Asset Management

A much smaller franchise was recently acquired for 5% for AUM, so this is conservative.

Figure 11: Valuation of asset management business

Assets under management by FY09E (Rs m)	656,198
HDFC's holding in Asset Management	50.1%
As % of assets (based on recent market transactions)	5%
Aggregate Value (Rs m)	32,810
Value attributable to HDFC (Rs m)	16,438
Cost of Acquisition (Rs m)	540
Per Share Value	64

Source: Deutsche Bank

HDFC Bank

The basis is not HDFC Bank's current market price but fair value, i.e. our target price.

Figure 12: Valuation of HDFC's stake in the bank

(Rs m)	
HDFC's Holding in HDFC Bank	22%
HDFC Bank Target Price	1,260
HDFC Bank No of Shares	314
HDFC Bank Target Market Cap	396,111
<hr/>	
HDFC's holding value	87,144
Cost of acquisition	1,507
<hr/>	
Per share contribution	343

Source: Deutsche Bank

Summary and conclusions

We reach our target price of Rs2200 (Figure 13) by summing up all the parts.

Figure 13: Final target price calculation

(Rs/HDFC share)		
Company	Value attributable	Remarks
HDFC - main business	1,512	PE Multiple of 18x assumed based on 20% earnings CAGR
HDFC Bank	343	Based on our target price of Rs 1,260 for HDFC Bank
Insurance - own stake	267	16x NBAP multiple with NBAP margin assumed at 22%
Insurance - on behalf of Standard Life	22	Pre-tax RoE on HDFC's investments for the 30% stake held as fiduciary
Intelenet Global Services	8	20x forward P/E multiple
Asset Management	64	5% of AUM
General Insurance	6	18x fwd P/E multiple
Gruh Finance	14	13x multiple on FY09E EPS, which is the current fwd multiple at which the company is trading
All other Subsidiaries	Minimal	
Total	2,234	
<hr/>		
Holding company discount	5%	
Net	2,198	
<hr/>		
ROUNDED OFF	2,200	

Source: Deutsche Bank

Update on affiliates

Asset management

HDFC Asset Management has been progressing very well on assets under management which have risen from Rs215.5bn on March 31, 2006 to Rs314.2bn on January 31, 2007. As equity assets have been rising in importance across the industry, it is likely that during this period the proportion of equity assets in the AUM has also risen, increasing the profitability. The company reported a net margin of 33% during FY06, up from 31% in FY05. It is among the top five AMC's in India on AUM.

Life insurance

HDFC owns approximately 80% in its life JV with Standard Life of UK. Of that, 51% is HDFC's 'own' stake and the balance of 30% is held 'on behalf of Standard Life'. This is because, as per their agreement, HDFC will have to sell this 30% to Standard Life as and when the rules governing foreign investment in insurance companies change. HDFC is expected to get a return on the 30% equivalent to its own pre-tax RoE, and not a 'market price', but these terms are not entirely clear and free from ambiguity. Gross written premiums rose 64.8% YoY during the April'06-November'07 period.

Non-life insurance

It is likely that HDFC and Chubb will separate as partners in their non-life JV. A decision on how that will happen is expected soon. We believe that it will be more feasible for HDFC (74% stake) to buy out Chubb and then look for a foreign partner (which is not necessary but desirable). HDFC is committed to the insurance business as it is distribution-dependent and is unlikely to sell out of it. Chubb cannot acquire HDFC's stake as per extant foreign investment rules on insurance, and has to find an Indian partner. Most of the capable (and interested) groups in India already have a presence in this business.

HDFC Bank

Unlike most mergers with a bank and conversions to a bank, which were driven by hard economic compulsions, a merger between HDFC and HDFC Bank does not have such a compelling rationale. However, we believe that, since HDFC is under-utilising its customer franchise by offering only mortgages and would ideally like to enjoy less volatility in funding cost through a chunk of low-cost funds, the management would like to consider a merger in the long run.

The main bottleneck at this point seems to be the 25% Statutory Liquidity Ratio (SLR) that banks are subjected to by regulation, which HDFC as a mortgage lender does not have to maintain (except for a small portion of its liabilities). If a merger takes place and a SLR-exemption is not given, then HDFC would have to find about Rs150bn in resources just for investing in government securities. This kind of liquidity is not only difficult to garner, but will most likely face negative carry – government securities yields are now less than (incremental) cost of term deposits.

As on Dec'06, HDFC Bank's loans increased 32.8% YoY and net profit 31.3% YoY during the Apr'06-Dec'06 period.

Business Process Outsourcing

We believe that, going by the success of recent listings of BPO companies in India, HDFC could be listing its BPO business Intelenet Global Services (HDFC owns 50%) sooner rather than later. However, the presence of a large client (contributing close to 40% of revenues), may influence the timing. This is not a financial services business and we do not believe HDFC would like to stay with it in the long term.

Appendix 1

Important Disclosures

Additional information available upon request

Disclosure checklist

Company	Ticker	Recent price*	Disclosure
Housing Development Finance Corp	HDFC.BO	1816.30 (INR) 9 Feb 07	6,14

*Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies.

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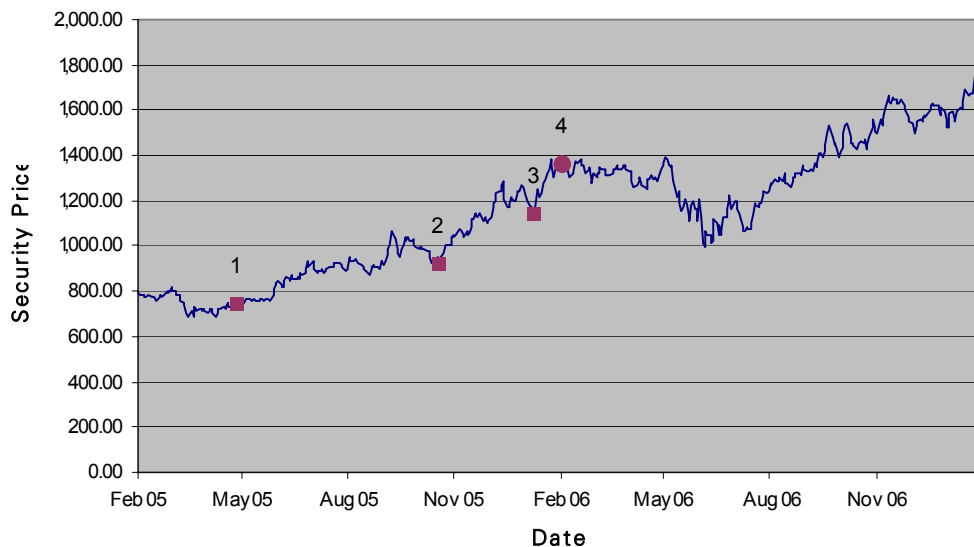
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Historical recommendations and target price: Housing Development Finance Corp (HDFC.BO)

(as of 2/9/2007)



Previous Recommendations

- Strong Buy
- Buy
- Market Perform
- Underperform
- Not Rated
- Suspended Rating

Current Recommendations

- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

*New Recommendation Structure as of September 9, 2002

1.	5/5/2005:	Buy, Target Price Change INR950.00	3.	18/1/2006:	Buy, Target Price Change INR1,350.00
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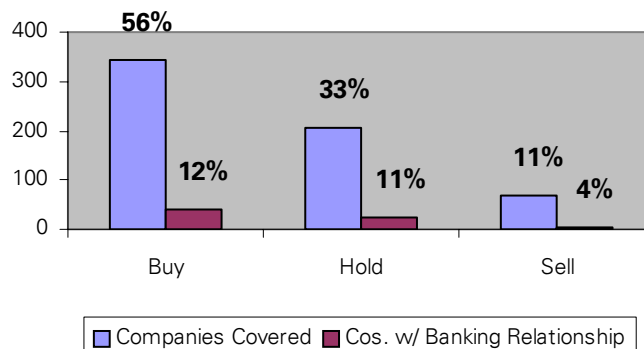
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