

**HOUSING DEVELOPMENT FIN. CORP. INR 1,777****Steady micro in a tough macro****BUY**

October 17, 2008

**Consistent growth in profits with relatively stable spreads**

Housing Development Finance Corporation's (HDFC) maintained its trend of reporting consistent growth with relatively stable spreads and robust asset quality, in Q2FY09. Net profit grew 32% Y-o-Y (14% Q-o-Q) to INR 5.3 bn in Q2FY09 after adjusting Q2FY08 numbers for one-time profit on sale of investments. Net revenues grew 29% to INR 8.6 bn, aided by 21% Y-o-Y growth in net interest income and higher non-interest income of INR 1.2 bn in Q2FY09 (compared to INR 527 mn in Q2FY08).

**Disbursements in individual loan segment continue to be strong**

HDFC seems to be focusing more on individual loan segment, which grew at a faster pace of 31% Y-o-Y in Q2FY09 compared to overall disbursement growth of 23%. The company is deliberately going slow in commercial and developers space, sensing the risk in this segment. We are building in 23% growth in disbursements for HDFC over FY08-10E, compared to a CAGR of 27% over FY04-08.

**Regaining pricing power; asset quality maintained**

With banks going slow on mortgage finance, HDFC seems to be regaining its pricing power. It raised its lending rates twice during the quarter - by 50bps in July 2008 and by 75bps w.e.f. August 2008, which was sufficient to offset the 56bps rise in funding costs, and NIMs (calc) improved by ~30bps to 3.4%. Despite increasing interest rates and a tight liquidity situation, HDFC's asset quality remained robust in Q2FY09 with non-performing loans at 1.04% in Q2FY09 (compared to 1.09% in Q1FY09); however, we would watch this space closely considering weak real estate sentiments.

**Outlook and valuations: Safety premium to stay; maintain 'BUY'**

Real estate lending is becoming more challenging due to high interest rates background and weak property prices. However, HDFC has a strong track record of consistent growth with relatively stable spreads and robust asset quality across business cycles. HDFC's pricing power and market share is improving, which will help it report growth of 20% plus and spreads of 2% plus. We are revising our EPS estimates downwards by 2% in FY09E and 12% upwards in FY10E considering higher investment profits in FY10E rather than in FY09E (owing to weak capital markets) and net interest income also being revised upwards by 7% in FY09E and 5% in FY10E.

In the current environment, though the growth premiums may shrink (as in case of its peers), the safety premium for HDFC is expected to remain. Our base case fair value of INR 2,034 assumes full subscription to HDFC Bank's warrants at INR 1,530/share; however if warrants are not subscribed to, the fair value of stock in FY10E would be higher by 10%. The stock currently trades at 2.8x FY10E book and 12x FY10E earnings, after adjusting for value of investments in subsidiaries/associates. We maintain our 'BUY' recommendation on the stock.

**Financials**

Year to March	Q209	Q208	Growth (%)	Q109	Growth (%)	FY08	FY09E
Inc. from oper. (INR mn)	8,578	6,649	29.0	7,451	15.1	30,335	36,664
PAT (INR mn)	5,342	6,464	(17.4)	4,681	14.1	24,363	25,720
BV per share (INR)						421	507
Adj book value*						317	397
Diluted EPS (INR)	18.4	22.8	(19.4)	16.1	14.5	85.8	89.8
Price/ Book (x)						4.2	3.5
Price/ Adj. book (x) *						3.2	2.5
Diluted P/E (x)						20.7	19.8
Price/ Adj. earnings (x) *						15.7	12.4

\* adjusted for the value of subsidiaries

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Reuters : HDFC.BO  
Bloomberg : HDFC IN

**Market Data**

52-week range (INR) : 3,257 / 1,600  
Share in issue (mn) : 284.2  
M cap (INR bn/USD mn) : 505 / 10,349  
Avg. Daily Vol. BSE/NSE ('000) : 1,170.3

**Share Holding Pattern (%)**

Promoters : 0.0  
MFs, FIs & Banks : 26.0  
FIIs : 60.4  
Others : 13.6

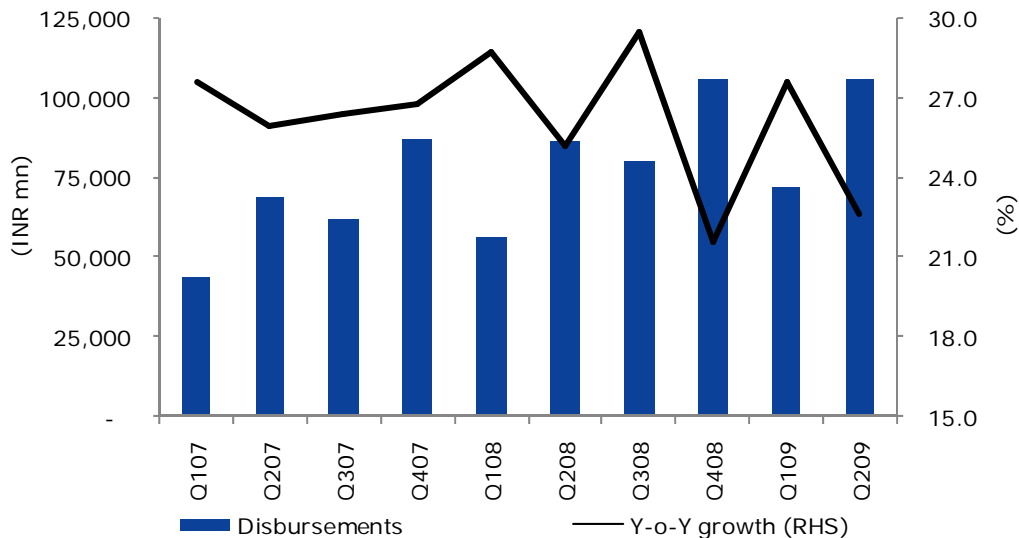
**Relative Performance (%)**

	Sensex	Stock	Stock over Sensex
1 month	(20.2)	(16.8)	3.4
3 months	(19.3)	(4.6)	14.7
12 months	(43.5)	(27.1)	16.4

### Disbursements in individual loan segment continue to be strong

HDFC seems to be focusing more on individual loan segment, which grew at a faster pace of 31% Y-o-Y in Q2FY09. However, the company is deliberately going slow in commercial and developers space, sensing the risk in this segment and overall disbursements grew by 23% in Q2FY09 (compared to 28% in Q1FY09 and 26% in FY08).

**Chart 1: Disbursement growth decelerated in Q2FY09**



Source: Company

Loan book grew 31% Y-o-Y to INR 812 bn, driven by lower repayment in the past few quarters. We are building in 23-24% CAGR growth in disbursements for HDFC over FY08-10E, compared to a CAGR of 27% over FY04-08.

**Table 1: Segment-wise loan book (INR mn)**

	Q2FY09	Q2FY08	Growth (%)	Q1FY09	Growth (%)
Mortgage loan assets	811,919	620,200	30.9	773,271	5.0
- Individual	547,276	418,740	30.7	520,093	5.2
- Corporates	245,093	185,945	31.8	234,279	4.6
- Others	19,550	15,515	26.0	18,899	3.4

Source: Company

### Regaining pricing power; hike in PLR offsets higher cost of funds

With banks going slow on mortgage finance, HDFC seems to be regaining its pricing power in this space. It raised its lending rates twice during the quarter. It first raised its retail PLR by 50bps and non-retail lending rate by 125bps in July 2008; thereafter, it hiked its retail PLR by 75bps w.e.f. August 2008. Consequently, its yields on mortgages increased by 80-85bps Q-o-Q, which was sufficient to offset the 56bps rise in funding costs during the same period, and NIMs (calc) improved by ~30bps to 3.4%. Spreads improved by 21bps Q-o-Q to 2.1% in Q2FY09. However, it declined by 58bps Y-o-Y as the company repaid high-cost borrowings of INR 12 bn from the preferential issue in Q2FY08. Overall, we expect its margins to remain in 3.2-3.7% range over FY08-10E.

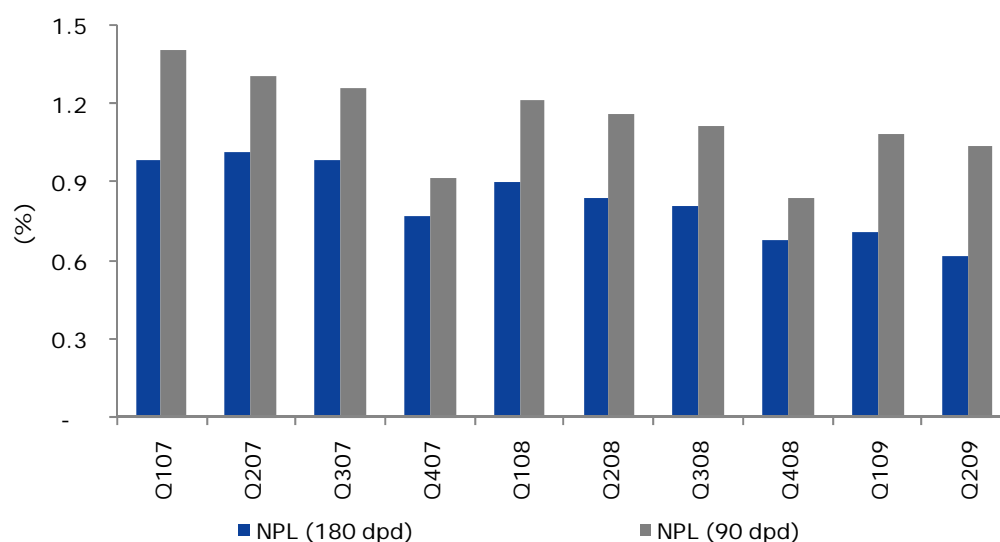
**Table 2: Higher yield led to sequential improvement in spreads (calc, %)**

	Q2FY09	Q2FY08	Change (bps)	Q1FY09	Change (bps)
Yield on home loans	11.9	11.1	79	11.1	82
Yield on assets	11.5	10.5	102	10.7	77
Cost of funds	9.4	7.8	160	8.8	56
Spreads	2.1	2.7	(58)	1.9	21

Source: Company, Edelweiss research

### Asset quality maintained; NPL at 1%

Despite increasing interest rates and a tight liquidity situation, HDFC's asset quality remained robust in Q2FY09 as well. NPL (90 dpd) declined 12bps Y-o-Y to 1.04% in Q2FY09 (compared to 1.09% in Q1FY09). The company has consistently maintained its NPL at the 1%-level across business cycles. However, we would watch this space closely considering weak real estate sentiments.

**Chart 2: Robust asset quality maintained**

Source: Company

### Other businesses

The asset management businesses grew at a higher rate than the industry, with AUMs growing at 26% Y-o-Y to INR 520 bn (INR 527 bn at end-Q1FY09), making it the second-largest asset management company in India. In its life insurance business, annualised premium equivalent (APE) grew 31% in the first five months of FY09 compared to industry-wide growth of 61%. Due to non-conducive capital market conditions, we are currently factoring in a lower growth rate (than it has historically maintained) for HDFC Standard Life and we expect its APE to grow at 25% over FY08-10E.

### Outlook and valuations: Safety premium to stay; maintain 'BUY'

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In the current environment, though the growth premiums may shrink (as in case of its peers), the safety premium for HDFC is expected to remain. Our base case fair value of INR 2,034 assumes full subscription to HDFC Bank's warrants at INR 1,530/share; however if warrants are not subscribed to, the fair value of stock in FY10E would be higher by 10%. The stock currently trades at 2.8x FY10E book and 12x FY10E earnings, after adjusting for value of investments in subsidiaries/associates.

**Table 3: SOTP valuations - FY10E**

FY10E	Method	AUMs/book /earnings (INR mn)	Multiple (x)	Value of business (INR mn)	HDFC holding (%)	Value of HDFC's interest (INR mn)	Value per share (INR)
Mortgage business	PB	102,065	3.5	361,787	100.0	361,787	1,263
HDFC Bank	Fair value @ INR 1,420	639,710	0.8	511,768	24.1	123,183	430
Asset management	% of AUMs	520,000	5.0	26,000	60.0	15,600	54
Venture Capital	% of AUMs	43,644	12.0	5,237	100.0	5,237	18
HDFC Life Insurance	Appraisal value	5,101	19.6	99,961	72.6	72,572	253
Gruh Finance	Market value	3,800	1.0	3,800	61.5	2,337	8
HDFC General Insurance	Economic profit multiple	295	10.0	2,952	74.0	2,184	8
<b>Total</b>				<b>1,011,506</b>		<b>580,716</b>	<b>2,034</b>

Source: Edelweiss research

#### Financials snapshot

(INR mn)

Year to March	Q209	Q208	Growth (%)	Q109	Growth (%)	FY08	FY09E	FY10E
Interest income	25,034	18,380	36.2	22,199	12.8	77,840	103,334	127,034
Interest exp	17,573	12,220	43.8	15,684	12.0	51,429	69,968	90,460
Net interest income	7,461	6,161	21.1	6,516	14.5	26,411	33,365	36,574
Dividend income	492	123	300.9	599	(17.7)	686	1,167	1,283
Others	625	365	71.0	337	85.4	3,237	2,132	2,468
Net income from ops	8,578	6,649	29.0	7,451	15.1	30,335	36,664	40,325
Other income	55	39	40.8	51	6.8	197	212	222
Net revenues	8,633	6,688	29.1	7,503	15.1	30,532	36,876	40,548
Depreciation	43	40	7.0	37	16.6	166	166	166
Other expenses	991	823	20.4	967	2.4	2,993	3,683	4,315
Profit before tax before extraord. item	7,600	5,825	30.5	6,499	16.9	27,372	33,027	36,067
Exceptional Items - Profit on Sale of Investments - Subsidiaries and Associates	0	3,133		0		6,363	2,000	9,000
Profit before tax	7,600	8,957	(15.2)	6,499	16.9	33,735	35,027	45,067
Provision for taxes	2,258	2,493	(9.4)	1,818	24.2	9,373	9,307	12,488
Reported net profit	5,342	6,464	(17.4)	4,681	14.1	24,363	25,720	32,579
Reported net profit (excl. extraord.)	5,342	4,035	32.4	4,681	14.1	19,442		
Diluted EPS (INR)	18.4	22.8	(19.4)	16.1	14.5	85.8	89.8	113.7
NII/GII (%)	29.8	33.5		29.4		33.9	32.3	28.8
Cost/income (%)	12.0	12.9		13.4		10.3	10.4	11.1
Tax rate (%)	29.7	27.8		28.0		27.8	26.6	27.7

#### Balance sheet data

Disbursements	105,840	86,300	22.6	72,040	46.9	328,750	406,006	499,388
Borrowings	767,528	629,520	21.9	727,684	5.5	691,512	862,307	1,101,797
Mortgage assets	811,919	620,200	30.9	773,271	5.0	729,980	916,992	1,141,282
Net worth	129,171	97,127	33.0	123,949	4.2	119,473	145,368	172,590

### Company Description

HDFC is India's largest provider of housing finance, primarily focusing on retail housing. The company has widened its distribution network to 254 offices in India. It also covers over 90 locations through its outreach programme, which has helped the corporation disburse housing loans in more than 2,400 towns and cities in India. It has also supplemented the distribution channel through the appointment of direct selling agents (DSA). As on September 30, 2008, 76% of the shares are held by foreign institutional investors/foreign direct investments and 11% by individuals.

Besides the core business of mortgages, HDFC has evolved into a financial conglomerate, diversifying into other businesses through its subsidiaries viz., HDFC Standard Life Insurance (73%), HDFC Asset Management Company (60%), HDFC Bank (19.4%), and HDFC General Insurance Company (74%).

### Investment Theme

HDFC is the strongest and the most venerable play on Indian mortgages over the long term. We expect the company, with its strong brand recall, superior real estate knowledge, and revamped distribution strategy, to attain 23% CAGR in loan disbursement over FY08-10E. Consequently, we expect HDFC to deliver growth of 25% CAGR in loan book.

HDFC has differentiated itself from its peers with its diversified network and revamped distribution strategy. Of the total individual loans disbursed during FY08, 65% were routed through third party channels viz., HDFC Bank, DSAs, and distribution subsidiaries. The company has been highly proactive in passing on the cost and benefit to customers. With strong pricing power in the housing finance space, we believe it will be able to pass on any increased funding cost to customers.

Besides the core business, HDFC's insurance, AMC, banking, BPO, and real estate private equity businesses are also growing at a rapid pace and the estimated value of its investments/subsidiaries explains HDFC's ~40% market capitalisation. Value of stakes in HDFC Bank and HDFC Standard Life form a significant portion of its unrealised gains.

### Key Risks

Increase in competition and sustained slack in the mortgage market can lead to lower growth than our estimates.

Higher-than-expected increase in funding cost and inability to pass the cost to customers in the current tightening monetary environment will adversely affect margins and profitability.

Risk of fraud and NPA accretion due to increase in interest rates and fall in property prices is inherent to the mortgage business.

## Financial Statements

Income statement					(INR mn)
Year to March	FY06	FY07	FY08	FY09E	FY10E
Interest income	37,066	53,169	77,840	103,334	127,034
Interest expended	24,911	36,669	51,846	69,968	90,460
Net interest income	12,155	16,501	25,994	33,365	36,574
Non interest income	5,718	5,824	10,900	5,511	12,974
- Fee & forex income	675	686	632	853	1,067
- Investment profits	3,145	3,549	8,813	3,230	10,353
- Misc. income	1,898	1,589	1,456	1,428	1,555
Net revenues	17,873	22,325	36,894	38,876	49,548
Operating expenses	2,146	2,391	2,735	3,364	3,932
- Employee exp	746	844	1,088	1,415	1,698
- Depreciation /amortisation	187	175	166	166	166
- Other opex	1,213	1,373	1,480	1,783	2,068
Preprovision profit	15,727	19,934	34,160	35,512	45,616
Provisions	154	256	425	485	549
PBT	15,572	19,678	33,735	35,027	45,067
Taxes	3,000	3,974	9,373	9,307	12,488
PAT	12,572	15,704	24,363	25,720	32,579
Basic number of shares (mn)	249	250	284	287	287
Basic EPS (INR)	50.4	62.8	85.8	89.8	113.7
Diluted number of shares (mn)	259	269	284	287	287
Diluted EPS (INR)	48.6	58.4	85.8	89.8	113.7
DPS (INR)	20.0	22.0	25.0	26.9	34.1
Dividend pay out (%)	45.3	41.5	34.1	35.1	35.1

### Growth metrics (%)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Net interest income	37.4	35.8	57.5	28.4	9.6
Net revenues growth	22.3	24.9	65.3	5.4	27.5
Opex growth	18.3	11.4	14.4	23.0	16.9
PPP growth	22.8	26.8	71.4	4.0	28.5
Provisions growth	7.1	65.7	66.1	14.2	13.2
PAT growth	20.2	24.9	55.1	5.6	26.7

### Operating ratios (%)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Yield on assets	8.1	9.4	10.9	11.4	11.2
Yield on advances	8.5	9.6	11.3	11.8	11.7
Cost of funds	6.3	7.4	8.5	9.0	9.0
Spread	1.9	1.9	2.4	2.4	2.1
Net interest margins	2.7	2.9	3.6	3.7	3.2
Cost-income	14.6	12.7	9.6	9.2	9.8
Tax rate	19.3	20.2	27.8	26.6	27.7

<b>Balance sheet</b>					(INR mn)
<b>As on 31st March</b>	<b>FY06</b>	<b>FY07</b>	<b>FY08</b>	<b>FY09E</b>	<b>FY10E</b>
<b>Liabilities</b>					
Equity capital	2,496	2,530	2,840	2,865	2,865
Share premium	6,659	8,520	56,391	59,834	59,834
Reserves & surplus	35,528	44,464	60,242	82,668	109,891
Net worth	44,683	55,514	119,473	145,368	172,590
Total deposits	87,414	103,844	112,963	135,555	154,533
Secured Loans	313,440	396,687	517,367	660,426	870,563
Unsecured Loans	66,359	71,399	61,183	66,326	76,701
<b>Total liabilities</b>	<b>511,897</b>	<b>627,444</b>	<b>810,986</b>	<b>1,007,674</b>	<b>1,274,387</b>
<b>Assets</b>					
Loans	449,901	565,124	729,980	916,992	1,141,282
Investments	38,763	36,662	69,150	77,845	119,242
<i>Current assets</i>	42,070	50,566	41,524	45,129	48,712
<i>Current liabilities</i>	22,085	28,269	33,220	36,153	39,094
Net current assets	19,985	22,297	8,305	8,977	9,617
Fixed assets (net block)	2,473	2,131	2,085	2,019	1,953
Other assets	774	1,231	1,466	1,842	2,293
<b>Total assets</b>	<b>511,897</b>	<b>627,444</b>	<b>810,986</b>	<b>1,007,674</b>	<b>1,274,387</b>
<b>Balance sheet ratios (%)</b>					
Loan growth	24.9	25.6	29.2	25.6	24.5
Deposit growth	11.5	18.8	8.8	20.0	14.0

<b>Sanctions and disbursements</b>					(INR mn)
<b>Year to March</b>	<b>FY06</b>	<b>FY07</b>	<b>FY08</b>	<b>FY09E</b>	<b>FY10E</b>
Sanctions (INR mn)	256,340	333,320	425,200	537,878	677,726
Disbursements (INR mn)	206,790	261,780	328,750	406,006	499,388
Disbursements to sanction ratio (%)	80.7	78.5	77.3	75.5	73.7
Disbursements growth (%)	27.6	26.6	25.6	23.5	23.0
Sanctions growth (%)	30.0	30.0	27.6	26.5	26.0

<b>RoE decomposition (%)</b>					
<b>Year to March</b>	<b>FY06</b>	<b>FY07</b>	<b>FY08</b>	<b>FY09E</b>	<b>FY10E</b>
Net interest income/assets	2.7	2.9	3.6	3.7	3.2
Non interest income/assets	0.7	0.5	0.4	0.4	0.3
Investment gains/assets	0.5	0.5	1.1	0.2	0.8
Net revenues/Assets	3.9	3.9	5.2	4.3	4.4
Operating expense/assets	0.5	0.4	0.4	0.4	0.3
Provisions/assets	0.0	0.0	0.1	0.1	0.0
Taxes/assets	0.7	0.7	1.3	1.0	1.1
Total costs/assets	1.2	1.2	1.8	1.5	1.5
ROA	2.8	2.8	3.4	2.8	2.9
Equity/assets	9.2	8.8	12.2	14.6	14.0
ROAE	30.1	31.3	27.8	19.4	20.5

<b>Valuation metrics</b>					
<b>Year to March</b>	<b>FY06</b>	<b>FY07</b>	<b>FY08</b>	<b>FY09E</b>	<b>FY10E</b>
Diluted EPS (INR)	48.6	58.4	85.8	89.8	113.7
<i>EPS growth (%)</i>	<i>15.8</i>	<i>20.2</i>	<i>36.5</i>	<i>4.7</i>	<i>26.7</i>
Book value per share (INR)	179	219	421	507	602
Adjusted book value per share (INR)*	138	170	317	397	356
Diluted P/E (x)	36.5	30.4	20.7	19.8	15.6
Price/ BV (x)	9.9	8.1	4.2	3.5	2.9
Price/ Adj. Earnings (x)*	25.3	20.4	15.7	12.4	11.5
Price/ Adj. BV (x)*	7.3	5.9	3.2	2.5	2.8
Dividend yield (%)	1.1	1.2	1.4	1.5	1.9

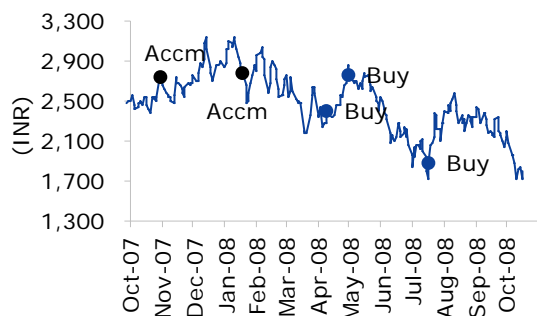
\* adjusted for value of investments in subsidiaries

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### Coverage group(s) of stocks by primary analyst(s): Banking and Financial Services:

Allahabad Bank, Axis Bank, Federal Bank, Future Capital Holdings, HDFC Bank, ICICI Bank, IOB, ING Vysya Bank, Karnataka Bank, Kotak Mahindra Bank, OBC, SBI, Yes Bank, IDFC, HDFC, LIC Housing Finance, PNB, Power Finance Corporation, Reliance Capital, SREI Infrastructure Finance, Shriram City Union, Syndicate Bank and Union Bank.

#### HDFC



#### Recent Research

Date	Company	Title	Price (INR)	Recos
16-Oct-08	<b>HDFC Bank</b>	A mixed bag; <i>Result Update</i>	1,087	Buy
14-Oct-08	<b>South Indian Bank</b>	Steady quarter; <i>Result Update</i>	96	Buy
13-Oct-08	<b>Axis Bank</b>	Delivering quarter after quarter; <i>Result Update</i>	663	Buy
10-Oct-08	<b>ICICI Bank</b>	Strong short-term upside; <i>Result Update</i>	363	Buy

#### Distribution of Ratings / Market Cap

##### Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	94	59	14	8	187

\* 10 stocks under review / 1 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	75	65	47

#### Rating Interpretation

Rating	Expected to
<b>Buy</b>	appreciate more than 20% over a 12-month period
<b>Accumulate</b>	appreciate up to 20% over a 12-month period
<b>Reduce</b>	depreciate up to 10% over a 12-month period
<b>Sell</b>	depreciate more than 10% over a 12-month period

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