

April 30, 2008

India

Indian Non-banking Financial Companies

HDFC (HDFC.NS - INR 2800.00) 1-Overweight

Earnings Review/Sales Analysis

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Robust earnings growth

Investment Conclusion

- HDFC reported strong 4Q08 earnings. The key highlight was the sharp increase in spreads QoQ as the company benefitted from higher lending yields on its commercial portfolio.

Summary

- NII came in at INR8.8 bn (69% YoY), well above our expectation of INR7 bn.
- This was driven by a 60bp QoQ increase in yields, which led to a significant expansion in spreads. We believe the company has benefitted materially from higher yields on its commercial mortgage portfolio.
- Disbursements growth at 21.5% YoY this quarter, on a high base (full year 25.6% YoY), continued to be robust, despite the weakness in the overall mortgage market. We believe HDFC will continue to report strong growth and are building in 25% per year disbursement growth over FY08-FY10E.
- HDFC booked INR2 bn capital gains on the sale of 26% stake in its general insurance subsidiary.
- We revise our EPS estimates upwards by 5.8% and 6.6% for FY09E and FY10E, respectively, primarily to factor in the higher NII base this year.
- We maintain our price target of INR2,900, which, after the recent run-up in the stock price, implies limited potential upside.

Stock Rating

New: 1-Overweight
Old: 1-Overweight

Target Price

New: INR 2900.00
Old: INR 2900.00

Sector View: 1-Positive

FY Mar	2008A	2009E		2010E		2011E	
		Actual	Old	New	Old	New	Old
Currency INR							
Adjusted Net Profit	18119.0	21505.0	22768.0	25614.0	27298.0	N/A	N/A
Adjusted EPS	63.0	75.0	79.1	89.4	94.9	N/A	N/A
Adjusted PE Ratio	27.5	23.2	22.0	19.5	18.3	N/A	N/A
BVPS	376.0	372.0	392.0	360.0	380.0	N/A	N/A
P/BV	4.6	4.7	4.4	4.8	4.6	N/A	N/A
ROE	20.1	20.3	20.3	24.0	24.3	N/A	N/A
Dividend Yield	0.9	1.4	1.3	1.4	1.6	N/A	N/A

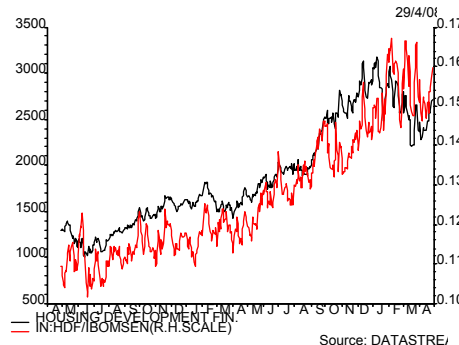
Market Data

Market Cap (mn)	795306.4
Shares Outstanding (mn)	284.0
Free float (%)	88.0
Dividend yield (%)	1.13
Convertible	0
Share per ADR	3

Financial Summary

Net Interest Margin	841470.0
Net NPL/Loans	N/A
PL Provisions/Loans	N/A
Tier 1 Ratio	N/A

Stock Overview



Reuters: HDFC.NS
Bloomberg: HDFC IN
ADR:

Performance	1M	3M	12M
Absolute %	4.1	-4.6	61.3
Rel. Market %	-1.0	2.5	25.4
Rel. Sector %	-	-	-

52 Week Range 3174.25 - 1596.10

Figure 1: 4QFY08 results

(INR mn)	4QFY07	3QFY08	4QFY08	4QFY08E	YoY growth (%)	QoQ growth (%)
Net interest income	5,224	6,656	8,805	7,026	69	32
Non-interest income	2,063	2,942	2,820	3,527	37	-4
Trading gains/(losses)	1,278	2,228	2,046	2,000	60	-8
Operating income	7,287	9,597	11,625	10,553	60	21
Operating expenses	(456)	(725)	(649)	(542)	42	-11
Operating profit	6,831	8,872	10,976	10,011	61	24
Net profit	5,501	6,489	7,681	7,456	40	18
Disbursements	87,130	80,100	105,900	104,375	22	32

Source: Company data, Lehman Brothers estimates

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4QFY08 results highlights

NII much higher than our expectation due to increase in lending spreads ...

HDFC reported net interest income (NII) of INR8.8 billion, 69% YoY growth, which was significantly above our expectation of INR7 bn. Loan growth at 29% YoY was broadly in line with our estimate. Clearly, the company saw a significant QoQ expansion in lending spreads. While funding costs were broadly flat, we note that lending yields have moved up by as much as 60bp QoQ. For FY08-FY10E, we are building in a marginal decline in margins from current levels and we estimate a 22% CAGR in NII on a 26% CAGR in advances.

... likely benefitting from pricing power in the commercial segment

We note that HDFC is a large player in lending to the commercial mortgage sector with a significant market share. We highlight that banks' lending to the commercial segment is constrained by the fact that risk weights are as high as 150%, which necessitates a higher capital requirement. Moreover, the Reserve Bank of India (RBI) adopts an unfavorable stance on banks lending to the commercial real estate sector. In the past quarter, the commercial segment has witnessed a strong demand for funds, but a tightened credit environment has meant that borrowing costs have moved up materially. Clearly, in wake of such a scenario we believe that HDFC might have been a key beneficiary in terms of pricing power by effectively tapping this demand.

Exceptional gains of INR2 billion booked on the sale of stake in general insurance

During the quarter, HDFC had received final regulatory approval for a 26% stake sale in its general insurance subsidiary to ERGO International AG. The company has booked capital gains of INR2.02 billion on this stake sale during the quarter.

Continued momentum in mortgage disbursements, bypassing the industry slowdown and gaining market share

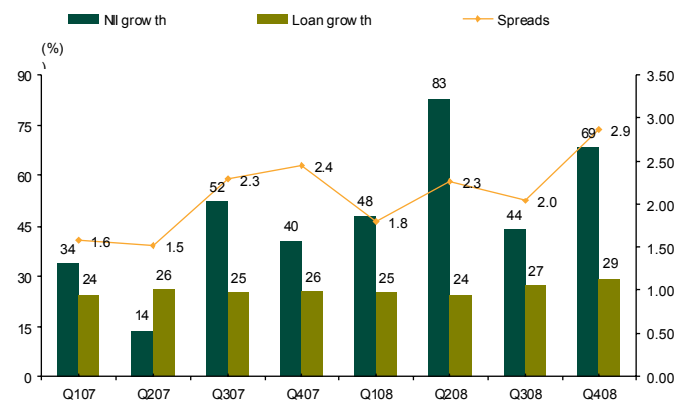
On a high base, HDFC reported healthy 21.5% YoY growth in mortgage disbursements in 4Q08. Full-year FY08 growth continues to be in line with the company's trend growth of 25%YoY. Thus, the company continues to bypass the weakness seen in the overall mortgage market. The other leading mortgage player ICICI (ICICIBC IN; INR 1315.0, 1-Overweight) had earlier reported 21% YoY decline in mortgage disbursements in 4Q08.

Figure 2: 4QFY08 results summary

(INR mn)	4QFY07	3QFY08	4QFY08	4QFY08E	YoY growth (%)	QoQ growth (%)
Net interest income	5,224	6,656	8,805	7,026	69	32
Non-interest income	2,063	2,942	2,820	3,527	37	-4
Trading gains/(losses)	1,278	2,228	2,046	2,000	60	-8
Operating income	7,287	9,597	11,625	10,553	60	21
Operating expenses	(456)	(725)	(649)	(542)	42	-11
Operating profit	6,831	8,872	10,976	10,011	61	24
Bad and doubtful debts charge	(70)	(60)	(60)	(70)		
Profit before tax	6,761	8,812	10,916	9,941	61	24
Tax provided	(1,261)	(2,323)	(3,235)	(2,485)	157	39
Tax rate (%)	19	26	30	25		
Net profit	5,501	6,489	7,681	7,456	40	18
Advances	565,124	669,759	729,980	722,812	29	9
Disbursements	87,130	80,100	105,900	104,375	22	32

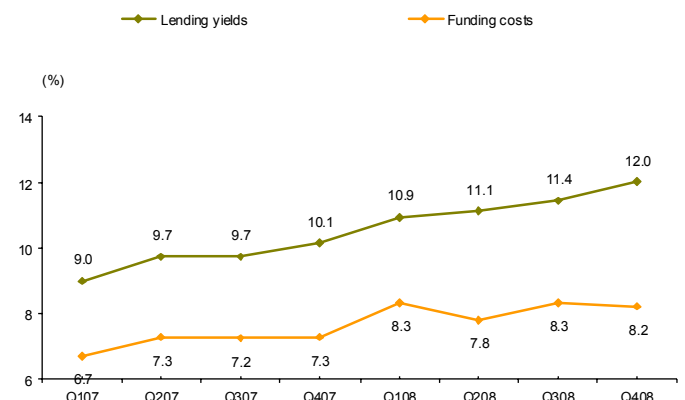
Source: Company data, Lehman Brothers estimates

Figure 3: Loan growth, NII growth, Lending spreads



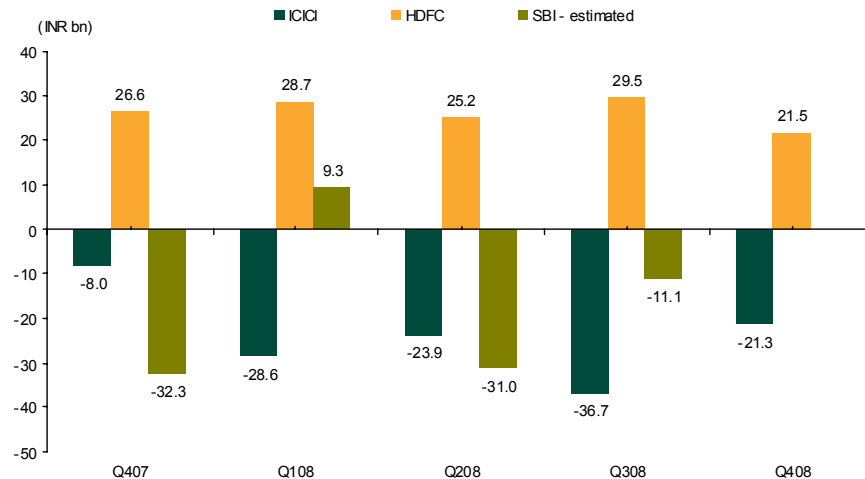
Source: Company data, Lehman Brothers research

Figure 4: Movement in yields



Source: Company data, Lehman Brothers research

Figure 5: Comparative disbursements growth



Source: Company data, Lehman Brothers research

We maintain our price target of INR2,900, implying limited potential upside

We believe that there continues to be strong growth visibility for HDFC and are building in disbursements growth of 25% per year over FY08-FY10E.

- We think FY09E will be a better year for mortgages compared to FY08. In FY08, we estimate that disbursements for the industry ex-HDFC will likely have declined by about 20% YoY. On this low base, we estimate 15% YoY industry disbursements growth in FY09E.
- HDFC has defied all odds by continuing to grow at 25% during FY08 when the rest of the industry declined by about 20% YoY. We believe that reporting 25% YoY growth is an easier proposition in an industry growing at 15% YoY, which we estimate for FY09E.
- Clearly HDFC is gaining market share in the current scenario. But we do not foresee any risk to the '25% HDFC growth rate'. The company has historically followed a strategy of calibrating its growth. Hence, while it had lost market share during FY01-FY05, when the mortgage market was in a boom, it has only currently regained some lost ground. Even under a pessimistic market growth scenario, we expect HDFC's market share to go up to only 32% in FY10 from around 25% currently.

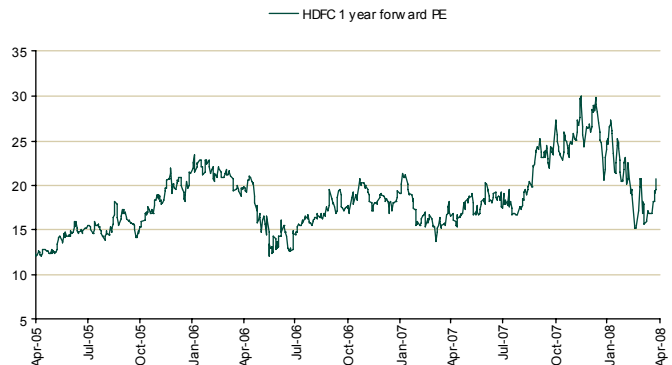
However, with the stock currently trading at 4.4x FY09E adjusted BV and 22x FY09E earnings, we believe much of this visibility in growth is already factored in. We maintain our price target of INR2,900, implying limited potential upside after the recent run-up in stock price.

Figure 6: One-year forward P/BV



Source: Lehman Brothers research

Figure 7: One-year forward P/E



Source: Lehman Brothers research

Financials

Figure 8: Income statement

(INR mn)	FY05	FY06	FY07	FY08	FY09E	FY10E
Net interest income	8,829	12,155	16,472	26,411	32,994	39,516
Non-interest income	5,682	5,718	5,822	10,483	5,687	6,395
Fee/Commission income	1,017	675	686	632	639	645
Other operating income	2,924	2,681	1,884	2,156	1,548	1,750
Trading gains/(losses)	1,741	2,362	3,253	7,695	3,500	4,000
Operating income	14,510	17,873	22,294	36,894	38,681	45,911
Core operating income	13,813	17,384	21,957	29,199	35,181	41,911
Operating expenses	(1,802)	(2,150)	(2,366)	(2,839)	(3,271)	(3,707)
Employee expenses	(649)	(803)	(913)	(1,178)	(1,355)	(1,558)
Administrative expenses	(966)	(1,159)	(1,279)	(1,496)	(1,749)	(1,980)
Depreciation	(187)	(187)	(175)	(166)	(168)	(169)
Operating profit	12,708	15,723	19,928	34,055	35,410	42,204
Provision Charges	(140)	(150)	(250)	(320)	(372)	(468)
Bad and doubtful debts charge	(140)	(150)	(250)	(320)	(372)	(468)
Profit before tax	12,568	15,573	19,678	33,735	35,038	41,736
Tax provided	(2,202)	(3,000)	(3,974)	(9,373)	(8,409)	(10,017)
Net profit	10,366	12,573	15,704	24,363	26,629	31,719
Adjusted profit	8,606	9,726	11,849	18,119	22,768	27,298

Source: Company data, Lehman Brothers estimates

Figure 9: Balance sheet

(INR mn)	FY05	FY06	FY07	FY08	FY09E	FY10E
Cash	1,572	417	1,014	1,000	2,064	2,054
Balances with other banks	5,669	11,598	12,718	12,000	12,600	13,230
Net advances	360,115	449,901	565,124	729,980	921,923	1,159,018
Individuals	242,591	302,618	373,625	483,781	617,867	782,641
Corporates	111,622	139,757	178,585	227,720	285,578	357,899
Investments	31,300	38,762	36,662	69,150	82,873	120,557
Other interest earning assets	21,928	29,486	36,129	28,524	32,803	37,724
Interest earning assets	420,586	530,165	651,647	840,654	1,052,263	1,332,583
Fixed assets	2,948	2,474	2,131	2,085	2,189	2,299
Other assets	1,315	1,342	1,934	1,466	1,466	1,466
Total assets	424,849	533,980	655,712	844,205	1,055,919	1,336,348
Deposits	78,225	87,230	103,693	112,963	118,611	124,541
Borrowings	288,073	379,797	468,085	578,550	763,353	1,019,075
Interest bearing liabilities	366,474	467,211	571,929	691,512	881,963	1,143,616
Other liabilities	19,574	22,085	28,269	33,220	36,542	40,196
Total liabilities	386,048	489,296	600,198	724,732	918,505	1,183,812
Shareholders funds	38,831	44,683	55,514	119,473	137,414	152,536
Capital	2,491	2,496	2,530	2,840	2,877	2,877
Reserves and surpluses	36,340	42,188	52,984	116,633	134,537	149,659
Total liabilities and equity	424,879	533,980	655,712	844,205	1,055,919	1,336,348

Source: Company data, Lehman Brothers estimates

Figure 10: Per share data

(INR)	FY05	FY06	FY07	FY08	FY09E	FY10E
EPS	41.6	50.4	62.1	85.8	92.6	110.2
Adj EPS	34.5	39.0	46.2	63.0	79.1	94.9
DPS	17.0	20.0	22.0	25.0	37.0	44.1
BVPS	155.9	179.0	219.4	490.0	477.6	530.2
Adj BVPS	130	230	272	376	392	380

Source: Company data, Lehman Brothers estimates

Figure 11: Profitability

(%)	FY05	FY06	FY07	FY08	FY09E	FY10E
ROE	28.5	30.1	31.3	27.8	20.7	21.9
Adj ROE	26.3	20.2	17.9	20.1	20.3	24.3
ROA	2.72	2.62	2.64	3.25	2.80	2.65
Adj ROA	2.33	2.10	2.07	2.55	2.58	2.47

Source: Company data, Lehman Brothers estimates

Figure 12: Valuations

(x)	FY05	FY06	FY07	FY08	FY09E	FY10E
P/E	41.8	34.5	28.0	20.3	18.8	15.8
P/Adj. E	50.4	44.6	37.7	27.6	22.0	18.3
P/BV	11.2	9.7	7.9	3.6	3.6	3.3
P/Adj BV	13.3	7.6	6.4	4.6	4.4	4.6
Dividend yield	1.0	1.1	1.3	1.4	2.1	2.5

Source: Company data, Lehman Brothers estimates

Analyst Certification:

We, Srikanth Vadlamani and Deepak Reddy, hereby certify (1) that the views expressed in this research Company Note accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Company Note and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Company Note.

Company Description:

HDFC was incorporated in 1977 with the objective of providing long-term housing finance. Its cumulative loan disbursements to date stand at INR 1,250bn. Consistent and predictable growth has been the hallmark of the company over the years. HDFC has also promoted various subsidiaries, which include HDFC Standard Life Insurance, HDFC Bank, an asset management business, and a real estate venture capital firm.

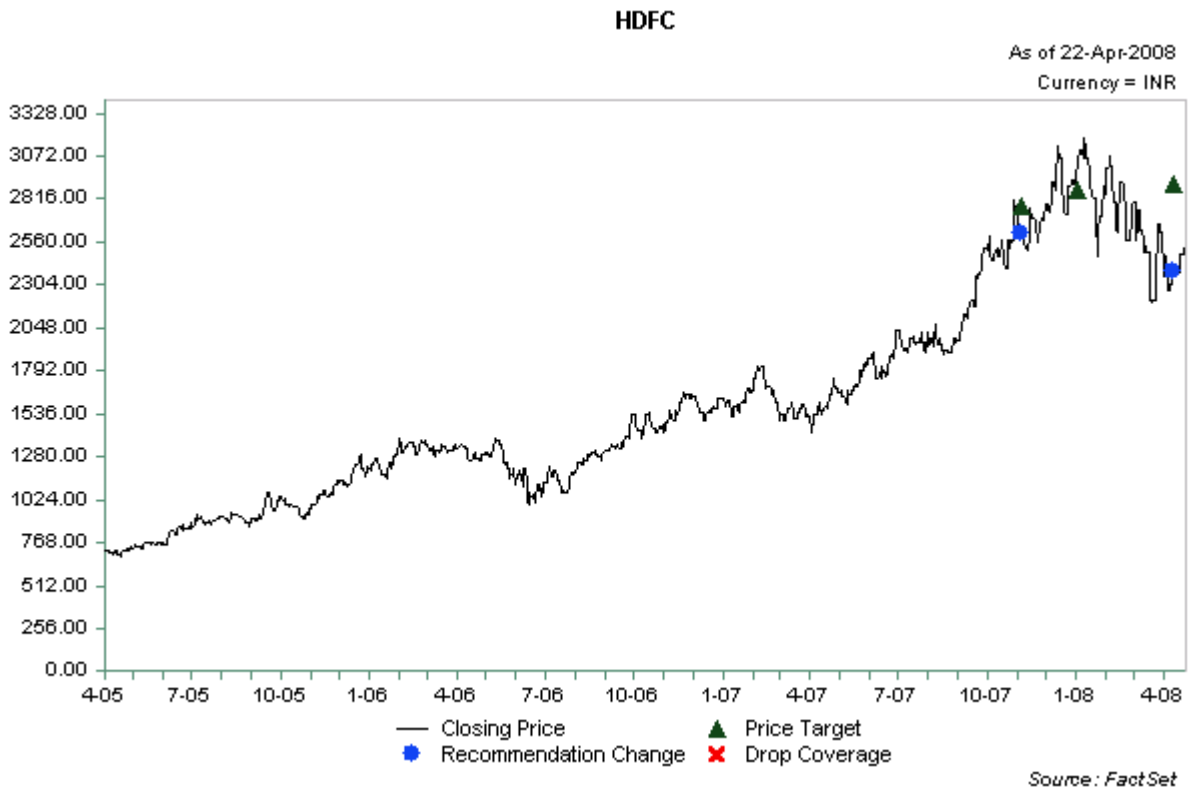
Important Disclosures:

HDFC (HDFC.NS)

INR 2800.00 (30-Apr-2008)

1-Overweight / 1-Positive

Rating and Price Target Chart:



Currency=INR

Date	Closing Price	Rating	Price Target
11-Apr-08	2381.15		2900.00
11-Apr-08	2381.15	1 -Overweight	
02-Jan-08	3057.55		2870.00

Date	Closing Price	Rating	Price Target
05-Nov-07	2607.15		2770.00
05-Nov-07	2607.15	2 -Equal weight	

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Valuation Methodology: We value HDFC using a SOTP valuation, valuing the parent and the subsidiaries separately. We value the core business using a three-stage DDM with explicit forecasts up to FY10E, an intermediate growth phase for FY10-FY28E and a terminal growth beyond that. We are building in a sustainable RoA of 1.8% and a risk-weighted asset CAGR in the intermediate phase of 20% over FY10-FY19E and 13% over FY19-FY28E. We arrive at a 12m forward fair value of INR 1,840/shr for the base business. We value the subsidiaries at a combined INR 1,030/shr, which includes: (a) the life insurance subsidiary, which we value at 20x FY10E NBAP; (b) the banking subsidiary, HDFC Bank, which we value using a DDM; (c) the asset management business, which we value at 7% of FY10E AUM; and (d) the venture capital business, which we value at 15% of current AUM. The unrealized gains on listed investments amount to INR 30/shr. We arrive at a 12-month forward price target of INR 2,900.

Risks Which May Impede the Achievement of the Price Target: (1) Subsidiary valuations have moved up sharply in the recent past, driven by strong business performance. In our valuations, HDFC's subsidiaries account for more than 30% of the fair value. Hence, stronger-than-expected performance by the subsidiaries could provide upside to our valuation. The two largest subsidiaries are the life insurance business and HDFC Bank. We estimate that a life insurance premium CAGR of 58% over FY07-FY10, compared with our current assumption of a 48% CAGR, would add INR50, or 2%, to fair value. (2) Continued strong performance in a period of prolonged sector weakness would warrant a premium. (3) The current strong performance has likely been driven by HDFC's ability to deliver in a severely weak mortgage market in the past two quarters. If the housing market were to witness prolonged weakness in the next quarters as HDFC sustained its growth rates, we believe the market would likely ascribe a premium to the franchise value of HDFC, which is an upside risk to our estimates.

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Company Name	Ticker	Price (30-Apr-2008)	Stock / Sector Rating
HDFC	HDFC.NS	INR 2800.00	1-Overweight / 1-Positive

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In addition to the stock rating, we provide sector views which rate the outlook for the sector coverage universe as 1-Positive, 2-Neutral or 3-Negative (see definitions below). A rating system using terms such as buy, hold and sell is not the equivalent of our rating system. Investors should carefully read the entire research report including the definitions of all ratings and not infer its contents from ratings alone.

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1-Overweight - The stock is expected to outperform the unweighted expected total return of the relevant country index over a 12-month investment horizon.

2-Equal weight - The stock is expected to perform in line with the unweighted expected total return of the relevant country index over a 12- month investment horizon.

3-Underweight - The stock is expected to underperform the unweighted expected total return of the relevant country index over a 12-month investment horizon.

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