Update
SECTOR: BANKING

HDFC

STOCK INFO.	BLOOMBERG
BSE Sensex: 19,785	HDFC IN
	REUTERS CODE
S&P CNX: 5,912	HDFC.BO

Equity Shares (m)	277.6
52-Week Range	2,965/1,397
1,6,12 Rel.Perf.(%)	3/21/31
M.Cap. (Rs b)	755.0
M.Cap. (US$ b)	19.1

15 November 2007

Buy

Previous Recommendation: Buy

Rs2,720

YEAR END	NET INCOME (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	CAR (%)	ROAE (%)	ROAA (%)	P/ABV* RATIO
3/07A	22,294	15,704	62.1	23.2	31.1	8.8	13.0	31.3	2.8	12.4
3/08E	28,317	23,449	84.5	36.1	22.9	5.1	16.0	21.7	2.4	7.1
3/09E	35,226	23,771	82.8	-2.0	23.3	4.2	14.0	20.0	2.6	5.7
3/10E	43,884	29,889	104.1	25.7	18.5	3.6	14.0	20.9	2.7	5.0

** Book Value is adjusted by deducting investments in key ventures from net worth*

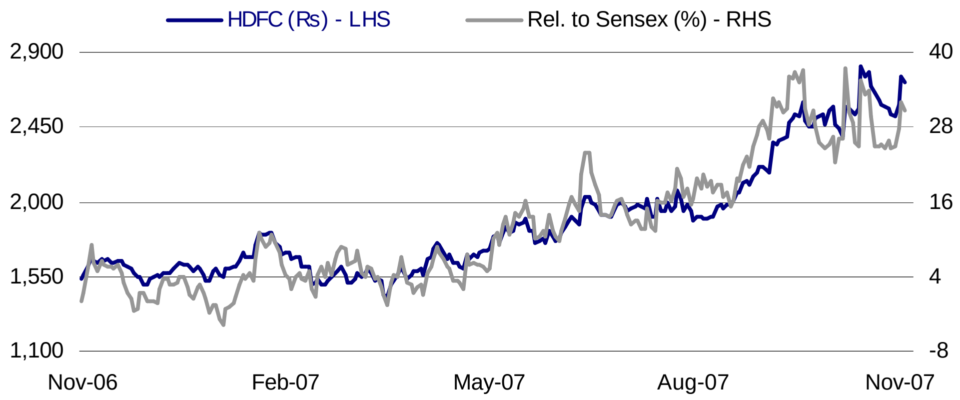
Remains 'ACE in the pack': HDFC's stronghold in the housing finance market has further strengthened with ICICI Bank and most state-owned banks going slow on mortgages. In 2QFY08, ICICI Bank's disbursements degrew 23% YoY whereas HDFC saw a 25% YoY growth. HDFC is confident of maintaining its asset growth rate at the traditional 25-30% over the next couple of years. We believe the slow down in the industry (mainly banks) will result in higher market share for HFCs, mainly the leader HDFC.

RBI regulations boon for HDFC; bane for banks: Even as funding costs have declined, banks are not yet decreasing lending rates as CRR hikes result in pressure on margins for banks. As HDFC need not maintain CRR, incremental spreads have widened for HDFC. Spreads improved to 2.3% in 2QFY08 from 2.2% in 1QFY08. Incremental spreads are running at 2.8-3%.

Earnings visibility extremely strong: Strong asset growth, improving spreads and significant capital gains would lead to strong profitability for HDFC in FY08. We expect core earnings growth to remain strong at a CAGR of 24% over FY07-10E.

Deserves premium valuations; maintain Buy: We believe HDFC deserves a premium valuation due to the continued traction in business and profitability, significant value unlocking from its various investments/ventures and supreme management capabilities. We value core lending business of HDFC at 24x FY10E earnings and its key strategic investments at Rs789 per share (post 20% holding company discount). We raise our target price to Rs3,288, implying an upside of 21%. We maintain **Buy.**

STOCK PERFORMANCE (1 YEAR)



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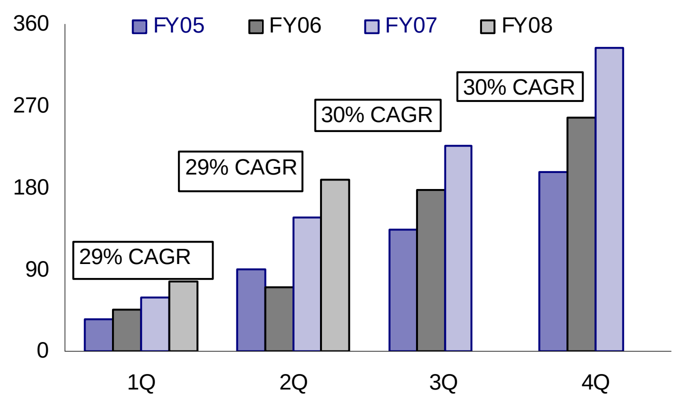
Remains 'ACE in the pack'

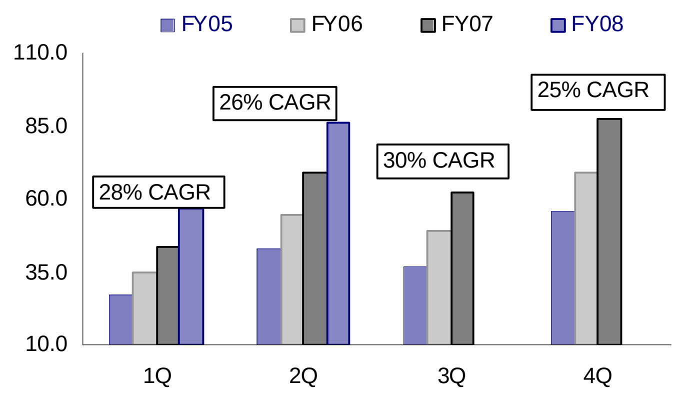
HDFC's stronghold in the housing finance market has further strengthened with ICICI Bank and most state-owned banks going slow on mortgages. In 2QFY08, ICICI Bank's disbursements degrew 23% YoY whereas HDFC saw a 25% YoY growth. HDFC is confident of maintaining its asset growth rate at the traditional 25-30% over the next couple of years. We believe the slow down in the industry (mainly banks) will result in higher market share for HFCs, mainly the leader HDFC.

CONSISTENT GROWTH IN APPROVALS AND DISBURSALS

QUARTERLY APPROVALS - STRONG (RS B)



QUARTERLY DISBURSEMENTS STRONG (RS B)

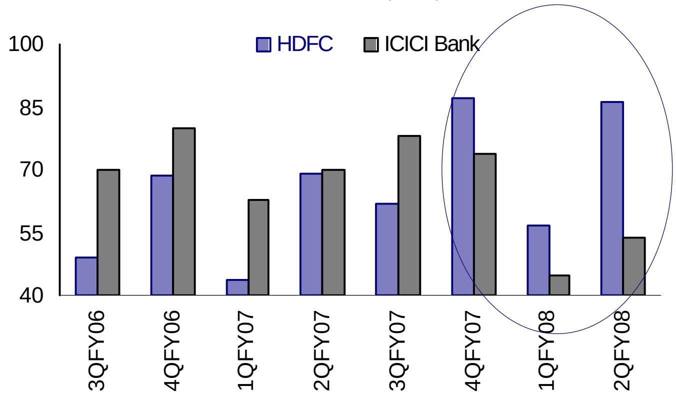


Source: Company/Motilal Oswal Securities

Consistency is the hallmark

Despite a slowdown in the overall mortgage disbursements, HDFC management is confident of maintaining the asset growth rate at the traditional 25-30% over the next couple of years. Even over the last six months, HDFC has not witnessed any slowdown and disbursements have grown by 27% YoY in 1HFY08.

DISBURSEMENTS - HDFC GAINING SHARE (RS B)



Source: Company/Motilal Oswal Securities

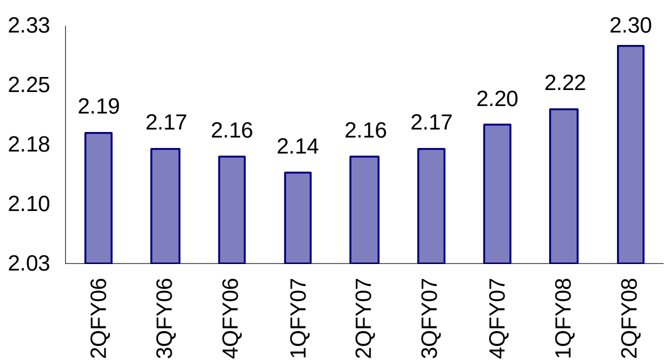
Regulatory requirements make housing finance unattractive for banks

With RBI raising CRR on a continuous basis, the cost of funds for the banking system continues to remain high, despite the declining trend in overall interest rates. Thus, banks are not yet reducing lending rates despite incremental funding costs declining. Further, owing to lower spreads, mortgages have not been an attractive proposition for many banks in the current environment.

Spreads to improve in FY08

Spreads improved to 2.3% in 2QFY08 and 2.27% in 1HFY08 as cost of funds declined for HDFC, while lending rates remained firm. Incremental spreads have improved to 2.8-3%. The management aims to maintain the spread in the historic range of 2.15%-2.20%. The management has been highly successful in playing the volatility in the interest rates over the past 12 months.

SPREAD (%)

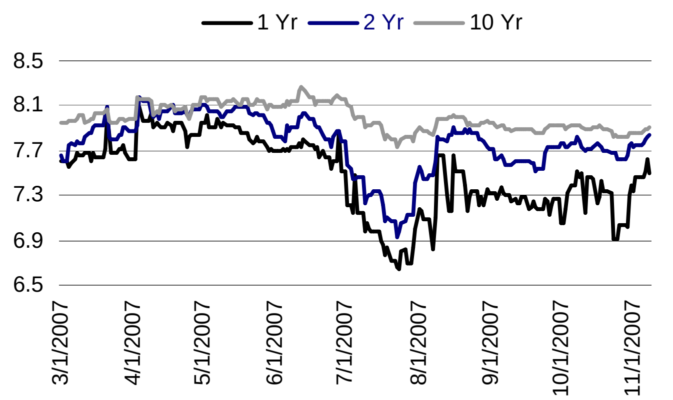


Source: Company/Motilal Oswal Securities

Cost of funds has reduced

Surplus liquidity in the system has led to softening of borrowing costs. Shorter as well as longer maturity cost of funds has come down by 25-50bp. The capital raising of Rs31b during 1QFY08 has also improved liquidity and helped HDFC lower its overall cost of funds. We estimate HDFC's cost of funds has reduced by ~50bp QoQ to 7.8% in 2QFY08.

G-SEC YIELDS CURVE – MODERATION ACROSS MATURITIES



Source: Company/Motilal Oswal Securities

Comfortable liquidity position; no need to chase borrowings

HDFC has aggressively built up its liquidity during 1HFY08 by issuing bonds as well as through bank loans as borrowing rates moderated for the company significantly. The capital raising has further added Rs31b to its kitty. The comfortable liquidity situation (contracted at moderated costs) would ensure that HDFC need not chase high cost funds in 2HFY08 once excess liquidity dries up as credit off take picks up.

Current environment supportive of higher spreads

Though cost of funds is reducing, the competition is not yet reducing lending rates due to the cost impact of CRR hike. As a result, HDFC despite passing on some of the benefits (through festival offers) is still making higher spreads.

The company had reduced its lending rate on new loans by 50bp in September to pass on the benefit of reduced cost of funds to the customers. However, the company has not affected any change in lending rates on existing loans in response to RBI's monetary tightening measures through successive CRR hikes, as the competition is averse to reducing rates.

On incremental basis, HDFC's cost of funds has come down to 7.8-8% pa while the incremental loan yields continue to be ~10.5-11%. Thus, HDFC is making spreads of 2.8-3% on incremental basis - much higher than its historical spreads of 2.1-2.2%.

Considering the improved liquidity situation, moderate costs of funds, we expect spreads to be higher in FY08 for HDFC. Over the long term, we expect spreads to fall in line with its historic spreads at ~2.2%, while near term spreads are likely to be higher. However the impact of any lending rate cut on the spread would be felt in 4QFY08 or 1QFY09 only.

For FY08, we believe HDFC's reported spreads would improve to ~2.3% from ~2.2% in FY07. Overall margins would be even higher as HDFC has raised capital in FY08. We expect margins to increase from 2.4% to 2.9%.

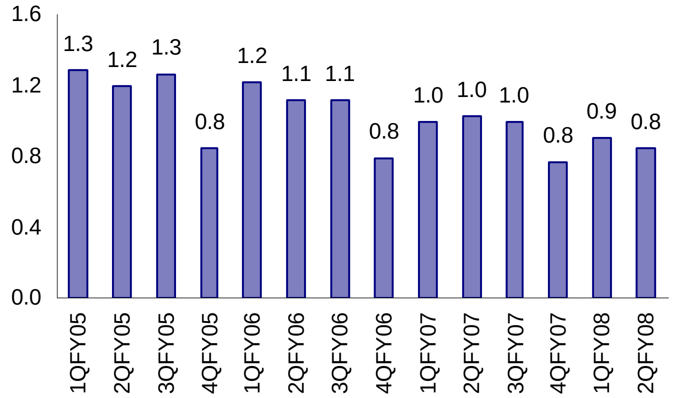
Do not see any concerns on asset quality

Despite the rising trend in interest rates and subsequent hikes in EMI, we do not envisage any concerns on the asset quality of HDFC as:

- It predominantly lends to end users (and not speculators/investors). More than 90% of its loans are to individuals who occupy the houses
- Strict adherence to credit appraisal and control procedures
- The debt averse and conservative characteristic of its customers, predominantly the middle income group, ensures low NPAs. The company's actual loan losses in the last 30 years have been mere 4bp of disbursement. Further, its NPA provisions have always been higher than what has been stipulated by the RBI.

HDFC's gross NPAs at <1% are superior to all banks and other housing finance companies, where gross NPAs are at 2-5% level.

GROSS NPAS % OF 180 DAYS BASIS



Source: Company/Motilal Oswal Securities

Earnings visibility extremely strong

Strong asset growth, improving spreads and significant capital gains would lead to strong profitability for HDFC in FY08. We expect core earnings to remain strong at a CAGR of 24% over FY07-10E.

Huge capital gains in FY08

FY08 would be a year of significant capital gains due to stake sales in its various investments/ventures including Intelnet and HDFC general and life insurance.

1. It has already sold its stake in Intelnet to Blackstone (transaction completed in 2QFY08), making a pre-tax profit of Rs3.13b.

2. HDFC would lower its stake in life insurance venture to 74% by selling ~5% stake to its JV partner Standard Life. Earlier, Standard Life was unable to increase its stake to permissible level of 26% on account of regulatory restraints as it was holding a stake in HDFC Bank as well. Standard Life has now sold off its stake in HDFC Bank and thus can increase its stake in HDFC Standard Life to 26%. The profit on this stake sale could be close to Rs1.2b. The stake sale price has been determined on the predetermined formula which implies a RoE of 30%+ on HDFC's equity investment in the life insurance venture.

3. The company has completed selling 26% stake in its general insurance venture to Ergo. This may bring in significant capital gains to the company. The company had acquired 26% stake from its ex-JV partner Chubb at Rs340m. According to media reports, the profit on this stake sale could be close to Rs1.7b.

4. The realization of gains on unlisted investments can add to the kitty.

Overall, we estimate exceptional (before tax) capital gains of ~Rs6b during FY08, of which Rs3b would be booked in 3QFY08.

Investment book can sustain high treasury gains

HDFC's unrealized gains on listed investments excluding HDFC Bank were close to Rs11b as of September 2007. It also has investments in various unlisted entities (costing Rs2.8b as of March 2007). Recently, HDFC sold one-third of its investment (costing Rs10m) in Computer Age Management Services Pvt Ltd at a profit of Rs1b. We believe these investments would ensure strong trajectory in capital gains going forward. We have not assigned any specific value to these investments in our SOTP, though we believe they can be multibaggers.

KEY UNLISTED INVESTMETS - COULD BE MULTIBAGGERS (RS M)

IL & FS	947
Lafarge India Pvt. Ltd	500
Chalet Hotels Ltd	350
PPN Power Generating Co. Pvt. Ltd.	275
Maruti Countrywide Auto Financial Services	148
Others	600
Total Investments in Unlisted Entities	**2,820**

Source: Company/Motilal Oswal Securities

Core earnings visibility extremely high

We expect core profitability for the company to remain robust on the back of better margins and declining cost/income. We estimate loan growth at a CAGR of 26% over FY07-10E and core PAT (adjusted for the one-off capital gains in FY08) to grow at a CAGR of 24% over FY07-10E.

Deserves premium valuations; maintain Buy

Adjusted for value of its key ventures (HDFC Bank, HDFC Standard Life, HDFC General Insurance, HDFC AMC, Gruh Finance, and property funds) - Rs789 (post 20% holding company discount) per share of HDFC - the stock trades at 18.5x FY10E EPS and 5x FY10E ABV. We believe HDFC deserves a premium valuation due to the continued traction in business and profitability, significant value unlocking from its various investments/ventures and supreme management capabilities.

We value core lending business of HDFC at 24x FY10E earnings and its key strategic investments at Rs789 per share (post 20% holding company discount). We raise our target price to Rs3,288, implying an upside of 21% from current levels.

SOTP FY10E BASED

	VALUE (RS)	RATIONALE
HDFC	2,498	24x FY10E EPS
Key Ventures		
HDFC Bank	418	Unrealized gains at Rs1825/share of HDFC Bank; our target price at 4xFY10E BV
HDFC Standard Life	377	20x FY10E NBAP; 55% CAGR in APE in FY07-10E
HDFC AMC	113	6% FY10E AUM
HDFC General Insurance	29	Current stake sale value + 20% growth assumed for FY10
Gruh Finance	28	Unrealized gains at Rs250/share of Gruh Finance; 3.5x FY10 BV
Property Funds	22	15% of total AUM
Total Value of Ventures	**987**	
Less: 20% Holidng Discount	197	
Value of Key Ventures	**789**	
Target Price Post 20% Holding Company Disc.	**3,288**	
CMP	2,720	
Upside (%)	*20.9*	

Source: Motilal Oswal Securities

INCOME STATEMENT (Rs Million)

Y/E MARCH	2006	2007	2008E	2009E	2010E
Operating Income	41,981	58,069	76,206	94,541	117,828
Fees and Other Income	803	893	1,020	1,240	1,490
Total Income	**42,784**	**58,963**	**77,226**	**95,781**	**119,318**
Growth (%)	*25.5*	*37.8*	*31.0*	*24.0*	*24.6*
Interest and Other Charges	24,911	36,669	48,910	60,556	75,434
Net Income	**17,873**	**22,294**	**28,317**	**35,226**	**43,884**
Growth (%)	*23.2*	*24.7*	*27.0*	*24.4*	*24.6*
Staff Expenses	803	913	1,095	1,260	1,448
Other Expenses	1,496	1,704	1,989	2,271	2,584
PBT	**15,573**	**19,678**	**25,232**	**31,695**	**39,852**
Growth (%)	*23.9*	*26.4*	*28.2*	*25.6*	*25.7*
Exceptional Item	*0.0*	*0.0*	*6,032.5*	*0.0*	*0.0*
Reported PBT	**15,573**	**19,678**	**31,265**	**31,695**	**39,852**
Tax	*3,000.0*	*3,974.0*	*7,816.2*	*7,923.7*	*9,963.0*
Tax Rate (%)	*19.3*	*20.2*	*25.0*	*25.0*	*25.0*
PAT Pre Exceptional	**12,573**	**15,704**	**18,924**	**23,771**	**29,889**
Growth (%)	*21.3*	*24.9*	*20.5*	*20.7*	*25.7*
Reported PAT	**12,573**	**15,704**	**23,449**	**23,771**	**29,889**
Proposed Dividend	4,991	5,566	6,940	7,896	7,896

BALANCE SHEET (Rs Million)

Y/E MARCH	2006	2007	2008E	2009E	2010E
Share Capital	2,496	2,530	2,776	2,871	2,871
Reserves and Surplus	42,188	52,984	102,407	130,136	150,788
Net Worth	**44,683**	**55,514**	**105,184**	**133,008**	**153,659**
Term Loans	199,954	242,242	295,535	369,419	461,774
Bonds	179,840	225,844	280,047	350,059	437,573
Deposits	87,421	103,844	124,613	149,536	179,443
Loan Funds	**467,214**	**571,930**	**700,195**	**869,013**	**1,078,790**
Growth (%)	*27.5*	*22.4*	*22.4*	*24.1*	*24.1*
Total Liabilities	**511,897**	**627,444**	**805,379**	**1,002,021**	**1,232,448**
Loans Granted	449,901	565,124	712,056	897,190	1,130,460
Growth (%)	*24.9*	*25.6*	*26.0*	*26.0*	*26.0*
Investments	38,763	36,662	50,120	60,970	66,820
Net Current Assets	**19,986**	**22,297**	**39,359**	**39,482**	**30,532**
Fixed Assets	2,473	2,131	2,344	2,578	2,836
Other Assets	774	1,231	1,500	1,800	1,800
Total Assets	**511,897**	**627,444**	**805,379**	**1,002,021**	**1,232,448**

ASSUMPTIONS (%)

Y/E MARCH	2006	2007	2008E	2009E	2010E
Growth in Sanctions	29.0	28.0	28.0	26.0	26.0
Growth in Disbursals	27.0	27.0	25.0	26.0	26.0
Dividend	200.0	220.0	250.0	275.0	275.0

RATIOS

Y/E MARCH	2006	2007	2008E	2009E	2010E
Spreads Analysis (%)					
Yield on Housing	8.5	9.6	10.7	10.6	10.6
Avg Yield - Earning Assets	8.5	9.4	10.1	10.0	10.1
Avg Cost - Int Bearing Liab.	6.0	7.1	7.7	7.7	7.7
Spread	2.5	2.4	2.4	2.3	2.3
Net Interest Margin	2.5	2.4	2.9	2.9	2.9
Profitability Ratios (%)					
RoE	30.1	31.3	21.7	20.0	20.9
RoA	2.7	2.8	2.4	2.6	2.7
Op. Exps / Net Income	11.0	9.8	9.2	8.5	7.8
Fee Income / Loan Portfolio	3.3	2.6	2.4	2.4	2.4
Int Charges / Operating Incom	59.3	63.1	64.2	64.1	64.0
Growth Ratios					
Operating Income	27.3	38.3	31.2	24.1	24.6
Interest Charges	27.1	47.2	33.4	23.8	24.6
Net Income	23.2	24.7	27.0	24.4	24.6
PBT	23.9	26.4	28.2	25.6	25.7
Loan Portfolio	24.9	25.6	26.0	26.0	26.0
Loan Funds	27.5	22.4	22.4	24.1	24.1
Efficiency Ratios (%)					
Gross NPAs (Rs m)	4,464	5,340	8,731	12,291	16,777
Gross NPAs	1.0	0.1	0.1	0.1	0.1
Net NPAs (Rs m)	659	1,240	1,831	2,091	2,577
Net NPAs	0.0	0.0	0.0	0.0	0.0
CAR	15.0	13.0	16.0	14.0	14.0
Valuation					
EPS (Rs)	50.4	62.1	84.5	82.8	104.1
Growth (%)	*21.1*	*23.2*	*36.1*	*-2.0*	*25.7*
P/E (x)	38.3	31.1	22.9	23.3	18.5
Book Value (Rs)	179	219	379	463	535
Growth (%)	*14.9*	*22.5*	*72.7*	*22.3*	*15.5*
P/BV (x)	10.8	8.8	5.1	4.2	3.6
Adjusted BV* (Rs)	138	156	272	339	390
P/ABV (x)	14.0	12.4	7.1	5.7	5.0

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N O T E S

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Disclosure of Interest Statement	HDFC
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No